



FINANCIAL REGULATION AND THE CSME. HARMONISATION OR STANDARDISATION?

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Abstract

In 1973, CARICOM Heads of Government agreed that in order to survive, it was necessary for CARICOM member states to strive for integration. The decision to establish the CARICOM Single Market and Economy (CSME) across the Caribbean with effect from 1 January 2005, makes this paper particularly apposite. This brief analysis aims to provide a concise, yet rigorous, examination of the issues underlying Chapter 3 of the Revised Treaty of Chaguaramas, pertaining to the mobility of capital. The examination focuses on the most significant changes that are expected to result in financial regulation and the implications for policy making and financial stability. This non-mathematical discourse relies on recent publications on the related issues and integrates the theoretical contributions from various academic debates. As part of the process, the paper will address, from a public policy perspective, the urgency for CARICOM regulators to proactively identify and measure potentially problematic risks in order to safeguard the financial environment in a liberalized, 'regionalised' and single economy context that is punctuated by increased capital mobility.

¹ The views expressed are those of the authors and do not necessarily represent those of the University of the West Indies or the Department of Management Studies. The author thanks Gavin Chen for helpful comments.

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1 BACKGROUND AND INTRODUCTION

In the face of increasing globalisation of financial markets and unprecedented financial innovation and liberalisation in the 1980s, the decades of the 1980s and 1990s showed a record number of bank failures and other incidences of financial instability in many developing as well as developed countries. These outcomes were primarily the result of structural changes within the banking systems and financial markets. Today, the issue of financial instability and bank failures continue to engage much of public policy debates in countries all over the world. The quest for improved operational performance is likely to be a key issue over the next few years, especially with the type of restructuring that is underway in many financial markets following periods of distress and crisis. At the same time, as efforts intensify to operationalise the single market programme for the Caribbean region, increased attention is being directed to barriers to competition and factor mobility in financial and related services. The removal of barriers within the regional financial markets should enhance the efficiency in the allocation of resources as the mobility of capital increases. Of particular import, as well, is the prominence of capital mobility among the factors that are thought to have a significant influence on financial stability. The World Bank notes that:

In the second half of 1997 several East Asian crisis countries experienced a massive reversal of the large foreign private capital inflows they had enjoyed through much of the 1990s. The net swing from inflows to outflows between 1996 and 1997 amounted to more than \$100 billion for the five crisis countries – Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand – or 11 percent of their gross domestic product (GDP) before the crisis. The reversal precipitated steep devaluations of currencies, large increases in interest rates, and severe declines in stock and other asset prices, initiating the deep financial and economic crises that have gripped these countries since. Contagion effects from the crisis spread throughout the developing world. But instead of dying away quickly, as they did after the 1994 Mexico peso crisis, they were the precursor of currency and financial crises in the Russian Federation in August 1998, followed by a more general withdrawal of private capital flows (1998:55).

For the member states of the CARICOM Single Market and Economy (CSME), harmonization is a key tool to support its various policies and legislative activities: in particular, the integration of the internal market environment, consumer protection, information technologies, and competitiveness. In order to facilitate the exercise of the rights provided for in the CSME, provisions have been made for the adoption of appropriate measures for ‘... the establishment of market intelligence and information systems in the Community’ as well as ‘... harmonised legal and administrative requirements for the operation of ... [financial] entities’ (Revised Treaty of Chaguaramas, Article 44). Due to the potential impact of CARICOM harmonization on individual member states, its potential challenges must be further explored.

A strong, robust and developing financial market is critical for economic development as it provides essential support activities for government operations. It is therefore critical that financial markets are properly managed to control the factors that influence growth in an increasingly globalised world. In the Caribbean, commercial banks alone comprise on average more than 50% of total financial sector assets. Any financial sector policy must therefore have the stability and development of the banking sector as one of its primary goals. The relative importance of different standards and practices to individual economies will depend on

individual financial structure and other domestic circumstances. Implementation must fit into a country's overall strategy for economic and financial sector development, taking account of its stage of development, level of institutional capacity, and other domestic factors.² It is therefore instructive to examine whether the harmonisation of financial regulation will assist in the creation of well-developed, efficient capital markets and stable financial systems within and across CARICOM member states. Some of the fundamental questions arising from this are: What exactly is meant by 'harmonisation'? What is the objective of this harmonisation as it is conceived? Is harmonization of financial regulation enough to secure a safe and sound financial environment? The hypothesis is explored that mixed levels of 'standardisation' and 'harmonisation' rather than 'pure harmonisation' is a more realistic objective for financial regulation within the CSME. As part of the process, the paper will propose a model to assist regulators in keeping abreast with, or, ideally, ahead of, the developments within the CSME.

1.1 Research questions, scope and methodology

This paper focuses on the CARICOM financial system and extends the usual focus of economic integration to consider the issues that are of particular relevance and import to financial regulation and, consequently, financial stability. The goal of this paper is to twofold: to identify and highlight the challenges facing international financial regulation today particularly as envisioned in a context of harmonisation across Caribbean states. The second goal of the paper is to take argument further by proposing the more practical and useful complement of standardisation along with harmonisation using the template of a model regulator to identify exactly what the key regulatory tasks might be and thereby to develop proposals as to how they might best be performed. In doing so, consideration has been given to the practical developments that have taken place up to now as well as to the international legal and institutional implications of these proposals. Specifically, output from the research aims to contribute to the debate as to what should be the optimal objectives for financial regulation within the CSME as well as contribute to the definition of a broad policy framework for financial regulators and supervisors across CSME member states.

To attempt to effectively respond to the issues posed above, this study employs a thematic examination of a series of questions and issues, having cognisance of the factors that influence capital mobility and financial stability. This paper will, in this instance, focus on data obtained from reviewing documents and records for CARICOM member states and the CSME. It will also involve a review of extant and proposed legislation as well as the governing Revised Treaty of Chaguaramas. In detail, the intellectual questions addressed are: What are the recommendations of the Revised Treaty in relation to capital mobility? How will these be

² This line of thinking implies the rejection of the idea of the wholesale adoption of (regulatory) policies and practices from developed societies for use in less developed countries, *per se*. This is in sympathy with North's non-transferability of rules across societies due to the influence of history and informal constraints (e.g. attitudes, norms, culture), *inter alia*, on outcomes (see North, 1990).

effected in a practical sense? What are the implications for financial stability? What is the recommended regulatory response? In addressing these questions, some of the other key questions/issues investigated are: What is the role of regulators in the prevention of financial system instability? What are the implications of the divergence among CARICOM member states as regards the major influences on capital mobility? Comparative analyses are undertaken to help to identify the specific underlying issues and peculiarities and to attribute causal relationships, where necessary.³

The paper proceeds as follows: Section 2 looks at integration. In Section 3 is a summary of the more significant issues expected in terms of capital mobility arising out of integration and increased capital mobility. In section 4, a discussion of the ethos of financial regulation is conducted, noting the linkages with integration, capital mobility and financial stability. Conclusions and policy recommendations are summarised in Section 5 in the form of policy initiatives to be pursued and policy questions to be addressed in measures aimed at financial regulation harmonisation/standardisation.

2 CARIBBEAN INTEGRATION IN CONTEXT

Theory indicates that countries may gain from tighter economic integration. Fostered by the accelerated pace in globalisation, many countries have found it beneficial to integrate economically in one or more ways – and others, politically as well – in order to strengthen their bargaining power in trade negotiations and to allow them to become more adaptable to changing economic situations within the international environment. Among the benefits that may be secured by integration are greater diversification within and across financial spaces resulting in risk reduction (resulting from an increased deposit base and lending portfolio), increased competition and lower transactions costs resulting in greater efficiency and a reduction in margins, a more efficient payments and settlement system as the benefits of technology are exploited, economies of scale and scope, and a mitigation of the 'brain drain' (often a casualty of developing economies) due to increased opportunities within the region.

