

The Cost of Commercial Bank Credit In Belize

Contributing Factors and Policy Implications

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I. Executive Summary	1
II. Introduction.....	3
III. Analysis of Commercial Bank's Credit Activities	5
A. Trends in Credit and the Associated Impact on the Cost of Funds.....	5
B. Intermediation and Liquidity.....	8
C. Analysis of Interest Rates and Spreads.....	11
D. Discussion of Factors Affecting Interest Rate Levels.....	14
IV. Alternative Policy Responses.....	16
A. Short Term Measures	17
1. Interest Rate Ceilings	17
2. Directed Credit	19
3. Reduction of Level of Social Security Deposits.....	19
B. Medium/Long Term policies.....	21
1. Introduction of New Financial Intermediaries.....	21
2. Encouragement of Private Sector Utilization of Alternative Financing.....	22
3. Establishment of Links with External Capital Markets.....	24
V. Conclusions.....	24
VI. Bibliography.....	26

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I. Executive Summary

Belize's financial system is dominated by the commercial banks, and it is often argued that the cost of raising capital through these institutions is exorbitant. An examination of the country's economic climate, the trends in commercial banks' credit and interest rates' spreads, the level of bank intermediation and structure of the system highlights the essence of the debate. Given the fixed exchange rate regime, the tantamount role of the monetary authorities is the defense of the par value of the Belize dollar vis-à-vis the US dollar. This requires that at all times monetary policy measures complement or counter-balance the prevailing fiscal stance. The implementation of these measures is largely achieved through the maintenance of reserve requirements, which places constraints on the pool of loanable funds. Furthermore, the thinness of the domestic financial system, the lack of viable financing alternatives, and the recent increase in the concentration ratio of the commercial bank sector and the level of banks' competition for deposits to fuel growth have all placed increasing upward pressure on rates.

With these factors identified, it is virtually impossible to accede that the level of interest rates charged by banks in Belize is exorbitant. Rather, it seems obvious that the present level of rates merely reflect the prevailing market conditions. This point is underscored by a comparison between Belize and other Caribbean countries with similar economic structures. The comparison is most meaningful with Barbados and demonstrates that, notwithstanding a larger economy, a fixed exchange rate regime and higher reserve requirements, the weighted average interest rate spread in that country is lower than that prevailing in Belize. This, combined with the aforementioned macroeconomic and structural aspects, indicate that the issue of increasing rates spread and cost of credit in Belize cannot be effectively addressed through direct controls on either rates or spreads. In fact, since interest rate trends merely reflect underlying fundamentals, any attempts to

directly influence the symptoms without corrective measures applied at the root could have deleterious effects on the economy, particularly through increasing pressure on the banking (more especially the payments) system and on exchange rate.

In order to effectively address the issue, then, any policy to reduce the cost of financing business activities in Belize should be geared at effecting an environment which fosters the provision of alternative capital for new ventures and the improvement of existing links to external markets, as well as significant improvements in fiscal performance. The establishment of such an appropriate environment requires timely adoption of the legal and regulatory framework that would facilitate financial sector expansion, as well as significant improvement in the efficiency of the information infrastructure. Together, these measures would constitute an effective and transparent approach to lowering the cost of financing that would have wide-reaching long term benefits vis-à-vis the short term “fix” that would result from interest rate regulation and directed credit.

II. Introduction

In any economy, the cost of raising capital, particularly interest and yield rates, is influenced by prevailing macroeconomic and structural conditions. The macroeconomic factors relate mainly to monetary and fiscal conditions, while the structural factors mainly involve the actions of individual agents that make up the general public and the quality of management of the intermediaries. These factors have direct bearing on the structure and complexity of the financial system, particularly the extent to which the intermediation activities of the commercial bank sector is complemented by those of other bank and non-bank intermediaries such as merchant banks, insurance companies and finance houses.

In general, macroeconomic factors are affected by monetary and fiscal policies, and in Belize's case these are dominated by one overriding consideration--the fixed exchange rate regime. This regime requires regular transactions by the monetary authorities in order to maintain the par value of the exchange rate. Consequently, it is the stance of the executive directorate during any given period which in effect dictates what the accompanying monetary policy should be since the latter must conform with or offset the former, as is appropriate. The objectives of a tight fiscal policy can be undermined by loose monetary policies or a lax fiscal stance may require certain monetary measures be imposed to dampen aggregate demand and reduce pressure on foreign reserves.

Clearly, in situations such as ours, it is the fiscal stance that has the more significant effect on overall macro-economic conditions. In addition to the direct effect on income and output, the monetary and fiscal policy affects the behaviour of economic agents. The general public keenly observes the actions of the monetary and fiscal agents, and draws conclusions and expectations based on these actions. These are in turn filtered into their day-to-day decision making process and so impact the business cycle. The resulting economic climate—confidence or the lack of it—is reflected in a number of macroeconomic indicators, including the price of loanable funds.

Recognizing the limitations on the extent to which the monetary authorities can directly influence fiscal policy, this paper emphasizes the structural issues affecting the cost of credit in Belize. The premise is that these are the issues which the authorities can directly affect through the exercises of its role, and that a strong financial system would be reflected in lower credit costs, notwithstanding prevailing macroeconomic policies. Furthermore, it is recognized that in periods dominated by a weak macroeconomic climate it is the level of soundness of a country's financial system that determines its capacity to survive.

Since Belize' domestic market is "thin", and is dominated by the commercial banks, the analysis of the structural issues throughout this paper will emphasize the nature and function of the commercial bank industry, and the pros and cons of policies that could be implemented to reduce the cost of bank financing. Also, while, it is recognized that the cost of transacting credit includes the explicit costs of interest and non-interest charges as well as implicit costs such as time consumed during processing, the analysis is limited to interest rates, the core element of total financing cost¹.

