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Social and Economic Studies 56:1&2 (2007): 322–351 *ISSN: 0037-7651*

ECONOMIC DEMOCRACY AND FINANCIAL REFORM IN VANUATU

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ABSTRACT

This article identifies the rationale and trajectory of finance sector reform as part of the donor-sponsored Comprehensive Reform Program (CRP) in Vanuatu and provides an analysis of the problems associated with the lack of affordable credit for sectors of the population that do not fulfill commercial lending criteria. The article relies on financial hegemony theory in order to explain Vanuatu's role within larger international financial structures and rationale for reform. The discussion shows that foreign banking institutions are not interested in broadening credit access to poorer sections of the population and that high levels of state dependence hinder the development of a sustainable micro-credit sector. However, using Robert Pollin's Exit, Voice and Ownership methodology the article shows that civil society organisations that seek to increase economic democracy and participation, although few in number, are present in Vanuatu and provide a model for best practice in the country.

Vanuatu used to be known as the 'Condominium of the New Hebrides' until July 1980 when it gained its independence from Anglo-French colonial control. The country consists of 83 islands with a total land area of 12,189 square kilometers. United Nations figures indicate a population of 207, 700 in 2003 (United Nations Department of Economic and Social Affairs 2003:45). Located in the Southwest Pacific some 1800 km east of Australia, the country is known for its tourist attractions, tax-free status and for hosting the 2004 series of the reality TV show 'Survivor'. Less known about the country, but of equal interest are the changes occurring within its banking sector and the effects these have on the population.

Since the late 1990s the government of Vanuatu has embarked on a series of donor-sponsored reform measures known as the Comprehensive Reform Program (CRP). The CRP succeeded in improving the country's economy from a situation of near financial collapse. However, despite a number of successes in monetary

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management, this study shows that the CRP failed to address some critical issues regarding support for a sustainable micro-credit system that would benefit the poorer sections of the population. This failure is largely due to the CRP's policy prescriptions that do not challenge foreign banks' dominance of the local credit market and do little to prevent credit unions and savings and loans cooperatives from becoming dependent on the state.

The reasons for studying financial reform in Vanuatu and beyond are important because the way it is managed gives us an indication of whether the state is committed to the welfare of most of its citizens or not. Moreover, the resulting banking practices impact directly on people's ability to access banking services and in turn affect their ability to create viable income-generating activities. Unfortunately literature dealing with the process of financial reform in general and acquisition of credit within Vanuatu is scant. Most of the literature written about the subject is derived from government reports or from Multilateral Financial Institutions (MFIs) such as the International Monetary Fund (IMF) and the Asian Development Bank (ADB).[1] This article critically engages those sources with findings from field research carried out in Vanuatu in 2004 and further research carried out in 2005.

The rationale for reform and the role Vanuatu plays within international financial markets are interpreted through the assumptions made by financial hegemony theory which is explained in the first section of this article. The second section reviews the international literature on the most common banking designs and forms of ownership found around the world that have been replicated in Vanuatu. This literature forms the basis for Pollin's *Exit, Voice and Ownership* matrix used in the analysis of the Vanuatu micro-finance entities that operate relatively independent from the state and practice member participation and economic democracy. The third section looks at the antecedents of the financial crisis that affected the country in 1998 and the subsequent implementation of the CRP. The final section analyses a few of the entities that fit within Pollin's 'democratic voice' category described in his matrix.

1 See for instance Asian Development Bank. (2001a); Asian Development Bank. (2001b); International Monetary Fund (2003); Chand (2002), VANWODS (2001) and Maurer (2002).

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Interpreting financial reform

In the finance literature there are at least three different ways of interpreting or theorizing reform. The first category focuses on market forces' influence on the process of reform and underestimates state intervention in this process. The second category belongs to the hegemony argument because it contends that financially powerful states are responsible for designing the financial order that was to replace the Bretton Wood agreements. The last category includes those observers who argue that recent financial transformations are the product of neglect not design.

Most market-centered accounts rely on monetarist principles that view liquidity or the ability to convert assets into cash as the prime factor affecting the economic conditions of a country. McKinnon (1973) developed the concept of financial 'repression' to describe the way that states interfere with financial freedom. Shaw (1973) on the other hand developed the concept of financial 'deepening', which suggests that the most efficient financial systems are those that achieve low transaction costs whilst providing an optimal risk/reward profile for firms and individuals (Pollin 1995: 33). Even though both Shaw and McKinnon were referring to developing countries' financial markets, their contributions provided the theoretical justification for the financial liberalisation projects undertaken in core countries during the 1980s. Market-centered explanations of financial reform then give a great deal of importance to international liquidity based on the growth of the Euro-currency market in the late 1950s and the opportunities this phenomenon provided for international financial and banking firms, especially after the petrodollar influx in the 1970s from members of the Organisation of Petroleum Exporting Countries (OPEC) (Michie 1992: 200).

The problem with this type of explanation is that it views state intervention as an impediment to financial sector growth and not as a benevolent force. State-led efforts to create legal and economic environments that make the expansion of financial markets possible are ignored or interpreted negatively. This is particularly important in the case of Vanuatu and its off-shore centre (OFC) which grew not so much as a result of local entrepreneur activity but more as a desire of the British colonial authorities to make the then condominium of the New Hebrides yet another part of the international circuit of British-spawned tax havens such as

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Bermuda, the Cayman Islands and Hong Kong. Their hub, the City of London, was already handling around US$60 billion of international money in the early 1970s and incorporating the new OFC into the system required state resources in order to take advantage of that money (Rawlings 2004: 19). Therefore even though the McKinnon/Shaw hypothesis can account for the growth in liquidity once the OFC was established it cannot account adequately for the state measures that created the OFC in the first place. Nor can this hypothesis be used to analyse Vanuatu's recent reforms in the on-shore sector because they do not include measures to liberalise or privatise the state-owned financial entities. Instead, the reforms aim to rescue them from collapse and improve the regulatory regime (ADB 1998).

