

## THE COSTS AND BENEFITS OF FINANCIAL GLOBALIZATION IN THE CARIBBEAN SUBREGION

International capital flows increased significantly during the 1990s due to advances in communication and information technology and the liberalization of national, financial and capital markets. Financial globalization has resulted in the increased interconnectivity of global markets. Net global capital flows increased from US\$500 billion in 1990 to nearly US\$1.2 trillion in 2000<sup>1</sup>. Although the larger proportion of these flows is concentrated in the developed economies, developing countries have also been receiving larger shares of private capital flows and decreasing amounts of official flows. The main component of the private flows has been Foreign Direct Investment (FDI). While the increase in these flows has been beneficial to the developing countries in financing development projects and in augmenting private savings, to name a few, they have brought with them potential costs. This Issue Brief will examine the main trends in capital flows in the Caribbean, with a view to determining the costs and benefits of the impact of globalization on capital flows in the subregion.

### Trends in Capital Flows

Total net financial flows to the Caribbean grew from US\$977.5 million in 1990 to US\$3334.75 million in 2000. During the 1990s, countries in the Caribbean subregion, as a response to globalization and as a reflection of the global trends, adopted outward-oriented policies which were reflected in increased trade liberalization and market-opening policies. These steps to liberalize the economies not only led to greater trade flows but also saw a rise in financial flows to the Caribbean.

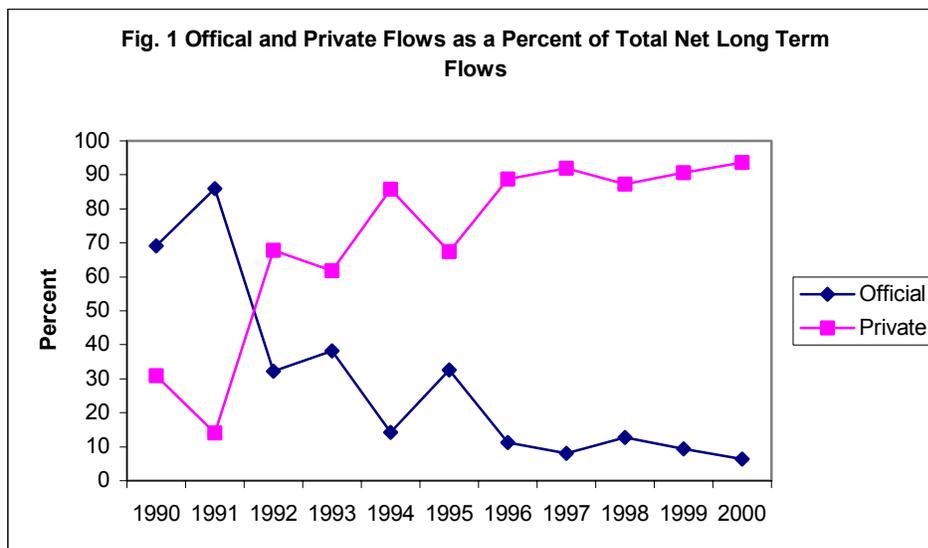
Financial flows comprise official and private flows. The former can be further classified into grants and loans and the latter into foreign direct investment as well as portfolio investment, including bonds and bank loans. A review of the financial flows shows two contrasting trends whereby official flows declined and private flows increased, private flows have therefore been replacing official flows. Official flows fell drastically during the 1990s. Net official flows of

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<sup>1</sup> Hausler, Gerd "The Globalization of Finance", *Finance and Development*, Vol. 39, No. 1, March 2002, pg. 2, Internet edition, [www.imf.org](http://www.imf.org).

resources, including grants, declined from 69% to 6% of the total between 1990 and 2000. On the other hand, private capital flows increased from 30% to 94% in the same period (See Fig.1).

These trends are reflective of the steps by the developed countries to increase their development assistance to the transition economies. Caribbean countries have been receiving decreasing amounts of aid assistance thus highlighting the importance of private flows to the subregion. Private flows are increasingly used to finance development projects in the subregion. Notwithstanding this fact, the data shows that some of the smaller countries in the Caribbean subregion are still very dependent on official flows because of their limited access to private international financial markets. The least developed countries have been unable to attract significant amounts of private flows because of their small size and limited resources or political instability. The combined effect of declining official flows and limited access to private international financial markets has affected the ability of smaller islands to finance viable development projects.



FDI is the main component of private capital flows in the Caribbean subregion averaging 85% of total inflows between 1990 and 2000. Total FDI to the Caribbean increased from US\$1062.8m in 1990 to US\$2052.4m in 2001 (see Table 1) mirroring the increases in capital flows worldwide. However, the subregion managed to attract only 3.7% of the total FDI received by the Latin American and Caribbean region. The bulk of FDI flows to the region went to the larger economies such as Argentina, Brazil and Mexico accounting for 12%, 38% and 15% of the total, respectively, in 2000. The main source of FDI flows to the Caribbean subregion comes from the United States followed by Europe.