In a study conducted jointly with the Caribbean Centre for Monetary Studies (CCMS), the World Bank (1998) strongly supports a call for economic integration in the Caribbean as a prerequisite for financial sector development. Integration of economic and, possibly, political systems, will constrain the Caribbean Community to seek to find creative ways of optimising the benefits of revolutions in technology, liberalisation of financial markets, globalisation, *inter alia*. The

³ It should be noted here at the outset that this analysis does not address the suitability of, or deficiencies inherent to, integration *per se*, nor does it address the problems relating to the implementation of a single market and economy. Rather, the analysis seeks to highlight the effect of capital mobility and harmonisation of financial laws on the function, structure and stability of financial markets. Essentially, it highlights whether harmonisation as proposed by CARICOM supports an ethos of efficiency, growth and stability within the financial systems of the various member states. This paper is guided by the view that the financial industry within any economy must be understood in terms of the quantitative as well as the qualitative factors that influence performance and, ultimately, stability.

recent thrust towards an integrated Caribbean Community is by no means novel. The first major attempt towards Caribbean unity in the twentieth century was manifested via the short-lived West Indies Federation in 1958. Subsequent thrusts towards Caribbean integration were propelled by the efforts of politicians, statesmen and businessmen who were of the view that a paradigm shift was necessary since a fragmented Caribbean ‘could not find its way in the world’ (Hall, 2000:11). It is noteworthy that despite the failure of the initial efforts at integration and the hiatus before the second major phase, the major motivating force for strength in unity was not abated by the shift in focus. Hall notes that:

... the philosophical outlook of the founding fathers and the early leaders of the Community was shaped by a different environment and a different experience. In their time, the overwhelming consideration was the question of sovereignty, in both political and economic terms. ... The development of the Community is now seen as requiring a more liberalised trade regime where protectionist measures are abolished and where the thrust of the activities of the Community is more driven by the need for a secure place in the changed global economy (2000:5).

Notwithstanding, the common thread in the thought process was that, despite their differences, unity was a necessity for the Caribbean economies to ensure survival. Of the three most important studies conducted to examine the prospects for the Caribbean Community in the new millennium, it was the measures outlined in the West Indian Commission of 1992 that formed the basis for what have now become pillars of the CARICOM Single Market and Economy.⁴

3 CAPITAL MOBILITY AND THE CSME

All members of the CSME subscribe to the Revised Treaty of Chaguaramas (RTC) – the governing treaty establishing the Caribbean community. In the third chapter of the RTC provision is made for ‘... the right of establishment, the right to provide services and the right to move capital in the Community’ (Article 30(1)). Article 40 further provides for the ‘Removal of Restrictions on Movement of Capital and Current Transactions’ and states that:

The Member States shall, in order to ensure the proper functioning of the CSME, remove among themselves restrictions on the movement of capital payments (Article 40(1)(a)

and that

For the purpose of this Article, capital and related payments and transfers include: equity and portfolio investments, short-term bank and credit transactions, payment of interest on loans and amortization, dividends and other income on investments after taxes, repatriation of proceeds from the sale of assets, and other transfers and payments relating to investment flows (Article 40(3)(a to f)).

⁴ The other two important studies are The Group of Experts Caribbean Report (1981) and the Bourne Commission Report (1988).

These provisions support the broader objective outlined to adopt ‘appropriate measures for the establishment of an integrated capital market in the Community’ (Article 44(1)(d)).

The ethos of capital mobility is effectiveness in resource allocation resulting from potential arbitrage opportunities among countries. In general, the promotion of capital mobility through integration should facilitate increased competition and, consequently, improved efficiency in financial markets thereby facilitating increased access to lower cost capital, convergence in asset prices in the different member states, increased financing for investment, and increased diversification and consequential reduction in risks. At the same time, there is a theory that suggests that much of the significant benefits are restricted to long-term capital flows; the balance of use among the various types of instruments is determined by investors’ preferences as regards various types of risks, including currency risks (World Bank, 1998).

Notwithstanding the potential benefits noted in relation to increased capital mobility, theory indicates that there are downside risks, the extent of which is dependent on a country’s ability to adjust to the shocks. In the first place, unrestricted capital movements can lead to lending booms and cause banking crises. This is particularly critical in the Caribbean region since these small, open economies are highly susceptible to financial volatility. The impact of these deleterious credit effects is, ultimately, financial system instability. Further, Jakubiak and Markiewicz note in respect of taxes that:

In the environment of increasingly mobile capital it is believed that freedom in setting corporate tax rates can produce a harmful tax competition between member states because differences in tax regimes can influence companies’ investment decisions and distort competition (2005:8).⁵

Tax competition can have harmful effects if it leads to insufficient funding for social and welfare programmes. The implication then is that there must be some standardisation of the tax structure so that competition will not adversely affect government funding. Surges in capital flows resulting from liberalisation may also lead to the ‘twin crises’ (bank and currency crises) – as in the case of East Asia in 1997 or Mexico in 1994 – unless reversals are adequately managed (see, e.g., Kaminsky and Reinhart, 1997). In addition, to these potential boom-bust cycles, it is possible that market failures in one part of the region or in other regions can have contagion effects on individual states or the region as a whole, particularly where institutional support is weak. The timing of the various integration activities is also of utmost importance as weaknesses in a local financial system or in macroeconomic policies may be exacerbated and may affect other economies. The World Bank highlights the importance of strategic planning

⁵ Notably, there are two antithetical views on tax competition: the standard tax competition model presents tax competition as harmful since it results in a fall in welfare arising from insufficient taxes to adequately supply public goods (see, for example, Janeba and Schjelderup (xxxx)). On the other hand, Wilson (1999) identifies efficiency enhancing roles from tax competition affecting output and location decisions.

and timing:

The larger risks and uncertain benefits of portfolio and short-term flows for countries with weak institutional capacity and financial systems suggest proceeding carefully with capital account convertibility. ... Since the capacity to implement such policies and their effectiveness may not be perfect, this approach must be pragmatic and take account of developing countries' specific conditions (1998:150).

The benefits of capital mobility must be matched against the costs, and liberalisation must proceed in an orderly manner, securing the appropriate institutional foundation as a priority. Notably, shorter-term capital flows, while also contributing less, carry the most risk as they tend to be more volatile, are subject to more speculative/confidence reversals and have a closer interaction with the financial markets. (This was evidenced in Argentina and Mexico over the period 1990 to 1996; see World Bank, 1998).

3.1 Influences on capital mobility

Capital mobility is especially influenced by prudential regulations that may indirectly restrict or distort capital flows. A Draft FSA prepared by the CARICOM Secretariat serves to guide the 'development and application of harmonised regional standards in the financial services sector ...'. The intention is to attempt to level the playing field as it relates to provisions affecting those factors that will have a direct or indirect impact on the extent and rate of capital flows among member states. Among the other important factors that influence the quantity and rate of capital mobility between economies are differentials in interest rates (and the concomitant effect on inflation and fiscal indicators); differentials in exchange rates, exchange rate policy, mechanism and path; relative access to funds at short notice (and related policies such as exchange controls); differential in taxes, tax structure, rates, administration, types and application to different market players; as well as other economic indicators such as GDP, debt and growth. The rate of transmission of capital between countries is also dependent on expectations, arising from opportunities for arbitrage.

