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FINANCIAL SECTOR REFORM IN THE CARIBBEAN

By

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CRPC ISSUE PAPER SERIES - # I
September 2010

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ABSTRACT

RELEVANCE: A healthy financial sector is essential to economic growth and development of the Caribbean economies.

ARGUMENT: This paper draws on the experiences of the USA, the origin of the global financial crisis, and of Iceland and Jamaica, two small developing countries to which CARICOM states can relate. In all three cases acceptance of financial liberalization, and certainty in the self regulatory powers of the "free market", led to an explosive growth of the financial sector that outstripped the capacity of regulatory authorities to comprehend and monitor, and ultimately to its catastrophic collapse.

CONCLUSION: Caribbean states must undertake urgent financial sector reform. The overall purpose of financial reform in the Caribbean must be protection against domestic risks, and from external shocks emanating from the current global financial crisis. Financial reform in the Caribbean must focus on the critical role of central banks in the maintenance of monetary and economic stability.

POLICY RECOMMENDATIONS: The enhancement of central bank governance in particular their operational autonomy and insulation against party-political considerations in their policy making and advisory functions is indispensable.

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Introduction

The overall purpose of financial sector reform in the Caribbean must be protection against domestic risks and potential shocks from an increasingly turbulent and uncertain external environment. Unlike the case of UK, France and some other Western European countries, the implosion of the US financial system in August 2008 did not have a direct impact on the financial sectors of CARICOM member states, though the indirect effects have been severe, e.g. decline in tourist arrivals, decline in remittances from the Caribbean Diaspora and diminished capital inflows. However, there are important lessons to be learned from the American experience and from the collapse of the financial system of Iceland. And let us not forget the dramatic collapse of the Jamaican commercial banking and insurance sectors in the 1990s!

The American Experience

Following the collapse of the American banking system in the 1930s comprehensive regulations were put in place to insure against a similar recurrence, so that until the 1980s developing countries could look to the USA as an exemplar of effective financial regulation. During that decade the Keynesian paradigm was superseded by free market fundamentalism, which became the conventional economic wisdom. The major premises of the new paradigm were that markets, including financial markets, are rational, efficient and self-regulatory. This led to progressive laxity on the part of regulatory authorities, as both former Fed Chairman Greenspan and incumbent Bernanke, both true believers in the "free market", now concede. The main pillar of the financial regulatory apparatus, the Glass Steagall Act of 1933, was repealed in 1999, and commercial banks were freed to participate in investment banking and trading of securities. Objectors to its repeal argued, correctly as it turned out, that depository institutions were supposed to be managed to limit risk, and that trading in securities could be extremely risky. The cost to the Federal Deposit Insurance Corporation could be enormous should such institutions collapse. The repeal of Glass-Steagall spawned a variety of novel and exotic financial products, so called derivatives, which were entirely unregulated. Wall Street became, in Keynesian terminology, a "casino" where financiers indulged in extreme and feckless risk-taking, playing for high stakes and outrageously high rewards. Moreover, the new financial products were so complex that few members of Top Management understood what they were selling, and even fewer clients understood what they were purchasing. In these circumstances it is not surprising that an already moribund regulatory establishment failed to keep pace with the freewheeling finance buccaneers. Ironically, it was the lowly sub-prime mortgage security that proved the tipping point which brought down the whole house of cards.

The Icelandic Experience

The collapse of the Icelandic financial system in 2008 is a clear lesson to the Caribbean of the financial fragility of small states. Iceland, an island state with a population of 320, 000, slightly greater than that of Barbados, was one of the richest countries in the world until the collapse in October, 2008 of its three main commercial banks, which in 2005 alone had issued about 14bn Euros in foreign debt securities. When the crunch came the Central Bank of Iceland, with foreign exchange reserves of less than $US2bn, could not act as lender of last resort and bail them out, and the slender deposit insurance scheme could not deal with the situation. Indeed Iceland was brought to the brink of national bankruptcy. In welcoming the investigative commission report on the financial catastrophe, the Icelandic government bitterly observed: "The private banks failed, the politics failed, the administration failed, the media failed, and the ideology of an unregulated free market utterly failed."

