5. Foreign Financial Intermediaries in Small Island Developing Economies

A bird's eye view of the financial sectors in all the sample countries is presented in Table 3. Of particular note is the fact that only Hong Kong and Singapore have any private joint stock domestic commercial banks. Barbados, Fiji and Papua New Guinea each have one government-owned domestic commercial bank and the governments of the Solomon Islands and Western Samoa have both participated with a foreign commercial bank in the establishment of one domestic commercial bank. A government-sponsored cooperative bank exists in St. Lucia. In three of the sample countries - Bahamas, the Maldives and Seychelles - there are no domestic commercial banks and all banking business is undertaken by branches of foreign commercial banks.

Commercial banks dominate the financial sectors of all the sample countries, except Hong Kong and, to a lesser extent, Singapore. Bahamas and Papua New Guinea have a few savings and loan associations (S&Ls), the Seychelles has the Government Savings Bank and there is a Post Office Savings Bank in Western Samoa. These are the only nonbank depository institutions outside Hong Kong and Singapore in all the sample countries. Other nonbank financial intermediaries found in the sample countries include pension/provident funds, insurance companies, finance companies (depository institutions found only in Hong Kong), trust companies and stock exchanges (in Fiji, Hong Kong and Singapore). There are also government-owned development banks and/or similar developmental financial intermediaries in all the sample countries, except Hong Kong and the Maldives. Finally, five countries - Bahamas, Barbados, Hong Kong, Seychelles and Singapore - have offshore banking. The operations in Barbados and Seychelles are still at an embryonic stage. The big offshore centres are located in Bahamas, Hong Kong and Singapore.

TABLE 3

Bird's Eye View of Financial Sectors in Sample Countries

Country	Monetary Authority	Commercial Banks		Nonbank Financial Intermediaries
		Domestic	Foreign	
Bahamas	Central Bank	0	11	4 S&Ls; 9 trust companies.
Barbados	Central Bank	1 (government-owned, universal bank)	5	Trust companies.
Fiji	Central Monetary Authority	1 (government-owned)	5	National Provident Fund; insurance companies; Unit Trust of Fiji.
Hong Kong	Financial Secretary	32 (all private)	81 (universal banks)	265 deposit taking companies; insurance companies; money and commodity brokers.
Maldives	Department of Finance	0	2	None
Papua New Guinea	Central Bank	1 (government-owned)	3	S&L societies; 1 merchant bank.
St. Lucia	Member of East Caribbean Currency Authority	1 (cooperative bank)	4	None
Seychelles	Monetary Authority	0	6	Government Savings Bank.
Singapore	Monetary Authority and Board of Commissioners of Currency	12 (all private)	37	Central Provident Fund; Post Office Savings Bank; insurance companies.
Solomon Islands	Monetary Authority	½ (government-owned)	2½	National Provident Fund.
Western Samoa	Monetary Board	½ (government-owned)	1½	National Provident Fund; Post Office Savings Bank; Public Trust Office; insurance companies.

TABLE 3 (Continued)

Country	Government-owned Development Banks	Institutional Interest Rate Setting Procedure	Offshore Banks	Remarks
Bahamas	0	No formal controls but bank cartel fixes rates in consulation with central bank.	263	
Barbados	1	Minimum deposit rates and maximum weighted-average loan rate set by central bank.	1	Some private companies and individuals borrow and lend directly without going through financial intermediaries because of wide spread.
Fiji	1	Maximum deposit and loan rates established with approval of Ministry of Finance.	0	Stock exchange established in 1979. Eight companies listed by June 1980.
Hong Kong	0	Maximum deposit rates fixed by bank cartel led by Hong Kong and Shanghai Bank.	378	Hong Kong and Shanghai Bank performs several central bank functions. Currency notes are issued by commercial banks which are universal banks in character.
Maldives	0	No controls. Loan rate is based on New York prime plus 1½ per cent. Bank cartel suspected.	0	Maldives Monetary Authority is due to be set up.
Papua New Guinea	2	Rediscount rate and moral suasion used by central bank to influence deposit and loan rates. Bank cartel suspected.	0	
St. Lucia	4	No control. Bank cartel suspected.	0	
Seychelles	1	Prime rate fixed by Monetary Authority. Maxima and minima for deposit and loan rates set by bank cartel in consultation with Monetary Authority.	1	
Singapore	1	All interest rates are determined competitively in a free market. Bank cartel was abolished in 1975.	70	
Solomon Islands	2	Monetary Authority fixes deposit rates and minimum and maximum loan rates.	0	The post office sells 3-year government national savings certificates. 5-year government development bonds are sold through Monetary Authority and commercial banks.
Western Samoa	1	Government fixes all institutional interest rates. Highly selective credit policy is pursued.	0	The Bank of Western Samoa is owned jointly by the government and a New Zealand commercial bank.

