INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/162

VANUATU

June 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR VANUATU

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 Article IV consultation with Vanuatu, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 5, 2019 consideration of the staff report that concluded the Article IV consultation with Vanuatu.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 5, 2019, following discussions that ended on April 8, 2019, with the officials of Vanuatu on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 20, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association (IDA).
- A **Statement by the Executive Director** for Vanuatu.

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INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
June 13, 2019

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2019 Article IV Consultation with Vanuatu

On June 5, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Vanuatu.

Four years after Cyclone Pam struck Vanuatu causing extensive damages, reconstruction is near completion with full recovery in sight. Real GDP growth reached 4.4 percent in 2017 and stayed strong, if somewhat softer, at 3.2 percent in 2018. There was a current account surplus in 2018 of 3.5 percent of GDP, driven by windfall revenues from economic citizenship programs, despite still-strong demand for imports for development-partner-financed projects. Consequently, there was also a fiscal surplus of 4.8 percent of GDP.

Going forward real GDP growth in 2019 will be slightly higher at 3.4 percent because of some delayed private investment but will ease to 2.9 percent as there are fewer projects financed by development partners, and tourism and agricultural diversification become the primary growth drivers. Vanuatu will graduate from LDC status in 2020, with little expected impact on their growth trajectory. Vanuatu is also are expected to implement the “PACER plus” free trade agreement with Australia, New Zealand and eight other Pacific island small states.

Modest fiscal and current account deficits are expected in 2019, at 3.2 and 1.2 percent of GDP, respectively. The deficits will widen thereafter, reflecting spending on new infrastructure projects financed more by concessional lending than grants and decreased revenues from Vanuatu’s economic citizenship programs. The current account deficit will face further pressure from imports of airplanes for the new *Shared Vision 2030* plan for air travel and tourism, jointly carried out by the Vanuatu Tourism Office, Air Vanuatu and the airports authority.

Monetary policy has maintained inflation within its 0 and 4 percent range using its pegged exchange rate regime to import low foreign inflation and used its statutory reserve deposit requirements and open market operations to overcome any domestic pressures, such as the increase in 2018 of the VAT rate. The monetary policy stance is projected to remain neutral

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

going forward. The financial sector is generally sound, but there exists ample room to support financial inclusion, as reflected by the new National Financial Inclusion Strategy 2018–23.

Executive Board Assessment[2]

Executive Directors welcomed the recovery from Cyclone Pam and the authorities' focus on broader development objectives to improve living standards and long-term growth. The high exposure to natural disasters remains a key risk to the outlook, and Directors underscored the need for additional efforts to build adequate fiscal buffers, strengthen governance, and to enhance disaster resilience. The authorities should continue constructive engagement with their development partners for technical assistance, capacity development, and financing.

Directors stressed the need for continued fiscal discipline. They noted that the long pipeline of development projects is likely to put upward pressure on debt ratios. To safeguard debt sustainability, the government should prioritize infrastructure investment and engage in further fiscal reform, including introducing corporate and personal income taxes while removing inefficient taxes, reducing reliance on revenues for the economic citizenship programs. Directors noted that this would allow the authorities to lower the public-and publicly-guaranteed-debt-to-GDP target to 50 percent.

Directors considered the monetary policy stance to be appropriate as inflation is expected to stay near the middle of the 0-4 percent target band. They recognized that excess liquidity in the system may be reducing monetary policy effectiveness and should be closely monitored.

Directors agreed that the authorities' strategy should be underpinned by diversification in agriculture and tourism. Directors noted that the diversification strategy should be complemented by improvements in the business environment to help trigger private investment and enhance competition and productivity.

Directors commended Vanuatu for its removal from the FATF grey list and recommended that the financial sector's regulatory and legal frameworks be further strengthened to account also for increasing fintech use. Together with ongoing progress in enforcing the AML/CFT framework, this should help maintain correspondent banking relationships. Directors also noted that the National Financial Inclusion Strategy 2018–2023 should help improve access to finance and inclusion more generally.

Directors noted that the national disaster planning framework has been improved substantially in recent years. Directors viewed the proposed Disaster Risk Management Act with its national emergency fund as an opportunity to establish a multi-year fund with consistent government funding.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors recognized that, with limited administrative capacity, Vanuatu is vulnerable to corruption from gaps in governance. To address these vulnerabilities, they suggested further strengthening the Reserve Bank of Vanuatu's autonomy, in line with recommendations from the IMF's 2016 Safeguards Assessment and strengthening fiscal governance by completing the Government Business Enterprises Act and the Tax Administration Act.

Table 1. Vanuatu: Selected Economic Indicators, 2014–21

Population (2017): 278,726
IMF quota: SDR 23.8 million (0.01 percent of total)
Main products and exports: Coconut oil, copra, kava, beef
Key export markets: New Zealand, Australia, Japan

Per capital DGP (2017): US$3,356
Literacy rate (2012): 83.4 percent

	2014	2015	2016	2017	2018	2019	2020	2021
					Est.	Projections		
Output and prices (annual percent change)								
Real GDP	2.3	0.2	3.5	4.4	3.2	3.4	3.0	2.8
Consumer prices (period average)	0.8	2.5	0.8	3.1	2.9	2.0	2.2	2.3
Consumer prices (end period)	1.1	1.5	2.1	3.3	2.6	2.6	2.2	2.5
Government finance (in percent of GDP)								
Total revenue	23.5	31.9	30.8	34.8	35.5	27.9	28.0	28.0
Taxes	17.4	16.3	16.3	17.1	17.9	17.7	17.7	17.7
Other revenue	2.0	3.9	6.2	7.1	11.9	4.9	4.7	4.5
Grants	4.1	11.8	8.3	8.4	5.6	5.8	5.8	5.7
Expenditure	27.0	39.3	34.7	35.7	30.7	31.1	31.6	32.0
Expense 1/	21.8	23.1	24.8	26.9	24.6	25.8	25.9	25.9
Acquisition of nonfinancial assets 1/	5.1	16.1	9.9	8.8	6.1	5.3	5.7	6.1
Net lending (+)/borrowing (-)	-3.5	-7.3	-3.9	-0.9	4.8	-3.2	-3.6	-4.0
Public and publicly-guaranteed debt (end of period)	26.1	35.9	46.4	53.2	52.4	52.9	53.9	55.3
Domestic	6.6	8.7	10.1	9.4	7.3	6.9	6.4	6.1
External	19.5	27.1	36.2	43.8	45.2	46.0	47.5	49.2
Money and credit (annual percentage change)								
Broad money (M2)	8.6	11.4	10.6	9.3	12.6	10.7	4.8	6.0
Net foreign assets	-14.5	71.6	46.5	11.0	36.5	12.2	3.1	5.0
Domestic credit	9.4	-8.0	-1.3	2.3	-2.3	5.8	5.2	5.4
Of which: Credit to private sector	9.0	1.4	1.3	4.7	3.0	4.1	4.1	4.1
Interest rates (in percent, end of period) 2/								
Deposit rate (vatu deposits)	2.3	2.3	1.6	1.4	1.4	…	…	…
Lending rate (vatu loans)	10.0	10.0	9.9	10.3	10.3	…	…	…
Balance of payments (in percent of GDP)								
Current account	6.2	-1.6	0.5	-6.5	3.5	-1.2	-5.4	-4.8
Trade balance	-25.3	-35.6	-33.6	-29.1	-30.3	-30.4	-34.0	-32.8
Exports of goods	7.8	5.1	6.2	6.9	6.4	6.1	6.1	6.0
Imports of goods	-33.1	-40.7	-39.8	-35.9	-36.7	-36.5	-40.0	-38.8
Tourism receipts	31.6	27.5	23.5	19.3	22.6	24.7	25.5	24.2
Capital and financial account	25.1	41.0	35.7	15.9	7.9	6.5	6.4	6.4
Of which: Foreign direct investment	5.4	5.3	4.4	3.7	4.3	4.2	4.0	3.8
Overall balance	1.2	11.3	3.3	11.8	11.4	5.2	1.0	1.6
Gross international reserves (in millions of U.S.$)	179.2	266.3	292.7	396.4	502.4	552.0	562.3	579.0
(in months of prospective G&S imports)	5.2	6.4	7.5	10.1	12.0	13.0	11.8	11.8
External debt service (in percent of GNFS exports)	2.0	2.1	2.1	2.3	5.1	4.1	3.6	3.9
Exchange rates 3/								
Vatu per U.S. dollar (period average)	96.9	107.0	109.3	107.8	108.5	…	…	…
Vatu per U.S. dollar (end of period)	102.5	109.6	113.1	106.5	112.3	…	…	…
Memorandum items:								
Nominal GDP (in billions of vatu)	79.1	82.8	87.3	94.9	100.7	106.3	112.0	118.0
Nominal GDP (in millions of U.S. dollars)	817	774	798	880	928	947	998	1,051

Sources: Vanuatu authorities; and IMF staff estimates and projections.
1/ Does not include consumption of fixed capital (depreciation).
2/ Weighted average rate of interest for total bank deposits and loans.
3/ The vatu is officially pegged to an undisclosed basket of currencies.

INTERNATIONAL MONETARY FUND

VANUATU

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

May 20, 2019

KEY ISSUES

Context: Four years after Cyclone Pam struck Vanuatu causing extensive damages, reconstruction is near completion with full recovery in sight. The authorities are now focused on implementing their broader development plans that were slowed by the rebuilding process, which will require fiscal discipline and reforms to maintain debt sustainability. The authorities should continue their constructive engagement with development partners for technical assistance, capacity development, and concessional and grant-based funding. In parallel continuing to reform and strengthen the governance of institutions and removing vulnerabilities to corruption will be important.

Outlook and Risks: Real GDP growth softened somewhat to 3.2 percent in 2018 but should remain relatively stable going forward. Modest fiscal and current account deficits are expected in 2019 (3.2 and 1.2 percent of GDP, respectively), but the deficits will widen thereafter, reflecting spending on new infrastructure projects and decreased revenues from economic citizenship programs. The largest uncertainty for the economy remains the ever-present danger of natural disasters. On current policies, there is little fiscal space to address another natural disaster as public-and-publicly-guaranteed debt is expected to breach the government's target of 60 percent of GDP by 2025.

Main Policy Recommendations:

- Further fiscal reform, including the introduction of a broader tax regime and more prioritization of expenditures, to reduce reliance on revenues from economic citizenship programs, and to remain well below the government's debt target. This would maintain an extra buffer to manage risks from natural disasters.
- Analyze excess liquidity and non-performing loans in the banking sector with assistance from development partners, so as to guide the sector in reducing those burdens as needed, and safeguard efforts at financial inclusion.
- Help ensure that Vanuatu's AML/CFT regime is properly applied to and mitigates ML/TF risks arising from new fintech usage, by adopting a clear mandate with deadlines for reporting and recommending for its Distributed Ledger Technology taskforce.
- Continue reforms to improve Reserve Bank of Vanuatu (RBV) governance, financial supervision and fiscal governance by leveraging technical assistance programs with PFTAC and its development partners, to counteract corruption.

Approved By
Odd Per Brekk (APD) and Maria Gonzalez (SPR)

Discussions took place in Port Vila during March 27–April 8, 2019. The staff team comprised Dirk Muir (head), Hidetaka Nishizawa, and Charlotte Sandoz (all APD). Anna Park (OED) participated in policy discussions with Anna Robinson (WB), Matthew Hodge and Jacqueline Connell (both ADB) as observers. The mission met with Minister of Finance and Economic Management Gaetan Pikioune, Governor of Reserve Bank of Vanuatu (RBV) Simeon Malachi Athy, and the economic committee of the Parliament, as well as other senior officials from the government and RBV, representatives from the private sector and civil society organizations, and development partners. Anthony di Bello and Antoinette Kanyabutembo (both APD) assisted in preparing this report.

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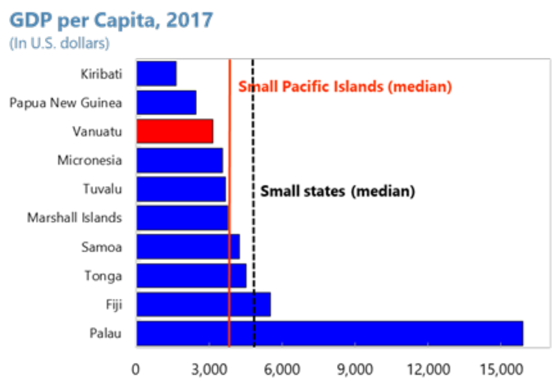
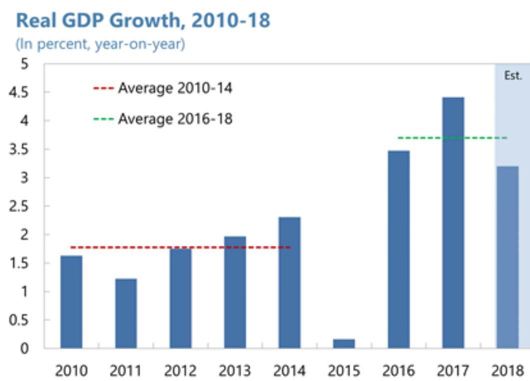
BACKGROUND

1. **Vanuatu is a small island developing state and low-income country.** Its income per capita is US$3356, with the economy dominated by tourism, construction, and agriculture. In the aftermath of the GFC (2010–14), real GDP growth averaged 1.8 percent per year. Following 2015's devastating Cyclone Pam, growth rebounded to almost 4 percent on average, backed by substantial public investment. The recovery phase has seen strong support by development partners through grants, concessional lending, and technical assistance.[1]



Sources: Country authorities; and IMF staff calculations



Sources: Authorities; and IMF staff estimates.

2. **Vanuatu is the world's most at-risk country for natural disasters, as measured by the UN World Risk Index.**[2] Cyclone Pam affected more than 70 percent of the population and required extensive development partner support, including US$23.8 million from the IMF's RCF and RFI. Vanuatu also faced volcanic eruptions on the islands of Ambae and Ambrym in 2018. While Vanuatu has adopted disaster planning, including the National Disaster Management Office (NDMO), funding and staffing shortages remain.

3. **The authorities have been improving governance and encouraging growth.** Under the *Vanuatu Infrastructure Strategic Investment Plan 2015–24,* they have been developing urban and rural areas, improving living standards and community services. They have also been improving government services, administration and legal and regulatory frameworks. Development partners have provided vital financial support for infrastructure and technical assistance towards better governance.

[1] The main development partners are Australia, China, New Zealand, the Asian Development Bank (ADB), the IMF, Japan International Cooperation Agency (JICA), the United Nations Development Program (UNDP), and the World Bank Group (WBG).

[2] UN World Risk Index measures exposure to natural hazards and the capacity to cope with and adapt to these events.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

A. Recent Developments

4. **Real GDP growth was strong in 2017 at 4.4 percent but slowed to 3.2 percent in 2018.** Construction was the main driver, sustained by development-partner-financed infrastructure projects, even with delays in completion. Agriculture was disrupted by a stronger cyclone season, the volcanic eruptions, and weaker prices for its agricultural exports. Tourism receipts grew 4.3 percent, the strongest since Cyclone Pam.

Major Development-Partner-Financed Infrastructure Projects 2013–19

Project	Started	Completed	Location	Development Partner(s)	Funding
Port Vila Urban Development Project	2013	2019	Port Vila	AUS, ADB	Grants, Loans (ADB)
Interisland Shipping Support Project	2013		Luganville, Ambae, Malekula, Tanna, Pentecost	NZL, ADB	Grants, Loans (ADB)
Lapetasi Multi-Purpose International Wharf Development	2013	2018	Port Vila	JICA, others	Loans
Road Rehabilitation & Upgrade Program, Phase 1	2014	2018	Tanna, Malekula	China EXIM	Loans
Vanuatu Tourism Infrastructure Project	2015	2017	Port Vila	NZL, EIF	Grants
Luganville International Wharf	2015	2018	Luganville	China EXIM	Loans
Vanuatu Aviation Investment Project	2015	2019	Port Vila, Luganville, Tanna	WBG	Loans
Vanuatu Pam School Reconstruction Project	2016		Tafea province	ADB, JPN	Grants (ADB), Loans (JPN)
Vanuatu Infrastructure Reconstruction & Improvement Project	2017		All islands	WBG (IDA)	Grants, Loans
Energy Access Project	2017		Malekula, Santo	ADB	Grants, loans
Vanuatu Agriculture & Development Project	2017		All islands	WBG (IFAD)	Loans
Vanuatu Pam Road Reconstruction Project	2017	2019	Efate	ADB	Grants, Loans
Vanuatu Cyclone Pam School Reconstruction Project	2017		All islands	ADB	Loans
Road Rehabilitation & Upgrade Program, Phase 2	2019		Tanna, Malekula	China EXIM	Loans
Roads for Development, Phase 2	2019		All islands	AUS	Grants

Source: Vanuatu authorities.
Notes: All loans are concessional; AUS is Australia, JPN is Japan, NZL is New Zealand, EIF is the Enhanced Integrated Framework
GREEN designates a post-cyclone-Pam reconstruction project
If no "completed" date is indicated, the project is ongoing as of March, 2019.

5. **Windfall revenues led to a strong fiscal position in 2018.** The projected 4.8 percent of GDP surplus reverses the 0.9 percent of GDP deficit from 2017. The surplus, resulting from an additional 5.9 billion vatu from the economic citizenship programs (ECPs), [3] was used for unexpected expenses (Ambae disaster relief, and the mandated restoration of public benefit cuts) and early debt repayments (about 3.2 percent of GDP).

6. **The 2018 external sector position is assessed to have been stronger compared with fundamentals and desirable policy settings** (Annex II)**.** The current account surplus stood at 3.5 percent of GDP, driven by surprisingly strong revenue collection from ECPs and significant growth in remittances from seasonal worker programs in Australia and New Zealand. Staff estimates a current account gap of 6.7 percent of GDP and a REER gap of -18.5 percent compared with fundamentals and desirable policy settings. As ECP inflows moderate, the current account is expected to quickly revert to a deficit, consistent with an external sector assessment as moderately weaker.

[3] The currently active economic citizenship programs (ECPs) include the Vanuatu Development Support Program (VDSP) and Vanuatu Contribution Program (VCP), outlined in Box 1 of *Vanuatu: 2018 Article IV Consultation*, IMF Country Report No. 18/109.

B. Outlook

7. After a rebound in 2019, growth is projected to slow going forward. Real GDP growth, after strengthening to 3.4 percent in 2019, is projected to reach 2.9 percent by 2024. Growth should be supported by continued development-partner-financed infrastructure projects. Outcomes for the agriculture sector could initially be weaker than previously expected because of negative impacts from natural disasters and the downward revision to the global outlook passing through to export demand. The increase in agricultural diversification efforts on the part of the authorities is expected to mitigate some of these effects. There is expected to be an increasing shift from public to private investment as delayed private-sector tourism investment commences in 2019.

8. Inflationary pressures are expected to remain low. CPI inflation, peaking at 2.9 percent in 2018, boosted by the 2.5 percentage point VAT increase, is expected to moderate in the medium term to 2.6 percent. Inflationary pressures are strongly linked to import prices. Provided that the Reserve Bank of Vanuatu (RBV) continues to successfully maintain its exchange rate peg, Vanuatu should benefit from the expected low inflation in its main trading partners, Australia and New Zealand. There is expected to be additional temporary downward pressures from a weaker global outlook for commodity prices relevant to Vanuatu, and the government increasing funding for education tuition fees.

9. The current account balance is projected to turn into a deficit of 1.2 percent of GDP in 2019, followed by average deficits of 4.6 percent of GDP from 2020 to 2024. The turnaround in the current account balance stems from lower revenues from the ECPs and higher goods imports reflecting airplane orders by Air Vanuatu as part of the *Shared Vision 2030* plan (Box 1). There are projected to be positive offsets – slowing imports of goods from fewer development-partner-financed infrastructure projects and stronger tourism receipts from more cruise ship arrivals at the new international wharfs, the renovated Bauerfield Airport, and increased tourist arrivals from the *Shared Vision 2030* plan. Gross international reserves are expected to cover 12.7 months of prospective imports in 2019 and remain strong from external financing through the current and financial accounts, even as external debt repayments begin to exert downward pressure on reserves in the medium term (Annex II).

10. Vanuatu stands to gain from the "PACER plus" free trade agreement with Australia, New Zealand and other Pacific island states. As members start cutting tariffs (assuming to begin in 2022 in the IMF staff forecast), Vanuatu would experience cheaper imports, mildly stimulating consumption. Required tariff cuts are expected to reduce government revenues up to 1 percent of GDP in the long term. "PACER plus" could have additional positive institutional effects, such as technical assistance by Australia and New Zealand for customs modernization.

11. Vanuatu is expected to graduate from LDC status in 2020 (Annex III)**.** This should not have a major impact on the growth trajectory. Where Vanuatu may face challenges is the reduction of preferential market access for trade. The government has ongoing efforts to find alternative means of preferential access through free trade agreements and should continue after graduation.

Box 1. Shared Vision 2030[1]

The Vanuatu Tourism Office (VTO), Air Vanuatu and the Vanuatu airports authority have elaborated a "shared vision" for tourism in partnership with tourism stakeholders and the government. The main goal is to raise holiday visitors from 87,000 in 2017 to 300,000 in 2030. The main targets are short haul markets such as Australia, New Zealand, and China and new market segments in long haul markets such as Japan, North America and Europe.

Route development is crucial to the plan's success. Air Vanuatu plans to improve air access from Australia and New Zealand and connections from long haul markets. This includes an expanded fleet of new more cost-effective and smaller aircraft to increase frequency to major destinations and to introduce non-stop flights to smaller cities. The centerpiece will be four 133-seat Airbus A220 airliners, with purchase rights for four more. The VTO is tasked with building demand in existing core markets and developing awareness in new markets ahead of entry by Air Vanuatu with the expectation that market development needs at least two years to show returns. Government support will come from the Ministry of Foreign Affairs (negotiating new bilateral air service agreements), the Ministry of Education (developing airline pilot training programs) and the Ministry of Agriculture (help increase food production for the growing needs of the hospitality sector).

Demand created by tourists and tourism businesses should flow through other sectors like agriculture, semi-skilled labor (handicrafts) and public transportation. This is expected to stimulate GDP growth, create employment, and increase VAT and other tourism-related tax revenues for the government.

The total cost and financing of the plan is uncertain. Growth forecasts in the associated *Vanuatu Tourism Marketing Plan 2030* are optimistic with arrivals averaging 10 percent growth per year. Total VTO marketing spending is expected to reach over 1 billion vatu (about 1 percent of GDP) by 2023, although the source of such financing remains unclear. Air Vanuatu is financially overexposed with weak capital and a 1 billion vatu loan has been requested from the VNPF. So far, the government has provided deposits for some airplanes and is at risk at being required to guarantee any debt financing, as Air Vanuatu is a SOE. This could also be the case for any financing provided by the VNPF, itself an SOE, using its depositors' monies.

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[1] Prepared by Charlotte Sandoz.

C. Risks

12. The main risk is that of natural disasters, but there are other significant risks (Annex IV). Weaker-than-expected global growth and global trade tensions could lower remittances, development partner funding, export demand and tourism. If correspondent banking relationships retract, remittances would be harder to access. Delays in infrastructure projects because of insufficient external financing or capacity issues from labor and capital could slow growth. On the upside, their benefits could be larger than expected through higher-than-expected productivity gains or stronger tourism growth. Other upside risks include the *Shared Vision 2030* plan for tourism growth and the expanded seasonal work programs in Australia and New Zealand for remittances and consumption growth. Continued strong ECP revenues are an upside risk for useful government spending, but a downside risk on the fiscal balance if they come in lower than expected or are used to justify further delays in tax reform.

Vanuatu: Summary Risk Assessment			
	High Vulnerability, Risks Skewed to the Downside	Likelihood	Impact
Upside	1. Positive spillovers from large infrastructure projects	Medium	High
	2. Higher-than-expected revenues from ECPs	Medium	Medium
	3. Stronger-than-expected growth in the tourism sector	Low	Medium
Downside	1. Natural disasters and climate change	High	High
	2. Delays in implementation of infrastructure projects	High	High
	3. Unstable revenues from ECPs	High	Medium
	4. Poorly-timed implementation of tax reform	Medium	High
	5. Weaker than expected global growth	Medium	High
	6. Rising protectionism and retreat from multilateralism	High	High
	7. Large swings in energy prices	Medium	Medium/High
	8. Sharp tightening of global financial conditions	Medium	Medium
	9. Reduced financial services by correspondent banks	Medium	Medium

D. Authorities' Views on Outlook and Risks

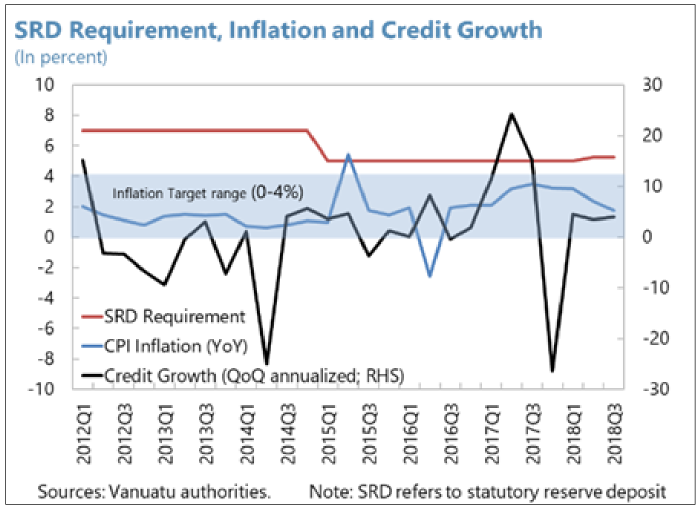
13. **The authorities broadly concurred with staff's assessment on economic developments, outlook and risks.** They noted that the completion of the major infrastructure projects by 2019 is expected to strongly support GDP growth. Their GDP growth forecasts were on average slightly higher than that of staff from 2018 to 2020, the difference driven primarily by stronger growth in construction. The authorities also expressed their commitment to foster economic diversification especially in agriculture and tourism. The authorities agreed that foreign reserves would slowly decline over the medium term because of high demand for imports and external debt repayment offsetting inflows of budgeted development partner funds and temporary ECP revenues. The prime risk they saw was the fragility of the tourism industry as it is highly dependent on the economic situation of their trading partners and vulnerable to disruption due to natural disasters.