The table below compares CARICOM member states as it relates to the major influences on capital mobility (limited by data constraints). Despite many common characteristics, it is clear that there is considerable diversity in the region, particularly in terms of their degree of development and sophistication of financial markets. There are also implications of significant differences in terms of fiscal and macroeconomic policy, inflation and resilience to external shocks. The divergences among CARICOM member states imply difficulties to the pre-conditions necessary for effective regulation, consistence in the implementation of methodologies, the convergence or standardisation of cross-border regulation, and also give rise to several important legal and economic implications as regards the drive towards integration. For example, in Trinidad and Tobago, it is illegal to trade in a security without physical possession; in Jamaica, the Central Securities Depository (CSD) facilitates the trading in securities without ever gaining physical possession. These differences, primarily resulting from size, stage of development of the economy, quality of macroeconomic management and the institutional and regulatory framework, will in fact foster greater mobility of capital as funds will flow to the country(ies) where the return is highest. There is, however, a counter-argument: these differences can in fact impede cross-border activities and efficiency in resource allocation.

Table 1 CSME member states compared – Some influences on capital mobility

INFLUENCES ON CAPITAL MOBILITY	BAHAMAS, THE	BARBADOS	BELIZE	GUYANA	JAMAICA	OECS*	SURINAME	TRINIDAD & TOBAGO
POPULATION (MILLIONS -2003)	0.32	0.27	0.26	0.77	2.6		0.44	1.3
GDP (US\$BN – 2003)	5.3	Na	na	0.74	8.1		na	10.5
AVG. ANN. % GROWTH PER CAPITA GDP 2003	Na	3.2	na	-1.2	1.4	Na	na	12.4
TOTAL DEBT %GDP (2003)	Na	27.5	na	195.2	66.2	Na	na	26.2
EXCHANGE RATE REGIME [†]	F	MF**	F	FL	MF	F		MF**
DOLLARISATION - FX DEPOSITS - FX LOANS								
INTEREST RATES (2002)								
- REAL	4.6	6.3	12.1	11.4	9.3		-6.2	19.3
- DEPOSIT	4.3	2.7	6.3	4.5	8.6	Na	9.0	4.8
- LENDING	6.0	8.5	14.8	16.3	18.5		22.2	12.5
FUNCTIONING CAPITAL MARKET	N	N	N	Y	Y	N	N	Y
SECONDARY MARKET	N	N	N	N	Y	N	N	N
ACTIVE EQUITY MARKET	N	Y	N	N	Y	N	N	Y
CAPITALISATION US\$BN – 2003	-	1.8	-	-	5.8	-	-	6.5

Source: World Bank; Inter-American Development Bank.

* The OECS comprises Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts & Nevis, St. Lucia, St. Vincent & the Grenadines

[†] F- fixed, FL – floating, MF – managed float.

** Exchange rates in these countries have effectively been fixed. Exchange controls are in force in Barbados.

na – not available

Where the divergence in the characteristics of the various financial sectors is indicative of risk perceptions, these perceptions, if significant enough, could significantly thwart financial sector development and devalue the potential benefits of integration. At the same time, the Draft FSA speaks to measures that will “ensure parity among member states in the provision and delivery of [financial] services” (Article 44:1). It is instructive to question, how this parity will be secured in a practical sense given the divergence among member states coupled with the fact that the transmission mechanism is imperfect.

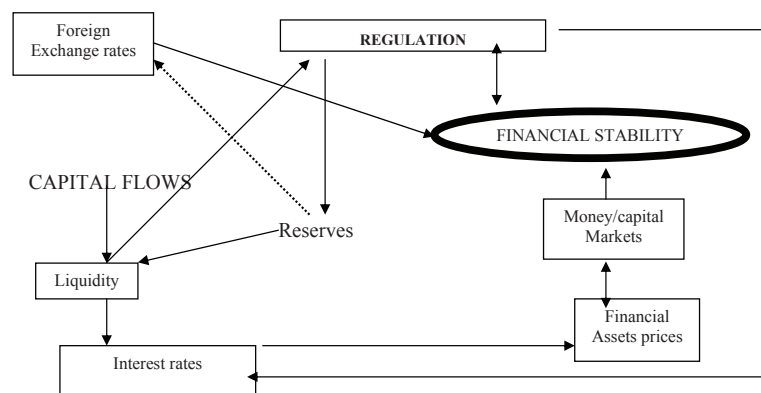
3.2 Capital mobility and financial stability

The liberalisation of capital flows within the Caribbean region, particularly within a context of ‘partial’ or ‘piecemeal’ integration, is likely to have a consequential and direct impact on financial regulation and financial stability. Generally speaking, the increased volatility in liquidity has critical implications for Caribbean regulators. One of the key concerns of the Council for Finance and Planning (COFAP) is to ensure that short-term market fluctuations will not lead to unnecessarily volatile liquidity positions, as this could devalue financial stability (see Article 42(2)).⁶ The literature suggests the use of appropriate monetary policy to enhance the effectiveness of risk management, and sterilisation to reduce volatility and the potential for lending booms. In this regard, policy makers must remain vigilant to ensure that there are no trade-offs between macroeconomic and financial sector stability objectives. It should also be noted that sterilisation may actually increase short-term capital flows depending on the nature of the exchange rate regime. In fact, the World Bank notes that:

Sterilisation presupposes that independent domestic monetary policies can be pursued effectively (to control domestic money supply) under conditions of international capital mobility. But when exchange rates are fixed or pegged and there is a large degree of capital mobility (that is, when a country’s financial assets issued in its currency are reasonably substitutable (in private portfolios) for other internationally accepted assets), sterilisation policies may be ineffective, because any contraction or expansion of the domestic assets of the central bank will give rise to an offsetting capital inflow or outflow (1998:132).⁷

As an illustration, consider the interrelationships depicted in Figure 1 below.

Fig. 1 Capital mobility, liquidity volatility and regulation with fixed exchange rates



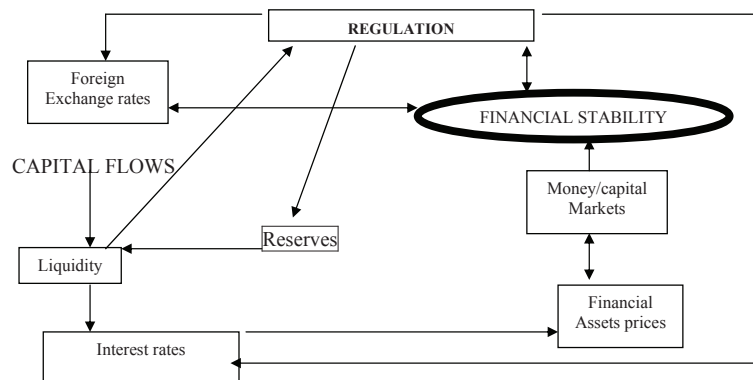
The figure indicates the likely flow of the impact of volatility in capital flows and the consequential effect on financial stability and monetary policy. The level and volatility of liquidity resulting from the free movement of capital will have a direct influence on interest rates (and less so on exchange rates). Excessive volatility in liquidity directly impacts the performance of, and returns available from, the money and capital markets, with consequential influence on financial stability and monetary policy. Depending on the signals from prudential indicators (some of which may also be influenced by capital flows), regulators may choose to respond with the use of (a) selected policy instrument(s). Each of these instruments influences, and is to some extent itself influenced by, the level of stability in the financial sector. As was the case in Thailand, sustainable management of surging capital flows in a fixed exchange rate regime is extremely difficult due to potentially adverse side-effects – such as inflationary pressures and increasing fiscal costs – on the local economy. It is noteworthy too, that there is an indirect pressure on exchange rates resulting from market expectations and confidence in the ability of the regulatory authorities to protect the local currency in the light of significant instability emanating from other sources (World Bank, 1998).

