

Coordination of Monetary and Fiscal Policies in Small Island Developing States: Two Case Studies

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Abstract The American financial crisis which began in the second half of 2007 ultimately deteriorated into a world economic downturn. Despite hopeful signs of recovery in early 2011, there was another setback in the second half of 2011, consequent to the euro zone debt crisis. These developments posed challenges of unprecedented nature to the small island developing states (SIDS). Being prone to shocks of all kinds, such as natural disasters and volatility in prices of fuel and food, SIDS have been struggling to keep their economies afloat with their limited range of fiscal and monetary policies, success of which depended on coordination between ministries of finance and central banks. This paper seeks to examine the subject with two case studies in two regions, the Indian Ocean and the Pacific.

Keywords Coordination · Recession · Monetary and fiscal policies · Indian Ocean · The Pacific

Introduction

Small island developing states (SIDS) in three regions of the world, the Caribbean, the Indian Ocean and the Pacific, whose vulnerability to shocks of all kinds and efforts towards building up resilience have been well documented by various studies (Briguglio and Kisanga 2004; Jayaraman 2004), have yet to recover from the severe impact of the economic downturn stemming from the American financial crisis of 2008. As the uncertainties were continuing, there was yet another, this time a debt crisis

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brewing in the euro zone in 2011. The SIDS responded with macroeconomic policies for reducing the adverse impact of global recession (Jayaraman 2011).

Two SIDS namely, Mauritius in the Indian Ocean region with a managed floating exchange rate regime and Vanuatu in the Pacific region with access to all policy tools, have now been recognized as top regional performers in the Indian Ocean and the Pacific regions respectively (UN ESCAP 2011). Responses of these two SIDS to the recession were aimed at stepping up domestic demand in the wake of declining external demand, through fiscal policy measures including increases in public expenditures and through expansionary monetary policy. However, as there were potential inflationary pressures due to unanticipated increase in oil and food prices and the resultant strains on foreign exchange reserves the need for effective coordination between ministry of finance and central bank has been stressed from time to time, as a major factor behind the successful response to the crisis.

While there are a number of notable studies on the subject in the Caribbean region including Worrell (1991, 2000), studies on SIDS in the Pacific and in the Indian Ocean are scarce. This paper seeks to fill the gap by documenting the experiences in the Indian Ocean and Pacific regions with studies on Mauritius and Vanuatu in regard to fiscal and monetary policy coordination. The paper is organized as follows. The next section reviews economic performance of the two countries; the third section deals with the institutional and procedural arrangements required for bringing about a high degree of coordination between central bank and ministry of finance in the context of the existing arrangements; the fourth section deals with the arrangements as obtained in Mauritius and Vanuatu; the fifth and final section presents a summary with a list of conclusions which have policy implications.

Mauritius and Vanuatu: A Brief Economic Review

Tables 1 and 2 present comparative pictures of macroeconomic performance of SIDS in the two regions. In terms of growth rates, inflation and fiscal performance, Mauritius and Vanuatu emerge as the best performers in their respective regions.

Mauritius

Mauritius is located in the Indian Ocean. In the first two decades following political independence in 1968, the Mauritian economy experienced “twin deficits”: budget and current account deficits. Mauritius undertook a structural adjustment program with two devaluations of domestic currency in 1970 by 30 % and in 1981 by 20 %.

Macroeconomic Reforms

Prudent economic policies since the 1980s set the economy on a growth path (Sacerdoti et al. 2005). However, the economy was affected by external shocks in the 2000s including reductions in European Union sugar protocol prices and the phasing out of the Multi-Fiber Agreement. Deterioration of balance of payments during 2003–2005 forced another round of reforms, including adoption of fiscal consolidation strategy, all of which made Mauritius a top performer with one of the highest per capita incomes in