ALIGNING MACROECONOMIC POLICIES FOR GROWTH

14. **Macroeconomic policies should foster growth and a stronger fiscal position help build buffers to manage natural disaster risks.** Monetary policy should hold the course to maintain Vanuatu's stable exchange rate and low inflation. Financial policy should focus on reducing non-performing loans (NPLs) and financial inclusion, extending access to credit while being mindful of risks. Fiscal policy should build buffers against natural disasters by completing the tax reform, reducing reliance on ECP revenues, and rationalizing spending. Structural policy should focus on diversification to foster stable growth and resilience. Development partners can back these policies through funding and technical assistance.

A. Monetary Policy

15. The RBV has successfully maintained CPI inflation in the target range of 0 to 4 percent. The RBV's defense of exchange rate peg allows it to import low inflation from Australia and New Zealand (Annex V). It mitigates additional domestic inflationary pressures through bank's statutory reserve deposit (SRD) requirements and mopping up additional excess liquidity through open market operations. By maintaining a stable exchange rate and rising the SRD requirement to 5.25 percent, along with other measures early in 2018, the RBV quelled inflationary pressures.



Staff's Views

16. The RBV's monetary policy stance is appropriate for the short term. Inflation is forecast to remain around 2.6 percent, calling for a continuation of a neutral monetary policy stance. With increased downside risks to the global outlook and therefore import prices, the RBV should maintain its stance, but be ready to loosen if necessary.

17. In the medium term, monetary policy may be hindered by excess liquidity in the banking sector (Annex VI). Banks have registered rapid reserve accumulation since Cyclone Pam and now hold large reserves, split between voluntary reserves as self-insurance, and excess liquidity, which can hinder monetary policy effectiveness. The RBV should investigate the factors behind the large reserves with the large financial institutions. The RBV and government can safeguard the effectiveness of monetary policy by facilitating competition in the banking sector, as highly monopolistic behavior dampens the sensitivity of bank interest rates to monetary policy.

Authorities' Views

18. The authorities agreed with staff's view and the monetary policy stance was appropriate. The exchange rate regime has worked well. Foreign reserves were at a comfortable level and inflation was under control. They raised concerns about excess liquidity in the banking system. This was inconsistent with the high lending rates of commercial banks, also a problem as they restrained credit to the private sector and consequently the level of private investment. The authorities recognized this is not a problem unique to Vanuatu and requested if staff could do analysis for the region for the next consultation.

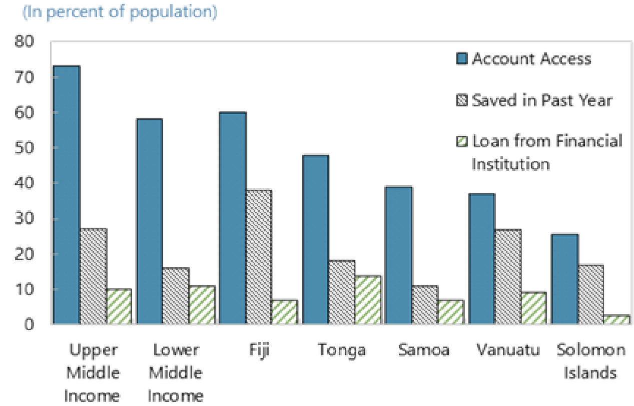
B. Financial Sector Issues

19. Overall, the banking sector has a strong capital and liquidity position.[4] The capital adequacy ratio (CAR) was 19.6 percent by 2018Q3, with most banks above the 12 percent minimum. The NPLs to gross loans ratio was at 14.9 percent in 2018Q3 (over half in the personal sector) although the distribution of NPLs among banks was highly uneven. One bank recorded both high NPLs and a low CAR, but both measures were improving over 2018. With consequent increases in provisioning, the banking sector recorded a decline in profit in 2017 but recovered in 2018.

20. The authorities have made good progress on Vanuatu's AML/CFT legal framework, although implementation has just begun. Staff commends the authorities' efforts that led to Vanuatu's removal in 2018 from the FATF's "grey list" of jurisdictions with strategic AML/CFT deficiencies. This was achieved through extensive legislative work undertaken in conjunction with several development partners.

21. The authorities are carefully considering the use of fintech in the financial sector and aim to better understand the possibilities and risks. Initially, there was little guidance on the use or expected regulation of new digital technologies, which could have increased Vanuatu's exposure to money laundering and terrorist financing (ML/TF) threats and magnify existing vulnerabilities. Failing to properly regulate virtual asset service providers for AML/CFT would not be in line with the FATF standard. In September, after some firms made claims about Vanuatu's use and official support of crypto-assets and currencies, the authorities issued a public warning stating that cryptocurrencies were not recognized for payment and ICOs were not allowed and declared a moratorium on fintech initiatives. As a response, the authorities established a Distributed Ledger Technology (DLT) taskforce comprising relevant financial regulators to consider related issues.

Financial Inclusion in the Pacific
(In percent of population)



Sources: PIRI Demand Side Surveys and Global Findex

Staff's Views

22. Given elevated NPLs and low profitability, the RBV needs to monitor the banking sector carefully and continue strengthening its supervisory framework. The IMF is assisting on both fronts, with a banking diagnostic assessment in May 2019 and ongoing PFTAC technical assistance. Ensuring that all banks meet the CAR and

[4] The sector comprises five major banks and a large financing company – three established foreign-owned banks (Bank of the South Pacific from Papua New Guinea, ANZ from Australia, and Bred Bank from France), a new foreign-owned bank that will be active only in Vanuatu (Wanfuteng Bank, with owners from Hong Kong SAR), a domestic bank that is majority-government-owned, the National Bank of Vanuatu (NBV), and Credit Corporation Vanuatu Limited, which primarily finances work and personal vehicles. There are also five credit unions (including one for teachers and one for the police force), plus some cooperatives have financial functions, which should shrink over time as the new credit union law, once passed, will force such cooperatives to reestablish as credit unions, shut down, or substantially reduce in size, while facing improved regulatory oversight.

reduce NPLs should ensure financial stability. Furthermore, it would send the signal that the banking sector remains a responsible partner in its correspondent banking relationships, alongside progress already made on AML/CFT issues.

23. Work on financial inclusion should help further development of the financial sector. The positive effect of financial deepening on growth could be large.[5] The authorities, with IMF/PFTAC assistance, have introduced a stronger legal framework for credit unions, which will also prevent cooperatives from operating as poorly-run, unregulated financial institutions. Staff commends the new *National Financial Inclusion Strategy 2018–23 (NFIS)* and the actions of the National Bank of Vanuatu (NBV). The *NFIS* provides for financial literacy programs, increased bank account enrollment and use, leveraging technology for inclusive products and services, and financing micro-, small-, and medium-sized enterprises (MSMEs). The NBV is migrating more of its rural base to mobile or electronic banking and using fintech solutions to extend other banking services into remote areas. Financial inclusion measures could stall because of high NPLs in the personal sector. Staff recommends that authorities act based on the recommendations from the IMF-led banking diagnostic assessment.

24. Ongoing improvements to Vanuatu's AML/CFT regime are needed to strengthen financial sector stability and ease potential pressures on correspondent banking relationships. The AML/CFT legal framework remains largely untested. Enforcement should be complemented by further requests for technical assistance from Vanuatu's development partners for risk-based financial supervision and capacity building at the Vanuatu Financial Services Commission (VFSC) and Financial Intelligence Unit (FIU). Improvements to the AML/CFT regime may help alleviate pressures on correspondent banking relationships.

25. Strengthening the financial sector's regulatory and legal frameworks to support fintech use is required. While the RBV has clearly stated restrictive positions on fintech until appropriate regulation is in place, progress on this front is not clear. A well-constructed, clearly delineated framework could harness fintech to make banks more internally efficient, and broaden financial innovation and inclusion, encouraging domestic growth, as well as stimulate its offshore financial sector, provided safeguards are put in place to contribute to the mitigation of ML/TF risks. IMF staff recommends that before expanding into new technologies, products and services the authorities:

- provide clearer public guidance regarding the DLT taskforce, including a statement of its mandate and interests, supported by timelines for reporting and recommendations, focused on mitigation of associated ML/TF risks and sufficient staffing for regulatory agencies.
- ensure implementation of the AML/CFT regime and effective oversight of the financial sector
- consider approaching development partners for assistance.

[5] See Sahay and others, 2015, "Rethinking Financial Deepening: Stability and Growth in Emerging Markets," IMF SDN/15/08.

26. Integrated financial sector policy making though regular meetings of the RBV, VFSC, FIU and MFEM is recommended.[6] It would allow for inter-institution sharing of information and knowledge to avoid duplication and inconsistency of policy actions between authorities with limited resources.

Authorities' Views

27. The authorities fully agreed with the staff's recommendation about careful monitoring of the banking sector and enhancing financial access. The RBV was closely monitoring individual banks' financial situation to safeguard financial stability. The RBV welcomed the upcoming banking diagnostic assessment to strengthen the banking sector. With the assistance of the PFTAC, the RBV planned to complete a review of its risk-based supervisory approach for banks by June 2019, followed by insurance and other financial institutions. Given limited financial access for MSMEs and households in rural areas and the outer islands, the authorities continue to implement the *NFIS* to promote financial inclusion, while keeping in mind credit risks, especially in the personal sector.

28. The authorities highlighted progress in the financial sector. The FIU, VFSC and RBV noted the substantial amount of new AML/CFT legislation that resulted in Vanuatu's exit from the FATF "grey list." Work continues on implementation, and the authorities welcomed additional technical assistance in this area to assist them achieve the best results most efficiently with scarce resources. They also continue to look at new issues particularly for fintech and AML/CFT and intend to use the resources made available to them by their development partners.

C. Fiscal Policy

29. The fiscal deficit is expected to be around 4 percent of GDP over the medium-term on current policies, requiring further action on revenue mobilization and expenditure prioritization to maintain debt sustainability. The government customarily runs a surplus of domestic revenues over government-funded expenditures. Expenditures prioritize infrastructure, tourism, education and healthcare, based on the *National Sustainable Development Plan 2015 to 2030* (*NSDP*). Nonetheless, the revenue base is limited, depending on VAT, excise taxes, tariffs and hard-to-predict revenues from the ECPs. There is reliance on development partner grants and concessional lending, which is the source of the deficit.[7] The current trajectories are expected to be inconsistent with the 60 percent public-and-publicly-guaranteed (PPG) debt-to-GDP target adopted in 2019.[8]

30. The debt management framework is being strengthened, and the process needs to be completed. The Ministry of Finance and Economic Management's (MFEM) updated debt management strategy is almost complete, with strong rules regarding concessionality. Once

[6] Several countries have adopted this approach, Australia's Council of Financial Regulators being one example. The Council of Financial Regulators comprises the central bank, the prudential regulation authority, the securities commission and the treasury. It meets regularly and publishes minutes of its meetings, discussing a variety of financial sector issues, including prudential policy and regulatory matters.

[7] Table 3 outlines the sources of the difference between the government's favorable domestic net lending versus its debt-expanding overall net borrowing over history and the forecast horizon.

[8] See Annex I for more background on the authorities' new PPG debt-to-GDP target.

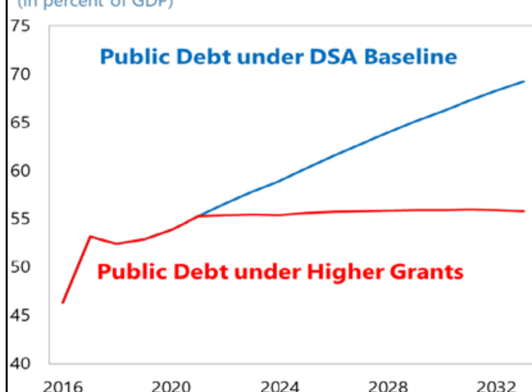
implemented, the strategy will be complemented by regulations that include a technical committee to make policy recommendations to a debt management committee composed of senior government officials. Some regulations might be embedded in law by amending the *Public Finance and Economic Management Act*. Consultation with development partners could strengthen the effectiveness of such emendations.

Staff's Views

31. The success of the debt management strategy is at risk in the medium term without changes in fiscal policy to maintain buffers in the event of potential natural disasters. Public debt rose substantially between 2014 and 2018, from 26.1 percent of GDP to 52.4 percent. While the risk of external debt distress remains moderate according to the joint IDA-IMF Debt Sustainability Analysis (DSA) like last year, it is now attributable to a perceived shift in the speed of accumulation of concessional lending instead of grants, after the November 2018 loan agreement with China. The DSA forecasts the government will breach its 60 percent PPG-debt-to-GDP target in 2025. The government can avoid this by ensuring a sound fiscal path accounting for the role of revenues and spending not just from domestic sources, but also the development partners, which includes better prioritization of proposed projects (often infrastructure). Staff recommends that authorities:

- ***Complete the proposed 2017 tax reforms to increase revenues.*** This includes introducing corporate and personal income taxes and shifting away from less efficient taxes that impede growth (especially those related to trade and government procedures). It broadens the basis for revenues, increasing resilience in the face of shocks, Also, it allows for a more progressive tax system. The VAT is generally a regressive tax, while personal income tax can be calibrated to skew away from low-income earners. A corporate income tax would ease the burden on low-profit-margin firms relative to the current turnover tax.
- ***Stabilize expenditures as a share of GDP.*** Expenditures under the domestically-financed budget are expected to be stable. However, this assumes the authorities follow the suggested path for compensation of employees in the staff's baseline forecast, where compensation only grows with inflation, and does not repeat the government's one-off 2018 level adjustment (which was justifiable, as it occurred after a number of years without any nominal wage increases). In terms of the development-partner-financed budget, the focus should be on the prioritizing financing as discussed in the following two bullet points.
- ***Focus on grants and loans with higher concessionality.*** Larger grants or grant components for concessional financing would help lower the path of the PPG-debt-to-GDP ratio. If the new bilateral financing assumed after 2022 relative to the 2018 DSA were to come from grants rather than concessional lending, the PPG debt target would not be breached, and the PPG-debt-to-GDP ratio would stabilize around 56 percent (figure above).

Vanuatu: Public Debt Financing Scenarios
(in percent of GDP)



Sources: Vanuatu authorities and IMF staff calculations.

- ***Limit and prioritize loans, especially less concessional lending.*** Current criteria for accepting loans focus on their intended use and their concessionality, which is commendable, but preventing the breach of the debt target should be a major criterion. The authorities should prioritize which loans to accept on this basis as well as limit the loans made available to state-owned enterprises (SOEs) or made by the Vanuatu National Provident Fund (VNPF, itself an SOE) as this debt would likely be publicly guaranteed and could lead to a target breach.

32. **An illustrative fiscal reform scenario based on the recommendations above suggests the deficit could be less than 3 percent of GDP** (table below). Tax reform could lead to a sustained revenue increase of around 2.5 percent of GDP.[9] The extra revenue could help achieve a lower deficit, even allowing for -1.0 percent of GDP lower ECP revenues and permanent funding for natural disaster relief of 0.5 percent of GDP.[10] Prioritization of new infrastructure spending to lower concessional borrowing by 10 percent would reduce expenditures around 0.3 percent of GDP. This would stabilize the PPG-debt-to-GDP ratio around 54 percent. Real GDP growth would be somewhat lower for 3 years.

Table. An Illustrative Fiscal Reform Scenario for Vanuatu Starting in 2021

Baseline Scenario	2018	2019	2020	2021	2022	2023	2024	2029
Real GDP growth rate	**3.2**	**3.4**	**3.0**	**2.8**	**2.8**	**2.9**	**2.9**	**2.6**
CPI inflation rate	2.9	2.0	2.2	2.3	2.5	2.6	2.6	2.6
Net lending (+)/borrowing (-)	**4.8**	**-3.2**	**-3.6**	**-4.0**	**-4.1**	**-4.1**	**-4.1**	**-4.3**
Government revenue	35.5	27.9	28.0	28.0	27.8	27.7	27.6	26.8
Taxes	17.9	17.7	17.7	17.7	17.6	17.6	17.5	17.2
Personal / corporate income taxes with offset	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Economic citizenship programs	9.9	2.8	2.6	2.4	2.2	2.2	2.2	2.2
Government expenditure	30.7	31.1	31.6	32.0	31.9	31.8	31.6	31.1
Contribution to National Emergency Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt interest payments	1.0	0.9	0.9	0.9	0.9	1.0	1.0	1.1
Public and publicly guaranteed debt	**52.4**	**52.9**	**53.9**	**55.3**	**56.6**	**57.9**	**59.0**	**65.1**
Fiscal Reform Scenario	2018	2019	2020	2021	2022	2023	2024	2029
Real GDP growth rate	**3.2**	**3.4**	**3.0**	**2.4**	**2.6**	**2.8**	**2.9**	**2.6**
CPI inflation rate	2.9	2.0	2.2	2.3	2.5	2.6	2.6	2.6
Net lending (+)/borrowing (-)	**4.8**	**-3.2**	**-3.6**	**-2.9**	**-2.8**	**-2.8**	**-2.7**	**-2.6**
Government revenue	35.5	27.9	28.0	29.3	29.2	29.1	28.9	28.2
Taxes	17.9	17.7	17.7	20.2	20.1	20.1	20.0	19.7
Personal / corporate income taxes with offset	0.0	0.0	0.0	2.5	2.5	2.5	2.5	2.5
Economic citizenship programs	9.9	2.8	2.6	1.4	1.2	1.2	1.2	1.2
Government expenditure	30.7	31.1	31.6	32.2	32.0	31.8	31.6	30.8
Contribution to National Emergency Fund	0.0	0.0	0.0	0.5	0.5	0.5	0.5	0.5
Debt interest payments	1.0	0.9	0.9	0.9	0.9	0.8	0.8	0.6
Public and publicly guaranteed debt	**52.4**	**52.9**	**53.9**	**54.3**	**54.5**	**54.5**	**54.3**	**54.3**
No national emergency fund contributions	***52.4***	***52.9***	***53.9***	***53.8***	***53.5***	***53.0***	***52.3***	***49.6***

		Direct effect on Deficit:
Assumptions:	Personal and Corporate Income Taxes (with reductions in less efficient taxes) increase government revenues annually	= -2.5 percent of GDP
	Government's concessional borrowing is 10 percent lower	= -0.3 percent of GDP (approximate)
	Lower government annual acceptance rate of applicants for ECPs	= +1.0 percent of GDP (about 50 people)
Optional:	Annual government contribution to the national emergency fund	= +0.5 percent of GDP

Sources: Vanuatu authorities and IMF staff estimates and projections.

33. **The authorities should then aim for a 50 percent PPG debt-to-GDP target.** The lower target would provide an additional buffer, of up to 10 percent of GDP, against fiscal risks from natural disasters, as recommended by the 2018 Article IV consultation.

Authorities' Views

34. **The authorities stressed their commitment to a balanced budget outside of the development partners' operations.** Given limited domestic financial resources, development-

[9] These figures are consistent with the work of the Revenue Committee of the government, published as the *2017 Vanuatu Revenue Review*. Staff have examined this issue before in "Appendix V. Revenue Modernization and Reforms in Vanuatu" in *Vanuatu: 2018 Article IV Consultation*, IMF Country Report No. 18/109 and "Appendix IV. Revenue Modernization in Vanuatu: Building an Effective Tax System" in *Vanuatu: 2016 Article IV Consultation*, IMF Country Report No. 16/336.

[10] For more on the suggested form of the fund for natural disaster relief as a national emergency fund, see Section E, "Addressing Risks from Natural Disasters."

partner-financed infrastructure projects were needed to meet the country's large infrastructure needs. Despite prioritizing grants and loans with a high concessional element, these projects, not domestic recurrent spending, have driven the increase in debt since 2014. The authorities recognized that there would be an upward pressure on maintenance costs for infrastructure going forward on the domestically-funded budget, even with some funding by grants. They also recognized that revenue mobilization, including the introduction of personal and corporate income taxes, may be needed in the future, as ECP revenues were not a stable and sustainable source of income.

35. The authorities underscored their strong commitment to make prepayments to contain debt accumulation and meet debt obligations. They plan to run down their solid cash reserves, which had been accumulated from ECP revenues. They were in the final stage of updating the debt management strategy and finalizing their debt on-lending policy and debt management unit procedure manuals. They agreed with the staff recommendations to focus on grants and high concessional loans to fund infrastructure projects. They remain committed to maintain a grant-element target of at least 35 percent on new loans. They stressed that it will be challenging for the government to provide any guarantee in the near future for borrowing by the SOEs.

D. Structural Policies

36. In response to policy initiatives, there has been increased activity in Vanuatu's largest sectors, agriculture and tourism. The government has introduced modern agricultural methods, worked to restock Vanuatu's cattle, and promoted export growth including through free trade agreements. They will receive grants from the European Development Fund (EDF-11) for enhancing production and value chains for beef, coconut products, and fruits and vegetables, starting with a EUR 3 million allocation. *Shared Vision 2030* has been launched as a cross-sector integrated plan to develop the country's air transportation and tourism sectors (Box 1), at a time when Vanuatu's share in the Pacific's tourism market is falling.

Staff's Views

37. The authorities should continue to promote agricultural diversification. They will receive budget and technical support from the EDF-11 grants. Domestic policy should continue its focus on market access and linking small landowners into stronger marketing cooperatives. There are proposed loans like that from the Israeli private-sector Agriculture and Services Technical Center that should contribute to diversification, but they must be examined within the context of debt sustainability and MFEM's best practices on concessionality of new loans.

38. The diversification strategy should be complemented by further improvements in the business environment. The current simplification of customs procedures at Port Vila is a good example. Similar efforts could be made on regulations for FDI and employment, and bottlenecks when registering property and land titling. These could trigger higher private investment and enhance competition and productivity.

Authorities' Views

39. The authorities have continued to shift their policies to strengthen economic diversification. They recognized that agriculture and tourism activities were critical for medium-term growth and they have formulated initiatives to improve productivity in both sectors. Policies in agriculture focused on diversifying the production chain by using development partner funds such as the EDF-11 and developing their policy frameworks to allow small landowners to have market power through larger cooperatives. The authorities see the Shared Vision 2030 plan for tourism as needed to accelerate momentum and noted that faster growth would also help minimize any related fiscal burden.

E. Addressing Risks from Natural Disasters

40. The authorities have enhanced Vanuatu's resilience to natural disasters, while coping with prolonged volcanic activity. They have strengthened the National Disaster Management Office (NDMO), launched the *National Policy on Climate Change and Disaster-Induced Displacement*. They introduced the *Disaster Risk Management Act 2018* (DRMA) bill to replace the *Natural Disaster Act 2006*, to better involve provincial and municipal participation in the process, facilitate donor-funded disaster assistance and humanitarian aid, and establish a national emergency fund, which has not yet been defined.

Staff's Views

41. The national emergency fund should be the central element of Vanuatu's fiscal framework, carefully designed with stable and substantial funding (Annex VII)**.** The authorities should pass the DRMA bill and provide specific guidelines on the proposed national emergency fund in 2019. The fund should be a multi-year fund that would grow over time, absent of any drawdowns, with an investment strategy focused on safe highly-liquid foreign assets. The authorities could approach its development partners to secure an endowment to which it would annually contribute.

42. The national disaster planning framework has improved substantially in recent years, and this process should continue. The framework has relatively strong planning and tools for public use, which are constantly being developed and improved. Additional measures that could bolster the effectiveness of the framework include:

- Allocating more funds as part of the annual budget prioritization exercise to meet staffing targets and strengthen training at the NDMO.
- Stronger monitoring and evaluation of the framework's performance to uncover further issues to address or possibilities for efficiencies in spending.
- Complementing large domestic buffers with insurance and externally financed instruments, such as contingent credit lines with multilateral partners, and stronger relations with development partners.
- Updating the *Vanuatu National Adaptation Plan for Action 2006*, focusing on investing in and maintaining resilient infrastructure, ensuring the plan is consistent with a multi-year fiscal strategy.

Authorities' Views

43. The authorities underscored the importance of enhancing natural disaster preparedness and investing in resilient infrastructure. They increased the size of contingency provision from 50 million vatu in 2018 to 150 million vatu in 2019 to be able to respond expeditiously to a series of natural disasters. Once the DRMA bill is passed, they intend to consider the design of their natural disaster fund. They were working with the WBG for a development policy grant with a Catastrophe-Deferred Drawdown Option (Cat DDO), a facility that would provide immediate liquidity to the country in the aftermath of a natural disaster. At the same time, they withdrew from a membership of the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI), judging its benefits too limited for the costs to Vanuatu.

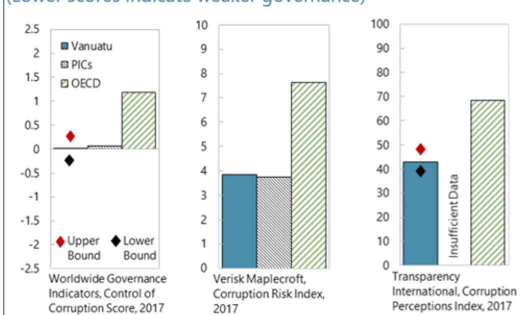
IMPROVING GOVERNANCE AND FOSTERING GROWTH

44. Vanuatu, being a small lower-income state with limited administrative capacity, is vulnerable to corruption from gaps in governance. These gaps leave parts of the economy either without appropriate supervision, or with excess regulation prone to bribery. This report focuses on removing gaps in the areas of revenue administration, central bank governance and AML/CFT. Other gaps include weak PFM practices and procurement practices; overly complex import procedures; and a lack of prudential standards at the RBV for the financial sector, along with broader governance concerns.

45. Vanuatu could foster growth by improving governance. Vanuatu has been strengthening its institutions through funding and technical assistance from its development partners, including the IMF and PFTAC. Recent IMF/PFTAC technical assistance has successfully focused on financial and AML/CFT legislation, tax administration and audit functions. The current focus should continue to be the major public institutions, so that the authorities can provide effective support to the economy.)