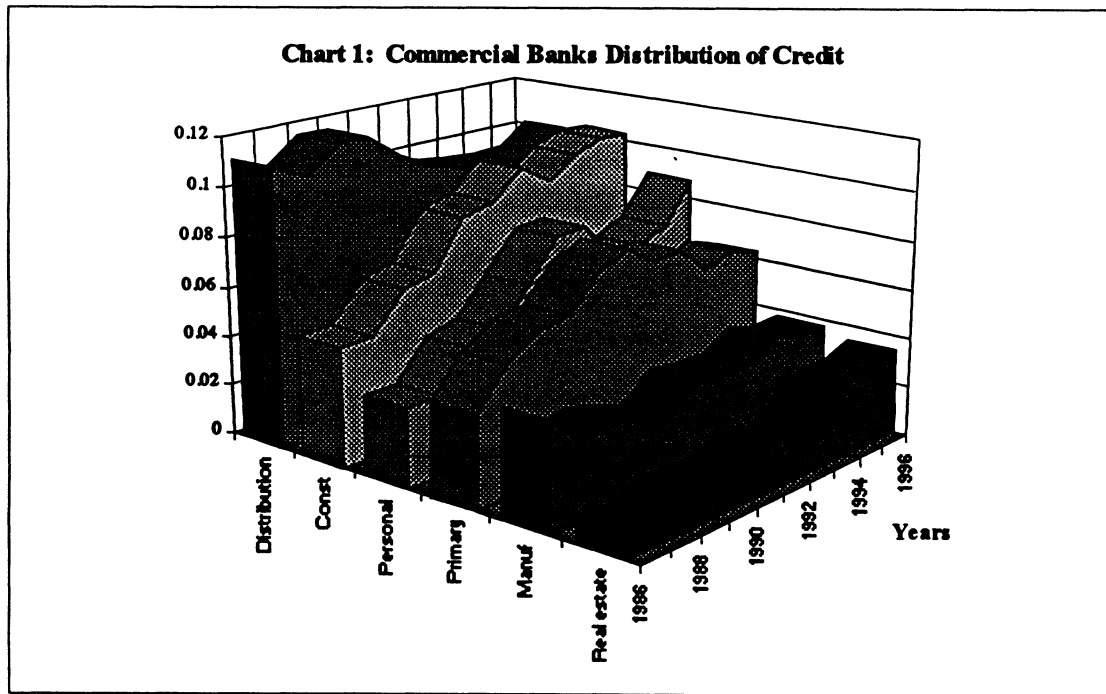
The issue of financing cost is thus explored in the next section. The analysis therein includes an examination of the trends in credit extended to the various sectors and their interaction with interest rates, as well as the macroeconomic and structural factors that have influenced interest rate levels over the recent past. Section IV contains discussion of various alternative policy responses that can be effected to bring about a reduction in the level of interest rate in Belize and the pros and cons of each and the salient points of the paper are highlighted in Section V, the conclusion.

¹ Non-interest charges include such fees as bond registration and legal charges. Although they are one-off expenses, these fees can be prohibitive, particularly for small loans. For consumer loans these fees range between \$200.00-\$300.00 per transaction, whereas for business and mortgage loans, they can be as high as \$1,200.00 - \$1,500.00.

III. Analysis of Commercial Bank's Credit Activities

A. Trends in Credit and the Associated Impact on the Cost of Funds.

In order to understand the issue of cost the trends in credit by sector extended by the main intermediaries, the commercial banks, and the interaction of between these trends and the various levels of interest rates charged must be analyzed (Chart 1)². Over the 1986-1996 period, banks have extended the bulk of their loans to the distribution, construction and primary sectors, and to individuals primarily for personal consumption³.



The magnitude of loans for personal consumption reflects a high level of demand due in part to relatively high levels of income and propensities to consume. In general, these loans attract the highest levels of interest, reflecting the fact that they are often backed by little or no security, or by collateral consisting for the most part of moving chattel.

² For purpose of comparison over time and across sectors, credit is measured here as a ratio of GDP.

³ Primary sector here comprises agriculture, forestry and fishing, of which the first by far accounts for the greatest share.

	Lending Rates				Deposit Rates	
	Personal	Commercial	Mortgage	Other	Savings	Time
1986	14.8	14.6	13.9	13.9	6.6	11.0
1987	14.0	14.1	12.7	12.5	7.8	9.4
1988	13.9	13.4	12.4	12.8	4.9	7.6
1989	14.7	14.0	12.6	13.8	5.3	8.0
1990	14.8	14.3	13.6	13.5	5.4	8.3
1991	14.4	14.1	14.4	15.9	5.4	8.3
1992	14.9	14.1	14.0	15.7	5.4	8.1
1993	15.0	14.4	14.0	16.2	5.4	8.3
1994	15.6	14.9	13.6	17.2	5.3	8.7
1995	17.0	16.2	14.6	17.9	5.3	10.0
1996	16.8	16.2	14.9	17.8	5.3	8.6

Source: Central Bank of Belize Statistical Digest

The extent of risk that is factored into the cost of consumer loans is underscored by the differential between the stated rates which comprise the weighted averages (Table 1) and the effective rates yielded through the use of the add-on method to calculate repayments (Table 2). This practice is not unique to Belize and is consistent across the industry. It is instructive to note that for the highest weighted average included in table 2, the effective rates can be anywhere from 23% to 25% for loans with durations of one to five years.

