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FACTORS INFLUENCING THE GROWTH OF FINANCIAL SERVICES IN JAMAICA

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ABSTRACT

Financial services and institutions have grown significantly in Jamaica over the last ten years. Of particular significance is the growth of trading in government securities and non-traditional instruments such as commercial paper, and the growth of financial conglomerates. This paper looks at the influences on these developments and at the low real growth that has been occurring in the economy. The paradox is the significant growth of financial assets and financial institutions and the downturn in productive sectors. Although the paper focuses on factors influencing the growth of financial services it nevertheless examines the relationship between financial services and economic growth as a factor affecting the translation of financial resources into productive growth. It was found that monetary and exchange rate stabilisation policies, financial liberalisation policies and limited regulation of financial institutions were the main factors influencing the expansion of the financial sector. These factors coupled with trade liberalisation and the difficulty in sustaining price stability constrained the expansion of the real economy. The softness of the stockmarket and some segments of the real estate and tourism markets has led to the collapse of some financial institutions and to loss of confidence in the financial sector. Government will have to focus on sustaining macroeconomic stability, improving the effectiveness of its regulatory functions and curbing the concentration in the financial sector arising from the rise of conglomerates.

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I. INTRODUCTION[1]

The service sectors in most countries have grown significantly over the past few decades with a concommitant growth in the trade of services by industrialised countries, in particular the United States. The growth of financial services in Jamaica has been taking place within the context of changing domestic and international environments; the liberalisation of trade, financial and capital markets at the domestic level and the liberalisation of trade in both goods and services at the international level. Economic reform measures in Jamaica (and other developing countries) have been aimed at integrating the domestic economy into the changing world economy. These measures form part of structural adjustment loan agreements with the World Bank which are intended to shift resources into export-oriented activities in the goods and services sectors.

Financial services include banking, deposit taking and lending, insurance, financial leasing and money transmission services. And the institutions that have been providing these services are the central bank, commercial banks, merchant banks, finance houses, trust companies, building societies, insurance companies and credit unions. In Jamaica, these services have grown and developed and the institutional structure within which they are provided has changed. We look at these, the factors

[1] The Author is grateful to Prof. Alfred Francis, Chairman of the Securities Commission and Mr. Kenloy Peart, Director of Research Services, Bank of Jamaica for their assistance in clarifying some issues and gaining access to information.

that influenced them and the resultant effects in the following sections.

II. GROWTH AND DEVELOPMENT OF FINANCIAL SERVICES

The theoretical literature seems to use the terms financial growth and financial development interchangeably. A study of financial intermediation and economic development in Barbados reviewed that literature and highlighted some findings. Of significance is the correlation found between various measures of financial development and the growth of real output in an economy. The conclusion therefore is that growth in financial services 'can stimulate economic growth by increasing the rate of capital accumulation and by improving the efficiency with which economies use that capital' [Craigwell, Haynes & Wood 1994, p.146]. However, of even greater significance is the view that the development of financial institutions is neither a necessay nor sufficient condition for economic growth in developing countries. The juxtaposition of these two views elicits the hypothesis that the growth of financial services without the concommitant development of financial institutions providing these services, is a sufficient condition for stimulating economic growth in developing countries. And it generates the question, could investible resources not be translated into economic growth despite the growth and development of financial intermediation. We will return to this later.

On the assumption that financial intermediation is positively linked to economic growth, the authors of the Barbados

study then focused on the determinants of financial development. Although a distinction is made between the size of the financial sector and the sophistication of the financial system [Haynes et al. p.143] financial growth is not clearly differentiated from financial development. Nevertheless, they identify public policy as the most significant determinant of financial development. This follows on the McKinnon/Shaw hypothesis that financial repression via restrictions on interest rates and credit allocations adversely affects capital accumulation; and hence its converse financial liberalisation should inform government policy [McKinnon 1988].

How then should we distinguish financial growth from financial development? Whereas financial growth would clearly refer to growth in financial assets and financial services, financial development would suggest increased product differentiation and backward linkages to the productive sectors of the economy.

Financial growth in Jamaica, in terms of the assets of licensed financial institutions, have grown significantly over the last 10 years, especially from 1993. The commercial banks are the dominant holders of assets. These have grown by 38 percent in real terms from 1990 to 1995. However, building societies have experienced faster growth in assets than the commercial banks. The value of their assets in real terms more than doubled from 1990 to 1994. On the other hand, the assets of merchant banks, finance houses and credit unions have hardly

grown over the period [Table 1].

The number of institutions providing financial services have also grown over the last ten years. There are 11 commercial banks, one of which is currently under temporary closure. Most of these banks have expanded the number of branches over this period. Moreover, four of them including the one that is temporarily closed have come into existence during this period. The number of merchant banks and trust companies or institutions licensed under the Financial Institutions Act increased from 8 in 1985 to 29 in 1996 including Century National Merchant Bank and Trust Company which is under temporary closure. Building societies have had the largest growth, from 5 in 1971 to 35 in 1995. These however numbered 15 in 1996 including Century National Building Society which is under temporary closure. This decline is the result of the licensing procedure which was instituted for building societies and the merger of some societies which has occurred. At September 1996 there were 87 credit unions in operation.

Services provided by financial institutions have developed from the basic services offered in the past. The range of banking services has expanded from traditional payments, deposit and credit services to include specialised services such as investment (unit trusts) and pension plans and consulting services for specific groups such as high-income earners. Traditonal services have also developed to include salary payments, self-service or automatic teller machines and issuance

of credit cards. And insurance companies have added mutual funds and equity-linked insurance services to their portfolios. Financial intermediation has also moved towards non-bank and non-financial institutions such as real estate agencies. Some of these institutions offer services such as loan and credit facilities that have traditionally been offered by commercial banks. Commercial and industrial entities offer money transmission services through the operation of agencies of international money transfer companies. However, it is the growth of non-depository institutions and tradeable securities that has become significant within the present decade.

