"Impact of Money Markets on Regional Competitiveness in the Caribbean"

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IMPACT OF MONEY MARKETS ON REGIONAL COMPETITIVENESS IN THE CARIBBEAN

Introduction

Money Markets are developing fast in the Caribbean, especially in the larger economies of Jamaica and Trinidad & Tobago. This paper aims at examining the impact of these money market players in affecting the competitiveness of the region through efficient allocation of resources and through direct market intermediation processes that enhance price efficiency of capital.

Role of Bond Markets in Capital Allocation Efficiency

A bond market is very important in the efficient allocation of capital resources in any country for the following reasons:

1. Price discovery
2. Price efficiency
3. Market completeness
4. Efficient risk allocation

Price Discovery:

One of the main characteristics of an efficient market is the ability of the market to discover the fair price level of a commodity or security through an objective process of bid and offer.

In a bank centric model of capital financing this is rarely possible as there are not sufficient number of bids and offers for a specific transaction. However, in a bond market, the issuer, with an independent credit rating, is able to approach the market for funding from a wide variety of investors. Similarly, an investor with a sum of money can invest in a wide array of fixed income investment options with full knowledge and understanding of the risks and return. Therefore, both parties have the ability to determine the fair price (yield) for the funds being borrowed (issuer) and invested (investor).

Price Efficiency:

Bond markets enable a more objective pricing of loanable funds based on supply and demand factors rather than arbitrary pricing determined by the lender or borrower. This efficient pricing for loanable funds enhances the ability of the funds to flow where they can earn the maximum risk-adjusted return. This enables a market to move from a weak form of efficiency to a semi-strong or strong form thus enabling the realization of the "efficient market hypothesis".
Through the collective process of market intermediation, the risks associated with a specific issue are factored into the price willing to be paid and accepted by the borrower and investors respectively.

Market Completeness:

Capital for any organization is sourced in the form of equity or debt. In order for any capital market to be complete it needs to have markets in which both these forms of capital can be raised and traded efficiently and effectively.

While stock markets in the major Caribbean markets have been established and operated for over twenty years the development of the bond markets has been lagging behind. This is despite the fact that, in most Caribbean markets, organizations depend largely on debt financing rather than equity financing. Without an efficient bond market the capital markets are incomplete.

The absence of an efficient market in fact limits the ability of the equity market to develop fully and thereby limits the overall development of the capital market. On the other hand the presence of a well-developed bond market aids the development of a vibrant stock market due to the interlinks between the two markets.

The interlink between the bond market and the equity market is an important one and is often overlooked in favour of a more adversarial paradigm where the bond and stock markets are competing for the same funds. The limiting view of this paradigm can be demonstrated by two phenomena – a) the vicious cycle of the cost of capital and b) the preferred habitat theory.

a) Vicious cycle of cost of capital:

There is a vicious and debilitating cycle that forces many Caribbean companies into a perpetual state of uncompetitiveness against global competition.

This cycle starts with the high cost of debt that bears down on the profitability of these companies and leads to low earnings. This adversely affects its P/E (Price to Earnings ratio) by pushing up the required rate of return. The higher required rate of return translates into a higher cost of capital. This works its way into the higher price that the companies have to charge to be viable. This higher price renders these companies to be uncompetitive. Due to the lack of competitiveness these companies have to pay a higher risk premium on its debt leading to a higher cost of debt. Back to square one.

On the other hand a low cost of debt can lead to higher earnings which lead to higher stock price which pushes the P/E higher, thus lowering the cost of equity, which then lowers the cost of capital for the company which then enables them to price their products competitively. A competitive price enables the company to command a lower risk premium which in turn lowers its cost of debt.

b) Preferred habitat theory:

Due to the differing risk profiles of investors, different investors prefer fixed income versus equity investments and vice versa. The same investor who prefers fixed income investments over equity investments may at a different time in her investing life cycle prefer equity over fixed income investment. This is known as the preferred habitat theory. Due to this phenomenon at any point in time there are likely to be an equal number of investors who would prefer fixed income to equity investments (not taking into account the changing patterns of population composition).

This provides issuers of both stock and debt to access the market with equal felicity if the markets are structured efficiently.

Due to the above two phenomena it is essential for the bond market to develop in order for the equity market to sustain and develop and for the overall capital market to develop in the region.

Status of Money Market in the Region

Among the Caribbean countries, the Jamaican money market has seen the most development in the last ten years with over J$200 million being traded daily. This has been due to many factors including:

- Large government borrowings
- High interest rates
- Unstable exchange rates

- Poor performance of the stock market
- And a large number of money market players

Trinidad & Tobago is beginning to see some money market developments and holds the potential for even exceeding the capacity of the other markets due to its buoyant economy and burgeoning government debt.

Although the other markets do not yet have active money markets most of these countries have raised funding from other regional markets (say, Trinidad & Tobago) and international markets. And these sovereign issues offer the potential for an active trading base. Many regional companies are beginning to recognize the potential for rising low cost funding directly from the market.

Infrastructure Elements for a Bond Market

One of the key infrastructure elements of a bond market is an independent and credible rating agency which can communicate credit risk information in an easy to assimilate form to the market. The absence of such a rating agency limits the ability of the Caribbean bond markets to reach its true potential.

Efforts underway to commence feasibility study for the establishment of such a regional rating agency and it is likely to take shape in the near future.

Other elements of an active bond market are a wide network of primary dealers who make a market in government securities, development of a yield curve for the respective markets with benchmark sovereign issues, and the training of securities dealers in pricing fixed income securities.

Case Study

THE JAMAICAN EXPERIENCE - Surviving the meltdown with capital from the money market.

In the early 90s Jamaica experienced unprecedented levels of inflation and interest rates. Shortly thereafter a number of financial institutions collapsed and the government had to step in to restore confidence and order to a vital sector under siege.

The government had to pump in over J$100 billion dollars over a period of four years in order to bring some semblance of solvency and liquidity to the financial system in Jamaica.

Early on during the crisis, the Jamaican government took a principled stand not to approach the international agencies such as World Bank or IMF for financial assistance. Instead it decided to depend heavily on borrowings from the capital markets.

According to Bank of Jamaica data, over a period of five years (1998-2002) the Jamaican government borrowed US$1.5 billion through bonds from the international markets. During the same period it also borrowed over JA$177 billion (US$3.9 billion) from the domestic market. Over 62% of the total borrowing is from the domestic market.

The domestic bond market played an important role in providing the liquidity needed to stabilize the Jamaican financial systems and the government borrowed in excess of 135% of its GDP in a short period of time. The bond market in Jamaica assisted during this difficult period in the following way:

1. It provided a ready market for government debt issues thus reducing the risk premium on these issues
2. It helped maintain retail price levels and inflation in check by sapping away the liquidity in the system
3. Interest rates in the money market acted as an effective lever to control the exchange rate by removing the pressure on the exchange *rate through varying the interest rates.*
4. It provided a back room market for its foreign debt

But for the domestic bond market, this excessive borrowing by the government of Jamaica could have led to higher risk premium on the international markets leading to runaway exchange rate, higher cost of borrowing, higher debt burden and higher debt servicing levels – all leading to the loss of confidence in the financial system when it was most needed.

Conclusion

In a post-mortem review of the "Asian Contagion" of 1997, when the Thai baht collapsed and precipitated the crisis in East Asia, the then Governor of Thailand's Central Bank said, "If I could turn back the clock and have a wish list, high in its ranking would be a well functioning Thai-baht bond market". Since that time the bond markets in the East Asia has been growing at a faster rate than anywhere else in the world.