

LIMITED
LC/CAR/L.104
7 December 2006
ORIGINAL: ENGLISH

**CAPITAL MARKET DEVELOPMENT IN THE CARIBBEAN
WITHIN THE CONTEXT OF THE
CARICOM SINGLE MARKET AND ECONOMY (CSME)**

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CAPITAL MARKET DEVELOPMENT IN THE CARIBBEAN WITHIN THE CONTEXT OF THE CARICOM SINGLE MARKET AND ECONOMY (CSME)

I. Introduction and background

Caribbean enterprises for the most part remain undercapitalised. The scarcity of capital has perverse feedback effects, as it affects the ability of firms to attract highly skilled labour, talent, access to cutting-edge technology and marketing systems. Further, capital shortage also impinges on the ability to undertake research and development and international service standards certification, and product/service innovation, all of which are critical catalysts for competitiveness and business success.

The banking sector in the region has made important development strides in recent decades, with product innovation, improved service delivery, moves towards universal banking and cross-border mergers and acquisitions. Nevertheless, banks can only and are indeed prepared to go only so far in meeting the spectrum of financing requirements of firms in the region. The reality is that in order to have a proper matching of assets and liabilities to meet prudential accounting and financial benchmarks and, most importantly, to ensure the long-term viability of banks, banks will not provide the quantum of long-term finance that is required to fire the growth and adjustment process in the region.

Economists have long proposed a strong link between the rate of capital accumulation and its productivity and the pace of economic development. Sir Arthur Lewis for example, argued that: “The central problem in the economic theory of development is to understand the process by which a community which was previously saving and investing 4 or 5 per cent of its national income or less, converts itself into an economy where voluntary savings is running at about 12 to 15 per cent of national income or more. This is the central problem because the central fact of economic development is rapid capital accumulation (including knowledge and skills with capital)”.¹

In more recent times, capital market liberalisation has helped to catalyse capital flows to developing countries. Premised on the efficient market thesis, liberalisation is expected to lead to number of benefits. In the first place, capital market liberalisation facilitates the movement of savings from surplus countries, with an abundance of capital to deficit countries, improving the allocation of resources and facilitating the direction of finance to the most profitable projects. Second, capital market liberalisation promotes diversification of investment decisions, reducing risk and lowering the cost of capital, which stimulates investment and growth. Importantly,

¹ See Lewis, Arthur, W. “Economic Development with Unlimited Supplies of Labour,” The Manchester School, May 1954.

liberalisation that spurs growth in foreign direct investment could facilitate technology transfer, learning by doing, and managerial and technical know-how that could catapult domestic firm competitiveness and export growth. At a conceptual level, the argument for capital market liberalisation was provided by way of analogy to that for free trade based on comparative advantage.

However, as Stiglitz² and others have highlighted, the case for capital account and market liberalisation is not as clear-cut as that for free trade, as it poses many more systemic and non-systemic risks that could undermine growth and stability in recipient countries.

Capital markets, as distinct from banks, are critical to transforming savings to appropriate finance capital for different types of business investment. The regional capital market is therefore challenged to provide the finance for enterprise development and competitiveness. Capital markets by their very nature have some inherent advantages over money markets. Capital markets undertake a number of specific functions that directly impinge on success of enterprises. In the first place, capital markets facilitate the mobilisation of long-term finance for long-haul projects-both Greenfield and restructuring of traditional production systems. The region faces major challenges in these two areas as efforts are made to beneficially insert the Caribbean economy into the global economy.

Capital markets also provide a mechanism for pooling funds from local and foreign investors that can be tailored using customised instruments for different classes of borrowers. The junk bonds market in the United States that evolved in past decades is a good example of this. Importantly, capital markets, especially stock markets, allow citizens to own a portion of companies and to have a direct stake in the management and direction of companies. This is a good means of enhancing redistributive equity in a country, particularly in a world economy where growth in returns on capital investment tends to far outpace growth in labour income (wages and salaries). Also, sound capital markets within a transparent framework tend to foster the financing of the most productive activities that are likely to be competitive and also to provide vital information on the direction and prospects for the economy. These crucial signals are important for decision makers to make informed choices and policies that could impact economic growth.

Importantly, capital markets are situated in the wider context of the financial system. According to Merton³, a financial system provides the following functions in an economy:

- (a) A payment system for settlement of transactions;
- (b) A mechanism for pooling funds to achieve economies of scale;
- (c) An avenue for transferring resources across space and time;

² See Stiglitz, Joseph, "Globalisation and its discontents", New York, Norton, 2002

³ See Merton, Robert, C, "A Functional Perspective of Financial Intermediation-Financial Management Silver Anniversary Commemoration", 1995.

- (d) A way to manage uncertainty and control risk to manageable levels;
- (e) Price information and discovery to allow an economy to implement a decentralised allocation of investment; and
- (f) A way to deal with asymmetric information problems that arise when one party to a financial transaction has information that the other party does not have; or is inclined to be imprudent after a transaction.

Capital markets are at the vanguard of performing most of the functions noted above for the wider financial system. Therefore the manner in which they function, that is their efficiency and effectiveness, impacts on financial development, productive investment and ultimately economic growth and development.

Caribbean capital markets are underdeveloped by international standards. However, in absolute terms they have posted robust growth in the last few decades. The regional stock markets have been the prime mover in this respect. However, the bond markets have been increasing in importance and scope, as a number of governments substitute regional debt with international debt in the hope of averting exchange rate and international interest rate risks. In particular, the regional bond market has been spurred in recent times by the growth in debt and deficits in the Organisation of Eastern Caribbean States (OECS) countries. This stems from the fact that the collapse of commodity exports, largely sugar and bananas and higher spending, as a result of hurricane damage, have led countries to borrow on the regional bond market to rehabilitate infrastructure and also to undertake social spending.

The development and effectiveness of regional capital markets continue to be hampered by both technical and institutional constraints and cultural impediments. At the technical level, the infrastructure needs to be further upgraded to facilitate real time settlements, to reduce transaction costs in issuing stocks and bonds and in raising venture capital among other activities.

This study undertakes an assessment of the development of capital markets in the Caribbean. The study evaluates the extent of development of these markets in terms of technical and institutional advancement and, critically, how far they have been effective in mobilisation of finance for productive activity that could catalyse equitable growth. Section 2 provides an overview of capital market development in the region, giving rationale for the sequencing of institutions. Section 3 assesses the performance of the capital market in the region both in terms of the own growth and development and also with respect to their ability to mobilise funds for productive activity. Meanwhile, section 4 examines the impediments to capital market development, while sections 5 and 6 look at the impact of government financing; and regionalisation and internationalisation on capital market development. Section 7 provides recommendations for developing deeper, more liquid capital markets that mobilise greater resources for production restructuring in the region. Finally, section 8 concludes the study.

II. An overview of capital market development in the Caribbean

The financial system in the Caribbean could be described as a largely bank-based system. This is both a product of historical legacy and evolution and structure of the business sector and the types of risks that they face. For example, bank finance is well suited to a relatively conservative business class that is fairly risk-averse and relies on a stable supply of finance based on reputation and bargaining leverage. Bank finance is also appropriate primarily for trading and commercial activities that comprise a significant portion of business activity in the region. On the other hand, evidence from a number of countries indicate that capital markets are often better suited to financing new activities in dynamic production and services, such as informatics. In the United States, for instance, the dotcom boom was largely funded by venture capital, stock and other capital market institutions that were prepared to take the risk on prospective ventures that were deemed capable of providing good rates of return.

In fact, this failing of banks to provide the quality term finance for development activities, especially in agriculture, light manufacturing and services such as tourism and transport, led to governments stepping in with nascent efforts to fill the breach with the introduction of development banks and the national commercial banks to provide longer maturity finance for productive commercial activity and the development of infrastructure. The promotion of development banks was one of the earliest attempts to facilitate the development of capital markets in the region. The Jamaica Development Bank, for instance, was tasked with *inter alia*, fostering the development of money and capital markets in Jamaica. The presumption was that development banks would fill the breach left by commercial banks in providing term finance for agriculture, manufacturing and services both in the export producing and import-competing sectors.

Complementing the development banks were the National Development Foundations in a number of countries which were created to provide longer maturity financing to small- and medium-sized enterprises (SMEs) in agro-industry, light manufacturing and services. These institutions could be classified as capital market institutions in both nature and logic, as the term structure of their assets exceeded a year and their rationale was to provide long-term finance to boost enterprise development and success. In Trinidad and Tobago, the Development Finance Limited (DFL) of Trinidad and Tobago emerged in 1970 with a mandate to help catalyse the development of capital markets to catapult risk finance for productive activity.

