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Central Banks and the Financing of Development

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Caribbean economies cannot contemplate quantitative easing (QE) of the sort engaged in by advanced economies because the resulting pressures on the balance of payments and international reserves would be unsupportable, in the absence of growth in exports, tourism and other services. However, there is a need for investment in infrastructure, systems for business facilitation and external marketing and branding, to increase productive capacity and competitiveness in the foreign exchange earning sectors in order to stimulate growth. In addition, there is a chronic shortage of funding for new ventures and innovation. This paper looks into the possibility of a form of QE specifically designed to address these requirements. We also review ways in which Caribbean central banks have attempted to address the issue of finance for development.

The insufficiency of finance is among the most frequently cited obstacles in the path of growth and development in the Caribbean.[1] Since these countries have a chronic surplus of bank liquidity, the problem cannot lie with the overall supply of finance in the economy. Moreover, the shortage of finance is not evident at large and multinational firms, which have no difficulty in financing any project which they find to be profitable. Rather, the shortage is felt most keenly by small and medium sized firms, startups, and

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[1] For example, World Economic Forum, *Global Competitiveness Report 2013-14*, where this is cited as among the three most frequently cited challenges of doing business in Barbados.

firms that are trying to introduce new products and processes, or trying to enter new markets or market segments.

This is an issue at the forefront of the development of Caribbean economies which are in the process of introducing new sectors of economic activity, principally green energy production and the production and export of cultural products. In the embryonic stages of these sectors, as has been the case with all industrial advancement worldwide, the firms need strong official backing in various forms, including equity and concessional finance. That is because the early growth stages of any activity involves a steep learning curve, and an inherently risky process of learning by doing. Inevitably there will be early stumbles, and there must be mechanisms to provide these firms with second chances, otherwise there is little prospect that the sector will grow to a size that permits the synergies and economies of scope and scale that are essential for an economic takeoff.

The development banks and other state owned supporting institutions that were so successful in this role in Asia have been an almost universal failure in the Caribbean, where they have been subject to political capture and insolvency. (The Caribbean Development Bank, a regional institution, is a success story and the most significant exception to a very poor record for development banks in the region. Its success is undoubtedly due to its regional character.) The nongovernmental and small business services that have replaced our development banks have had modest success, but the scale of resources needed for the development of new economic activity that is of national significance is well beyond their capacity.

The burden of this essay is that Caribbean central banks are in a position to step into this breach. The global movement for the independence of central banks over the past decades has spilled over into the Caribbean. Provisions for central bank independence are written into the central bank statute in many cases, and central banks now have greater autonomy almost everywhere within the region. That puts the central banks in a position where they may provide financing for innovation and diversification in ways that are insulated from political capture.

The provision of finance for development by central banks is not without precedent. Some central banks have provided funding directly for major projects.[2] Others have supported financial institutions in the private sector with a view to increasing the efficiency of financial flows for development.

The central bank, in its role as overseer of the financial system and in making and implementing financial policy, has to embrace all aspects of financial development, and cannot be concerned only with stability and inflation. This is not a novel idea. The Central Bank of Barbados, and most central banks that were established from the 1960s onwards, have charters which include financial development as a central objective of the bank's mandate. Moreover, in the conceptualisation and development of the Financial Sector Adjustment Programme (FSAP) by the IMF and World Bank there was an explicit focus on financial development, which is now reflected in the publication by the World Bank of an annual *Global Financial Development Report*, the first of which was issued in 2013.

Financial Stability & Development

Caribbean financial markets are characterised by a widely perceived scarcity of finance for investment, particularly in innovative activity, in environments where there is ample liquidity lying idle with commercial banks. There is an opportunity for central banks to increase the efficiency of use of financial resources by considering novel ways to rechannel some of that finance to activities that are high national development priorities.

Our starting point is the importance of financial systems to development: financial development is about the efficient allocation of finance to enhance economic growth and the wellbeing of citizens. The focus on financial stability should be seen in this light: stability is a means to an end, namely the overall development of the economy and the improvement of the living standards of all citizens. Stability, which tends to get top billing in popular discussion, is one of four benchmarks suggested by the World Bank's

[2] The massive tourist resort at Cancun, Mexico was developed with funding provided by the Banco de Mexico.

Global Financial Development Report (GFDR) for assessing the level of financial development. The others are: financial depth, access to finance, and the efficiency of the delivery of financial services.

The rationale for a central bank role in development is therefore twofold:

- The necessary role of the public sector in innovation and the development of new products, services and markets; and
- The opportunity for an independent central bank to increase the efficiency of financial allocation for high priority investment, in ways that avoid political capture.

