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SOUND FINANCIAL INSTITUTIONAL FRAMEWORKS, UNSOUND OUTCOMES: THE CASE OF JAMAICA

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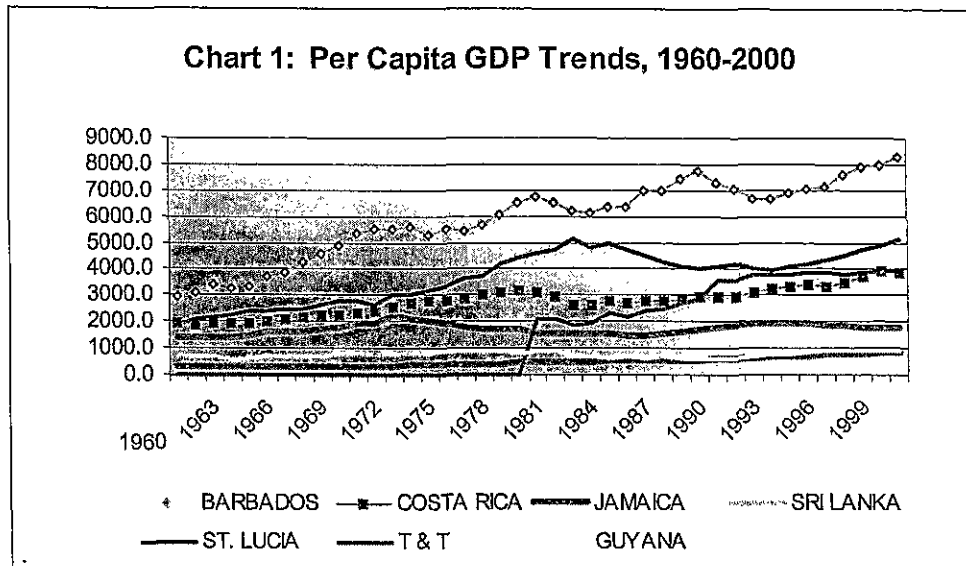
SOUND FINANCIAL INSTITUTIONAL FRAMEWORKS, UNSOUND OUTCOMES: THE CASE OF JAMAICA

INTRODUCTION

Over the last three decades, Jamaica has failed to realize the potential that could have been achieved if only the country had sustained the high growth rates of the 1950s and the 1960s. In the 1960s, GDP growth varied from 3 to 12 percent and averaged 5 percent annually, as the economy was boosted by expansion of the bauxite/alumina industry and the tourism industry. From the 1970s onwards, GDP growth has been anemic at best, resulting in a general decline in *per capita* income. Consequently, in 2001 *per capita* income was about the same as in 1978 and substantially lower than it was in 1970. As Chart 1 shows, Jamaica's per capita income has been generally stagnant since the 1960s while other countries in the area have shown some improvement. High unemployment rates, severe poverty and a deteriorating social situation characterized by a worsening incidence of violent crime have added urgency to the concerns with respect to the unsatisfactory economic performance over the years.

The failure to generate sustained growth and development over the last three decades has occurred despite the pursuit of significant structural reforms and some recent progress with respect to macroeconomic policy. Since the 1970s, Jamaica has pursued a number of economic reforms usually in collaboration with major multilateral and bilateral development agencies. Such collaboration has included several Fund facilities, World Bank structural adjustment loans and sector loans from the IDB (See Annex I for a chronology of multilateral supported programs). The reform agenda has concentrated on reversing the interventionist policy framework which was established in the 1970s, and has included import liberalization and tax reform in the 1980s and the liberalization of the foreign exchange regime and the financial sector in the 1990s.



The 1980s were marked by fluctuating economic performance in Jamaica as the bauxite industry experienced sharp swings in demand. The economy recorded its highest GDP growth rates toward the end of the decade, raising the prospect of sustained economic improvement. At the same time, Jamaica benefited from several debt relief initiatives which reduced the severe burden of its high external debt. However, although some growth occurred in the early 1990s, sustained economic growth failed to materialize over the decade as a whole. Real GDP growth averaged 0.3 percent and –0.9 percent during the periods 1992-2000 and 1996-99, respectively, and *per capita* income declined at an annual rate of one percent over the decade. This poor performance represented considerable lost opportunity as Jamaica failed to capitalize on the generally buoyant conditions in the US, its main trading partner, and the rest of the world as a whole.

Jamaican economic management was not without some significant successes in the 1990s. While the economy struggled for growth, there were some macroeconomic successes in the form of reduced inflation rates, the achievement of fiscal surpluses in the first half of the decade and the accumulation of international reserves. However, as the decade wore on, the shock of the financial sector crisis that surfaced in 1996 resulted in a return to large fiscal deficits, unsustainable debt (public debt/GDP has reached 155 percent in 2003) and high real interest rates. Inflation continued to be contained at

single-digit rates and attention started to shift to the issues of growth as a necessary element in the search for sustained stabilization and welfare improvements.

