



An Update of the Economy And Financial Services

Address

by

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to

**The Barbados Association of Insurance
and Financial Advisors**

Sherbourne Conference Centre

April 22, 2005

Good afternoon ladies and gentlemen,

Mr. Catwell, Secretary, Mr President, distinguished ladies and gentlemen, I am once again pleased to be here today to address the membership of the Association of Insurance Advisors, in what has now become an annual event. Given your organisation's important role within the financial system, I welcome the opportunity to discuss with you the performance of the economy, and to also share some of my views on developments in the financial sector.

I will begin by highlighting the key areas of Barbados' economic performance in 2004, and then provide an outlook for the short-run, more specifically, for 2005.

Good Growth Areas

In 2004, Barbados continued to grow quite briskly as real economic activity expanded by an estimated 3.7%. Like 2003, there was continued strengthening in the tourism sector, which grew by just over 9.3%, on the strength of record tourist arrivals. There was also strong activity in the non-traded sectors, primarily in the construction, and the wholesale and retail sectors. However, despite such strong

numbers in the tourism sector, net international reserves fell dramatically to settle at \$1.2 billion, a decline of approximately \$314 million. This outcome can be explained by the strong performances in the non-traded, foreign exchange-using sectors, as the strong surge in import demand borne out by a 17.8% increase in retained imports, combined with sluggish performances in other export sectors, overwhelmed any tourism gains. These combined effects also led to a further widening of the external current account deficit.

In terms of government operations, rising indirect tax collections were typically consistent with an economy on the rebound, and a scaling back of on-budget capital expenditure were the main proponents of the improved Government position. Government's fiscal deficit, which in 2002 was 6.3% of GDP if measured on a Central Bank basis, was scaled down considerably to 2.1% of GDP.

Looking ahead to 2005, what can we expect? With the 2007 Cricket World Cup games quickly approaching, and with the number of planned projects in the pipeline, we are projecting continued economic growth in 2005. Along with construction and its associated sectors, the positive outlook is also based on the strength of good performances in tourism – though at a slower pace than last year

when there was the English cricket tour. Generally, the rate at which the economy continues to rebound is expected to benefit from continued global economic growth and continued strength in the European currencies relative to the US dollar. From the region, we have witnessed the continuation of encouraging arrivals numbers coming out of Trinidad and Tobago and several other countries in the OECS region. This is a good sign and something that should continue to be encouraged in the interest of Caribbean unity. In 2004 the average unemployment rate stood at 9.8% and with the expected construction and services sector activity, it is anticipated that unemployment will remain below 10% and may decline further.

However, economic success is not without its challenges. The level of spending, though boosting growth, has had an adverse impact on foreign exchange reserves. Simply put, our current level of spending is not sustainable unless Barbados earns more foreign exchange. The loss in foreign exchange is largely a result of steeply rising imports (import rose by 17.8%) and continued sluggishness in domestic exports, and partly as a result of some capital market liberalisation. However, with \$1.2 billion in reserves at the end of 2004, Barbados still has just over 23 weeks of imports, considerably higher than the internationally-recognised standard of reserves equivalent to 12 weeks

of imports. In addition, we have accumulated a second tier of foreign exchange reserves amounting to \$180 million at the end of 2004. In addition, a large component of imports was related to construction, and to some extent, could be viewed as a capacity building exercise. However, a significant proportion was also attributed to consumer imports, and it is this aspect of the import spree that needs to be addressed.

Notwithstanding the generally positive outlook, the Barbadian economy will confront a number of challenges during the coming year, and beyond. Despite the anticipated good performance, and a narrowing of the government's fiscal deficit, the manufacturing and agriculture sectors will need to be restructured in the face of continued competition.

While import growth is likely to slow from the pace of 2004, growth is still expected to be high unless measures are taken to dampen spending, as, in addition to consumer imports, Barbadian businesses as well as the public sector will be gearing up for World Cup 2007. Intermediate and capital goods imports are therefore likely to increase. The Central Bank will also continue to keep a close watch on consumer imports. With the benefit of lower taxes, higher tax

thresholds and salary increases in 2005, some of which are already committed, disposable incomes will rise and without counterbalancing policies, there will be a propensity for higher spending. However, the Central Bank would prefer to see a higher propensity to save, and we have already taken measures to induce this through a shift in monetary policy towards higher interest rates, intended to discourage spending and encourage saving.

Government's fiscal position continued to improve in 2004. In 2005, though direct tax revenues will be under pressure, the continued expansion in economic activity will boost indirect tax revenues, while expenditure should be further, as government plans to maintain tight control of overall spending, according to the recent estimates of revenue and expenditure. But off-budget spending, including expenditures in preparation for world Cup 2007, could offset this restraint exercised by the Central Government and could cancel the benefits of restrained central government spending, unless further cutbacks in the central government budget are achieved to provide a better outcome. In addition to planned expenditure, recent events of a critical nature – namely the destruction of Her Majesty's Prisons – will have to be added to government's unscheduled expenditure for the current year. These factors make the needed restraint difficult at a

time when it is most necessary. It may be useful, therefore, to consider several policy measures as interim restraining measures which can take us through to 2007 so that we arrive there in good shape, despite the interim spending over the next two years. Also, given the lowering of tax rates on individual incomes and the pressure on revenues, raising appropriate revenues must be a consideration.