Non-depository institutions are institutions such as insurance companies, securities brokers and securities dealers. These have grown over the last ten years to between 100 and 200 companies. They offer investors a variety of instruments with different degrees of risks and returns. Some insurance companies operate unit trust funds as well as mutual funds; the latter are like unit trust funds in that units are invested in various markets such as equities and government securities; the essential difference is that the company determines how mutual funds are invested. The investment and stockbroking companies operate money market funds some of which are unit trust funds which are suject to the rules governing unit trusts.

The extent of disintermediation (or the shift of financial intermediation from banks and savings institutions) is determined by the share of credit funds mediated by the non-depository

institutions. The share of funds mediated by these institutions in the United States grew from 20 percent in 1950 to 50 percent in 1983 [UNCTAD 1994]. We do not have enough data to determine the extent of disintermediation in Jamaica within the last 5 to 10 years; although Bank-Of-Jamaica data show a much more significant growth of commercial paper transations than commercial bank loans to the private sector between June 1994 and June 1995 [BOJ 1995].

Dealing in securities has become significant over the past five years. Securities are traded on the equities market or on the money market. The former type of securities are traded through the Jamaica Stock Exchange whereas the latter are traded through commercial banks, non-banking financial institutions, non-financial institutions such as real estate companies and securities dealers. The stock market received a fillip from government's privatisation programme during the latter half of the 1980s and boomed during the early 1990s. It has however been in a slump since early 1993. On the other hand, trading in commercial paper has grown significantly over the past few years. Outstanding commercial paper transactions at June 1995 were J$4 billion whereas they were J$1 billion at June 1994 BOJ 1995]. The Securities Commision give an estimate of J$8 billion in commercial paper that is traded monthly for periods averaging 30 days [Stephenson 1996].

Trading in securities is one of two significant features of the financial structure that have emerged. The other is the

linkages within the financial sector and between the financial and commercial sectors. In other words, the growth of financial institutions has been taking place within the context of the growth of financial and commercial conglomerates. Almost every commercial bank is linked to either a merchant bank or a building society or both and several of these institutions are part of conglomerates which include insurance companies and security brokers among others [See CNB Case and Chart at Appendix 1].

III. FACTORS INFLUENCING THE GROWTH OF FINANCIAL SERVICES

There are three main sets of factors that have contributed to the growth of financial services in Jamaica: demand management policies, financial liberalisation and regulation of financial services. These are not mutually exclusive, and in fact their combined effect has increased the complexity of the financial sector.

Monetary and exchange rate policies have been pursued since the early 1980s under stabilisation agreements with the International Monetary Fund in order to achieve the objective of internal and external balance. Policies centred on constraining the growth of the money supply and achieving a market-determined exchange rate. Credit controls and high reserve requirements were used to contain demand. The result has been high interest rates and currency depreciation which became long-term measures given the difficulty in achieving price stability and balance in the external accounts. For example, inflation which had been

brought down to single digit in 1988 increased significantly from 1989 to 1992 and the current account of the balance of payment which was in surplus in 1988 deteriorated from 1989 to 1991 [Tables 4 & 6].

The financial liberalisation programme which was part of the structural adjustment loan agreement with the World Bank was embarked on in the mid 1980s. Credit controls were removed and interest rate determination liberalised by linking the savings rate to the unregulated time deposit rate of commercial banks. This resulted in the reduction of savings rates. The secondary reserve requirement was to be phased out between 1985 and 1988; and in fact by 1988 the statutory reserve requirement of commercial banks consisted only of a cash reserve ratio of 20 percent. In addition, interest was paid on a portion of the statutory reserves from 1986. However, inflationary and balance-of-payments pressures from 1989 led to reimposition of both credit controls and the secondary reserve ratio. Interest payment on reserves was discontinued. Although these were eliminated in 1991 the secondary reserve requirement was again increased in 1992 resulting in a liquid assets ratio of 50 percent which is the same as it was before the liberalisation in 1988. This was reduced to 47 percent in 1995 [Table 6].

Progressive increases, since 1990, in the statutory reserve requirements for non-banking licensed financial institutions constrained the process of financial disintermediation. However, it encouraged intermediation by non-licensed financial

institutions as well as by non-financial institutions. This along with the high interest rates to curb demand encouraged the growth of commercial paper transactions. It also encouraged inefficiency in the operations of banks and other financial institutions as indicated by the wide spread in interest rates. High interest rates result in the reduction of the volume of loans [Shaw 1994]. Banks and other financial institutions have had to diversify their sources of income to maintain their profit margins which have not grown significantly between 1992 and 1995 [Tables 9A & 9B]. Fee income, income from foreign currency trading and from investment have become major sources of income for commercial banks.

The liberalisation of the foreign exchange market in 1991 has resulted in the growth of currency trading by both commercial banks and non-banks. Interbank trading - spot purchases and sales - increased significantly, by over 80 percent, between 1991 and 1995. Commercial banks were empowered to operate foreign currency accounts in 1990. They also have to hold a prudential reserve of 40 percent against these accounts. The cash reserve ratio of foreign currency deposits was reduced from 25 to 22 percent in 1994; and banks are paid interest on these reserves. Foreign currency deposits in banks and non-banks also increased significantly, although the bulk of deposits have remained within the commercial banks. Commercial bank balances grew by 55 percent from 1993 to 1995; those of merchant banks grew by over 200 percent during the same period; and building society balances

declined between 1993 and 1994 but grew by 44 percent from 1994 to 1995. High interest rates on Jamaica dollar loans resulted in an increase in foreign currency loans. Foreign currency loans increased by over 100 percent each year between 1992 and 1994 [Table 8]. These loans are used mainly by export-oriented firms.

Financial institutions have also increased their income through increased investment in securities. Increases in the liquid assets ratio resulted in banks increasing their holdings of government securities [Shaw 1994]. In fact, with the reimposition of the liquid assets ratio in 1992, commercial banks increased their holdings of treasury bills by 176 percent [Table 7]. However, holdings of treasury bills by entities other than commercial banks, merchant banks, finance houses and trust companies have grown larger. For example, in 1988 commercial banks held 48 percent of the value of treasury bills; merchant banks, finance houses and trust companies held 10 percent; and other entities held 41 percent. However, in 1994 the third category increased its holdings to 72 percent whereas the share held by commercial banks fell to 21. The high interest rates on government securities have resulted in the establishment of a number of money market (trust) funds, a large percentage of which is usually invested in these securities. Because these funds are held by a trustee the investor pays no tax on the yield.