Vanuatu: Governance 1/ 2/

(Lower scores indicate weaker governance)



Sources: Worldwide Governance Indicators, D. Kaufman (Natural Resources Governance Institute and Brookings Institutions), and A. Kraay (World Bank), 2017. Verisk Maplecroft's Corruption Risk Index, 2017. Transparency International's Corruption Perceptions Index, 2017.

1/ Use of these indicators should be considered carefully, as they are derived from perceptions-based data. Ranges are for a 90 percent confidence interval. Confidence intervals for peer group averages are negligible.

2/ Confidence intervals are not available for Verisk Maplecroft.

Staff's Views

46. Strengthening the RBV's governance would help ensure the continuation of effective monetary and financial policies that support growth. Central banks that follow best practice have substantial autonomy, and strong internal controls. The 2016 *Safeguards Assessment* made several recommendations on these issues.[11] There has been progress on the internal audit function, and the overall structure of the RBV. However, greater autonomy for the RBV would help ensure continued policy effectiveness and formally guard against political influence by amending the *RBV Act*. Staff recommends continued engagement with PFTAC for internal audit functions and the IMF's Legal Department for the *RBV Act*.

[11] For more on the *2016 Safeguards Assessment*, please refer to the Informational Annex.

47. The ability of government to support growth depends on strong processes and good management of government assets. The authorities could build on work already completed for the budgetary process, with PFTAC and UNDP technical assistance. Tax administration will be strengthened once the introduction of a tax identification number (TIN) regime for individuals and firms under the *Tax Administration Act* is completed. The authorities should complete and pass the *Government Business Enterprises Act* bill, which will be complemented by the upcoming report by MFEM's Government Business Enterprise Unit that will discuss the financial position of, and fiscal risks posed by SOEs. Further staffing and training of that unit, possibly with assistance from Vanuatu's development partners, would support effective monitoring and governance of SOEs going forward. The Machinery of Government Review taskforce has been examining the effectiveness of the government's structure and its performance, looking for further efficiencies and should continue, but not at the expense of pursuing tax reforms.

Authorities' Views

48. The authorities highlighted progress in governance. The RBV noted the restructuring of the units within the bank and improvements in its audit function, line with the *Safeguards Assessment* recommendations. The government should complete this year several legislative efforts that are expected to improve governance. This included completing the new framework for tax administration and governance reform for credit unions and SOEs.

OTHER ISSUES

49. Statistical issues. While broadly adequate for surveillance purposes, large revisions, quality and timeliness remain a concern for some data (Informational Annex). Vanuatu has a National Summary Data Page as part of the e-GDDS, with some work still needed (Annex VIII). Staff recommend that the authorities seek further support from PFTAC and STA on the compilation and development of national accounts statistics and improvements to local technical capacity.

STAFF APPRAISAL

50. Four years after Cyclone Pam struck Vanuatu causing extensive damages, reconstruction is near completion with full recovery in sight. The authorities are now more focused on implementing their broader development plans that were slowed by the rebuilding process, which will require fiscal discipline and some further reforms to maintain debt sustainability. The authorities should continue their constructive engagement with their development partners for technical assistance, capacity development, and concessional and grant-based funding. By doing so, the authorities can continue to press ahead with reforming and strengthening the governance of its institutions and removing vulnerabilities to corruption.

51. The outlook is relatively stable and should be underpinned by continued efforts at economic diversification. Real GDP growth is set to average 3.3 percent from 2018 to 2020, but is expected to be 2.9 percent by 2024, underpinned by diversification in agriculture and tourism. Current agricultural diversification efforts are positive, but the authorities also need to consider domestically-funded agricultural policies beyond reliance on development partner funding. The new integrated air travel and tourism plan *Shared Vision 2030* is expected to drive tourism growth. Risks associated with new debt arising from airplane purchases by Air Vanuatu and optimistic air-travel tourist arrival assumptions make the projected gains increasingly uncertain after 2021. The government must carefully consider the degree of its financial involvement, which also extends to SOEs such as the VNPF, so that the government maintains its debt sustainability, and help maximize the success of the plan, even without full implementation in later years. The diversification strategy should be complemented by improvements in the business environment to trigger private investment and enhance competition and productivity.

52. The monetary policy stance is appropriate. Inflation is expected to stay near the middle of the 0-4 percent target band, as the exchange rate basket peg administered by the RBV remains broadly stable allowing for low inflation from imported goods. Given the downside risks to growth and inflation, RBV should stand ready to ease as needed.

53. There are downward pressures on the external sector. The current strength of the external position is temporary, driven by strong revenues from the economic citizenship programs. Going forward, it is expected there will be a current account deficit averaging 4.0 percent of GDP. This can be mitigated by a stronger fiscal position, discussed below.

54. Building on the recent improvements in the fiscal policy framework, further efforts are needed to safeguard debt sustainability over the medium term. Domestic revenues and government-funded expenditures are projected to be in balance or surplus. Given the strong pipeline of development projects with associated concessional lending, the overall fiscal deficit is expected to be around 4 percent of GDP through 2024, leading to debt exceeding the public-and-publicly-guaranteed-debt-to-GDP target of 60 percent of GDP as of 2025. The government should engage in further fiscal reform, including introducing corporate and personal income taxes while removing inefficient taxes as outlined in the *2017 Vanuatu Revenue Review,* reducing reliance on ECP revenues, and prioritizing the reduction of future borrowing for infrastructure. This should reduce the pressure on public debt, contribute to an external position consistent with fundamentals, and allow for a lower public-and-publicly-guaranteed-debt-to-GDP target of 50 percent.

55. The financial sector is broadly stable but should be carefully monitored because of excess liquidity and vulnerabilities to ML/TF. Most banks are performing well, but some still face some uncertainties over NPLs, capital adequacy. Excess liquidity in the system may be reducing monetary policy effectiveness, but the extent of the excess is unclear. An IMF-led banking sector diagnostic assessment in May 2019 should provide clarification and suggest some possible solutions. Together with ongoing progress in strengthening the AML/CFT framework, this should help maintain correspondent banking relationships and allow for continued progress on financial inclusion. Staff commends the activity of the RBV and the broader financial sector in pursuing the authorities' *National Financial Inclusion Strategy 2018–2023*, which is expected to provide clear gains for financial inclusion. The financial sector's regulatory and legal frameworks should be carefully examined and strengthened to account for increasing fintech use. This would be complemented by the authorities clarifying the mandate and responsibilities of the Distributed Ledger Technology (DLT) taskforce and publicly providing relevant information.

56. The national disaster planning framework has improved substantially in recent years, and further strengthening should focus on meeting future funding demands. The proposed *Disaster Risk Management Act 2018* establishes a national emergency fund. Staff recommends that the fund not just legally enshrine the current year-by-year framework for disaster relief but be used as an opportunity to be establish a multi-year, self-replenishing fund with consistent government funding, possibly with an initial endowment from Vanuatu's development partners. There should also be continued efforts to increase insurance and externally financed instruments.

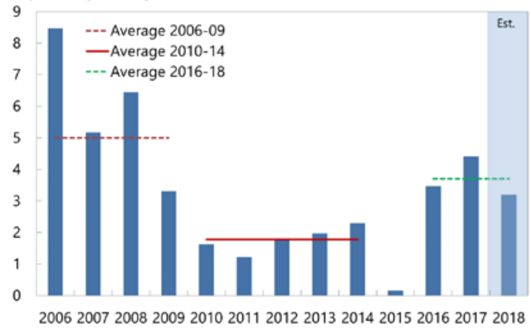
57. Vanuatu, being a small lower-income state with limited administrative capacity, is vulnerable to corruption from gaps in governance. The authorities should focus on strengthening the RBV's autonomy, in line with recommendations from the IMF's *2016 Safeguards Assessment*; and strengthening fiscal governance by completing the *Tax Administration Act* (also a precondition for tax reform) and the *Government Business Enterprises Act* (which also strengthens SOE governance).

58. It is recommended that the next Article IV Consultation takes place on the standard 12-month cycle.

Figure 1. Vanuatu: Reconstruction is Drawing to a Close but Growth Could be Stronger

Growth was strong after Cyclone Pam, but slowed down in 2018…

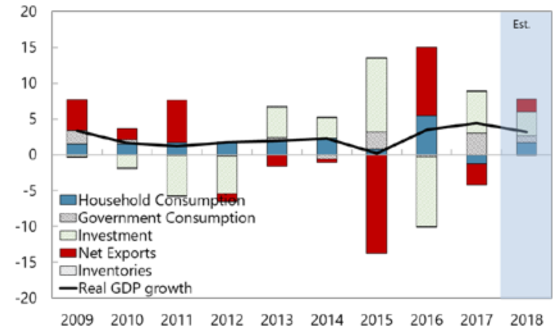
Real GDP Growth, 2006-18
(In percent, year-on-year)



Sources: Authorities; and IMF staff estimates.

Because of weakening private investment and lower growth in government infrastructure investment …

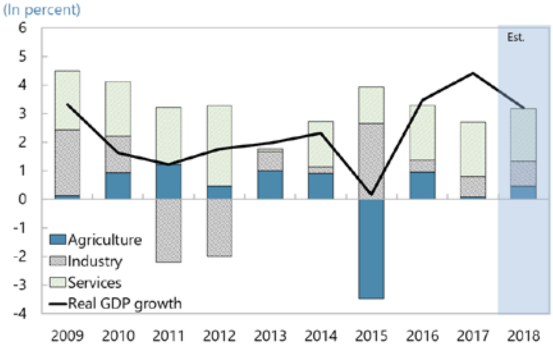
Contribution to Real GDP Growth by Expenditure
(In percent)



Sources: Vanuatu authorities; and IMF staff calculations.

… but with services and industry (lead by construction) holding their strength from a production perspective.

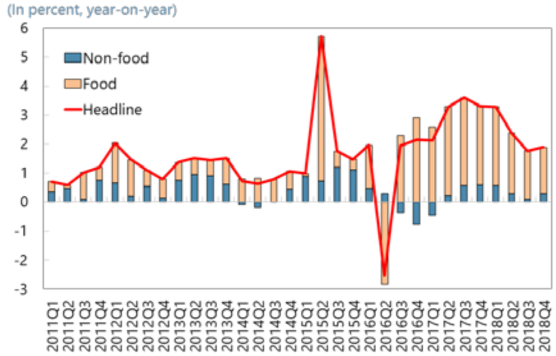
Contribution to Real GDP Growth by Sector 1/
(In percent)



Sources: Authorities; and IMF staff calculations.
1/ Sectors do not add to GDP; excludes effects of taxes and bank charges.

Inflation peaked at 3.4 percent in early 2018 due to the VAT rate increase, and then has decelerated.

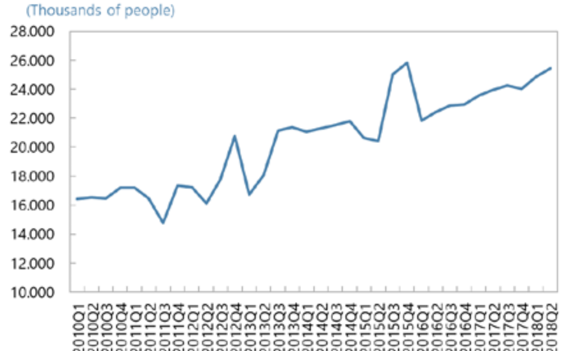
Contribution to Inflation
(In percent, year-on-year)



Sources: Vanuatu authorities; and IMF staff calculations.

Since 2016, formal employment returned to its upward trend, with some softening late in 2017.

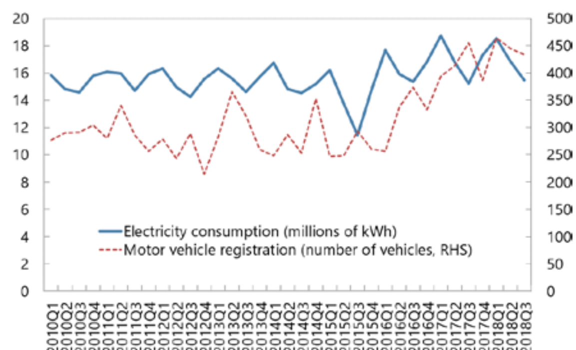
Contributors to Vanuatu National Provident Fund
(Thousands of people)



Source: Vanuatu authorities.

Indicators of private demand recovered after Cyclone Pam but stalled in 2017.

Electricity Consumption and Motor Vehicle Registration

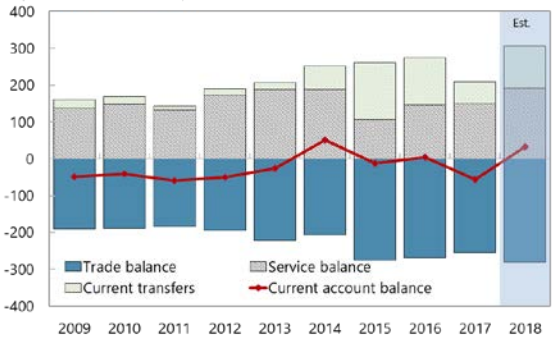


Source: Vanuatu authorities.

Figure 2. Vanuatu: Development Projects Exert Pressure on External Balances While Stimulating Growth

The current account turned into surplus in 2018 from economic citizenship programs ...

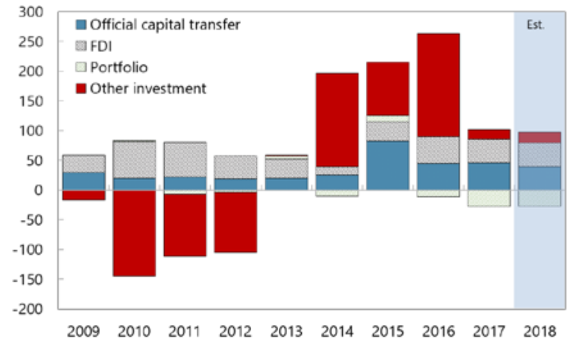
Current Account
(In millions of US dollars)



Sources: Vanuatu authorities; and IMF staff calculations.

... at a time when FDI and other investment have weakened as a source of financing.

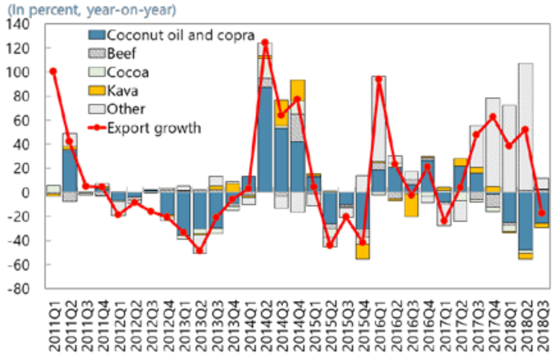
Capital and Financial Accounts
(In millions of US dollars)



Sources: Vanuatu authorities; and IMF staff calculations.

Export growth remains weak as the agriculture sector recovery is still sluggish.

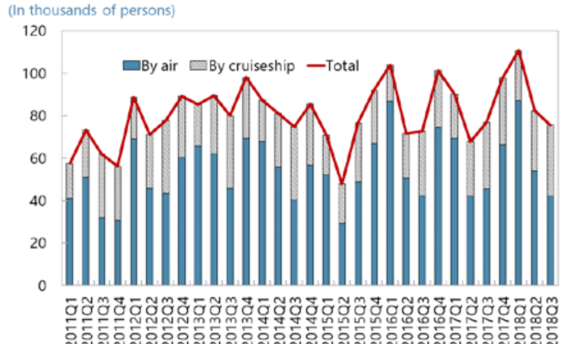
Export Growth
(In percent, year-on-year)



Source: Vanuatu authorities.

After tourism arrivals fell with the delay in the Bauerfield Airport renovation, they should recover in 2019.

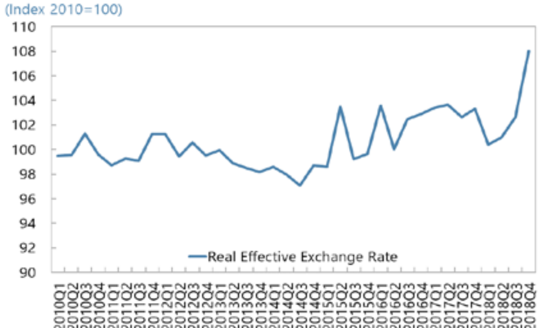
Tourist Arrivals
(In thousands of persons)



Source: Vanuatu authorities.

The vatu depreciated against the U.S. dollar but appreciated against the Australian dollar in 2018.

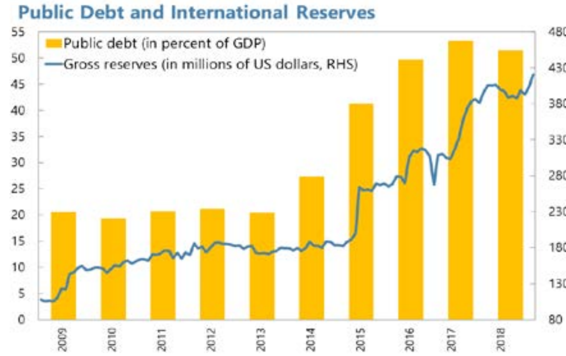
Real Effective Exchange Rate
(Index 2010=100)



Sources: Vanuatu authorities; Bloomberg LP; and IMF staff calculations.

Reserves remain at a comfortable level, but public debt has significantly increased since Cyclone Pam.

Public Debt and International Reserves

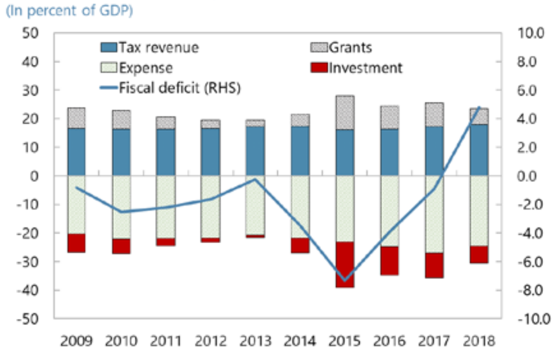


Sources: Vanuatu authorities; and IMF staff calculations.

Figure 3. Vanuatu: Public Finance Needs More Reform While Monetary Policy is Supportive

The fiscal position has deteriorated in the wake of post-Cyclone-Pam financing needs covered by lending…

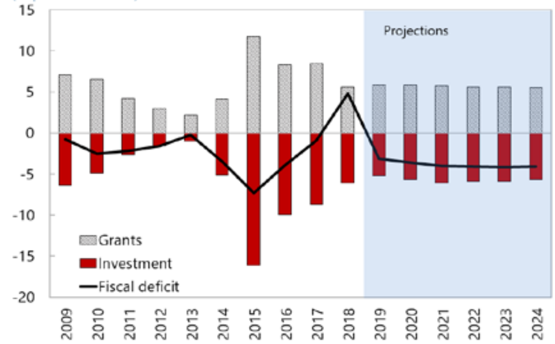
Fiscal Revenue and Expenditure
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff calculations.

.. but the deficits will remain large, as 2018 gains were driven from economic citizenship program revenues…

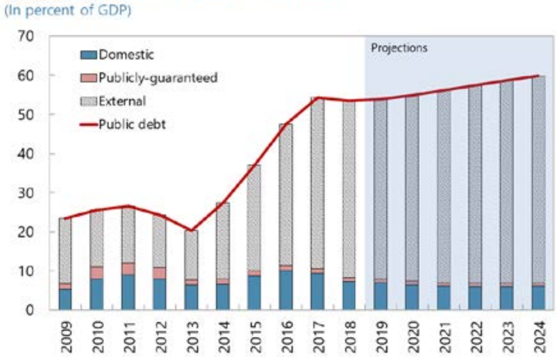
Fiscal Balance
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff estimates.

…and will lead to the continued increase in public sector debt following extra debt repayments in 2018.

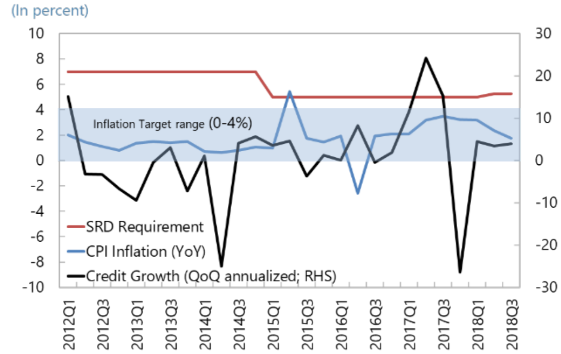
Public and Publicly-guaranteed Debt
(In percent of GDP)



Sources: Authorities; and IMF staff estimates.

The RBV increased the SRD requirement to 5.25 in 2018 to help contain domestic inflationary pressures.

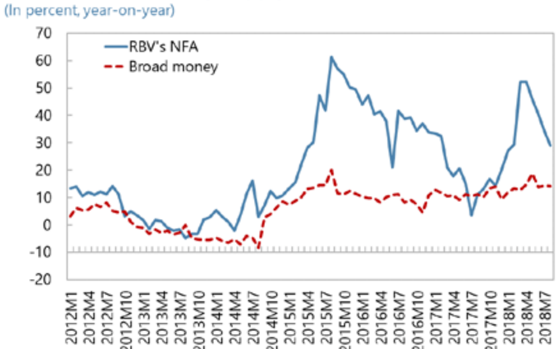
SRD Requirement, Inflation and Credit Growth
(In percent)



Sources: Vanuatu authorities. Note: SRD refers to statutory reserve deposit

Money supply growth his stabilized since the second half of 2015 but RBV's net foreign assets have strengthened.

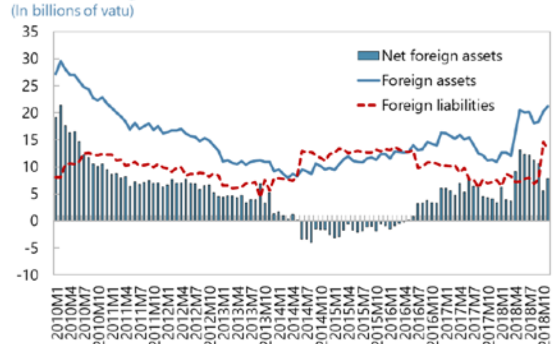
RBV's NFA and Money Supply Growth
(In percent, year-on-year)



Source: Vanuatu authorities.

Net foreign assets of commercial banks turned positive in May 2016 and continued to grow.

Banks' Foreign Assets and Liabilities
(In billions of vatu)

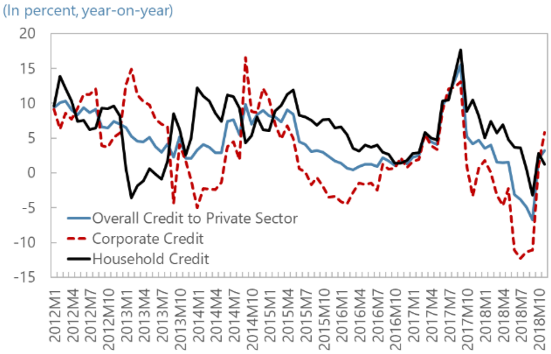


Source: Vanuatu authorities.

Figure 4. Vanuatu: Financial Sector is in Recovery, while Financial Inclusion is Increasing

Private credit growth faltered in mid-2018, after strong increases to both corporate and household sectors in 2017.

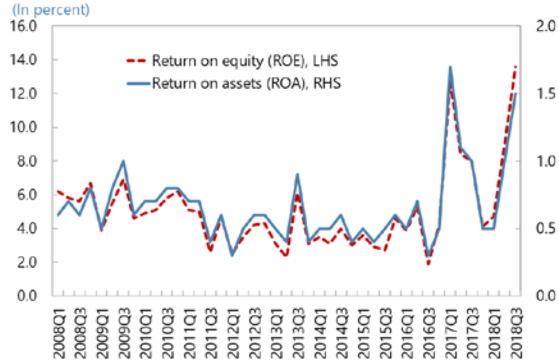
Private Credit Growth
(In percent, year-on-year)



Sources: Vanuatu Authorities

Bank profitability has been weak over the past ten years but began to strengthen in 2017.

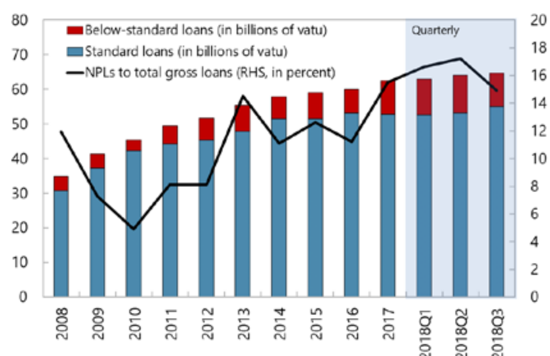
Bank Profitability
(In percent)



Source: Vanuatu authorities.

After Cyclone Pam, increasing NPLs continued into 2017, before showing some signs of stabilizing in 2018.

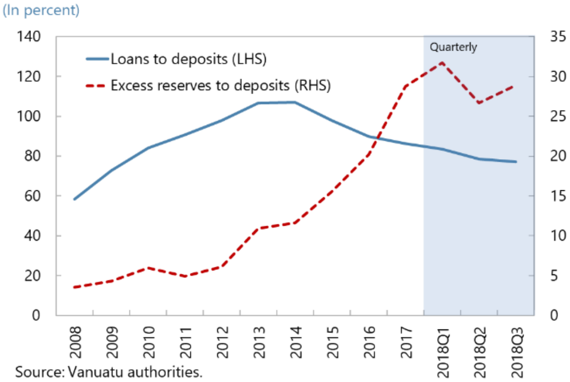
Non-Performing Loans



Source: Vanuatu authorities.

Despite the high loan-to-deposit ratio, overall bank reserves have been growing.

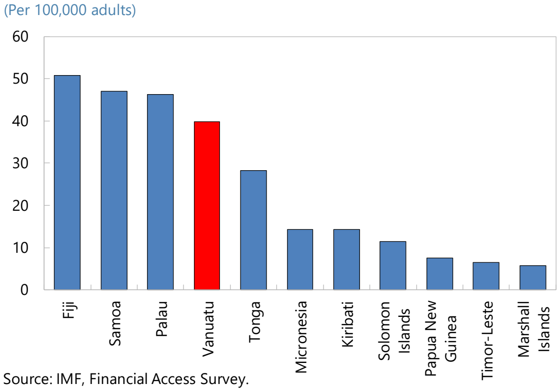
Loan-to-Deposit and Excess Reserve Ratio
(In percent)



Source: Vanuatu authorities.

