

THE FINANCIAL STRUCTURE OF BARBADOS

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1. Introduction

This work describes and evaluates the financial structure of Barbados during the 1990s, when the Barbadian economy can be described as a service economy led by tourism. Following Goldsmith (1969), the term financial structure refers to the institutional and instrument composition of an economy's financial sector. It has become customary in economic analysis to relate a country's financial structure to economic growth and development. However, the role of the financial structure in the savings/investment process is theoretically ambiguous, because the line of causation between finance and development is not uni-directional. The impact of finance depends on the degree of institutional development of the financial structure, as well as the choice of financial instruments to mobilize the economic surplus.

This paper builds on previous work in order to interpret the contemporary financial structure. The outline is as follows. The first section discusses measures of financial structure, and the definition of financial instruments. This is followed by a review of the relevant literature on Barbados. Subsequent sections examine the diversification of the financial sector, looking at the structure of financial assets, the mobilization of domestic savings, and the importance of major lending instruments. This leads us to an evaluation of the major institutional changes in the financial system, particularly offshore banking, mutual funds, the securities exchange, and venture capital. In our analysis two Barbadian dollars are equivalent to one United States dollar (Bds \$ 2.00 = US \$1.00).

2. Methodology

Our analysis is informed by the approach introduced by Goldsmith (1969), and partially applied to Trinidad and Tobago by Bourne (1988). Financial ratios are employed drawing on the work of Bourne (1988). This approach relates various financial magnitudes to the level of GDP overtime. However, it is instructive to discuss Goldsmith's definition of financial instruments and the measurement of financial structure.

According to Goldsmith (1969:3), financial instruments are "evidences of claims

against other economic units or of ownership in them, particularly in forms easily marketable." He distinguishes between two basic types of instruments, namely, claims and equity securities. He identifies three groups of issuers including business enterprises, governments and households. The types of instruments examined in this paper consist of claims against financial institutions such as money, deposits, and reserves of insurance companies. Claims against non-financial sectors include mortgage loans, consumer credit, other bank loans and government securities.

Goldsmith (1969:26) also observes that "the presence, nature, and relative size of financial instruments and financial institutions of various types then characterize a country's financial structure." Our analysis uses certain measures of financial structure as far as the data allow. Goldsmith's financial interrelations ratio (FIR) is defined as the ratio of all financial assets in existence to national wealth. It was not possible to obtain this statistic for Barbados. However, in examining the size and growth of the financial structure in Barbados we calculated the value of assets of all financial institutions as a ratio of GDP.

The composition of the financial structure can be measured by looking at the percentage distribution of assets of financial institutions, the distribution of financial savings, and the distribution of specific financial instruments such as loans and government securities. Again, the available data did not allow a computation of the share of all financial institutions in the total financial assets of the economy. We were also unable to use Goldsmith's financial layering ratio which measures the ratio of intra-financial transactions to total financial assets. This involves flow of funds statements which are not available in Barbados.

3. Previous Work

The analysis by Worrell and Prescod (1983) highlighted certain early developments in the Barbadian financial structure between 1946 and 1980. They discussed the leading role played by the commercial banks and the National Insurance Fund (NIF) in the mobilization of financial savings. This study observed that the outstanding features of Barbadian financial development during this period were the role played by the Government, and the improved access to credit by

householders. Government's establishment of the National Insurance Scheme (NIS) accelerated the growth of financial liabilities in the banking system.

Worrell and Prescod (1983) contended that during the early post-World War II period, the most significant development by private sector institutions relates to the increase in personal and mortgage lending. The introduction of consumer instalment credit by commercial banks, as well as the expansion in mortgage facilities, altered the sectoral allocation of credit. However, during this period venture capital facilities were deficient. Further, few shares were quoted for sale or purchase. Foreign capital was the main contributor to long-term lending.

The study by Worrell and Prescod was not only concerned with the changing financial structure but with policy issues. The work examined interest rate determination and the impact of interest rates on the economy. They argued that the role of interest rates was the most contentious issue in financial development in the 1970s. The early monetary policies of the Central Bank of Barbados were also discussed in detail.

