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Social and Economic Studies; Jun 2005; 54, 2; ProQuest Central
pg. 1

Social and Economic Studies 54:2 (2005): 1–27 *ISSN: 0037-7651*

FDI AND FINANCIAL SECTOR STABILISATION IN JAMAICA AND LATIN AMERICA*

ALVIN G. WINT, ARCHIBALD CAMPBELL AND LOU ANNE BARCLAY

ABSTRACT

This paper examines the role of foreign direct investment (FDI) in the stabilisation of financial sectors in Latin America and the Caribbean (LAC), with special reference to foreign investment and financial sector stabilisation in Jamaica. Much of the literature on foreign direct investment and development has examined its costs and benefits, particularly in relation to the impact of different types of FDI on development. This study continued that tradition by focusing on the role of FDI in economic stabilisation, which is a particularly important element in the development process for the countries of the LAC region, many of which have struggled for many years with levels of economic instability. The study concluded that foreign direct investment has played an important role in assisting countries within the region emerge from financial sector crises by improving micro-economic efficiencies, largely through the adoption of international prudential and operating standards. At the same time, improved micro-economic efficiency has yet to be translated into overall macro-economic efficiency as financial sectors in many LAC countries have yet to see significant improvements in the cost and availability of credit or the narrowing of intermediation spreads.

Foreign Direct Investment and Development

Since the post-World War II growth of the scholarly field of international business, much work has been done in terms of seeking to understand the circumstances under which FDI assists in the development process. This research has focused on the

* An earlier version of this paper was presented at a conference on FDI-Assisted Development in Oslo, Norway. The authors wish to thank participants at this conference, in particular Michael Mortimer who served as discussant, for their insightful comments. The authors also thank two anonymous reviewers for their useful comments.

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bargaining power of MNCs vis-à-vis host governments (Vernon 1971; Fagre & Wells 1982; Encarnation & Vachani 1985; Ramamurti 2001) and on the relative merits of different forms of FDI (Lall & Streeten 1977; Wells 1977; Wells 1986). Against the background of these analyses, of the three types of FDI most prevalent in developing countries, resource-seeking, market-seeking and efficiency-seeking, developing country governments have become most comfortable with efficiency-seeking FDI.

It is this type of FDI that has seemed to demonstrate the most favourable ratio of benefits relative to costs, because, to the extent that efficiency-seeking FDI is producing goods and services for world markets, it is unlikely for there to be a disjuncture between the private benefits to the investor and the social benefits to the country. Market seeking FDI that is sheltered from competition, on the other hand, provides a significant opportunity for dissonance between private and social benefits, with the possibility of private benefits being juxtaposed with social costs.

Resource-seeking FDI, some argue, is prone to be accompanied by social costs in the form of exploitation of economic rents, negative externalities in the form of pollution and the exacerbation of inequalities through dualistic economic structures. Consequently, governments of developing countries, in recent years, have been extending a particularly warm welcome to efficiency-seeking FDI, leading to intense competition among countries seeking to attract such investment, and a convergence among the policy and promotional environments of countries in pursuit of FDI (Wint & Williams 2002).

Recent trends in which developing countries are liberalising their economies, however, create the possibility of more nuanced approaches to understanding the role of FDI in the development process. In the presence of trade liberalisation and competitive domestic market structures, for example, the distinction between market-seeking and efficiency-seeking FDI becomes blurred. Developing countries are now also seeking FDI in areas such as infrastructure and domestic financial services, which were, until recently, off limits to foreign investors. An important issue is the extent to which FDI in these areas is contributing to the development process.

Thus, one approach to understanding the role of FDI in development is to examine the benefits of FDI in particular sectors.

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This is the objective of the research upon which this paper reports, which sought to examine the role of FDI in the financial sector of the Latin America and Caribbean (LAC) region, with a special focus on the role of FDI in the Jamaican financial sector.

Much of the focus on the links between FDI and development has been on FDI and growth, or FDI and technology transfer, or FDI and trade, or FDI and linkages or FDI and infrastructure. This study argues that an important approach to understanding the link between FDI and development is through a study of the relationship between FDI and stability, given the importance of stability to development, particularly in small countries (Wint 2003).

Clearly, a stable financial sector plays an important role in the overall stability of an economy. The financial sectors of many LAC countries were not stable during the 1990s: in fact, they were engulfed in crisis. But by 2002, a level of normalcy had been restored to the financial sectors in these countries. In Jamaica's case, in particular, a striking feature of the crisis recovery effort was the fact that it occurred in the absence of significant multilateral or bilateral financial assistance (Kirkpatrick and Tennant 2002). But there was an international presence in the recovery of these financial sectors, in the form of FDI.

Research Questions and Methodology

This study sought to assess the extent to which, and the particular methods by which, the stabilisation of the financial sectors of LAC countries, and particularly the Jamaican economy, during the latter half of the 1990s, was influenced by the activities of foreign firms. The study focused on the activities of those firms that operated in Jamaica at the onset of the crisis, and their response to the contextual environment; and also on those firms that were attracted to Jamaica to purchase investments that were acquired by the government as a result of an intervention designed to avoid the collapse of the sector.

