

REPORT OF THE SEMINAR ON

THE GLOBAL FINANCIAL CRISIS AND THE CARIBBEAN: IMPACT AND RESPONSE

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Introduction

The seminar, *Global Financial Crisis and the Caribbean: Impact and Response*, took place against the background of the challenge emerging from the ongoing global financial and economic crisis. It was intended to provide a better understanding of this crisis and recommend possible ways in which the Caribbean Development Bank (CDB) and other stakeholders could be of assistance to the Region in dealing with this issue.

Mr. Desmond Brunton, Vice President, Operations, CDB welcomed participants comprising members of the private and public sectors; the diplomatic community; staff of international financial institutions; and directors and staff of CDB. He noted the historic nature of the financial crisis, and emphasised the need for a regional response.

Dr. Compton Bourne, President, CDB in his feature address, sketched the broad outlines of the crisis and its impact on the Caribbean. He noted the increasing concern over the effects of a potentially long and deep economic downturn on the Caribbean. He made reference to the lack of confidence in the financial sector abroad; the closure of bank and non-bank institutions; the reduced access to credit; the instability in equity markets; the substantial injection of liquidity into banks; and the decline in economic activity within the United States, and other developed countries in the latter half of 2008.

Dr. Bourne pointed to several concerns in the Caribbean such as, the possible exposure of the regional financial sector to the crisis. He indicated, however, that while the regional financial sector might be sufficiently delinked from the international financial sector, concerns linger with respect to the possible impact on mutual funds which he defined as an area of risk. Other concerns noted were the negative effects of the crisis on the export of goods and services; on real income growth and on remittances. The decline in the latter will likely influence the domestic asset portfolios of banks. With respect to capital inflows, he expressed concern over the widening of sovereign spreads due to higher risk premia and the possible decline in foreign direct investment (FDI) inflows. Reduced FDI inflows can have a significant impact on construction, which is a major contributor to real income growth in many countries.

Particular attention was paid to the potential impact on tourism, the Region's main export industry. Dr. Bourne outlined the reasons for his deepened concern for the industry in the current crisis, citing in particular the substantial decline in household wealth due to the fall in real estate and equity prices, together with the massive squeeze on consumer credit within the United States (US) and the United Kingdom (UK). He also cautioned that the banking industry in several Caribbean countries may be over-exposed in the real estate sector, given the likely over-extension of credit to the sector over the last decade. He warned that this could pose substantial difficulties to the banking industry if the current crisis significantly impacts employment and incomes. Dr. Bourne concluded by offering a few policy suggestions to the new players – Government, businesses and households. He advised Governments to identify the components of their expenditure budgets susceptible to reduction with least disruptive effects on their capital investment programmes and on the scope and depth of their social safety nets.

For business enterprises, the lines of adjustment are somewhat varied. Debt management may be generally necessary, especially to control interest costs. Some squeeze on profit margins may also have to be accepted in an effort to maintain sales at a level sufficient to cover operating costs. Intelligent product pricing, rather than profit maximising behaviour, might be the appropriate main in depressed markets for goods and services. Commercial banks and other financial enterprises would be wise to increase their provisions for loan losses and to investigate the scope for loan restructuring.

Households also have to engage in precautionary behaviour, adjusting their expenditures to a higher level of income uncertainty and restructuring their asset and liability portfolios, particularly through stricter control on consumer debt.

A. The Likely Impact of the Global Financial Crisis

In the first session, following the opening ceremony chaired by Dr. Denny Lewis- Bynoe, Director, Economics Department, CDB, Mr. Marcello Estevao, Deputy Division Chief, International Monetary Fund (IMF), made a presentation on the global economic outlook. Mr. Trevor Alleyne, Division Chief, IMF, presented his views of the impact of the crisis on the financial and real sectors. This was followed by presentations on specific sectors by four panellists: (i) Mr. Kelvin Dalrymple, Chief Research Economist, CDB, on tourism; (ii) Dr. Garth Nicholls, Senior Director, Research Department, Eastern Caribbean Central Bank (ECCB) on banking; (iii) Mr. John Howard, First Vice President, Barbados International Business Association (BIBA) on offshore finance; and (iv) Mr. Ehurd Cunningham, Secretary for Revenues, Ministry of Finance, The Bahamas, on the overall economic activity.

