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BETTER OFF WITHOUT THE IMF?
THE CASE OF JAMAICA**

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RESPONDING TO FINANCIAL CRISIS: BETTER OFF WITHOUT THE IMF? THE CASE OF JAMAICA

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Summary

The adverse economic and social effects of the financial crises that have afflicted many developing countries in recent years, have highlighted the need to develop a policy response which addresses the vulnerability of financial systems to systemic instability and crisis. The paper examines the experience of Jamaica, a country which successfully managed a financial sector crisis during the 1990s, without the assistance or involvement of the IMF. Lessons are drawn from the Jamaica case study for the reform of IMF support to developing countries in managing financial sector instability and crisis.

Key words: financial sector crisis; financial sector policy; IMF; Jamaica.

1 Introduction

The financial crises that have swept across many developing countries in recent years have been a painful reminder that market failure is endemic to financial markets (Stiglitz, 1994). Largely unforeseen, these crises have imposed severe economic and social costs on the affected economies and threatened the stability of the international monetary system. The recurrence of financial crises in the developing world, and the adverse effects which they have had on economic growth, have highlighted the need to develop a policy response which addresses the vulnerability of the financial system to systemic instability and crisis.

The international financial institutions (IFIs) have been heavily involved in formulating the developing countries' policy response to financial crisis, as sources of both external financial support and prescriptive advice. The International Monetary Fund (IMF) in particular has played a central part in the IFI's contribution to financial crisis resolution in developing countries, both in its traditional role of providing short-term balance of payments finance and in its more recent role as provider of longer-term development finance.

The Fund's involvement in managing the Asian financial crisis of 1997 has provoked a strongly contested discussion as to the appropriate policy response to systemic financial crisis. This debate has gone on within the Fund itself, between the Fund and its major partner, the World Bank, and among the wider international research and policy communities (IMF, 1999b, 2000b; Stiglitz, 1998, 1999).¹ The Fund's policies of closing troubled financial institutions and concentrating on restoring stability in the foreign exchange markets by raising interest rates, have been widely criticised as further weakening public confidence in

the financial system, and damaging the social capital and political stability upon which economic recovery and growth depend.

The perceived failure of the IMF in managing recovery from the Asian crisis has stimulated a wider and more fundamental debate on the future role of the IMF within the overall international financial architecture. Some critics of the Fund have argued that the Fund should 'return to basics', concentrating exclusively on its traditional role of providing short-term balance of payments support to stabilise the economy and preventing outflows of foreign exchange reserves, which would require the IMF to abandon its more recently assumed role of providing longer-term adjustment finance intended to strengthen the supply side of the economy.

This paper speaks to both these issues, by providing a detailed case study of the government's policy response to financial crisis in Jamaica in the 1990s. Prior to the 1990s, Jamaica had a long and often troubled history of involvement with the IMF. By the early 1990s, however, Jamaica had met its outstanding commitments to the Fund and decided to avoid further engagement with the IMF, if possible. Jamaica provides, therefore, a particularly interesting (and atypical) case study of a developing country which managed the crisis in its financial sector during the 1990s without IMF assistance or involvement.

The remainder of the paper focuses on Jamaica's response to, and management of, its financial crisis. It will be argued that the outcomes of the measures adopted in addressing the crisis were superior to what might have been the outcome if the standard 'Asian financial crisis' IMF prescription had been adopted instead. The lesson drawn will be that crisis management programmes, as with any form of economic policy management, are more likely to succeed if they draw on the national stakeholders' expertise and knowledge of the particular structural characteristics, past experience and political economy of the affected economy.²

There are a further five sections to the paper. The next section describes the evolution of Jamaica's financial sector, and outlines the anatomy of the crisis. Section 3 discusses various explanations of the crisis, and Section 4 provides a detailed examination of the Jamaican government's response to the crisis. Section 5 evaluates its response using a counterfactual based on a hypothetical IMF response. The final section summarises the general lessons that can be drawn from the Jamaican experience.

2. ANATOMY OF THE JAMAICAN FINANCIAL CRISIS

Jamaica, a relatively small island of 2.5 million people, is known more for its music and beaches than for its financial prowess. However, the Jamaican financial system has been growing and developing to keep pace with the changing domestic and international environments. As part of structural adjustment loan agreements with the World Bank, economic reform in Jamaica has been aimed at integrating the domestic economy into the global economy (McBain, 1997: 132). This has included the liberalisation of the financial sector, and has resulted in the growth in the number of financial institutions operating in the island and in the range of financial services being offered. The banking and insurance services are now major sectors of the Jamaican economy, and are regarded as exemplars of the country's open, free-market policies.

However, the rapid expansion of Jamaica's financial sector between 1991 and 1997 exposed significant problems within the banking and insurance sectors, as evidenced by capital shortages and asset quality problems at several financial institutions. Since 1993, the Minister of Finance has placed 12 financial institutions under temporary management and intervened in 10 financial institution groups, which includes banks, insurance companies and non-core businesses.

The evolution of the financial sector in Jamaica has been very similar to that in much of the developing world, particularly South East Asia, having undergone five distinct phases in its development – pre-liberalisation, liberalisation, post-liberalisation/pre-crisis, crisis and post-crisis.³

Pre-Liberalisation

Jamaica went through a period of strong financial repression in the 1970s to mid-1980s characterised by strong public sector leadership, government involvement in the operation and development of financial institutions, bureaucratic controls on entry, and the dominance of commercial banks in the financial intermediation process (Peart, 1995: 3).

Firm control over the financial system was part of the government's attempt to adhere to policies agreed with the IMF under stabilisation programmes, focused on constraining the growth of money supply and achieving a market-determined exchange rate. Credit controls and high reserve requirements were used to contain demand (McBain, 1997: 145). Additionally, the central bank administered a minimum savings deposit rate which was an important determinant of the overall level and structure of interest rates, and was used as a tool to reduce domestic demand. Supplementary measures such as preferential interest rates and central bank rediscount financing to priority sectors were also implemented (Peart, 1995: 6).

The effect of financial repression in Jamaica was adverse. At the end of 1989, the real savings rate for commercial bank deposits was only 0.8 per cent and by the end of 1990, this position had worsened to -11.8 per cent (Bank of Jamaica, 1999: 52 and 107). This had adverse implications for the rate of growth in domestic savings, and thus on the amount of funds available for investment. Financial repression also led to a dualistic financial sector, particularly through the prevalent 'partner system' and various money lending schemes. Furthermore, inefficiency in the financial sector was rife, as credit ceilings and directed credit contributed to allocative inefficiency. Relatively large interest rate spreads and low competition within the banking system exacerbated this inefficiency.⁴

Liberalisation

Attempts at financial liberalisation in Jamaica took place in two clearly defined stages. The first phase of liberalisation was between 1986 and 1988 as part of a structural adjustment loan agreement with the World Bank. The principal objectives of the financial reform programme were the creation of an environment conducive to efficient financial intermediation, and the strengthening of the central bank's ability to influence money and credit variables (Lim, 1991: 6). The reform of interest rate policies, and the development of the money and capital markets were two key areas of focus at the time (Peart, 1995: 7).

