2010 SHIRLEY PLAYFAIR LECTURE
Delivered by
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<u>Financing for Economic Growth: The New Frontier</u>

The Theme of the 11th annual Shirley Playfair Lecture ***"Competition Law and Policy"*** is very timely for a number of reasons.

Today and going forward, individuals, institutions, the private and public sectors and indeed the government…all of us together…. must now focus on the critical reality --- that the ultimate and only solution to our economic dilemma is to grow the Jamaican economy. Every sector has a role to play and our collective action must be the guarantee to underpin our success.

Even as the economy is being nurtured back to good health, its ability to grow and drive the process of development must be supported by the efforts of all sectors and stakeholders. In this regard, the financial services sector and our commercial banks in particular have a critical responsibility.

After the trauma of the financial sector melt-down in the 1990s; the continued contraction of the economy; the suffocating impact of unsustainably high interest rates; a huge debt burden; the erosion in the value of our domestic currency; high and debilitating inflation and in general a loss of confidence by the productive sector in all efforts to grow the Jamaican economy; we took bold steps to correct what ails the economy, but more importantly we have undertaken measures to change the approach to governance and the culture of conducting business in Jamaica.

We are now moving in earnest to break the country from the syndrome of underdevelopment, liberate the economy from the shackles of high and expensive debt, reform the way public affairs are conducted, and fundamentally, shift the focus from the money illusion and paper profits to a vision of sustained growth and development through investments in the real economy of Jamaica.

Issues of production, productivity, competitiveness, savings and investment must become our national pre-occupation. Jamaica needs to generate sustained growth in excess of 3 per cent per year over the medium-term to allow for an improved standard of living for all its citizens. Over the last fifteen years we have recorded average annual growth of just 0.7 per cent. Given the size of the domestic economy, it is clear that the transition to a strong and sustained growth has to be led by the productive sector, our exporters in particular.

The highly commendable embrace of the Jamaica Debt Exchange signals that we are willing to embrace bold and daring measures in the national interest. The JDX represented a voluntary par-for-par exchange of domestic bonds for longer dated, lower coupon instruments. The new instruments have provided liquidity; are now facilitating greater trading of securities and contributing to the development of the domestic financial markets. In addition, the significant reduction in the Government's refinancing needs is serving to ease the crowding-out effect of Government debt and the upward pressure that this had placed on domestic interest rates.

Given the low interest rate environment that has ensued following the successful completion of the Jamaica Debt Exchange and the signing of the Stand-by Agreement with the IMF, the maintenance of low investment-friendly inflation is a necessity if your financial planning is to bear any real fruit. Low and stable inflation will engender the expectation that the returns on investments will be more predictable and savings will maintain their purchasing power. Businesses will be able to plan with greater certainty thus minimizing the wild fluctuation in consumer prices.

Critical to a stable macroeconomic environment is a sound financial system. In this regard, the Bank of Jamaica Act is being amended to vest in the Central Bank the responsibility for overall financial system stability. The financial sector reform process will also stimulate the expansion of the types of investment vehicles available to individual savers, thereby expanding the pool of loanable funds for the productive sector.

There is now no debate as to whether the economy has been stabilized. The macroeconomic fundamentals are all pointed in the right direction:

- The **exchange rate** is stable
- **Interest rates** on Government paper and on Central Bank deposit instruments are at a 33 year low.
- The **inflation rate** is projected in the 6-7% range.
- The level of the **Net International Reserves** is at a healthy US$1.9 billion, of which gross reserves stand at US$2.7 billion.
- The economy, for the first time since 2008, is set to grow in the December and March quarters of this fiscal year.
- We have secured an agreement with the International Monetary Fund (IMF) which opens the door to US$2.4 billion (20% of GDP) in inflows from the IMF and other multilaterals.
- We have passed the first and second IMF tests with flying colours.

Ladies and Gentlemen, the economy is stable and provides a launching pad for investment, employment and growth.

The pass-through of low interest rates on Government debt to rates in financial institutions since the successful debt swap, has been cause for concern. This reluctance on the part of commercial banks to adjust rates is not a new phenomenon, but this time round, the situation is most glaring.

