

BACKGROUND

Vanuatu is an archipelago of 80 mostly mountainous islands with a total land area of 12,336 square kilometers and an exclusive economic zone of around 700,000 square kilometers. The population in 1999 was estimated at 188,000, two thirds of them living on Espiritu Santo, Malakula, Efate and Tanna, and around 80 percent engaging in subsistence farming and supplementary cash crop production in rural areas. Vanuatu is well endowed with natural resources, but the scattered nature of the islands makes infrastructure development difficult and costly.

The population has a low level of human development, ranking tenth amongst 12 PDMCs on both the Human Development Index and Human Poverty Index scales, ahead of Solomon Islands and Papua New Guinea. The level of GDP per capita was approximately US\$1,200 in 1999, but this average obscures considerable inequality of income distribution: the richest 25 percent of the population (including expatriates) earn 4.6 times as much as the poorest 25 percent. Life expectancy is 66 years. The infant mortality rate is 45 per 1,000, and the adult literacy rate is just 34 percent overall and 30 percent for females (ADB 2001).

Vanuatu achieved its independence from the United Kingdom and France in 1980. It is a Republic with a democratic system of government based on a Westminster-style constitution. There is a unicameral legislative chamber of 52

members elected by universal suffrage for a four-year term. The prime minister and eight or nine co-members of the council of ministers comprise the cabinet. Vanuatu's head of state is a President, who is elected by an electoral college composed of members of parliament and the presidents of the six provincial governments. A national council of chiefs advises parliament on all constitutional matters relating to Vanuatu's traditional customs.

Political instability has been a problem in recent years, with many votes of no confidence in governments. Governments have responded by reducing parliamentary sittings, or by curtailing them; this has resulted in a backlog of legislation awaiting approval. Another problem is that many senior officers in the civil service are political appointees and when the government changes, these appointees also change. This has resulted on occasion in inexperienced and unqualified people holding senior positions. Board members of public entities are also political appointees and sometimes change when the government changes. Corruption is also a problem in Vanuatu, as evidenced by a number of Ombudsman's reports, and has caused economic efficiencies and reduced business confidence.

The majority of land is owned and used by ni-Vanuatu (indigenes) according to custom, and it is difficult for business people to obtain leases. Large areas of customary land are in dispute; and where leases are obtained, the commercial banks are reluctant to accept them as collateral. The exceptions are leases of government land, usually in the capital of Port Vila on the island of Efate and the urban center of Luganville on Espiritu Santo.

THE MACROECONOMIC ENVIRONMENT

Vanuatu's economic growth rate since independence has barely kept pace with the rate of population growth of almost 3 percent per year. In the late 1990s, there was a deterioration in the growth performance. Real GDP fell by 2.9 percent in 1995; recovered to grow by 4.8 percent in 1996; stagnated in 1997; and then declined in each of the next two years (Table 8.1). Activity in the offshore financial sector was weak in 1999

because several major US banks banned US dollar transactions with Vanuatu following allegations of money laundering. There was an economic recovery in 2000, with estimated growth of 2.8 percent. This was led by tourism, which benefited from political instability in the Fiji Islands, and construction. Exports of kava, a regionally popular, mildly alcoholic beverage, also grew. At the end of the decade, the service sector accounted for 65 percent of GDP, industry for 11 percent, and the primary sector for 24 percent.

Modest and erratic growth partly reflects the fact that growth is driven by tourism and a narrow range of primary product exports (copra, beef, cocoa, coffee, kava) that is susceptible to external shocks. It also reflects poor economic management, weak governance, and political instability.

Tourism was affected by the declaration of a state of emergency during the January 1998 Port Vila riots, which occurred after the publication of an Ombudsman's report questioning the soundness of investment decision making at the Vanuatu National Provident Fund (VNPF). Following the riots, the government of the day allowed unconditional withdrawal of retirement savings from VNPF. Since VNPF itself could provide less than half the required funds, the Government as guarantor had to make up the shortfall. The consequent injection of liquidity placed great pressure on the balance of payments, and a new government had to raise interest rates and devalue the currency (the vatu [Vt]). Similar pressure on the foreign exchange market developed in late 1999 and early 2000 when there was another change of government. On this occasion, regulations restricting access to foreign exchange for capital transactions that were removed in October 1999 were reintroduced (in February 2000). These regulations specified that requests for foreign exchange related to forward contracts would not be approved if the Reserve Bank of Vanuatu (RBV) deemed them to be speculative.

The inflation rate during the late 1990s was low, largely tracking the Australian inflation rate because of the reliance on imports from Australia and the pegging of Vanuatu's currency, the vatu to a basket of major trading partner currencies. The slight jump to 3.3 percent in 1998 reflected the one-off impact of the newly-introduced value-added tax.

The twin objectives of the Government's monetary policy are the maintenance of price stability and a viable balance of payments position. The scope for independent monetary policy is limited by the openness of the external accounts and the exchange rate peg. However, RBV introduced its own monetary instruments (RBV notes) in 1998, following the VNPF crisis. The Bank is now running weekly auctions in order to control monetary movements. RBV also runs auctions for government bonds, although it has been difficult to place one- and two-year Government instruments. Also in 1998, RBV replaced the 6-percent statutory reserve requirement (SRR) with a 16 percent prescribed reserve asset requirement (PRA), toward which banks could count their holdings of Government bonds. In late 1998, a repurchase facility covering short-term bonds and RBV notes was introduced to facilitate liquidity management. In April 1999, a 16-percent liquid asset requirement (LAR) was introduced for prudential purposes, the PRA was abolished, and the SRR—which had been reintroduced in late 1998—was raised to 10 percent on average *vatu* deposits plus 50 percent of foreign currency demand deposits.

Monetary policy was relaxed slightly in 1999 as economic activity weakened. Nominal interest rates dropped as RBV repurchased its notes and private sector demand for credit slackened. Total broad money fell by 10 percent as a result of a drop in net foreign assets (Table 8.1). The current account balance shifted into deficit as agricultural exports and tourism receipts declined. Import cover of foreign reserves still remained above six months, however.

Fiscal policy has generally operated under the rule that the recurrent budget should be balanced. This has usually been achieved, although often without reference to allocative efficiency. The same discipline has not always applied to the development budget, however (ADB 1997). In the late 1980s, there was a rapid increase in domestic debt issues to fund development expenditure. The overall budget balance went from an average surplus of 2.5 percent of GDP in 1986–89 to an average deficit of 7.0 percent of GDP in 1989–92. The deficit dropped to 2.9 percent of GDP in 1992–95, and then declined until 1998, when the VNPF crisis caused it to blow out to 7.5 percent of GDP (Table 8.1). In 1999, the deficit was lower than

budgeted: although revenue was below estimates because of the recession, spending on infrastructure projects was delayed and tighter control was exercised on current expenditure. By contrast, an 8-percent deficit in 2000 was well in excess of the budgeted deficit of 3 percent. This reflected the rollover of the delayed infrastructure projects. The medium-term target is for overall budget deficits of 2 percent, with recurrent budget surpluses and external concessionary loans financing capital expenditure.

Since 1997, governments have been implementing a Comprehensive Reform Program (CRP) with support from ADB and bilateral donors. The program encompasses governance, fiscal management, public service reform, reform of public financial institutions, improvement in the private sector enabling environment, outer island development, and mitigation of the social impact of reforms. The key theme of the CRP is redefining the role of government and facilitating an improvement in accountability, transparency and performance of government.

