CHAPTER 6

The role of non-bank financial institutions in the Jamaican economy, 1979–88

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The assets (and liabilities) of bank and non-bank financial institutions in Jamaica grew at a substantial rate in real terms over the ten-year period 1979–89. However, there was only marginal increase in aggregate real income (Gross Domestic Product) over the same period. The increase in real resources mobilised by financial institutions, and the evident growth in the level of financial intermediation was not associated with a corresponding increase in aggregate real incomes during the period. This chapter will analyse the developments which might contribute to an explanation of this paradoxical situation, with emphasis on the role of the non-bank financial institutions.

Generating development

The mobilisation of savings and the development of the financial structure are issues central to the process of development. Development depends on increasing the savings rate and on the capacity to transform savings into financing for investment and development. An increasing proportion of savings should be held in financial instruments which can be transformed from units or sectors with surplus resources to those entities which need the resources for investment and expansion. Non-bank financial institutions contribute to the development process because they add to the variety of instruments which are available to an increasingly diverse group of saving entities. They are also able to utilise the resources mobilised for capital investment in specific areas, such as the financing of investment in housing and residential construction.

As financial transformation grows, and the role of financial institutions expands in the developmental process, the ratio of financial assets to income (GDP) is expected to increase (Goldsmith, 1969). A necessary condition for the transformation of savings into finance for investment and growth is that the rate of return on investment should be high enough to justify the use of such resources. Real loan rates should not be so high as to reduce or inhibit the opportunities for the profitable use of such capital.

Over the 1979–89 period, exchange rate devaluation and problems associated with the shortage of foreign exchange were dominant issues in the economic problems confronting the government of Jamaica. There is much controversy concerning the precise impact of exchange rate devaluation on growth and development. Nevertheless, a certain view-point appears to be gaining general acceptance that devaluation may have a net deflationary impact on aggregate real income and output in the economy (Taylor, 1989). This may occur through the redistribution of income from low to high-income earners as a consequence of devaluation and a high marginal propensity to save of such income earners. This scenario might, in part, explain the high volume of resources mobilised by financial institutions during the period against the background of marginal change in aggregate real incomes, and the fall in the value of the Jamaican dollar to less than a third of its previous US dollar value.

Interest rate policy associated with maintaining the stability of the exchange rate would also help to reinforce this pattern of development. Under the conditions which existed during the period, stability of the exchange rate became the main policy objective, and domestic interest rates were used to maintain this stability.

The relationship of interest rates to the rate of return on investment has not been fully assessed, but it is very likely that in many instances this policy caused loan rates to rise well above the rate of return on investment. Hence, while resource mobilisation remained high, the demand for finance might have been weakened, lending to less than optimal levels of real investment.

A vibrant underground economy is believed to have developed during the period. Although there are no available estimates of the size of this underground economy, the evidence of the substantial increase in real resources within the financial system, set against the background of marginal growth in reported aggregate real incomes, both support the hypothesis of its existence and help to explain the disparity in the rates of growth of output and financial assets.

Finally, the overall macro-economic policies of the government, if strongly interventionist in character, can have an adverse effect on the extent to which resources can be transformed into investment and growth.

In tracing the development of non-bank financial activity during the period, two sub-periods can be distinguished. The first relates to the years 1979–84, and the second to the developments in the 1985–8 period.

The 1979–84 period

This period was characterised by much turbulence in exchange rate and monetary policy developments as the government attempted to deal with

CCMS 1989 Annual Monetary Studies Conference the deteriorating foreign exchange situation. Government policy was strongly interventionist in character, despite the removal of control on some prices and the removal of subsidies on others. There was substantial public-sector borrowing from the banking system with consequent increases in the money supply. The growth in public-sector demand for resources was associated with quantitative controls on credit to the private sector and other regulations affecting commercial banking transactions. These included an increase in the liquid assets ratio of the banks to 44% by 1984, and an increase in the cash reserves ratio to 10% in the same year. The increase in domestic demand was reflected in pressures on the exchange rate and price increases, particularly in 1984, when retail price inflation was 34.9% (see Table 6.1). There was a substantial depreciation of the exchange rate over the period with the US dollar appreciating by about 172.4% against the Jamaican dollar. There was a cumulative decline in real GDP of 2.4% over the six year period.

Despite the high demand for resources by the public sector, the ratio of non-bank assets to GDP increased from 25.2% in 1979 to a peak of 32.8% in 1983, as Table 6.2 portrays. There was a more rapid increase in the ratio for the banking system which more than doubled during the period, rising from 71.9% of GDP in 1979 to 147.1% in 1984.

