



## **Financing Growth in Jamaica: Constraints, & Policies**

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November 2001

Presented to the XXXIII Annual Monetary Studies Conference  
20 – 23 November 2001  
Belize City

JEL Classification Number: G10

Keywords: financial institutions, growth, securities markets

*The views expressed in this paper are those of the author and not necessarily those of the Bank of Jamaica.*

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## **Introduction**

The financing of private investment in developing countries from domestic sources has always presented a problem in countries with underdeveloped financial systems. In the absence of a more developed financing system, commercial banks have grown to become the dominant source of financing. Consequently, commercial banks have tended to play a pivotal role in many developing countries. The experience in Jamaica has been somewhat similar, although some changes have emerged over the last two decades with appreciable growth in the number of specialized financial institutions. These changes took place within the context of a more market-oriented domestic and international environment. This paper explores the performance of some of these financial intermediaries over the course of the 1990s from the perspective of their role in providing financing for economic growth. More specifically, the paper assesses the performance of the institutions relative to their traditional role and function and international benchmarks, where data are available.

While commercial banks have dominated the financial sector in Jamaica, relative to a select set of countries, private sector credit by Jamaican commercial banks has been low. A similar pattern is replicated in the balance sheet of near banks. Building societies have also been observed to deviate from their core business of providing residential mortgages. However, credit from the development banks has recorded growth in recent years in the context of subsidized credit arrangements and generally lower interest rates. The same is true for credit from micro and small business financiers in Jamaica. Notwithstanding the potential of the stock market for providing low cost financing, the market has experienced little primary activity.

The main factors that influenced the performance of the institutions were the authorities' effort to stabilize the economy as well as deterioration in the fiscal accounts and the impact of these two developments on rates of return on alternative investments.

The remainder of the paper will evolve as follows: section 1 discusses the evolution of financial intermediation in a global context; section 2 provides an overview of the structure of the Jamaican financial system, while section 3 briefly outlines the

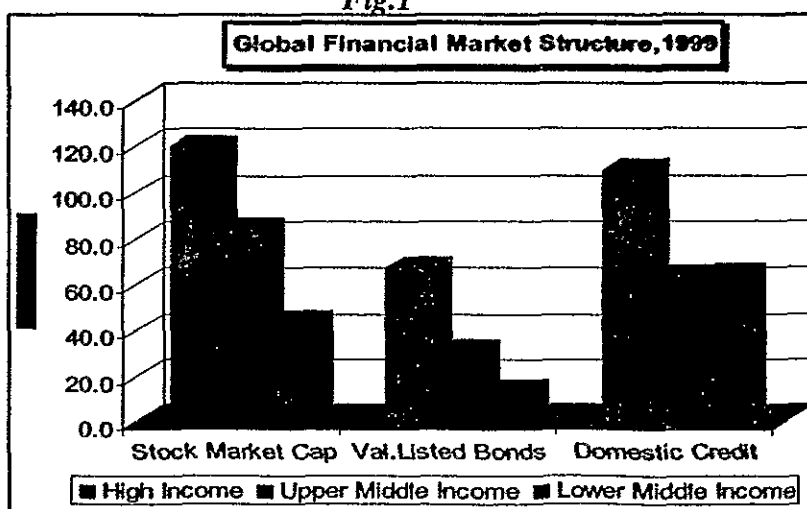
macroeconomic environment within which Jamaican financial institutions operated over the period 1980 – 2000; section 4 discusses the performance of the major institutions that provided financing in Jamaica over the period 1990 – 2000; section 5 highlights the policy initiatives that will be necessary for enhancing the level of intermediation in the financial system. The final section summarises the issues discussed.

### Financing From a Global Perspective

The nexus between finance and economic growth has spawned a large body of research over the last 30 years. Despite this, there seems to be no general consensus on whether the financial system responds to industrial and economic development or leads the process of economic growth. Notwithstanding this, a growing body of empirical analysis demonstrates a strong positive link between the sound and efficient functioning of the financial system and long run economic growth.

Research has also shown that the financial structure differs considerably across countries and changes as the economy expands. As countries experience an increase in per capita income, the operations of financial intermediaries expand relative to GDP. Simultaneously, non-bank institutions, such as insurance companies and investment banks, as well as private pension funds and stock markets grow in importance. This is illustrated in figure 1. While banking sector credit to the private sector, as a percentage of GDP, was an average of 110.0 per cent in the high income countries and 64.1 per cent in upper middle income countries, the same ratio was 64.6 per cent in lower middle income countries.

*Fig.1*



Conversely, the securities markets in the upper middle and high income countries played a greater role in financing economic activity in those economies than the comparable markets lower middle income countries. As a percentage of GDP, capitalization of the securities markets in the upper middle and high income economies was 116.8 per cent and 187.8 per cent, respectively. On the other hand, a relatively lower ratio of 58.6 per cent obtained in the lower middle income economies.