The role of the state in the financing of innovation

Historically, the state has played the leading role in all major economic transformations in economies of every political stripe, including the US, Canada, modern Europe, Japan and South Korea, countries with liberal, market-oriented economies, as well as in countries and regions such as Russia, China and Latin America which are reputed to have more interventionist traditions. The reasons why this is so are well known: early movers entering new markets, using new technologies, developing new products and services, do not have a track record of performance by which their credit worthiness may be judged. Potential financiers, whether lenders or equity partners, therefore lack what is the most dependable marker of a credit worthy borrower, that is their track record of performance in areas pertinent to the intended financing. In the early days of any new activity, external economies such as widespread availability of relevant skills, supporting services and information such as marketing and quality control, etc., are not widely available. A gestation period is invariably needed, when the enterprise is working out teething problems, before production can be ramped up and secure marketing arrangements put in place to ensure a steady revenue stream. For all of these reasons, conventional market financing mechanisms such as term loans, equity participation and the issue of corporate bonds have failed to meet the financing needs of innovating firms and small and medium enterprises.

This much is not new. In the World Bank's *GFDR 2013* it states "there are sound economic reasons for the state to play an active role in financial systems". However, the report also cautions that "there are practical reasons to be wary of the state playing too active a role" (Page 1). Caribbean experience bears testimony to both statements. Over the past half century, Caribbean nations have experimented with state owned commercial enterprise, directed commercial bank credit, specialized financing institutions for credit and insurance, development banks, credit guarantees and other credit support facilities, the promotion of stock and bond markets, tax incentives and direct subsidies. The extent of success has been very limited, and as a result Governments have retreated from the most intrusive forms of intervention. That remains problematic, however, because it results in a situation where there is inadequate finance for innovation, even in the presence of excess funding in the financial system as a whole.

The Barbadian state intervention experience

Over the past several decades the Barbadian Government has financed and supported innovation in a variety of ways, ranging from state ownership of enterprise, at one end of the spectrum, to various measures of support and incentive to private financial institutions. In this paper we are concerned with Government interventions in the financial market, to the exclusion of tax policies, state ownership and other forms of intervention.

Over the past fifty years the Barbados Government has owned or established specialised banks and financial institutions, all of which have now been liquidated or sold into the private sector. The Barbados Development Bank had to be liquidated when it became insolvent, weighed down by an excess of bad loans. It operated on a scale that turned out to be too small to make a decisive impact on the overall magnitude or direction of investment in the productive capacity of the economy. A number of other state owned financial institutions, including the Barbados Savings Bank, the Barbados Mortgage Finance Corporation and the Agricultural Credit Fund, were consolidated to form the Barbados National Bank, in the late 1970s. The BNB was in direct competition with privately owned commercial banks, and its portfolio and pricing came to resemble them

in every way. Over time it became clear that the BNB could not address the perceived lacunae in the financial market, especially with respect to the financing of investment, and when the opportunity arose to earn foreign exchange by sale of the BNB, the Government sold its entire stake in the bank. Government established a successful general insurance company, which also operated much like its commercial competitors. It too was sold to private sector interests.

Government has established several small funds in support of small and medium enterprises, most in the last two decades. They have all been modestly funded and where initial funding has been exhausted funds have become dormant for want of adequate reflows or new funding. The aggregate impact of these funds on investment and growth has been very little.

The role of the Central Bank of Barbados

The Central Bank of Barbados has always had financial development as part of its mandate, and it has used both interventionist measures and support for financial market development in pursuit of this objective. In the 1970s credit directives were seen as an important tool in the Bank's armoury, mainly in an attempt to bias commercial bank lending away from consumer durable purchases. By the mid-1980s it was evident that these directives were ineffective: there was no change in the allocation of bank credit away from consumer purchases. What is more, the Central Bank stipulations, which applied only to commercial banks, had the unintended effect of diverting business from commercial banks to credit unions and other financial institutions which were not regulated by the Central Bank. The credit stipulations were quietly laid to rest in the late 1980s.

A second and more successful thrust for financial development by Central Bank was by way of its schemes in support of lending by banks and other financial institutions. The Central Bank acted as conduit for funding from official foreign sources to the financial system. However, the demand for additional finance by commercial banks was always very weak, because the banks suffer from a chronic surplus of finance over the amount

that credit worthy borrowers' needs. There has been somewhat greater interest in the Bank's credit guarantee schemes, which insure some credit risk for banks, at a subsidised rate. These schemes have had some small beneficial effects on SME finance, but have not made much of a contribution at an aggregate level.

