NATIONAL DEVELOPMENT STRATEGY
(2001-2010)

A POLICY FRAMEWORK

ERADICATING POVERTY AND UNIFYING GUYANA

A CIVIL SOCIETY DOCUMENT

ANNEX 4

FINANCIAL SECTOR POLICY

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The Annexes to the National Development Strategy: An Explanatory Note

In June 2000, the National Development Strategy (NDS) of Guyana was formally presented to the President of Guyana and the Leader of the Opposition in the form of a core document, a 348 page distillation of the main elements of the analysis of the Guyana situation and the resulting strategy for action drawn from material prepared by 24 sectoral committees of the National Development Strategy Committee (NDSC). While Chapter 1 of the core document provides an outline of the origins of the NDS and the methodology of its preparation, the purpose of the present note is to explain the Annexes to the core document.

The Annexes are edited versions of the original drafts that the sectoral committees prepared, using a format that facilitated systematic thinking, though at the cost of some repetition. They are therefore longer than the corresponding Chapters of the core document, and also differ from them in other ways:

1. While the Annexes were individually edited in terms of their content, in the core document, disagreements or dissonances between Chapters were removed; for example, if the Chapter on the Private Sector proposed a strategy for Education that was in contradiction with a strategy proposed in the Chapter on Education, the two were rationalised.

2. While the core document was updated with the most recent data where possible, the Annexes generally retain their original data; for recent economic and social statistics, the attention of readers is particularly drawn to the recently completed *1999 Guyana Survey of Living Conditions.* In addition, again because of differences in when they were prepared, what was a Bill at the time of the original draft may have become an Act by the time the core document was being edited. This type of difference may be footnoted in the Annexes.

3. The treatment of the Annexes as historical documents occasionally produced another kind of difference, the main example of which is the Annex on Energy which was written before the privatisation of the Guyana Electricity Corporation, and whose strategy was largely preempted by that privatisation; while the edited Annex deliberately relied on the original material, new material was developed for the core document. These differences may also be footnoted.

It is worth noting that the updates found in the core document usually demonstrate the soundness and continued applicability of assessments made on the basis of earlier data or other information.

There are fewer Annexes than there are Chapters in the core document. For various reasons, some sectoral committee drafts were finalised in the same format as the Chapters of the core document, and there would therefore be little difference between the Chapter and the corresponding Annex. (Examples of this are the Macro-Economic Strategies and the Management of the economy; Sugar; Urban Development; Land; Housing; and The Family). The core document also includes Chapters for which there were no corresponding sectoral committee drafts; the first three Chapters of the core document (Origins and Methodology, National Objectives and Governance) are examples.

For those sectors where there are both separate Annexes and core document Chapters, the titles and numbering of the two correspond except in two cases: one, the corresponding Annex for the Chapter on Manufacturing is titled Manufacturing and Technology and includes material on Science and Technology that the core document had placed elsewhere; and two, the corresponding Annex for Chapter 4, Macro-Economic Policy, is Annex 4, Financial Sector Policy, because the material prepared for the Financial Sector Policy Annex was incorporated into the Chapter on Macro-Economic Policy.

The National Development Strategy was published in summarised form (the core document) for the practical reason that few people would have the time to read the over 700 pages represented by the Annexes. Yet the Annexes have a clear value. They include background information and assessments that were too detailed for inclusion in the core document, but which trace the process that shaped the strategy. Above all, they preserve for us and for posterity the earlier thinking, and the full range of thinking, of the women and men whose work provided the foundation of the NDS. In doing so, they honour the labour which the sectoral committees put into distilling their own work and life experience and the views of the public they consulted in the process. It is this foundational material that is now being published, making the National Development Strategy of Guyana available in both summary and extended forms.

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LIST OF ACRONYMS

ATM	Automated Teller Machine
BOP	Balance of Payments
BIS	Bank for International Settlements
ERP	Economic Recovery Programme
FIA	Financial Institutions Act
GBTI	Guyana Bank for Trade and Industry Limited
GDP	Gross Domestic Product
GNCB	Guyana National Co-operative Bank
IMF	International Monetary Fund
NBIC	National Bank of Industry & Commerce Limited
ROA	Ratio of Net Profit to Assets
ROE	Rate of Net Profit to Equity

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ANNEX 4

FINANCIAL SECTOR POLICY

Introduction

During the second half of the 1970s and 1980s, Guyana experienced unfavourable macroeconomic conditions. The underlying imbalances came to the fore in the early 1980s as flows of financial foreign assistance declined substantially. The authorities responded to these developments by resorting to external and domestic commercial bank borrowing to finance increasingly large budget deficits. These fiscal deficits and a number of steep official devaluations, contributed to a rise in inflation that reached 120 percent in 1989. Moreover, negative economic growth with real GDP declining by an average of 3 percent per year and high interest rates in world markets, caused the debt burden to reach unsustainable proportions, and Guyana's external vulnerability to be exacerbated.

Table 4-1 illustrates the crisis situation at the end of the 1980s. The external debt exceeded annual GDP by nearly fivefold, internal payment arrears had accumulated to over US$500 million, and official international reserves had declined to below one month of imports.