Codrington and Coppin (1989) were primarily concerned with the sectoral distribution of credit at commercial banks between 1977 and 1987. They argued that during this period, despite policies implemented by the Central Bank, the share of credit at commercial banks did not significantly shift to the foreign exchange earning sectors such as export manufacturing, tourism and agriculture. However, they observed that by 1987 the manufacturing and tourism sectors received a greater share of long-term lending than in previous periods. This study also discussed the growth of assets of non-bank financial intermediaries including life insurance and trust companies. The role of credit unions was also briefly examined. Haynes (1997) also provides a historical analysis of the evolution of the financial system after 1970.

Howard's work (1989) partially applied Goldsmith's (1969) approach to financial development between 1946 and 1985. Howard's analysis reached the following conclusions:

- (1) The efficiency of bank lending improved only slightly towards the end of this period, as the manufacturing and tourism sectors received higher shares of credit.

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- (2) Short-term bank lending remained predominant, but there was an increase in the share of long-term credit towards the end of the period.
 - (3) Non-banks increased their financial assets as a ratio of GDP while the share of commercial bank financial assets fell between 1968 and 1985. This trend followed Goldsmith's prediction.
 - (4) Commercial bank savings mobilization remained strong as shown by the rise in the ratio of deposits to GDP during the period.
 - (5) Savings mobilization by non-banks was modest compared with commercial banks.
 - (6) The role of the Central Bank was important in sterilizing excessive bank liquidity, as well as instituting controls on commercial bank consumer credit.

Our rationale for examining the contemporary financial structure using data for the 1990s is that the Barbados economy has become a service economy, and this is reflected in significant changes in the institutional financial structure, as well as the role played by the commercial banks. These changes contrast with the early post-colonial period of the 1960s and 1970s, when the economy was making a transition from a sugar economy to a service economy based on tourism, financial and other services.

4. Development of the Financial Structure

It is possible to gauge the growth of the financial structure of Barbados by examining various financial ratios. These ratios are indicated in Table 1 as follows:

- (1) TFA/GDP
- (2) ACB/GDP; ANB/GDP
- (3) TD/GDP; M_1 /GDP

where

TFA = Total assets of the financial system

ACB = Total assets of commercial banks

ANB = Total assets of non-bank financial intermediaries

TD	=	Total deposits of the financial system
M_1	=	Currency with the public and demand deposits at commercial banks.
GDP	=	Gross Domestic product at factor cost.

In our analysis M_1/GDP is regarded as a measure of monetization, and TD/GDP is a measure of financial deepening (See Lawrenceson and Chai, 1998). The other measures are indicators of the size of the financial structure relative to the real sector.

Our analysis shows a number of significant changes in the financial structure. First, the financial system experienced a rapid expansion relative to the real sector during the 1990s as evidenced by the increase in the TFA/GDP ratio from 1.46 in 1990 to 1.81 in 1998 (Table 1). This was similar to an expansion observed by Howard (1989) for the late 1960's and early 1970s. Second, this expansion was led by the commercial banking system, as shown by the increase in the ACB/GDP ratio from 0.73 in 1990 to 1.09 in 1998. Howard (1989) had observed a decline in the ACB/GDP ratio between 1970 and 1985. Third, the ANB/GDP ratio rose up to 1995 and then declined. This was due mainly to the relatively slower growth of assets of life insurance companies and trust and mortgage finance companies. Fourth, the Barbadian economy experienced fairly strong financial deepening and monetization as shown by the increases in the TD/GDP and M_1/GDP ratios.

What was the major cause of buoyant financial growth in the Barbadian economy? The answer to this question can be found in the real growth of the service economy after 1992. Except for a period of negative growth between 1990 and 1992, the economy rebounded to record real growth rates averaging 3.1 percent per annum between 1993 and 1998. Buoyant real growth, stimulated by tourism expansion and services, increased the demand for loans as well as deposits in the commercial banking system. For example, the ratio of commercial bank private sector credit to GDP rose from 41.6 percent in 1990 to 59.0 percent in 1998 (See Table 5). Real growth did not have as strong an expansionary effect on the assets of life insurance companies. Households seemed to prefer investment in relatively liquid assets. The mid-1990s were characterized by high levels of liquidity in the banking system.

