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FINANCIAL REFORM AND FINANCIAL SECTOR DEVELOPMENT IN JAMAICA

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BY

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INTRODUCTION

An important component of structural adjustment programmes undertaken by developing countries during the 1980s and the early 1990s was the implementation of financial reform measures aimed at increasing the efficiency of financial markets. Financial reforms implemented throughout the period reflected the influence of the adoption of the neoclassical paradigm enunciated by McKinnon (1973) and Shaw (1973). The reforms were a response to perceptions of repression of financial markets arising from excessive government regulation. Tseng and Corker (1991) identified the features of financial repression in developing countries as including: interest rate restrictions, domestic credit controls, high statutory reserve requirements, segmented financial markets, underdeveloped money and capital markets, and controls on international capital flows.

The background to and rationale for the imposition of direct financial controls in developing countries are extensively discussed elsewhere in the literature (e.g. Fry 1988). The imposition of direct controls was heavily motivated by the desire of national governments to direct low cost funds to "priority economic sectors", and to prevent increases in interest rates that were considered inimical to investment and economic growth. There is evidence to suggest, however, that the sustained application of direct controls and restrictive credit policies over time, have accelerated the process of financial disintermediation with adverse consequences for domestic capital formation, sustained expansion in output, and from a policy perspective, weakened the efficiency of monetary policy. McKinnon (1973) and Shaw (1973) identified the principal effect of repressive financial policies as a secular decline in "the real rate of growth and the real size of the financial system relative to non-financial magnitudes". Indeed, McKinnon and Shaw adduced that the application of "the strategy of direct financial controls by developing countries gravely retarded the development process".

Against the background of declining national savings, stagnant output and severe macroeconomic disequilibria, many developing countries introduced financial reforms as an integral part of a much broader programme of structural reform during the 1980s. Multilateral financial institutions supportive of the neoclassical paradigm of financial reform played a critical role in sponsoring (financing) and initiating reform programmes. At the local level, technical considerations supporting financial reform reflected the need to reduce the savings-investment gap, as well as an appreciation of developments in the international economy, in particular the behaviour of international capital no longer confined by geographic borders. Financial reform was therefore seen as a necessary step towards the development of efficient financial systems that were more conducive and responsive to internal and international competition.

Johnson (1991) identified the principal elements of financial reform as comprising: (a) the deregulation of interest rate regimes, supported by market-based monetary control procedures and the development of money markets; (b) reforms of prudential regulations and the supervisory system; (c) measures to strengthen competition among financial institutions, including the relaxation of entry restrictions; (d) reform of selective credit regulations; and (e) development of long-term capital markets. While emphasizing the importance and appropriateness of each reform measure, Johnson underscored "the precise sequencing" of reform measures as a critical factor in the successful achievement of financial reform objectives. In the sequencing of reform measures, financial reform should, ideally, be preceded by a programme of macroeconomic stabilization and structural adjustment as well as fiscal adjustment.

The importance of precise sequencing in the formulation of reform programmes is underlined by the experience of several countries, particularly in Latin America and Asia. In some of these countries, severe macroeconomic dislocations following the implementation of financial reform programmes have been associated with the inappropriate sequencing of reform measures. To a lesser extent dislocations have been related to institutional constraints, as well as to the pressure of social forces (vested interests in the private and public sectors) to maintain existing arrangements. Additionally, the experience of some countries, notably Uruguay and the Phillipines, clearly suggests that for financial liberalization to be successful, financial reforms must be accompanied by other macroeconomic reforms notably fiscal, trade, real sector adjustment and capital account liberalization.

This paper attempts to explore the main elements of Jamaica's financial reform programme implemented during the 1980s, and examine the effects of financial reform on developments in and through the financial sector. The paper is divided into three sections. The first section analyses the Jamaican financial system in the pre-liberalization period. The second overviews the financial reform programme in Jamaica. The third section provides a preliminary assessment of the impact of the reform programme. The paper concludes with some general considerations and conclusions.

A. Overview of Jamaica's Financial System

Jamaica's financial system[1] evolved within the context of a highly regulated financial environment characterised by strong public sector leadership, government involvement in the operation and development of financial institutions, bureaucratic controls on entry and the dominance

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1/ Jamaica's financial system is comprised of a range of financial intermediaries including: commercial banks, near banks, building societies, credit unions, insurance companies, development banks and a stock exchange.

of commercial banks in the financial intermediation process. At December 1985, there were 10 commercial banks with 154 branches distributed across the island, with a high concentration of branches in the capital city and urban towns. The extensive branch network which existed was primarily a reflection of intense non-price competition for deposits, in a context where deposit rates and in particular the savings deposit rate was administratively determined. As a group, commercial banks accounted for more than 50 percent of the total assets of the financial system. The distribution of these assets was unevenly distributed, however, as the two largest institutions accounted for almost two-thirds of the total assets of the banking system.