Table 4-1
Selected Economic Indicators

	1980-85	1986	1987	1988	1989	1990
GDP Growth	-2.9	0.0	0.6	-3.0	-4.8	-6.0
Inflation	18.7	7.9	28.7	40.0	120.0	85.0
External Debt/GDP	1.7	2.5	3.9	3.4	5.1	-
BOP Deficit/GDP	-130.9	-136.6	-152.0	-69.3	-187.0	-193.7
Exchange Rate (G$ per US$)	3.2	4.3	9.8	10.0	27.2	39.5
External Debt Stock (US$M)	700.0	1035.6	1117.4	1233.5	1391.9	1820.1
Domestic Debt Stock (G$M)	2828.0	6100.0	6810.0	7078.0	9267.0	
Gross International Reserves (US$M)						
Debt Service Ratio	7.9	8.6	8.9	4.0	14.1	26.6
Import Cover	2 wks	2 wks	2 wks	1 wk	3 wks	4 wks

Source: Bank of Guyana Annual Reports (various years)

To address the rapidly growing imbalances, at the end of the 1980s Guyana adopted a market-oriented Economic Recovery Program (ERP), supported by arrangements with the IMF, structural adjustment and sectoral loans from the World Bank, balance of payments support from bilateral creditors in the form of new loans, and debt relief through restructuring arrangements. Key policy elements of the program have been prudent demand management policies to reduce internal and external imbalances and wide-ranging structural reforms to increase aggregate supply.

The financial system, being crucial in promoting growth through mobilising savings, allocating capital, facilitating transactions, and easing risk management, was subject to intensive reforms aimed at improving its structure and efficiency. This Annex analyses financial sector policies adopted by Guyana since the late 1980s to identify their strengths and the remaining vulnerabilities of the sector, and discusses policy measures that would enhance financial intermediation in the context of the challenges associated with trade liberalisation and globalisation.

I. Basic Features of the Sector

A. The Banking System

The financial system in Guyana has experienced significant changes over the last decade. Prior to October 1965, commercial banking was conducted by two foreign-owned banks, namely, the Royal Bank of Canada and the Barclays Bank, D.C.O. The Royal Bank of Canada started operations in Guyana in 1914 when it took over the activities of the British Guiana Bank. The latter had been incorporated on November 11, 1836, and began operations on February 16, 1837. Barclays Bank commenced business in 1925, following the merger of three banks - the Anglo Egyptian Bank Ltd., the National Bank of South Africa, and the Colonial Bank which had been operating in the colony of British Guiana since 1837. In October 1965, the Chase Manhattan Bank of the United States established a branch in Guyana. This was followed in March 1966 by the opening of the Bank of Baroda, with head offices in India.

By the end of 1966 the two dominant banks, the Royal Bank of Canada and Barclays, were together operating more than 25 branches, sub-branches, and agencies, a third of which were located in Georgetown. In the following years many rural branches and agencies were closed. These institutions essentially provided short-term trade and working capital finance. Making the analysis that the commercial banking sector was not adequately providing the type of financing required to develop the Guyanese economy, the authorities embarked on a strategy aimed at shaping a financial system that would mobilise deposits and provide loans to the rural areas, provide long-term finance for investment, and supply resources to support local firms.

The Government also established the Guyana National Co-operative Bank (GNCB) in February 1970, to carry out the tasks of providing for the commercial financing requirements of Guyanese business, supporting investment in new business areas, and extending financial services to rural communities where such services were nonexistent.

As part of its financial sector restructuring programme, in 1984 the Government also started a process of nationalising foreign-owned commercial banks, beginning with the Royal Bank of Canada, which changed its name to the National Bank of Industry and Commerce (NBIC). The next bank to experience a change in ownership was the Chase Manhattan Bank in 1985 (renamed Republic Bank), followed by Barclays in 1987 (renamed the Guyana Bank for Trade and Industry). Government took full control of the latter in 1988[1], and it was merged with Republic Bank in 1990. Thus, the Government assumed ownership of a substantial part of the commercial banking system and by 1990, owned 95.3 percent of GNCB, 51.02 percent of NBIC and 30.0 percent of GBTI. In 1994, the Government sold most of its shares in GBTI, retaining only 1.3 percent. The Bank of Baroda and the Bank of Nova Scotia continued to be owned by the Government of India and a private Canadian bank, respectively.

Guyana's banking system is quite concentrated, with the two largest banks accounting for 65 percent of the total bank assets. The main sources of commercial bank funding are deposits held by the public, which represented 85 percent of total liabilities at the end of June, 1998. Credit facilities to residents (both the private and public sector) represent the largest share of assets (see Table 4-2). Investment in treasury bills accounts for 26 percent of the share of commercial banks assets.

Table 4-2
Composition of Commercial Banks Assets and Liabilities

	1980	1985	1990	1995	1997
Assets					
Foreign Sector	58989	34665	2408519	3798211	3497458
of which balance due from banks abroad	45616	28384	2318333	2559528	2152522
Public Sector	450938	1665196	4878244	15540327	19644894
of which securities	216432	816471	4075721	14814142	18024933
Private Sector Loans and Advances	195800	520075	4108696	20656770	42920893
Bank of Guyana	125861	627948	1802424	10326443	13315475
of which deposits	43760	99191	691206	9355904	11720910
Other, including non-bank	92726	228290	1104867	7256504	9912009
Total Assets	**924314**	**3076174**	**14302750**	**57578255**	**89290729**
Liabilities, Capital and Reserves					
Foreign Sector	55599	62737	862399	2883269	4963726
of which balance due to banks abroad	23043	1192	545294	278596	782677
Public Sector Deposits	51249	152694	1971186	4695213	9631037
Private Sector Deposits	562766	1410607	7042765	39634076	52116931
Non-Bank Fin. Insti. Deposits	59151	155409	1436619	1827478	3777663
Other Liabilities	195549	1201759	2192970	3146354	3747309
Capital and Reserve		92968	796811	5391865	15054063
Total Liabilities	**924314**	**3076174**	**14302750**	**57578255**	**89290729**

Source: Bank of Guyana

[1] In technical terms, the Barclays Bank and the Royal Bank of Canada were not nationalised. They were sold to the Government of Guyana for G$1.00 each.

