Public Organization Review: A Global Journal **1**: 261–278 (2001)

Central Bank Independence in the Pacific Island Countries: A Case Study of Vanuatu

T. K. JAYARAMAN*
Senior Lecturer in Economics, University of the South Pacific, Suva, Fiji

Key words: South Pacific island nations, central banking, Vanuatu

Abstract

Central banks are an important element of governance in most countries, although surprisingly neglected in the public administration literature. The South Pacific island nations have established central banks for regulating their payment systems and financial and banking sectors. They are pursuing monetary policies towards the objectives of growth and price stability under fixed exchange rate regimes. Although these bank authorities have been given enough powers to assert themselves under the relevant statutes, institutional experiences indicate that some of these powers are eroded over time by political interference, as well as by acts of omission and commission by officials both in the central banks and in governments. This is illustrated by particular reference to the case of Vanuatu, a young South Pacific republic.

The American humorist Will Rogers saw fire, the wheel and central banking as "the three great inventions since the beginning of time". Recording this, however, *The Economist*'s economic editor placed central banking clearly as a 20th century invention, and noted that 173 countries had central banks at the close of that century (Woodall, 1999, p. 4). The vast majority of modern states thus have one, and this is mostly true of small states as well. The nature of the relationship between these institutions and the government itself becomes a question of major importance for the healthy conduct of political and economic systems, but it is one that has been surprisingly neglected in mainstream public administration literature.

This article begins with a brief introduction to the general issue of central bank independence, and then examines the playing-out of the relationships in the case of the small Pacific state of Vanuatu.

*The author expresses his grateful thanks to Governor Andrew Kausiama, Reserve Bank of Vanuatu; Mr. Simeon Athy, Director Research, Reserve Bank of Vanuatu; Mr. Jeffrey Wilfred, Director-General, Ministry of Finance; and Mr. Jimmy Andeng, Director, Department of Strategic Management; all of Port Vila, for their review of earlier versions of this paper and useful comments. Any errors that remain are the author's own responsibility.

The general issue of central bank independence

Some central banks began their lives quite early in the century, and they found themselves involved in the administration of exchange controls. During the past two decades, however, industrialized nations have moved away from fixed exchange rate regimes towards freely flexible exchange rates, and have lifted exchange controls. Under the conditions of perfect capital mobility, monetary policy has become more effective. Therefore traditional objectives, including exchange rate stability, have come to be modified. Most of the central banks in advanced countries have now only price stability as their objective.

Principal-agent relationship

Once the objective of the central bank is specified in the legislation governing the institution, its performance and in particular that of its chief executive (often styled "governor") is evaluated on the basis of achievement of the objective. For example, it is customary to find today that the governor's salary and service conditions are regulated on the basis of inflation. In New Zealand, the contract of appointment provides for the dismissal of the governor of the Reserve Bank in the event that he fails to keep annual inflation within a stipulated range of a few percentage points. Thus central banks are now made accountable in the best traditions of good governance. Accountability is defined in the *Oxford English Dictionary* as "obliged to give a reckoning or explanation for one's action" and responsibility is in turn defined "as liable to be blamed for loss or failure". Since an irresponsible act would lead to termination of contract or loss of face for anyone in a position of responsibility, the natural context in which the relationship between the government and the central bank is to be considered is one of principal and the agent (Briault, Haldane and King, 1996).

If an agent has to perform, he has to function with certain well-defined powers and a measure of independence (Fischer, 1994). In the case of the central bank, one has to distinguish between central bank *goal* independence, namely the central bank setting its own targets (monetary aggregates or interest rate or inflation) and *instrument* independence (tools of monetary policy), namely the central bank's ability to choose its own instrument settings (Briault, Haldane and King, 1996) and the ability to say "no" to fiscal abuse (Fry, 1993).

In their study of 17 industrialized nations, Alesina and Summers (1993) came to the conclusion that performance in controlling inflation rated best in countries with the most independent central banks. A similar conclusion was reached by Cukierman (1992). However, although a more independent central bank appears to lead to a lower inflation rate, this is not achieved at the expense of poorer real economic performance: Alesina and Summers (1993) find no correlation between central bank independence and growth. Similarly, in a study of developing countries (other than South Pacific Island Countries), Cukierman, Webb and Neyapti (1992) find that central bank independence and inflation are uncorrelated.

Measures of central bank independence

Certain yardsticks for measuring degrees of central bank independence have been evolved by researchers (Fry, Goodhart and Almeida, 1996; Cukierman, 1992). They relate to institutional autonomy and instrument independence. Institutional autonomy requires security of tenure and assurance of full freedom to perform legally imposed functions. Instrument independence requires both full powers to exercise the monetary instruments available under the law and absence of any interference by the government.

The items used to assess central bank performance are shown in the first column of Table 1. Year-by-year indicators of the Vanuatu situation, based on Asian Development Bank assessments, are shown in the other columns. These assessments will be further considered below.

Application in Small Pacific Island Countries

Small Pacific Island Countries (SPICs) which became independent during the late 1970s have inherited many of their erstwhile colonial masters' institutions and

Table 1. Central banks: key economic indicators and Vanuatu results.

