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CENTRAL BANK OF BELIZE

A NOTE ON CAPITAL MARKET OPERATIONS IN BELIZE

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Introduction

The traditional functions of a capital market involve the complex of activities necessary to match the asset- and risk-holding preferences of savers with the liability preferences of entrepreneurs and other spenders who do not save enough to finance their proposed investment and expenditure operations. Reflecting the level and growth of income in an economy, the extent of specialization and the degree of monetization, the structure of its production and the composition of output, the sophistication of consumption patterns, the importance of trade in economic activity, in addition to the overall size of the economy and a number of institutional factors, capital market structures and activities may range from the rudimentary, with only a few institutions and institution-types offering a narrow range of financial assets and maturity distributions to savers and being willing to accept a commensurately restricted range of liabilities from entrepreneurs, to the sophisticated, with stock markets, facilities for options and futures trading, currency and instrument conversions, ease of movement over the entire maturity range from overnight to very long-term, and no effective restrictions on cross-border transactions.

On this formulation a capital market exists wherever there are institutional arrangements for the sustained transfer of financial savings from those who consume less than their income to those who would wish to spend in excess of their savings, taking into account the shifts which will inevitably occur in the composition of both groups. Whether a particular capital market is efficient, in the sense of meeting the asset preferences of savers and satisfying the liability-issue capacity of borrowers, and thus moves in the direction of promoting an optimum allocation of investment and contributing to the maximum possible rate of activity expansion, would depend on institutional factors and constraints, including the legal and bureaucratic environment, the liability preference-structure of borrowers, the capacity and policy focus of the intermediating institutions, and the effects of public policy and government operations.

Where institutional arrangements in a relatively low-income country fail to meet the requirements of savers and spenders, either because of inadequacies involving instruments and maturities or because intermediating institutions are unable or unwilling to absorb or supply financial savings in the volumes required, residents may be able to access facilities which are based in other countries. Such a development, if it persists over time, would tend to indicate fundamental imbalance between the needs of savers and spenders which would hopefully evoke a response in the direction of encouraging inflows of loanable funds (where there is excess demand for funds), or public policy action to remove obstacles to funds placement (distortions in the system) and/or to provide incentives to potential borrowers (where there is an excess of loanable funds) on the assumption that in the excess funds case the situation is amenable to public policy action. Whether the action taken would facilitate the external placement of excess domestic savings would depend on the willingness of the authorities to encourage demand for loanable funds and to force structural changes in the policies of financial intermediaries, particularly where the excess savings situation occurs alongside external public or private sector borrowing.

Domestic Structure

Belize is a small country, in terms of population (about 180,000 people), land area (22,960 km^2), and the value of output (estimated at BZ$403m for 1987 in nominal terms at factor cost). The economy is typically small-island Caribbean, although Belize is a mainland territory: narrow range of items in output with a high proportion of the value of output entering international trade; concentration on primary items in production and export; high proportion of exports and imports to total output; low domestic inter-industry and inter-sectoral linkages; high product and market concentration in exports as against diversified products and markets in imports; government revenue heavily dependent on foreign trade taxes; high proportions of government revenue and expenditure to GDP. In addition, the population is substantially dispersed across the country, resulting in high per unit costs for administration and for the provision of basic infrastructure. Substantial out-migration of skilled people in the past together with a recent influx of refugees (from) for the rest of Central America has adversely affected the absolute supply and distribution of skills in the society, particularly management-related skills, and some concerns have been expressed in the recent past over perceived deficiencies in the supply of entrepreneurship. Although there is still substantial subsistence agricultural production, the economy is effectively monetized.

The main operators in the financial system in the public sector are the Central Government, the Social Security System, the Central Bank, and the Development Finance Corporation. A Government Savings Bank still functions in a desultory manner; at the present time it is operated as a "super" below-the-line account for the central government. In the private sector, there are four commercial banks (two of which are branches of metropolitan institutions; the other two, though locally incorporated, are effectively controlled by owners who reside outside of Belize), insurance companies (some local, some branches of foreign companies, with all the life companies being branches), and a number of credit unions. A building society, never large enough to have any impact on the system, operated briefly during the early part of the 1980s. Financial intermediation is dominated by the domestic banking system, although in addition there has been substantial external borrowing by the public sector for development projects (and by the private sector as well, though the extent of outstandings is not known), and although the authorities are aware of private sector holdings of funds outside the country.

