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FEATURE ADDRESS
ON
INVESTMENT POLICY AND THE FINANCIAL ENVIRONMENT IN THE CARIBBEAN

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Salutations!

It is an honour to be asked to deliver the feature address in the Third Session of this Senior Level Policy Seminar on 'Risk Management and Investments in the Caribbean'. The theme for this segment is "Investment Policy and the Financial Environment" and in treating with the subject I am mindful of other contributions to the seminar programme that are expected from a number of private and public sector experts. I have been alloted only twenty (20) minutes and in that time I shall endeavour to deal with the various dimensions of investment policy; the impact of the financial system on investor performance; and the behaviour of investors, host and home governments and the international community in mitigating risk.

(i) Dimensions and Characteristics of Investment Policy

There are a number of instruments that constitute investment policy. These include domestic legislation and regulation; regional harmonization measures; bilateral investment treaties; investment chapters in bilateral trade agreements; and multilateral agreements of which Caribbean countries are participatory signatories.

The investment regime in Caribbean countries is one that is basically quite open and liberal even though there is the hassle factor, delays in approval and in the granting of licenses, and at times less than full transparency or excessive use of discretionary power. There are not many restrictions with respect to entry and establishment. For example, market access limitations have been significantly reduced as a result of privatization of certain important and sensitive sectors, including major public utilities. In some cases, the Governments have retained a certain percentage of shares of the utilities but invariably a foreign company had control as the strategic investor. With respect to other sectors, in Saint Lucia a non-national cannot own more than 49 per cent of the shares of a company registered under the Companies Act of 1996; in Suriname 50 per cent local ownership is normally required for commercial presence, and in Trinidad and Tobago, approval is still required if a foreigner wishes to acquire over 30 per cent share ownership. Although Jamaica relaxed its joint venture restrictions a few years ago, the only areas in which total entry restrictions exist relate to small services establishments, such as hotels below a certain size, tour guide activities, taxi services, hair dressing activities, etc. Similarly, small scale manufacturing, such as handicraft production have establishment restrictions so as to encourage indigenous activity.

Intra-CARICOM investors have begun to face an even more liberal regime since their agreement in 2000 to institute Protocol II (revising the Treaty of Chaguaramas) allowing for cross-border rights of establishment, provision of services and movement of capital to take effect by the end of the year 2005. In addition a CARICOM Double Taxation Agreement has come into being. In anticipation of the removal of intra-regional restrictions, many CARICOM firms have already begun to gear up with the new investment opportunities in mind and this partly accounts for the explosion of cross-border investment, particularly by Trinidad and Tobago firms.

The result is that foreign direct investment increased about four times between 1990, when it was US$448 m, to an average of about $700 during the recent 1999-2001 period, with Trinidad and Tobago accounting for roughly 40-45 per cent of the total inflows in recent years, with mergers and acquisitions playing an important role. The foreign investment inflows represent a very large part of domestic capital formation, constituting one of the highest proportions in the developing world, and reflecting a situation of low domestic savings and even lower domestic investment.

While there are certain determinants of investment over which the macro-economic policy makers have little impact, such as the availability of natural resources; basic infrastructure, market size and adequate quantities of skilled and disciplined labour, the increase of investment could safely be said to be a product of the improved investment climate for both extra-Caribbean and intra-CARICOM inflows.

While the investment legislation and regulations of CARICOM Member States tend to be scattered in a number of instruments, the gist of the regime is contained in about forty (40) or so Bilateral Investment Treaties (BITs) that have been signed with major trading and investment partners and with other important economies. These BITS represent a codified and clear statement of the existing regime in Member States and make for a considerable amount of transparency. In essence, with the BITs considerable protection and rights are extended to foreign capital, but there is silence with respect to investor obligations to the host country and developmental aspirations.

Despite the fairly favourable nature of the regime, there is pressure towards further liberalization of the investment policy. The granting of incentives based on export and local content performance requirements is proscribed under the WTO rules of the game, because of the supposedly distortionery effects on trade. CARICOM States have argued before the WTO Committee on Subsidies and Countervailing Measures that the performance requirement in their incentives legislation is based on value added and not local content but these countries may eventually have to find new bases for offering incentives. The time has probably come for a thorough going tax reform that includes less emphasis on traditional incentives and more reliance on a system of low corporate tax rates combined with a broader tax base.

AT the FTAA negotiations on investment, the USA and Canada are campaigning for a WTO-*plus* regime and the inclusion of transfer of technology among the proscribed performance requirements. They also want to extend the meaning of expropriation to include the effects of any new tax or other change of the investment regime that adversely affects the profitability of the enterprise. In addition, the USA and Canada would like portfolio investment to be included under the general rubric of investment, with all the capital control implications in times of balance of payments crisis. These two developed countries also wish to include rules relating to the treatment of foreign investors in both the pre- and post-establishment phases. If the USA and Canada were to have their way, the result would be a FTAA investment regime which in some respects would be even more "liberal" than that of the post Protocol II arrangement among CARICOM Member States. This would be somewhat grotesque and absurd.