Methodologically, the study relied upon interviews with individuals who managed local and foreign financial firms during the crisis, with investors who entered the Jamaican financial system by purchasing firms from the Government of Jamaica and with individuals involved in the regulation of the Jamaican financial sector during the crisis and post-crisis periods. Finally, the study

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drew upon secondary research on the role of FDI in the stabilisation of the financial sectors of LAC countries.

Financial Sector Reform and Crisis in Jamaica and Latin America

In order to understand the role of FDI in the financial sectors of countries in the LAC region, it is important to understand the changing nature of the financial sectors within this region of the world. Generally speaking, countries in the LAC region have gone through two generations of reforms in their financial sectors (UN ECLAC 2002). The "first generation" of reforms primarily involved the liberalisation of the financial sector by removing state controls on interest rates and financial sector resource allocation, and by lowering the barriers of entry to the financial system.

These reforms had the intended consequences of increasing competition and entry to the financial sector, including, in some countries, the entry of foreign financial institutions. In many cases, however, first generation reforms were also implemented without first reinforcing the financial sector regulatory systems. In the absence of appropriate regulation, and with financial institutions encountering unfamiliar terrain, first generation reforms in several LAC countries resulted in systemic financial crises.

The typical response to these crises involved the government being forced to intervene in the financial system, at great cost to the treasury, in order to restore public confidence. These responses have been characterised as "second generation" reforms (UN ECLAC 2002). These second generation reforms involved establishing more robust regulatory systems and promoting, to an even greater extent, the entry of foreign banks, which were viewed as having the capacity to improve the level of stability of the banking system to reduce the potential of future banking crises. In order to understand the role played by these financial institutions, it is useful to investigate more comprehensively the nature of these financial sector crises.

The Jamaican Financial Sector Crisis

The Jamaican financial sector crisis, like that of other countries in the LAC region, had its origin in the manner in which enterprise managers and regulators responded to the first-generation financial sector reforms in Jamaica. The liberalisation of the financial sector,

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which constituted these first-generation reforms, took place in two phases. In the first phase, during the 1980s, interest rate policies were reformed, credit controls were relaxed and money and capital markets were developed. During this phase, a number of new players entered the banking sector, operating with the low capital limits allowed by the legislation of the period.

The second phase of liberalisation took place in the 1990-1991 period. In this period, there was complete removal of credit controls, total deregulation of saving rates, the imposition of differential cash reserve requirements across different types of financial institutions and the liberalisation of the foreign exchange system, with respect both to current and capital account transactions (Kirkpatrick & Tennant 2002).

The government regulators responded to liberalisation, of the foreign exchange market, in particular, by rapidly acquiring newly-discovered foreign exchange. In the absence of a policy of sterilisation of the foreign exchange acquired, the significant expansion of foreign exchange reserves led to a dramatic growth in the supply of money and the related rapid growth of inflation and significant depreciation of the Jamaican currency. The inflation rate peaked at 80.2% in 1991, for example, while the Jamaican currency (at its market rate) depreciated by an annual average of 56% between 1990 and 1992 (King 2001).

After the rapid money supply expansion, high inflation and significant currency depreciation that followed liberalisation, the Jamaican Government sought to re-establish macro-economic stability. The policy tool of choice, however, was tight monetary policy, resulting in high and differential cash reserve ratios and significant increases in benchmark rates for government securities. The result was a decline in inflation but a significant increase in nominal and real interest rates. In particular, interest rates, post-liberalisation, became highly positive, in contrast to the negative real interest rates that had typified the Jamaican policy environment for some time.

Enterprise managers responded to liberalisation by creating financial conglomerates to respond to the regulatory arbitrage opportunities created by differential cash reserve requirements and by differences in the levels of supervision of different sub-sectors of the financial system. These structures were usually composed of a merchant bank, commercial bank, insurance company, building

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society and other firms, often with complex structures of inter-company share-holdings, interlocking boards and extensive intra-group transactions (Kirkpatrick & Tennant 2002). Additionally, several of these structures suffered from corporate governance weaknesses, including extensive connected party transactions, and a heavy reliance on non-independent directors, many of whom had insufficient banking experience (Campbell and Barclay 2005).

Several of these entities began with low levels of deposit market-share and so they aggressively sought to attract deposits in a liberalised interest rate environment by offering very attractive interest rates. The insurance companies also moved to offer interest-sensitive insurance products to maintain their share in the savings market. Often, the short-term funds realised through these interest-sensitive products were invested in long-term commercial real estate, which had traditionally been a safe haven for insurance companies, given the inflation, exchange rate depreciation and negative real interest rates that had characterised the prior two-decade history of the Jamaican economy.

The combination of these responses to liberalisation precipitated a crisis in the Jamaican financial sector by the mid-1990s. With the downturn of the real estate and stock markets caused by the sudden transition from negative to positive real interest rates, financial conglomerates began to experience liquidity problems. By 1994, the Government had intervened in one financial group, the Blaise Financial Entities (BFEs), placed the institutions under temporary management, and announced that depositors would receive a significant level of protection on their deposits. In July 1995, this was followed by intervention into the Century Financial Entities (CFEs), under a similar arrangement of protection of depositors.