The increased investment in government and other high-yielding securities has been at the expense of investment in the equities market. Government's divestment of public enterprises

through public offers contributed toward market capitalisation and the stock market index increased during the late 1980s. However, the most significant upward movement in stock prices occurred from early 1990 to early 1993. Thereafter prices fell and the market has remained soft as investors shifted to the money market. One of the casualties of the stock market decline has been mutual funds operated by some insurance companies. These funds have been invested in a mix of government securities, real estate and the stock market. With the decline of the stock market in early 1993 the investing public cashed in their units consequent on the fall in the value of units invested in equities. This has had an adverse effect on the fee income and hence total income of some large insurance companies which have since instituted staff reduction (downsizing) programmes.

The third set of influences on the growth of financial services has to do with the regulatory capacity of the authorities. The regulation of financial entities is provided for by various pieces of legislation. Commercial banks are governed by the Banking Act of 1992 (amemded in 1985) whereas other financial institutions come under the Financial Institutions Act of 1992. Securities transactions will now be regulted under the Securities Act of 1993 (amended in 1996).

Regulatory functions are carried out by the Central Bank, as stipulated under the Bank of Jamaica Act (amended in 1992), in respect of commercial banks and financial institutions licensed under the Financial Institutions Act. The BOJ Act was further

amended in 1995 to extend the Bank's regulatory oversight to the Cambios (Bureaux de Change) that have been licensed to carry out foreign exchange transactions consequent on further liberalisation to achieve a market-determined exchange rate. Insurance companies are regulated by the Superintendent of Insurance and a Securities Commission was recently established to regulate securities transactions.

The Department of Supervision of Banks and Financial Institutions in the BOJ is responsible for supervising the entities subject to the Banking Act and the Financial Institutions Act. Efforts to strengthen the supervisory functions of the BOJ in terms of number and technical capability of staff, have been pursued under structural adjustment loan agreements with the World Bank. However, the recent failure of a number of financial institutions including a commercial bank indicates that strengthening the regulatory capacity of the Central Bank may be a necessary but not sufficient condition for ensuring prudential practices by licensed financial institutions.

A major contraint on effective regulation is the interconnectedness among financial institutions and between financial institutions and commercial and industrial companies. Although the Banking Act (Section 19) stipulates that consolidated accounts must be submitted where a bank has one or more subsidiaries and that an audited balance sheet and profit and loss account must be submitted in respect of all business transacted by the bank and its parent or subsidiary, this does

not guarantee transparency of relations or even the accuracy of information as the case of Century National Bank illustrates. Transactions are shifted between member companies of the same corporate group. As has been the case with transnational corporations, the group can determine where losses should be located, among other things. BOJ inspection personnel would need more than technical skills per se to effectively perform their regulatory function. The solution to this problem seems to be less a question of improving the regulatory capacity of the authorities and more a question of pursuing antitrust measures to prevent financial and industrial concentration.

It was the inadequacy of the regulatory framework for financial services that contributed to the phenomenal growth in these services as well as the growth of financial conglomerates. Before the amendment to the Bank of Jamaica Act in 1992 which included licensed financial institutions within the purview of BOJ supervision, and the increase of the statutory reserve requirements of these institutions, financial intermediation shifted from commercial banks to finance houses and merchant banks and then to building societies. Since then financial intermediation has shifted to securities dealers (investment banks and stockbrokers). Hence the incorporation of these institutions into financial, industrial and commerical groups. Nevertheless, since the establishment of securities legislation and regulation a number of mergers have occurred within the financial sector; between entities such as investment banks and

merchant banks and between merchant banks and stockbroking companies.

The Securities Commission has been in operation since June 1994. It is currently in the process of licensing securities dealers, investment advisors and their representatives. The Commission has within its regulatory jurisdiction all institutions dealing in securities (including the Jamaica Stock Exchange) except for commercial banks, merchant banks and other financial institutions licensed under the FIA which are regulated by the Bank of Jamaica [Stephenson 1996]. The new regulatory body will regulate securities traded both in the equities market (stocks and shares) and in the money market (commercial paper and mutual funds) in order to ensure "appropriate standards of conduct and performance" [Securities Act, 1993, Sec.5.1a].

We can therefore ask what effect the improvement in securities regulation would have on the growth and development of financial services and institutions, since it was financial liberalisation and limited securities regulation that influenced the growth of the latter. For one thing this should reduce the risk that investors are presently exposed to in relation to unsecured commercial paper. For another, it should encourage the orderly development of the securities and capital markets.

IV. FINANCIAL SERVICES AND ECONOMIC GROWTH AND DEVELOPMENT

In this section we return to the question of translating investible resources into economic growth which is facilitated by

financial institutions through the services they provide. The first consideration is the magnitude of loanable funds; the second is the direction of flow of those funds; and the third is the resulting growth sectors of the economy.

The growth of loanable funds, measured by the M_2/GDP ratio, was insignificant between 1991 and 1994. This means that the pool of investible resources was not high and growing during the 1990s. Hence we should not be surprised that the rate of real growth declined or increased marginally over the period.

Data on loans and advances made by financial institutions to the real economy give some indication of the transfer of funds into areas of economic activity. The largest share of loans and advances went to the manufacturing and construction sectors. However, the share of credit to the manufacturing sector has been declining over the years, from 20 percent at the end of 1987 to 11 percent by April 1996. The share to construction has been declining since 1990. Credit to the agricultural sector also declined significantly over the years. On the other hand, the share of loan allocations to financial institutions and the distribution sector have increased, especially over the 1990s. The share of personal credit has been the fastest growing allocation by the banking sector [Tables 3A].

As far as institutions registered under the Financial Institutions Act are concerned, the allocation of credit has followed a somewhat similar pattern to that of the commercial banks. The major share of the loans and advances went to

manufacturing, construction and individuals, although loans to manufacturing have been declining since 1994. On the other hand, the share of personal loans almost doubled from the end of 1988 to early 1996 [Table 3B].

