SUSTAINABLE CAPITAL MARKETS AND REGIONAL INTEGRATION:

The Experience of the Eastern Caribbean Currency Union

A Paper

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Sir Dwight Venner was also a member of the Expert Group appointed to review the impact of the FTAA on the small states of Central America and the Caribbean and a member of the Group of Experts appointed by the Commonwealth to review the volatility of the International Financial System as a consequence of the Asian Crisis. He is currently a member of the Commonwealth Group of Experts on Development and Democracy, and Chairman of the Organisation of Eastern Caribbean States (OECS) Technical Restructuring Committee. He is also a member of the Institute for Connectivity in the Americas (ICA) Advisory Board.

In 1996 Sir Dwight Venner was awarded the Commander of the British Empire (CBE). He was recognised as a Distinguished Graduate of the University of the West Indies on its 50th anniversary in July 1998. In June 2001, he was conferred with the order of Knight Commander of the Most Excellent Order of the British Empire (KBE).

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Introduction

Investment and finance have become a global matter, and, for developing and developed economies alike, liberalization is not enough. To reap all the economic benefits that can come with contemporary financial systems, countries must integrate their domestic financial systems into the emerging global system. With an eye on that ultimate objective—integration into a global financial system—many countries are coordinating their liberalization and integration efforts with neighboring countries. The best known example of this is the European Union (EU), but regional and sub-regional cooperation and integration efforts are also to be found in other regions of the world.

Liberalization and integration are intertwined. Liberalization without integration certainly produces benefits, but much of the potential that liberalization offers in a globalized financial system is not realized without the mechanisms for smooth business and regulatory interaction that are established through integration. On the other hand, efforts to achieve integration will be frustrating and fruitless if the countries attempting to work together do not have open, compatible financial systems.

Global integration is the ultimate goal while regional and subregional integration are progressive steps along the road to global integration. In fact, regional cooperation can speed the integration process by giving the countries of the region a framework and guidelines for action; it can support progress by creating a regional network of people focused on financial system liberalization and integration; and it can bring interim benefits to the countries of the region as investment and financial transactions among them expand.

This paper examines the issue of sustainable capital markets and regional integration with special emphasis on challenges facing small states in their efforts to develop well functioning and efficient financial markets. It highlights the effects of industry fractionalization that have generated diseconomies of scale due to the fragmentation of the sub-regional market, proliferation of transaction intermediaries that add little value to resource mobilization efforts in the industry, and high costs of intermediation due to scale of lending. The paper discusses developments in the Eastern Caribbean Currency Union (ECCU) and suggests that this experiment with sub-regional integration, if successful, could provide a useful model for the Caribbean region and other small states in the international system.

Principles for Pursuing Regional and Sub-Regional Capital Market Integration

Several principles should be kept in mind as regional and sub-regional integration is pursued. First, the ultimate objective of both liberalization and integration of financial systems is to improve the efficiency of the movement and investment of private sector resources as a means to improve economic performance and growth. Therefore, liberalization and integration efforts should always focus on private sector behavior and incentives. Second, policy makers must concentrate on five policy or functional areas related to integration, namely: a) financial sector environment, b) depository/credit institutions, c) cross-border capital flows, d) foreign direct and foreign portfolio investment and e) financial services. Third, regional and sub-regional integration are progressive steps along the road to global integration. Fourth, integration must be initiated and directed by government leaders and institutions, although the process can be made more effective by including private sector interests. Fifth, existing regional institutions can be of great value in leading and/or supporting the regional integration process.

Even though there is a natural sequence to the development of financial systems, given the speed with which global financial systems and markets are developing; it is desirable, even essential, that many aspects of liberalization and integration are dealt with concurrently.

Putting Principles into Practice: Introduction to the Organization of Eastern Caribbean States (OECS)

The countries of the Organisation of Eastern Caribbean States (OECS), eight of whom form the Eastern Caribbean Currency Union (ECCU), have embarked on a process of money and capital market development which will lead to the establishment of sustainable capital markets through deeper financial integration.

These countries could be described as small-island developing economies facing major challenges in a fast changing and rapidly globalising environment. This has been clearly manifested by the imminent loss of preferential market access for their primary agricultural export commodities--sugar and bananas--and also in the prospect of entering into reciprocal trading relationships--under the COTONOU, FTAA and WTO regimes--with states which are far better endowed with physical resources, capital, population, as well as technical, managerial and negotiating capacity.