Reform of the financial sector is central to the private sector development component of the CRP, and focuses on the restructuring and streamlining of government-owned financial institutions and the enactment of related legislation to ensure their sustainable effectiveness. Progress has been made, but it has slowed down and much remains to be implemented. Amongst other requirements, public expenditure management needs to be improved and integrated with CRP, and a regulatory framework established for the private utility monopolies.

STRUCTURE OF THE FINANCIAL SECTOR AND INSTITUTIONS

The financial sector comprises RBV, four commercial banks, one finance company specializing in leasing equipment, five trust companies, two insurance companies, VNPF, and around 46 credit unions. The Offshore Finance Center was established in 1971 and includes around 50 banks with offshore banking licenses. These banks are not allowed to accept local deposits from Vanuatu nationals or to make loans domestically; but three of them have been granted domestic banking licenses.

Three of the four commercial banks are foreign: ANZ Bank (ANZ), the Bank of Hawaii, and Westpac Banking Corp. (Westpac). The other bank is the Government-owned National Bank of Vanuatu (NBV). The assets of the four commercial banks accounted for just over 83 percent of total assets of the financial sector in 1999. Foreign banks dominate the banking sector. NBV accounts for less than 6 percent of total assets (Table 8.2). Commercial banks have increased their market share as a result of the 1998 merger of the Development Bank of Vanuatu (DBV) into NBV and the VNPF payout of virtually all its members' contributions.

For the vast majority of ni-Vanuatu citizens, access to financial services is poor. Urban areas are provided with much better banking facilities than rural areas. Vanuatu has one branch or agency for every 7,161 people; most of the outer island branches are run by NBV. However, bank branches and agencies have declined over recent years, particularly since the closing of DBV.

Credit unions in Vanuatu are part of the semiformal system and are covered by the Credit Union Act of 1999. They are registered with the Vanuatu Credit Union League (VCUL). In 1996, there were 60 credit unions/savings clubs.

PERFORMANCE OF COMMERCIAL BANKS

The foreign commercial banks focus on low-risk lending and foreign exchange dealings. The clientele is largely urban-based and requires personal loans and overdrafts, trade finance, fixed-term loans and housing finance. In the second quarter of

Table 8.2
Total Assets/Liabilities of the Financial Sector, 1994–1999

	1994	1995	1996	1997	1998	1999 ^a
	(in percentage of Total Assets/Liabilities)					
Reserve Bank of Vanuatu	15.3	15.2	13.2	13.0	15.2	14.6
Commercial Banks	78.6	78.0	79.6	79.4	83.5	83.3
National Bank of Vanuatu	—	—	4.5	3.5	5.4	4.8
ANZ Bank	—	—	—	—	31.7	32.4
Westpac Banking Corp.	—	—	—	—	22.8	22.4
Bank of Hawaii	—	—	—	22.5	23.7	23.7
Nonbank Financial Institutions	6.1	6.9	7.1	7.6	1.2	2.1
Vanuatu National Provident Fund	6.1	6.9	7.1	7.6	1.2	2.1
Development Bank of Vanuatu	—	—	—	—	—	—

— Not available.

a. To June 1999.

Source: RBV 1999b and commercial banks.

1999, the commercial banks' outstanding portfolio comprised 95 percent private sector loans, of which 25 percent were for housing and land purchases, 11 percent for personal loans, and 12 percent for distribution. Only 3 percent of loans were for agriculture and fisheries.

Each of the three banks operates out of two offices in Port Vila and Luganville, Espiritu Santo. The minimum loan size is usually Vt100,000; and personal loans are usually no more than 5 percent of loans outstanding, secured against deposits for terms of up to 12 months. Other forms of collateral for personal loans could include vehicles, property, or guarantees. Interest rates on personal loans are in the range of 16 to 21 percent. Residential housing loans are usually for 15 years at 11 percent.

NBV was established in 1971 when it took over the assets of the Vanuatu Cooperative Savings Bank Ltd (VCSBL). It was set up to provide credit and banking services to ni-Vanuatu, particularly in the rural areas and outer islands. NBV expanded its operations rapidly in the first years of operation, but as a

result of losses inherited from the VCSBL, start-up costs, and the rapid rate of initial expansion, its capital base was substantially eroded. NBV, with Government appointees on its Board, lacked independence from the Government and had serious management problems. A review undertaken by ADB in 1998 found that NBV was close to insolvency, substantial losses having been incurred as a result of a very high level of nonperforming loans (70 percent of total loan portfolio), weak local management, and poor banking and information systems.

As part of restructuring under the CRP, DBV was merged with the NBV to create a commercially viable bank. This process was facilitated by the transfer of DBV's good loans to the NBV as of 30 October 1998 and of the bad loans portfolio to an Asset Management Unit (AMU) created by an Act of Parliament in June 1998 to manage and recover bad debts from DBV, NBV, and VNPF. An externally recruited managing director took up his post with the NBV in late 1998. NBV has subsequently cleaned out its loan portfolio and profitability has begun to improve. Its strategic focus is on serving ni-Vanuatu clients.

FINANCIAL DEEPENING AND INTERMEDIATION

There was some reversal of financial deepening during the 1990s. The ratio of broad money to GDP increased slightly from 110.8 percent in 1995 to 111.6 percent in 1999, but this reflects growth in mostly non-indigenous holdings of foreign currency deposits. Broad money exclusive of foreign currency deposits actually declined from 40.9 percent of GDP in 1995 to 38.5 percent in 1999; and the ratio of narrow money to broad money (both in vatu) rose from 40.9 percent to 41.6 percent. Time deposits in vatu grew at less than 1 percent per year during this period, while demand deposits in vatu fell as a percentage of narrow money, and currency in circulation correspondingly increased (Table 8.3). All of this suggests a declining use of the formal banking system by the ni-Vanuatu population.

Loans to the private sector grew from 36 percent of GDP in 1995 to 43 percent in 1999, but again this largely reflected growth in foreign currency lending. Commercial bank claims

Table 8.3

Financial Intermediation Statistics, 1994–1999

	1994	1995	1996	1997	1998	1999
	(Vatu million)					
Money Supply (M2)	24,070	28,296	31,371	31,251	35,219	31,609
Narrow Money (M1)	5,762	6,255	6,489	6,615	7,576	7,342
Currency (outside banks)	1,351	1,566	1,571	1,662	2,042	1,743
Demand Deposits	4,411	4,689	4,918	4,953	5,534	5,999
Demand Deposits (vatu)	2,596	2,695	2,653	2,821	2,925	2,541
Demand Deposits (foreign currency)	1,815	1,994	2,265	2,132	2,609	3,058
Quasi Money	18,308	22,041	24,882	24,636	27,643	27,869
Time Deposits (vatu)	3,852	3,634	3,858	3,739	4,484	6,315 ^a
Savings Deposits (Vatu)	2,568	2,624	2,859	2,570	2,650	
Time Deposits (foreign currency)	11,769	15,705	18,079	18,218	20,404	18,496 ^b
Savings Deposits (foreign currency)	118	78	86	109	105	
	(in percent)					
Growth of Demand Deposits		6.3	4.9	0.7	11.7	8.4
Growth of Time Deposits		23.8	13.4	0.1	13.4	—
	(in percent of GDP)					
Currency	5.5	5.9	5.6	5.6	6.9	6.2
Narrow Money	23.4	23.6	23.1	22.4	25.6	24.7
Narrow Money (Vatu)	17.3	16.7	15.6	16.4	16.8	16.0
Broad Money	94.1	106.6	111.6	106.0	119.2	112.8
Broad Money (Vatu)	42.0	40.9	38.9	36.6	41.0	38.5
Foreign Currency Deposits	55.1	66.7	72.3	69.0	77.9	73.0
	(in percent)					
Private Sector Credit (percent of GDP)	34.9	35.9	35.2	32.9	36.3	43.4
Private Sector Credit (% of total credit)	115.9	109.3	104.9	103.9	94.1	94.8
Currency (per cent of broad money)	5.6	5.5	5.0	5.3	5.8	5.5
Narrow Money (percent of broad money)	23.9	22.1	20.7	21.2	21.5	22.9
Quasi Money (percent of broad money)	76.1	77.9	79.3	78.8	78.5	77.1
Demand Deposits (% of narrow money)	76.6	71.3	72.7	73.9	73.8	73.2
Total Domestic Credit/ Banking Assets	24.9	25.1	26.2	24.1	28.3	28.1