Generally capital markets, as we know them today, can be deemed a recent feature in the evolution of Caribbean financial systems. Stock, bond and limited venture capital institutions are relatively recent in the Caribbean and, as such, these markets remain fairly underdeveloped by international standards.⁴ This pinpoints that the level of development of capital markets in the Caribbean is less than would be expected for a region of that population size and levels of income. Palpably, therefore, capital market development is lagging behind broad economic development in the region. The question is why is this so?

⁴ Although reference is made here to the broad international market since this is the ultimate standard in a rapidly globalising world, this might not be the best comparator for benchmarking capital market development in small underdeveloped markets such as those of the Caribbean. Countries of similar size (GDP per capita and Population) and levels of development, for example Costa Rica and Mauritius, might provide more realistic comparators.

A. The stock market

The second major era in the development of the Caribbean capital market was the establishment of stock exchanges in the larger Caribbean Community (CARICOM) countries of Jamaica, Trinidad and Tobago and Barbados and, later, the Eastern Caribbean Central Bank (ECCB). Again this development was largely supply-driven and stemmed from the recognition of the authorities that the banking sector was inadequate to the needs of development finance, particularly for risky, new investments in production for export. The Jamaica Stock Exchange, the forerunner exchange, was founded in 1968, as a private limited liability company. Its mandate centred on the orderly development of the stock market in Jamaica; the development and enforcement of the rules to ensure public confidence in the stock market; and the conduct, research and dissemination of information consistent with the development of the market. Although not explicitly mentioned, probably in keeping with the conservative language of the times, the ethos behind the formation of the Jamaica Stock Exchange was the need to raise risk capital for venturing enterprises that found the commercial banking sector a constraint on their expansion and operations.

The Trinidad and Tobago Stock Exchange was established in 1981 replacing a fragmented securities market system. The objective of the exchange was to facilitate the efficient mobilisation and allocation of capital for enterprises and to promote dynamic secondary trading of securities. However, at the back of this ostensible objective was the goal of localisation of ownership of assets and businesses and also the divestment of a number of State enterprises, as part of the reform programme. The stock exchange was governed by the Securities Industry Act (SIA) which placed much emphasis on investor protection, including the requirement for indemnity insurance from member companies and disciplinary action for breach of the rules. Nevertheless, the SIA was ineffective because it sought to unify legislation for both the primary and secondary markets and also many of its provisions were not wide enough to cover eventualities as they arose. Critically, there was no securities and exchange body to oversee the fair and orderly conduct of transactions on the market.

In 1995, the SIA 1981 was replaced by the Securities Industry Act 1995 (SIA 1995). An important remedial action was the establishment of a Securities and Exchange Commission, charged with the responsibility of prudential regulation and oversight of the market to ensure fair trading and sound standards. The stock exchange bodies were set up as a self-regulatory organization with rules and regulations subject to the approval of the Exchange Commission.

The Barbados Stock Exchange was established in 1987, as a privately owned,⁵ non-profit organization. The exchange is effectively an association of member brokers who have centralised their market activity to reap scale economies and efficiency. The exchange is self-regulating which operates under the Securities Act 2001-13. The Securities Commission regulates the Barbados Stock Exchange and the Central Securities Depository.

The infrastructure of the Barbados Stock Exchange has been upgraded over time and the trading system is now fully electronic with settlement done on a T+3 basis. Settlement is done

⁵ It is interesting that the Barbados Stock Exchange was set up as a non-profit organization in the era when stock markets tend to be for profit organizations, whether they are mutual societies or private limited liability companies.

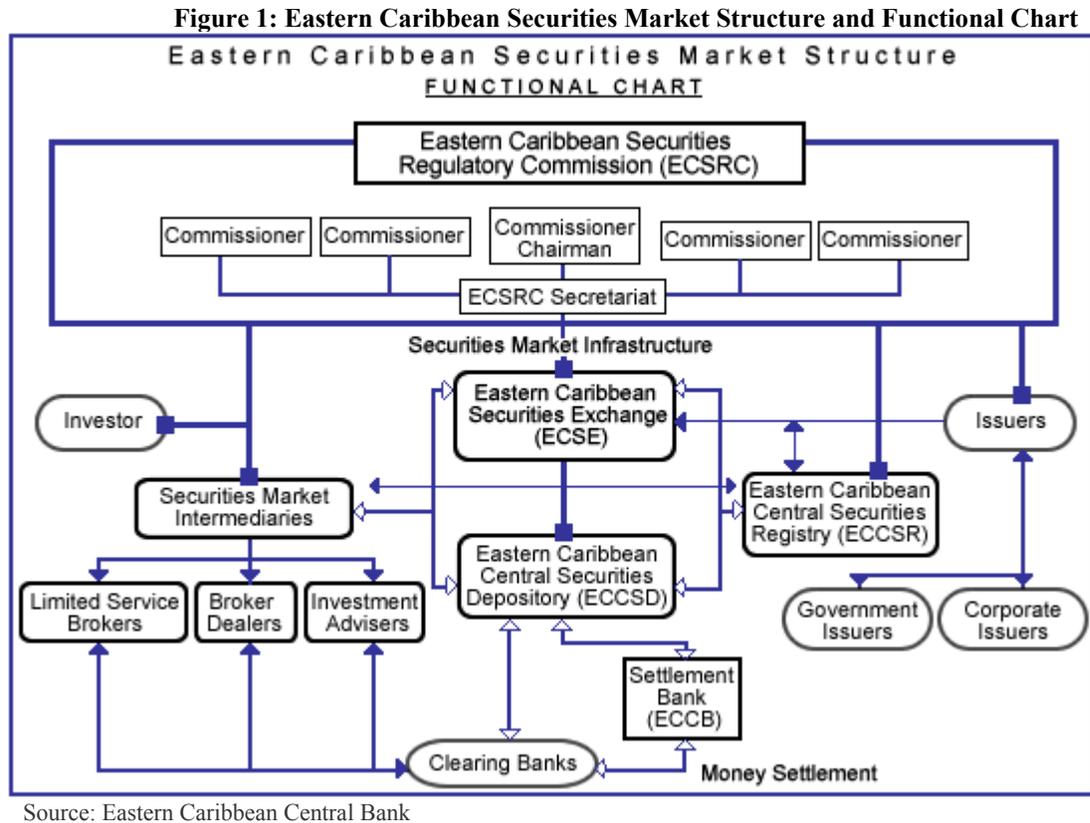
under the Real Time Gross Settlement System (RTGS) at the Central Bank of Barbados. Brokers are responsible for ensuring that customers settle their accounts on or before the settlement date.

The Bahamas International Stock Exchange Limited (BISX) was established in 1999 and started listing and trading in 2000. At present, there are 17 companies listed on the exchange, and a Mutual Fund listing facility was set up in 2001 to attract international investors to the market. The architects of the exchange envision a harmonious balance between commercial operations and prudential regulation to guarantee a profitable and resilient exchange. The exchange is incorporated as a private company owned by its shareholders, which include stockbrokers, investment companies, banks and pension funds.

At the behest of the ECCB, the OECS has undertaken an active programme of capital market development. The capital market initiative is driven by the recognition that the cost-effective and stable medium- and long-term finance is a major constraint on the growth of productive business in the region especially for SMEs and that banks, given their short-term liabilities and high risk aversion, have not been prepared to fund the very productive activity that is necessary for economic restructuring and transformation in a region most in need of it. Indeed, the development of capital markets is consistent with Article 4 clause 3 of the ECCB Agreement 1983 that is “to promote credit and exchange conditions and a sound financial structure conducive to the balanced growth and development of the economies of the territories of the participating governments”.

The capital market development programme in the OECS has been based on creating a number of institutions to fill “missing markets”. These include the inter-bank market for matching liquidity demand and supply in commercial banks. This is strictly a money market vehicle, but is an important prerequisite for capital market development. Second is the regional government securities market (RGSM).

Figure 1 below shows the Eastern Caribbean Securities Market (ECSM) structure and functional chart, underscoring the institutional and regulatory framework that has been put in place to promote the development of capital markets in the region. The regional approach taken by the currency union helps to reduce costs and duplication of functions and institutions.