Financial access of households measured by number of ATMs is moderately high compared to its Pacific peers …

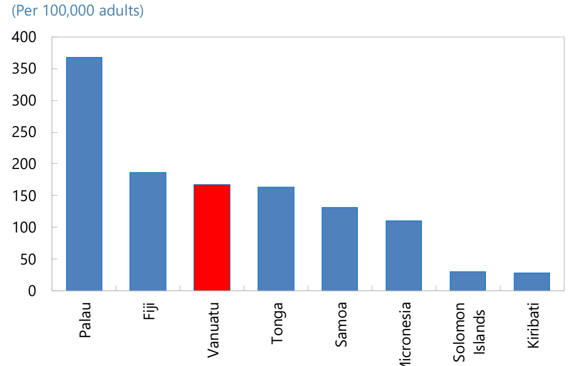
Number of ATM, 2016
(Per 100,000 adults)



Source: IMF, Financial Access Survey.

… and with respect to the number of bank loans.

Commercial Bank Loan Accounts, 2016
(Per 100,000 adults)



Source: IMF, Financial Access Survey.

Table 1. Vanuatu: Selected Economic and Financial Indicators, 2014–21

Population (2017): 278,726 | Per capita GDP (2017): US$3,356
IMF quota: SDR 23.8 million (0.01 percent of total) | Literacy rate (2012): 83.4 percent
Main products and exports: Coconut oil, copra, kava, beef
Key export markets: New Zealand, Australia, Japan

	2014	2015	2016	2017	2018	2019	2020	2021
					Est.	Projections		
Output and prices (annual percent change)								
Real GDP	2.3	0.2	3.5	4.4	3.2	3.4	3.0	2.8
Consumer prices (period average)	0.8	2.5	0.8	3.1	2.9	2.0	2.2	2.3
Consumer prices (end period)	1.1	1.5	2.1	3.3	2.6	2.6	2.2	2.5
Government finance (in percent of GDP)								
Total revenue	23.5	31.9	30.8	34.8	35.5	27.9	28.0	28.0
Taxes	17.4	16.3	16.3	17.1	17.9	17.7	17.7	17.7
Other revenue	2.0	3.9	6.2	7.1	11.9	4.9	4.7	4.5
Grants	4.1	11.8	8.3	8.4	5.6	5.8	5.8	5.7
Expenditure	27.0	39.3	34.7	35.7	30.7	31.1	31.6	32.0
Expense 1/	21.8	23.1	24.8	26.9	24.6	25.8	25.9	25.9
Acquisition of nonfinancial assets 1/	5.1	16.1	9.9	8.8	6.1	5.3	5.7	6.1
Net lending (+)/borrowing (-)	-3.5	-7.3	-3.9	-0.9	4.8	-3.2	-3.6	-4.0
Public and publicly-guaranteed debt (end of period)	26.1	35.9	46.4	53.2	52.4	52.9	53.9	55.3
Domestic	6.6	8.7	10.1	9.4	7.3	6.9	6.4	6.1
External	19.5	27.1	36.2	43.8	45.2	46.0	47.5	49.2
Money and credit (annual percentage change)								
Broad money (M2)	8.6	11.4	10.6	9.3	12.6	10.7	4.8	6.0
Net foreign assets	-14.5	71.6	46.5	11.0	36.5	12.2	3.1	5.0
Domestic credit	9.4	-8.0	-1.3	2.3	-2.3	5.8	5.2	5.4
Of which: Credit to private sector	9.0	1.4	1.3	4.7	3.0	4.1	4.1	4.1
Interest rates (in percent, end of period) 2/								
Deposit rate (vatu deposits)	2.3	2.3	1.6	1.4	1.4	…	…	…
Lending rate (vatu loans)	10.0	10.0	9.9	10.3	10.3	…	…	…
Balance of payments (in percent of GDP)								
Current account	6.2	-1.6	0.5	-6.5	3.5	-1.2	-5.4	-4.8
Trade balance	-25.3	-35.6	-33.6	-29.1	-30.3	-30.4	-34.0	-32.8
Exports of goods	7.8	5.1	6.2	6.9	6.4	6.1	6.1	6.0
Imports of goods	-33.1	-40.7	-39.8	-35.9	-36.7	-36.5	-40.0	-38.8
Tourism receipts	31.6	27.5	23.5	19.3	22.6	24.7	24.5	24.2
Capital and financial account	25.1	41.0	35.7	15.9	7.9	6.5	6.4	6.4
Of which: Foreign direct investment	5.4	5.3	4.4	3.7	4.3	4.2	4.0	3.8
Overall balance	1.2	11.3	3.3	11.8	11.4	5.2	1.0	1.6
Gross international reserves (in millions of U.S. dollars)	179.2	266.3	292.7	396.4	502.4	552.0	562.3	579.0
(in months of prospective G&S imports)	5.2	6.4	7.5	10.1	12.0	13.0	11.8	11.8
External debt service (in percent of GNFS exports)	2.0	2.1	2.1	2.3	5.1	4.1	3.6	3.9
Exchange rates 3/								
Vatu per U.S. dollar (period average)	96.9	107.0	109.3	107.8	108.5	…	…	…
Vatu per U.S. dollar (end of period)	102.5	109.6	113.1	106.5	112.3	…	…	…
Memorandum items:								
Nominal GDP (in billions of vatu)	79.1	82.8	87.3	94.9	100.7	106.3	112.0	118.0
Nominal GDP (in millions of U.S. dollars)	817	774	798	880	928	947	998	1,051

Sources: Vanuatu authorities; and IMF staff estimates and projections.

1/ Does not include consumption of fixed capital (depreciation)

2/ Weighted average rate of interest for total bank deposits and loans.

3/ The vatu is officially pegged to an undisclosed basket of currencies.

Table 2. Vanuatu: Central Government Budgetary Operations, 2014–24[1/]

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Est.	Projections					
					(In millions of vatu)						
Total revenue	18,585	26,424	26,872	33,029	35,755	29,720	31,342	33,018	34,618	36,401	38,218
Domestic revenue	15,308	17,036	20,637	22,964	30,073	23,974	25,037	26,134	27,250	28,701	30,230
Taxes	13,747	13,467	14,231	16,254	18,069	18,810	19,820	20,875	21,953	23,109	24,326
Other revenue	1,561	3,209	5,403	6,711	12,004	5,164	5,217	5,259	5,297	5,592	5,903
Of which: Economic citizenship programs	...	...	3,645	4,731	9,954	3,000	2,937	2,857	2,764	2,918	3,081
Grants from development partners	3,277	9,748	7,238	10,065	5,682	5,746	6,305	6,884	7,368	7,700	7,989
Expenditure	21,336	32,500	30,309	33,893	30,932	33,081	35,385	37,777	39,745	41,829	43,875
Expense [2/]	17,268	19,152	21,629	25,569	24,787	27,488	29,000	30,594	32,392	34,112	35,926
Compensation of employees	8,582	8,893	9,107	9,967	12,540	13,451	14,198	15,007	15,893	16,680	17,506
Use of goods and services	5,185	5,843	5,995	8,374	6,747	7,548	7,954	8,377	8,835	9,326	9,846
Interest payment	573	700	908	973	1,034	948	1,010	1,060	1,179	1,259	1,347
Subsidies	0	0	0	0	0	188	198	208	220	232	245
Grants by central government	2,035	2,530	3,217	2,408	2,465	2,815	2,966	3,124	3,295	3,479	3,672
Social benefits	241	476	1,542	2,649	1,049	1,320	1,391	1,465	1,545	1,631	1,722
Other expense	652	710	860	1,198	952	1,218	1,283	1,351	1,425	1,504	1,588
Acquisition of nonfinancial assets [2/]	4,068	13,348	8,680	8,324	6,144	5,593	6,385	7,183	7,353	7,717	7,948
Gross operating balance [3/]	1,317	7,272	5,243	7,460	10,968	2,231	2,341	2,424	2,226	2,290	2,292
Domestic fiscal balance [4/]	-174	852	2,235	2,294	7,894	1,509	1,581	1,623	1,381	1,397	1,350
Net lending (+)/borrowing (-))	-2,750	-6,076	-3,438	-864	4,823	-3,362	-4,044	-4,759	-5,127	-5,427	-5,656
Net acquisition of financial assets	460	5,682	3,050	2,386	3,384	72	73	73	73	73	73
Net incurrence of liabilities	6,182	7,067	10,599	7,173	2,068	3,434	4,116	4,832	5,199	5,500	5,729
					(In percent of GDP)						
Total revenue	23.5	31.9	30.8	34.8	35.5	27.9	28.0	28.0	27.8	27.7	27.6
Domestic revenue	19.4	20.6	23.7	24.2	29.9	22.5	22.3	22.1	21.9	21.8	21.8
Taxes	17.4	16.3	16.3	17.1	17.9	17.7	17.7	17.7	17.6	17.6	17.5
Other revenue	2.0	3.9	6.2	7.1	11.9	4.9	4.7	4.5	4.3	4.3	4.3
Of which: Economic citizenship programs	...	...	4.2	5.0	9.9	2.8	2.6	2.4	2.2	2.2	2.2
Grants from development partners	4.1	11.8	8.3	10.6	5.6	5.4	5.6	5.8	5.9	5.9	5.8
Expenditure	27.0	39.3	34.7	35.7	30.7	31.1	31.6	32.0	31.9	31.8	31.6
Expense [2/]	21.8	23.1	24.8	26.9	24.6	25.8	25.9	25.9	26.0	26.0	25.9
Compensation of employees	10.8	10.7	10.4	10.5	12.4	12.6	12.7	12.7	12.8	12.7	12.6
Use of goods and services	6.6	7.1	6.9	8.8	6.7	7.1	7.1	7.1	7.1	7.1	7.1
Interest payment	0.7	0.8	1.0	1.0	1.0	0.9	0.9	0.9	0.9	1.0	1.0
Subsidies	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.2	0.2	0.2
Grants by central government	2.6	3.1	3.7	2.5	2.4	2.6	2.6	2.6	2.6	2.6	2.6
Social benefits	0.3	0.6	1.8	2.8	1.0	1.2	1.2	1.2	1.2	1.2	1.2
Other expense	0.8	0.9	1.0	1.3	0.9	1.1	1.1	1.1	1.1	1.1	1.1
Acquisition of nonfinancial assets [2/]	5.1	16.1	9.9	8.8	6.1	5.3	5.7	6.1	5.9	5.9	5.7
Gross operating balance [3/]	1.7	8.8	6.0	7.9	10.9	2.1	2.1	2.1	1.8	1.7	1.7
Domestic fiscal balance [4/]	-0.2	1.0	2.6	2.4	7.8	1.4	1.4	1.4	1.1	1.1	1.0
Net lending (+)/borrowing (-)	-3.5	-7.3	-3.9	-0.9	4.8	-3.2	-3.6	-4.0	-4.1	-4.1	-4.1
Net acquisition of financial assets	0.6	6.9	3.5	2.5	3.4	0.1	0.1	0.1	0.1	0.1	0.1
Net incurrence of liabilities	7.8	8.5	12.1	7.6	2.1	3.2	3.7	4.1	4.2	4.2	4.1
Memorandum items:											
Public and publicly-guaranteed debt	26.1	35.9	46.4	53.2	52.4	52.9	53.9	55.3	56.6	57.9	59.0
Domestic	6.6	8.7	10.1	9.4	7.3	6.9	6.4	6.1	6.0	6.0	6.0
External	19.5	27.1	36.2	43.8	45.2	46.0	47.5	49.2	50.6	51.9	53.0
Of which: RCF/RFI	0.0	3.0	2.9	2.3	1.6	1.1	0.8	0.6	0.3	0.1	0.0
Debt service	2.5	2.6	3.1	3.4	4.4	2.9	3.3	3.0	3.1	3.1	2.2
Of which: External debt service	1.0	0.9	0.9	1.0	2.3	1.9	1.7	1.8	1.9	1.9	1.8
Primary balance	-2.8	-6.5	-7.6	0.1	5.8	-2.3	-2.7	-3.1	-3.2	-3.2	-3.1
Nominal GDP (millions of vatu)	79,109	82,798	87,250	94,887	100,727	106,339	112,048	118,013	124,460	131,388	138,701

1/ Fiscal year corresponds to the calendar year.
2/ Does not include consumption of fixed capital (depreciation).
3/ Gross operating balance is used instead of net, as there is no data on consumption of fixed capital (depreciation).
4/ Defined as domestic revenue minus government-funded expense and acquisition of nonfinancial assets.
Sources: Vanuatu authorities; and IMF staff estimates and projections.

Table 3. Vanuatu: Reconciling the Domestic Budget with the IMF Presentation, 2014–24[1/]

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Est.			Projections			
Domestic budget (excluding development partners)											
					(In millions of vatu)						
Revenue (excluding development partner grants)	15,308	17,036	20,637	22,964	30,073	23,974	25,037	26,134	27,250	28,701	30,230
- Expense (excluding development partners)	15,243	15,765	17,806	19,951	21,700	21,742	22,945	24,214	25,661	27,009	28,432
= Gross operating balance (excluding development partners)	**66**	**1,270**	**2,830**	**3,013**	**8,372**	**2,232**	**2,092**	**1,920**	**1,589**	**1,692**	**1,798**
- Acquisition of non-financial assets (excluding development partners)	240	418	596	720	478	722	761	801	845	892	942
= Net lending/borrowing (excluding development partners)	**-174**	**852**	**2,235**	**2,294**	**7,894**	**1,510**	**1,332**	**1,119**	**744**	**800**	**856**
					(In percent of GDP)						
Revenue (excluding development partner grants)	19.4	20.6	23.7	24.2	29.9	22.5	22.3	22.1	21.9	21.8	21.8
- Expenses (excluding development partners)	19.3	19.0	20.4	21.0	21.5	20.4	20.5	20.5	20.6	20.6	20.5
= Gross operating balance (excluding development partners)	**0.1**	**1.5**	**3.2**	**3.2**	**8.3**	**2.1**	**1.9**	**1.6**	**1.3**	**1.3**	**1.3**
- Fixed assets (excluding development partners)	0.3	0.5	0.7	0.8	0.5	0.7	0.7	0.7	0.7	0.7	0.7
= Net lending/borrowing (excluding development partners)	**-0.2**	**1.0**	**2.6**	**2.4**	**7.8**	**1.4**	**1.2**	**0.9**	**0.6**	**0.6**	**0.6**
Consolidated budget (including development partners)											
					(In millions of vatu)						
Gross operating balance (excluding development partners)	**66**	**1,270**	**2,830**	**3,013**	**8,372**	**2,232**	**2,092**	**1,920**	**1,589**	**1,692**	**1,798**
+ Additional revenues (development partners grants)	3,277	9,389	6,235	10,065	5,682	5,746	6,305	6,884	7,368	7,700	7,989
- Additional expenses (using development partner grants and/or loans)	2,025	3,387	3,823	5,618	3,087	5,746	6,056	6,380	6,731	7,102	7,494
= Gross operating balance (overall)	**1,317**	**7,272**	**5,243**	**7,460**	**10,968**	**2,232**	**2,341**	**2,424**	**2,226**	**2,290**	**2,292**
- Fixed assets (excluding development partners)	240	418	596	720	478	722	761	801	845	892	942
- Fixed assets (using development partner loans)	3,828	12,929	8,084	7,604	5,666	4,871	5,624	6,382	6,507	6,825	7,007
= Net lending/borrowing (overall)	**-2,750**	**-6,076**	**-3,438**	**-864**	**4,823**	**-3,361**	**-4,044**	**-4,759**	**-5,127**	**-5,427**	**-5,656**
					(In percent of GDP)						
Gross operating balance (excluding development partners)	**0.1**	**1.5**	**3.2**	**3.2**	**8.3**	**2.1**	**1.9**	**1.6**	**1.3**	**1.3**	**1.3**
+ Additional revenues (development partners grants)	4.1	11.3	7.1	10.6	5.6	5.4	5.6	5.8	5.9	5.9	5.8
- Additional expenses (using development partner grants and/or loans)	2.6	4.1	4.4	5.9	3.1	5.4	5.4	5.4	5.4	5.4	5.4
= Gross operating balance (overall)	**1.7**	**8.8**	**6.0**	**7.9**	**10.9**	**2.1**	**2.1**	**2.1**	**1.8**	**1.7**	**1.7**
- Acquisition of non-financial assets (excluding development partners)	0.3	0.5	0.7	0.8	0.5	0.7	0.7	0.7	0.7	0.7	0.7
- Acquisition of non-financial assets (using development partners' loans)	4.8	15.6	9.3	8.0	5.6	4.6	5.0	5.4	5.2	5.2	5.1
= Net lending/borrowing (overall)	**-3.5**	**-7.3**	**-3.9**	**-0.9**	**4.8**	**-3.2**	**-3.6**	**-4.0**	**-4.1**	**-4.1**	**-4.1**
Memorandum items:											
Nominal GDP (millions of vatu)	79,109	82,798	87,250	94,887	100,727	106,339	112,048	118,013	124,460	131,388	138,701

1/ Fiscal year corresponds to the calendar year.

Table 4. Vanuatu: Monetary Survey, 2014–21

	2014	2015	2016	2017	2018	2019	2020	2021
					Est.	Projections		
	(In millions of vatu; end of period)							
Net foreign assets	13,908	23,867	34,976	38,818	52,997	59,452	61,293	64,351
Monetary authorities	16,533	24,693	28,876	35,447	44,741	50,314	51,471	53,337
Commercial banks	-2,625	-826	6,100	3,371	8,256	9,138	9,822	11,014
Net domestic assets	44,483	41,193	36,993	39,843	35,578	38,574	41,400	44,502
Domestic credit	56,988	52,415	51,728	52,929	51,686	54,682	57,508	60,610
Claims on government (net)	-1,153	-6,368	-7,913	-9,474	-12,300	-12,227	-12,431	-12,468
Claims on municipalities	91	74	129	108	72	72	72	72
Claims on other sectors	58,050	58,710	59,513	62,296	63,914	66,838	69,868	73,007
Claims on nonfinancial public enterprises	1,303	1,177	1,245	1,269	1,043	1,393	1,743	2,093
Claims on private sector	56,747	57,532	58,268	61,027	62,872	65,446	68,125	70,914
Other items (net)	-12,505	-11,222	-14,735	-13,086	-16,108	-16,108	-16,108	-16,108
Total broad money (M2)	58,391	65,061	71,969	78,661	88,575	98,026	102,693	108,853
Narrow money	28,202	35,468	42,658	46,510	55,483	65,813	71,152	78,400
Currency outside banks	5,532	6,284	7,151	7,832	8,519	16,114	18,718	23,230
Demand deposits	22,669	29,184	35,506	38,678	46,964	49,699	52,435	55,170
Quasi-money	30,189	29,593	29,311	32,150	33,092	32,214	31,540	30,453
	(Annual percentage change, unless otherwise indicated)							
Net foreign assets	-14.5	71.6	46.5	11.0	36.5	12.2	3.1	5.0
Net domestic assets	18.6	-7.4	-10.2	7.7	-10.7	8.4	7.3	7.5
Domestic credit	9.4	-8.0	-1.3	2.3	-2.3	5.8	5.2	5.4
Private sector credit	9.0	1.4	1.3	4.7	3.0	4.1	4.1	4.1
Total broad money	8.6	11.4	10.6	9.3	12.6	10.7	4.8	6.0
Vatu broad money	8.0	15.9	10.8	17.9	6.3	12.1	5.4	6.8
Memorandum items:								
Vatu broad money multiplier	1.8	1.6	1.5	1.6	1.4	1.4	1.3	1.3
Total broad money multiplier	2.1	1.8	1.7	1.7	1.6	1.5	1.4	1.4
Velocity								
Narrow money	3.0	2.7	2.4	2.3	2.1	1.8	1.6	1.6
Vatu broad money	1.7	1.5	1.4	1.4	1.3	1.3	1.2	1.2
Total broad money	1.4	1.3	1.3	1.3	1.2	1.2	1.2	1.1
Reserve money (in millions of vatu)	16,851	20,287	33,093	42,226	45,913	52,235	54,098	56,740
Reserve money (annual percentage change)	9.9	20.4	63.1	27.6	8.7	13.8	3.6	4.9
Credit to private sector (in percent of GDP)	71.7	69.5	66.8	64.3	62.4	61.5	60.8	60.1
Foreign currency deposits (annual percentage change)	7.7	7.2	19.5	8.9	49.8	-2.7	-2.1	-3.4
Foreign currency deposits/total deposits (percent)	16.3	12.6	12.5	4.7	10.6	10.1	9.7	9.1
Foreign currency credit/total credit (percent)	26.5	26.0	27.0	27.0	27.0	29.0	29.0	29.0
Net foreign assets of banks (in millions of U.S. dollars)	-25.6	-7.5	54.0	31.6	73.5	81.4	87.5	98.1
Net foreign assets (in percent of GDP)	17.6	28.8	40.1	40.9	52.6	55.9	54.7	54.5
Nominal GDP (in millions of vatu)	79,109	82,798	87,250	94,887	100,727	106,339	112,048	118,013

Source: Vanuatu authorities, and IMF staff estimates and projections.

Table 5. Vanuatu: Balance of Payments, 2014–24

(In percent of GDP, unless otherwise stated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Est.			Projections			
Current account balance	**6.2**	**-1.6**	**0.5**	**-6.5**	**3.5**	**-1.2**	**-5.4**	**-4.8**	**-4.4**	**-4.1**	**-4.2**
Trade balance	**-25.3**	**-35.6**	**-33.6**	**-29.1**	**-30.3**	**-30.4**	**-34.0**	**-32.8**	**-31.6**	**-30.9**	**-30.5**
Exports of goods (f.o.b.)	7.8	5.1	6.2	6.9	6.4	6.1	6.1	6.0	5.9	5.9	5.8
Domestic exports	5.9	4.7	5.8	6.3	5.9	5.6	5.6	5.5	5.5	5.4	5.4
Re-exports	1.9	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Imports of goods (f.o.b.)	-33.1	-40.7	-39.8	-35.9	-36.7	-36.5	-40.0	-38.8	-37.6	-36.8	-36.3
Services balance	23.1	13.7	18.2	16.9	20.6	23.3	23.1	22.8	22.5	22.3	22.0
Receipts	40.9	37.3	37.0	34.6	38.0	40.7	40.5	40.2	39.9	39.7	39.4
Of which: travel	31.6	27.5	23.5	19.3	22.6	24.7	24.5	24.2	23.9	23.7	23.5
Payments	-17.8	-23.6	-18.8	-17.7	-17.4	-17.4	-17.4	-17.4	-17.4	-17.4	-17.4
Primary income	0.6	0.3	-0.3	-1.2	0.9	0.9	0.9	0.9	0.7	0.6	0.4
Receipts	4.4	4.2	4.1	4.2	5.0	5.1	5.1	5.1	4.9	4.7	4.6
Payments	-3.9	-3.9	-4.3	-5.4	-4.0	-4.2	-4.2	-4.2	-4.2	-4.2	-4.2
Secondary income	7.8	20.0	16.1	7.0	12.3	4.9	4.6	4.3	4.0	3.9	3.9
Official	7.3	19.8	10.9	1.8	2.2	1.8	1.7	1.6	1.5	1.5	1.4
Private	0.4	0.2	1.0	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Capital and financial accounts	**25.1**	**41.0**	**35.7**	**15.9**	**7.9**	**6.5**	**6.4**	**6.4**	**6.1**	**5.9**	**5.8**
Capital account	3.9	10.9	6.0	5.6	4.5	3.5	3.1	2.9	2.7	2.7	2.6
Of which: Official capital transfers (net)	3.1	10.6	5.7	5.2	4.2	3.2	2.8	2.6	2.5	2.4	2.3
Financial account	21.2	30.1	29.7	10.3	3.4	3.0	3.3	3.4	3.3	3.3	3.2
Foreign direct investment	1.7	4.3	5.6	4.5	4.4	4.2	4.0	3.8	3.6	3.4	3.2
Portfolio investment	-1.3	1.3	-1.4	-3.2	-2.9	-2.8	-2.6	-2.4	-2.3	-2.1	-1.9
Other investment	19.3	11.7	21.7	1.9	1.9	1.6	1.9	2.1	2.0	2.0	1.9
Net errors and omissions	**-30.1**	**-28.2**	**-32.9**	**2.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Overall balance	**1.2**	**11.3**	**3.3**	**11.8**	**11.4**	**5.2**	**1.0**	**1.6**	**1.7**	**1.8**	**1.6**
Financing:	**-1.2**	**-8.3**	**-3.3**	**-11.8**	**-11.7**	**-5.9**	**-1.5**	**-1.8**	**-1.9**	**-2.0**	**-1.8**
Change in international reserves (- = increase)	-1.2	-11.3	-3.3	-11.8	-11.4	-5.2	-1.0	-1.6	-1.7	-1.8	-1.6
IMF's RCF/RFI	0.0	3.0	0.0	0.0	-0.3	-0.6	-0.4	-0.2	-0.2	-0.2	-0.2
Memorandum items:											
Gross international reserves	21.9	34.4	36.7	45.0	54.1	58.3	56.3	55.1	53.9	52.9	51.6
In months of prospective imports	3.8	6.4	7.5	10.1	12.0	13.0	11.8	11.8	11.8	11.7	11.5
Net official reserves	21.9	34.4	36.7	45.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross international reserves (with RCF/RFI)	21.9	37.4	39.6	47.7	56.6	60.7	58.7	57.3	56.0	54.8	53.5
In months of prospective imports	4.1	7.7	8.8	10.6	12.6	12.7	12.3	12.2	12.2	12.1	12.0
Exports of goods (annual percentage change)	42.6	-37.6	25.4	21.2	-2.2	-2.0	4.4	4.3	4.5	4.6	4.6
Imports of goods (annual percentage change)	1.5	16.5	1.0	-0.6	7.7	1.5	15.6	2.1	2.2	3.4	4.2
(excluding official transfers)	-1.2	-21.3	-10.4	-8.2	1.4	-3.0	-7.1	-6.4	-5.9	-5.6	-5.6
Exchange rate (vatu per U.S. dollar, period average)	96.9	107.0	109.3	107.8	108.5	...	...	...	...	...	...
Exchange rate (vatu per U.S. dollar, end of period)	102.5	109.6	113.1	106.5	112.3	...	...	...	...	...	...
Public external debt	19.5	27.1	36.2	43.8	45.2	46.0	47.5	49.2	50.6	51.9	53.0
Public external debt service (in percent of GNFS exports)	2.0	2.1	2.1	2.3	5.1	4.1	3.6	3.9	4.1	4.2	4.1
Nominal GDP	817	774	798	880	928	947	998	1051	1109	1170	1236

Sources: Vanuatu authorities; and IMF staff estimates and projections.