This initial attempt at financial liberalisation involved the removal of credit controls, and the phasing out of the statutory reserve requirement of commercial banks, which had traditionally been used as a means to finance the fiscal deficit. The privatisation of the National Commercial Bank, a major commercial bank, was also initiated in 1986. Additionally, there were attempts to reform the interest rate policy. First, the central bank introduced a market determined interest rate instrument (the CD) to facilitate its open market operations and second, the savings deposit rate was linked to a market determined interest rate – the average weighted term deposit rate of the commercial banks.

In 1989, following the onslaught of Hurricane Gilbert, this financial reform programme was interrupted. The government was forced to re-impose the statutory reserve requirement and credit ceilings, and to increase the savings deposit rate. This was in response to growing bank liquidity, caused by the reinsurance inflows and increased government expenditure associated with the rehabilitation effort (Lim, 1991: 37; Peart, 1995: 12).

The second, accelerated phase of financial liberalisation started in Jamaica in late 1990 to early 1991. In accordance with IMF targets, the central bank removed the ceilings placed on banking system credit, and announced the unification of the cash reserve and liquid assets ratio. Savings rates were totally deregulated, with the commercial banks now being authorised to set their own rates. At about the same time the foreign exchange system was liberalised. Jamaica began dismantling exchange rate controls in 1990 and had formally abolished all remaining controls by 1992. Since then, the exchange rate has been determined by market conditions and the movement of foreign exchange in and out of the country is unrestricted.

Post-Liberalisation/Pre-Crisis

The rapid liberalisation of the 1990s led to significant changes in the financial landscape. In the post-liberalisation era, there was rapid asset expansion and deepening within the financial sector, with the operations of commercial banks and NBFIs increasing significantly. By the end of 1997, the assets of the commercial banks represented 50 per cent of the total assets of the financial sector. Of this amount, three large banks accounted for 75 per cent (Stennett et al., 1998: 11). Additionally, the number of NBFIs increased from 8 in 1985 to 25 in 1993, with their assets increasing in nominal terms from J\$1.4 billion in 1986 to J\$11.4 billion in 1993 (Peart, 1995: 15).

There was also the emergence of large financial conglomerates during this period. They were mainly created by insurance companies to take advantage of the financial arbitrage provided by the existence of differential cash reserve requirements, and differences in the level of supervision over the various sub-sectors of the financial system (Green, 1999: 4). These large conglomerates were usually composed of a merchant bank, a commercial bank, a building society, an insurance company and other business firms. They often had complex structures of inter-company share holdings, interlocking boards of directors, common management and extensive inter-group transactions (Stennett et al., 1998: 12). Following liberalisation, these new entities expanded aggressively, venturing not only into more innovative financial activities, but also stretching beyond the boundaries of prudent financial practices into investment in real sector activities. These conglomerates often engaged in the acquisition and operation of agricultural enterprises and tourism ventures (Green, 1999: 13). Due to the interlocking nature of these so-called “One-Stop Financial Supermarkets”, the risk of contagion was high, and the entire sector became vulnerable to financial instability.

The rapid expansion of lending to the private sector was also a feature of the post-liberalisation era. Green (1999: 4) notes that there was an unsustainable credit boom in which loans and investments were made without proper risk assessment or appropriately valued collateral. The private sector's allocation of banking system credit increased markedly throughout the period, moving from J\$2.9 billion in 1985 to J\$21.5 billion in 1993. A particularly worrying feature of this expansion was the rate of growth in consumer-oriented credit relative to credit for productive activity.

One of the reasons for this credit boom was the inflow of capital associated with the liberalisation of the foreign exchange regime, as a result of which foreign currency deposits in Jamaican banks and NBFIs increased significantly (Green, 1999: 4). Commercial bank balances grew by 55 per cent from 1993 to 1995, and those of merchant banks grew by over 200 per cent in the same period. Foreign currency loans also increased by over 100 per cent each year between 1992 and 1994 (McBain, 1997: 146). However, also associated with foreign exchange liberalisation was a rapid depreciation in the exchange rate, which moved from US\$1.00=J\$7.90 at the end of September 1990 to US\$1.00=J\$27.38 by the end of March 1992. This slide in the currency pushed inflation to over 80 per cent for fiscal year 1991/92 (Stennett et al., 1998: 7).

Following the dramatic expansionary period of the early 1990s, the fortunes of the Jamaican financial sector changed rapidly by the mid 1990s. This was evidenced by a number of factors. Private sector credit which grew by almost 70 per cent in 1993, slowed significantly to 25 per cent in 1996 and actually declined in 1998. The profitability of the sector was also declining, with a reduction in the return on assets of commercial banks. There was also a deterioration in the banking system's capital base - whereas the international standard for capital adequacy is set at 8 per cent, in 1995 most Jamaican banks were below 3 per cent (Green, 1999: 21).

The problems in the Jamaican financial sector were further reflected in the high level of non-performing loans (NPLs). NPLs as a percentage of total loans in commercial banks grew from 7.4 per cent in 1994 to 28.9 per cent in 1997. There was also evidence of a high level of problematic related-party loans, a large percentage of which were associated with the relationship between insurance companies and their related commercial banks (Green, 1999: 21-22).

Finally, the Jamaican financial institutions, especially the insurance companies, were plagued by the mismatch of assets and liabilities. In the early 1990s, the life insurance industry entered into the aggressive marketing of short-term and equity-linked products, by offering high rates of return. Imprudent investment of these short-term savings in long-term assets, mainly real estate, resulted in illiquidity problems for the life insurance industry and by contagion, the affiliated commercial banks, when the equity market collapsed in 1992 and policyholders sought to encash their policies. The illiquidity problems associated with these encashments were too much for the troubled Jamaican financial sector to bear, and the full onslaught of the crisis was felt in 1997.

Crisis

The crisis in the Jamaican financial sector was severe, although not accompanied by a currency crisis. It started because of illiquidity problems in the life insurance industry, which

were precipitated by the downturn in the real estate and stock markets. These problems quickly spread to affiliated commercial banks, which were then forced to turn to the central bank for liquidity support. In 1995 one commercial bank received J\$4.0 billion in liquidity support, and in 1996 approximately J\$6.0 billion was given to two other banks. As the problems in the sector became more evident, there was a “flight to quality” within the domestic financial system. Depositors withdrew their savings from what were perceived to be weak institutions, mainly indigenous with local managers, and deposited these funds with branches of foreign banks (Green, 1999: 24). This necessitated government intervention. Beginning in 1993 the Ministry of Finance has had to place 12 financial institutions under temporary management, and has intervened in 10 financial institution groups.

Post-Crisis

The Jamaican government’s initial response was to close the distressed institutions. However, as the problem was seen to be more extensive than at first estimated, a new strategy was developed to avert a collapse of the system. A study was done to evaluate the extent of the problem, and a number of fast-track items of legislation were introduced to strengthen the regulatory framework (Green, 1999: 4). Also, two institutions – Financial Institutions Services Limited (FIS) and the Financial Sector Adjustment Company Limited (FINSAC) were created by the government to facilitate the resuscitation of the failed banks and to proceed with the restructuring and reorganisation of the financial sector. The operations of FIS were subsequently merged with FINSAC. As at January 2000, the total cost of FINSAC’s intervention in the financial sector amounted to J\$106.9 billion (Government of Jamaica, 2000: 47).