By 1995, the insurance companies were facing severe liquidity problems. In July 1996, the chairmen of the country's three largest life insurance companies, all of which had affiliate commercial banks, approached the Government for assistance, pointing to the perilous nature of the sector and the systemic nature of the crisis. The Government proceeded to embark on a study of the problem, but events unfolded quickly. Holders of interest-sensitive policies became unnerved at the potential problems of instability dramatised by the government's intervention into the BFEs and CFEs.

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A process of rapid encashment of policies began. With their mismatch of assets and liabilities, the insurance companies had no ability to fund the encashment from their own resources, and so they turned to their affiliate commercial banks for liquidity support. The attempt by several financial institutions to rapidly sell assets, at the same time, also contributed to a reduction in the value realised from these sales, exacerbating the liquidity, and ultimately solvency, problems of these institutions. The commercial banks were faced with severe cash demands from their affiliate companies, in addition to the declining confidence of their own customers. Consequently, they were forced to obtain liquidity support from the Central Bank through overdrafts at penal rates of interest.

The Central Bank funded these overdrafts out of concern for the impact of disorganised and haphazard bank closures on the confidence of the entire financial system. By the time the Government was able to intervene in a structured way through the Financial Sector Adjustment Company (FINSAC), created in January 1997, the contagion had spread throughout the system. By 2000, of the eleven commercial banks that existed at the beginning of 1995, just before the crisis, only four did not receive funding from FINSAC. Similarly, of the nine life insurance companies that operated in Jamaica in 1995, only two had not been recipients of financial assistance from the Jamaican government by 2000. By that time, the government's financial assistance had climbed to over 40% of the country's GDP.

It is against the background of this crisis that it is useful to examine the impact of internationalisation of the Jamaican financial system on the management and resolution of the financial sector crisis. Such an examination, however, is best informed through an assessment of the role of a key element in the internationalisation process, foreign direct investment, on financial sector development.

FDI and Financial Sector Development

The literature on FDI and financial sector development does suggest that internationalisation of financial services can help countries build more robust and efficient financial systems. Internationalisation achieves this result because it allows the introduction of international practices and standards; improves the quality, efficiency and breadth of financial services; and allows for more stable sources of funds. Internationalisation assists in the development of financial sectors in part because foreign and

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domestic financial institutions differ in their performance, interest and operational focus (Claessens & Jansen 2000).

In addition, internationalisation may enhance the efficiency of the financial system infrastructure, in the form of accounting practices and regulation. It may also stimulate an increased presence of supporting agencies such as auditors and credit bureaus (Dages et al 2000).

Foreign banks tend to be drawn to countries because they face less effective domestic competition and are thus attracted by profitable opportunities in these countries (Clarke et al 2001a). Generally, foreign banks that invest in countries have efficiency advantages, and they provide direct benefits by introducing modern banking skills, technologies and products and by introducing banking competition (Claessens at al 1998). They also add to the stability of domestic banking systems by improving credit allocation due to the availability of more sophisticated systems for evaluating and pricing credit risks. These banks also assist in maintaining stability because they import the strong prudential supervision of their parent companies (Frauendorfer & Gantenbein 2002).

There is a concern that the entry of foreign banks might have an impact on the profitability of domestic banks. Recent cross-national research suggests that a large foreign ownership share in a country's banking sector does reduce the profitability and the overall expenses of domestically owned banks, but this leads to an improvement in the functioning of national banking markets and the welfare of banking customers (Claessens et al 1998).

Another concern is that foreign banks may skew lending practices because, it has been thought, they tend to give preference in their lending activities to large rather than small firms. The research evidence on this matter does, indeed, suggest that foreign banks lend less to small and medium sized enterprises. But the effect is ambiguous because the improved competition and reduced interest rates that result from their entry benefits all firms, including small and medium-sized firms (Clarke et al 2001b). Of note, there is the possibility that the imminent movement to new capital adequacy (Basle 2) standards could reduce the level of lending to companies in developing countries because of the higher capital requirements related to lower rated borrowers. But it is not clear

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that this will result in differences in lending between foreign and locally-owned banks.

In sum, there is an emerging consensus in the literature that the internationalisation of financial services through the operations of foreign-owned banks has a salutary effect on the development of financial markets. And it is also quite clear that there is an important causal relationship between financial sector development and economic growth (Levine 1997).

Analysing the Role of FDI in the Jamaican Commercial Banking System

In order to understand the role of FDI in the stabilisation of the Jamaican financial system, one needs to understand the role played by foreign firms before, during and after the financial sector crisis.

The Pre-Crisis Role of FDI in the Jamaican and LAC Financial Systems

Prior to the financial sector crisis, the Jamaican financial system comprised a range of different types of institutions. In 1995, for example, the financial sector consisted of 11 commercial banks, 25 merchant banks, 4 finance houses, 32 building societies, 82 credit unions, 3 venture capital institutions, 9 life insurance companies and 16 general insurance companies. (Wint 1997). Of these, the most important sub-grouping was the commercial banking sub-sector. In December 1995, this sub-sector accounted for 71% of the assets of BOJ regulated institutions (Bank of Jamaica 1995). The commercial banking sub-sector was also the one in which FDI featured most prominently.

