Marion Williams: Safeguarding our future in the face of global economic challenges

Opening remarks by Dr Marion Williams, Governor of the Central Bank of Barbados, at the Seminar "Safeguarding Our Future in the Face of Global Economic Challenges" to the Caribbean Association of Indigenous Banks, Bridgetown, 17 November 2008.

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Mr. Chairman, Honourable Ministers, Chief Minister of Anguilla, Minister of State, President and Board of Caribbean Association of Indigenous Banks, Distinguished guests,

I first would like to congratulate the organisers of this conference for the foresight and the tenacity in keeping this annual conference going. Thirty five years is a long time to have kept this up.

Indigenous banks are a most important part of our economic landscape and even though, as we become more regional it seems we have tended to change our definition to a regional definition of indigenous, they remain as important as before.

Indigenous institutions tend to have an ethos which is Caribbean and which I trust helps them to focus on the longer term goals of the region and not just on profitability and market share.

Today more so than ever, it is necessary for financial institutions to take the long view about where they are going. It has been fortunate for the Caribbean that we have so avoided the impact of much of the global financial turbulence. This is partly because we were not on the cutting edge of the financial technology but also because we did not stray too far from the basics of good credit assessments and sound financial management. I would like to believe that the Central Banks within the region contributed to this approach and I know too that the calibre of managers which we have within the region make their regulations sound. After all this is your home. Indigenous banks will not leave at the sign of a downturn. They will stay and overcome any challenges.

Having said that, the world has become a global village, and we cannot isolate ourselves from global developments.

Given the unprecedented events that have occurred in the global economy over the past eighteen months, the theme for this year's conference is quite appropriate. In my opening remarks this evening, I will restrict my focus to the main sources of risk and vulnerability which have emanated from four areas: (i) the global macro-financial environment; (ii) financial markets; (iii) the balance sheets the region's households and businesses; and (iv) financial intermediaries. At this time, I am sure many do not envy our respective positions, since policies at both the micro and macro level face no shortage of challenges. Internationally, with economic growth slowing in the major developed economies, the problems in international credit markets are still serious, and inflation rates still strong, and although there are signs of some deflationary trends, the task for policy makers is as delicate as any faced in many years.

Though the region has over the years substantially improved its macroeconomic fundamentals and is better suited to face external shocks, there will be fallout from the current turmoil. Market volatility will undoubtedly lead to sharp downward growth revisions for 2008 and 2009, as the decline in global demand will tend to reduce regional exports of goods and services. In addition, the fall in interest rates in the U.S. will impact on both fixed and floating exchange rate regimes, while the decline in global liquidity will force curtailment of Foreign Direct Investment and cross border flows. How we respond to the problems posed to us by the recent upheaval will be important for the robustness of the regional economy going forward.

Though the direct impact on the regional domestic banking sector has not been significant, largely because of the lack of sophistication and the relative of risk aversion if our regional banks, there are lessons we can draw from these events. We must respond to these changes by further strengthening our efforts at maintaining financial system stability with adequate rules and regulations while avoiding over-regulation. It happened after Enron with Sarbannes Oxley which tended to go overboard without, some would say, achieving sufficient strengthening of the system – the results of which we are seeing today.

Many have now related the current crisis to market over-exuberance, coupled with less than all-encompassing regulation which was necessary to monitor the very rapid changes in derivative and structured finance instruments. The innovations and developments which spawned such instruments increased the complexity of financial transactions and made their traceability difficult. Such changes were also supported by increasing levels of excess liquidity, low interest rates in the global financial market and the increased demand for variations in financial instruments, given different consumers' risk profiles. Consequently, there was a further blurring of financial intermediation roles between the traditional banks and non-bank market players. Risk-shifting and risk transfer eventually forced the collapse we are witnessing today. What these developments have demonstrated is that adequate regulation of the financial system in the US is important to the rest of the world. While these guidelines are set in the developed world the failure of regulation impacts us all. Developing countries therefore have an interest in making sure that the US gets it right. While the global recession will have significant implications for the region, inflation continues to be a regional concern though there is evidence that this should ameliorate in the future. It is our hope that with oil and other commodity prices falling, the region will be a beneficiary of a substantially lower inflation rate in 2009. In some of the Caribbean islands, demand growth evidenced by still strong credit, has not dropped dramatically, and in many instances, interest rates are below inflation rates. That is to say, real interest rates are negative; and this has occurred at a time when banks anticipate heightened levels of delinquencies, and would prudently adjust their credit standards. This has the potential to force individuals to use their savings to cope with normal activities. As a regulator it is important that we encourage the right balance, that is both the concerns of the depositor as it affects his earnings on the one hand, and the borrower as it affects his costs on the other. Over the most recent past, we have also seen a tighter level of integration between international markets and regional economies, which is reflected in a higher volume of cross-border financial flows, FDI or otherwise. Greater integration between the markets is supported by the emergence of new players, who operate across borders and are often privately-owned, or are subsidiary companies of state-owned institutions.