Other theoretical explanations take into account the importance of increasing levels of liquidity but give more weight to policies adopted by the governments of the US and the UK that sought to maintain their hegemonic position within the world financial system as a response to Euro-currency growth. The major proponents of the hegemony thesis are Gilpin (2001) and Helieiner (1994). Their accounts put the growth of Euro-currency at a historical juncture where successive balance of payments in favour of Europe and Japan in the 1960s and military expenditures during the Cold War (especially those resulting from the Vietnam War) drove the US into a deficit that the Federal Reserve refused to monetise for fear of spiraling inflation. The first major step to deregulation was the Nixon administration's unilateral decision to suspend convertibility of the US dollar against gold in 1971 (Hirst and Thompson 1996: 33). Instead of renewing or re-negotiating the terms of the Bretton Woods agreement with its major allies and trading partners, the US sought to "[U]tilize its dominant position in the open, liberal, international financial system to encourage foreigners both to finance and to bear the burden of adjustment to its growing current account and fiscal deficits" (Helleiner 1994: 202) or as Henry Nau, an ex-adviser to the Reagan administration working at the National Security Council argues "[the US] used its hegemonic influence to promote the development of free markets and forced countries like France to pursue pro-market policies" (Loriaux 1997: 9). Other measures to further the liberalization process included the floating and subsequent devaluation of the US dollar to encourage foreigners to invest in the US. This also required

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the easing of capital controls and deregulation of its stock markets. The New York Stock Exchange (NYSE) took the lead in 1975 by eliminating fixed charges to customers.

Anticipating capital outflows, the US's major trading partners reacted by deregulating their own markets. The UK, after years of taking advantage of international legal loopholes that made the City of London the forerunner and main center of the Eurodollar market, sought to legitimise its position by abolishing exchange controls in 1979 thus giving the City a clear advantage over New York and Tokyo (Schenk 1998: 229). The Japanese government's initial reply was to let inflation rise, hoping it would keep the yen's value lower than the US dollar. The OPEC oil prices made this strategy redundant and it was replaced by deficit financing and the opening and expansion of Japan's financial markets (Michie 1992: 202). As will be explained later, during this period Vanuatu took advantage of increased international liquidity by attracting large capital inflows to its recently established OFC.

The move to financial liberalisation amongst the world's leading economies and the Euro-currency financial pressure led an increasing number of countries to follow suit to prevent further capital flight. Increased liquidity in the financial markets, worsening commodity prices and accompanying low interest rates allowed oil-dependent developing countries to borrow heavily to finance their energy requirements. In the early 1980s, when interest rates rose, the same countries found themselves in trouble for not meeting debt repayments. To get out of the debt trap, developing countries followed multilateral financial institutions' advice that included liberalisation of their financial and banking systems giving firms from developed countries more access to otherwise restricted markets. A manifestation of this was the growth, in the 1980s and 1990s, of cross border equity trading done through stock markets. While the higher presence of foreign capital in the developed countries' stock markets came from other equally rich countries, foreign capital in poor countries came from rich countries searching to buy cheap companies and stock that resulted from the IMF-sponsored privatization drives.[2]

2 According to Michie, the growth of share markets during the 1980s has been phenomenal: cross border trading of international equities, for example, expanded from a mere US $73 billion per annum in 1979 to US$1598 billion in 1989 and those stock exchanges which could take advantage of the trend saw their business in that area grow enormously, as with London (Michie 1992: 202).

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An alternative explanation to the hegemony thesis is given by Susan Strange who argues that the whole process was the result of policy negligence by state elites[3]. These 'non-decisions' as she refers to them include:

- Failure to peg major currencies to an equivalent of the gold exchange standard after Bretton Woods collapsed in 1971.
- Failure to establish a new set of regulations governing international financial transactions.
- Failure to accommodate the economic power of the OPEC countries and subsequent debt crisis.
- Failure to establish a new lender of last resort to replace or complement the World Bank (Barry Jones 1995: 180).

The result of these failures has given rise to a disorganised form of capitalism that literally gambles with the financial stability of whole nations if not the whole world thus the name 'casino capitalism' (Strange 1986). Proponents of hegemony theory agree with the observation that capitalism is unstable. This is due, in part, to the effects of deregulation but they disagree with the motives identified by Strange. Cerny, for example, argues that the hegemonic position of the US not only allowed it to influence the design of the international financial system but its leaders also knew the objectives and conditions of the new financial environment. He argues that US proposals for new international financial regimes such as the Multilateral Agreement on Investment (MAI) were designed with the unchallenged assumption that the US dollar will remain the currency of choice in the world economy (Cerny 1993: 14). Moreover Strange assumes that the US simply withdrew its regulating responsibilities from the international financial system without giving more weight to policies by poorer states around the world designed to adapt to the new financial environment. This has resulted in a system which is much more controlled by US interests than the 'casino' economy she suggests.

In view of these arguments it is clear that the hegemony thesis is much more useful in explaining international financial reform and the consequences of these processes at the national level. It is able to account for how hegemonic states continue to influence financially weak states through market mechanisms, as exemplified by the success of Vanuatu's OFC and through institutions such as the ADB

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and the IMF as exemplified by their successful implementation of the recent on-shore sector reforms.

However maintaining hegemony is not a homogenous process and needs to be carefully examined within the national context. The period before the reforms took place saw the design and replication of a particular type of on-shore banking system which needs to be adequately explained before an analysis of the reforms can be made. The next section also reviews the literature on the relationship between forms of ownership and economic democracy. This is relevant to the foregoing because this literature suggests one way of identifying institutional arrangements and entities that have the potential to improve economic democracy within predominantely private banking environments where elite hegemony is dominant.

Democratic banking designs and their advocates

Despite some of its shortcomings Rudolf Hilferding's work *Finance Capital: a Study of the Latest Phase of Capitalist Development* (1981 [1910]) started a line of inquiry that sought to explain the differences between financial designs based on universal banks and those based on debt equity by joint stock companies. Later Gerschenkron developed this distinction in his book *Economic Backwardness in Historical Perspective* (1962). In it he points out that the contrasts between the German and British financial systems stem from the latter's earlier more disorganised development in which companies, because of a lack of sufficient sources of external credit, sought to finance investment out of their own profits. British companies therefore developed capital markets independently of large banks. Germany's late industrialisation on the other hand, meant that efforts at catching up with British industry were supported by the state. The creation of large banks to satisfy demand for credit was one such form of support and the ties that developed between companies and their respective banks was much closer than in the British case (Frankman 1995: 21).