B. Non-Bank Financial Institutions

By 1997, the financial system consisted of a small but wide range of bank and non-bank financial institutions with the Bank of Guyana at its apex. Seven commercial banks (four domestic and three foreign-owned banks), with a network of 30 branches, dominate the financial system, holding 73 percent of the total financial assets at the end of 1997 (see Table 4-3). The non-bank financial sector comprising insurance companies, credit unions, the New Building Society, trust companies and a mortgage bank accounts for the remaining 27 percent of financial assets.

Table 4-3
Percentage Distribution of Assets of Financial Institutions in Guyana

	1980	1985	1990	1995	1997
Commercial Banks	63.9	73.9	64.2	71.6	73.3
Non-Bank Financial Institutions	36.0	26.1	35.8	28.4	26.7
Building Society	5.3	5.8	4.7	7.3	7.7
Trust Companies	1.6	2.0	2.2	5.5	5.6
Insurance Companies	14.6	9.6	15.4	9.5	7.9
Life	9.0	7.1	13.1	6.8	5.5
Non-Life	5.6	2.4	2.3	2.8	2.4
Pension Schemes	8.8	3.5	4.1	6.0	5.5
Mortgage Bank	1.9	1.0	0.3	0.1	0.0
Development Bank[2]	3.8	4.2	9.1	0.0	0.0
Total Assets	100.0	100.0	100.0	100.0	100.0

Source: Bank of Guyana

II. Policies of the Sector

A. Policies to improve efficiency and competition in the financial sector

In mid-1991, the Central Bank introduced a competitive bidding process for treasury bill auctions. The bank rate and the rediscount rate were determined in relation to the market-determined treasury bill rate for 91 day bills. The frequency of treasury bill auctions increased to bi-weekly in 1995 and to weekly in February 1996.

[2] In 1995 the Development Bank was merged with the state-owned Guyana National Cooperative Bank.

While the above measures have helped to strengthen monetary control and increase the role of market forces in the financial system, monetary policy has continued to rely on direct instruments of monetary control in the form of reserve requirements on commercial banks, because of excess liquidity in the financial system. In mid-1991, reserve requirements on demand deposits were increased from 6.0 to 11.0 percent and on savings and time deposits from 4.0 to 9.0 percent. In April 1994, the reserve requirements went up further from 11.0 percent of demand deposits and 9.0 percent of savings and time deposits, to 16.0 and 14.0 percent respectively. In February, 1999, the requirement was reduced to 12 percent of both demand and saving deposits and time deposits. In addition, the scope of reserve requirements was extended to include licensed non-bank depository institutions and the definition of reserves to include foreign currency deposits in order to provide a level playing field for all licensed depository financial institutions. The liquid assets ratio has remained at 25.0 percent of the banks' demand deposits and 20.0 percent of time deposits since May 1991. The scope and reporting period have been changed to reduce administrative costs.

In the external sector, measures included the abolition of exchange control and the establishment of a market-determined exchange rate system. In 1990, both bank and non-bank foreign exchange markets (cambios) were allowed to begin operating. Partial convertibility of the Guyana dollar was introduced during the same year. Under the new system, two markets - the official and the cambio co-existed. In February 1991, the exchange rate in the two markets was unified and the official rate determined weekly, based on the average free-market rates for the preceding week. In 1993, the Central Bank began inter-bank cambio market operations to achieve a closer integration of the official and cambio markets. In 1995, the Exchange Control Act was abolished.

A critical element of financial development is the payment system, which has been a neglected area. However, steps have recently been taken to improve the payment system. At the retail payments level, cheque clearing was projected to be fully automated by the end of 1999.

Reducing the role of the State in the financial sector is seen as critical to improved competitiveness and efficiency. At the end of 1997, government ownership of financial entities was reduced to 25 percent of the end of 1993 asset value of the group of banks owned by the Government. This was achieved through the sale of all government shares in the GBTI and the NBIC.

B. Policies to strengthen the prudential framework and bank supervision

Concomitant with the relaxation of structural regulations was a step up of prudential regulations. This was brought about through the enactment of the Financial Institutions Act (FIA) in March 1995. The legislation requires all institutions carrying on banking and financial business to be licensed by the Bank of Guyana and centralises the surveillance responsibility over all licensed financial institutions within the Central Bank.

The improvement of supervision of financial institutions is primarily to promote the transparency of the status of financial institutions, to increase consumer protection and to ensure the safety and soundness of the system. The prudential requirements emphasise capital adequacy

and asset quality. A capital adequacy requirement in line with internationally-accepted standards has been implemented. In addition, commercial banks are required to follow the guidelines on the calculation of risk assets adopted by the Bank of Guyana from the Bank for International Settlements (BIS) guidelines.

The FIA also addresses issues of large exposures, limits on investment in non-bank companies, liquidity ratio, minimum capital for the setting up of a bank, licensing of new banks, insider lending, prohibited operations, loan classification, provisioning and other regulations that would limit risk and concentration of ownership of financial institutions. The off-site surveillance and on-site inspection of banks were strengthened. In addition to the FIA, a revised Central Bank Act, designed to increase the independence of the Central Bank in the formulation and operation of monetary policy, was passed in Parliament.

