

Marion Williams: The current turbulence in the US financial markets and its implications for Barbados

Comments by Dr Marion Williams, Governor of the Central Bank of Barbados, on the current turbulence in the US financial markets and the implications for Barbados, Bridgetown, 24 September 2008.

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While the current turbulence in the US financial markets is unlikely to have a significant impact on Barbados immediately, as the US economy slows or goes into recession as it copes with these difficulties, the result could be a slowdown in the growth of the Barbados economy going forward. Recession in the UK and some European economies would also impact adversely on our tourism prospects and our investment inflows. However, the Barbados financial system should remain sound although there may be some loss in value (realised and unrealised) on US dollar fixed income securities held by financial institutions, including the Central Bank, as securities' prices in the US markets tumble. However, such losses in value are not expected to be significant in relation to the overall portfolios of these institutions, particularly over the medium term and especially for those who tend to hold short to medium term securities to maturity. For non-bank institutions with US equity portfolios, long-term investors would have some tolerance to the current volatility in the equity market but may record unrealised losses in the short term.

For some institutions in the international financial business (or offshore) sector who trade more aggressively in US stocks and in fixed income securities and more especially in derivative instruments, particularly those who may have been doing active business with those US financial institutions involved in the US financial melt down, realised losses may be recorded. This is likely to be mitigated by the actions of the US Government to bail out these institutions. Details of the bailout are not yet clear, but it is expected that there will be free access to assets placed with these institutions where funds are held in an agency or custodial capacity on behalf of overseas investors. Funds held in the capacity of agent by these US institutions should retain their agency status and should not be affected by the financial losses of these institutions. Administrative hurdles during the adjustment period may however hamper immediate access. Any problems of access to funds held in an agency capacity are expected to be short-lived if the bailout goes through. In any event, the investment activities of the offshore sector are segregated from the local banking system.

In the interim, investors in overseas markets should be cautious about the external financial advisers, consultants and custodians they choose. Barbadian investors holding direct deposits with commercial banks in the US can take comfort from the fact that the Federal Reserve Bank appears to be taking a protective stance and is unlikely to allow any large US commercial bank to fail. Certainly, the decision of Morgan Stanley and Goldman Sachs to convert their status to that of a commercial bank (from that of investment bank) suggests that this is the market sentiment. There is much discussion about the moral hazard effect of such support as it reduces the incentive to increase the level of care required of these institutions.

In the US system, ordinary depositors are assured US\$100,000 in federal deposit insurance per depositor per bank. In Barbados, deposit insurance is also in place up to an amount of BDS\$25,000 per depositor per bank. This was put in place in 2007. It applies to Part III companies, as well (that is, Merchant Banks, Trust and Finance Companies). In the meanwhile, the business of local financial institutions with their overseas correspondent banks continues. Such overseas correspondent banks are assured of liquidity support from the Federal Reserve Bank in the US. The Central Bank of Barbados also provides liquidity support to domestic banks but there is no reason to expect that this will be called upon as our banks (except for possible losses in value on their US dollar securities) have not been

directly impacted by the developments in the US market. It is expected that investors may turn to safe havens. Barbados is generally viewed as a well regulated domicile.

Over the longer term and into 2009, given the size of the bailout by the US government, we can expect larger US fiscal deficits, possibly a further depreciation in the US dollar and a likelihood of a longer US recession than was anticipated. The likelihood of a global slowdown also becomes greater. The international credit markets are likely to be hesitant to lend for a while until markets settle. However, given the healthy level of Barbados' foreign exchange reserves, this is unlikely to be significant for Barbados at the level of official borrowing at this time, but foreign investors into Barbados who were depending on borrowing on the international markets may be put on pause.

The one positive outcome of all this is that if there is a global slowdown as expected, and therefore lower demand for oil, oil prices should contract.