One significant consequence of buoyant real growth in Barbados in the second

half of the 1990s was an increase in the profitability of commercial banks. The rate of return on assets (ROA), defined as net income as a ratio of average assets, averaged 1.8 percent between 1994 and 1998, with a high of 2.4 in 1998. High ROAs reflect financial inefficiency because they indicate the appropriation of monopoly rents by the banking system. Banks were able to sustain their profitability by maintaining wide interest rate spreads between deposit and loan rates.

Table 1: Indicators of Financial Development (1990 - 1998)

	ANB/GDP (%)	ACB/GDP (%)	TFA/GDP (%)	TD/GDP (%)	M ₁ /GDP (%)
1990	0.52	0.73	1.46	0.79	0.21
1991	0.58	0.75	1.53	0.80	0.19
1992	0.66	0.84	1.76	0.92	0.22
1993	0.63	0.82	1.71	0.92	0.22
1994	0.63	0.90	1.80	0.96	0.27
1995	0.64	0.96	1.80	1.01	0.28
1996	0.51	1.10	1.88	1.11	0.30
1997	0.48	1.11	1.84	1.03	0.35
1998	0.41	1.09	1.81	1.00	0.33

Source: Central Bank of Barbados, *Annual Statistical Digest*, 1999.

Table 2 shows the composition of assets of the financial system. The commercial banks increased their share of assets from 49 percent in 1990 to 62.3 percent in 1998. Howard (1989) had shown that the commercial banks' share of financial assets had actually declined between 1971 and 1985, and the share of non-banks had increased. The reverse was true for the period of the 1990s. The share of assets of the National Insurance Fund and credit unions also increased slightly in the 1990s. The assets of life insurance companies, and trust and mortgage finance companies remained relatively stable over the period. These companies are less likely to invest in high risk assets, and this may explain why the financial growth of these companies slowed during the 1990s.

The assets of credit unions and merchant banks have remained small relative to commercial banks. However, credit union activity has expanded since 1994, as the financial system became more liquid. Credit unions were also able to market their services and convince many lower-income earners of the benefits to be derived from

credit union membership. Credit union membership expanded from 37,586 in 1990 to 69,097 in 1998. (See Central Bank of Barbados, *Annual Statistical Digest*, 1999).

Table 2: Percent Composition of Assets of the Financial System

Institution	1990	1992	1994	1996	1998
Central Bank	14.7	16.0	14.2	11.5	10.2
Commercial Bank Assets	49.0	47.1	50.3	56.0	62.3
Assets of Life Insurance Co's	11.1	11.7	11.3	8.9	-
Assets of Credit Unions	3.4	3.9	3.5	3.8	4.7
Assets of Trust and Mortgage Co's	8.7	8.5	8.2	7.2	6.7
Assets of Finance Co's and Merchant Banks	1.3	1.3	1.2	1.2	1.8
Assets of National Insurance Fund	11.7	11.5	12.2	14.4	14.3
Total	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Barbados, *Annual Statistical Digest*, 1999

5. Saving Mobilization

Although the TD/GDP ratio gives an idea of savings mobilization in the economy as a whole, it is necessary to examine the separate contributions of banks and non-banks to financial deepening. Further, we examined other financial magnitudes such as life insurance premiums and national insurance contributions to gauge the level of contractual savings. These instruments were not included in the TD/GDP ratio. We also regard the share capital of credit unions as a measure of savings in credit unions.

distributive sector rather than the productive sectors. The pattern of distribution changed in the 1990s as banks extended an increased proportion of credit to the personal and service sectors. This reflected the fact that Barbados had become a service economy where over 70% of the country's GDP was derived from services. In 1997, Table 6 shows that the major sectors using credit were distribution, the personal or household sector and services which include transport, professional services and other government services. The decline of the manufacturing sector is reflected in the small 5.5% of loans going to that sector in 1997. The same is true for the agricultural sector where sugar has declined since the 1960s.