Table 1 shows the relative assets and the current and historical nationality of ownership of the eleven commercial banks that existed in Jamaica on 31st December 1994, just before the onset of the financial sector crisis. The history of banking in Jamaica was somewhat different from that of other LAC countries in that Jamaica had a long, and uninterrupted, history of foreign investment in the banking sector. National Commercial Bank traces its origins in the island to 1837, when it entered as a foreign bank. Bank of Nova Scotia (BNS) set up an operation in Jamaica in 1889 to support the trade in cod-fish between Jamaica and Canada. At this time BNS had not yet even established a branch in Toronto.

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Table 1: Pre-Crisis Structure of Commercial Banks in Jamaica

Commercial Bank	Assets as a % of Total Dec. 1994	Ownership Structure & History
National Commercial	29.44	In Jamaica since 1837 as affiliate of the UK's Barclays Bank; Nationalised in 1977. Privatised by an IPO in 1986. Merged with Mutual Security in 1995.
Bank of Nova Scotia	25.65	Entered Jamaica in 1889 as a subsidiary of Canada's Bank of Nova Scotia.
Mutual Security Bank	11.58	Entered Jamaica as subsidiary of Royal Bank of Canada in 1911. Acquired by Jamaica Mutual Life Assurance Society (Jamaica's oldest life insurance company) in 1985.
Citizens Bank	7.86	First indigenous bank. Began operations as joint venture between Citizens & Southern National Bank of Georgia (49%) and Jamaican executives (51%). Acquired by Life of Jamaica in 1980.
Century National Bank	7.31	Locally-owned since 1986. Formerly Girod Bank of Puerto Rico.
CIBC	5.38	Subsidiary of Canadian Imperial Bank of Commerce in Jamaica since 1920
Workers Savings & Loans	4.99	Locally owned – part of Workers Group of Companies – formerly Government Savings Bank.
CITIBANK NA	2.92	Subsidiary of CITIBANK Group, operating in Jamaica since 1962.
Island Victoria Bank	2.44	Locally-owned joint venture between life insurance company and second largest building society.
Eagle Commercial Bank	2.17	Locally-owned affiliate of Eagle Group.
Trafalgar Commercial Bank	0.27	Locally-owned JV with one of Jamaica's largest conglomerates.

Source: Bank of Jamaica, Statement of Quarterly Assets & Liabilities.

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BNS (Jamaica) continued throughout the 1990s to be a star in the network's crown. During the 1990s, the Jamaica operation contributed 10% of the profits of the Group, and 25% of the profits of the Bank's International Division. BNS' Canadian counterpart, Canadian Imperial Bank of Commerce (CIBC) joined it in Jamaica in 1920. Mutual Security Bank was formerly the Royal Bank of Canada, which entered Jamaica in 1911 and Century National Bank was formerly Girod Bank of Puerto Rico. A relatively late pre-crisis foreign arrival was CITIBANK, which invested in Jamaica in 1962, the year the country gained its independence from the United Kingdom.

Seven of the eleven commercial banks that were in operation in Jamaica prior to the financial crisis had begun their operations in Jamaica with a majority or minority foreign equity position. But by 1994, Jamaica had moved closer to the LAC norm, and only three of these institutions (BNS, CIBC and CITIBANK), comprising 34% of banking assets, were still under foreign control.

In contrast, elsewhere in the LAC region in 1994, as shown in Table 4, foreign banks controlled 18% of assets in Argentina, 16% in Chile, 8% in Brazil, 7% in Peru, 6% in Columbia and a miserly 1% in both Mexico and Venezuela.

The three foreign-owned institutions in Jamaica, although controlling a minority of the assets of the commercial banking system, played a critically important role during the financial sector crisis.

The Role of FDI in Jamaica During the Financial Sector Crisis

Recall that of the eleven commercial banks in operation in Jamaica prior to the financial crisis, four did not require assistance from FINSAC. But the need for assistance did not vary randomly between foreign-owned and locally-owned commercial banks. None of the three commercial banks that were foreign-owned in 1994 required financial assistance during the financial crisis. On the other hand, of the eight locally-owned commercial banks, only one, Trafalgar Commercial Bank, which boasted the smallest share of assets of all commercial banks at 0.27% in 1994, avoided governmental intervention.

The information provided in Table 2 provides an indication of why governmental assistance had to be directed towards locally-

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Table 2: Differences in Performance Between Foreign and Locally-Owned Banks

Performance Ratio (%)[1]	Foreign-Owned	Locally-Owned
Interest Cost		
Interest Cost/Total Liabilities:		
1992-1995	8.56	11.55
1996-1998	8.31	13.09
2003-2004	5.97	9.92[2]
Net Interest Margin/Interest Income:		
1992-1995	53.00	29.88
1996-1998	51.61	25.86
2003-2004	55.85	29.35
Liquidity:		
Total Liabilities/Total Assets:		
1992-1995	91.64	95.62
1996-1998	90.89	97.70
2003-2004	88.78	90.51
Fixed Assets/Equity:		
1992-1995	31.73	96.50
1996-1998	28.56	163.83
2003-2004	16.98	3.97
Credit Management:		
Provision for Loan Losses/Total Loans:		
1992-1995	2.32	3.05
1996-1998	1.97	7.15
2003-2004	2.38	2.18
Profitability:		
NPAT/Total Assets:		
1992-1995	4.05	1.30
1996-1998	2.77	-1.80
2003-2004	2.67	2.45
Capitalisation (Basle Ratio)		
Capital/Risk-Weighted Assets		
1992	15.95	9.17
1996	19.84	9.02
2002	30.80	16.30

1: These ratios are the weighted average, for the period, of all banking groups for which data were available. Data were available for all foreign-owned banks, but there was no information available for several of the locally-owned banks most severely affected by the crisis. Thus, the ratios understate the differential performance of foreign and locally-owned banks over the following periods. (1992-95: pre crisis; 1996-98: crisis).

