The Caribbean Capital Markets: Unlocking the potential from within the region

Address delivered by Dr. E.D. Tromp during the 5th Caribbean Hotel & Tourism Investment Conference
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Introduction
Good morning chairman, members of the panel, ladies and gentlemen. I am pleased for the invitation extended to me to address you at this Fifth Caribbean Hotel and Tourism Investment Conference here in Curaçao. Considering the recent developments in the tourism industry in the Netherlands Antilles, I believe that the timing of this conference is excellent, as we currently have more tourism related investment projects on stream than ever before.

These investments require, of course, a substantial amount of capital, both foreign and local, in the form of equity and loans. However, this poses a significant challenge for us here in the Netherlands Antilles, since our capital market, just like many other countries in the Caribbean, is not that well-developed. Consequently, the desired funds for the aforementioned investment projects are often times not raised in our capital market. Therefore, I would like to address the following question in my presentation: "How can we unlock the potential capital from within the region?"

It must be noted that I will not attempt to cover the subject of attracting financing from outside the region this morning. I am ascertained that everyone is aware of the need to liberalize cross-border transactions, especially with regards to the capital account of the balance of payments, the need for policy coordination within the region, and the importance of international initiatives, such as the OECD Caribbean Basin Investment Initiative, which was presented earlier this month here in Curaçao. In contrast, I will specifically focus on ways to unlock the potential capital from within the region.

Before going any further, I would like to give you an indication of the economic importance of the tourism industry, which will also explain the need for sufficient capital. Furthermore, I will discuss the way in which the government influences the amount of capital available for investments. Finally, I will present several ways to mobilize savings. Although I will present these issues from the perspective of the Netherlands Antilles, I am sure that you will find most of my comments generally applicable.

The importance of tourism for our economies can be appreciated by examining the contribution of the tourist sector to the balance of payments, Gross Domestic Product (GDP), government revenues, and employment.

Tourism earnings play a major role in alleviating a source of fundamental disequilibrium in Caribbean economies, namely, the region's chronic deficit on the trade balance. Without tourism, these deficits would be unmanageable. In the Netherlands Antilles, tourism has generated almost USD 840 million in foreign exchange in the year 2000. This amount equals 28% of our total foreign exchange revenues and approximately 84% of the deficit on our trade balance.

The contribution of the tourist sector to GDP is measured by both direct and indirect value added. Estimates show that travel and tourism activities account for over 30 percent of GDP in the Caribbean region. In terms of government revenues, many Caribbean governments have become increasingly dependent on tourism and tourism-related economic activities as sources of direct and indirect tax revenues. The sector's average contribution to total government revenues ranges from 15 to 20 percent in the Caribbean region. As for job creation, it is well-known that the tourist industry is a labor-intensive industry. For the Caribbean as a whole, the total number of people employed in this sector is estimated to be 2.4 million or 20% of the employed population.

With tourism having such a broadly established impact on Caribbean economies, at the moment, the importance of this sector is very clear. But what about future prospects? Will tourism continue to play such a dominant role in our economies? In fact, it is believed that tourism is one of the three industries which will drive the services led economy of the 21st century, thereby increasing its impact on our economies. Since tourism has such a significant growth potential, investments in the tourism industry are very much needed to tap in on this potential. However, the financing of these investments requires the availability and supply of capital, which is often times limited in most Caribbean countries.

Although one could look at the international financial markets as a way of financing, I would like to focus on the potential domestic or regional sources for investments while attempting to answer the question I posted at the beginning of my speech: "How can we unlock the potential capital from within the region?"

Let me now discuss the impact of the government on the availability of capital. A government can either increase or decrease the amount of capital available for investments. It can increase the amount of funds available by concluding loans and using the proceeds to invest in tourism projects, such as hotel construction. Once proven profitable, the hotels can be sold to the highest bidder, enabling the government to repay its loans. This approach has been used by several governments in the Caribbean, with varying degrees of success. The rationale behind this approach is that the social benefits of increased activity in the tourism industry are not taken into account by a project developer, and therefore he might reject a project, which is in fact beneficial to the economy as a whole. By incorporating these social benefits and providing the needed capital, the government is eliminating this market imperfection.

Another reason why the government may want to borrow funds and invest the proceeds in investment projects is because the perceived risks of the tourism project might discourage potential investors or induce them to charge unrealistic high-risk premiums. The intermediating role of the government reduces the risk premium, making more and cheaper capital available for investments. This could also be attained by extending capital guarantees to the investors. In both cases, however, the government runs the risk of failure, and may end up with large claims. Again, there are various examples where governments received claims on the guarantees they extended. Therefore, a government guarantee should, in my opinion, never cover the whole financing requirement. The government should always try to find developers who are willing to participate in the project. If not, the viability of the project should be seriously questioned.

Furthermore, the government may increase the amount of funds available for investment by earmarking a portion of its revenues to a development fund, created with the purpose to invest in the tourism industry. These earmarked revenues might be financed out of the normal budget, implicitly swapping government consumption for government investment, or through new taxes.

An example of the latter could be the tax revenues from the international financial and business services sector in the case of the Netherlands Antilles. In stead of treating these tax revenues as a regular source of income, the government could treat them as a temporary windfall and earmark them to finance a special purpose fund geared towards investing in the tourism sector. For the Netherlands Antilles, I advocate this approach, as the new tax treaty within the Kingdom (BRK), will result in higher tax revenues, at least temporarily.

