

**“Financial Liberalisation and the Likely Impact on Businesses
in Barbados”**

To

The Barbados Chamber of Commerce



by

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March 24, 2004

Good afternoon, Mr. Ruall Harris, Executive Director, Mr. Robert Foster, President, Mr. Mark Thompson, Vice President, ladies and gentlemen, thank you for inviting me to speak to you on a topic that is not only of importance to businesses, but to every single Barbadian. Financial liberalisation is but one of the features of the so called "Washington consensus" which was popularised by the international financial institutions a decade ago. I shall first briefly describe the lessons drawn from the experience of capital account liberalisation in other countries. Then, I shall sketch some key features of the Barbadian economy, highlighting the key considerations in the liberalisation process. In doing so, I shall allude to Barbados' specific issues and possible strategies for dealing with them.

General Facts and Conventional Wisdom

Liberalisation is defined as the freeing up of product, labour and financial markets, usually to respond to price incentives. Financial liberalisation applies this principle to the financial markets. The underlying rationale of financial reforms has been to move to systems which respond to market signals, on the grounds that it leads to greater efficiency. This is a desirable goal. The experiences of other countries suggest that financial liberalisation must be implemented only in the context of a full appreciation off all factors, both global and domestic. At the same time financial liberalisation

must be compatible with the degree of resilience of the domestic financial sector and with its ability to deal with large flows of capital in either direction.

Inward capital inflows are welcomed. They add to reserves and though they can lead to excess liquidity, and can influence interest rates, in a foreign exchange constrained economy, these are implications that can be accommodated. However, when capital inflows are reversed, as has happened in many Latin American countries and South East Asia, capital account liberalisation may give rise to capital outflows, and (where the outflows are at heavily discounted prices), to losses and to institutional distress. Financial liberalisation however is important to allow us to effectively integrate ourselves into the international landscape. With respect to CARICOM, it is a critical factor in the effective functioning of the CSME to which we are all committed.

Capital account liberalisation is the most important aspect of financial liberalisation and from the experiences of other countries there are some lessons to be learnt. Firstly, it should take place in a context of sustainable macroeconomic and trade policies so as to minimise risks. Secondly, developed financial systems and supervisory infrastructures need to be in place before complete opening of the capital accounts. The broad lesson is that financial liberalisation in general is likely

to succeed if it forms part of a coherent programme of economic reform, and the financial sector should be opened when the economy is able to cope with the adjustment.

Let me say up front that this discourse will not discuss our exchange rate regime as there is sufficient evidence to confirm that for small developing economies fixed exchange rates work very well. Our fixed exchange rate acts as an anchor, which helps to stabilise the economy.

Main Characteristics of the Barbadian economy

The Barbados' financial system is a stable one, dominated by a banking sector that is large and liquid. It also features a new, but increasingly active domestic capital market. However, so far, the level of trading and range of investors have been limited. Certain liberalisation measures – some of which have already been undertaken – should have helped quicken the capital market, but responses have been slow.

For example, there are presently no controls on the purchase or sale of listed securities within CARICOM, but there has been no noticeable change in the willingness to buy regional securities on the part of Barbadian investors. Very soon

as we honour our commitments under the CSME, there will be no restrictions on investment in unlisted equities.

Barbados is already largely open to regional capital movements. We are also very open to international capital inflows, particularly foreign direct investment.

Barbados has been undergoing a process of gradual financial liberalisation and reform. In fact, a large part of the financial sector is already largely deregulated, as 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. This should ultimately reduce delays and hence costs and improve the level of efficiency in the system. The benefits of liberalisation take time to permeate through the economy, and there will be an intervening period of adjustment.

I am sure that 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 reserves, which now stand at over US \$750 million. There is now more scope for outward investment. Indeed, one of the main reasons behind the

foreign borrowing undertaken in 2000 and 2001 was to position the country to further liberalise its exchange control regime. This it has been doing, particularly with respect to CARICOM.

The question for Barbados is, no longer whether funds will be allowed to flow out of the country in response to market signals, but rather, how much and how can the country be assured of reflows of dividends, interest and profits from these outward investments, and what conditions need to be fulfilled in order to ensure a smooth changeover to this new regime. The extent to which this economy can facilitate the transition to greater openness will be influenced by the likelihood of reflows to replenish the foreign exchange reserves.

The question is often posed as to whether the Barbadian economy is able to accelerate the rate of economic growth, will this be sufficient to ensure a healthy level of foreign exchange reserves? The answer depends on our ability to influence the structure of production of goods and services, to increase output in tourism and international business, to generate new foreign exchange earning activities and on our ability to continue to attract foreign direct investment.

