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S&P action makes Cayman ‘a prisoner of events’

By: Patrick Brendel | patrick.brendel@cfp.ky
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Economists said the downgrading of the US federal debt rating might not impact the Cayman Islands in the short term, but generally the future of the local economy will largely be dictated by conditions in US and global markets.

Additionally, further instability throughout the world economy could drive more money into ‘safe havens’ such as Cayman.

Economist Richard W. Rahn, a senior fellow at the Cato Institute and an editorial board member for the Cayman Financial Review said decisions made here could make a difference.

“Cayman will largely be a prisoner of events in Europe and the US, unless it comes up with innovative products that can appeal to those who are trying to protect themselves from bad policies in Europe and the US, and also to attract Asian money from those who would like to invest in the US or even protect themselves,” he said.

Standard & Poor’s lowering its long-term sovereign credit rating of the US from AAA to AA+ probably will not lead to an immediate increase in interest rates in the US and Cayman, Mr. Rahn said, especially considering the comparatively worse financial situation in Europe. However, he predicted interest rates will definitely increase in the longer term, or else countries will have to deal with economic stagnation.

Andrew P. Morriss, a professor at the University of Alabama School of Law and chair of Cayman Financial Review’s editorial board, said the US still looks like a safe place to be compared to Europe.

“In the short term, maybe nothing huge will happen, but further down the road a lot is going to happen,” he said.

Economist Warren Coats, who is a director of the Cayman Islands Monetary Authority, said the downgrading of the US debt could potentially impact Cayman in two ways: the Cayman government’s borrowing costs and the exchange rate between the US dollar and the Euro and other currencies.

“The Cayman government has been forced into the market to borrow. It is hard to see much impact for Cayman in this area in the short term, but the US downgrade can’t help,” he said. “In the long term, interest rates everywhere will have to rise and those in Cayman as well, quite independently of the downgrade, though again that doesn’t help. Everyone needs to tighten their belts and start living within their means.”

Mr. Coats said any devaluation of the US dollar could also have an impact.

“The Cayman dollar is fixed to the US dollar, but it trades a lot with Europe and attracts European visitors, especially from the UK. Any depreciation of the dollar would make a Cayman vacation more attractive to Europeans, but would make importing European goods more expensive. All in all, I see little impact for Cayman,” he said.

Kelvin Sergeant, an economic affairs officer for the United Nations Economic Commission for Latin America and the Caribbean, noted that Cayman’s economy depends on offshore financial institutions and tourism. He said they expect borrowing costs to rise in the US, including credit card debt, some mortgages and car loans.

“The net result is that consumers in the USA may have to pay more for loans, and as such may curtail their expenditure on holidays in the short run which may affect the tourist sector,” he said in an email. “In the offshore sector, if interest rates increase in the US, and if these rates are higher than those offered in the Cayman Islands, then competition may force some of these financial institutions to stay in the US. The downgrade could also tighten lending by banks in the USA and this could restrict investments to the island.”

Mr. Sergeant said, “The real issue is really the uncertainty at this time and the effect which this uncertainty could have on the US economy and by extension the rest of the world.”

University of Texas at Austin economics professor James Galbraith said S&P’s downgrade will have the greatest negative impact on S&P itself. “It’s a further blow to the already low reputation of the already discredited company,” he said, alleging that S&P’s move was politically motivated.

“Once you have basically right-wing politicians calling the shots at rating agencies, it’s just a short stretch before they lose all credibility,” he said, pointing to a rise in the bond market immediately after S&P’s announcement.

Mr. Galbraith attributed the concurrent drop in the stock market to investors reacting to the realisation that “every government in the world is screwing up”.

Mr. Rahn said S&P's downgrading is "only a reflection of reality" and should serve as a warning to governments against carrying unsustainable debt.

Like the US, Cayman has a bloated government, Mr. Rahn said. "The fact is the Cayman government, like so many places in the US, has allowed expenditures to get out of control. The civil service is too fat and too overpaid, with excessive benefits. That leads to problems."

On the other hand, worldwide fiscal instability – and the spectre of increased taxation – could create new openings for financial entities in Cayman's private sector, he said.

"It presents almost an opportunity in disaster," Mr. Rahn said. "This sort of thing can't be done by the government, but financial players could think of ways to help protect people around the world, using the legal and tax infrastructure of Cayman. Government has to be flexible enough to go along with the kinds of changes, as people to come up with innovative ideas."

In its report, S&P said its decision to lower the US' long-term sovereign credit rating was based on its opinion that the recent US plan did not do enough to stabilise government debt burden in the next few years, and its disbelief in the political parties being able to come up with a viable financial plan toward sustainability. S&P noted that it "takes no position on the mix of spending and revenue measures that Congress and the (Obama) Administration might conclude is appropriate for putting the US's finances on a sustainable footing."