The World Bank (1998) further notes that although sterilisation may be effective over the short term, it is quite costly and may be reflected in higher interest rates. In a context of flexible exchange rates, policy makers might experience more success with sterilisation in order to mitigate the boom-bust effects of increased capital mobility, but may be also be faced with increased volatility in interest rates and exchange rates, both of which are conducive to financial crises in the absence of proper management of the associated risks (see Figure 2).

⁶ COFAP is the administrative body with primary responsibility for economic policy coordination and financial and monetary integration within the CSME.

⁷ These views are supported by Montiel, 1993.

Fig. 2 Capital mobility, liquidity volatility and regulation with flexible exchange rates



The figures show the pervasive influence of liquidity on the wider financial system. The impact of increased liquidity on these key indicators will follow through to influence the perceptions and expectations of market participants and, ultimately, on the conduct of monetary policy and financial regulation and supervision. For example, the volume of liquidity relative to total assets reflected on a bank's balance sheet will influence the available window for additional lending. Based on prudential norms, banks must maintain a required level of capital to risk-weighted assets, and loans are among banks' riskiest assets. Any resulting rationing or expansion in credit is likely to have a concomitant impact on interest rates and, consequently, open market operations and monetary policy.

Within a context of mixed exchange rate regimes, the Caribbean Community presents a challenge to policy makers in terms of addressing the attending risks of capital mobility for the region as a whole. Consideration should therefore be given to accelerating provisions for currency conversion or, ideally, the adoption of a single currency. Theoretically, a single currency has several advantages including enhanced growth prospects through reduced transactions costs and elimination of the exchange risk premia in interest rates. A single currency may also catalyse fiscal consolidation and structural reforms, both necessary for boosting investment prospects and facilitating the desired deepening of capital markets. The absence of a single currency within this context can act as a non-tariff trade barrier since real exchange rate movements will affect the allocation of resources between tradable and non-tradable sectors (such as real estate) as well as worsen external competitiveness.

The foregoing illustrations give a clear indication that considerations of financial stability are not only highly dependent on effective regulation but are also inextricably linked to considerations regarding risk management, market discipline and enforcement.

3.2.1 CAPITAL MOBILITY AND RISK MANAGEMENT

There is a bias towards the call for more effective risk management in financial firms that is doubtlessly due to the high correlation evidenced between financial firms and excessive risk taking. Consequently, it is arguable that the potential increase in volatility (resulting from unrestricted capital flows into thin, under-developed markets) might belie or negate current risk management practices. Moreover, efforts aimed at effectiveness risk management will be thwarted and forecasts will require more cautious interpretation because of the potential increased uncertainty regarding interest rates and, ultimately, asset values. Certainly, the probably of this resulting in instability in the financial sector is beyond the tolerable level.

To achieve optimal returns, effective risk management must be complemented by effective market discipline as it is considered a key confluence factor to financial instability.

3.2.2 CAPITAL MOBILITY AND MARKET DISCIPLINE

There is a presumption that standardisation of information and improved transparency through increased disclosures will assist in ensuring market discipline and therefore promote financial stability. The strengthening of market discipline has long been considered as an avenue to safe and sound banking systems. Moreover, the provision of information that is readily interpretable and comparable across geographical boundaries through the process of international accounting standardisation, is likely to have positive repercussions on international capital flows and inward investment (both at a country level and a regional level) as international investors will have sufficient information at their disposal to assist in making investment decisions. This is likely to have favourable effects on economic growth, and any resulting inflow of foreign currency will undoubtedly impact international reserves and the conduct of monetary policy. Furthermore, it is also likely that there will be potential spin-off effects on the activities on the local and regional stock markets (see Figure 1 and discussion below). Additionally, in the light of the recent collapses of Enron and WorldCom, for example, there is also a critical need for improvements in corporate governance, as firms seek to strengthen and preserve investor confidence and enhance stability.

The implementation of standards *per se* is not sufficient to ensure financial stability; standards are not an end in themselves but a means for promoting sound financial systems and sustained economic growth.⁸ Successful implementation of standards also involves a process of interpretation, application, assessment, and enforcement.

⁸ See also FSF – <http://www.fsforum.org/Standards/WhatAre.html>

3.2.3 CAPITAL MOBILITY AND ENFORCEMENT

The recent corporate collapses in the form of Enron and WorldCom highlight the need for effective enforcement and underscores the point that the best principles are meaningless if not implemented and enforced. It is critical, therefore, that economies have in place an effective legal framework and infrastructure for enforcement.

For integration to achieve the desired outcomes, it is necessary for all the above activities and inputs to be effectively operational so as to secure an efficient and robust regional financial market. This begs the question as to who will be responsible to secure such an environment. Will the local regulators and supervisors in each territory have the responsibility for their designated area? If yes, what of the regional coordination? If no, the regional situation remains to be addressed in addition to the local coordination. Will this situation require the adoption of either the financial holding company regulator model or the single, mega-regulator model? Whatever the decision, there is obviously need for a regulatory authority to negotiate and agree rules and protocols for common implementation: A discrete set of recommendations for local regulators is simply not enough. The difficulties associated with this line of thinking are obvious since it suggests serious consideration of the sensitive areas of political unity and single currency, to name a few, that would be necessary to 'iron out the kinks.'

Integration of Caribbean economies has the potential to assist in the strengthening of domestic financial systems by encouraging sound regulation and supervision, greater transparency, and more efficient and robust institutions, markets, and infrastructure. Integration and its attendant results may also affect financial stability through facilitating better-informed investment and lending decisions and by its impact on market integrity and contagion. Regulators and supervisors (policy makers in general) play a vital role in securing the appropriate environment for financial stability. It is incumbent on these market participants to respond in like manner to the dynamism evidenced in financial markets and to establish the appropriate platform for securing financial stability. Efforts at integration and capital market liberalisation must be further supported by the appropriate policy initiatives. Obviously, the impact of increased capital mobility on individual member states will depend on the respective regulators' ability to manage shocks. It is to these that attention is now focused.

3.3 The implications capital mobility in the CSME on the regulatory Framework

Central to these structural prescriptions noted above is the imperative for CARICOM financial policy makers to further commit to address, accounting, taxation and regulatory rules so that the ensuing benefits will be realised to offset any related costs. Efforts at standardisation must be accelerated if the benefits of capital mobility are to be optimised. This is equally true for all the factors influencing capital mobility (and therefore relates to all the relevant provisions of Chapter 3). In this regard, the challenge is for regional policy makers to be able to respond to the various demands, while balancing the issues of sequencing and timing on a national as well as regional basis. In their review of the Caribbean financial sector the World Bank noted that:

While financial sector reforms would ideally be conducted on a regional basis as a first step towards establishing global links with international financial markets, experience has shown that it is difficult to implement reforms simultaneously. For this reason, countries should begin a process of *harmonisation* through reciprocal liberalisation of tax, legal, capital, and other regulations, while *standardising* financial sector regulators and their enforcement (1998:45) (emphasis supplied).

Of course, the relationship between capital mobility and financial regulatory standards is significant and direct, particularly as prudential regulation and supervision of financial entities is a key component of any safety net. Undoubtedly, the lack of standardization regarding financial regulatory policy, implementation, enforcement and comprehensiveness across CARICOM member states bears real and potential impact for capital availability and cost. The absence of a level playing field carries significant potentialities which can be misused within a context of increased capital mobility. With this in mind, it is instructive to consider what is the role of regulators across the CSME in the evolving process of capital mobility and harmonization of financial regulatory laws.