The main asset forms available to savers are commercial bank deposits and share- and deposit-holdings in credit unions (passbook savings accounts in commercial banks and holdings in credit unions are mainly owned by lower-middle and lower-income groups, while current accounts and time-deposit accounts are mainly held by business firms and by middle- and upper-income groups), but the credit union holdings feed back into the commercial banking system since the credit unions invest their cash holdings in commercial bank deposits, and the return paid to credit union depositors is in effect based on what the unions earn on their bank deposits (in addition, of course, to the interest income earned from loans to union members).

It is assumed that a substantial number of residents hold life insurance policies; data are not readily available on this. Similarly, life insurance companies operating in Belize maintain a number of group and individual medical insurance policies. It is not clear whether life insurance policies are purchased and held mainly as an instrument to place financial savings (while enjoying the accompanying life insurance benefits), or whether the life insurance cover is the crucial element. Whatever the situation, the life insurance companies have tended to remit the bulk of their premium income to their foreign parents, and only a limited proportion of their investible funds have been made available to local borrowers; the bulk of what has been made available has gone to policyholders to finance residential construction or house purchases.

The Central Bank is not primarily a deposit-taking institution. However, in recent times the institution has been holding small amounts of funds on behalf of international institutions and foreign governments lending to Belize (the funds being held pending satisfaction of disbursement conditions), larger amounts on behalf of a number of local statutory bodies which transact some of their international business through the central bank, and increasingly the institution has been holding fairly large balances for the Social Security System (SSS). Within the past six months, the accounts of the Central Government in the Central Bank have been turned around from a net overdraft position to one of substantial credit, as a result of a determined effort to improve the financial situation of the public sector together with capital inflows relating to the privatisation of the telephone company (formerly a statutory body) and as a result of a programme to attract funds placements from overseas. Central Bank funds are invested either in government securities locally or in foreign currency instruments abroad.

The Development Finance Corporation is a statutory body which essentially borrows from abroad from international institutions for re-lending to the private business sector (including substantial credits to agriculture) and for residential construction. The Social Security System, which was set up in , has been a major accumulator of financial surpluses. Currently its funds are held in the banking system, including holdings in the central bank, with a small proportion being held in government paper, mainly treasury bills. In the recent past, the SSS has been providing funds for housing development.

As is normal in Third World countries, particularly those in which the central government is sensitive to the development needs of the society, government spending has generally exceeded revenue collections, and the difference has usually been financed through a combination of local and foreign borrowing. Foreign borrowing has generally been on concessional terms from governments and international institutions and has mostly been used to finance development projects. Locally-raised financing has been used both to finance smaller capital projects and to bridge the financing gap on recurrent account, whenever that appeared. The main source of domestic borrowing, prior to the establishment of the central banking institution in 1976, was the commercial banking system and the captive Government Savings Bank; since 1977, the establishment of the central bank has facilitated a measure of direct money creation (via the central bank advance account device) and an expansion of borrowing from the commercial banks through the treasury bill/liquid assets and commercial bank minimum-balance deposit arrangements, with further money creation being represented by central bank holdings of both treasury bills and longer-dated paper, the issue of the latter being made through the central bank. The main holders of government paper have been the central bank, the commercial banks, the Social Security System, insurance companies (the latter to satisfy a small domestic assets holding requirement) and the Government Savings Bank.