(ii) Impact of the Financial System

The financial environment is an important factor in determining the ease of access to investment funds. The nature of the financial environment is perhaps more critical to the fortunes of the domestic investor than to those of the foreign investor who not only brings in his own equity funds but, also, can rely on parent company loans for construction and expansion purposes. The financial environment in the Caribbean exhibits considerable weaknesses.

The banking system throughout the Region is characterized by very high interest rates on loans. Although deposit rates are significant (partly to inhibit capital flight and reduce pressures on the exchange rate), it is the considerable interest rate spread that mainly accounts for the very high lending rates. The risk factor only very partially accounts for the high rates. Such rates are conducive to speculative activity, since there are not many investment opportunities that can earn a sufficiently high rate of return to accommodate the expensive borrowing. In addition, the traditional banking system is not well geared and designed to assess loan applications from numerous small borrowers who typically lack adequate collateral, and sufficient experience and business plan formulation and execution skills. Instead, there seems to be a preference for making loans for consumption purposes (with a relatively high consumer loans to total loans ratio) in the absence of any form of credit control. These issues of high interest rates on loans and non-accessibility of certain segments of the business community have never been adequately addressed by the investment policy decision makers.

With respect to access to the banking system, a foreign investor does not enjoy national treatment in all parts of the Caribbean. In Guyana, working capital loans to foreign companies need to be approved by the authorities. Similarly, in Dominica, loans to non-citizens and non-residents need approval and, in St. Kitts and Nevis, non-nationals are charged an extra 2½ per cent interest on loans. These restrictions are designed to maximize the availability of funds to domestic players and to prevent crowding out by foreigners.

The insurance industry also constitutes an important source of investible funds. The premium collected by the insurance companies is considerable and the funds can be used by these so-called "institutional investors" to purchase stocks and shares. In order to promote economic development, some CARICOM countries have imposed certain local asset ratios. For example, in Belize and Jamaica the local asset requirement is 50 per cent and 70 per cent respectively, in Dominica the local asset requirement is equivalent to at least 25 per cent of the premium income of the past year and 30 per cent of the current year and, in Guyana, there is a local asset requirement of 95 per cent of the statutory fund for the last preceding year. Given the objective of forging a CARICOM Single

Market and Economy, the local asset ratios should be transformed into regional asset ratios, whereby an institutional investor could source assets in any CARICOM country to satisfy the statutory requirement.

The market for equity capital in the Region is quite limited despite government efforts to encourage the development of same and to wean companies away from the family firm syndrome and excessive dependence on loans. With respect to companies listed on the stock exchange, there are only 16 in The Bahamas, 23 in Barbados, 38 in Jamaica, 7 in Suriname, 2 in the OECS (although there are 27 public companies) and 30 in Trinidad and Tobago. The stock markets are not very active. Trading is light, partly because of the tendency to purchase shares for keeps. (Guyana has 12 public companies and it is expected that at least three will apply for listing when the stock exchange opens for business in the near future).

As part of the regional harmonization of financial policy and the objective of efficient allocation of resources, a process of integrating the stock markets, beginning with a mechanism involving Barbados, Jamaica and Trinidad and Tobago, was begun in the early 1990s. Unfortunately not much progress has been made and only ten (10) companies have chosen to cross-list.

Despite the limited cross-listing of companies, there has been a considerable amount of cross-border investment in recent years, most frequently via a process of mergers and acquisitions, led by Trinidad and Tobago firms. It is for this reason that the number of public companies in Jamaica fell from 45 at the beginning of the financial and economic crises in the 1990s to 38 at the end of 2002. Government policy seems to be that a significant amount of consolidation is necessary for Caribbean firms to be able to compete in the liberalizing global environment and this is serving to inform their interpretation of monopoly power and what constitutes appropriate competition policy.

A vital component, though not yet implemented, in a regional harmonization of investment policy would be the instituting of a monetary union. A single currency would cause a lowering of transactions costs and would encourage cross-border investment, particularly with respect to flows from flexible exchange rate countries whose currencies are held at a premium, given the risk of valuation changes. The progress towards monetary union has been frustratingly slow.

(iii) Risk Management by Investors, Host and Home Governments and the International Community

There are at least four major types of risk that confront investors. These investors, in turn, try to adopt various operational practices and procedures in order to combat same. Such defensive action is frequently supported by host Governments, although, in certain cases, the latter can be the very cause of the increased risk that the investor is trying to avoid, such as when abusive transfer pricing is intensified to avoid increasing tax imposts. In addition, home governments and the international community play their part in the business of mitigating risk. Frequently various types of financial instruments and devices are utilized in dealing with the risk factor by these various players.