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.

Interest rates are much less controlled than they were 5 years ago. The administered lending rate has been removed. Cash and securities requirements for commercial banks have moved from 33% to 17%. However, to date the Central Bank has continued to set a minimum deposit rate. This is based on the view that the market is oligopolistic. In addition, the Central bank tries to keep interest rates low in order to control operational costs of businesses but tries to keep them high enough to permit a positive real interest on savings or to at least avoid a negative real return. This is assisted by the fact that international rates are low, - for in US dollars, euros and sterling and by the fact that the Barbados' economy has been able to benefit from constancy in prices. With inflation averaging 2 - 2.5% and real interest rates remaining mostly positive.

Our ability to remove controls will depend to a large extent on the level of competition which develops among commercial banks and the options which we are able to offer depositors to permit them to avoid a captive local market in deposits market.

A relatively stable inflow of foreign direct investment, some through acquisitions, has dominated the capital account, allowing official reserves to be comfortable in relation to short-term debts. Outward investment has been timid. Barbadians must now buy into the parents of regional acquiring companies. For the most part, these are listed companies so there is no barrier. As the saying goes, "If you can't run the show at least get a piece of the action".

The situation demonstrates the earlier maxim that it is desirable to develop one's capital markets before accelerating the process of liberalisation. Here is the example of investment by Barbadians in listed CARICOM companies lagging purchase of local assets by non resident CARICOM nationals - a factor attributable in part to the under developed attention to capital markets by local investors.

If we are to move beyond depending on natural comparative advantage and on our economic stability, it means we must work on our competitiveness. If we are to

accelerate the pace of financial liberalisation beyond CARICOM, improved competitiveness will be absolutely necessary, in every field, including the financial field.

Challenges and Opportunities

There is at times, a common misconception that the trend towards liberalisation means that policy authorities have to abdicate their role completely. On the contrary - they should not abdicate their roles, but simply change the manner in which the roles are performed. Greater attention is now being paid to establishing the general set of institutional arrangements within which the private sector operates, rather than to directing individual decisions. This is particularly so in the financial sector.

Financial liberalisation is normally accompanied by enhancements in the transparency of markets. Timely and reliable information relevant to decision making by market participants, as well as, by the regulatory authorities is crucial to the effective functioning of a market. It is thus important that there be an adequate public disclosure framework to provide information that is necessary for counterparties, creditors and investors to assess risks properly. The tasks also include developing still higher standards for financial data collection, and promoting transparency through the sharing of information.

This is Chamber of Commerce gathering, so many of you might pose the question: what impact is financial liberalisation likely to have on the corporate sector? There will be some elements of competition, some of which will be external and internal factors. The internal factors are those directly emanating from the firms themselves under the pressure of competition, while the external ones are those common to all firms, being the effects of the new liberalised environment. The ultimate impact however, depends upon how a firm has been able to manage the challenges of increased competition, and how they respond to new opportunities.

Financial sector reforms tend to open up new avenues for raising funds for the corporate sector. Companies though, tend to shy away from the capital market. If more resources are required they use long-term loans, or bank borrowings, and only as a last resort go to the capital market. In many small economies the underlying reason for this is that equity finance reduces the control of the traditional management. Still, domestic equity markets could become a major source of funds. Access to foreign funds should also be increased in due course, through a liberalised external commercial borrowing policy, provided there is sufficient evidence of adequate reflows sufficient to cover the cost of overseas borrowing. This suggests a degree of interlinkage between reflows from investing overseas (or from any other incremental increases in foreign exchange earning activities) and borrowing

overseas. The interest element is an additional 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 going to be used to earn foreign exchange. Otherwise some other entity has to earn additional foreign exchange.

Companies may be enticed to use new money market instruments, such as commercial paper, certificates of deposit and inter-corporate deposits. These new instruments may enlarge the corporate sector's access to funds and enable it to choose between various sources of competitively priced financing. However this is about the methodologies to be used and about how financing is to be achieved, not about determining the quantum that is affordable. The key to determining the extent of affordable liberalisation is estimating the affordable quantum.

In the past exchange control liberalisation was about increasing the allowable quantum of a particular controlled item. However, since we are moving away from quantity controls, liberalisation announcements tend to be general. We tend to lift controls on certain items based on our projections of an affordable quantum which will result from a general decision to liberalise some aspect of capital controls.