Against this background, it is useful to review the evolution of benchmark sources of financing in the more developed markets. In the United States of America (USA), commercial banking has traditionally entailed making long-term loans funded by the issue of short-dated deposits. However, innovations and greater competition in the financial markets have altered the position that banks once enjoyed as the major providers of finance. This competition has largely come from activities on the securities markets and, to maintain adequate profit levels, many banks have increased their risk exposures. This typically involved the placement of a greater percentage of their total funds in commercial real estate loans. In addition, there has been increased lending for corporate takeovers and leveraged buyouts. Commercial banks have also sought to maintain former profit levels by pursuing off-balance-sheet activities such as trading in derivatives. These activities served to double the share of their income from non-interest-income activities.

Building societies, like those in the United Kingdom (U.K.) and the Savings and Loan institutions in the U.S.A. have traditionally been specialist, mutually owned deposit-taking financial institutions, commanding a prominent position in the mortgage market. In the U.K, the activities conducted by the building societies, and the extent to which they could be diversified, were initially defined by an Act of Parliament. Under this legislation, the only assets (other than their holdings of liquid assets) held by the institutions were mortgages, which accounted for over 80 percent of the building societies' total assets.

This position was changed radically with the passing of the 1986 Building Societies Act in the U.K. The Act enabled societies to diversify into a wide range of financial services

including new lending for consumption oriented activities, banking services, parallel financial services such as insurance broking and underwriting, money transmission services and the management of unit trust funds, and increased agency business such as links with pension and insurance business. Building societies therefore have drifted away from their core function of providing mortgage financing into a wide range of business areas.

The operations of merchant banks were traditionally geared towards the provision of both international trade finance and debt financing for governments. However, since the 1950s merchant banks in the U.K expanded their operations and have become actively engaged in the business of selling private companies to the public and undertaking rights issues of equities. These specialized institutions have also built up substantial businesses as investment managers on behalf of UK institutions such as pension funds, governments and other major institutions worldwide.

Stock markets have been providing long-term capital to the private sector since the 17th century. The level of activity on stock exchanges in the more developed markets has increased over the years, particularly since the 1900s with improvements in technology and the liberalization of capital markets.

### **The Financial System in Jamaica: An Overview**

These differing modes of financing which are available on the international financial market have also emerged in the Jamaican economy, initially as a result of colonial heritage and ownership and, subsequently, through specialization to meet specific needs. These include commercial banks and near banks, development banks, building societies, the stock market and a bond market. Further, a number of institutions have emerged that specialize in providing financing to small and micro enterprises.

Commercial banks have been operating in Jamaica since the 1800s and have been the traditional sources of domestic financing for businesses, with their options been largely circumscribed in the context of various policy emphases. For example, during the 1980s,

consumer-oriented loans extended by commercial banks were restrained by credit controls imposed by the monetary authorities.

Near banks have been operating alongside commercial banks in the credit market. This set of institutions includes merchant banks, finance houses and trust companies with merchant banks dominating the group in terms of asset size. These institutions grew out of a need for medium and long term financing by the business sector, given that commercial banks operated mainly in the short-term market. By the 1980s merchant banks had expanded their operations, providing a range of services inclusive of trade financing, underwriting services, short term credit facilities, and in some instances foreign exchange trading facilities.

The building society movement also started in Jamaica in the 1800s, with the asset base of these institutions recording noteworthy expansions during the 1980s and the early part of the 1990s. This growth was driven by a variety of factors. Prior to 1994, building societies were not subject to statutory reserve requirements. Further, these institutions enjoyed direct tax advantages, since profit tax rates for these institutions were lower than those for banks. In addition, unlike commercial banks, interest on share savings in building societies was not subject to a withholding tax. Against this background, the number of building societies increased to 34 in 1994 from 6 in 1990. This dramatic increase occurred without a commensurate expansion in private housing stock, as most of the assets were held in Government securities. As a consequence they came to be regarded as non-traditional building societies

In 1994, building societies were specified under the Bank of Jamaica Act, bringing them under the supervision of the Central Bank. The Central Bank sought to induce the building societies to return to their core function of providing mortgage financing by imposing a system of dual cash reserve ratios on the institutions. As such, a higher ratio was applicable to those societies with investments in residential housing falling below 15 per cent of deposits and withdrawable shares. That ratio was gradually increased to 40 per cent of deposit and share liabilities.

The Jamaica Stock Exchange (JSE) was established in 1969 to provide long-term capital financing to complement the short-term credit orientation of the commercial banks. However, the stock market in Jamaica was never really fully utilized to mobilize investment capital. Peart (1995) notes that the failure of local investors to utilize the market to initiate and expand business activity reflected a combination of factors. The principal factors included a high concentration of family businesses which had relatively easy access to bank credit to finance fixed and working capital requirements; strong resistance within the private sector to the sharing of ownership and control and Government's double taxation of company dividend. During the latter half of the 1980s the privatisation of a number of state owned entities through the stock exchange served to increase the level of activity on the market.

Development banking began in Jamaica in 1969 with the establishment of the Jamaica Development Bank to assist small farmers and entrepreneurs through the provision of medium to long term financing. With the winding down of the Jamaica Development Bank in 1981, two other development banks, the Agricultural Credit Bank and the National Development Bank were established. By 1986 there were 4 development banks, the new entrants being the National Export – Import Bank (EX-IM) which was set up to assist exporters, and Trafalgar Development Bank, a only privately owned institution. Funding of the public development banks has been provided from foreign and local sources with Government of Jamaica guarantees. These funds have been channelled through commercial banks, near banks and People's Co-operative Banks (PC Banks). The lending activities of these institutions have been facilitated by concessionary rates, which they offer on loans, as well as the exemption of their funding from credit controls.