C. Policies to develop and deepen financial markets

Money market and long-term debt securities are thin and secondary markets are almost nonexistent. To encourage the latter development, the interbank market has been supported by the provision of the enabling framework (i.e. interbank transfer system) recently announced by the Central Bank. Similarly, the Government encouraged capital formation and the growth of an efficient securities market, while protecting purchasers of securities and promoting ethical behaviour in the industry through the Securities Act 1998. This provides for the registration of securities brokers and dealers, certain self-regulatory organisations and certain issuers of securities. Notwithstanding this, there are virtually no capital account restrictions.

III. Issues and Constraints

A. The pre-reform financial sector

Until the end of the 1980s, Guyana's financial system had been characterised by selective credit allocation and interest rate controls. Credit was increasingly directed to specific industries, sectors and public sector corporations while interest rate restrictions were in the form of interest rate ceilings. These policies, which were motivated by the social aspect of banking, i.e., to guard against increases in interest rates and to provide low-cost funding to priority sectors, achieved their objectives. However, they restricted monetary policy to direct controls and changes in the minimum liquid assets and reserve requirements. In addition, financial institutions and markets had either deteriorated or failed to develop. Accounting systems were lax, disclosure was poor and surveillance weak. An unstable financial system with a defective regulatory framework made commercial lending very risky, with banks burdened with portfolios dominated by unproductive and nonperforming assets. The operational efficiency of the banks was highly unsatisfactory.

B. Financial Sector Reforms: 1988-1997

However, as mentioned in the Introduction, since 1998/99 Guyana has been undertaking reforms of its financial sector as part of a broader macroeconomic adjustment program and structural reform, and the key elements of these reforms were aimed at improving the efficiency

of the financial system and enhancing competition among institutions, strengthening the prudential framework, and developing and deepening financial markets. The central features of the measures comprised the removal of restrictions on interest rates, credit and foreign exchange transactions and the use of indirect instruments of monetary policy.

C. Effects of Financial Sector Reform

The impact of these reforms is difficult to assess, since developments in the financial system have been driven by other factors including the macroeconomic environment and developments in emerging and other markets. In addition, data and information inadequacies constrain conclusive analysis of their effects. An assessment of the impact will therefore focus on areas where tangible results of the reforms have been witnessed: efficiency in intermediation, monetary management and quality of banks' loan portfolio.

Liberalisation and the maintenance of positive real interest rates have caused the range of financial services to expand considerably, especially in the form of deposits and credit instruments. Time and savings deposits increased sharply from G$3.8 billion in 1989 to G$18.4 billion in 1992 and to G$46.9 billion in 1997. As a percentage of broad money, quasi-money increased from 62 percent in 1989 to 70 percent in 1992 and to 73 percent in 1997. This indicator suggests that reasonable interest rates, more branches, better service and more diversified savings instruments have contributed to a deepening of the financial system, which increased aggregate savings.

In contrast to the quasi-liquid assets to M2 ratio (see Table 4-4), the standard financial depth indicator of the ratio of money stock to GDP declined substantially after 1989. It fell from 114.5 percent in 1988 to 68.1 percent in 1990, increasing slightly to 72.3 percent in 1997. In the 1990-1997 period, the ratio remained relatively stable except for a sharp decline in 1991. Similarly, the ratio of financial assets to GDP, which declined from 162.0 percent in 1988 to 96.0 percent in 1989 and to 84.0 percent in 1997, remained relatively stable over the 1989-1995 period with the exception of 1991. The decline in these ratios is attributed to the large devaluations of the Guyana dollar between 1989 and 1991, which resulted in considerable expansion of nominal GDP. Specifically in 1989, the Guyana dollar was devalued by 70 percent to G$33 per US$1. In 1990, it was further devalued from G$33 per US$1 to G$45 per US$1, and in 1991, from G$45 to G$101.75 per US$1. The use of intermediate monetary targets during the period of macroeconomic stabilisation has helped to create a consistent framework within which the financial sector can grow further.

Table 4-4
Selected Monetary Indicators, 1985-1997

Year	Broad Money M2 % GDP	Deposit % GDP	Finan-cial Assets % GDP	Credit to Private Sector % GDP	Quasi Money (G$ Million)	Quasi Money % M2	Real Deposit Rate[1]	Real Lend-ing Rate2	Infla-tion Rate	Interest Rate Spread3	Aver-age Money Multiplier
1985		109.2	181.8	31.1	1215.4	64.5	-3.1	-0.1	15.1	...	
1986	122.7	117.5	201.4	36.5	1453.6	65.1	4.1	7.1	7.9	...	
1987	105.2	117.5	155.3	32.3	1859.9	62.0	-16.7	-13.7	28.7	...	
1988	114.5	127.0	161.9	43.9	2462.6	59.8	-28.0	-25.0	40.0	5.5	
1989	68.2	78.3	96.2	27.8	3809.3	61.5	-87.8	-84.0	120.0	6.6	
1990	68.1	77.9	97.0	29.7	5982.9	63.6	-56.9	-54.0	85.0	4.9	
1991	48.4	56.7	71.4	19.8	10256.9	63.1	-41.1	-36.8	70.3	9.0	3.2
1992	64.6	76.1	87.9	21.5	18355.0	70.3	4.0	11.7	14.2	13.1	2.5
1993	67.4	75.9	89.7	20.7	23991.8	71.9	2.2	8.8	8.7	8.7	3.1
1994	61.9	63.7	86.0	27.8	26849.3	68.6	-3.3	3.8	16.1	9.8	3.2
1995	67.3	66.5	90.8	28.2	35332.7	71.6	4.7	11.0	8.1	9.9	3.2
1996	70.0	73.0		44.1	41543.1	72.1	4.5	12.5	4.5	10.73	2.7
1997	72.3	78.4		50.5	46930.5	73.0	4.2	12.8	4.2	10.93	2.8