3. THE CAUSES OF THE JAMAICAN FINANCIAL CRISIS

It has been shown that financial sectors are more vulnerable to crises following liberalisation. Demirguc-Kunt and Detragiache (1998a: 303) note that over the past 30 years many countries have liberalised their financial systems. However, “during this period, the frequency of systemic banking problems has increased markedly, raising the possibility that greater fragility might be a consequence of liberalisation” (Pleskovic and Stiglitz, 1998: 6). Stiglitz (1998) more directly states that, “theory would predict that financial market liberalisation preceding the development of adequate regulatory capacity is likely to lead to an enhanced likelihood of a financial crisis.” There are numerous reasons for the increased vulnerability of financial systems to crises following liberalisation, most of which have been clearly evidenced in the Jamaican crisis.

Liberalisation increases banks’ opportunities to take on risk as once interest rate ceilings and credit controls are lifted, banks can finance riskier ventures in exchange for higher promised returns. While this may result in the increased funding of socially desirable projects, “banks in newly liberalised systems are likely to be particularly vulnerable because the skills needed to screen and monitor risky borrowers, (and) manage risky loan portfolios... can be acquired only gradually through learning by doing” (Demirguc-Kunt and Detragiache, 1998a: 306).

Second, financial liberalisation also engenders mechanisms that facilitate increased moral hazard. One such mechanism involves agency conflicts, which arise because of informational imperfections. A key imperfection of information is the asymmetric distribution of information, with insiders (the bank owners and managers) having an informational advantage over outsiders (their depositors and other creditors). This leads to

agency conflicts between depositors and banks because depositors are unable to perfectly monitor and therefore control the decisions of banks, and between debtors and creditors because of the fixed value nature of contracts. Agency conflicts give bank equity holders the incentive to gamble with their depositors' money in order to maximise the value of their equity, knowing that with limited liability, their own losses cannot exceed their equity. Liberalisation, which facilitates increased risk-taking, heightens the probability of the occurrence of agency conflicts, thus leading to decreased managerial prudence, greater financial fragility and often precipitating financial crises.

Third, moral hazard may increase with the erosion of bank franchise value once ceilings are lifted on deposit interest rates and entry barriers are reduced. Because increased bank competition causes monopolistic profits to disappear, the costs of losing a banking licence when the bank becomes insolvent decrease and incentives to take on riskier loans increase.

Fourth, rapid balance sheet growth can also contribute to financial crises following liberalisation (Llewellyn, 1998: 257). Such growth, which can also result from the abolition of interest rate ceilings and credit controls, almost inevitably involves banks incurring more risk and becoming more vulnerable. The reasons for this include, *inter alia*: the tendency for control systems to weaken in periods of rapid balance sheet growth; the unwarranted optimism which is generated by growth; and the likelihood of unbalanced portfolios when new lending opportunities are concentrated in a narrow range of business sectors.

Fifth, financial liberalisation may also lead to temporary liquidity shortages, when interest rates are more volatile. This in turn may necessitate government intervention of some form which increases moral hazard (Stiglitz, 1994: 27). Thus, inappropriate risk-taking and heightened financial fragility again increase as a result of financial liberalisation.

The actualisation of these theoretical arguments has been clearly evident in Jamaica. As outlined in section 2, following the second, accelerated phase of financial liberalisation, risk-taking by financial institutions increased significantly. This was evidenced by the deterioration in the quality of the rapidly expanding loan portfolios, and the exceedingly high levels of NPLs. Instances of financial imprudence due to inexperience, over-work of loan staff, agency conflicts between managers/owners and depositors, unwarranted optimism in the economy or in particular sectors, innovative but risky attempts to maintain market share, related-party transactions, managerial overspending, and the perception of government guarantees, are numerous. The rapid growth in the financial sector, induced by liberalisation, placed pressure on the management of financial institutions and on the supervisory authorities, and thus exposed managerial and legislative inadequacies, which in turn contributed to the liquidity and solvency problems that later emerged (Stennett et al., 1998: 22).

In a liberalised financial system, the government plays an important role in regulating the system and in establishing the corrective incentives to encourage prudential and productive behaviour (Brownbridge and Kirkpatrick, 2000; Caprio and Honohan, 1999). However, in Jamaica, such incentives were undermined for several reasons. Insider transactions were rife due to crony capitalism and the existence of large conglomerates. The interconnection of financial institutions and between financial institutions and the corporate sector exacerbated the regulatory problems, as the transparency of relations and the accuracy of information could not be guaranteed. Consequently, transactions were being shifted between member

companies of the same corporate group, thus allowing, *inter alia*, the group to determine where losses were to be located.

In addition to these adverse incentives, it is widely acknowledged that the regulatory and supervisory systems in Jamaica had numerous weaknesses in the post-liberalisation period.⁵ Although reforms to the financial legislation and supervisory systems were implemented in the post-liberalisation period, the manner of implementation was found wanting in many respects. A commonly cited example is the excessive flexibility given to bank managers when classifying and provisioning for loan losses. An amendment to the Banking Act in 1992 made it mandatory for commercial banks to make provisions for NPLs six months and over, however, it was only in 1996 that loans past due for three months were classified as non-performing. Consequently loan loss provisions in Jamaica were inadequate to provide cover against likely losses, which meant that earnings and capital levels were overstated. If capital levels had been accurately computed, banks would have had to restrain the rapid growth of their lending, or raise new capital, in order to maintain compliance with the capital adequacy requirements, and as such would have been less vulnerable to financial distress (Brownbridge and Kirkpatrick, 1999: 17).

It is also acknowledged that even where effective regulations were in place, they were often not properly enforced. This was caused by inadequate supervisory capacity in the central bank, and also by restrictive legislation limiting the ability of the Minister of Finance to intervene in distressed institutions.⁶

4. GOVERNMENT RESPONSE TO THE CRISIS AND ITS CRITICS

In this section we describe the government's response to the crisis, and identify the main criticisms that have been made of it. The response has progressed in two distinct phases – an initial response followed by a reassessment of the situation and a change in *modus operandi*.

The Government's Initial Response

The Jamaican government's initial response to the crisis was relatively straightforward and was not complicated by the exigencies of having to deal with the simultaneous occurrence of a currency crisis. In 1994, numerous weaknesses were uncovered in a group of financial institutions called the Blaise Financial Entities (BFEs). When these problems were fully revealed, it was noted that the institutions were insolvent and plagued by a co-mingling of assets and liabilities and high levels of related-party loans. In December 1994, the government intervened and placed the BFEs under Temporary Management while a Scheme of Arrangement was developed. In a decision that completely shaped the rest of the government's crisis management efforts, it was announced that the BFE's 3,800 depositors would be fully protected by the government, and were to be reimbursed the full amount of their deposits (J\$972.1 million). The payment to depositors was financed by budgetary allocations, and an Executive agency – FIS – was incorporated in October 1995 primarily to implement the provisions of the Scheme of Arrangement. FIS was also mandated to pursue recovery of all assets of the BFEs in order to minimise the burden on the budget, and pursue civil litigation against former directors and shareholders of the institutions deemed responsible for their demise (Davies, 1998: 1).