It will be recalled that one of primary reasons proffered for the market failures from the experiences of several developing countries spanning a wide geographical area was that of inadequate or lax regulation and supervision of financial entities.⁹ More specifically, the market failures of the past may be attributed to intense competition in an over-banked environment that resulted in product innovation *ultra vires* the provisions of the governing legislation. Furthermore, regulators have been blamed for exercising undue forbearance in the light of unambiguous breaches of the law. With the constantly changing financial marketplace, particularly over the past three decades, financial regulators in the Caribbean (and the world over) are faced with an increasing challenge to regulate in an increasingly risky environment. Of course, regulatory rules and policies in developing countries are usually an adaptation of rules and policies developed in more advanced societies. In the absence of a set of generally accepted rules on how to regulate, policy formulation has been, in many cases, a response to the current urgent need.

Because the assumptions of perfect competition - many willing buyers and sellers and perfect information about the goods or services involved in each transaction - do not always hold, regulation is imposed to eliminate or, at least, mitigate, information asymmetries, moral hazard and adverse selection. Any undue advantage that one party to the transaction (usually the seller) has over the other can lead to market failure, as can an inadequate number of sellers or a complex product. Generally speaking, financial regulators are relied on to provide authorisation of market participants; surveillance and supervision to ensure adherence to regulatory codes; enforcement of the punitive measures for non-compliance; timely and relevant adjustments to

⁹ Jamaica in the mid-1990s, countries in East Asia in 1997/8, Mexico in 1994/5, Uganda in 1997/8.

regulations; and the provision of information to enhance market transparency.

The theory of regulation must be applied as an attempt is made to try to analyse the situation facing CARICOM member states at this time. Financial regulators and supervisors are particularly concerned, ultimately, with regulatory capital and its underlying risks. High on the priority list are concerns regarding, for example, solvency, liquidity and capital adequacy. An unquestionable source of substantive information for economic analysis and policy decisions lies in the provision that speaks to ‘the establishment of an integrated capital market in the Community’ (Article 44(1)(d)).¹⁰ While it is acknowledged that surveillance and enforcement are critical to the effectiveness of regulation and supervision, it is also acknowledged that comprehensive surveillance requires significant outlay in resources; this might be prohibitive for some member states. With this in mind, policy makers must be alert to the interactions within the marketplace and any resulting risks created as a result of the dissolution of geographical boundaries due to integration. Arising from this, consideration must be given to the structure and administration of formulation, surveillance and enforcement of regulatory rules and codes? In what ways will the answer to the previous question be influenced by politics, legal practice and the variation among CARICOM member states in legal systems, financial structure, cultural business practices and governance arrangements? Will there be a single regional regulatory agency? A central theme of Eatwell and Taylor (2000) is that efficient regulation requires that the domain of the regulator should be the same as the domain of the market that is regulated. However, whilst financial markets may be considered ‘seamless,’ they are not homogeneous. Of course, failure to reach consensus on information standards, legal systems, and corporate governance will increase the difficulty of standardising regulatory codes and undermine the efficient operation of financial markets. This will create undue risks since regulation that enhances efficiency in one state may expose another to a greater level of risks due to peculiarities in the environment and the resulting differential impact of the provisions on different jurisdictions (see ECOFIN, 2000, for similar views expressed in relation to the EU; Alexander and Dhumale, 2000).

While it is impractical to attain the utopia in financial regulation where codes are tested for their effect on each jurisdiction as a precondition for *consensus ad idem*, a practical compromise is possible. In such a case, ECOFIN (2000) recommends a two-stage regulatory process. The first stage involves the selection and acceptance of general and basic universal tenets that are critical to the success of financial regulation. Practically speaking, these could refer to the provisions of the Basel Accord or capital market regulations to prevent insider-trading or manipulation of markets. The second stage, which presupposes the first, would involve the construction of flexible codes that can adapt to a changing environment as well as to the peculiar governance

¹⁰ See the Appendix for a full list of related provisions as outlined in Article 42 and Article 44, extracted from Chapter 3, Revised Treaty of Chaguaramas.

structures and commercial practices within each member state.¹¹ |

4 INTEGRATION, FINANCIAL STABILITY AND FINANCIAL REGULATION

The need for an appropriate institutional structure is a recurring theme in the debates and discussions about Caribbean integration and capital mobility. This is because policy makers have come to acknowledge that while the potential benefits of both integration and capital mobility are being stressed, these goals are meaningless if considered in isolation. The potential gains in terms of efficiency in resource allocation and deepening of financial markets, for example, for CARICOM states will be stillborn if due consideration is not given to the wider institutional structure and the regulatory environment within which market participants operate. This theme draws attention to the nature and character of the regulatory and supervisory environment within which banks and other financial entities operate and the entities themselves. Having established the major regulatory requirements necessary to realise financial stability, we now turn to examine the extent to which these pre-conditions have been satisfied and the implications.

Indeed, one of the main reasons that has been suggested for the recent banking crisis in Jamaica is the lack of an adequate regulatory framework to support initiatives to relax regulations imposed on banks (see, for example, Daley, 2002). In recognition of the potential for regulations to secure the conditions for preventing certain events that led to the recent crises, regulators have introduced new provisions and the amended existing statutes governing the operation of banks and other financial entities in Jamaica. This paper focuses on the consequences of the existence of institutions, and supports the view that the presence of institutions in society reduces the level of uncertainty by ‘establishing a stable structure to human interaction’ (North, 1990:6). What, then, are the preconditions for this institutional regulatory structure that would foster a stable, secure and efficient financial system?

Policy makers seeking to secure a safe, sound, and efficient financial environment should ensure that high standards of regulatory codes are uniformly maintained so that those economies with high standards are not undermined by less stringent and riskier economies.

4.1 Core competences for achieving financial stability through effective regulation

The economic and financial literature widely supports the view that regulation and supervision play a significant role in the efficiency and stability of the financial system (see, for example, Gavin and Hausmann, 1996; Goodhart et al., 1998). It is also important to recognise that there is a symbiotic relationship between financial regulation and financial stability. Since one of the primary reasons underlying the notion of integration is founded upon considerations of financial

¹¹ ECOFIN proposals are couched in the existence of a central regional regulatory authority.

¹² This applies only to those member states that have signed on for integration at this time. See the Appendix for a full list of related provisions as outlined in Article 42 and Article 44.

sector development (and therefore financial stability), there is therefore an inextricable link between economic integration and financial regulation.¹³

This paper supports the view that legal reform *per se* is insufficient to secure or restore the stability of a financial system. As noted by the World Bank:

Table 2 Comparison of financial regulation and supervision across CARICOM

CHARACTERISTICS OF FINANCIAL REGULATION	BAHAMAS, THE	BARBADOS	BELIZE	GUYANA	JAMAICA	OECS	SURINAME	TRINIDAD & TOBAGO
RISK-BASED CAPITAL					Y			
PRUDENT LOAN LOSS PROVISIONING (>90 DAYS NON-ACCURAL CONSISTENT CLASSIFICATION)					Y			
DOLLARISATION - FX LOANS - FX DEPOSITS								
RESERVE REQUIREMENTS FOR NON-BANKS V. BANKS					≠			
INDEPENDENCE OF REGULATOR/SUPERVISOR					N			y
ADOPTION OF BASLE I					Y*			
ADOPTION OF IFRS ⁸					Y			
INFORMATION-SHARING AMONG SUPERVISORS					Y^			
DEPOSIT INSURANCE EXPLICIT FIXED RATE - RISK-BASED CO-INSURANCE					Y Y N N			

Source:

⁸International Financial Reporting Standards

¹³ Brownbridge and Kirkpatrick (2000), for example, record substantial empirical evidence to demonstrate the crucial role played by the development of financial markets and institutions in economic growth and development.