Table 1 Indian Ocean region: key indicators of SIDS

	Maldives	Mauritius	Seychelles
Population ('000): 2014	400	1300	100
Land area Sq.km	300	2030	460
Per capita GDP (US\$) 2013	5,750	9,183	12,680
Growth rate (%)			
2001–2005 (ave)	4.7	3.1	1.3
2006–2010 (ave)	6.7	4.52	4.72
2011	6.5	3.9	5
2012	1.3	3.9	2.9
2013	3.7	3.2	3.5
Inflation (%)			
2001–2005 (ave)	1.7	5.1	2.9
2006–2010 (ave)	6.64	6.56	14.42
2011	12.8	6.5	2.6
2012	12.1	3.9	7.1
2012	2.3	3.5	4.3
Budget balance (% of GDP)			
2001–2005 (ave)	-6.1	-2.4	1.8
2006–2010 (ave)	-14.82	-2.32	1.94
2011	-8.7	-1.1	5.6
2012	-9.3	-0.6	5.3
2013	-4.7	-2.2	4.3
Current account balance (% of GDP)			
2001–2005 (ave)	-14.4	1.2	-13.7
2006–2010 (ave)	-36.74	-8.54	-17.16
2011	-19.6	-13.4	-26.5
2012	-20.2	-11.4	35.1
2013	-18.2	-10.2	-17.8

Source: For Maldives: Asian Development Bank (2011, 2014)

For Mauritius and Seychelles: World Bank 2014

Africa. Foreign direct investment (FDI) rose, complementing a major restructuring of the traditional sugar and textile industries (Zafar 2011).

Response to Global Recession

With the beginning of the global recession in 2008, followed by a decline in tourism and textile exports earnings, Mauritian growth showed signs of slowing down. As macroeconomic fundamentals being sound with reduced public debt to GDP ratio (from 75 % in 2003 to 60 % in 2008), Mauritius could afford a proactive policy response (Morisset et al. 2010). The stimulus measures to the tune of about 5 % of GDP (infrastructure and provision of financial relief to the firms hit hard by the global crisis

Table 2 Pacific region: island countries

	Fiji	Papua New Guinea	Samoa	Solomon Islands	Tonga	Vanuatu
Population ('000): 2013	881	7321	191	561	105	253
Land area	18,274	462,840	2831	28,896	747	12,189
Per capita GDP (US\$):2013	4572	2088	3647	1954	4427	3303
Growth rate (%)						
2001–2005 (ave)	2.4	1.7	4.3	1.7	2	1
2001–2005 (ave)	-0.3	5.7	0.9	5.5	-0.1	5.4
2011	2.7	11.3	-1.3	10.6	3.3	1.6
2012	1.7	7.7	1.5	3.3	2.9	1.4
2013	3.6	5.1	1.0	3.1	0.8	1.5
Inflation (%)						
2001–2005 (ave)	2.9	7.9	6.2	8.3	10.0	2.2
2001–2005 (ave)	5.2	5.4	5.4	9.2	5.8	3.9
2011	7.3	8.4	5.2	7.4	6.3	1.0
2012	3.4	2.2	2.1	5.9	1.1	1.4
2013	3.4	2.5	0.6	5.4	0.8	1.4
Budget balance (% of GDP)						
2001–2005 (ave)	-5.1	-1.3	-1.1	-5.9	2.3	-0.9
2001–2005 (ave)	-3.0	0.6	-2.8	1.4	-0.6	0.0
2011	-1.4	-0.2	-13.1	6.4	-7.6	-2.0
2012	-1.1	-1.5	-11.5	2.4	-7.1	-2.3
2013	-1.2	-7.2	-4.4	3.2	NA	1.6
Current account balance (% of GDP)						
2001–2005 (ave)	-5.0	4.8	-16.8	0.1	-1.1	-6.4
2001–2005 (ave)	-12.1	-2.6	-8.6	-13.5	-8.0	-4.5
2011	-5.3	-1.3	9.9	-8.4	-9.3	-6.9
2012	-1.8	-14.9	-11.5	-0.1	-6.9	-5.9
2013	-1.2	-21.5	-4.4	-9.9	NA	-4.3

Source: Asian Development Bank (2014)

World Bank (2014)

and social and job protection measures) were combined with easy monetary policy, including reduction in discount rate by 250 basis points and reduction in reserve requirements (IMF 2010; Zafar 2011). The government enacted the Public Debt Management Act in 2008, targeting at reduction in the ratio of public sector debt to GDP by 50 % by 2013.

Mauritius growth recovered at 4 % in 2010, as compared to 3 % in 2009. However, the euro zone debt crisis in mid 2010 necessitated another round of stimulus package in 2011. These measures included restructuring state enterprises and training of retrenched workers. Expansionary fiscal stance was accompanied by a loosened monetary policy with policy rate being cut from 5.75 to 4.75 %.