Table 6. Vanuatu: Medium-Term Baseline Scenario, 2014–24

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Est.			Projections			
Output and prices (annual percentage change)											
Real GDP	2.3	0.2	3.5	4.4	3.2	3.4	3.0	2.8	2.8	2.9	2.9
Consumer prices (period average)	0.8	2.5	0.8	3.1	2.9	2.0	2.2	2.3	2.5	2.6	2.6
Consumer prices (end period)	1.1	1.5	2.1	3.3	2.6	2.6	2.2	2.5	2.6	2.6	2.6
Government finances (in percent of GDP)											
Total revenue	23.5	31.9	30.8	34.8	35.5	27.9	28.0	28.0	27.8	27.7	27.6
Taxes	17.4	16.3	16.3	17.1	17.9	17.7	17.7	17.7	17.6	17.6	17.5
Other revenue	2.0	3.9	6.2	7.1	11.9	4.9	4.7	4.5	4.3	4.3	4.3
Grants	4.1	11.8	8.3	8.4	5.6	5.8	5.8	5.7	5.6	5.6	5.5
Expenditure	27.0	39.3	34.7	35.7	30.7	31.1	31.6	32.0	31.9	31.8	31.6
Expense 1/	21.8	23.1	24.8	26.9	24.6	25.8	25.9	25.9	26.0	26.0	25.9
Acquisition of nonfinancial assets 1/	5.1	16.1	9.9	8.8	6.1	5.3	5.7	6.1	5.9	5.9	5.7
Net lending (+)/borrowing (-)	-3.5	-7.3	-3.9	-0.9	4.8	-3.2	-3.6	-4.0	-4.1	-4.1	-4.1
Public and publicly-guaranteed debt (end of period)	26.1	35.9	46.4	53.2	52.4	52.9	53.9	55.3	56.6	57.9	59.0
Domestic	6.6	8.7	10.1	9.4	7.3	6.9	6.4	6.1	6.0	6.0	6.0
External	19.5	27.1	36.2	43.8	45.2	46.0	47.5	49.2	50.6	51.9	53.0
Of which: RCF/RFI	0.0	3.0	2.9	2.3	1.6	1.1	0.8	0.6	0.3	0.1	0.0
Balance of payments (in percent of GDP)											
Current account	6.2	-1.6	0.5	-6.5	3.5	-1.2	-5.4	-4.8	-4.4	-4.1	-4.2
Trade balance	-25.3	-35.6	-33.6	-29.1	-30.3	-30.4	-34.0	-32.8	-31.6	-30.9	-30.5
Exports of goods	7.8	5.1	6.2	6.9	6.4	6.1	6.1	6.0	5.9	5.9	5.8
Imports of goods	-33.1	-40.7	-39.8	-35.9	-36.7	-36.5	-40.0	-38.8	-37.6	-36.8	-36.3
Tourism receipts	31.6	27.5	23.5	19.3	22.6	24.7	24.5	24.2	23.9	23.7	23.5
Capital and financial account	25.1	41.0	35.7	15.9	7.9	6.5	6.4	6.4	6.1	5.9	5.8
Of which: Foreign direct investment	5.4	5.3	4.4	3.7	4.3	4.2	4.0	3.8	3.6	3.4	3.2
Overall balance	1.2	11.3	3.3	11.8	11.4	5.2	1.0	1.6	1.7	1.8	1.6
Gross international reserves (in millions of U.S. dollars)	179	266	293	396	502	552	562	579	598	619	638
(in months of prospective G&S imports)	5.2	6.4	7.5	10.1	12.0	13.0	11.8	11.8	11.8	11.7	11.5
External debt service (in percent of GNFS exports)	2.0	2.1	2.1	2.3	5.1	4.1	3.6	3.9	4.1	4.2	4.1
Memorandum items:											
Nominal GDP (in billions of vatu)	79.1	82.8	87.3	94.9	100.7	106.3	112.0	118.0	124.5	131.4	138.7
Nominal GDP (in millions of U.S. dollars)	817	774	798	880	928	947	998	1,051	1,109	1,170	1,236

Sources: Vanuatu authorities and IMF staff estimates and projections.

1/ Does not include consumption of fixed capital (depreciation)

Table 7. Vanuatu: Banks' Financial Soundness Indicators, 2012–18Q3

	2012	2013	2014	2015	2016	2017	2018Q3
Capital adequacy							
Regulatory capital to risk-weighted assets	20.5	18.1	17.6	16.4	19.2	18.0	19.6
Regulatory Tier 1 capital to risk-weighted assets	18.3	15.9	16.7	16.2	16.4	15.6	16.5
Asset quality							
Nonperforming loans net of provisions to capital	12.0	42.5	43.2	69.3	36.5	49.7	42.8
Nonperforming loans to total gross loans	8.1	14.5	11.1	12.6	11.2	15.5	14.9
Earnings and profitability							
Return on assets	0.6	0.4	0.4	0.6	0.5	0.5	1.5
Return on equity	4.3	3.1	3.0	4.6	4.2	4.1	13.6
Interest margin to gross income	46.5	50.1	54.3	49.7	55.3	53.8	57.0
Noninterest expenses to gross income	52.4	46.9	55.2	51.4	54.0	53.5	54.6
Liquidity							
Liquid assets to total assets (liquid asset ratio)	18.8	26.1	23.8	26.2	32.3	35.6	45.0

Source: Reserve Bank of Vanuatu.

Table 8. Vanuatu: SDGs Identified in the National Sustainable Development Plan 2016 to 2030 (Vanuatu 2030)

Key elements identified by the Vanuatu 2030	Corresponding SDGs[1/]	Role of the IMF
I. Society Pillar		>TA on PFM with a particular focus on increased fiscal resilience, transparency and accountability > TA on financial supervision to support financial deepening and inclusion
1. Vibrant cultural identity		
2. Quality Education	4 Quality Education	
3. Quality Health Care	3 Good Health and Well Being	
4. Social Inclusion	5 Gender Equality; 10 Reduced Inequality	
5. Security, Peace and Justice	16 Peace, Justice, and Strong Institution	
6. Strong and Effective Institutions		
II. Environmental Pillar		> Provide analytical and policy framework on how to incorporate the cost of natural disasters and climate change > Coordination with the World Bank Group and development partners
1. Food and Nutrition Security	2 Zero Hunger	
2. Blue-Green Economic Growth	7 Affordable and Clean Energy	
3. Climate and Disaster Resilience	13 Climate Action	
4. Natural Resource Management	6 Clean Water & Sanitation; 14 Sustainable Use of Oceans	
5. Ecosystems and Biodiversity	12 Responsible Consumption; 15 Protect Forests & Ecosystem	
III. Economy Pillar		> Surveillance and policy advice on macro-economic policies > TA on tax administration reform and domestic revenue mobilization > Coordination with the World Bank Group and development partners > Capacity development
1. Stable and Equitable Growth	8 Inclusive Economic Growth & Decent Work	
2. Improve Infrastructure	9 Resilient Infrastructure & Innovation	
3. Strengthen Rural Communities	11 Sustainable Cities & Communities	
4. Create jobs and business opportunities	1 No Poverty; 17 Partnerships for the Goals	

1/ Staff compilation.

Table 9. Vanuatu: Indicators of Capacity to Repay the Fund, 2019–28

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
	Projections									
Total obligations based on existing and prospective credit										
In millions of SDRs	4.5	3.2	1.9	1.9	1.9	1.9	1.0	0.2	0.2	0.2
Principal	4.3	3.0	1.7	1.7	1.7	1.7	0.9	0.0	0.0	0.0
Charges and interest	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
In millions of U.S. dollars	6.4	4.5	2.7	2.7	2.7	2.7	1.5	0.2	0.2	0.2
In percent of gross international reserves	1.2	0.8	0.5	0.5	0.4	0.4	0.2	0.0	0.0	0.0
In percent of government revenue	2.4	1.6	0.9	0.9	0.8	0.8	0.4	0.1	0.1	0.1
In percent of exports of goods and services	1.4	0.9	0.5	0.5	0.5	0.5	0.2	0.0	0.0	0.0
In percent of debt service 1/	10.8	7.8	4.5	4.3	4.1	3.9	2.1	0.3	0.3	0.3
In percent of GDP	0.7	0.5	0.3	0.2	0.2	0.2	0.1	0.0	0.0	0.0
In percent of quota	26.6	18.6	11.0	11.0	11.0	11.0	6.0	1.0	1.0	1.0
Outstanding Fund credit										
In millions of SDRs	10.6	7.7	6.0	4.3	2.6	0.9	0.0	0.0	0.0	0.0
In millions of U.S. dollars	15.1	10.9	8.5	6.1	3.7	1.2	0.0	0.0	0.0	0.0
In percent of gross international reserves	2.7	1.9	1.5	1.0	0.6	0.2	0.0	0.0	0.0	0.0
In percent of government revenue	5.7	3.9	2.9	2.0	1.1	0.4	0.0	0.0	0.0	0.0
In percent of exports of goods and services	3.2	2.2	1.7	1.1	0.7	0.2	0.0	0.0	0.0	0.0
In percent of debt service 1/	25.4	18.9	14.2	9.7	5.5	1.8	0.0	0.0	0.0	0.0
In percent of GDP	1.6	1.1	0.8	0.6	0.3	0.1	0.0	0.0	0.0	0.0
In percent of quota	62.5	45.0	35.0	25.0	15.0	5.0	0.0	0.0	0.0	0.0
Net use of Fund credit (in millions of SDRs)	-4.3	-3.0	-1.7	-1.7	-1.7	-1.7	-0.9	0.0	0.0	0.0
Disbursements	0	0	0	0	0	0	0	0	0	0
Repayments and repurchases	-4.3	-3.0	-1.7	-1.7	-1.7	-1.7	-0.9	0.0	0.0	0.0
Memorandum items:										
Nominal GDP (in millions of U.S. dollars)	947	998	1051	1109	1170	1236	1301	1370	1442	1518
Exports of goods and services (in millions of U.S. dollars)	464	485	508	533	559	588	617	649	682	716
Gross international reserves (in millions of U.S. dollars)	552	562	579	598	619	638	650	660	666	669
Government revenue (in millions of U.S. dollars)	265	279	294	308	324	340	356	373	390	410
Debt service (in millions of U.S. dollars)	59	58	60	63	66	69	70	72	78	83
U.S. dollars/SDR (period average)	1.42	1.43	1.43	1.44	1.44	1.44	1.44	1.44	1.44	1.44

Source: IMF staff estimates and projections.

1/ Total debt service includes IMF repurchases and repayments.

Annex I. Authorities' Responses to Fund Policy Advice

Fund Recommendation	Policy Actions
Fiscal Policy	
Embarking on medium-term fiscal adjustment to address the rising debt and rebuild fiscal buffers. Measures include (i) restraining recurrent spending and (ii) prioritization and selection of public infrastructure projects.	• In 2018, fiscal revenue windfalls from ECPs partially used for debt repayments. • In November 2018, a new concessional loan agreement with China for road construction was reached.
Implement tax reform to introduce personal and corporate income taxes in a timely and orderly manner.	• The authorities plan to revise tax administration bill, which prescribes an introduction of a tax identification number. • The authorities' target of introducing the income tax in 2019 is likely to be missed.
Update the debt management strategy annually to safeguard debt sustainability.	• The authorities will finalize an updated debt strategy in 2019.
An appropriate medium-term fiscal anchor should be considered based on the nominal public and publicly-guaranteed debt-to-GDP ratio in the range of 50–60 percent.	• The authorities adopted a public-and-publicly-guaranteed debt ceiling as 60 percent of GDP. This includes an implicit understanding that there should be a buffer left for responding to natural disasters, which was also only implicit in the Fund recommendation
Monetary Policy	
Tighten its monetary policy stance through a gradual increase of reserve requirements, with due consideration to financial stability.	• In April 2018, the RBV tightened policy by raising the policy rate by 0.05% to 2.9% and the SRD requirement by 0.25% to 5.25%, without any financial stability implications.
A comfortable level of international reserves should be maintained, at above 5 months of imports, to prepare for debt repayment obligations and to provide a buffer against potential external shocks.	• Throughout 2018, foreign exchange reserves continued to remain above 5 months of imports as identified by the External Sector Assessment in the 2018 Staff Report.
Exchange Rate Policy	
Maintain the exchange rate basket peg at the current level for now but be ready to review and adjust the level and composition if external position worsens significantly.	• The basket peg regime has been working well, and the REER has remained roughly stable.
Financial Sector Policy	
Increase access to financial services and ensure inclusive growth.	• In March 2018, the authorities launched the *National Financial Inclusion Strategy 2018-2023*.
Closely monitor individual banks' liquidity situation to secure the stability of financial system and strengthen banking supervision frameworks	• The RBV continued monitoring developments in domestic banking system, including profitability and NPLs.
Accelerate the implementation of the AML/CFT action plan and ensure its legal framework is in line with international standards.	• In June 2018, Vanuatu was removed from the FATF "greylist." • The authorities began looking for assistance from other jurisdictions to put in place a proper legal framework for blockchain and distributed ledger technologies.
Structural Policy	
Support the private sector by improving the ease of doing business to promote diversification.	• Will use E.U. EDF-11 grants for production and processing of beef, coconut products and fruits and vegetables. • *Shared Vision 2030* integrated plan for tourism and air travel.
Natural Disasters and Climate Change	
Enhance preparedness to natural disaster risk by strengthening risk assessment and planning, building buffers, and promoting resilient infrastructure and adequate maintenance.	• In December 2018, the *Disaster Risk Management Act 2018* bill was tabled in Parliament, including the establishment of an emergency fund, to be defined by the MFEM. • In September 2018, the authorities launched the *National Policy on Climate Change and Disaster-Induced Displacement*.

Annex II. External Sector Assessment[1]

In 2018, the external sector position was stronger compared with fundamentals and desirable policy settings. The policy gaps, on net, help improve the external sector position. The external position is driven largely by windfall revenues from the economic citizenship programs, without which the external sector position would have been judged as moderately weaker.

External Balance Assessment[2]

1. **The external balance assessment is based on the revised EBA-lite current account (CA) approach.**[3] Preliminary data for 2018 indicate a large current account surplus compared to previous years and is the focus of this assessment.

2. **The revised EBA-lite methodology using the current account approach estimates an adjusted current account gap of 6.7 percent of GDP in 2018.** This is the gap between the current account norm and the cyclically-adjusted current account surplus. The cyclically-adjusted surplus, in turn, is the actual surplus adjusted to reflect cyclical factors and the fact that a significant share of imports is financed by capital grants, which are insensitive to changes in exchange rates. This approach implies that in 2018 the real effective exchange rate was undervalued as the REER gap is -18.5 percent.

Revised EBA-lite – CA approach	2018 (in percentage)
CA – Actual	3.5%
Cyclically adjusted CA	**3.7%**
CA – Norm	**-3.0%**
Elasticity	-0.4%
CA – Gap (Adjusted)	**6.7%**
of which: policy gap	0.8%
REER Gap (Adjusted)	-18.5%

Source: IMF staff estimates.
Note: All numbers are percentage points of GDP, except for the elasticity and the REER gap, which are expressed in percent.

3. **The policy gap reinforces the adjusted current account gap.** The regression-based model results rely on the private credit growth, the change in official reserves, the share of the overseas population as a proxy of remittance inflows, a control for the health expenditure to GDP ratio and a dummy variable for natural disasters. These all affect intertemporal decisions for savings and investment and the level of the current account deficit. The policy gap positively contributes to the current account surplus and it is driven by Vanuatu's absence of capital controls.

4. **The external position would have been moderately weaker compared with fundamentals and desirable policy settings without the extraordinary revenue windfall from the economic citizenship programs (ECPs) in 2018.** The government received around US$9 million (about 10 percent of GDP) from the ECPs, almost 4 times higher than estimated in the 2018 budget.

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[1] Prepared by Charlotte Sandoz (APD).

[2] See *Methodological Note on EBA-lite* (mimeo). The revised EBA-lite for Vanuatu cannot be calculated using the REER model due to data limitations. Revised EBA-lite does not capture fully the characteristics of small states, hence there is significant uncertainty around the estimates.

[3] As the net international investment position (NIIP) improved in 2018 and debt sustainability is not a concern for the external sustainability in the medium term, the bottom-line assessment only draws from the CA approach. The external sustainability approach, particularly because of the role of rapidly increasing revenues, gives a REER measurement opposite to, and unreconcilable with, the CA approach.

Otherwise, the current account could have fallen to an estimated deficit between 5–6 percent of GDP and a current account gap around -2.5 percent of GDP.

5. **Vanuatu's external sector position is likely to shift over the medium term.** The current account deficit is expected to stabilize around 5 percent of GDP after 2020 as strong revenues from the ECPs are expected to be temporary. The deficit is forecast to be driven by high import demand from public and private infrastructure projects, financed by sustained inflows from remittances, tourism activities, development partners' grants and concessional loans. As there is no major expected change in the policy variables, the external position is expected to be moderately weaker compared with fundamentals and desirable policy settings over the medium term.

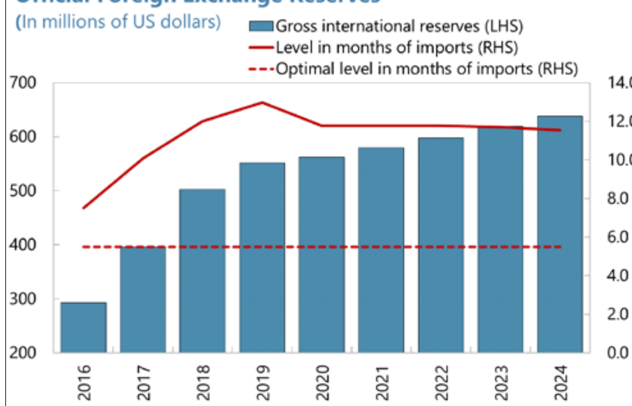
Foreign Exchange Reserves

6. **Vanuatu's gross official reserves stood at US$502 million (around 12 months of imports) in 2018, reflecting grants and FDI for infrastructure projects.** Official reserves grew in 2018 and remained at comfortable levels because of the windfall inflows from the ECPs. They will continue to be strong from external financing even as external debt repayments begin to exert downward pressure in the medium term.

Reserve Adequacy

7. **A cost-benefit analysis on the level of reserves held suggest an optimal level between 4.1 to 5.5 months of imports.** When measured against Vanuatu's vulnerability to external shocks, the adequate level of reserves is estimated to lie in the range of 4.1 to 5.5 months of imports, depending on the probability of a large shock event, based on the sample average of countries (50 percent) and Vanuatu's high vulnerability to natural disasters (75 percent). The staff's estimate for reserve adequacy is somewhat higher than the RBV's objective to maintain enough official reserves to cover at least 4 months of imports. Even if the current need to finance construction-related imports for infrastructure projects and loan repayments exert downward pressure on official reserves, inflows from remittances, tourism, FDI and capital grants are expected to remain strong over the medium term.

Official Foreign Exchange Reserves
(In millions of US dollars)



Sources: Authorities data; and IMF staff calculations and projections.

8. **The latter estimate, however, likely underpredicts the actual optimal level of reserves needed and should be considered a minimum benchmark.** Since Vanuatu is at the upper tail of the distribution of shocks because of a high likelihood of the occurrence of natural disasters, the cross-country comparators may underestimate of Vanutau's reserve needs. For instance, Cyclone Pam in 2015 destroyed between 70 and 80 percent of GDP, corresponding approximately to the total amount of reserves in 2018 or the estimated optimal level of reserves if the probability of a large shock event was 100 percent. In this context,Vanuatu needs extra buffers to cover its external needs for reconstruction and losses in domestic production in the event of natural disasters. This pressures on reserve needs would be less in the presence of the national emergency fund discused in Annex VII.

Annex III. Graduation from the Least Developed Country (LDC) Category[1]

1. Vanuatu was included in the category of the least developed countries (LDCs) in 1985, five years after its independence. The LDC category was established by the United Nations' General Assembly in 1971 for developing countries, which were characterized by a low level of income and structural impediments to sustainable development and require special measures to deal with those problems. The LDC category allows the country to access certain international support measures, such as access to concessional finance and preferential market access. As of 2018, 47 countries were included in the category. Five countries have graduated – Botswana, Cabo Verde, Equatorial Guinea, Maldives and Samoa. The graduation of LDCs is based on meeting any two of three criteria in two consecutive triennial reviews: 1) GNI per capita of US$1,230 or above; 2) a Human Asset Index rating of 66 or above; and 3) an Economic Vulnerability Index rating of 32 or above.

2. Vanuatu is scheduled to graduate from the LDC category in December 2020. At the 2015 triennial review, it was decided that the country would graduate from the LDC category in December 2017. However, in December 2015, the United Nations decided to extend the preparatory period before graduation by three years until December 2020 because of the economic disruption caused by Cyclone Pam in March 2015. At the 2018 triennial review, Vanuatu still met all three criteria.

Vanuatu: LDC Criteria Indicators

	Criteria	2014	2015	2016	2017	2018
GNI per capita (US$)	1,230	2,869	3,011	3,092	3,070	3,014
Human Asset Index	66	79.2	78.9	78.7	78.5	78.5
Economic Vulnerability Index	32	46.6	46.3	46.1	47.1	47

Source: Monitoring of Graduated and Graduating Countries from the LDC Category: Vanuatu

3. The impact of graduation on bilateral and multilateral cooperation is likely to be limited. Bilateral development partners generally consider not only the LDC category, but other factors including historical and cultural ties, diplomatic relations, and their own national policies, to determine grant allocation. Australia and New Zealand have recently embarked upon programs of enhanced engagement with the Pacific small states. China has also strengthened its economic ties with Vanuatu under the Belt and Road Initiatives. International institutions, such as the IMF, the WBG, and the ADB, do not use the LDC category itself as a determinant, while the IDA uses GNI per capita to determine eligibility for their funds. Vanuatu's GNI per capita in 2018 is US$3,014, higher than the established threshold of US$1,145 in 2019, but the Small Island Economies Exception will allow the country to continue to have access to IDA resources at concessional terms, despite graduation.[2] Recently, both IDA and ADB have scaled up their financing to the Pacific island states.

[1] Prepared by Hidetaka Nishizawa (APD).

[2] In 1985, the World Bank's Board approved the Small Island Economies Exception in recognition of small islands' special characteristics (of size, remoteness, etc.). Currently, 15 middle-income small island states have access to IDA

4. There might be some impact of graduation on preferential market access. The graduation might affect the duty-free quota-free market access, which some developed countries grant to Vanuatu under their Generalized System of Preferences (GSP) schemes, leading to higher tariffs on the country's main exports such as fish, coffee, beef, kava, copra and cocoa. However, Vanuatu can continue to access to benefits of the UN's Enhanced Integrated Framework (EIF) automatically for three years after graduation, which should aid a smooth transition.[3]

5. Even after the graduation, Vanuatu can access markets in Australia and New Zealand for most products on a preferential basis. This currently the case under the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA). This one-way agreement will be replaced by the Pacific Agreement on Closer Economic Relations (PACER Plus), a reciprocal arrangement, which maintains this market access but obliges the Pacific island signatories to reduce import tariffs over time.[4] The PACER Plus includes a delayed tariff reduction schedule for LDCs. While tariffs in non-LDCs must fall to zero by 25 years after the calendar year of the date of entry into force of PACER Plus, tariff reductions in LDCs begin in the 11th calendar year. PACER Plus states that in the event of graduation, the first year for tariff reductions will be the calendar year following the date of a country's LDC graduation – potentially 2021 in the case of Vanuatu if PACER Plus were to enter into force by 2020. In that case, most tariffs would have to reach zero by 2031 and tariffs on all goods would have to be removed by 2046.

6. Vanuatu can learn from the experience of Samoa. Samoa successfully graduated from the LDC status in January 2014. Samoa has been receiving support for a smooth transition from its trading partners and development partners. For example, the EU provided a transition period for the its duty-free, quota-free "Everything, but Arms' arrangement until 1 January 2019, after which normal tariffs will apply.[5] China granted a three-year transition period from duty-free treatment. The EIF provided support for trade facilitation and implementation of institutional reforms for the trade, commerce and manufacturing sectors.

7. The government has been participating in the graduation process, but more remains to be done. The government established the National LDC Coordinating Committee to prepare for the smooth transition strategy in 2017, but limited progress has been made. The government is encouraged to start bilateral discussions with its main trading partners.

under the Exception, including Vanuatu. Small country loan terms are 40 years of maturity, a 10-year grace period, and an interest rate of 0.75 percent.

[3] The EIF is a multi-donor program which supports LDCs to increase their participation in the international trading system by strengthening trade institutions and building capacity and country ownership needed to roll-out coordinated trade and development assistance.

[4] PACER Plus is a comprehensive free trade agreement covering goods, services and investment. PACER Plus opened for signatures in June 2017, and has been signed by Australia, New Zealand and 9 Pacific island states (Cook Islands, Kiribati, Nauru, Niue, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu). Australia and New Zealand have ratified it, but other signatories are working towards ratification. The PACER Plus will come into force 60 days after being ratified by an eighth signatory.

[5] Samoa completed its accession to the EU's comprehensive *Economic Partnership Agreement for Pacific Countries,* joining Fiji and Papua New Guinea. The agreement is intended for all Pacific island states. Solomon Islands and Tonga have moved towards negotiating accession agreements.