<u>Add-on Rate</u>	<u>Duration of Loan</u>				
	<u>1 Year</u>	<u>2 Years</u>	<u>3 Years</u>	<u>4 Years</u>	<u>5 Years</u>
10.0	17.97	18.15	17.91	17.60	17.27
10.5	18.84	19.01	18.74	18.39	18.04
11.0	19.71	19.87	19.56	19.18	18.80
11.5	20.58	20.72	20.38	19.97	19.56
12.0	21.45	21.57	21.20	20.75	20.31
12.5	22.32	22.41	22.00	21.52	21.05
13.0	23.18	23.25	22.81	22.29	21.79
13.5	24.04	24.09	23.60	23.05	22.52
14.0	24.90	24.92	24.40	23.81	23.24

In many cases the loans extended to the distribution and construction sectors are collateralized with mortgages, and while the stated weighted average rates for these, as shown in Table 1, do not appear to vary significantly from those for personal loans, differences in the method of calculating repayments yield effective rates reflecting significant variations in risks. Particularly for mortgage lending, where in many cases the loan is fully collateralized with real estate, the stated rate is quite close to the effective rate since these are amortized on a declining balance basis.

The magnitude of credit extended to the distributive sector further reflects the high income and consumption levels, as well as a high import content of GDP. The trend in construction loans has varied with the development of the economy, and consistent with theory, have increased more so in times of economic expansion. A significant portion of these loans are overdraft facilities, and the relative weight of the risk entailed is enshrined in the practice of charging interest based on average daily balances.

One of the more interesting aspects of the trend in commercial bank credit is the apparent antithesis in the level of credit borne by the primary sector. Theoretically, the fact that this sector is dominated by the agricultural sub-sector—which by its nature is prone to the vagaries of natural phenomena and market fluctuation—lends to high levels of risks. This in turn should result in low priority rating by those lending institutions which rely significantly on collateral. The conflict is resolved if one considers that the magnitude of credit extended to this sector over the years has been influenced by the fact that it is dominated by the larger enterprises engaged in the production of *traditional* agricultural commodities intended for export to *guaranteed markets*. These guarantees have served to significantly reduce the risk attached to the agricultural sector in Belize. The eminent phase-out of these preferential arrangements presently threatening the industry should result in an increase in the perceived risks and thus a reduction in the level of access to domestic credit and/or an increase in the interest rates charged.

B. Intermediation and Liquidity

An important aspect of banks' intermediation is the level at which they are able to channel surplus funds to finance economic activity. Based on total deposits, commercial banks in Belize consistently experience excess liquidity⁴, suggesting that there is room for improving the level of intermediation. However, measures of loan/deposit ratios based entirely on local currency deposits, and taking reserve requirements into consideration, indicate that banks are in effect "loaned up". Such analysis of banks' intermediation based on local currency deposits is reasonable since the bulk of foreign currency deposits are IBC funds and so are, in effect, foreign demand deposits which cannot be used to finance domestic activity.

The issue of IBC deposits has further implications for the calculation of liquid asset holdings and requirements. Constraints on the use of these deposits to finance domestic activity suggest that they should be excluded from any calculation of deposit liabilities and liquid asset holdings. In the first instance at least such an adjustment, while it would reduce banks' liabilities, would have a severe effect on their compliance position, as illustrated below (Box 1).

Box 1: Example of Likely Immediate Effect of changing Basis for Liquidity Calculations

Case I (Status-Quo): Including IBC Deposits in Calculation of Average Deposit Liabilities and Foreign Asset Holding.

Average Deposits: Local Currency = \$380mn; IBC Deposits = \$20mn; total \$400 mn

Required Liquid Asset Holding: 28% of average total deposits

Deposit Liability : $\$400 * 0.28 = \112.00

Actual Holdings: Foreign Balances = \$85mn (incl. \$20mn IBC deposits); other = \$30mn; total=\$115mn

Excess/(deficiency) in actual holdings: \$3.0 mn.

Case II (Counter-factual): Excluding IBC Deposits in Calculating Average Deposit Liabilities and Foreign Asset Holdings.

Average Deposits: Local Currency only = \$380mn.

Required Liquid Asset Holdings: 28% of average total deposits less IBC deposits.

Deposit Liability: $\$380 * 0.28 = \$106.4mn.$

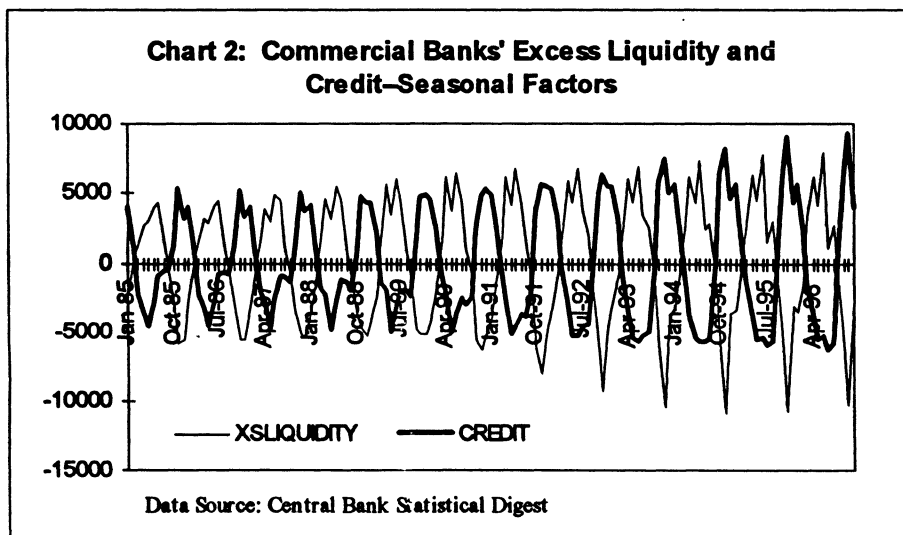
Actual Holdings: Foreign Balances = \$65mn (exc. \$20mn IBC Deposits); other = \$30mn; total \$95mn.