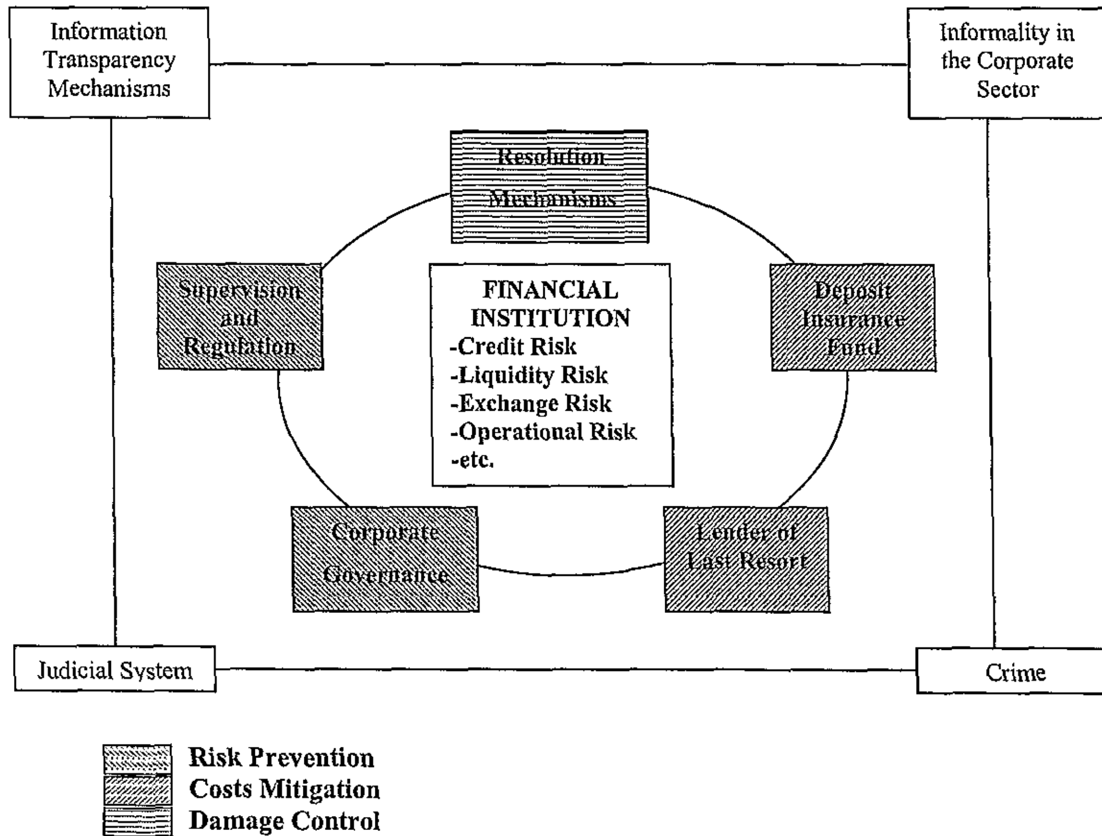
Against this background of deepening concern about low economic growth performance, the Bank commissioned a group of five studies on the theme of how to achieve sustained growth. The objective was to identify the major obstacles to growth in order to find ways of stimulating the economy and to inform Bank support for this process. This was done with an awareness that considerable work has been done and continues to be done on Jamaica by other agencies and academics. Consequently, it was decided to build on that body of work by structuring the papers along institutional lines with a view to identifying specific interventions that would put Jamaica on the road to sustained growth. It was felt that the thrust of the work should be to investigate the issues of competitiveness and the institutions of public sector management and policy that could provide a strong framework and environment for efficiency, competitiveness and growth. In addition, there was a recognition of the vital relevance of the social context for the promotion of growth.

This paper draws specifically on three of the papers which focus on the main institutions that govern the financial policies in the country, namely, ***Fiscal Policy Issues in Jamaica: Budgetary Institutions, the Tax System and Public Debt Management, by Daniel Artana and Fernando Navajas, Monetary and Exchange Rate Policies in Jamaica, by Roberto Zahler, and Jamaica Financial System, Diagnostic and Recommendations, by Martin Naranjo Landerer and Emilio Osambela Zavala.*** These papers may for analytical purposes be distinguished in the following terms, i.e., the Artana and Navajas paper focusing on the institutions related to fiscal policy and directly managed by the Ministry of Finance, the Zahler paper dealing with the institutional framework for monetary and foreign exchange policies, managed directly by the Bank of Jamaica (BOJ, the central bank) and the Naranjo and Osambela paper dealing with the supervisory issues for banks and non-banks. Even though the BOJ is responsible for bank supervision, it is handled by a separate department under a deputy Governor and, besides, is subject to its own legislative framework. Indeed, it makes sense to analyze

bank supervision along with non-bank supervision which is now the responsibility of the recently established Financial Services Commission.

In particular, this paper attempts to address the conundrum of unsatisfactory outcomes with respect to stabilization and growth despite the existence of an institutional framework that appears to be relatively sound for the most part. It endorses the idea that sound institutions constitute a necessary condition for development but underlines the position that development outcomes depend on the interplay of the institutions with the policy, social and business environment. A suitable analytical framework for this purpose is that adopted by Naranjo And Osambela which juxtaposes the institutional framework with its socio-economic environment and is represented by Figure 1. The terms in this figure relate specifically to the issues of financial supervision but could be modified for the other institutions. In addition, it must be pointed out that the range of factors that make up the economic environment is virtually unlimited and not necessarily restricted to the four indicated. Indeed, apart from the elements indicated in Figure 1, some other relevant factors would include the policy framework, the buoyancy of economic conditions, the level of social consensus on economic policy and the sense of urgency and commitment to development. Recent analysis of the Jamaican economy has tended to be dominated in their perceptions of the problems by the financial sector crisis that occurred in the 1990s. However, this paper takes the view that it is important to pay attention to the *persistence* of the weaknesses and, therefore, to look at the interaction between the institutional framework and the economic environment over an extended period.

FIGURE 1

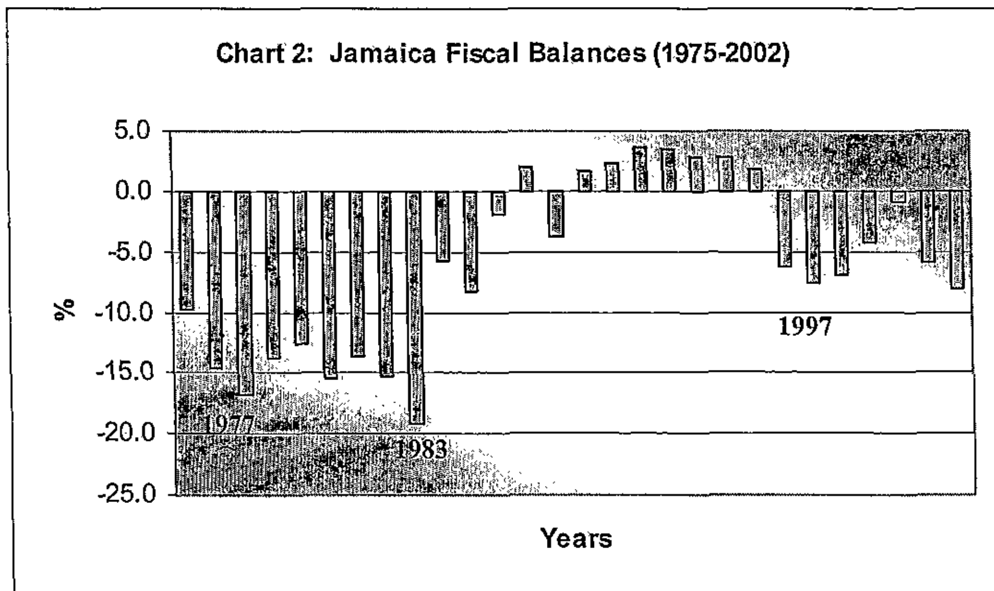


This paper is essentially discussion paper in the sense that it raises a number of issues for reflection without attempting to test any specific hypothesis. In terms of its organization, Sections I, II and III will discuss outlines of the institutional framework and other relevant features with respect to budgetary and fiscal operations, monetary and exchange rate policies and supervision and management of the financial system, respectively. These sections will rely mainly on the three papers mentioned above which were prepared last year with IDB support. The final section will be dedicated to some conclusions, paying particular attention to the interaction of institutional aspects with policy and social context considerations.