### **The Jamaican Macroeconomic Environment**

The macroeconomic environment of the last two decades underpinned the performance of financial institutions in Jamaica. Real GDP growth was cyclical during the period 1980-2000. While real GDP declined by 7.5 per cent in 1980 this performance was reversed in 1981 with real growth of 2.5 per cent being recorded. During the next two years however, the economy declined by 1.4 per cent and 4.5 per cent, respectively. It was not until the



last four years of the decade that sustained growth was realized at an annual average rate of 5.4 per cent.

The instability in the real sector, particularly in the early 1980s, could be attributed to a chronic shortage of foreign exchange to support an import dependent production structure. Towards addressing this problem, the Jamaican Government embarked on a programme of economic reform the latter half of the 1980s involving financial and trade liberalization. The programme also included the privatisation of a number of state owned entities. Coupled with this, there was a tightening of monetary policy with the aim of containing liquidity and reducing the high level of demand for foreign exchange.

Despite the initiation of these measures, the growth that was recorded in the latter half of the 1980s did not extend beyond the first half of the 1990s. Growth averaged 0.3 per cent for the decade, largely a reflection of years in which GDP contracted.

The structural adjustment programme that began in the 1980s culminated in the liberalization of the financial system in 1990 and full liberalization of the foreign exchange market in 1991. However, this shift towards a market-oriented economy occurred without the requisite adjustments to monetary and fiscal policies to ensure stability. As such, following the change in the exchange rate regime, there was a sharp depreciation of the exchange rate, which pushed inflation to in excess of 80 percent in 1991. In order to contain the spiral in inflation, there was a tightening of monetary and fiscal policies in 1992, but this was not sustained during the first half of 1993. The exchange rate again came under pressure in the latter half of 1993. In response, monetary conditions were tightened through a significant increase in interest rates on Certificates of Deposit, from 25.5 percent in the early part of the year to 48.4 percent by December. The Central Bank also curtailed its liquidity support to commercial banks, the penal rate on bank overdraft was increased to 120.0 percent, and the liquid asset requirement was maintained at 50.0 percent.

The relatively attractive interest rates to be earned on domestic financial assets served to engender significant growth in the country's net international reserves, which resulted in

an expansion in money supply, that in turn threatened to derail the authorities' efforts at demand management. This was averted however as the government's debt raising activities and an intensification of open market operations by the Central Bank facilitated a tightening of liquidity conditions. In this regard, the stock of domestic debt increased from J\$23.6 billion at the beginning of 1994, or approximately 24 per cent of GDP, to J\$70.6 billion, or approximately 30.2 per cent of GDP by the end of 1996. Over the same period, the stock of Central Bank instruments increased from \$3.2 billion (2.7 per cent of GDP) to \$16.7 billion (7.1 per cent).

The authorities were again challenged in 1997. This time, the challenge emerged from instability in the financial sector that required the Central Bank to provide liquidity support to weak institutions. In the context of the aforementioned tightening of monetary and fiscal policies in 1993, commercial bank loan rates rose to an average of 50.0 per cent in that year, resulting in a contraction in aggregate demand, a decline in output and subsequently a fall off in the servicing of bank loans. As a consequence, there was a notable growth in the ratio of non-performing loans to total loans in the banking system. This problem was exacerbated by the inability of insurance company affiliates to service their debt obligation with the commercial banks. These institutions experienced liquidity problems, as a mismatch of short-term 'deposit like' liabilities with traditional long-term assets could not be sustained.

To maintain stability in the financial system, the Central Bank provided liquidity support to weak commercial banks that experienced cash flow problems, and to re-absorb the excess liquidity, intensified open market operations through reverse repurchase agreements. As a result, the stock of reverse repurchase agreements increased to \$24.2 billion (9.5 per cent of GDP) at the end of 1997. The stock of Central Bank instruments further increased to \$42.2 billion (13.1 per cent of GDP) at the end of the decade given the need to contain liquidity expansions that emanated from a build up in the net international reserves (NIR)<sup>1</sup>.

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<sup>1</sup> This growth in the NIR resulted from a significant increase in official capital inflow as the government sought to finance its operations from external sources and reduce the demand for financing from the

Another policy response to the financial sector crisis was the establishment of a resolution company, the Financial Sector Adjustment Company (FINSAC) in January 1997 to assist in the restructuring of the sector. Weak institutions were placed under temporary management, merged, restructured, recapitalized, or closed. In addition, non-performing loans were purchased from institutions undergoing difficulties in exchange for FINSAC securities.

While the restructuring programme restored the health of the financial system, the problems that arose in the sector affected the ability of the institutions to carry on intermediation. As a consequence, banking system credit to the private sector as a proportion of GDP declined to an average of 17.7 per cent during the second half of the decade from an average of 27.9 per cent during the first half of the 1990s.