Growth in real assets of non-bank institutions averaged 18.2% during the period, and the trust companies experienced the most rapid growth rate, averaging 30.5% yearly. These institutions benefited from their close rela-

Table 6.1 Jamaica: Real sector variables and the real interest rate, 1979–88

Year	*% Change in GDP deflator*	*Real GDP ($ M)*	*Real GDP growth (%)*	*Real treasury bill rate*
1979	16.6	1940.0	–1.8	n.a.
1980	17.9	1838.8	–5.7	7.5
1981	8.4	1875.5	2.5	1.4
1982	9.2	1898.7	1.2	0.0
1983	16.5	1942.2	2.3	–3.8
1984	34.9	1925.0	–0.9	–13.8
1985	25.0	1837.2	–4.7	–3.0
1986	17.1	1870.1	1.9	–1.0
1987	12.2	1967.5	5.2	6.6
1988	13.7	1977.6	0.5	3.8

Sources: National Income and Product, 1988 Statistical Institute of Jamaica; *Statistical Digest*, (various issues), Bank of Jamaica.

Table 6.2 Jamaica: Assets of the financial system, 1979–88 ($ Millions)

	1979	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
Banking System[1]	3,090.8	4,319.8	5,059.1	5,907.8	9,840.1	13,759.8	17,803.2	20,371.2	22,079.0	27,000.9
Central Bank	1,447.0	2,219.4	2,424.9	2,757.4	5,520.4	8,333.8	11,180.8	12,131.0	12,478.6	14,188.5
Comm. Banks	1,643.8	2,100.4	2,634.2	3,150.4	4,319.7	5,426.0	6,622.4	8,240.2	9,600.4	12,812.4
Non-bank Fin. Inst.[2]	1,083.9	1,245.1	1,465.4	1,798.0	2,293.3	2,869.0	3,637.3	4,266.6	5,369.9	7,204.2
Life Ins. Co[a]	375.8	452.0	523.4	590.1	737.8	868.1	1,108.1	1,231.4	1,451.2	1,584.2
Bldg. Soc.	254.9	331.1	387.6	500.3	580.1	675.2	802.2	1,049.3	1,353.7	1,864.4
Merchant Banks	123.6	84.2	92.7	109.8	125.2	221.1	348.0	636.4	1,200.6	1,956.7
Trust Cos.	130.1	132.5	162.6	251.0	373.6	544.3	735.8	682.5	592.7	871.3
Fin. Houses	52.0	56.6	61.3	59.4	120.4	139.2	163.8	123.1	147.5	178.7
Credit Unions	114.6	146.7	185.1	224.4	269.8	312.6	347.0	379.1	432.2	492.7
Others[b]	32.9	42.0	52.7	63.0	86.4	108.5	132.4	164.8	192.0	256.2
(1)/GDP (%)	71.9	90.5	95.3	100.7	140.7	147.1	159.6	153.0	140.5	150.3
(2)/GDP (%)	25.2	26.1	27.6	30.6	32.8	30.7	32.6	31.3	34.2	40.1

(a) Data for three largest life insurance companies – Mutual Life, Life of Jamaica and Island Life.
(b) Estimates are based on the assumption that these stocks represent about 25% of commercial bank assets.

Sources: Statistical Digest, Bank of Jamaica; Annual Reports, Building Societies Association.

deposits at a time when there was less competition from [illegible] and finance companies. Credit unions and building societies grew at average annual growth rates of 19.4% and 18.6% respectively. These institutions provide the facility of 'tied' savings which are linked to the provision of mortgage loans for residential construction, and to loans for consumption.

The assets of finance companies grew on average by 22.3% in the period, and were particularly high in 1983 when these institutions took an active role in the operation of the parallel market for foreign exchange and in the establishment of a special retained account for import financing. The assets of the life insurance companies[1] grew at an average of 15.1% being particularly low in 1984 when the rate of growth amounted to 1.6%. The average rate of growth of the merchant banks was the lowest among non-bank institutions, averaging 12.8% for the period. These institutions experienced substantial decline in 1980, and this has been associated with a reduction of external financing during the year. Their assets grew substantially in 1984, but for the period as a whole the overall rate of growth was moderate as the institutions had not yet assumed the highly competitive stance which has been evident since 1985.

Other miscellaneous forms of non-bank financial intermediation, such as the transactions of attorneys-at-law, informal credit revolving schemes (the 'partner') and miscellaneous money lending entities which fall outside the scope of central banking control, are assumed to have grown at least on a par with the growth of assets of the commercial banks. The flow of such resources have been tentatively estimated at about 2.0% of the assets of the commercial banks. These funds are estimated to have increased, on average, by about 28.4% yearly over the period.

The 1985–8 period

In spite of the restrictive monetary and credit conditions and high interest rate regime which prevailed for most of 1985, there was clear indication by the end of the year of attempts to restructure the financial system and to reduce the interventionist policies of the government. Global ceilings on commercial bank credit were removed and revisions to the banking legislation were initiated.

In 1986, liberalisation of the monetary system continued with reduction in the liquid assets ratio of the commercial banks from 48.0% to 38.0%. This removed the pool of funds available to the government at preferential rates of interest, which was a major source of distortion in the interest rate structure. The external transactions showed a sharp reduction in the current

[illegible] base with the imposition of new taxes on a wide range of commodities. There was also relative stabilisation of the exchange rate and, consequently, inflation fell to 10.4% from 23.3% in the preceding year.

1987 saw a continuation of the financial sector reform programme and a liberalisation of exchange control as part of an overall structural adjustment. Inflation fell to 8.4%, the fiscal deficit was reduced to 1.0% of GDP and real growth rose to 5.0% for the calendar year. This programme of economic liberalisation continued in 1988 with the reduction of the savings deposit rate from 15.0% to 13.0%. This was a signal for reducing nominal interest rates as a means of influencing investment activity. There was also a relaxation of exchange control regulations, particularly with respect to foreign travel and remittances.

But the economic programme was severely interrupted by a natural disaster (Hurricane Gilbert) in September of that year. Resulting from the reinsurance inflows consequent on the damage caused by the hurricane, the monetary system became very liquid with a build-up of substantial deposit balances in the banking system. However, inflation, which was running at a relatively moderate rate before the hurricane, still amounted to only 8.8% compared with 8.4% in the preceding year. The public-sector deficit rose following increased expenditure by government as part of its post-hurricane reconstruction efforts, but it was still relatively low compared with the levels which had been achieved in the pre-1985 period.

For the five-year period aggregate real growth amounted to 2.9% compared with –2.4% for the preceding period 1979–84. Within the framework of the more liberalised macro-economic environment there was an acceleration in the level of financial intermediation by the non-bank institutions. The ratio of non-bank financial assets to GDP rose from 32.6% in 1985 to a peak of 40.1% in 1988. These changes reflected strong real growth in the financial assets of these institutions, averaging 31.5% for the period, compared with an average of 18.2% during the 1979–84 period.

By far the most spectacular growth occurred in respect of the merchant banks, whose assets grew at a yearly average of 80.7%. These institutions developed a large and diversified asset portfolio, including lease financing, insurance premium financing and credit for investment in tourism, manufacturing, construction and other areas associated with growth in the economy. The assets of the building societies showed the next highest average rate of growth with 34.6% for the period, which compared favourably with an average of 18.6% in 1979–84. Life insurance companies were next in importance with an average growth rate of 22.1%, followed by the trust companies with 20.1%, credit unions with 16.9% and finance companies with 12.9% (a decline from 22.3% during 1979–84); this can be attributed to the reorganisation and transformation of some of these entities into the business of merchant banks, which correspondingly accounted for part of the rapid growth rate in the assets of these institutions during the period. The growth rate of the group of miscellaneous financial intermediaries including attorneys-at-law, was estimated at 29.4% for the period, and follows the trend established by the commercial banks. These estimates must be treated with some caution, however, because of the weak basis of estimation.

The increase in the rate of financial intermediation by non-bank institutions during the period can clearly be related to the programme of financial liberalisation and the reduced interventionist stance of the government. This was reflected chiefly in the reduction of the public-sector deficit and the existence of positive real rates of interest which was achieved not by raising nominal rates but by the reduction in the rate of inflation.

Flow of funds

The flow of funds into the non-bank financial intermediaries rose from $161.2 million in 1980 to $1,834.3 million in 1988, an increase of over ten times (see Table 6.3). The distribution of resources moved in the direction of short-term deposits and shares held in building societies and credit unions. These short-term balances accounted for 48.6% of the sources of funds in non-bank institutions in 1980 compared with 74.3% in 1988. The shift to deposits appeared to be associated with changes in the real rate of interest which became positive in real terms in 1981, 1987 and 1988. Corresponding to this change was the relative decline in the proportion of resources accounted for by the life insurance funds which fell from 33.2% of the total in 1980 to 7.6% in 1988. If life insurance funds are associated with long-term savings then the shift in favour of deposits reflects a possible preference for short-term over long-term savings during the period. This development can be related to the volatility in the financial and money markets which existed, and was a direct consequence of the sustained depreciation of the exchange rate which occurred during the period.

Table 6.3 Jamaica: Sources of funds of non-bank financial institutions, 1980–8 ($ Millions)

Year	Capital and reserve	Deposits and shares	Life insurance fund	Loans	Other	Total
1980	44.2	78.3	53.6	13.6	–28.5	161.2
1981	3.1	164.3	52.7	5.1	–4.9	220.3
1982	11.9	224.7	53.4	23.6	19.0	332.6
1983	19.6	323.5	88.6	9.3	54.3	495.3
1984	41.8	300.0	108.4	99.1	26.4	575.7
1985	34.0	454.7	149.1	–23.8	154.3	768.3
1986	125.3	406.3	166.4	13.6	–82.3	629.3
1987	71.2	836.5	121.8	–26.8	100.6	1,103.3
1988	63.2	1,362.7	140.1	148.5	119.8	1,834.3

Sources: Annual Reports of merchant banks, trust companies and finance companies, Annual Reports of three largest life insurance companies, *Fact Book* 1988, Building Societies Association, Annual Report of Jamaica Credit Union League.

A large proportion of short-term deposit balances, particularly those held in the building societies, possess the character of long-term funds, since they are 'tied' to the provision of housing credit. Hence the apparent shift in favour of short-term funds may not be as great as is indicated in the tables. Resources obtained from capital and reserves remained small, and no discernible pattern of change was observable over the period. To a certain extent, the same was true in respect of loans and other sources of funds.

With regard to the uses of funds (see Table 6.4), the proportion of resources allocated to mortgage financing (both residential and non-residential) in the 1980–4 period varied between 28.1% and 41.2%, and was the largest single use of funds except in 1981, when there was an almost equal distribution between corporate securities, personal loans, liquid balances and mortgage loans. However, in the high real interest rate regime between 1985 and 1988, the use of funds for mortgage financing fell off sharply. This decline in mortgage loans can be attributed partly to weak demand in response to high positive loan rates. Correspondingly, the large build up of liquid balances reflected institutional preferences for high-yield, low-risk instruments in the environment of a fairly volatile money and capital market. Substantial resources were also put into other loans, particularly in 1985, 1987 and 1988. This was a reflection of strong demand for the new credit facilities, such as lease financing which was provided mainly by the merchant banks.

A relatively high volume of funds was also put into government securities between 1985 and 1988. These funds comprised largely treasury bills and certificates of deposit issued by the Bank of Jamaica. These securities provided relatively high yields, and satisfied the same institutional preference as was reflected in the demand for liquid balances. The provision of personal loans remained an important use of non-bank funds, but the proportion declined in the later years compared with the situation between 1980 and 1984. Overall, the pattern of use of funds appeared to have shifted in favour of short-term as against long-term assets, matching the change in the source of funds.

Table 6.4 Jamaica: Use of funds by non-bank financial institutions, 1980–8 ($ Millions)

Year	Fixed assets	Real estate	Government securities	Corporate securities	Residential mortgages	Non-residential mortgages	Personal loans	Liquid balances	Other loans	Other	To[illegible]
1980	4.9	0.8	13.2	33.4	105.7	–47.2	51.1	33.9	–7.7	–26.9	[illegible]
1981	12.0	0.5	–21.2	60.8	59.8	2.3	55.7	65.6	20.2	–35.4	[illegible]
1982	16.2	2.5	11.9	33.5	121.1	16.0	51.9	22.7	45.0	11.8	[illegible]
1983	22.0	40.5	3.0	0.5	152.7	35.2	78.5	100.4	42.9	19.6	[illegible]
1984	47.2	37.3	–7.0	45.0	170.8	19.2	66.3	124.4	26.5	46.0	[illegible]
1985	101.8	26.0	113.9	92.7	64.2	–3.5	59.8	135.3	249.5	–71.4	[illegible]
1986	113.8	23.8	75.9	100.3	41.3	9.9	67.6	294.5	–80.7	–17.1	[illegible]
1987	–24.3	–48.3	70.3	–3.8	78.6	46.0	60.5	240.5	400.0	138.6	[illegible]
1988	28.4	26.3	202.8	72.0	174.3	207.2	121.6	479.3	473.3	49.1	[illegible]

Sources: Annual Reports of merchant banks, trust companies and finance companies, Annual Reports of three largest insurance companies, *Fact Book* 1988, Building Societies Association, Annual Reports of Jamaica Credit Union League.

An increase in the level of financial intermediation [illegible] not sufficient, condition for growth and development. Integral to the overall process of development is the extent to which macro-economic policies implemented by the government provide a satisfactory environment for the financial intermediation process.

In the 1979–84 period a relatively high rate of resource mobilisation by non-bank institutions was associated with cumulative negative real growth in the island's economy. On the other hand, between 1985–8, within an environment of financial liberalisation, strict fiscal management and low inflation, financial intermediation attained a relatively high level, but in this case was associated with real growth expansion in the economy. The implication is that the financial sector reform programme initiated by the government in 1985 (with World Bank assistance), is a vital element in the growth and development of the Jamaican economy.

Note

1 The data relate only to the three largest companies which are believed to account for about 70% of aggregate life insurance business in Jamaica.