Back to Regional Connection

Small Open Economy Capital and Financial Market Policy:

(Building Caribbean Capital and Financial Markets)

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The Caribbean has historically been comprised of small open economies with no influence on global economic relations. At the turn of the century the Caribbean is forced to grapple with a number of salient and serious policy predicaments as they relate to social, cultural, geographic and economic imperatives. While this website is directed at examining various conundrums facing Dominica, at the turn of the century, these dilemmas are not unique to Dominica, neither can they be considered in isolation or in a vacuum without due consideration to the Caribbean at large. It is the intention of this commentary to examine policy conundrums (which have implications for Dominica and direct relevance to the Caribbean region at large) as they relate to a specific issue - capital and financial market policy.

I think it is fair to say that the single greatest threat to the small open economies of the Caribbean is the on-going globalization process (in its current form) both because these countries remain largely marginalized in the precipitous integration of trade, finance and services but also because these nations are ill prepared to optimally position themselves to take advantage of the opportunites globalization brings with it and to better integrate into the sociolegal dynamics of the global order and transboundary interactions within that system.

Cross border private financial flows are a critical component of globalization. Such flows act as catalysts for economic integration. Capital markets act as platforms where individual, private sector or public sector creditors who have no immediate productive use for their wealth make those funds available, through the purchase of debt instruments, through stock (equity securities) and bond markets to those who do have that immediate need (i.e. borrowers). Because capital is directed at productive uses economic efficiency is encouraged. However, for the lenders whose assets become risky upon entry into stock or bond markets, the incentives for converting risk-free assets into risky assets remains the liklihood that returns on that investment would be greater than if they held on to risk-free assets. Stocks and bonds securities are common in primary markets where new securities are underwritten and finance issued, however secondary markets, which comprise stock exchanges, dominate a greater number of capital transactions – regarding equity and debt trading - than primary markets. These secondary markets, although sources of short-term speculative activity, play a considerable role in increasing liquidity and enabling diversification.

The internationalization of capital markets, in large part, has been facilitated by the development especially of one of its component markets – the foreign exchange market. The purpose of foreign exchange markets are to buy and sell foreign currency. Inherent in this concept of buying and selling is foreign exchange arbitrage as the parties involved seek to buy currency when its price is low and sell when the price is high.

The financial system, however, acts as an intermediary for the allocation and transformation of economic resources. The financial system comprises a number of financial intermediaries such as equity and debt markets. The System (more so a well performing System) agglomerates capital, allocating it in such a way that it is efficiently made use of through allocation to productive investments. Equity, long-term loans and short-term loans being the most important types of capital play a critical role in the functioning of financial markets. Financial markets themselves have associated risks linked to the pursuit of efficacy within the intertemporal allocation of funds. It is precisely because of this risk that uncertainty arises. That risk is diversified through the instruments or institutional arrangements provided by capital markets, that enable effective pricing and trading as regards associated risks.

The above theoretical account serves to highlight the fact that robust and effective capital and financial markets are critical to consolidating and enhancing a nation's role in the on-going globalization process. However, capital markets and the financial system, at large, in many Caribbean countries remain acutely underdeveloped. In the following account, I will speak to the Caribbean case with specific reference to its secondary markets, i.e. stock exchanges and policies that need to be more aggressively pursued to rectify bottle-necks and incapacities in the Caribbean's capital and financial market regimes.

The past performance of Caribbean stock markets has been a checkered one at best; the Fortress Caribbean Growth Fund has extensively documented the continued plight of the three main Caribbean stock markets. In the fourth quarter of 1999, for example, Jamaica's Market had shown incremental gains from its roller coaster performance in earlier quarters. Barbados' Market continued its downward slide in the fourth quarter, as did Trinidad's Market. The Jamaican stock market has only recently been home to just a dozen well performing companies and the Market itself continues to suffer the effects of continued currency devaluations. Low volume trading and pricing falls have continued to plague the Barbadon Market. Trinidad's Exchange, however, is forecasted to pick up, reflecting broader growth imperatives in the Trinidadian economy at large. While the performance of these stock markets have, in large part, been predicated on macroeconomic and industry related shortcomings, they also suffer from an urgent need for the more effective execution and diversification of securities so as to reflect the evolving imperatives of the global financial architecture.