In trying to ensure a safe and sound banking system, it is a fundamental error to rely on regulation and supervision alone. If the banking system is structurally vulnerable and if the economic environment is highly volatile, no amount of regulation and supervision can prevent banking problems. Minimizing macroeconomic volatility through sound fiscal and monetary policies, is the basis for a sound financial sector. It is no coincidence that the economies that have achieved macroeconomic stability also have the healthiest banking systems (1998:20).

The Caribbean region by its very size and nature – thin, under-developed markets – is susceptible to shocks and financial volatility. What is needed, then, is a whole concatenation of policies, tools, and techniques that are applied with sustained purposefulness. This can be further enhanced by continual reassessment and modification and by enforcing punitive measures for non-compliance.

First, there is a definite need for greater transparency and enhancement of the disclosure of key financial information to facilitate more informed decision-making, and to assist regulators in carrying out their responsibilities. The importance of timely and accurate information within individual financial entities as well as a fully developed culture of transparency and accountability cannot be overstressed. Tentative evidence suggests that in recent years, much more importance has been placed on enhancing the relevance, reliability, comparability and understanding of information disclosed by banks and other financial entities throughout the region (World Bank, 1998; BoJ, 1998). Furthermore, continuing deregulation, increasing globalisation and the accompanying cross-border and multi-currency financial transactions, and the international transfer of capital have played an important role in catalysing the need for international financial standards to harmonise accounting practice and improve transparency. In this regard, there has been increased emphasis on the role of accounting and accountants as important prerequisites for effective regulation and efforts aimed at financial stability. This is because increased disclosure requirements cannot by themselves secure the desired results, particularly where firms have incentives to distort reported figures (for example, for tax purposes). The Basle Committee on Banking Supervision (BCBS) underscores the importance of accounting and accountants to the regulatory process in a report to G7 Finance Ministers:

Banking supervisors have an interest in the quality of accounting standards and their effective implementation, as a means of providing a basis for relevant and reliable measures of assets, liabilities, equity and income, as well as capital adequacy, and enhancing market discipline through transparent financial reporting. They want to ensure that the accounting standards used by banks both support and facilitate supervisors' objective of fostering safe and sound banking systems (2000:6).¹⁴

¹⁴ See also, Daley (2002).

International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) are among twelve standards identified by the Financial Stability Forum (FSF) as critical for securing sound financial systems.¹⁵ The BCBS, the International Organisation of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) support the spirit of the IFRS and similar efforts to harmonise international reporting standards to enhance interpretation and comparability and, as noted by the BCBS, could strengthen the link between public reporting and prudential requirements.¹⁶ Jamaica's adoption of IFRS as of 01 July 2002 signified Jamaica's acknowledgement of the role of robust and effective accounting and disclosure standards and practices in effective financial regulation and supervision and the country's integration into mainstream accounting practice on par with world standards. Within CARICOM, Barbados, the Dominican Republic, Haiti, and Trinidad and Tobago have also adopted IFRS as the national accounting standards.

There is also a critical need for sufficient mechanisms for enforcing prudential requirements and for improving the intelligence of regulators generally. The functions of regulation may be classified by regulatory activity into: a set of preventative strategies and policies employed for bank safety and soundness reasons that are designed to limit risk-taking by banks, and a protective dimension that focuses on activities such as deposit insurance that offers protection to depositors in the event of failure of banks. Since the 1980s, bank regulators and supervisors have had to adjust to more sophisticated supervisory methodologies for monitoring and assessing banks in a potentially riskier and more complex, competitive, and volatile market environment. Certainly, the approach and conduct of supervision will vary in terms of its extent, scope and frequency, as well as in the effectiveness of its monitoring surveillance available in any particular country. This is particularly critical in developing countries where 'the regulatory capacities are weaker and information is poorer' (Stiglitz, 1999:1514). Generally, internationally accepted standards are usually considered to be more effective at promoting sound domestic financial systems and international financial stability, since these standards are considered to be more objective and relatively free of national biases (White, 1996). Consequently, it is expected that the adaptation, adoption and successful implementation of international standards and provisions such as those proposed by the BCBS (frequently referred to as Basle I and Basle II) will yield both national and regional benefits.¹⁷ Within these principles are provisions that address many of the factors to which financial system instability in developing countries has been adduced: insufficient levels of capital to support risk-weighted assets, high levels of non-performing loans, poor corporate governance, poor liquidity management and poor risk

¹⁵ The IASB is an independent private sector body based in the UK aimed at promoting convergence of accounting principles worldwide.

¹⁶ See, e.g., Jain (2002) (<http://www.pwcglobal.com/im/images/pdf/IAS%20to%20be%20adopted%20in%20Jamaica.pdf>).

¹⁷ It can be questioned whether the optimal regulatory framework for developing countries is equivalent to that for more developed countries. This study supports the view of Goldstein and Turner (1996), Stiglitz (1999) and others who propose that the regulatory framework for developing countries may need to show marked differences because the risks are greater. The issue of 'adaptation' is therefore a very important one.

management within financial firms. In addition, the use of an appropriate 'early warning' system to complement 'traditional' regulation would significantly enhance the effectiveness of regulators' surveillance through systematic assessment within a formalised framework on an on-going basis, the identification of weak or potentially weak entities, the prioritisation of examinations between 'weaker' and 'stronger' entities, and the initiation of timely remedial action.

As regards the protective dimension to regulation, attention should be devoted to the potential implications for deposit insurance and the portability of risks within the context of deposit insurance – in particular, a fixed rate deposit insurance scheme. Considerable scope exists for shifting the incentive structure facing bank owners and managers, as well as depositors, so that excessive risk-taking is penalised. Whilst it is in the interest of stability to establish protection in the form of deposit insurance, the scheme must be so designed that the extent of coverage, administration of the fund, and the moral hazard it induces (manifested in the pricing of the premia) are effectively managed so as to reduce the frequency or extent of bank failures. In addition, integration requires that a clear outline for the financial markets infrastructure as it relates to the establishment of an efficient payments and settlement system, which is also critical to well functioning regulatory framework as this will increase efficiency, decrease transactions costs, and increased reliability and transparency will reduce risks.

Regulatory policies and practices as it relates to the CSME are being developed in the context of integration, market developments and broad monetary policy. The Economic Intelligence and Policy Unit of the CARICOM Secretariat has drafted a Financial Services Agreement (FSA) to guide the harmonisation of the regulation and delivery of financial services across member states. If it is to be effective in serving the interests of the public and ensuring financial stability, then such regulation must move in tandem with the structural and operational changes within the various financial systems of the member states. The issues are parallel to considerations extending to the wider regional financial system. In other words, careful examination of individual countries is needed in order to determine what are the most appropriate as well as the most practical solutions for both the country and the region at large. Within this context, there is increasing pressure for regulators, not only to develop adequate and appropriate reforms to keep abreast of developments within the financial markets, but also to enforce these reforms free from political interference. Hanohan (1997) notes that:

Weak enforcement due to political interference is the Achilles' heel of any regulatory system (1997: 21).

The ability to enforce reforms with in a consistent and unbiased manner may require increasing levels of regulator independence and autonomy. This is particularly important within a context where integration is being propelled devoid of a framework of political unity.