I. BUDGETARY INSTITUTIONS, TAX ADMINISTRATION AND DEBT

Jamaica has been plagued by large fiscal deficits and debt for most of the time since the 1970s (see Chart 2). It is clear that the achievement of sustained macroeconomic stability

and growth hinges considerably on resolution of the problems of fiscal imbalances and debt. For a while in the early 1990s, it appeared that fiscal stability was being achieved as the Central Government recorded six surpluses averaging 2.9 percent of GDP between 1990/91 and 1995/96. With respect to debt, the external debt which had been a severe burden in the 1980s was substantially reduced by substantial episodes of bilateral debt relief. The favorable trends were short-lived as the country suffered severe stability reverses after the mid-nineties. While the external debt was contained, the domestic debt grew rapidly partly as a result of the fall-out from the financial sector crisis. The burden of the mostly domestic debt was aggravated by the high real interest rates prevailing at the time as part of the tight monetary policy regime.



At the same time, the Central Government recorded large fiscal deficits, as debt service and wages and salaries expanded dramatically. The Government resorted to major cuts in capital expenditure and various revenue increasing measures but these were not enough to achieve a lasting macroeconomic recovery. The debt service in particular became a huge obstacle, absorbing three-quarters of government revenue and amounting to nearly 20 percent of GDP. With debt service being such a huge burden, it means that even with a valiant fiscal effort represented by the achievement of double-digit primary surpluses, a large fiscal deficit cannot be avoided.

Artana and Navajas' examination of the budgetary institutions and tax system produced mixed results. Their analysis agrees with earlier studies by Alesina, Hausmann, Hommes and Stein (1996) and Stein, Talvi and Grisanti (1998) that found that Jamaica has sound fiscal institutions. In the Alesina et al. study, Jamaica placed first out of 20 countries in terms of an index of budgetary institutions (average 1980-92) while Jamaica placed second in the Stein et al. study[1].

In assessing Jamaica's budgetary institutions, Artana and Navajas adopt a framework which focuses on the criteria of fragmentation versus centralization, and transparency. Jamaica scores high in terms of centralization of the budget process with the Minister of Finance acting as 'fiscal entrepreneur' with clear responsibility for achieving set targets and able to impose cash limits on the whole government in order to achieve those targets. Another major plus is the constitutional mandate for debt service to be met before other expenditures. Artana And Navajas attribute to these features the ability of the Jamaican Government to achieve the high primary surpluses of recent years. They refer to the World Bank Country Financial Accountability and Assessment Report for 2001 which finds gaps between formal procedures and actual practice and calls for more centralized cash management. While acknowledging the cash management issue, they conclude that it is of marginal importance. They also refer to a KPMG evaluation which argued that a significant amount of recurrent expenditure is being classified as capital expenditure which undermines macroeconomic planning and capital expenditure programming.

The main weakness of the system identified by Artana And Navajas is the weak budget control and oversight of the public sector enterprises in their ability to incur debt and otherwise operate off-budget. A second weakness observed by Artana And Navajas is that Jamaica is susceptible to fiscal liabilities surprises resulting from hidden liabilities outside formal budget allocations. To address the off-budget operations of the public enterprises, they recommend that the hard-budget constraint institutional framework that

[1] The other countries in the Alesina et al. Study, in order of their ranking, were Mexico, Chile, Colombia, Panama, Uruguay, Paraguay, Costa Rica, Venezuela, Ecuador, Brazil, Bahamas, Guatemala, Honduras, Trinidad & Tobago, Argentina, El Salvador, Dominican Republic Bolivia and Peru.

applies to the central government be extended to the rest of the public sector. With respect to the fiscal liabilities surprises, they urge a number of measures including the application of explicit fiscal rules as formal constraints and the use of contingency funds to absorb external shocks.

Despite the high ranking obtained by the research cited, Jamaica's generally unsatisfactory fiscal performance over an extended period suggests that there is no room for complacency with respect to the adequacy of the institutional framework. For one thing, the high ranking may reflect the sample of countries and *a priori* assessment of the features of the framework. Indeed as Chart 3 indicates, it has little bearing on actual performance as some of the countries of the sample that did not score as well as Jamaica actually have a better record[2]. These considerations support the case for careful examination of the actual and informal practices to ensure that they accord adequately with the formal procedures, and to strengthen transparency and monitoring with regard to cash management and other day-to-day execution aspects.

In the area of tax policy and administration, the institutional framework shows significantly more weaknesses than the budgetary framework. By way of background, it should first be noted that tax revenue has risen in recent years reaching 27 percent of GDP in 2002/03. The recent increases are attributable to improvements in tax administration and collection as well as the introduction of new revenue measures. With the fiscal deficit widening, there has been significant pressure for higher tax revenue levels to be achieved. However, it is arguable that, with tax revenue running at between 26 and 30 percent of GDP, the importance of reviewing the tax system in the context of long-run development is not in order to increase tax revenue but to identify the reforms needed to address the issues of efficient investment, resource allocation and equity, and to encourage formal business practices.