Source: Bank of Guyana's:

Statistical Abstract (Dec 1994, Mar 1998)

Annual Report (1991, 1997)

... Not available

1/ Commercial Banks' three month time deposit rate

2/ Average prime lending rate

3/ Weighted average lending rate less average savings rate

As regards credit dispensation (see Table 4-5), since 1989 the bulk of commercial bank credit has gone to the private sector. Not only has the credit growth been significant in absolute terms, but the ratio has also improved. The share of credit to the private sector rose from 39.0 percent in 1985 to 88.0 percent in 1992 to over 94 percent between 1993 and 1997. With fiscal adjustment, the public sector, which was the largest borrower, became a net depositor to the banking system. The increase in private sector credit indicates that the banks have been diversifying their loan portfolio and looking out for new loan accounts. However, the sectoral distribution of the stock of private sector credit shows that credit to business enterprises, including agriculture, manufacturing, mining and services, declined from 85.0 percent in 1989 to 83.0 percent in 1992 and to 80 percent in 1997. The share of credit to households has, however, gone up from 13.3 percent in 1989 to 20 percent in 1997.

Table 4-5
Commercial Banks Credit Allocation, 1995-1997

Year	Banking System Net Dom. Credit1 (G$Million)	Private Sector (G$Million)	Public Sector (G$Million)	Credit to Private Sector as % GDP	Private Sector Share of Total Credit	Business Ent. Share of Private Sect. Credit	Household Share of Private Sect. Credit
1985	1411	557	848	28.4	0.39	0.75	0.25
1986	1009	663	334	29.8	0.66	0.76	0.24
1987	1355	943	398	28.1	0.69	0.74	0.26
1988	2145	1559	580	37.7	0.73	0.84	0.16
1989	3219	2519	688	24.4	0.78	0.86	0.13
1990	4914	4109	791	26.0	0.84	0.84	0.16
1991	7092	6620	403	17.0	0.93	0.85	0.15
1992	9896	8680	903	18.6	0.88	0.83	0.17
1993	11277	10207	544	17.3	0.91	0.79	0.20
1994	15076	13799	221	18.2	0.92	0.77	0.23
1995	22190	20657	479	23.4	0.93	0.74	0.26
1996	37162	35864	284	36.2	0.97	0.83	0.17
1997	44540	42921	221	41.0	0.96	0.80	0.20

Source: Bank of Guyana Annual Report (1997)

1/ Includes Non-Bank Financial Institutions

The key element of reform from the point of view of monetary management has been the transition to indirect instruments of monetary policy, largely through the regular auction of treasury bills at present. This has resulted in an improvement in the capacity of the Bank of Guyana to regulate the growth in money and credit, through a market mechanism. The absorption of excess liquidity through the issue of treasury bills has brought about better control and management of the money supply, as evidenced by the relative stability of the money multiplier during the 1992-1997 period. The auction mechanism is helping to create competitive market conditions by compelling banks to critically examine their funds management practices and the manner of pricing their deposits and loans.

Banks have emerged as the largest holders of treasury bills, i.e., the share of treasury bills in the asset portfolio of banks has gone up from 35.0 percent in 1991 to 59.0 percent in 1997. This has been largely due to their high-yielding and riskless investment character. It is important to note that the auctioning of treasury bills for sterilisation purposes, which has improved the management of liquidity, resulted in a high interest expenditure to the Government of approximately G$25.0 billion during 1991-1997.

The greater freedom to acquire foreign exchange, combined with a market-determined exchange rate, has enhanced the availability of foreign exchange to the country. The volume of all foreign exchange transactions has grown considerably. Total recorded transactions increased from US$329 million in 1991 to US$1.29 billion in 1997. The cambio market accounted for US$946.5 million or 73.4 percent of total foreign currency transactions. While the foreign exchange market remains shallow, there has been an increase in the volume of interbank foreign exchange trading which reached almost US$14 million in some recent quarters. Within this total, the Central Bank has been very active. The spread between purchase and sales rates among bank and non-bank institutions has been decreasing. This is shown in Table 4-6.

While partial internal financial and economic convertibility has enhanced the transparency of intermediation of foreign exchange in the economy, efficiency remains constrained due to the lack of full financial market flexibility; this is because complete internal convertibility, i.e., the legal right of residents to acquire and maintain domestic holdings of certain assets denominated in foreign currencies, has not been granted. It is argued that complete internal convertibility may lead to currency substitution or dollarisation and consequent loss of revenue from seigniorage and inflation tax. The authorities' ability to conduct monetary policy and hence, to control inflation, may also be substantially weakened because the foreign currency component of total money supply cannot be directly controlled

Table 4-6
Exchange Rate (1991-1997)
(Guyana Dollars Per US$)