— Not available

a and b: figures include savings deposits

Sources: RBV 1999b; IFS

on the private sector in vatu terms increased from 31 percent of GDP to 32 percent during the same period. This reflects a fairly low level of financial intermediation.

Total domestic credit still only accounts for 28 percent of total banking sector assets, primarily because of the relatively modest share of loanable funds that is used for private sector credit.

Weighted average deposit rates moved from 5.5 percent in 1992 to 4.1 percent by mid-1999, while weighted average lending rates increased from 13.3 percent to 14.1 percent. In consequence, the nominal interest rate spread increased from 7.8 percent to 10.0 percent. Both savings and lending rates remained positive in real terms (Table 8.4).

Table 8.4
Nominal and Real Savings and Lending Rates (percent)

	Weighted Average Deposit Rates	Weighted Average Lending Rates	Nominal Interest Rate Spread	Inflation Rate	Real Deposit Rates	Real Lending Rates
1994	5.35	13.80	8.45	2.3	3.1	11.5
1995	4.90	12.70	7.80	2.2	2.7	10.5
1996	4.95	12.70	7.75	0.9	4.1	11.8
1997	4.35	13.20	8.85	2.8	1.6	10.4
1998	5.45	15.00	9.56	3.3	2.1	11.7
1999	4.14	14.10	9.96	2.0	2.1	12.1

Source: RBV 1999c.

COMPETITION

The interest rate spread is comparatively high by regional standards and reflects Vanuatu's high cost structure, a relatively risky business environment, excess liquidity, and the oligopolistic banking structure. Each commercial banks tends to have its own group of clients and there is not much competition. Interest rates have been inflexible and each bank has pretty much the same rates, especially on the lending side.

Much of the profits of the foreign commercial banks comes from foreign exchange and relatively low-risk lending to foreign companies doing business in Vanuatu. There is little incentive for these banks to expand their lending into higher-risk areas, especially in the absence of political stability.

NBV is trying to compete with the other three commercial banks for customers and for foreign exchange business by upgrading its products and services, but to date this has made little impact. The government needs to encourage the development of nonbank financial institutions (NBFIs) and financial markets in order to broaden the range of services and to stimulate competition and efficiency. An encouraging development in this regard is the introduction of a functioning auction system for RBV notes and Government bonds. This has helped mop up some excess liquidity, although it is important that interest rates on RBV instruments be market-determined.

NONBANK FINANCIAL INSTITUTIONS

Vanuatu National Provident Fund

VNPF was established in 1986 under the Vanuatu National Provident Fund Act, which specified the two potentially conflicting objectives of investing contributions in the interests of the members and assisting the economic and social development of the country. VNPF grew to become a major financial intermediary, but became highly politicized and poorly managed. As a result, the return on members' funds frequently fell short of 3 percent (ADB 1997). In 1997, a report issued by the office of the Ombudsman was extremely critical of the returns being achieved and the investment practices of VNPF. The events that followed were summarized above.

The new general manager who commenced duties in 1998 encountered a host of problems needing attention: members' records had not been reconciled for some time; the system for recording members' deposits and withdrawals was seriously flawed; there was some evidence of deliberately fraudulent entries being made; no inventory of equipment had been undertaken; staff had been reduced from 43 to 26; and there

were no experienced managers in place. The computer system that had been installed in 1995 was not Y2K compliant. The Fund had a deficit of Vt400 million due to investments in overpriced properties, unauthorized loans, and an error in the act that meant that interest was being paid twice when members withdrew funds.

Following the review undertaken by ADB in early 1998, the VNPF Act was amended in the November session of Parliament in order to restructure and focus the Fund on its main functions of contribution management and benefit payments. The investment and administrative functions were separated. The investment function has now been contracted out; the nonperforming loans transferred to the AMU; and the board restructured to allow for greater private sector involvement, better transparency in decision-making, and more accountability.

There are, however, a number of ongoing problems resulting from the 1998 withdrawals of Vt3.4 million. VNPF paid out only the capital and not the interest. The question is whether members are now entitled to the interest in accordance with the old law.

The change in the Act required 50 percent of members' funds to be invested abroad. An investment manager, a subsidiary of the Bank of Hawaii, has been appointed. Initially the overseas investments were to be invested in US government bonds, as VNPF's board wished to adopt a conservative investment policy. As of February 2000, no investments abroad had been made due to lack of funds. At the end of 1999, VNPF's investment portfolio stood at Vt1.2 million. Almost half of this was deposits with the commercial banks, 39 percent were fixed assets, and the remainder was in real estate and government bonds.

Development Bank of Vanuatu

DBV originated in the Development Bank of New Hebrides, which was established in 1979. It became a statutory corporation under the Development Bank of Vanuatu Act in May 1983. DBV's goal was to promote economic development of the natural resources of Vanuatu through provision of finance;

equity participation; and technical, managerial and financial consultancy services, including the identification and promotion of projects. DBV's main source of income was to be interest earned from lending and from funds placed on deposit, as well as, potentially, dividends from equity projects. In the event, funding support was provided in the 1980s from Caisse Centrale and the European Investment Bank, and in the 1990s from ADB.

DBV recorded consistent operational losses after its inception because of bad lending practices and political interference, especially in the 1990s. By 1996, it was experiencing a liquidity crisis, meeting its operating expenses from the cash inflows from loan repayments; arrears were running at one quarter of loans outstanding; and the capital base had been being seriously eroded (Table 8.5). In response to its weakened financial position, management had closed down many outer island offices and only operated in Santo and Tanna, with the inevitable effect of undermining the objective of supplying credit to agriculture and the rural areas.

The ADB review of NBV and DBV in early 1998 concluded that there was no point in continuing to support both loss-making institutions and recommended that DBV be merged with NBV after hiving off nonperforming loans to the AMU. Following the merger, there was little if any development lending taking place. The management of NBV, as a commercial bank, focused on the implementation of the strategic plan in order to achieve a return to profitability.

The new Government that came to office in late 1999 determined that there was a need to reintroduce a development bank. An alternative proposal was to establish a separate fund for the purpose of lending to the rural sector, to be administered through an existing agency such as NBV.

LEGAL AND REGULATORY FRAMEWORK AND SUPERVISION

RBV was set up under the Central Bank Act of Vanuatu in 1988, with an amendment to the law in 1989 stating that one objective was to supervise and regulate domestic banking

business and extend credit.²³ There was, however, little effective banking supervision by RBV in the first half of the 1990s, as evident in the 1996 failure of one commercial bank (Ohlilan Bank), the move into insolvency of NBV (established as noted under its own act of parliament), and the demise of DBV. The foreign commercial banks were subject to the supervision of their head offices.