The Jamaican Experience

Jamaica's experience was not very dissimilar from those of the USA and Iceland but, being more economically and socially vulnerable than either of them, the fall out from her financial collapse has been more devastating and persistent. In the late 1980s and early 1990s, Jamaica embraced financial liberalization, a critical tenet of the "Washington Consensus", a framework of economic policies based on the ideology of "free market" fundamentalism and marketed by the Washington Financial Institutions via their structural adjustment programs for developing countries. The number of financial institutions grew from 67 in 1989 to 105 in 1995, with the major increases being among building societies and merchant banks. Meanwhile, the deposit liabilities of commercial banks increased from J$10.5 billion in 1990 to J$89 billion in 1995, and the contribution of the financing and insurance services to GDP rose from 9% in 1987 to 50% in 1994. The Jamaican authorities were not unmindful of the need for financial regulation, but the task proved beyond them. Between 1995 and 1998 six banks, accounting for about 60% of total commercial bank deposits, five life insurance companies, accounting for over 90% of premium income in the business, one third of all merchant banks, and some building societies had to be rescued by government injections of capital or closed.

The Regulatory Imperative

The two fundamental lessons from the recent financial disasters in both developed and developing countries are, as Professor Mark J. Flannery acutely observes: (1) "Providing financial services requires a combination of private and public actions." (2) "The private banks should not get too far ahead of their supervisor's ability to monitor them because prudential oversight helps assure the banks' solvency and liquidity." It is equally true that regulatory authorities should not let financial institutions get too far ahead of them, and this applies equally to insurance companies, savings and loans and credit unions.

Government investigations of financial collapse in Jamaica, Iceland and the USA have all traced the root cause of the disasters to inadequate regulation of the financial sector. Indeed, the US Congress recently passed a Bill for far-reaching re-regulation of Wall Street. The catastrophic extent of these financial collapses reflects the critical importance of the financial sector in a capitalist economy. Indeed, as the late Professor Hyman Minsky reminded us, it is the financial sector which defines the capitalist economy. There was no financial sector in the former USSR, and there is none today in Cuba or North Korea!

The financial sector is important for two main reasons. First, it mediates the transfer of savings between savers, who may wish to put their financial assets to work, and business persons who need additional funds for investment projects; such investments, in turn, promote economic expansion and job creation.

Normally, the financial sector expands more or less in tandem with the real sector of the economy – goods and non-financial services. However, expansion of the financial sector at a far more rapid rate than that of the real sector should raise a red flag. What is more, as novel types of securities are introduced, the financial sector becomes more complex, less comprehensible and more difficult to manage. In fact, this was the case in all three of the examples to which we have alluded. Leading up to Jamaica's financial collapse in the 1990s one financial reporter naively hailed that nation's overheated financial system as its new growth sector, replacing bauxite-alumina, manufacturing and tourism; in Iceland the three main commercial banks grew 20-fold in size between 2001 and 2008; in the USA, profits in the financial sector ballooned in 2007 to over 40 % of total corporate profits; in Jamaica GDP slowed from 6.8% in 1989 to an average of 1.25 during 1991- 4 and was negative during 1996and 1997 - in spite of the boom in the financial sector. In every case financial innovation was readily embraced to the point where neither Top Management nor their regulators could comprehend what was going on, so that the disastrous outcomes come as no great surprise.

Secondly, the financial sector is the medium through which the Central Bank regulates monetary and credit conditions in the economy by raising or lowering the level of liquidity in the financial sector as economic conditions require. Central banks therefore function best when financial markets are competitive and transparent, and banking institutions are managed with prudence and integrity. Central banks also function as lenders of last resort to financial sector. By intervening in the financial markets through open market operations they can effect a change in the rate of interest or, through specific directives, drain liquidity out of the system if inflation threatens; if tight money threatens the solvency of financial institutions, they may pump liquidity into the system–a function which only central banks can perform since their monopoly of money creation within their jurisdictions endow them with infinite liquidity. As Professor Simmons puts it, "There are no liquid assets apart from money–the liquidity of things which may not be absorbed by central banks is a fair weather phenomenon." In short, the Central Bank is the keystone of a modern financial system.

Imperatives of Caribbean Financial Reform

The appropriate mindset of decision-makers in small and vulnerable open economies with little margin for error, such as those in the Caribbean, is one of extreme caution. Their strategy in the face of turbulence and uncertainly must be, in game theoretical terms, the "**maximin"**. At a minimum financial reform within CARICOM should include urgent action the following four areas:

(1) <u>Central Banks</u>

Central banks are indispensable to the economic stability of a capitalist economy: by balancing monetary expansion with the rate of with economic growth; by regulating the conduct of commercial banks, and as lender of last resort they rescue individual banks by feeding liquidity into the financial market in times of crisis. There have been strident calls in the USA for a reduction of the scope and discretionary authority of the Federal Reserve System; such a measure would is ill-advised. Only well staffed and managed institutions, with considerable discretionary powers, can fulfill the onerous responsibilities of central banks. In general Caribbean central banks lack the operational autonomy, flexibility and insulation from political considerations that their mission requires. Caribbean governments should take the necessary steps to correct this situation.

