BACKGROUND

The Jamaican economy which historically has been characterized as a story of paradoxes and potential has been plagued over the past 35 years or more with chronic problems of disequilibria in its internal and external accounts. In the quest to treat effectively with these issues, successive governments have routinely embarked on stringent demand management policies, which have only served to exacerbate the dilemma. This is compounded by the fact that the economy is estimated to boast an informal sector of some 40 percent which compromises the efficacy of the various policy instruments that have been brought to bear rendering them largely ineffectual.

In the immediate post–Independence period of 1962 - 1972, Jamaica experienced sustained macroeconomic stability. However this was relatively short lived and the economy was buffeted by extreme volatility in the 1970s occasioned by both endogenous and exogenous shocks. Indeed for the period 1972 – 1980, the Government of Jamaica adopted an aggressive interventionist strategy influenced by a political ethos of democratic socialism which reflected a substantial departure from the pro-capitalist stance hitherto practiced. This period was heralded by capital flight (private net capital outflows), substantial exchange rate depreciation, high cost push inflation, deficits in the fiscal and external accounts, negative net international reserves and general economic malaise. Indeed, average real GDP growth fell from 5.4 percent in 1962 – 72 to negative 2.4 percent per year in 1973 – 80, inflation averaged 22.0 percent in 1975 – 80 compared to 3.9 percent in 1960 -70 and the balance of payments showed an accumulated deficit of US$679.2 million in 1972 – 80 compared to a surplus of US$95 million in 1960 – 71.

In an effort to effectively treat with the economic malaise, Jamaica commencing in 1977 engaged with the International Monetary Fund (IMF) into a succession of stabilization programs, and culminating in the completion of an Extended Fund Facility program in 1996. This can be characterized as a fairly acrimonious relationship, with the IMF and the conditionalities attached to their lending programmes, being frequently used as political fodder in successive election campaigns. The IMF intervention was complicated by an international recession and oil crisis coupled with falling bauxite prices. The 1970s were also marked by a substantive ideological shift as the political party in power decided to adopt and be guided by the principles of democratic socialism. However after a less than successful attempt to address the issues of income mal-distribution and equity, the regime decided to take control of the "commanding heights" of the economy through a program of nationalization. Indeed by 1980, the Government of Jamaica owned approximately 50 percent of hotel room capacity, 8 of 12 sugar factories and had established a State Trading Corporation to regulate the importation of goods.

However, some major initiatives adopted in the 1980s under these programs included (i) divestment of Government-owned banks; (ii) tax reform; (iii) exchange rate reform which saw the discontinuation of multiple exchange rate systems; (iv) import liberalization; and (v) deregulation of the financial sector facilitating easier entry and participation. It is worthy of note that during the 1980s three World Bank structural adjustment loans (1982, 1983, 1984) and two sector adjustment loans in 1987 (trade and finance and public enterprises) supported reforms covering trade and foreign exchange regime, taxes, financial and fiscal policy. Nevertheless, private capital inflows failed to recover and the net international reserves remained negative. The balance of payments deteriorated and the national external debt burden escalated.

In 1989, the Jamaican economy achieved positive growth, due to buoyant construction, mining, manufacturing and tourism partially influenced by the rebuilding efforts consequent on the passage of Hurricane Gilbert in 1988. Unemployment was reduced to approximately 15%, gross fixed investment was posited at 26% and there was a fiscal surplus of 2.2% of GDP. Nevertheless, the current account deficit exceeded 7% of GDP, net international reserves were negative, public debt exceeded 100% of GDP, and debt service accounted for 43% of public expenditures. These imbalances were sheltered by unsustainable external aid and credit, with official capital inflows bordering 10% of GDP. This was further compounded by considerable increases in Money supply (M1) which increased by 97 percent in 1991. These imbalances were helping to fuel inflation, which continued its growth trend reaching over 80% by 1991.

Formatted: Font color: Red

Indeed 1991 was a watershed year of sorts for the Jamaican economy, as the Government sought to deepen the process of Structural Adjustment, with several major liberalization initiatives being introduced. Some of these initiatives were:

- The implementation of the Common External Tariff
- The elimination of subsidies
- The introduction of the GCT

- The liberalization of exchange controls
- Wide-scale removal of price controls

However the exchange rate depreciated from USJ$7.18 = US$1 in 1990 to J$12.85=US$1 in 1991 resulting from the liberalization programme in September 1991 and the resultant speculation against the currency. Indeed with an absence of reserves, the Jamaican dollar deteriorated further to J$23 to US$1 by 1992, significantly increasing prices of imports and forcing the GOJ to reorient its policy thrust and adopt an anti-inflation strategy as its main macroeconomic policy initiative. This manifested itself in a stringent demand management programme which resulted in persistently high domestic interest rates and an appreciation of the real exchange rate, both of which had a dampening effect on GDP and exports. However the liberalization process has been characterized as premature as a sustained fiscal surplus, local currency stability, and a prudential financial and regulation system oriented to preserve soundness are necessary prerequisites to optimize the transition to market mechanisms. In the Jamaican case, none of these conditions were met.

Formatted: Font color: Dark Blue

Formatted: Font color: Red

Further for the period 1991-1995, money supply averaged 48.2 per cent; inflation averaged 40.6 per cent annually; interest rates averaged 45 per cent; and domestic debt exploded from $10.1 billion to $60.2 billion over the period.

At the same time, by 1995 the Minister of Finance in an effort to stabilize the economy cut broad money supply. In 1996, money supply growth was cut from 47 per cent in 1995 to 12.3 per cent in 1996. This initiative dried up liquidity and Banks found themselves with a smaller pool of funds to lend. Their own debts had to be serviced at excessive interest rates and their customers were in the same position. This together with loose lending arrangements, and poor banking diligence, set the stage for the collapse which began in 1996.

Former Prime Minister and Finance Minister Edward Seaga argued that the government was reckless in its approach to monetary policy. In his Parliamentary contribution to the Budget Debates of 2001/02 he opined that had the Government curtailed money supply gradually to allow the system to adjust and at the same time introduced amending legislation to tighten banking regulations; there would have been a smooth transition instead of a crash. He cautioned that in financial systems, sudden drastic movements create repercussions sometimes as disruptive as the disorder.

Formatted: Font color: Green

With per capita GDP growth being stagnant for most of the last 25 years, average incomes in Jamaica have not improved. This has occurred against the backdrop of very high investment to GDP ratios (approximately 30 percent), which implies highly inefficient investment. This is in stark contrast to comparator economies, where high investment ratios, have been accompanied by improvements in productivity and growth. Indeed, the Jamaican economy has stagnated over the period 1993 to 2007 with an average real growth in Gross Domestic Product of less than one (1) percent. Further, the economy is seemingly undergoing a gradual process of structural transformation, which has manifested itself in the declining share of manufacturing - used as a proxy for production- versus the Services sector notably lead by Tourism. Over the period 1989 to 2007, the share of Manufacturing as a percentage of GDP at constant prices has fallen from twenty (20) percent in 1989 to 12.6 percent in 2007 whereas Services account for 72.9 percent.