### **Financial Intermediation in the 1990s**

The available data suggest that, in the context of changes in the domestic and international environment, the major financial institutions in Jamaica have diverted from their core function of providing credit.

#### ***Commercial Banks***

Despite the structural changes in the economy over the decades prior to the 1990s, commercial banks continued to dominate the banking sector<sup>2</sup>, accounting for an average of 73.1 per cent of total banking system assets during the 1990s. In 1990 there were 11 commercial banks with assets amounting to 53.9 per cent of GDP. By the end of 2000, the number of commercial banks had contracted to 6, with total assets amounting to 66.9 per cent of GDP.

In spite of the dominance of these institutions, the level of private sector financing by Jamaican commercial banks is low when compared with the performance of banks in

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domestic market. At the end of 2000, the domestic debt stock amounted \$184.4 billion (57.7 per cent of GDP).

<sup>2</sup> Comprising of commercial banks, near banks, development banks and building societies.

other Caribbean countries and selected high performing Asian economies (HPAE). While commercial banks' credit to the private sector averaged 18.3 per cent of GDP for Jamaican banks between 1990 and 2000, the ratio over the same period for banks in Trinidad & Tobago and Barbados was 31.5 per cent and 39.4 per cent, respectively. Lending by banks to the private sector, in the HPAE was even more outstanding. Over the period, commercial banks' credit to the private sector as a percentage of GDP amounted to 93.6 per cent and 88.8 per cent for Singapore and Malaysia, respectively<sup>3</sup>.

Table 1

<b>Commercial Banks: Private Sector Loans Outstanding (In % of GDP)</b>			
<b>1990 - 2000</b>			
	<b>Avg. 1990-1995</b>	<b>Avg. 1996-2000</b>	<b>Avg. 1990 - 2000</b>
<b>Jamaica</b>	<b>20.7</b>	<b>15.4</b>	<b>18.3</b>
Trinidad	30.5	32.7	31.5
Barbados	35.2	44.5	39.4
Singapore	86.4	104.3	93.6
Malaysia	77.9	101.8	88.8

Source: International Financial Statistics

A more detailed breakout of the Jamaican banks' asset portfolio revealed that private sector credit as a proportion of total assets declined from 47.4 per cent in 1990 to 15.3 per cent in 2000. In contrast, bank holdings of securities increased from 6.3 per cent in 1990 to 39.7 per cent in 2000 and resources channelled into other assets<sup>4</sup> increased from 41.7 per cent in 1990 to 51.9 per cent in 2000 before declining to 42.0 per cent in 2000.

<sup>3</sup> It should be noted however that the higher ratio for Barbados reflects the absence of well-developed alternative modes of financing in that economy. In the case of the HPAE, the banks' performance ensues from a heavy reliance on the use of directed credit to finance selected industries.

**Table 2**  
**Jamaican Commercial Banks' Asset Portfolio**  
**% of Total Assets**

	1990	1995	2000	Avg. 90 - 2000
<b>Loans</b>	51.9	37.8	18.3	34.2
<b>Public Sector</b>	4.5	2.8	3.0	3.1
<b>Private Sector</b>	47.4	35.0	15.3	31.1
<b>Securities</b>	6.3	10.3	39.7	15.7
<b>Other Assets</b>	41.7	51.9	42.0	50.1
<b>Total Assets</b>	100.0	100.0	100.0	100.0

The structure of the asset portfolio of commercial banks during the 1990s reflected a confluence of factors. The notable shift in the banks' resources out of private sector credit was attributable to the developments in the macroeconomic environment, particularly the stabilization effort and the deterioration in the fiscal accounts and the impact of these developments on relative returns on different asset types. Beyond this, the cost of credit was affected by the banks' operational expenses, that were two or three times those of banks in developed countries. These occurrences, along with the crisis that emerged in the banking sector served to restrain loan expansion.

A further disaggregation of the data on private sector credit reveals that there was a shift of credit allocation away from productive activities to loans for consumer-oriented purposes. During the period 1990 – 1995, loans for productive activities declined from an average of 61.3 per cent of total loans to an average of 42.4 per cent during the period 1996 - 2000. Simultaneously, over the similar period, loans for consumer-oriented purposes increased from an average of 31.8 per cent of total loans to an average of 44.6 per cent.

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<sup>4</sup> This category includes bank's cash holding, balances with the Central Bank, foreign assets and OIs.

**Table 3**  
**Commercial Banks' Sectoral Credit Allocation**  
**(Average % of Total Loans)**

	1990-1995	1996 - 2000	1990 - 2000
<b>PUBLIC SECTOR</b>	6.9	13.0	9.7
<b>PRIVATE SECTOR</b>	93.1	87.0	90.3
<b>Productive</b>	<b>61.3</b>	<b>42.4</b>	<b>52.7</b>
Manufacturing	14.4	9.7	12.2
Construction & Land Dev	16.8	6.3	12.1
Tourism	8.0	9.4	8.6
Transport, Storage & Comm.	9.7	5.1	7.6
Agriculture	7.0	4.2	5.7
Financial Institutions	3.4	6.2	4.7
Entertainment	0.9	0.4	0.7
Electricity, Gas & Water	0.6	0.6	0.6
Mining	0.5	0.4	0.5
<b>Consumption</b>	<b>31.8</b>	<b>44.6</b>	<b>37.6</b>
Personal	14.4	24.5	19.0
Professional & Other Services	11.3	12.4	11.8
Distribution	6.1	7.7	6.8
<b>TOTAL</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

