FINANCIAL LIBERALISATION AND CARIBBEAN ECONOMIC INTEGRATION

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INTRODUCTION

As part of the process of structural adjustment, CARICOM States supported by international and bilateral financial institutions are actively contemplating/debating or actually implementing a number of measures aimed at deregulating and liberalising their financial sectors. Commercial banking and other financial intermediation, foreign exchange markets and capital movements which traditionally have been highly regulated are the prime targets for reform. The magnitude and range of reforms under consideration/being implemented represent both the influence of the neo-classical paradigm espoused by the international lending institutions and a pragmatic response to the new requirements of global interdependence, international division of Labour and behaviour of international capital.

Simultaneous with financial reforms in these States, is the renewed enthusiasm to revitalise the economic integration arrangements by moving towards a Single Market and Economy (a truly Common Market) by January 1994. Integration of markets for goods, services and capital as well as the harmonisation and coordination of macroeconomic and sectoral policies are the key features of such a Single Market. Clearly this step involves far-reaching

implications for the range and flexibility of national economic policies.

The theoretical logic and policy imperatives of national financial liberalisation and deeper economic integration - both undertaken in responses to the challenges of the international environment - pose important questions of compatibility, consistency and sustainability for CARICOM States. This Paper discusses some of the issues involved - trade and payments, investment, exchange rate management and welfare - in the adoption of these two seemingly divergent initiatives and suggests areas for further research to assist policy formulation in the short and mediumterm.

I. RATIONALE FOR FINANCIAL LIBERALISATION AND ECONOMIC INTEGRATION

Changes and challenges in the international economic environment are pressuring CARICOM States towards a) closer regional cooperation and economic integration; and b) greater liberalisation and openness of their market s in respect of global transactions. Among the dynamic influences in this process are:

(1) the shift to market solutions (get prices right) and liberalisation for achieving competitiveness, viability and improved welfare in the international community. The IMF, World Bank,

GATT and other lending institutions are key actors in this process.

(2) the move towards formation of economic blocs eg. Europe 1992 and North America Free Trade for preserving and enhancing regional welfare.

(3) the impact of technology, telecommunications and global interdependence which lead to the interlinkage of goods, capital and labour markets.

As a matter of economic survival, CARICOM States must grapple with these changing realities and it is within this context the proposed measures for financial liberalisation and deeper integration will be examined.

A. OBJECTIVES AND INSTRUMENTS OF FINANCIAL LIBERALISATION

Generally it can be said that financial liberalisation seeks to ensure economic agents face a set of relative prices in their financial and capital markets which are as close as possible to relative world prices (give or take a premium for higher risks (Renshaw, 12). The objective is to abolish fragmented and distorted markets which are caused by repressive State policies through releasing credit and interest rate controls, increasing the competitiveness of the financial market, lowering the statutory reserve ratios and deregulating capital transactions. Some of the specific measures which can be instituted are:

(i) Financial Market Sub Sector

a) Remove interest ceilings - low, stable interest rates fixed by the State penalise depositors, benefit favored borrowers eg. the public sector, large firms and consumers and suppress entrepreneurial development (MacKinnon

11). Such rates are usually negative when adjusted for inflation - this encourages capital flight and leads to inefficient investment.

b) Remove selective and directed credit - cheap, subsidised money only encourages large-scale, inefficient investment by favored borrowers in the public and private sector. This leads to a high percentage of non performing assets.

c) Reduce statutory, cash and liquidity ratios - Such high ratios imposed by the State reduce the supply of loanable funds.

d) Deregulate financial market eg. banking hours; restrictions on the scope of operations of financial intermediaries - This will encourage competition in an otherwise oligopolistic and segmented market.

(ii) Foreign Exchange Market

a) Abolish administered exchange rates - Market rates (floating) or crawling should follow from supply and demand for foreign exchange. This removes the tendency to overvalue exchange rates leading to parallel markets.

b) Liberalise payments - remove exchange controls which favour particular transactions and lead to parallel markets.

c) Permit foreign exchange accounts for nationals also make loans available to nationals in foreign exchange - Restrictions on such accounts (even where retention schemes are in place) encourage capital flight.

(iii) Capital Market

a) Remove controls on capital transactions - Controls restrict foreign investment and generally leads to capital flight. Removal of controls along with positive real interest rates lead to return of 'flown' capital, increased inflows of capital to take advantage of higher

> interest rates and more foreign investment. It also encourages cross trading on Stock exchanges.