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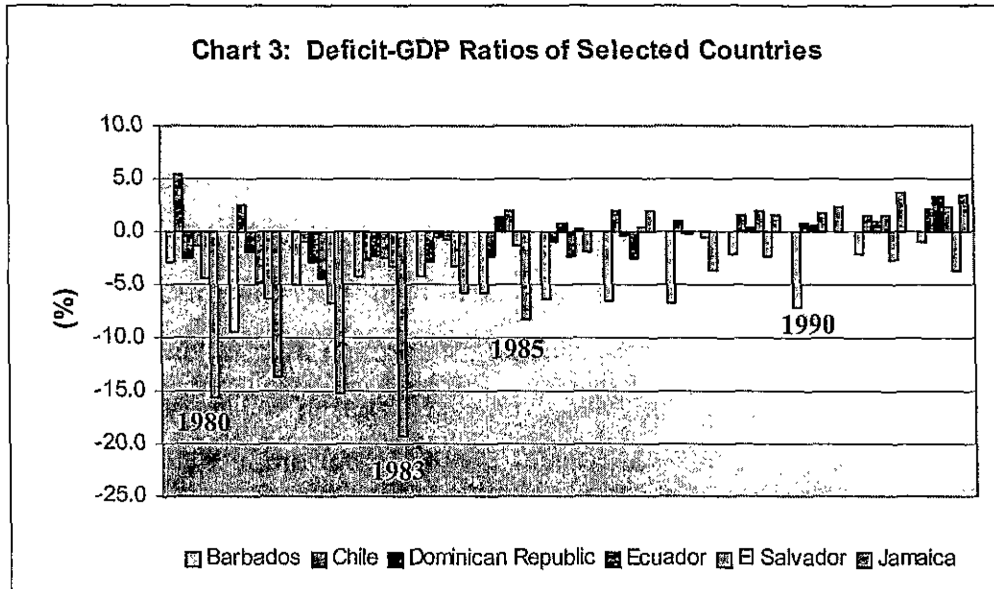
[2] It is recognized that this is a casual comparison as different levels of fiscal deficit may be targeted by different countries and success should be judged relative to those targets and not fiscal balance.



The main elements of the tax system are (i) the General Consumption Tax (GCT) which is a 15 percent value added tax on consumption, (ii) personal and corporate income tax, presently at 25 percent and 33.3 percent, respectively, (iii) excise taxes and import duties, (iv) taxes on labor income, and (v) property taxes, stamp duties and other levies.

Artana and Navajas identified some significant weaknesses of the system. With respect to income tax, the system allows firms to deduct interest payments which gives a bias in favor of debt financing relative to equity financing and this bias is strengthened in the presence of inflation. The system allows deduction of depreciation on the basis of historical costs of assets which penalizes capital in the presence of inflation. However, this penalty is more than offset by generous tax breaks which include tax holidays, an investment tax credit and partial expensing of investment, resulting in a substantial subsidy to capital. Artana and Navajas show on the basis of hypothetical assumptions that it is possible for a firm in the sugar industry, for example, where a 40 percent tax break applies to have a social rate of return of *negative* 17 percent and come out with a 10 percent private return because of the tax break. The tax system is also replete with exemptions and uneven treatment of different commodities, sectors and firms for purposes of GCT and income tax.

This system can be criticized on a number of grounds. It is not unusual for a tax system to be biased in favor of capital. However, there is no conclusive evidence that tax breaks have a significant favorable impact on investment. Moreover, in the Jamaican case, it is arguable that the subsidization of capital combined with labor taxation encourages firms to be labor saving which is not desirable, given the high level of unemployment. The widespread application of exemptions and lack of uniformity in some areas are criticized on the grounds that they encourage resource misallocation as unproductive activities are supported at the expense of others. Moreover, exemptions in one area force increased tax burdens to be imposed in other areas that may be more productive in order to meet revenue targets. It is evident that there is considerable scope for reform of the tax system to make it more equitable and favorable to efficient resource allocation.

On the question of **fiscal performance and public debt sustainability,** it should be observed that Jamaica has experienced fiscal deficits and public debt problems since the 1970s. The persistence of the fiscal imbalance and debt over an extended period is one justification for addressing this area as a fundamental challenge with respect to long-term development in Jamaica. In addition, the role of interest payments as a major current fiscal expenditure and the role of the primary surplus as the essential channel for debt reduction establishes the strong linkage between the fiscal and public debt issues. Over the years, the debt problem has taken different forms, being predominantly an external debt problem in the 1980s but with domestic debt emerging as the leading problem in the 1990s. With the debt-to-GDP ratio rising to over 155 percent and interest payments alone absorbing two-thirds of government revenue and grants, the debt situation represents a severe crisis in the financial management of the country.

The analysis of Artana and Navajas applies a framework developed by Edwards (2002) to the Jamaican case to estimate the primary surplus necessary under different assumptions about interest levels, the GDP growth rate and changes in the debt-to-GDP ratio. The estimates arrived at are guidelines especially considering that the debt ratio assumed is at least 20 percentage points less than the level it has since reached. One approach that may be adopted is to allow the debt ratio to decline over time by holding it constant in

nominal terms or allowing it to grow more slowly than GDP. This is clearly what is necessary in Jamaica since the debt is unsustainably high. It is evident that reduction of the debt ratio to sustainable levels in Jamaica will call for double-digit primary surpluses for some years to come. The size of the primary surplus and the length of time involved will be reduced to the extent that GDP growth is increased and interest rates are reduced.

In analyzing the deficit problems, Artana and Navajas draw attention to a number of issues that are relevant in the current episodes, including the high debt service emerging from the financial sector crisis, the relatively high wage and salary payments in the public sector as a percentage of GDP, the contraction in capital spending and the struggle to meet the demands in the social sectors for continued spending. In addition, mention is made of the quasi-fiscal impact of Bank of Jamaica losses which brings into perspective the cost of tight monetary policy for the purpose of reducing inflation. Inevitably, the fiscal and debt problems have been analyzed against the background of current problems. However, the fact that these problems have prevailed for decades raises the question as to whether there are more fundamental issues involved.

II. MONETARY AND EXCHANGE RATE FRAMEWORK

Like the Budgetary institutional framework, the monetary institutional framework in Jamaica displays a high degree of coherence and soundness. Although the Cabinet, through the Minister of Finance, is the ultimate authority, the Bank of Jamaica has responsibility for the day-to-day operation of monetary and exchange rate policy within a relatively sound legislative framework. The main institutional issue about which there is constant debate is the question of the relationship between the Government and the BOJ as it relates to central bank independence. There are some other issues connected to the role of bank supervision which is also the responsibility of the BOJ but they will be addressed in Section III. Apart from that, most of the issues with respect to the management and execution of monetary and exchange rate policy relate to the economic and policy environments.