The structure of commercial banks' loan portfolio can be explained by high inflation, the relatively high cost of credit and the low rate of growth in economic activity. As already mentioned, the rates charged on loans from commercial banks increased to a high of 50.0 per cent during the 1990s. This dampened the demand for financing by real sector entities, and probably contributed to weak performance in selected industries. In this context, the value added of the Jamaican manufacturing sector declined at an average rate of 0.6 per cent over the first half of the 1990s, and accelerated to an average of 2.3 per cent during the period 1996 – 2000. Simultaneously, the output of the construction and land development sector declined by 3.3 per cent during 1996 – 2000 following a marginal growth rate of 0.3 per cent in the first half of the 1990s.

### *Near Banks*

The structure of the asset portfolio of near banks' showed a similar trend away from private loans towards risk-free debt instruments. Loans as a proportion of total assets declined from 62.3 per cent in 1990 to 34.5 per cent in 2000. In contrast, near banks'

holding of securities and other assets increased from 6.9 per cent and 30.8 per cent of total assets in 1990, respectively, to 11.9 per cent and 53.6 per cent in 2000.

Table 4

<b>Jamaican Near Banks' Asset Portfolio</b>				
<b>% of Total Assets</b>				
	<b>1990</b>	<b>1995</b>	<b>2000</b>	<b>Avg. 1990 - 2000</b>
Loans	62.3	34.7	34.5	39.6
Public Sector	2.4	0.3	2.0	1.0
Private Sector	59.9	34.4	32.5	38.7
Securities	6.9	15.7	11.9	10.8
Other Assets	30.8	49.7	53.6	49.6
Total Assets	100.0	100.0	100.0	100.0

Source: BOJ's Statistical Digest

Table 5

<b>Near Banks' Sectoral Allocation of Loans</b>			
<b>% of Total</b>			
	<b>1990 - 1995</b>	<b>1996-2000</b>	<b>1990-2000</b>
<b>GOVERNMENT</b>	2.1	1.6	1.9
<b>PRIVATE SECTOR</b>	97.9	98.4	98.1
<b>Productive</b>	<b>64.6</b>	<b>49.7</b>	<b>57.9</b>
Agriculture	2.6	4.8	3.6
Mining	0.8	0.6	0.7
Manufacturing	15.2	13.4	14.3
Construction & Land Dev	26.2	15.3	21.2
Financial Institutions	3.2	1.6	2.5
Transport, Storage & Comm.	8.3	4.5	6.6
Electricity, Gas & Water	0.4	1.0	0.7
Distribution	7.7	7.8	7.8
Entertainment	0.4	0.7	0.5
<b>Consumption</b>	<b>33.2</b>	<b>48.7</b>	<b>40.2</b>
Professional & Other Servs	16.3	28.9	22.0
Personal	9.5	10.9	10.1
Tourism	7.5	8.8	8.1
<b>TOTAL</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

In terms of the sectoral allocation of credit, a shift out of loans for productive activities towards consumer-oriented loans was also evident in the portfolio of the merchant banks. During the period 1990 – 1995 loans for productive activities declined from an average of 64.6 per cent of total loans to an average of 49.7 per cent during the period 1996 - 2000. In contrast, consumer-oriented loans increased from 33.2 per cent to 48.7 per cent over the same interval.

There was also notable shift in the maturity profile of the loans on the books of the institutions. Loans with a longer maturity profile such as mortgage, lease financing and term loans, which constituted 52.1 per cent of total loans in 1990, declined to 28.4 per cent in 2000. On the other hand, loans of a shorter maturity profile such as demand and instalment credit increased from 38.8 per cent and 5.6 per cent of total loans, respectively, in 1990 to 55.1 per cent and 9.8 per cent, respectively, in 2000.

Table 6

Near Banks' Loan Portfolio By Loan Type			
Type	1990	1995	2000
Demand	38.8	45.0	55.1
Mortgage Loans	29.5	19.2	11.6
Lease Financing	14.1	8.8	12.4
Term(Time)	8.5	2.9	4.4
Instalment Credit	5.6	9.4	9.8
Insurance Premium Financing	1.2	3.1	1.7
Accounts Receivable Financing	1.2	5.5	0.0
Commercial Paper	0.0	0.0	0.3
Other Loans	1.1	6.0	4.7
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: Bank of Jamaica

Some near banks further increased their concentration of assets into public debt instruments through the provision of managed funds services. These services are off-balance sheet activities, which were unregulated prior to 1995. The growth in managed funds activity was accompanied by declines in the banks' deposit taking operations and asset base. As such, during the period 1996–2000, while funds managed on behalf of clients increased to \$64.3 billion (20.0 per cent of GDP) from \$14.2 billion (6.0 per cent



of GDP), the asset base of the institutions shrunk to \$9.2 billion (2.8 per cent of GDP) in 2000 from \$25.0 billion (10.7 per cent of GDP) in 1996.