TREND ANALYSIS

Whereas primarily from the standpoint of its geographical location, Jamaica remains poised to benefit from regional integration and trade flows, economic growth in Jamaica has been anemic relative to its Caribbean counterparts and has been substantially below growth rates experienced by other comparative emerging economies. Indeed it is instructive to note that whereas the economy recorded growth of 5.5 percent in 1990, for the remainder of the decade the highest growth rate achieved was a mere 2.7 percent in 1992. In fact, during the period 1991–96 GDP growth averaged less than two percent annually and per capita income declined by one percent. Economic performance deteriorated further in the late 1990s with output declining at an average rate of 0.5 percent per year in the 1996-99 period. This reflected the vulnerability of the country to both exogenous and endogenous shocks inclusive of natural disasters. Indeed the economy declined from 1995 to 1999 while unemployment exceeded 15 percent. The rate of inflation during this time interval steadily declined after peaking at 80.2 percent in 1991. For the 1990s, Jamaica’s external debt service ratio exceeded 15 percent while the trade balance deficit continued to expand. The value of merchandise exports fell between 1995 and 1999 reflecting low output levels and a deteriorating exchange rate while visitor expenditure grew at a slow rate. The fiscal deficit however remained under 8 percent of GDP. For the period 1993–2003, real GDP per capita (base year 2000) remained unchanged at about US$3,150, but lower than US$3,328 which obtained in 1970.

During the period 1990 – 1999 and particularly in the aftermath of the liberalization of the foreign exchange system, there was a marked emphasis on stabilization manifesting itself primarily in stringent monetary policy thrust aimed at restraining inflation. Indeed, there was a shift from direct monetary policy instruments like credit controls to indirect monetary policy instruments such as open market operations and interest penalties on overdrafts at the Central Bank. This strategic shift operated in tandem with a policy of fiscal restraint which led to the realization of primary surpluses averaging 13 percent per year during the first half of the 1990s. During 1996/97 to 1998/99 primary surpluses averaged 4 percent which was reflective somewhat of a relaxation of the previous policy thrust. For the period 1996/97 – 1999/2000 fiscal deficits averaging 7 percent were realized. Indeed, during 1998/99 the overall public sector deficit exceeded 11% of GDP which was primarily attributable to the large interest payments on Government-backed securities associated to the financial sector bailout. Nonetheless by 2000/01, occasioned by significant and rigorous expenditure restraint, a primary surplus of 12.6% was realized.

However the utilization of both a stringent monetary policy and a proactive fiscal policy in the 1990s led to increased interest rates, with the weighted average loan interest rate reaching as high as 49 percent in 1994. This provided the requisite fillip to stimulate private capital inflows, causing net international reserves to become positive by 1993 and to grow to significant levels by 1997. With the exception of 1992 and 1994 when the current account recorded a small surplus, Jamaica's Balance of Payments (BOP) realized a deficit during the period 1990-2000. The capital account was in deficit during the period 1990 to 1993, while realizing a surplus from 1994 to 1999 period. Over the decade of the 1990s there was a surplus in the combined capital and financial account of the BOP. The net inflow of capital was however insufficient to prevent an overall BOP deficit during 1997 (US$170.4M) and 1999 (US$136.4M) when significant deficits were recorded.

The BOP problems were partly affected by the fiscal position of the government. The fiscal balance (excluding amortization) was in deficit during the 1996/7 to 2000/1 period. These periods were associated with negative or low rates of economic growth and deficits on the BOP. During the 1996/97 to 2000/01 period the fiscal deficit as a percentage of GDP ranged from 1.1 to 8.4 percent. There was however a significant rise in net foreign assets between 1993 and 2000, that is, from J$1.4 billion in 1993 to J$64 billion in 2000 which is indicative of the high levels of foreign borrowing by GOJ in an effort to meet its external financial obligations.

It is instructive to note that high interest rates while attracting external capital, traditionally leads to the appreciation of the domestic currency and/or increasing the level of international reserves. However the former undermines the competitive position of the tradables sector and amplifies the current account deficit of the balance of payments. In light of the fact that one of Jamaica's policy imperatives has been to facilitate international reserves accumulation, its sterilization during this time increased the Central Bank losses.

However the latter half of the 1990s was marked by a period of high real interest rates occasioned by the drastic reductions in the rate of inflation versus the slower response of nominal interest rates. During the period 1995 – 1998, real Treasury bill yield averaged 14.6 percent and the real interest costs on government internal debt increased by 213 percent from 1994 to 1998. This created a scenario whereby GOJ was borrowing to finance interest charges which resulted in a de facto capitalization of interest and subsequent growth of amortization creating a cycle of increased borrowing. Specifically, interest rates had been forced up by a combination of high public sector borrowing requirement and a continuing need to sterilize the excess liquidity generated by capital inflows occasioned by the borrowing. With interest payments accounting for in excess of 50 percent of total revenue, increases in interest rates therefore translate into substantial additional fiscal costs to the central government. Further the high interest rates also succeeded in depressing real output in the economy and by extension tax revenues would be suppressed.

The high real interest rates also had the further negative impact of discouraging investment and impeding economic growth in productive areas (with the attendant risk and high real interest rates), instead, inducing persons to invest in government securities, which offered safe and high real rates of return. At this time, businesses in Jamaica boasted on average a debt/equity ratio of 70:30 which translated into a scenario where the banks were funding heavily indebted, under capitalized companies that borrowed by way of overdrafts. This type of bank financing came to be regarded as a form of semi permanent capital. Indeed, during 1996 for example at the now defunct Century National Bank loan rates peaked at 76 percent and penalty rates on overdrafts peaked at 105 percent. In an effort to encourage more regular debt servicing, there was a concerted effort to reorient the financing of business activity from asset based financing to one geared towards cash flow. This was achieved by converting overdrafts into term loans with fixed repayment obligations, however while obviously well intentioned, it had an adverse impact on the cash flows of many companies at the time merely compounding the problem.

Similarly the nominal exchange rate depreciated from J$7:US$1 in 1990 to J$42:US$1 in 1999 but, for the most part, the real effective exchange rate appreciated during the 1990s. This undermined the competitiveness of the economy, encouraging import growth and weak performance of exports. In Jamaica, the real effective exchange rate appreciated by more than 35 percent from 1990 to 2001, leading to a decline in external competitiveness. This manifested itself in a 50 percent decline in Jamaica's market share of world merchandise exports from 1994 to 2001, World Bank (2003). At the same time, real wages increased rapidly. From 1994 to 2001, unit labor costs increased twice as fast in Jamaica as in its major trading partners, without clear evidence of a comparable increase in labor productivity.

Reinforcing the need for structural adjustment, bank lending in Jamaica is basically centralized around a limited number of sectors. This is illustrated with the breakdown of commercial banks' loans and advances by sector. For the period 1992 – 2001, government services share of loan and advances moved from 5.8 - 21.0 percent, whereas personal loans ranged from 15.1 percent as at December 2002 to 28.2 percent as at December 2001. Similarly loans and advances to the Tourism sector moved from 7.3 percent in 1992 to 10.5 percent in 2001. Over the same time interval, loans and advances to the manufacturing and construction sector declined from 1.5 percent to 0.6 percent and from 17.5 percent to 4.8 percent of total loans respectively. The increase in retail lending likely reflects the risk-averse attitude of banks and their preference for intermediating short-term loans. The data is reflective of the scarce availability of bank credit for the private sector, with close to 59.7 percent of total credit dedicated to government services, personal loans, and tourism. In light of the high levels of investment prevailing in the country, the data suggest that a substantial share of that investment is financed through retained earnings and foreign financing. This reinforces the fact that access to finance for the private sector has been limited, given the narrow scope of the financial sector, and the crowding out of credit to the private sector by the public sector. The quantum of public sector debt held by Financial Institutions which stood at 22.0 percent in 2007/08 (not inclusive of public enterprise debt) is high by international standards. Capital costs have also remained high because high levels of public debt have pushed up interest rates.