Previous writers such as Howard (1989), Codrington and Coppin (1989) and Worrell and Prescod (1982) observed the tendency of banks to prefer short-term credit and overdrafts in the 1970s and 1980s. Howard (1989) argued that short-term credit was not necessarily an indicator of allocative inefficiency because it provided working capital during recessionary periods. Codrington and Coppin (1989) noticed that by 1987, the tourism sector held 60% of its loans with maturities over five years. In the 1990s, the category of loans over five years had the highest proportion of credit.

Our analysis shows that by 1998, 44.3 percent of bank loans to all sectors had maturities over five years. In 1990, the corresponding proportion was 47.7 percent. Close inspection of the data leads to the view that there was a shift to longer-term credit in the 1990s, and the sectors receiving increases in such credit were the tourism and household sectors. This supports our view that in order to satisfy the long-term demands of the service economy, the banks have increased their long-term lending, which contrasts with the predominance of short-term credit in the early post-colonial economy.

Banks are the main suppliers of consumer credit, controlling 87.7 percent of the market in 1998. In recent years finance companies have been active in this area with the expansion of the market for imported reconditioned vehicles. Their market share of consumer credit remained small at 12.3 percent in 1998. The value of consumer lending in Table 5 did not include the credit unions. Although credit unions are involved in consumer instalment lending, I was unable to decompose their lending portfolio which also includes mortgages.

Commercial banks, trust companies and the NIF are the main holders of government securities. The share of commercial banks and trust companies was 40.5 percent in 1998 while that of the NIF was 35.7 percent. Commercial banks are required to maintain a liquid assets requirement at the Central Bank. This requirement was 20.0 percent of deposit liabilities in 1998 and partly explains investment by commercial banks in the securities market. Further, in periods of excess liquidity, government securities provide a safe instrument for investment by commercial banks. This also explains the investment in government securities in the 1990s.

Mortgage loans have remained stable in relation to GDP. Trust companies are the main mortgage lenders in Barbados holding about 46.0 percent of the long-term residential mortgage market. These are followed by the insurance companies (24.6 percent), the commercial banks (14.9 percent), and the Barbados Mortgage Finance Company (14.5 percent).

Table 5: Major Domestic Lending Instruments

	1990 Bds \$m	Percent of GDP	1998 Bds \$m	Percent of GDP
Consumer Credit	171.4	6.0	561.0	14.2
Commercial bank Credit to private Sector	1235.6	41.6	2315.4	59.0
Mortgages	562.0	18.2	758.6	19.3
Government Securities	892.6	30.1	2145.6	54.7
Credit Union Loans	109.2	3.7	234.4	6.0

Source: Central Bank of Barbados, *Annual Statistical Digest*, 1999.
Bds \$ 2.00 = US \$1.00.

Table 6: *Sectoral Distribution of Commercial Bank Credit*

Sector	1990		1997	
	Bds \$m.	%	Bds \$m.	%
Agriculture	30.4	2.4	45.4	2.3
Manufacturing	173.5	14.0	109.0	5.5
Distribution	204.7	16.5	259.4	13.1
Tourism	82.9	6.8	194.5	9.8
Public Utilities	22.8	1.8	24.9	1.3
Construction	49.1	4.0	91.2	4.6
Personal	283.3	22.9	732.5	37.1
Financial Institutions	90.3	7.3	86.6	4.4
Services	211.5	17.2	250.8	12.7
All Other	87.4	7.1	182.3	9.2
Total	1235.9	100.0	1976.6	100.0

Source: Central Bank of Barbados, *Annual Statistical Digest*, 1999.
 Bds \$2.00 = US \$1.00

7. Financial Innovation

Financial innovation was a characteristic of the Barbadian financial structure in the late 1980s and 1990s. Government played an important role in providing tax incentives to stimulate the growth of the capital market, and to encourage international banking. Fabozzi et al (1994:24) have identified a number of causes of financial innovation. These include changes in computer and telecommunications technologies, greater sophistication and training among professional market participants, competition among financial intermediaries, incentives to circumvent regulations and tax laws, and changing global patterns of financial wealth. Innovation in the Barbadian context has been designed to provide alternative avenues for

investment, as well as to achieve benefits from the globalization of financial flows.