As pointed out earlier, there is strong correlation between strength and breadth of these financial sectors and economy size. The financial sector of the Maldives with a 1979 GNP of $30 million is rudimentary in the extreme. Financial sectors of St. Lucia ($95 million GNP), Seychelles ($91 million), Solomon Islands ($96 million) and Western Samoa ($66 million) are just one rung further up the ladder. Papua New Guinea ($1,950 million GNP) has a marginally more extensive financial sector, despite the fact that its per capita income is about half that of Seychelles. The "big" economies of Hong Kong ($19 billion GNP) and Singapore ($9 billion) possess financial sectors comparable to any found in the Western industrial countries. The correlation is caused, in the main, by the economies of scale which exist in financial intermediation.

In unit banking states in the U.S., there was one bank for every $65 million of 1979 GNP. However, these banks can and do share services such as computer facilities, etc., so enabling them to reap the benefits of scale economies. Furthermore, they can easily purchase intermediate inputs such as cheque books from specialised firms supplying the U.S. banking industry as a whole. Labour costs of all insured banks in the U.S. were 1.6 per cent of their earning assets in 1976. The comparable 1977 figure for Turkey, for example, was 5.8 per cent. Unit labour costs of banking in the U.S. cannot, therefore, be presumed to exceed unit labour costs of banking in any of the sample countries.

From all this, one might accept that the minimum economy size needed to support one viable de novo domestic bank would be a 1979 GNP of at least $100 million. This implies that not even one private domestic bank could survive without government subsidy in the Maldives, St. Lucia, Seychelles, the Solomon Islands and Western Samoa. On this estimate, Bahamas and Barbados could support six each, Fiji

ten and Papua New Guinea 20 private domestic banks, provided each bank had only one branch.

The estimate for Papua New Guinea brings home the fact that not only is economy size crucial but so also is expertise. Qualified personnel to run 20 private domestic banks in Papua New Guinea is just not available there. Even with adequate economy sizes, Afghanistan and Nepal illustrate well the problems of establishing and maintaining all-domestic financial sectors without a sufficient supply of trained personnel. Specifically, foreign trade financing constituted a serious impediment to foreign trade in these countries. The banks could not be relied upon to execute correctly such standard operations as opening letters of credit [Fry (1974a, Chs. 5 and 8; 1974b; 1976b, p.1137; 1978e)]. Foreign banks tend to have strong comparative advantages in terms of expertise and experience in foreign trade finance. For some of the sample countries, economy size, training and know-how deficiencies leave no room for choice. Either financial intermediation is undertaken by foreign banks or there will be none at all.

Grubel (1977) has provided probably the most comprehensive framework with which to assess the benefits and costs of permitting foreign banks to establish branches in countries where a choice is actually possible. The main advantages to be measured are: (a) increased competition forced on domestic financial intermediaries which would form an oligopolistic if not cartelised industry in the absence of foreign banks; (b) the importation and use of existing stocks of knowledge capital or know-how at a very low marginal cost; and (c) increased efficiency of international capital flows [Grubel (1977, pp.357-358)].

The disadvantages of hosting foreign banks, according to Grubel, may include: (a) their exemption from socially beneficial regulations; (b) loss of control over

eurodollar liquidity; and (c) inflation created by multiple deposit creation of eurodollars [Grubel (1977, p.358)]. Clearly, these disadvantages are valid, if they are at all, only for offshore foreign banking.

For the present purposes, the potential disadvantages which should be considered include: (a) inefficiency in resource mobilisation and allocation resulting from unfamiliarity with local conditions; (b) export of national saving to country of origin resulting again from unfamiliarity with or unresponsiveness to local conditions; (c) formation of a foreign bank cartel which dictates or thwarts monetary policy measures; and (d) increased difficulty of starting a domestic bank when foreign banks are well established and hold all the best accounts.

The four potential disadvantages listed above can be realised and magnified all too easily by inappropriate laws and regulations. Inefficient resource mobilisation and allocation is assured when the monetary authority sets binding deposit and loan rate ceilings. Conversely, permitting and encouraging mobile bank branches, providing partial loan guarantees, ensuring prompt and effective legal redress in cases of loan delinquencies and defaults, contributing towards training costs, etc., can promote efficient resource mobilisation and allocation on the part of both domestic and foreign financial intermediaries.

