



**CASE STUDY**

**ON THE**

**FINANCIAL SECTOR PROGRAM  
(Loan 1608-SAM[SF])**

**EDUCATION SECTOR PROJECT  
(Loan 1752-SAM[SF])**

**IN SAMOA**

**AND**

**URBAN INFRASTRUCTURE PROJECT  
(Loan 1448-VAN[SF])**

**COMPREHENSIVE REFORM PROGRAM  
(Loan 1624-VAN[SF])**

**IN VANUATU**

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REPORT PREPARED FOR  
THE ASIAN DEVELOPMENT BANK  
AUGUST 2002

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## **ABBREVIATIONS**

ADB	–	Asian Development Bank
AusAID	–	Australian Agency for International Development
TA	–	technical assistance

## **NOTE**

In this report, "\$" refers to US dollars.

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## I. SAMOA

### A. Financial Sector Program

#### Direct Controls to Market-Based Monetary Policy

1. In January 1998, the Asian Development Bank (ADB) approved a loan<sup>1</sup> of \$7.5 million in support of financial sector reforms in Samoa, and a technical assistance (TA) grant<sup>2</sup> for institutional strengthening of the Central Bank, the development bank, and the national provident fund.<sup>3</sup> This was an omnibus loan, with many commitments by the Government of Samoa to financial liberalization.

2. One part of the liberalization program was directed to monetary policy. In the Pacific small island states<sup>4</sup> that use the currency of the United States, New Zealand, or Australia, macroeconomic policy is limited to tax and fiscal measures. However, the six biggest island states, including Samoa, issue their own currencies. This calls for more sophisticated skills to manage monetary aggregates, interest rates, credit, inflation, and external accounts.

3. Also, in these very small markets, monetary policy can be overmanaged through direct interventions. Until 1996, the Government of Samoa fixed interest rates directly, set a ceiling on the amount of credit banks could provide, and required banks to hold 20–30% of their assets in liquid deposits, a quarter of which were non-interest-bearing deposits with the Central Bank. The result was serious distortions of Samoa's financial economy. High liquidity requirements, together with credit ceilings, had eroded the incentives of banks to expand their deposit base, and had produced an "overhang" of uninvested funds. For considerable periods after-inflation, interest rates on deposits were negative, and there were few alternative instruments for savers. Investors' decisions were distorted by interest rate rigidities and volatile inflation rates. Credit rationing resulted in the priorities of the Government and special interests sometimes dominating normal risk and rate-of-return considerations in the banks' allocation of capital. All of these factors contributed to an excessive growth of unregulated nonbank lenders relative to the regulated banking sector.

4. At the same time, the system did not allow easy adjustment of the Government's monetary policy. Excess bank liquidity made it difficult to ease policy and the large unregulated sector of nonbank lenders made it difficult to tighten policy.

5. In January 1998, the Government of Samoa began a financial liberalization program, removing interest rate controls and credit ceilings, phasing out banks' liquid assets requirements, and starting weekly auctions of Central Bank securities as the main instrument of monetary policy. By the end of that year ST25.9 million in Central Bank securities had been issued. The outstanding amount peaked at ST28 million in 1999, and declined to ST18.5 million the following year, and ST8.87 million in 2001.

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<sup>1</sup> Loan 1608-SAM(SF): *Financial Sector Program*, for \$7.5 million, approved on 19 February 1998.

<sup>2</sup> TA 2989-SAM: *Institutional Strengthening of Government Financial Institutions*, for \$950,000, approved on 19 February 1998.

<sup>3</sup> This TA also covered assistance for corporatization or privatization of eight state-owned enterprises over 2 years.

<sup>4</sup> Four Micronesian states, Cook Islands, and Tuvalu.

6. To facilitate this transition, ADB provided funds, most of which were for general support of the national budget,<sup>5</sup> but some, approximately \$1 million,<sup>6</sup> were to cover the annual interest costs that the Central Bank incurred when it abandoned direct controls of interest rates and credit ceilings, and, instead, issued securities in competitive open-market operations. The cumulative interest costs are already a little higher than this amount.

7. ADB's TA grant, along with TA from the International Monetary Fund, helped build the capacity of the Central Bank to manage the new system.