The dominance of the commercial banks within the financial system is due to several factors. These include: a long tradition of commercial banking in the island, the wide geographical distribution of bank offices islandwide, and strong utilization of banking services to finance investment and consumption activities by individuals, government and private enterprise. Further, to the extent that several commercial banks own other financial intermediaries, notably trust companies and finance houses, the dominant position enjoyed by commercial banks is substantially more pervasive. Financial intermediaries which are associated with commercial banks, usually as fully owned subsidiaries, initially complemented the short-term lending activities of the commercial banks by providing long-term mortgage financing. In recent years banks have added, either through direct ownership or equity participation, building societies, insurance companies and mutual funds (unit trusts) to their operations creating what is popularly termed "One-stop Financial Supermarkets". These developments have served to further strengthen the dominant position held by banks within the banking system.

Even though commercial banks and their related subsidiaries dominated the financial system prior to 1986, other financial institutions, namely the Central Bank and a nascent Stock Exchange, helped to shape the structure of the financial system. The Central Bank, which was established in 1961, was an important part of the institutional arrangements which preceded independence in 1962. Its principal objectives were: to control the supply of money consistent with orderly growth, to maintain a stable currency and to safeguard the balance of payments. To achieve its objectives the Bank was endowed with the orthodox tools of monetary policy inclusive of open market operations, the rediscount rate, reserve requirements, as well as the power to impose selective credit control measures.

Throughout the 1960s and 1970s the Bank of Jamaica played an activist role in the development of the financial system. It aided and supported the development of specialised financial institutions e.g. Export/Import Credit Bank, and the Students Loan Bureau, and was instrumental in the establishment of the local Stock Exchange.

The Jamaica Stock Exchange, which was established in 1969, was created primarily to provide a vehicle for the mobilization of long-term capital to finance industrial development. The stock market, along with the Government owned development banks and insurance companies, was expected to provide long-term capital financing to complement the short-term credit orientation of the commercial banks.

However, during the 1970s and early 1980s the stock exchange was never fully utilized to mobilize investment capital. In fact, in the six years to 1985, the value and volume of shares traded moved from $0.6 million and 7450 units in 1969 to $15.6 million and 1,379,127 units respectively in 1985. The failure of local investors to utilise the stock exchange to initiate and expand business activity reflected a combination of factors. The principal factors could be identified as: a high concentration of family businesses which had relatively easy access to bank credit to finance fixed and working capital requirements; strong resistance within the private sector to the sharing of ownership and control; Government's double taxation of company dividends; and the adverse effects of socio-political and macroeconomic developments on the financial sector during the 1970s.

Without a vibrant stock exchange the capital market was of marginal importance to the mobilization of long-term capital financing. Medium/long-term market activity was confined primarily to transactions in government securities (Local Registered Stocks) the proceeds of which were used to finance public sector capital investments.

While the level of activity on the money market was higher than that exhibited on the capital market, the money market remained relatively underdeveloped throughout the 1970s and early 1980s, offering a narrow range of instruments inclusive of Government of Jamaica treasury bills, commercial banks short-term deposits and, to a lesser extent, short-dated instruments of life insurance companies.

The absence of an active capital market had an adverse impact on the cost and availability of long-term financing within the economy. Private sector entities were forced to borrow at relatively high commercial bank loan rates or forego feasible projects. From a monetary policy perspective, the absence of an active money market limited the efficient conduct of open market operations. The Bank of Jamaica was therefore forced to rely heavily on variations in the commercial banks statutory reserve requirements and the imposition of credit controls to execute monetary policy, at a high cost to the private sector and the economy in general.

In terms of monetary policy operations, prior to 1986 the Central Bank relied heavily on variations in the reserve requirements of the commercial banks as the main tool of monetary policy. The reserve requirements which applied to commercial banks, and intermediaries registered under the Protection of Depositors Act, were a cash reserve ratio and a secondary reserve ratio. The secondary reserve ratio consisted of short-term government securities - Treasury Bills and Local Registered Stocks with maturities of 90 days or less. The requirement of the commercial and near banks to hold statutory reserves above levels required for prudential purposes, provided a captive market for the financing of the Government's fiscal deficit. Furthermore, the secondary reserve requirement had the inherent effect of distorting credit allocation in favour of the public sector, and also the interest rate structure by raising the interest rate on loans to the private sector in order to compensate for relatively low interest funding to the Government.

The entanglement of monetary and fiscal policy which arose from the use of a monetary policy instrument to finance public sector deficits, adversely affected the ability of the Central Bank to use variation in reserve requirements to affect the process of money and credit control, in the attainment of the Bank's macroeconomic objectives. Additionally, financing of the fiscal deficit through the commercial banking system served to retard the development of an active capital market, as well as imposed quantitative restraint on the volume of credit made available to the private sector (crowding-out effect) to finance private sector activity.