When we look at real economic growth this has increased marginally in real terms since 1990. The rate of growth of output has been significant (16 percent) between 1987 and 1990 [Table 4A]. Some sectors of manufacturing such as textiles and apparel, furniture and machinery and equipment had significant and positive rates of growth for most of the present period although overall production of manufactured goods declined. Growth of the construction sector also slowed during the 1990s. Although the rate of growth of agriculture has been significant it has been declining since 1993.

However, it is the total services sector that has had the most significant growth. The three major contributors to output of the services sector are distribution, financial institutions and financial services. These along with insurance and real estate contributed significantly to the positive rates of growth. Financial institutions and financial services along with textiles and apparel had high rates of growth, 47, 53 and 30 percent respectively in 1994 [Table 4B]. These increases could be attributed to the significant decline in inflation and average loan rates from 1993 and the significant increase in foreign currency deposits and loans; most of the textile and apparel production is for export.

While aggregate real economic growth has not been significant, the (visible) trade deficit has increased significantly over the last ten years, from US$378 million in 1986 to US$941 million in 1995. Exports have not been growing as fast as imports. In other words production and exports of goods have not kept pace with increased imports facilitated by trade liberalisation since the 1980s. This means that increased consumption has had to be financed by means other than production and exports of goods. The deterioration in the current account balance has been mitigated by a positive balance on the trade in services as well as increased private transfers from abroad. In fact, since 1990 the current account balance has been positive in 1992 and 1994. However, the deterioration in 1993 and 1995 was of almost similar magnitude to the deterioration between 1989 and 1991. This shows that the growth in the trade deficit was higher than the growth in net services and current transfers [Table 5].

This raises two questions: (1) why the significant growth in assets and deposits of financial institutions has not been translated into increased inflows into the productive sectors of the economy; and (2) who benefited from the increased mobilisation of funds by financial institutions.

Access to funds in lending institutions is determined by the cost of the funds and the ability of borrowers to satisfy the criteria set out by these institutions. The basic cost of funds is the interest rate on deposits. However, the cost to borrowers includes the interest rate on deposits as well as the cost of the

cash reserve requirement imposed on the lending institution [Shaw 1994]. The average lending rate for commercial banks at the end of the 1980s was 25 percent. This increased to as much as 48 percent in 1994 and declined to 43 percent in 1995. On the other hand, the average deposit rate at the end of the 1980s was 16 percent. This increased to 33 percent in 1994 and declined to 22 percent in 1995 [Table 2].

Savings deposit rates which partially determine commercial bank lending rates have not increased significantly in nominal terms and have become increasingly negative in real terms since 1990. On the other hand lending rates have increased in both nominal and real terms. In addition, the spread between deposit and loan rates has increased significantly for both banks and non-banking financial intermediaries [Table 6]. What we need to ask then is, if the cost of mobilising deposits has not increased significantly then why has the spread between deposit and loan rates increased so significantly since 1991.

Now the cost of the statutory reserve requirement constitutes an element in the cost structure of loans. Commercial banks had their liquid assets ratio increased from 24 percent in 1976 to 48 percent in 1985. The secondary reserve portion of the liquid assets ratio was eliminated by 1988. The liquid assets ratio was therefore reduced to 20 percent. The non-bank financial institutions which fall under the regulatory authority of the Central Bank were required to maintain minimum liquid assets of 15 percent in 1984. This was increased to 25 percent in 1985.

With the elimination of the secondary reserves this was reduced to 5 percent in 1988. The latter was further reduced to 4.5 percent in 1989. The ratio was temporarily increased for banks in 1990 but reduced again in 1991. However, the secondary reserve requirement was reimposed in 1992 and the cash reserve ratio increased to 25 percent thus raising the liquid assets ratio for commercial banks to 50 percent. The requirement was reduced to 47 percent in 1995. On the other hand, the liquid assets ratio for the non-banks continued to increase to 25 percent in 1995 with the cash reserve portion set at 17 percent. This was further increased to 35 percent at May 1996 [Table 5].

The significant increase in reserve requirement in 1992 is reflected in the significant increase in the average lending rates of commercial banks. The latter increased by 46 percent from 1991 to 1992 compared to an increase of 20 percent in 1990 when the liquid assets ratio moved from 20 to 32.5 percent. The non-banks were subject to increasingly stringent reserve requirements which is reflected in both the increasingly high loan rates and high interest rate spread over the past five years. Nevertheless, this does not fully explain the growth in interest rate spreads. For example, the interest rate spread of commercial banks increased from 15 percent in 1994 to 21 percent in 1995 although their liquid assets ratio was reduced from 50 to 47 percent.

The missing element in the cost structure of loans is the cost of non-performing loans. The latter measured as the ratio

of receivables to total loans averaged 8.5 percent for the 11 commercial banks at the end of 1995. Five of the eleven banks had non-performing loans between 5 and 10 percent of their loan portfolios; three had ratios of between 10 and 15 percent; two between 4 and 5 percent and one, the failed Century National Bank, the highest ratio of 24 percent. The non-performing loans are also a function of the high interest rate regimes. We therefore seem to have a situation in which high interest rates contribute to the level of non-performing loans which in turn contributes to the structure of high interest rates. However, more research needs to be done on this aspect.

The question that should be asked is who are the beneficiaries, if not the productive sectors of the economy, of the increased mobilisation of deposits by financial institutions regulated by the Central Bank. We saw earlier that increasing allocations of loans from financial institutions have been flowing to construction, trade, individuals and financial institutions. Most of the construction taking place over the past few years has been related to housing and office complexes and the significant growth in trading has been facilitated by trade liberalisation policies. The high levels of inflation experienced since the late 1980s have encouraged consumption despite demand management policies as individuals acted on the basis of inflationary expectations. The redistribution of income, towards the financial sector in particular which was facilitated by monetary and exchange rate policies, has also contributed to

increased demand which has been satisfied by increased imports.