8. In the post-liberalization period, there have been some signs that the program is being effective. For example, private sector credit grew faster, at an annualized rate of 13.6% in the 2 years after reform, compared with 10.6% in the 2 years before, which was a good sign given that inflation moderated at the same time.<sup>7</sup> Average inflation 1996–1997 was 6.2% per annum, and in 1998–1999, 1.5%. The commercial bank share of total lending was 14%, less than nonbank lending in 1997, and is now about 15% greater with a corresponding decline in nonbanks lending, particularly with the Vanuatu National Provident Fund. Interest rates have been noticeably more stable and positive, although a considerable spread between deposit and loan rates has remained, and loan rates are high relative to major markets. Lenders are now better able to factor credit risks into lending rates.

9. Over the 4 years of the program, the Central Bank's interest rate on 91-day securities has varied between 5.25% and 7.0% per annum, and has tended to remain around the middle of that range. The Bank has not yet aggressively used interest rates to manage inflation targets, and, given the limited clientele for its securities (so far only the three commercial banks that operate in Samoa) the ability of the Central Bank to manage rates is still constrained.

## **B. Education Sector Project**

### **Village Self-Help Proves a Limited Resource for Modern School Construction**

10. In August 2000, ADB approved a loan<sup>8</sup> of \$6.5 million for the physical rehabilitation of 16 schools in Samoa, and a TA grant<sup>9</sup> of \$820,000 for in-service teaching training in these schools.

11. In the past, other aid agencies<sup>10</sup> had used a shared-cost model for micro-projects in Samoa, whereby the village contributed about one quarter of the costs, in cash or kind, for small construction projects such as the installation of a water tank. Typically, the village contributed labor preparing and cleaning up the site and simple building materials.

12. Therefore, the ADB team decided to take a similar approach, although with the possibility of a full or part waiver of the local contribution if circumstances proved this necessary. In the event, of the 14 resource agreements that have been concluded with school committees, 5 received complete waivers, and 9 partial waivers. The share of costs borne by the local

<sup>5</sup> About 85% of the first tranche and 70% of the second was for general liquidity support.

<sup>6</sup> ST1.69 million in the first tranche and ST1.8 million in the second.

<sup>7</sup> ADB. 2000. *Samoa 2000: Building on Recent Reforms*. Manila, p.39.

<sup>8</sup> Loan 1752-SAM(SF): *Education Sector Project*, for \$7 million, approved on 5 September 2000.

<sup>9</sup> TA 3498-SAM: *Education Support*, for \$820,000, approved on 5 September 2000.

<sup>10</sup> The European Union Development Agency and Japan International Cooperation Agency.

community, where the waiver has been partial, varied between 5% and 16%.<sup>11</sup> There were no cash contributions; rather all was in kind. However, the cash equivalents were substantial, varying from ST46,000 to ST200,000. The in-kind contributions tended to include land (typically owned communally), demolition and fill costs, clean up, fencing, walkways, and, in some instances, power and water supply to the site.

13. The need to negotiate "resource agreements" between the local school committee and the Department of Education in each instance was one factor leading to delays in project implementation, but probably not the most important. At the midpoint of the project, three of 16 subprojects are complete, one of which was designed before the loan was granted.

14. There were several reasons why the shared-cost approach has proved of limited value in this case. First, the scale and sophistication of construction did not lend itself to a self-help approach. The construction costs were too large for villages to fund 25%. Many of the materials and types of labor needed are not available in the villages except from commercial contractors. The projects involved extensive upgrading or complete reconstruction of school buildings to meet building code standards for the first time. In some cases, the project involved the construction of special facilities such as libraries, teachers' rooms, and classrooms designed to accommodate agricultural studies or food and textiles studies under a new curriculum. School fees are a major source of school resources in Samoa but they were typically already fully committed and could not be tapped for capital investment.

15. Another factor that worked against the self-help approach was that ADB contracting rules exclude the possibility of informal "mates rates" work on the project sites.

16. Second, the school committees were made up of people who represent the group that "owns" the school. These people were chiefs and other people important in the local village, but not necessarily parents. In fact, parent and teacher associations are a recent innovation in Samoa. The composition of the school committee was particularly relevant in those cases where the school drew pupils from several villages. The committee might have been able to find volunteer inputs from the village that "owns" the school, but were less likely to be able to mobilize proportionate contributions from other villages. On the other hand, two-tier school fees for in-village and out-village pupils are not uncommon. All in all, the traditional concepts of village ownership of the local school, and ideas about who has "speaking rights" in regard to the school, have been important factors. The ADB project team is large for the amount of construction involved, but reflects the extensive discussions and the careful tailoring of the subproject design to local "owners" that is necessary in the Samoan context.