Table 1  
Net Inflows of Foreign Direct Investment, 1990-2001 (US\$m)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Anguilla	10.7	6.3	15.5	6.6	11.1	17.7	33.2	21.0	28.0	38.0	39.1	27.3
Antigua & Barbuda	60.4	54.5	19.5	15.2	24.7	31.4	19.3	22.9	27.3	36.4	33.0	53.5
Bahamas	-8.0	9.0	3.0	42.2	42.9	27.0	88.2	209.6	146.4	149.1	249.6	70.9
Barbados	19.9	33.8	26.3	1.2	40.9	-5.4	23.5	31.7	16.7	54.1	155.7	93.4
Belize	20.7	23.9	40.0	84.8	127.7	82.7	115.1	249.7	240.2	151.4	76.1	96.3
Dominica	12.8	15.2	20.5	13.1	22.5	53.9	17.7	21.0	6.5	17.9	10.8	14.1
Grenada	12.8	15.2	22.5	20.2	19.2	19.9	19.3	33.4	48.5	41.4	35.6	34.2
Guyana	16.4	28.0	137.9	63.3	46.8	53.4	59.0	52.0	44.0	46.0	67.1	56.0
Haiti	0.0	-1.8	-2.2	-2.8	0.0	7.4	4.1	7.0	10.8	30.0	0.0	0.0
Jamaica	291.7	51.4	336.3	309.1	446.6	285.0	476.6	-7.3	135.9	-3.8	422.0	880.3
Montserrat	9.6	8.0	4.6	4.8	7.2	3.0	-0.3	2.5	2.5	8.2	3.4	3.5
St. Kitts and Nevis	9.6	8.0	4.6	13.7	15.3	20.4	35.1	19.6	31.8	57.5	95.9	82.6
St. Lucia	44.6	8.0	4.6	34.0	32.4	32.6	18.3	47.6	83.1	82.8	48.8	50.7
St. Vincent & Grenadines	7.6	8.8	14.8	31.3	47.1	30.5	42.5	92.1	88.6	55.9	28.1	35.5
Trinidad & Tobago	554.0	144.1	171.0	372.6	521.0	295.7	356.3	999.6	731.9	379.2	654.3	554.0
Total	1062.8	412.3	818.9	1009.4	1405.3	955.2	1307.9	1802.6	1642.3	1144.0	1919.4	2052.4

Source: ECLAC based on national data

Trinidad and Tobago and Jamaica are the main recipients of FDI in the accounting for 60% of the total average FDI flows between 1990 and 2001. The lion's share of FDI received by Trinidad and Tobago (37% of the total) has been channelled into the petroleum industry (exploration, refining, production facilities and petrochemical firms) (ECLAC 1998 and 1999). FDI flows to Jamaica have been channelled into light manufacturing activities such as textiles and apparel, and, more recently, tourism. Recently, FDI flows have picked up considerably since 1992.

FDI flows to the Organization of Eastern Caribbean States (OECS) accounted for an average of 18% of the total for the subregion from 1990 to 2001. Interestingly, FDI as a percentage of GDP is higher for the OECS countries than for the resource-based countries such as Trinidad and Tobago and Jamaica. The size of the economies explains this trend, since the service based economies such as those in the OECS are smaller relative to those in the resource-based economies.

In the Caribbean, FDI comprises equity capital, reinvested earnings, land sales and company loans. For the OECS economies, intra-company loans accounting for 39% of the total on average between 1997 and 2000, comprised the bulk of FDI flows, followed by equity capital. These were in turn focused on the tourism sector. In the case of the larger Caribbean countries, Belize, Trinidad and Tobago and Guyana, equity capital was the largest component of FDI flows for the first two countries. However, reinvested earning also played an important role in the case of Trinidad and Tobago (See Tables 2 and 3).

	1997	1998	1999	2000
Reinvested	19.8	18.0	18.8	18.9
Land Sales	15.7	9.4	10.1	15.6
Equity	21.0	17.1	52.6	26.6
Other	43.5	55.5	18.4	38.9
Equity and other by economic sector (as percentage of the total)				
Tourism	60.2	75.8	88.7	1.7
Manufacturing	10.8	0.2	0.7	1.7
Utilities	1.3	9.2	0.7	7.8
Technology	0.9	7.6	1.2	0.0
Petroleum	5.8	0.7	0.0	0.0
Agriculture	0.4	4.1	2.2	0.0
Other	20.7	2.5	6.3	6.7

Source: Eastern Caribbean Central Bank (2001)

	Belize	Guyana	Trinidad and Tobago
Equity Capital	80	16	54
Reinvested Earnings	20	12	43
Other	5	73	4

Source: CAIRCOM (2000); Statistical Office of Trinidad and Tobago (2000)

The other components of private flows, that is, equity portfolios, bonds and commercial bank lending, have been of less significance to the Caribbean subregion. Recently, these countries have been using bonds to finance development projects.