	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Buying	117.27	123.97	125.89	137.64	140.28	138.25	140.51
Selling	119.80	125.91	127.82	140.14	143.42	141.84	143.28
Spread	2.53	1.94	1.93	2.50	3.14	3.59	2.77
A. Bank Cambio Exchange Rate:	**1994**		**1995**		**1996**		**1997**
Buying	136.56		139.22		137.55		141.02
Selling	139.60		143.61		142.36		144.00
Mid Rate	138.08		141.42		139.96		142.51
B. Non-Bank Cambio Exchange Rate:							
Buying	138.76		141.30		139.32		140.43
Selling	140.71		143.42		141.41		143.00
Mid Rate	139.74		142.36		140.37		141.72
Spreads							
Bank	3.04		4.39		4.81		2.98
Non-Banks	1.95		2.12		2.09		2.57

Source: Bank of Guyana

Financial intermediation costs have not shown significant positive adjustment with the liberalisation of interest deposits, and lending rates, often used as a proxy for efficiency of financial intermediation, remain high because of a lack of flexibility in bank interest rates. However, in the recent period a narrowing of the spreads has been observed; after increasing from 4.94 percent in 1990 to 13.18 percent in 1992, it declined to 12.9 percent in 1997. The large spreads reflected administrative costs, loan loss provisioning, taxes, after-tax profit margins and required reserves. Administrative costs are the major contribution to the spread, accounting for over 50 percent of the total spread. They stand out across all banks, though for the small private banks, they are far more significant, averaging more than 75 percent of their individual spread. The high administrative costs of these banks is partly explained by financial innovation, in the form of computerisation, ATM machines and debit card facilities they have introduced. In addition, the employment of qualified staff necessitated by these innovations has resulted in a higher wage bill and further increases in the administrative costs. Moreover, except for one, these banks do not have branches, making for higher average fixed costs which limit the sale and scope of their operations and therefore add to their intermediation costs.

Financial results of banks (Table 4-7) show that returns on equity and on assets fell during the 1991-1997 period. The ratio of net profit to equity (ROE) declined from 53.5 percent in 1991 to 27.7 percent in 1993 and to 8.4 percent in 1997. Similarly, the ratio of net profit to assets (ROA) declined from 9.1 percent in 1991 to 4.0 percent in 1993 and to 2.4 percent in 1997. The decline in profit is explained by falling earnings. The ratio of operating income to assets declined from 21.3 percent in 1991 to 10.7 percent in 1997, while the operating expenses to assets ratio declined from 14.5 percent in 1991 to 8.4 percent in 1997. Moreover, the ratio of total operating expenses to total operating income increased from 68.3 percent in 1991 to 72.5 percent in 1993 and to 77.9 percent in 1997. Provision for bad loans and narrow opportunities to invest excess resources also had an impact on bank profits. In 1991, the ratio of excess reserves to total deposits which was 1.03 percent declined to 0.16 percent in 1994 but increased sharply to 3.41 percent in 1995. The relatively large ratio in 1995 is explained in part by the removal of interest earnings on the special deposit scheme at the central bank at the end 1994.

Table 4-7
Commercial Bank Performance Indicators, 1991-1997

Percent	1991	1992	1993	1994	1995	1996	1997
Net profit to equity – ROE	53.5		27.7	27.7	16.5	11.5	8.4
Net profit to asset – ROA	9.1	5.0	4.0	3.9	2.9	3.2	2.4
Operating income to assets	21.3	16.7	14.6	13.9	14.1	12.2	10.7
Operating expenses to assets	14.5	11.7	10.5	10.0	11.2	9.0	8.4
Operating expenses to operating income	68.3	70.1	72.5	71.9	79.7	79.7	77.9

Source: Bank of Guyana

The inability of banks to predict long term interest rates and assess risk also partly explains the banks' excess reserves, falling profits and consequently, wide interest rate margin. Specifically, when interest rates are forecastable, the expectation theory of the term structure implies that long-term rates should always reflect actual short-term rates. If interest rates are unforecastable, then there will be mismatches between long and actual short rates. These maturity gaps cause problems for financial intermediaries which typically borrow short-term and lend long-term. In view of this, banks are reluctant to lend in the long term.

Prudential regulations and banking supervision have been strengthened considerably in recent years. As a result, the soundness of the banking system has improved. The capital base of banks has been enhanced since 1991. The level of capital increased from G$2.1 billion in 1991 to G$5.4 billion in 1995 to G$15.1 billion in 1997. As a share of total assets, capital increased from 8.2 percent in 1991 to 9.4 percent in 1995 to 17 percent in 1997. The average risk-weighted capital adequacy ratio was well above the minimum 8 percent required after 1995.

Non-performing loans declined between 1992-1997. In 1997, these amounted to 14 percent of total loans3, much lower than the 22.7 percent in 1995 and 40.69 percent in 1992. Expressed in terms of total assets, there was also a decline from 10.4 percent in 1992 to 8 percent in 1997. The share of general provisions decreased with a reduction in non-performing loans. Provisions as a percentage of non-performing loans have decreased from 63.5 percent in 1992 to 51 percent in 1997.

IV. Sectoral Objectives

Guyana has made significant progress in enhancing the effectiveness of monetary policy and reforming its financial system. In the future, to achieve high sustainable rates of growth, the reform efforts will have to continue to enhance the mechanisms for efficient mobilisation of domestic and foreign savings and ensure their efficient allocation. In this regard, the thrust of reform efforts will have to be on financial deepening, that is, development of institutions, markets and instruments. In addition, it is crucial that a sound financial system is maintained to support the process.

