

Finance and private sector development in the South Pacific

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It is often suggested the success of the private business sector is closely linked to the availability of suitable finance. Most South Pacific countries offer local savers and borrowers some choice—banks, credit unions and credit cooperatives exist in every country and so offer some competition for small-scale loans and savings (Table 1). Life insurance companies likewise provide savings and small-scale borrowing against policies services. National provident funds also force formal sector employees to accumulate some savings and provide some direct lending or loan assistance.

For businesses, development banks are generally the only alternative to commercial bank loans. Life offices, national provident funds and development banks have made some equity investments, but access to the capital markets is not afforded except perhaps in Fiji. Further financial development would certainly enhance local choice, but attention must also be directed at encouraging local participation in the private sector.

Upgrading access to formal finance

It is often suggested that the South Pacific business people have difficulty in accessing financial institutions. There are many reasons for this, but at least some relate to the level of business conducted. It is uneconomic for the formal sector to finance small part-time income generating activities. Nevertheless, it is only through such exposure that people can initiate formal businesses.

Enhancing business awareness at the village level

A common complaint regarding the private sector in the South Pacific is that business is a Western invention—it is not part of the Pacific Way. There are, however, many significant pre-European history examples of South Pacific enterprise such as Tonga–Fiji trade and intra-country commerce. Trade or commerce is not so foreign to the Pacific culture—it has in fact existed for centuries—it is operating a business in a

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Table 1 **Financial institution numbers by type**

	Fiji	Kiribati	Solomon Islands	Tonga	Tuvalu	Vanuatu	Western Samoa
Central banks	1	-	1	1	-	1	
Commercial banks	6	1	3	3	1	4	3
Development banks	1	1	1	1	1	1	1
Housing finance firms	2	1	1	..	..	1	1
National provident funds	1	1	1	1	1	1	1
Life insurance firms	4	1	2	1	-	2	1
Non-life insurance firms	6	1	2	1	-	3	2
Finance companies ^a	3	-	1	-	-	1	6 ^b
Investment corporations	1	-	1	1	-	-	-
Unit trusts	1	-	-	-	-	-	-
Credit unions	67	33	133	44	1	30	20
Credit cooperatives	123	-	-	-	-	5	-
Pawnshops	8	-	-	-	-	-	-
Village banks	-	101	-	-	-	-	-

^a Despite its name, the Merchant Bank of Fiji operates as a finance company not a merchant bank.

^b Institutions with finance in their name operate more like private money lenders than finance companies.

Source: Author's correspondence and interviews with respective institutions and governments, 1996.

Western or developed country sense that is new. The challenge is to assist South Pacific people to adapt to these new methods.

Many South Pacific countries are blessed with a generally good climate which offers its people a range of local foods with only nominal effort to ensure substance. In such an environment, planning is considerably less important as food is generally available and extended families serve as an insurance against unexpected shortfall.

Unfortunately, Western businesses do not succeed without careful planning. So perhaps the first step is to start with the concept of planning. One can lecture on the need for strategic planning, but there are more effective ways to deliver this message at the village level. The International Labor Office's (ILO) planning game is one such vehicle. It was developed in Fiji after significant research and testing in rural villages. It operates like a

monopoly board game where one moves one's marker through a 52-week year. The seasons are noted. So one must plant cassava now in order to harvest some time later on the board. School fees likewise are scheduled just as in real life with the prices in Fijian dollars. Tests suggest that this game is not only fun to play, but also illustrates the advantages of forward planning—an important lesson for any potential business person. The concept seems very appropriate for other South Pacific countries and it could be customised in terms of local prices, seasons and crops without too much expense.

'Start your business'/'improve your business' programs

Once accustomed to the idea of planning in relation to traditional activities, the next step is to introduce more Western concepts. Here the 'Start Your Business' programs of United Nations Development Programme (UNDP) and other

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awareness ideas become valuable. They raise the idea that other, less traditional business opportunities are also available.

While these programs are already conducted frequently in towns and capital cities, they are eventually needed at the village level as well.

Such programs must be 'entertaining with a message' as opposed to a formal lecture with homework. A few minutes 'soap opera' styled case studies followed by group discussion would seem particularly effective.

Promoting business at the school level

School students are a promising target for a 'doing business' program. Most countries offer commerce studies at high school. These should be encouraged. They would also benefit from such activities as the Young Achiever Program or Distributive Education / Work Experience. Both programs have already proven successful in some South Pacific countries and can be structured to include youths no longer in the education system.

New business award programs

Local business success stories must be given publicity. Some countries have national contests with cash awards and press coverage, particularly radio broadcasting. These success stories serve as examples for others considering local business and provide excellent case studies for formal training.