Indeed, one of the costs of stabilization was the substantial increase in domestic debt commencing in 1994/95. In addition to deficit financing, the increase in the stock of domestic debt was incurred largely to provide assistance to the Bank of Jamaica (BOJ) in its liquidity management objectives and to cover BOJ losses. The stock of domestic debt rose from J$11.8 billion at the end of FY1990/91 to J$50.1 billion at the end of 1994/95. At the end of FY2000/01, the stock of domestic debt stood at J$215.1 billion. Increases were also due to the assumption of debt obligations of public enterprises. The debt problem was also exacerbated by the financial sector crisis which emerged in 1996 and the cost to the government of rehabilitating and restructuring the sector. Jamaica's total public debt/GDP ratio amounted to 116.1% at the end of 2000/01 compared with 102.6% at the end of FY1994/95. Over the period, domestic debt as a percentage of GDP increased from 30.1% at the end of FY1994/95 to 65.6% at the end of FY2000/01. With the Government's assumption of the remaining liabilities associated with the restructuring of the financial sector, the domestic debt increased to 94.5% of GDP on April 1, 2001.

It is instructive to note that between 1996 and 2003, public debt rose by 67 percentage points of GDP (from 76 to 143 percent).This was reflective of an expansion in the domestic capital market in response to financial liberalization in the early 1990s. This increased the absorptive capacity of the economy for domestic debt growth.

However for this period, the largest part of that debt absorption was due to the costs and debts associated with the financial crisis of the late 1990s. From 1998 through 2001, FINSAC accounted for most of the debt accumulation. This was due, initially, to the capitalization of interest due on the government paper that had been used to purchase the non-performing loans of the financial sector. The interest was eventually converted to Local Registered Stock and hence became government debt. However the most substantial debt accumulation occurred in 2001 as government assumed the liabilities of FINSAC accumulated in the rehabilitation of the “nationalized” financial sector entities. Indeed in 2000 and 2001, GOJ assumed FINSAC debt to the extent of 11.6 and 22.7 percent of GDP respectively. Additionally, an average one percent of GDP annually was due to the debts of public enterprises, in particular Air Jamaica and the National Water Commission.

The substantial debt burden has severely constrained Government’s ability to invest in physical and social infrastructure necessary to promote investment and growth. Therefore, since the second half of the 1990s, the major thrust and policy challenge has been the management of the debt dynamics. Emphasis has been placed on the management of domestic debt, the larger and more expensive share of the public debt. This threatens not only the fiscal operations but also the achievement of the macroeconomic objectives.

Monetary Policy

For the period 1960 –1985, Jamaica operated with a typically repressed financial system which was facilitated by a high statutory reserve requirement, fixed exchange rate, the non price rationing of credit, and an administered interest rate. Indeed the Central Bank sought to regulate growth of money in line with the objective of price and exchange rate stability, while allowing for sufficient monetary expansion to finance growth in economic activity. This approach is often associated with limited intermediation and slow growth of the financial sector as measured by M2/GDP.(Define M1 and M2). This was also borne out by the fact that Jamaica at the time had an underdeveloped money and capital market and the financial intermediation was dominated by the Commercial Banks. As a group, commercial banks with an extensive branch network accounted for about 33.5 percent (2008) of the total assets of the financial system, down from 50 percent (1995). A further consequence was that local enterprises were highly dependent on bank funding, which then meant bank loan portfolios were often concentrated.

Nevertheless, the Jamaican financial system experienced substantial growth through the 1960's reflective of a buoyant economy, and inflows of FDI.(Define FDI) This scenario suggests a high income elasticity of demand for money, common in early development would have allowed for this rapid expansion in liquidity without a threat to inflation. However, the second phase of rapid expansion occurred between 1979-83 when the domestic economy had suffered several years of poor growth, high inflation and negative real interest rates. The reforms of 1985 seem to have been accompanied by a fall in growth of M2/GDP which actually contracted until 1992 when it again showed positive and steady expansion.

The reforms enacted under The Financial Sector Reform Programme (1985), which heralded the first attempts at financial deepening, involved the reduction of the statutory reserve requirement from 48% to 20%, removal of the secondary reserve requirements, and the utilization of open market operations to control interest rates. This resulted in increased intermediation and a disentangling of monetary and fiscal policy (Peart, 1995). Nonetheless with the shift to inflation targeting, the Bank of Jamaica became responsible for setting and managing the operating targets through the interest rate subject to approval of the Ministry of Finance. However, the financial surge associated with aid inflows consequent on the passage of Hurricane Gilbert in 1988 interrupted reforms and statutory primary and secondary reserve requirements were reintroduced.

The growth in M2/GDP from 1992 up until 1997 is surprising given the deep financial sector crisis from 1994 through~~u~~ 1997. However after 1997 the ratio remained relatively flat until 2007. This development suggests that demand for money is relatively inelastic with respect to real interest rates, which is indicative of the limited impact of the monetary policy being pursued. This is not particularly surprising in light of the Study on the Informal Economy in Jamaica (Witter) which suggests that the informal sector is some 40 percent of GDP. However the growth from 1992 through 1997, despite the difficulties which commenced in 1994, can also be interpreted to be demonstrative of the success of the Jamaican government's intervention policy in failed institutions in stabilizing the financial system.

The Bank of Jamaica

In 1990 and 1991 the Bank of Jamaica liberalized foreign-exchange controls, culminating in the removal of many controls on September 25, 1991. The Jamaican dollar became largely convertible for the first time since 1970. Inflation, however, increased from a low of 8.4 percent in 1987 to 80.2 percent in 1991.

Inflation was being fueled by large government budget deficits and substantial increases in money supply. The Bank of Jamaica financed some of the deficits in the form of "BOJ losses." The losses began in the 1970s. They resulted from the Bank of Jamaica making loans that the government did not repay with real assets. The government did not repay anything, or repaid the Bank with low-interest, long-term government bonds (Local Registered Stock) that financial markets would not purchase from the Bank and which had extremely low present value (Black 1990: 9; Mackenzie 1994). In 1993 Bank of Jamaica losses of J$3.1 billion was recorded (Bank of Jamaica Annual Report 1993).

The Bank of Jamaica through its Governor G Arthur Brown also led discussions with the banking community on the role of the banking sector in Jamaica's development. This as the new political regime (elected in 1989) was of the view that the banking sector had the primary responsibility and greatest resource base to invest in Jamaica. Under his leadership the issue was finally resolved with limits of 20 percent of capital in any one entity other than financial institutions and 40 percent for all investments, were established. No investment limits in financial institutions were imposed, however, all this was supposed to occur within the context of a tighter regulatory framework (Chen-Young, 1998)

The reputation of the Bank of Jamaica was also tarnished by irregularities in its foreign-currency trading. In 1992 the Bank in a controversial move, financed agents (suitcases of cash) to buy foreign currency on its behalf in the parallel market. These agents while charged to pay no more for foreign currency than the official market rate routinely bought and sold currency at higher rates. The Bank of Jamaica was not only placed in the invidious position of betting against itself while being exposed to losses but did not share in any additional profits. Effectively, the Central Bank was giving agents low-cost loans to speculate in foreign-currency trading. These irregularities resulted in a government enquiry (the Barber Commission) and the dismissal of some officials of the Bank in 1993.

This led to the appointment of a new BOJ Governor Mr. Jacques Bussières, a consultant who had previously been an official of the Bank of Canada and governor of the Bank of Zambia. Mr. Bussieres successfully broke the back of the informal parallel foreign exchange market through the introduction of cambios and effectively broadening and deepening that market. However, he adopted a public anti-financial conglomerate stance routinely stating that the Jamaica was overbanked and really only needed a few banks to service its needs. He also advocated separate ownership of financial entities such as banks and insurance companies. His stance however began to undermine confidence in the domestic financial sector and culminated in the 1996 report by the IDB/IBRD/IMF which indicated an immediate need to "limit statements by public officials on issues related to financial system soundness." Bussieres was replaced by Derick Latibeaudiere as Governor in 1996.

For the period 1990 to 1996, the Bank of Jamaica relied extensively on the use of liquid reserves from commercial and merchant banks in an effort to curb the growth in credit and the demand for foreign exchange. Between 1990 and 1992, the BOJ increased the cash reserve ratio for commercial banks from 19 to 25 percent and the liquid asset reserve from 25 to 50 percent respectively. For the near banks which did not offer checking accounts, the cash reserve ratio was increased from 5 percent in 1990 to 17 percent in 1993 and the liquid asset ratio increased from 7.5 percent to 35 percent in 1996. While near banks were not able to offer non-interest bearing current accounts and low interest bearing savings deposits, the increase in the reserve ratio particularly the non-interest bearing cash component compromised their viability.

This was occurring within the context of a process of liberalization of the foreign exchange control system that had existed in Jamaica during 1990 to 1991. However there was concern that full liberalization would have led to substantial capital flight and hence in an effort to discourage foreign exchange demand, a number of monetary policy strategies were implemented. In December 1989 credit ceilings were imposed on banks and in January 1990 the BOJ closed its foreign exchange market and the liquid asset ratio for both commercial and near banks were increased prior to and subsequent to liberalization. At the same time the Bank of Jamaica was increasing money supply (M1) by 97 percent or M2 by 54.6 percent in 1991. This led to inflation of 80.2 percent and substantial devaluation of the currency effectively negating the use of the liquid assets ratios.

The phenomenal increases in money supply coupled with high reserve requirements and tight credit controls heralded a period of extraordinary high interest rates. This created wide disparities with overseas interest rates, with local T-Bills offering yields of 50 percent versus a mere 4 percent for a similar instrument in the US market. This led to a situation where local and overseas investors alike invested in Jamaica dollar instruments as well as US dollar accounts which also offered premium interest rates. Hence with these substantial flows of these short term foreign exchange funds the BOJ/GOJ chose to build up the net international reserves primarily from overseas borrowing and the purchasing of foreign exchange versus the more traditional route of building reserves through exports or through long term investments.

This led to a scenario whereby the BOJ was seeking to defend the exchange rate and contain inflation which resulted in an overvalued exchange rate which was being artificially buoyed by "borrowed" reserves in the context of high interest rates but which also succeeded in basically sterilizing the funds. As a result, the foreign exchange "windfall" was not used to facilitate productive investments. This eventually led, not unexpectedly, to a scenario where exports between 1991 and 1999 were about US$1.2 billion while imports ballooned from US$1.8 billion to US$2.9 billion. Indeed the contractionary stance adopted by the authorities through this stringent demand management strategy led to anemic growth in GDP during 1990 – 1996 and declines thereafter.

Given a declining economy, high interest rates and low levels of capitalization in the business sector (70:30 debt to equity ratio) where financing was primarily from overdraft facilities there was a substantial increase in loan losses with the resultant negative impact on the financial sector. Additionally, cash rich corporate entities and individuals caught in a web of uncertain and inconsistent policy tools became more risk averse and opted for investments in government paper and short term investments to take full advantage of the high interest rates in liquid instruments.

There is an inverse relationship between high interest rates and the stock market index and unsurprisingly with the maintenance of the high interest rate policy the fortunes of the stock market started to wane as did the construction sector which is extremely sensitive to interest rates.

The Banking System

The Jamaican banking system which predates Independence in 1962 was initially dominated by branches of foreign financial institutions which were governed by the prudential framework and control mechanism which obtained in their home countries obviating the need for development locally of an effective prudential regulatory framework. These institutions were principally from the United Kingdom and Canada. Furthermore, foreign banks resisted efforts to introduce regulations that would be administered by the Jamaican Authorities.

However, this dynamic changed in the 1960s and 1970s when the Government nationalized the majority of the financial institutions which meant that the prudential standards previously employed by the foreign originated institutions were slowly phased out. Indeed, the process was initiated with the sale by the Bank of Nova Scotia of 25 percent of its shares to the Jamaican public in 1966, later to be followed up by the nationalization of Barclays Bank and the Bank of Montreal in 1977, creating the National Commercial Bank by merging them. However, the Government failed to use the intervening time interval to strengthen its local financial regulatory and supervisory framework as it was not apparently deemed to be a matter of priority. However given the economic buoyancy of the 1960s (economic growth averaged 5 percent over the decade) coupled with an expansionary credit environment which persisted in the 1970s, the financial sector expanded in terms of the growth of assets and the establishment of new institutions.

The system dynamic was yet again changed and in 1986, the Government as a matter of policy commenced the privatization of previously "nationalized" banks. Indeed, the National Commercial Bank led the process with the Government divesting some 40 percent of its holdings to the private sector. This was replicated in 1991 when the assets of the Workers Savings and Loan Bank were also divested to the Corporate Group. However these privatization initiatives occurred in an environment of weak institutional controls. In an effort to address these deficiencies the Government introduced new legislation in 1992, however the influential and effective financial sector lobby, influenced the outcome, resulting in provisions that gave inadequate powers of intervention, sanction and enforcement to the supervisory authorities. This lack of effective supervision, regulations, and entry barriers created a moral hazard which allowed the massive entrance of financial institutions. Indeed in the first half of the 1990s, there was exponential growth in the number of merchant banks, finance houses, and trust companies with the total number of institutions rising from 67 in 1989 to 105 in 1995. It is worthy of note that at this juncture that the growth of the financial sector outpaced that of the overall economy during the early 1990s, reaching 14.7 percent of GDP in 1994.

This happened in an environment of insufficient institutional control, where there were significant disparities between the prudential norms governing different segments of the financial sector and fostering regulatory arbitrage. Indeed while deposit taking institutions under the supervision of the Bank of Jamaica became subject to increasingly stringent prudential norms, this supervisory approach was not replicated in the rest of the market with the most glaring omission being the life insurance industry. The differential prudential requirements were creatively used by most financial industry players to operate beyond the effective reach of the banking supervisors. In this vein, it is worthy of note that the supervisor of deposit taking institutions only had access to those institutions which were licensed to take deposits.

Indeed, the opportunities for regulatory arbitrage were manifested by the formation of financial groups. Most of these groups boasted membership of at least a Commercial

Bank, Insurance Company, Merchant bank, investment, trust and leasing company, Building Society and Security Brokerage. Indeed, one could find that a group was being supervised / regulated by one or more of three agencies – Bank of Jamaica, the Office of the Superintendent of Insurance and the Securities Commission (When was the Securities Commission introduced) – with there being no coordination of their efforts. It is worthy of note that at that juncture, building societies, securities brokers, investment advisors and investment banks operated primarily in a self-regulated environment as the financial sector had been liberalized prior to the establishment of the Securities Commission. With specific reference to Building Societies and Investment Banks, entry requirements were basically non-existent. To register a Building Society and begin accepting deposits merely required the applicant to obtain a form from the Attorney General's Office, complete and submit it to the Registrar of Births and Deaths with the payment of a minimal fee. Hence it does not occasion any surprise that as at 1995 there were some 34 building societies in operation. With respect to Investment Banks, these were basically limited liability companies which were allowed to designate themselves as Banks. However they were not allowed to accept deposits but largely treated this stipulation as a mere bit of semantic sophistry and therefore employed every euphemism imaginable for collecting money from depositors without acknowledging them as depositors. Ironically, former Central Bank Governor Headley Brown (November 1989 – March 1989) operated one such institution Universal Investment Bank Limited which also collapsed in 1995.

Formatted: Font color: Red

Formatted: Font color: Red

Anatomy of the Crisis

The accelerated liberalization in the early 1990s led to rapid growth in the financial sector and was manifested not only in terms of unprecedented growth in the assets and liabilities of financial institutions but in the quantum of new entrants to the market. In fact Jamaica became overbanked. Further, the liberalization process generated greater volatility in nominal interest rates so that both risk and the incentive to undertake risk were increased. This period generated particularly rapid growth of non- bank financial intermediaries, and fierce competition between institutions in what remains a relatively thin market. This emboldened some which often acted outside prudential limits, creating a scenario where credit risk management and collateralization assumed scenarios that later proved to be too optimistic culminating in a situation where poor loan assessments facilitated risky investments but within a context where there was no significant increase savings. Indeed, the aggressive expansion of the banking sector occurred in the context of insufficient attention to internal supervisory mechanisms. The commercial banks sought to use the lower regulation of the NBFI (Non-bank financial institutions) sector, by establishing financial conglomerates and then shifting risk onto the less supervised institutions. The overall result was a massive but unsustainable credit boom, concentrated in private sector credit (70% in 1993), and a consequent consumption boom, but by 1997 almost 30% of loans were non- performing. (Kirkpatrick & Tennant, 2002 p.1936).

Indeed by the mid-1990s, the subsequent tight anti-inflationary policies had an adverse impact on the financial sector as non-performing loans increased which was initially masked by extension of liquidity support from the Central Bank. In addition, the high interest rates and depressed economic conditions encouraged a shift from the traditional financial intermediation to trading in securities, mainly government securities issues for financing the deficits. This shift was reflected in falling shares of loans and advances relative to the proportions of assets held in the form of securities by financial institutions. In turn, these conditions were further exacerbated by the collapse of the financial sector that occurred, starting in 1996. However as highlighted before, regulation and supervision were not in place for the financial institutions to adequately manage the implicit credit risks being assumed and therefore there was an overheating of the local credit markets manifested by exponential growth particularly in consumer loans. This development was also compounded by increased lending to related parties, as well as a maturity and currency mismatches, among other characteristics, that point to an ineffectual risk management mechanism. For example, "in the case of Workers Bank, owned and controlled by the Corporate Group, over 60 percent of loans were to the Corporate Group and its component institutions and another 10 percent was to staff of the bank" (Bonnick 1998). Generally, excessive growth periods point to the utilization of a sub-optimal control mechanism and are usually indicative of the onset of financial crisis.

For the period 1996 – 1999, six commercial banks accounted for about 60 percent of deposits in the population of nine commercial banks, five life insurance companies accounted for over ninety percent of premium income in the business, one-third of all merchant banks and several building societies were found to be insolvent and closed. In 1996 and 1997 there was a run on two commercial banks (which commercial banks) triggered by rumours of their insolvency. Depositors feared a repetition of the experience of late 1995 when depositors were initially unable to access their funds in Blaise Trust and Merchant Bank which had been put under temporary management and later closed.

It is significant to note however that during this period, the Bank of Nova Scotia continued to produce improved results with each quarter, experiencing a slight dip in 1997 before continuing its record of increased profitability. Citibank, Canadian Imperial Bank of Commerce (CIBC) and other foreign banks also performed well during and after the crisis, as there was a "flight to quality" within Jamaica from indigenous to foreign-owned banks. However it should be noted that the foreign owned institutions stuck to the traditional conservative lending path and had a significantly higher percentage of their deposits in government paper. In fact, the resilience of the foreign banks relative to the indigenous institutions to the financial crisis is attributable to better management and effective internal supervisory and regulatory standards. For example, many indigenous banks used a period of 180 days before categorizing a loan as non-performing in stark contrast to an international norm of 90 days.

Hence, many indigenous financial institutions faced a high percentage of non-performing loans, which were not being booked as such, high interest rates and ultimately a liquidity crisis. To truly illustrate the adverse impact of this divergence from international norms on the local banking sector, when the requisite amendments to the Banking Act were made, along with the enactment of the Financial Institutions Act to regularize the situation, the financial crisis deepened. Indeed, with the amendments, Banks were required to reverse their interest accruals from income once loan repayments were 90 days in arrears. The impact was immediate and severe on the financial bottom-line of the banks. In the case of NCB, they were forced to classify J$13.5 billion of its loans as non-performing. This was approximately four times its capital base and required state intervention.

Commercial bank deposits increased from US$1.45 billion in 1990 to US$2.51 billion in 1995 peaking at US$3.31 billion in 1998. Commercial bank credit also expanded from approximately $8 billion in 1990 to $46 billion in 1995 peaking at $69 billion in May 1997, before slipping to US$939 million in September 2001 (What slipped to US$939 million in in 2001). Credit growth during the first part of the 1990s occurred both in the private and public sectors. Not to be outdone the credit union movement's assets grew by 69.2 percent in 1996 and by a further 26.1 percent in 1997. On the other hand, the banking sector's assets increased by just 12.1 percent in 1996. It is important to note that the percentage share of total assets enjoyed by Jamaica's two largest banks (NCB and BNS) increased from 69.9 percent in 1990 to 76 percent in 1999. This was reflective of the increased number of mergers and acquisitions and consolidated on what took place in the financial sector.

It is interesting to note that the Jamaican banking sector is oligopolistic in nature with the banks basically colluding in determining interest rates. Indeed competition in the industry is non-price and is founded primarily on advertising, product differentiation, quality improvements and services. Jamaican commercial banks also enjoy the highest interest margins (the spread between lending and deposit rates) in the region. For instance, for the

Formatted: Font color: Red

decade of the 1990s, interest margins increased from 21.6 percent in 1991 to a peak of 43.1 percent in 1993 thereafter declining to 21.8 percent in 2000. These high interest margins were also influenced by the tight monetary policy in vogue coupled with high reserve requirements. Similarly, the high percentage of non-performing loans and relatively high operating cost structure of the institutions were also important determinants in the high interest margins.

Formatted: Font color: Red

The issue was further compounded by the paucity of reliable and timely information flows from the financial institutions and the Central Bank and hence the investing public was left to assess its risk exposures based on anecdotal evidence and the dated release of specified information from the Central Bank. Indeed, though existing regulation demands that financial institutions present their financial statements to the Central Bank, the BOJ does not disseminate this information to the public in its totality. In the 1990s the information was printed in the local newspapers but at the time of publication, the data was outdated and therefore of little more than academic interest. The BOJ has also subsequently been posting these "published accounts" on its website but with the continued relatively low internet penetration in the Jamaican market the utility of this particular exercise is dubious. As a result, efficiencies are severely compromised and the market is effectively precluded from acting as an additional enforcement mechanism (in particular punishing financial institutions when they assume excessive risk), forcing an undue reliance on the information flows from the Bank of Jamaica.

During the same period, the central bank used a stringent demand management strategy to control high inflation levels. This however led to an increase in real interest rates which impacted negatively on portfolio quality, investment, economic activity and fiscal accounts. The increase in interest rates also characteristically attracted increased short term capital inflows which translate into greater levels of liquidity in the system, which further informed the need to adopt an even more restrictive monetary policy to combat this effect and to control inflation. This encouraged the rise of interest rates, thus resulting in a vicious circle. However, the commensurate liquidity restriction encouraged by the monetary policy equally had a negative effect on insurance companies.

Indeed at this time, the local life insurance companies were in expansion mode and used their long term funding to increase their participation in banking institutions. This participation was particularly useful to insurance companies as it allowed the banks to grant them credit exceeding credit limits. It is also important to point out that during this period the life insurance companies aggressively raised short term funding at high interest rates in the form of "equity and money market linked products" at a time of high inflation when it was difficult to market long-term insurance savings plans (e.g. endowment policies).

Indeed, the life insurance companies acting independently entered this market in order to compete with the banking sector and the government for local savings. Insurance companies were gathering these short term liabilities and investing in long term assets, mainly real estate or linking them to an initially bullish stock market. As the stock market

Formatted: Font color: Red

and interest rates declined, people withdrew their money from the insurance companies and in order to meet this demand, the insurance companies accessed funds from their banking affiliates thus creating contagion for the banks. At this juncture it is useful to recognize that whereas taxes on interest are now levied at a rate of 33.33 percent for corporate accounts and 25 percent for individuals, prior to 1999 taxes were withheld only on savings deposits. In 1999, the Government increased the number of financial institutions which were required to withhold taxes on interest as well as broaden the range of financial instruments so affected. In this regard withholding taxes were increased from 15 percent to 25 percent on all financial instruments. Corporate entities were liable for the additional 8.33 percent when tax returns were filed. In an effort to encourage long term savings by individuals, the Government granted tax-free status to approved long term savings accounts. These were deposits where the principal amounts were held for at least (5) years with the stipulation that if those deposits were broken before the minimum 5 year period, then tax was payable at 25%. However this was exacerbated by comments by then Finance Minister Omar Davies indicating his intention to freeze short term liabilities for the prescribed period up to five years as there was widespread abuse and tax avoidance through this mechanism (in an attempt to discourage the short termism, particularly in the insurance sector). The threat was never actualized but given the context of uncertainty at the time coupled with less than adequate information flows it merely succeeded in compounded the issue.

This created a run on the sector which culminated in several companies being faced with an acute liquidity crisis whereby funds were tied up in relatively illiquid long term assets such as real estate and non-core business activities which values had already been compromised by a general recessionary environment in the real estate market. The interlocking of these entities with the banking sector meant that the illiquidity crisis of the non banks quickly spread across the sector with several commercial banks requiring liquidity support by 1995/96. As a result, the Ministry of Finance placed a number of institutions under temporary management. In response to the growing crisis, depositors started withdrawing savings from weak indigenous institutions and relocating to foreign banks (Kirkpatrick & Tennant, 2002). Initially the Bank of Jamaica (as at March 1997) had provided approximately J$18 billion of special liquidity support for the affected banks, however with the continued drains, the BOJ support was insufficient and the insolvency of the banks was unavoidable.

In 1996, a number of insurance companies requested assistance from GOJ for liquidity problems (J$19 billion in aggregate). A working group to review the matter was established by GOJ which findings subsequently guided GOJ to seek the assistance of the IMF, IBRD and IDB which sent a combined team in 1996 to study the situation. The IMF/IBRD/IDB report in October 1996 concluded that "almost all banks except those that are foreign owned are insolvent …" Indeed it is instructive to note that fourteen institutions including four commercial banks reported losses for the financial year ended December 1995. Furthermore, the Century Group which had become insolvent, continued operations during 1995 and early 1996 only with substantial liquidity support from the BOJ.

According to the report by the Washington triumvirate, "...the resolution strategy should aim at removing all insolvent and unviable financial institutions through a preemptive and wide scale intervention." It was also recommended that there be accelerated passage of legislation that would allow for the authorities to assume management and ownership control of insolvent or unviable institutions in order to cauterize the hemorrhaging. The team also pointed to the need for strengthening the Central Bank's ability to employ prudential regulations by effecting the requisite amendments to afford the application of penalties for non-compliance. The team further indicated that "…regulations to enable monitoring and limiting transactions among affiliates of financial groups and providing for consolidated supervision were recommended. The authorities have indicated that this approach, which the missions still consider to be technically superior, is not now politically feasible and would be logistically difficult." In the end, resolving the problems of the Banking system ended up costing the Jamaican economy nearly 40% of GDP.

Formatted: Font color: Purple

The IFI's mission and subsequent report on the Jamaican financial sector reflected a sector in the throes of crisis. The 1996 Report noted:

"Regulatory oversight of the financial system is weak. While bank supervision capacity of the BOJ is being substantially strengthened – although much remains to be done – the supervision of insurance companies (most of which are part of conglomerates) is virtually nonexistent. Additionally, BOJ's ability to carry out effective supervision is severely constrained by the lack of authority to apply sanctions in the event of noncompliance. Furthermore, the Minister of Finance is charged with "intervention" (via placement of a

Formatted: Font color: Red

temporary manager) thereby introducing a political element into what otherwise would be a strictly regulatory function. As a consequence, institutions regularly flaunt prudential regulations and BSD directives/ undertakings. Institutions that represent a clear risk to depositors' funds remain open for an inordinate amount of time. Finally, a number of institutions (mainly building societies) have been operating for some time without being duly licensed. In one case official unwillingness to stop activities of an unlicensed building society was reportedly on account of concerns of contagion to affiliates; this conglomerate is now insolvent. Another unlicensed institution is reportedly being supported by public enterprise deposits."

Indeed once the crisis hit, the IDB was the only institution willing to work actively with Jamaica to help the country manage it. Initially, as indicated above the prescribed approach by the IMF/IDB/IBRD was for Jamaica to agree upon a program with the IMF, which recommended resolving the crisis by allowing banks to fail and for some depositors to lose their money arguing that compensation should only be limited to demand and savings deposits and should definitively not cover managed trust accounts or other such instruments. However the GOJ was unwilling to enter into an IMF program and began to examine other options.

It is also instructive to note that from November 1995 the IMF was reporting that

"Reportedly, BOJ is not currently performing individual bank surveillance, generating reports of analysis based on such data or conducting special studies on bank operations.

A related problem involves the lack of reliable financial data received from the financial community. Both the BOJ and the MOF expressed serious concerns about the integrity of the data submitted by the banks, including audited financial statements. Furthermore, adherence to international accounting standards and practices is not required in Jamaica. Effective off-site supervision is critically dependent on the receipt of reliable and accurate information from the financial sector." (IMF, 1995).

The fact that this was not disclosed to an unsuspecting public and that the lack of timeliness in the dissemination of the information by the Central Bank was also of serious concern, could well have created a scenario of regulatory forbearance that could result in adverse rulings in a Court of Law where it could be held that the public was misled, with attendant consequences for burden sharing. It is likely that these considerations influenced subsequent actions by GOJ.

The GOJ decided on a more comprehensive approach, establishing the Financial Sector Adjustment Company (FINSAC) in January 1997 to intervene and rehabilitate (an institution similar to the Resolution Trust Corporation set up by the United States in 1989 to deal with the savings and loan crisis.). Facing systemic insolvency, the Government in February 1997 placed a universal guarantee on deposits in licensed deposit-taking institutions, pension funds and insurance companies and provided liquidity to weak banks through extensive overdraft facilities from the central bank with the aim of maintaining confidence. The Government also started a process of strengthening the regulatory and supervisory framework, aimed at reducing the vulnerability of the financial system to

Formatted: Font color: Red

future crises. This involved initial interventions followed by a series of rationalizations and mergers, evident in the numerical shrinkage of all the sub-sectors.

Although an unorthodox approach which created a large government deficit, the short run money supply effect was largely sterilized by use of bonds to finance the deficit so that the package remained compatible with short term inflation targeting. Being cash constrained, FINSAC was capitalized through relatively illiquid government guaranteed bonds (on which interest was capitalized) to intervened financial institutions in exchange for non-performing assets or equity stakes. Indeed, GOJ was seemingly relying on assistance through the MFI's to solve its short term liquidity requirements occasioned by the intervention but this was not forthcoming given primarily the refusal to engage with the IMF, forcing GOJ to capitalize the interest on the bonds. For intervened institutions who were in receipt of bonds, it must be noted that they routinely received a mere fraction of the liquidity support requested and those with acute liquidity problems were forced to discount these even further at other financial entities, notably Investment Banks. Therefore, for some institutions the issuance of the bonds provided little or no real assistance militating against the potential efficacy of the strategy employed.

The ensuing rapid growth of FINSAC debt worsened as interest rates continued to rise adding to an already large pre-crisis public debt burden of about 100 percent of GDP, leading to an extremely high overall level of debt as well as to adverse debt dynamics. Indeed, total public debt increased to 140% of GDP by the early 2000s, while debt service costs grew to close to 50% of revenues owing to the high local interest rates on these bonds suggesting imminent servicing problems and new risks to the financial and real sector. The cost of the financial crisis had a huge burden on Jamaica, significantly increasing public debt, leading to the debt and fiscal problems the country is facing today. Indeed, because of the large debt overhang, the crisis cannot be deemed to be totally resolved and that vulnerability to future crises has been eliminated. This approach, at odds with the recommendations of the IMF, was also not supported by the World Bank, leaving the IDB as the only source of multilateral support for the operation until 2000.

Formatted: Font color: Dark Blue

A study financed by the IDB (Cole, Slade and Power 1997) diagnosed the problem, reviewed earlier advice and made recommendations. Both the 1996 IFIs report and the IDB study influenced the actual strategy used by GOJ and implemented by FINSAC/FIS. The GOJ approached the IDB to finance a MIF grant (MIF/AT-141) of US$1.445 million for Institutional Support for FINSAC. FINSAC ultimately intervened in 13 financial groups with more than 200 subsidiaries and associated companies. The result of the financial sector intervention, bolstered by strong Government commitment and ownership of the program, albeit in circumstances with sub-optimal information flows, was the restoration of public confidence in domestic financial institutions. By April 2002 most of the institutions taken over had been liquidated or returned to the private sector.

Whereas GOJ commenced negotiations with the IMF in 1998, no agreement was arrived at until June 2000 when a Staff Monitored Program (SMP) was negotiated opening the way for support of the reform program from the IBRD, IDB and CDB. By this time and though difficult to achieve, cash interest payments on FINSAC bonds became a central component of the Government's strategy to complete the resolution of the crisis. Indeed, the resolution strategy employed by GOJ utilized a two-pronged approach which involved restoring liquidity to the financial system and disposing of the Government's equity stakes in the system. The Government approached the IBRD, IDB and CDB for funds that would support this strategy. Shortly after the agreement on the SMP, the IFIs agreed to provide resources for financial sector reform – IBRD (US$150 million in two loans), IDB (US$150 million), and CDB (US$25 million). Bilateral agencies also provided resources.

With the support of these International Financial Institutions' (IFI's) loans to retire a portion of FINSAC paper, the Government sought to improve its debt profile by replacing high-cost short-term domestic debt with cheaper, longer-maturity, international debt. The Government also requested IFI support in formulating a strategy for resolution of the crisis and strengthening the financial sector in order to reduce the vulnerability of the system to future crises. The overall strategy formulated by the Government with IFI support involved a phased approach to crisis resolution.

The first loan supported the formulation of a strategy for the full disposal of non-performing loans acquired by FINSAC. Under the second loan, FINSAC disposed of its entire portfolio of non-performing loans to a foreign bank. Specifically, IDB approved the US$150 million (JA0049) in conjunction with the IBRD - a two-tranche Finance Sector Reform loan in late 2000. The project was restructured in early 2002 when most of the second tranche conditions were met and US$40 million was released following the request of Jamaica for early release. The remaining US$35 million was disbursed in December 2002 as Jamaica showed compliance with the macroeconomic policy targets and conditionality regarding FINSAC. The final Tranche Report of the loan argued that "The borrower has fully complied with the conditions of the program and as such has made significant strides toward achieving its broad objectives."

By this time, FINSAC had acquired a non-performing loan portfolio of J$74 billion (face value of J$33 billion along with accrued interest) from intervened financial institutions. FINSAC established a workout unit to manage this portfolio and attempt its recovery. A large part of intervened bank portfolios was concentrated in real estate – either as assets financed through loans or as collateral. FINSAC therefore became the owner of numerous real estate assets (such as hotels, commercial and residential real estate, furniture & equipment, artwork, and motor vehicles) and other non-core assets. The first loan supported FINSAC's efforts in continuing the disposal of these assets, under a plan acceptable to the IDB.

Formatted: Font color: Red

Under the first loan, by August 2001, FINSAC had sold J$11 billion of other assets it had acquired. As part of the actions supported by the second loan, FINSAC made further progress in this area, with total sales of J$15 billion. It sold 98 percent of the portfolio of residential properties – realizing a total amount of J$0.5 billion. It disposed of J$10.6 billion of commercial properties (including freehold land, industrial assets, & hotels) accounting for about 75 percent of the total. Out of six hotels it had acquired, FINSAC sold four, entered into a lease agreement for another hotel with an option to buy (by end-

2003), and put the remaining hotel under a long-term management contract with an international private hotel management firm. As of May 2003, the Government had also sold J$3.9 billion in other assets (including motor vehicles, artwork, furniture and equipment etc.). However given the rapidity with which the real estate assets in particular were disposed of, points to the fact that given the vast quantities of real estate that were placed on the market at the same time, this only succeeded in creating the notion of a fire sale and led to unusually depressed prices which is indicative of sub-optimal yields.

As part of the actions supported by the second loan, the balance of the portfolio was sold to a subsidiary of Beal Bank of Texas in January 2002. The Government received a down payment of US$23 million (about J$1.1 billion), and the sale was structured so that the government shares in the recoveries actually made by the purchaser were in keeping with the following schedule: 15 percent of the first US$50 million recovered, 25 percent of the second, 35 percent of the third, 45 percent of the fourth, and 50 percent of the remainder. It was estimated that this would result in a recovery rate of about 22 cents per dollar face value of non-performing loans. As of May 2003, FINSAC's total recoveries amounted to about US$27.3 million (about J$1.3 billion).

However, whereas the GOJ had committed to a macroeconomic framework, which had been tailored to place the overall public debt on a sustainable path, this did not occur. Despite a period of relative stability of the debt/GDP ratio during 2000-02, GOJ was unable to reverse the increasing trend of the debt/GDP ratio, although its significant fiscal efforts had been commended by the IBRD and the IMF. Indeed, the debt ratio increased from 131.2 percent in 2000 to approximately 143 percent by 2003 instead of declining as projected.

Government's actions since the crisis have placed the banking and insurance sectors almost entirely in private hands with the majority of the ownership now being overseas based. The regulatory and supervisory structure has been significantly strengthened. However, it must be noted that the present banking and regulatory framework in Jamaica evolved in direct response to the financial crisis and not in a structured and planned way. This as there were only three amendments to the banking legislation in five years crisis primarily to close the varying loopholes and weaknesses that the financial crisis unearthed.

Within this context, cognizance must be taken of the fact that the extraordinarily high and arguably unsustainable levels of public debt constitute the major risk to the Jamaican economy, whereas the greatest risk to financial sector stability is the Government's overall macroeconomic performance. In the process of restructuring the financial sector, the Government replaced non-performing loans at banks ultimately with tradable Government bonds thereby providing liquidity to the financial system to support economic growth through increased lending. Currently, approximately a quarter of all banking sector assets in Jamaica are public sector debt (excluding debt from public enterprises) and the particular exposure of individual institutions varies to the nature of their specific portfolio mix. In any event as long as the Government continues to service these debt instruments in a timely manner the financial sector stability is relatively safe.

If, however, GOJ macroeconomic performance deteriorates and there is a difficulty in debt servicing with regards to the banking system, the quality of assets are likely to erode rapidly potentially leading to another systemic crisis. The cause of such a crisis, however, would be the Government's macroeconomic performance and not the inherent structure, regulation, and supervision of the financial system

Post-FINSAC Era

In the aftermath of the post-FINSAC era, the Jamaican economy continues to be buffeted by a substantial debt burden, persistent external and internal deficits, consistently anemic economic growth, structural imbalances and an inefficient tax system. This has been exacerbated by the impacts of varying exogenous shocks, such as the global recession and oil shocks, to which the economy is particularly vulnerable given its high degree of openness coupled with endogenous crises such as the financial sector crisis which dominated the period 1996 – 2003. Indeed, the central challenge facing the Jamaican economy at this juncture is the need to improve fiscal conditions in an effort to facilitate optimal levels of productivity and wealth effected through the transformation of the current macroeconomic framework.