There are two important points to note in relation to the increased availability of financial resources and the decline in the share flowing into the productive sector. The first one is the growth in the allocation of loans and advances to financial institutions. At present, this level of flow is similar to that into the agricultural sector. Now, the financial sector includes commercial banks, merchant banks and trust companies, building societies, insurance companies and investment banks and brokerage houses. This means that loans and advances from commercial banks and FIA institutions to financial institutions are in fact intra-sectoral loans.

The second and related point is the interconnectedness of financial institutions. All of the commercial banks presently operating in Jamaica are connected to either other financial institutions or groups of companies including other financial institutions. Of the 10 banks presently in operation, 3 are foreign owned. Two of the latter are each connected to a merchant bank and a building society whereas the third is connected to a merchant bank and a finance house. Four of the seven locally owned banks are part of corporate groups which include other companies in the financial sector, namely, merchant banks, building societies, insurance companies and stock brokers as well as companies in the agriculture, information, real estate and tourism industries. The interconnectedness within these groups facilitate non-arms-length relations between member companies.

The relationship between entities are somewhat complex. Although in general the holding company is the parent of the members, in some cases the commercial bank is the parent company of or has shares in some of the other members of the group. In other cases it is the merchant bank which is the parent company or owns shares in the commercial bank. This connectedness would seem to allow for favourable access to loan funds from the commercial bank as the case of the Century National Bank (CNB) which has been temporarily closed by the government illustrates. The CNB experience is indicative of the crisis that has developed in the financial sector as a whole where major banks have invested in real estate and productive activities in the tourism and agricultural sectors and are now seeking to divest their holdings in a non-vibrant economic environment [Appendix 1].

Productive enterprises that are members or associates of financial conglomerates are in a better position to gain access to funds than the rest of the productive sector. Given the direction of loans and advances by the financial institutions, how can we explain the increase in agricultural activities which has been occurring despite the fact that loan allocations by financial institutions have not grown or have even declined. Financing of agricultural activities has been done by the public sector - the Agricultural Credit Bank (ACB) and the Jamaica Agricultural Development Foundation (JADF) at interest rates that were lower than market rates. Loan allocations made by the ACB to the agricultural sector almost doubled from 1994 to 1995.

Interest rates on loans to small farmers were reduced from 37 percent in 1994 to a range from 24 percent to 33 percent in 1995.

The actual or potential instrument for funding productive, as well as commercial and financial activities is the commercial paper which is a promissory note secured or unsecured that is issued by a firm. The equities market whose development the government has fostered through its privatisation policy, is not a preferred option for many firms in Jamaica which do not want to change their structure of family ownership. Commercial paper provides firms with funds that are cheaper and easier to obtain than more expensive bank loans. Unfortunately, there is not much information on issuance and trading of commercial paper although the Bank of Jamaica has recently surveyed transactions undertaken by commercial banks and financial institutions licensed by the Central Bank.

Nevertheless, it was found that companies that are listed (on the stock exchange) have been the main issuers of commercial paper. Most of these tend to be large-scale firms in tourism, export agriculture, import-substitution-type manufacturing and trading. Building societies were also found to be issuing these instruments, although it is thought that the objective may be that of obtaining cheaper savings for parent companies [BOJ 1995]. There is little information on commmercial paper transactions mediated by other security dealers. The BOJ survey revealed significant differences between interest rates on commercial paper and average lending rates of commercial banks.

The difference which was 14 percent in January 1994 was almost doubled to 27 percent in January 1995 [BOJ 1995]. Interest rates on these papers are currently estimated to be 32 percent which is almost 14 percentage points lower than the lowest commercial bank rate of 45 percent [Gleaner, October 2, 1996]. The other advantage to investors in these instruments is that tax is not withheld at source as is the case in relation to interest earned in commercial banks and licensed financial institutions.

It is the large companies that seem to rely heavily on commercial paper financing. Some conglomerates raise more than half of their financial requirements through the issue of this instrument. Other large-scale companies such as Courts Jamaica secure between 20 and 30 percent of financing through such issues [Gleaner, October 2, 1996]. Most of the firms that obtain cheaper funds through commercial paper transactions seem to be large-scale commercial and trading companies. This reinforces the historical bias of lending institutions which directed loans into commercial and traditional export activities. And it raises the question of the ability of smaller scale (innovative) firms in manufacturing and agro-processing to gain access to this method of financing.

V. CONCLUSION

We began this paper by making a distinction between financial growth and financial development. We drew an implicit

conclusion from the conclusions of other writers, that the growth of financial services could stimulate economic growth without the necessity of having developed financial institutions, that is, institutions offering newer and nore sophisticated products. However, we did not attempt to test this hypothesis since our terms of reference were the factors influencing the growth of financial services. We nevertheless found that having more financial institutions operating at higher levels of sophistication has not meant that the Jamaican economy is now more sophisticated and productive, although there are pockets of sophistication and productivity.

The Jamaican economy has depended originally on export agriculture, minerals and tourism, and more recently on export manufacturing (textile and apparel products) for its earnings. Export agriculture, tourism, import-substitution manufacturing, government, construction, distribution and other services including real estate have been the main contributors to output. Traditional financial services, namely banking and credit, were provided by the established financial institutions - banks and merchant banks - for the large-scale enterprises in export and import-substitution production. Development banks were established to provide lower cost credit to non-traditonal production. Building Societies financed the housing need of lower-income groups whereas credit unions catered to their other consumption needs.

Financial services developed in line with the structure and

growth pattern of the Jamaican economy. However, within the last ten years, the financial sector has become decoupled from the real economy. Financial services and institutional structures have grown and developed in keeping with developments in more developed countries. However, the real sectors except for a few medium to large and modern enterprises have not kept pace as many firms, both large-scale and smaller-scale, have been unable to survive the competition introduced by trade liberalisation. As a result, there have been both mergers and closures of firms in response to the changing domestic environment. Nevertheless, it is resources from the real sector that have allowed the financial sector to develop. Government policy has facilitated the redistribution from the productive sectors towards commerce, real estate and the financial sector.