It is for this reason that we have settled on equity investment as the item to be liberalised before moving to fixed income securities. The sequence is driven by affordability. A massive outflow of funds for equity investment is hardly expected and has not occurred to date. Given market capitalisation it is possible to estimate a maximum outflow that is manageable. 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 - and the sums at stake can be very large. Countries can issue several hundred million in bonds at a time. This is unlikely with shares.

Fixed income securities can include corporate bonds, but in the Caribbean they are mostly government bonds – US\$200 is a normal figure. We mentioned the need to liberalise by way of general policy, not quantitative approaches, while at the same time forecasting the impact of the policy change in quantity terms. Issues of fixed income government securities can be very large. Large movements have the potential for leading to volatility in financial markets. It is for this reason that investment in government fixed income securities has been the exception to the rule of liberalisation by general permissions and not by quantum.

New money market instruments may be employed so as to provide some element of substitutability with bank borrowings. Financial institutions are encouraged to see themselves more as providers of financial assistance and not only as loan providers. This will put more dynamism into the financial market since they can become more involved in underwriting and direct subscription to capital market instruments. This requires more skill and a greater ability to estimate outcomes but is well within the competence of local technicians. There was a time when regulators required Chinese walls between brokers and bankers but with acceptance of deregulation worldwide, this is becoming more and more acceptable.

Interest rate differentials tend to be cited almost as if they are the only factor which are an example of market imperfections at the regional level. Differences in access to credit across firms in the same jurisdiction also obtain. Large firms will still have an advantage in raising funds from the market at a lower cost, since borrowing costs tend to decline with the increase in the size of the firm and the size of the loan. Small firms may face the disadvantage of paying higher interest rates, while having less access to capital market share premium and borrowings. This is less likely to be the case with cross border transactions in the Caribbean where large is still small. There is also no major perceptible difference in tax incidence of companies based on size, but larger firms may have a marginally lower effective tax rate. However, there

is a difference in taxation rates among countries in the region and that will influence net effective costs.

Monetary Policy and Liberalisation

The gradual removal of capital controls has led to an increased monitoring and a less controlling by the Central Bank. Openness to international capital flows can help to support the development of small island economies. Long-term capital, as opposed to very short-term flows are preferable. In the absence of major investors, substantial pooling is required or Initial Public offerings (IPOs) may be attempted. In the developed world, this is standard. However, our investors tend to want to see a track record before investing. They are not risk takers. However, existing successful firms which wish to expand cross-border, may be well placed to launch IPOs even in our conservative investment climate.

The challenge for 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. Some developing countries (Chile) have dealt with this by discouraging short-term capital inflows where they think that the risk of volatility outweighs the benefits of a temporary boost

to foreign exchange reserves. Our interest rates are sufficiently low to pre-empt most investors from taking the route of short-term investments.

Financial Stability and Institutional Structures

Though efficient and well-defined regulatory and monitoring structures are essential to creating the incentives needed to generate substantial benefits the downside of all this if all actors have the same information is the likelihood of herding. While transparency permits more rational decision-making, particularly with regard to assessing the levels of risk associated with transactions, if all actors have the same acumen, the same information, they arrive at the same result – leading to increased volatility.

Financial liberalisation is almost inevitable. What is important is that we use the time before the technology makes it unavoidable to create a cushion for ourselves. This cushion is the development of our second tier foreign exchange reserves. We have given the name second tier foreign exchange reserves to that portion of foreign investment which we have permitted insurance companies and pension funds to invest overseas over and above the amounts normally permitted, provided they are made repatriable. Since these funds are in the long-term going to be used domestically any way, no one is the loser. This is an exciting new concept.

Presently, such reserves amount to close to \$100 million. We have even had requests by individuals who wish to invest overseas to be part of the facility, as a means of their investing overseas. We are working on how and if monitoring of this is possible.

Let us address the question of lending and borrowing. Logically, at the regional level, deficit regions should be able to borrow from surplus regions. Why then is Barbados not allowing this freely to take place? The answer does not simply lie in the opportunities for profiteering (termed arbitraging in the discipline) borrowing low and investing high is a typical form. Equally important is the fall out for monetary stability from the movement of funds without regard to domestic circumstances, which by moving in a direction contrary to monetary policy could frustrate that policy. It is for this reason that regional central banks speak of the need for greater convergence in our regional economies. Such convergence will help to bring relative interest rates closer together and so facilitate unfettered cross-border flows without the possible adverse implication for interest rate arbitrage and for unhinging their neighbour's monetary policy..

Questions: What is required in order for this to change? Answer: When regional economies converge further. Will flows will help them to converge? Yes, the flows

will accelerate convergence. However they must be monitored so as to minimise disruption in the process, hence the need for quantitative impact assessments to precede liberalisation measures.