2: Note that in the post-crisis period there was only one local bank accounting for just 2% of total assets.

Source: Capitalisation ratio: BOJ Statement of Quarterly Assets and Liabilities; Other ratios – Bank Annual Reports.

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owned banks. The ratio analyses of the operations of the commercial banks before (1992-1995), during (1996-1998), and after (2003-2004), the crisis years indicate that there were clear differences between foreign and locally-owned banks in the management of banking operations and in the levels of capitalisation.

These ratios provide an indication of the comparative management of these operations in several areas: interest cost, captured in the ratio — interest cost/total liabilities and non-interest expenses/income; liquidity, captured in the ratios — total liabilities/total assets and fixed assets/equity; credit management, captured in the ratio — provision for loan losses/total loans; and profitability, captured in the ratio of net-profit-after-taxes (NPAT)/total assets. The ratios also indicate how well capitalised these institutions were based upon a combination of tier one and tier capital, as defined by the Basle banking capitalisation standards, and reflected in the ratio of total capital (that is, tier one plus tier two capital), to risk-weighted assets. Note with respect to this latter ratio, that while both foreign- and locally-owned companies exceeded the minimum Basle standard of a capital to risk-weighted asset ratio of 8%, foreign-owned banks were significantly better capitalised than their locally-owned counterparts.

As indicated earlier, with liberalisation of the financial sector, financial institutions were able to set their interest rates. Several smaller locally-owned banks, in particular, saw this as an opportunity to increase market share by "buying business." In several cases, because of the absence of a branch network, these institutions also did not have access to relatively low cost savings accounts and therefore had to rely on higher cost, and more fickle, term deposits.

Against this background, it is not surprising that locally-owned institutions had higher interest costs to total liabilities and lower net interest margins than their foreign-owned counterparts. Other studies of banking failure have also indicated that "buying business" is a recipe for banking failure. In a study of the banking crisis in the United States in the 1980s, for example, researchers discovered that 42% of failed banks exhibited aggressive behaviour in the form of "buying business," whereas in banks that remained healthy over the period of the study "overly aggressive behaviour

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was virtually non-existent" (US Office of the Comptroller of the Currency 1988).

Another feature of the financial sector environment during the mid-1990s was the absence of liquidity in several financial institutions. As pointed out earlier, insurance companies were particularly compromised by liquidity problems as they sought short-term responses to the changing interest rate environment, while not responding adroitly to the impact of changes in interest rate structures on real estate and equity markets. But several local commercial banks were also negatively affected by liquidity problems. This is reflected in the differential performance between local and foreign banks in relation to the overall liquidity ratio.

A more telling indicator of the differences in approach, however, is captured in the ratio of fixed assets to equity. The Jamaican Banking Act allowed commercial banks to hold 100% of their statutory capital in the form of fixed assets and 100% in the form of investment in non-financial subsidiaries. Most local banks took advantage of these regulations, as reflected in the very high average ratio of fixed assets to equity among locally-owned commercial banks, as reported in Table 2 (Note that statutory capital is generally lower than equity, since equity also comprises retained earnings), and in the significant incidence of group holding companies in the locally-owned banking sector.

But foreign-owned commercial banks operating in Jamaica maintained much lower levels of fixed assets, and avoided investments in non-financial subsidiaries, because they were following the guidelines of their parent companies, which had more prudent restrictions in these areas relative to the Jamaican legislation. So, for example, the ratio of fixed assets to equity was three to five times as high for locally-owned banks as it was for foreign-owned banks during the pre-crisis and crisis periods.

With the onset of the crisis, locally-owned banks found it very difficult to respond to customer withdrawals because of much lower levels of liquidity and capitalisation. As a result, they were forced to go into overdraft at the central bank. Further, even before the onset of the crisis, the high levels of non-income earning fixed assets in their capital base also forced locally-owned banks to fund their operations from high-cost customer deposits.

Yet another area of difference is reflected in the management of credit. In the period immediately preceding the crisis, and even

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more dramatically during the crisis period, locally-owned banks had significantly higher loan loss provision/total loan ratios, and higher loan losses and provisions in absolute terms, than their foreign-owned counterparts (See Table 2).

These ratios, however, actually understate the level of difference, since dissimilar standards were used in determining when specific loan provisions should be made. Locally-owned banks used a standard in which interest only ceased accruing to loans that were 180 days in arrears, and it was this level of arrears that would trigger a specific loan provision. Foreign-owned banks, on the other hand, used the more stringent international standard of ceasing to accrue interest on loans that were 90 days in payment arrears, and they even reversed interest charges that had previously been accrued.