The difficulty in sustaining macroeconomic stability is manifested in the tight monetary policies that have been pursued to restrain demand and the resulting high interest rate regime which has constrained productive activities. This leads us to adjust McKinnon's thesis, namely, that "sustained stability in the domestic price level is a necesary condition for achieving high real financial growth" [McKinnon 1988, p.401] by adding "and for translating high financial growth into real productive growth". Having done this, we need to consider the effect of financial liberalisation.

Financial liberalisation, as well as trade liberalisation, were accelerated in an environment that was not conducive to

investment in productive activities. Liberalisation of the capital and foreign exchange markets were undertaken before trade liberalisation was complete; and liberalisation and privatisation measures were pursued before appropriate legislative and regulatory frameworks were established. These measures made monetary management difficult as traditional instruments of stabilisation became ineffective due to prolonged usage. Policy has therefore had to be reactive rather than pro-active as the consequences of each set of policy measures became evident.

One of the lessons learned from the Japanese experience is that liberalisation of the banking system was gradually pursued. Although Japan did not have the level of price instability as Jamaica, its government nevertheless did not decontrol interest rates on deposits nor neglected close monitoring of banks and other savings institutions in the early phase of liberalisation. On the other hand, the Jamaican government deregulated interest rates on deposits in keeping with its agreement with the international financial agencies rather than in response to its achievement of price stabilisation. Close monitoring of the financial institutions regulated by the Central Bank was not effected. Moreover, the interconnectedness of financial institutions and industrial and commercial enterprises makes traditional monitoring difficult.

The imprudent practices of some financial institutions along with the downturn in markets such as real estate have resulted in the collapse of a number of financial institutions, the most

significant of which were the Blaise Merchant Bank and Blaise Building Society in 1995 and the Century National financial entities in 1996. A crisis of confidence seems to have developed in the financial sector consequent upon the recent run on the deposits of another commercial bank, Citizens Bank Limited. These are the manifestations of problems rooted in government's monetary and financial liberalisation policies, the inadequacy of financial regulation, the constraints on productive activities and the structure and management within financial institutions.

We suggest at this time three responses to the above issues. Firstly, it is important for government to try and sustain the low inflation that has been achieved in recent months so that high nominal interest rates can be reduced. Secondly, government should consider antitrust policy to restrict the formation of financial conglomerates (or supermarkets) and extend the mandate of the Fair Trading Commission to financial services; or amend the Banking Act and the Financial Institutions Act to restrict ownership by or in commercial and industrial enterprises. And thirdly, government needs to ensure effective regulation of the financial entities. This will depend on improvement in the monitoring capability of the Central Bank and greater coordination among the three regulatory bodies, namely, the Central Bank, the Superintendent of Insurance and the Securities Commission. Access to information and a better understanding of the structure and function of financial institutions would enhance the process.

TABLE 1. **REAL ASSETS OF FINANCIAL INSTITUTIONS**, 1990-1995 (J$bn)

YEAR	COMMERCIAL BANKS	FINANCE HOUSES & TRUST COMPANIES	MERCHANT BANKS	BUILDING SOCIETIES	CREDIT UNIONS
1990	9.94	0.15	2.57	1.68	0.46
1991	10.77	0.10	2.34	1.70	0.37
1992	11.39	0.08	2.60	2.11	0.31
1993	11.49	0.09	2.01	2.20	0.35
1994	13.40	0.10	2.07	2.45	0.37
1995	13.63	0.07	2.11	n.a.	0.46

Source: Statistical Digest, Bank of Jamaica

TABLE 2. **DEPOSIT AND LOAN RATES OF COMMERCIAL BANKS**, 1988-1995

YEAR	AVERAGE WEIGHTED DEPOSIT RATE Nominal	AVERAGE WEIGHTED DEPOSIT RATE Real	AVERAGE SAVINGS RATE Nominal	AVERAGE SAVINGS RATE Real	AVERAGE WEIGHTED LOAN RATE Nominal	AVERAGE WEIGHTED LOAN RATE Real
1988	14.3	6.0	14.0	5.7	43.6	23.7
1989	16.4	5.9	14.2	0.1	48.7	13.6
1990	23.5	1.5	18.0	-4.0	44.3	22.2
1991	23.5	-27.5	18.2	-32.8	46.6	-30.7
1992	32.5	-44.8	21.3	-56.0	31.8	-19.2
1993	29.5	7.4	19.8	-2.3	30.7	8.7
1994	33.6	-1.5	21.5	-13.6	25.4	11.1
1995	22.0	2.1	20.3	0.4	25.1	16.8

Source: Same as for Table 1

TABLE 3A. COMMERCIAL BANKS' ALLOCATION OF LOANS AND ADVANCES 1988 - 1995 (Percentages)

SECTOR	1988	1989	1990	1991	1992	1993	1994	1995
Agriculture	11.6	9.4	9.7	7.9	7.9	6.0	6.3	4.1
Manufacture	21.1	19.6	17.6	15.9	15.0	12.8	11.9	13.2
Construction & Land Development	22.8	23.2	22.9	19.8	17.5	14.0	14.3	12.1
Financial Institutions	2.2	1.0	2.6	3.1	2.3	3.3	3.3	5.1
Government	7.5	7.7	8.5	5.9	5.7	5.5	8.2	7.3
Distribution	3.0	3.4	4.1	5.3	5.9	7.0	6.3	7.6
Tourism	7.3	8.2	8.3	6.2	7.2	8.4	9.0	8.3
Personal	4.3	5.5	6.2	11.2	15.1	17.1	17.4	19.4
Other	19.2	22.0	20.0	24.7	23.3	25.9	22.3	22.9

Source: Same as for Table 1

TABLE 3B. FIA INSTITUTIONS' ALLOCATION OF LOANS AND ADVANCES 1988 - 1995 (Percentages)