B. The government securities market

It is well established that an efficient and liquid government securities market with adequate secondary trading is an important catalyst for the development of deeper and long-term capital markets. A well functioning government securities market provides the platform for developing private securities and bond markets, since it lowers the marginal cost of developing private securities markets, which can use the government market as a benchmark. Also, a deep secondary market for government securities helps in price discovery, promotes market making and provides benchmark prices for private securities.

The treasury bill market has been a key pillar of the government securities market in the region. The uptake of treasury bills by the public in most countries is quite good because they are a favourable rate of return compared with commercial bank deposits and are gilt edged.⁶

C. The bond market

A deep and liquid bond market is an important complement to stock markets in providing term finance for private enterprise development and also for public investment in infrastructure and other public goods that are growth-facilitating. Caribbean governments have long issued bonds both on the local and international markets to raise capital mainly for infrastructure

⁶ Governments cannot default on the payment of interest returns on treasury bills.

projects such as ports, airports, road construction and public housing programmes. Unfortunately, bond markets remain nascent in the Caribbean, with relatively little secondary trading. Sovereign bonds (issued by governments and parastatals) continue to dominate the market, with the corporate debt market remaining weak.

A positive development has been the move towards an auction system for issuing bonds in Jamaica, the OECS and Trinidad and Tobago. This system is more transparent and allows a better pricing to market values. Barbados, however, maintains a tendering system for the purchase of bonds on the primary market. Further, there has been some financial innovation in the bond market with some governments, for example in Jamaica, issuing Eurobonds.

One problem is the infrequent issue of bonds and narrow spectrum of maturities. This constrains the depth and liquidity in the market, making it difficult to develop a benchmark yield curve that relates interest rates to the maturity structure of different bonds.

D. The money market

Although our focus is on capital markets because of their capacity to mobilise risk and term finance for development, a dynamic and efficient money market is usual a catalyst for a sound capital market. The money market in the countries of the region consists of the market for short-term borrowing and lending to facilitate liquidity management and settlements.

III. The performance of Caribbean capital markets

Although exhibiting some variety depending on the type of market (stock, bond, government securities, etc), Caribbean capital markets have not performed well compared with their counterparts in Asia and some Latin American countries. The performance of the capital markets in the region could be assessed from two vantage points. First, these markets can be examined based on their own growth and deepening and the rate of return they provide to asset holders. On the other hand, Caribbean capital markets can be assessed based on the extent to which they mobilise and channel capital into entrepreneurial activity, infrastructure and other development projects. In a real sense, the second objective is probably much more important for a fledgling region with limited production bases, particularly in manufacturing.

A. The government securities market

1. The Treasury bill market

Although it was hoped that the government securities market in the region would provide a benchmark to catalyse the development of a deep and liquid corporate debt market this expectation has not been fulfilled. In the early post-independence period in the larger countries, governments' outward orientation meant that development projects were funded overwhelmingly by external debt. This led to limited use of the domestic market for debt financing. In the early period, external debt was preferred because it was often obtained on concessionary terms and

was therefore cheaper than domestic debt. However, in recent times, with the graduation of most Caribbean economies from the 'soft window' of the International Financial Institutions (IFIs), external debt has been obtained on more onerous terms. Moreover, financing based on external debt is fraught with exchange rate and international interest rate risks that could seriously inflate debt servicing costs over a short period of time. In fact, the debt crisis in Latin America was catapulted in part by the resurgence of international interest rates and currency depreciations relative to the major creditor nations.

An important challenge for the government securities market, particularly the market for treasury bills, is the need for the right impetus and market dynamics to promote the development of a genuine secondary market. There are a number of impediments to the development of a robust secondary market. Important among these are: a relatively weak public demand for government securities, especially treasury bills. Generally, households have shown a preference for commercial bank deposits instead of treasury bills, although the rate on treasury bills is usually higher. Apparently the requirement to tender for treasury bills deters a number of households, even though it is relatively straightforward. Moreover, banks provide a one-stop entrepot for a number of financial services, including mortgages, consumer loans and trust services and are therefore preferred overall for their bundled services, which save time.

The market also suffers from a limited number of market makers and a lack of active promotion by incumbent market makers, largely commercial banks. The development of a market for securities is a process that must be shepherded and driven by vibrant market makers who promote active buying and trading. However, in most Caribbean countries a strong 'buy and hold' culture among holders of government securities and the non-development of a yield curve could provide a benchmark to investors of the costs, returns and depth of the market.

Data limitations preclude an incisive analysis of the treasury bill market. However, the available data provide some indication of the breath, depth and performance of the market.

In the Bahamas, the amount of allotted treasury bills increased from BHS\$391 million in 1994 to BHS\$6375.1 million in 2005. This represented robust average annual growth of over 37 per cent. Moreover, the demand for treasury bills seems to have been relatively strong as evidenced by the amount applied for exceeding the amount allotted for almost the whole period. The institutional holders of capital market instruments provide some indication of the market, since some institutions are more likely to trade their instruments and provide liquidity to the market than others. For example, commercial banks tend to be more active traders than public corporations and pension funds, since the latter institutions tend to hold for the long haul, as they are not strongly driven market incentives. In the Bahamas, almost 40 per cent of treasury bills were held by public corporations, while commercial banks held over 31 per cent and the Central Bank held 28.4 per cent for monetary policy operations.

On the pricing side, the average discount rate stood at 2.45 per cent for the period 1994 to 2005. Moreover, treasury bill yields were not particularly volatile as evidenced by a standard deviation of around 1.5. It is anticipated that with further development and deepening of the market, an indicative benchmark yield curve could be developed to provide a standard bearer for assessing the relative returns on stocks, bonds and other capital market instruments.

The treasury bill market in Barbados has seen progressive growth over the years. The total treasury bills outstanding posted average growth of 5.9 per cent from 1986 to 2005, increasing from B\$422.5 million in 1986 to B\$622.7 million in 2005. Reflecting their strong presence in the market, and the limited availability of alternative financial investment instruments, commercial banks and trust companies were the overwhelming takers with 61 per cent of holdings. The National Insurance Board held almost 15 per cent of the outstanding issues. On the face of it, although this might seem a risky mismatch of assets and liabilities (i.e. short-term assets to meet long-term pension liabilities, most of these bills are probably continually rolled over and are thus de facto long-term investment instruments).

Apart from the treasury bill market, which has a fairly well developed primary market, other aspects of the money market also need to be developed. Money market instruments such as the repo market, negotiable certificates of deposits, commercial paper help to reduce liquidity risks for bondholders by providing timely injections of liquidity when required.

The primary and secondary markets for treasury bills are fairly well established in Trinidad and Tobago. However, the secondary trading of treasury bills has been declining since 1996. The sale of treasury bills has contracted from TT\$6963.8 million in 1996 to TT\$605.2 million in 2005. This probably reflects an increasing 'buy and hold' culture, where most investors hold treasury bills to maturity and roll them over.

B. The stock market

The regional stock market is seen as one of the more important pillars of the capital market development programme. This is because one of the major concerns of regional policy makers is how to increase the quantum and lower the cost of finance for enterprises to accelerate economic transformation and growth, and also how to strengthen the ownership stake of citizens in companies, while providing them with vehicles for garnering good rates of returns on their investments. The stock market is therefore viewed as the ideal vehicle to achieve these objectives.

The performance of Caribbean stock exchanges has not fulfilled the expectations of the heady days of anticipation when they were established. The sub-optimal performance based on the standard performance benchmarks reflect as much cultural and institutional factors and well as size and liquidity constraints. Although market value and market capitalisation have posted strong growth on the three major exchanges, trading remains thin, the number of companies listed continues to be a small portion of the potential companies that can be listed and SMEs are basically non-existent on the market.

With respect to the Barbados Stock Exchange (BSE), market capitalisation recorded impressive growth of 36.2 per cent between 1995 and 2004 (see table 1 below). Market capitalisation increased from B\$988.7 million in 1995 to B\$10.4 billion in 2004. This growth is in line with what is expected of small exchanges that post fairly strong growth from a low base. The number and value of shares traded has posted strong average growth over time. However, the thinness of the market is revealed by the low turnover ratio (i.e. value of shares traded/market capitalisation). The average turnover ratio of 0.06 between 1995 and 2004 indicates that value

traded only accounted for 6 per cent of the market capital, which is quite low by international standards. This low level of trading accounts in part for the low liquidity in the market and prevents the development of a dynamic secondary market in equities.