Annex IV. Risk Assessment Matrix[1]

Likelihood	Impact		Policy Response
Medium	**High** **1. Positive spillovers from large infrastructure projects** The implementation of major infrastructure projects, including Port Vila Urban Development project and inter-islands shipping facilities, could have positive spillovers into the economy from 2019 onwards.	**Upside**	• Take advantage of upside surprises to lock in an improvement in fiscal buffers and to foster sustainable medium-term growth. • Use some of the gains to invest in resilient infrastructure.
Medium	**Medium** **2. Higher-than-expected revenues from ECPs** There could be more applications and stronger revenues than MFEM's forecasts.	**Upside**	• On an annual basis, use excess ECP revenues annually as national emergency fund contributions up to a threshold (such as 1 percent of GDP) and devote the remainder to reducing public sector debt.
Low	**Medium** **3. Stronger-than-expected growth in the tourism sector** New development-partner-financed projects are under discussion: Luganville Urban Development Project, Port-Vila Urban Development Project II, Integrated Outer Island Transport and Pacific Sustainable Tourism Project. Air Vanuatu, VTO and Airports Vanuatu Ltd have ambitious expansion strategies dubbed '*Shared Vision 2030*.'	**Upside**	• Assess the economic and environmental sustainability of development plans. • Continue to promote cooperation among public and private partners as in *Shared Vision 2030*. • Stimulate investment by improving business environment through improved regulation and facilitating credit provision.
High	**High** **1. Natural disasters and climate change** Vanuatu faces many natural disasters, including tropical cyclone, earthquakes, floods, and volcanic activity. Climate change is likely to alter weather and precipitation patterns, raise sea levels and increase the intensity and frequency of some types of natural disasters.	**Downside**	• Build greater resilience to natural disasters by enhancing adaptation measures (better infrastructure, territorial planning, fiscal buffers). • Improve disaster response planning with more swift coping mechanisms. • Seek global/regional climate financing opportunities.
High	**High** **2. Delays in implementation of infrastructure projects** The delays in implementation of major infrastructure projects could have negative spillovers into the economy.	**Downside**	• Prioritize public investment project selection and implementation. • Stimulate private sector investment by improving business environment and facilitating credit provision.
High	**Medium** **3 Unstable revenues from ECPs** Stronger revenues could motivate delays in tax reform, while weaker could lead to a larger fiscal deficit.	**Downside**	• Continue to push ahead on tax reform and maintain the current prudent approach to forecasting and spending the ECPs' excess revenues.
Medium	**High** **4. Poorly-timed implementation of tax reform** Introduction of personal and corporate income taxes without proper preparation would cause disturbances in the economy with contractions in household consumption and business investment. But extended delays could also lead to weaker-than expected social spending or higher-than-expected levels of public debt.	**Downside**	• Seek TA from the IMF on the implementation of tax reforms to secure the expected revenue return and fairness of tax system. • Pass enabling legislation in a timely fashion, preferably in 2019.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Nonmutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Medium	**High** **5. Weaker-than-expected global growth, especially China and Australia** A decline in exports and tourism receipts by an economic slowdown in China and/or in Australia would worsen the current account balance. It would also reduce fiscal revenue and weaken the reserves buffer.	• Accelerate infrastructure investment where possible to stimulate short-term domestic demand and improve long-term competitiveness • Facilitate diversification by introducing new activities and expanding into new markets.
High	**High** **6. Rising protectionism and retreat from multilateralism** Weaker global and regional growth could result, with outcomes for Vanuatu being like that of the risk above (weaker-than-expected global growth).	• Accelerate infrastructure investment where possible to stimulate short-term domestic demand and improve long-term competitiveness • Facilitate diversification by introducing new activities and expanding into new markets. • Engage in regional multilateral deals to offset loss of support from the global system.
Medium	**Medium/High** **7. Large swings in energy prices.** Sharp swings in the energy prices could drive up inflation, causing a slowdown in lending activity and output. Rising energy prices would worsen the current account, drain the economy of foreign exchange reserves, and dampen consumption and investment.	• Expand domestic power sources where available, such as hydroelectric and geothermal (for some islands). • Expand efforts to deepen and develop the financial sector and improve the monetary transmission mechanism to assist the foreign exchange market. • Diversify the export base to support the current account.
Medium	**Medium** **8. Sharp tightening of global financial conditions** Continued strengthening of the U.S. dollar may pose challenges to effective management of the basket peg, which may exacerbate real exchange rate appreciation and lead to eroding competitiveness.	• Short-term: Authorities should continue with the basket currency peg. • Medium term: Consider changes to basket currencies and weights if the underlying fundamentals worsen.
Medium	**Medium** **9. Reduced financial services by correspondent banks (de-risking)** De-risking could have a significant impact on money transfer operator and banks, increasing the cost of inward remittances.	• Follow recommendations of banking diagnostic assessment. • Ensure timely financial reporting, meet AML/CFT ownership reporting requirements, improve banking regulation and supervision to mitigate risks. • Continue to strengthen the AML/CFT framework and tax transparency in line with the international standards through TA from development partners.

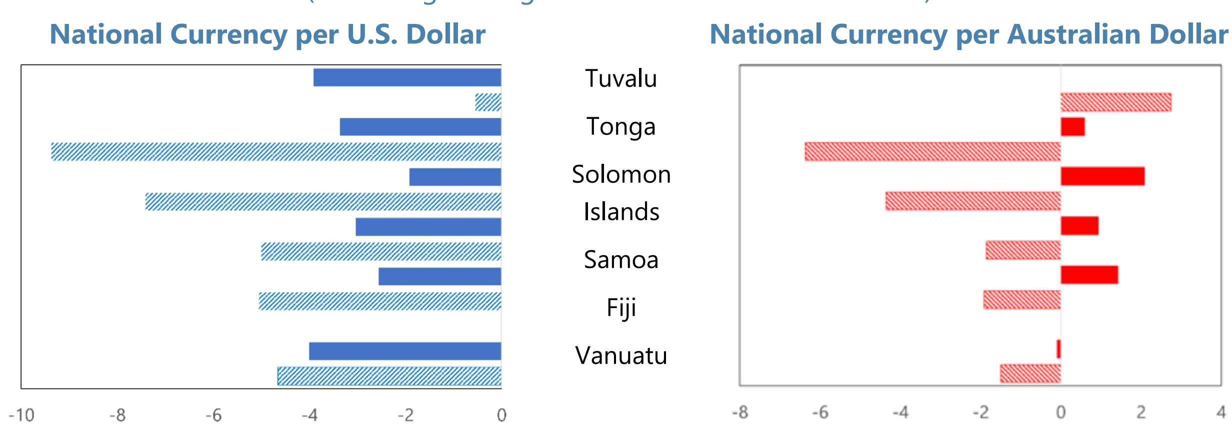
Annex V. An Update on Exchange Rate Issues: Competitors and Sectors[1]

1. This annex updates previous analysis on exchange rates for Vanuatu and its Pacific island small state competitors in international markets. Vanuatu continues to exhibit relatively stable effective exchange rates in comparison to other Pacific island small states, and across different sector-based weighting schemes for its real effective exchange rates (REERs). Nonetheless, that stability may be somewhat disadvantageous for tourism, and to a lesser extent, agriculture, two of its largest sectors not related to development partner activity (such as construction, the largest sector).

2. Notable exchange rate fluctuations with main trading partners' currencies is not exclusive to Vanuatu. Most Pacific island small states, whom compete against one another in the tourism industry, have experienced some degree of depreciation of their currency against the U.S. dollar, and appreciated against that of Australia (except Tuvalu and Vanuatu). For Vanuatu's tourist sector, the Australian dollar is a better indicator than the U.S. dollar – Australia accounts for roughly 54 percent of tourist arrivals after Cyclone Pam. The Vanuatu vatu has slightly depreciated in both nominal and real terms against the Australian dollar unlike the other currencies, so Vanuatu is more competitive for Australians looking to go abroad and may be a more favored destination. Tourist arrivals have also been responding positively to other factors since Cyclone Pam such as the renovation of Bauerfield International Airport and the general improvement in tourist-related infrastructure in Port Vila and Luganville.

Exchange Rates with U.S. and Australian Dollars

(Percentage change between 2018H2 and 2016H2)



Sources: National Authorities and IMF staff calculations

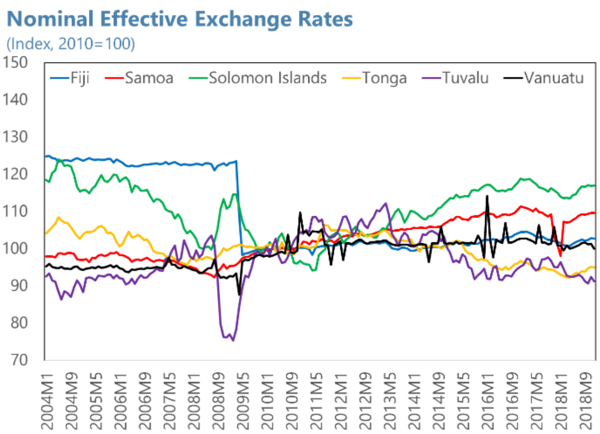
Note 1: An increase indicates an appreciation

Note 2: Dark color indicates a real bilateral exchange rate; light color indicates a nominal bilateral exchange rate

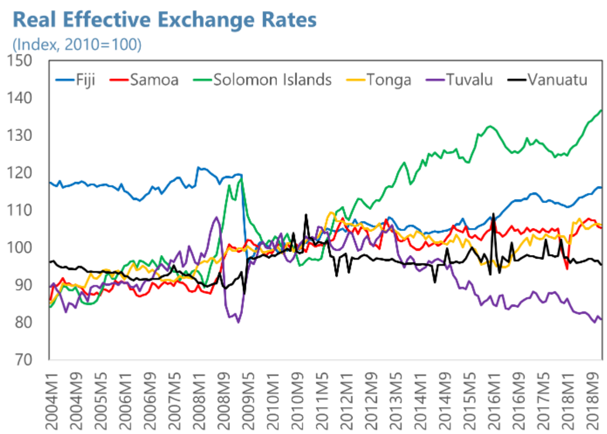
More generally, if the effective exchange rates are compared across Pacific island small states, Vanuatu's REER seems to be broadly stable over time (shown in black). Most of the others, except Tuvalu, are appreciating relative to Vanuatu, leaving Vanuatu more competitive against its peers in broader markets, making their exports more attractive to most of its trading partners. The REER is

[1] Prepared by Dirk Muir (APD) based on "Appendix VIII. Exchange Rate Issues: Competitors and Sectors" in *Vanuatu: 2016 Article IV Consultation*, IMF Country Report No. 16/336 by Ricardo Marto (RES).

also more relevant for the agricultural sector, as agricultural exports are dispersed across many countries – Australia accounts for only 18 percent (over the 2010-2015 period) with over half covered by other Asian and Pacific economies (Philippines, Malaysia, Japan, New Caledonia, Fiji, and Papua New Guinea). The behavior of Vanuatu's REER relative to other Pacific islands can work in favor of its agricultural sector.

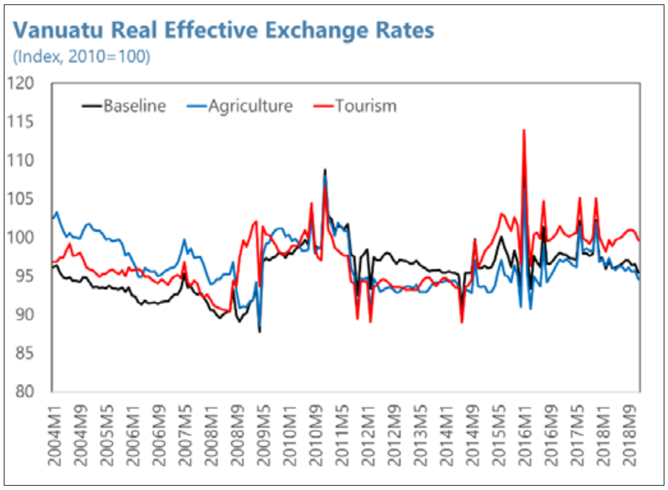


Sources: National authorities and IMF staff calculations.
Note: An increase indicates an appreciation



Sources: National authorities and IMF staff calculations.
Note: An increase indicates an appreciation.

3. A sectoral decomposition of the REER can help illustrate the competitiveness challenges faced by certain sectors.[2] To assess price competitiveness in a specific sector, weights of the REER can reflect sectoral measures (such as trade flows or other quantity measures), while inflation can be expressed in terms of a subset of its components. With data availability as a constraint, we compute alternative specifications of the REER assuming weights are implied by tourist arrivals (2016–18) and agriculture exports (2005–15). Within Vanuatu's economy, the tourism sector has faced a price competitiveness loss since 2014, while agriculture producers were less affected by exchange rate fluctuations than what the baseline REER suggests into mid-2017, after which point the agricultural sector more or less tracks the baseline REER.



[2] The REER is a function of a weighted average of indexed nominal bilateral exchange rates and inflation differentials. There are several measures of aggregate price fluctuations, such as the consumer price index, wholesale or producer price index, GDP deflator, or unit labor costs, and weights can be underpinned by trade flows in goods or goods and services. For the baseline scenario, inflation differentials are based on consumer price indices and weights in Vanuatu's effective exchange rates are based on 2013 trade flows – common practice in the IMF's Information Notice System when calculating any country's effective exchange rates.

Annex VI. Excess Liquidity and the Effectiveness of Monetary Policy in Vanuatu[1]

1. **Vanuatu has rapidly accumulated liquid reserves in the recent years.** It likely reflects the easing of monetary policy and subdued economic conditions starting with the GFC around 2009 (RBV 2017). In 2018, strong revenue inflows from the economic citizenship programs (ECPs) have bring up additional liquidity in the banking system as open market operation were insufficient to sterilize them. The large increase in the RBV balance sheet might reveal a liquidity overhang that has weakened the monetary policy transmission mechanism. Even if inflationary pressures seem well contained and liquidity well managed in the short term, excess liquidity remains a long-standing problem in Vanuatu.

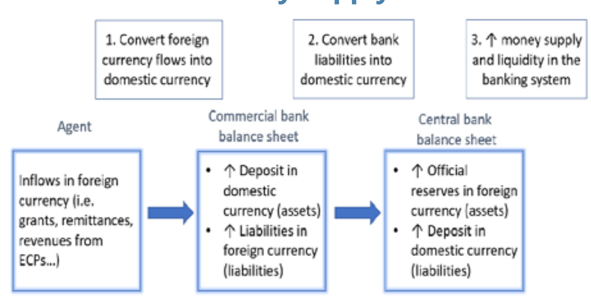
2. **This annex aims to examine the issues around excess liquidity in Vanuatu.** The first section defines concepts around the purposes of reserves held in the banking sector and about liquidity. The second section looks at the measurement of reserves and liquidity, just not in Vanuatu, but in a boarder set of Pacific island states as well. The third section links liquidity issues with monetary policy, both in general and in Vanuatu. The fourth section explores the specific example of Fiji. This motivates the final section's policy choices and recommendations for Vanuatu.

Defining Excess Liquidity and Associated Concepts

3. **When discussing Pacific island states, excess liquidity is considered below as a subset of another concept, that of free reserves.** Free reserves are the presence of more liquid reserves than are required to meet central bank obligations and lending. Many Pacific island states have issues with large amount of free reserves, as is the case with Vanuatu.

4. **Free reserves have two common causes, both relevant for Vanuatu.** Many small states, especially in the Pacific, are dependent on remittances from nationals working abroad and transfers from international development partners. The flows from export receipts, FDI and grants are then converted into local currency. When the central bank converts foreign currency inflows into domestic currency, this registers as increase in its official reserves in foreign currencies on the asset side of its balance sheet, and a rise in the deposits of commercial banks in local currency on the liability side. Therefore, the expansion of central bank's balance sheet mechanically creates a high level of liquidity in the banking system.

Inflows in Foreign Currencies and Domestic Money Supply



Source: IMF staff.

5. **The central bank may offset some of the free reserves held by banks through a statutory reserve deposit (SRD) requirement.** The total amount of commercial banks' reserves at

[1] Prepared by Charlotte Sandoz (APD).

the central bank gives the overall level of liquidity in the banking system. The central bank can require commercial banks to hold a defined share of their liabilities for monetary policy purposes in their central bank accounts. This freezes at least some portion of commercial banks' free reserves and reduces liquidity in the banking system (Keister and McAndrews 2009). This is a common practice in many Pacific island states, including Vanuatu.

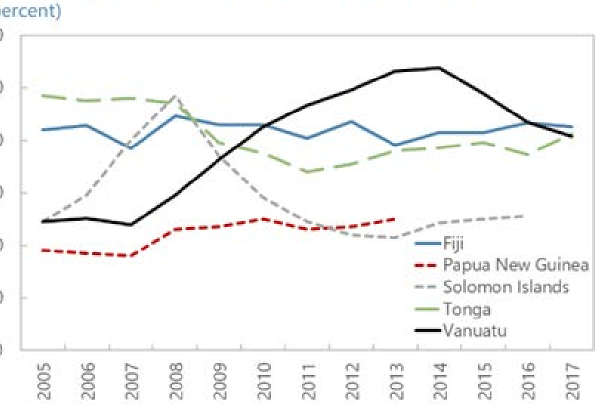
6. **Free reserves can be further decomposed into two categories.** There are: (i) voluntary reserves held by commercial banks for precautionary motives (self-insurance), (ii) excess liquidity because of the lack of other liquid and investment opportunities consistent with a bank's risk appetite. The level of voluntary reserves depends on banks' risk appetite and the ease of liquidating non-reserve assets. From the point of view of monetary policy, a rise of voluntary reserves is not an issue, unlike excess liquidity in the banking system (Darvas and Pichler 2018).

Measuring Free Reserves and Excess Liquidity in the Small States of the Pacific

7. **Liquidity has significantly risen in the small states of the Pacific since the GFC.** Since 2008, Fiji, Papua New Guinea, Tonga and Vanuatu have been holding reserves significantly above their national regulatory requirements, with high proportions of assets in liquid form.

8. **Vanuatu had the highest loan-to-deposit ratio in the region on average between 2009 and 2016.**[2] During that period, its loan-to-deposit ratio rose from 73 percent to 107 percent. In many Pacific island states, foreign-owned banks usually provide a limited amount of loans to domestic private sector as there are few projects with low risk. In the case of Vanuatu, the situation is different. The domestic-owned bank (National Bank of Vanuatu, NBV) provides loans to a large set of clients and promotes financial inclusion, which helps explain the high level of Vanuatu's loan-to-deposit ratio. More data would be useful to assess the distribution of liquidity among domestic banks and determine if banks behave differently according to ownership.

Loan-to-Deposit Ratio for Selected Pacific Islands
(In percent)



Sources: Central bank prudential data

9. **Given the high number of nonperforming loans in Vanuatu, it should be expected that banks would hold higher-than-normal ratios of liquid assets for self-insurance.** Before Cyclone Pam, nonperforming loans rose from 7.3 percent to 12.6 percent of total gross loans, while the share of liquid assets to total assets in domestic banks followed the same trend and grew from 16.5 percent to 26.2 percent. Poorly-implemented financial inclusion leading to lower ability to repay

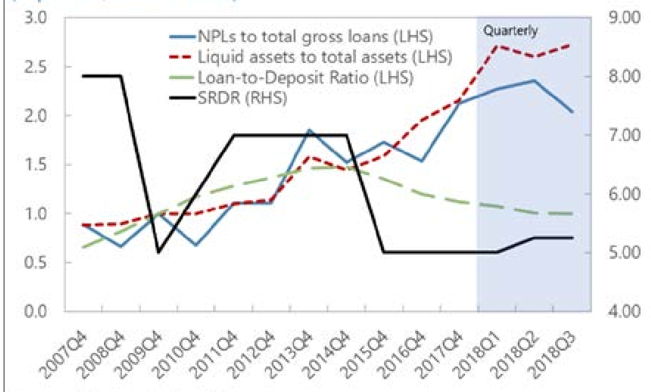
[2] Because of lack of available data, not all countries can be compared after 2013.

loans (that is lower asset quality) could explain the growth of NPLs before Cyclone Pam, but further data would be needed to assess the impact.

10. After Cyclone Pam, the accumulation of free reserves in the Vanuatu banking system accelerated, while commercial banks' vulnerabilities worsened. Free reserves in form of liquid assets owned by commercial banks represented 15 percent of total assets in 2015 and built up to 29 percent by 2017, roughly stabilizing afterwards. At the same time, credit to the private sector declined from 72 percent of GDP in 2014 to 60 percent of GDP in 2018Q2 and nonperforming loans reached 17.9 percent of total gross loans in 2018Q2. In addition, the share of nonperforming loans net of provisions to capital sharply declined from 70 percent in 2015 to 36.5 percent in 2016 but moved up to 55.0 percent by 2018Q2. Given that the last ratio demonstrates the capacity of domestic banks to withstand losses from nonperforming loans, banks were highly vulnerable in 2015 after the cyclone, recovered in 2016, but backslid afterwards.

Domestic Banks Liquidity in Vanuatu

(In percent, Base 1 = 2009)



Sources: Vanuatu Authorities

11. In 2018, an extraordinary revenue windfall from the ECPs brought extra liquidity into the banking system and increased money supply. The government received around US$90 million as revenue inflows from ECPs in U.S. dollars in 2018. Government converted them into domestic currency using a deposit account in a commercial bank. This raised the money supply and liquidity in the banking system as open market operations were not enough to fully sterilize the extra liquidity.

How Excess Liquidity and Reserves Interact with Monetary Policy Transmission

12. The main monetary policy transmission channel depends on how liquidity affects interest rates. An increase in liquidity should lead to a decline in interest rates across maturities and activities, stimulating demand for loans, which can then be easily met by banks. In presence of excess liquidity, passthrough to interest rates can be weakened. For instance, if the central bank attempts a contractionary monetary policy, it will cause banks to reduce their free reserves, but it will be only effective if the contractionary action reduces commercial banks' free reserves below the level of voluntary ones (Saxegaard 2006).

13. Interest rate pass-through in the Pacific island states is likely to be further limited because of monopolistic behavior of banks and credit market frictions. Limited competition in the banking sector implies that individual banks can charge higher markups due to market power and this generates incomplete pass-through. Moreover, interest rates can be sticky if adjustment costs of changing lending rates are high for the banks (i.e. printing new promoting materials or investment in information technology systems) or if the elasticity of loan demand is low (i.e.

customers are less likely to leave a bank in response to a better loan offer from elsewhere because of high switching costs). Finally, asymmetric information and relationship banking between a bank and its borrowers can reinforce the previous mechanisms, leading to high lending rates and credit rationing.

14. An increase in domestic lending does not absorb excess liquidity, unlike open market operations. Changes in volumes or interest rates are more relevant than the level of free reserves to determine if the monetary policy transmission mechanism is effective. The level of free reserves in the banking system is only determined by the balance sheet of the central bank. If a bank buys an asset from another domestic bank or makes a loan, the reserves will return to the central bank balance sheet through another commercial bank's account. To reduce excess liquidity in the domestic banking system, the central bank can use sterilized intervention to reduce the monetary base (bank reserves and currency). For instance, a sale of foreign currency on the open market would result in a reduction of the central bank's net foreign assets and a contraction of the monetary base (Dominguez 2009).

Monetary Policy and Foreign Exchange Reserves in Vanuatu

15. The RBV faces issues from excess liquidity, but its monetary policy framework may help lessen its importance. The RBV manages a pegged exchange rate for reserve stability, in addition to price stability, achieved with a CPI inflation target range of 0-4 percent. The RBV has been able to maintain the inflation rate within the target range over a long time period because a main driver of inflation is import prices, which dominate much of the CPI basket. Import prices, in turn, are determined by their trading partners (in particular Australia and New Zealand) who main low inflation rates themselves, and benefit from the stable exchange rate. Their monetary policy instruments – primarily an SRD requirement and open market operations – are most useful in targeting domestic inflationary pressures. This motivated the RBV's increase in the SRD requirement from 5 to 5.25 percent and the use of open market operations in 2018.

16. After the Cyclone Pam in 2015, a large share of foreign exchange inflows was not sterilized by the central bank because of a voluntary increase in the RBV capital base and the high costs of sterilization. From January 2013 to end-2014, the vatu depreciated by 13 percent against the U.S. dollar while appreciating by 11 percent against the Australian dollar. The value of international reserves in U.S. dollars increased considerably less than would have been expected from overall surplus in the balance of payment, indicating valuation losses because of U.S. dollar appreciation. This trend is somewhat obscured by large errors and omissions in the balance of payments. After the large revaluation, the RBV had to strengthen its capital base to cushion the effects of such shocks and build up reserves (IMF 2015). In addition, sterilizing large capital inflows is costly for a small central bank as the RBV. Open market operations to reduce the domestic component of the monetary base would offset the reserve inflows and ease the threat of inflation, but the operations for smaller authorities such as the Vanuatu government and the RBV are difficult to execute without incurring substantial fiscal costs (Lee 1997).

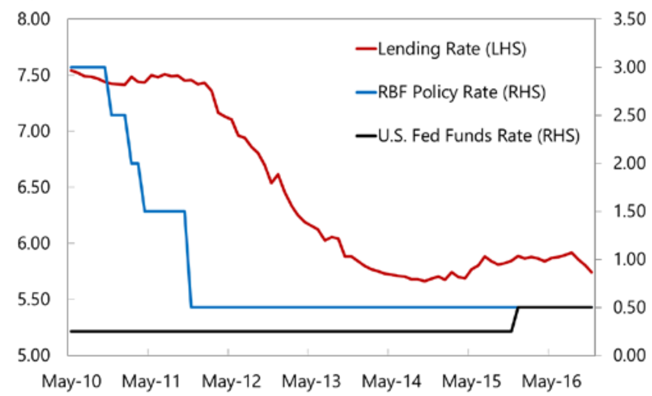
Monetary Policy in Another Pacific Island State: The Case of Fiji

17. The Reserve Bank of Fiji (RBF) does not actively manage foreign reserves, as its monetary policy is akin to a currency board system. The RBF has a pegged exchange rate and its last devaluation was in 2009. Since GFC, the RBF has not carried out any open-market operations or changes in its reserve requirements for commercial banks.