Another part of the credit problem confronting locally-owned commercial banks was that significant components of the outstanding loans, in several instances, were intra-group related party loans, in circumstances where dominant shareholders controlled all elements of the group network. It should be noted that these levels of loan losses need to be understood relative to risk-free interest rates of more than 50%, and lending rates at obviously higher levels, during the mid-1990s in Jamaica. The high levels of loan losses in locally-owned banks also led to a worsening of their liquidity situation, because they had to resort to fickle deposits to replace the cash-flow that should have been forthcoming from loan servicing and repayment.

An interesting data point on the loan losses of foreign banks comes from the Jamaican branch office of CITIBANK. That institution had long sought to carve out a niche in the Jamaican commercial banking market. It eschewed competing as a retail bank and, instead, engaged in corporate banking by selecting strong local businesses and seeking to meet the credit requirements of these entities. Additionally, CITIBANK structured financial products to meet the specific needs of other targeted clients. During the entire banking crisis, CITIBANK did not experience a single non-performing loan.

Obviously, the differential performance in the above areas also led to differential performance in profitability levels between foreign and locally-owned banks, as reflected in the profitability

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ratio of foreign versus locally-owned banks during the pre-crisis and crisis periods (Table 2).

Clearly, foreign-owned banks weathered the financial sector crisis far more effectively than their locally-owned counterparts because of their control structures and their adoption of international banking practices. The importance of international benchmarks in this respect also relates to the countries of origin of the foreign banks operating in Jamaica.

During the 1980s and 1990s in Jamaica, there was a debate about the appropriate model of banking practice, with some arguing for German/Japanese banking arrangements in which commercial banks were tightly linked to groups with investments in the "real" sectors of the economy. Indeed, some of Jamaica's larger locally-owned commercial banks claimed that they had often received encouragement from policy makers to invest directly in real estate and "productive" ventures (Chen-Young 1998). Indeed, the Government of Jamaica sold Jamaica's largest hotel, the Jamaica Grande, to the CFEs in the early 1990s.

At the other side of the debate were those who argued that Jamaica should have an "Anglo-American" banking system in which there were, to use the words of a former governor of the Bank of Jamaica, "Chinese walls" between banking operations and other activities. The parent companies of the foreign-owned banks in Jamaica were all North American, and believed strongly in a clear line of separation between banks and other forms of business.

In sum, the fundamental role of FDI during the financial crisis in Jamaica is that the foreign-owned banks, because of their levels of risk management, provided Jamaican depositors with locally-based deposit options as locally-owned banks floundered. They provided the opportunity for a "flight to quality" in the locally-based commercial banking sector.

The presence of FDI in the commercial banking system allowed a "flight to quality" rather than a "flight of capital." It seems reasonable to conclude that, in the absence of these institutions, there would have been a much greater chance of capital flight, even with government's promises to protect depositors. Instead, even while experiencing a financial crisis that was to consume over 40% of GDP, Jamaica, while receiving no bilateral or multilateral financial support, or the promise of same, saw no significant decline in its level of net international reserves over the

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period of the crisis. Clearly, the presence of FDI in the commercial banking system played a critical role in averting a full scale financial and balance of payments crisis in Jamaica.

It should be noted, however, that while there was a transfer of deposits from locally-owned to foreign-owned institutions, the pre-crisis, crisis and post-crisis period also saw a trend toward disintermediation within the financial system. In particular, sophisticated investors began placing funds with local money market brokers, rather than with commercial banks, in an effort to generate higher interest rates. Funds under management in Jamaica's largest such broker, for example, Jamaica Money Market Brokers, increased from US$86m to US$1.06 billion between 1995 and 2004 (JMMB 2004). Thus, the flight was not from local financial institutions en masse, but from locally-owned commercial banks.

The Role of FDI in the Rehabilitation of the Jamaican Financial Sector

But the role of FDI did not end with the averting of a balance of payment crisis in Jamaica. As indicated earlier, the Jamaican Government set up an institution, FINSAC, to rehabilitate the financial sector. FINSAC embarked upon a three-phase course of action to be completed over a 5-7 year life-span: intervention, rehabilitation and divestment. The intervention involved the swapping of FINSAC bonds for the liabilities owed by commercial banks to the central bank.

The rehabilitation process involved the creation of a single entity, christened Union Bank of Jamaica in a report on "the way forward", out of the crisis, developed by the Financial Institutions Supervisory Division of the Bank of Jamaica. Union Bank represented the coalescing of the assets, liabilities and operations of all the locally-owned commercial banks into which the government had intervened, with the exception of the largest bank, National Commercial Bank.

The divestment process, as it related to the commercial banks in which the government intervened, involved the sale of Union Bank of Jamaica and National Commercial Bank to private sector interests. But these private sector interests were both foreign companies.

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In 2000, Union Bank of Jamaica was sold to the Royal Bank of Trinidad & Tobago (RBTT Financial Group). This was followed, in March 2002, with the sale of the Government of Jamaica's 75% shareholding of the publicly-listed National Commercial Bank of Jamaica to AIC Group of Funds. AIC is an investment management company with headquarters in Canada, 92% of whose shares were owned by Michael Lee-Chin. Lee-Chin, at the time of this investment, was the richest individual of Jamaican heritage in the world.