Excess/(deficiency): Actual holdings of \$95mn less required holdings of \$106.4 mn = (\$11.4 mn)

⁴ The trend in excess liquidity is consistent with foreign exchange inflows and counter-cyclical to credit-- increasing from January/February to a peak in July period, then falling during the latter half of the year

This example shows that changing the method of calculating deposit liabilities to one which excludes IBC deposits could result in a systemic shock. Such a shock would be averted, however, if one of three measures are taken. The first is a pre-announced phased approach, that would require that the present practice of using 100% of IBC deposits to calculate liquid asset liability and compliance be changed over a specified period (e.g. 1 year, 18 months, etc.) to one that uses 0-10%. The second option is that of combining the exclusion of IBC deposits in the calculations with a simultaneous reduction in the stipulated average deposit liability that would be sufficient to offset the reduction in foreign asset holdings. The third option could be a combination of the two, perhaps by simultaneously reducing both the level of IBC deposits included and the ratio of liquid asset requirements at the first stage, followed by consequent stages of further reductions in the proportion of IBC deposits.

One important qualifier is required here. While it is relatively easy to assess the effects of excluding IBC deposits from the calculation of loan/deposit ratios so as to better gauge banks' efficiency, it is virtually impossible to measure the extent of banks' ability to meet credit demand. Banks' supply of funds is not limited to total deposits because, notwithstanding the variations in organizational structure, they each have access to offshore financing for domestic on-lending from either parent companies, holding companies or affiliates.



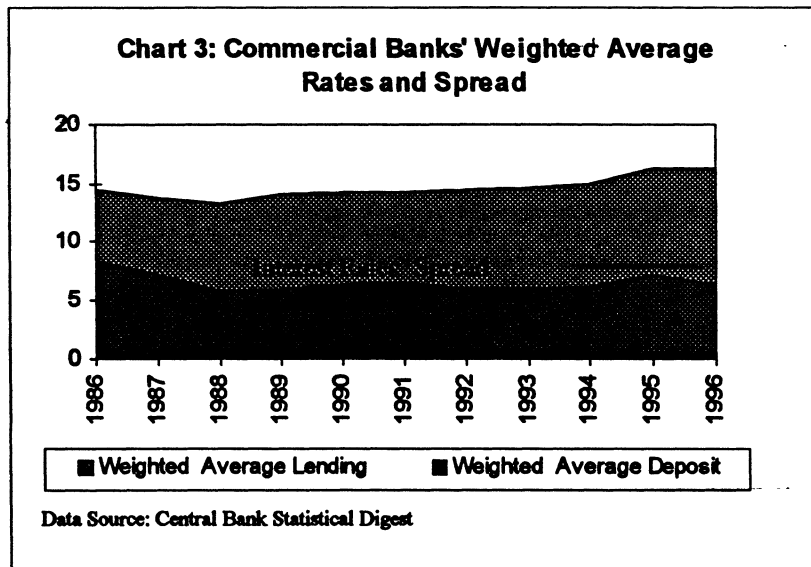
Although a “loaned-up” status is one indicator of banks’ efficiency, it does not measure the extent of overall credit demand. Theoretically, the demand for loanable funds is the sum of idle money balances and demand for capital investment. Assuming that supply is somewhat responsive to demand, variations in commercial bank credit may be seen as a “proxy” for the trend in the demand for funds. This trend exhibits a seasonal pattern--mirroring that of excess liquidity—with lower levels of demand for commercial bank loans in the first half of the year and higher levels in the latter half (Chart 3). In fact, it is the seasonal trend in credit demand that gives rise to these statutory excess liquidity and traditionally, banks utilize a conservative approach to this interaction, investing in highly liquid assets during the period of low credit demand. It is ironic that while this in itself is an efficient use of funds and is generally considered a prudent practice, it lends to the measure of “excess” liquidity since much of the investment consists of deposits abroad.

Often coinciding with the charge of usury are allegations that the commercial banks in Belize are too conservative in their practices and too reluctant to channel financing to the productive sector. A fundamental reason for banks’ reluctance to finance projects is the mismatch in assets and liability that this would entail. Technically, banks’ deposits are short term in nature while most productive sector projects require long term lending. Anecdotal evidence suggests, however, that even in instances where commercial banks have had access to long term sources of financing they were reluctant to undertake long term on-lending. On at least two occasions attempts were made to channel funds earmarked for lending to the productive sectors through the commercial banks⁵. In the first instance, banks utilized some 50% of the funds, whilst in the second no on-lending was effected.

Anecdotes such as these are cited as proof that banks are comfortable with the returns of their operations and that, furthermore, these returns are a reflection of a lack of competition in the industry. For their part, bank personnel often cite a dirge of viable projects, poor project preparation and poor revenue prospects due to market limitations as

⁵ Funds earmarked in the first instance was the Commercial Banks Discount Fund provided under the CBI umbrella which was channeled through the USAID. In the second instance, the funds were from the World Bank and were intended for agricultural credit.

reasons for their reluctance to engage in what may be considered as unduly risky ventures. Indeed, given the fact that there is no shortage of demand thus far for commercial bank credit and that loan servicing has been adequate, there is in fact no economic incentive for banks to increase the level of risk that they undertake. In addition, the more than proportionate costs that banks would have to bear to build the level of expertise necessary for proper assessment and management of projects that are more venture oriented in nature serves an economic disincentive.



C. Analysis of Interest Rates and Spreads

Any discussion of credit cost is underscored by the magnitude of the spread between banks' loan and deposit rates. This spread is calculated as the difference between the weighted average of the first four columns and the last two columns of Table 1. Key to the analysis in this paper is the fact that over the past decade there has been an increase in this spread as a consistent rise in banks' weighted average lending rate has been accompanied by an overall decline in the weighted average deposit rate (Chart 1).

The parallels between the Belizean economy and those of the commonwealth Caribbean region—specifically small populations, narrow commodity export base, high labour costs, a high degree of openness⁶, and dependence on preferential arrangements—allow for a meaningful comparison of commercial banks' rates across the region (Table 3). Several points can be gleaned from this comparison. In the first instance, Belize's weighted average lending rate, adjusted for inflation, was higher than the comparable rate for Barbados and Trinidad and Tobago, but lower than that of Jamaica. A comparison of the spreads yields a similar analysis.