18. Instead, when FX reserves are too high, the RBF allows the national pension fund to invest abroad. The pension fund always has an interest to invest abroad, but its access to foreign exchange reserves is capped by the RBF through two channels. First, the RBF governor sits on the board of the pension fund and has direct power over the pension fund's decisions. Secondly, the RBF has capital controls on both inflows and outflows. The pension fund must request the RBF's permission prior to transferring large amounts of foreign currency out of the country. Otherwise, the RBF's primary objective is to manage foreign exchange reserves through the capital controls on residents' overseas investment.

19. Liquidity does not appear to be excessive and monetary policy transmission is effective in Fiji. During 2009–17, the loan-to-deposit ratio was high, stabilizing around 84 percent. Commercial banks in Fiji hold most of their nonlending assets as reserves and have adequate liquidity levels to manage short-term liabilities and shocks (Gottschalk 2016). Moreover, the influence of the RBF's policy rate on lending rates was significant between 2010 and 2014, confirming the effectiveness of monetary transmission despite a thin interbank market and limited capital mobility (IMF 2018).

Policy and Lending Rates in Fiji
(In percent)



Source: Reserve Bank of Fiji

Policy Recommendations to Manage Excess Liquidity and Reserves

20. The banking system in Vanuatu has large free reserves but a significant portion are being held for precautionary motives, which makes it difficult to properly assess the potential impacts on monetary policy transmission. More disaggregated data on commercial banks' reserves would be useful to identify the share of excess liquidity in free reserves. To the extent that excess liquidity is an issue, there are policy measures that can be taken.

21. To improve effectiveness of monetary policy in presence of excess liquidity, the RBV could tighten its monetary policy stance through a gradual increase of banks' SRD requirement over the medium term. While the SRD requirement was increased to 5.25 percent in April 2018, relative to historic norms there is still room for further increases to normalize monetary policy. For example, the SRD requirement was at 8 percent before the GFC. This would be necessary only if the central bank decided to raise interest rates because of strong domestic inflationary pressures, which are not currently present in the economy.

22. Higher SRD requirements would mop up excess liquidity but could also shrink voluntary reserves in some banks and increase financial stability risks. An increase of the SRD requirement has a symmetric impact on all banks, but it may cause some banks to reduce their free reserves below the level of voluntary ones and lead to upward pressure on interest rates. As banks with higher NPL ratios tend to hold a larger share of liquidity for precautionary reasons, the liquidity position may also worsen for those banks and financial instability risks may arise. Prior to any changes of SRD requirement, a banking diagnostic with the assistance from their development partners would help to analyze excess liquidity and NPLs among individual banks to avoid unintended consequences of recalibrating the SRD requirement to reduce excess liquidity.

23. Considering the example of Fiji discussed above, the authorities could also encourage the VNPF to invest abroad. In 2018, the VNPF invested 1.3 percent of its portfolio abroad, while the required benchmark in the VNPF's policy guidelines has been 15 percent. Greater portfolio diversification would help with diversifying risk, and potentially improve portfolio performance in the longer term. The added benefit would be to contribute to the reduction of excess liquidity.

24. To reduce lending rates of commercial banks and reinforce monetary policy passthrough over the long term, the authorities should improve the functioning of the banking sector. To foster competition, the authorities should continue to promote financial inclusion and the use of new technologies. Investing in infrastructure to improve access to fintech, and information and computer technology in general, should help to overcome the asymmetric information problem and reduce switching and adjustment costs. Screening costs for banks are an important concern in the Pacific as the necessary instruments such as credit histories and credit scores are less available

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Annex VII. The Fiscal Framework in the Event of Emergencies and its Application[1]

Current Practice

1. **Vanuatu's fiscal framework allows for swift disbursements to meet immediate needs in the aftermath of national emergencies, including natural disasters.** The *Public Finance and Economic Management Act* allows the authorities to swiftly draw down up to 1.5 percent of a given year's total appropriation (around 330 million vatu or 0.3 percent of GDP in the 2018 budget), with the prior approval of the Council of Ministers (COM), to either alleviate a state of emergency or a financial emergency. The withdrawal does not require passage in Parliament, but it must be later appropriated by Parliament.

2. **In practice, the annual budget sets aside contingency provisions for emergency purposes, given Vanuatu's high vulnerability to natural disaster risks.** The allocation has increased from 25 million vatu in the 2017 budget to 150 million vatu (about 0.6 percent of government-funded expenditure) in 2019.

3. **The government used swift disbursement to cope with volcanic eruptions on Ambae and Ambrym islands.** A state of emergency was declared on Ambae after the September 2017 eruption and the COM quickly endorsed a 200 million vatu fund (about 0.2 percent of GDP), which was appropriated along with the 2018 budget that December. COM added 40 million vatu in March 2018 to address the devastating impacts from volcanic ash and 200 million vatu in August 2018 upon the compulsory evacuation of Ambae's population of 10,000. The June 2018 supplementary budget included a further 362 million vatu for disasters. Following December 2018's volcanic eruption on Ambrym island, the COM put aside up to 100 million vatu from the Ambae recovery fund, adding another 50 million vatu in January 2019. In 2018, the government appropriated a further 532 million vatu for emergency relief from Tropical Cyclone (TC) Hola and again from the Ambae volcanic eruption.

4. **The VNPF, as directed by the government, provided financial assistance to its affected members on Ambae.** It released about 90 million vatu from their retirement accounts (up to 20 percent) to help rebuild accommodations and livelihoods. Relative to Cyclone-Pam-related withdrawals, the amount is relatively small (1.7 billion vatu), limiting the impact on the VNPF's liquidity.

5. **Development partners have provided financial support and humanitarian assistance in both cases.** Some support came through NGOs such as the Red Cross and Oxfam, helping with essential relief, water, sanitation, and education services for the evacuees.

Looking Forward – The Proposed National Emergency Fund

6. **To prepare for impacts from prolonged volcano activity, or another large natural disaster like Cyclone Pam, the authorities should consider establishing a multi-year**

[1] Prepared by Hidetaka Nishizawa (APD)

contingency fund. The authorities' intention to establish an emergency fund under the *Disaster Risk Management Act 2018* bill (DRMA) is a welcome step. The authorities (specifically, the Department of Finance within the Ministry of Finance and Economic Management, MFEM) will prescribe a guideline for the use of funds, including procedures for the urgent request of funds and types of emergencies or disasters for which the funds could be utilized. However, those guidelines are not part of the act, and have yet to be defined.

7. The first key issue is the source of funding for the national emergency fund, which can come from a variety of sources. The fund should consist of the government's contribution and any contribution or donation by other sources – initial gifts from development partners would be desirable. On the part of Vanuatu's government, the revenue windfall from ECPs could fund it, but this would not be a stable source of funding. Another possibility would be a repeated, permanent government contribution to such a fund. In the current fiscal environment, if the government were to continue with its program to increase revenue mobilization, it could earmark some of the new taxes raised as a substantial contribution, perhaps 0.5 percent of GDP or higher.

8. Second, a strong governance structure is needed to promote transparency and avoid the misuse of the fund. In this regard, IMF staff (Cevik and Huang 2018) provides the following recommendations for establishing and operating a well-designed framework, all highly relevant of Vanuatu:

- The fund should be consolidated with budget information to allow for a proper assessment of the overall fiscal situation. At a minimum, the fund balance should appear in financial statements, and drawdowns from the fund should appear in budget execution reports.
- The fund should generally apply best PFM practices to promote transparency. Specifically, it should have clear rules governing the use of resources, follow normal government accounting standards, prepare and publish audited financial statements, and define its governance rules.
- Drawdowns should be authorized only above a minimum level of fiscal cost, as use of the fund should be limited to responding to disasters with large fiscal impacts.
- The size of the fund should be based on a calibration of the fiscal impact of natural disasters. Too much cash accumulated in a fund might tempt policymakers to use it for other purposes.
- The fund's financial investment strategy should aim to maintain a relatively high degree of liquidity, given the potential urgency of disaster relief expenditure. The fund should invest in liquid foreign assets because of the high likelihood of post-disaster stress in domestic financial markets.

9. The current intentions for the fund are not yet clearly articulated. The Vanuatu government, in the DRMA bill, establishes the fund, but without stating any details, leaving it to future guidelines. Staff recommends that the purpose of the fund, in line with best practice, should be for large disasters, and should consider providing more than just immediate assistance. Such a fund could finance, for example, disasters such as the Ambae island volcanic eruption, which required both a large-scale evacuation and financial support to victims to both establish them in their new locations and until more permanent solutions could be formulated. For Vanuatu, this suggests the need for a large fund, with suggestions for quantification below.

10. Establishing the size of the fund can be calibrated from prior experiences in Vanuatu and elsewhere, and analytical work from other international organizations. This provides two approaches. Prior country experiences are best for understanding the amount required for immediate relief. Analytical work provides a fuller view on longer-term demands on the fund.

11. Immediate relief costs are best indicated by experiences in Vanuatu, and preparatory measures in other Pacific island states. After Vanuatu was hit by Cyclone Pam in 2015, the government used its own resources, amounting to 401.6 million vatu (about 0.5 percent of GDP), for the relief and recovery efforts. In 2017 and 2018, the government appropriated 200 million vatu (about 0.2 percent of GDP) and 532 million (about 0.5 percent of GDP), respectively, for emergency relief for Ambae volcano and TC Hola. A cross-country experience shows that Fiji has a National Disaster Relief and Rehabilitation Fund, whose size is US$1.9 million (0.04 percent of GDP) as of March 2019, while Marshall Islands had US$1.5 million (0.8 percent of GDP) of a Disaster Assistance Emergency Fund as of June 2013.

12. If the fund has a more ambitious intent to also contribute to longer-term support or perhaps even starting reconstruction, its size would need to be much larger. PCRAFI (2015) estimates that Vanuatu will incur average annual long-term annual losses of US$48 million because of cyclones and earthquakes. Public sector assets have no insurance coverage, and the insurance market overall is small, with yearly premiums totaling only US$13.5 million (about 2 percent of GDP) in 2012. In 2015, there was a 50 percent probability of a disaster with losses of over US$330 million, and a 10 percent probability of one greater than US$540 million. TC Pam fit this definition, yet the risk remains.

13. The intention to establish a national emergency fund is a welcome development. However, it will require a clear purpose for either immediate relief or perhaps some contributions to reconstruction, and strong funding with strong rules to govern those funds – something not yet established under the proposed DRMA bill. Having a fund of sufficient size would also reduce potential pressures on Vanuatu’s external position when addressing natural disasters, particularly large ones.

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Annex VIII. Implementation of the Enhanced General Data Dissemination System (e-GDDS)[1]

Vanuatu published at the end of April 2019 key macroeconomic data in a new National Summary Data Page (NSDP) under the enhanced General Data Dissemination System (e-GDDS) to support surveillance and improve data transparency. This will represent a major structural reform in statistical developments and help create strong synergies between data dissemination and surveillance.

1. A renewed data initiative. The e-GDDS was established in May 2015 resulting from introduction of new features to the General Data Dissemination System. The e-GDDS refocuses on data dissemination to support transparency, encourage statistical development, and help create strong synergies between data dissemination and surveillance. It is designed to assist participants in improving data transparency and governance through release of key macroeconomic and financial data in a standardized format and disciplined manner. Implementation of the e-GDDS would lead to structural change in countries' statistical system. Staff analysis has shown that data transparency reforms reduce borrowing costs and enhance resilience of the economy (Choi and Hashimoto, 2017).

2. A focus on dissemination of data for surveillance. The e-GDDS recommends dissemination of 15 data categories that are considered essential for the analysis and monitoring of macroeconomic and financial conditions. These data categories are aligned with those as listed in the Table of Common Indictors Required for Surveillance (TCIRS). Such alignment facilitates to integrate and leverage both e-GDDS and data provision for TCIRS and create synergies given the central role of TCIRS in surveillance activities.

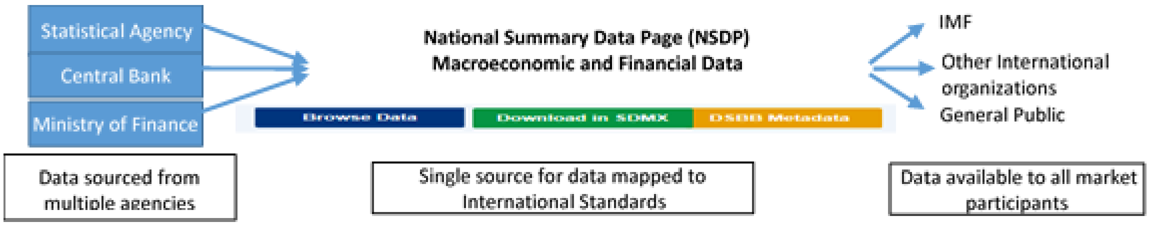
3. An impetus given to data dissemination as part of the e-GDDS framework. An STA mission visited Vanuatu in August 2018 to support the authorities in preparing to publish key macroeconomic data via NSDP. The authorities committed to publish all core e-GDDS data categories except for general government operations and stock market. Currently there is only one level of government in Vanuatu—fully covered by the central government—and no stock market exists in the country. The authorities have also opted to disseminate two supplementary datasets—labor market indicators and financial soundness indicators. Other additional datasets for publication to support surveillance work include tourism statistics, government bonds outstanding, and financial access survey. The implementation of NSDP has accelerated the authorities' ongoing efforts to enhance data dissemination via improved data coverage and user accessibility. It has also helped to identify data gaps and thus high priority areas for targeted technical assistance. As a result, data for the Balance of Payments (BOP) and the International Investment Position (IIP) will be included in the NSDP at a later stage, so that the authorities may benefit from an STA technical assistance mission in May 2019 to help further improve BOP and IIP data.

4. NSDP's features and benefits. The NSDP is a national "data portal" that assembles links for e-GDDS recommended data categories and supplementary datasets for a country. The links provide access to time series in formats readable by humans and computers. These data are usually compiled

[1] Prepared by Xiuzhen Chao (STA)

by multiple agencies, but their dissemination and regular updating are coordinated by one designated agency.

Inputs and Outputs for the National Summary Data Page



Source: IMF Statistics Department.

The NSDP ***benefits data users*** with (i) browse data via link to online datasets that can be easily viewed in time series format or as graphics; (ii) download data in SDMX, a format used for machine-to-machine data sharing; and (iii) access to metadata, which describes a country's practice for data compilation and dissemination. The NSDP also ***benefits*** (i) ***data reporters*** by reducing reporting burden via posting data in one data portal in a standardized format that can be accessed by different agencies; (ii) ***data managers*** by allowing them to control data updating processes; and (iii) ***international/regional organizations*** and other institutional data users by making processing easier due to data dissemination in machine readable format.

INTERNATIONAL MONETARY FUND

VANUATU

May 20, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of May 14, 2019)

Membership Status: joined September 28, 1981; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	23.80	100.00
Fund holdings of currency	24.92	104.70
Reserves tranche position	4.20	17.63

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	16.27	100.00
Holdings	0.82	5.02

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	8.50	35.71
Emergency Assistance [1/]	5.31	22.32

[1/] Emergency Assistance may include ENDA, EPCA, and RFI.

Latest Financial Arrangements: None

Projected Payments to the Fund [2/]

(SDR million; based on existing use of resources and presenting holdings of SDRs);

	Forthcoming 2019	2020	2021	2022	2023
Principal	3.19	2.98	1.70	1.70	1.70
Charges/Interest	0.21	0.20	0.18	0.18	0.18
Total	3.40	3.18	1.88	1.88	1.88

[2/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative: Not applicable

Implementation of Catastrophe Containment and Relief: Not applicable

Exchange Arrangements

Since 1988, Vanuatu has officially maintained an adjustable peg exchange rate arrangement. Currently, the exchange rate of the vatu is linked to a transactions-weighted (trade and tourism receipts) basket of currencies. The weights and composition of the basket, which are not publicly disclosed, are adjusted periodically. The Reserve Bank of Vanuatu (RBV) quotes daily buying and selling rates for the vatu against the U.S., Australian, and New Zealand dollars; the euro; the U.K. pound; and the Japanese yen. The rate in terms of the U.S. dollar as of May 14, 2019 was VT 115.01 per U.S. dollar. The de facto classification is "other managed," as the composite weights are not disclosed and cannot be confirmed. Vanuatu has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

Article IV Consultation

Vanuatu is on a 12–month consultation cycle. The previous Article IV consultation mission took place during January 29-February 8, 2018 and the consultation was concluded on a lapse-of-time basis on April 6, 2018 (Country Report No. 18/109).

OFC Assessments

The most recent Offshore Financial Center Module II Assessment, conducted by MFD, was concluded in May 2006.

Safeguards Assessment

The first safeguards assessment of the RBV was completed in October 2016 in connection with emergency financing received in 2015. The assessment found that the RBV has a recognized accounting framework and publishes annual financial statements, albeit with some delay. It also identified several weaknesses in its governance arrangements, autonomy, transparency, and audit mechanisms. Recommendations included: (i) drafting amendments to the *Reserve Bank of Vanuatu Act* to align it with leading practices for central banks; (ii) establishing an Audit Committee; (iii) outsourcing internal audit services to an independent international audit firm; and (iv) formulating a recapitalization plan. While the RBV received technical assistance on the recapitalization framework and recently appointed an internal auditor, progress in implementing the safeguards recommendations has been slow.

Technical Assistance

Technical assistance on public financial management, central bank audit functions, financial supervision, and statistics (GDP and government finance) has been provided mainly through PFTAC, with additional support for training on the LIC DSF at CICDC.

Resident Representative

The resident representative office for the Pacific Islands, including Vanuatu, was opened in September 2010 in Suva, Fiji. Ms. Leni Hunter is the current Resident Representative.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS (IFIs)

Relations with other IFIs:

- World Bank Group:

http://projects.worldbank.org/search?lang=en&searchTerm=&countrycode_exact=VU

- Asian Development Bank:

https://www.adb.org/countries/vanuatu/main

- Pacific Financial Technical Assistance Center:

https://www.pftac.org/content/PFTAC/en1/reports11.html#tab_5

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance	
General: Data provision has shortcomings but is broadly adequate for surveillance. In particular, national accounts and external sector statistics need to be further improved, while the coverage of government finance statistics could be expanded. Reporting lags could be shortened.	
National accounts: While there have been improvements in the methodology and the development of additional data sources, the accuracy of expenditure-based GDP estimates could be further improved. Data are compiled only on an annual basis. Unsettled staffing has set back plans to rebase GDP and develop a new quarterly measure to at least 2019. 2016 data have been updated, and 2017 preliminary estimates published in December 2018. PFTAC is providing technical assistance in national accounts compilation and has refocused on core capacity development to provide a solid basis for reviving development work in FY2021 and FY2022. **Price statistics:** The CPI weights are based on 1998 household surveys, and only cover the two urban centers of Port Vila and Luganville. Rebasing the CPI to a more recent base year may start after a new Household Income and Expenditure Survey in 2019.	
Government finance statistics: The budget classification is broadly consistent with the *GFSM 2001*. Work is underway to migrate budget classification to the *GFSM 2014*. The latest data submitted for the annual GFS database were budgetary central government for 2017. Data produced by Department of Finance and Treasury (DoFT, part of the Ministry of Finance and Economic Management, MFEM), Vanuatu National Statistics Office (VNSO), and the Reserve Bank of Vanuatu (RBV) still have discrepancies that should be reconciled. Statistical discrepancies also exist in the balance sheet for transactions in assets and liabilities. Coverage is being expanded to the general government but there have been significant time delays and data gaps. GFS data are compiled and published monthly by the DoFT but not reported to STA for inclusion in the *International Financial Statistics (IFS*); the latest information available in *IFS* is for December 2016.	
Monetary statistics: Monetary statistics are compiled broadly in line with the *Monetary and Financial Statistics Manual*. The RBV reports monthly monetary data, using Standardized Report Forms (SRFs) for the central bank and other depository corporations, which are published in the *International Financial Statistics*. Following a regional workshop in 2016, the RBV also reports Financial Soundness Indicators (FSIs) on a quarterly basis, including all 12 core and 7 encouraged indicators for deposit takers. The data reported by Vanuatu to the Financial Access Survey (FAS) are sparse but include the two indicators adopted by the UN to monitor Target 8.10.1 of the Sustainable Development Goals (SDGs). The last data submission to FAS was in 2017.	
External sector statistics: The RBV releases quarterly BOP and IIP data in its *Quarterly Economic Review*, although issues were not published in 2018Q1 and 2018Q2, but resumed in 2018Q3. The Debt Management Unit within the MFEM has been responsible for public debt management and recording since 2015; however, these processes need further improvement. Two external sector statistics missions visited Vanuatu in the second half of 2015 to assist the authorities in improving the collection and reporting of external debt and external sector statistics. The latest mission was conducted in May 2019 to improve the reporting of data for services and the financial account, in particular.	
II. Data Standards and Quality	
Participant in the General Data Dissemination System (GDDS) since April 2004. Started implementing the enhanced General Data Dissemination System (e-GDDS) in 2018.	No data ROSC is available.

Vanuatu: Table of Common Indicators Required for Surveillance

(As of May 2019)

	Date of latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	2/2019	4/2019	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	11/2018	1/2019	M	M	M
Reserve/Base Money	11/2018	1/2019	M	M	M
Broad Money	11/2018	1/2019	M	M	M
Central Bank Balance Sheet	11/2018	1/2019	M	M	M
Consolidated Balance Sheet of the Banking System	11/2018	1/2019	M	M	M
Interest Rates[3]	9/2018	4/2019	Q	Q	Q
Consumer Price Index	9/2018	4/2019	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[4]—General	N/A	N/A	N/A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing[4,5]—Central Government	12/2018	2/2019	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]	2018	4/2019	A	A	A
External Current Account Balance	9/2018	4/2019	Q	Q	Q
Exports and Imports of Goods and Services	9/2018	4/2019	Q	Q	Q
GDP/GNP	2017	12/2018	A	A	A
Gross External Debt	12/2017	4/2019	Q	Q	Q
International Investment Position	9/2018	4/2019	Q	Q	Q

[1] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), and Not Available (N/A).

[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[3] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[4] Foreign and domestic financing.

[5] The central government is only the budgetary central government. The data not monthly to STA or IFS. The last available information in IFS available is December 2016. On April 30, 2019 the Government started to release the data through its e-GDDS National Summary Data Page

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

VANUATU

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS[1]

May 20, 2019

Approved By
Odd Per Brekk (IMF)
Lalita Moorty (IDA)

Prepared by the staff of the International Monetary Fund and the International Development Association

Risk of external debt distress:	Moderate
Overall risk of debt distress:	Moderate
Granularity in the risk rating:	Limited space to absorb shock
Application of judgement:	No

The updated DSA suggests that the external risk of debt distress for Vanuatu remains moderate with limited space to absorb shocks. All external debt indicators remain below the relevant indicative thresholds under the baseline scenario, incorporating the average long-term effects of natural disasters on growth and the fiscal and current account balances. A tailored natural disaster shock, reflecting Vanuatu's vulnerability to disasters, would cause the present value (PV) of public and publicly guaranteed (PPG) external debt-to-GDP ratio to breach the threshold from 2024 onwards.

The overall risk of debt distress is assessed as moderate. Although the PV of the public-debt-to-GDP ratio remains below the 55 percent benchmark under the baseline scenario, the public-debt-to-GDP ratio would breach the authorities' debt ceiling of 60 percent by 2025. Moreover, a tailored natural disaster shock would lead to a significant deterioration in debt sustainability, breaching the benchmark. The breach of the authorities' debt ceiling and of the benchmark indicates the need for rebuilding fiscal buffers and enhancing resilience against shocks, including from natural disasters. This requires both stronger revenue mobilization measures, including an introduction of the proposed income taxes, and expenditure rationalization in the medium term. When contracting new public infrastructure projects, the authorities are encouraged to seek grants or concessional loans as much as possible to contain its debt burden.

[1] The two most recent observations for Vanuatu's Composite Indicator (CI) index are 2.94 and 2.99, indicating that the country's debt-carrying capacity is medium. According to the new "Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries" (http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf), the relevant indicative thresholds for the medium category are: 40 percent for the present value (PV) of the debt-to-GDP ratio,180 percent for the PV of the debt-to-exports ratio, 15 percent for the debt service-to-exports ratio, and 18 percent for the debt-service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed (PPG) external debt. The benchmark of the PV of total public-sector debt for a medium debt carrying capacity is 55 percent.

PUBLIC DEBT COVERAGE

1. The coverage of public sector debt for this debt sustainability analysis is central government debt, central government-guaranteed debt, and central bank debt, which has been borrowed on behalf of the government. [2] Because of data limitations, non-guaranteed SOE debt and private external debt are not included in the analysis.[3] Given the limited capacity to borrow both externally and domestically by Vanuatu's state and local governments, SOEs and its private sector, data deficiencies do not affect the overall assessment.

Coverage of Public Sector Debt

	Subsectors of the public sector	Sub-sectors covered
1	Central government	X
2	State and local government	
3	Other elements in the general government	
4	o/w: Social security fund	
5	o/w: Extra budgetary funds (EBFs)	
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	X
8	Non-guaranteed SOE debt	

BACKGROUND ON DEBT

2. After Cyclone Pam struck Vanuatu in 2015, public sector debt has increased sharply to 52.4 percent of GDP in 2018 from 26.1 percent in 2014. This was mainly caused by new disbursement for infrastructure development supported by bilateral partners, including the Japan International Cooperation Agency (JICA) and the Export-Import Bank of China (China EXIM Bank). In addition to the IMF's disbursement of USD 23.8 million in June 2015, the IDA and ADB have provided loans and grants to support the reconstruction and improvement of

Stock of Public Debt (External and Domestic) at End-2018

	In million of Vatu	In million of US dollars	As a share of total debt	In percent of GDP
Total public debt	52,826	471	100.0	52.4
External	45,520	406	86.2	45.2
Multilateral	16,466	147	31.2	16.3
ADB	7,726	69	14.6	7.7
IDA	6,478	58	12.3	6.4
IMF	2,262	20	4.3	2.2
Bilateral	27,332	243	51.7	27.1
China EXIM Bank	17,080	152	32.3	17.0
JICA	10,201	91	19.3	10.1
Others	51	0	0.1	0.1
Publicly guaranteed debt	1,722	15	3.3	1.7
Domestic	7,307	65	13.8	7.3
Government bonds	6,267	56	11.9	6.2
RBV	2,513	22	4.8	2.5
Public Corporation	2,350	21	4.4	2.3
Commercial Banks	1,288	11	2.4	1.3
Others	116	1	0.2	0.1
Publicly guaranteed debt	1,040	9	2.0	1.0

Source: Vanuatu authorities and IMF staff estimates.