Charging licence fees, as St. Lucia does for both head offices (EC$20,000 annually) and branches (EC$1,000 each), is likely to reduce efficiency of financial intermediation. Setting minimum deposit rates, as Barbados does, may raise efficiency. No matter how small the number of financial intermediaries, whether domestic or foreign, regulations can be desígned and implemented to simulate competitive conditions, i.e., by setting minimum deposit rates of interest. Equally important, discriminatory taxation of financial intermediation can and should be avoided in the interests of efficient financial intermediation.

Most measures discussed above in connection with increasing or decreasing financial intermediation efficiency also affect the incentive on the part of foreign financial intermediaries to siphon off national saving to their home countries. Additionally, a rapidly depreciating domestic currency tends to stimulate capital flight, whereas a smoothly appreciating exchange rate may well deter it.

That foreign bank cartels in the sample countries can indeed influence if not dictate domestic monetary and/or fiscal policy is illustrated by a recent event in St. Lucia. In 1980, the government proposed, albeit misguidedly, to impose a 2 per cent tax on banks' deposit liabilities. The proposal was dropped after discussions with the foreign banks. A potential or existing foreign bank cartel may perhaps best be averted or undermined by relatively free entry conditions. However, very small island developing economies could realise substantial savings in information gathering costs from granting licences only to large, reputable foreign banks which would be least likely to risk adverse publicity from sharp, if not illegal, practice. There might also be some advantages, as Seychelles appears to have recognised since 1976, in encouraging foreign banks from several different countries to set up offices.

There seems to be no proven way of solving the problem of subsequent domestic entry into the financial intermediation industry which historically has been the exclusive territory of foreign financial intermediaries. Government-ownership is the only method so far attempted with respect to commercial banking in all the sample countries, except Hong Kong and Singapore. An alternative technique could be to reserve the field of thrift intermediation, i.e., S&Ls, finance companies, trust companies and mutual savings banks, for domestic enterprise. At an

appropriate moment, thrifts could be put on an equal footing with commercial banks, as is now happening in the U.S. Yet another alternative might be to issue fixed period, e.g., 15-year, licences to foreign banks with an agreement that the intermediary would be transferred to national ownership at the expiration of the licence.

This section concludes with a brief discussion of offshore banking in the sample countries. Offshore banking consists of banking operations conducted solely for and with nonresidents in foreign currency denominated claims. Offshore centres can be classified as "paper" or "functional" centres [McCarthy (1979, p.45)]. Paper centres act solely as locations of record for the purpose of tax avoidance. Functional centres actually carry out deposit taking and lending, acting as "important links between Eurocurrency markets, helping to channel funds from major international financial centers (such as London and New York) to final borrowers" [McCarthy (1979, p.45)].

Three of the sample countries - Bahamas, Hong Kong and Singapore - host large functional offshore banking centres. Recently two others - Barbados and Seychelles - enacted the legislation necessary to permit offshore banking. Both of these countries have so far each attracted one offshore bank. Several other countries in the sample are flirting with the idea of opening up offshore centres. It is, therefore, appropriate to consider here some of the major benefits and costs of hosting offshore banks.

The direct benefits to be derived from offshore banking centres include: (a) licence fees and profit taxes; (b) domestic currency capital and liquidity requirements; and (c) the benefit of the offshore banks' operating expenditures. The indirect benefits may consist of: (a) improved access to international

capital markets; (b) increased efficiency of domestic financial intermediaries resulting from greater competition and/or demonstration of more sophisticated banking techniques; (c) training; and (d) attraction of ancillary institutions, e.g., insurance, merchant banking, brokerage houses, etc.

Few of the benefits listed above can be expected from paper offshore centres. Indeed, paper centres yield only extremely modest income from licence fees and taxes. The demand for such centres springs from a desire to avoid taxes. There is a competitive supply of paper centres. Hence, licence fees of a few thousand dollars are sufficient to divert business elsewhere. Paper centres incur virtually no local operating expenses, bar the costs of cleaning the brass plates. And, clearly, there can be no indirect benefits.

In functional centres, licence fees and profit taxes levied on offshore banks can produce significant revenue. In the Cayman Islands, for example, licence fees paid by offshore banks produce annual revenue equal to $70 per capita. Withholding tax on interest earnings appears to inhibit offshore banking, as evinced by Hong Kong's experience. Profit taxes, on the other hand, are clearly not so much of a deterrent, as the Singapore case attests. And Bahamas has raised revenue successfully through stamp duties.