These very small economies are extremely vulnerable to external shocks and natural disasters and have little or very limited access to international capital markets. In the past decade economic growth has declined and this has resulted in increased fiscal pressures and mounting debt service payments. This decline can be attributed to external shocks resulting from a slow down in the world economy, loss of preferential access and the devastating effects of several hurricanes.

With the decline in export agriculture, tourism has become the leading foreign exchange earner. However, this industry has been affected by a slow down in the United States economy and the events of September 11, 2001.

Another area that several countries were hoping to develop, namely offshore financial services, has been virtually decimated through new rules by such institutions as the OECD, FATF, and FSF.

The net result of these circumstances is that the OECS countries are having to reformulate their policies at the most fundamental levels in order to address the short term challenges of stabilization, and the medium to long term issues of economic transformation. The OECS Heads of Government at a special meeting in November 2002 set some broad objectives and a time frame covering the period January 2003 to December 2007 to stabilize, stimulate and transform their economies. The overall thrust of these initiatives involves the creation of an economic union and a single financial space as fundamental to the reform process.

The Heads approved an Economic Development Strategy and publicly endorsed a Development Charter that would inform and guide the development process as the countries moved forward. The Heads of Government specifically endorsed the following objectives:

1. A GDP growth rate of no less than 6%;
2. A rate of unemployment of no more than 6%;
3. A poverty level of no more than 6%;
4. The achievement of specific targets in the Human Development Index; and
5. The creation of a broad based, adaptable and internationally competitive economy within the economic union.

Two pillars of the process of reform and development will be the freedom of movement of labour and capital. The countries of the OECS are proceeding to address both in a very determined and systematic way, and significant progress has been made to date.

Characteristics of the Financial System in the ECCU

The current financial system in the ECCU comprises the following:

1. A central monetary authority- the Eastern Caribbean Central Bank;
2. A domestic commercial banking sector comprised of banks with total assets of EC$12.7 billion;
3. An insurance sector providing both life and general insurance services;
4. A credit union sector;
5. A number of credit institutions;
6. Social security schemes;

7. A secondary mortgage facility; and a
8. A securities exchange.

Despite having a common currency, the Currency Union has eight separate financial markets and this factor has led to the assertion by the World Bank of the problems of fragmentation and fractionalisation. The problem becomes manifest when the principles and facts are applied to the members of the Currency Union on an individual island basis. The largest island in terms of population is St Lucia with approximately 150,000 people. The smallest is Montserrat with 4,500.

The OECS financial sector lacks the vibrant participation of institutions and mechanisms deemed essential for efficient allocation of capital to the productive sectors of the region's economies. In the ECCB region, over 70% of assets are still held by the banking sector. The limited type of financial instruments available includes: a) treasury bills, b) government bonds and c) private corporate securities. The financial sector in the countries is small, fragmented and has limited liquidity. Non-bank financial institutions are limited in scope and not integrated into the overall financial system. Social security schemes, insurance companies and credit unions do not play a major role in capital markets intermediation. Most of their capital accumulations are held in bank deposits. There is a lack of well-developed collective investment vehicles such as mutual funds or unit trusts. The base of public companies is limited; existing public companies are slow to respond to a listing and there is no venture capital development yet in the region. Institutional investor participation in the securities market is limited due to paucity of instruments.

The risks, which are involved for a single financial institution in such small states, are significantly multiplied. The narrow range of economic activities and the narrowness of the domestic market multiply credit risk. Price risk has been mitigated by the currency arrangements on the exchange rate side and by inertia on the interest rate side. However, interest rates are somewhat distorted due to the lack of market efficiency which can itself be connected to extremely small size. Liquidity risks are high because secondary markets are uneconomical in such small spaces. Systemic risks are inordinately high as the demise of one institution can precipitate the potential collapse of the entire system.

The continued existence of these small and separate financial markets has the tendency to keep the financial system in a low level equilibrium trap with distorted prices for money and other financial instruments, and the inability of the private sector to raise funds on the appropriate terms, and in sufficient quantities for raising output and levels of income. The situation is now compounded by the increased cost of regulation, which is being imposed by the international financial community.