It should be noted that financial liberalisation is neither a costless nor painless process. When implemented in conditions of macro-instability (high fiscal deficits, negative foreign exchange reserves and high inflation) it can perpetuate rather than halt a downward spiral in the economy. The experience of the Southern Cone countries in Latin America (Argentina, Uruguay, Chile) show how the model of liberalisation could work in reverse. The opening of their capital markets led to a heavy inflow of capital which rapidly appreciated the currency, discouraged exporters and led to deeper balance of payments problems. (Diaz-Alejandro 4). In Jamaica, aggressive commercial and other banks make super-normal profits in the liberalised foreign exchange market through speculation. The result is high interest rates to mop up local currency, wage disputes, increasing inflation, currency instability, and further speculation. In Guyana, the establishment of the Cambio System had fairly similar results in 1989 and 1990. Production was affected, industrial conflict ensued and the exchange rate and economy suffered (Thomas, 16).

Financial liberalisation permits the financial sector to mobilise resources more effectively, allocate them more efficiently to quality investments (in spite of adverse selection, (Bourne, 3) and maintain macro economic stability. But this is a role which requires careful (rather than,

restrictive) Central Bank supervision to smooth out financial system. Financial liberalisation and deregulation should not be seen as laissez - faire policies which minimize the need for prudence and discipline.

B. OBJECTIVES AND INSTRUMENTS OF ECONOMIC INTEGRATION

Caribbean economic integration, despite its viccissitudinous history, is now considering a quantum leap, through the establishment of a Single Market and Economy by 1994. It is expected that the increased market size, pooling and more efficient use of resources and enhanced bargaining power would lead to increased productivity, competitiveness and welfare in all Member States, (1973, Treaty of Chaguaramas, 5). Theoretically the gains from trade creation and trade diversion as well as economies of scale in production and investment should result in "the sum of the whole being greater than the sum of the individual parts" (CARICOM Secretariat, 6). This depends on the distribution of the benefits as the tendency to polarisation is perhaps the major cause of the collapse of integration arrangements in the Third World (Balassa, 1).

The specific measures and instruments for achieving the Single Market include:

a) the Common External Tariff (CET)

b) Trade liberalisation for goods satisfying the Rules of Origin

c) Equal treatment of nationals/enterprises from other Member States in respect of trade in services and investment

d) Coordination and harmonisation of economic policies eg. fiscal incentives, industrial and agricultural development

e) Harmonisation of monetary, payments and exchange rate policies.

Some of these measures represent modifications or full implementation of policies and instruments formalised in the Treaty of Chaguaramas. Quite significantly, the large number of derogations, qualifications and safeguards which currently hamper the achievement of substantial welfare gains from integration, is to be drastically reduced in the Single Market proposals. As such, the central role of the pecial Regime for Less Developed Countries in the objectives and programmes of CARICOM, will be minimised or abolished all together.

Economic integration arrangements, like CARICOM, are generally considered as "second best options" in terms of the Neo-Classical paradigm and are discriminatory in relation to transaction from Third countries. In a liberalised world environment, characterised by interdependence and the unrestricted flow of goods and capital, economic integration represents a "distortion". The recent formalisation of CARICOM's entry into the Enterprise for the Americas Initiative will require a range of obligations from CARICOM States that stress preferential treatment for transactions and transactors from the United States (since it is unlikely that CARICOM will enjoy non-reciprocal privileges in the EAI). The implications of

these obligations for the Single Market preferences as well as for commitments made in other agreements eg. Lome Convention, GATT, Canada - CARICOM etc. need to be carefully studied to avoid potential conflict.

II. NEXUS BETWEEN FINANCIAL LIBERALISATION AND ECONOMIC INTEGRATION

The basic issue which arises from an examination of the theoretical logic and operational practices of financial liberalisation and economic integration is: does liberalisation impede or enhance integration? If there is some incompatibility between the two, a second question can be posed: given the current economic challenges facing Member States, which of the two initiatives will be given primacy? Of course it is quite conceivable that CARICOM States will pursue both initiatives simultaneously through partial implementation. However, there are several concerns which will need to be addressed:

a) Welfare Gains

Financial liberalisation requires independent national action without reference (or perhaps very little) to what others Members may be doing. The focus is more global with the international community as the point of reference and the objective of action rather than the regional community. It seeks to integrate the national economy more closely with the global community. As such trade, payments, investment, exchange rate issues are dealt with bearing in mind the dictates of the rest of the world rather than the Region. In other words, a Member State undertaking financial liberalisation reforms does so because of the perceived welfare gains from greater international competitiveness and

sustainability. As such regional issues are secondary to this overall objective.