Table 1: Barbados Stock market selected statistics

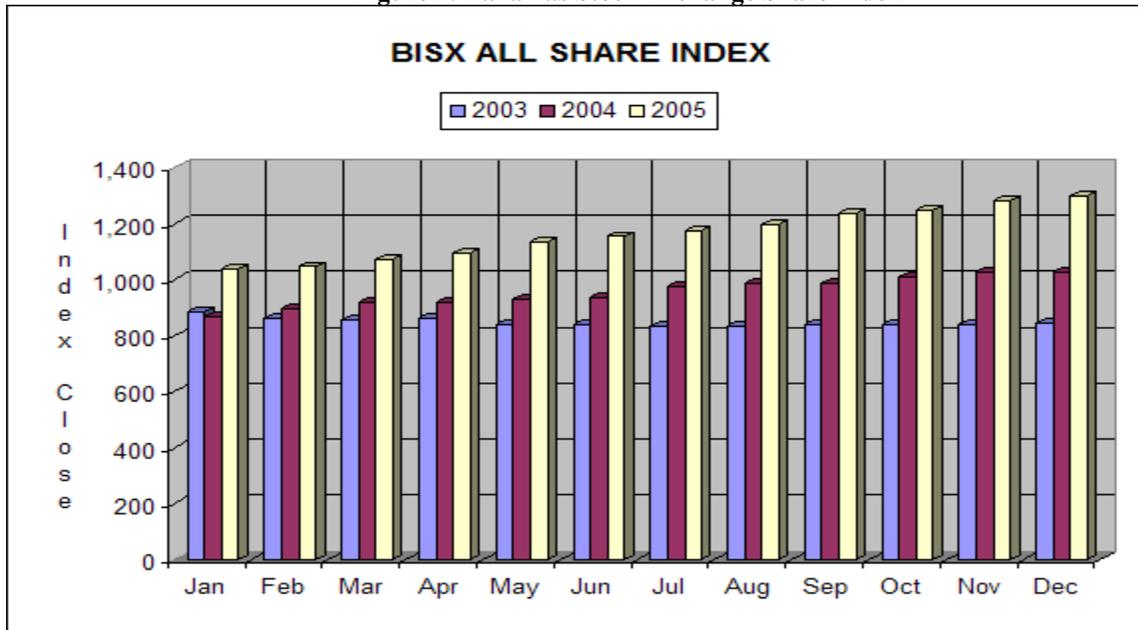
Year	No. of trading sessions	No. of shares bought/sold	Market value bought/sold	No. of transactions	Market capitalisation	Index	Turnover Ratio
		('000)	('000)		('000)	Jan. 1998=100	
1988	100	1480	4169	384
1989	100	2120	4427	421	583622	1268.75	0.01
1990	98	3775	10144	416	563131	1205.95	0.02
1991	100	7208	18273	634	616548	1205.95	0.03
1992	98	1897	4396	289	518336	1099.13	0.01
1993	99	3532	8923	500	652287	1338.58	0.01
1994	98	6417	11504	499	1035423	1395.18	0.01
1995	105	3013	6254	562	988787	1297.63	0.01
1996	102	5482	12399	603	1540132	1257.93	0.01
1997	102	17154	46594	1128	4444372	1893.45	0.01
1998	100	326775	2036759	1560	4824128	2794.41	0.42
1999	102	12402	81176	909	4015331	2560.57	0.02
2000	100	4432	13950	599	3379039	2196.13	0.00
2001	100	3781	38476	544	3652214	2107.29	0.01
2002	103	40609	187633	428	6882517	2276.12	0.03
2003	147	56648	155280	5141	7125269	2937.13	0.02
2004	149	19713	352946	6390	10407249	3711.31	0.03

Source: Barbados Stock Exchange and Central Bank of Barbados

As shown below, although the BISX is nascent and not as well known as the other three exchanges in CARICOM, the all share index, which is weighted by market capitalisation and has been increasing over time, reflecting increasing market capitalisation. By the end of 2005, the market capitalisation on the BISX had reached BH\$2.6 billion. There are 19 shares listed on the exchange, with a volume 6,723,973 traded at a value of BH\$36.34 million. Therefore, the turnover ratio was a mere 0.1, even smaller than the other markets in the region.

It is anticipated that as the BISX develops over time, market capitalisation and turnover should increase. However, as has been evidenced in the more established markets in the region, it seems difficult to grow turnover beyond a certain threshold given the institutional and trading culture. The BISX would need to try to attract some of the leading firms in principal sectors, such as tourism and financial services, to add vibrancy to the market and to raise domestic capital for projects in tourism and infrastructure, among other activities.

Figure 2: Bahamas Stock Exchange Share Index



Source: Bahamas Stock Exchange

The Eastern Caribbean Stock Exchange (ECSE) has been in operation for only five years. By mid-2006, there were nine equities, one corporate bond listed on the ECSE and 18 government securities listed on the RGSM. As table 2 below shows, by some of the standard indicators, the ECSE has registered some growth over the period of its existence. Both the volume and value traded posted strong average growth in the first few years of operation. However, in last few years, activity has tapered off, with both the volume and value traded declining by 72 per cent and almost 80 per cent, respectively, between 2004 and 2005. At the same time, the domestic market capitalisation on the ECSE had grown to US\$282.5 million. Moreover, the volatility in the market and the relatively low levels of trades indicate that there is still significant scope for further market development.

With respect to the types of equities listed on the ECSE, a notable feature is the absence of any tourism-related firm, in a region where the sector is a major contributor to GDP. The companies listed include financial institutions, utilities and trading and retailing companies. A welcomed development has been the cross-listing of two regional companies-Grace Kennedy Ltd of Jamaica and First Caribbean International Bank (Barbados) Ltd on the exchange. This has led to a sharp increase in the market capitalisation to US\$3.85 billion.

Table 2: Stock market indicators for the Eastern Caribbean Stock Exchange (ECSE)

Year	2001	2002	2003	2004	2005	2006
Number of Transactions	66	174	158	270	276	86
Volume traded	40636	1051347	1392413	1477267	409242	373392
Value traded (US\$)	79204.07	2429800	3584084	4757603	962106.3	659876.3
Trade days/ No. of trading days	47.40%	36.40%	33.50%	50.40%	53.50%	36.90%
Avg transactions per trading day	1.16	0.7	0.64	1.11	1.13	0.7
Avg volume per trading day	712.9	4256.5	5683.3	6054.4	1670.4	3060.6
Avg value Per trading day (US\$)	1389.544	9837.248	14628.91	19498.37	3926.963	5408.822
Source: Eastern Caribbean Central Bank						

The Jamaica stock exchange, the longest established exchange in the region has witnessed rapid average growth in market capitalisation over the period of its existence. For example, market capitalisation grew by over 34 per cent on average from J\$66.1 billion in 1996 to over J\$839 billion in 2005. However, the turnover ratio has remained flat on average at around 0.04, indicating very limited trade relative to market capitalisation. Therefore, the market remains relatively illiquid, in spite of its fairly long existence.