V. The Strategy

Financial institutions in Guyana have to be efficient, innovative and productive in conducting their basic function of intermediation to reduce costs, and tap new areas of activity to increase profitability levels. To achieve this, institutions will have to have the necessary capital strength, personnel and expertise. With adequate capital, they will be able to invest in information technology, training and product development. Information technology is crucial in contributing towards improvement in services, convenience, productivity and profitability and will have to assume a greater role in the financial sector and in particular, the banking industry. While it has already played an important role in the modest modernisation of financial

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3 Net of non-performing loan of the merged GAIBANK with GNCB.

transactions in Guyana through the electronic payment mechanism using credit cards, debit cards and ATM, one critical gap is an electronic clearing house for cheques which could alleviate the long delays encountered by the present manual system. A national automated cheque clearing system using image-based technology is being acquired by the Bank to provide same day clearing of all local cheques nationwide.

To meet the challenges ahead and respond to the needs of a changing economy (especially with globalisation of financial markets), information technology must be extended to other more strategic areas such as the creation of new products and services, enhancing productivity through better use of resources and productive capacity, corporate planning, risk management to assess the risk exposure of financial institutions, and market analysis. Effective use of information technology, however, will require its promotion within the organisation, effective flow and use of information, training and development of information technology skills, and the optimising of the use of the technology within the context of business volume, operating cost and improvement of consumer service.

To remain adequately sound and profitable, the institutions must provide continuous training for staff at all levels. Since financial reform usually entails a portfolio shift associated with increased risks, it is important that all players understand the risks involved and acquire the necessary skills to deal with such risks. In view of this, it is imperative that banks invest in risk management that will provide for adequate assessment of borrowers' condition, collateral values, portfolio risks under various scenarios and the adequacy of provisions to absorb potential losses. The Guyana Association of Bankers, through the establishment of an Institute of Banking, can contribute significantly to human resource development in banking and finance, which is crucial for a sound financial system.

The high level of concentration of the Guyanese banking system is a source of systemic risk. While there are no legal barriers to entry into the system, the small size of the market acts as an impediment to entry. There is therefore a need to expand the smaller banks' market share and to strengthen levels of competition in the banking system. In this regard, smaller banks will have to enhance their competitive edge through operational efficiency, introduction of new products and access to foreign markets. To provide more competition in the market, the entry of specialised banks into the corporate end of the market and into trade finance, where current services are inadequate will be encouraged.

Financial markets have to be developed to provide additional instruments to serve the needs of both savers and borrowers, providing additional avenues to mobilise and allocate resources. Given the present thrust of market-oriented reform in Guyana, and given the continuing downsizing of Government's operations through the privatisation of public enterprises and the emphasis on the private sector as the main engine of growth, there is tremendous potential for the development of capital markets. The establishment of a merchant bank or of merchant banking activities, mostly with equity participation from foreign investment banks to tap their expertise, can play an active role in innovating and promoting new capital market instruments.

The non-bank financial institutions and the manner in which they allocate their funds is also linked to the development and growth of financial markets. There is little doubt that with appropriate investment regulations, life insurance companies, which hold the largest share of the assets of non-bank financial institutions, can play a major role in mobilising long-term financial resources as well as promoting capital market development by providing an effective demand for viable investment instruments. The Insurance Act of 1998 will be implemented and the institutional capacity to enforce the Insurance Act will be properly developed, starting with the appointment of a Commissioner of Insurance.

The Central Bank will also help in the reform process by stimulating growth of financial markets and instruments. A well-functioning interbank market will be a cornerstone in the development of financial markets in Guyana. The development of the interbank market, however, requires continuation of Bank of Guyana efforts to absorb excess liquidity in the banking system and to ensure that the minimum prudential standards are followed by all banks in Guyana. The setting up of a repurchase agreement (repo), which is similar to a collateralised loan and is used by commercial banks for cash management and by central banks in monetary management, is also important for promoting interbank lending. A prerequisite for repo operations is the formulation and adoption of a Master Repurchase Agreement by all the banks, including the Bank of Guyana. The Bank of Guyana will also develop its internal procedures for registering the transfer of ownership at the book-entry system and for handling all the corresponding accounting entries (Vollan, 1997).

A viable secondary market should also be developed for government securities. This should start with the strengthening and deepening of the primary market. It requires the introduction of bills with shorter maturity (for example, 30 day bill) to promote interest from new investors in the primary market while channelling the demand for treasury bills into a few maturities to deepen the market. To encourage secondary transactions, it is important that the procedures for transfer of ownership and settlement are clearly established (Vollan, 1997). As a first step, the Bank of Guyana will hold discussions with other banks on procedures for carrying out transactions through its book-entry system which can offer settlement on a “Delivery versus Payment” basis to banks. The next step will be to establish the settlement framework for handling transactions between banks and non-bank investors.

The profitability of institutions and the efficient functioning of markets depend crucially on the continued existence of a sound financial system. While the Parliament has legislated the banking law so as to assure depositors’ trust in the soundness of the banking system and ensure strong bank governance via the Financial Institutions Act, the regulatory regime will be reviewed to provide for an integrated supervisory regime for the financial system, given the growth and importance of the non-bank financial institutions. It is also important that the resources and skills base be enhanced to enforce the law and effectively deal with the changes in the banking environment. Institutional strengthening through the garnering of expertise and resources, training, stronger collaboration in the sharing of information between countries of the region, introduction of new accounting standards, self regulation through strengthened internal bank governance, and use of external auditors can go a long way toward fostering bank soundness. The establishment of a legal framework with clear rules, to ensure an orderly process to meet the banking system’s needs in accordance with the objectives of more flexibility and greater freedom

of action, is required. The existing bankruptcy law is limited in scope and incomplete for a market economy, and will be seriously reviewed. In addition, the court systems are limited in judicial capacity, resulting in long delays and inefficiency.

Bank soundness also depends on a non-inflationary macroeconomic environment that is conducive to efficiency within the sector and to the efficient transmission of monetary policy signals to the economy. In this regard, it is important that monetary and fiscal discipline as well as a realistic exchange rate[4] are adhered to, so that relative prices are not distorted and the price system is able to perform the role of resource mobilisation and allocation on the basis of sound criteria relevant for improving investment and productive efficiency. In addition, the recent financial turmoil in Asia and elsewhere has underscored the importance of having more comprehensive and timely economic and financial data for more effective management and hence, a sound financial system.

Monetary management as a complement of macroeconomic policy in general is another key component of bank soundness. Between 1991 and 1997, monetary control improved as a result of the transition to indirect instruments (treasury bills) and this is evidenced by the substantial decline in the volatility of the money multiplier. The Central Bank will continue to work towards an independent monetary policy through the conduct of open market operations, where the money supply is influenced through base reserve money. This operation is very complex and requires timely and accurate data on financial sector developments, the balance sheet of the Central Bank and quantification of key monetary relationships. In addition, projections of the demand for and supply of currency and bank resources, as well as estimates of their effect on money aggregates, are crucial (Alexander, W.E., Balino, T., Enoch, C. 1995). The Central Bank's technical capacity will be strengthened and investment will be made in information technology, as two keys to the success of this undertaking.

It is also important to note that open-market operations cannot be continuously relied on, particularly when securities markets are thin and illiquid and where there is sustained fiscal imbalance and major capital inflow. In these situations, open-market operations are extremely costly, and they frustrate macroeconomic policy objectives, especially higher domestic interest rates (Lee, 1996). Government will therefore consider alternative or supplementary techniques and instruments that would provide scope for more efficient monetary management, which has been focussing on sterilisation of excess liquidity. Judicious use of direct controls, altering access to the Central Bank’s refinance facility, switching government deposits between commercial banks and the Central Bank, and using currency swap operations, are some supplementary sterilisation measures.

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4 It is crucial to maintain real exchange rate stability as well as an equilibrium real exchange rate. Real exchange rate stability is an important objective not only with respect to price stability but to provide an enabling environment to foster investment and growth. In view of this, volatility of the real exchange rate should be avoided with appropriate intervention, when the nature of pressures on the real exchange rate is temporary. The real exchange rate equilibrium level is important to avoid the risk of severely affecting the development of the tradable sector (especially non-traditional, since the traditional is a price taker under a preferential market) of the economy. Also, when the long-term equilibrium level is returned, pressure on prices risk the inflationary objective.

An important element in the achievement of price stability will be monetary policy transparency and hence, effective and efficient monetary policy accountability. While legislation has provided increased Central Bank independence to achieve this policy objective, this by itself cannot guarantee monetary policy credibility. The structure of the Central Bank, as well as the relationship between the Central Bank and the Government, are equally important. With respect to the structure of the Bank, studies by Persson (1998) and Vollan (1997) have pointed out the need for decentralised decision-making and the delegation of authority in the use of market-based instruments and mechanisms. This requires changes in the organisational structure, given the present compartmentalisation of the Bank into separate departments with little interaction For effective organisation of the Bank, the structure will be organised along functional lines, with a focus on decision-making. While central banks have different structures, the Bank of Guyana, as a small central bank, should implement a structure based on the four major functions of strategic planning, research, operations and services, with well-articulated rules to define accountability, authority, responsibility and performance criteria.

Other potentially important components of the Bank's structure are the appointment of a Governor who will function as an advisor to the Government, and of a Board of professionals with a broad-based but relevant background in law, economics and accounting; to effectively carry out the mandate outlined in the Bank of Guyana Act (1998). It is important that the respective roles of the Bank and the Government are clearly defined and consistent, and that the relationship between the two is transparent. The design of conflict resolution procedure, and the appointment and dismissal procedures for senior executives are particularly important. Specifically, therefore, steps will be taken to establish a governance contract which details the respective roles of the Government and the Bank; the system of governance and accountability, quantitative and time-bound targets by which the Bank will be measured, and consequences of failure to achieve targets or to comply with established standards.

Conclusion

The financial sector in Guyana has undergone a far-reaching process of reform. Controls on interest rates and bank credits have been removed, and a more market-oriented approach through the indirect instruments of reserve requirements, open market-type operations and discount facilities control have been implemented. The reforms have had positive effects. They have created an environment conducive to financial intermediation and a sound banking system. They have enabled the economy to mobilise funds for investment and growth, and contributed to the development of the private sector. In spite of the positive developments that are taking place in the banking system, Guyanese policy-makers have to understand and appreciate that with widespread globalisation, there is need for further banking reform and hence for more steps to be taken to restructure the financial system on an ongoing basis to equip financial institutions with the necessary strength and stability to cope with future challenges.

The need to intensify financial reforms is overwhelming, since Guyana's achievement of high, sustainable rates of growth depends on enhancing the mobilisation of domestic and foreign savings and ensuring their efficient allocation. Bringing the fiscal deficit under control is vital for financial stability since it is directly related to high rates of inflation which hamper desired

improvements in the performance of the productive sector. Heightening the operational efficiency of the financial system is crucial. Institutional development, the creation of new products for fund mobilisation and credit expansion, and the deepening of financial markets are all necessary. Macro-economic policies must also be consistent with financial reform.

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