Economic integration requires more collaborative and joint action. While the focus is on achieving international competitiveness the approach calls for becoming competitive regionally, achieving the required economies of scale and then interacting with the international community. Regional integration is based on preferential treatment, protection, programmed development and special concessions and derogations if there is "injury". As such, the force of international competition is absent and some inefficient producers could stay in operation for some time (perhaps a long time) because of protection, special treatment and the lack of sanction power in regional agreements.

If international efficiency and competitiveness is the objective, it appears that regional integration is a slower method of reaching that target compared to strategies centred on financial liberalisation.

b) <u>Trade and Payments</u>

The critical issues in trade and payments follow from the adequacy of intraregional clearing arrangements, the availability of foreign exchange and the level of protection (advantage) offered by the CET.

- In an environment of financial liberalisation, exporters may be encouraged to sell more to third countries than to the regional market,

especially if issues of payments are likely to arise. This would appear more advantageous to the exporter as the proceeds from his sales can be placed in foreign accounts thus facilitating rapid access when working capital is needed. In fact, liberalisation provides an incentive to produce directly for the international market without reference to the local/regional market. This situation is not uncommon where intraregional payments problems are experienced and when liberalisation has proceeded faster in one country than in others.

- A producer who is unable to compete effectively in the world market may resort to the protected CARICOM market where the Common External Tariff (CET) provides a 5% - 30% advantage to regional products.

- Importers are faced with trying to find the best bargains given the higher price they have to pay for acquiring foreign exchange. To optimise their returns, they may opt for a cheaper priced import from a Third Country after consideration of the advantage given to a regional product by the CET. On the other hand, if regional clearing arrangements do not require the use of foreign

exchange, the importer may, in the face of exchange risks and limited supply of foreign exchange, choose to buy from the regional exporter.

c) <u>Investment</u>

Capital flows involve equity, direct investment, joint ventures and the repatriation of profits.

- Liberalisation can enhance regional equity markets and intraregional transactions. The biggest obstacles are the availability of foreign exchange and exchange risks. The experience of the Regional Stock Market show that between April - September 1991, the value of transactions was about US$8.3m. This is broken down as follows:

Purchases	Value(US$)	No. of Shares
Trinidad & Tobago from Jamaica	2,300	3,500
Jamaica from Trinidad	3.9m	4.4m
Barbados from Trinidad	2.2m	2.3m
Trinidad from Barbados	2.0m	4.0m
Barbados from Jamaica	less than 1,000	
Jamaica from Barbados	less than 1,000	

Source: Jamaica Stock Exchange

	B'dos	FROM J'ca	TT
B'dos	—	<1000	~~2.3~~ 2.3
J'ca	<1000	—	4.4
T'T	—	3500	—

Since September 13, activity on the Regional Stock Exchange has slowed down considerably. The US$8.3m worth of shares traded is less than the US$11.0m set aside by the Governments of Trinidad and Tobago (5m); Jamaica (5m) and Barbados (1m) to encourage stock trading.[2]

The removal of exchange controls could revitalise the Stock Exchange. It can also make it easier for nationals to purchase equity in international Stock Exchanges. This seems to be a more likely occurrence.

- The removal of restrictions on capital flow can encourage the establishment of joint ventures and branch banks and the trade in services within the Region. Surplus, investible funds from one country can, where profitable, find their way into capital-scarce countries.

  This also opens up the possibilities of increasing production integration to take advantage of complementarities and resource differentials among countries.