The first major innovation was the introduction of the Securities Exchange of Barbados (SEB) in 1987. The rationale for the SEB is to enhance capital market development. Most firms in Barbados rely on bank loans rather than equity for financing investment. Craigwell and Grandbois (1999) have maintained that equity investment has become necessary to absorb the excess liquidity in the financial system.

The SEB is a small financial institution compared with stock markets in developed countries. The number of firms trading on the SEB was 20 in 1999. Table 7 shows the value of shares traded, as well as the market capitalization. The latter concept has been defined by the Central Bank of Barbados as the market value of all listed companies at the end of the period. Despite the growth in capitalization, it appears that the SEB is not price efficient in the informational sense defined by Fama (1970). A price-efficient market is one in which security prices reflect all available information. Craigwell and Grandbois (1999) have found that the SEB is inefficient both in the weak-form, semi-strong form and strong-form sense.

Another innovation which started before the 1990s is offshore banking. Doyle and Johnson (1999) have estimated that Barbados had 44 licenced offshore banks and five of these accounted for approximately 85 percent of the industry. They further estimate that the local expenditure by offshore banks was Bds \$50 million in 1996. Offshore banks employed 169 individuals in 1998, 77 percent of whom were local individuals. Doyle and Johnson reported that offshore banks contributed Bds \$1,771.5 million to the GDP of Barbados in 1998. However, offshore banking output is not normally included in the official GDP estimates of Barbados. Doyle and Johnson's GDP estimate for offshore banks cannot be regarded as conclusive, because the methodology for calculating offshore output needs to be defined more clearly.

Table 7: Indicators of Stock Market Performance: Barbados (1990 - 1998)

Year	Market Value of Shares Bds \$m	Market Capitalization Bds \$m	Market Capitalization as percent of GDP
1990	10.1	563.1	18.9
1991	18.3	616.5	21.3
1992	4.4	518.3	19.2
1993	8.9	656.2	23.4
1994	11.5	1035.4	35.3
1995	6.2	988.7	31.4
1996	12.4	1,540.1	45.6
1997	46.6	4,444.3	123.2
1998	2,036.7	4,824.1	122.9

Source: Central Bank of Barbados, *Annual Statistical Digest*, 1999.

Bds \$2.00 = US \$1.00

Another significant financial innovation is the institution of mutual funds. These constitute a pool of savings contributed by many investors which is used to purchase a portfolio of securities. The investment company which is known as the mutual fund sells shares to the public, and reinvests those shares in a portfolio of securities. Mutual funds help to diversify savings and minimize financial risks. They also provide investors with liquidity because the shares are redeemable. A mutual fund also provides professional management of investors' funds. In Barbados the government has encouraged investment in mutual funds by allowing an income tax deduction of up to Bds\$10,000 from assessable income.

There are three mutual funds in Barbados which are specialized in different types of instruments. For example, the Mutual Global Balanced Fund offers a mixture of investments including equities, income and money market securities which are

invested globally. In contrast to the balanced fund, the Barbados National Bank offers separate mutual funds including an income fund, a capital growth fund, a gift trust fund and a property and unlisted securities fund. These funds have different investment objectives. The objective of the income fund is to provide high income by investing generally in government securities, and high yielding stocks. The capital growth fund aims at long term capital appreciation by investing in equities issued by companies. The property and unlisted securities fund is aimed at long-term capital appreciation through investments in real estate both in the commercial and residential market. The other mutual fund in Barbados is the Fortress Mutual Fund.

The quarterly reports of the mutual funds companies in Barbados indicate that the funds are small but growing slowly. The net assets of the Mutual Global Balanced Fund was Bds\$41.0 million at the end of June 1999, and 2600 shareholders were enrolled in this fund. The net assets of the Fortress Mutual Fund at the end of February 1999 were Bds \$33.1 million. The performance of these funds has been affected by the volatility of Caribbean stock markets. The companies international equity funds performed better than regional investments because it was possible to hedge more effectively in international markets.

Venture capital funding is another innovation in the financial system, but the high risk nature of this activity deters many investors from participating. Venture capital requires an adequate pool of risk capital, and the availability of high growth investable projects. Venture capital investment in Barbados is small and has been estimated at Bds\$23.0 million (See *The Business Authority*, Monday, October 18, 1999 published by the *Barbados Advocate*).