17. These issues were particularly sensitive since Samoa is in the midst of implementing a school zoning system which requires relocating large numbers of pupils from "overcrowded" but prestigious schools in the capital Apia to their home community schools. In fact, the first ADB subprojects to be funded and completed all relate to this pupil redistribution effort. The rural schools among the subprojects are yet to be reached.

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<sup>11</sup> The school committees contributed ST90,000 (10%), ST98,000 (7%), ST63,000 (16%), ST200,000 (11%), ST92,000 (9%), ST46,000 (5%), ST69,000 (6%), ST140,000 (10%), and ST61,000 (6%).

## II. VANUATU

### A. Urban Infrastructure Project

#### Urban Infrastructure Project Reduces Scope to Finish on Time and Budget

18. In June 1996, ADB approved a loan<sup>12</sup> of SDR6.913 million<sup>13</sup> for a 5-year program of road and bridge rehabilitation, port rehabilitation, water supply, drainage, and sanitation in Port Vila and Luganville, the two main towns in Vanuatu.

19. At the same time, ADB approved two TA grants.<sup>14</sup> One TA was for drafting three key pieces of legislation.<sup>15</sup> The second TA was to produce a sanitation master plan for Port Vila.

20. The loan took a year to become effective, obtaining formal government agreement to the conditions and covenants in June 1997. A project management engineer was engaged under an Australian Agency for International Development (AusAID) grant.<sup>16</sup> However, physical implementation of the project took another 2 years to get substantially underway. Nevertheless, a good part of the works were begun in 2000 and finished before the December 2001 loan termination date.

21. The scope of the works associated with the loan was adjusted in two ways. First, the contractor engaged to resurface Luganville roads pointed out that the improvements would not be sustainable unless substantial improvements in drainage around the road were completed first. Second, in 2001 the scope of the whole project was reduced when it became apparent that the funds available would be inadequate for full completion. Specifically, the sanitation component<sup>17</sup> and the Port Vila traffic intersection improvements were put on hold pending allocation of counterpart funds.

22. In summary, the program has significant achievements. Most of the works associated with the program, with a few significant exceptions, were completed by the end date of the loan. At the same time some important TA in regard to environmental and water resource regulation and building codes was undertaken.

23. However, the late changes in scope highlighted weaknesses in initial cost estimating and in project monitoring. Reporting completion percentages is unhelpful if delays and potential overruns are accommodated by scope reductions. Similarly, the ADB practice of calling an underrun "savings" is also unfortunate when the components that are completed have exceeded their estimated costs and the "savings" are only enabled by scope reductions.

24. The loan period ended without government compliance with several key loan covenants. These covenants were intended to ensure the long-term sustainability of the works, and included changes to the water tariff structure in Luganville, corporatization or privatization of the

<sup>12</sup> Loan 1448-VAN(SF): *Urban Infrastructure Project*, for \$10 million, approved on 27 June 1996.

<sup>13</sup> SDR6.913 was initially the equivalent of \$10 million, but after exchange rate fluctuations \$9.07 million was actually realized.

<sup>14</sup> TA 2596-VAN: *Urban Growth Management Strategy for Port Vila*, for \$600,000; and TA 2597-VAN: *Sanitation Master Plan for Port Vila*, for \$360,000, both approved on 27 June 1996.

<sup>15</sup> The Environmental and Resource Management Act, the Water Resources Management Act, and Building Regulations.

<sup>16</sup> Government of Australia, AusAID, \$0.4 million.

<sup>17</sup> Erakor Bridge and Causeway Replacement.