In addition to the distortions caused by the maintenance of high reserve requirements throughout the pre-reform period, the Government imposed and maintained a variety of financial and administrative controls, namely interest rate floors, preferential interest rates to specific sectors, and central bank rediscount financing to priority sectors. Selected credit controls extended from quantitative restrictions on consumer credit to selective rediscounting facilities for specific types of lending. In the main, selective credit controls were directed towards controlling the rate of increase in less socially productive forms of credit to more socially desirable activities in the "national interest". However, while selective rediscounting and preferential rates did facilitate the credit needs of specific sectors, e.g. tourism, construction and agriculture, it also served to reduce competition within the financial system.

By 1986, elements of financial repression were well entrenched within the financial system. Real interest rates were generally low, and in many instances negative, contributing to strong non-price competition for savings. Interest rate spreads within the banking system were relatively large, while credit ceilings and directed credit contributed to reduced allocative efficiency within the financial market.

B. Financial Reform in Jamaiaca

The programme of trade and financial reforms implemented by the Government of Jamaica, and financed by the World Bank under the Trade and Financial Sector Adjustment Loan Programme, formed a part of a broader programme of Structural Adjustment and macroeconomic stabilization initiated in the early 1980s. The programme of structural adjustment was aimed primarily at creating a more efficient market-oriented economy that was export driven and in which the private sector was the main engine of economic growth.

The financial aspect of the reform programme was designed to achieve several objectives. The principal objectives were: the separation of monetary and fiscal policies, the elimination of distortions in the financial market and the creation of a fiscal and institutional environment which would strengthen the capital market. Financial reform measures that were implemented during the period 1986-1988, and in recent years, were therefore focused on three main areas: monetary policy implementation, reform of interest rate policies and money and capital market developments.

(i) Monetary Policy Implementation

As indicated above, a major goal of the financial reform programme was the separation of monetary and fiscal policies. The need for the disentanglement of monetary and fiscal policies arose in a context where high statutory reserve requirements applicable to commercial banks and near bank institutions served as a captive market for the financing of fiscal deficits. The use of the reserve requirement and Central Bank overdraft facility to finance excessive fiscal deficits adversely affected the ability of the Bank of Jamaica to achieve the objectives of price stability, sustained balance of payments and a realistic exchange rate. Additionally, financing of the fiscal deficit through the secondary reserve requirement served to retard the development of an active capital market, a prerequisite for the efficient implementation of monetary policy as well as imposed quantitative restraint on the volume of credit available to the private sector (crowding out effect).

To enhance the Central Bank's ability to efficiently implement monetary policy, the secondary reserve requirement of the commercial banks and near bank intermediaries was eliminated over the three year period 1986-1988. During this period, the statutory reserve ratio, inclusive of the secondary reserves of the commercial banks and near bank institutions, was reduced on a phased basis, from 48.0 percent and 25.0 percent respectively in 1986 to 20.0 percent and 5.0 percent in 1988, making the cash reserve ratio equivalent to the statutory reserve requirement.

The phased removal of the secondary reserve ratio, beginning in 1986, was accompanied by a significant increase in the private sector's usage of bank system credit. During the period, the stock of banking system credit to the private sector increased by 89.2 percent or J$2.7 billion, with sectors such as tourism, agriculture and manufacturing accounting for the bulk of this increase. It is important to note, however, that while banking system credit to the private sector expanded, the stock of credit to the public sector declined by 28.1 percent or J$839.6 million over the same period. The fall-off in the public sector's use of banking system credit was due to two major factors: a contraction in the public sector deficit resulting from improvements in public sector management and an increase in the importance of treasury bills as an instrument for financing the deficit.

The increased significance of treasury bills as a financing instrument arose within the context of the elimination of the secondary or non-cash liquid asset ratio which forced the Government to market its own instrument, specifically treasury bills, to finance inequalities between revenue and expenditure. The marketing of treasury bills was done through a Bank of Jamaica administered auction system in which interest rates (yields) were market determined, and instruments of different maturities made more widely available within the economy. Perhaps the most significant long-term impact that this shift in public sector financing had on the financial sector was that it forced the Government to compete for resources within the market and thereby created the basis for the development of an active money and capital market. See Table 1.

Simultaneous with the elimination of the secondary reserve requirement, the Bank of Jamaica sought to develop its capacity to conduct Open Market Operations and influence money supply through base money control. Simply defined, base money control is based on the algebraic equation:

$$M = kB$$

where

M is the money supply

k is the money multiplier

B is reserve or base money.

From the equation, changes in the money supply are dependent on changes in k the money multiplier as well as B, the reserve or base money. Open market activity therefore sought to influence base money to attain desired changes in the level of money supply given any particular value of the money multiplier.