### ***Building Societies***

Similar to the other deposit taking institutions, the performance of the building societies in their role as providers of mortgage credit was a function of the macroeconomic and regulatory environment of the early 1990s. According to Bailey (2001), during the period 1990 - 2000, the ratio of loans to total assets for the building society industry averaged 37.4 per cent, significantly below the international benchmark of 72.5 per cent for such institutions. The performance of the industry was in part influenced by the activities of those societies that were established during the early 1990s to avoid the regulations and other issues faced by the banking entities. The funds garnered by these institutions were not channelled into loans but were used to purchase Government securities. For these non-traditional building societies, while the ratio of loans to total assets averaged 16.4 per cent during the period 1990–1994, investments as a share of total assets averaged 58.1 per cent. In contrast, the ratio of loans to total assets averaged 45.1 per cent for the traditional building societies while investments accounted for an average of 41.1 per cent.

Table 7

<b>Building Societies: Selected Performance Indicators (in %)</b>				
	<b>Avg. 1990 – 1994</b>	<b>Avg. 1995 - 2000</b>	<b>Avg. 1990 - 2000</b>	<b>International Benchmark</b>
<b>Loans: Total Assets</b>	37.8	37.7	37.4	72.5
<b>Traditional</b>	45.1	42.1	43.5	
<b>Non-Traditional</b>	16.4	27.1	22.0	
<b>Investment: Total Assets</b>	43.6	31.4	37.0	10.0
<b>Traditional</b>	41.1	29.9	35.1	
<b>Non-Traditional</b>	58.1	36.5	46.3	

Source: Bailey (2001)

The imposition of reserve requirements on the building societies in 1995 led to a reduction in their holdings of investments to an average of 36.5 per cent of total assets and 29.9 per cent of total assets for non-traditional and traditional building societies, respectively. The ratio has however, remained below the international benchmark.

The performance of the industry was affected by low effective demand for mortgages, competition from the National Housing Trust (NHT)<sup>5</sup> and other providers of mortgage financing and a significant contraction in savings inflow. Low effective demand was associated with the slow down in economic activity and the attendant rise in unemployment, a decline in income and the high cost of mortgage financing. Beyond this, the contraction in savings was particularly significant in 1999 following the imposition of a withholding tax, which resulted in depositors moving their funds in search of more attractive interest rates. With the imposition of the withholding tax, the building societies were challenged to mobilize savings given increased competition for funds from other financial institutions. Beyond this, the Government's debt raising activities also made it difficult for the institutions to mobilize savings.

### ***Development Banks***

The precise level of private sector credit provided by the four development banks is unclear given that the resources of these institutions are typically channelled through other financial intermediaries. Notwithstanding this, the structure of the institutions' asset portfolio suggests that, unlike commercial banks, near banks and building societies, the resources of the development banks were largely concentrated into loans. However, the level of financing by development banks in Jamaica was low when compared with similar institutions in Trinidad and Tobago. While the ratio of loans to total assets averaged 63.8 per cent for Jamaican development banks during the period 1996 – 2000, a ratio of 82.0 per cent obtained for development banks in Trinidad and Tobago. In terms of the share of resources which development banks placed into investment, this performance indicator was higher for Jamaican development banks relative to the similar institutions in Trinidad & Tobago. As a proportion of total assets, investment was 12.0 per cent for Jamaican development banks compared with 9.8 per cent for Trinidad and Tobago. The low level of economic activity during the 1990s, would have negatively affected the structure of the development banks portfolio.

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<sup>5</sup> The NHT is a public sector organization geared towards the provision of mortgage financing. Contribution to the NHT is compulsory and deducted directly from the payroll of employed persons.

### ***The Bond Market***

There was no appreciable level of activity on the corporate bond market in Jamaica over the decade of the 1990s. A survey conducted by the Securities Commission in 2000 indicated that commercial paper transactions outstanding as at September 2000 amounted to \$6.5 billion. Assuming there was no increase in these assets by the end of 2000, the value of the commercial paper market at that time would have amounted to 2.0 per cent of GDP. Market analysts suggest that the value of the market was somewhat greater in the early 1990s.

The low level of activity on this market was negatively affected by a number of factors. These include financial losses incurred by several well-established companies, the default of another established company on the international bond market and uncertainty of the financial status of private companies given the absence of a credit rating agency. Another contributing factor was the high inflationary environment of the early 1990s that induced domestic institutional investors such as life insurance companies to make significant investments in real assets instead of financial assets. As a proportion of total assets, the real estate holdings of the life insurance companies increased consistently from 23.2 per cent in 1992 to 42.2 percent in 1997 (Foga 1999). In contrast, during the same period, commercial bonds accounted for an average of 1.3 per cent of the companies' asset portfolio.

### ***The Stock Market***

Since 1990 there have only been eight initial public offerings (IPOs) on the Jamaican stock market. The paucity of new listings on the stock exchange over the last decade reflects weaknesses in the institutional framework (Bailey 1999), and as already mentioned, the general financial orientation of businesses. Since 1998 initiatives have been implemented to improve operational efficiency and reduce settlement risk while a phased elimination of the withholding tax on dividends began in 2000. While these initiatives did not result in any IPO, market capitalization increased from 33.0 per cent of GDP in 1998 to 54.0 per cent of GDP in 2000.

