



**EXCHANGE CONTROL LIBERALISATION
AND CAPITAL MARKET DEVELOPMENT**

Presentation by

**Dr. Marion Williams
Governor
Central Bank of Barbados**

At the Conference

“Charting our Course in CSME”

Sherbourne Conference Centre

May 5, 2005

There are a number of widespread benefits which result from active capital markets.

Capital market development requires a clear strategy aimed at:

- (i) raising the level of savings and improving its composition;
- (ii) enhancing the economic efficiency of the capital markets;
and
- (iii) promoting the harmonisation and integration of the region's capital markets.

We can also speak of the characteristics of developed capital markets. Typically, they:

- (i) direct savings into the most profitable investments available within the economy;
- (ii) provide competitive financing alternatives;
- (iii) give price signals to gauge the cost of government borrowing; and
- (iv) provide a link between the funding needs of borrowers and lenders,

We can also speak of the development objectives of capital markets: These are usually:

- (i) to raise the level of savings and improve its composition;

- (ii) to enhance economic efficiency of the capital markets;
- (iii) to promote the harmonisation and integration of the region's capital markets;
- (iv) to permit monetary authorities to evaluate liquidity needs;
- (v) to offer a wider variety of instruments;
- (vi) to effect efficient fund allocation;
- (vii) to allow for greater securitisation;
- (viii) to allow riskier firms to access financing; and
- (ix) to value securities realistically.

Furthermore, investors who are seeking to diversify their portfolios, invest in countries with more developed liquid and transparent capital markets, particularly if they offer a wider variety of instruments. Such markets encourage more frequent trading of shares.

The role of a capital market is to provide a link between the funding needs of borrowers and lenders, and in so doing realise efficient fund allocation. Pension funds and vehicles such as mutual funds will also help to boost capital markets in the region and the demands of institutional investors for long-term investment opportunities constitute a challenge for capital markets to provide a sufficient volume of long-term financial products.

Securitisation allows comparatively riskier firms to access to capital markets, and to lower financing costs by segregating higher quality receivables or assets from the risky firm.

Liberalisation of the financial industry over the past two decades has helped to support creative financial markets throughout the region, particularly in Trinidad and Jamaica, and can drive the same type of evolution in Barbados.

It is also recognised that the existence of exchange controls on capital adversely affect the flow of foreign funds and slow the development of capital markets.

Why then do we have capital controls if it is clear that the removal of capital controls help to develop capital markets?

Firstly, the maintenance of exchange controls in Barbados is inextricably linked to the preservation of its fixed exchange rate regime. Any attempt to relax or remove these controls must therefore be seen within this context.

Barbados maintains exchange controls on capital flows in order to:

- *Help to prevent the opportunistic outflow of foreign exchange which could undermine the exchange rate.*
- *To protect the existing level of foreign exchange reserves, since this affects confidence in the exchange rate.*

- *Allow for a low interest rate regime in the domestic economy to help increase competitiveness and maintain lower borrowing costs.*
- *To enhance macroeconomic stability particularly in periods of economic downturns when speculative flows are more likely to occur.*

CSME and Liberalisation

The removal of controls, therefore, must be carefully evaluated in the context of desired macroeconomic stability, so that its downside impact on capital markets development is minimised while macroeconomic stability is not compromised.

Barbados has therefore taken several careful steps toward removal of capital controls with the objective of integrating into the regional capital market while allowing for the opportunity to monitor the impact of each step toward liberalisation, since it is felt that reversal of liberalisation is more damaging than measured implementation.

Presently, exchange controls exist only in the fixed exchange rate regimes within CARICOM. In Barbados, since the mid-1990s, despite the arguments for maintaining exchange controls, the Central Bank of Barbados has moved to gradually liberalise its exchange control regime in order to comply with its commitments to the CSME.

Institutional infrastructure

The existence of capital controls, however, cannot explain altogether the slow development of capital markets in the region. For example, the national savings rate needs to be raised. The national savings rate in the Caribbean is less than 20% compared with more than 30% in – say South East Asian jurisdictions and 40% in China.

One of the factors which is most important to the deepening of capital markets is the institutional infrastructures such as legal, taxation, and accounting systems. Greater harmonisation of this aspect of capital market development would be an advantage. The presence of transnational financial institutions makes greater harmonisation even more important, since, in operating in several jurisdictions, it is important that, in order to maximise the benefits of scale that the differences in the legal and tax environment are minimised.

Barbados has been undergoing a process of gradual financial liberalisation and reform. For example, there are presently no controls on the purchase or sale of listed or unlisted equities within CARICOM. The Central Bank has already conferred delegated authority status to the commercial banks for authenticating almost all current account transactions. The main aims of such forms of liberalisation are to increase efficiency in key areas of the economy so as to reduce delays and hence costs and improve the level of efficiency in the system.

The question is sometimes posed as to the extent to which Barbados is in a position to permit money to flow freely out of country. Backed by the increase in foreign inflows over the last few years, Barbados has produced a relatively healthy level of foreign exchange reserves, which now stand at approximately \$1.2 billion. This allowed greater scope for foreign investment in 2004. Indeed it permitted, in the second half of 2004, a surge of capital outflows. While flows to international destinations carried a pledge of repatriation under the “second tier” foreign exchange programme, regional investments did not. About \$150 million, or just about half of the decline in foreign exchange reserves in 2004 was attributable to capital outflows of which the second-tier reserves amounting to just under \$100 million, is repatriable. The regional capital outflows are not.