The two venture capital companies in Barbados are the Barbados Investment Fund (BIF) and the Enterprise Growth Fund (EGF). The BIF was established in 1992 by the Central Bank of Barbados and the Caribbean Financial Service Corporation (CFSC). The BIF was initially capitalized at Bds\$6.0 million, of which Bds\$5.0 million was contributed by the Central Bank, and Bds\$1.0 million by CFSC which is the Funds Manager. At the end of 1999 the BIF had invested \$8.0 million in 24 projects since the fund's inception in 1992. (See Central Bank of Barbados, *Annual Report*, 1998). The EGF by the end of 1998 had committed Bds\$2.0 in venture capital

investment to six Barbadian companies (See *the Business Authority*, Monday, October 18, 1999, published by the *Barbados Advocate*).

Financial instrument innovation was another prominent feature of financial development. The Barbados Government introduced a range of instruments to provide medium-term investment alternatives in a market dominated by short-term treasury bills and long-term debentures. These included savings bonds and national development bonds which were tax free up to a limit per issue of Bds\$50,000. After 1987, refunds of income tax could be obtained in whole or part in the form of tax refund certificates, which were interest-bearing and exempt from income tax. Treasury notes are medium-term instruments with a maturity of more than one year and up to ten years.

Zephirin and Seerattan (1997) have also mentioned other financial innovations, but it is difficult to obtain data to document the impact of these instruments. They include Automatic Teller Machines (ATMs), credit and debit cards, commercial paper, credit union deposit accounts, sale and leaseback arrangements and syndicated loans.

8. Conclusion

The most significant feature of the Barbadian financial structure is the dominant role played by the commercial banks. Goldsmith (1969) had observed that non-banks increase their share of financial assets during the course of development. This was so during the 1970s and 1980s in Barbados, but the commercial banking system in the 1990s has shown a remarkable resurgence. The banks have increased considerably their share of assets in the financial system, and have eclipsed all other institutions in mobilizing savings. The pattern of lending by commercial banks has changed. Banks now extend more credit to the household and services sectors, and their portfolios contain a higher proportion of long-term lending. Apart from the increased dominance of the commercial banks, the Barbadian financial system has experienced a significant degree of financial innovation, including the institution of mutual funds, venture capital companies, a stock market, as well as the introduction of new financial instruments. The policy of the government is to continue to broaden the capital market by providing appropriate fiscal incentives.

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Abstract

This paper examines the contemporary financial structure of Barbados. The analysis suggests that commercial banks dominate the financial structure, and the role of non-banks is relatively small. Commercial banks are the major mobilizers of financial savings. Commercial bank lending is oriented towards the household and services sectors including tourism, transport, entertainment and professional services. The decline of manufacturing and agriculture has reduced the share of credit going to these sectors. Credit unions and the National Insurance Fund are becoming more important in mobilizing financial savings. The Barbadian financial system has experienced a significant degree of financial innovation including the institution of mutual funds, venture capital companies, a stock exchange, as well as the introduction of new financial instruments. Government's policy is to continue to broaden the capital market by providing appropriate fiscal incentives.

LA STRUCTURE FINANCIÈRE DE BARBADE**Résumé**

L'article examine la structure financière actuelle de la Barbade. L'analyse suggère que les banques commerciales dominent la structure financière, et que le rôle des institutions non-bancaires est relativement petit. Les banques commerciales sont les mobilisateurs les plus importants d'épargne financière. Le prêt bancaire commercial est orienté plutôt vers les ménages et les services - tourisme, transport, loisirs et services professionnels inclus. La baisse des secteurs de fabrication et d'agriculture a réduit le pourcentage de crédit qui leur est attribué. Néanmoins, les sociétés de crédit et le Fonds d'Assurances Sociales (National Insurance Fund) deviennent plus importants dans le processus de mobilisation d'épargne financière. En outre, le système financier de la Barbade est devenu plus innovateur avec la création des fonds communs de placement, société de capital risque, la Bourse, et la production de nouveaux instruments financiers. La politique de gouvernement est de continuer à élargir le marché de capital en apportant les incitations fiscales appropriées.