Capital market stability

Speech by Dr E.D. Tromp at the occasion of the First Latin-American & Caribbean Trade Fair and Congress April 14, 1999

Ladies and gentlemen,

It was with a great deal of pleasure that I accepted the invitation to address this first conference on Latin America and Caribbean trade fair and capital markets. I welcome the opportunity to address such a distinguished gathering of financial professionals about the role of capital markets in our economies, their characteristics and possibilities. I am pleased to note that the first securities exchange has been established in the Netherlands Antilles and that trade in stocks, fixed-income securities, options, and other financial assets soon will be part of our domestic capital market. The establishment of such an exchange is a milestone in our capital market development because it is an important step toward a well-developed and diversified capital market. Given the globalization and the integration of capital markets in the world economy, a well-developed capital market for our small-scale economy is of paramount importance.

The presence of well-developed capital markets will enhance the efficiency of the allocation of financial resources in our economies. Financial institutions have played a prominent role in the allocation of resources in our economies, and they are the main channels through which economic development is financed. However, our experience in recent decades has been that bank-based financial systems have not always been able to adequately meet the need for capital, especially long-term capital. In this regard, capital market development increasingly is being seen as a critical factor for the long-term growth prospects of countries in development.

Besides stimulating economic growth, a well-developed capital market will contribute significantly to the further development of the financial sector in our Caribbean economies. In particular, a well developed capital market will introduce new financial products and incentives for existing financial institutions to become more competitive. In other words, it will enhance market mechanisms in our financial sector with benefits for the broader economy.

The strengthening of the market mechanism in the financial sector also will be beneficial to the conduct of monetary policy. As is well known, efficient capital markets are important in improving the use and effectiveness of market-oriented instruments of monetary control because they contribute to a better pricing and allocation of financial resources. In particular, the determination of the short-term and long-term interest rates and the impact of these interest rates on the entire economy are enhanced through efficient capital markets.

Moreover, a well-developed capital market can contribute to the fiscal discipline of the government. As more domestic corporations commence raising funds in the domestic capital market, a level playing field for available savings will emerge, because the government will have to compete with the private sector to borrow funds. Subsequently, the government will have to accept the high costs of its borrowing in terms of high interest rates or impose more fiscal discipline on itself to reduce its financing requirements.

Given its effect on the flow of capital, a well-developed domestic capital market also can have a positive impact on the capital account of our balance of payments. Until now, many local investors have had only two alternatives: place their money on deposits at commercial banks, or buy government securities. Consequently, to diversify their portfolios, many local investors have had to seek access to foreign financial markets. The further development of a domestic capital market not only will provide local investors with a variety of investment opportunities, but also will provide them with alternative instruments that can be used as substitutes for foreign instruments. The result, a larger share of domestic savings will be used to finance domestic investments. Furthermore, a well-developed domestic capital market attracts foreign investors, which also will contribute to the capital account of our balance of payments.

Ladies and gentlemen, emerging markets have experienced several waves of pressure since early 1997 emanating mainly from Asia. As a result, the international investment community has become more apprehensive about the risks of propagation from emerging markets to the world financial system. Recent events in these markets have affected all aspects of the international financial landscape and have brought to the fore the high degree of globalization and integration of financial markets. Those events served to underscore that developments in the international financial markets, while improving efficiency also have enhanced the potential for contagion when disruptive shifts in investor sentiment occur. A key lesson from this experience is the need to address promptly any sign of weaknesses in policies and institutions that ultimately may provoke sharp revisions in investor perceptions of a country’s prospects.

The turmoil generated by the fall in the Asian markets exposed the vulnerability of financial markets to reversals of capital flows. If capital flows are not based on sound fundamentals they will only heighten the risks of disruptions and precipitate crises.

Ladies and gentlemen, it is, therefore, a fallacy to think that capital markets will bring benefits if the institutional infrastructure is unstable. It is equally mistaken to think that markets will operate efficiently without a stable macroeconomic environment.

Put differently, the main objective in increasing the resiliency of the international monetary system against financial market crises has to be to create the necessary conditions under which markets can function more effectively and impart a stabilizing influence on the broader economy.

Against the background of increased globalization of financial markets and altering investors' attitudes, we should ask ourselves the following critical questions:

What can a well-developed capital market in the Netherlands Antilles offer to the international investment community? More specifically, what are our comparative strengths and weaknesses in the global financial marketplace?

I think this conference is an appropriate forum for discussing these questions and the role of the Netherlands Antilles as an international financial center. From the Central Bank's perspective, one of the main conditions for attracting foreign investors in this "new era" is stability in the financial system. Financial market stability derives from an improved institutional infrastructure, an adequate supervisory and regulatory framework, enhanced transparency, market discipline, and corporate governance, and enhanced risk management by financial institutions.

The increasing volume of cross-border financial flows and the greater potential of financial markets to propagate financial instability to the financial institutions that deal actively in them, raise the question of whether the current regulatory structures, which remain fragmented along industry and national lines, are adequately suited to an emerging financial landscape where these borders are becoming increasingly blurred.

Given this progressively complex environment, the Basle Committee promulgated the Core Principles for Effective Supervision. These principles are the result of the joint efforts of supervisors acting internationally through the Basle Committee to focus on financial stability. The Core Principles constitute a codified version of best practice in the field of banking supervision. Similar initiatives now are being considered in the fields of insurance and financial conglomerates and securities regulation, and in the management of payment and settlement systems.

