

FINANCIAL SECTOR DEVELOPMENT IN SMALL ECONOMIES

The important roles that money and credit play in the functioning and growth of market economies have been analyzed in a large literature. The specialization, trade, and investment that drive economic growth require the parallel development of money and of a credit mechanism that stimulates voluntary saving and efficiently allocates it to productive uses.

The use of money allows exchange of goods and services to be split into the separate transactions of sale and purchase, and also allows these transactions to be separated in time. A person holding money is able to purchase any item of choice at any time: money is thus the most liquid of financial assets, serving as a unit of account, medium of exchange, and store of value. However, where money is the only financial asset, there are constraints on deficit spending (that is, expenditure in excess of current income) and saving, and these constraints retard economic growth. Deficit spenders can only finance expenditure by running down saved money balances or selling tangible assets (such as land or jewelry); or by convincing suppliers to wait for payment, in which case the suppliers themselves spend less or run down their stocks of wealth. The result is that deficit spending is confined largely to the rich, while poorer households, farmers, and potential entrepreneurs are unable to acquire the durables, equipment, and buildings needed for increasing future income. In the money-only exchange economy, savings are in the form of money itself or of assets with marketability and, therefore, a

degree of liquidity. Savings held as idle money balances or in the form of land, houses, precious metals, or other goods do not add to an economy's productive capacity. Nor is there much of an incentive to save, since idle money balances and idle land or jewelry offer no rate of return.

Financial innovation eases the constraints of the simple exchange economy by stimulating saving and linking it to the provision of credit, defined as the means by which transactors are enabled to acquire commodities against a promise to pay later. This innovation takes two main forms. One is the development of financial instruments or primary securities (bonds, bills, and shares) and of markets in which such instruments can be exchanged. These instruments provide an attractive means of accumulating savings, while allowing real investment by those with entrepreneurial ability. Transactions occur directly between savers and the users of finance.

The second main form of financial innovation is the development of financial intermediaries. These intermediaries offer savers claims on themselves (so-called secondary securities) that are safer, more convenient, and of shorter maturity than primary securities; and they lend money to deficit spenders quite independently. Credit facilities are usually cheaper and more convenient than direct issue of primary securities. Financial intermediaries thus stimulate and mobilize saving and reduce the cost to investors of borrowing. Financial intermediaries also offer valuable technical advice to potential borrowers, and support other credit mechanisms by trading in primary securities and acting as a source of borrowed funds. In all these ways, financial development stimulates the economic growth process.

As Furness (1975, 25–26) notes:

In Western countries financial innovation evolved in response to the needs of expanding economic activity. Rapid economic growth created a demand for better credit provision and, as saving rose with real income, there was also a demand for convenient ways in which saving could accumulate. It was therefore profitable to meet these needs by establishing financial institutions and markets.

The financial innovation stimulated by economic growth in turn had a crucial feedback effect on growth by further boosting savings and investment.

Financial innovation in the developing world has also been driven by economic growth. However, governments anxious to reduce poverty have promoted financial innovation as a means of accelerating economic growth. They have sought to stimulate domestic savings facilities, domestic demand for credit, and the necessary financial infrastructure, rather than waiting for a "natural" evolution. Public ownership of financial institutions therefore became more common in developing countries than was historically the case in the West. Such institutions offered a wide range of technical services, and often had to lend at rates that did not cover costs, despite high risks of default and poor security. Governments and central banks generally played active roles in financial market development.

Financial development in the small island states of the Pacific follows the broad pattern of economic growth stimulating financial innovation, with governments seeking to strengthen the reverse feedback loop; but the extent of that development has been limited by the specific nature and performance of the island economies. These economies are small in terms of land area, population, and gross domestic product (Table 1.1); and nonmonetary production is significant, accounting for perhaps 20 percent or more of GDP in some countries. Almost all households have some involvement in the cash economy, but for the many households in remote rural areas and outer islands, subsistence production for home consumption is dominant. Growth in the monetary component of GDP, driven by primary product exports and aid-supported public sectors, has varied substantially across countries and time. Generally, however, it has been disappointingly slow, despite investment ratios in the range of 25–35 percent of GDP (ADB 2000a).

The small size of the economies of the Pacific developing member countries (PDMCs), the semisubsistence lifestyles of their rural populations, and their modest economic growth rates are reflected in relatively simple financial systems. Fry (1994, 11–12) reports a "strong correlation" between strength and breadth of financial systems and economy size, and goes on to observe that:

For some small economies, economy size, training and know-how deficiencies leave no room for choice. Either financial intermediation is undertaken by foreign banks or there will simply be none at all.