The question for Barbados is, how much can we permit and how can the country be assured of reflows of dividends, interest and profits from these outward regional investments, and what conditions need to be fulfilled in order to ensure a smooth transition to complete capital market liberalisation.

Barbados depends on capital inflows to offset the deficit on the current account and to contribute to reserve build up. The country’s economic stability continues to allow it to attract foreign direct investment, while its natural comparative advantage in tourism is the basis of its tourism success. By far the largest share of the FDI market is in tourism related activity or real estate, but it is important to note however, that the stability of the country’s financial markets is

related to confidence in the value of investment in the country, that confidence is integrally linked to the level of foreign exchange reserves which we are able to maintain.

In the past, the Central bank tried to keep interest rates low in order to control operational costs of businesses so as to increase their competitiveness, but high enough to permit a positive real interest on savings and to keep funds in the country. With international rates rising the current level cannot achieve the latter objective unless domestic rates are raised.

Up until 2004 outward investment had been timid. Barbadians started in 2004 to accelerate outward investment and it is not too clear whether this will be a continuing phenomenon or whether it was a one-time response to capital account liberalisation. Relative costs of operations within the region may have prompted outward investment and these costs continue to be low.

Challenges and Opportunities

Improved financial liberalisation will mean that it is important for authorities to track the volume of movement in the foreign exchange market at a higher level of detail. Timely and reliable information relevant to decision making by market participants, as well as, by the regulatory authorities will be crucial to the effective functioning of a market. The tasks also include developing still higher standards for financial data collection, and promoting transparency through the sharing of information.

It is, however, important to note that foreign interest for those who wish to access overseas borrowing is an important foreign exchange cost which has to be borne. It is for this reason that up to now foreign private sector borrowing is usually limited to borrowing that is intended to be used to earn foreign exchange. In this context, interest rate differentials within the region are important.

The key to determining the extent of affordable liberalisation is estimating the foreign exchange impact. Hence, we have settled on equity investment as the item to be liberalised before moving to fixed income securities. The sequence is driven by foreign exchange affordability. In the case of fixed income securities, the ability to forecast the quantum of foreign exchange outflow is more complex, since there are so many constantly changing variables – interest rates, exchange rates principally.

Since issues of fixed income government securities can be very large, and large movements have the potential for leading to volatility in financial markets, investment in government fixed income securities has to be approached with caution.

In addition since we now have several pan-Caribbean banks, it has become clear that they are engaging in increased foreign exchange risk management cross-border. This is quite acceptable provided it is taking place in the context of guidelines set by the Central Bank but it is an area which now requires greater monitoring.

Future Challenges

There is no doubt that the removal of exchange controls on transactions within CARICOM is an essential part of Barbados' commitment to the creation of a single market within CARICOM. Neither is there any doubt that substantial progress has already been made in terms of Barbados' liberalisation programme.

Exchange control liberalisation has progressed furthest with respect to transactions in East Caribbean Dollars between residents of Barbados and residents of the Organisation of Eastern Caribbean States. Since 1998, all such transactions have been delegated to the commercial banks, except for transactions in debt issues of OECS governments.

As fixed exchange rate economies are less open with respect to floating exchange rate economies, floating rate economies who are fully liberalised could conceivably act as conduits for uncontrolled outflows of capital into the rest of the world. This is a concern.

Interest-based securities such as debt securities and purchase and sale of real estate and depositing and lending are the three areas which remain to be liberalised and we will be working towards further liberalisation in these areas within the very near future - consistent with ensuring financial and macroeconomic stability.

It is for this reason that economic convergence and macroeconomic policy coordination are seen as important supporting environments for financial liberalisation. Different interest and exchange rate regimes lead to the potential for arbitrage. Financial liberalisation, therefore, could result in higher interest rate regimes at home, which may make the goal of keeping costs low, difficult to maintain. This is one of the trade-offs which need to be taken into account.

Monetary Policy and Liberalisation

The challenge for regional central bankers is to capture the benefits that come from openness to financial flows, while avoiding the risks associated with increased volatility caused by sharp changes in the size and direction of capital flows.

With or without liberalisation, market forces in Barbados will encourage residents to seek more diversified and better returns within the region and beyond. Will overseas investors honour their commitments to repatriate their reflows without incentive? Returns on local funds may have to be attractive enough to attract dividends, interest and profits earned on outward investment back to Barbados.

Ideally, greater macroeconomic convergence of interest rates within CARICOM is desirable as a precondition for full liberalisation. In its absence, the effectiveness of Central banks' monetary policy could be influenced by inward investment or outward flows which are not synchronised with the desired monetary policy of individual countries at particular points in time.

Were we able to establish a single regional currency, many of these difficulties would be diminished, since all intra-regional transactions would then be in the “regional” currency, which would be the same as our “domestic” currency, and so foreign exchange would only be needed to service extra- Caribbean transactions, thus economising tremendously on foreign exchange reserves, not only for Barbados but for every CARICOM country. However, whether or not this outcome occurs, Barbados is committed to the further liberalisation of exchange controls within Caricom. We think that this is feasible firstly because capital controls would be totally removed only with respect to Caricom and, secondly, we expect that within the next few years a single regional currency will be in place, so further economising our foreign exchange.