Given the boost in spending, as activity intensifies and consumer business and consumer expectations rise, the level of liquidity within the banking system will tighten, but should remain adequate. There is also expected to be some growth in the export sectors, mainly tourism and sugar.

There are several approaches to economic development. One is to concentrate on the standard of living and allow growth to follow, the other is to concentrate on growth and allow the standard of living to be an outcome of growth. Barbadians have focused on the first approach. In Barbados (and indeed some others in the region are not far behind) we can boast one of the highest standards of living in the world among developing countries. However, it has come at a price in terms of the call on foreign exchange reserves.

The manufacturing sector has been seriously affected by the competition. It is important therefore, that every level of support is given to those who have been able to withstand the rigours of competition so far, so that they can reposition themselves to compete in the new competitive environment. Our manufacturing sector may now be smaller but we must help to make those that have potential to compete and to grow.

Both our external debt to GDP and central government debt to GDP have improved, falling gradually in the past three years. In the case of the external debt, from 30.1% of GDP in 2002 to a projected 26.8% by the end of 2005. Similarly central government debt has fallen from 78.7% in 2002 to a projected 72% in 2005. At the same time our external debt service ratio has continued to fall – from 7.9% in 2002, to a projected 7.1% at the end of 2005. These are small but important improvements. The central government's fiscal accounts have been therefore very controlled.

Government guaranteed debt however, has not been included in these numbers and when these are included the ratio of government debt to GDP rises somewhat. The implication of this is not severe if it is a temporary phenomenon and it may be useful to consider temporary

levy to finance the World Cup and other associated development initiatives in the pipeline over the next few years. It would also help to dampen the simultaneous growth in and private sector spending which is about to occur.

With respect to wages, given the lower tax rates and the raising of the tax threshold from \$17,500 to \$20,000 (recall it was raised last year from \$15,000 to \$17,500) several thousand persons have been freed from paying income tax - and this facilitates spending, it would be prudent if wage restraint were exercised during the next two years. I hesitate to use the word wage freeze, but the schedule of tax reductions which are in train suggests that a wage freeze should be seriously considered in order to avoid high levels of spending and losses in foreign exchange reserves.

In the international financial services sector, in terms of new registrations, this sector continued to grow in 2004 after wobbling a bit in 1999-2002. The sector has been the subject of greater oversight following the Financial Sector Assessment by the IMF, changes have taken place, particularly in the exempt insurance sector where on-site supervision has commenced. Growth in the sector has resumed. This resumption of growth shows that the sector can hold its own and

continues to be a major foreign exchange earner. Presently, it is more important that we continue to ensure that it is well supervised so that we may continue to grow in the face of increasing external pressure.

At the level of the skills of practitioners in the international financial services sector, it is important that we equip the sector to provide the same quality of financial skills from Barbados as can be provided from New York or London. I am particularly pleased to note that the Association of Financial Analysts has been growing in Barbados and that the country is providing a greater number of persons skilled in this area.

Our educational system will need, however, to prepare students to move into this area by providing them with the appropriate building blocks from the level of the school system. A good finance specialist needs to have a strong mathematical background. The schools must therefore be a on board. This will help the international sector to perform at the highest levels of efficiency in order to compete, as that market too faces increased competition from North America and Europe who are both trying to reclaim this business from offshore jurisdictions.

A Stable Industry

Nowhere have we seen more changes in the past few years than in the financial sector. In the banking and insurance sector there has been a spate of mergers and acquisitions, the most current being the pending acquisition of the ICB by a Bermudan company. The privatisation of the government-owned ICB can also be seen as a catalyst for significant foreign direct investment flows. It is likely to bring more competition and could add diversity to the market.

More importantly, however, there has been a consolidation in both the banking and insurance sector to the extent where a single player dominates the industry. This is good for the positioning of companies who wish to become more competitive within the region and beyond as they can benefit from greater economies of scale. However, what is important from a regulatory perspective is that regulators be conscious of the possibility of excessive influence which can result from dominance of the market by a single player, and of the implication for price setting and for service.

Insurance companies generally continue to do well, and profits of the industry as a whole continue to grow. In the most recent publication of the Central Bank's Annual Statistical Digest, the local assets of the

general insurance and life insurance companies continue to rise. But naturally, such performances do not occur in a vacuum and the industry here has, to a great extent, been influenced by international developments.

In the global non-life insurance industry, the good feeling built up in early 2004, was taken away towards year-end by major catastrophes during the hurricane season and then the tsunamis in Asia and Africa. At the same time, reports from the US suggest that price competition is now returning to the market. For property business, a RIMS survey suggested that costs fell by about 9% towards the end of 2003, and early 2004, the first decline in about four years.

At the local level, there are developments in Barbados occurring relating to the compensation culture. Many of you might have once viewed the compensation culture as a North American problem, and in Barbados we still continue to view it that way. But there appear to be signs that the compensation culture is starting to spread and is affecting us as well.