Table 3: Commercial Banks Weighted Average Rates and Selected Indicators
(December, 1995)⁷

	Weighted Average Lending	Weighted Average Deposit	Interest Rate Spread	Average Annual Inflation Rate	Required Liquid Asset Holding	Exchange Regime
Barbados	11.8	5.2	6.6	1.8	29.0	Fixed
Belize	16.3	7.2	9.1	2.8	26.0	Fixed
Jamaica	48.6	26.2	22.4	19.9	47.0	Managed Float
Trinidad Tobago	13.4	5.8	7.5	4.7	16.0	Managed Float
Guyana	20.4	n.a.	n.a.	n.a.	20/25 [†]	Managed Float
<i>Small Savers</i>		10.47	9.9			
<i>12 month deposits</i>	..	14.43	6.0

Source: Annual and Quarterly Economic and Financial Statistic Digests for Jamaica, Barbados, Guyana, Trinidad & Tobago, & Belize, IMF International Financial Statistic

† Stipulated as 20% on average time deposits and 25% on average demand deposits.

Despite the similarities that this analysis is based on, there are important differences in the economic structures across the region. These arise from the fact that Jamaica, Guyana, and Trinidad and Tobago have moved to managed floats, while Belize and Barbados have maintained fixed exchange rate regimes, both with par rates of two local currency dollars to one US dollar. Guyana and Jamaica instituted these “liberalization” measures amidst economic instability which, in addition to the recent financial crises in Jamaica, contributed to high levels of interest as their inflation rates spiraled upward. The most substantial comparison, then, must be made between the Belizean economy and that of

⁶ Measured by the ratio of the sum of imports and exports to GDP. For all countries in the region, this ratio exceeds 70 percent.

⁷ The end-1995 period precedes the point of implementation of the Value Added Tax in both Belize (April '96) and Barbados (January '97), so that inflation rates are comparable, particularly since both countries have a fixed exchange rate regime.

Barbados. At the cursory level, such a comparison shows that, despite higher reserve requirement in Barbados the adjusted weighted lending rate and the interest rate spread is considerably lower than that of Belize.

A major reason for this difference may be there is greater competition among the Barbados commercial banks. Despite the fact that Barbados' population is only slightly higher than Belize's, the economy is more than four times larger and the commercial Bank industry is larger both in terms of numbers and of the ratio of assets to GDP⁸. In terms of GDP, however, the average assets of each commercial bank in Barbados accounts for 11.6% compared to 16.9% in Belize.

In addition to the larger size of the commercial banking industry in Barbados, the country boasts a financial system that is more complex than Belize's. This includes a variety of non-bank financial institutions such as finance houses, and leasing corporations, and an established stock exchange where securities trading is conducted twice weekly. Together these factors infuse a significant level of competition in the financial market as investors face a wider variety of financing options and savers are better able to diversify their portfolios.

Further comparative analysis of the Barbados and Belize economies would no doubt prove instructive, but is outside the scope of this study. Inter-alia, such an analysis should attempt to pinpoint measures applied by the monetary authorities in Barbados that may be effective in promoting further development of Belize financial system, particularly those that would affect credit conditions such as Barbados Central Bank's rediscounts of "special" loans and "repos"—repurchase agreements—with the commercial banks.

⁸ Provisional estimates of output at market price in Barbados during 1995 stand at US\$1,883 mn compared to Belize's output for the same period of US\$493.8 mn.

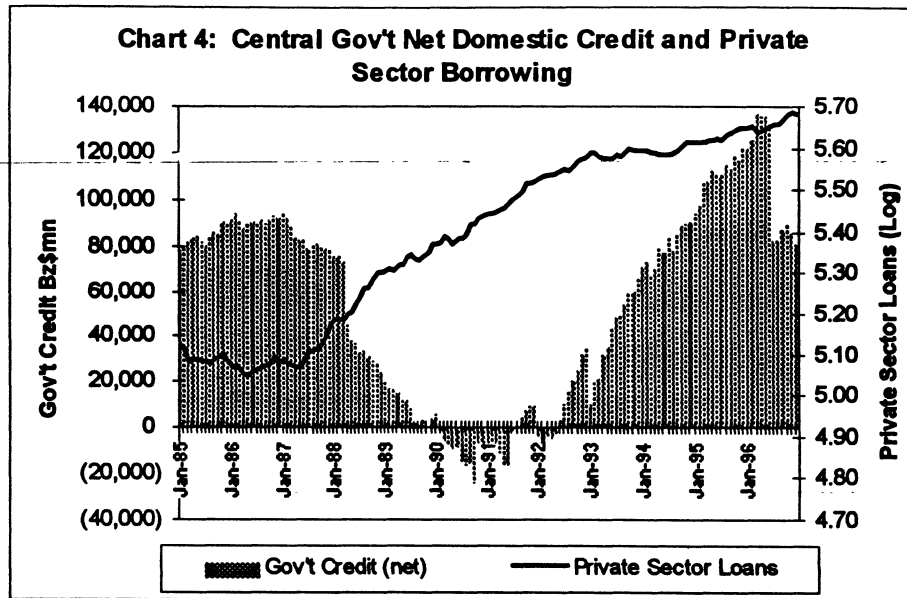
D. Discussion of Factors Affecting Interest Rate Levels

As shown in Table I, the most marked increase in the level of weighted average interest rates since end-1993 has been in the personal loans category. These increases coincide with the acquisition of credit card franchises by two of the local commercial banks, and although data is unavailable at this point, it is well known that card usage has since become more prevalent. Consequently, the rates attached to credit card loans would have contributed considerably to the rise in interest rate levels.