Under the Bank of Jamaica Act (1960), the BOJ is charged with influencing the volume and conditions of supply of credit so as to promote the fullest expansion of production, trade and employment, consistent with the maintenance of monetary stability in Jamaica and the external value of the currency. In practice, the BOJ appears to see its role as primarily ensuring the maintenance of monetary stability and the external value of the currency. It is armed with the tools to influence the volume and conditions of credit, such as open market operations and changes in reserve requirements. In recent years, it has abandoned the use of reserve requirements and discount rate instruments, relying mostly on open market operations with the use of repurchase agreements and reverse repurchase agreements. The institutional framework underwent major reform in 1990-91 with the lifting of foreign exchange controls and adoption of a flexible exchange rate mechanism, and the use of credit controls was abandoned.

The main economic challenge in Jamaica is to create investment and economic growth. In this regard a major obstacle is high real interest rates. Consequently, the efficacy of monetary policy must be judged against its success in creating favorable conditions for investment and growth through the lowering of interest rates in a sustainable way.

Zahler's main recommendations with respect to monetary and exchange rate policy are: (1) for the highest priority to be given to efforts to reduce the interest rates, (2) for a policy of more exchange rate flexibility to be adopted to promote international competitiveness. This recommendation is also associated with the effort to reduce the interest rate, (3) adoption of inflation targeting in place of the current approach of base money management, and (4) central bank independence. Of these four recommendations, it can be seen that only the fourth one represents institutional change, the others being essentially a matter of policy change.

In the narrow pursuit of the specific objective of price and exchange rate stability, the BOJ's operations can be judged to be relatively successful. Indeed, Zahler has observed that,

> [T]he authorities have improved the instruments and the operational indicators used to implement monetary and exchange rate policy. In fact, both policies,

while not following a clear cut analytical model, have been adequately designed and applied towards the objective of lowering inflation. Furthermore, the relationship and interaction between BOJ and the market participants can be assessed as good.

Consequently, the BOJ achieved success, through the exercise of tight monetary policy, in reducing the inflation rate from an average of about 40 percent in the first half of the 1990s to single-digit rates since 1997. In addition, it is possible to link the highly impressive growth of net international reserves in the 1990s, following nearly two decades of negative net stocks, to the combination of tight monetary policy and the elimination of foreign exchange controls.

The successes achieved with respect to inflation reduction and reserve accumulation have come with a high level of collateral damage. The main adverse effect has been the exorbitantly high real interest rates as a result of tight monetary policy combined with fiscal deficits, which have helped to choke off investment and growth. The need for sterilization as a result of the foreign capital inflows that gave rise to the reserve accumulation also contributed to the interest rate increases. Another major drawback has been the added fiscal burden of sizable BOJ losses incurred in the open market operations conducted to control the money supply and maintain exchange rate stability.

With respect to the overall macroeconomic situation, a major event in the mid-nineties was the financial sector crisis which the Government responded to by protecting depositors to the tune of 40 percent of GDP. This financial sector rescue operation was responsible for a large increase in the debt stock and debt burden and aggravated the adverse combination of high interest rates, fiscal deficits and low growth. Issues related to the financial sector crisis are addressed in the section on the financial system.

A major controversy affecting the monetary policy is the assumption by the BOJ of a high pass-through of external shocks to prices via the exchange rate. Consequently, a cornerstone of BOJ policy has been the need to keep the exchange rate stable as part of

the pursuit of price stability. This has led the BOJ to take a rather cautious position with respect to interest rates, raising it whenever the value of the currency comes under attack. In fact, this approach has been a major contributor to difficulties experienced in attempting to reduce the interest rate. The assumption of a high pass-through has been questioned by Zahler on the grounds of research which suggests a low pass-through in economies in a similar condition to Jamaica, i.e., where economic activity is depressed and inflation is low. Zahler therefore supports the recommendation that the BOJ should more aggressively encourage interest rate reduction, even if depreciation results, in order to promote international competitiveness and investment growth.

The path of inflation in 2003 seems ironically to vindicate both positions. The Jamaican Dollar depreciated by around 20 percent in the first half of the year but, while the inflation rate has increased, it has not been the run-away inflationary response that might have been feared[3]. It may be concluded that the pass-through is, indeed, significant but modest at this time. The modest pass-through can be explained by the fact that the economy is operating with substantial excess capacity after years of negative and sluggish growth. Another factor that should not be underestimated is the announcement by the Government of its determination to intervene and support the exchange rate and the credibility that has been built up around the government's commitment to a stable exchange rate on the basis of its policy in recent years. In addition, one must take into account the strong reserve position at the beginning of the year in giving credibility to such an announcement.

On the question of central bank independence, the proponents would argue that this would ensure that monetary policy is de-linked from fiscal policy and prevent the temptation to monetize fiscal deficits. On the other hand, it could be argued that in a country like Jamaica with such a strong parliamentary tradition, it is proper for the authority responsible for monetary policy to be an elected official like the Minister of Finance who is answerable to Parliament. Moreover, BOJ independence sets up the

[3] The exchange rate was actually depreciated by 34 percent between January and May before a slight rally in June.

possibility of conflicting policy mixes rather than promoting policy consensus. It is interesting to note that in the current Jamaican experience, it is not the BOJ that is building up claims against the Central Government, but virtually the reverse as the BOJ suffers quasi-fiscal losses in the execution of monetary policy.

Besides, a crucial question is the extent to which there is effective coordination between the monetary and fiscal authorities to ensure that conflicts do not develop between the narrow pursuit of price stability objectives and the promotion of economic growth. In the final analysis, the appropriate design of central bank independence should take these considerations into account, ensuring full accountability through Parliament and adequate coordination to promote growth. Zahler has drawn attention to different models of central bank independence including 'instrument independence' where the Central Government sets the policy and the central bank is independent with respect to its implementation. In the context of Jamaica and the urgency of promoting growth, the appropriate model to follow would appear to be along these lines.

On the question of inflation targeting, this is clearly a matter of policy rather than institutional design. The likely efficacy of inflation targeting compared to base money control in achieving inflation objective without inhibiting growth is, in the final analysis, an empirical question. However, to the extent that it is adopted, it may have implications for institutional design insofar as it calls for greater transparency in the form of regular announcements of inflation targets and greater public access to information about monetary outcomes.