The increasingly open environment seen in the liberalization of foreign investment regimes as well as the privatization programmes implemented by many countries in the subregion have resulted in an increase in intraregional cross-border flows of capital in the subregion. FDI has been the main component of these flows (at present, comprehensive and reliable data are not readily available although preliminary data point to this trend). Caribbean firms have also been faced with intense competition in investing in the advanced economies, and thus have begun to view the subregional markets as attractive destinations for their investments. It has even been suggested that these firms are being used as springboards for their gradual insertion into the global market of finance and capital. This is being facilitated by efforts aimed at regional integration, particularly implementation of the Caribbean Single Market (CSME) and Economy, especially Protocol II (ECLAC 2002).

Intra-Caribbean investment flows are dominated by Trinidad and Tobago, Barbados and Jamaica. Not only are these countries the largest outward investors in the other Caribbean countries but they also direct substantial investment to each other. Trinidad and Tobago is the largest outward investor among the More Developed Countries (MDCs)<sup>2</sup> as well as in the whole Caribbean subregion.

### **Costs and Benefits of Financial Globalization**

Acknowledging the benefits to be gained from liberalized capital flows, governments have been putting measures in place to facilitate and attract them. Feldstein<sup>3</sup> (2000) notes the following advantages of unrestricted flows of capital: first, international flows of capital reduce the risk faced by owners of capital by allowing them to diversify their lending and investment; second, the global integration of capital markets can contribute to the spread of best practices in cooperate governance, accounting rules and legal traditions; and third, the global mobility of capital limits the ability of governments to pursue bad policies.

Although there have been benefits associated with financial globalization, there are costs that countries will have to manage. Caribbean countries will be subject to greater risks by putting policies and provisions in place to further integrate into world capital markets. In fact, these countries have to develop and deepen their capital markets in order to attract further private investment. The shallowness of capital and equity markets, especially in the smaller Caribbean countries, may have deterred the use of bonds and equity flows to finance private investment. Only few Caribbean countries have stock exchanges - Barbados, Jamaica and Trinidad and Tobago, however, the Caribbean Community (CARICOM) has proposed the formulation of a Regional Stock Exchange.

Noting that the main component of capital flows to the Caribbean subregion has been FDI, the following section highlights some of the **benefits** to be gained from increasing inward flows of FDI:

- The increase in FDI flows to the Caribbean subregion can be seen as a boon in light of the trends of decreasing official aid and grants to the Caribbean which were primarily used to finance development projects. Thus increased FDI flows will fill the gaps left by the decreases in official flows and assist in financing development projects (which have already been started).
- Apart from being a primary source of private external finance, FDI flows have proven to be more resilient during financial crises since they are more long term in nature. FDI is largely motivated by investors seeking long-term gains in investment activities that they directly control and thus the fear of capital flight would be less.
- FDI not only adds to the stock of capital, that is, investible resources and capital formation, but it also allows the transfer of technology, skills, innovative capacity, and

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<sup>2</sup> These include Barbados, Guyana, Jamaica and Trinidad and Tobago.

<sup>3</sup> Feldstein, M. "Aspects of Global Economic Integration: Outlook for the Future," NBER Working Paper No. 7899 (Cambridge, Massachusetts: National Bureau of Economic Research), 2000

organizational and managerial practices between locations, as well as accessing international marketing networks. Countries are therefore able to develop their human resource potential since their citizens are often offered training to be able to operate in the new business environment. Enterprises that are part of transnational systems (consisting of parent firms and affiliates) or that are directly linked to such systems through non-equity agreements are the first to benefit, however, these assets can also be transferred to domestic firms and the wider economies of host countries if the environment is conducive. The greater the supply and distribution links between foreign affiliates and domestic firms, and the stronger the capabilities of domestic firms to capture spillovers from the presence of and competition from foreign firms, the more likely it is that the attributes of FDI that enhance productivity and competitiveness will spread<sup>4</sup>.