In addition to increased credit card usage and the high level of demand for personal consumption, distribution and construction loans, there are several macroeconomic factors which would have affected the supply and demand for credit and further influenced the cost of funds. During the first four years of the 1986-1996 period reserve requirements were high (30% of total liquid deposits), consistent with the austerity programme that was in effect at that time (Table 4). Although the rate was reduced 1989, it was increased again both in 1992 and 1993. This point coincided with the resumption of build-up in public sector domestic credit as government reversed its 1989-1991 position of net creditor. It is here also that the rate of increase in the weighted average interest rate spread began to rise. For much of the period, then the monetary stance has been relatively tight, placing constraints on the extent to which deposits could be transformed into loans.

Table 4: Changes in Liquid Asset Stipulations

Effective Dates	Cash	GOB T-Bills	GOB Securities	GOB Loans & Advances	Loans & Advances	Total Assets
February 1, 1977	5%	--	--	80%	10%	20%
January 1, 1978	--	--	--	100%	5%	--
Jun-98	--	--	--	--	0%	--
November 1, 1984	7%	--	--	--	--	--
March 1, 1985	9%	--	--	--	--	25%
April 1, 1985	--	--	--	--	--	30%
February 1, 1989	7%	--	--	--	--	28%
September 1, 1991	6%	--	--	--	--	25%
October 1, 1992	7%	--	--	--	--	27%
November 1, 1993	--	--	--	--	--	28%
January 1, 1995	5%	--	--	--	--	24%
December 1, 1995	7%	--	--	--	--	26%



Together these factors demonstrate that for much of the period monetary policy measures were adopted to mitigate the effects of the prevailing fiscal stance. This is furthered underscored by the interaction between trends in fiscal borrowing and private sector credit (Chart 4). Over the 1985-1996 period increases in government borrowing were accompanied by declines in the rate of growth of private sector credit and slowdown in government borrowing were closely followed by increases in private sector loans. This interaction was most marked between mid-1992 and mid-1996. Since this is also the period during which increases in lending rates were most consistent, it may be deduced that there was some level of crowding out of private sector investments which, given the structure of the economy—small, open and based on a fixed exchange rate regime—would be manifested in higher interest rate levels.

In addition to the macroeconomic factors and the increased demand for credit, there were structural changes within the banking industry which may have further contributed to the upward pressure on loan rates. The most significant of these was the transformation of a Canadian bank subsidiary into a locally incorporated bank, and the later introduction of the International Business Company (IBC) Act, and its appendage Public Investment Company section which rendered tremendous benefits to IBCs and their subsidiaries.

With its new status as an IBC subsidiary, the transformed bank enjoyed tax leverage benefits which, combined with more aggressive management, propelled remarkable growth, so that at the end of 1996 it accounted for some 56% of total deposits and loans, compared to its share of 36% at the end of 1993 and the original foreign subsidiary's share of 23% at end-1986. With the other three commercial banks left to compete for the remaining 44% of total deposits, bank practices become more aggressive. This was reflected in the fact that banks increased their competition for customers' long-term deposits by bidding up interest rates. This was especially marked during 1995 and by early 1996 the weighted average rate on time deposits had risen from an annual rate of 8.6 percent to a rate of 10.0 percent (Table 1).

Aside from creditor risk and cost of operations, banks' loan rates reflect the natural outcome of external conditions imposed on their operations. In general, commercial banks in Belize are discouraged from relying on the Central Bank to finance credit demand or meet liquid asset requirement. Furthermore, each of the four banks is accountable to either a head office or shareholders, so that management is always wary of incurring undue losses. While the systemic loan loss ratio is only slightly higher than international levels, there is significant disparity between banks, despite the conservative approach of relying on highly collateralized lending. The end-result of these constraints is that the commercial banks are relatively conservative in their practices, preferring not to incur undue risk. This, combined with cost considerations (for specialized training and allocation of resources), is a key determinant of banks' reluctance to undertake development financing, regardless of the source of funding.

IV. Alternative Policy Responses

Despite the number of fees involved, interest rates make-up the major portion of the cost of credit. It is rational to assume then, that policies to lower that cost could be aimed at lowering interest rate levels. This can be done through any one or a combination of short and/or medium-long term measures. The following is an examination of the merits and demerits of some of these measures. It should be noted here that, as the analysis of the

individual measures will show, the short term “solutions” will serve to increase the level of distortions. Banks are highly resourceful and profit oriented, so that they would be able and willing to apply innumerable measures to circumvent regulations. The likely result, then, is that the regulatory body would become ineffective as it is forced to devote increasing resources to enforcement rather than prudential regulation, and eventually monetary and credit policy would be compromised.

A. Short Term Measures

1. Interest Rate Ceilings

The most obvious short term “solution” to high credit costs is to impose a ceiling on the level of interest rates charged by the commercial banks. However, there are a number of issues which must be taken into consideration when assessing the effectiveness of such a measure. The first issue is a method of implementation. It can be readily assumed that banks would counter the reduction in spread arising from the imposition of lending rate ceilings by lowering deposit rates. In such an event, it may be deemed necessary to protect depositors and ward off potential capital flight by increasing minimum deposit rates. Theoretically, however, ceilings and floors should be set at optimal levels and the reality is that informational asymmetries make it difficult to determine what these are.

The second issue is that of the direct effect of imposed lower rates on the banks’ performance. Imposing a ceiling on lending rates implies that the rate at which banks would be allowed to lend would be below domestic market rate. This would result in a positive net present value (NPV) of borrowing, particularly since gilt edged securities presently yield anywhere from 9.0 to 12.0 percent, and BTL dividends can be as high as 25%. While a positive NPV would be attractive from the point of view of businesses, the fact that the alternative cost of capital would lie somewhere above 12% implies that banks

would be forced to absorb the cost of risk for certain ventures, and in time increase loss. This would be particularly true for those banks with cost structures that are higher than the industry aggregate.