Due to this comprehensive intervention by the government, relative calm was restored to the Jamaican financial sector until July 1995, when the problems of another financial

conglomerate – the Century Financial Entities (CFEs) – were made public.⁷ The government placed the CFEs under Temporary Management in July 1996 and again decided to protect the CFEs' 43,000 depositors, at a cost to the public sector of approximately J\$10 billion. This decision was taken by the government both to protect the depositors immediately affected, and more importantly, to maintain the public's confidence in the local financial sector. The government's resolve was, however, tested by a run on another commercial bank in October 1996. Its management, however, was able to withstand the pressure and avoid an overdraft at the central bank. The Minister of Finance and the Bank of Jamaica quickly moved to restore confidence by reassuring the public of the soundness of the financial system and the government's support of it (BOJ, 1996).

During this time, the government did not change either its monetary or fiscal policies in response to the emerging crisis. From as early as 1991, the government pursued tight demand management policies with the aim of reducing a burgeoning inflation rate which reached 80 per cent in 1991. Interest rates were consistently high (average savings and lending rates reaching their maximum levels in 1994, 19.3 per cent and 66.9 per cent respectively), but as inflationary expectations were dampened, interest rates were gradually reduced. Consistent with such demand management policies, the government maintained an increasing fiscal surplus from 1991/92 to 1994/95, which was then allowed to decrease (BOJ, 1999: 100).

Thus, it is evident that the Jamaican government maintained its composure in responding to the initial onset of the financial crisis. Depositors were protected, the public's confidence was restored, and fiscal and monetary targets were maintained. This, however, was at a high cost to the public purse, for the benefit of a relatively small proportion of the population. Critics complained of the poor taxpayers having to "bail-out" the rich. The government was criticised for not intervening in the distressed institutions sooner, and for not exercising greater vigour in prosecuting the persons responsible for their collapse. Another more fundamental criticism focuses on the issue of moral hazard. Many critics argued that the government's actions in guaranteeing the deposits in the failed entities created the perception by all depositors and institutions that they were similarly protected. This fostered greater incentives for risk taking and imprudence by both savers and lenders.

Comparison of the much-publicised IMF response in South East Asia to that of Jamaica, adds another dimension to the argument. It is evident that one of the major differences in response in the two regions relates to the issue of public confidence. The IMF gave explicit directives to close banks and financial institutions without protecting depositors which severely eroded the public's confidence in the financial system, and worsened the extant financial panic (Bullard et al., 1998: 88, 94; Hahm, 1999: 133; Radelet and Sachs, 1998: 53, 62). This had dire consequences not only on the financial sector, but also on the real economy, causing severe social hardships (Kregel, 1998: 59; Nixson and Walters, 1999: 498). These consequences were largely avoided in Jamaica, because the government assumed the responsibility of protecting depositors and thus maintained public confidence. This bound the government however, to an immensely costly course of action once the true depth of the crisis was revealed.

The Government's Response as the Crisis Deepened

In July 1996, representatives of the life insurance industry approached the Jamaican government and requested assistance to address problems that had emerged in that sub-sector,

and had spilled over into the commercial banking sector. The Minister of Finance asked a team of specialists to determine the extent and nature of the problems in the financial sector, and to develop appropriate solutions. The team recommended that the government intervene in the sector in a comprehensive manner, addressing the problems of illiquidity and insolvency, as well as problems related to weak management, the structure of ownership and control, and the regulatory framework (Davies, 1998: 2-3).

The Jamaican government established FINSAC in January 1997 to undertake these functions. Upon its formation, FINSAC embarked upon a three-phased course of action to be completed over its expected five to seven year life span. The phases are known as intervention, rehabilitation and divestment (FINSAC, 1998: 12).

Intervention usually involved FINSAC “stepping in” to assist troubled institutions with an injection of capital. In exchange, FINSAC acquired a combination of equity, board seats and other assets. Occasionally, FINSAC’s intervention has taken the form of take over and/or closure, but such actions are last resorts reserved for deeply distressed institutions. When this has happened, FINSAC took on the deposit liabilities of the intervened institution and placed matching funds in replacement accounts at a stable institution. This was done so as to ensure that depositors have uninterrupted access to their deposits. This is all funded by government-guaranteed securities. This phase left FINSAC with equity and/or board seats in four of the island’s nine commercial banks, five of its twelve life insurance companies, and two merchant banks (Davies 1998: 3).

Following intervention, FINSAC proceeded to the rehabilitation phase. Intervened banks are relieved of their bad loans so that they can focus on their own rehabilitation (FINSAC, 1999: 20). Additionally, the entities are required to strengthen their credit evaluation systems and loan portfolio management, and to implement improved internal accounting controls (Davies, 1998: 4).

As part of the rehabilitation phase, FINSAC also attempted to restructure the financial sector through mergers and closures as appropriate. At the end of June 1999, Union Bank Ltd. was created as a result of the merger of three commercial banks and two merchant banks. FINSAC also assisted the country’s largest commercial bank (NCB), by providing financing of J\$19.5 billion and facilitating the development of a plan for the bank’s rehabilitation (FINSAC, 1999: 14). Similar activities took place in the life insurance industry, where FINSAC facilitated the sale of the combined portfolios of three life insurance companies, and transferred the management of their pension schemes to two major, viable life insurance companies.

The government also focused its attention on regulatory and supervisory reform. A Task Force was established to examine the existing legislation, with a view to strengthening the rules and standards governing the financial sector. As a result of the recommendations of the Task Force, key amendments to the legislation came into effect in October 1997.⁸ Additionally, the Deposit Insurance Act was passed in March 1998, to establish a scheme for the protection of depositors.

FINSAC’s third and final phase – divestment – involves the return of the real estate, shares and businesses acquired by FINSAC, to private hands. The intention is to both maximise the selling price of its assets, and to ensure that the resultant configuration of the financial sector is optimal. As at December 1999, FINSAC had sold J\$6.6 billion of assets, and sales of

assets valued at a minimum of J\$4.1 billion were expected to be conducted in the following six to nine months (Davies, 1999: 2-3).

This, however, falls far below the government's total expenditure on the restructuring of the financial sector. At the end of February 2000, FINSAC had total debt (principal plus interest) of approximately J\$108 billion. About J\$38 billion was owed to other government agencies, and the remaining J\$70 billion was owed to third party creditors. While means of clearing the intra-public sector debt are relatively easy to decipher, the issue of solving the third party obligation remains a major concern.

This has been one of the main criticisms of the Jamaican response to the financial sector crisis. Most commentators agree that the government's intervention was necessary, and have supported, for the most part, FINSAC's *modus operandi*, but have expressed concern about the cost of the intervention. Chen-Young (1998: 10, 14) notes that, "there is no doubt that FINSAC's intervention in the financial sector was vital, if late, and that it helped to restore confidence and stability", (but) "the FINSAC debt... could (represent)... approximately two-thirds of GDP, more than triple that in Indonesia (20 per cent), six times that in Thailand (10 per cent), and nearly five times that in Mexico (14.4 per cent). Public sector debt is now a matter of grave concern..."