Open market operations conducted by the Bank of Jamaica through the sale and purchase of its own market based Certificates of Deposit (CDs), were designed with the objective of enabling the Bank of Jamaica to pursue an independent monetary policy. Purchases and sales of CDs in principle would expand or contract base money, thereby leading to the desired expansion or contraction of the money supply. However, CD transactions carried out by the Bank of Jamaica, at least in the initial stages, were predominantly sale transactions which sought to contract domestic money supply. To a large extent, this uni-directional approach to base money management was directly related to the requirements of macroeconomic stabilization, principally the correction of macroeconomic disequilibria and protection of the external accounts.

Table 2 reveals that over the period 1986-1988, the outstanding stock of Bank of Jamaica CDs increased substantially, moving from J$176.7 million at January 1986 to J$2,299.6 million at December 1988. Subsequently, the outstanding stock of CDs rose to a record J$7,081.7 million at July 1992. The phenomenal growth in the outstanding stock of CDs occurred within the context of the authorities' excessive reliance on CDs to mop up banking system liquidity, arising in part from the removal of the non-cash liquid asset reserves, the failure of the government to exercise fiscal prudence in public sector operations and some substitution by banks between CDs on one hand and treasury bills and local registered stocks on the other.

The introduction of CDs in 1985 served other useful purposes. It provided an additional financial instrument to the market place, and along with Government of Jamaica Treasury Bills and Local Registered Stocks, increased the range of instruments available to financial institutions, non-financial entities, government entities and private individuals. Additionally, because interest rates on CDs were market determined, a more competitive interest rate structure, particularly for term deposits, was created.

(ii) Reform of Interest Rate Policies

Prior to reform, the minimum savings deposit rate administered by the Bank of Jamaica was the principal determinant of the overall level and structure of interest rates. While there existed some market based rates, notably interest rate paid on term/fixed deposits, the relatively large share of savings deposit (40.0 percent) in the deposit base of the commercial banks meant that changes in the savings deposit rate had a significant impact on lending rates. The variation in the saving deposit rate therefore assumed major importance as an instrument for regulating credit demand. Consequently, over the years, and particularly in 1985 and 1986, frequent adjustments in the savings deposit rate were directly associated with efforts of the government to reduce domestic demand in defence of the external accounts. See Table 4.

Administrative control of the saving deposit rate setting mechanism in a high inflation environment meant, however, that savers, and in particular small savers, regularly received negative real returns with adverse implications on the rate of growth in domestic savings and investments. It was envisioned that with the removal of interest rate controls, the real rate of interest would move towards equilibrium inducing increased savings and investments.

The movement towards a market oriented interest rate regime proceeded along two fronts: first, the Bank of Jamaica introduced a market determined interest rate instrument (CD) in November 1985. CDs were primarily used to facilitate Bank of Jamaica open market operations. Interest rate on CDs was generally determined by the market through an auction mechanism. Yields on treasury bills were determined in a similar manner following the removal of the secondary reserve requirements which forced the Government to market its treasury bills actively.

The second approach to interest rate liberalization was the linking of the savings deposit rate to a market determined interest rate, i.e. the average weighted term deposit rate of the commercial banks. Henceforth, the savings deposit rate was adjusted in line with movements in the banks' term deposit rate. In the period 1986-1988, the savings deposit rate was adjusted downwards from 20.0 percent in 1986 to 13.0 percent in 1988. Similarly, under the influence of market forces, the weighted average loan rate of the commercial banks also declined moving from 29.52 percent to 24.92 percent over the same period.

With the removal of the floor on the savings deposit rate in October 1990, this rate became determinable and variable within the discretion of individual commercial banks. The individual banks' determination will be influenced, inter alia, by the cost of mobilizing deposits and the monetary policy stance of the government.

iii. Reform in the Money and Capital Markets

An important aspect of the reform programme with which the Bank of Jamaica was integrally associated, was with efforts to develop more active financial markets in which government and other public sector securities (Bank of Jamaica CDs) could be traded, and to facilitate the mobilization of resources for long-term investment. A vibrant financial market was deemed necessary to increase the capacity of the Bank to conduct open market operations, improve the allocative efficiency of the financial market, and importantly, promote the mobilization of domestic savings to finance public and private sector investments.

Proposals to strengthen the financial market included:

(i) the elimination of stamp duties associated with transactions in securities on the stock exchange, as well as the withholding tax on the payment of dividends;

(ii) the broadening of the maturity range of the Government's short-term debt instrument;

(iii) the broadening of the membership base of the stock exchange to include merchant banks and trust companies, and to license securities firms and brokers;

(iv) the establishment of a Securities Commission to devise and operate a supportive regulatory framework for the new stock exchange; and

(v) the strengthening of the superintendency of banks to ensure the proper evaluation, monitoring and supervision of financial intermediaries.

While initiatives have been taken by the Government to implement some elements of the reform proposal, namely, the elimination of stamp duties on transactions in securities on the stock exchange, the strengthening of the operational and regulatory framework of financial institutions and the broadening of the maturity range of Government securities, delays have occurred in the implementation of others, notably the elimination of the withholding tax on dividends. Importantly, the Securities Commission, which has statutory responsibility for the orderly and efficient operation of the capital market and the maintenance of professional standards began operations in June 1994. It is expected that a fully functioning Securities Commission will provide the guidance and supportive infrastructure necessary to facilitate increased efficiency within the local capital market.

A recent development initiated by the Bank of Jamaica was the creation of a secondary market for trading in Government of Jamaica/Bank of Jamaica securities. An active secondary market involving a select group of financial intermediaries - commercial banks, merchant banks and brokers, known as "primary dealers" provides underwriting support for all new issues of Government of Jamaica securities and simultaneously provide liquidity for two-way transactions in the market. To date, the Bank of Jamaica has done a substantial volume of transactions within the secondary market mainly by means of repurchase agreements. These transactions which are conducted as a part of the Bank's overall macroeconomic policy initiative were aimed primarily at managing liquidity within the financial system. As at November 1, 1994, the Bank of Jamaica had repurchase agreements totalling J$4.0 billion outstanding, with maturities ranging from 8 days to 26 days.

While BOJ activities on the secondary market have enhanced the capabilities of the Bank to influence liquidity levels within the financial system, the extent to which the Bank provided financing to primary dealers to hold inventories of securities rather than dealers sourcing financing from the market may have served to reduce the potential effectiveness of repurchase agreements in liquidity management. To further develop the secondary market and enhance its effectiveness in the mobilization and allocation of financial resources will require, inter alia, the wider dissemination of market based information on prices and trends in the secondary market for government securities, fiscal incentives e.g. the removal of the withholding tax on secondary market securities transactions and income earned (dividends) from shares traded on the stock market, as well as proper monitoring and assessment of the solvency of brokerage firms.

C. A Preliminary Assessment of the Financial Reform Programme

Following a prolonged period of inflationary recession in the mid- to late-1970s and the continuing recession of the early 1980s, the mid- to late-1980s witnessed the emergence of buoyant economic conditions within the major industrial economies. The expansion in economic activity was accompanied by the recovery in metal prices, including aluminium, a reduction in interest rates on international financial markets and significantly lower oil prices. The positive effect of these developments on the local economy was reinforced by: signs of improvement in public sector administration, reflected in a reduction in the overall public sector deficit, from $659.6 million in FY 1985/86 to $202.5 million in FY 1986/87, a marked increase in the flow of banking system credit to the private sector, and a generally positive outlook within the private sector.

It was against this relatively favourable economic background that the financial reform programme was implemented in 1986. The subsequent interruption of the programme, through the reimposition of the secondary reserve requirements and credit ceilings in 1989, was considered an unavoidable necessity given the exigencies of stabilization in the post-hurricane era.

There was strong growth in banking system liquidity which arose in part from reinsurance inflows, and increased government expenditure associated with the rehabilitation effort. While credit ceilings were eventually eliminated in 1991, the statutory reserve ratio has remained at 50.0 percent, following the re-imposition of the secondary reserve ratio in 1989 in the aftermath of the hurricane of September 1988. Arrangements under the current Economic Programme (EFF) provided for the phasing out of the secondary reserve ratio by March 1995, but this has again been delayed due to the exigencies of economic stabilization. The continued return to non-market means of monetary control raises the issue of the appropriate balance between monetary, fiscal and foreign exchange policy.

An assessment of the impact of reform measures implemented over the period 1986 to 1988, and developments in the financial sector to 1993 indicate that growth in financial intermediation was substantial. Total financial assets of the banking system[2] measured in 1987 prices, rose from J$11.4 billion in 1985 to J$16.1 billion in 1993. Similarly financial deepening, crudely measured by the ratio of M_2/GDP, rose rapidly during the period. The ratio of M_2/GDP rose from 46.0 percent in 1985 to 58.0 percent in 1993, peaking at 65.0 percent in 1989. While interest rate reforms and foreign exchange

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2/ Includes commercial banks, near banks and building societies.

liberalization in 1991 may have accounted for a significant share of the increase in the ratio of M_2/GDP, a major contributing factor would have been the monetary expansion arising from large central bank losses. These losses which are interest payments on maturing CDs would have added to the stock of M_2 as losses were not made good by actual cash transfer from the Government to the Bank of Jamaica. Subsequent arrangements have seen quarterly payments by the Government to cover outstanding losses. Another possible factor contributing to the rapid expansion of financial assets was the reflow of repatriated capital that was deposited within the domestic banking system, particularly in the period following the suspension of exchange control regulations in 1991.

TABLE 5 SELECTED FINANCIAL STATISTICS 1986-1993

Year	Banking System* Assets (J$mn)	M_2/GDP (%)
1986	10547.8	0.47
1987	12657.6	0.52
1988	16834.5	0.54
1989	20719.8	0.65
1990	24048.9	0.56
1991	37207.1	0.57
1992	65074.2	0.57
1993	83372.8	0.58

Source: BOJ Statistical Digest

*Current Dollars

In an environment of rapid asset expansion and deepening within the financial sector, the operations of commercial banks and near bank intermediaries, particularly merchant banks, increased numerically and qualitatively. In 1985, there were One Hundred and Fifty-four (154) commercial bank branches, by 1993 the number had increased to Two Hundred and One (201). Qualitatively also, the commercial banks and merchant banks sought to increase the quality and range of services offered to customers. Elaine Hayle in "Financial Innovations in Commercial Banking in Jamaica Since 1985", highlights the strong competition in the provision of banking services which emerged within the local banking sector during the late 1980s. Hayle posits the view that this competition was largely due to the deregulation of the financial sector as well as the emergence of innovations in the provision of financial services in the rest of the world. (Hayle 1994).

Preliminary indications are that relative to 1985, the competitive structure of the commercial banking industry has strengthened. At the end of June 1994, there were 11 commercial banks compared to 10 at the end of December 1985. In addition, the concentration of assets among the three largest commercial banks weakened, moving from 73.8 percent of total assets at December 1985 to 64.0 percent of total assets at June 1994. There is evidence to suggest, however, that commercial banks may have extended their control and influence through the management and/or ownership of a large proportion of the combined assets of other financial institutions. The extent to which this has occurred may have allowed the commercial banks to maintain their dominant position, but in a less obvious way.

Somewhat similar to the German and Japanese banks, commercial banks have moved stridently into non-financial areas of activity and, through corporate arrangements involving holding companies and subsidiaries, have formed "One-stop Financial Supermarkets", offering a range of banking and non-banking services. Separate and apart from concerns with regard to effective supervision, this development raises the question as to whether the concentration of financial services may, in the long run, contribute to reduced competition within the financial sector. Further research will seek to determine the likelihood of this occurring as well as the extent to which the distribution of financial assets has shifted among the different financial institutions.

Occurring alongside the growth in commercial banking activity, was the increased importance of near bank intermediaries, particularly the increased activity in merchant banking. During the period 1986-1993, the assets of near bank institutions increased in nominal terms, from J$1.4 billion in 1986 to J$11.4 billion in 1993. Merchant banks accounted for the bulk of the overall increase, moving from J$348.0 million to J$10.9 billion over the period.

The rapid growth of near bank intermediaries occurred in a context where commercial banks sought to circumvent financial repressive controls (credit ceilings and high statutory reserves) in the banking sector by channelling business to subsidiary companies largely to evade the relatively tighter restrictions which applied to commercial banks. A second factor was an increase in the number of licences granted to individuals and commercial entities to operate near banks. Over the period 1985-1993, the number of near bank institutions increased from 8 in 1985 to 25 in 1993.

In a context where near banks enjoyed the benefits of lower reserve requirements and less restrictive central bank control, these institutions expanded their activities, providing a range of services inclusive of trade financing, underwriting services, short- and long-term credit facilities, and in some instances foreign exchange trading facilities. The rapid growth in these institutions and the similarity in the services to that provided by commercial banks appear to lend credence to the view that the cash reserve ratio should be equalized across both types of institutions to eliminate segmentation within the financial market. A more desired approach, however, could be the application of differential reserves ratios, based on the maturity profile of loans extended.

The question as to whether financial reform, and in particular interest rate liberalization, has led to increased savings and investments is best answered by a cursory examination of Table 6.

SUMMARY ACCOUNTS
OF JAMAICA'S BANKING SYSTEM
(CONSTANT PRICES - 1987 J$MN)

Year	Deposits	Loans & Advances
1985	8,658.5	5,569.2
1986	9,088.5	5,685.5
1987	9,666.6	6,523.2
1988	10,813.0	6,812.1
1989	11,323.9	8,496.2
1990	10,767.2	8,255.9
1991	10,429.0	7,436.1
1992	11,527.6	5,323.9
1993	11,810.4	6,211.6

Source: Bank of Jamaica Statistical Digest

Information contained in Table 6 suggests that while the banking system reported an appreciable increase in the levels of deposit and loans and advances for the period 1986-1993, most of the increase, particularly in deposits, coincided with the most intense implementation of the financial reform programme 1986-1988. For the period 1986-1988, deposit liabilities, in constant terms, increased by 24.9 percent. In the post 1988 period, however, the rate of increase in deposits slowed to 9.2 percent. Similarly, loans and advances registered an increase of 22.3 percent in the 1986-1988 period, but thereafter fell by 8,8 percent. While the data does not show a sustained increase in the rate of banking system deposits and loans over the period 1986-1993, the faster rate of growth evidenced in the period 1986-1988, for both deposits and loans, suggests that macroeconomic conditions during the period of intense reform were more conducive to increased savings and investments.