More recent studies by Zysman (1983), Cox (1986) and Mayer (1988) have found that these two initial designs were replicated in other countries. Nowadays the bank-based system is dominant in most of continental Europe, Japan and the majority of the developing South, including Vanuatu. The capital market-based

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system is dominant in the UK, USA, the Netherlands, Switzerland, Malaysia, Singapore, South Africa, Chile and the Philippines. The distinction is usually made by measuring the ratio of market capitalization to that of total bank credit. In the former countries market capitalisation is more than two times lower than total bank credits, whereas in the former it is nearly the same as the banking sector's aggregate domestic credit (Popov 1999: 6).

Apart from analysing the process of replication, Zysman's volume *Governments, Markets and Growth* (1983) is significant because he identified the nature of state intervention in both systems. In the bank-based system, governments tend to intervene at the level of individual economic sectors or firms, resulting in close connections between the two that ensure that credit allocation, rolling over of debts, preferential interest rates and terms of debt repayment are used as mechanisms for economic restructuring. Moreover bank-based systems create business dependency on lending institutions whose lending rates for industries or sectors can be controlled by government policy. In the capital market based-system on the other hand, companies rely on equity funding and government intervention is carried out indirectly through monetary and fiscal policy. Restructuring of capital is determined by stock market prices, which means that financial instability will directly affect company performance. Finally, because the relationship between banks and enterprises is more distant in capital market-based systems companies are more susceptible to the dangers of hostile mergers and acquisitions (M&As) and leveraged buy outs (LBOs) (Popov 1999: 5).

Therefore Zysman's study and those of others not only found that the two systems are sufficiently different and that the bank-based system is better equipped at avoiding financial instability and short-term syndrome common in market based-systems but also that despite the recent trends toward financial integration, the bank-based system is more favourable to state intervention in the economy (Pollin 1995: 28). However, the literature that Zysman and others have produced has not critically analysed bank-based systems' governance mechanisms and the political and economic interests banking institutions serve within highly fragmented or clan-based societies such as that of Vanuatu. Studies based on Network Theory such as those by Fitch and Oppenheimer (1970), Mintz and Schwartz (1985), Glasberg (1989) and Murray (1989) have

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found that in industrialised countries the close inter-locks between board members of banks and enterprises and the alliances between them and state bureaucrats give rise to economic networks ruled by elites who are resistant to calls for economic and political democracy.

Despite the problems associated with bank-based systems, Roemer *et al.*, (1992), Harris *et al.*, (1988), Lipietz (1992), Pollin (1995) and Dymsky *et al.*, (1993) contend that these systems are more susceptible to government intervention than capital-based systems. As will be shown later this certainly applies to Vanuatu and its state-owned financial institutions but less so to the foreign-owned on-shore and off-shore banks. But most importantly they also argue that, given a particular mixture of the type of ownership and access to decision-making (in other words if the financial system itself becomes more democratic), these systems have the potential to facilitate economic democracy in the rest of the country. In order to identify this mixture, Pollin devised the Exit, Voice and Ownership matrix to categorise each financial system or entity according to its potential to advance economic democracy (1995: 61). The matrix, a combination of Hirschman's (1970) exit/voice framework for financial systems and the various types of ownership observed in banking systems, goes beyond the simple bank-based/capital markets-based dichotomy described earlier.[3] It classifies banking and financial systems and individual entities according to whether they are predominantly private, public or a mixture of both. In the matrix, current bank-based systems and public-owned entities are categorised as voice-led because they tend to be influenced by political and/or bureaucratic decision-making processes. Capital market systems on the other hand tend to be influenced by individuals and organisations exercising their exit option when dissatisfied with market performance. As such these systems' potential for economic democracy and representation of citizens who do not participate in capital markets is limited.

Because Pollin recognizes that the voice component in bank-based systems is currently represented by elite interests (public or private) but has *the potential* to be represented by more diverse

3 Exit in an economic relationship is the equivalent to divorce in a marital relationship, *ie.* withdrawing from a partnership when dissatisfaction occurs in the relationship. Voice on the other hand refers to the ability of expressing one's concerns to the individual or organization with whom one is involved.

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interests and become more democratic, he divides this component into 'Elite Voice' and 'Democratic Voice'. The matrix is illustrated below.

Table 1: Pollin's framework for financial systems and forms of property

Predominant Financial Institutional Framework	Predominant Ownership Form		
	Private	Mixed	Public
Exit	US, UK in the 1980s	UK in the 1960s and 1970s*	N/A
Elite Voice	Japan, Germany	France, South Korea** Vanuatu from 1980 to 1998***	Former USSR
Democratic Voice	Cooperatives, credit unions and mutuals.	Worker-owned banking systems.	Democratization of central banks and supervision agencies. Security transaction taxes.

Adapted from Pollin (1995: 61).
* Predominance of public ownership of non-financial firms.
** Predominance of public ownership of financial firms.
*** Public ownership of two banks co-existing with private ownership of banks. Off-shore sector is predominately private.

Democratic voice is present in banking systems/entities where the majority of citizens/members can participate directly in the decision-making process. Currently there are no country-wide banking systems where this feature is predominant but empirical evidence from studies carried out by Harris et al (1988), Lipietz (1988), Bardhan and Roemer (1992), Dymsky *at al.* (1993) and Pollin (1995) in industries where member input and participation is high shows that democratic voice can be increased in the banking sector.[4]

4 Based on these studies a number of proposals to improve economic democracy are provided in the literature. Bardhan and Roemer (1992) is the most comprehensive as it includes public ownership of enterprises beyond the financial sector. Those outlined for the US (and countries where exit is dominant and whose predominant ownership structure is private) are summarized by Dymsky *at al.* (1993) and Pollin (1995). They include, among others, reforms to the Community Reinvestment Act, the US pension fund system, the Federal Reserve and corporate governance structures (Block 1992). Proposals by Lipietz (1988), Harris and Coakley (1988) correspond to mixed ownership systems such as those operating in France and Italy where the main aim is to improve the democratic voice component within the current system.

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The matrix, therefore is not only useful in tracking institutional and ownership changes in banking systems over time but can also be used to identify, as in the case of Vanuatu, single entities that correspond to the 'democratic voice' category by virtue of their ownership structure and level of member participation. These entities developed over a period of time within the larger Vanuatu banking structure. It is necessary then to analyse the structure's trajectory and peculiarities since its inception.