Chionesu (2000: 11) further argues that, "the stability of the Jamaican economy and the financial sector... are threatened by a burgeoning public debt... Growth of the debt stock and servicing demands have enlarged the public deficit to the point where the existing stock cannot be serviced by current tax revenues." The prospect of medium term public insolvency (as indicated by an estimated debt-GDP ratio of between 130 per cent-140 per cent, inclusive of net FINSAC obligations) raises the question of the capability of the economy to service additional debt, with implications for the financial sector's stability given the public debt exposure of numerous financial institutions.

5. WHAT IF? A STUDY OF THE COUNTERFACTUAL

Section 4 provided a detailed account of the Jamaican financial crisis and the government's response to it. This section attempts to develop an ex-post evaluation of the impact of the policies that were adopted in response to the crisis. An effective measure of the impact of a policy response is to compare performance under that response to the 'counterfactual'.⁹ Such measures define the effectiveness of the policy response as the difference between the actual macroeconomic performance observed consequent to the policy response, and the performance that would have been expected in the absence of such a response (Goldstein and Montiel, 1986: 305). However, the counterfactual cannot, by definition, be observed and must be estimated or approximated. This section develops a hybrid method of estimating the hypothetical counterfactual to the Jamaican government's actual response, which is used to explore the consequences of the alternative response which was available to the Jamaican government, namely, to request IMF assistance.

The Simulated With-Without Approach

The approach adopted first assumes that market forces could not be relied on to resolve the problems of the Jamaican financial sector, and that some form of government intervention was necessary. Thus, a counterfactual to the Jamaican government's response was developed by creating a hypothetical IMF programme in response to the financial crisis. The actual

effects of the Jamaican government's response will therefore be compared to the simulated effects of the hypothetical response, so as to obtain an estimate of the impact of the government's response. The results of the simulated with-without approach are summarised Table 1. The analysis is divided into five key areas: the financial sector, other structural concerns, monetary policy, fiscal policy and financing the responses. Columns a, b and c of the table summarise the findings of previous sections, and columns d and e briefly outline the hypothesised IMF response and the expected effects. The comparison of columns c and e will allow conclusions to be drawn about the impact of the Jamaican government's response.

A strict adherence to the traditional with-without approach was rejected. This approach would have entailed a comparison of the consequences of the Jamaican response to the effects of the IMF programmes in Thailand, Indonesia and Korea (the control group of countries assumed to be the counterfactual). However, the differences in the external and macroeconomic environments of these two regions, particularly the capital flight and currency crisis which affected South East Asia but which were absent in Jamaica, make this approach unsuitable. Similarly, the traditional use of the comparison-of-simulations approach was rejected because of the desire to avoid the problems inherent in developing complex econometric models.

However, principles from both methodologies were utilised in developing the hybrid. The principle of comparing the consequences of an actual policy response with the simulated effects of a 'modelled' response was adopted from the comparison-of-simulations approach. While, from the with-without approach, the comparison of the experience in South East Asia with Jamaica, when appropriately modified, proved to be feasible in developing the simulated IMF response and consequences. The simulated with-without approach draws heavily on the experiences in Thailand, Indonesia and Korea, in addition to the IMF's public statements with respect to the Jamaican financial crisis. However, this hybrid model is inevitably more qualitative and subjective than other approaches, reflecting the authors' judgement and interpretation of events.

Table 1: A Counterfactual Assessment of Jamaica's Policy Response to Financial Crisis

Conditions Prior to Response (a)	With: Actual Scenario		Without: Hypothesised IMF Scenario	
	Policy Response (b)	Effect (c)	Policy Response (d)	Effect (e)
<p><u>The Financial Sector</u></p> <ul style="list-style-type: none"> - Rapid expansion of financial sector following liberalisation. - Emergence of large financial conglomerates, which diversified out of core business and were plagued by 	<ul style="list-style-type: none"> - Initially liquidity support provided through the central bank. - The government intervened in the distressed institutions usually through capital injections, in exchange for 	<ul style="list-style-type: none"> - Relative calm was maintained within the financial sector. Apart from a 'flight to quality' within the domestic system, there was no wholesale financial panic, 	<ul style="list-style-type: none"> - Initially, immediate closure/suspension of troubled institutions, without arrangements to protect depositors. - Eventual moderation of stance, with more focus placed on 	<ul style="list-style-type: none"> - Loss of public confidence in the financial sector, financial panic, and international capital flight. - Crippling of the domestic financial system, and

Conditions Prior to Response (a)	With: Actual Scenario		Without: Hypothesised IMF Scenario	
	Policy Response (b)	Effect (c)	Policy Response (d)	Effect (e)
<p>connected party transactions.</p> <ul style="list-style-type: none"> - High levels of NPLs. - Declining profitability in the sector. - Deterioration in the banking system's capital base. - Mismatch of assets and liabilities. - Liquidity problems in the life insurance and banking industries precipitated by the imprudent over-investment in real estate and equity, and the subsequent collapse of these markets. - Impending panic within the domestic financial system, as problems within numerous institutions were revealed. 	<p>equity, board seats and assets.</p> <p>Occasionally institutions were closed.</p> <ul style="list-style-type: none"> - deposits were protected, and repeated assurances were given as to the government's support of the financial system. - A financial restructuring agency – FINSAC was created to aid in the restructuring of the sector. - Creation of 'good bank/bad bank scenario' to relieve banks of NPLs. - The consolidation and rationalisation of the sector through mergers, closures, and sale to overseas entities, as appropriate. - Regulatory and supervisory reform. - The divestment of equity and assets acquired by FINSAC to the private sector. - Attempts to prosecute and pursue civil action against those responsible for the demise of the institutions. 	<p>nor international capital flight. The relatively smooth operation of the financial sector was preserved, as depositors' confidence in the system was bolstered.</p> <ul style="list-style-type: none"> - Possible moral hazard, which may have fostered greater incentives for risk taking and imprudence by savers and lenders. (Attempts to avoid this in the future include the creation of a Deposit Insurance Scheme). - Leaner, more efficient financial sector. - Improved regulatory and supervisory structure. - Exposure of numerous financial institutions to the perceived threat of public debt insolvency. 	<p>recapitalisation of institutions, and restoration of public's confidence.</p> <ul style="list-style-type: none"> - Restructuring of the industry to proceed in a manner similar to that under FINSAC's mode of operation (see column b and chapter 4). 	<p>consequent credit crunch.</p> <ul style="list-style-type: none"> - Contraction in economic activity. - Pressure placed on the currency because of the capital flight, either resulting in a depreciation of the exchange rate, or constrictive corrective measures by the government. - Social unrest as the public reacts to the loss of deposits. - Impact following change in IMF's stance positive but slow, with FINSAC's task being more difficult and costly, because of IMF's initial mistakes.