Table 3: Jamaica Stock Exchange indicators

Year	Year end Market capital	No. of listed Companies	Volume traded	Value traded	Year end JSE Index	No. of Transactions	No. of Brokers
	J\$(million)		million	J\$(million)			
1969	146.1	34	7.5	6.5	94.98	5156	7
1970	137	38	5.1	3.9	76.26	3756	6
1971	143.2	38	8.4	6.5	77.3	3779	5
1972	157.1	40	12.1	11.5	86	6259	5
1973	203.6	41	9.5	7.8	78.94	4525	5
1974	129.7	40	19.4	10.7	61.97	2679	4
1975	126.5	38	6.9	5.3	66.22	2104	4
1976	106.4	43	5.7	2.8	55.72	1170	4
1977	89.8	43	2.2	1.3	46.99	459	6
1978	93.5	40	13.8	10.1	49.28	583	6
1979	109.6	39	4.8	2.2	59.28	420	5
1980	124.1	41	7.4	5.1	69.83	502	5
1981	225.8	33	4.2	3.3	152.23	799	5
1982	316	32	5.5	10.2	211.16	1375	5
1983	359.2	32	5.2	9.8	240.38	1566	5
1984	697.7	32	9.7	26	461.1	2117	5
1985	1456.6	33	37.6	117.1	941.5	3049	6
1986	3085.8	36	59.3	374.6	1499.87	6691	8
1987	3468.7	41	71.9	400	1515.09	11187	8
1988	4290.3	44	43.5	136.7	1439.22	6446	8
1989	6228.4	44	95.2	516.5	2075.85	13892	8
1990	7321.3	44	58	230.8	2539.36	8691	9
1991	22214.7	44	144.3	1156.6	7681.5	24072	9
1992	76974.3	48	395.6	4687.3	25745.88	49791	9
1993	41879.3	48	567.5	8346.8	13099.68	55519	9
1994	58018	50	741.8	5155.5	16676.74	43144	10
1995	50755.8	51	3565.6	11560.5	14266.99	42600	10
1996	66116.3	50	560.5	4629.4	16615.99	23189	8
1997	79619.6	49	905.4	4594.4	19846.66	18623	8
1998	79038.7	48	604.5	2064.2	20593.33	13748	8
1999	104041.5	45	520.5	2218.7	21892.58	9256	6
2000	160135.7	45	694.9	3441.1	28893.24	21066	6
2001	222006.2	43	2845.2	5948.4	33835.59	20979	10
2002	292297.9	41	1604.6	7636.9	45396.21	26999	10
2003	512884.4	42	4290.4	24237.3	67586.72	35954	10
2004	879297.3	40	5194.56	35994.85	112655.5	86875	11
2005	839852.8	41	2498.03	40746.68	104510.4	75001	11

Source: Jamaica Stock Exchange

C. The bond market

Similar to stock markets, the development of a deep, liquid, efficient and active bond market is essential to providing a broad spectrum of finance for development in the Caribbean. Government bonds (sovereign issues) overwhelmingly dominate the bond market in the Caribbean. This reflects in part a historical legacy of governments going to market to raise capital for infrastructure and other development projects, and also a financial structure that is largely bank-based, where businesses tend to finance their activities largely through bank credit and internal equity.

As table 4 below shows across the region in 2005, the bond market remains relatively smaller than the stock market and bank deposits, except in Jamaica where it was larger than bank deposits. The Jamaican case reflects the active substitution of foreign debt with domestic debt and the resultant growth in the government bond market. In Barbados, the bond market accounted for 1.1 per cent of GDP relative to 5.5 per cent for the stock market and 3.4 per cent for bank deposits. Meanwhile, in Trinidad and Tobago, the stock market has posted strong growth to account for 17 per cent of GDP, surpassing bank deposits (5.5 per cent) and the bond market (4.5 per cent) combined. This is a favourable sign for enterprise financing, especially start-ups and firms undergoing transformation of their product lines to improve competitiveness. In the OECS, the cross-listing of some regional conglomerates has meant that the stock market now surpasses the banking sector and bond market in capitalisation.

Table 4: Relative Size of Caribbean Bond Markets (2005)

Country	Bond market	Stock market	Bank deposits
Barbados	1.1 (41.90)	5.5 (209.80)	3.4 (130.80)
Eastern Caribbean	0.2 (7.6)	4 (116.7)	3.2 (91.5)
Jamaica	3.9 (50.80)	13.8 (177.50)	3.7 (47.40)
Trinidad and Tobago	4.8 (47.50)	17.1 (167.60)	5.4 (52.90)
/Figures in brackets represent percentage of GDP Source: Caribbean Money Market Brokers (CMMB)			

The bond market in the region has shown a fair amount of volatility over the years as reflected by outstanding issues from year to year. Nevertheless, the market has registered robust average growth of over 127 per cent between 1999 and 2005. Jamaica had total government bonds outstanding of US\$508.3 million according to data gathered⁷. In Barbados, total

⁷ Note that the data on bonds issued and outstanding are not complete, as some placements, for example, public corporations' placements have not been captured.

government bonds issued amounted to US\$223.7 million, with issues only brought to market between 2003 and 2005. Meanwhile, in the OECS, US\$426.8 million worth of bonds were issued over the period. A few stylised patterns emerge from the data. In the first place, the total bond issues are very small, even when compared with disbursements of bank credit and stock market capitalisation. This suggests that the bond market is not providing the kind of catalytic competition that could push banks and equity markets in the direction of further efficiency and lower cost of capital for business development.

As table 5 below shows, holdings of Government of Jamaica United States dollar bonds and notes, declined from J\$99.1 billion in 2003 to J\$85.3 billion in 2005. Over the three-year period, merchant banks, trust companies and brokers combined were the dominant holders of these bonds (over 46 per cent), followed by commercial banks (26 per cent). The other holders included pension funds, individuals and buildings societies.

Table 5: Bond holdings in Jamaica by Institution

Year ending	Commercial Banks	Merchant Banks, Trust Cos. & Brokers	Insurance Companies	Superann & Pension Funds	National Insurance Fund	Other Institutions	Building Societies	Other Gov't Funds	Individuals	Total
2003	33456.96	37804.8	4620.23	5270.49	4200.94	4482.67	2616.31	726.3	3952.12	99133.82
2004	20027.83	45408.82	3702.83	5084.11	3360.05	3557.46	2701.07	400.9	4591.81	90838.88
2005	18829.2	44503.16	2831.95	4158.55	3516.53	2136.29	2467.14	612.72	4198.31	85258.85
Percentage of total										
2003	33.7	38.1	4.7	5.3	4.2	4.5	2.6	0.7	4.0	
2004	22.0	50.0	4.1	5.6	3.7	3.9	3.0	0.4	5.1	
2005	22.1	52.2	3.3	4.9	4.1	2.5	2.9	0.7	4.9	
Average % share	26.0	46.8	4.0	5.3	4.0	3.6	2.8	0.6	4.7	

Source: Bank of Jamaica

Similarly, in the OECS bonds issued amounted to US\$462.8 million, which is meagre compared with accrued external debt and bank credit. Therefore, even with the efforts to develop the regional government securities market in the OECS, the traditional preference for bank credit and external loans remains very strong. This stems in part from the limited and sporadic bond issues, which does not help in the development of a benchmark yield curve that could provide vital pricing information for investors.

D. Venture capital institutions

Firms require appropriate finance over their whole life cycle, from start-up to middle stage to maturity. Venture capital finance is well suited to financing the start-up of new firms in Greenfield projects. This is because these institutions are prepared to take the risk that the project will produce positive expected returns in the future, and so invest based on prospective cash flows rather than established financial metrics and company reputation.

As table 5 below shows, venture capital is not a well-established feature of the Caribbean financial landscape. As reflected in the limited number of firms and relatively quite small market capitalisation compared with banks, stock and bond markets, there is considerable scope for the development of a more robust venture capital sector. Market incentives and demand will have to play an important part in the development of this subsector, however, as venturing is often driven by innovative Greenfield projects that hold out good prospects of above market returns in the future.

Table 6: Venture capital in the Caribbean

Country	Firms	Capital (US\$ millions)
Barbados	3	20
Jamaica	2	60
Puerto Rico	8	n/a
St. Lucia	1	6
Trinidad and Tobago	5	20

Source: Jelle Sjoerdsma, 2004

Financial institutions, such as Development Finance Ltd (DFL) in Trinidad and Tobago, have been engaged in venturing to promote the development of SMEs. They provide equity to companies not yet listed on the stock market, and use a wide array of instruments, including venture capital, private equity funds, mezzanine investments and leveraged buyouts. Importantly, unlike traditional development banks that focus on statist objectives and projects, DFL is largely a private sector institution focused on a good mix of private motive, profit focus and development initiative.

Box 1

The Eastern Caribbean Enterprise Fund: A Novel Idea

One of the key issues that the region has had to grapple with is what balance to strike between purely market forces and government or institutional activism in creating the mechanisms and institutions required to provide the range of finance for development. This is a crucial issue, especially in small States where there are missing markets, a weak private sector and high sunk costs in setting up certain institutions.

Given the limited number of initial public offerings (IPOs) in the ECCU, the ECCB is spearheading the development of the Eastern Caribbean Enterprise Fund (ECEP). This omnibus vehicle will provide debt and equity finance, especially to Greenfield enterprises with sound business potential. In this regard, the ECEP will act as a venture capital provider with an equity input into these businesses. Therefore, it will monitor the operations and expansion of the enterprises to ensure that they follow sound business practice. Importantly, the financing would be staged according to business performance as a disciplining and prudential measure.