Growth was continued to be supported by fiscal stimulus and accommodative monetary policy in the context of declining inflation pressures. Yet, growth fell to 3.2 % in 2013, slightly below potential mainly due to weak demand for construction, sugar and tourism. Conscious of potential inflationary pressures, Bank of Mauritius (BoM) resorted to mopping it up excess liquidity through tightening monetary policy measures. Fiscal consolidation was delayed in both 2013 and 2014, which saw historically high level budgets. Since the debt risks were limited, with debt consisting of low external debt from multi- and bilateral sources, budget deficits of small magnitudes were of no immediate concern.

Thus, appropriate fiscal policies followed by Mauritius in the wake of economic downturn for mitigating the adverse impact of the global economic downturn. As the economy recovered, the stabilizers ceased to operate. Along with fiscal policy measures, monetary policy was not only supportive but was also on guard to keep inflationary potential under check.

Vanuatu

Vanuatu is one of the 14 Pacific island countries (PICs), which are members of the intergovernmental organization, known as Pacific Islands Forum. Vanuatu is located in the South Pacific. The island nation is heavily subsistence oriented, dominated by root crops; and commercial ranch and fishery activities to a small extent. Its manufacturing sector is small, confined to bread and biscuit making and coconut oil production.

Vanuatu is a pure tax haven being open economy with no taxation of any kind or exchange controls ever since its independence in 1980, except for a brief period during 1998–99 following the payout crisis experienced by the state sponsored Vanuatu National Provident Fund (VNPF) (Jayaraman 2000). Vanuatu's financial sector includes the Reserve Bank of Vanuatu (RBV), five commercial banks, a number of trust and insurance companies, VNPF, and several smaller financial institutions, including a credit institution and the state owned Vanuatu Agriculture Development Bank. Since Vanuatu has no vibrant primary and secondary markets in bond and other financial securities, there are no attractive financial assets other than saving and time deposits for savers to invest in (Jayaraman 2011).

Macroeconomic Performance

The objectives of RBV are to keep inflation low, maintain an adequate level of international reserves and support orderly economic development. As there are no capital controls in Vanuatu, there is not much room for an independent monetary policy under a fixed exchange rate regime. Until 1998, the statutory reserve deposit (SRD) ratio was the only monetary policy instrument of RBV. In 1998, RBV introduced open market type operations in its own papers for mopping up excess liquidity in the wake of VNPF crisis, and eventually towards influencing the market rate of interest rate.

Vanuatu's economic performance during 1980–1990 has been uneven (Crane 2006). With fall in bilateral grants, which accounted for 80 % of public sector expenditure in 1980 to 21 % in 1989, government trimmed recurrent expenditures and increased revenue through indirect taxes. In the early 1990s, government resorted to overseas borrowing for funding projects including telecommunication network and airport

development. These helped to augment tourism receipts by allowing larger aircrafts to land.

During the period 1991–1995, there were several unanticipated shocks, including the aforementioned VNPF crisis, leading to loss of foreign reserves and deterioration of overall macroeconomic performance. Fiscal and monetary tightening helped economic recovery in the early 2000s, producing a string of budget surpluses in the subsequent until 2007.

Global Economic Downturn Since 2008

The global recession originating in the US spread across to Australia and New Zealand (ANZ), which are Vanuatu's two main sources of aid, tourism earnings and foreign direct investment. In the second half of 2008, capital inflows and tourist arrivals began to decrease. In such an unfavourable environment, well coordinated monetary and fiscal policies were adopted to lessen the impact of the world economic downturn. In late 2008, RBV adopted easy monetary policy, including reductions in rediscount rate and in SRD ratio. Fiscal surpluses of past 4 years came handy, providing fiscal space to accommodate expansionary fiscal measures during 2009–2011. As inflationary pressures crept in, brakes were applied with increases in SRD ratio in two steps: August 2010 and in August 2011.

To sum up, Vanuatu handled its response to global economic crisis creditably, with prudent fiscal measures much before the global crisis. When the economy showed signs of heating, direct monetary policy instruments were relied upon to a far greater extent.

Coordination Between Central Bank and Ministry of Finance

The functions of central banking relate to maintenance of internal equilibrium (price stability) and external equilibrium (exchange rate stability), which is essentially a 20th century development by separating two sets of functions, namely monetary policy and fiscal policy.