Following the withdrawal of Ohlilan Bank's license, RBV established a supervision unit. Then, with the passage of the Financial Institutions Act in 1999, it converted the unit into a supervision department. The new act formalized the RBV's prudential guidelines and gave it the legal powers to protect depositors of a troubled bank. ANZ, Westpac, Bank of Hawaii, and NBV are all now incorporated under the Financial Institutions Act, which provides that investments cannot exceed 25 percent of capital; restricts unsecured loans to directors and related parties to 1 percent of capital; and restricts lending, guarantees, and other exposures to any one borrower or group to 25 percent of capital. RBV conducts its supervisory activities through both on- and off-site inspections.

Under the Financial Institutions Act, new domestic banks (previously licensed by the Ministry of Finance) will be licensed by RBV, which is responsible for entry and exit policy in accordance with the Basle core principles. However, NBFIs will continue to be supervised by the Ministry of Finance. The Financial Services Commission (FSC) is responsible for supervising insurance and trust companies and credit unions. The FSC is also the registrar of companies and charitable associations.

The National Bank of Vanuatu Act of 1989 was amended in July 1998 to allow NBV to sell its nonperforming loans to the AMU. Other sections of the act prevent the Government from changing the board and ensure that NBV devotes most of its resources to loans. The changes were designed to protect

²³ Offshore banks are governed by the Banking Act and subject to supervision by the Financial Services Commission (FSC) as established by the Financial Services Act 1993. The Commission consists of the Commissioner, the RBV Governor, the Attorney General, and not less than two or more than four persons appointed by the Minister of Finance.

Table 8.5
Operations of Development Bank of Vanuatu, 1989–1996
(Vt millions)

	1989	1990	1991	1992	1993	1994	1995	1996
Liabilities	759	793	811	737	888	890	932	896
Equity	300	257	412	373	302	190	145	140
Capital issued and reserves	409	409	450	450	450	450	535	535
Retained profits (losses)	-109	-152	-38	-77	-148	-260	-390	-395
Term Loans	459	536	399	364	586	700	787	756
Government	84	75	69	111	203	293	394	431
International Organizations	354	422	296	238	283	132	102	68
Other	21	39	34	15	100	275	291	257
Assets	758	793	811	737	887	890	932	895
Project Finance Portfolio	529	531	474	502	622	703	758	613
Equity Investments	18	3	15	0	0	0	0	37
Government Bonds	60	60	60	50	60	10	10	10
Bank Deposits	39	59	91	30	43	15	5	3
Fixed Assets	14	11	36	66	91	93	88	84
Other	98	129	135	89	71	69	71	148
Interest Received	65	67	65	63	74	126	133	61
Interest Expense	18	24	13	13	23	29	36	29
Operating Profit/(loss)	-36	-43	-22	-31	-38	-103	-80	-130
Interest Spread	8.2	7.7	10.2	8.8	8.0	13.3	12.8	11.6
Interest Margin	8.9	8.0	11.0	10.0	8.2	13.8	12.8	10.4
Arrears as percent of total loans					27.2	25.7	22.4	25.1

Source: DBV 1989>1996.

the tenure of the chief executive officer from political intervention on any grounds other than performance. To date, the changes to the act appear to have succeeded in preserving the decision making processes of the board and management from political intervention.

The Credit Unions Act of 1999 covers all aspects of credit union activities, setting out detailed registration procedures and establishing the legal basis for the credit union apex body, the Vanuatu Credit Union League (VCUL).

DEVELOPMENT OF MONEY AND BOND MARKETS

RBV began issuing its own monetary instruments (RBV notes) in 1998 as a liquidity management tool. Tenders are invited for specified amounts of bills with maturities of 28 and 91 days. Tenders are made on a discount basis and accepted by RBV to the extent of the bills on offer, with each bank paying the rate it tendered for the amount accepted. The tender is open to everybody but in reality only the banks bid. The interest rate was originally about 8 percent but has now come down to around 3 percent. There is no secondary market for RBV notes, though the RBV provides repurchasing and rediscount facilities if the banks miscalculate their liquidity requirements.

The Government funds 80 percent of its borrowing from overseas, where it can generally borrow more cheaply than domestically, although account needs to be taken of the exchange rate risk. Currently, domestic borrowing is short term and the government rolls over bonds as they mature. There are no plans for regular issues.

Government bonds are issued through RBV. RBV invites tenders for a specified amount at a fixed price. If the full amount cannot be sold on the market, they are bought by RBV, to the maximum extent allowed by the Banking Act. The major holders of government bonds are the commercial banks. There is no secondary market in Government bonds and no other Government, quasi-Government, or Government-guaranteed bonds are currently on issue.

DEVELOPMENT OF DEBT AND CAPITAL MARKETS

The Companies Act requires that companies and business names are registered with the Registrar of Companies, which operates within FSC, and that a prospectus is registered before a company can make a public offer. No such offers have been made to date.

There is no domestic stock exchange and little potential for listing: public enterprises that might be privatized are likely to be more suitable for trade sale, and most of the 400 companies that must file audited accounts are foreign or joint ventures

that can readily raise finance from existing sources. There are two licensed stock brokerage companies that trade for individuals and groups on overseas stock exchanges. The Prevention of Fraud Act requires that dealers in securities apply for a license to the Ministry of Finance, through the FSC. The existing dealers make annual returns to establish their capital adequacy, but the regulator does not otherwise closely monitor their activities.

There may be some interest in a regional stock exchange facility provided

- (i) the minimum investment levels are small;
- (ii) the return is tax free (there are no company and income taxes in Vanuatu);
- (iii) the service is cheap to use; and
- (iv) it is easy to access.

There would also have to be a greater willingness on the part of the Government to allow foreign investment in domestic companies.

Generally, the operative constraint on the development of debt and equity markets is the lack of bankable projects in an economy perceived as subject to political instability and associated unpredictability in the policy and regulatory environments.

MICROFINANCE

Like its Melanesian neighbors, Vanuatu faces the difficult challenge of creating sufficient income-earning opportunities for its rapidly growing population. Many new entrants to the workforce must be absorbed into the semisubsistence sector or join the informal sector in urban areas. In either case they are likely to be underemployed. Open unemployment is the fate of an increasing number. Private sector development is a basic component of the CRP, and reforms are underway to promote ni-Vanuatu-owned businesses, especially small businesses in the rural areas. Microfinance can play a crucial role in supporting these reforms.

Formal Sector

The formal financial sector has limited outreach to rural and remote areas. The three foreign commercial banks operate in Port Vila and Luganville, while NBV has 19 branches in rural areas. The minimum loan sizes for these banks is Vt100,000 (or Vt50,000 in the case of NBV loans for school fees); and deposits equivalent to the loan size are required as security. The foreign banks require minimum opening deposits of Vt5,000–20,000, while NBV requires Vt100 (but charges an administration fee and pays no interest on accounts under Vt5,000). The savings and credit needs of the vast majority of the rural population therefore cannot be met by the banks.

The Ni-Vanuatu Smol Bisnis Development Center has received a loan from the People's Republic of China to establish a fund for lending to ni-Vanuatu small business. The minimum loan amount is Vt50,000 and the maximum is Vt3 million. The Center provides training and support services to small businesses operated by ni-Vanuatu; and attendance at a training course is a prerequisite to participation in the loans scheme. At the time of the field visit for this study, the Center had approved 2 out of 87 loan applications. Successful loan applicants will be required to be audited annually by the Department of Cooperatives.