Vanuatu banking structure then and now

Like most developing countries around the world, Vanuatu relies on a bank-based system developed during the colonial era. Trading houses such as the *Compagnie Çaledonienne des Nouvelles Hebrides* and the Australian-based Burns Philp Company were the first ones to provide banking services for colonial economic interests. After WWII metropolitan banks such as the *Banque de l'Indochine* and the Australian-owned Commonwealth Savings Bank began operating in towns where the plantation economy was most widespread (Busai 2000: 45). Seeking to take advantage of the expanding Eurocurrency markets the British colonial authorities introduced company and banking legislation in 1970 and 1971 that resulted in the sudden increase in the number of international banks, trust companies and ancillary financial services in the then New Hebrides OFC. The legislation was intended primarily to legitimise off-shore operations in the capital, Port Vila, but on-shore operations also benefited in a number of ways. In the period from 1969 to 1978 the number of banks servicing the local market went from one to five in addition to a merchant bank and a government-owned bank serving the country's cooperatives (the Cooperative Savings Bank-CSB). Apart from the government-owned CSB (precursor of the Vanuatu Savings Bank) all other banks were privately owned (Busai 2000: 45).

Private banks on both sides of the fiscal divide not only created a demand for legal and other services but also provided employment and revenues for the colonial administrators (Van Fossen 2002: 44-45). However, once the first OFC growth period began to slow down in the mid to late 1970s, the number of on-shore banks remained stable for almost 20 years[5]. From the early 1980s to the late 1990s a number of commercial banks attempted to

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set up business in the on-shore market but failed while others succeeded largely through mergers and acquisitions of already established entities. Amongst the most notable examples are the ANZ Bank purchase of Barclays Bank in 1985 and Bank of Hawaii acquisition of Banque Indosuez in 1993 (Busai 2000: 46).

Thus the average number of commercial banks during the above period was five until 2002 when the ANZ Bank, now a wholly owned subsidiary of the ANZ Banking Group, domiciled in Australia, bought the local subsidiary of Bank of Hawaii. This move brought the number of commercial banks down to four and created a duopoly of the ANZ Bank with over 60 percent of market share (in terms of assets) dominating the market, followed by Westpac Bank, a branch of the Westpac Banking Corporation, domiciled in Australia, with an estimated 30 percent market share. The government-owned National Bank of Vanuatu controls six percent of the market share and the rest is made up by the European Bank, which holds a domestic license but does not take deposits from or offer credit to the local market (Reserve Bank of Vanuatu 2003).[6]

According to the IMF the gradual exit of foreign banking institutions from the on-shore market is the result of banks seeking "to consolidate and to close their marginal operations" (IMF 2003: 13). But marginality is not the only reason to leave this small but lucrative market. Private banks that win the intense competition between them not only benefit from the country's tax free status but allows them to become part of the duopoly that enables them to realise high profits. In 1995, a bad year for Vanuatu private banks, Van Fossen found that "the Bank of Hawaii and ANZ reported operating net profits of 48 per cent and 36 per cent [respectively] on shareholder's equity" which are still high, compared to metropolitan bank's profits reported on average business periods (2002: 44).

The development of this duopoly situation has resulted in a number of problems for the national economy. From the figures it appears that the main function of these entities within the on-shore market is to siphon off local capital as large proportions of their

5 Van Fossen identifies three other OFC growth periods: 1988-90; 1995 and 1999-2000 (2002: 43).

6 The European Bank is a wholly owned subsidiary of European Capital Holding Corporation registered in Delaware, USA and offers private banking for non-residents and companies only (RBV 2003).

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assets move to headquarters, leaving Vanuatu with only 42 percent of the assets generated in the country. Moreover, only 36 percent of total bank assets is denominated in Vatu, the local currency, while the rest (approximately Vt.42.2 billion) is made up of foreign currency deposits (IMF 2003: 13). One impact of this high level of dollarisation on local costomers is that intermediation rates are tilted against the borrower. Since the 1990s the intermediation spread between lending and saving rates has remained at between 7 to 8 percent (ADB 1992: 18). Not surprisingly, private banks do not mobilise deposits for the benefit of the local market. In 2002 for instance, a technical assistance report for the ADB warns that "out of Vt. 33.6 billion in deposits by residents, only Vt. 12.4 billion [were] transformed into loans and advances to residents" (Maurer 2002: 9).

This means that even though these banks have very good access to financial resources their role as facilitators of credit for the local market is somewhat narrow and socially exclusive. In a country where half of the population is considered to live below the poverty line (ADB 2005: 2) on-shore private banks are still directing their services to a very small section of the population, namely civil servants and big businesses. As far back as 1990, relatively wealthy expatriates, who make up only 3-4 percent of the country's population, received 65 percent of the credit (ADB 1992: 18).[7] This is also evident in the way that banks allocate credit. From the figures in Table 2, it is clear that banks allocate over a third of the credit available in the country to consumption activities that only a few can afford.

A further example of the socially exclusive nature of on-shore private banks is the limited geographic spread of branch offices. Apart from their head offices in the capital city private banks have only one branch office each in Vanuatu's second largest city, Luganville. In contrast, the National Bank of Vanuatu (NBV) has a network of 19 rural branches on 12 major islands (Maurer 2002: 9). The lack of interest in local and community development by foreign banks is a post-independence phenomenon and the result of political and economic changes within Vanuatu. In the early 1970s a number of private banks contributed to the development of Port

7 In 2000 the reported average income for expatriates working in the OFC was US$59,900 per person while that for Ni-Vanuatu employees was US$7,400 per person (Van Fossen 2002: 44).

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Table 2: Vanuatu credit allocation by sector (2001)

Economic Sector	Million Vt	Share
Personal loans	4,171	34 %
Construction	2,242	18 %
Trade and commerce	1,806	15 %
Transport	1,084	9 %
Tourism	918	7 %
Professional services	909	7 %
Mining and manufacturing	408	3 %
Public utilities and government	311	3 %
Agriculture and fishing	281	2 %
Miscellaneous	261	2 %
Total	12,390	100 %

Source: Reserve Bank of Vanuatu. *Monetary and Banking Statistics*. Port Vila. July-September, 2001.

Vila's infrastructure and other long term development projects. On this point Rowlings reports that:

> In 1974 the Joint Administration borrowed A$2 million from two of these banks to fund infrastructural projects. These included upgrading telephone facilities in Vila and Santo, expanding the Vila wharf, civil service housing and compensation pay-outs to indigenous land owners for road construction (2004: 13).

After independence private bank credit for these kinds of projects was overshadowed by official aid from regional donors and multilateral financial institutions. In the period 1982-2003, the Asian Development Bank alone provided over US $64 million in loans and technical assistance to Vanuatu (ADB 2005: 2). The increasing reliance on multilateral aid and state funds rested on the assumptions that private banks could not be relied upon to provide the kind of long-term credit necessary for development projects and poverty alleviation. This task was first conferred on the Development Bank of the New Hebrides during its inception in 1979 and continued with the Vanuatu Development Bank (VDB) after independence (Busai 2000: 46). The VDB provided loans for small business and long term loans for large development projects in both rural and urban areas. The beneficiaries of small loans were usually people who did not have a long track record of credit acquisition but good business prospects or who would otherwise be

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considered 'non-bankable' by commercial establishments (Nicklam 2004).

Like other banks of its type the VDB's income originated from interest earned from loans and funds and from equity in development projects. Other assistance for the bank came from overseas donors such as the Caisse Centrale and the European Investment Bank (VDB 1991: 11). However, these sources were not sufficient to cover operating costs and the bank began to experience significant losses in the late 1980s and continued doing so into the next decade until the government, on ADB's advice, closed it in 1998.

Many of the reasons for the VDB's closure are linked to the 1998 financial crisis that was also experienced by other financial institutions in the country. Therefore it is worthwhile examining the background of this crisis before moving on to explain the bank's internal problems.

The 1998 financial crisis and its causes

As argued earlier, the liberalization projects launched in many developing countries during the 1980s and 1990s have created financial environments that are highly dependent on larger, more developed financial markets. This increased dependency means that banking systems in 'emerging' economies become vulnerable to financial speculation and macro-economic instability far beyond their shores. It is not surprising then that financial and banking crises have become more common, confidence has been eroded, and solutions involving socially painful structural adjustment programs and rescue packages such as the CRP have become the MFI's usual remedy. In many cases, financial reform has not been accompanied by the development of effective regulatory, supervisory and institutional frameworks that restrict managerial malpractice and speculative bubbles. Moreover, the newly deregulated environment sometimes aggravates the micro- and macro-economic causes of a banking crisis.

Before 1998 Vanuatu shared many characteristics of the more highly regulated financial systems found in other developing countries but it also differed in many significant aspects. For instance, unlike countries with restricted current accounts where the monetary authorities' control of the money supply and interest

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rates is strong, the monetary powers of the Reserve Bank of Vanuatu (RBV) are weak due to OFC operations and access to foreign currency deposits which makes the country susceptible to economic shocks (Chand 2002: 28). Generally, economic shocks, such as the presence of an overvalued exchange rate, a fall in the terms of trade, the sudden onset of recession or high real domestic interest rates, can all negatively impact on the profitability of businesses with bank debts. This affects the quality of banking assets and in turn diminishes a bank's loan portfolio (Duran and Mayorga 1998: 6). Similarly, macro-economic instability due to high inflation or fiscal deficits can shrink the demand for deposits and affect the ability of a bank to procure funds for its operations. The financial system also becomes more vulnerable when there is an explosion of credit offering associated with speculative bubbles. In instances like these, banks follow strong pressures to overvalue assets (whether they are real estate in tourist destinations, 'dot com' firms or financial instruments like shares and derivatives), but are placed at risk when market bubbles burst (Goldstein and Turner 1996).

Vanuatu experienced declining investment from its Asian trading partners who suffered severe financial downturns in 1997. This was accompanied by a budget deficit blow-out of 7.2 percent of GDP and attempts to devalue the Vatu by 20 percent which led to loss of investor confidence and a sharp decline in foreign currency deposits (Ala and Arubilake 2000: 17; Chand 2002: 31). All of these factors point to a macro-economic environment in the period leading to 1998 that was not very promising and brought to the surface some of the micro-economic problems that institutions such as the VDB had experienced since their inception.

Micro-economic causes such as managerial malpractice and weak regulatory and supervisory frameworks can cause the collapse of individual financial entities. However, even though managers might take excessive risks, regardless of the regulatory environment in which they operate the magnitude of those risks can be greatly diminished by a strong regulatory framework. Weak regulatory environments may promote opportunistic behaviour such as not maintaining synchronization between asset and liability operations, concentrating credit portfolios and providing generous loans to related firms. In the case of the VDB, some members of the board of directors facilitated generous loans to their relatives, which were never repaid in full (Port Vila Presse 2003: 1; Hill 2000: 97).

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The severity of a financial crisis depends on the response time of the relevant authorities and the existing safeguards against collapse. Micro-economic causes require clear guidelines for authorities to follow in the event of a crisis, and macro-economic causes require institutions or plans such as deposit insurance schemes to be in place well in advance of any crisis. Before 1998 these safeguards were very weak if at all present in Vanuatu. It must be said also that although these measures cannot prevent a crisis, their absence can prolong or deepen its effects. The VDB's financial woes, for instance, lasted almost 10 years until ADB recommended the closure of the bank in 1997. The reasons for this advice include: unsustainable lending practices (as described above), high costs of recovering loans and political interference that robbed the bank of much needed funds and independence (ADB 1997: 7).

Even though ADB's assessment is correct, macro-economic causes should not be underestimated in explaining the VDB's deteriorating financial position and that of other Vanuatu entities in 1998. To these, one must add the political events that surrounded the economic crisis and the eventual implementation of the CRP.