Domestic capital and/or reserve requirements - capital requirements of this type are imposed by Panama and Singapore - yield a net benefit equal to the return on the funds expropriated minus any interest earned by the offshore banks on their local capital or reserves. Such requirements have not commonly been imposed. Like withholding taxes on interest earnings, they tend to deter offshore banking.

Operating expenses are probably the most important benefit accruing from functional offshore centres. Of course, the net benefit is the relevant figure. This can be calculated by subtracting expatriate labour costs, imports' costs and the opportunity cost of local employees and local capital, e.g., buildings, from the gross expenditures of the centre. However, indirect taxes, e.g., import duties, should be added back to the net benefit figure. Indeed, import duties paid by offshore banks can be considerable.

The indirect benefits of offshore banking centres are much more difficult to measure. The supposed improved access to international capital markets is likely to be due to the same factors that attracted the functional offshore centre in the first place, rather than to the subsequent existence of the centre itself. Competition will not be stimulated if offshore banking is kept, as it easily can, strictly separated from the onshore financial sector. Training may be of little benefit to onshore financial intermediaries if offshore banks keep the trained labour. Indeed, they may create a brain drain. Finally, only the largest functional offshore banking centres can expect to attract any significant number of ancillary institutions. In sum, the net benefits may not be as substantial as has sometimes been thought [McCarthy (1979, p.48)]. Hodjera (1978, p.242) estimates that Singapore's large functional offshore banking centre contributed only about 1 per cent of gross domestic product in 1976.

On the obverse side of the coin are the costs involved in attracting offshore banks. The direct costs include: (a) legislative and regulatory changes; (b) communications; (c) education and training; and (d) regulation and supervision. There may possibly also be an indirect cost in the form of weakened monetary autonomy.

The largest costs of attracting offshore banking involve the expenses of installing and maintaining a modern and highly efficient communications system. Functional offshore centres will not be attracted unless the local population has received a reasonable level of education and training.

Regulation and supervision can be extremely costly. The results of easy entry combined with the absence of any supervision are well illustrated by the recent case of St. Vincent. Towards the end of 1978, St. Vincent opened its doors to all foreign banks wanting to establish offshore branches. No regulations or supervision were imposed. By early 1979, organised crime had become well established in St. Vincent's offshore banking centre. After the U.S. exerted pressure, St. Vincent closed the centre down amid a considerable scandal in mid-1979. Because of the high costs of supervision, it may well pay to licence only large, reputable banks and dispense with formal supervision on the grounds that such banks will not risk any activities which might cause scandal.

McCarthy (1979, p.48) concludes his analysis of the benefits and costs of hosting offshore banking centres as follows:

> While the benefit-cost equation appears favorable for existing centers, it seems possible, indeed probable, that there is little unsatisfied demand for new offshore centers. There are even some signs at present of an excess supply. If one looks at the existing geographical coverage provided by offshore centers, virtually every area of the world has a selection of offshore centers readily accessible. In addition, improved telecommunications render it easier than before to route paper business through a limited number of centers rather than setting up operations in several widely dispersed centers. In general, therefore, new paper centers are not likely to succeed. In addition, even existing centers might become less important and less profitable if moves to impose controls on the Euro-currency markets are successful, and/or if New York establishes an International Banking Zone.

The probability of New York's International Banking Zone getting launched was increased considerably at the end of 1980 by the submission of the Federal Reserve Board's proposal to permit U.S. banks to establish International Banking Facilities within the U.S. [Cheng (1981)]. The acceptance of this proposal would be a crippling blow to some of the existing offshore banking centres, particularly those located in the Caribbean.

6. Policies for Effective and Efficient Domestic Resource Mobilisation and Allocation in Small Island Developing Economies

The objective of any financial development programme is to raise both the quantity and quality of investment and, hence, to accelerate the rate of economic growth. The majority of such programmes have, in practice, stressed institution building plans - development banks, stock exchanges, etc. They incur substantial resource costs. However, Khatkhate and Villanueva (1978, p.982) conclude:

> The evidence is strong that the specialized institutions are no panacea for solving the basic problem of credit allocation ....

An appropriate legal framework together with price stability are two basic prerequisites for promoting efficient financial intermediation. The legal framework will determine, in large part, the structure of the financial sector. Khatkhate and Riechel (1980) point out the drawbacks of banking laws which enforce specialisation: