

# FINANCIAL INTERMEDIATION IN SMALL ISLAND DEVELOPING ECONOMIES

## 1. Introduction

The purpose of this paper is to provide a background survey of financial intermediation in small island developing economies. An attempt to achieve this aim is made here by examining the roles of financial intermediaries, measuring the efficiency with which they perform these roles, describing briefly the financial intermediaries operating in a sample of 11 small island developing economies, discussing the part played by foreign financial institutions, analysing advantages and disadvantages of alternative financial systems for these economies, and, finally, outlining the elements of a monetary policy strategy designed to promote effective and efficient domestic resource mobilisation and allocation in small island developing economies.

At the outset, 12 countries were chosen for analysis and illustration. One of these - Antigua - was dropped for lack of data. The remaining 11 are listed with their 1979 populations and per capita gross national products (GNP) in Table 1. They were selected on the basis of size (population under 5 million), geographical spread (four from the Pacific, three from the Caribbean, two from Southeast Asia, and two from the Indian Ocean), and data availability.

On average, these small island developing economies have a population of 1.1 million and a per capita income of \$2,730. However, populations range from 65,000 in the Seychelles to 4.7 million in Hong Kong. Per capita incomes vary from \$200 in the Maldives to \$4,000 in Hong Kong. Given this degree of variation in size and income, it is no surprise to find the economies of these countries are far from homogeneous. About the only common economic characteristic is openness. All these economies have relatively high ratios of foreign trade (imports plus exports) to GNP.

*The author wishes to thank Warren Coats, Vicente Galbis, Tony Hughes, Deena Khatkhate, Ian McCarthy, Rupert Mullings and Yuzuru Ozeki for their help.*

TABLE 1

1979 Population, Per Capita GNP and Aggregate GNP in Sample Countries

Country	Population (in thousands)	Per Capita GNP (in U.S. dollars)	GNP (in millions of U.S. dollars)
Bahamas	231	2,780	642
Barbados	253	2,400	607
Fiji	618	1,690	1,044
Hong Kong	4,671	4,000	18,684
Maldives	149	200	30
Papua New Guinea	3,000	650	1,950
St. Lucia	122	780	95
Seychelles	65	1,400	91
Singapore	2,368	3,820	9,046
Solomon Islands	219	440*	96
Western Samoa	158	420*	66
<hr/>			
Total	11,854	2,729	32,351

Source: World Bank Atlas, 1980

\* Estimate from alternative source.

In general, the poorest countries in this sample, i.e., the Maldives, Papua New Guinea, the Solomon Islands and Western Samoa, rely on agriculture (including, of course, fishing) for the majority of their income and employment. The middle income group, i.e., Bahamas, Barbados, Fiji, St. Lucia and Seychelles, produce a significant and growing proportion of their GNP in the tourism sector. In several of these countries, agriculture is a minor source of income and employment. Finally, the two higher income countries, Hong Kong and Singapore, have diversified economies with sizable manufacturing and service sectors.

Financial systems in this sample of countries are just as varied as their economic structures. They range from one of the most primitive monetary systems in the world, that of the Maldives, to two of the most advanced, those of Hong Kong and Singapore. In all but these latter two countries and Papua New Guinea, the financial sectors are dominated by branches or subsidiaries of foreign commercial banks. Indeed, in five of the smaller countries (as measured by the size of GNP) - Bahamas, the Maldives, Seychelles, the Solomon Islands and Western Samoa - there are no purely domestic commercial banks.

It is no coincidence to find a strong negative correlation between economy size and the preponderance of foreign banks in a country's financial sector. It reflects the basic fact that there are important economies of scale in the banking industry. These can be exploited by multinational banks even in the smallest economy, provided only that the economy is large enough to support one bank branch. The critical economy size of a bank branch's viability is much smaller than the cutoff point for a de novo bank's viability. This is simply because a branch has recourse to head office services, whereas a de novo bank must set up those services itself within the economy.