The reform: successes and failures

In January 1998 the ombudsman's office exposed senior politicians of indulging in loans from the Vanuatu National Provident Fund (VNPF), a government compulsory pension scheme. Soon after, people began rioting in the streets of Port Vila demanding access to their savings in the VNPF (Freedom House 1999). The government allowed the payments but the inflationary pressure from increased liquidity led to a slight rise in inflation. In order to avoid losing the value of their savings people exchanged their Vatu for foreign currency which led to a reduction in the country's reserves to an equivalent of 3 months of import (Ala and Arubilake 2000: 17). The government's weak fiscal position affected its capacity to fund financial entities such as the VDB and the NBV. The latter was in the process of recovery since 1995 but its financial position quickly deteriorated in 1998 due to operational losses and mismanagement of loans (ADB 1997: 4-5; Busai 2000: 46). This together with the already diminishing markets of Vanuatu's main exports during the previous year meant that people's confidence in the economy and the recently elected government (the fourth since 1995) was already low.

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The implementation of the CRP, which had been signed the previous year, now seemed a real necessity and the ADB disbursed the first loan in July 1998 (ADB 1998). The provisions of the CRP introduced, amongst other measures, legislation that improved governance procedures within government-owned financial institutions. The government established the Asset Management Unit (AMU) to recover bad loans made by the VNPF, the VDB, and the NBV, it dissolved the VDB and strengthened the NBV by injecting Vt 400 million in capital (Freedom House 2001; Busai 2000: 46). The input of funds was accompanied by changes in the NBV's management structure. The bank went through corporatisation of it's operations soon after the old top level managers were replaced with foreign bankers with no ties to local political elites.[8] The result of these and other transformations was a slow turnaround and by 2002 Vanuatu's financial system showed its first signs of recovery (Chand 2002: 24).

Even though the banking system was brought under control and the CRP's rescue of government-owned financial institutions was a success the same cannot be said of the reforms' socially oriented objectives. These objectives state that the benefits of the reforms should be "shared throughout the population" (Chand 2002: 33). This is particularly the case with credit acquisition amongst marginal populations. The CRP Rural and Business Development Subsection 5.11 states that "attention will be paid to closing the gap between commercial banking and the informal credit arrangements that exist within communities, to provide rural people and aspiring small business people with accessible long term credit" (VANWODS 2001: 1). As demonstrated earlier, credit from commercial establishments is not readily accessible to large sections of the population because the CRP has failed to reform the foreign-owned duopoly that exists in the onshore sector.

In terms of strengthening informal credit arrangements the results are mixed. The state has made various efforts at harnessing the potential of civil society organizations. For instance, the Department of Co-operatives and Rural Business Development (DCRBD) has been proactive since the early 1980s in providing

8 After the reforms the NBV became more interested in pursuing a purely commercial approach to banking. A recently introduced rural credit scheme, for instance, was carefully labeled a "bank product...not a loan scheme" to sufficiently differenciate it from the type of credit that the now-defunct VDB offered (Konusi 2004).

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general business and legal training, marketing and business advice for cooperatives. This support was important during 1998 when many cooperatives went bankrupt and is a continuation of the support that they used to receive from the CSB since it was founded in 1975 (ADB 1997: 4). Similarly, credit unions (CUs) grew in number as a result of state support. During the 1980s there were 60 CUs operating in the country but this number dwindled to six in 2000 as a result of insufficient management skills and the lack of financial supervision (ADB 2000: 2). To address this problem the government established the Credit Union League (CUL) in 1992 and charged it with promoting savings throughout the country and offering technical and legal assistance to CUs. In 1999 the state reinforced the sector's legal framework by enacting the Credit Union Act. The Act gives the Financial Services Commission (FSC) the authority to register CUs and pass relevant legislation affecting them (Busai 2000: 49). Related efforts include overseas donor funding of the Credit Union League's (CUL) Savings Clubs Program in 2003 (Denise 2003) and the creation of a national legal framework for the micro-credit sector in 2004 (Port Vila Presse 2004).

From the above it is clear that state support for a civil society-based system of credit for those who do not fulfill commercial lending criteria has been continuous. However this support resulted in state dependence that has not produced the right conditions for savings clubs, cooperatives and credit unions to grow in a sustainable and independent fashion. The economic success of the recent reforms has only exacerbated the problem of state dependence and has done little to improve the sustainability of micro-credit schemes. For instance, in response to the closure of the VDB and subsequent decrease in rural finance, the NBV introduced an ADB-supported rural loan scheme in 2002 (Maurer 2002) and a year later the Chamber of Commerce began to disburse funds from a European Union line of credit for agricultural producers and tourism operators (ADB 2003: 2). These moves were followed by government agencies such as the Department of Trade and the Department of Co-operatives and Rural Business Development Services which began lending money to individuals and cooperatives in 2003 (Licht 2003). These programmes have improved credit supply in rural areas but the low loan recovery

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rates experienced in the past indicate that this type of finance is likely to be depleted within a few years of its establishment.[9]

One consistent feature of state support before and after the CRP took place is elite hegemony over decision-making and programme delivery. The hegemonic position of elite groups determines the types of government credit programmes and most importantly, affords them political clout with their subalterns. This situation does little to increase non-elite voice and participation in micro-credit schemes and increases the incidence of corruption and administrative malpractice as the VDB's collapse and the diminishing number of CUs shows.[10]

Despite the high level of dependence on state funds and resources, a few micro-credit schemes have thrived by offering alternatives to elite hegemony and the top-down approach that accompanies state support. However, the number of entities is miniscule: there is only one member-run organization offering credit to low income urban women in the country and only a handful of cooperatives are run with any significant member input. It is very common for cooperatives in the country to start out with the involvement of large number of members but in time only a few remain active and begin to run the cooperative as if it was their own business. By retaining the cooperative license they get access to

9 During the final years of operation, the VDB's yearly and monthly collection rates were 62 and 43 percent respectively (ADB 1997: 7).

10 The Vanuatu political and bureaucratic elites are characterised by clan and regional alliances that transcend ideological positions. The government apparatus is therefore highly fragmented, unstable and prone to administrative malpractice and corruption. The country's Ombudsman recorded 73 cases of abuse of high public office in the period 1996 to 2000. Of relevance is the case of the 'official' 1995 trip to Fiji by the NBV board of directors and the general manager. The group took a week-long trip to Fiji claiming that they were on official business to visit the National Bank of Fiji but instead took sightseeing tours and held a beach party. The various expenditures for the trip, including alcohol, cigarettes and telephone calls were all added to the trip budget which rose from the original 1 million vatu to 1.5 million vatu at the end of the trip. On their return, the general manager lost his luggage but did nothing to retrieve it from the airline they used. Instead, he reimbursed himself US$200 from NBV funds for this item. A day after the trip the group held an extraordinary meeting where they decided to increase their daily allowance from 5,000 vatu to 12,000 vatu. No prosecutions were made thanks to the strong connections the group had with other government officials and all members of the group continued to hold government posts after the incident despite the Ombudsman's recommendations that those involved "should never be appointed to any government or statutory institution" (Hill 2000: 43).