Conditions Prior to Response (a)	With: Actual Scenario		Without: Hypothesised IMF Scenario	
	Policy Response (b)	Effect (c)	Policy Response (d)	Effect (e)
<p><u>Other Structural Concerns</u></p> <ul style="list-style-type: none"> - Inclusion of non-financial businesses within financial conglomerates 	<ul style="list-style-type: none"> - Restructuring of the financial sector to focus on dismantling such financial conglomerates. - Progress made in other structural reforms, including privatisation and trade liberalisation. 	<ul style="list-style-type: none"> - Financial institutions forced to revert to a concentration on core business. - Economy increasingly being operated on market principles. 	<ul style="list-style-type: none"> - Dismantling of financial conglomerates. - Increased pace of privatisation and trade liberalisation efforts. - Rationalisation of the public service. 	<ul style="list-style-type: none"> - Similar to column c, except that Jamaican government expected to take more moderate stance than the IMF when required.
<p><u>Monetary Policy</u></p> <ul style="list-style-type: none"> - High interest rates resulting from tight demand management policies. However, interest rates gradually trending downwards as inflationary expectations are dampened. 	<ul style="list-style-type: none"> - No significant change. 	<ul style="list-style-type: none"> - Even throughout the crisis, inflation has remained within the single-digit target. - Inflationary expectations are being dampened, as evidenced by wage demands. - Exchange rate stability maintained. - Criticised as being detrimental to economic growth, which has been declining since 1996. 	<ul style="list-style-type: none"> - High interest rate regime to be maintained, with marginal increases in interest rates to aid in the stabilisation of the currency (necessitated by IMF induced capital flight). 	<ul style="list-style-type: none"> - Similar to column c, except that Jamaican government expected to take more moderate stance than the IMF, if necessary.
<p><u>Fiscal Policy</u></p> <ul style="list-style-type: none"> - In line with monetary policy: Increasing fiscal surplus till 1994/95. Allowed to decrease 	<ul style="list-style-type: none"> - Fiscal position moved from a surplus to a large deficit in response to, <i>inter alia</i>, the 	<ul style="list-style-type: none"> - This was seen to have been necessary to aid in offsetting the cost of the financial 	<ul style="list-style-type: none"> - Immediate significant fiscal tightening expected. - Measures to 	<ul style="list-style-type: none"> - A further contraction in economic activity. - Increased

Conditions Prior to Response (a)	With: Actual Scenario		Without: Hypothesised IMF Scenario	
	Policy Response (b)	Effect (c)	Policy Response (d)	Effect (e)
in 1995/96 as demand management policies were relaxed	<p>financial crisis.</p> <ul style="list-style-type: none"> - Fiscal position expected to worsen in future years, as the cost of FINSAC's operations is gradually integrated into the budget. - Efforts at fiscal consolidation were undertaken in 1998/99, including measures to strengthen tax administration and to reduce nonwage primary current expenditures and capital outlays. 	<p>restructuring, without creating undue social hardships.</p> <ul style="list-style-type: none"> - The enormity of the fiscal deficit necessitates that further tightening measures will have to be taken. This may have adverse impacts on the country's growth and development aspirations, and involve increased social hardships. 	<p>include: elimination of general consumption tax (GCT) exemptions, increases in the rates for GCT, personal and corporate income tax, and increases in nonfuel excises.</p> <ul style="list-style-type: none"> - Expenditures to be cut by rationalising the public sector. - Stance eventually moderated, with a relaxation of fiscal targets. - Social Policy instituted. 	<p>poverty.</p> <ul style="list-style-type: none"> - Increased hardships for the poor as basic food, educational and health necessities are taxed and become more expensive. - Increasing unemployment, specifically within the public sector, with very little prospects for reemployment in a contracting economy. - Social upheaval, with dire consequences for tourism, and precipitating further capital flight. - Change in stance, has little immediate effect (too little, too late), but in the long run results in the creation of social safety nets.
<p><u>Financing the Responses</u></p> <ul style="list-style-type: none"> - Not applicable. 	<ul style="list-style-type: none"> - Generally, Government-guaranteed 	<ul style="list-style-type: none"> - This means of financing is expensive, as the 	<ul style="list-style-type: none"> - Large official financing package from the IMF. 	<ul style="list-style-type: none"> - This means of financing is almost

Conditions Prior to Response (a)	With: Actual Scenario		Without: Hypothesised IMF Scenario	
	Policy Response (b)	Effect (c)	Policy Response (d)	Effect (e)
	securities were issued.	interest payments are high, and demanding, as most of the government's creditors are local and international private sector individuals and firms. This makes the possibility of debt-relief and rescheduling more unlikely. - As noted above, this represents a major cost to the Jamaican economy, creating a large, worrying debt overhang, which may act as an impediment to future economic growth.		immediate, low-cost, and flexible (with debt-rescheduling being more of an option than with private lenders). - The nature of IMF's conditionalities increased the amount of funds required to restore stability to Jamaican financial sector.

The Hypothesised IMF Response to the Jamaican Financial Crisis

The hypothesised IMF response to the Jamaican financial crisis and the simulated effects are based on two key assumptions. First, it is assumed that the IMF programme would have commenced subsequent to the deepening of Jamaica's financial crisis, that is, in mid to late 1996. This means that the IMF would be in the initial phase of its response to the South East Asian crisis. Based on the IMF's track record, and on the obvious similarities between the two crises, it is reasonable to assume there would be significant commonalities between the two programmes. Second, it is assumed that the Jamaican government implements all the IMF's conditionalities. As reflected in Table 1, the IMF's response is hypothesised to have focused on the following key areas:

?? The Financial Sector

The immediate closure/ suspension of numerous troubled institutions was an integral part of the IMF's initial response to the SEA crisis (Bullard et al., 1998: 88, 94; Hahm, 1999: 1333). Such measures were seen as being necessary to "...arrest further deterioration and signal the

governments' resolve..." (Hamann and Ghattas, 1999: 69). The hypothesised IMF response in Jamaica includes a similar proviso and the simulated effect is based on Radelet's and Sachs' (1998: 62) 'logic of creditor panics', and is evidenced by the consequences in South East Asia. It is expected that the closure of financial institutions in the absence of arrangements to protect depositors, would lead to wholesale financial panic in Jamaica. There would be international capital flight, and even the local branches of foreign institutions would be undermined by the lack of confidence shown by the IMF and the government in the entire financial sector. As in SEA, the domestic financial system would be damaged, and the real economy would be adversely affected by the consequent credit crunch, leading to a further contraction in economic activity. Also, international capital flight would put a strain on the currency, leading to a significant depreciation in the exchange rate, or alternatively, to constrictive corrective measures by the government. Furthermore, the Jamaican public, especially in light of the previous protection of the Blaise and Century depositors, would react adversely to the loss of deposits and social unrest is probable.

However, it is also assumed that as the IMF learned from the SEA crisis, such knowledge would be applied in Jamaica.¹⁰ An eventual moderation of this initial stance is theorised, with a shift in focus from bank closures, to the recapitalisation of weak institutions, and the issuance of government guarantees for bank liabilities.¹¹ Also, based on the IMF's validation, it is assumed that FINSAC, with its three-pronged approach would be a feature of the IMF's moderated response.

