

Website Abstract for Financial Liberalization and the Regulation of Capital Flows

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BROAD OBJECTIVE OF STUDY

1. To undertake qualitative and quantitative research towards the design and development of a policy-based framework that best facilitates financial services liberalization in Barbados.

TERMS OF REFERENCE

1. To consider the impact of financial services liberalization from a cost-benefit analysis perspective. This is important since full liberalization of financial services is a prerequisite of the monetary union to be established under the CSME.
2. To undertake research on the effects of capital account liberalization and present the findings in this regard.
3. To identify and present best-practice models based on the experience of other countries which have undertaken financial services liberalization.
4. To specifically assess the impact of removing **all**, **some**, or **none** of the existing controls.
5. To undertake analyses which reflect the economic effects of the CSME and the FTAA agreements. Taking into account, inter alia, the following:
 - i. The convergence criteria governing the CSME arrangement (fiscal size, reserves, debt, inflation).
 - ii. The degree of divergence in economic maturity of Caribbean islands, and the differing exchange rate regimes. Note: Ratification of this chapter in the context of the CSME can only occur if fiscal harmonization exists.
6. To assess the impact of financial markets liberalization on economic growth.
7. To recommend the appropriate legislative changes to facilitate financial market liberalization.
8. To identify key impediments, constraints and challenges, to financial market liberalization and subsequently prescribe relevant initiatives and strategies.

MAJOR FINDINGS AND RECOMMENDATIONS

This paper which draws on the academic literature, the experience of thirteen developing countries in liberalizing their capital accounts and new empirical research, makes ten main points:

1. In its commitment to its fixed exchange rate regime, Barbados has an extensive regulatory framework governing capital account transactions. Standard capital account liberalization measures suggest that Barbados has one of the most restrictive capital account regimes in the world. History suggests that there has been no major crisis and that the Central Bank approves the large majority of requests for foreign exchange approval. Despite this reality, the study reveals a widely held view among domestic financial sector players that these restrictions serve to hamper the further development of the financial services sector.
2. If countries do not seek to integrate their financial systems with the global economy in an orderly fashion, the global economy will likely integrate them in a disorderly fashion. Some degree of capital account liberalization is therefore a necessary response to the inexorable process of globalization.
3. The opening up of the capital account is complicated and is a process accompanied by significant risks in a small open economy like Barbados. The implication is that any program of capital account liberalization must as a matter of priority include an assessment of the level of financial sector development, and the implementation of policy measures to achieve the required level of financial sector development.
4. By global standards, Barbados has a stable financial sector, that intermediates funds between savers and borrowers at modest costs, and there is no evidence of financial repression. However, the non-bank segment within the financial sector is rather underdeveloped. Policies to foster the development of the domestic capital markets by increasing the range and scope of domestic financial instruments should be seen as a necessary corollary to capital account liberalization. Such developments would also serve to reduce the potential outflow of capital by the resident sector as well as attract foreign capital flows.

5. Capital account liberalization can play an important role in deepening domestic financial markets. However, foreign capital complements, but cannot substitute for, a domestic investor base, which is critical to developing resilient domestic capital markets. Before capital from abroad can play a constructive role, critical mass must be reached as it relates to terms of the depth of domestic markets, the diversity of local investors, the effective oversight and governance of market institutions, and the length and distribution of instrument maturities.
6. The evidence presented in this study suggests that a lack of liquidity is a major weakness in the Barbados capital market. As a mean of addressing this, the government should invite bids from financial institutions including the National Insurance Scheme to be primary dealers in government securities. As part of the contract, primary dealers in government securities should agree to act as market makers for securities traded on the Barbados stock exchange. The presence of primary dealers will add liquidity to the market thereby addressing one of the major shortcomings of the financial system and providing an impetus for capital market development.
7. Further capital market development is currently hampered by the limited range of domestic investment instruments. As a response to this phenomenon, the government of Barbados should devise a package of incentives for financial institutions to develop a secondary mortgage market and engage in the securitization of consumer loans (mortgages, credit card receivables, auto loans etc.) as means of providing a broader range of investment options in the domestic market. The introduction of these new instruments would not only serve to spur further capital market development but may also attract foreign investors.
8. The available evidence also suggests that further capital market development is hampered by the presence of closely held securities and a shortage of new issues in the market. To address these shortcomings the government should divest some of its domestic holdings in an attempt to bring new issues to the market. Where possible, such divestment should include a broad range of instruments including bonds, common shares, convertible bonds and other hybrid securities.

9. The government should remove the restriction on mutual fund overseas investments to allow these institutions to achieve adequate levels of diversification. Mutual funds should be allowed to increase their overseas holdings to 40% over a five-year period. As part of this reform the government may wish to revisit the tax credit for mutual fund investments. Removal of the tax credit may spur capital market development by putting pressure on funds to be more aggressive in terms of attracting customers as well as encouraging consumers to be more sophisticated and demanding in relation to their mutual fund investment decisions. One may also argue that the tax incentive has served its purpose by creating a vibrant mutual fund sector and the government should now shift its emphasis to subsidizing newer investment vehicles and financial institutions as it seeks to stimulate capital market development.

10. Policy makers must be guided by the notion that capital account liberalization is not an all or nothing affair. A range of capital accounts controls are available to policy makers, and it would be prudent if certain controls are applied in the initial phase of liberalization, while others are applied in the long run to maintain macroeconomic stability or maybe contain macroeconomic instability. It is crucial that policy makers realize that the orderly liberalization of the capital account also requires a heightened institutional capacity for setting up prudential regulations and a supervisory framework for monitoring and enforcing them.