

Marion Williams: The development of the Caribbean capital market

Speech by Dr Marion Williams, Governor of the Central Bank of Barbados, at the Capital Markets Seminar, Central Bank of Barbados, Bridgetown, 11 May 2004.

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First of all, I take this opportunity to express my great appreciation to Geoffrey Bell & Co. in assisting the Central Bank, in organising this seminar at relatively short notice. This is the fourth biennial capital markets seminar sponsored by the Central Bank. Geoffrey has featured prominently in organizing all of them. Thank you Geoffrey.

I would like to express thanks to Geoffrey also in his role as a presenter as well as to thank the other presenters, Dr. Carl Ross, Ms. Marie Cavanaugh, and especially Mr. Wain Iton who kindly stepped in as our regional voice when Steve Bideshi informed us that he was no longer able to attend. The purpose of this seminar is to stimulate discussion and generate ideas with respect to the development and direction of local and regional capital markets and to place it in the context of what is happening in the international capital markets.

Our presenters will cover topics such as the global economy, a topic which is important if regional investors are to fully understand how to position themselves in the international markets and how international interest rates and exchange rates are likely to move. Dr Ross's presentation on how Caribbean bonds stack up in the international capital market is also important as it will help us to gauge our performance relative to others.

The role of rating agencies has become increasingly important and this will become even more so with the introduction of the new Basle Accord, which places greater emphasis on credit ratings. We thank Mrs. Marie Cavanaugh for giving us an inside view of how this is done. Our fourth presenter will give us a good perspective on how close we are to realising a Regional Stock exchange and our last item will be in the form of a panel discussion. We will have two question and answer sessions, one before the coffee break and one before we close.

I thought I would set the stage by speaking about the importance of capital markets in the Caribbean and outlining some of the challenges which we face.

An efficient market provides competitive financing alternatives, which then generate spin-off benefits to the real economy. In addition, money market 'price signals' gauge the costs of government capital, and permit monetary authorities to control liquidity. In addition, market participants enhance the level of professionalism, independence and corporate governance.

Both primary and secondary markets are important to the effective allocation of scarce capital. To the extent that capital markets are poorly developed, or lack liquidity and transparency, domestic investors will reduce investment in favour of consumption, and thereby lower savings. Furthermore, investors, both regional and non-regional will seek to diversify portfolios, and will tend to invest in countries with more developed liquid and transparent capital markets which offer a wider variety of instruments. These factors and the ability to enter and exit at will are critical to a well functioning market and are still challenges in most Caribbean markets.

There is substantial room for improving debt markets in the region - where the development of secondary debt markets lag equity markets. Possibly only Jamaica and Trinidad can be considered to be countries with a genuine secondary market. However, unless we are able to further develop our secondary markets, the role of capital markets in providing the link between the funding needs of borrowers and lenders, in realising efficient fund allocation and assisting in accelerating economic development will not be fully realised.

The demands of institutional investors for long-term investment opportunities have risen, so that a challenge for capital markets is to provide a sufficient volume of long-term financial products in response to the heightened need to deploy funds. In Barbados and indeed in many capitals across the Caribbean there is a heavy build-up in liquidity and this is evidence that there is a demand for investment vehicles.

We have now acquired the savings in the banking system but appropriate investment vehicles continue to be in short supply. It is important that such vehicles be developed soon or there is a risk of funds leaving the region. Fortunately, international interest rates are low so this is not an immediate

risk but it looms on the horizon as a possibility if we are unable to deploy excess funds before international interest rates rise.

Capital controls, though important for maintaining the adequacy of international reserves, affect the flow of foreign funds and the development of domestic capital market. Controls are therefore being carefully evaluated and scaled back in the context of macroeconomic objectives, so that their downside impact on capital markets development is minimised. The liberalisation which we desire has to be achieved without creating other macroeconomic difficulties.

We have positioned ourselves to be part of an integrated financial system and already our systems allow for funds to flow across national boundaries in seamless bank transfers. In this context, Barbados is possibly ahead of many other developing countries in the sophisticated nature of its payments and settlement systems. We also continue to integrate ourselves more fully into the regional capital market. This has been most evident by the number of mergers and acquisitions and privatisation involving regional companies within the past two years. Meanwhile our integration into the international capital markets system at the level of government issues is progressing steadily, but is constrained by the small size of issues. Again, macroeconomic stability must take precedence over market impact and our desire for integration into the global market.