Informal Sector

The usual sources of informal credit are friends and relatives. The *wantok* (friends and family network) system is well entrenched in the culture of Vanuatu. Moneylenders usually operate in urban areas. According to the Department of Cooperatives, there are around 10 operating in Port Vila, who charge interest rates of about 10 percent per month. Moneylending is not regulated, but the need for it is being examined by the Department of Cooperatives.

Semiformal Sector

The semiformal financial system in Vanuatu comprises savings clubs/credit unions, finance companies extending

small-scale credit, and the only microfinance project: the Vanuatu Women's Development Scheme (VANWODS).

Credit Unions. Credit unions were first introduced in Vanuatu through the Roman Catholic Church in 1981. The Vanuatu Credit Union League (VCUL), the apex organization of credit unions, was formed in 1992 with 34 affiliated credit unions. By 1997, there were 60 credit unions/savings clubs established; but the number has dwindled since. At present, there are 20 savings clubs being nurtured by VCUL for eventual registration as credit unions under the 1999 Credit Union Act. Of these, six are active, with 652 members.

Credit unions provide their members with savings services and loans for provident or productive purposes. A few operate their own small enterprises. Dividends are paid to members out of surplus income and loans are usually secured against deposits. Saving before borrowing is encouraged. Interest of 1 percent per month on a declining balance is charged on loans, which are mostly for a term of 12 months. Pursuant to the new act, a member should have at least a total investment in shares of Vt1,000 in order to join a credit union. The act requires that any 50 or more citizens of Vanuatu can join together and register themselves as a credit union with the FSC, the registrar of Credit Unions. A credit union must become a member of the League within 28 days of being registered. Each credit union has to establish a reserve fund representing 30 percent of the credit union's gross income. Credit unions are owned and governed by members and managed by a set of elected officers who have been trained to manage the operations of their individual credit unions.

The credit union movement has extended its outreach to Pentecost, Ambae/Maewo, Paama and Ambrym, and has the potential to extend it further, provided adequate training and supervision is provided at the early stages of development, and provided that adequate financial controls are put in place. VCUL provides supervisory and auditing services, training, and other support services to member credit unions/savings clubs. The League is affiliated with the Oceania Confederation of Credit Union Leagues, the regional credit union governing body, which in turn is affiliated with the World Council of Credit

Unions. VCUL also has received assistance from other international agencies such as the Hans Seidel Foundation and the Credit Union Foundation of Australia, and is now establishing linkages with the Department of Cooperatives for business training to credit union members and officials. VCUL is, however, faced with manpower and financial constraints on effective service delivery. These constraints need to be eased through raising funds from user fees and from donors.

Finance Companies. Two finance companies extend small loans. The Melanesian Co-operative Savings and Loans Society (MCSLS) was formed in 1984 by a group of people in Ambrym, who organized themselves into a cooperative in order to have access to credit for agricultural development. In 1996, the cooperative was registered as a finance company owned and managed by private individuals. The main office is in Port Vila, with one branch in Ambrym. The clients in Port Vila are mostly government employees, while those in Ambrym are usually farmers. Loans between Vt40,000 and Vt1 million are offered against security of a 70-percent deposit for government employees and 100 percent for all other borrowers (except that for loans above Vt100,000 the deposit is negotiable). All loans are charged interest of 15 percent per year on a monthly reducing balance, and a loan approval fee of Vt5,000 is paid up-front with the security deposit. Loans are for agricultural projects, consumer durables, house repairs, education expenses, and social obligations.

The Vanuatu Indigenous Melanesian Enterprise Business Association (VIMELBA) Company was organized as an NGO in 1997, with the assistance of the Government, to encourage ni-Vanuatu to engage in business. Members pay an annual subscription fee of Vt2,000 and a membership fee for life of Vt2,500. Since the Charitable Trust Act precludes NGOs from engaging in profit-oriented activities, VIMELBA was transformed into a company in 1998. There are approximately 1,400 members, both men and women. VIMELBA operates only in Port Vila and offers savings accounts of two types: a working account for a minimum deposit of Vt500, and a savings account for a minimum deposit of Vt500 with interest at 3 percent per year. Loans are also offered for income-generating projects and

to cover traditional and social obligations. The minimum loan is Vt5,000. For business loans, a borrower must have a deposit equivalent to at least 20 percent of the loan amount to act as security for the loan, while for social loans a 50–60 percent deposit is required. Small loans are payable within 6–12 months, and larger loans within 24 months. Interest on loans is 10 percent per year, with a loan fee equivalent to 1 percent of the loan amount. There are no additional charges for default as long as a loan is repaid within a year. VIMELBA works closely with the Department of Cooperatives to provide business training to members, and is seeking financial assistance to augment funds and cover operational costs.

The finance companies provide both savings and credit services for people with credit requirements below the minimum loan sizes set by the commercial banks. However, the security requirements can be very difficult for the poor to meet.

VANWODS. VANWODS is a Grameen Bank replication scheme that targets poor women in Port Vila, especially those residing in squatter settlements. The project is operated by the Department of Culture, Religion, Women's Affairs and Archives, with financial and technical support from the United Nations Development Programme (UNDP).

The project adheres strictly to the Grameen methodology of forming solidarity groups comprising five women members. Solidarity groups federate into centers, and weekly meetings are held to discuss problems as well as to collect weekly loan repayments and individual and group savings. Groups are self-selecting and have to undergo training. Once a group passes the test, it is recognized and a set of officers is elected. Loans are disbursed to members of the group that have satisfactorily completed the training. Each center has a chief, secretary, treasurer, project manager, and auditor. The group and center members guarantee the loans of the members. This arrangement has proven effective, as evidenced by VANWODS' consistent 100-percent loan repayment. All transactions are done at the community level.

Loans to members are provided on a progressive scale. The first loan is at Vt15,000, and subsequent loans may increase by Vt15,000 intervals. The first loan is payable in 24 weeks,

while subsequent loans are payable within 50 weeks. Interest on loans is 16 percent per year. Loans do not require any collateral because of the group guarantee. Loan release is done on a staggered basis, with two members receiving loans first and the remaining three members receiving subsequent loans, provided the first borrowers have good repayment performance and the group has regularly attended the weekly meetings.

VANWODS has a built-in savings mobilization to inculcate good savings habits among the members and to provide cover for normal business risks and emergency needs, such as death or sickness in the family. Each member saves Vt100 every week and continues to do so while remaining an active member. Five percent of the loan is automatically deducted and added to each borrower's savings. This constitutes the regular savings. Another 5 percent of the loan is deducted for the center fund. Members' savings cannot be withdrawn unless a member leaves the group. No interest is payable on the savings. Members can borrow from the center fund upon the approval of other members and when the fund has reached a specified level. Loans from center funds are to be paid within five months.

VANWODS is in a transition stage to becoming an independent NGO. As of December 1999, it had established 17 centers with 88 groups and 405 members. Of the total members, 361 had current loans. Loans totaled 648, with a disbursement of Vt11.2 million. Of those 648, 444 were regular loans (for microenterprises), 12 were for housing improvements, and 19 were for social purposes. VANWODS has not yet achieved financial self-sufficiency, since income does not cover operating costs: it is dependent on UNDP's financial as well as technical support for survival. Its linkages with the Department of Cooperatives need to be strengthened so that training and advisory services can be provided to clients on a regular basis.