Indicators	1980–90 (Av'ge)	1991	1992	1993	1994	1995	1996	1997
Annual growth rate (%)	1.4	4.4	1	4	2.6	3.2	3.5	1.7
Per capita income growth rate (%)	1	1.5	1.7	1.3	−0.2	0.6	0.8	−0.9
Government revenue (% of GDP)	22	24.5	24.7	23.1	24.9	26.7	23.5	23
Government expenditure (% of GDP)	23	38.4	33.4	26.9	26.5	29.4	25.3	23.7
Overall fiscal balance (% of GDP)	−1	−13.9	−8.7	−3.8	−1.6	−2.7	−1.8	−0.7
Current account balance (% of GDP)	NA	−10.8	−9.9	−1.3	−9.9	−2.1	−0.6	2.2
Foreign direct investment (millions US $)	13	25	26	27	30	31	28	30
External debt (% of GDP)	8	22.8	23.2	24.8	24.4	22.2	20.4	20.5
Debt service ratio (% of GDP)	0.8	1.4	1.3	1.4	1.6	1.5	1.4	1.5

Source: ADB (1998).

laws. In the economic and financial fields, all the trappings of Western commercial and financial systems were adopted. Although new to modern concepts in many areas of production and exchange as well as the monetarization process, the SPICs were quick to imitate and learn.

Prior to their independence, most SPICs used the currencies of their colonial rulers. After independence some of them set up monetary authorities, introduced their own currencies, and pursued independent monetary policies. However Kiribati and Tuvalu resisted the temptation. They continue to use the Australian dollar as their domestic currency, denying themselves any luxury of monetary independence; they have no monetary authorities or currency boards. In a way, this has been hailed as a right step for small countries, as it is said to have instilled fiscal discipline. Because of this self-denying ordinance, these two island nations have no way of monetarizing their budget deficits, and their fiscal policies have no monetary implications endangering price stability. Any inflation would thus be purely imported.

The Cook Islands, which introduced its own dollar in the early 1990s along with the New Zealand dollar as the medium of exchange, has now discontinued its own dollar. It was a classic case of Gresham's law: bad money driving away the good money, once the fiscal deficits were found unsustainable.

The monetary experiences of those SPICs where central banks have been in existence for the past two decades have been mixed. At one end of the spectrum the Solomon Islands, which resorted to substantial deficit financing in the mid-1990s, experienced unprecedented inflation during these years; other countries, including Fiji, Tonga and Vanuatu, adopted more conservative fiscal policies and avoided inflation. Periodical cyclones, which provided negative shocks, did affect the price levels in all SPICs for shorter periods. However, in keeping with empirical evidence recorded elsewhere, rapid and continuing price level increases in SPICs have been observed to be a monetary phenomenon.

Naturally a question that arises is how far the central banks in these countries have been able to assert their independence by saying "no" to governments. As has been documented by Fry (1993), governments in developing countries have consistently displayed a tendency to "fiscally abuse" their central banks, merely looking upon them as their handmaids. But there is a related question as to whether governments in developed countries have done much better: thus a former British chancellor of the exchequer, Stafford Cripps, described the mother of all central banks, the Bank of England, as "his bank" (Woodall, 1999, p. 4).

Most of the institutional arrangements, including the legislative measures regulating the powers and responsibilities of central banks in SPICs, are patterned after those of other Commonwealth countries. However broader environment or institutional endowments, unique to the island nations in which those formal arrangements are embedded, have exerted major influences on central banking behavior, as they have on other government operations. As will be indicated further below, these institutional endowments include informal social, political and economic institutions as well as formal and informal arrangements for policy-making in monetary and economic areas other than (North, 1990; Ball, 1999, and see the accompanying article by Poirine and Moyrand).

Viewed against this background, this article now examines issues relating to central bank independence in the case of Vanuatu. The following section presents brief background information on the economy of Vanuatu, and the next outlines the objectives of the Reserve Bank of Vanuatu (RBV) and its functions and achievements during its years of existence. The final section deals with governance issues relating to RBV's independence against the backdrop of institutional endowments and the formal institutional structure of rules and regulations. Some conclusions are then presented.

Vanuatu's economy

Background

The Republic of Vanuatu, formerly known as the New Hebrides, consists of about 80 islands. It is located 2,300 kilometers east of Australia and has a total land area of 12,200 square kilometers. Its population stands, according to latest provisional estimates, at 192,000. About 20 percent of the population live in two main urban centers: Port Vila on the central island of Efate, and Luganville on Santo, the largest island. The rest of the population is dispersed among other islands that have limited communication facilities. While the two urban centers are marked by thriving tourism activities, with Port Vila, the capital, having the most sophisticated offshore finance center institutions in the South Pacific, subsistence agriculture characterizes the rest of the country. Inadequate transport communications between the islands have inhibited inter-island trade, and in some of the remoter islands the cash economy has not evolved and some kind of barter trade is still ongoing.