Internationally, there has been a wide level of disintermediation and an increase in non-bank competition in the financial markets worldwide.

Indeed, in many regional jurisdictions - less so in Barbados and more so in Trinidad and Jamaica - firms can satisfy their needs by obtaining funding through the capital markets directly.

This should not be seen as a circumvention of the banking system. It is quite normal in the development of financial systems. Markets evolve in different ways as economic and financial environments lead participants to seek alternative credit intermediary channels. Capital markets are to be seen as complementary to traditional financial intermediaries, and should therefore not be viewed as a substitutes for a well-functioning banking system. While there is evidence of disintermediation in some Caribbean countries, capital markets cannot substitute for banks as capital markets are sometimes better positioned to provide longer term financing and sometimes higher risk financing than banks.

Typically, firms in the region have been generally reluctant to expand their funding sources, seemingly for fear of weakening of their relationship with banks. However, it is important for firms to feel free to select what they judge as the most advantageous way to obtain funding in order to ensure a smooth system of corporate financing.

As markets become deeper banks themselves will tend to seek to securitise existing loan assets and to provide advisory and underwriting services for the issue of securities. This has been the trend elsewhere, where bank securitisation has become quite normal.

Securitisation has its advantages as it allows comparatively riskier firms to access to capital markets, and it lowers financing costs by segregating higher quality receivables or assets from the risky firms. Properly used, in conjunction with derivatives, it can facilitate the transfer of risks of commodities, foreign exchange and interest rates, to investors willing to accept these risks for a fee or profit.

Conditions necessary for the development of capital markets

Institutional infrastructure

One of the factors which is most important in the deepening of capital markets is the institutional infrastructure - that is, the legal, taxation, and accounting systems. While, for the most part accounting systems are reasonably up-to-date, many Caribbean territories have recognised that their legal and tax systems require improvement if they are to be able to facilitate the rapid changes taking place in commercial transactions.

If tax and accounting treatments are not clear, the evaluation of risks of individual products becomes difficult and if such treatment is vague, one cannot as effectively and with certainty use technologies to meet market demands. Institutional development must therefore be appropriate to objectives of having a modern capital market system and must be clear in its framework.

Credit ratings are increasingly important. However, though they have the advantage of protecting the investor, it is important that the investor who is willing to accept higher risks for higher returns, not be discouraged by the system as this could have the result of suppressing the most important function of capital markets, which is to attract investors with different risk appetites. Protection without over-protection is what is desirable.

This caveat also applies to Securities Commissions. Investors look to Securities Commissions to safeguard markets through establishing minimum standards of capitalisation, registration of securities and market participants, timely and material disclosure, and effective enforcement. However, commissions have to strike the middle ground of being strong managers without being overly intrusive. In many emerging markets also the timely disclosure of material information is often inadequate. Adequate financial disclosure is crucial for investors to make informed investment decisions - and though we have had few issues of improprieties as has occurred in other developed country markets, the Caribbean still needs to work on this aspect of its information sharing.

Utilization of evolving innovation in information technology

Another necessary condition for capital market development in the region is the aggressive incorporation of innovative techniques offered by advances in information technology. Perhaps in no other activity, with the possible exception of information technology itself, is the pace of innovation as great, or the cost of failure to utilize the technology as high as in capital markets. One can miss major opportunities if the technology is not able to identify them quickly.

Access to software to calculate default probabilities and various risks, which are critical when dealing with financial products, can now be completed almost instantaneously with the appropriate technology. In addition, due to the progress in telecommunications, including the Internet, massive data collection has become far easier than in the past, so that investors - say in Hong Kong - can spot opportunities as they arise, and can access information on the Barbados market and vice versa. We therefore have to cease thinking of our markets as isolated. They are not. Investors are better positioned than ever before to spot opportunities, and there are such opportunities in the Caribbean.