The compensation culture can start with seemingly insignificant things. For example not too long ago, I read in one of the British dailies – I

think the Daily Telegraph - that a postman in the UK who pulled a muscle was taking legal action against a university lecturer. What was the crime? The lecturer had simply put too many letters in the mailbox. The postman's lawyers highlighted that in posting such heavy items, the professor was negligent in failing to appreciate the risk to the postman. I am sure you have also heard of these types of stories, and I only hope that such cases never become prevalent on these shores.

Actuaries predict that this culture is costing companies in Europe and North America billions each year, and has risen by more than 15% in the past few years. There is a cost to us, as insurance protection will rise as a result. And naturally there are economic implications, as we pay more for protection.

Developing an Education Culture

In terms of other international developments, the recent questioning of the Chairman of AIG has also adversely affected the entire industry and has had its repercussions for Barbados because of an associated exempt insurance company based in Barbados.

These perceptions can be damaging and the financial sector generally will wish to ensure that the public, both local and international, has the right perception of the industry. I therefore heartily support the view of the Minister responsible for International Business, the Honourable Dale Marshall, who affirmed Barbados' well-earned reputation as a jurisdiction which is committed to the highest level of probity in the operations of companies doing business from within Barbados. It is important that we dispel any concerns in the minds of overseas regulators, for regulators are taking an ever-closer interest in the financial services sector. It is therefore vital that Barbados is part of the dialogue so that people are aware of changes we have made, how it affects them and how those changes impact on the business reality.

The crucial role played by professional insurance intermediaries has received insufficient recognition. Not only do these parties often assist assureds in pursuit of the most cost-effective means of managing the transfer of risk, their role in risk management techniques and in providing services designed to minimise companies' exposure to risk is an essential contribution to economic growth.

Indeed, the insurance industry is a critical part of the overall financial sector. The industry also has an important role to play within the

context of an expanded regional bloc. For if we are to transform the CARICOM region into one that can compete within the global marketplace, the creation of a solid financial market is vital. A competitive industry has important spin-off effects, which are in the interest of the domestic economy. It contributes towards a stable capital and financial market, it buttresses the pool of the region's savings, allows for private savings invested in pension funds, life insurance and other financial vehicles – all of which work to the full advantage of regional savers and corporate borrowers.

One recent, positive development is the increasing participation of the private sector in the creation of an integrated financial services sector in the region. Indeed, the regional private sector has been at the forefront of certain initiatives, such as the exploratory work with respect to the development of a regional stock exchange and a credit rating agency. This is a good sign and such moves should be applauded and continued.

Emphasis needs also to be placed on strengthening national savings, so as to enhance the deepening of domestic financial markets and to reduce the dependence on external flows. In the absence of a well-developed financial market, a number of investors – usually the larger

institutional investors and borrowers – turn to external sources of finance. I urge the life insurance sector to step up their efforts to offer attractive products so as to keep more foreign exchange at home. The opportunity is there as disposable incomes have risen. In addition, to the extent that some of the World Cup 2007 projects are appropriate for the portfolios of local insurance companies, investment in some of the underlying securities which underpin the expenditures is also urged.

Improved regulation and Supervision

Naturally, as a regulator, I must speak about changes to regulation and how they are conceptualised and implemented within a harmonised regional setting. At the technical level, the Central Bank remains alert to how future consolidation may affect the competitiveness of the markets and is continuously monitoring potential future changes in the transmission mechanisms for its monetary policy through financial institutions.

Finally, I would like to touch briefly on the challenges of regionalism in terms of harmonised systems. The implementation of the CSME provides an opportunity to improve the quality and cost efficiency of regulation and supervision through the sharing of resources and

technical expertise. Regulation should be rigorous enough to provide for consolidated supervision across the various jurisdictions in the region and, for information sharing among regulatory entities. We must ensure that consolidated supervision of the industry within the region is adequate.

The harmonisation of financial services regulation within the region has been the subject of much discussion and the preparation of guidelines by the Caricom Secretariat is being undertaken.

Presently, there are differing capital criteria for establishment of financial institutions in each Caribbean territory. This leads to greater administrative headache than would be necessary had these rules been unified. Much work has been done on co-ordination, presumably as the first step towards unification. However, there is increasing evidence of the need for greater unification of rules so as to minimise the oversight needed by different levels of compliance and so as to reduce administrative requirements.

In addition, varying capital criteria across the region, in a context where we are setting up one market puts some at an advantage and others at a disadvantage. It would seem therefore, that the time is

coming closer when we have to cease to speak of harmonisation and speak of unification of criteria. If we are able to achieve this, companies would benefit more meaningfully from economies of scale, as current varying levels of compliance in each jurisdiction are an additional administrative cost.

It is clear that 2005 will be a year of change, of challenge and response, both at the regional and the national level. It will be important for us to analyse quickly, diagnose and respond quickly. The pace of the 21st century demands it of us; we must minimise the time between analysis and action.

Conclusion

In conclusion, 2005 will be a challenging year. It will be a year of positive growth, but the implication of the anticipated high levels of spending will need to be closely monitored.