### ***Micro and Small Business Enterprise Financing***

A number of institutions, both public and private, within the Jamaican economy are geared towards providing financing to micro and small businesses. These institutions include credit unions, the National Development Foundation of Jamaica, Jamaica National Micro Credit Company and the Self Start Fund. These specialized institutions have sought to provide financing to the small and micro business sector given that the sector is challenged in meeting the requirements for credit from commercial banks.

During the last decade, there was a notable expansion in credit to the micro and small business sector but not sufficient to fill the financing gap left by the banking system. In real terms, credit outstanding to the sector increased from \$67.0 million in 1994 to \$280.5 million at the end of 2000.

There has been a heavy demand for the resources available from institutions that provide financing to the micro and small business sector. For example, during the period 1995 to 2000, a significant proportion of the funds projected for lending by the National Development Foundation of Jamaica (NDFJ) were disbursed. In fact, in 1999 and 2000 the amount of funds disbursed exceeded the amount projected for lending (see table 8). Loans to the services sector, in particular restaurants and fast food outlets, as well as distribution account for the largest share of funds disbursed by NDFJ.

Table 8

<b><i>National Development Foundation of Jamaica:</i></b>			
<b><i>Disbursements (J\$mn.)</i></b>			
<b>Year</b>	<b>Projected</b>	<b>Actual</b>	<b>Actual : Projected (%)</b>
1995	126.0	120.1	95.3
1996	80.5	70.0	87.0
1997	90.0	65.0	72.2
1998	85.0	64.4	75.8
1999	85.0	86.7	102.0
2000	85.0	88.5	104.1

While demand for financing has been relatively high, the inability of some prospective investors to produce financial statements, the lack of managerial experience and the cost of funds are some of the constraints to a greater utilization of the NDFJ's funds. These constraints have also dampened the demand for financing from other institutions. In recognition of this problem, a number of institutions have begun to provide training in financial accounting and management to entrepreneurs in the small business sector. These institutions include the Small Business Association of Jamaica, The Entrepreneurial Centre, University of Technology, NDFJ and JAMPRO.

### *Venture Capital Financing*

During the 1990s there were at least 3 institutions operating in the Jamaican economy that offered venture capital financing to the business community. These entities were the Jamaica Agricultural Development Foundation (JADF), the National Development Foundation of Jamaica (NDFJ) and the Jamaica Venture Fund (JVF). Of the three, the JVF is the only institution that operates exclusively as a venture capital financing institution. The institutions were all granted venture capital status at different periods during the 1990s. The Caribbean Investment Fund (CIF) was granted venture capital status in 2000. The institution is supported through tax incentives by CARICOM member governments. To date, the Fund has invested approximately US\$5.0 million in the Region. It receives financing from nine investors including international agencies, as well as, public and private sector entities in the Region.

The level of venture capital funding has been relatively low when compared with the experience of the United States of America (See appendix 1). Data obtained from the JADF indicate that during the 1990s, venture capital financing accounted for an average of 11.0 per cent of the total amount of funds available for this kind of financing from the institution. Among the reasons identified for the low utilization of these funds, is the unwillingness of entrepreneurs to allow outside participation in their businesses.

## **Expanding the Role of Financial Intermediaries in Jamaica**

The attainment of higher levels of growth in the Jamaican economy will require *inter alia* an enhancement of the level of intermediation between the household sector that saves and the business sector that invests. As noted earlier, the balance sheets of financial institutions have come to reflect the extent to which the public sector has dominated the use of domestic financial resources over the past ten years. The degree of reallocation that would be consistent with increased private borrowing requires the deliberate amortization of domestic debt by Government. That effort was the chief objective of the 2001/02 economic programme and the collaboration with the IMF, IADB, IBRD and CDB. While recent events may retard progress in fiscal and debt reform, a net repayment of domestic debt took place in the first half of the fiscal year. This will facilitated a lowering of interest rates.

As interest rates decline and the demand for financing increases, it will be critical to ensure that stability is maintained in the financial system. Significant progress has been made in rebuilding a sound, stable and viable banking system since the financial sector crisis of the 1990s. With the recent amendments to the banking regulations, the supervisory powers of the Central Bank have been strengthened to take corrective measures against institutions, which operate in contravention of the law. Further, the Central Bank requires banks to meet more stringent capital requirements. Jamaican banks are now mandated to maintain a capital to risk-based assets ratio of 10 per cent relative to the Bank for International Settlement (BIS) Basle risk-based standard of 8 per cent.

The revamping of the regulatory and supervisory framework governing the operations of non-deposit taking institutions will also be integral to the process of deepening the corporate bond market and ensuring its stability. In this regard, a new non-bank supervisory entity, the Financial Services Commission (FSC) was established in 2001. This entity will be responsible for the licensing, regulation and supervision of institutions dealing in securities, collective investment funds (e.g. unit trusts and mutual funds), investment advisors, the insurance industry and private pension funds. The powers granted to the FSC will enable the institution to *inter alia* (i) introduce risk-based capital

standards to engender investor protection (ii) enhance disclosure practices for listed and other public companies and improve regulation related to "fit and proper" standards.