The Central Bank's most aggressive and sustained effort to stimulate financial development was in the establishment and support for the securities market. In terms of its impact on the allocation of finance for development the Bank's efforts in this direction cannot be considered a success. The Barbados Securities Exchange, of which the Central Bank was a promoter, founding member and part financier, has been a stilted infant. There have been very infrequent new issues, and none has been for a major investment project. The largest have been associated with mergers and acquisitions, and the firms that have attracted buyers' greatest interest are those large and established business who have no difficulty in funding investment from their own or borrowed resources, including foreign sources. On an annual basis the average contribution to investment of the Barbados securities Exchange over its life has been no more than one percent.

The current paradox of finance in the Caribbean

Countries have an excess of short term funds, represented by noninterest bearing balances at central banks, at the same time that innovators are unable to obtain financing on suitable terms. This is a situation that may be observed throughout the Caribbean, and one which characterises small emerging market economies worldwide.

The reasons for this persistent mismatch would appear to lie with the institutional structure of small economies, in particular the observation that economic activity in these economies is dominated by a handful of conglomerate companies and companies with interlocking directorships. Companies of this size and range will always have external commercial and financial links, which give them access to global financial markets, and they are therefore never short of funding for viable projects. By the same token, they are not constrained by the availability of local savings. What is more, because of the high import content of investment in the small open economy, access to foreign exchange sets

a limit: investment stalls when there is a shortage of foreign exchange, even in circumstances where domestic savings are readily available.

The strategy for accelerating investment in these circumstances must be twofold: 1) to provide incentives for the dominant conglomerates with international market access to invest in innovation and emerging competitive activities, and 2) to provide alternative financial instruments and channels for innovators to finance new processes, products and industries such as culture and green energy. This essay speaks to the second element of that strategy.

A potential role for the central bank

The burden of this essay is a proposition that the most impactful contribution the Central Banks of small emerging market countries may make to promote financial development is to provide these alternative channels and instruments for the finance of innovation. By doing so the central bank applies a remedy directly to the heart of the problem, which is not the availability of finance per se, but rather the supply of finance in a form that meets the requirements of an innovator.

The initiatives that the Central Bank of Barbados and other central banks in the region have taken have all failed to achieve anything like the intended impact. Securities markets have been a disappointment: issues of new securities have been few and far between, trading volumes have been low, trades are infrequent, prices are highly volatile, and price movements often do not reflect perceived fundamentals. Most relevant for our purposes, new issues were mostly motivated by mergers and acquisitions rather than to finance new projects, and innovators attracted no interest in a market dominated by conglomerates and mainstream establishments.

Barbados' experience with credit insurance and other forms of credit support is typical: the schemes are helpful, but their overall effects are too little to make a marked difference to the overall growth and development of their economies. This is the conclusion reached in the World Bank's *GFDR 2013*, in relation to similar schemes worldwide.

Central banks' efforts to stipulate credit limits and the direction of credit allocation by commercial banks and other financial institutions have not achieved the objective of relieving the perceived shortage of finance. The fact that the inadequacy of finance remains so high on the list of obstacles to doing business in the region, after many decades of effort in this direction by central banks, itself is evidence of failure. The deficiencies were numerous and were manifest in every aspect of the application of directed credit: the allocation of limits among institutions, defining limits in relation to unused overdraft limits, and avoiding diversion of activity to informal markets and institutions not subject to control.

All the mechanisms that have been tried to date have failed because, in the final analysis, they do not provide those with surplus funds to invest, and those with investment projects that promote growth and development, with market incentives to apply surplus funds to growth promoting investments. In relation to the development of new products and markets, and other types of innovation, this is a familiar problem. It sometimes happens that a financial market solution emerges, as in the case of Amazon, but this is the exception that proves the rule. Typically, government intervention is needed in order to assist and promotion of the new initiatives, until they reach full maturity.

There is, therefore, a strong argument for government intervention to provide appropriate financial services for this type of activity. However, the institutional mechanisms that have been tried in the Caribbean have failed in their intended purpose, largely because of political pressures. Central banks are protected from such pressure. Central bank independence is a central tenet of international financial theory and practice, and it is reflected in central bank laws throughout the Caribbean. In most cases central bank decisions may be overridden by Ministers of Finance only with the assent of Parliament, and the independence of the central bank is one of the criteria by which the soundness of financial regulation is judged by the IMF and World Bank in periodic Financial Sector Assessment Programmes.

To sum up

The independence of the central bank allows it to stand in for Government in the provision of infant industry finance in appropriate forms and linked to demonstrated performance, measured against clearly stated objectives. The focus on financial development reflected in the World Bank's *GDFR* is welcome, offering a perspective on global financial reform which properly reflects the priorities and circumstances of emerging market economies. For economies such as ours, financial stability is the means to an end, that is, financial development. In pursuit of financial development the central bank may play the vital role of providing performance related finance for innovation, by virtue of its independent stature within the public sector.