Charting a Way forward for the Financial Sector of the ECCU

It has been accepted by most analysts who work on small states, especially extremely small ones such as the OECS, that two of the major strategic objectives would be to –

1. Exploit all possible economies of scale and scope, and

2. Expend the greatest effort to mitigate risk.

For small states this can be interpreted to imply the deepest possible integration of the real and financial sectors. The World Bank in a paper entitled *"OECS Financial Sector Review"* May 1 1997, identifies three serious problems for the financial sector of the OECS, namely, geographic fragmentation, industry fractionalisation and the shortage of institutions to provide long term and venture capital to the private sector. They explained these three issues as follows:

1. Fragmentation results from legal and regulatory obstacles that block integration within the Eastern Caribbean and de-links it from the international financial system;
2. Industry fractionalization which generates diseconomies of scale in each country, results from fragmentation of the sub-regional market, proliferation of 'transaction intermediaries' that add little value to resource mobilisation efforts in the industry, and high costs of intermediation due to the scale of lending and other financial institutions;
3. Developments in technology and global trading patterns should be opening new opportunities for the economies to shift away from declining sectors, such as sugar and bananas. However lack of institutions to mobilise financing for private sector ventures, combined with a scarcity of human resources, and regulatory barriers, hinders dynamic adaptation of the economies.

The World Bank review of the financial sector predates the Asian financial crisis and the subsequent exponential increase in the regulatory environment. A new dimension to financial sector development would now have to give very high priority to an appropriate and effective regulatory regime and environment.

The OECS countries have been fortunate to date in having currency and financial systems which have not been subjected to the instability that has been the experience of most of the international system over the last two decades. The IMF has in fact concluded that at least two thirds of its membership comprising both developed and developing countries have had currency and banking crises. The OECS countries have operated a quasi currency board system with a fixed exchange rate regime which has delivered low inflation and currency stability over the last 27 years. The domestic banking system has also been stable and receives the confidence of the community.

Developing an Integrated Money and Capital Markets Development Strategy for the ECCU

The above-mentioned issues facing the region have called for a strategy that leads to the creation of a single financial space, and the development of money and capital markets within such a space. The issues identified as critical to the strategy are the role of finance, and the benefits of integration.

The logical and strategic response to this problem has been to identify finance as a leading sector and to postulate that an integrated, developed and well-regulated financial sector across a single financial space could be a significant and major facilitator of growth and development. The reasons for postulating the role of finance as a lead sector would be that there are certain critical advantages already alluded to which gives it a comparative edge. That is, currency stability, low inflation and a sound domestic banking system. In addition, there is a reputable legal system, which requires some element of reform to continuously upgrade its efficiency and effectiveness.

Finance is critical to the development process. Financial systems, it is asserted provide payment services, mobilise savings and allocate credit. They limit, price, pool and trade risks resulting from these activities. Financial systems bring together the users of such services, namely, households, businesses and governments, through the work of institutions, for example, banks, insurance companies, credit unions, which issue instruments such as cash, cheques, credit cards, bonds and shares. Financial systems contribute to growth and development through the quantity and quality of services they deliver in the most efficient manner to the economy.

The countries of the OECS, as part of an overall development strategy, are seeking to establish the markets and institutions to facilitate the process. The literature has referred to finance as either supply leading or demand following (Hugh T Patrick). That is, *is finance a passive, permissive or facilitating agent rather than a factor of production, or is it a dynamic precursor to the growth process stimulating the real economy through the allocation of resources and providing new financial products?* There is usually some balance in the process with the two processes intersecting. The fact is that if there is no latent demand for institutions or products they would not be developed.

The ECCB has set out a strategy, which involves the development of institutions and markets across the entire Currency Union. At the apex of these institutions is the ECCB whose main objectives as a multinational central bank are as follows:

1. To maintain the stability of the currency;
2. To maintain the stability of the financial system;
3. To develop money and capital markets; and
4. To regulate the availability of money and credit.