Theoretical support for assigning the functions of monetary policy and fiscal policy to two different agencies comes from the contributions by the Nobel Laureate, Tinbergen (1952, 1956), who stressed the need for as many number of policy variables as there are policy goals. If price stability were to be the goal, the policy or instrument variable would be monetary policy, which would be targeting an intermediate target, such as monetary aggregate, reserves, or interest rate; and if growth were to be the goal, the policy variable would be fiscal policy (Hasan and Isgut 2009).

All open economies are exposed to balance of payments problem, posing threats to exchange rate stability. In flexible exchange rate regimes, automatic macroeconomic adjustment falls on exchange rate, which is not possible under a fixed exchange rate regime. Countries with fixed exchange rate regimes have to assign the goal of balance of payments equilibrium to the tool of exchange rate. However, it is well known that the three goals in an open economy: price stability with monetary policy as a tool, growth with fiscal policy as a tool, and balance of payments equilibrium with exchange rate policy as a tool, present the classic situation of impossible trinity (Obstfeld et al. 2005).

Shared Goals

Fiscal policy measures have monetary implications. Deficit financing through public borrowing exercises upward pressure on market interest rates; and the monetization of government debt in the event of public failing to purchase government bonds, adds to high powered money with inflationary potential (Worrell 2000). In these circumstances, it is more expedient to concentrate on two goals of price stability and growth. In SIDS, price stability and growth are the shared goals of governments and central banks. Although the central bank is entrusted with monetary policy in most of the SIDS which have independent currencies, instrument independence is not fully enjoyed by them. Studies (Fry et al. 1996) show that in SIDS which had a history of low inflation, monetary policy changes were implemented after they were duly endorsed by Ministry of Finance (MoF).

In SIDS whose financial markets are at early stages of development, monetary policy transmission mechanism has been found weak (Jayaraman 2011). Although fiscal policy is more effective than monetary policy, time lags involved in implementation render it as a blunt tool. Therefore, it is recognized that central banks and governments should evolve a cooperative monetary-fiscal coordination framework for successful policy making and implementation (Fry et al. 1996; Eijffinger and de Haan 1996; Allsopp and Vines 1998).

An important reason behind effective coordination between ministry of finance and central bank relates to maintaining adequate fiscal space, which is defined as the availability of budgetary room that allows a government to provide resources for a desired purpose without prejudice to the sustainability of a government's financial position (Heller 2005). Inadequate fiscal space leads to rise in debt stock, resulting in higher debt servicing costs and recurrent expenditures of the government, which would eventually raise the size of any fiscal space the government would be targeting. Rise in debt servicing costs would also lessen the efficacy of monetary policy tools. Deficit financing would push up cost of domestic credit as government would be competing with private sector for resources. If the central bank were to ease the pressure on interest rate, it would face the risk of adding to inflationary pressures. In these circumstances, the need for coordination between central bank and ministry of finance becomes more critical (Hasan and Isgut 2009).

Coordination Framework

The coordination framework depends on four stages of financial sector development (Laurens and de la Piedra 1998). In countries with undeveloped financial markets and a small number of financial institutions, formal rules are required to constrain domestic credit, as the latter is often dominated by government borrowing. In the second stage, with reforms taking shape towards developing markets for central bank issued securities for influencing short-term interest rates, government's debt service costs are reduced. In these two stages, financial programming, involving government spending decisions on one hand, and money supply changes by central bank on the other hand, can be undertaken only under some coordination mechanisms.

The third stage refers to the emergence of money market for short term instruments issued by central bank, when the country concerned has only a primary market

developed but with no secondary market yet. The fourth and final stage refers to fully developed money market with secondary markets as well. In the third stage, central bank aims at reserve money; and in the fourth stage central bank has greater control over money supply. Since the last two stages have yet to be reached in SIDS, financial programming is critically needed.

The SIDS' financial sectors are at early stages of development with a small number of players in the primary market for financial securities, which are dominated by state sponsored pension institutions. Further, they are marked by the absence of secondary markets in which securities could be traded. As a result, prices do not provide appropriate signals for economic agents to act and react. In these circumstances, institutional arrangements have also to ensure that monetary and fiscal policies are consistent with each other ex-ante for maintaining their credibility. Furthermore there are implications for one another, since these policies are implemented at different times by two distinct agencies: central bank and ministry of finance (Worrell 2000). These institutional constraints can be overcome only by coordination.