- Liberalisation of capital flow on a global level (as contemplated in GATT) and on a hemispheric level (as enacted in the EAI) may require Member States to offer investment from non-regional

countries similar treatment as that from the region. In such a case, there is no preference for regional as against extra-regional investors and while the Region as a whole may attract a larger volume of investment funds, it might be useful to examine ways of encouraging more joint ventures rather than totally foreign-owned enterprises. The issue of polarisation would arise if investments flow continuously to particular countries because of perceived advantages. In fact in the absence of a Special Regime and the establishment of a "level playing field" for all, the flow of investment can be seen as an indicator of the efficiency of investment in the Region.

d) Exchange Rate Management

- Financial liberalisation requires national action. As such sovereignty in exchange rate management is paramount and decisions on pegged or floating rates, use of reserves to defend particular rates, and competitive devaluation based on national strategies are primarily national. If exchange rates are to reflect market forces, then floating rates may become the norm with greater uncertainty and instability in the foreign exchange market. The impact on inflation, production and capital

flows would depend on the frequency and amplitude of changes in the exchange rate.

- Economic integration calls for greater coordination and harmonisation of exchange rate policies among Members to avoid competitive devaluation. The move towards a Single Market may induce more cooperation in terms of establishing a Caribbean unit of account and perhaps a system like the European Monetary System and its Exchange Rate Mechanism.[3]

III. CONCLUDING COMMENTS

Financial liberalisation and economic integration are neither mutually exclusive nor fully compatible. One stresses national action, the other regional coordination. Both initiatives set forces at work which can conflict in some instances and can be mutually beneficial in other areas. Additionally, while the long term efficiency gains from liberalisation and integration are generally acceptable, the short term distributional effects may be more problematic.

Liberalisation creates the environmental where regional and extra-regional transactions are treated similarly or at least in a neutral manner. In a situation where foreign exchange is scarce, regional clearing arrangements are weak in terms of conserving foreign exchange and complementarity in production is minimal (or not fully developed) the tendency will be for liberalisation to favour extra regional transactions in trade and investment. Once more, regional integration will be treated as a secondary rather than central to the developmental strategy in Member States.

Since Member States are not faced with the choice of either one or the other but will seek to achieve substantial progress in implementing both initiatives, there are a number of areas which merit deeper analysis so that the benefits of both can be maximised and friction (costs) minimised. These are:

a) the experience of the Regional Stock Exchange which has been operating in a constrained environment with respect to foreign exchange availability for transactions by Member States. It would also be interesting to examine the implications of integrating the proposed OECS Stock Exchange and of involving Guyana (where financial liberalisation is quite extensive) in the Regional Exchange.

b) the sequencing of liberalisation reforms. The literature suggests (Renshaw 12, IDB 8, Fry 7) that trade liberalisation should be followed by financial (domestic money) market liberalisation and then foreign exchange and capital transactions. It also indicates that liberalisation does not necessarily lead to macroeconomic stability (though it requires stability if benefits are to be optimised) but could result in a stagflationary disequilibrium without much transfer of resources to the tradables sector. The experiences in Guyana, Jamaica and in other Member States with liberalisation programmes should be examined to determine the full macroeconomic implications of sequential or simultaneous liberalisation.

c) the directional flow of investment among Member State if full liberalisation and economic

integration (Single Market) are implemented. The basic issue will centre on the determination of efficiency of investment and possible polarisation once a "level playing field" is created.

d) the precise nature of domestic/regional rigidities i.e. behavioral, technological or institutional which affect the adjustment of various sectors especially the tradeables sector to take advantage of positive interest rates, exchange liberalisation and competitive exchange rates.

It is quite clear that Member States will seek to implement both initiatives simultaneously. Adequate and timely data in respect of the above research areas could help to sharpen perceptions about financial liberalisation and economic integration and provide policy makers with a more substantive basis for appropriate rather than ad hoc action.

NOTES

1. The Single Market and Economy represents a significant advance from the type of Union envisaged in the 1973 Treaty. It seems to be following the European Community model:

   The European Economic and Monetary Union (EMU) is proposed to take place as follows:

Stage 1....end 1992......	Single Market, Coordinated economic policies, all currencies in the EMS
Stage 2....early 1994....	European System of Central Banks to coordinate and formulate common monetary policy
Stage 3....early 1997....	Full EMU.....Single Central Bank, pooling of reserves, common economic policies

2. Another reason for the slow pace of activity in the Exchange is the continuing preference for loan as against equity capital by firms

3. The European Monetary System (EMS) was established in 1979. It includes all 12 EC members. The Exchange Rate Mechanism (ERM) keeps participating currencies within certain upper and lower limits in relation to each other. These limits are 2.25% and 6% respectively in either direction. 10 Members belong to the ERM - the next two have opted for floating currencies.

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