III. THE JAMAICA FINANCIAL SYSTEM

The financial sector crisis that occurred in Jamaica in the mid-nineties has thrown into focus the issues of management and supervision of the sector and created an impetus for significant change. The analysis of Naranjo And Osambela clearly indicates that the Jamaican financial system has been characterized by major weaknesses, with respect to management, supervision and the financial safety network. As part of the rehabilitation

of the sector following the crisis, significant steps have been taken to strengthen its institutional foundations but there is room for further institutional improvements to be made. The institutional changes required for improved functioning of the financial system are less policy oriented than those considered in the previous two sections and, consequently, they are less controversial. The need for effective supervision and other safeguards is widely recognized and the international standards and principles generally accepted. The improvements called for are therefore largely a matter of design and implementation. Perhaps the only significant contentious issue is the question of independence of supervisory bodies from the political directorate.

The financial sector crisis erupted against the background of a liberalization of the sector in the early 1990s which caused it to expand phenomenally in terms of numbers of institutions and asset values. However, this expansion outpaced the development of an adequate supervisory framework. The increased competition by this glut of institutions encouraged aggressive risk-taking, neglect of prudential restraints, maturity and currency mismatches of asset and liability structures, connected party lending above recommended levels and other unadvisable practices. In addition, the existence of opportunities for regulatory arbitrage and tax advantages encouraged the formation of conglomerates for which the supervisory institutional set-up was not geared. Finally, the environment of overall economic stagnation and high interest rates contributed to deteriorating portfolio quality and an eventual vicious cycle. As things grew worse, the conglomerates became channels for contagion and a widening crisis.

Below we discuss a number of areas in which institutional improvements are recommended by Naranjo And Osambela.

Information transparency

Information transparency is a vital necessity if market forces are to work effectively in the financial sector. The maximum availability of information will improve the competitive environment in the financial sector, contributing to sound investment and credit decisions by all agents in the market. Moreover, this competitive environment can be expected to be reflected in narrower interest-rate spreads. To this end, it is recommended that disclosure of financial statements by institutions should be increased and that the BOJ should publish more statistical reports providing more risk analysis about the financial system in user-friendly formats regularly. In addition, it is argued that a credit bureau should be established to help inform decisions with respect to credit risk. The supervisor of the financial institutions should have the power to impose sanctions for "creative accounting" in financial statements. Information transparency should also be encouraged in the non-financial firms that are customers of financial institutions. There should be greater pressure for acceptable accounts registers with respect to the firms' activities to be kept. A general regulatory and incentive environment that is consistent with the promotion of formality should be built up.

Corporate governance

The need for improvements to corporate governance practices applies to both financial sector institutions and non-financial firms that are their customers. With respect to non-financial firms, the main challenge is to improve the availability of good accounting information in order to strengthen credit risk assessment and facilitate the credit granting process. This is linked to strengthening general compliance with formal economic practices and requirements. Naranjo And Osambela propose a two-pronged approach to achieving this, i.e., on one hand, simplifying regulations and otherwise improving the environment to discourage informality, and on the other hand, applying pressure through regular mandatory audits.

With respect to financial institutions, Naranjo And Osambela address practices of board members, their responsibilities, issues of audit and internal controls, conflict of interest, etc. They comment on the common occurrence prior to the financial sector crisis of board members sharing executive responsibilities in the corporation or being members of other boards. In a small country such as Jamaica, some of this overlapping responsibility may be unavoidable and the response to this problem has inevitably to be tailored accordingly. The answer may involve limiting rather than prohibiting some of these practices, in terms of the number and nature of the firms where persons can be board members, combined with stricter requirements with respect to information availability and accountability. These issues are being addressed as part of a Technical Cooperation Program being developed with IMF and IDB assistance.

Supervision autonomy

A major recommendation with respect to the supervisory framework for financial institutions is for greater autonomy. At present, both bank supervision, carried out by the BOJ, and non-bank supervision, carried out by the newly established Financial Services Commission, are subject to oversight and intervention of the Minister of Finance. Naranjo And Osambela recommend that supervision should be carried out by an autonomous and independent institution, fully dedicated to supervision and not subject to political interference. The case for autonomy with respect to supervision is stronger than the case for independence of the central bank with respect to monetary and exchange rate policy because of the specialized, executive nature of the supervisory activities. Although there has been significant progress in strengthening the autonomy of the financial supervision under the Financial Sector Reform Program supported by the IDB, CDB and World Bank, there is considerable room for increased autonomy. A list of ministerial powers that Naranjo And Osambela argue should be devolved to the supervisory bodies is provided in Box 1.

BOX 1

I. Main Ministerial Duties under the Banking Act

Minister may:

- draw up regulations in general

- define the scope of banking business, approve institutions, receive applications for banking licenses, authorize use of the word "bank" in a name, and also revoke such approval, vary the minimum capital requirement for a bank to get a license, approve ownership of bank by foreign government in excess of 5% of issued shares, as well as the exercise of any voting powers by such government in excess of 5%, approve agreements for transfer of control of a bank and grant conditional approvals (section 20 & 21), take temporary management, revoke the license, or present a petition for winding up a bank and direct bank where persons notified to him not fit and proper.

- request information

- vary ratio of deposit liabilities and other indebtedness to capital base, grant approval and set conditions for a bank to hold fixed assets of an amount in excess of its capital base, specify that capitalized structure may be paid on a bank's shares without including expenditure to purchase goodwill, vary the percentages applicable to permissible levels of lending outlined in section 13(1)(f), extend the time for disposal of lands held in excess of fixed assets limits, determine other assets which will qualify as "liquid assets", also prescribe the percentage of prescribed liabilities which money at call or short notice will meet, prescribe amounts and bases for calculating proper levels of loan loss reserves .

- draw up provision for the extension of credit in excess of statutory limits where facility secured by cash, other resources of the borrower or a guarantee approved by BOJ, approve the form of returns for BOJ and extend time for filing return.

- appoint a borrower company for a credit facility to qualify as "specified" and approve it

- **restrict Supervisor** from exercising powers of obtaining undertakings, issuing directions or cease and desist orders

- require disposal of shares in a local bank acquired (in breach sections 20 & 21), apply to the Supreme Court for an order for the sale or transfer of specified shares

- notify bank in writing of intention to make vesting order, and acquire powers of the directors and managers

- pursue transactions to restructure the bank including sale of shares and/or subordinated debt, amalgamation of the bank, sale or assumption of liabilities, any other transactions for the purpose of restructuring. He must also publish a notice in the Gazette specifying the date of completion of such transactions

Consolidated Supervision

It is recommended that major economies can be gained by consolidated bank and non-bank financial supervision in place of the present arrangement where bank supervision is carried out by a Department of the BOJ and supervision of insurance, securities (and pensions) is the responsibility of the Financial Services Commission. Among the economies that can be gained, Naranjo And Osambela draw attention to savings with respect to *coordination costs* and *redundant costs*. Coordination costs arise from the need for the bank supervisor and the FSC to exchange information especially for purposes of supervising conglomerates of financial institutions to reduce contagion effects and regulatory arbitrage possibilities. This coordination is provided for at the present time by a memorandum of understanding between the supervisory bodies and a Regulatory Policy Council. It is argued that a single body would be able to carry out these functions more effectively and at lower costs.