The economy has done well since independence in 1980 from the joint condominium rule of the British and French. Despite the adverse effects of periodical cyclones, the economy has grown at 3 percent a year. Since the population is estimated to be growing at 3 percent a year, per capita incomes have mostly remained stagnant. However, the subsistence-affluence style of living in the remote islands has kept the nation free from any inadequacies in the availability of food and nutrition. It is only in urban areas, where modern medicines and processed and imported foods have to be purchased with cash; that the stagnant incomes have hurt the natives, known as ni-Vanuatus.

Structural changes

Structurally the economy has undergone slight changes in recent years. The primary sector, including subsistence activities, has marginally declined in importance, from 26 percent to GDP in 1983 to 23 percent in 1998. The services contribution has also slightly declined from 67 percent in 1983 to 64 percent in 1998. On the other hand, the secondary sector (manufacturing, electricity and construction) has increased its share from 8 percent of GDP in 1983 to 14 percent in 1998. The economy continues to depend heavily upon the services sector, mainly tourism and construction activity in the hotel and resort industry.

Open economy

Vanuatu's economy is the most open of all the SPICs. It has no exchange controls and residents can hold their deposits in both vatu (VT: the domestic currency—the exchange rate at 31 August 2000 was US$ 1 = VT 139.95) and in any foreign currency. The vatu is pegged to a basket of major currencies of the trading partners and the weights attached to them reflect the proportions of trade. Vanuatu has no income tax, capital gains tax or any tax on any kind of income. All these features and a relatively untarnished reputation have made Vanuatu a leading tax haven in the South Pacific (Jayaraman 1998a).

The macroeconomic environment has been stable (Table 2). Inflation has remained low, which is broadly in line with Vanuatu's major trading partners, Australia and New Zealand. As there is no income tax or capital gains tax, the main revenue sources have been indirect taxes in the form of import duties, the recently introduced value-added taxes, and non-tax measures such as fees. The government followed prudent fiscal policies: the recurrent budget was always balanced until the end of one-party majority rule in 1992. After the split in the ruling party in

Table 2. Comparative economic and monetary characteristics.

Variables	Vanuatu	Developing Countries	Bank of England Group
Annual growth rate (%)	3.7	2.9	3.3
Annual inflation (%)	2.4	2.5	2.9
Broad money: GDP (%)	105.3	38.9	44.2
Reserve money: broad money (%)	53.3	40.3	33.2
Government revenue/GDP (%)	24.2	25.2	26.8
Government deficit/GDP (%)	−2.2	−5.9	−5
External debt/GDP (%)	20	68.6	67.2
Per capita income (US$)	1420	1149	1440

Vanuatu: Figures are averages of 1993–1997. Broad money for Vanuatu includes deposits in vatu and foreign currencies.
Developing countries: Includes 122 countries—figures are averages for 1979–1995.
Bank of England Group: Includes 43 countries—figures are averages for 1979–1995.
Sources: Developing Countries and Bank of England Group countries: Fry et al. (1996); Vanuatu: IMF (1998) and ADB (1998).

1991, the national elections conducted in late 1991 did not produce any stable environment. The fragile coalition governments which followed did not last long and early elections have had to be called. With political instability, Vanuatu also began to experience fiscal deficits (Jayaraman, 1993).

Up to 1992, the capital budget was fully met by external aid, consisting of grants and concessional loan assistance from bilateral government agreements. From 1993, however, recurrent budgets were no longer in balance and capital budgets were in deficit. Governments sought to plug these fiscal gaps through domestic borrowing under the Special Project Implementation Schemes. Most of the projects were poorly appraised and were not viable as they were politically motivated. Moreover the external accounts depended on a narrow range of exports of beef, copra, coffee and *kava* and, as world prices of primary exports have been declining in recent years, export earnings have also been declining.

Confidence crisis

In early 1998, Vanuatu was rocked by a series of domestic and external shocks, which finally resulted in a speculative attack on the vatu. These shocks actually stemmed from a confidence crisis that had its origins in poor governance connected with public custody and management of pension funds. The crisis forced RBV to devalue the vatu; but the decision was reversed by government within a few days. These events finally led to the unceremonious removal of the RBV governor, who at that time had completed his first five-year term and was on extension with the possibility of another term. This crisis is further discussed below.

Reforms in governance

In the context of new developmental challenges imposed by stagnant per capita incomes, the government in 1997 undertook to implement a Comprehensive Reform Program (CRP) aimed primarily at ensuring good governance for sustainable economic growth, through improvement in public sector management and promotion of private sector participation. The CRP was described as a very ambitious program: it identified 120 activities and some 50 legislative reform items, and covered upgrading various agencies and institutions of governance, streamlining the public sector, improving public sector accountability and efficiency, encouraging private sector-led growth, and enhancing equity (ADB 1997).

As good governance is considered a prerequisite to all the aforesaid reforms, CRP had several proposals clarifying legally the roles of ministers, their political advisers and the civil service; improving parliamentary procedures; improving the capacity and independence of the judiciary; removing political interference; and developing a performance-oriented culture. CRP also strongly recommended discontinuance of government involvement in commercial activities. To sum up, the objectives of CRP were to establish a stable, non-distortionary, business-friendly environment and to devote greater resources to physical and social infrastructure, including education and health (World Bank, 1998).