As in SEA, the simulated effect of this change in stance by the IMF is positive, but slow, reflecting the damage already done to the public's confidence in the financial sector. FINSAC's task is made more difficult, and the cost of restructuring is magnified.

?? *Other Structural Concerns*

An increasingly popular theme in all IMF programmes is the focus on structural reforms.¹² Generally, these reforms are aimed at reducing government-imposed distortions and other structural and institutional rigidities that impair the efficient allocation of resources and hinder growth (Mussa and Savastano, 1999: 22). In SEA, "the structural reform strategy in the programmes was exceptionally comprehensive" (Lane, 1999a: 18), and incorporated a wide range of policies beyond the immediate financial crisis, including trade liberalisation, demonopolisation and privatisation (Radelet and Sachs, 1998: 67).

It is assumed that similar reforms would be insisted on in Jamaica. This is justified by the fact that even while lauding the government's recent efforts at privatisation and trade liberalisation, the IMF was calling for an increase in the extent and pace of the reforms, with a comprehensive reform of the public sector being advocated (IMF, 1999a: 19). The simulated impact of such reforms is, however, not as large as in SEA, as the Jamaican government was already positioned to make these changes, and thus the pressure on the government (as highlighted by Radelet and Sachs, 1998: 67-68) would not be as great.

?? *Monetary Policy*

IMF stabilisation programmes typically require a tightening of the country's monetary policy (Mussa and Savastano, 1999: 21). In SEA interest rates were raised sharply to restore stability to foreign exchange markets (Camdessus, 1999). However, in Jamaica, interest rates were already high due to anti-inflationary measures. While some increase would be expected

to aid in the stabilisation of the currency (necessitated by the IMF-induced capital flight), it is hypothesised that the IMF would not have much scope for significantly changing Jamaica's monetary policy in the immediate post-crisis period.

?? *Fiscal Policy*

The same cannot be said of the country's fiscal policy. It is assumed that the IMF would attempt to make up for its lack of leverage over monetary policy, by a significant fiscal tightening. Such proclivity is implied in the IMF's 1999 Staff Report, where it is suggested that in order to facilitate an easing of the monetary policy, a large fiscal adjustment should be pursued. Furthermore, if fiscal tightening was required in SEA, where the fiscal positions were strong relative to Jamaica, it seems reasonable to assume that similar measures should be included in the hypothesised response, even if only for "covering the prospective...costs of financial sector restructuring" (Lane, 1999a: 18).

Thus, it is assumed that the IMF would require a significantly reduced fiscal deficit. Measures to achieve this would include: elimination of most general consumption tax (GCT) exemptions, increases in the rates for GCT, increases in the personal and corporate income taxes, and increases in nonfuel excises. Also, expenditures would be cut by, *inter alia*, rationalising the public sector, particularly in the health and education sectors (IMF, 1999a: 16,18,19).

The impact of such measures would be severe. In SEA there is now general consensus that the IMF's fiscal objectives were too tight (IMF, 1999b), and had a contractionary impact (World Bank, 1999: 57). In Jamaica, the consequences would be magnified, as, in contrast to SEA, the economy was already experiencing a recession in 1996. Any further contraction in economic activity would push numerous households over the poverty line, worsened by the fact that inflows of foreign capital and remittances, which previously acted as a cushion against the impact of poverty, would be depleted because of the domestic financial panic.

Furthermore, many of the measures suggested by the IMF (1999a: 16,18,19) to reduce the fiscal deficit, would directly affect the poor. For example, the exemptions on the GCT are placed on staple food products and basic educational and health necessities. Removal of these exemptions would price these goods out of the range of the poor. Reducing the size of the public sector, while being necessary, would also create social hardships if pursued in a period when unemployment is increasing (because of the large-scale rationalisation in the financial sector, and the economic contraction), and when many of these public servants would have lost all of their savings in failed institutions. These conditions, combined with the politically sensitive move to increase the income tax, would create an environment ripe for social unrest and upheaval, especially as public demonstrations and riots have been a feature of Jamaica's history. This in turn creates a recessionary cycle, as such social unrest would have an immediate and disastrous impact on one of Jamaica's major industries – tourism, and would precipitate further international capital flight.

Again, although it is theorised that the IMF would respond to these negative results by eventually relaxing its fiscal targets and implementing social policies (Radelet and Sachs, 1998: 60), it can be argued that as in SEA, these actions would be too little, too late. The only positive long-run benefit that could reasonably be expected from this sequence of events is the institutionalisation of social safety nets, which would aid in sheltering the poor from the adverse effects of future economic crises (Camdessus, 1999).

?? *Financing the Response*

It is only in this last area of focus that a clear advantage of seeking the IMF's assistance is evident. The SEA economies benefited from very large official financing packages from the IMF, and as is usually the case, other multilateral and bilateral funding followed (Lane and Schulze-Ghattas, 1999: 20; Radelet and Sachs, 1998: 49). In Jamaica, due to the difference in magnitude of the crises, the financial support would not need to be as large, but was needed just as much. Financial support from the IMF would have the advantage of being almost immediate (consequent on the meeting of conditionalities), low-cost, and flexible (with debt rescheduling being more of an option than with private lenders). However, it can also be argued that the nature of the IMF's response increased the amount of funds required to restore stability to the Jamaican financial sector.

To conclude, comparing the effects of the Jamaican government's response (table 1, column c), to the counterfactual – the simulated effect of the hypothesised IMF response (table 1, column e), indicates that in all areas of concern, except that of financing the policy response, the impact of the former was less harmful than that of the latter.

In the financial sector, relative stability, even with the risk of increased moral hazard, is preferable to wholesale financial panic and collapse, with the consequential adverse effects on the real economy. In the area of fiscal policy, although a growing deficit with the need for substantial future tightening is a cause for concern, it again seems preferable to the economic contraction and social upheaval envisioned under the IMF response. In the case of monetary policy and other structural issues, although not much difference was predicted, it is expected that the Jamaican government would tend to take a more gradualist position when necessary, than the IMF. Finally, with regards to financing the response, it is evident that whereas IMF financial support would be preferred to private finance, this would have been accessed only at considerable social cost to the Jamaican economy and society by adhering to the attached conditionalities. It is concluded, therefore, that the Jamaican government's response to the financial crisis was superior in terms of its economic impact, to that of the IMF.

6. CONCLUSION AND LESSONS TO BE LEARNT FROM THE JAMAICA CASE STUDY

Any research on financial crises quickly reveals the lack of consensus among academics, policymakers and the wider public about the critical issues relating to the fundamental causes of, and appropriate responses to, financial crises. However, if policymakers are to be more effective in responding to such crises, the pool of knowledge on the nature of financial crises must be broadened. Crises from various regions around the world must be researched and analysed in an attempt to develop a better understanding of the way in which policies for avoiding and recovering from such crises can be fashioned to meet the particular features and conditions of the affected economy. This study of Jamaican experience has attempted to do just that, by showing how the relative success of the Jamaican government's response to financial crisis was due in large measure to the formulation of policies which were appropriate to the financial sector's structure and history and to the broader social and economic context of Jamaican society.