Market Operations

Prior to 1977, the only financial asset instruments available to savers were commercial and Government Savings bank deposits and credit union shares and deposits (the latter, as indicated previously, ending up in the commercial banking system as credit union deposits of funds surplus to immediate lending requirements; in fact, credit unions then and now extend loans by writing cheques on commercial bank accounts). While central government did offer debentures (bonds) to the general public, the amount sold to the household or private business sectors was small - mainly on account of the long maturities on offer (15 to 20 years, although the device of a lottery drawing of debentures every quarter did offer the prospect of an earlier payout), the absence of special incentives (eg, tax exemptions), and the substantially lower national income levels then obtaining. An additional factor was, and is, the relative lack of financial sophistication of the population, including the business sector. So that, by and large, a saver placed his financial holdings with a branch of a metropolitan commercial bank in a savings or time-deposit account depending on the level of his savings, accepting the oligopolistically determined level of interest rates; with the potential entrepreneur or investor financing his activities with commercial bank loans basically on terms and conditions determined by the banks. Collateral security arrangements were quite strict: in the absence of substantial capacity within the branch banks to prepare or appraise projects or to evaluate business plans, banks, in order to protect shareholders' and depositors' funds, sought claims on assets that could be sold to liquidate debt. Any mismatch of funds in the system, for example, excess deposits not matched by loan requests from creditworthy borrowers, could be sorted out through operations with the head office; excess deposits could be placed with the head office fund managers while excess domestic loan demand could be met through borrowings from head office. These arrangements were facilitated by Belize's membership in the sterling area and the operation of the currency board system.

The arrangements, at least on the domestic borrowing side, were further facilitated by the fact that business firms operating in the country were, where they were not branches or subsidiaries of integrated foreign operations, either proprietorships, partnerships or private companies, the owners of which were not interested in broadening the ownership base and opening capital subscriptions to the general public. In the majority of cases the business operations were involved either directly in production for international trading operations; or indirectly in servicing those operations. One consequence of this, although it is not an inevitable logical next-step, is that business operations were increasingly undercapitalised, and relied heavily on commercial bank loan financing, generally through overdrafts, to meet the capital deficiencies. To the extent that those business operations could continue to function and produce annual profits on this kind of capitalisation format, to the extent that the commercial banks could place funds relatively easily, and to the extent that the financial assets offered by the banks continued to be acceptable to savers, to that extent operations in the system could continue without significant difficulty. Domestic borrowers which were branches or subsidiaries of foreign operations could switch between the limited range of liability instruments which would be accepted by the local intermediaries and the more sophisticated arrangements that could be made through the respective head offices.

The increasing need for financing by the central government to pay for its development programmes together with a desire to redirect the focus of commercial bank operations led to the establishment of the central banking institution in late 1976. The institution immediately ran into difficulties with the commercial banks over arrangements for the banks to satisfy the liquid assets and minimum cash balance requirements. In respect of liquid assets, there was not enough qualifying domestic paper available locally. With regard to the minimum balance requirement, the banks proposed to borrow from the central bank in order to meet the requirements immediately and to repay the loans as they adjusted their positions over the short-run. It turned out that the central banking legislation required the banks to provide tradeable paper as security for the loans, and that the banks were not holding sufficient of the only available paper (central government debentures) to meet the requirements. In the liquid assets' situation, certain proportions of outstanding bank loans to the public and private sectors were designated liquid assets for the purposes of the law; in the other case, the central bank merely accepted promissory notes from the banks.

The commencement of 90-day treasury bill issues early in 1977, initially on a quarterly basis but with a subsequent shift to monthly issues, represented what was hoped to be the first step in the development of a range of instruments that would contribute to the broadening of financial intermediation arrangements in the country. The issuing of the securities, under the management of the central bank, provided an opportunity for the phasing-out of the interim liquid asset arrangements (which essentially involved calling non-liquid assets liquid) at the same time that it facilitated an increased flow of financial resources to the central government. The value of treasury bills outstanding rose from BZ$3.6m at the end of 1977 to BZ$15m at the end of 1980, at the same time that commercial bank loans outstanding to central government rose from BZ$0.3m to BZ$2.2, and at the same time that central bank credit to central government (other than via treasury bill holdings) rose by BZ$1m.