There is a need to strengthen the institutional capacities of VANWODS and the credit unions through provision of medium- to long-term technical and financial assistance from the Government and the donor community. Given the limited entrepreneurial skills of microfinance clients, the minimalist approach is not appropriate. There is a need to provide

continuous support services to microfinance clients to enable them to manage their microenterprises better. VANWODS and VCUL therefore must build strong linkages with institutions or agencies that can provide the required support services.

NGOS. With regard to NGOs in general, the enabling legal framework is in place for them to become involved in microfinance. The Charitable Association (Micro-Finance) Regulations No. 41, issued by the Minister of Finance and Economic Management in November 1999, declares nonprofit microfinance schemes targeting poor and disadvantaged people to have a charitable purpose. The regulations allow nonprofit microfinance schemes to extend small loans at reasonable, operational cost-covering rates of interest, and to receive savings from clients. These savings may be deposited in any bank or invested by on-lending to clients. Any surplus of income over expenditure may be used to build up the lending capital of the organization.

Microfinance development in Vanuatu cannot be achieved in the short or medium term, given a high cost structure and the low volume of clients that results from high population dispersal and low population density. The timetables set by donor agencies of 3–7 years for operational self-sufficiency and 5–10 years for financial self-sufficiency apply to highly populated countries in Asia, Africa, and Latin America.

LAND OWNERSHIP STRUCTURES

Prior to independence, Vanuatu was jointly controlled by the United Kingdom and France. The so-called condominium administration recognized the indigenous population as the owners of the land in accordance with rules of customary land tenure. The condominium administration also recognized that ni-Vanuatu could sell these rights of land ownership to European settlers and to the condominium government; and it passed a regulation permitting the compulsory acquisition of land in the public interest.

At independence, foreign ownership rights to land were swept away by the Constitution, which vested all land

ownership in the custom owners and their descendants, except that the Government could own land acquired in the public interest, with appropriate compensation to the previous owners. In 1994, legislation was enacted to permit indigenous citizens who held leases of land in urban areas to apply to the Minister of Lands for the grant of a freehold title to that land. This Act has not been implemented, and no grants of freehold land have yet been made.

Land ownership in Vanuatu thus effectively falls into two categories: public land, which is owned by the government; and customary land, which is owned by custom owners.

Public Land

Public land consists of all land that is not customary, i.e., declared to be public land, acquired with compensation to the custom owners, and owned by the Government in the public interest.

For some years after independence, there were continuing complaints from the custom owners of the land on which the two main towns of Port Vila and Luganville were established, which had been declared to be public land but for which the Government had paid no compensation. In the early 1990s, the Government finally arranged to pay, and although there were some grumblings at the time about its adequacy, these now seem to have died away.

Customary Land

The great majority of the land is owned by indigenous ni-Vanuatu in accordance with rules of customary land tenure. The Constitution provides that where there is a dispute concerning the ownership of land previously alienated by ni-Vanuatu, the government shall hold the land until the dispute is settled. In fact, large tracts of customary land, especially lands of commercial significance, are under dispute, and so are held by the Minister of Lands.

The Land Reform Act authorizes the Minister of Lands to exercise powers of management and control over customary land where the ownership is in dispute and to conduct

transactions in respect of the land, including the granting of leases. Accordingly, despite the large areas of customary land where the ownership is disputed, leasing of that land can still continue. Where the ownership of land is not in dispute, the custom owners can themselves negotiate a lease with a potential lessee. The one proviso is that, if the transaction is not in accordance with custom, the Minister of Lands must approve the potential lessee. Leases must be registered in the Land Leases Register if they are for a period of three years or more. Once registered, a lease may be mortgaged, and the leasehold interest serves as a security for the loan. The mortgage operates as a charge on the lease and not as a transfer of the leasehold interest. If there is a default in the payment, the mortgagee can apply to the Supreme Court for an order to authorize the sale of the lease, or to enter into possession of the mortgaged land and take any rentals payable in respect of the land, or to vest the mortgaged land in the mortgagee.

No legislation regulates the way in which members of a landowning group are to make decisions or to take action with regard to customary land. The customs of most areas require that such decisions and actions are unanimously supported. Sometimes such unanimity is achieved under the dominance of chiefs or members related to chiefs. Sometimes it is achieved under pressure from the most forceful personalities of the group. Also, uncooperative or fractious members of a group can block a decision or action until their demands are fulfilled. Because most landowning groups are families or kinship groups, the resolving of differences between members of landowning groups has been traditionally regarded as a family concern—a private matter, not of concern to the public or to the Government. The larger groups often establish committees or trustees to act on behalf of the groups, but these are established on a voluntary, private basis, and are not regulated by legislation.

Disputes

Nonetheless, there are widespread disputes about ownership of customary land, and also disputes about title to chiefly rank, which demand Government involvement.

Legislation provides that disputes about ownership of customary land are to be determined initially by Island Courts. An Island Court is established in most of the larger islands, and it normally comprises three justices knowledgeable in custom, at least one of whom should be a custom chief residing within the district of the court. When an Island Court is adjudicating land disputes, the court must be presided over by a magistrate nominated by the Chief Justice.

Appeals of Island Court decisions on land ownership disputes are to be dealt with by the Supreme Court. However, the latter has refused to hear appeals in recent years, on the grounds that the three judges of the Supreme Court do not have the time to hear land cases, which are usually very lengthy and contentious. Since almost all decisions of Island Courts on land disputes are appealed, the result is that no land dispute can be resolved.

There is wide agreement that the Supreme Court is not the most appropriate body to hear appeals on land cases. Not only are proceedings expensive and lengthy, but the judges of the Supreme Court have other important judicial functions to perform and cannot hope to build up the requisite expertise in customary land matters. There has been talk of the establishment of a land court to replace the Supreme Court to hear customary land appeals, but to date no action has been taken. There is also a concern that Island Courts may not be the most appropriate bodies to determine land disputes in the first instance, because they have other judicial functions.

Central to the debate about the appropriateness of Island Courts and the Supreme Court in relation to disputes about ownership of customary land is the question of the role of the chiefs. Chiefs, who are usually hereditary but sometimes elected, have a very important role to play in the maintenance of law and order. The Constitution recognizes the National Council of Chiefs, which symbolizes the significance of chiefs in ni-Vanuatu communities. Advocates of chiefs' adjudicating land disputes argue that the chief of the community within which the land is situated should adjudicate the dispute, or if the land is situated within more than one community, then the chiefs of those communities should decide. Proponents of chiefly adjudication contend that the decision of the local chief

should be final. Others argue that there should be an appeal in case of error or interest by the local chief, but the appeal should then be dealt with by a meeting of three or more chiefs from the area in which the land in dispute is situated.

Thus, although there is general recognition that the existing Island Courts and Supreme Court do not provide an appropriate structure for determining disputes about ownership of customary land, there is no clear consensus as to how best to replace them.

Because of the great significance attached to chiefs in Vanuatu society, it is important that disputes as to who is entitled to hold the position of chief be speedily and effectively resolved. However, no legislation expressly authorizes a court or any other body to fulfill this function. In some islands, chiefs have claimed to establish custom courts for this purpose, as well as to determine title to customary land, but these courts have been challenged by other chiefs and their followers, and the rulings of these custom courts have not been widely accepted or respected.