Six PDMC economies use the currencies of larger, developed economies. The Australian dollar circulates in Kiribati, Nauru, and Tuvalu; the New Zealand dollar in the Cook Islands; and the US dollar in the Federated States of Micronesia and the Marshall Islands. The other six PDMCs have central banks that issue their own currencies and manage money, banking, and foreign exchange. Otherwise, PDMC financial systems consist of a small number of commercial banks (mostly branches of foreign banks); a state-owned development bank; a housing or home finance corporation (usually state-owned); a national provident fund (NPF); some credit unions; perhaps some private merchant banks and leasing and finance companies; and various informal savings and borrowing mechanisms. There has been very little development of capital markets.

The simplicity of PDMCs' financial systems has neither guaranteed their stability nor facilitated the creation of a virtuous circle of economic growth-financial sector development-economic growth. Hughes (1998) notes that there were signs of stress in some PDMC financial systems during the 1990s, including failure of state-owned banks, the weak state of development banks, and high proportions of government debt in the asset portfolios of commercial banks and provident funds. Identifying the causes of stress, and formulating and implementing strategies to strengthen and develop financial systems, constituted a major policy challenge for governments and their development partners at the start of the new millennium.

PURPOSES OF THE REPORT

This report seeks to make a useful contribution to meeting the policy challenge of strengthening and developing PDMC financial systems. It is the product of a regional technical assistance (TA) project funded by the Asian Development Bank

Table 1.1
Key Indicators of Pacific Developing Member Countries of ADB

Country	Land Area (^{'000} sq. kms.)	2000 Population (^{'000})	1999 GNP/GDP (\$USmillion)	Trade/GDP 1999 (%)	Aid/GDP 1998 (%) ^a
Cook Islands	0.2	17.9	75	57.6	10.8
Fiji Islands	18.3	811.0	1,848	81.1	1.8
Kiribati	0.7	89.8	81	42.3 (1998)	17.1
Marshall Islands	0.2	51.7	99	79.1	52.4
Fed. States of Micronesia	0.7	118.5	212	25.2 (1998)	39.3
Nauru	0.02	11.8	48 (1995)	164.0 (1995)	5.2 (1995)
Papua New Guinea	462.8	5,100.0	3,834	88.4	7.3
Samoa	2.8	170.7	181	56.1	17.6
Solomon Islands	28.9	458.6	320	110.0 (1995)	13.2
Tonga	0.8	100.3	172	55.5	13.2
Tuvalu	0.02	11.0	14	52.1	2.3
Vanuatu	12.2	187.7	227	54.0	17.6
Total	527.64	7,129.0	7,111		

Sources: ADB 2001a; Hughes 1998.

a. For Fiji Islands, PNG, Samoa, and Vanuatu, refers to net flows of long-term public and publicly guaranteed debt from official creditors and grants, including technical cooperation grants. For other countries, refers to official development assistance only.

(ADB) and cofinanced by the Government of New Zealand.¹
 The objectives of the TA were to

- Assess the state of financial sector development in selected PDMCs; and
- Formulate a strategy for the sustainable development of sound financial systems, taking into account the specific characteristics of PDMCs.²

The suggested strategy was to form the basis of a policy dialogue between ADB and the PDMCs and of future ADB

¹ TA 5853-REG, Technical Assistance for the Financial Sector Study in Selected Pacific Developing Member Countries, August 1999.

² The issues of offshore financial centers and money laundering are to be addressed in a separate study.

assistance to the financial sector in PDMCs. (Appendix 1 summarizes past assistance and its changing nature).

Seven PDMCs were selected for study in late 1999 and early 2000. They included the six countries issuing their own currencies (Fiji Islands, Papua New Guinea [PNG], Samoa, Solomon Islands, Tonga, and Vanuatu), and one representative of the group of very small states using the currency of a larger economy (Kiribati). This selection ensured coverage of the current diversity of monetary arrangements, financial system sophistication, economy size, and income levels. Individual country reports were prepared as the basis of this regional report, and appear as a second volume. Drafts of all reports were circulated for comment to the governments of participating PDMCs and concerned external agencies (most notably the Pacific Financial Technical Assistance Centre). Findings were also presented and discussed at the Pacific Governors' Meeting at ADB's annual general meeting in Chiang Mai, Thailand, in May 2000; at the 15th annual conference of Development Financial Institutions in the Pacific held in Pohnpei, Federated States of Micronesia, 4–6 July 2000; at the Forum Secretariat's Financial Sector Reform Workshop in Nadi, Fiji, 28–30 November 2000; and during the seminar on Financial Sector Stability and Development: The Case of the Pacific Island Countries, organized by the International Monetary Fund (IMF) and the Pacific Financial Technical Assistance Centre, held in Apia, Samoa, 20–21 February 2001. Comments received have been incorporated into the revised versions of the regional and country reports.

The next six chapters (2–7) present the assessment of the state of financial sector development in PDMCs, starting with the macroeconomic environments that are critical determinants of the efficiency of financial intermediation, and proceeding to the banking sector, nonbank financial institutions (NBFIs), financial markets, microfinance, and the impact of land tenure systems. Chapter 8 then provides an overall assessment of the key constraints on financial sector development. The final chapter presents the recommended strategies for promoting financial sector development.