Lending rates need to become more attractive in the new interest rate environment. There was a reduction of 1.6 per cent in the stock of private sector credit in commercial banks during the period January – June 2010. This represented the first time in seven years that there was a contraction in credit during the first half of a calendar year. The decline in the loan stock was solely reflected in a decline of 9.3 per cent in foreign currency loans and was primarily in the productive sector in *Manufacturing* and *Tourism.* We only have to think about the implication of this on our export sector if the trend continues.

The Government remains committed to its support of the productive sector and the encouragement of manufacturing. This includes the commitment to reviewing our tax waiver policy in relation to the Tourism Industry Refurbishment Programme (TIRP).

Jamaica still has a long way to go in the process of attaining a low interest rate regime and economic growth.

For comparison, The **Prime lending rate** in Jamaica is 18.00%**.** For the United Kingdom it is 0.50%, for the U.S. 3.25%, and for Canada it is 2.75%. Regionally, for Guyana it is 14.54% and for Trinidad & Tobago it is 9.50%.

Earlier this year, **the 3-month Treasury bill rate** in Jamaica was 9.97%. For the United Kingdom it was 0.49%, for the U.S. 0.06%, and for Canada it was 0.18%. Regionally, for Guyana it was 3.81% and for Trinidad & Tobago it was 1.36%.

Comparative Treasury Bill and Prime Rates (%)					
Jamaica	**United Kingdom**	**United States**	**Canada**	**Guyana**	**Trinidad & Tobago**
Treasury Bill (3-month) (January 2010)					
11.76 9.97 (March)	0.49	0.06	0.18	3.81	1.36
Prime Rates (June 2010)					
18.00	0.50	3.25	2.75	14.54	9.50

<u>Bank Competition Studies for Jamaica:</u>

Many developing economies have recognized that initiatives geared at lowering interest margins are crucial to stimulating growth in the wider economy. However, the accomplishment of these objectives depends, to a large extent, on the degree of competitiveness within the banking system. **Research at the Bank of Jamaica has explored the degree of competition in the Jamaican banking sector. All studies have advocated the need for policies geared at stimulating competition, as findings have shown that there is need for greater competitiveness in the sector.**

Initial work in the area suggests that the behavior of participants in the banking system mirrors that of monopolistic market behavior. Indeed, the research suggests that there has been declining competition in the sector for the period 1989 to 2002. Furthermore, work on the structure of the sector showed that the cost of financial intermediation was largely explained by bank-specific variables, rather than macroeconomic parameters, such as inflation and GDP, suggestive of weak competition in the sector.

An important and an ongoing concern for regulators and the wider public is whether there is collusive behaviour among market leaders in the industry. Research at the Bank of Jamaica has shown that while there is no evidence of collusive behaviour among major banks, the 'stickiness' in lowering lending rates can be explained by the structure of the financial sector. Recent studies suggest that the industry in Jamaica became more concentrated after the financial crisis in the mid-1990s, and with the significant fall-out, there has been a decline in competition among the banks.

In fact, findings have showed that efficiency, or rather the absence of it, has been driving the performance of dominant banks. However, improvements in efficiency for these dominant banks may not be reflected in their pricing policies due to the absence of strong competition in the sector.

Against this background, many studies have advocated the need for a more competitive environment in stimulating reductions in interest margins and fostering growth in the production sector.
Put another way, can new entrants spur competition for borrowers and reduce margins? The simple answer is a resounding 'Yes.'

Greater competition would lead to banks pricing their products more competitively, reduce stickiness in lending rates and overall lowering of interest margins to more sustainable levels. This desirable proposition, of more entrants, however, is easier said than done. The fact is that new players in the financial sector would have to have the capital required as well as pass the necessary 'fit and proper' requirements of the regulatory authorities and have the necessary risk management capacity to manage periods of 'excess' volatility in the economy and the market. Secondly, they would have to find new and innovative ways of meeting client demand while keeping their cost (funding or otherwise) low. This is challenging in Jamaica where there are few players who have the scale to attract competitively priced sources of funding.