Examined on the basis of the distribution of banking system credit, in nominal terms, there was a distinct shift in the allocation of credit towards the private sector. See Table 7. The private sector's allocation of banking system credit increased markedly throughout the period, moving from J$2.9 billion in 1985 to J$5.0 billion in 1988 and subsequently increasing to J$21.5 billion in 1993. On the other hand, net banking system credit to the public sector declined, falling from J$4.9 billion in 1985 to J$3.0 billion in 1988. The sector accumulated deposit balances amounting to J$2.4 billion within the banking system by the end of 1993, coming from J$414.0 million at the end of 1991.

The marked shift in the distribution of banking system credit towards the private sector reflects a combination of factors. These include: the decline in the rate of public sector investment as part of the overall programme to reduce the budget deficit, improved performance within the the public sector and a shift towards the use of treasury bills in the financing of budgetary shortfalls. Additionally, reforms in other areas of the economy, notably tax reforms, tariff reforms, the removal of price control and the divestment of government owned assets served to enhance the investment environment with the attendant increase in private sector activity.

While there was a clear shift towards the allocation of banking system credit to the private sector a particularly worrying feature of the shift in resource use was the rate of growth in consumer-oriented credit relative to credit for productive activity, particularly in the post 1988 period. A disaggregation of commercial bank credit to the private sector for the period 1985-1993 shows a substantial increase in credit for consumer-oriented purposes in 1991, 1992 and 1993. See Table 8. It is to be noted that the growth in consumer-oriented credit accelerated in 1991 following the removal of previously imposed restrictions on commercial bank lending operations. Since 1991, credit for consumer-oriented purposes increased from J$3.6 billion to J$4.8 billion and J$9.3 billion in 1992 and 1993 respectively. Over the same period, credit to the productive sector increased from J$7.2 billion to J$7.9 billion and J$12.2 billion. While the growth in consumer-oriented credit may be attributed to the release of pent-up demand following reductions in the tariff and income tax regimes, the allocation of such a large share of available credit for consumer type purposes may have displaced credit which would otherwise have gone to the productive sector.

In terms of money and capital market developments, efforts by the Bank of Jamaica to develop a vibrant financial market has preceded apace. While the market may be considered thin by international standards, i.e. in relation to the variety and maturity profile of available instruments, relative to the pre-reform period, there has been a significant increase in financial market activity involving a wider range of instruments. These instruments include Bank of Jamaica CDs, repurchase agreements, Government of Jamaica securities (treasury bills and local registered stocks) of varying maturities and commercial paper.

From a monetary policy perspective, the emergence of an active money market has provided the Bank of Jamaica with an improved means for managing liquidity through open market operations. It is important to note, however, that while open market operation is an important policy tool for fine-tuning liquidity management, an over-reliance on open market operations, particularly in a context of sustained fiscal imbalance, will undermine the achievement of macroeconomic policy objectives, with severe costs to the economy.

An important feature of the financial market which evolved in the post 1988 period has been the emergence of a vibrant unregulated market in commercial paper. Commercial paper is an unsecured short-term promissory note issued by non-financial corporations via banks and money market brokers acting as intermediaries. The market for commercial paper evolved in a context where due to the high cost of banking system credit, arising from high reserve requirements, non-financial entities have sought to acquire cheaper funds outside of the banking system. Current estimates are that transactions in excess of J$1.0 billion are done on the market, and the potential for future growth and expansion is tremendous.

Although the commercial paper market provides relatively cheap funds to borrowers, the unregulated nature of the market poses an element of risk to the financial system both in terms of potential financial loss and possible implications for the Bank of Jamaica as a lender of last resort. Additionally, from a monetary policy perspective, the use of commercial paper by corporate entities serves to undermine the effectiveness of monetary policy. The growth in the use of commercial paper largely reflects the existence of residual elements of financial repression in the form of the relatively high reserve ratio (50.0 percent) and the 25.0 percent withholding tax on interest income. Consequently, the disintermediation which arises can only be effectively corrected by the elimination of the secondary reserve requirement and the subsequent reduction in the cash reserve ratio.

SUMMARY CONCLUSION

The foregoing analysis of the evolution of the programme of financial reform in Jamaica reveals that attempts to liberalize Jamaica's Financial System has profoundly affected the functioning of the financial system and the conduct of monetary policy by the Bank of Jamaica. The tightly regulated financial system of the pre-reform period promoted a monetary policy strategy that used direct controls to influence economic activity with the attendant distortions and inefficiencies. Against the background of changes in the international economy, particularly with regard to regulations, as well as technological and product innovations, the structure of government finance and government control was gradually undermined.