The ECCB in managing the currency arrangements has provided a stable environment for the development of both the real and financial sectors. Currency stability in addition to the safety and soundness of the domestic banking system has provided the environment for increased savings and investment. However, the size of the individual country financial markets has narrowed the range of saving and investment products and increased the risks to both parties. The development of money and capital markets across the entire Currency Union addresses this problem by widening the markets in the first instance, and by providing the framework in the second instance for a more effective integration into regional and international markets.

The ECCB is very much involved in monitoring standard setting arrangements at the international level and their appropriate application to the Currency Union. In this regard, the institution has been collaborating very closely with the national authorities to ensure that these standards are flexible and adaptable, and that they will be uniformly applied across the Currency Union.

The ECCB also functions as an interlocutor between the international public and private financial sector and the Currency Union. In the private sector area contacts are maintained through the institutions investment bankers and global custodian in addition to other market players, such as broker dealers and rating agencies. On the public sector side close contact is maintained with the IMF, World Bank, other central banks, the BIS and the multinational development banks, for example, the IDB.

The ECCB on the domestic side has identified a critical role for itself in fostering financial and economic literacy. Without a working knowledge of these issues at the community level the possibilities for development in both the real and financial sectors are limited. The full and effective utility of markets is based on the dissemination and use of information. Transparency and accountability leading to good governance can only be assured if the public is provided with the information and means to make efficient choices in saving and investment.

Institutions and Mechanisms Being Created as Part of the ECCU Money and Capital Markets Development Program

The following institutions and mechanisms have been created as part of the ECCU Money and Capital Markets Development Program:

The Eastern Caribbean Securities Exchange

The ECCB in establishing the **Eastern Caribbean Securities Exchange** (ECSE) saw this institution as the platform and core of the development of a region wide financial system. The ECCB took the decision to operate at the high end of the technology scale and therefore created a system with a T+1 settlement time and a dematerialised environment. This has given the ECSE a technological edge, which will prove to be very significant as we proceed. The ECSE is supported up by a first class depositary and registry as well as a Securities Commission, which is carefully establishing the appropriate regulatory environment to provide confidence and credibility to users of the exchange.

Rapidly evolving business models and the changing competitive landscape in the region is mandating companies to not only re-assess their operating strategy but also the capital raising process used to finance growth and expansion. Large exposure to one particular class of financial assets (i.e., bank loans) coupled with rising interest costs are hurting the bottom-line and further stifling expansion plans of firms within the region. Although high leverage by itself may not be an indication of capital starvation (as may be the case for some regional companies), it does indicate that too much of the firms' finance is based on term borrowing, thereby leaving them exposed to fluctuations in the business cycle. It may also indicate that the firms' have reached the debt limits, and that further finance for expansion will only come from equity or retained earnings. The ECSE brings in this new frontier of equity- and debt- financing to growth-oriented companies of the region, while generating new opportunities for investors to start or diversify their securities investments. For issuers wishing to undertake a public offering, a single approval from the Eastern Caribbean Securities Regulatory Commission (ECSRC) will allow them to raise capital in any of the 8 territories presently covered by the ECSE platform.

The introduction of the ECSE will usher in a new era in business models and practices in the Currency Union. Corporate governance will be improved and the methods of financing business will be transformed. It will also have an important impact on economic democracy, as new avenues for participating in the ownership of the productive enterprises will now be available for a wider range of citizens. This will increase the need for and drive the demand for more knowledge about the economy and the financial system.

The central vision of the ECSE is to employ its unparalleled technological resources to link pools of liquidity for its corporate sector and government issuers. The logic of this vision leads to regional linkage. The benefits are significant for all market participants:

- Regional listing provides vastly enhanced exposure and interest for issuers and enlarges the investor base;
- Investors are provided with far broader choices; and
- The value of the ECSE network increases as the network enlarges.

The ECSE is in the process of expanding its scope to provide its services to issuers and intermediaries across the CARICOM region.

Regional Government Securities Market (RGSM)

The ECSE is also providing the platform for the **Regional Government Securities Market** (RGSM). The establishment of this market has had a number of beneficial effects. It is integrating the 8 fragmented government securities markets of the ECCU, creating a single regional market to facilitate the cross-border issue and secondary trading of government securities. It is deepening the region's financial markets and facilitating their integration across the currency union. It should also assist in the further development of the private debt and equity market, and should provide a fillip to the Eastern Caribbean Securities Market (ECSM). The regional nature of the market is assisting in promoting the unfettered flow of capital and liquidity across the currency union and lead to increased savings and investment opportunities for the private sector, which should augur well for the overall growth objective. The removal of existing impediments should result in a shift in the holder base. While the institutional investors will continue to dominate the market, cross-border activity should increase, as these investors seek to exploit arbitrage opportunities that may exist initially, and more fundamentally, to diversify their portfolios. Retail investor interest is also likely to increase in the primary- and secondary- market through licensed intermediaries that will make a market for such securities.