Luganville water supply authority, changes to road tax policy to generate funds for maintenance, and changes to port operations. This raises questions of priorities and process. If the covenants were essential to ADB's interest in the program, then there should probably have been a more detailed process of steps laid out to achieve the covenants and disbursements linked to those steps. Among the steps there should have been opportunities built in for ADB to change its mind about a covenant if it proved to be undesirable after all. The failure to honor the covenants raises the question whether some of them were too specific, given that a clear evidence-based consensus had yet emerged on the best way to proceed.<sup>18</sup>

## **B. Comprehensive Reform Program**

### **A Comprehensive Reform Program Under Crisis Conditions Tests the Limits of Borrower Commitment and Donor Cooperation**

25. In July 1998, ADB approved a loan<sup>19</sup> of \$20 million (with attached TA grants<sup>20</sup>) for a Comprehensive Reform Program in Vanuatu. Over the previous decade, the Government's financial situation had deteriorated steadily, with large fiscal deficits that started with Development Fund overspending, and spread to recurrent expenditures. At the same time, government revenues were declining, reflecting failures of tax policy and enforcement, and the quality of the public service was eroded by patronage appointments.

26. The crisis came to a head in January 1998 when there were serious riots in the capital when details of certain investments by the Vanuatu National Provident Fund became public. The Government stood by its guarantee of Fund deposits but at the cost of a fiscal deficit that reached 12.7% of the gross domestic product, with dramatic implications for inflation and the balance of payments. A run on the currency began in March 1998. At the end of that month, a new government assumed office, and opened negotiations with ADB in regard to a loan. The loan involved payment of a first tranche of \$10 million to help restore liquidity to collapsing government finances. This and two further tranches of \$5 million were contingent on certain commitments by the Government for policy and institutional changes.

27. The loan covered a broad program of reform, encompassing three key areas of the economy;

- (i) In the financial sector, the Government dissolved the Vanuatu Development Bank and recapitalized and restructured the National Bank and the Provident Fund. Nonperforming investments were segregated into an Asset Management Unit.
- (ii) The public sector fiscal regime was restructured with the introduction of a 12.5% value-added tax to replace a number of other indirect taxes.
- (iii) The public sector was reformed with the introduction of a merit-based professional cadre of department and agency heads, under life appointments (recently changed to 3-year performance contracts), with a changed relationship

<sup>18</sup> The requirement that Luganville Water Authority switch to a two-tier water tariff structure perhaps falls into this category.

<sup>19</sup> Loan 1624-VAN(SF): *Comprehensive Reform Program*, for \$20 million, approved on 16 July 1998.

<sup>20</sup> TA 2984-VAN: *Institutional Support to Central Agencies for the Comprehensive Reform Program*, for \$630,000, approved on 23 January 1998; and TA 3046-VAN: *Institutional Support to Central Agencies for the Comprehensive Reform Program (Phase II)*, for \$1.2 million, approved on 16 July 1998.

with the Minister. The Government undertook to reduce the size of the public service by 10–15% and to withdraw from its excessive ownership of commercial enterprises.

28. This ambitious program was supported by grants from a number of donors who had a long-term interest in development in Vanuatu. However, each donor came with administrative and political models that reflected its own background and historical experience. This proved problematic in a situation where such fundamental changes in governance were being attempted under crisis conditions and where political and administrative friction had arisen during the incorporation of the English-French condominium into the new nation. What was needed exceeded the normal coordination of like-minded donors and stretched ADB's governance expertise.

29. The covenants undertaken by the Government in regard to the Comprehensive Reform Loan were extensive and controversial. One result was that the functioning of the program became a highly-charged political matter. When the Government changed about 18 months after the initiation of the loan, this set back the implementation agenda and timetable. In retrospect, ADB may not have moved fast enough immediately after loan approval to disburse funds and to encourage immediate performance of agreements.

30. Four years after loan approval, it seems that the program made a significant difference to the political economy of Vanuatu in a short time, although it is impossible to tell what reforms might have been made if the financial crisis had been allowed to run its course without external intervention.

31. Key reforms that were achieved include the introduction of a value-added tax, the downsizing of the public service, the strengthening of the merit principal within the senior public service, and some improvement in fiscal discipline. Nevertheless, fiscal deficits remain high, the Government has not withdrawn significantly from involvements in commercial enterprises, and the quality of social services and hopes of spurring development in agriculture and tourism have not borne fruit. Private investment remains low because of political uncertainty, lack of security of property, and structural problems in finance and regulation. On balance, the program loan supported some important, but fragile, policy and institutional reforms, under extreme stress, but the work may have been more effective and more sustainable if there had been a narrower focus on the highest priorities.