(2) Deposit-taking Institutions

It was the repeal of the Glass-Steagall Act in 1999 which precipitated the implosion of the US financial system. Wall Street banks were given free rein to engage in non-banking financial activities, and to use the funds of their depositors to indulge in extreme risk-taking. The largest of them established in-house hedge fund operations or made huge and under-collateralized loans to private hedge funds in pursuit of outsize profits and mega bonuses for their CEOs. The catastrophic consequences of the implosion of the US financial system, with the drying up of loans to enterprises in the real economy, suggests that Caribbean governments should regard the commercial banking sector as a utility–much like water supply or electricity–and maintain a strict distinction between banking and non-banking financial institutions. Strenuous efforts must also be made to strengthen regulation across the entire financial system.

(3) Derivatives

Derivatives are financial instruments that derive their value from other instruments. For example, instead of buying a stock, i.e. a share in a company, one might buy an option to buy or sell a stock at a specific price within a specific time. An "option" derives its value from the stock. We may think of options then as imaginary securities dreamed up by dealers. In the run up to the Wall Street financial collapse the number and variety of derivatives grew at an exponential rate, becoming in the process increasingly complex, opaque and toxic. The legendary investor Warren Buffet famously called them "weapons of mass destruction". Two years after he stepped down former Fed Chairman Greenspan conceded that "some of the complexities of some of the instruments that were going into CDOs (collateralized debt obligations) bewilder me." Some Wall Street bankers and mainstream US economists still argue against regulation of derivatives; in view of the primitive state of our financial markets, Caribbean economic policy makers should not touch them with a ten foot pole.

(4) Risk Diversification

"The financial system failed to perform its function as a reducer and distributor of Risk. Instead, it magnified risks, precipitating an economic contraction that has hurt businesses and families around the world." This is the joint verdict of Timothy Geithner, current Secretary of the Treasury, and Larry Summers, former Secretary of the Treasury, on the recent collapse of U.S. financial system. We in the Caribbean must avoid the errors made by U.S. financial policy makers. We must obviously guard against institutions that "are too big to fail", and financial instruments so complex that only a few understand.

One of our greatest sources of risk and uncertainty derives from the long increase in longevity over recent decades; it is already clear that out Governments cannot build and maintain safety nets sturdy enough to provide our low income groups with a dignified retirement. Much of this burden will fall on the Private Sector – the Pension Funds, Insurance

Corporations, Cooperatives, etc. that offer annuities and similar financial products. But governments not only bear the responsibility for monitoring the integrity of financial institutions involved, but also for ensuring dispersion of risks across financial instruments and jurisdictions in such a way that the default of a single claim does not create a domino effect leading to universal failure, as in the American case.

(5) Foreign Exchange Reserves

Whether the source of financial distress is domestic or external, relief in the case of small open developing countries, like those of CARICOM, hinges on access to an adequate reserve of foreign exchange. If the source of instability is domestic, we do not have the US option of unlimited purchases of its securities by China and Japan to cover our fiscal deficits, or of paying for imports in domestic currency. If the source of our financial difficulties is external, e.g. declining foreign exchange inflows, our depressed credit rating does not allow us to buy time with foreign loans. It is instructive that the three Asian Tigers, Hong Kong, Taiwan and Singapore, which normally hold very large foreign exchange reserves, emerged from the Asian financial crisis of the 1990s virtually unscathed. Note that developed countries whose currencies are traded on the foreign exchange markets, e.g. UK, USA or France, can safely hold quite low levels of reserves.

CARICOM states must treat foreign exchange holdings as the critical variable in macroeconomic management. We must therefore craft our economic policies to limit costly non-essential imports, and substitute domestic for foreign imports wherever feasible - as is certainly the case in respect of agricultural foodstuffs and energy. Foreign exchange holdings often earn a significant return; when they do not, as in these times of low interest rates, their cost should be regarded as an insurance premium against domestic and external threats to our financial instability. Finally, we must dramatically improve the quality of management in the Public Sector where substantial economies are no doubt possible.

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