With the formation of the FSC, the regulatory authorities have move towards effecting a separation of the banking and investment businesses of the near banks. It is anticipated that this process will induce these institutions to return to their traditional function of providing credit to the private sector.

Within the Jamaican financial system, life insurance companies have been dominant institutional investors. However, inadequate supervisory and legislative controls governing the operation of the life insurance industry had made it possible for the companies to engage in imprudent practices. Towards correcting this, the Government has sought to improve the supervision and regulation of the insurance industry. A new Insurance Act has already been drafted to include measures to strengthen corporate governance, the rulemaking process and establish prompt corrective action. Regulations will be in effect with regards to solvency requirements, investment guidelines, market conduct rules and actuarial standards. Further, the FSC is in the process of establishing the necessary infrastructure to conduct effective supervision of the insurance industry.

A properly organized pension system can also contribute to a deepening of the capital market. As a result, efforts are underway to reform the pension system in Jamaica to encourage greater participation in pension schemes. This has involved the preparation of a new National Pensions Act to provide for the regulation of pension schemes established in Jamaica and the managers or administrators of these schemes. The current draft addresses topics such as registration, licensing, investment limits, minimum solvency standards and information disclosure.

Coupled with these initiatives, the availability of more information on individuals who are seeking credit should reduce the recurrence of the same bad debtors across the banking system. In this regard, the establishment of a credit bureau as exists in the United States of America, would also contribute to increased debt financing and activity in the corporate bond market. A credit bureau would give licensed financial institutions access

to the payment history of individuals who are seeking credit. This would reduce the time for processing loans. The establishment of such an agency would however, require an amendment of the banking regulations that currently restrict the sharing of client information by banks.

It is anticipated that the establishment of the credit bureau would also facilitate a lowering of the expenses which banks' incur in the processing of loans. This, in addition to the streamlining of other activities would auger well for a general reduction of the banks' operational expenses and interest rate spread.

### **Summary and Conclusion**

Over the last two decades there has been a proliferation of financial intermediaries on the financial landscape in Jamaica. An analysis of the performance of a select set of these institutions revealed that some institutions diverted from their core function of providing financing for the business sector. This shift towards non-core activities followed the pattern which emerged in the developed markets and occurred within the context of a more market-oriented domestic and international environment and less than stringent financial regulations. Within the banking sector, the proportion of funds channelled into loans, was significantly lower than resources channelled into securities and other assets. This was due to the high cost of credit relative to the rates of return on alternative investments, the stabilization programme and the restructuring of the banking sector following the financial crisis. With regard to alternate modes of financing there was relatively little activity in the corporate bond market given a significant increase in the availability of risk-free public sector securities over the last decade. On the other hand, while equity financing was available, there was a notable paucity of demand for these resources by the private sector.

An enhancement of the level of intermediation in the financial system is an imperative if higher levels of economic growth are to be attained. Towards achieving this objective, the minimization of the Government's activities in the bond market is critical. It is also imperative to ensure continued improvements to the regulations, that not only allow for a



deepening of the securities markets but also safeguard against excessive risk taking that could threaten the stability of the financial system.

Future research work should seek to quantify the demand for domestic financing and hence the extent of the gap that has to be filled by other sources. In addition, it is also important to determine the threshold level of interest rates above which firms would not demand bank financing. They would either rely on internal financing, foreign loans or equity.

## **APPENDIX**

**Evolution of Selected Financial Institutions in the Jamaican Economy**

	1990	1997	2000
<i>Commercial Banks</i>			
No. of Institutions	11	9	6
Asset as a % of GDP	53.9	58.3	66.9
<i>FIA licensees</i>			
No. of Institutions	21	27	11
Asset as a % of GDP	15.2	6.9	2.6
<i>Building Societies</i>			
No. of institutions	6	10	5
Asset as a % of GDP	9.5	15.1	13.8
<i>Credit Unions</i>			
No. of institutions			
Asset as a % of GDP	2.5	3.0	4.5
<i>Life Insurance Companies</i>			
No. of institutions	10	8	6
Asset as a % of GDP	10.1	10.7	7.3
<i>Development Banks</i>			
No. of institutions	4	4	3
Asset as a % of GDP	4.3	4.0	4.6
<i>Stock Exchange</i>			
Market Capitalization as a % of GDP	22.1	31.0	54.0

Source: Bank of Jamaica, Author's calculations.

**U.S.A.**

**Venture Capital Investments**

<b>Year</b>	<b>No. of Companies Funded</b>	<b>Investment (US\$Mn.)</b>
1990	1,317	3,376.21
1991	1,088	2,511.43
1992	1,294	5,177.56
1993	1,151	4,962.87
1994	1,191	5,351.18
1995	1,327	5,608.30
1996	2,004	11,277.67
1997	2,696	17,207.05
1998	3,155	22,576.49
1999	3,956	59,163.93
2000	5,458	103,848.59

Source: Venture Economics/National Venture Capital  
Assoc.

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