What is now increasingly recognized is the need for frequent exchange of information between the ministry of finance (which is responsible for fiscal policy formulation and implementation) and the central bank (which is responsible for monetary policy formulation and implementation) for ensuring the shared goals of price stability and growth being achieved. Since the two entities have independent jurisdictions, the joint setting of monetary and fiscal policies is not suggested here. But, what is stressed here is coordination, which has to be achieved by taking into account the other agency's reaction to each agency's policy move with the full appreciation on the parts of both central bank and government. Each of them has to respect their respective spheres of assigned roles, objectives and instrument freedom to pursue the mandated goals (Reserve Bank of New Zealand 2012)

Two Mechanisms

Two mechanisms are in vogue. One is the rule-based approach and the other is the committee approach. Under the rule-based approach establishing rules and procedures, limits on public debt and budget deficit laid down as targets to be achieved over time. The rule based approach ensures the conflicting positions that arise from time to time are kept to a minimum since the central bank and the government have different time horizons in mind. Governments have always the next elections in mind. Their spending decision has implications of longer term nature, which are of central bank concerns. Financing a budget deficit by borrowing from central bank would eventually cause a rise in money stock with pressures on price level. Central bank would be forced to adopt a tightening monetary policy. By so doing, it might find itself at loggerheads with government.

The rule based approach would also require MoF to issue a Budget Policy Statement 3 months in advance of the date of formal budget presentation, indicating government's long term and short term objectives for operating expenses, revenues and total debt. Such an advance notice would then enable central bank to plan its moves accordingly (Hasan and Isgut 2009). If countries do not have parliamentary statutes laying down the legal limits for guidance, it is the committee approach which promotes coordination through contacts and exchange of information (Worrell 2000).

In some countries which have constituted joint committees for coordinating monetary and fiscal policies, it is found that these committees do not meet regularly. If they do, it is only to decide on major shifts such as targets for the medium term and overall debt strategy, rather than for a continuous review of changes in monetary and fiscal policies. Further, the formal work link through membership of MoF officials in the central bank's board of directors is not reciprocated for the central bank participation in the fiscal policy making in MoF.

As regards autonomy of central banks, appointment of board directors including the governor as the chairman of the board on merit for a fixed period subject to renewal for an equal period, would send out a strong signal of seriousness of government's intention. In some SIDS, the tenure of the board is coterminous with the period of government. Such an arrangement does not ensure independence, as well as continuity. Unexpected changes in the government between two general elections are followed with consequent changes in the central bank as well would contribute to disruption at the policy level.

It is now recognized that keeping the board of directors away from political influences ensures a high degree of professionalism. Strengthening the research capabilities would contribute to the build-up of the reputation of central bank, which inspires public confidence in the institution. Consequently, the government is put on guard once the public begins to look upon the central bank as a repository of expertise (Worrell 2000). Based on the foregoing discussion, Box 1 presents an ideal situation of institutional arrangements for central bank and government coordination.

Box 1: Coordination: Suggested Institutional Arrangements

A joint economic policy committee (JEP) chaired by Governor of the Central Bank (CB) and Chief Technical Officer (CTO) of Ministry of Finance (MoF).

JEP firms up in advance the annual forecasts prepared by CB and MoF, as the basis for budgetary exercises. JEP also undertakes periodical review of the forecasts as and when situations warrant for any revision.

Forecasts are formally communicated by JEP to Minister of Finance before . MoF begins its budgetary exercises for the ensuing year

Minister of Finance is responsible for the budget formulation, reconciling differences between MoF and the spending ministries..

Revised forecasts are prepared by JEP by incorporating Minister's final decision on budget outcome

Differences between CB and MoF remain within the committee. It is left to Minister to choose risky options.

In majority of countries, Governor of CB maintains regular contacts with CTO, MoF and Minister of Finance. Such an arrangement works well provided forecasting, publishing and expenditure control are in place.

Protection of tenure of CB Governor and Board of Directors from political influence; assignment of operational responsibility and freedom; and explicitly requiring CB to report to parliament

High quality research output by CB promotes CB reputation, integrity and autonomy and accountability
CB's influence on determination of policy and on public preferences which determine targets of policy depends on soundness of CB's past analytical.

Equally important is strong technical capability of MOF in tax policy analysis, strict expenditure control, skillful cash management and effective monitoring and information systems for fiscal operations

Additionally developing its own capability to formulate and articulate policy raises the image of MoF.