The enforcement of mortgages of leasehold interests, by way of entry into possession or sale of the lease, has not been much disputed or resisted by kinspeople or neighbors, either of the persons claiming to be owners, or of the lessees. However, once it becomes clear who the owners of customary lands are, it is quite likely that some resentment or hostility may be shown towards mortgagees who enter into possession or to persons who purchase a mortgaged leasehold.

No legislation in Vanuatu allows a mortgage or lien to be placed over crops, trees or livestock, so that they can serve as a security for a loan.

KEY CONSTRAINTS ON FINANCIAL SECTOR DEVELOPMENT

Slow Growth, Geographic Fragmentation, Limited Economic Integration

The biggest constraint on financial sector development is slow economic growth and the limited integration of the majority of ni-Vanuatu into the money economy. As in other PDMCs,

smallness, geographic fragmentation, and remoteness from markets limit development options to those for which there is strong comparative advantage. The population of 188,000 lives on 69 widely dispersed islands, making it difficult to build infrastructure, find and reach markets, and achieve the critical mass of clients for microfinance. The primary products in which the country specializes are subject to a long-term decline in prices that also fluctuate substantially; tourism can be a fickle source of growth. Nonetheless, the natural resource endowment is good and must be seen as the basis for development.

Limited Human Resource Development

The human resource endowment is limited and constrains economic growth. The literacy rate is just 34 percent and the combined gross enrollment rate in schools only 57 percent (ADB 2001). Of the 70 percent of young people leaving the education system at the end of primary and junior secondary school, most have insufficient skills to be employed and are absorbed back into the rural sector. The few qualified and skilled people are quickly absorbed into the private and public sectors. Women are an underutilized human resource. They have no control over land or other resources. They have a relatively low level of education, and they are subject to cultural restrictions that define them as homemakers. It is therefore difficult for women to take a leading role in business, although this is slowly changing.

The major constraints to small business development are the lack of commercial and entrepreneurial skills, lack of access to credit and, arguably, cultural attitudes. The *wantok* system is often viewed as a deterrent to accumulating savings and investment. However, some indigenous people have been able to use the system to help them prosper in their business enterprises.

Political Instability and Poor Governance

Private sector development in general is hindered by political instability and a poor governance environment. The key theme of the CRP has been redefining the role of

Government and facilitating an improvement in its accountability, transparency and performance, with the ultimate objective of providing more effective public service. In the first two years of implementation, simplification of government occurred through a reduction in the number of ministries. In addition, there was progress in the introduction of performance measures and their monitoring in some departments. Public servants' autonomy and efficiency improved substantially through the selection of directors-general on the basis of competence and merit, and the good and independent functioning of the Public Service Commission. Modernization of formal rules and new legislation was extremely rapid (Knapman and Saldanha 1999). However, there are concerns over backtracking in respect of the autonomy of the public service and public enterprise management; and major concerns remain over effective, predictable, transparent, and fair rule enforcement. Problems in the area of rule enforcement predated the CRP, and involve both public malfeasance and basic law and order. The five key links in the enforcement chain are the Auditor-General's office, the Ombudsman's office, the public prosecutor's office, the judiciary, and the police. All have suffered from severe financial and human resource constraints.

Land Tenure Problems and Disputes

One specific issue that underlines the heavy pressures on the judicial system is that of land disputes. As noted above, large areas of customary land, especially those of current or potential commercial value, are in dispute. Although the law provides for these lands to be held by the Minister of Lands, who can lease them, there may be some reluctance to do so because this may be interpreted as favoring a particular side in the dispute; and in any case, the existence of a dispute is likely to give rise to nervousness on the part of potential lessees. Accordingly, it is very important that ways be found for adjudicating land disputes speedily and in a manner that will find acceptance by indigenous ni-Vanuatu. At the present time, however, the Supreme Court, which has the appellate powers, has not heard appeals for several years; and the Island Courts, which hear disputes at first instance, do not exist in all

islands and, where they do exist, are slow and lack public confidence.

Where customary land is not in dispute, there is no legal provision for land to be leased to the Minister of Lands or some other authority, and then leased back to some or all of the custom owners, so that they can use their leasehold interest as a collateral security for a loan (as in Papua New Guinea). No legislation in Vanuatu permits people to use growing crops, trees, or livestock as security for a loan. Nor is there machinery to review decisions made by ministers and staff with regard to the leasing and mortgaging of customary land, except investigations by the Ombudsman. Recent reports of the Ombudsman have disclosed misuse of power by ministers and staff, indicating the desirability of providing some established independent means of review.

Poor Public Sector Performance

The public sector in Vanuatu is smaller than in most other PDMCs; some community services that are in the public sector in other PDMCs, such as electricity supply, have been privatized. For these enterprises, the main concern is the formulation of an appropriate regulatory framework. Only two of the 20 or so public enterprises are profitable candidates for privatization (Civil Aviation and the Post Office); but in the absence of company tax, there would be a significant revenue loss to the Government. The real need is to improve the performance of the public enterprise sector by promoting good corporate governance, sound management, and appropriate pricing policies.

Small Financial Sector, Excess Liquidity

The size of the financial sector is a constraint to more banks coming into the system and competing. Other impediments to the system are the absence of efficient and competitive NBFIs, the lack of a fully functioning money market, and the lack of a capital market. The credit union movement and savings and loan societies are too small to provide much competition. The

auction system for RBV notes is functioning on a weekly basis and has mopped up considerable liquidity from the system. Nevertheless, the money market is still very rudimentary: RBV has difficulty placing all its notes because the banks do not participate beyond what they need for to meet statutory reserve requirements, and secondary market activities have not occurred.

Inadequate Supervisory Framework

A supervisory framework for the financial sector is in place, but is rather fragmented. The RBV supervises the commercial banks under the Financial Institutions Act. The FSC supervises offshore banks. The Ministry of Finance supervises VNPF. These arrangements make it difficult for RBV to make a complete assessment of the financial system. Effective coordination and information sharing between the FSC and RBV are needed; and it would be preferable for VNPF to be supervised by RBV. There is a recognized need for institutional strengthening of the RBV.

VNPF needs recapitalizing. Another constraint to its operations is government's failure to pay its fund contributions since the 1998 riot, to the amount of around Vt500 million plus interest.

The merger of DBV into NBV has all but brought development lending to a halt. NBV management is, understandably, focused on being a commercial bank.

Lack of Legal and Policy Framework for Microfinance

Although there is considerable development potential in the rural sector, microfinance schemes must be formulated in a broad context that recognizes the need for marketing systems. Legislation is in place that will allow NGOs to engage in microfinance. Credit unions operate under the comprehensive Credit Unions Act of 1999, although the Act specifies that 50 members are needed to establish a credit union a total of 50 members are needed, which may prevent some village populations from involvement. However, there are legal constraints affecting small and micro enterprises. A review of

Vanuatu laws and regulations conducted by UNDP in 1998 (Eugenio 1998) found that current laws and regulations favor formal businesses and fail to accommodate the special requirements of small and microenterprises. Business license fees are beyond the means of small entrepreneurs. The law fails to take into account the fact that small and microenterprises are often home-based. Some bureaucratic procedures and requirements need to be streamlined. And microenterprises tend to suffer from a relative lack of support services.

RECOMMENDATIONS

Continue implementing the CRP to ensure macroeconomic stability and improved governance.