The coordinating mechanisms of economic transactions are markets and associated heirarchies. The modalities inherent in both and in turn the effectiveness of capital markets themselves, are heightened by the use of more sophisticated technologies and financial instruments. While the globalizing economy acts as a catalyst for and has tremendous multiplyer effects on investment opportunities, this alone is not sufficient to enable capital market growth in the developing countries of the Caribbean. There is an evident need for more aggressively continuing to build financial intermediary infrustructure and instruments in the region. The future success of the Caribbean Markets, specifically, depends among other things on a more aggressive adoption of new technologies and financial instruments.

Caribbean stock markets must adopt, with the help of government regulators, more aggressive policies so as to position the region to meaningfully attract and capture global capital flows (U.S. capital flows, alone, have increased considerably, especially to the emerging markets. U.S. flows that were $9 billion in 1990 skyrocketed to $60 billion in 1996, totalling over $400 billion in overseas investment). Most importantly these Markets must leverage their capacity to 'attract' and 'retain' based on strengthening the instruments and architecture of financial intermediation. Caribbean financial markets must also adopt more aggressive measures to reflect the significant expansion, especially among financial markets in a number of countries, of the types of securities being issued and traded, especially in the secondary markets. Again, this can only be realized through aggressive steps to promote innovation. It is financial innovation that has accounted for and resulted in the issuance and trading of derivative products, for example. This has only served to further develop financial markets. For this reason Caribbean financial markets must strive to better integrate products such as options, futures and swap contracts into their financial architecture, so as to further develop financial markets. Inevitably, the more efficient allocation of capital to productive investment opportunities in the Caribbean can be better prosecuted through such standard risk management tools.

The financial system in any nation is focused on acting as an intermediary for the allocation and transformation of economic resources. However, financial markets themselves have associated risks linked with the pursuit of efficacy within the intertemporal allocation of funds. It is precisely because of this that uncertainty arises. That risk is diversified through the instruments or institutional arrangements provided by capital markets, that enable trading and pricing as regards associated risks. Risk, therefore, remains at the centre of financial markets. Derivatives, then, serve to share economic risk allowing the investor to hedge the risk. Many skeptics will speak to how derivatives concentrate capital in short term speculative transactions that may have systemic ramifications for financial systems. The development, especially of OTCs, derivative markets have been the subject of countless studies by central banks and academics alike however, the fact remains risks associated with financial markets can only be effectively managed through a more aggressive adoption of tools and institutional arrangements that help in the diversification of risk. It is for this precise reason that in the wake of the contagion effects of financial meltdowns, notable in East Asia, it is incumbant upon policy makers in the Caribbean to ensure the aggressive maturation of the instruments and architecture of the region's financial, capital and stock markets. To this end, Caribbean stock exchanges could learn important lessons from the Mauritian Stock Exchange. The Exchange was established in 1988 and during its short tenure it has been a good example of a small island Exchange success story. While the underlying macroeconomic and sectoral conditions differ from those of the Caribbean, there are certain commonalities/complementarities inherent in island economies. The Mauritian Exchange experience is particularly notable as it is attempting to more aggressively respond to the imperatives of the evolving international financial architecture, through the inclusion of new financial products in its framework. In addition, the Exchange has made commendable strides as regards controls on currency repatriation, institutional and transactions based transparency, currency convertability as well as in having no capital gains taxes and not withholding taxes on dividends from trading in officially listed companies. It is also encouraging to note that market capitalization, excluding debentures, in 1999 hovered at over USD$ 2 billion. Cumulatively, recent developments in this stock exchange offer important lessons for small island stock exchange capacity development in the Caribbean.

The above account served to illustrate how crucial capital and financial market development is to the Caribbean. The World Bank notes that net long-term private capital flows to developing countries stood at $256 billion in 1997; in effect, skyrocketing from the $42 billion level in 1990. However, much of these flows were directed toward Asia. While there were several factors at play that determined the scale of flows to Asia, capital and financial market development there had a significant role to play in making the region more attractive to such flows.

Globalization's cross-currents have had the effect of broadening and deepening linkages between global financial and capital markets. Caribbean capital and financial markets, however, have been slow to adjust to and therefore take advantage of the benefits of these cross-currents. Any economist will acknowledge that while globalization presents many challenges to small open economies, it is incumbant upon policy makers in these countries to position their nations in such a fashion as to better take advantage of the tremendous benefits of continued global financial and economic integration. At the turn of the century leaders of the various Caribbean states, Dominica included, can ill afford to raise their arms in the air and lament the perils of globalization. This analysis highlights the fact that Caribbean capital and financial markets remain underdeveloped; if they continue to remain so this will have serious implications for the effective participation of the region in the on-going and revolutionary changes in the global economic and financial architecture.

Back to Regional Connection