To finance CRP, the ADB approved a loan of US$ 20 million. The first tranche of this loan was to be released in two parts: one (US$ 10 million) following satisfaction of ten conditions, and the other (US$ 5 million) as an incentive subtranche upon satisfaction of five conditions. Both parts were successfully released in September 1998. The last tranche of US$ 5m was to be released in October 1999 subject to the satisfaction of five conditions. As there was a change in government in April 1999, there were some setbacks in progress towards satisfaction of the prescribed conditionalities; also there were some adverse developments in regard to the enactment of the Foreign Investment Act. Certain provisions of this Act were unacceptable to ADB, as they prohibited foreign investment from a range of sectors in the economy. Further, ni-Vanuatus were denied a business license if they intended to form a partnership with foreign investors. ADB took strong exception to these provisions and refused release of the final tranche. After a year, the matter is still pending, and it seems the new government is not keen to take up the remaining part of the loan. However, with the earlier release of the US$ 15 million, nearly 85 per cent of the targetted downsize of the public service has been achieved—there have been 232 retrenchments. The fundamental interest now lies in "how effectively the changes introduced so far translate into improved governance and economic management" (Knapman and Saldanha, 1999, pp.143–168; Jayaraman, 1999b).

Monetary sector and central bank in Vanuatu

The process of monetization

Coming to independence in 1980, Vanuatu had to bring about an orderly transition from a mixed system under the joint condominium rule of the British and French to a national monetary economy. The Central Bank of Vanuatu (later renamed Reserve Bank of Vanuatu or RBV) was officially established on 18 December 1980, and immediately it had to take steps to withdraw the then circulating New Hebrides Franc and Australian dollar and replace them with the newly issued national currency, the vatu. As the remote islands continue using some form of barter trade, the monetization process is ongoing. Moreover residents are legally allowed to keep demand deposits as well as savings and time deposits in any foreign currency, a practice carried over from the colonial days but not common in other SPICs. The ratio of "narrow money" (currency and demand deposits in vatu and foreign currency) to GDP, currently at about 25 percent, presents an ongoing problem, affecting as it does the nature of the money supply: this ratio is much higher than that for any of the other SPICs, including Fiji (14 percent) and Solomon Islands (13 percent) (Skully, 1996; Jayaraman, 1999b).

Objectives of reserve bank of Vanuatu

The objectives of RBV are spelt out in the Central Bank of Vanuatu Act 1980, as amended from time to time. They are to: (i) regulate the issue, supply and availability of money; (ii) supervise and regulate banking business; (iii) promote monetary stability; (iv) promote a sound financial structure; (v) foster financial conditions conducive to the orderly development of Vanuatu; and (vi) advise the government on banking and money matters.

As part of the function of regulating the money supply, there is a requirement that RBV should hold statutory reserve deposits (SRDs) on behalf of other banks, and the SRD ratio has varied over time in relation to the extent to which demand deposits in foreign currencies are included in the ratio calculations. RBV has also been empowered with the permission of the minister of finance to prescribe minimum as well as maximum interest rates chargeable by financial institutions on deposits and loans, as well as ceilings on their loan amounts; however, such powers have not been exercised so far. Thus as of now, RBV does not regulate interest rates and there are no credit controls. But the issue of government bonds has proved troublesome.

Until 1987, there was no significant primary market for treasury bills or government bonds or central bank securities. The first set of government bonds of major significance, issued in 1987 and known as "development bonds", was for an amount of VT 500 million, followed by another issue of development bonds for VT 200 million in 1988. Most of the bonds were purchased by the then three existing commercial banks, all of them foreign-owned. However, when another set of bonds for an amount of VT 1,000 million was issued for the purchase of a 737 Boeing jet for the national carrier Air Vanuatu, the commercial banks could not absorb them, as they were holding sufficient bonds for their needs. Only VT 300 million was taken by the domestic institutions and the remaining unsold bonds of VT 700 million were picked up by RBV (Sturton and McGregor, 1991). With this transaction, the first act of monetization of the public sector deficit was witnessed in Vanuatu's history.

As the resource situation improved, however, net central bank credit to government decreased. Over the next five years, the claims on government by the central bank were far exceeded by government deposits with the central bank, with the result that the net claims on government in recent years have been negative. Part of the reason is that government has been able to borrow from the domestic banking system that was experiencing excess liquidity, meeting the deficit-financing needs without having to go to RBV.

Excess liquidity

This brings us to the discussion of reasons behind excess liquidity in the system and its implications. The banking institutions, including the Development Bank of

Vanuatu (DBV), originally set up to meet the credit needs of ni-Vanuatu entrepreneurs, have not been able to find suitable projects and consequently, until 1988, excess funds found their way into deposits with the RBV. In a small way the introduction of government bonds, and their regular issue since, have proved quite beneficial as financing institutions could now deposit their excess liquidity in income-earning assets.