(i) Economic Forecasts

Mr. Marcello Estevao, Deputy Division Chief, IMF presented forecasts of the global and regional economies. His message was that the global economic downturn is about to deepen substantially. He indicated that economic activity in the developed countries and in emerging market economies will decelerate markedly and that the global economy is facing a U-shaped recession. In other words, the upturn is likely to be slow. In all countries and regions, a substantial deceleration in growth is being projected for 2009. Mr. Estevao noted, however, that some of these forecasts will be revised further downwards. On a more positive note, inflation is subsiding. However, there are now risks of deflation.

According to Mr. Estevao, the protracted deleveraging of financial institutions (FIs) and continuing squeeze on credit was suspected to deepen the recession which are generally longer when accompanied by financial sector crises. He predicted that financial conditions will generate a protracted contraction in economic activities in the US and indicated that past experience with housing busts also pointed to a slow recovery. Another complicating and contributory factor to the length and depth of the economic decline and the slow recovery, is the substantial deceleration in household net worth. Overall, Mr. Estevao noted that the recession, while severe, is not likely to be as bad as that of 1982. He concluded with two observations: (i) that while emerging market economies have not decoupled from the developed economies, they are still a source of resilience; and (ii) there is need for a comprehensive, coordinated policy response in order to mitigate potential outcomes of the crisis.

(ii) Financial Portfolio Effects

Mr. Trevor Alleyne in his presentation, "The Global Financial Crisis – Implications for the Caribbean", detailed the transmission channels of the crisis via the financial sector and the real economy. In the case of the financial sector, he noted that there would likely be some deterioration in asset quality through the depreciation of foreign investments of banks and non-banks (securities firms, insurance companies, pension funds). He noted also that regional FIs may face liquidity problems through lack of access to liquid assets which may be tied up in problem institutions. This is a distinct danger posed, for example, by correspondent banks. Also, the global credit freeze would likely impact negatively on domestic liquidity and result in an increase in interest rates. With respect to foreign capital inflows, the expectation is one of increased sovereign spreads and rollover risks.

As regards the Region's financial system, Mr. Alleyne noted that an often mentioned source of stability is foreign ownership (approximately 50% of regional banks are foreign-owned) and particularly, ownership by Canadian banks. [Banks in the Organisation of Eastern Caribbean States (OECS) are mainly Canadian-owned and indigenous]. It was pointed out, however, that foreign ownership in the current crisis can also be a source of vulnerability, that the status of foreign banks can change dramatically within a short period of time. For example, recent information indicates some weakening in performance in the Canadian banking industry. However, the industry is well capitalised and, relative to banks in the US, for example, continues to perform well.

Dr. Garth Nicholls expressed concerns about the impact on deposit growth as a result of the weakening in economic activity; declines in remittances; export revenues; and foreign capital inflows, especially related to the tourism industry. It should be noted, however, that deposit growth may also be affected by the decline in inflows of official development assistance, as donor governments steel themselves for the economic downturn and engage in fiscal and other policies to mitigate its worst effects.

Dr. Nicholls noted that, with credit growth in the Caribbean financial sector closely tied to deposit growth, expectations are that there will be a tightening in financial sector credit both in terms of volume and in the terms and conditions. In addition, the expectation is that the head offices of foreign banks operating in the Region, because of reduced access to funds abroad, are likely to instruct moderation in lending. On the demand side also, there is likely to be some moderation by the private sector as a result of the decline in economic activity. According to Dr. Nicholls, the abovementioned impacts on the credit market are already visible in the OECS. Also, while evidence to this effect is not yet available, expectations are that revenue growth in the financial sector will likely be impacted by the economic downturn as unemployment increases. Additionally, the level of non-performing loans (NPLs) is likely to rise. The increase in NPLs may emerge not only from the private but also from the public sector in the face of fiscal deterioration. Mr. Ehurd Cunningham reported that in The Bahamas, there is already some indication of a rise in NPLs. However, he noted that it is too early to say with certainty whether this will be a major problem.