Local entrepreneurs' association network

One succeeds in business through hard work; there are no easy short cuts. There are, however, mistakes that can be avoided. A local small business or entrepreneurs'

association would help prospective business people to learn from the experiences of others. They could also create networks which in turn may provide additional business opportunities and thus more successes.

More coordinated business advisory service

On paper, most South Pacific countries seem well served by a host of government, non-government, and private organisations providing advice to small business. If better coordinated, perhaps through a business advisory council, these various activities could provide a far more effective support over a much greater area.

Enhancing institutional funding of the private sector

Much can be done to improve the existing financial institutions' financing of local businesses such as credit guarantee schemes and ensuring that any new credit delivery programs are structured to be sustainable.

Credit guarantee schemes

A major complaint of the private sector is that banks seldom lend without some collateral. While this is certainly the case for any reasonably sized loan, it is neither surprising nor objectionable. Cash flow expectations should certainly decide whether a loan be considered further, but some security is needed for when these expectations are not realised. Not surprisingly, banks in the South Pacific are more cautious than in developed countries insofar as their economies are subject to greater instability and many, typically newer, businesses frequently lack sufficient reserves to withstand major setbacks.

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One solution for the lack of collateral is a credit guarantee scheme. While such schemes have drawbacks, the more effective ones cover the unsecured part of small business loans where the banks and the government, typically via the central bank, shares part of any resulting loss. The Solomon Islands scheme, which shares losses 80 per cent government and 20 per cent bank, seems an excellent tool to support small project lending.

Some schemes, currently limited to development banks, should be extended, subject to a well determined criteria, to all financial institutions. The client should pay commercial rates of interest and be subject to an administrative fee on a cost recovery basis when a guarantee is required. As the Central Bank of the Solomon Islands commented, the 'lack of bankable security is no longer a major problem for getting loans because of the existence of the Small Business Finance Scheme.' (1994:43). In its five years of operation, the scheme has financed 233 loans worth a total of SI\$8 million.

Improving local managerial and technical skills

Another serious problem facing South Pacific financial institutions is a shortage of qualified and experienced staff—a problem not confined to the financial sector. Staffing remains a significant constraint on local financial development. Local nationals, once trained for a specific position, are often given responsibilities far beyond their professional qualifications or experience. Similarly, as institutions expand both in size and number, these skills are quickly stretched too thin and so inhibit sound managerial practices and supervision. As a report on the Development of Bank of the Solomon Islands commented, 'the low level of training and

experience of the majority of staff has been identified as one of the major weaknesses' a comment which could be applied, with perhaps greater or lesser emphasis, throughout the South Pacific.

While good training is essential, other institutions may hire away the better staff and leave the trainer worse off than before. For example, the Development Bank of Western Samoa had a 40 per cent staff turnover rate. Many other institutions experienced similar unacceptable results. Obviously competitive salary packages are one part of good retention rates: a linkage with public servant pay-scale and conditions is not recommended. Overseas, fringe benefits, such as non-transferable housing finance and retirement packages, often encourage staff to remain.

As a short to medium-term measure, the alternative is to import staff with specific technical skills and, equally important, proven managerial experience. Unfortunately, the tendency is to use these personnel directly in management functions and in many cases they are appointed without a local counterpart. Personal experience suggests that the institutions themselves feel that such doubling of positions is simply too expensive and that the counterpart is needed for urgent work in other areas. This produces a Catch-22 situation as the long-term staffing problems will simply continue as before.

Mobilise overseas expatriate savings

Many South Pacific countries such as Tonga, Niue, Cook Islands, Kiribati and Western Samoa obtain a major portion of their foreign exchange through remittances from their nationals working overseas. Unfortunately, these funds are typically used to purchase imported consumer durables.

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Given these expatriates' relatively high disposable cash incomes compared to their local counterparts, they may be willing to assume more risk for higher return and therefore invest indirectly into local equities rather than just fixed-interest investments. While Fiji and Papua New Guinea have had only limited success with a unit trust, a special tax-exempt version for non-residents might expand induce further investment in the smaller South Pacific countries.

Promoting long-term savings via insurance policies

A further incentive for local savings is to widen the choice of financial assets. Life offices, through their investment or endowment products, are an alternative to normal deposit savings. Savings-based endowment policies, have proven very successful in Fiji. Other local life operations have been established in Kiribati, Western Samoa, Solomon Islands and Papua New Guinea. More investment-linked policies, particularly ones based on a widely diversified portfolio of overseas equities, would no doubt be popular with sophisticated investors.

Creating other sources of funding

South Pacific business should, however, have a wider range of finance alternatives. Some additional sources for consideration might include venture capital companies, investment holding companies, and capital markets/stock exchanges.

Venture capital companies

The lack of equity capital is frequently expressed as a reason for local businesses not receiving funding. Venture capital

finance is a particularly risky business. This is even more so where start-up equity investments are concerned. For every ten investments only a couple at best will prove successful.