Beginning from July 1998, RBV introduced its own short-term paper, known as RBV Notes of 91 days maturity, which have become very popular short-term assets within the economy. In a way, the yield on the 91-day RBV Note has become an indicator interest rate. The rediscount rate levied by RBV at 7 percent has taken into account the yield to maturity rate of one-year bonds issued by RBV on behalf of the government. However, no secondary markets have developed so far for long-term government bonds, government treasury bills and RBV notes.

Comparative picture

The monetary characteristics of 122 developing countries and 43 Bank of England countries (BOE group) have been compiled by Fry, Goodhart and Almeida (1996). A comparison of data (see Table 2) shows that the Vanuatu system has performed better than the systems of many developing countries and of the BOE group. Annual inflation has been lower and economic growth rates higher, and the ratios of budget deficits and external debt to GDP have been much less.

To what extent can it be said that this relatively favourable Vanuatu position results from the independence of RBV?

The independence of RBV

The notional criteria for measuring central bank independence, drawn from surveys of the experience of many countries, were shown in Table 1, along with indicators showing how the Vanuatu situation lines up with those criteria.

Vanuatu rates relatively well in respect of the security of tenure of the governor. Since the country's independence in 1980, there have been three RBV governors. The first two had periods of extension, but neither was re-appointed (although there is provision in the Central Bank Act for such reappointment). The present governor is the third. No governor has been dismissed prior to the completion of the five-year term.

The board of directors, which is appointed by the Minister of Finance, consists of two representatives from the private sector and one from the Ministry of Finance and Economic Management, besides the bank governor who is board chairman. Although the duration of the board under law is three years, changes in the government do bring about changes in the composition, as private sector representatives are replaced by new faces. The present board was constituted on 8 May 1998, soon after a new government took over after the March 1998 elections.

Instrument independence

RBV is empowered to act independently of government in respect of SRD ratios and discount and re-discount rates. Prior consultation with Minister of Finance is required in certain matters relating to fixing minimum or maximum rates on deposits or loans charged by banks and credit ceilings. Further, if RBV wants to revalue the external assets it holds, or if the value of the reserves of external assets falls below the prescribed level of 50 percent of its total liabilities including currency in circulation, RBV is required to inform the Minister of Finance with a recommendation. If the situation persists for 90 days and the minister has not responded, the board is empowered to take a decision on its own and inform the minister forthwith.

Relations with government

The Central Bank Act has a separate section on relations with government. The Act specifically uses the words "may grant" in regard to advancing temporary loans to government to meet deficiencies of current budget revenue for six months at rates determined by the board. The borrowing limit is set at 20 percent of the average annual ordinary revenue of government. If the limit has been reached, RBV is required to inform the Minister of Finance and under ordinary circumstances it can stop further loans. However, RBV can be directed by the minister to lend further, subject to an overall limitation of 30 percent of the average annual revenue of government.

RBV is required by law to advise the minister on any matter referred to it by him, In turn, RBV is entitled to be consulted on any proposed bill or order concerning money and credit, including the value of currency and any change in its value and estimated revenue and expenditures of the government.

When conflicts occur, the Minister of Finance and RBV are required to resolve them by mutual consultation. If the minister, after due consultation, finds in his opinion that the policies pursued by RBV are not adequate or conducive to the achievement of its objectives, he is expected to submit his recommendation to the Council of Ministers. The latter can then issue a directive to RBV which is binding on RBV; the government is in turn required by law to publicize the directive by publishing it in the Gazette.

An evaluation

These institutional arrangements show that Vanuatu's lawmakers have taken pains to lay down a strict framework within which the government and RBV have to function to pursue their objectives. Past implementation of the legislation reveals, however, that the board has been changed coinciding with changes in government without regard to the completion of its tenure. Secondly, there is no provision for ascertaining the views of the outgoing governor in the appointment of his successor. Further, the law does not totally empower the central bank to refuse the government's request for monetizing deficits. Instead, it provides for some discretion which can be exercized by government to revise upwards the ceiling of borrowing from the central bank. In regard to resolution of conflicts between government and RBV, the government has the final say.

Anecdotal evidence also informs that some of the provisions of the Act relating to consultation by the government with RBV have not been observed at all, as in the case of matters relating to licensing of new banks and the introduction of a new tax measure. On this latter issue, involving a turn-over tax of 4 percent effective from 1 Jan 1995, the Minister of Finance decided unilaterally and did not consult RBV, which has been mandated to regulate and ensure orderly financial sector development and price stability. The banking licenses given to Olilian and Dragon banks without appropriate checks resulted in a fiasco in 1996. The depositors in these two banks were left high and dry as unscrupulous expatriates suddenly folded their business and left. Price stability was endangered by the introduction of a tax on consumption, and RBV could not cope because it was caught unawares. The Act does not provide any penalty for such lapses by government, although sanctions and procedures for such sanctions against an erring RBV board for any acts of omission and commission are clearly indicated.