However, whereas in the Pre-JDX (Jamaica Debt Exchange) paradigm banks had the luxury of making significant interest margins on instruments with very low levels of risk, post-JDX banks, in order to survive, will have to either contemplate significant cost cutting measures to improve their level of efficiency or adjust their business models (and pricing policies) to become more competitive.

<u>Commercial Bank Initiatives that will lead to greater competition and lower interest rates</u>

Technological Innovation

Financial Institutions should seek new technological methods outside of the traditional bank client/teller contact in relation to how clients carry out their transactions on a regular basis. Major advances in electronic banking are being made globally. It is just a matter time for them to be unfolded in the Jamaican retail banking system increasing the potential for competition among our institutions. In this paradigm, the Bank of Jamaica will have to review its regulatory framework to ensure that it maintains relevance and flexibility to a changing banking landscape.

New areas of credit demand and credit services

Commercial banks can be a more dynamic and flexible force in channelling government funds to student loans and small business. There have been new streams of education courses opened up in certain faculties of the UWI and Utech that are not subsidized. I'm saying to financial institutions: "Here is a window of opportunity for you". Banks can seek innovative ways of lending to these students.

I also repeat an idea I floated last week for banks to give serious thought to the kinds of new services they can offer to small businesses. For example, developing business plans. This is a need that can be met by the banking sector: special windows can be set up in commercial banks to assist persons in developing business plans. This service will ensure the soundness of potential small business borrowers. Importantly this initiative can go a far way in helping businesses to return to a formal structure and rebuild the formal economy.

I challenge commercial banks to compete with the Student Loan Bureau, the EX-IM Bank of Jamaica and other such entities in helping to meet these types of demand for loan funding.

Widen Special Windows

I have been advised that the pool of funds operated by some banks for lending to small and medium-sized enterprises (SME's) at attractive fixed rates has been fully exhausted or oversubscribed in some cases. In the transitional period of a lower interest rate regime, banks are therefore urged to widen this special window and increase the pool of funds to small businesses as an incentive to the productive sector.

<u>Government Initiatives that will lead to greater competition and lower interest rates</u>

Credit Bureau

One innovation which has the potential to increase competition in the loan market is the planned implementation of a credit bureau. The Governor General has recently assented to the Bill making way for the Credit Reporting Act 2010. It has been argued that part of the ‘stickiness’ of lending rates is attributable to embedded costs associated with locating and maintaining loyal and reliable creditors. It is envisaged that the availability of credit scores for households and businesses alike will foment increased innovation in the credit market while reducing the costs (and risks) associated with on-lending funds to the productive and household sectors. This in turn has the potential to result in the narrowing of the spreads between loan and deposit rates.

Special Funds

The Government is initiating a programme in which funds form the PetroCaribe Fund are channeled into the Ex-Im Bank of Jamaica and the Development Bank of Jamaica (DBJ) for them to be made available, at special rates of interest, for export, production and development initiatives.

Commitment to Fiscal Discipline

For our part the Government reiterates its commitment to a low interest rate regime. Underpinning the decline in interest rates is a low inflation regime that will target single digit inflation. Low and stable inflation will facilitate longer-term planning by the productive sector. It will also temper the rate at which labour and other input costs will rise, thereby enhancing the competitiveness of the productive sector and increasing its appetite for lower cost funding. We need to open our minds to operating in a low interest rate environment.

In addition to the task of controlling inflation, the Government is bound by law to eliminating the fiscal deficit by fiscal year 2015/16, within the Fiscal Responsibility Framework. This requires fixity of purpose in the control of Government expenditure - including expenditure on public sector wages.

Conclusion

It is time to take financing for sustainable development seriously.

We cannot for any longer remain risk averse and entertain the expectation that real economic growth will take place without a return to the fundamentals of a productive culture that is characterized by creativity, inventiveness, risk taking, initiative and enterprise.

We must resolve to return to a formal economy. We urgently must return to a culture of production and productivity. It is a vital prescription and prerequisite for re-socialization, wealth creation and crime reduction.

This collective vision cannot be beyond our capacity to aspire toward; and the role of financing for growth is an integral part of the new economic frontier.

The Economy has been stabilized…… Now it is time to go for growth.