An overarching factor is systemic risk. In the Caribbean, the economies are small and very open (with a high ratio of imports or exports to GDP) dependent on one or two commodities or other resource based industries, and reliant on a few key export markets, including preferential arrangements that are currently under threat. These structural factors give rise to high volatility of income. Partly in order to offset these economic weaknesses, Governments in the Caribbean have seen it fit to have an investment policy that includes a comprehensive set of fiscal and other incentives. The only real solution to the vulnerability and volatility is sectoral and market diversification but supply capacity and market intelligence are a problem.

Second, there is project risk. In the pre-project phase the investor may employ various scenario and sensitivity tests. The government may even guarantee the strategic investor a certain rate of return as with public utilities, if the economic environment is a particular difficult one. The Government may also guarantee the repayment of a major loan. Once established with various sunk costs, the investor may wish to reduce his exposure by futures contracts that hedge against price fluctuations. He may also decide to minimize the rate of re-investment, and utilize more borrowed funds and less owner resources. In this regard, an investment policy that restricts access to working capital in the banking system could make for operating difficulties, even if at the same time it prevents the possibility of financial crowding out by foreign investors of bankable indigenous projects.

With specific reference to the insurance industry, excessive risk associated with the property business is dealt with via re-insurance, whose incidence (using a re-insurance costs to total premium measurement) is very high in the Caribbean. This high ratio partially caters for the catastrophic risk factor associated with hurricanes, floods, volcanic eruptions, earthquakes, etc. All risk averse practices may not necessarily be entertained by the authorities. Cross border supply, which is less risky than commercial presence, is not permitted in the financial sector in the Caribbean.

Third, investment policy in the Caribbean seeks to insulate the investor against foreign exchange risk by either instituting a fixed exchange rate regime or operating a floating exchange rate regime which is designed to fluctuate only within a very narrow range (as for example, the 1½ per cent range movement over a continuous 36 month period that is a stipulated requirement for stability before monetary union and a single currency could be adopted). Free transfers of dividends are permitted in practice even in fixed exchange rate regimes that stipulate a remittance figure beyond which approval is necessary. In the event of a winding up of the firm's operations, free repatriation of capital is also an integral part of the liberal investment regime in the Caribbean.

Fourth, ensuring against political risk is equally important. Home governments seek to protect the foreign investor by negotiating BITs with the host government. Some home governments also offer protection against political risk, as in the case of the USA's Oversees Private Investment Corporation (OPIC) arrangement. The Caribbean is also presently negotiating a plurilateral agreement with FTAA partners which includes Articles relating to Compensation for Losses, associated with domestic strife and upheaval, as well as a tighter Dispute Settlement mechanism. At the multilateral level, Caribbean countries have benefited from the multilateral investment guarantee arrangement (MIGA) that is operated by the World Bank.

Further, at the multilateral level, a comprehensive Commonwealth Secretariat proposal (entitled, 'Changing Private Investors'

Perceptions by Reducing the Cost and Risk of Investment in Least Developed, Small and Vulnerable Economies') was made a year ago, subsequently endorsed by the Commonwealth Finance Ministers, for reducing the risk involved in small vulnerable economies and least developed economies, since comparative disadvantages require 50-100 per cent higher rates of return than in developed economies. Under the proposed system finance would be available under special terms, the exchange risk would be absorbed and packaged insurance provided against political risk. Such a system would operate through domestic commercial banks on an off balance sheet basis, and its net costs would be met by International Financial Institutions (and aid donors) who would progressively modify their facilities. And, at the FTAA level, a proposed Hemispheric Cooperation Programme has been designed not only to provide technical assistance to those economies in need but, also resources for the required industry adjustment effort in a liberalized hemispheric environment.

Conclusion

What we have been saying for the last twenty minutes is that there has been a convergence of multilateral, regional, bilateral and national thinking as to what constitutes best practice with respect to investment policy and various financial and other measures have been introduced for mitigating risk to the respective players. In recent years, this issue of risk management has become even more critical for investors, regulators, and international financial institutions, owing to increasing liberalization and globalization and the greater level of risk and uncertainty associated with unprotected domestic markets and freely contested export markets. More therefore needs to be done in the area of risk management, especially since international rating agencies, such as Moodys and Standards and Poor, tend to take an excessively sinister view of risk in small open economies like those in the Caribbean.

In this regard, there is still some degree of contention as to how small economies, with their well known limitations and various types of market failure, can compete for investment in a global environment whose rules of the game imply that one size fits all. Special and differential treatment is still a requirement for these challenged economies.

I thank you for listening.

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