In addition, the ECEP will also provide export insurance services, and business advisory and consulting services. This would fill a critical gap, as many good business ideas fail to reach fruition for want of proper project planning, assessment of potential future cash flows and management training. Consequently, any assistance provided in technical, operational and managerial training could go a long way in promoting the success of businesses in the region.

Table 6 below shows that micro small- and medium-sized enterprises (MSMEs) in developing countries tend to use relatively little external equity financing compared with bank financing and informal sources, such as own funds and borrowings from friends and relatives. Also, an uncomfortably large proportion of these firms, over 50 per cent, use no form of external financing at all and this no doubts limits their growth potential and capacity to innovate and restructure to meet competitive market pressures. Indications are that the pattern is similar for Caribbean MSMEs, where internal funds and bank finance and development funds, such as export credit guarantee schemes, predominate as sources of financing. There is therefore some scope for equity financing to be provided to these firms via stock markets and also debt finance via the corporate bond market. This might require pooling of financing in these markets for a number of MSMEs to reduce the costs of issues and to reap economies of scale.

Table 7: Sources of Financing in Developing countries (Percentage)

Size	Informal Sources	Banks	Equity, Sale of Stock	Leasing, Trade Credit, Credit Card	No External Finance
Micro	16.5	8.6	8.9	8.6	57.4
Small	10.1	17	5.4	14.9	52.7
Medium	5	24.7	4.1	16.4	49.9
Large	3.8	29	5.4	16.9	44.9
Very Large	3.4	30.8	4.5	14.6	46.6

Source: R. Cull, Historical Financing of SME Enterprises, World Bank 2002-2003 survey of developing countries

IV. Impediments to the development of deep, liquid and efficient capital markets in the Caribbean

Financial systems could be viewed from different approaches that provide different information to analyse these systems. An important, though sometimes overlooked, view is the institutional one. According to Arestis and Stein,⁸ financial systems can be broken down into five institutional components:

- (a) Norms that provide rules for proper conduct and behaviour;
- (b) Incentives that focus on rewards and penalties for certain types of behaviour;
- (c) Regulations which provide legal boundaries and rules of operation;
- (d) Capacities linked to inherent capabilities of constituent organizations that enable them to achieve their goals;

⁸ See Arestis, Philip and Stein, Howard, "An Institutional Perspective to Finance and Development as an Alternative to Financial Liberalisation", *International Review of Applied Economics*, Vol. 19. No. 381-398, October, 2005.

(e) Organizations that are legally recognised financial structures that link groups of people with clear and common rules of operation.

This institutional perspective is revealing in that it underscores that financial systems operate against the backdrop of important socio-cultural norms and modes that impact on their effectiveness. However, in this paper we will focus more on financial structure which is a more traditional way of looking at financial markets.

Financial structure as it relates to the institutions and architecture, financial technology and the rules of the game that govern financial transactions and activity is important in determining the relative importance of financial intermediaries, such as banks, and direct financiers, such as capital markets. Bank-based and market-based financial structures can be found in both developed and developing economies. For example, the classic case of a bank-based economy is Japan and a classic market-based economy is the United States.

Caribbean financial systems are effectively bank-based and the predominance of banks has probably impeded the development of capital markets. This does not suggest that banks are not important for the development of capital markets. Indeed, the liquidity and settlement systems that are created by banks facilitate the evolution of markets. However, there seems to be a threshold above which banks as actors in the financial system become competitive, rather than complementary to the development of markets, and this seems to be far exceeded in highly bank-based financial systems as those in most Caribbean countries.

Apart from financial structure, a number of other factors constrain the development of deep liquid capital markets in the region. One important factor is the large number of relatively small, family-owned businesses, where there is little or no effective division of ownership and control. This type of business structure conduces to internal shareholding, the bequeathing of shares to family members and use of own funds and bank credit rather than capital market financing.

Another important factor is limited market making function and weak development of institutional investors to drive the market. In some countries, such as the OECS, market making and underwriting remain underdeveloped thereby limiting trading activity. Moreover, where banks and insurance companies are the dominant institutional investors they provide little impetus to capital market trades, as these are seen to compete with their core loan and premium investing functions.

Market regulation is another critical bottleneck in the region. Effective regulation is necessary for good corporate governance, which ensures that investors make a rate of return commensurate with the risk that they take and also to prevent market manipulation, including insider trading and other collusive practices. This guarantees fairness and transparency in the market, an important factor in boosting activity. Caribbean capital markets have securities and exchange commissions that supervise the operations of the equity and debt markets and enforce rules and regulations. One weakness, however, is the limited extent to which these regulatory systems are able to pre-empt new market developments, especially rise of universal banks that

are involved in a range of activities and financial engineering that allows creating packaging of risky instruments.

Other regulatory hurdles need to be overcome to facilitate the smooth operation of a regional capital market. With respect to the incentive framework, the varying levels and relatively high rates of corporate tax encourage companies to provide inaccurate tax information and leads to arbitrage in investing across the region.

Credit rating is a crucial factor in assessing the credit risk of government and corporations and viability of companies that are issuing capital market instruments. In a non-transparent market, low grade instruments might not be forced to pay the risk premium that they should pay to attract investors, who might not make any return on their investment. Moreover, by providing information on firms with a variety of risk profiles, credit rating agencies allow investors to hold a portfolio with varying levels of risk. This facilitates the demand for a variety of fixed income and other instruments with allows a benchmark yield curve to arise.

Market players in the region have argued in favour of a regional credit rating agency, rather than an international agency. There are indeed merits to this view, as given the size and structure of Caribbean companies, an AAA credit rated company in the Caribbean would not be the same as such a company in the United States or other Organization for Economic Cooperation and Development (OECD) member State. In addition by being domiciled in the region, a regional agency has the time and can create the institutional infrastructure to study regional companies in detail to get an understanding of off-balance sheet factors that might affect company profitability, growth and viability. CariCRIS, a regional credit rating agency, was established in Trinidad and Tobago in 2004. Similar to the regional approach to the development of capital markets, a regional credit rating agency is deemed suitable to economies that are broadly similar in size and structure. By providing benchmark assessments of sovereign and corporate credit risk, CariCRIS hopes to catalyse the development and efficiency of a regional capital market.

Although progress has been made, the capital market infrastructure in the region still needs to be finessed out.

The macroeconomic health of regional economies is crucial to the development of deep and efficient capital markets. Three planks of macroeconomic policy are particularly important for the confidence and stability required for the development of a robust regional capital market. These are fiscal prudence, inflation control and balance of payments equilibrium. A stable fiscal stance is critical as unsustainable growth in government deficits and debt can crowd out private borrowing on the debt market, leading to weak and inefficient debt markets that do not channel investments into their most productive uses. Moreover, current fiscal deficits might signal higher future taxes to households and firms which might prefer to consume now rather than save for the future when tax liabilities are imposed. This undermines the development of liquid capital markets.

Inflation acts as tax on saving and investing and reduces business optimism, leading to a dampening effect on capital markets. A high inflation environment leads market participants to

focus on the short-term, rather than longer-term contracts, which may prove costly in terms of returns due to rising prices and reduced real returns. This is the very opposite of lengthening of maturity profile of debt that is required in an underdeveloped capital market such as the Caribbean.

V. Government financing requirements, debt accumulation and their impact on the development of capital markets

We have already pointed to the role of the government securities market when properly developed to provide the benchmark yield curve and information that could catalyse the development of capital markets in general. However, at a wider level, the nature and structure of government financing requirements and debt can either catapult or impede the development of deep capital markets that can properly provide affordable finance for entrepreneurs and reasonable yields for investors.

In the 1970s and 1980s, when Caribbean governments had more liberal access to development assistance and concessionary debt, sufficient attention was not paid to the currency composition, maturity structure, servicing costs and risk profile of contracted debt. However, in more recent times as a number of countries have chalked up increasing debt, which might be unsustainable in some cases given their chronic balance of payments current account deficits, governments have been increasingly looking to the domestic market for financing.

Heavily indebted governments in the region have increasingly issued domestic bonds to finance their debt. This is part of a strategy of substituting foreign debt with domestic debt to reduce exposure to currency and international interest rate risks. This has been particularly the case for Jamaica and the OECS. Indeed regional financial conglomerates have increasingly taken up OECS government debt as they seek to diversify their portfolios. This has contributed to the development of the bond market in these States.