Ladies and gentlemen, the Netherlands Antilles not only has fully endorsed the Core Principles, but also our current supervisory regime is fully in line with those core principles. In the fields of insurance and securities regulation, the Netherlands Antilles has made considerable strides in modernizing and updating its regulatory framework. Our current regulatory regimes in these fields are in line with internationally accepted standards.

Improved supervision, however, is only one aspect of financial stability. Stability can be underpinned only by strengthening the internal discipline of the markets. The task of the supervisor is to find ways to work with the market forces in encouraging prudent behavior by market participants. The emphasis should be on good governance, sound risk management, and effective audit and control procedures. It should be based on the capacity of the financial intermediaries to weather the adverse shocks they are liable to encounter. In these areas, the Netherlands Antilles also can pride itself on a track record of good practices.

For markets to operate efficiently, it also is necessary to have a stable macroeconomic environment. Macroeconomic setbacks, interacting with weaknesses in the financial sector, can bring even expanding economies to a halt. When the macroeconomic climate worsens, more loans go bad and more provisions have to be made. The resulting decreased credit availability further weakens economic activities. This vicious cycle helps explain the increased vulnerability of financial systems and the complex relationship between the stability of markets in general and the performance of the real economy. Therefore it is essential that a macroeconomic climate be created conducive to stability in the financial markets.

Turning our attention to the domestic front however, I have to say that the current macroeconomic environment still is clouded by the near-term outlook for a credible and sustainable fiscal program. A multitude of inter-related risks makes the current economic situation unusually fragile. To deal with the worsening economic situation and prospects, confidence-restoring policy adjustments are needed.

The creation of conditions that would encourage more stable longer-term capital flows still lags despite a series of adjustment programs initiated or announced in the past. A moment's reflection on those programs reveals that they failed in varying degrees because of shortcomings in policies and implementation. While some of the announced stabilization programs contained all the necessary elements to achieve their stated objectives, much too often the measure did not go far enough in their implementation to bring about the structural adjustment necessary. Other programs were abandoned due to windfalls – transitory by definition - that have masked the need for structural adjustments and subsequently precipitated future crises.

This review of failed programs leads us to the far-reaching question of how the current adjustment efforts should be redesigned to ensure that we reap the benefits of a stable macroeconomic environment conducive to stable financial markets and, hence, stable and sustainable economic growth. That is to say, where are we heading now? Broadly speaking, a consensus seems to have emerged about the nature of our fiscal and economic problems, and an agenda for action. The basic thrust of this agenda is better behavior and practices for both public and private entities based on transparency, accountability, and cooperation. The implementation of this agenda—a daunting task indeed—implies considerable challenges ahead.

For strong growth to resume on a sustained basis, fundamental economic, financial, and institutional reforms clearly will be required. For the envisaged National Recovery Plan to achieve its stated objectives, the following line of action needs to be adopted and its enforcement ensured: (1) the current constitutional arrangement with two layers of government has created a government bureaucracy that has led to wasteful duplication of activities and has become prohibitively expensive to maintain. This waste must be eliminated; (2) current efforts to broaden the tax base and place more reliance on indirect taxes are commendable. However, the current practice of allowing a large number of exemptions has eroded the tax base and has rendered this policy ineffective. Additional income enhancing measures are likely needed to prevent a further deterioration of the current fiscal situation; (3) current widening budget deficits are mainly the result of a failure to contain wage pressures in the public sector. Resolution of this issue is the key to providing a structural and lasting solution to the budgetary problem. It is therefore critical that decisive action be undertaken to underpin the authority’s commitment to adjustment. Given the downside risks and the current financing constraints facing the governments, a swift downsizing of the government bureaucracy accompanied by adequate social provisions would seem desirable; and (4) the current privatization efforts ought to be accelerated to achieve the objective of a smaller role for the state and to take advantage of the current world economic situation.

It is erroneous to believe, ladies and gentlemen, that economic recovery can be achieved without addressing our economic ills. I have said it before and would like to repeat it here: our problem is not the economy, it is rather too much government. Fiscal consolidation is an indispensable requirement to create the necessary conditions to restore sustainable economic growth.

Ladies and gentlemen, gone are the days when governments could intervene to counteract undesired market developments. Stability can be effectively underpinned only by strengthening the internal discipline of markets.

Thus efforts to increase the flexibility of the labor market should be further pursued, and a phased elimination of the trade barriers that have been erected is called for. Another important variable in the investment climate equation is unnecessary bureaucracy and red tape. The elimination of these impediments should be at the forefront of the economic agenda.

Further, governments are required to conduct macroeconomic policy in a transparent framework, and to provide timely, high-quality information. This policy of good governance will have to be rounded off with a firm commitment to sound social and human development policies. The task ahead is to pursue sound fiscal policy and at the same time make adequate budgetary provision for social spending in order to protect those groups most affected in the adjustment process. Experiences with initiatives such as the Reda Social have been encouraging.

Private sector participants are required to adhere to internationally recognized standards and to behave according to accepted standards of corporate governance.

Ladies and gentlemen, we must keep moving forward steadily and inject the best possible contributions to this process. If these challenges are met, we should be able to achieve quite rapid rates of economic growth.

In conclusion let me bring you back to the topic of this conference, namely, capital market stability. The stability of financial markets has to be based on a search for ways to reinforce the stabilizing forces of the markets and the self-regulating instincts of market participants.

The best way to achieve that is to create conditions conducive to best practices, market transparency and a stable macroeconomic environment. I wish you a fruitful conference and hope you have a pleasant stay on our island.

Thank you