SECTOR	1988	1989	1990	1991	1992	1993	1994	1995
Agriculture	3.1	2.7	2.5	3.6	2.0	1.8	1.5	3.9
Manufacture	14.1	19.4	16.8	16.7	18.9	19.1	11.0	7.7
Construction & Land Development	44.7	35.4	35.8	29.1	21.3	22.8	23.8	23.3
Financial Institutions	6.2	4.0	2.4	2.3	2.2	3.8	5.0	3.0
Government	2.4	3.8	3.2	3.8	1.1	1.6	2.0	0.8
Distribution	4.1	6.5	6.4	7.5	4.1	7.4	12.9	7.8
Tourism	4.7	6.1	6.1	6.6	9.7	7.2	6.7	8.3
Personal	8.8	4.9	5.8	7.7	7.3	8.3	11.1	13.9
Other	11.9	17.2	21.0	22.7	33.4	28.0	26.0	31.3

Source: Same as for Table 1

TABLE 4A. **BANK LOANABLE FUNDS AND RATE OF GROWTH OF REAL GDP,** 1988 - 1995

YEAR	M_2/GDP RATIO	TOTAL GDP	GOODS	SERVICES	AGRI-CULTURE	MANU-FACTURE	CON-STRUC TION
1988	0.535	2.9	4.2	3.7	-3.4	5.4	14.3
1989	0.405	6.3	10.8	5.5	-9.1	7.3	18.0
1990	0.370	5.5	7.4	5.1	11.5	3.7	1.6
1991	0.389	0.8	-2.2	4.5	-0.2	-7.3	0.6
1992	0.379	1.5	1.9	4.8	13.0	1.3	0.4
1993	0.398	1.4	0.7	2.0	10.1	-1.9	-0.5
1994	0.408	0.8	1.0	9.5	7.5	0.5	-6.3
1995	0.452	0.5	0	3.7	2.2	-1.0	6.7

Source: Economic and Social Survey, PIOJ; National Income and Product, STATIN

TABLE 4B. **RATE OF GROWTH OF OUTPUT OF SELECTED SUBSECTORS,** 1988 - 1995

YEAR	TEX-TILE	FURN-ITURE	MACH. & EQUIP	DIS-TRIB-UTION	FINAN CIAL INST.	FINAN CIAL SERV-ICES	INSUR ANCE	REAL ESTATE
1988	-13.7	11.5	10.8	1.0	21.8	39.3	2.3	2.9
1989	-1.3	8.9	9.8	3.4	23.2	12.4	7.5	1.9
1990	-1.3	0	14.0	4.6	11.4	14.9	7.3	6.9
1991	11.1	0.2	2.3	2.2	18.9	-0.6	4.1	4.1
1992	8.1	-13.3	3.3	5.3	8.0	8.3	4.8	5.4
1993	3.1	7.4	13.7	4.0	-7.2	-9.1	9.3	2.5
1994	30.7	13.9	-1.2	1.7	47.3	53.2	5.4	5.0
1995	6.8	8.9	10.2	5.7	-2.6	-3.1	2.0	5.8

Source: Same as for Table 4A

TABLE 5. **CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS**, 1988 - 1995
US$ Mn

YEAR	BALANCE ON TRADE	NET SERVICES	TOTAL TRANSFERS NET	PRIVATE TRANSFERS	CURRENT ACCOUNT
1988	-357.3	183.8	205.6	125.6	32.1
1989	-606.0	-14.4	322.9	135.2	-297.5
1990	-522.1	-77.3	271.4	155.4	-328.0
1991	-424.3	-84.3	252.8	153.3	-255.8
1992	-475.6	146.7	339.8	248.2	10.9
1993	-804.7	233.6	376.9	306.4	-194.2
1994	-652.0	195.0	475.3	447.2	18.3
1995	-941.2	106.3	579.3	521.3	-255.1

Source: Same as for Table 4A

TABLE 6. **SELECTED FINANCIAL VARIABLES**, 1988-1995

YEAR	EXCHANGE RATE J$ To US$1 (Average)	INFLATION RATE (Average)	COMMERCIAL BANKS LIQUID ASSETS RATIO	FIA INSTI-TUTIONS LIQUID ASSETS RATIO	COMMERCIAL BANKS INTEREST RATE SPREAD	FINANCE HOUSES INTEREST RATE SPREAD
1988	5.49	8.3	20	5	10.8	n.a.
1989	5.75	14.3	20	4.5	9.0	5.4
1990	7.18	22.0	32.5	8.5	7.2	9.5
1991	12.85	51.0	20	9.5	8.3	15.1
1992	23.01	77.3	50	13	14.1	24.4
1993	25.68	22.1	50	17	14.8	20.7
1994	33.35	35.1	50	17	15.1	25.6
1995	35.54	19.9	47	25	21.6	35.0

Source: Statistical Digest, Bank of Jamaica

TABLE 7. **HOLDERS OF GOVERNMENT TREASURY BILLS**, 1988-1995
(Percentage)

YEAR	COMMERCIAL BANKS	MERCHANT BANKS & FINANCE HOUSES	OTHERS
1988	48	10	42
1989	26	18	56
1990	26	24	50
1991	24	17	59
1992	37	13	50
1993	32	17	51
1994	34	11	55
1995	21	7	72

Source: Same as for Table 1

TABLE 8. **FOREIGN CURRENCY DEPOSITS AND LOANS**, 1990-1995
(US$Mn)

YEAR	COMMERCIAL BANKS DEPOSITS	MERCHANT BANKS DEPOSITS	BUILDING SOCIETY DEPOSITS	TOTAL LOANS	SAVINGS RATE Average)
1991	n.a.	n.a.	n.a.	n.a.	4.47
1992	n.a.	n.a.	n.a.	68.3	4.08
1993	428.4	4.7	55.5	142.3	3.61
1994	597.0	13.7	39.0	312.2	3.88
1995	665.6	14.7	56.3	333.7	3.96

Source: Economic Statistics, Bank Of Jamaica

TABLE 9A. **SELECTED INDICATORS OF COMMERCIAL BANKS**, 1990-1995

YEAR	RATE OF GROWTH OF ASSETS	RATE OF GROWTH OF DEPOSITS	RATE OF GROWTH OF LOANS	GROSS PROFIT MARGIN	RETURN ON AVERAGE ASSETS	RETURN ON AVERAGE CAPITAL EMPLOYED
1990	13	19	21	13.9	2.9	55.4
1991	60	47	32	18.0	3.3	56.2
1992	70	88	19	16.3	3.3	63.3
1993	32	38	68	16.5	2.6	57.4
1994	54	50	36	17.9	4.5	68.0
1995	26	30	42	12.7	2.6	43.0