At the same time it is acknowledged that, in addition to financial regulation and supervision, a broad range of political, social, legal and institutional factors impinge on financial stability. This underscores the importance of the interaction of the provisions among the local environment of each member state in creating the optimal environment for financial stability. Among these is the establishment of a rating agency and a credit bureau that are vital to the maintenance of integrity in the credit process and there could help to strengthen market discipline. Certainly, this

takes on added significance within a context of increased liquidity resulting from capital market liberalisation. Further, legal reforms to address out-dated provisions for bankruptcy and relating to the pledging and seizure of collateral could also enhance the regulatory process. Not only can laws governing bankruptcy act as a deterrent against default on debt and ultimately enhance stability, but they can also provide a way of salvaging a proportion of loans in case of failure.

5 CONCLUDING REMARKS

This paper has sought to identify and isolate the potential impact of capital mobility on financial regulation and, ultimately, financial stability within the context of integration of CARICOM member states. Although this study is still preliminary to the more comprehensive goal of contributing to the procedures that guide the integration process and assessing the impact of Caribbean integration on individual territories and the region at large, there are far-reaching implications because it anticipates some of the real issues that have yet to be addressed.

5.1 Harmonisation or standardisation?

Several analytical themes have been presented in this paper: first, the integration of CARICOM member states is a positive step towards improving the quality and efficiency of markets in an increasingly globalised world. The second theme is that integration under the CSME will mark significant changes in the context and operation of financial markets within the region. The third theme relates to the increased volatility in financial systems resulting from the increased mobility of capital across member states. Planned harmonisation of product delivery and the regulatory framework is expected to influence the work of regulators, supervisors and other policy makers, as well as real and perceived influences on financial stability. Moreover, capital mobility will influence, and be influenced by, the effectiveness of risk management, corporate governance and market discipline, *inter alia*.

Preliminary findings suggest some important questions for the policy makers within CARICOM. To some extent, these questions will intensify some of the recent pressure that has been brought to bear on governments and policy makers within the region as different interest groups seek to understand and improve the areas of focus. The dynamic nature of the financial services sector presents a challenge to regulators and policy makers worldwide. Of particular note is the need for policy formulators and regulators to bear in mind the interrelationships at work within the financial system, and between the financial system and the wider economic systems. This is especially important with regard to the instruments that are used to effect changes as well as the instruments that are used to measure change within the financial system. As noted by Eatwell in a recent publication:

... it is clear that criteria for authorisation should be at the same high level throughout the international market: ensuring that a business is financially viable, that it has suitable regulatory compliance procedures in place, and that the staff of the firm are fit and proper persons to conduct a financial services business. If, in a liberal international financial environment, high standards are not uniformly maintained then firms authorised in a less demanding jurisdiction can impose unwarranted risks on others, undermining high standards of authorisation elsewhere (pg. 7).

In reaching a consensus for optimising the benefits of integration, policy makers will have to weigh the potential consequences of various policy actions and any necessary redress effected.

Efforts at harmonising regulatory norms will, of course, be influenced by financial sector efficiency and the presence of an environment that facilitates the mobilization of capital and a reduction of risks. There is also strong support for consistency in regulation and supervision among the various financial entities to mitigate or eliminate regulatory arbitrage (World Bank, 1998; McCreedy, 2005). In this regard, does the concept of a single market and economy require harmonised or standardised legislation?

No clear definition has as yet emerged to clarify exactly what is meant by 'harmonisation' as used in the context of the CSME. Certainly, this is one issue that would require clear and unambiguous resolution in order to guide the integration process.

5.1.1 HARMONISATION

The Concise Oxford Dictionary (1997) suggests that it means to bring into, or to be in, agreement. Alternative actions suggested are 'agree,' 'cooperate' and 'coordinate.' Such coordination or cooperation implies the coexistence of the regulations of the different CARICOM member states, even where there is a potential for conflict or where there is a need for combined action (Chetcuti, 2001). Obviously, this sort of arrangement lacks binding force and does not promote the neutrality necessary to secure the benefits of capital mobility as indicated. If this is indeed what is to be understood is required by Chapter 3 of the RTC, there is an implication for member states to enter reservations against items specified in the RTC; it is certainly implied in Article 43 (see Appendix).¹⁸ If member states reserve the right to maintain restrictions, then the harmonisation that is desired supports a form of 'integration-lite' that could lead to market distortions and a possible loss of confidence by the market of the authorities' ability to commit and deliver as promised. This is not to deny flexibility or voluntary convergence, but it remains a significant issue that due to the nature of Caribbean economies – small, open, economies with macroeconomic imbalances and thin, underdeveloped markets – there is an apparent greater susceptibility to shocks. Depending on the nature of reservations entered, this could have adverse effects on the function of the markets in (an)other region(s) and could produce adverse results.¹⁹

¹⁸ In his discussion of tax harmonisation in the EU, Chetcuti (2001) offers a continuum of definitions of harmonisation that may be adapted for implementation.

¹⁹ EU member states subscribe to the OECD Codes of Liberalization and are allowed to enter reservations against items that they may be unable or unwilling to liberalize. Certainly, the EU is very dissimilar to CARICOM in size, nature, level of development and sophistication of markets. See National Institute of Economic & Social Research (1996) *The Single Market Review Series*, available at Internet

5.1.2 STANDARDISATION

Standardisation, as defined in the reference, suggests conformation to a standard, and alternative actions include 'equalize' or 'homogenize.' Taken as given, standardisation of financial regulation would imply full unification of regulatory codes within the Caribbean Community. In its most advanced stage, this suggests an extreme level of integration that would encompass the sensitive areas of monetary union and dispossession of sovereignty. Intuitively it can be appreciated that standardisation on a broad scale is impractical in the short (and possibly even longer) term if only because it lacks political acceptability since no government would readily cede national sovereignty. Furthermore, standardisation at this level presupposes the existence of an organ in the nature of the 'multi-country commission' recommended by the World Bank (1998) to ensure political neutrality and optimise economies of scale in regulation and supervision, which would take some time to be agreed upon and an even longer time to be established.

While this paper has consistently argued for regulatory policies and codes that take account of the peculiarities of different economies, the foregoing analysis has clearly shown that there are some areas that may require a more 'rules-based' approach if the benefits of integration are to be optimised. For example, it is suggested that while harmonisation may be sufficient for accounting and disclosure in order to present a true and fair view of economic events under consideration, standardisation may be required for taxation structures and codes in order not to devalue other efforts at market efficiency and resource allocation. Furthermore, the National Institute of Economic & Social Research reports a useful lesson from the EU:

Our evidence suggests that exchange rate uncertainty in recent years has inhibited and distorted the free movement of capital. The elimination of uncertainty would result in greater borrowing and investment and inward and outward capital flows between the Member States (1996:5).

In other words, what is suggested here is a carefully constructed mix of harmonisation and standardisation pursued with sustained purposefulness and commitment to reaping regional as well as local benefits. It would also be worthwhile for regulators and policy makers to agree on exactly what is desired from the harmonisation/standard as this will ensure that the type and extent of harmonisation/standardisation that is pursued is in fact optimal for achieving the desired goals.²⁰ This would allow for some decisions to be taken at the country level (such as those relating to implementation) rather than at the regional level (which could involve the broad standard-setting process), having cognisance of the peculiarities with the various economies. In this increasingly globalised world, these considerations must be influenced by broader efforts at

²⁰ Chetcuti (2001) summarises various types and degrees of harmonization: horizontal harmonization, vertical harmonization, gradual harmonization, partial harmonization, and imposed v. market-led harmonization.

harmonisation and standardisation of rules and codes within world financial markets (for example, IFRS and Basle principles).