In these circumstances, the only conclusion that can be reached is that RBV's independence does not measure up to present standards of central banks in industrialized countries. However, RBV's performance in terms of achievement of its objective of price stability since its establishment in 1980 has been commendable. Inflation in Vanuatu has been much lower than in other developing countries (Table 2). As already noted, Cukierman, Webb and Neyapti (1992) concluded from their study of central bank performance in non-SPIC developing countries that central bank independence and inflation are uncorrelated, and it is apparent that this is the case in Vanuatu as well. This supports the broad conclusion that central bank independence is neither necessary nor sufficient for achieving monetary restraint (cf Ball, 1999).

Fiscal restraint

Fiscal deficits have monetary implications and they endanger price stability. Vanuatu's fiscal deficits have been low and this appears to be the basic reason behind price stability (Jayaraman, 1993). Ball's conclusion (1999), following a study of Argentina, Cote d'Ivoire, Thailand and New Zealand, that the achievement of fiscal restraint is a necessary condition for achieving monetary constraint thus also seems applicable to Vanuatu.

Since formal institutional arrangements were not themselves the cause of commendable performance by RBV, it becomes necessary to inquire about the influence of the country's institutional endowments on RBV's performance. These "institutional endowments" include informal, social, political and economic institutions as well as formal and informal arrangements in policy-making in other areas. Ball (1999) notes that in Thailand such institutional endowments have played a major role in promoting monetary restraint and price stability. Thailand's commitment to monetary stability is seen as a means to avoid colonization, and this commitment has been deeply influenced by history, ideology and international relations.

Role of institutional endowments

In Vanuatu, *kastom* (or perceived traditional lifestyle) plays a significant role in shaping local and public affairs. It has been identified with attempts to kindle and develop a sense of nationalism, first of all against the colonial masters, as *kastom* is equated with reclaiming land, and later as the foundation of independent Vanuatu's national unity and identity (Miles, 1998). Some of the popular symbols of *kastom* are: drinking kava, pig-killing ceremonies, *kastom* dress, and string bands. The management of affairs by chiefs or local leaders in accordance with *kastom* or traditional lifestyle and values is considered to be different from "politics" or management of affairs at the national level (Huffer and Molisa, 1999). Since the influence of *kastom* in bridging the boundaries of national and local affairs, between rival villages and between the modern and commercial and the traditional and subsistence styles of living (Miles, 1998) is considerable, issues of governance relating to the authority, control and functions of the national government and the mechanisms to ensure accountability of its officials are vastly different from those of Western democracies.

Ombudsman reports

Recent exposures of corruption in high places and instances of discretionary powers by ministers to the benefit of "own people" (*wantok*)—reported by Vanuatu's Ombudsman, another institution borrowed from Western democracies—did not yield any result. No sanctions were imposed on erring ministers and their crony officials and beneficiaries. Penalties and sanctions are considered as running against societal norms (World Bank, 1998). Most of the politicians who were found *prima facie* guilty were returned to power by legitimate ballot, and their re-entry by the ever-revolving door made a sham of such investigating bodies (Ambrose, 1996; Ambrose and Siwatibau, 1997; Larmour, 1998; Jayaraman, 1999b).[1]

Thus, no norms have been evolved so far in regard to running national affairs. Although concepts, legislative provisions and institutions have been borrowed from the West and adopted in many areas, including central banking, terms such as accountability, the purpose and importance of sanctions against erring behavior and transparency in operations have not been clearly understood. Two instances relating to RBV deserve mention here. Although one scam personally connecting a former RBV governor and a Minister of Finance was ignored after it was exposed, another involving the same former governor, which was in hindsight an error in judgment, was blown out of proportion.

Two instances

The first instance was the US$ 100 million guarantee scam, investigated by the Ombudsman in 1996. In the report submitted, it was revealed that ten letters of guarantee, each worth US$ 10 million, were signed by the then Prime Minister, Minister of Finance, Governor of RBV and First Secretary of Finance. These letters were traded for a commission by an Australian businessman who was favored with a Vanuatu diplomatic passport. Due to timely exposure by the Ombudsman and intervention by Scotland Yard in the United Kingdom, the letters of guarantee were located in London and were returned to the Vanuatu government. The foreign businessman was extradited to Vanuatu and found guilty of various crimes including fraud, deception and dealing in securities without a license, and sentenced in December 1997 to 18 months in jail. However, the politicians and the RVB governor were not proceeded against at all. There was no action against the governor and the case was conveniently forgotten.

The second instance also involves a case investigated by the Ombudsman. In her report, the Ombudsman presented *prima facie* evidence of abuse of contributions that were held in trust by the Vanuatu National Pension Fund (VNPF). It was alleged that VNPF lent enormous sums of money to government ministers and politicians and their cronies for projects of dubious nature. The public became suspicious about the possibility of VNPF collapsing under the weight of bad loans and demanded the return of their contributions. Inaction by the government to further investigate and bring the culprits to book led to riots in Port Vila town as the depositors feared that their contributions were abused by the fund authorities with connivance of government ministers.