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DCRBD services.[11] This is not dissimilar to the entities listed below in the second example. Weak enforcement of business regulations has led to the establishment of two privately-owned entities that accept deposits and offer credit to the public. These entities trade as pseudo co-operatives even though they do not fulfill the standard criteria. However, from a socio-legal standpoint there are significant differences between not properly run co-operatives and pseudo co-operatives. Firstly unlike cooperatives, these entities offer no legal mechanisms for co-ownership or for profit-sharing. Secondly, unlike cooperatives, the membership in these entities does not have any legal way to have a say in the running of the business. Thirdly, whereas the two pseudo co-operatives operate as a result of entrepreneural ingenuity and inefficiencies in state surveillance and legal enforcement, a badly run cooperative is usually the result of weak social capital.

When examined using the ownership category within Pollin's matrix, one entity in the cases below, is publicly owned, and the other two are privately owned (one collectively through its members and the other by an individual). Using the same matrix, two out of three of these entities fit the category of democratic voice because they use decision-making mechanisms that ensure broad and effective representation of members. In the three examples below, both ownership type and democratic voice are established by examining the organizations' charter. Unless otherwise indicated all figures quoted below are sourced from the entities' annual reports for various years and open-ended interviews with the directors of each entity.

A savings and loans cooperative

Established in 1987, Klat Savings and Loans Society began with less than 10 members. Since then Klat has grown steadily and by 2004 the number of members reached 168. This cooperative serves people living in the province of TAFEA.[12] All of its assets, including

11 There is no published data on this problem. An interview with the director of the DCRBD confirms that this is a breach of the law but his office is unable to prosecute offenders (Sandy 2004). According to the Informal Sector Survey there were 108 informal sector cooperatives in the country in 2000 (VNSO 2001: 38).

12 TAFEA is an acronym that stands for Tanna, Aniwa, Futuna, Erromango and Anatom. The last census in 1999 reports a population of 29, 047 people (VNSO 2001).

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wholesale, fuel and grocery stores, office space, hotel and butcher shop are located in Lenakel in the island of Tanna. The cooperative issues shares that give members voting rights and other benefits such as access to loans and discounts in the cooperative's stores. All members have equal voting power and members meet on an irregular basis throughout the year and for the annual general meeting. Attendance at these meetings varies depending on the relevance of agenda items but a quorum of a simple majority is required to change the charter and for elections. Anyone who has been a member of the cooperative for one year can run for election (Samuel 2004; KSLS 2000).

In terms of services, members are allowed to borrow up to 50 percent of the value of their shares in the cooperative. A fee equivalent to 20 percent of the requested loan is payable upfront as well as some form of guarantee that can include tangible assets such as livestock, personal items and farming tools in addition to character references from the borrower's traditional chief. Repayments are usually made on paydays as most members are employed in the formal sector. Members working in the informal sector with irregular income do save in Klat but cannot access loans from the cooperative. The bulk of the loans requested are for small business ventures for the borrower's partner and to pay school fees, medical visits and transport costs. Most members use Klat to save money for specific purposes and to keep it away from home where it can be spent or stolen. The repayment rate is 95 percent and this is due to the strict lending rules and the involvement of the borrower's community in the lending process.

According to Klat's treasurer, the central government through the DCRBD provides technical assistance when requested but the cooperative has never received a grant from the government, a fact that is expressed with pride because it allows Klat complete political and economic independence (Samuel 2004). However, the then parliamentary member for TAFEA province, argues that part of Klat's success is largely the result of the provincial government's protective policies that give preferential treatment to local businesses (Nicklam 2004).

A pseudo co-operative

There are two entities of this type in the country, one in Malo Island near Luganville, Vanuatu's second largest city, and one in the

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capital, Port Vila. The directors of both entities were interviewed but because of its larger size and longer history the current case study refers to the latter entity which trades as the Melanesian Co-operative Savings and Loans Society Limited (MCSLS). It is clear from the interview that this 'cooperative' was a 'one-man show' because the director was the owner of the entity and he did not have a charter to indicate that member input was present in the running of the organization. The director did not provide an annual report when asked for one and says that MCSLS does not receive funding from any government agency. This ignores government leniency toward MCSLS' informal status as a co-operative. The information that follows was obtained from the MCSLS interview and a publicity brochure.

MCSLS was established in 1984 and its membership grew from 30 to over 500 in 2004. Clients can borrow money from MCSLS as soon as they start saving but the security over any loan must equal 70 percent of the client's deposits. The minimum amount that clients who are government employees can borrow is 100,000 Vatu (Vt) or approximately US$ 860.00. For all other clients, loans start at Vt 40,000 or approximately US$345.00 at the 2004 exchange rate.

MCSLS' preferential treatment to government employees means that its client base is made up of full time wage earners. Long term clients who borrow in excess of Vt 100,000 are required to negotiate the amount of security deposit. Regardless of the amount borrowed the security deposit earns 2.75 percent interest but loans are charged a rate of 16 percent per annum on monthly reducing balances. The fees on loan approval start at Vt. 5,000 or approximately US$43.00 payable up front. In 2004 the MCSLS was beginning to offer mortgages and business loans for its long term clients.[13] The on-time repayment rate is above 90 percent and most small loans are paid within a year (Bangtor 2004).

A micro credit scheme

The Vanuatu Women's Development Scheme (VANWODS) was established in 1996 by the Department of Women's Affairs with assistance from the United Nations Development Program (UNDP). The scheme continues to get support from its donors: in the period 2003-2006 VANWODS received over US $600,000 from the UNDP

13 A business loan requires a 100 percent security deposit and is means tested.

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and the government of Vanuatu (UNDP 2006). The information below is sourced from annual reports, an interview with the director and a report from donors (VANWODS 2001: 1-5).