.

These profound challenges have resulted in an ever-tightening fiscal space, limiting the Government's capacity for development financing. Jamaica is the fourth most indebted country in the world (measured either relative to GDP or population), behind Lebanon, Japan, and the Seychelles. The debt/GDP ratio stood at 132 percent in 2007/08. Debt

Formatted: Font color: Red

servicing consumes about 53 cents of each dollar of the national budget. Within the context of the global recession, the fallout in economic activity continues to emanate primarily from the major contractions in Tourism, Mining and Transport, Storage and Communication sectors. This coupled with the fallout in remittance flows has led to a substantial contraction in foreign exchange flows. As foreign exchange earnings deteriorated, the local currency depreciated 5.5 percent in 2008 against the US dollar and 9.4 percent in the March quarter of 2009. There was an element of speculation as business persons sought to pre-purchase foreign exchange to meet overseas claims as uncertainty prevailed.

The pervasive yet debilitating impact of the debt overhang is evidenced by the fact that despite the aggressive reduction of interest rates in an effort to stimulate the economy, the public debt crowds out private sector credit and thereby hinders investment. This impacts negatively on growth prospects for the economy and facilitates a perpetual cycle of increasing the stock of public debt and associated interest costs. Indeed, according to Jamaican Prime Minister Bruce Golding during his September 30, 2009 address to Parliament:

"So burdensome is the total debt that for the last 10 years our interest costs and principal repayments have exceeded our total revenues. For this year our interest costs and principal repayments total $325 billion while our total revenue is estimated at $310 billion".

However, it is instructive to note that Jamaica's national debt, both that denominated in local and foreign currency is mainly held by local economic agents. The domestic debt is almost 100 percent owned by local economic agents, while between 44 to 50 percent of the external debt is held locally. Overall, an estimated 75 percent of Jamaica's total public debt is held by local economic agents including pension funds, the national insurance scheme, securities firms and insurance companies. Specifically approximately 40 percent of private sector credit goes to GOJ. The capital base supporting these activities is estimated at J$150 billion with exposure to approximately J$380 billion.

Consequently, the stability of the financial system is inextricably linked with the macroeconomic environment, particularly the domestic sovereign credit risk, due to the exposure of the financial institutions and hence the continued risk. The resulting dependence has, however, also created systemic risks, in that shocks to either the government or the financial sector could quickly transmit to the other and on to the broader economy. In this regard, GOJ has approached the United Kingdom to lead an international effort to relieve the debt burden of lower middle-income countries like Jamaica and also asked the World Bank to explore ways to help with the debt (IMF 2008). However, given that multilateral and bilateral debt accounts for less than 10 percent of total, the scope for official assistance to ease the debt remains limited. Hence, fiscal consolidation remains an integral element of any debt resolution strategy over the medium term.

Nevertheless, the country's continued deteriorating economic performance, along with the Government's inability to rein in the fiscal deficit within projected levels, has resulted in downgrading of Jamaica's international credit rating, from B- to CCC+ in August 2009 with further downgrade to CCC in November 2009 both with a negative outlook. Indeed, Standard and Poors (S&P) have repeatedly expressed concerns about the long term sustainability of the US$1.27 trillion debt and raised the possibility of a distressed debt transaction or default. This, within a context of a projected decline in tax revenues of J$13.4 billion or 1.1 percent of GDP in 2009/10 and seven consecutive quarters of negative growth. This only serves to compound the difficulty which the country faces in its efforts to obtain financing on the global capital market. Equally, because Jamaica is classified as a middle-income country, Official Development Aid is reducing steadily.

On the monetary side of the equation, the requisite regulatory and legal framework (considered to meet international standards) is now in place coming out of the lessons learnt from the financial sector crisis in the mid 1990’s. Deposit taking institutions such as commercial banks, building societies and merchant banks are regulated and supervised by the Bank of Jamaica. The Financial Services Commission was established in 2001, replacing the Office of Superintendent of Insurance and the Unit Trust and the Securities Commission, and regulates non-bank financial institutions.

However, the current segmented supervisory structure (between the BOJ and the FSC); gaps in apportioning responsibilities across supervisory agencies; and, insufficient technical collaborations risk creating supervisory gaps for the system as a whole. This is evidenced by the recent upsurge in activity by "unregulated investment schemes" in Jamaica, which the Caribbean Policy Research Institute (CAPRI) estimates had investments amounting to 12 ½ – 25 percent of GDP and the ineffectual policy responses brought to bear by the authorities which claimed that "grey areas" in the legislative framework restricted their ability to effectively intervene. Whereas though there was a 9 percent shift from household deposits to enterprises (which these schemes were likely to be classified as) during 2001 – 05, there seemingly was little risk of banking disintermediation as deposit and credit growth remained buoyant. However in an effort to avoid their assets being frozen, the schemes were involved in the export of funds under their control which is consistent with the weakening of the exchange rate and reserve losses experienced over their life span (most collapsed in 2009).

Further, the Jamaican financial system remains large and interconnected (by way of a few dominant conglomerates) albeit within the confines of a reasonably well developed market. Total assets amount to about 185 percent of GDP in 2006. The difference in terms of structure from the mid-90s is that currently the majority have foreign parent companies while at that time the majority was locally owned. However the true growth area in the financial sector has been the security dealers sector. Whereas with other factors such as the increased securitization of debt and the general deregulation of the industry to allow retailers to participate, it is apparent that it is the legislation in 2002 (which separated banking from non-banking activities) which led to the large transfer of funds under management (FUM) from merchant banks to the less regulated securities dealers. Currently dealers assets and FUM exceed the deposit base of commercial banks.

As at September 2008, FUM at Securities firms was J$624.7 billion more than at the end of September 2007. However dealers finance their long term investments with repos of very short term maturities with retail and institutional clients, exposing dealers to interest rate and liquidity risks.

Similarly in terms of pension plans, the FSC regulates private pension plans which are subject to the requirements of the Pensions Act and its associated regulations. However a specified pension fund or specified pension scheme which is a superannuation fund or retirement scheme that is established by law does not fall within the regulatory ambit of the FSC. In 2009 there are approximately 500 private pension plans with a total membership of approximately 64,000 persons.

That the financial crisis of the mid-90's heralded a period of a strengthening of the regulatory framework and the adoption of international best practices in some areas is not in question. However there are regulatory gaps within the system which must be attended to, coupled with the fact that financial institutions are operating in a risky environment given their exposure to the large domestic debt of GOJ. Indeed the public debt holdings by the financial institutions mean the stability of the financial system is closely tied to the sustainability of the macroeconomic environment. For example, if there is default by GOJ this could well trigger a similar crisis as obtained in the mid-1990s.

Hence, the GOJ is faced with constraints which require it to make significant adjustments to its fiscal trajectory. These constraints have largely emanated from long term structural deficiencies and policy recklessness driven to some degree by political opportunism and a legislative framework that in some respects remains moribund. The impact of these governance missteps have been exacerbated by exogenous shocks which have been compounded by negative market perceptions about available policy options. With a domestic debt profile in 2009 in which 84 percent of same was contracted at an average interest rate of 16 percent and over 50 percent boast interest rates averaging 22 percent, points to the likelihood that the debt management strategy to be employed will involve options geared towards replacing high with low cost debt. This, in an effort to restrain interest costs in an effort to reduce "crowding-out" of the private sector and spur economic growth thereby finally breaking the cycle of debt.

November 23, 2009