VI. Regionalisation of capital markets: synergy or disharmony

The free movement of capital and the right of establishment of enterprises are crucial planks of the CARICOM Single Market and Economy (CSME) integration programme. CARICOM anticipated that the free movement of capital would facilitate the transfer of money for financial settlements among member States. Consequently, most countries have eliminated exchange controls that set limits on the amount of currency that individuals can take out of their own country to engage in financial transactions in other member States. Free movement of capital would also provide individuals with the equal right to purchase stocks and shares and transfer capital across member States and also promote the diversification of investment holdings, thereby reducing the risks of portfolio concentration.

CARICOM views the regionalisation and integration of capital markets, especially stock and bond markets, as crucial to meeting the development finance needs of the region. CARICOM has embarked on a programme of integrating the stock and bond markets in the

region. With respect to the stock market, the goal is to create a dynamic, liquid market that operates under fair and transparent rules and is able to raise a large quantum of finance for businesses and households across the region.

Currently, there are only three active stock exchanges in CARICOM, that is in Barbados, Jamaica and Trinidad and Tobago. The other exchanges in the Bahamas, The Eastern Caribbean Currency Union (ECCU) and Suriname are relatively inactive. The ECCU has developed the most state-of-the-art exchange and trading system, but the small market size and risk averse investor culture has constrained activity on the exchange. Further, the high market concentration as evidenced by the predominant trading of shares of a few large and well-established firms (often conglomerates) and the small number of companies listed clearly point to the need for integration to create critical mass and economies of scale in the operation of the stock market. Moreover, regionalisation would help to reduce trading and transactions costs through the pooling of trades and the harmonisation of the trading platform.

A critical way in which regionalisation of the capital market can have a positive impact is by boosting investor confidence and expectations of improved returns. An integrated market is likely to be seen as more robust and resilient than the individual markets. Moreover, with lower transactions costs, a regional stock market should be able to offer better returns to investors. This is particularly important for pension funds and life insurance companies where households' rate of return impact directly on their quality of life during retirement or the assets bequeathed to descendents. Further, market integration can help to reduce volatility in stock and bond prices and also in rates of returns and yields. This is vital because investor confidence and willingness to invest in capital markets is directly related to the stability of major market indicators such as prices, yields and liquidity.

Moreover, a regional capital market could provide impetus for foreign direct investment, as foreign investors' confidence increase from dealing with a harmonised capital market space and a larger more liquid market.

On the empirical side, some fledgling integration has been taking place in the stock and bond markets in the region. In 1991, the BSE, the Jamaica Stock Exchange (JSE) and the Trinidad and Tobago Stock Exchange (TTSE) established an arrangement for cross-border listing and trading of stocks/shares and bonds on these markets as a precursor to further market integration. This was the first major thrust in the creation of a regional stock exchange, and was aimed at increasing cross-border movement of capital, liberating finance at lower cost and in greater quantities for firm financing and improving the investor climate in the region. The ECSE, which commenced operations in 2001, is also a part of the cross-listing and regionalisation initiative.

Cross-listing of stocks and shares in the region got off to a slow start, reflecting some caution and uncertainty on the part of investors as to the functioning of other exchanges and the security of their investments. However, with development in more recent times of truly regional firms, most of them being the larger more integrated conglomerates, there has been growth in cross-border investments and trading and this has provided impetus to cross-listing on regional

exchanges. Currently, there are only 13 cross-listed securities on the four exchanges, out of a total of 118 shares representing only 11 per cent of the total.

As has been noted, the technological architecture is not a major constraint on cross-border activity in regional stock exchanges. The technology now exists, albeit at a significant sunk cost, to integrate the different stock markets effectively. The more important constraints lie in the demand for cross-listing and further market integration, costs and institutional arrangements and regulatory arrangements.

On the demand side, cross-listing is constrained as is domestic listing by the lack of division of ownership and control in many companies. Most family-owned companies in the region are not prepared to open their companies to external part ownership through shareholding. Outside shareholding, it is believed, would dilute the command and control of existing owners. Another important factor that is hindering cross-listing for companies that are willing to do so is the relatively high cost involved.

Another important constraint on cross-border listing and trading is the use of multiple currencies, which present transactions costs and settlement risks, with exchange rate fluctuations. Compounding the currency problem is the different levels at which the takeover code is triggered in member countries. In Barbados, the take-over code is triggered at 25 per cent, while in Jamaica the benchmark is 50 per cent. Meanwhile, in Trinidad and Tobago the code is triggered at 30 per cent. Moreover, some of the exchanges, including the BSE, allow restrictions on shareholding in publicly-traded companies. Investors in the OECS have to acquire broker dealer status and their officers must have sat and passed the Eastern Caribbean Securities Regulatory Commission examination.

Lack of legal and regulatory harmonisation is a major impediment to cross-border trading. The problem is that listing, reporting and disclosure requirements vary across countries and this does not make for an integrated and transparent trading platform. Taxation and prudential regulation would need to be standardised to create a uniform trading space across the region. This would reduce arbitrage among markets due to varying incentives and transactions costs.

A. Internationalisation of capital markets

Caribbean capital markets should not try to isolate themselves from international markets, but should seek to benefit from linkages with major markets. Some degree of integration into major markets could help to increase domestic market liquidity, providing more and cheaper finance for domestic firms. This is because the cost of finance on the international market is often cheaper than on the domestic market. Further, internationalisation allows diversification of country-specific risk, which makes for more stable returns over time. This is important in the Caribbean, where many countries are prone to disasters and economic shocks.

Importantly, international linkages could provide an avenue for boosting FDI in plant, factories and other productive capacity in both the domestic and export markets. A well regulated, open and internationally-linked capital market stimulates confidence in foreign

investors who are then more likely to undertake FDI in the region. FDI is also important since it adds directly to productive capacity and job creation. Indeed, the composition of flows is important for the region, as it needs to control inflows of short-term, speculative flows or ‘hot money’ that tends to flow out of countries at the earliest signs of economic difficulty or just on the impulse of herd behaviour. In fact, as was indicated for some countries during the Asian crisis in the 1997, these reverse flows might not be related to economic fundamentals as such, but pure contagion effects.

B. Remittances: a force for development

With migration a long-established and important part of the Caribbean social scene, remittances have come to play an important role as a source of receipts and spending in a number of economies. However, for the most part, remittances have been used to smooth consumption over time in order to maintain the welfare and living standards of recipients. It has been noted that in some countries, it is actually more beneficial for a recipient to stay at home and collect remittances than to enter the job market given the low wages for unskilled work and the relatively high cost of living. In a number of countries, including El Salvador and Jordan, they account for more than 10 per cent of GDP.⁹

Underscoring the potential of remittances, it has been noted that after FDI and receipts from trade, remittances are third largest financial flows to developing countries, far surpassing official development assistance.

Caribbean policy makers have long grappled with how to convert remittances from a short-term poverty alleviation instrument to a long-term sustainable development vehicle. This is akin to teaching the recipient to “fish for himself, rather than repeatedly giving him a fish when he is in need”.

VII. Recommendations and the way forward

There is a clear rationale for the development and integration of capital markets in the region. Indeed, this is an important plank of the free movement of capital under the CSME. The critical issue is how to tackle the bottlenecks whether from the demand, supply and institutional sides that currently impede the development, efficiency and effectiveness of these markets.

Although the size of the economies in terms of population, per capita incomes and firm size and activity imposes a constraint on size of capital markets, there is still much scope for the further development of these markets. On the demand side, measures should be taken to boost investor preference for stocks, bonds, venture capital and other capital market instruments. One means of doing this is to provide incentives for emergence of more institutional investors and to strengthen the prudential standards for their operations. The main institutional investors are insurance companies, pension funds, mutual funds. With respect to pension funds, including a private pillar where contributors can invest their funds in the capital market could provide

⁹ See O’Neil, Kevin, “Using Remittances and Circular Migration to Drive Development”, Migration Policy Institute, 2003.

significant impetus to the development of capital markets in the region. Moreover, with prudential management of these markets, contributors should be able to earn better long-term rates of return, enabling them to enjoy an improved standard of living in retirement than currently exists with the pay-as you-go pension systems. Walker and Lefort¹⁰ have suggested three ways in which pension reform could support capital market development: accumulation of ‘institutional capital’ that may go untapped, increased specialisation in investment decision-making and improved incentives for financial innovation and creation of new products. These are critical areas that can help to drive the development of these markets in the Caribbean.