Some apprehension was expressed with respect to the impact of the crisis on the non-bank financial sector (mutual funds; insurance companies; pension funds etc.) which is generally not as well monitored as the banks, and is therefore potentially a greater source of risk to the financial system, hence the need for increased vigilance. In fact, it was pointed out that the problems in the financial sector abroad emanated mainly from the non-bank sector.

Overall, the general agreement was that while the Region's financial sector, to date, seems to have remained largely untouched by the financial crisis abroad, the sector is still vulnerable. There is need for continued vigilance and where necessary, pre-emptive action.

(iii) Impacts on Fiscal Position

The impacts of the crisis on fiscal positions of governments within the Region are already evident. Mr. Cunningham indicated that in The Bahamas, the projection is for a decline in revenues of some 10% as a result of the decline in tourist arrivals, increased unemployment and under-employment. Mr. Arthur Been, Under Secretary, Government of the Turks and Caicos Islands, reported that TCI, which was already in substantial fiscal difficulty prior to the crisis, is projecting a significant decline in revenues. The Ministry of Finance is projecting that revenues for the current fiscal year will decline to US\$205 million (mn) from US\$239 mn, a drop of approximately 14%. In order to address the fiscal crisis, the government is cutting back on its capital programme, and has indicated that there will be no additional projects in the next fiscal year. The government intends to cut significantly its expenditure over the next two years, and will also be instituting new revenue measures. A similar concern with respect to the likely decline in revenues was expressed by Mr. John Howard, First Vice-President, BIBA. He noted that the offshore financial sector provides

close to BD\$270 mn annually in revenues to the Barbados government. Current expectations are that there will be a decline in revenue from the sector as a result of the global economic downturn. Similarly, Mrs. Janet Harris, Financial Secretary of St. Kitts and Nevis, reported a drop in imports and in border taxes. The issues regionally, however, are: (i) how steep will be the decline in revenues? (ii) what are the implications for the provision of government services? (iii) what will be the likely impact on the size of the fiscal deficit? and (iv) how is the latter to be financed in the context of the tightening of credit markets?

The drop in revenues is occurring at a time when governments in the Region are likely to be called upon to increase expenditure so as to alleviate the worst effects of the crisis on the poor. This was an issue raised by several panellists. There seemed to be general agreement that the poor should be helped in this crisis. However, Mr Andrew Powell, Regional Economic Advisor, Inter-Development Bank (IDB) emphasised the need for targeting and thereby enhanced efficiency in the use of funds. In fact, in response to the crisis, he advocated an improvement in the overall quality of government expenditure through public sector information systems; performance management indicators; and evaluation systems. There was some concern also, that governments may be approached to give substantial subventions to industries under stress, such as, for example, the tourism industry.

Mr. Cunningham reported that, to sustain employment in the short to medium term and to provide some support to lower income groups, The Bahamas was expanding its capital programme (new international airport; office complexes; new schools; new sports centre; new magistrate and supreme courts etc.). The Bahamian Government is also increasing the level of transfers (rent and utilities assistance; repair to senior citizens' homes; and mortgage relief programme (under consideration). This is possible within the Bahamian context because of the relatively low public sector debt, estimated at approximately 35% of Gross Domestic Product (GDP). Mr. Cunningham reported that The Bahamas government intends to use the National Insurance Board and the domestic financial sector to finance its expanded programme. In those countries with considerable liquidity in the banking system, this provides some relief, within limits, from the credit crunch abroad.

(iv) Impact on the External Sector

There was general agreement that the impact of the crisis on the external sector (tourism, offshore finance, commodity exports) would be negative. In addition to the impact of a decline in global economic activity, the reduced availability of trade financing has become an additional constraint to trade.

The Bahamas, with a significantly higher dependence on the US tourism market seems to be much more vulnerable than the Jamaican or the Barbadian tourism industry. Other destinations showing some deceleration in arrivals growth include Barbados, St. Lucia, and Puerto Rico. As a result, as reported by Mr. Kelvin Dalrymple, some discounting in the industry is taking place as a means of maintaining occupancy levels. He also reported that some hotels were attempting to compensate for the decline in arrivals with home vacationers. Other strategies currently in use to address the crisis include the laying off of workers, and/or a decline in working hours. In some cases, the opportunity is being used to embark on training.

Mr. Cunningham indicated that, with respect to the construction of new tourism plant, there has been some slowing down in project implementation in The Bahamas. There has also been some slowing in the second home market because of difficulties in accessing finance abroad. He reported, however, that in the case of the cruiseship subsector, arrivals in the Bahamas were relatively stable.

While significant attention was paid to the impact on exports, less attention was paid to imports where the impact is likely to be positive with the decline in import prices and particularly, the price of food and fuel imports. Also, growth in import expenditure will likely decelerate with the

slow down in private and public expenditure and also the difficulties in accessing import credit. The net effect on the trade balances in the Region is largely unknown at the moment.

With respect to remittances, the consensus was that the impact would most likely be negative. However, there was some disagreement as to the size of the likely impact, given the resilience of inflows in past crises. Also, it was pointed out that Caribbean emigrants, because of high skills levels, are less likely to be unemployed in this crisis, as opposed to their Latin American counterparts.

Much emphasis was placed on the significantly reduced access to international credit markets within the context of a potential widening of the current account deficits in the balance of payments. As noted by Mr. Alleyne, this has implications for debt repayment and for reserve holdings in the Caribbean. For example, the inability to roll over credit would most likely mean either a rescheduling of external loans, defaulting on repayments or a decline in reserves. Those economies with substantial reserves are in a better position to withstand the external shocks. Those without an adequate reserve cushion are very vulnerable. In this regard, Dr. Maurice Odle, Advisor, Secretary General, CARICOM Secretariat raised the issue of the possible establishment of a Caribbean reserve pool. Reserve pooling is one of the objectives of the Single Economy and is one of the strategies for making the Region more resilient in the face of external shocks. He reminded conference participants that in 2002, there was a proposal to establish a Regional Stabilisation Fund (RSF) using 1% of reserves and he noted that regional reserves currently are estimated at US\$21 billion (bn). Dr. Kevin Greenidge, Deputy Director, CBB, recommended some form of reserve pooling, or reserve swaps.

Given its reserve pool, the OECS is better placed to face the crisis than many other Caribbean countries with the exception perhaps of Trinidad, which has a substantial accumulation of reserves. The ECCB Central Bank Governor, Sir Dwight Venner, reported that in the OECS reserves currently are equivalent to between five and six months of import cover. Given the excessive volatility in the current international economic environment, it is impossible to know what is an adequate level of reserves. It is possible that several countries may need to access IMF or other International Financial Institutions (IFI) assistance to shore up their reserves, if the economic downturn is as deep and prolonged as suggested by the IMF forecasts. There is also need for careful reserve management.

A related issue is that of the stability of exchange rates in the Region, most of which are tied to the US dollar. Mr. Robert LeHunte, Managing Director, Barbados National Bank, expressed concern about the stability of the US dollar, given the rapid accumulation of debt arising from the substantial fiscal bailout and fiscal stimulus packages by the US government. In response, Mr. Estevao noted that there was no need to be overly concerned about the stability of the US dollar, given the willingness of the rest of the world to lend to the US. However, the willingness to hold US dollars may wane if the crisis is prolonged and the US continues to pursue an aggressive fiscal stance in order to sustain economic activity. A significantly weakened US dollar could potentially force the Caribbean to rethink its exchange rate regime.

(v) Real Income Growth and Employment

As indicated by both Mr. Alleyne and Mr. Estevao, there was expected to be a decline in real income growth in the Caribbean as a result of the crisis. In fact, the recent decline in export performance and in revenue intake in several Caribbean countries indicated clearly that the weakening in real sector activity had begun. However, the duration and severity of the downturn are not known. Recent data on major economic indicators (real income growth, unemployment, manufacturing sector performance, consumer purchase, housing prices etc.) from the developed countries (US, United Kingdom, European Union, Japan) indicate a substantial weakening in economic activity in the third and fourth quarters of 2008. The hope is that the resilience in economic activity in emerging economies will help to compensate somewhat for the economic decline in the developed economies.

Current IMF projections are for economic growth of 2 to 3% in the Latin American and Caribbean Region stemming from the continuing growth in China.

The downturn in economic activity is already impacting employment levels. This is most evident in, for example, the tourism industry. The expectation is also that there will be increased unemployment in the construction sector as a result of slowdown or cancelation of projects in both the private and public sectors. Unemployment in other sectors will undoubtedly increase, particularly if the downturn in economic activity is prolonged.

B. Policy Considerations in the Short and Medium Term

Presentations in this session were made by Mr. Andrew Powell, Regional Economic Advisor, Caribbean Department, IDB (Short and Immediate Response: What is the space for counter-cyclical policy?) and Mr. Eric Vincent Guichard, Chief Executive Officer, GRAVITAS (Medium-Term Issues: Implications for the Financial Regulatory Environment). Sir Dwight Venner, Governor, ECCB chaired this session. This was followed by a panel discussion on the question “What has been and should be the Nature of the Response by Countries?” Panellists were Sir Dwight Venner, Governor, ECCB; Dr. Kevin Greenidge, Deputy Director, Economic Modelling, Central Bank of Barbados; Mr. Ehurd Cunningham, Secretary for Revenues, Government of the Bahamas; Mrs. Janet Harris, Financial Secretary, Government of St. Kitts and Nevis; and Mr. Arthur Been, Under Secretary, Government of the Turks and Caicos Islands. Mr. Rodinald Soomer, Head, Macroeconomic and Sectoral Policy Unit, Economic Affairs Division, OECS moderated the session.

The issue of counter-cyclical policy was very much a part of the discussion and was addressed by Mr. Powell and Dr. Greenidge. Mr. Powell intimated that in some cases, countercyclical fiscal policy will be very difficult, given the high level of public sector debt. Notable examples in this regard are Jamaica, Grenada, and St. Kitts and Nevis, with public sector debt-to-GDP ratios of more than 100%. However, there are also other countries in the Region in which the debt-to-GDP ratio, while lower, is still quite high. These include Barbados; St. Vincent; St. Lucia; Guyana; and Belize. Mr. Powell emphasised that even in the case of countries such as The Bahamas, with relatively greater fiscal space, the use of expansionary fiscal policy may be constrained by limited access to finance in the current environment and also by the inadequacy of international reserves. This has implications for the sustainability of exchange rates. He cautioned that trying to be a lender of last resort without access to adequate reserves or credit, can lead to monetary and fiscal instability. He emphasised the importance of “systemic liquidity” in the current circumstances. The latter can be maintained through an adequacy of international reserves; the availability of assets which can be swapped for hard currency and access to finance from IFIs. He also emphasised the important role played by vigilance in the management of critical institutions, those deemed systemic, in order to maintain confidence.

Dr. Greenidge indicated that fiscal policy should play a central role in sustaining output in developing countries given: (i) the already low interest rates in some developing countries; and (ii) the limited effectiveness of monetary policy in the context of fixed exchange rate regimes. Like Mr. Powell, he emphasised the need to maintain international liquidity. He supported the introduction of swap lines as in developed countries and consideration of regional pooling of international reserves.

A major portion of the policy discussion centred on financial sector reform. An important part of the discussion, spearheaded by Mr. Guichard, was the issue of regulatory reform. The need for greater regulatory reform was generally accepted. However, the focus of the reform and the appropriate institutional infrastructure needed to enact the reform was the subject of debate. Mr. Guichard argued that regulatory reform should be based more on an appropriate incentive infrastructure, rather than a set of sanctions. Sir Dwight Venner, however, emphasised the need for both. Also emphasised was the need for greater private sector cooperation in the management of the sector.

Another aspect of the discussion focused on innovation. It was evident that there was a tension between innovation and regulation which needed to be resolved appropriately in order to maintain a dynamic but stable financial sector. Mr. Guichard warned about using regulation to stifle innovation, which he argued was not the cause of the current crisis.

The role of the Caribbean Single Market and Economy (CSME) in financial sector regulation was also an important part of the discussion on the financial sector. Several participants suggested the need for harmonisation regulatory systems of the regional financial sector. This is consistent with current initiatives of the CSME. Another suggestion made was that there should be a single financial act governing the Region's financial sector to obviate the potential for regulatory arbitrage. It was acknowledged that a single financial act may also have the disadvantage of facilitating the spread of contagion.

The possibility of an increase in deposit insurance in the financial sector was also raised, but not substantially discussed. It was mentioned that the issue of the adequacy of deposit insurance was very much a part of the initial discussion of the current crisis in the developed countries. Several countries increased their deposit insurance in order to help stabilise the financial sector. In the Caribbean only a handful of countries have deposit insurance schemes.

C. The Policy Response of the International Financial Institutions

This set of policy discussions focused on policy initiatives by CDB and the other FIs to help the Caribbean in the current crisis. Presenters were Mr. Pablo Fajnzylber, Chief Economist for Latin America and the Caribbean, World Bank; Mr. Andrew Powell, IADB; Mr. Trevor Alleyne, IMF; and Mr. Desmond Brunton, Vice-President Operations, CDB. Dr. Maurice Odle, Advisor, Secretary General, CARICOM Secretariat, chaired the session.

Mr. Fajnzylber reported that the World Bank intended to double its lending to the Region. He indicated that World Bank funding is available for traditional investment loans; policy lending/budgetary support; for social sector development projects, of which an important component should be improved targeting of beneficiaries. He also indicated that there is a contingency credit line.

Mr. Powell noted that the IDB was planning to increase its lending to the Region to US\$12 bn in 2009 from US\$9 bn in 2007/2008. This level of lending, he pointed out, would not be sustainable beyond 2009 and hence the need for recapitalisation thereafter. He encouraged participants to be more proactive in the pursuit of loans. The US\$12 bn is additional to the US\$6 bn available as a contingency facility which was established in the 1990s. Lending through this facility is of short maturity and would generally be channelled through a development bank or a central bank to first tier institutions. He noted that the Funds for Special Operations (FSO) countries, that is those countries eligible for concessionary financing, have access to three windows: (i) emergency loans (US\$6 bn); (ii) concessionary loans (US\$12 bn for 2009); and grant finance (for example, Haiti, Guyana).

Mr. Trevor Alleyne intimated that the IMF is ready to help in whatever way necessary. He reported the existence of a short-term facility but opined that the facility, with lending of up to three months, was not appropriate for the Caribbean. He suggested that it would be better for countries to use the standby arrangements. In fact, he pointed out that the recent assistance given by the IMF to provide support to governments (for example, Pakistan, Hungary, Iceland) in the current crisis, were all standby arrangements.

Mr. Desmond Brunton, Vice-President, Operations, CDB highlighted the variety of instruments for helping Caribbean countries in the current crisis. They include policy-based loans; policy-based guarantees; interest stabilisation fund; investment loans for infrastructure; credit lines to institutions; and direct poverty reducing investments, for example, through the Basic Needs Trust

Fund. He suggested, however, that there is need also to explore innovative funding mechanisms such as the securitisation of remittances, which is already being done in Jamaica, and the use of diaspora bonds, which have been used successfully in India and Israel.

D. Conclusion

Dr. Compton Bourne summed up the seminar by identifying the major themes or areas of discussion. These included trade and investment credit; domestic and international liquidity; financial portfolio effects; impacts on revenues, foreign exchange earnings and reserves; the adequacy of financial sector regulatory reform, of deposit insurance; the possible establishment of a Regional Stabilisation Fund; social safety nets; and financial innovation. One of the positive outcomes potentially of the crisis was the increased appreciation of the need for regional action.