After days of rioting and near anarchy, the government took the unprecedented step of ordering VNPF to return the deposits to savers much ahead of their maturity. VNPF could not fully implement the order as most of its funds were locked up in long-term investments or in bad loans. With a view to restoring credibility to its decision, the government financed the return of savings to depositors. It was estimated that, out of VT 3.3 billion (about 10.5 percent of both GDP and broad money), about VT 2.4 billion were disbursed during February and March 1998; the net addition to liquidity was about VT 1.5 billion. RBV tried to mop up excess liquidity by imposing a prescribed asset ratio of 16 percent on vatu deposits, replacing the 10 percent statutory reserve ratio. However, the situation of excess liquidity could not be corrected and the banks continued accommodating clients' devaluation-fear-induced demands.

Devaluation of currency

By late March 1998, capital outflows were so substantial that the international reserves held by RBV dwindled rapidly and at one point they were just sufficient for a few weeks as against the usual comfortable reserve cover of six to seven months' imports. Faced with declining reserves, RBV announced its decision to devalue the vatu in late March 1998, just before a new government was to assume office. The Minister of Finance in the outgoing cabinet reversed the decision and restored the *status quo ante* just a few hours before the swearing-in of the new cabinet, on the grounds that devaluation was not warranted. He also announced the termination of the appointment of the RBV governor, who had completed a five-year term and was on extension pending the announcement of a new appointee, on the grounds that RBV did not consult the government before announcing devaluation.

On the information available, one cannot ascertain whether, as required by Section 23 of the Central Bank Act, the governor had submitted a report at an earlier stage on the international reserve situation. Nor can it be ascertained whether he had to take the decision on devaluation at the end of a period of 90 days after submission of a first report because the minister had failed to respond to the earlier report. As already noted, the Act empowers RBV to take such a decision on devaluation in the absence of ministerial advice if the international reserves have fallen below the desired level for 90 consecutive days. Because of the lack of firm evidence, it is difficult to say whether or not the actions taken by the governor and the government were appropriate. Further, it is also not known whether the government consulted RBV as provided under section 35(l)(g) of the Act, prior to issuing the order to VNPF to release pension savings to depositors, which had such serious liquidity implications. For a fuller appreciation of the case, one has to recognize that, in those months of uncertainty in the first quarter of 1998, RBV was heavily influenced by devaluation decisions by two major countries in the region: Fiji in January 1998 and the Solomon Islands in February 1998. These two countries devalued to counter the effects on exports of devaluation of the Korean, Indonesian, Malaysian and Thailand currencies.

Whether or not the RBV decision on devaluation was justified, the method of conflict resolution adopted by the government—the removal of the RBV governor—considerably damaged the reputation and credibility of the institution. It would take a long time for RBV to recover from these shocks. The subsequent actions of RBV were in accordance with textbook solutions. Interest rates were raised and exchange controls were imposed. These standard remedies helped to restore order in the financial sector. As the fundamentals in terms of fiscal restraints were sound and speculative fears were receding, the external reserves improved in the next six months.

Conclusions

The performance of RBV in terms of realizing the statutorily imposed objectives was indeed praiseworthy. Relatively low inflation, a stable exchange rate and comfortable external reserves during the past two decades are certainly achievements any central bank can be proud of. However, in recording its achievements, due recognition should be given to the government's conservative fiscal policies from the time of independence until the early 1990s. Furthermore, the presence of excess liquidity in the system in subsequent years played a major part. Heavy borrowing from the domestic banking system to finance certain periodical fiscal deficits in the mid-1990s did not result in any crowding out of private sector investment. Thus, inflationary pressures were relatively absent. And the overseas recession in the early 1990s, and low price levels in the later 1990s in Australia and New Zealand, contributed to price stability as Vanuatu imports major consumer goods and intermediate and capital goods from those countries.

Although the legislation under which RBV has been set up provides for a degree of independence, the fact that changes in the RBV board have been made before terms have been completed, invariably coinciding with changes in the government, does not give high marks to RBV. Further, there has been a lack of consultation by the government with RBV on important money bills and credit matters.

In addition, there was no response from government when a serious governance issue arose with the exposure of the US$ 100 million guarantee scandal with which a former governor was associated. Although the businessman was duly convicted and sentenced to imprisonment, no action was taken against the high officials including the governor. The Central Bank Act provides for remedial action, but the standard norms of public behavior and enforcement of accountability and imposition of sanctions were all absent, perhaps having been neutralized by *kastom*. Thus, institutional arrangements alone have proved to be inadequate. Mere legal trappings and institutional arrangements such as the ombudsman and other such mechanisms borrowed from the West have been of no help.

The institutional endowments, as distinguished from institutional arrangements, in terms of social norms which govern good behavior and acceptability at the local and public level, have to be extended at the national or government level as well. The public-spirited men and women of Vanuatu are well aware of these deficiencies. The ongoing reform implementation under the externally funded CRP is just a beginning and should be carried further.

Notes

1. Readers will note, however, that other references to the Vanuatu ombudsman elsewhere in this symposium indicate that that institution has earned considerable respect in the country (eds.).