In the initial stages, this micro-credit scheme relied entirely on its donors for funding but organizers have tried to establish some independence from them. However, this goal has not been achieved at the time of writing as the director declared that UNDP was still providing some support to the organization. The members themselves have a great deal of freedom in day-to-day business decisions, the type of business they want to operate and the provision of advice to VANWODS' management. Members are encouraged to attend the annual general meeting and to try to influence the organization's general direction. According to the director, this input is essential in VANWODS' survival (Marasigan 2004).

The scheme builds on Grameen Bank principles[14] in order to cater for its female clientele which is drawn largely from low socioeconomic areas around Port Vila. The loans are relatively small and start at Vt 5000 with the uppermost limit being around Vt. 30,000. Despite the small nature of the loans themselves by 1999 the organization dispensed Vt. 3.1 million to 179 women (ADB 2000: 3). VANWODS' potential clients are means tested and if approved, are required to work in groups of 5 members. These groups receive training prior to undertaking a business venture and receiving loans. Each member is deducted five percent of the loan which is added to each member's savings. In addition each member in the group is required to save Vt 100 per week for the duration of her membership and is encouraged to save some of her profits. The interest rate for the actual loan is 16 percent per annum. The repayment rate is 98 percent which, according to the scheme's managing director, is the result of monitoring mechanisms and most importantly, the high level of group commitment each member is instilled with prior to obtaining loans (Marasigan 2004; ADB 2000: 3).

VANWODS' membership has steadily increased from 20 in 1997 to 700 in 2004 but due to a shortage of managerial expertise and logistical problems the organisation has no plans for expansion into rural areas.

14 Grameen's four principles are Discipline, Unity, Courage and Hard Work.

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From the above examples, it is clear that the voice component or ability to influence decision-making within these entities differs depending on the ownership structure and the way they are legally organised. If members' ability to influence decision-making is taken into account then privately run MCSLS offers the least amount of voice to its membership/clientele while community-run Klat offered the most opportunity for members to participate. From the number of meetings and the type of participation reported in their annual reports, VANWODS' membership ability to influence decision-making is not as strong as Klat's. This situation has the potential to change once the scheme attains more independence from donors. In terms of state support however, MCSLS and Klat receive the least amount of support which translates into little interference from elite voices. VANWODS on the other hand receives the most support and is more dependent on elite voice.

Conclusion

Using Pollin's matrix for financial systems and forms of property, the CRP has changed the on-shore Vanuatu banking system from a predominantly elite voice with mixed ownership (with two public banks, one state-owned pension entity (the VNPF) and four private banks) to one that is characterized by a predominant private form of ownership (with only one public entity, the VNPF and three private banks) but whose overall framework is still led by elite voices. The nature of the voice component, however, has changed from mixed local and foreign to one that is predominantly foreign with only a small minority of local non-elite voice institutions. This shift has made the on-shore banking system look more like the institutional framework of the off-shore sector where private ownership is dominant.

In terms of its social oriented programs the reforms have not challenged the duopoly of the commercial financial entities, their socially narrow service delivery record and their role as siphons of funds generated within the country. Finally, state support to community-based financial institutions has stunted the growth of an independent non-elite financial sector. As such, the sector has had limited impact on redressing the main poverty trends in the country (Asian Development Bank 2001b; UNESCAP 2003). However, their resilience shows that non-elite based organisations

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within the sector can, with non-dependent forms of state support, supply credit for large numbers of the population that private banks refuse or are not interested in serving.

Note: Thanks to Thomson Pakoa, Vincent Saksak, Ronald Sandy, Michael Hililan, Marian Samuel, Jioji Konusi, Marjorie Marasigan, Ezra Bangtor, Maki Simeli, Jimmy Nicklam, Joshua Tari, Sheryl Dan, John Paton, Georgi Calo, Mary Kalmet and others for their assistance and comments. The School of Social and Economic Development at the University of the South Pacific provided funding for this research. All opinions expressed herein are solely the responsibility of the author and should not be attributed to the above mentioned persons or the institutions the author is associated with.

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Democracia Económica y la reforma financiera en Vanuatu

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Este artículo identifica la razón y trayectoria de la reforma del sector financiero como parte del donante-patrocinado Programa de Reforma Integral (CRP) en Vanuatu y proporciona un análisis de los problemas asociados con la falta de crédito razonable para los sectores de la población que no reúnen los criterios de préstamos comerciales. El artículo se basa en la teoría de hegemonía financiera con el fin de explicar el papel de Vanuatu dentro de estructuras financieras internacionales y la razón para la reforma. La discusión muestra que las instituciones bancarias extranjeras no están interesadas en ampliar el acceso a crédito para los sectores más pobres de la población, y que los altos niveles de dependencia estatal impiden el desarrollo de un sector sostenible de micro-crédito. Sin embargo, utilizando el método de Salida, Voz y Posesión de Robert Pollin, el artículo muestra que las organizaciones de la sociedad civil que busca aumentar la democracia y participación económica, aunque pocos en número, están presentes en y proporcionan un modelo para mejores prácticas en el país.

Démocratie économique et réforme financière

Le présent article identifie le bien-fondé et le trajectoire de la réforme du secteur financier qui fait partie du Programme de réforme détaillé (PRD), financé par les bailleurs de fonds au Vanuatu. Il fait une analyse des problèmes relatifs au manque de crédit abordable pour les secteurs de la population qui ne remplissent pas les critères commerciaux pour obtenir des prêts. L'article emploie la théorie de l'hégémonie financière pour expliquer le rôle du Vanuatu au sein des structures financières internationales plus larges et les raisons pour la réforme. La discussion montre que les institutions bancaires étrangères ne veulent pas élargir l'accès aux crédits pour les secteurs les plus pauvres de la population. Elle montre également que les niveaux élevés de dépendance sur l'état entravent le développement d'un secteur de micro-crédits soutenable. Néanmoins, à l'aide de la méthodologie de Robert Pollin relatif à la Sortie, la Voix et la Propriété, l'article démontre que les organisations de la société civile qui cherchent à accroître la démocratie et la participation économiques, bien qu'elles soient peu nombreuses au Vanuatu, représentent un modèle de meilleures pratiques pour le pays.

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