The Eastern Caribbean Home Mortgage Bank (ECHMB)

The **Eastern Caribbean Home Mortgage Bank** (ECHMB) is another Currency Union institution, which has achieved some success. The ECHMB was established some 6 years ago and has paid a dividend to its shareholders over the last 3 years. The ECHMB has several critical functions, it buys primary mortgages, it issues bonds on the capital market, and it sets underwriting standards and tries to influence the primary issuers to insist on high quality building codes and standards. The ECHMB holds annual home ownership days in each member country to improve understanding of the mortgage market.

The Eastern Caribbean Institute of Bankers (ECIB)

The **Eastern Caribbean Institute of Bankers** (ECIB) has been established by the ECCB in very close collaboration with the banking community to raise professional standards and to provide opportunities for certification. The Institute is affiliated with similar bodies in the rest of the region, the United Kingdom, Canada and the United States. The Institute is also working closely with the University of the West Indies to create courses and programmes in banking and finance. The establishment of the Institute has led to even closer networking among the members of the banking community in the Currency Union, and has a proposal for the establishment of a currency union wide Association of Bankers.

Other Planned Initiatives

The ECCB has been very closely involved in trying to establish an **Institute of Accounting** in the Currency Union. The legislation has been drafted and the project is almost ready to be rolled out. The importance of this institution to standard setting and good governance has been recognised by all the important actors, including governments and the profession itself.

The ECCB has also identified two new regional institutions to be brought on stream to complete its critical list of intermediaries, they are, the *Eastern Caribbean Enterprise Fund (ECEF) and the Eastern Caribbean Unit Trust (ECUT).* The ECEF will be an omnibus institution involving itself in Venture Capital activities, medium to long term lending, export credit finance and insurance, and technical assistance. This is intended to be a dynamic institution which in conjunction with other development finance partners will have the role of private sector development, and the creation of innovative and competitive export oriented industries.

The ECUT will provide to a broad base of citizens the opportunity to be involved in the economies even if their savings are relatively small. The movement towards a single financial space will have an impact on the traditional financial institutions such as commercial banks, insurance companies and credit unions. There will be consolidation of these institutions leading to stronger institutions which can bear more risks and finance larger projects. More opportunities will also be provided for local staff to provide services, which were not economical to provide in limited national markets. The increase in market size will also make it economical for new institutions to be established to provide these services or the services to be provided by existing institutions. Services such as investment banking, factoring, leasing, and providing financial advice should now be more attractive to service providers.

It is possible to envisage the evolution with time across the Currency Union of a concentration of services in a small number of financial conglomerates. This will require an integrated response to financial supervision in order to ensure an appropriate regulatory framework.

The ECCB has proposed and the Monetary Council has accepted the need to move towards an Integrated Regulatory Framework for the Currency Union. Market development has of course been closely connected to institutional development. The intention is to create across the Currency Union markets of depth, breadth and resiliency. The markets start with that for the EC dollar, which, because it is a common currency, lowers the transactions costs of buying and selling. This is followed by an Interbank market for liquid funds of the commercial banks, which assists them in their liquidity management and sets the price for short-term funds. The Regional Government Securities Market which deals with short term instruments, Treasury Bills, and medium to long term bonds follows this in sequence. And the Eastern Caribbean Securities Market on which debt and equity securities are traded. Finally, there is the secondary mortgage market in which instruments of long duration, for example, 15 years can be exchanged for instant liquidity, allowing the banks to recycle those funds.

There is the intention to establish as well a market for corporate debt and possibly a US dollar and a commodities market.

The use of technology and a highly sophisticated payments system, which is now being developed, will be the basic underpinning of this Currency Union wide market development.