As regional exchanges develop themselves, their structure will be vastly different from those of the 1980s. Markets which mature or develop at different times do so in different ways, since the environment is different. Derivative transactions, which isolate risks intrinsic to underlying assets and enable trading in these risks separately are now becoming the norm in other exchanges and will become the norm in the region as well. These derivative transactions have enabled and facilitated the unbundling and re-bundling of risks to generate combinations of risks and returns different from those of underlying assets. This kind of modernisation is important, irrespective of size and scale and though it is costly for small-scale operations it is essential in order to be competitive.

Importance for adequate levels of domestic savings

Although much attention is focused on international capital flows and foreign savings, which indeed are important, domestic savings are a more stable and important source of investment funding for the region. For capital market development, local currency debt and equity markets are paramount. However, maturities need to be lengthened. The goal is therefore to promote the issuance and transactions of longer-term securities with an overriding aim of extending the yield curve for public and private debt.

There has been a challenge generally in the region in extending the yield curve. Bondholders are exposed to inflationary situations in some economies, insufficient information in others, and legal systems which for the most part do not fast track commercial judgments. There is much to be done. These goals are best achieved in tandem with enhanced trading systems, clearance and settlement mechanisms and efficient depository systems. However, the development of clearance settlement and depository systems seem to be moving faster than other market developments.

As in many emerging markets, these hurdles can be structural barriers to foreign portfolio investment in the region by private firms. Without resolute action to address this trend, small markets like those in the Caribbean can be kept on the outer fringes of global finance. If we wish to feature prominently on the world stage it is important that these niggling hurdles be crossed. It is also important that we face the world as a single exchange with a little more depth than is possible with individual exchanges.

Acceptance of a 'credit culture'

Another condition for capital market development is the establishment of 'credit culture' in which investors in general accurately evaluate risks and returns and follow investment and financing, based on the results derived from such evaluation exercises.

It can be said that the development of capital markets has been retarded partly because of the lack of an entrenched credit culture, and conversely, that a credit culture has not become entrenched because capital markets are not sufficiently developed. However, there is evidence of the formation of credit rating agencies in the region. These can be of assistance to investors who do not have the time or the training to conduct their own credit analyses.

Efforts by the Central Bank of Barbados

Lastly, let me touch on the Central Bank of Barbados' efforts with respect to capital market development.

The Bank has a close relationship with capital markets through its central banking operations. Financial and capital markets serve as an important vehicle for transmitting monetary policy to economic agents. If the financial and capital markets do not function sufficiently, policy effects can be dampened. Interest rate changes, for example, represent just one example of the importance of an efficient market in the effectiveness of policy as this change works itself through to lending costs and hence to competitiveness and to profits and to asset prices. In terms of new instruments the Bank is at the forefront in developing new secondary mortgage market products to potential investors in the belief that capital markets require a wider range of products. It has also started a series of workshops with the objective of assisting in the development of new financial instruments. Increasingly also, Credit Unions need to be more integrally involved in the process of financial development.

At the regional level, governments need to include convergence of Caribbean economies as an important goal in their national planning since greater convergence of Caribbean economies is important for the development of a truly regional capital market. While there has been much progress on the ground in terms of cross border ownership changes, there is still a wide disparity in interest rates and inflation rates across the region. This is not a great deterrent for the growth of a regional equities market and for the cross trading of equities but it is not the most propitious environment for the development of a regional government securities market or for the cross-trading of government securities of a higher interest rate regime in the jurisdiction of a low interest rate regime.

The opportunities for arbitrage are tremendous so it is desirable that there be greater convergence of regional economies as soon as possible. The country most out of line both in terms of exchange rates and interest rates is Jamaica, as the interest rate and exchange rate regimes of most other countries in the region, perhaps with the additional exception of Guyana, are much closer to convergence.

Indeed, in early 2003 it looked as if interest rates and inflation in Jamaica were moving closer to convergence with that of the rest of the Caribbean as well, but this changed sharply in early 2003 and the convergence for which we hoped was abruptly dislodged.

We need to get back to that situation where economic convergence is a likelihood. Capital markets need it.

Conclusion

Not only do authorities need to deliberately target economic convergence we also need to build incentives into our operational frameworks and to reward desired outcomes. This calls for more specific recommendations and for even closer interaction between market participants and the authorities. It also underscores the need for cooperative mechanisms in building our markets.

Thank you ladies and gentlemen.