Source: Same as for Table 8

TABLE 9B. **SELECTED INDICATORS OF FIA INSTITUTIONS**, 1990-1995

YEAR	RATE OF GROWTH OF ASSETS	RATE OF GROWTH OF DEPOSITS	RATE OF GROWTH OF LOANS	GROSS PROFIT MARGIN	RETURN ON AVERAGE ASSETS	RETURN ON AVERAGE CAPITAL EMPLOYED
1990	22	12	13	6.1	1.6	27.9
1991	30	9	23	5.8	1.6	23.1
1992	73	98	27	11.1	3.9	39.3
1993	2	11	19	7.4	2.1	16.2
1994	36	4	(10)	12.8	4.8	28.4
1995	16	1	18	11.1	2.9	17.3

Source: Same as for Table 8.

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APPENDIX I

THE CASE OF CENTURY NATIONAL BANK

Century National Bank (CNB) Limited was the result of the Jamaicanisation in 1986 of the Girod Bank (Jamaica) Limited which started operations in Jamaica in 1984. CNB was the 4th largest commercial bank in Jamaica with an asset base of J$6.6 billion and 9 branches island wide before its closure in July 1996. CNB was part of a group of companies in which CNB Holdings Limited, the parent company, had shares. The other financial members of the group are Century National Merchant Bank and Trust Company Limited, the 6th largest merchant bank in the country which operated lease-financing and other services such as deposit and mortgages and Century National Building Society, the 3rd largest building society which offered services such as savings and mortgage financing. The other non-financial subsidiaries of CNB Holdings are Fordix Limited which owns real estate in one of the prime tourist areas and planned to develop entertainment facilities; Shape Corporation Limited which holds residential lots on Jamaica's North Coast; and Spring Park Farms Limited which owns a Great House and operated a farm on Jamaica's South Coast dealing in broilers, beef cattle and pigs. The associated companies of the group, in which the holding company has shares, are the Jamaica Grande Hotel, General Consultants and Insurance Brokers Limited and Blue Cross of Jamaica (Health Insurance).

The increasing liquidity crisis of the Century financial entities led the Minister of Finance to close them in July, 1996 and install a temporary manager. In his interim report, the temporary manager estimated the deficit of the companies at J$6.3 billion with assets valued at J$4.6 billion as against the estimate of the deficit by the Century managers at J$1.9 billion. The conclusion in the report is that the managers deceived the regulatory authorities by understating the liabilities and overstating the assets of the financial entities. This points to the difficulty in determining the value of the assets of the financial entities since they are part of the CNB group whose total assets were estimated at about J$12 billion in 1994. CNB's asset base deteriorated in 1995 from J$8.6 billion to J$6.6 billion. The government, CNB and other interested parties attempted to broker a deal in July 1995 in order to address the liquidity problems of the bank. The announced failure led to a J$3 billion run on CNB's deposits and resulted in the BOJ providing liquidity support of J$3 billion. Subsequent attempts to inject capital into the bank failed and the liquidity situation deteriorated.

The main issues in relation to CNB are: the type of activities into which its loans were directed; the significant amount of investment in connected companies; the significant amount of non-performing loans in its loan portfolio; and the inability of the regulators to closely and effectively monitor CNB and hence prevent the deterioration of its liquidity position and the large BOJ overdraft which totaled over J$4 billion. Most of the bank's loans and investment went into real estate and tourism property development. Actual investment was undertaken by the non-financial members of the CNB group since the Banking Act precludes commercial banks from investing in land other than for the purpose of conducting banking business. At the end of 1992 CNB had invested in member companies and affiliates of the CNB group J$280 million which was more than half the amount invested by all of the commercial banks in their members and affiliates. The three financial entities provided substantial loans to the parent company, CNB Holdings.

Some of the subsidiaries and associated companies of CNB's holding company were found to have significant outstanding debts to the bank at the time of closure on July 10, 1996. The merchant bank and the building society had overdrafts with the bank totalling US$7.5 million whereas the parent company and one of the non-financial subsidiaries had outstanding debts of US$6.0 million. A retail business owned by the president of the holding company was

listed as having an outstanding debt of US$0.7 million whereas an associated company in the tourism industry had a debt of US$1.0 million. Three years ago a Coopers and Lybrand inspection team found that the three CNB financial institutions had been engaging in non-arms length dealings with insiders and granting credits exceeding the statutory limits (Minister of Finance Press Conference, July 12, 1996). Sufficient information is not available at this time to facilitate an assessment of the extent to which the bank was in breach of Section 13 of the Banking Act.

Among the commercial banks, CNB had the largest amount of non-performing loans. At the end of 1992 these loans represented 30 percent of the bank's loan portfolio which was almost four times as high as the average (8.5%) for the banking sector. The ratio increased to 50 percent in 1994 but was reduced to almost 24 percent in 1995 - a figure still high relative to the ratios for the other banks. The reasons given by officials for these high ratios are bad management decisions and the poor handling of the non-performing loans. The other contributing factor is the high interest rate regime since 1990. Deposit and loan rates increased significantly between 1991 and 1994. However, CNB's loan portfolio grew only marginally, for example from J$1.1 billion in 1992 to J$1.2 billion in 1993. Deposits experienced a similar level of growth from J$2.4 billion in 1992 to J$2.8 billion in 1993. The high cost of loans and slow growth of the loan portfolio resulted in the growth in the ratio of non-performing loans. Related to this issue is the investment in real estate and tourism properties. The returns from these have been less than envisaged on account of the slump in the real estate market which in turn constrained the divestment of these assets; the hotels in which CNB acquired shares had been loss-making properties. At the present time, the temporary manager is still trying to determining the ownership of assets and the true extent of liabilities of the Century National financial institutions.

INTERCONNECTED COMPANIES OF CENTURY NATIONAL