It is not the intent of this paper to outline a detailed and comprehensive prescription as the panacea to Caribbean integration. After all, there is much devil in the detail! Instead, two broad sets of recommendations arising from the analyses are outlined below.

5.2 Conclusions and policy recommendations

This section outlines briefly a recommended set of policy initiatives to be pursued as a vital component of any measures aimed at financial stability. What is required of policy makers is that these be developed into a specific and coherent set of provisions and institutions through which the emerging regional policies may be implemented and maintained. In practical terms, this must involve the development of guidance for effective cooperation in cross-sectoral and cross-border regulation. Practical everyday operational rules and tools must be identified and coherently assured including, but not limited to, exchange of information and expertise and the design of regulation such as setting up common reporting formats and common training of personnel (McCreevy, 2005).

The prime issue is the development of institutional structures that support the ethos of international harmonisation and cooperation. To give the matter due consideration, policymakers must establish the appropriate linkages with, and secure an appropriate environment for, macroeconomic stability as a necessary precondition for a robust and efficient financial sector. Capital mobility must be pursued within a context of financial stability or where conditions exist for that to occur.

The second recommendation is inextricably linked to the first set. Essentially, the second recommendation is the set of some of the critical questions to be addressed by policy makers and regulators in their efforts at financial stability within a context of 'partial' economic integration. Among the most incisive questions are: Do regulators support the efforts at integration and is this support evident in the approach to regulation? Are organisations, regulators and policy makers aware of the benefits to be derived from integration and the attendant effects, including increased capital mobility, and are they committed to optimising the benefits? Do the various financial entities have the appropriate foundation on which to function within an integrated, regionalised environment? Has regulatory staff (and the staff of oversight bodies such as the stock exchanges) been educated in the requirements of the protocols and the spirit of the provisions and have they demonstrated buy-in and a commitment to be effective enforcers?

It should be noted that the results reported in this paper do not bear on the issue of the relative efficacy of integration vis-à-vis 'fragmentation.' Rather, the paper has sought to examine the broad potential impact of the effect of integration on financial regulation specifically through the avenue of capital mobility. Policy makers would also undoubtedly be interested to have an estimate of the quantum of the effect of increased capital mobility on the national accounts and also to be able to test empirically whether, and how, regulation responds to changes in capital. It is suggested here that a logical extension of this work could involve an examination of these quantitative measures using statistical estimations.

This, of course, is conditional on the availability of appropriate data that would facilitate the construction of suitable proxies for estimation.

Vexed questions remain in terms of the state of readiness of the CARICOM member states for integration as well as the fact that a referendum has not been held to seek the views of the populace on some critical issues. In fact, the newly elected leader of the Opposition Jamaica Labour Party was recently reported to have issued new calls for plebiscites on various issues (*Daily Gleaner*, July 4, 2005). In the meantime, while it is understood that integration in the wider sense is a gradual process, it is suggested that for the benefits of integration to be optimised as intended, the provisions in the Revised Treaty must be considered as a unit. The issues which the relevant articles address are so inextricably linked that within this context, any piece-meal implementation of the requirements must be rejected, since that is likely to lead to sub-optimal results. Not only so, but it points to the need for what Mishkin calls 'getting regulation and supervision right' (2000:32). What is required is a specific and coherent set of provisions and institutions that will add value and through which the emerging regional policies may be implemented, complemented and maintained. This is an imperative to ensure that, as was done in the case of financial liberalisation in many developing countries, the cart is not put before the horse.

Appendix

Extracts from the Revised Treaty of Chaguaramas: Chapter 3

ARTICLE 42

Co-ordination of Foreign Exchange Policies and Exchange of Information

1. The Member States shall take such measures as are necessary to coordinate their foreign exchange policies in respect of the movement of capital between them and third States.
2. The Member States shall keep the competent authorities in other Member States informed of significant unusual movements of capital within their knowledge to and from third States.

ARTICLE 43

Restrictions to Safeguard Balance-of-Payments

1. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member State may, consistently with its international obligations and subject to paragraph 5 of this Article, adopt or maintain restrictions to address such difficulties.
2. The restrictions which may be adopted or maintained pursuant to paragraph 1 of this Article may include quantitative restrictions on imports, restrictions on the right of establishment, restrictions on the right to provide services, restrictions on the right to move capital or on payments and transfers for transactions connected therewith. However, such restrictions:
 - (a) shall, subject to the provisions of this Treaty, not discriminate among Member States or against Member States in favour of third States;
 - (b) shall at all times seek to minimise damage to the commercial, economic or financial interests of any other Member State;
 - (c) shall not exceed those necessary to deal with the circumstances described in paragraph 1 of this Article; and
 - (d) shall be temporary but in any event not longer than a period of eighteen (18) months and be phased out progressively as the situation described in paragraph 1 improves.
3. In determining the incidence of such restrictions, the Member State concerned may accord priority to activities which are essential to its economic stability. Such restrictions shall not be adopted or maintained for the purpose of protecting a particular sector in contravention of the relevant provisions of this Treaty, due regard being paid in either case to any special factors which may be affecting the reserves of such Member State or its need for reserves.
4. Restrictions adopted or maintained pursuant to paragraph 1 of this Article, or any changes therein, shall be promptly notified within three (3) working days to COFAP and to COTED, and, in any event, the Member State concerned shall immediately consult with the competent Organ if and when requested.
5. COFAP shall establish procedures for periodic consultations including, where possible and desirable, prior consultations with the objective of making recommendations to the Member State concerned for the removal of the restrictions.
6. The consultations referred to in paragraph 5 of this Article shall:
 - (a) be designed to assist the Member State concerned to overcome its balance-of-payments and external financial difficulties;
 - (b) assess the balance-of-payments situation of the Member State concerned and the restrictions adopted or maintained under this Article, taking into account, inter alia:
 - (i) the nature and extent of the balance-of-payments and the external financial difficulties;

(ii) the external economic and trading environment of the Member State applying the restrictions; and

(iii) alternative corrective measures which may be available.

7. The consultations shall address the compliance of any restrictions with paragraph 2 of this Article and, in particular, the progressive phase-out of restrictions in accordance with paragraph 2(d).

8. In such consultations, all findings of statistical and other facts presented by the Committee of Central Bank Governors relating to foreign exchange, monetary reserves and balance-of-payments, shall be accepted and conclusions shall be based on the assessment by the Committee of the balance-of-payments and the external financial situation of the Member State concerned.

ARTICLE 44

Measures to Facilitate Establishment, Provision of Services and Movement of Capital

1. In order to facilitate the exercise of the rights provided for in this Chapter, COTED and COFAP shall, subject to the approval of the Conference, adopt appropriate measures for:

- (a) the establishment of market intelligence and information systems in the Community;
 - (b) harmonised legal and administrative requirements for the operation of partnerships, companies, or other entities;
 - (c) abolition of exchange controls in the Community, and free convertibility of the currencies of the Member States;
 - (d) the establishment of an integrated capital market in the Community;
 - (e) convergence of macro-economic performance and policies through the coordination or harmonisation of monetary and fiscal policies, including, in particular, policies relating to interest rates, exchange rates, tax structures and national budgetary deficits;
 - (f) the establishment of economical and efficient land, sea and air transport services throughout the Community, and
 - (g) the establishment of efficient communication services.
2. COFAP and COTED shall establish a comprehensive set of rules in respect of the areas listed in paragraph 1 of this Article for approval by the Conference.

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