Financial reform in Jamaica has reduced the relative importance of government in directly allocating financial resources, eliminated a number of policy tools that restricted bank behaviour and created a more competitive environment conducive to intermediation. In response, the Bank of Jamaica has gradually developed the capacity to become more dependent on its ability to influence macroeconomic developments through the conduct of open market operations.

The analysis further suggests, however, that liberalization has brought many new challenges both for regulators and the designers of monetary policy. Foremost amongst these are:

(i) the rapid expansion in the activities of near bank institutions (merchant banks), providing somewhat similar services like commercial banks but operating within a different regulatory framework;

(ii) the development of "one stop financial supermarkets" with oligopolistic tendencies;

(iii) the emergence of a buoyant but unregulated capital market with strong growth potential; and

(iv) the need to direct a greater flow of financial resources to the productive sectors; and in particular to export oriented activities.

Against the background of a rapidly changing global environment and the accompanying need to strengthen the capacity of the financial system and the economy to function more efficiently, further efforts must be directed at completing the process of financial and macroeconomic reforms. This includes the removal of the secondary cash reserve requirement along with the gradual reduction in the cash reserve ratio. However, to be successful, this must be done within the context of a more vibrant financial market and a strong commitment to fiscal prudence.

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APPENDICES

CHARTS

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TABLES

TABLES

TABLE 1

OUTSTANDING STOCK OF GOVERNMENT OF JAMAICA
TREASURY BILLS, 1985-1993
(End of Period)

J$ million

YEAR	AMOUNT OUTSTANDING
1985	924.0
1986	999.0
1987	1500.0
1988	2878.0
1989	3319.0
1990	3498.0
1991	3616.1
1992	6461.0
1993	6645.0

Source: BOJ Statistical Digest

TABLE 2

OUTSTANDING STOCK OF BANK OF JAMAICA CERTIFICATES OF DEPOSIT, 1985 - 1993* (END OF PERIOD)

J$ MILLION

YEAR	AMOUNT
1985	123.8
1986	1010.0
1987	1666.0
1988	2299.6
1989	2426.0
1990	2986.0
1991	3618.0
1992	3491.7
1993	3128.4

* The outstanding stock of Certificates of Deposit peaked at J$7081.7 million in July 1992.

Source: BOJ Statistical Digest

TABLE 3

HOLDERS OF BANK OF JAMAICA'S CERTIFICATES OF DEPOSIT
(END OF PERIOD)

YEAR	COMMERCIAL BANKS	PUBLIC SECTOR	NON-BANKS	OTHER	CERTIFICATES OUTSTANDING
1985	22.2	45.7	5.6	49.3	123.8
1986	468.2	202.2	170.3	169.3	1010.0
1987	579.2	600.2	271.0	215.7	1666.1
1988	1142.6	702.5	227.0	227.5	2299.6
1989	1172.2	486.3	379.9	387.6	2426.0
1990	468.8	1307.6	406.2	803.3	2986.0
1991	577.3	1117.8	984.1	938.8	3618.0
1992	N/A	N/A	N/A	N/A	N/A
1993	N/A	N/A	N/A	N/A	N/A

Source: BOJ Statistical Digest

TABLE 4

QUARTERLY MOVEMENTS IN SELECTED INTEREST RATES*

(%)

END OF PERIOD	COMMERCIAL BANKS OVERALL AVERAGE WEIGHTED DEPOSIT RATES	COMMERCIAL BANKS OVERALL AVERAGE WEIGHTED LOAN RATES	SAVINGS RATE
1986:			
MARCH	20.0	29.52	20.0
JUNE	18.5	26.82	16.0
SEPTEMBER	16.1	25.75	15.0
DECEMBER	14.8	25.60	15.0
1987:			
MARCH	14.4	24.44	15.0
JUNE	14.9	25.54	15.0
SEPTEMBER	15.1	25.44	15.0
DECEMBER	15.5	25.19	15.0
1988:			
MARCH	15.6	25.40	15.0
JUNE	14.9	25.02	15.0
SEPTEMBER	14.3	25.17	13.0
DECEMBER	14.3	24.94	13.0
1989:			
MARCH	14.4	24.39	13.0
JUNE	15.0	24.49	13.0
SEPTRMBER	16.2	24.85	13.0
DECEMBER	20.2	28.15	18.0

Source: BOJ Statistical Digest

* Nominal Rates

TABLE 7

SECTORAL ALLOCATION OF DOMESTIC CREDIT
1985 - 1993

(J$ MILLION)

YEAR	TO PUBLIC SECTOR* (Net)	TO PRIVATE SECTOR
1985	3828.4	2412.6
1986	4847.5	2937.5
1987	4407.3	3913.3
1988	2988.8	4895.6
1989	2304.3	6305.8
1990	1436.5	7341.7
1991	-414.0	10230.7
1992	-501.7	12518.0
1993	-2408.1	21148.0

Source: BOJ Statistical Digest.

* Minus sign indicates a build up of deposit balances within the banking system.