Redundant costs relate to activities and expenditures that are common to and currently duplicated by both the Bank supervisor and the FSC. These areas include administration, infrastructure and research activities. In particular, efficient supervision that is forward-looking with respect to risk assessment and information dissemination will require a considerable on-going research capability that could be more efficiently carried out in one institution. Indeed, the existence of such a facility might encourage the strengthening of the research capability and dissemination of relevant financial information in order to improve credit conditions generally.

Recognizing the complexities involved in moving from the present structure to a consolidated supervisory structure, Naranjo And Osambela recommend a staged process for the establishment of the consolidated structure, starting with the design of the regulatory framework, through generation of information on the types of risks to be faced, to the definition of capital requirements and concentration limits for related lending in a consolidated basis.

Resolution mechanisms

Naranjo And Osambela observe that the financial institutions resolution legislation of Jamaica is relatively well developed. One weakness which emerged in the financial crisis was, however, that capitalization by FINSAC was carried out before the losses of the financial institutions being intervened were written off. It is recommended that resolution mechanisms should follow the underlying principle of concentrating the losses of a financial institution in difficulty on the group that generated them in the first place, ensuring that shareholders become the first affected by a government intervention.

Financial crimes and the judicial system

An important part of the investment climate in Jamaica is the question of crime and the existence of effective measures to address the situation. In the context of the financial sector, the main concerns are securities fraud and money laundering. With respect to the judicial system, there is the question of the availability of adequate resources to investigate and prosecute financial crimes and an adequate framework to protect creditors. Given the fact that the judicial system as a whole is overwhelmed as a result of inadequate resources and the pressure of serious crimes such as murder, judicial processes with respect to less serious crimes can be subject to serious delays. Recent efforts to strengthen the financial system included the formation of a special Financial Crimes Unit within the Police Force and the Commercial Court as a specialized branch of the Supreme Court. Nevertheless, the problem of adequate resources remains an issue and steps still need to be taken to accelerate recovery proceedings for collateral and to strengthen the protections for creditors.

Risk management

Naranjo And Osambela recommend a general reorientation of financial sector practices and supervision to emphasize risk assessment and management. At the present time, bank supervision, for example, is organized in terms of on-site versus off-site teams. Naranjo And Osambela propose that the appropriate arrangement would be supervision

by regulated institution (Commercial Banks, FIA Licensees, Building Societies) and type of risk (credit risk, exchange risk, etc.). They also suggest that the implementation of such a system could start with regulation by institution, making the specialization by risk over a period of time. This is a worthwhile suggestion because it would also permit a period of experimentation and adaptation in order to arrive at the precise specializations that are appropriate for Jamaica.

Naranjo And Osambela propose several kinds of risk that need to be addressed specifically in the case of Jamaica, including:

- Credit risk: in this regard, it is noted that provisions are backward-looking and therefore sub-optimal. It is recommended that an effort be made to estimate future expected risk and provision accordingly.
- Exchange rate risk: there is no regulation of exchange rate risk in the current legislation. This omission is defended on the grounds that foreign currency loans are only granted to exporters. However, as a practical matter, foreign currency lending has grown rapidly in recent years and its growth appears to be exceeding the performance of exports, suggesting some vulnerability.
- Liquidity risk: it is recommended that the Jamaican financial system should address the question of liquidity risk, establishing minimum liquidity levels to prevent the system from becoming excessively vulnerable during times of sharp liquidity reduction. This would appear to be a significant prudential measure, especially in the context of current tight monetary policies.

CONCLUSIONS

On the basis of theoretical criteria and by comparison with other developing countries, the institutional framework for macroeconomic policy appears to be reasonably sound in Jamaica. The budgetary institutions and monetary and exchange rate systems, though displaying some weaknesses, have sound legislative frameworks, are reasonably well equipped in terms of the tools necessary and appear to have competent management. Major weaknesses are to be found in the tax system and the supervision and intervention framework for the financial system. However, regarding the latter, it is arguable that, prior to the financial sector crisis in the 1990s, the system was not worse than those of other countries in the region, and the rehabilitation and reform efforts following the crisis have strengthened the system substantially.

Against the background of this general assessment of the institutional framework, the question arises as to why macroeconomic instability persists in the form of high interest rates, inflation and debt and the sluggish growth of the economy. In general, this paper advances the view that the quality of the institutional framework should not be analysed in isolation from the socio-economic environment. In this regard, it is arguable that the weaknesses of the institutional framework may have been obscured by the approach of isolating the different policy areas, which is a matter of analytical convenience. For example, it is arguable that the persistent weaknesses of the tax system throws into question the perceived strengths of the budgetary system viewed in isolation.

In addition, there are a number of other factors that are worth considering. A major issue is the lack of social consensus on economic policy, reflected in the sometimes violently confrontational conditions surrounding the Budget presentation. One stumbling block for macroeconomic adjustment resulting from this is the difficulty in achieving a harmonious resolution of how the burdens should be shared by the major social groups. Consequently, while Jamaica has signed on to a long series of structural adjustment programs in the last two decades, the follow-through to full implementation has not been steady (see Annex I). In addition, there are issues with respect to the pace and

sequencing of reform execution which some argue were inappropriate in the early 1990s and contributed to the financial sector crisis. A second consideration is the high degree of informality in Jamaica reflecting an atmosphere of non-compliance with formal institutions, which tends to weaken the impact of policy interventions. Recent studies of the informal sector in Jamaica have estimated its size at 40-45 percent of the measured GDP. A third consideration is the adverse social environment highlighted by the high incidence of violent crime which presents a major obstacle for investment and business activity, generally. This is a significant deterrent to investment through the additional security costs imposed on firms, creates a dangerous environment that is a deterrent to education and adds to health sector spending. A fourth factor is the investment climate represented by public sector regulations and the procedures for starting up new investments. Evaluations of Jamaica's investment promotion framework relative to those of other developing countries has been mixed. However, it is evident that there is room for improvements in this area that could contribute to higher investment.