Given the size of the market and the number of banks operating, the failure of any one of the institutions would result in systemic disruption. In order to avoid failure, and in the absence of accompanying restrictions on lowering deposit rates, bank's could be moved to reduce savings rates in order to maintain their spread. This in turn could trigger a disintermediation process as depositors seek safety in cash and/or foreign exchange. The imposition of a floor on imposed on deposit rates would increase the likelihood, already discussed above, of those banks with a higher cost structure experiencing loss as the rate of return they are forced to accept could be inadequate to cover operating costs. Consequently, restrictions on either lending rate levels or interest rate spreads could result eventually in systemic disruptions that would be costly to the economy as a whole.

The third issue is the possible effect of lower lending rates on the present levels of consumption and capital flows. It is likely that the lending rate ceiling would fuel further credit expansion for the purpose of consumption, distribution and commercial purposes since these are the established and thus "safe" sectors. Such expansions would impact directly on the visible trade balance and consequently place further pressure on foreign reserves as imports would increase.

The final issue has to do with the likely effect of such stipulations on the supervisory and regulatory resources. The introduction of ceilings and floors would need to be enforced both through routine scrutiny of bank returns and through on-site surveillance. This need would be driven by attempts to circumvent the stipulations, such as unduly increasing transaction fees. Attempts to address this issue, as well as other eventualities, would significantly

increase demands on the technological and human resources of the supervisory authority. Furthermore, country experiences have shown that once ceilings are imposed, regulation tends to increase to the point where the situations can spiral into financial repression as the system becomes rigid and is unable to respond readily to internal and external shocks⁹.

2. Directed Credit

In many instances, the argument for lower interest rates goes hand in hand with that for a need to channel credit to the productive sectors. Directed credit could be seen solely as a means of supporting certain sectors or as a counter to increases in credit for distribution and/or consumption that would follow from the implementation of ceilings. This “channeling” could be achieved either through a cap on the quantity of credit to be extended for these purposes, and/or through the imposition of targets for credit to certain sectors. As in the case of ceilings, directed credit places additional demands on supervisory resources since there may be a need to detect and/or deter intentional loan misclassifications. The end-result of both measures would be increasing emphasis on enforcing directives as opposed to prudential regulation, and ultimately increasing the cost of supervision. These options are thus both costly and ineffective, and thus not recommended.

3. Reduction of Level of Social Security Deposits.

This measure would be based on the argument that deposit rates are under upward pressure from banks’ tendency to bid for large deposits, particularly those of the Social Security Board and the largest private sector organization, the Belize Telecommunications Authority. In the absence of corresponding increases in lending rates, the cost to banks of attracting these deposits would

⁹ Here internal shocks refers to significant systemic disturbances, while external shocks may refer to macroeconomic shocks both within the domestic economy and the broader international arena. In most instances involving small, open economies systemic disturbances/failures are precipitated by external macroeconomic shocks and perpetuated by structural problems within the system which lead to an incapacity for timely and appropriate adjustments.

reduce their spread. The rational, then, is that sterilizing the Social Security Board deposits would significantly reduce the upward pressure so that lending rates can return to lower levels.

While there may be some merit to this argument, two related issues must be considered. The first is that, since Social Security funds represent a significant portion of total deposits, any sudden withdrawal of these funds from the system would constitute a systemic shock to which the commercial banks may not be able to readily respond. To the extent that such withdrawals would reduce the pool of loanable funds, the upward pressure on interest rates may increase rather than subside. This latter effect could be counteracted by reducing required liquid assets ratio so that a higher proportion of the remaining deposits would be available for lending.

The second issue is that of performance. While recent commercial bank bidding for deposits can be viewed as competitive behaviour, it can also be an indication of deeper systemic flaws. A number of country experiences of systemic failure have been preceded by banks' aggressive bidding for deposits in an effort to acquire cash flow sufficient to cover mounting losses from bad debt. *It is important to note that many of these cases were precipitated by galloping inflation/exchange rate collapse and exacerbated by financial repression and macroeconomic instability.* Furthermore, the periods of instability were preceded by periods of unusually high growth, sometimes fueled by windfalls, which led to bubbles in the value of assets such as real estate and stocks. Once the economy returned to normal growth levels and these asset markets "collapsed", there were sudden significant depreciation in commercial banks' collateral. Clearly, then, analyses of Belize' situation must be qualified by a thorough examination of the prevailing macroeconomic environment and the state of the financial system. Furthermore, consideration of measures to "improve" credit conditions must be viewed in light of the likely long term effects on both the financial sector and the wider macroeconomic environment.

B. *Medium/Long Term policies.*

1. Introduction of New Financial Intermediaries.

It is often argued that there are too few commercial banks operating in Belize and that the level of competition (and consequently banks' performance) would be improved through the operation of at least one additional bank. Considering the small population size, however, it is unlikely that an additional bank would infuse any significant increase in competition. Rather, the management of such an institution may find it easier to conform to the status quo, so that at best clients would be faced with an additional choice to place deposits and/or source borrowing. While this may result in some reduction of the spread, it will not address the underlying structural problem. Commercial banks are especially tailored for short term lending to finance commerce, and as the credit trends examined in Section 3 indicate, banks in Belize are adequately meeting these needs. Rather than increasing the number of banks, then, a more efficient approach may be to introduce *other types* of financial institutions.

As has been indicated in previous studies, the financial system is deficient in its provision of specific types of credit—notably mortgage financing for low and middle income families, capital provision for small and medium sized enterprises and export credit/guarantee. These studies further point out that the optimal approach is the development of existing specialized institutions and/or the introduction of new ones tailored to fill these needs. While there has been some developments in this area, there has not been a sufficiently concerted approach. Improvements in mortgage financing and export credit/guarantees should provide more efficient and cost effective alternatives to commercial bank credit and thus improve the level of competition that banks face.