This has important implications for us in the Caribbean in the current situation. As we have witnessed, that changes in the global financial markets have the potential to rapidly alter levels of global liquidity. The sharp growth in excess liquidity that started in the early 2000's, and cheaper financing costs which fuelled the export of wealth and capital from the financial capitals to all parts of the globe is now at a premium. This boom in growth, liquidity and employment served to fuel heightened levels of Foreign Direct Investment flows to the region through interests in real estate and other forms of investment. These “boom” conditions also led to strong performances in the flow of remittances, which has been a vital component of virtually all regional economies' balance of payments. With the turmoil in the international markets, there has been a liquidity crunch, coupled with the higher-than-usual levels of risk aversion. As a result, access to this kind of funding has contracted sharply.

The excess liquidity which we observed in the past few weeks could well be called upon and could contract as players who had previously been accessing the international markets turn to the local market now that these markets are closed.

While we do need Foreign Direct Investment and value it highly, thankfully, the region has not been overly reliant on portfolio cross-border flows. This was a direct consequence of the thinness of our financial markets but has turned out to be a benefit. A decline in net inflows of funds into the region would have had large spillover effects on the domestic economy, and some impact on the international business sector had the region been more securitised.

Although short-term capital inflows can be useful to meet short-term national financial requirements, they can also be very volatile and vulnerable to sudden reversal. Short term borrowers are more influenced by market expectations. The factor of expectations is currently clearly evidenced in the sensitivity of some regional currencies towards changes in the risk appetite of global investors towards US dollar-denominated debt instruments in the region. At least one central bank in the region had to provide support for issuers of national bonds denominated in US dollars as a result of this volatility. We may therefore need to turn increasingly to the region and support each other. It would seem obvious that what I have outlined so far implies that maintaining regional macroeconomic stability is clearly one of the supporting pillars of overall financial system stability.

As for the resilience of the banking system, I can say that the regulatory actions of the regional central banks have categorically shown that our banks are able to overcome the market risk related to the current macro instability in the global market. However, we need to constantly reinforce the resilience of the banking industry and guard against over-confidence.

Ladies and gentlemen, we should be grateful for the strength and resilience of the banking industry when confronting these various risks and shocks. Industry performance has steadily improved. Bank profits remain healthy and are in line with expansion of the intermediation function and with efficiency improvements, as well as effective risk management. Although much has been accomplished, a lot more still remains to be done. In this current globalisation era, the speed of change is rapid. Our achievements up until now do not guarantee success tomorrow. We have always relied on this awareness as the foundation of banking industry policy. From here every step needs to be carefully and cautiously calculated. It is imperative that we remain always sensitive to our long term goals and to the impact on the financial system when addressing the changes and dynamics of the current crisis. We also have to be able to calculate the implications of each step, prioritize policy, and maintain a good balance in the implementation.

I know that the negative credit trends will filter through to our markets and is likely to affect corporations in some key sectors, particularly those who entered this phase with low levels of liquidity. This underscores the challenges of slower economic growth and, shrinking liquidity in the global economy and may mean that they turn to regional banks and to indigenous banks in particular.

These challenges facing regional macroeconomic policy makers look more difficult than they have been for a long time; but with the collaborative efforts at the micro level, the region will weather the storm. I am sure that the discussion over the next few days will help us focus on the severity of the issues, and will help us to find viable solutions to head off any potential adverse impacts.

I wish again to congratulate the CAIB for their commitment to commercial banking in the region and to the exchange of views and ideas on the safeguarding of our future, given the global financial challenges. Sometimes collaboration is important in order to make a breakthrough. I thank you and wish you a successful conference.