- Economic theory states that if all countries start from identical levels of physical capital per capita, identical technologies and faced financial constraints in accessing the international financial markets, then countries which are better able to access the international capital market, and in this way have higher net external financial flows, should be able to grow at faster (and decreasing marginal) rates. Therefore, once policies are geared to ensure that the increase in FDI is generating sustained economic activity in the domestic economy, instead of being used to finance the trade deficit, for example, the increased FDI flows would have been an indirect agent for economic growth.
- FDI has assisted in the process of structural change in the Caribbean subregion. Due to their historical background, these economies were predominantly dependent on primary products and on preferential markets and treatment by the traditional importers of their products. However, during the 1990s, there was a shift from dependence on agriculture and mining, in terms of a declining contribution to GDP, to a dependence on the services sector while the manufacturing sector remained more or less stagnant during the period. The trends in FDI flows also mirror these changes, that is, the sectors in which the main proportion of FDI has been flowing in these economies mirror the sectors which contribute the most to output. A breakdown of the investment in the OECS shows that it is geared to the services sector either in tourism services or offshore banking services. Thus FDI flows can also assist countries that have been trying to diversify their economies by allowing investment in non-traditional contributors to output. Additionally, as these sectors grow and become more competitive, this, in turn, will facilitate increased private flows into these countries and sectors<sup>5</sup>.
- Capital flows have assisted in financing domestic investment. Caribbean countries have traditionally relied on foreign capital flows to close both foreign-exchange and savings-

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<sup>4</sup> Mallampally, P and Sauvart, Karl " Foreign Direct Investment in Developing Countries", Finance and Development Magazine, March 1999, Vol. 36, No. 1. Pg. 3 (Internet Edition [www.imf.org](http://www.imf.org))

<sup>5</sup> However, it must be noted that all Caribbean countries are not service-based economies some are goods-producing. Thus, the development of services has reinforced a dual trade specialization in these economies. Trinidad and Tobago, for example, is dependent on its petrochemical sector. In fact, the increased investment in that country in its natural resources has contributed to that country becoming a leading producer and exporter of methanol and ammonia.

investment gaps. FDI as a percentage of gross fixed capital formation increased significantly during the 1990s from 14.8 per cent in 1990 to 24 per cent in 1999.

The following are some of the negative effects of increased flows of FDI on a domestic economy:

- Liberalized foreign investment regimes eliminate the restrictions on the mobility of capital. Therefore, foreign direct investors would be able to repatriate their total profits, which would have provided a base for further growth. Also, these liberalized regimes may imply decreases in corporate taxes spelling a reduction in the revenues to the State. However, it must be noted that the gains from the increasing amounts of FDI might mitigate the lower tax revenues and that the reduction in corporate taxes may have been put in place to attract foreign investment in the first place.
- FDI provides an avenue through which transnational corporations or foreign residents obtain ownership of a domestic firm. In such instances, foreign investors have the potential to exercise management and control over the host country firms.
- Another concern lies in the fact that although FDI may result in increasing employment, such as seen in the maquiladora sectors in the Dominican Republic and Jamaica, this employment is only at the low technology end of the production process. The higher technology jobs are usually reserved for the investors themselves. Additionally, there may not be any backward linkages from the foreign affiliates to domestic firms or the foreign investor might have the in-house capacity to compete some domestic firms out of the markets.

## **Conclusion**

The globalization phenomenon spurred by the advances in communication and information technology has resulted in increasing flows of capital globally. These increases were also experienced in the Caribbean subregion. During the 1990s, official flows decreased while private capital flows increased with the main component of these flows being FDI, net FDI to the subregion grew substantially from US\$651 million in 1990 to US\$3465 million in 1999. Also, intra-Caribbean investment increased during the 1990s with the MDCs, excluding Guyana, being the main investors and recipients of FDI in the subregion. The increasing competition brought about by the globalization process would make it more difficult for Caribbean firms to invest in the advanced economies. The argument was put forward that intra-Caribbean investment increased not only because Caribbean firms are increasingly exploiting all the avenues of competitiveness, including locational advantages and mergers and acquisitions, but that they are being used as springboards for their gradual insertion into the global market of finance and capital.

The benefits to be accrued from increasing flows of private capital to the Caribbean have to be viewed from the framework of increasing flows of FDI since the latter was the main component of private capital flows to the subregion. These benefits range from augmented

domestic savings; technological transfer, better management practices, expanded access to global markets, training prospects, employment opportunities. It also provided governments with the financing for development projects in light of decreasing official aid and has assisted in the diversification of the economies in the subregion. The costs of the increasing flows of FDI to the subregion are seen in: the loss of ownership and control of domestic firms to foreign investors; the loss of income through reduction in corporate taxes and reduction in international reserves as a result of repatriation of profits by foreign investors; the problems of adverse selection and excessive leverage; also the potential for foreign investors to only hire locals at the lower end of the production scale and not provide them with the opportunities for upward mobility. However, Caribbean governments have more to gain from opening their economies to unrestricted flows of capital providing that they adopt policies that foster more efficient investment, domestic as well as foreign, and that they have proper safeguards in place to manage the increased flows of capital.