The question that remains relates to the areas of action that would be recommended in order to address the weaknesses that have been identified. With respect to the financial systems, a number of recommendations may be highlighted, despite the significant improvements achieved since the mid-1990s. The tax system needs major overhaul to reduce the exemptions and unevenness of tax treatment in order to promote efficient resource allocation and equity. In the budgetary area, more needs to be done to extend the oversight with respect to borrowing to the public enterprises. With respect to monetary and exchange rate policies, the main challenge is to adopt a policy framework that will lead to a sustained reduction of interest rates in line with regional averages. Inevitably, such a policy framework would mean having to compromise on the defense of exchange rate stability as a priority objective. In the area of supervision of financial institutions, much strengthening of the institutional framework has been achieved in recent years but the reform agenda has not been exhausted yet. Financial supervision could be strengthened by consolidation of bank and non-bank supervision and by allowing the supervisory body to be more independent of the political directorate.

These recommendations specifically with respect to the financial systems need to be supported by several practical changes. Mechanisms for greater transparency and access to information on the part of all parties in the financial system would strengthen the institutions and help to forestall the recurrence of a financial sector crisis. Going hand-in-hand with this step is the need to strengthen accountability in order to facilitate credit decisions. The level of compliance with formal institutions and practices needs to be increased through simplification of procedures and other measures to address the informal sector. This would permit, for example, the reduction of tax burdens in some areas with loss of revenue by increasing the tax base. More resources are needed to support efforts to fight financial crime through training of members of the Financial Crimes Unit, and to facilitate the operations of the Commercial Court so that resolution of credit disputes and contract enforcement could be expedited. Inevitably, these proposals will depend on the allocation of resources for different inputs to the reform process including training of the relevant personnel and the generation of important information on the financial system through research.

Chronology of Multilateral Supported Programs and Events

July 1977	IMF Stand-by Agreement
Dec.1977	World Bank Program Loan
1978	Devaluation, unification of exchange rates
May 1978	IMF Extended Fund Facility (EFF)
May 1979	World Bank second Program Loan
March 1980	Negotiations with IMF broken off.
Oct. 1980	JLP led by Seaga elected
April 1981	New IMF EFF agreement
Feb.1982	World Bank Stuctural Adjustment Loan 1 (SAL I)
1983	Foreign Exchange Auction Market introduced.
March 1983	IMF waiver
June 1983	World Bank SAL II
Sept. 1983	IMF EFF canceled
June 1984	IMF Stand-by Agreement
July 1984	Paris Club Classic Debt Treatment
Nov. 1984	World Bank SAL III
Dec. 1984	IMF waiver to conditions
April 1985	IMF waiver
May 1985	World Bank SAL III release of 2nd tranche - some conditions waived
June 1985	IMF Stand-by completed (first IMF program fully disbursed)
July 1985	New 21 month IMF Stand-by
July 1985	Paris Club Classic Debt Treatment
Sept. 1985	PM Seaga asks for joint IMF, IBRD, USAID team to examine economy
May 1986	Report of Tripartite Mission
May 1986	Government rejects Report reforms - Stand-by canceled; rescheduling with commercial banks stopped; Bank lending suspended.
Fall 1986	Dialogue resumed. Government implements some of the recommendations
1987	World Bank and Government agree on Medium Term Economic Framework Paper, which became the basis for future loans
Jan.1987	IMF 15 month Stand-by
March 1987	Paris Club Classic Debt Treatment
June 1987	World Bank lending resumed: Public Enterprise Sector Adjustment Loan, Trade and Financial Sector Adjustment Loan, loans for Second Sugar Rehabilitation, Population and Health, and Fourth Power
Sept. 1988	Hurricane Gilbert caused extensive damage, hurt all segments of economy, and led to rapid expansion of budget deficit. IMF Standby
Dec.1988	World Bank Emergency Reconstruction Import Loan
Oct. 1988	Paris Club Classic Debt Treatment
Feb.1989	PNP led by Manley returned to power. Fiscal deficit increased.
May 1989	IMF Stand-by suspended.
March 1990	World Bank Agriculture Sector Adjustment Loan; IMF Stand-by;
April 1990	Paris Club Classic Debt Treatment

June 1990	**IDB Agriculture Sector Adjustment Loan (ASAL) (JA0097)**
Feb. 1991	**IDB Country Programming Paper (CPP)**
March 1991	World Bank Trade and Financial Sector Adjustment Loan II
May 1991	**IDB Socioeconomic Report and Country Strategy Brief**
July 1991	Paris Club Houston Debt Treatment
Sept. 1991	**IDB Trade, Finance and Investment Sector Loan (TFISL) (JA0019)**
Sept. 1991	Exchange rate effectively floated. Devaluation of more than 60%
March 1992	PM Manley retired for health reasons, replaced by Patterson
May 1992	World Bank Medium Term Policy Framework Paper
Dec. 1992	IMF EFF
Jan. 1993	Paris Club Houston Debt Treatment
March 1993	Elections: PNP led by PM Patterson reelected.
March 1993	World Bank first Country Assistance Strategy (CAS1)
June 1993	World Bank Private Sector Development Adjustment Loan
Jan. 1995	**IDB first Country Paper (CP1)**
Dec. 1995	Final review of EFF left incomplete
Jan. 1996	Agreement with IMF on tighter fiscal policy, etc.
March 1996	IMF EFF concluded
Sept. 1996	Joint WB/IMF/IDB missions (financial sector diagnostic)
Jan. 1997	FINSAC established to clean up financial institutions
July 1997	Government borrowed US$200 million from international capital markets
Dec. 1997	Elections: PNP led by PM Patterson reelected
Dec. 1997	Government borrowed US$100 million from Citibank
June 1998	**IDB second Country Paper (CP2)**
July 2000	IMF Staff-Monitored Program agreed upon
Sept. 2000	**IDB Financial Sector Loan (FSL) (JA0049)**
Nov. 2000	World Bank second Country Assistance Strategy (CAS2)
Dec. 2000	World Bank first Financial Sector Loan
Oct. 2001	**IDB Social Safety Net Reform (JA0115)**
Dec. 2001	World Bank Emergency Economic Rehabilitation Loan