The results of these efforts will have far reaching effects on households which will have a wider range of savings instruments to choose from, or investors who will have a wider range of investments with lower risks. Governments will also benefit through the ability to change the profile of their debt both with respect to price and maturity.

The successful creation of the single financial space will not only have a fundamental impact on domestic developments but will also give the Currency Union a more enhanced profile and image within the regional and international communities. This will have a very important influence on our ability to integrate smoothly into the international financial system, and to have easier and more advantageous access to capital markets.

The individual members of the Currency Union will have to adopt and consolidate policies which will ensure fiscal and debt sustainability, and lead to international credit ratings at the higher levels.

Regional (CARIBBEAN-WIDE) Relevance of the ECSE Model

The ECSE represents a viable alternative for securities market integration in the broader Caribbean. The ECSE is the first successful regional initiative aimed at securities market integration in the sub-region and beyond. It has successfully linked 8 island nations and its scope could be increased to cover the rest of the Caribbean. Unlike traditional exchanges that only provide a secondary-trading platform, the ECSE offers both primary and secondary trading platforms, creating a single focal point for all securities activities. The derived benefits of this design include greater efficiencies and economies of scale as well as an innovative way of raising capital. The ECSE serves as the platform for the primary issuance and trading of government- and corporate- securities.

The ECSE is providing an efficient market and creating visibility for issuers (government and private) and thus the opportunity to raise capital from a larger universe of investors at lower cost on a region-wide basis. It is designed to concentrate liquidity on one unified platform across the region with a view to eventually link to global liquidity centers. It has defined what a financial market ought to be for island economies pursuing economic integration. Further, it is an embodiment of institutions; technology, information and processing that are a way of the future.

The following features of the ECSE infrastructure exemplify its regional market capabilities:

- It is the first fully electronic regional securities market in the Western Hemisphere connecting issuers, intermediaries and investors from multiple locations across the region.
- It is governed by a uniform body of legislation (a regional securities act) and accompanying regulations that provide for market transparency, investor protection and minimization of systemic risk throughout the sub-region.
- The Eastern Caribbean Securities Regulatory Commission (ECSRC) serves as the regional regulatory body responsible for registration, licensing, monitoring and surveillance of market participants.
- The ECSRC shares its regulatory responsibility with self-regulatory organisations such as the Eastern Caribbean Securities Exchange.
- The market consists of institutions that are adhering to global norms such as those recommended by the CPSS, IOSCO and other similar global institutions/arrangements.
- Demutualized ownership structure of market institutions represents a diversified ownership base committed to the success of the institutions from all quarters of society.
- Trading engine has both a primary- and secondary- market platform; a medium for primary issuance of government and corporate securities as well as their trading on the secondary market.
- Automated order processing transcends national boundaries.
- Maintenance and servicing of shareholder records on behalf of issuers comes from a dematerialized registry environment that has the capability to accommodate the needs of an investor base throughout the region.
- Confirmation of trades between direct market participants occurs on trade date. Final settlement occurs no later than T+1; dematerialized environment allows for transfer of securities by book entry.
- All money settlements are processed through the Eastern Caribbean Central Bank using SWIFT generated messages.
- On-line database for regulatory filings as well as historical market data.
- Connectivity to market institutions is provided via direct dial-up networking as well as internet access.
- Provides for investor diversification across geographical boundaries and sectors to preserve and grow investments. Provides increased visibility for listed companies.

The ECSE and its subsidiaries have invested heavily in technology to ensure an efficient and modern market. Designed to deliver a host of benefits that are vital to investors, issuers and intermediaries, it is this system that defines the ECSE, ensures its reliability, and provides it with its key competitive advantage—the scalability to build the first truly regional securities market.

Conclusion

In conclusion, it would be fair to say that the experiment in financial integration among the states of the ECCU if successful could provide a working model for small states in the international system, and should be supported by critical actors both within the union and by the international community. The experiment is now gathering momentum and the ECCB, ECSE, ECHMB, and ECIB look forward to working with other interested parties in bringing this phase of the programme to a successful conclusion.

Further, as the region's economies become more interdependent, an institution like the ECSE would welcome the opportunity to serve the entire Caribbean region with a securities market infrastructure that is open, fair and efficient. The ECSE also looks forward to driving the discussion on a single securities market within the CARICOM region.