The International Finance Corporation's quasi-equity fund, the Pacific Islands Investment Facility in Brisbane and the Commonwealth Development Corporation's Pacific Venture Capital Fund in Papua New Guinea already provide some funding, but the need for a South Pacific regional venture capital fund, however, must be questioned. The size required by formal venture capital sources, however, of at least \$200,000 means that they will be unreachable for many smaller businesses.

A 'business angel,' where a successful business person will provide equity as well as technical support in return for part of the business, is perhaps more relevant.

In Australia, various chambers of commerce and industry groups have tried to network both the providers and seekers of capital. Their South Pacific counterparts or local entrepreneur associations may follow.

Investment holding companies

Once local companies succeed, the next question is how to raise additional funds. With more established firms, or the privatised state-owned enterprise, an investment holding company might be useful. It would act similarly to a unit trust whereby local investors can participate.

The advantage that an investment company offers is that its share capital is fixed and so any subsequent trading is between investors. In contrast, a unit trust manager normally will buy back its units at any time. This means that the trust

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must maintain significant liquidity to handle any large redemptions. In contrast, an investment company can be fully invested. Given the generally limited resale market for equities within the South Pacific, an investment company would seem most appropriate.

Capital markets/stock exchanges

A capital market has commenced in Fiji where some state enterprises have issued promissory notes; other countries might consider similar steps. While commercial banks may lose some lending business as a result, it would add to the diversity of financial instruments within the country. Once privatised, these state businesses could expand use of promissory notes and other capital market instruments.

As corporate debt markets develop, so too should the market for corporate equities. Thus far, the Suva Stock Exchange is the only stock exchange in the region.

Expanding the importance of the private sector

Privatisation of state-owned enterprises

The quickest action for private sector expansion would be to privatise state-owned enterprises. Within the South Pacific economies, particularly the smaller ones, the public sector is the dominant force. It is not only typically the provider of infrastructure (for example, power, water, and telephones), but also normally commercial ones. State-owned enterprises in Kiribati, for example, run the major local hotel, airline, home builder, ship repair yard and retail stores. There is no economic justification for such state ownership.

Small economies may have difficulty finding private sector buyers for their state enterprises. However, it is more a lack of profitability than size that will discourage bidders. Countries may need to reconsider the prices necessary so these services can become economic and not serve as an excuse for continued public sector ownership.

Interestingly, some seek to justify public sector ownership retention due to cultural factors. The suggestion is that the communal ownership ideas, that work in practice at the village level, should somehow be applied on a national basis. In practice, most older state enterprises were established by highly interventionist and paternal colonial governments. It reflected a view that the South Pacific people were totally unable to manage their own affairs: hence the government would do it for them.

Foreign investment promotion and approval processes

Increased foreign investment facilitation is a rapid means of expanding the private sector's importance. Such investment can come in the way of funds for new investments or in the purchase of existing state-owned enterprises.

Unfortunately, some countries seem uncertain as to whether they want foreign investment or not, but most are now re-examining their policies. The majority also realise that their existing regulatory systems are unduly complex. Discussions with expatriate investors indicated substantial dissatisfaction with the systems, particularly in respect to labour market regulations, and the legal system.

Foreign investors require substantial perseverance to comply with a host of

approving agencies. It is also clear that these approvals are sequential, rather than concurrent. In Vanuatu, for example, one needs the approval of one agency before another can be approached. This both delays and complicates the process. ‘One-stop shops’ for foreign investment approval seem an obvious solution for large investors but one wonders could the same concept be applied to local businesses, too. In practice, however, few bureaucrats, be they in Australia or the Pacific, are keen to relinquish their powers or any fee income that the current system provides their office budgets. South Pacific leaders will need sufficient strength to overcome these ‘red tape’ vested interests.

The Fiji Trade and Investment Board (FTIB), though frequently cited as an example, is not the full solution. The FTIB is not an approver in its own right. Moves to make it more effective as a facilitator of approvals are to be encouraged. Streamlining the process itself would also be useful. Limiting the agencies and departments involved would greatly speed up matters.

Reducing government controls over business

The private sector would benefit from decreased government regulation. It seems that each government department has managed to add to an ever increasing number of approvals required for even the smallest business to commence operations. While local business permits provide important revenue for some South Pacific governments, they discourage petty trading and other part-time income generating activities that serve as the incubator for private business development.

Other government actions

Market interest rates and lending policies

Traditionally, South Pacific governments have viewed their financial sector as a vehicle for achieving government policy objectives through lending guidelines favouring certain types of businesses, owners or localities; through specific interest rate ceilings on lending; or via overall loan portfolio controls.

Interest rate ceilings effectively precluded good bankers from funding higher-risk projects—projects which may have otherwise benefited these countries. Similarly, average weighted lending-rates controls restrict funding to lower-risk projects and again effectively preclude many potential developments.