Even without full pension reform, pension systems should be allowed greater latitude to invest in securities provided prudential guidelines are followed. Currently, in the OECS, Barbados and Trinidad and Tobago, pension funds face restrictions in investing in securities. These restrictions should be removed to encourage such investments. Given the regional approach to pension and social security matters, including the portability of pensions, there is a clear case for a regional approach in dealing with optimisation of the returns from pension funds, especially through investment in a regional stock market vehicle that could raise funds for productive investment and provide good returns for pensioners.

As the Caribbean population ages, robust and dynamic capital markets will be even more required to drive business productivity and competitiveness and to provide adequate rates of return on pension funds and other institutional financial investments.

Although there are a fair number of players, the insurance market in the Caribbean remains underdeveloped. In the first place, the sector needs to be better regulated to boost consumer confidence in it. Also, educational awareness is required to inform the public of the importance of insurance as a security and risk mitigation measure. An important insurance pillar that is required and could contribute to the development of regional capital markets is catastrophe insurance to cover for disasters such as hurricanes floods, industrial accidents. Given the increasing costs of insurance as a result of the spate of hurricanes and floods in the last decade and half, such a facility, through risk pooling, could allow the region to acquire insurance at a lower cost and at the same time contribute to a deeper and more liquid bond market.

Listing and trading costs and requirements are important impediments to the demand for stocks and bonds, especially by smaller family-owned businesses. Regional exchanges need to streamline their operations to reduce operations costs and thereby reduce the costs of listing and trading. Importantly, the creation of a fully integrated regional capital market and the increasing cross-border flows of capital, mergers and acquisitions and competition should provide greater incentive for family-owned firms to open up and adopt a better mix of equity capital and debt in their financing portfolios. This is critical for these firms to keep ahead of the curve in innovating and strengthening their competitiveness to face more intense international competition. Indeed, education and awareness building is required to encourage small family-owned companies to be willing to explore the full potential for growth as many them seem to be ‘satisficing’ at sub-optimal size and scales of operation.

¹⁰ See Walker, E, and Lefort, F (2002), “Pension Reform and Capital Markets: Are There Any (Hard) Links? Social Protection Discussion Paper 24082, World Bank.

Another important bottleneck that has to be overcome is the limited product offering on capital markets in the region. Overall the product offerings on the individual markets in the region are narrow compared with capital markets in advanced countries. However, more important is the variation in product offerings on the different regional exchanges. Whereas the exchanges in Jamaica and Trinidad and Tobago offer a number of instruments, including commercial paper, stocks/shares, bonds, employee stock options, in the OECS and Barbados the product offerings are more limited. There is a need for a degree of harmonisation in product offerings with the development of a regional exchange to reduce arbitrage across countries.

On the supply side, privatisation of more public enterprises that clearly do not meet the market failure and public good criteria could help to bolster market capitalisation and trade. Privatisation and deregulation provided initial impetus to stock and bond markets in the region, when a number of formerly public companies were privatised and listed on the stock exchanges. In all of the countries, however, a number of public companies remain that might be made more efficient and profitable if they operate as private entities. These companies should be privatised and opened up for shareholding by the public to deepen the capital markets in member countries. Of course, this should be handled carefully, because simply operating as a private entity is no guarantee of the profitability and competitiveness of a company.

Linkages with the international market also hold the prospect for increasing the supply of companies and instruments to invest in. The Caribbean capital market should seek out active linkages with other markets (stock, bond, venture capital, etc.) in other countries on favourable terms to increase the range of offerings and to benefit from the 'reputational' capital of well established exchanges, such as the New York Stock Exchange and the London Stock Exchange.

On the macroeconomic front, Caribbean policy makers should be careful to maintain macroeconomic stability, where they have achieved this, and to deal with pockets of instability, where they exist. Particularly, inflation and unsustainable fiscal stances are inimical to the development of capital markets as they tax future transactions and cause investors to operate over a short time horizon. This prevents the elongation of maturity profiles of debt instruments and weak secondary trading of stocks. Strategies should focus on containing the growth of debt in the OECS, debt sustainability in Jamaica and inflation in Trinidad and Tobago, for example.

With respect to market infrastructure and institutional arrangements, there is still much that needs to be done to promote a harmonised market across the region. In the first place, an integrated harmonised regulatory framework should be put in place. This framework should focus on a balance between self regulation and external regulation. The regulatory rules should be clear and relatively easy to implement and should not allow for regulatory arbitrage across countries. Institutional investors, dealers and market makers should be co-opted to help in self regulation and regulatory oversight.

Moreover, accounting and audit systems need to move towards a risk-based approach and away from a transactions balance approach to examine the levels of risk in a given portfolio. Indeed, the risk-based approach is now the focus of Basel II with respect to banking sector regulation.

The regulatory framework must have built-in flexibility to deal with financial innovation and new and more risky instruments that might be brought to market by, for example, hedge funds and certain derivatives. However, regulation should not stifle market development by viewing new products as an inherent risk in and of themselves. The enforcement of insider trading laws, for example, sends a clear signal of the authorities' intention to protect investors. Bhattacharya and Daouk¹¹ find that the cost of equity capital decreases significantly after the first prosecution under insider trading regulation.

The technical staff of the Caribbean Court of Justice (CCJ) should be strengthened to deal with dispute settlement and arbitration in matters of dispute between parties dealing on the regional capital market.

As the Caribbean population ages, robust and dynamic capital markets will be even more required to drive business productivity and competitiveness and to provide adequate rates of return on pension funds and other institutional financial investments. Pension reform has facilitated the development of capital markets in countries such as Chile. Although a fully funded system might not be well suited to the Caribbean, including a funded pillar that allows investment in capital market instruments could both promote market development and provide better rates of returns for contributors.

VIII. Conclusion

As the Caribbean attempts to integrate effectively in the global economy, development finance is seen as key to building competitive enterprises, infrastructure and institutions to fast forward this process. Although the region has long been a bank-based financial area, banks are not well positioned to provide the long-term financing that is required for development because of their liability structure, prudential regulation and a culture of risk aversion. Capital markets are much better placed to raise the long-term capital that could finance productive investment in tourism, agriculture and information services, among other areas, to galvanise production and exports from the region. Importantly, equity markets by entrenching division of ownership and control and facilitating changes in ownership of enterprises can make it easier to restructure these enterprises to make them competitive. This is very relevant for family-owned businesses in the region, which are often unwilling to innovate or grow beyond a minimum size and profitability.

Caribbean governments in the post-independence period recognised the need for capital markets as a second pillar of financing. Therefore stock markets have been established in the larger countries for some time now. In addition, governments have increasingly raised capital for infrastructure and other projects from bond issues. Nevertheless, these markets have not matched expectations in terms of the quantum of finance raised and the level of activity in the markets. Moreover, an active secondary market is yet to be developed in the region that could provide finance for major enterprise restructuring and investment in large projects such as in oil and gas. Importantly, the expectation that capital markets would help to ameliorate the financial constraint of SMEs has not materialised.

¹¹ See Bhattacharya, U. and Daouk, H (2002), "The World Price of Insider Trading", *Journal of Finance*, 57:1, pp.75-108.

Therefore, under the auspices of the CSME, CARICOM has been promoting a regional approach to market development, particularly for the stock and bond markets. Regionalisation would unlock economies of scale, strengthen market competition and efficiency and provide a fairly uniform platform for regulation and prudential oversight of capital markets. Moreover capital market integration would complement the growth in intraregional mergers and acquisitions, as firms consolidate to achieve minimum efficient scales to confront international competition. Indeed, consolidated firms should be encouraged to list on the regional stock exchanges to provide citizens with an opportunity to partake in shareholding in these companies.

In spite of some progress, much remains to be done to develop and fully integrate the capital market in the Caribbean. To unlock demand for capital market finance, the macroeconomic and incentive framework must stimulate entrepreneurship and the growth and restructuring of enterprises. This would require pro-market activist policies, with the emphasis both on market forces and State prodding. In addition, SMEs must be encouraged and provided with incentives to open up their firms to new investors and ideas that could foster innovation and firm growth and competitiveness. Mechanisms for a group of SMEs combining to access a pool of capital market finance to reduce costs and increase the uptake should be considered.

Generally, the region has made some positive steps to develop its capital market to provide term financing for firms and governments. However, much remains to be done to strengthen the technical, institutional and regulatory systems to realise the goal of a reasonably integrated and liquid market that could provide capital in sufficient quantity and at lower cost. The pace of reform and strengthening of the systems required to achieve this need to be quickened.

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