Competition for market share amongst financial institutions increases with liberalisation, and can lead to excessive risk taking. However, the potential exists for the development of skills in financial analysis and financial management with increased levels of liberalisation – always however, with an eye to the impact on the strength of commercial banks' balance sheets. Risk-taking is to be encouraged, but risks must be calculated. Governments in Jamaica were forced to undertake substantial bailouts, at taxpayers' expense as a result of institutional failure, some of which was related to bullish playing of the markets.

I am taking this opportunity to respond to a comment which I saw in the press about the ability to move funds from one account to another both locally and account and to credit third parties both locally and abroad, and the assertion that this was prevented by exchange controls and by anti-money laundering guidelines. First let me say that with respect to the international business sector there are no exchange controls. Indeed, offshore banks have been conducting business in that way for many years.

With respect to direct, party-to-party transactions where both parties are domestic entities, there are no regulatory barriers, the constraint is the availability of the technology. With respect to party-to-party incoming transactions there is no difficulty either. With respect to outgoing transactions for quid pro quo that is where value is received, these are considered pre-payments and are permitted up to \$250,000 per transaction as long as the commercial bank gives permission – such authority has been delegated to banks. Transactions where there is no quid pro quo are capital transactions – no goods or services are being bought. Most current account transactions are already liberalised or are being considered for liberalisation, and it is the capital transactions which the bank is presently addressing. Presently, the technology is for the most part not available, so the problem is not with the regulator. However, we recognise that the technology it is only a matter of time before the technology becomes available, and the intermediation of the commercial bank for payment, in the context of which exchange controls were developed, will not apply as direct payment will be possible.

This will change the face of supervision and regulation and the techniques of monitoring. E-audits and e-supervision will become more the norm. One possibility is no controls, but our foreign exchange reserves cannot afford this as it applies to

capital accounts. The other is an honour system backed up by e- audits and e – supervision and audit trails.

Globally, there is some contradiction in the trend towards financial liberalisation. Even as international financial institutions espouse financial liberalisation, they have taken significant steps to stem capital outflows by companies who seek to benefit by low tax rates. So much so, that the same countries which prepare general guidelines rather than quantitative rules are now prepared- at least at state level- to be quantitative. A 10% tax or below is unreasonable, it is argued. The wheel is going full circle and the liberalisers are becoming the controllers. For this reason also, with respect to third countries (i.e. non CARICOM), we cannot get ahead of ourselves – or ahead of the proponents. We go at their pace but not faster.

Also, with respect to low tax jurisdictions, formerly, risk was reflected in price. This was the principle of liberalisation. Now risk can mean non-inclusion of banking entities from international transactions. This is the outcome for US dollar transactions through what is termed high-risk jurisdictions.

We have to be ahead of the curve strategically though not necessarily in implementation. Adequate training and upgrading of skills will be necessary not only

in the Central Bank but in commercial banks as well. An expanded set of skills will be required by the financial sector, both supervisors and practitioners, in a relatively short space of time. Indeed there are opportunities for the development of high-level skills in the international business sector. Increasingly, location will not matter. Skills efficiency and competitiveness will be the key and the skilled persons in our international business sector must take advantage of the opportunities.

The Implications of Initial Conditions

In general, an economy's initial conditions shape the approach to financial liberalisation. With or without liberalisation, market forces in Barbados will encourage residents to seek more diversified and better returns within the region and beyond. In this case, Barbados' initial conditions has implications for the future interest rate scenario. Will overseas investors honour their commitments to bring home the 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. Making this attractive could push interest rates up. To date we have tried to keep interest rates low in order to bring operational costs down. It will be a challenge to attract reflows in a low interest rate regime.

Reflows will occur down the road, perhaps 5-10 years from now. Will our emphasis still be on keeping costs low? Competitive forces should have taken care of that by then and costs should by then be low. Investment returns should therefore be possible and reflows should occur without any special encouragement.

It will be important to be proactive, to anticipate changes ahead of time. Also, the liberalisation experiences of economies in the past may help guide us. However, history can never be repeated exactly Circumstances will differ. We can be informed by the experiences of other but we cannot replicate their responses.

Conclusion

Ladies and gentlemen, the process of liberalisation is on-going and has already started to impact on the way we do business. It will bring challenges as well as opportunities. We do not, however, have the option of turning our backs on it. Rather, I believe that we should do whatever we can to exploit the tremendous opportunities which present themselves. I am confident that the Barbadian private sector will respond in a timely and effective way to these challenges.

Thank you ladies and gentlemen.