The result of these sales was to substantially change the extent of foreign ownership in the Jamaican commercial banking system. Prior to the crisis, recall that 34% of the assets of the banking system were represented in foreign-owned banks. Table 3 indicates that by 2002 there were six commercial banks in Jamaica, down from eleven in 1995. Five of the six commercial banks were foreign-owned, and about 98% of the assets of the commercial banking system was owned by foreign institutions, representing one of the highest levels of foreign banking ownership within the LAC region, and among developing countries (Clarke et al 2001b).

The level of foreign ownership of commercial banking assets, though never reaching the level of Jamaica, also increased considerably within the LAC region during this period. Indeed, as shown in Table 4, Mexico's shift from local ownership to foreign ownership was far more dramatic than that of Jamaica, with the proportion of banking assets controlled by foreign banks increasing from 1% in 1994 to 90% over a seven year period, and in the aftermath of Mexico's "Tequila" banking crisis and its greater integration into North America with its entry into the North American Free Trade Area.

The motivations for entry of RBTT and AIC into Jamaica differed, but link to research on the motivations for FDI. The RBTT Financial Group consisted of 32 companies including nine commercial banks with 79 branches located throughout the Anglophone Caribbean, Suriname, Aruba and the Netherlands Antilles. Thus, RBTT's Jamaican investment represented one element of a corporate strategy of regional investment.

From the perspective of Trinidad & Tobago, Jamaica, the largest English-speaking island in the Caribbean, represented an important market. Trinidadian companies, in the food processing, cement and financial services industries, were active investors in

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Table 3: Post-Crisis Structure of Commercial Banks in Jamaica

Commercial Bank	Assets as a % of Total Dec. 2002	Ownership Structure
Bank of Nova Scotia	39.55	Subsidiary of BNS (Canada)
National Commercial Bank	35.84	75% Subsidiary of AIC (Canada), which is 92% owned by Jamaican/ Canadian Billionaire, Lee-Chin.
RBTT (Jamaica)	12.95	Wholly-owned subsidiary of Royal Bank of Trinidad & Tobago
CIBC	6.06	Subsidiary of Canadian Imperial Bank of Commerce. Name changed to First Caribbean in 2003.
CITIBANK NA	3.55	Subsidiary of US Citigroup, Inc.
First Global Bank	2.05	Formerly Trafalgar Commercial Bank. Subsidiary of Jamaica's largest conglomerate – Grace, Kennedy & Co. and the only locally-owned commercial bank in Jamaica in the post-crisis period.

Source: Bank of Jamaica, Quarterly Statement of Assets and Liabilities

Jamaica in the 1990s. In addition, there were relations at the level of inter-locking board directors in the companies that invested in these sectors of the Jamaican economy. Indeed, these interlocking relations were important in the decision of Trinidadian financial firms to enter the Jamaican market. In addition to the investment of firms from Trinidad in the banking and insurance sectors, Barbadian firms were also involved in the acquisition of insurance companies into which FINSAC had been forced to intervene.

Indeed, it is noteworthy that the substantial source of foreign investment in the Jamaican financial system came from Third World, in this case Caribbean, Multinationals. Their motivations for entry, including access to markets and diversification, were quite compatible with the existing literature on investment by Third World Multinationals (Wells 1983; Lall 1983). On the other hand, Jamaica's small market did not encourage the entry of financial firms from developed countries.

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Table 4: Foreign Bank Share of Banking Assets in Select LAC Countries 1994-2001 (%)

Country	1994	2001
Argentina	18	61
Brazil	6	49
Chile	16	62
Colombia	6	34
Jamaica	34	98[1]
Mexico	1	90
Peru	7	61
Venezuela	1	59

1: Data for Jamaica are for 1994 and 2002.

Source: Jamaica – Bank of Jamaica; Other countries, UN, ECLAC 2002.

The single case of an investment into the Jamaican financial system by a company based in a developed country also sits in accord with the extant literature on motivations for foreign direct investment. Lee-Chin of AIC indicated that his firm's motivation to invest in Jamaica occurred at two levels. At the first, the investment opportunity was a good one. The National Commercial Bank had a strong brand name in Jamaica and an emotional attachment with its people. NCB had wide share-ownership among Jamaicans, with 25,000 shareholders, having been one of the first Jamaican privatisations conducted successfully through an initial public offering (IPO) (Leeds 1991).

The company had recently experienced problems, but the sale specifically excluded past bad loans. AIC purchased a "clean bank" from the government. Further, the Jamaican environment provided financial incentives from a tax perspective, since Jamaica had no capital gains tax and no tax on dividends distributed. The investment allowed AIC to enter into a product line in which it had little direct experience, but was complementary to its existing line of mutual fund management operations.

At the second level, of critical importance to AIC's decision to acquire NCB was the fact that, as a Jamaican, Lee-Chin was eager to take the opportunity to help in the development of his country of birth. While this objective was largely cultural, the fact that AIC was privately owned, and that Lee-Chin was the majority shareholder

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(92%), facilitated his ability to incorporate non-financial criteria into the investment decision. But Lee-Chin also saw the possibilities for using NCB as a platform for marketing financial services across the Caribbean and to the broader Caribbean diaspora in North America. Of course this objective would require the agreement of Jamaican banking regulatory authorities. One of the challenges of banking regulation in relation to foreign investment was that of consolidated cross-border supervision of banks owned by foreign companies that were not operating in the field of commercial banking.