There are at least two attendant issues that would need to be addressed where introducing other types of financial institutions are concerned. In the first instance, it may not be possible, nor indeed necessary, to “home-grow” these

institutions. Rather, it may be sufficient, and from an efficiency standpoint, desirable for established sources in external markets to be tapped. The second issue is that of enabling legislation. An increase in joint venture activity, regardless of the residence of the investors, is only acceptable under conditions where parties have redress to the law. Although there are no laws specific to joint ventures, such activity may be covered under current company and partnership laws, so that at least it may be required that these laws be adequately revised/updated. *Furthermore, while it may not be desirable for these to be taken up directly by the regulatory and supervisory institutions, the latter can play a significant role in fostering an environment that could foster private sector provision of these needs.*

The issue of appropriate legislation applies not just to joint venture activity, but to all financial institutions. The 1995 BFIA represents a significant improvement in that it broadly allows for a variety of institutions (schedule, section 2) and is therefore an appropriate enabling legislation. Further financial market development requires, therefore, that the relevant authority maintain current information so as to be in a position to introduce more comprehensive regulations, when appropriate. Timing is important—over-regulation must be avoided so that the relevant industry is not stifled and inadequate regulation must be avoided in order to minimize instances of moral hazard and adverse selection and thus protect the industry and cultivate its' growth. At present, for instance, there is a thriving finance house operating, as well as some four building societies.

2. Encouragement of Private Sector Utilization of Alternative Financing.

Like many small Caribbean States, individuals engaged in commerce and would be entrepreneurs in Belize have a strong preference for ownership and control by family members only and therefore tend to rely heavily on commercial credit rather than financing through public offers. An even more compelling incentive

is the tax structure, which allows deductions of interest payments from business expenses. Together, these two factors have so far resulted in a lack of “critical mass” that would propel private sector involvement in the development of a securities market. Consequently, measures to address the need for access to new types of financing must be applied concurrent with an approach to address the problem of inadequate demand and supply of securities.

On the demand side, tax incentives and educational campaigns on the mechanics of financing through public offers are key to the further development of the market. Tax rebates on securities investments can be incorporated in the system in order to provide a tangible incentive for individuals to use public offering as an alternative to commercial bank lending. Furthermore, individuals must be empowered to weigh the benefits of balancing equity and debt financing even in the context of the present tax structure. Despite the deductions allowed, reductions in interest expenses are desirable, especially where companies face tight market conditions, such as declining prices and recessions. Furthermore, companies should be made aware that in addition to voting shares (equity), public offers can involve debt securities as well as some optimum level of non-voting shares, both of which can yield financing that in the long run may be less costly than commercial bank credit.

On the supply side, the main thrust should be in terms of tax incentives. Present tax legislation favors debt financing through the allowance for interest payments on loans to be included in business expense deductions. Consequently, incentives to increase the level of public financing would require measures such as tax credits for investors. Additionally, initiatives, such as regulation regarding disclosure and provisions for organized primary and secondary market trading on a regular basis, must be introduced to further develop the local financial infrastructure.

3. Establishment of Links with External Capital Markets.

The effectiveness of demand and supply side provisions for alternative capital can be greatly improved in the more distant future if deficit and surplus individuals in Belize are faced with a wider market. To this end, a structured approach can be implemented to develop links with regional capital markets. To be effective such an approach must follow significant implementation of IV.B.1 and IV.B.2 above. Clearly, then, this option is the most long term in nature and requires significant levels of planning, coordination and commitment.

V. Conclusions

Analysis of 1986-1996 data showed that there had been a significant increase in the spread between the weighted average deposit and lending rates, particularly in recent years. Moreover, comparison with the spreads of other countries in the Caribbean, particularly Barbados, showed that Belize's were among the highest, and that the levels reflected the absence of a critical set of conditions that would lend to an increase in competition and a reduction in rates. In essence, this set of conditions entail a more complex financial system that would provide greater variety of alternative instruments to savers and investors. Some measures that could be implemented toward establishing these conditions are listed below.

- Remove existing market deficiencies by strengthening key institutions such as the Development Finance Corporation, and encouraging the establishment of new types of financial institutions. While the introduction of a finance house--Courts--has been a significant development along these lines, there is scope for introduction of other institutions, particularly those geared to venture capital operations.
- Improve the tax incentive for market activity through provisions such as rebates.
- Increase the private sectors' level of awareness and acceptance of a viable securities market. This should be aimed in the first instance at understanding the rudiments of a market, including the types of securities that can be floated (equity and debt) and the nature of those instruments that have already been floated. Later stages of public education can be geared at providing insight into benefits that can offset the tax payoff from bank financing.

- Accommodate market development by providing for greater exchange of information and establishing regular trading, and ultimately, by improving existing links to creditors and debtors in external markets.

In addition to the “thinness” identified in Belize’s domestic system, developments over the decade have led to an increase in the concentration ratio of the banks, with the largest banks accounting for some 56% of total deposits. This has resulted in an increase in the level at which banks compete for deposits, so that interest rates on term deposits rose and, as banks sought to maintain their spread, lending rates increased as well. Macroeconomic developments further contributed to upward pressure as government domestic borrowing crowded private sector credit and a tight monetary policy was maintained to mitigate the effects of fiscal deficit spending.

These factors, then, indicate that the rates charged by the commercial banks may be mere reflections of market conditions. In order to reduce the cost of financing it is the market conditions that will have to be addressed. Already, there have been efforts to ease some of the effects of expansion in government domestic credit by increasing the level at which sovereign debt is being sourced abroad. While such a policy, if not well managed, can have negative repercussions on the stock of external debt in the future it is beyond dispute that an optimum balance between domestic and foreign public debt is a desirable insofar as it limits constraints on the credit activity of the private sector.

Notwithstanding these recommended changes in market structure, the imposition of greater fiscal discipline is critical to amelioration of agents perceptions that would lead to improvement in market confidence. Altogether, these measures, while not allowing for a “quick fix” in the short-run, would lead to improvements in the medium/long term that should reduce the cost of capital while improving the soundness of the financial system and thus allowing it to survive through business cycle fluctuations.

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