References

ADB. (1997a). *Vanuatu: Economic Performance and Policy and Reform Issues*. Manila: Asian Development Bank.

ADB. (1997b). *The Comprehensive Reform Program* presented by the Republic of Vanuatu, Consultative Group Meeting, Noumea, New Caledonia. Manila: Asian Development Bank.

ADB. (1998). *Key Indicators of Developing Asian and Pacific Countries*. Manila: Asian Development Bank.

Alesina, A. and L.H. Summers. (1993). "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence." *Journal of Money, Credit and Banking*, 14, 151–162.

Ambrose, D. (1996). *A Coup that Failed? Recent Political Events in Vanuatu*, Discussion Paper 96/3. Canberra: Research School of Pacific and Asian Studies, Australian National University.

Ambrose, D. and S. Siwatibau. (1997). "Recent Developments in Vanuatu." *Pacific Economic Bulletin*. 12(1): 1–14.

Ball, R. (1999). "The Institutional Foundations of Monetary Commitment: A Comparative Analysis." *World Development*, 27(10), 1821–1842.

Briault, C.B., A.G. Haldane, and M. King. (1996). "Independence and Accountability in Central Banks." Working Paper No. 49. London: Bank of England.

Cukierman, A. (1992a). *Central Banking Strategy, Credibility and Independence*. Cambridge, Mass: MIT Press.

Cukierman, A., S. Webb, and B. Neyapti. (1992b). "Measuring Central Bank Independence and its Effect on Policy Outcomes." *World Bank Economic Review*, 6(3), 353–398.

Fischer, S. (1994). "Modern Central Banking." In F. Capie, C. Goodhart, S. Fischer and N. Schnadt (eds.), *The Future of Central Banking*. Cambridge: Cambridge University Press.

Fry, M.J. (1993). *The Fiscal Abuse of Central Banks*. Working Paper WP/93/58, Washington: International Monetary Fund.

Fry, M.J., C.A.E. Goodhart, and A. Almeida. (1996). *Central Banking in Developing Countries: Objectives, Activities and Independence*. London: Routledge.

Huffer, E. and G. Molisa. (1999). "Governance in Vanuatu." *Pacific Economic Bulletin*, 14(1), 101–112.

IMF. (1998). *International Financial Statistics Yearbook 1998*. Washington: International Monetary Fund.

Jayaraman, T.K. (1993). *Fiscal Deficits and External Imbalances in the South Pacific: A Case Study of Vanuatu*. Manila: Asian Development Bank.

Jayaraman, T.K. (1998a). "Offshore Finance Activities in Vanuatu: An Empirical Study of Determinants and Growth." In M. Bowe, L. Briguglio, and J. Dean (ed.), *Banking and Finance in Islands and Small States*, London: Pinter, pp. 103–133.

Jayaraman, T.K. (1998b). "Private Sector Development in the South Pacific: Some Issues of Governance: A Case Study of Vanuatu." *Journal of the South Pacific Society*, 21, 21–45.

Jayaraman, T.K. (1999a). "Private Sector Development and Competition in the South Pacific: A Case Study of Vanuatu." *South Pacific Study* (University of Kagoshima). Vol. 19, pp. 1–22.

Jayaraman, T.K. (1999b). *Financial Sector and Private Sector Development in Vanuatu*. Christchurch: Macmillan Brown Centre for Pacific Studies, University of Canterbury.

Knapman, B. and C. Saldhana. (1999). *Reforms in the Pacific: An Assessment of the Asian Development Bank's Assistance for Reform Programs in the Pacific*. Manila: Asian Development Bank.

Larmour, P. (1997). *Corruption and Governance in the South Pacific*. Discussion Paper 97/5. Canberra: Research School of Pacific and Asian Studies, Australian National University.

Miles, W.F.S. (1998). *Bridging Mental Boundaries in a Postcolonial Microcosm: Identity and Development in Vanuatu*. Honolulu: University of Hawaii Press.

North, D. (1990). *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press.

Skully, M. (1997). *The South Pacific: Finance Development and the Private Sector*. Canberra: Australian Agency for International Development.

Sturton, M. and A. McGregor. (1991). *Vanuatu: Toward Economic Growth*. Honolulu: East West Center.

Woodall, Pam. (1999). "The Navigators: A Survey of the World Economy." In *The Economist, A Survey of the World Economy*, September 25, pp. 3–6.

World Bank. (1998). *Enhancing the Role of Government in the Pacific Island Economies*. Washington: World Bank.

T. K. Jayaraman Dr Jayaraman was on the staff of the Asian Development Bank (ADB) for 15 years. Prior to joining ADB in 1982, as a member of the Indian Administrative Service he held various positions in civil service at both policy making and implementation levels in the State of Gujarat. After retiring from ADB in 1997, he pursued post-doctoral research for a year at Macmillan Brown Centre for Pacific Studies, University of Canterbury, Christchurch, New Zealand. Since 1998, he has been a senior lecturer in the Economics Department, University of the South Pacific, Suva, Fiji.