Continued strong commitment to the full implementation of the CRP is essential if private sector-led economic growth is to be facilitated. This encompasses further efforts to improve the governance environment and ensure the maintenance of a stable macroeconomic environment. It also includes implementation of the Outer Island Infrastructure Development Program, which is a major initiative in the 2001 CRP.

Provide legal machinery to deal with disputes over customary land.

Urgent steps need to be taken to provide for legal machinery that can speedily and acceptably adjudicate the many ongoing disputes over ownership of customary land. It is recommended that amendments be made either to the Land Reform Act Cap 123, or to the Land Leases Act Cap 163, to insert provisions empowering custom owners to lease their land to the Minister or to some other body, which in turn can lease the land back to some or all of the owners, so that the leasehold interest may be used as security for a loan. It is also recommended that legislation be enacted to allow people to register charges or liens upon crops, trees, and livestock, so that they can be used as collateral for a loan, as in the Fiji Islands and Papua New Guinea.

It is acknowledged that resolving land-related issues is a sensitive, complex, and lengthy process. However, these issues must be addressed in order to facilitate the commercial use of land, including use of land as collateral. It is therefore suggested as a first step that a conference/workshop be convened to discuss and reach consensus on a range of issues, including what body or bodies should determine disputes about ownership of customary land; what body or bodies should determine disputes about entitlement to chiefly rank; and what measures should be instituted to regulate decision making by landowning groups.

Such a conference/workshop could be convened jointly with the National Council of Chiefs or the South Pacific Community, and should involve wide representation from ni-Vanuatu society. A related conference/workshop should be convened to discuss and disseminate knowledge about the use of leaseholds as security for loans; the use of "leaseback" leases to some or all custom owners, to provide them with an asset that they can use as collateral; and the extent to which entry into possession and sale of a leasehold interest are necessary to enable a mortgagee to recover a loan that has not been repaid by the mortgager. These conference/workshops could be linked as part of a series concerned with issues relating to customary land and development in Vanuatu.

Develop the financial sector.

The financial sector can be developed by

- (i) running a more effective monetary policy to mop up liquidity, providing a wider array of instruments for savers, and developing secondary markets for RBV instruments;
- (ii) ensuring that efficient interbank markets develop;
- (iii) providing institutional strengthening for microfinance, especially the credit union movement;
- (iv) creating conditions for other NBFIs, such as unit trusts, to provide greater competition for banks; and
- (v) developing capital markets so that savers have an opportunity to invest in equity as well as debt instruments.

Develop the money market through weekly auctions, repos.

To promote money market development, continue the weekly auctions of central bank securities. RBV should also build the capacity to conduct outright purchases and sales of securities to adjust liquidity flows, as well as repurchase (repo) operations for fine-tuning short-term operations. To aid development of a secondary market, a primary dealer system should be adopted to facilitate market making and to ensure that there will be adequate demand for the securities. An automated book-entry system for banks could also enhance payments, interbank market activities, and open market operations. As an alternative to the secondary market, RBV could conduct open market-type operations through repos and reverse repos.

Develop a corporate bond market.

The development of a primary corporate bond market is a long-term proposition and requires at least

- (i) an active Government debt market to provide a yield curve;
- (ii) institutional buyers who need long-term, relatively risk-free investments;
- (iii) a credit-rating agency to enable buyers to make consistent decisions about the risk/reward ratio being offered; and
- (iv) banks or NBFIs that are prepared to place bonds with their customers and to manage and underwrite bond issues by their corporate customers.

Give RBV enough autonomy to perform its supervisory duties efficiently.

RBV should be granted enough autonomy to perform its supervision functions effectively. Its governor and members of its board of directors should be left free of political influence. RBV requires institutional strengthening and capacity building in order to ensure that it fulfills its supervisory role effectively.

Strengthen regional cooperation and consultation; consider participation in a regional stock market and venture fund when these develop.

The Government should continue to enhance and strengthen the process of regional cooperation and consultation in regulatory and supervisory matters, as begun in the recent regional initiative by PDMCs to strengthen their financial sectors through the Pacific Islands Prudential Regulation and Supervision Initiative. Further, a formal analysis is needed of the regulatory system and supervisory practices of Vanuatu for their compatibility with international accepted norms, to lay the foundation for the timely harmonization of financial sector regulation and supervision on a regional basis.

The Government should consider participation in a regional venture capital fund and a regional stock exchange facility should the options arise. At this stage, the prospect of getting companies to list does not seem good. Public enterprises are loss making and seem to be more suitable for trade sale than for listing in the medium term. There are few incentives to form companies in Vanuatu and much local business is undertaken under business names. This would mean that to prepare an entity for listing would be a medium-term objective. The issue of some foreign ownership (through the purchase of shares by investors in other PDMCs) of domestic Vanuatu companies would also need to be addressed.

Recapitalize and reimburse VNPF.

The government needs to recapitalize VNPF to reduce the deficit of Vt460 million that is still left over from the payout in 1998. In addition, the Government needs to pay VNPF the back contributions it owes, amounting to Vt500 million plus interest, either by converting the contribution to bonds or by paying cash. Technical assistance should be provided to improve VNPF's organizational structure and operating systems. The development of model investment criteria and members rules on a regional basis would be useful. Thought should also be given to paying most of the contributions in the form of a pension rather than as a lump sum, in order to ensure that a retiree

retains sufficient annual income flows to live on. Finally, consideration should be given to placing VNPF under the supervisory responsibility of RBV.

Revive development lending by establishing a development arm at NBV.

Development lending is needed to provide funds for riskier projects, which are not now covered by commercial banks, and for which there is considerable demand. It is therefore recommended that NBV establish a development banking arm, as envisaged at the time of merger with DBV.

Strengthen microfinance and credit unions, lift restrictions on microenterprises.

Microfinance schemes need to be owned by the people and organized on a local basis through cooperatives, credit unions, or the like. The institutional capacity of VANWODS and the credit unions needs to be strengthened by supporting VCUL in its role. VCUL is responsible for the organization of credit unions, educating members in the use of money and savings processes, and providing advice on accounting and audits. It requires technical assistance and financial support. Training should focus on

- (i) organizational development and financial management skills;
- (ii) strengthening of outreach strategies and development of innovative delivery approaches in targeting the poor;
- (iii) social mobilization, especially in strengthening solidarity groups and individual credit unions;
- (iv) viability planning and portfolio management;
- (v) setting up of computerized management information systems and training in their use;
- (vi) development of innovative products and services; and
- (vii) resource mobilization.

This is an opportune time to strengthen VANWODS, as it is now in the process of transforming itself into an NGO; while for credit unions, the enactment of the Credit Union Act ushers in an opportunity to revitalize the movement.

NBV should also be encouraged to open a microfinance window through wholesale lending to VANWODS, VCUL, Melanesian Cooperative and Savings, and VIMELBA. The Government could explore the possibility of a credit guarantee scheme under which it would guarantee the loans provided by NBV to these institutions. Support services to microfinance clients need to be enhanced by establishing linkages between microfinance institutions and agencies that can provide training, advisory services, market linkages and other assistance to microentrepreneurs.

Means of lessening legislative and regulatory restrictions affecting small and microenterprises should be explored. Granting business license exemptions or reducing fees can be an incentive for microentrepreneurs. Educational campaigns on the merits of saving and credit discipline could be conducted through the media.

Feasibility studies of innovative schemes to expand microfinance outreach to rural areas (e.g., VNB wholesale lending) should be undertaken. Studies are also needed on potentially viable microenterprises, including linking them with private entrepreneurs/exporters to market their products.