Another possibility for the government to increase the amount of capital available for investments is providing tax benefits to investors. Tax benefits often include tax holidays, but these have several drawbacks. It would be better to introduce a limited set of rules-based tax incentives. In that case, investors will be able to evaluate up front what the financial impact will be on their investment. The rules-based incentives, should, in my opinion, link the size of the tax incentive to the actual investment made in the local economy and the number of persons employed in the project.

So far we have discussed the possibilities for the government to increase the amount of capital available for investment. Let me now turn to the case where the government is actually reducing the amount of capital available for productive investments.

First, if a government runs large budget deficits, these may eventually crowd- out private investments. Second, and perhaps more important, the government may reduce the amount of both foreign and local funds if market perceptions on the sustainability of economic policies are negative. To prevent this, governments should pursue policies that the market believes will result in growth and stability. This means that we have to pursue: (1) consistent and stable macroeconomic policies, (2) comprehensive structural reform and (3) good governance.

On all three counts the Netherlands Antilles is recently improving its track record. The agreement reached with the IMF in September 2000 provides a basis for financial reform in the government sector, which will gradually restore confidence. In addition, efforts are under way by the Foreign Investment Advisory Service and the World Bank to increase the attractiveness of the Netherlands Antilles for foreign investors and to provide a comprehensive long-term growth strategy for the economy. Therefore, I believe that the perception of the Netherlands Antilles in the international financial community will further improve, which will lead to increased investments in the Netherlands Antilles by the international financial community.

So far I have discussed the impact of the government on the availability of capital. Let me now turn to the promotion of savings in our economies. Savings may take many forms, but in the Caribbean financial sectors, where banks are by far the most dominant players, bank deposits are still an important investment instrument. Economic theory on financial development tells us that we should increase the deposit rate in order to increase the attractiveness of savings over consumption. However, a general increase in interest rates might be unfavorable in light of the economic recession in the Netherlands Antilles. Therefore, I will focus on reducing the interest rate spread, which would make it possible to increase deposit rates without a simultaneous increase in lending rates.

The magnitude of the interest rate margins is explained largely by two factors: the costs of financial intermediation and the degree of competition. In the Netherlands Antilles, we plan to reduce the costs of intermediation in three ways. First, the introduction of a financial statement law will oblige every registered company to file audited financial statements with the Chamber of Commerce. This will provide the banks with accurate and timely financial data on companies, which apply for a loan. To increase the amount of information available on individual debtors, we are discussing the creation of a bureau for credit registration, where banks can inform if a client has other loans outstanding, or if any of his loans are non-performing. Therefore, banks will be better capable of assessing the risks involved in a loan, thus reducing uncertainty and the costs of intermediation. Furthermore, the recent elimination of the reserve requirement on long-term deposits and interbank deposits is aimed specifically at reducing the costs of financial intermediation for commercial banks.

The second element influencing the size of the interest rate margin is the degree of competition in the financial sector. Competition asserts pressure on commercial banks to increase efficiency, reduce overhead, and shrink interest rate margins. The change in monetary policy a few years ago from direct credit controls to indirect policy instruments has undoubtedly increased competition. As an indication, the number of commercial banks active in the local market has dropped by 20%, creating a smaller number of bigger banks, better able to compete in this oligopolistic market. In addition, the interestrate margin declined significantly.

Another way to increase savings is educating the public. In the Netherlands Antilles and numerous other islands and countries in the world, the turn-over in the gambling industry is considerable compared to the size of the economies. Which means that lotteries and casino's count on a disproportionately high level of private sector spending. The risk return profile of these activities does not justify this, as lotteries or gambling games have a negative expected return. In contrast, every single financial asset will present a positive expected return on investment. So why is so much money being spent on gambling and lotteries, instead of being invested? The answer, in my view, is one of timing. Lotteries give the 'investor' the chance of winning a relatively large amount of money in a relatively short period of time. Investments in bonds, equities, or even time deposits, however, require a much longer time horizon. As it is not a financial matter (the money is available) it is more a matter of education to show the man in the street that he will be better off investing his money instead of throwing it away in a casino.

Therefore, the man in the street needs to be educated about the pro's and con's of investing in either risk capital or debt securities. It should be made clear that ultimately, not only the small investor himself would benefit, but the country as a whole too. Even small amounts could be mobilized if investment funds would be created. One could even think of the possibility where the government enables investors to participate in the special purpose fund I discussed earlier. If the contributions to investment funds by local individuals are tax deductible, this might just provide the financial incentive needed to persuade the average person to invest.

Tax deductibility could also be used to increase contractual savings. Although employee pension premiums are fully tax deductible in the Netherlands Antilles, the problem is that only about 30% of the working population participates in a pension scheme. For the other 70%, tax incentives to save for their post-retirement age are very limited. A broadening of tax incentives would almost certainly lead to increased contractual savings, providing long-term capital for investments.

Ladies and gentlemen, I discussed with you this morning the impact of the government on the availability of capital and I have illustrated that this impact can either be positive or negative. To prevent a negative impact, governments should adhere to sound macro-economic policies. Next, I elaborated on the reduction of the interest rate margin, the education of the public and the introduction of tax incentives as ways to promote domestic savings. All these measures have a significant local content. Therefore, I would like to stress again: notwithstanding the importance of international initiatives to stimulate investments in the region, a lot can be done within the region to unlock potential capital.

Thank you for your attention.