Source: Laurens and de la Piedra (1998); Worrell (1991, 2000). Hasan and Isgut (2009)

Two Case Studies

Arrangements in Mauritius

The 2004 Act of the parliament lays down the objectives of Bank of Mauritius (BoM) as promoting growth and development and maintaining price stability within the range of accepted inflation after due consultation and approval by Minister of Finance. Thus, price stability and economic development become the shared goals between the government and the monetary authority. The BoM has been given instrument independence in regard to monetary policy formulation and implementation for maintaining price stability. The Act empowers the Monetary Policy Committee (MPC) set up under the Act to function independently of government without representation from Ministry of Finance and Economic Development (MoFED). The MPC is chaired by the Governor consisting of two Deputy Governors; two Directors on the Board and four others outside the Board, with experience in economics, banking or finance, all appointed by the Minister.

For maintenance of financial stability, the statute has provision for a joint committee, known as Financial Stability Committee, which is chaired by the Minister. The other members are the Governor; the Financial Secretary Head of MoFED; and the Chief Executive of the Financial Services Commission established under the Financial Services Act. The functions of the Committee are to review and ensure the soundness and stability of the financial system.

Fiscal Discipline

Mauritius relies upon the rule-based approach towards fiscal discipline. In his 2006–07 budget speech the Minister of Finance announced that government would enforce three rules: (i) the golden rule limiting the government borrowing to only investment financing; (ii) the sustainable investment rule requiring the net public debt ratio to GDP be on a downward track; (iii) the constant expenditure rule requiring total expenditure remains constant after adjusting for inflation, which meant in 2006/07 containing the net government's recurrent expenditure to 20.5 % of GDP. The so-called golden and sustainable rules aim at maintaining the public expenditure and limiting public debt at an agreed level of GDP. The Public Debt Management Act (PDMA) of 2008 requires the public sector debt be reduced to 50 % of GDP by 2013.

While MoFED is guided by the principles of responsible fiscal management by the golden and sustainable investment rules; and BoM role and functions are spelt out under the statute, coordination arrangements between them remain to be administrative. The latter are formalised through committee procedures. There are three levels of committees: (i) Minister-Governor; (ii) High-level official; and (iii) Staff level. The Minister-Governor level meeting takes place each year at the start of preparations for the budget. The purposes are to take stock of the economic situation and to assess prospects for the country in the short to medium term. The committee meets on an ad hoc basis depending on issues under consideration. These meetings enable both the government and central bank to come to an understanding of the current economic situation and exchange views before budget preparation.

The High-level official committee, known as Macroeconomic Coordination Committee, is chaired by the Financial Secretary. It comprises representatives of BoM and the Statistics Office for discussing macroeconomic forecasts and for reviewing progress in regard to achievement of objectives. The Staff Level Committee is concerned more with detailed measures and it meets as and when required during the year. As the Minister reconciles differences between the budget requests of spending ministries and resources available, the Committee revises forecasts in the light of the recommendations by the Minister.

There is also a committee known as Short Term Borrowing Requirements Committee comprising officials from MoFED, the Treasury, the Debt Team and the BoM, which meets on a regular basis to discuss and analyse the results of the government's cash balance projections, to monitor overall liquidity and market developments, and to discuss the strategy for achieving public debt and monetary management objectives.

Arrangements in Vanuatu

We obtain the rule-based approach in Vanuatu as well. Vanuatu enacted Public Finance and Economic Management Act (PFEMA) 1998 making the Minister of Finance accountable for fiscal policy and implementation. The PFEMA requires the government to: (i) produce statements of economic policy; (ii) announce confirmation of adherence to fiscal disciplines prescribed under this Act; and (iii) issue budget policy statements; economic and fiscal forecasts; updates; financial management information; and comprehensive annual reports.

Unlike the PDMA (2008) of Mauritius, Vanuatu's PFEMA does not prescribe caps on public debt and budget deficit in terms of percentages of GDP. However, it requires the Minister of Finance to issue a statement on economic and financial policy, which would present a general picture of revenue and expenditure positions of the government. The statement on economic and financial policy has to be followed by a budget policy statement each year before end of September and it has to spell out or re-affirm long term objectives to be pursued for the next two calendar years and specify strategic priorities. Further, another legal requirement is that Minister has to submit the Budget along with the Bill for an Annual Appropriation Act and submit a report on the Government's fiscal strategy. The PFEMA empowers the government to raise loans. However, the Act does not prescribe the debt ceiling either in absolute amounts or as a percentage of GDP. The above legal provisions make it clear that formulation and implementation of fiscal policy and management of public finances are the exclusive function and responsibility of Ministry of Finance and Economic Management (MoFEM).