The motivations associated with the post-crisis investment into the Jamaican banking system are linked to the literature on ethnic ties in investment decisions (Wells 1983; Limlingan 1987; Kapur & Ramamurti 1001), the role of tax factors in FDI decisions (Grubert & Mutti 1991; Woodward & Rolfe 1993) and strategic asset-seeking as a motivation for FDI (Dunning 1998).

In particular, the literature has shown that the motivations for Third World Multinationals engaging in FDI are quite different from those of Developed Country Multinationals. Research has shown that ethnic ties are important sources of motivation for investment by third world multinationals (Wells 1983), such as, for example, the heavy business investment in Korea made by Korean citizens residing in Japan, and the capital inflows and foreign direct investment into Singapore from Chinese firms based in Hong Kong and Taiwan (Ghymn 1980).

Indeed, most of the research that has explored the relationship between ethnic ties and inward foreign direct investment has focused on the Chinese diaspora engaging in FDI in the newly industrialising Asian countries (Wai-Chung Yeung 1998) and more recently, in China (Kao 1993, Ding & Ganti 1995). In the former case, the intra-regional cross border investment flows among South-East Asian countries played a critical role in the economic development of these countries. (Wai-Chung Yeung 1998). A similar process is on-going in China. Indeed more than 60% of the total contracted FDI in China for the period 1979 to 1994 was made by ethnic Chinese entrepreneurs from the newly industrialising Asian countries (Wei et al 1999). Many of these overseas Chinese have close family ties with residents in China's coastal areas where most of its FDI is concentrated.

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By 2002 the Jamaican commercial banking sector was earning significant profit levels, new foreign firms had entered, existing foreign firms had expanded their operations, and the single locally-owned bank was in an expansion mode. But while the commercial banking sector could safely be considered rehabilitated, the high levels of indebtedness of the Jamaican government, in part due to the intervention into the financial sector, and the high real interest rates that related to the debt levels and the tight monetary policy in use, continued to put the financial system at risk and to contribute to an on-going level of macro-economic instability in the country. Like elsewhere in the LAC, FDI in the banking sector in Jamaica had not, by 2003, played a role in remedying some of the macro-deficiencies of the financial system.

The Role of FDI in Remedying the Macro-deficiencies in the Banking System

Banking systems in the LAC region have been characterised by high overall credit costs and limited availability of credit. Governments of the region hoped that foreign banks would be able to remedy these systemic deficiencies. Generally speaking they have not. The availability of credit, as reflected in the ratio of private sector credit to GDP has not increased for several LAC countries (UN, ECLAC 2002) This ratio has also showed no increase for Jamaica in the post-crisis period, with the 2002 ratio of 12.8% contrasting unfavourably to the ratio of 19.9% in 1994, although the ratio of 12.8% in 2002 reflected a steady but marginal increase from the lowest level in recent years in Jamaica; 9.5% in 2000. The cost of credit has also not declined, and bank intermediation spreads remain very high throughout the region (UN, ECLAC 2002), and in Jamaica.

This data suggests that, throughout the region, the microeconomic efficiency that has been demonstrated by foreign banks has not resulted, yet, in improved macroeconomic impacts. This result is unsurprising, however, since in the post-crisis periods, overall macro-economic conditions have not been favourable to private sector borrowing. The Jamaican situation illustrates this problem well, since the Jamaican Government continues to crowd out the private sector, in part as a result of the debt obligations that resulted from its intervention into the financial sector. The translation of greater stability in the financial sector into overall

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macro-economic stability and improved macro-economic efficiency is a challenge that continues to confront several of the economies of the LAC region.

Conclusions

FDI has clearly played an important role in the stabilisation of the Jamaican financial sector and those in other LAC countries. This finding is quite consistent with the literature, reported upon earlier in this paper, on the synergies between foreign bank entry and the development of financial sectors in developing countries.

Developing countries need to consider carefully their areas of competitive advantage and consider the possibility of attracting FDI that can assist in cementing these advantages. It is in this respect that it is unsurprising that FDI in commercial banking provides substantial potential benefits to developing countries, particularly small developing countries, given the importance of stability to the competitive advantage of these countries.

The lessons from this study also suggest that the principal benefit of FDI in assisting in the stabilisation of the Jamaican financial sector lay in the extent to which foreign-owned banks adopted international prudential standards. This suggests that these benefits may be possible even in the absence of FDI. They may be achieved through regulatory processes and company standards that involve international benchmarking.

This is important for developing countries because many are finding it difficult to attract FDI. Managers of the subsidiaries of the foreign banks in Jamaica whose headquarters were in developed countries, indicated, for example, that given the consolidation of banking systems around the world, they considered that it would be unlikely that their parent companies would consider establishing operations in Jamaica if they were confronted with a first-time investment decision in the early twenty-first century.

But there is another important lesson from this study. It is that developing countries need to be very careful in their targeting of prospective investors. And that, in so doing, important potential investors are Third World Multinationals and citizens from the diaspora of these countries.

In sum, this paper has suggested that there are lessons for developing countries from the experiences of Jamaica and other

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countries in the Latin American region in relation to the potential benefits of FDI and international benchmarking in sectors such as finance and, also, with respect to the types of FDI that may well provide the best alignment between the needs of these countries and the goals of prospective foreign investors.

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 ISSN: 0037-7651

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