Although there has been no resolution to the debate about the appropriate responses to the financial crisis in Jamaica, a number of tentative general principles for recovery can be derived.

The first principle relates to the government's approach to intervention in distressed institutions in a period of financial panic. The Jamaican experience reflects the need for the government to adopt an approach aimed at restoring the public's confidence. The use of public resources for bank restructuring and protection of deposits is usually necessary, but should be complemented by strong incentives against future moral hazard. Typically, this should include writing off bad debt against the capital of existing shareholders, replacing bank management, and otherwise ensuring that those who benefited from earlier risky behaviour bear a significant part of the cost of restructuring (World Bank, 1999: 94-95).

Secondly, the creation of institutions to carry through financial restructuring, such as FINSAC, is advisable. Strong, independent, public agencies, with the political and legal clout to implement difficult decisions are essential for successful financial restructuring. These agencies should be responsible for evaluating financial institutions, their portfolios, systems and management, and for restructuring the financial sector through mergers, closures, or other appropriate means.

The revision of legislation to strengthen prudential regulation and supervision of the financial sector is another vital complementary measure. Tightened loan classification and provisioning requirements, improved disclosure, accounting and auditing standards, limits on lending to shareholders and other connected parties, and strengthened rules to limit maturity and currency mismatches are all desirable. However, it must be remembered that the priority during periods of crisis is to keep credit flowing and to prevent the crippling of the financial system. As such, banks should be given appropriate leniency during the crisis to meet these regulatory standards (Stiglitz, 1999: 418).

Experiences both in Jamaica and other regions (importantly in South East Asia) have also highlighted the important linkages between the financial sector and the real economy, and the spin-off effects that a financial crisis can have on economic growth and development. Consequently, an important element of recovery is the focus on the reduction of social hardships. This should include ensuring food security, maintaining the purchasing power of vulnerable households, and maintaining economic and social services for the poor, including spending on education and healthcare (Stiglitz, 1999: 423-424). This will all require significant expenditure by the government, and implies an expansionary rather than contractionary fiscal policy.

These principles are admittedly very general, and intentionally avoid the contentious, unresolved issues in the debate. Nevertheless, they provide useful guidelines for recovery from future crises. It is, however, important to note that this analysis has focused solely on the principles for recovering from a crisis, and has not considered the equally, or perhaps more important, question of how to prevent such crises.¹³

The Jamaican case study also has a number of general implications for the broader debate on the role of international financial institutions in financial crisis. It is widely agreed that large injections of finance are needed to aid in the recovery from financial crises. For developing countries, the first source of assistance will be the IMF, acting in its traditional role of provider of short-term adjustment assistance. This is likely to be followed by longer-term

financial assistance from the Fund (and the other IFIs), under the Fund's Poverty Reduction and Growth Facility (previously the Enhanced Structural Adjustment Facility, ESAF).

For many developing countries, IMF assistance has failed to make a significant contribution to a sustained recovery of the financial sector and economic growth. Conditions have often aimed at a rapid balance of payments recovery, failing to allow for the supply side constraints which must be eased for economic recovery to occur. Indeed, misguided policy may make recovery more difficult if it damages the social capital or political stability upon which long-term economic growth depends, and fails to put in place the medium-term measures that are needed to build up the supply of both governance and physical output (Mosley, 2000b: 37-38).¹⁴

This should not, and need not be the case. The IMF and other international financial institutions no longer have a monopoly on economic expertise, and are not immune to poor diagnoses and recommendations. Many developing countries have the economic, technical and financial expertise, the knowledge of their own economy, and the commitment to reform, which are needed for effective policy formulation and implementation. The IMF needs to continue its financial support for countries experiencing financial crisis, but at the same time to work in partnership with national stakeholders to refine and develop its role to better reflect the realities of the policy environment in low-income economies.

Notes

- ¹ The differences between the IMF and the World Bank's Chief Economist at the time, is reflected in the titles of his contributions to the debate (Stiglitz, 1998, 1999).
- ² Mosley (2000a: 632 and 633) makes the same point with respect to development policy in general: "it is crucial to the argument that 'good policy' and 'bad policy' should be seen as *relative* to the economy's resources and state of development, and not as absolutes ... the design of both macro- and micro-policies in a developing country needs to be sensitive to a country's existing level of market and institutional development and its vulnerability to external shocks, as well as to its social and political objectives".
- ³ Tennant (2000) compares the financial systems and crises in Jamaica and South East Asia.
- ⁴ One example of this inefficiency is the excessive managerial expenses incurred by institutions throughout the Jamaican financial sector, with the ratio of employee remuneration to average assets 3.3 per cent over averaging the period 1991-1995, as compared to the United States benchmark of 1.6 per cent (Green, 1999: 23).
- ⁵ McBain (1997: 148) notes that the 'regulation of financial institutions ... has centred more on ensuring compliance with monetary and foreign exchange objectives than with prudential requirements'.
- ⁶ See Davies (1999) for a detailed description of regulatory inadequacies.
- ⁷ From as early as 1993, the government was aware of numerous weaknesses in these institutions. Impending illiquidity, imprudent credit and management practices, and the high levels of NPLs and related-party transactions are just a few of the problems that were reported. For years the central bank provided overdraft facilities to the group's commercial bank while the government took a conciliatory stance, trying to negotiate a resolution strategy with the CFE's management.
- ⁸ The legislation that came into effect in October 1997 provided for, *inter alia*:
 - ? more efficient and effective powers for remedial action taken by the supervisory authorities in respect of distressed institutions
 - ? reduced capacity for institutions to lend to, or invest in, related parties
 - ? a more stringent computation of capital adequacy
 - ? a more precise definition of NPLs and power for the supervisory authorities to prescribe accounting rules
 - ? greater control by supervisory authorities over changes of ownership and a stricter definition of a "fit and proper person" for management, directors and owners of financial institutions (Davies, 1998: 4-5).
- ⁹ The counterfactual is defined as "a comparison of *what is* versus *what would have been*" (Guitan, 1982: 99). Khan (1990) describes the four approaches that have traditionally been used to evaluate policy interventions, and have commonly been applied to IMF programmes – before-after approach, the actual-versus-target approach, the with-without approach and the comparison-of-simulations approach. Each of these approaches is associated with methodological problems.
- ¹⁰ This is based on Lane and Phillips' (1999: 27) concession with regard to SEA, that "the slowdown in economic activity was dramatically different from that assumed in formulating the programmes, and its magnitude, once appreciated, prompted revisions in economic policies".
- ¹¹ This is supported by the IMF's positive assessment of Jamaica's restructuring of the financial sector in its 1999 Staff Report (IMF 1999a:3).
- ¹² See Mosley (2000b) for a defence of this role of the IMF in developing countries.
- ¹³ On crisis-prevention policies, see Demirguc-Kunt and Detragiache (1998a, b), Caprio and Honohan (1999), Brownbridge and Kirkpatrick (2000).
- ¹⁴ Mosley (2000b) argues that the Fund has become more sensitive to these issues: 'The Fund has made major gains in recent years, in understanding of response-mechanisms within developing countries and in ability to meet the financial needs of a wider range of countries and constituencies'.

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