The hope for the development of market instruments has not been realised, although there has been a substantial increase in the outstanding value of treasury bills (from BZ$15m at the end of 1980 to BZ$62.2m at present) and some increase in the value of longer-dated debentures as well. Preliminary indications are that the domestic intermediation system has not been entirely successful in meeting the demands of savers and borrowers from the point of view that there is indication of an increasing level of foreign financial asset holdings by residents at the same time that there is increasing demand for longer-term funds for business project development and for housing. Suggestions by the central bank for the development of market instruments have been limited to a proposal to convert some of commercial banks' hard core overdrafts into tradeable paper bearing the acceptance of the bank initially making the loan. The intention of the proposal was to allow commercial banks to substitute higher-yielding liquid assets for government treasury bills in meeting liquid asset requirements, particularly in periods of tight liquidity, and would have put some pressure on government to pay market rates for funds and thus provide some restraint on its ability to crowd out the private sector. The proposal was not implemented for two reasons: firstly, government stamp duty on the promissory note portion of the paper, payable four times a year if the paper would always qualify for liquid asset treatment, would have substantially eroded bank revenues; secondly, individual banks indicated that their customers would not take kindly to other banks or institutions becoming aware of their use of banking system resources.

With the recent removal of government stamp duty on eligible paper and with the introduction of new attitudes in the banking system following on the purchase of the

Royal Bank of Canada operations by a non-banking group, the proposal has been reactivated and is under consideration.

The proposal, however, is not seen as having any immediate impact on the longer end of the market, nor is it seen as affecting residents' financial asset holdings abroad. Information regarding the composition of these holdings are of course not readily available; scattered information suggests that the bulk of holdings are in dollar assets in the US in the form of deposits in commercial banks and S&Ls. If this is so, then the transfer of financial savings from Belize to the US may reflect, or may have reflected, concerns which are or were not necessarily related to the performance of the intermediation system, except to the extent that deposits were refused by domestic institutions or to the extent that financial asset holders were sufficiently interest-sensitive to react to positive external differentials coming from the US. There has been no indication of deposit refusal, except in the very recent past, and interest-sensitivity would suggest that inflows of funds would occur when the differentials run the other way, as they have done since 1980. The indications are that the level of foreign holdings have risen rather than fallen; unfortunately, no data are available on the growth rates of holdings in different periods.

On the matter of longer-term lending in the domestic system there are a number of considerations which may be of some interest. Firstly, as indicated earlier, the commercial banks remain the principal provider of financial assets to savers. Treasury bills are nominally available to all comers, but the complications of the tender procedure and general unfamiliarity with financial operations on the part of the household sector have apparently combined to discourage participation in this area of activity. Secondly, business operations remain private, in the sense that business ownership is a family matter. Not more than three companies qualify as public companies, and of those only one - the recently privatised telephone operation - has elicited any response from the public to a share-sale offer. There is no formal market for shares, although it is now likely that some informal operation will come into being to provide information on share sale- and purchase-offers. There have been no serious attempts on the part of entrepreneurs to float public issues to finance investment operations; there have been a small number of attempts at private issues (aimed at larger groups than families), but these have generally been poorly organised and unsuccessful.

Thirdly, the commercial banks argue that they are primarily short-term institutions, and that the nature of their funding operations make it risky for them to extend long-term credits. The argument is easy to understand from the point of view of the banking prudence stipulation that requires institutions to match maturities of loans and deposits: an institution would find itself in some difficulty if it financed 15-year loans with 2-year deposits and then discovered that the 2-year money subsequently dried up. The argument is not so easy to understand in the context of continued growth in deposits, particularly in a situation where only a portion of the portfolio would comprise long-term loans. An additional consideration is the fact that commercial bank revolving overdrafts which are nominally short-term credits to businesses in many cases form permanent capital in those operations: the overdrafts can technically be repaid within a year or so; such a repayment could force liquidation of some businesses or drastic curtailment of the size of their operations since most of the stock-in-trade is financed with overdrafts.