Central Bank Responsibility

The Reserve Bank of Vanuatu (RBV) Act 12 of 2002 lays down the functions and responsibilities of the central bank. The RBV Act lists the objectives of central bank, specifying promotion of monetary stability and fostering conditions conducive to orderly and balanced economic development. The RBV and the government thus have economic development as a shared goal. The RBV Act clearly confers freedom of action to the Board of Directors comprising of five members, one of which is the

Governor and the Chairman and the other four include three members from the public with proven ability in business, professional or academic matters and a representative from the MoFEM. The members of the Board, including the Governor, are appointed for a 5- year term. The appointment is not coterminous with the government in power and the terms of appointment cannot be altered to their disadvantage. These provisions ensure certain measure of autonomy.

The RBV is given instrument independence to determine interest rates and prescribe reserve requirement ratios. However, there is a provision which does not rule out the authority of MoF to have a say in these matters, as it refers to the need for prior approval of the Minister of Finance, generally for giving effect to the purposes of the Act. However, there is no instance in recent years of any interference in this regard. The authority under this provision would, if and when exercised, no doubt compromise the independence of the central bank. It should be noted that the representation from MoFEM in the RBV Board of Directors is not reciprocated by a similar formal arrangement in the formulation of fiscal policy and budget preparatory exercise. A provision in the RBV Act restricts the freedom of MoFEM in regard to government's borrowing from the central bank by fixing the upper limit of advances to government at 20 % of the average annual revenue of the government. However, this restriction is diluted by another provision that under special circumstances the limit of 20 % can be extended to 30 % for a period of 6 months by Minister of Finance.

Coordination Arrangements

A joint Macroeconomic Committee (MEC), which was set up in 1998 to meet the consequences of the VNPF crisis, has proved its usefulness in monitoring the economic conditions and taking corrective steps has become a permanent committee. The MEC is chaired by the Governor with following as members: (i) Director General, Ministry of Finance and Economic Management (MoFEM); (ii) Director, Treasury Department; (iii) Director, Research and Statistics Department, RBV; (iv) Principal Statistician, Government Statistics Office; and (v) Director, Customs and Inland Revenue. (vi) representatives from the Prime Minister's Office. The MEC's functions include (i) reviewing economic development activities; (ii) identifying current and impending risks and vulnerabilities and providing advice in mitigating them; and (iii) reviewing the effectiveness of monetary and fiscal policies.

The recommendations of MEC though not binding are given due regard in the budget formulation by the Ministerial Budget Committee (MBC), a sub-committee of the Council of Ministers under chairmanship of Minister of Finance. The RBV Governor attends MBC, as the chairman of MEC and offers his views before the budget is finalized. The consultative process is complete with full participation by the central bank governor in the budget preparation, which ensures coordination at the highest level.

Summary and Conclusions

Coordination between fiscal and monetary policies has become an important subject of discussion ever since the global economic downturn in 2008. This paper reviewed the

coordination arrangements in small island developing states, with two case studies of Mauritius and Vanuatu, which have been recognized as top performers in their two respective regions, the Indian Ocean and the South Pacific.

The study shows that Mauritius, in addition to more streamlined administrative arrangements has increasingly relied upon self-denying ordinances of limiting public debt and fiscal deficits by enacting legislative measures in recent years. Vanuatu, on the other hand has yet to adopt a more stringent framework. It has placed considerable emphasis on the cooperative framework of consultative procedures between ministry of finance and central bank. By inviting central bank participation at the highest level, the Budget Committee and a sub-committee of the Council of Ministers in Vanuatu has the benefit of the central bank governor's views and advice, retaining its own final say.

Although a high degree of independence assured by legislative provisions is helpful for raising the credibility of central bank as an institution in SIDS, it is the professionalism and integrity of the institution built over decades that matters. The government of the day becomes appreciative of the central banks only if the latter become credible through high quality research and analytical and reporting skills (Worrell 2000). As for integrity, it is men at the helm of affairs who matter most. This requires appointment procedures to be above politics assuring full tenure and terms of appointment of the governor and board directors.

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