Given the relatively fixed nature of many lending costs, the smaller the loan size, the greater the effective interest rate that must be charged. The interest rates and other fees charged on lending must be allowed to cover the full costs of the loan appraisals and supervision as well as creating adequate provisions for loan losses. So any rate ceilings mean that smaller borrowers will be the losers in terms of bank funding.

Fortunately these old practices have become less common. Direct interest rate controls (through interest rate ceilings) and credit growth quotas now operate only in Western Samoa. The Central Bank of Samoa sets the maximum interest rate (12 per cent) and limits credit growth to a certain percentage over the previous year.

Ensuring sustainable credit delivery

Typically, formal institutions have higher operational costs than many non-

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government organisations. In particular, local village-based institutions have the advantage of basically volunteer labour and can potentially grasp the full support of the local culture to ensure their success.

Informal finance, however, does not mean concessional finance. Micro-credit, by its very nature, is far riskier than a normal commercial bank loan. Small agriculture and income-generating projects offer little, if any, security and are risky undertakings even with solely equity finance. If micro-credit schemes finance more risky loans, then they should also charge more than commercial banks. Ironically, South Pacific governments often insist that such lending, be it through development banks or other means, be done for less. Even at standard commercial bank rates, this would represent a concession. Micro-credit schemes handle lots of small loans. Each loan requires an application and some assessment. They also require careful monitoring and, in the case of default, considerable collection efforts. Such schemes must charge enough to cover these expenses. When market rates are not charged, borrowers consider these loans as gifts and therefore repayment unnecessary.

In Indonesia, for example, Kredit Umum Pedsan (KUPEDES), found that margins of 18 per cent or so were needed to cover its full rural credit costs. Despite a resulting effective 31.76 per cent per annum rate, there was still significant demand for these loans.

Not surprisingly, most South Pacific development banks are now unwilling to enter concessional-based micro-credit programs. Governments, however, continue as before. New channels now push below market funds to reach rural and other special interest groups. In Fiji, for example, local councils now allocate 4

per cent per annum concessional finance to ethnic Fijian-owned small businesses. These funds will certainly be disbursed, but repayment may prove a quite different matter. In the meantime, such programs help confuse the market. If these institutions fail to collect arrears, then other borrowers may also cease their repayments.

South Pacific governments must understand that concessional finance, or keeping the national interest rates below market, has substantial long-term opportunity costs for the economy.

Revising and updating legislation

Versions of the UK's Companies Act of 1948, or slightly more recent Australian or New Zealand legislation, continue to dominate the South Pacific business environment. This problem has been well identified and most countries have already gone through a review process with joint private sector task forces. New legislation has not been forthcoming. If national parliaments would agree to pass the legislation, then technical assistance in drafting the appropriate legislation would be very useful.

Liberalising national provident funds investment

Provident funds invest mainly in government securities and often loans to public sector enterprises. Typically, the remainder is held on deposit with commercial banks or in real estate investments.

This places undue emphasis on protecting the nominal value rather than the purchasing power of these funds. While some South Pacific provident funds have made some unlisted equity investments, a prudent manager would

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invest only a small portion of total funds in what are effectively illiquid investments.

One solution, which would also provide some foreign exchange risk diversification, would be to invest in overseas equity markets. Investments in the faster growing economies within the Asia Pacific might also provide greater capital appreciation than a strictly local portfolio. The Kiribati National Provident Fund, for example, places the bulk of its funds in overseas equities and debt securities. Significantly, Kiribati offers its members the highest returns of any South Pacific provident fund.

Where maximum diversification at minimum expense was sought, an equities (Global or Asia Pacific) index fund would seem a very useful alternative. These funds by their very nature require only administrative-styled management and entail only limited trading. As a result, they have very low overall expense ratios. While fund managers may sometimes beat the market, few show a consistent performance in excess of the market index when adjusted for the risk undertaken and all expenses.

Rather than restricting provident funds from making such investments, a prudential regulator would insist on international equity diversification. Offshore investments, however, would not preclude participating in any attractive local equities.

Lessening restrictions on life office investment

Where insurance companies are subject to local investment regulation, these laws often reflect the thinking of the 1950s rather than the 1990s. In Fiji, for example, the life offices must hold 50 per cent of

their assets in government securities. While insurers should retain liquid assets, they should have greater investment freedom, particularly in holding overseas assets.

Conclusions

A number of ways the financial sector and its interaction with private businesses might be improved have been suggested here. A more fundamental problem, though, is the South Pacific people's interest and capabilities to engage in formal business activities. It is at this fairly basic level, particularly at the village level, that the long-term impact is likely to be most effective. In the short-term, further privatisation would result in the most significant increase in private sector participation.

Note

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