A fourth consideration in the long-term credits issue involves security and the capacity of institutions to prepare and appraise investment projects. As indicated earlier, commercial banks have not installed capacity to appraise projects and as a result have either tended not to contemplate financing them or have done so, not on the basis of the merits of the project, but on the basis of creditworthiness criteria unrelated to the project. In recent times there has been somewhat of a tendency to consider medium-term project financing together with some relaxation of the strict collateral requirements. It is probably important to note in this context that there have been loan losses on a number of larger, project type loans.

As a result of the tendency not to encourage longer-term borrowing, the Development Finance Corporation has come to play an important role in the provision of financing for productive sector investment projects and for housing, particularly where, in the case of projects, newer entrepreneurs have been involved. It is a little difficult to assess at this point how successful the DFC has been since, although there have been both project successes and failures, pressure has been brought on the DFC in the past to extend loans that probably would not have been otherwise approved, and pressure has been exerted as well to reduce the vigour of collection efforts in respect of non-performing loans. What is clear is that substantial cleaning-up of the DFC portfolio is now required, and this has resulted in a hold being put on a proposal for the DFC to supplement its external fund-raising efforts with domestic deposit-taking activity.

Liquidity in the banking system in Belize since 1977 and the step-up on government use of banking system resources has generally tended towards tightness. In 1984, following a period of worsening balance of payments developments, a stabilisation programme was introduced as part of a standby arrangement agreed with the IMF. The programme included monetary restraint measures, including credit ceilings and hikes in interest rate levels. Since 1985, there have been substantial net inflows into the system, reflecting favourable developments on the trading accounts (higher export earnings from sugar, citrus and bananas, increased inflows from tourism, declines in foreign payments for petroleum, declines in some unit import prices for household staple items as a result of a switch in sourcing to Mexico where the peso has been depreciating) and increased public and private sector foreign borrowing. As a result there has been substantial excess liquidity in the banking system, at the same time that domestic interest rates have, in effect, continued to reflect the stabilisation requirements.

Initially, the liquidity build up was regarded as a temporary phenomenon, and there was some reluctance on the part of the authorities to take action particularly in view of existing tightness in the fiscal accounts, and because a breakdown of the government accounting system made it difficult to project central government financing requirements. The persisting excess liquidity in the system prompted a reassessment of the situation. The available data suggested that the growth in deposits at least partly reflected the relatively attractive interest rate situation; it was felt that given the difficulties normally encountered in raising saving rates in developing countries, it might be more productive to encourage "supply-led" operations and attempt to utilise the financial savings generated in the system rather than encourage a reduction in rates and thereby either raise the consumption ratio or encourage financial savings to flow abroad. The burden of spending adjustment under the stabilisation programme had fallen mainly on the private sector, with banking system credit to the private sector falling by 12% between January 1985 and April 1987.

Although credit growth has resumed since then, the rate has been below that experienced for deposits. The central government has continued to borrow abroad to help finance the public sector investment programme (PSIP); one of the possibilities currently being explored involves increasing the size of the local-costs portion of the programme and/or switching the financing of local-costs parts of the existing programme from foreign to local sources. The financing instrument would be some kind of tradeable paper. Maintaining excess liquidity pressure would also encourage the banks to become more active in seeking out lending opportunities, and this could have the effect of broadening their lending focus away from the traditional concentration on the import-export trade and on the financing of consumer imports. It was recognised that adjustment would carry a cost, most likely in the form of increased loan-loss experience in the early stages, and in some possible difficulties with commercial bank refusal of deposits on the grounds that interest rate levels were excessive and that banks should not pay for funds they are unable to place. It remains to be seen what the eventual outcome will be, although there is already evidence of loan-loss difficulties, banks have been imposing restrictions on the acceptance of deposits, and there has been noticeable broadening and lengthening of portfolios, particularly in relation to lending for residential construction.

The basic structure of the market has, however, not changed very much, particularly from the point of view of the instruments available to savers. It may be that the critical factors in market development are attitudinal and are related to the spread of information about possibilities, so that opening the system to penetration by new institutions, methods and ideas could have salutary effects. At the same time one might need to be careful not to develop for development's sake.

Belize City