[2] The technical assistance provided by PFTAC helps the country's authorities expand the coverage of government financial statistics (GFS) from budgetary central government to general government. The broader coverage of public sector debt can be expected as a result of the PFTAC TA program. For non-guaranteed SOE debt, the authorities are currently revising the *Government Business Enterprises Act* bill, which will be complemented by the upcoming report that will discuss the financial position of, and fiscal risks posed by SOEs. The report should enable staff to identifiy or estimate the size of the SOE debt.

[3] Please note that the size of private external debt does not affect the risk rating for PPG external debt and public-sector debt, which does not include private external debt.

roads and schools. As of end-2018, the share of bilateral and multilateral creditors amounted to 51.7 and 31.2 percent of total public debt, respectively. Of public domestic debt, central government bonds were largely held by public corporations (primarily the Vanuatu National Provident Fund, VNPF), followed by the Reserve Bank of Vanuatu (RBV) and commercial banks. There are also government-guaranteed debts for state-owned enterprises (SOEs), such as Air Vanuatu prior to 2019.[4]

3. **Windfall revenues from the economic citizenship programs (ECPs) have enabled the authorities to embark on a debt reduction program.**[5] They paid off domestic and external debt in the amount of VUV 1.8 billion and VUV 1.5 billion, respectively, in 2018. External loan repayments included VUV 1.0 billion to China, VUV 0.4 billion to the ADB, and VUV 60 million to the IDA.

4. **Following the end of the Tanna and Malekula Road Rehabilitation and Upgrade Program (Phase I), the authorities signed a Phase II loan agreement, amounting to VUV 5.7 billion, with China in November 2018.** As the Phase II project was effectively an extension of the Phase I project, the financing terms and grant element were the same.[6] The grant element was 29.2 percent, lower than the authorities' commitment of a 35 percent grant component, which was first introduced in 2015 under its *Debt Management Strategy (2015–17)*, one year after the Phase I project was signed. The authorities intend to retain their 35 percent grant component target as they update the debt management strategy.

BACKGROUND ON MACROECONOMIC FORECASTS

5. **Similar to the last DSA, the baseline scenario, which is consistent with the macroeconomic framework, incorporates the effects of natural disasters and climate change over the longer-term.** The years 2019–24 are assumed to be free from newly-occurring major, costly disasters to simplify the policy discussion of the near-term outlook - standard practice in DSAs for other Pacific island small states with a similar risk profile. However, from 2025 onwards, the baseline incorporates the average long-term effects of natural disasters and climate change. Based on staff's research on the impact of natural disasters, real GDP growth is lowered by 0.5 percentage points annually, the current account deficit is raised by 1.3 percentage points of GDP and the fiscal deficit is increased by 0.35 percentage points of GDP relative to disaster-free projections.[7] The projected changes in 2025 for these three variables are smaller than the effects listed above. This is because real GDP growth is projected to rise in 2025 (in the absence of newly-occurring natural disasters), as the negative effect of recent natural disasters such as the Ambae and Ambryn volcanic

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[4] The amounts are the original guarantees as provided by the authorities. The current outstanding amount might be lower, if some of the guaranteed debt has been repaid by the debt's issuer.

[5] The ECPs include the Vanuatu Development Support Program (VDSP) and Vanuatu Contribution Program (VCP), outlined in Box 1 of Vanuatu: 2018 Article IV Consultation, IMF Country Report No. 18/109.

[6] The financing terms of China's new loan are an interest rate of 2 percent, a grace period which shall not exceed 7 years, and a maturity of 20 years. A grant element has been calculated based on financing terms with a 5 percent discount rate.

[7] Please see the detail in the, Lee and others, 2018, "The Economic Impact of Natural Disaster in Pacific Island Countries," IMF Working Paper 18/108 (https://www.imf.org/en/Publications/WP/Issues/2018/05/10/The-Economic-Impact-of-Natural-Disasters-in-Pacific-Island-Countries-Adaptation-and-45826).

eruptions and Cyclone Oma wanes. Similarly, the assumed increase in the fiscal and current account deficits from 2025 onwards (due to incorporation of the average effect of natural disasters and climate change) is masked somewhat by a coincident decline in the projected acquisition of non-financial assets. The discount rate used to calculate the net present value of external debt remains at 5 percent. The main assumptions are:

- ***Real GDP growth*** is projected at 2.8 percent on average during 2019–29, which is lower than growth rates in the past three years, during which public investment has boomed and reconstruction efforts have been ongoing after Cyclone Pam. It is also lower than the 10-year average of 3.1 percent in the previous DSA, better reflecting the authorities' longstanding views.
- ***Inflation*** (measured by the GDP price deflator) is projected to average 2.2 percent (in U.S. dollar terms, the relevant measure for external debt), and 2.5 percent (in domestic currency term, the relevant measure for public debt) during 2019–29 both similar to their historical averages.
- The ***non-interest current account deficit*** is projected to rise to 3.8 percent of GDP on average over 2019–29, relative to the historical average of 2.7 percent. This reflects the high import content for key infrastructure projects. It is lower than last year's assumption of 6.6 percent because of higher expected ECP revenues and remittances.
- ***Foreign direct investment inflows*** are expected to average 3.3 percent of GDP over 2019–29, lower than the historical average of 5.1 percent, which included the post-Cyclone-Pam investment boom.
- The ***primary deficit*** is expected to be 3.1 percent of GDP on average over 2019–2029, more negative than the historical average of 1.1 percent and last year's assumption of 2.5 percent. This reflects higher infrastructure spending going forward than the previous DSA, and a more accurate accounting of maintenance costs for infrastructure. Staff does not take into account the possible introduction of income taxes.
- ***External borrowing and grants*** will continue to be strong. Borrowing is driven in the short term by the disbursements for the new USD 51 million project supported by China, that should take place from 2019 to 2021. From 2022 onwards, staff assumes a slightly lower disbursement as a percent of GDP from bilateral development partners. The level of new annual external borrowing is expected to average around 5.0 percent of GDP, higher than last year's assumption of 4.2 percent of GDP, reflecting the new loan from China and the authorities' increased willingness to borrow externally to promote infrastructure development. Grant and lending flows from multilateral development partners are expected to increase over the medium term because of the scaling-up of IDA and ADB financing.[8] However, grants are expected to decline over the longer term, as the country's economy grows.

[8] With respect to projected new borrowing from IDA and ADB, DSAs always assume terms that would prevail if the country was at low risk of debt distress, independent of current actual terms (which can change on a year to year basis). This is done to avoid a circular situation where the assumption that future commitments will be on grant terms would yield actual commitments on credit terms.

- The **government-guaranteed debts** as of end-2018 will continue for the projection period. Staff assumed that the government would not provide any guarantees for any new borrowing by SOEs, including Air Vanuatu.

6. **The realism tool highlights that assumptions on the primary balance are conservative (Figure 4).** The three-year adjustment in the primary deficit between 2018 and 2021 is at 8.9 percent of GDP. The deteriorating fiscal position is based on a conservative assumption for the proceeds from the ECPs and stronger infrastructure spending. The assumption on real growth in 2019 and 2020 is lower than possible growth paths which are calculated by the model based on a one-year fiscal adjustment. Two charts on public and private investment rates and their contributions to real GDP growth are not available because of a lack of data. Staff will try to estimate the capital stock if relevant information becomes available.

Vanuatu: Baseline Macroeconomic Assumption

(In percent of GDP, unless otherwise stated)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2008-18 Historical average	2019-29 average	2018 DSA 2018-28 average	Effect of natural disaster and climate change
Real GDP growth	3.4	3.0	2.8	2.8	2.9	2.9	2.6	2.6	2.6	2.6	2.6	2.3	2.8	3.1	0.5
GDP deflator in US dollars (change in percent)	-1.3	2.3	2.5	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.2	2.2	3.5	
Non-interest current account deficit	0.7	4.9	4.2	3.8	3.5	3.6	4.1	4.2	4.2	4.3	4.4	2.7	3.8	6.6	1.3
Net FDI (negative = inflow)	-4.2	-4.0	-3.8	-3.6	-3.4	-3.2	-3.1	-2.9	-2.8	-2.6	-2.5	-5.1	-3.3	-3.6	
Primary deficit	2.3	2.7	3.1	3.2	3.2	3.1	3.2	3.2	3.2	3.2	3.2	1.1	3.1	2.5	0.35
Grants	5.8	5.8	5.7	5.6	5.6	5.5	5.5	5.5	5.5	5.6	5.6	6.1	5.6	7.6	

Source: IMF staff projections.

COUNTRY CLASSIFICATION

7. **The country's debt-carrying capacity as applied in the 2019 DSA is medium.** The Composite Indicator (CI) index for Vanuatu, which has been calculated based on the April 2019 WEO (but with updated data on remittances) and the 2017 CPIA, is 2.94, indicating that the county's debt-carrying capacity would be medium in the revised LIC-DSF framework.

Calculation of the CI Index

Components	Coefficients (A)	10-year average values (B)	CI Score components (A*B) = (C)	Contribution of components
CPIA	0.385	3.388	1.30	44%
Real growth rate (in percent)	2.719	2.840	0.08	3%
Import coverage of reserves (in percent)	4.052	54.466	2.21	74%
Import coverage of reserves^2 (in percent)	-3.990	29.665	-1.18	-40%
Remittances as percent of GDP (in percent)	2.022	4.846	0.10	3%
World economic growth (in percent)	13.520	3.579	0.48	16%
CI Score			2.99	100%
CI rating			Medium	

Source: IMF staff calculations.

8. The relevant indicative thresholds for the medium category are: 40 percent for the PV of debt-to-GDP ratio,180 percent for the PV of the debt-to-exports ratio, 15 percent for the debt service-to-exports ratio, and 18 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed (PPG) external debt. The benchmark for the PV of total public sector debt under medium debt carrying capacity is 55 percent of GDP.

PPG External Debt Thresholds and Total Public Debt Benchmarks

Debt carrying capacity (CI classification)	PV of PPG external debt in percent of		PV of PPG external debt in percent of		PV of total public debt in percent of
	GDP	Exports	Exports	Revenue	GDP
Weak	30	140	10	14	35
Medium	40	180	15	18	55
Strong	55	240	21	23	70

DETERMINATION OF SCENARIO STRESS TESTS

9. Given Vanuatu's vulnerability to natural disasters, staff conducted a tailored stress test for a natural disaster shock. Vanuatu, which is defined as a small developing natural-disaster-prone state in the IMF (2016) policy paper on small states, is automatically subject to the LIC-DSF standard natural disaster shock. This is a one-off shock of 10 percentage points to the debt-to-GDP ratio in the second year of the projection period (2020 in this case). Staff adjusted the default parameters by assuming a reduction of real GDP and export growth by 4 and 10 percentage points respectively.[9] For combined contingent liability shock, staff adjusted the levels for the increase in public debt from SOEs from 2 percent to 4 percent of GDP to reflect the government's financial support to Air Vanuatu in 2019.[10] Staff continued using the default decrease in GDP of 5 percent from financial market turbulence. For Vanuatu, the default 5 percent of GDP value of the contingent liability can be interpreted as including a capital injection to an undercapitalized domestic bank.

Combined Contingent Liability Shock

1 **The country's coverage of public debt**	The central government, central bank, government-guaranteed debt			
	Default		**Used for the analysis**	**Reasons for deviations from the default settings**
2 Other elements of the general government not captured in 1.	0	percent of GDP	0.0	
3 SoE's debt (guaranteed and not guaranteed by the government) 1/	2	percent of GDP	4.0	To reflect the government's financial support to Air Vanuatu
4 PPP	35	percent of PPP stock	0.0	
5 Financial market (the default value of 5 percent of GDP is the minimum value)	5	percent of GDP	5.0	
Total (2+3+4+5) (in percent of GDP)			9.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

[9] Please see the details in IMF, 2016, "Small States' Resilience to Natural Disasters and Climate Change: Role for the IMF," *IMF Policy Paper December 2016* (https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Small-States-Resilience-to-Natural-Disasters-and-Climate-Change-Role-for-the-IMF-PP5079).

[10] In February and April 2019, the government provided two loans to Air Vanuatu, totaling VUV 1,230 million. The money is being used as deposits to purchase new aircraft. Further costs associated with these aircraft purchases have not been incorporated into this DSA because of a lack of confirmed information on the terms and potential financing sources.

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

10. All external PPG debt indicators remain below the policy-relevant thresholds for the projection period under the baseline scenario (Figure 1 and Table 1). These thresholds include the present value (PV) of the external-debt-to-GDP ratio, the PV of the external-debt-to-exports ratio, the external-debt-service-to-exports ratio, and the external-debt-service-to-revenue ratio. The PV of external-debt-to GDP ratio is expected to increase continuously from 27.0 percent in 2018 to 35.6 percent in 2029 mainly because of new disbursements for key infrastructure projects. As Figure 3 shows, the main driver of debt dynamics during the projection period is the current account deficit.

11. The stress tests indicate that a tailored natural disaster shock has the largest impact on debt trajectory, causing a breach of the external-debt-to-GDP threshold from 2024 onwards. This suggests the need for rebuilding fiscal buffers to enhance resilience against natural disasters. Other tests, including shocks to exports, other flows and the nominal exchange rate (depreciation), would also lead to breaches in the thresholds (Table 3). The export shock, which was the largest impact under the 2018 DSA, still is the fourth largest impact, which continues to suggest the need for expanding the export base through economic diversification.

B. Public Sector Debt Sustainability Analysis

12. The PV of public-debt-to-GDP ratio does not breach the 55 percent benchmark under the baseline scenario (Figure 2 and Table 2). However, the public-debt-to-GDP ratio would rise from 52.4 percent in 2018 to breach the authorities' stated public-debt-to-GDP target of 60 percent by 2025 (Table 2). As Figure 3 indicates, the breach is primarily driven by a primary deficit caused by elevated capital spending.

13. The stress tests, including the contingent liability shock, demonstrate deteriorating debt sustainability (Figure 2 and Table 4). The tailored natural disaster shock would breach its benchmark in 2029, while other shocks would not result in a breach (Table 4). The shock to real GDP growth has the third largest impact on debt sustainability. This highlights the need for encouraging stronger economic growth and the importance of rebuilding fiscal buffers against external shocks in the medium term. The contingent liability shock would not lead to a breach, but would result in an average deterioration of the debt position relative to the baseline of 5 percent of GDP. The authorities need to consider fiscal risk from contingent liability across SOEs when they provide guarantees to them.

RISK RATING AND VULNERABILITIES

14. The debt sustainability analysis under the revised LIC-DSF framework suggests that Vanuatu's risk of external debt distress remains moderate, with limited space to absorb shocks. While there is no breach of external debt thresholds under the baseline scenario, the results of the stress tests indicate that the tailored natural disaster shock would result in a breach of the threshold for the PV of external-debt-to-GDP ratio. This underscores the importance of enhancing resilience against natural disasters. Figure 5 shows that there is limited space to absorb shocks, indicating the need for creating fiscal space to address future shocks. Even though debt service indicators remain well below their thresholds both under the baseline and stress test scenarios, loan-funded projects should be contracted as much as possible on favorable concessional terms to help contain the debt burden and respect the authorities' stated goal of achieving a 35 percent grant element for such loans.

15. The DSA suggests that overall risk of debt distress is moderate. Even though the 55 percent benchmark for the PV of the external-debt-to-GDP ratio would not be breached under the baseline scenario, the public-debt-to-GDP ratio would breach the authorities' target of 60 percent by 2025. This suggests the need for both stronger revenue mobilization measures, including the introduction of an income tax (personal and/or corporate), and expenditure rationalization in the medium term. Additional borrowing from other bilateral partners and a provision of additional debt guarantees would result in a breach of the authorities' target in the short term. The authorities need to prioritize which loans to accept and limit guarantees to SOEs, including Air Vanuatu, to safeguard debt sustainability. The tailored natural disaster shock has the largest impact on public debt sustainability, resulting in the PV of external-debt-to-GDP ratio reaching 55 percent in 2029. The authorities are encouraged to rebuild fiscal buffers to enhance resilience against external shocks.

AUTHORITIES' VIEWS

16. The authorities broadly agreed with the staff assessment of debt sustainability analysis under the revised LIC-DSF. Given high infrastructure needs, the authorities underscored the need for financial support from bilateral and multilateral donors for any new projects. At the same time, they intended to maintain a grant-element target of at least 35 percent and seek grant financing as much as possible to reduce debt burden. They stressed their commitment to make prepayments to contain debt accumulation by using their strong cash reserves, which had been accumulating from particularly strong ECP revenues starting in 2016. They noted a difference in the coverage of public sector debt relative to published *Budget 2019* figures, which did not include the IMF loans disbursed after Cyclone Pam in 2015 in their definition of public debt, as the payments had been directed to the RBV. The difference is very limited at 2.2 percent of GDP as of end-2018. The authorities noted that the DSA uses the original guaranteed debt amounts provided by the authorities.

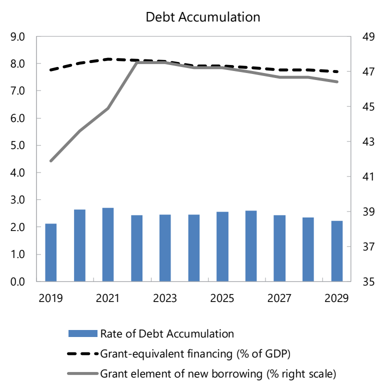
17. The authorities also agreed with the assumptions in the DSA used in its forecasts. This included assumptions on the grant element of new loans and emphasis on the PPG debt target, as they remained committed to maintaining a grant-element target of at least 35 percent on new loans and the PPG-debt-to-GDP target of 60 percent. The DSA's approach to the forecasts for publicly-guaranteed debt matched the government's strongly stressed intention that it will be difficult to provide any guarantees in the near future for borrowing by SOEs.

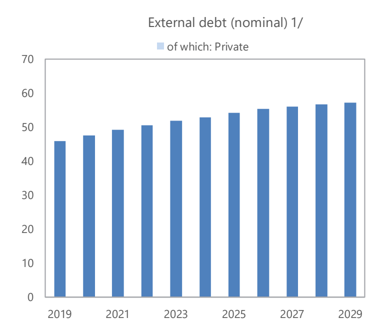
Table 1. Vanuatu: External Debt Sustainability Framework, Baseline Scenario, 2016–39

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 8/	
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029	2039	Historical	Projections
External debt (nominal) 1/	36.2	43.8	45.2	46.0	47.5	49.2	50.6	51.9	53.0	57.2	54.0	19.8	52.5
of which: public and publicly guaranteed (PPG)	36.2	43.8	45.2	46.0	47.5	49.2	50.6	51.9	53.0	57.2	54.0	19.8	52.5
Change in external debt	9.1	7.5	1.4	0.8	1.5	1.7	1.4	1.2	1.1	0.4	-0.6		
Identified net debt-creating flows	-6.9	-1.4	-10.1	-4.5	0.1	-0.3	-0.5	-0.7	-0.5	1.2	0.4	-4.9	-0.2
Non-interest current account deficit	-0.8	6.1	-4.0	0.7	4.9	4.2	3.8	3.5	3.6	4.4	2.6	2.7	3.8
Deficit in balance of goods and services	15.4	12.2	9.7	7.1	10.9	10.0	9.2	8.7	8.5	8.1	4.6	9.0	8.8
Exports	43.2	41.5	44.3	46.8	46.5	46.2	45.8	45.5	45.3	44.8	44.9		
Imports	58.6	53.7	54.1	53.9	57.4	56.2	55.0	54.2	53.7	52.9	49.5		
Net current transfers (negative = inflow)	-16.1	-7.0	-12.3	-4.9	-4.6	-4.3	-4.0	-3.9	-3.9	-3.5	-3.0	-7.6	-4.0
of which: official	-10.9	-1.8	-2.2	-1.8	-1.7	-1.6	-1.5	-1.5	-1.4	-1.1	-0.6		
Other current account flows (negative = net inflow)	0.0	0.8	-1.4	-1.4	-1.4	-1.4	-1.3	-1.2	-1.0	-0.2	1.1	1.3	-1.0
Net FDI (negative = inflow)	-5.6	-4.5	-4.4	-4.2	-4.0	-3.8	-3.6	-3.4	-3.2	-2.5	-1.5	-5.1	-3.3
Endogenous debt dynamics 2/	-0.5	-3.0	-1.8	-1.0	-0.8	-0.7	-0.7	-0.8	-0.8	-0.7	-0.7		
Contribution from nominal interest rate	0.3	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.7	0.7		
Contribution from real GDP growth	-0.9	-1.4	-1.3	-1.5	-1.3	-1.3	-1.3	-1.4	-1.4	-1.4	-1.4		
Contribution from price and exchange rate changes	0.1	-1.9	-0.9	...	...	...	...	...	...	...	...		
Residual 3/	16.0	8.9	11.5	5.3	1.5	2.0	1.9	1.9	1.6	-0.7	-1.1	10.2	1.3
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	...	...	27.0	28.5	29.5	30.6	31.3	32.0	32.7	35.6	34.4		
PV of PPG external debt-to-exports ratio	...	...	60.8	60.9	63.5	66.3	68.4	70.3	72.1	79.6	76.7		
PPG debt service-to-exports ratio	2.1	2.3	5.1	4.1	3.6	3.9	4.1	4.2	4.1	4.5	5.1		
PPG debt service-to-revenue ratio	4.1	3.6	7.6	8.6	7.5	8.2	8.5	8.6	8.4	9.6	11.1		
Gross external financing need (Million of U.S. dollars)	-43.2	22.5	-56.9	-14.9	25.2	23.7	22.9	23.5	27.0	62.7	91.4		
Key macroeconomic assumptions													
Real GDP growth (in percent)	3.5	4.4	3.2	3.4	3.0	2.8	2.8	2.9	2.9	2.6	2.6	2.3	2.8
GDP deflator in US dollar terms (change in percent)	-0.3	5.6	2.1	-1.3	2.3	2.5	2.6	2.6	2.6	2.6	2.6	2.2	2.2
Effective interest rate (percent) 4/	1.1	1.2	1.2	1.1	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.4	1.2
Growth of exports of G&S (US dollar terms, in percent)	5.0	5.7	12.8	7.7	4.7	4.6	4.6	4.9	4.9	5.1	5.3	4.6	5.2
Growth of imports of G&S (US dollar terms, in percent)	-6.0	1.0	6.2	1.7	12.3	3.1	3.2	4.1	4.7	4.9	2.9	3.3	4.9
Grant element of new public sector borrowing (in percent)	...	...	...	41.9	43.6	44.9	47.5	47.5	47.2	46.4	44.5	...	46.0
Government revenues (excluding grants, in percent of GDP)	22.5	26.4	29.9	22.1	22.1	22.2	22.2	22.1	22.0	21.3	20.5	21.1	21.9
Aid flows (in Million of US dollars) 5/	66.2	74.1	52.4	82.5	91.2	99.1	107.2	112.4	115.9	143.5	218.6		
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	7.8	8.0	8.2	8.1	8.1	7.9	7.7	7.3	...	7.9
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	74.5	73.9	73.2	74.7	74.8	74.8	75.7	78.0	...	74.8
Nominal GDP (Million of US dollars)	798	880	928	947	998	1051	1109	1170	1236	1598	2675		
Nominal dollar GDP growth	3.1	10.3	5.4	2.1	5.4	5.3	5.5	5.6	5.6	5.3	5.3	4.6	5.1
Memorandum items:													
PV of external debt 7/	...	...	27.0	28.5	29.5	30.6	31.3	32.0	32.7	35.6	34.4		
In percent of exports	...	...	60.8	60.9	63.5	66.3	68.4	70.3	72.1	79.6	76.7		
Total external debt service-to-exports ratio	2.1	2.3	5.1	4.1	3.6	3.9	4.1	4.2	4.1	4.5	5.1		
PV of PPG external debt (in Million of US dollars)			250.2	269.9	295.0	321.9	347.6	374.7	403.5	569.7	920.3		
(PVt-PVt-1)/GDPt-1 (in percent)				2.1	2.6	2.7	2.4	2.4	2.5	2.2	1.5		
Non-interest current account deficit that stabilizes debt ratio	-9.9	-1.5	-5.4	0.0	3.3	2.5	2.4	2.3	2.5	4.0	3.3		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**No**





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g) + Ɛα (1+r)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, ρ = growth rate of GDP deflator in U.S. dollar terms, Ɛ=nominal appreciation of the local currency, and α= share of local currency-denominated external debt in total external debt.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Current-year interest payments divided by previous period debt stock.

5/ Defined as grants, concessional loans, and debt relief.

6/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

7/ Assumes that PV of private sector debt is equivalent to its face value.

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

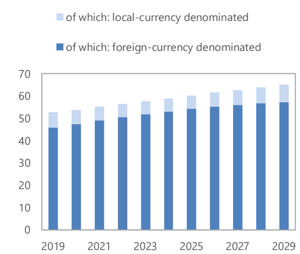
Table 2. Vanuatu: Public Sector Debt Sustainability Framework, Baseline Scenario, 2016–39

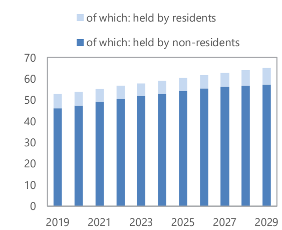
(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 6/	
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029	2039	Historical	Projections
Public sector debt 1/	46.4	53.2	52.4	52.9	53.9	55.3	56.6	57.9	59.0	65.1	74.4	27.6	59.0
of which: external debt	36.2	43.8	45.2	46.0	47.5	49.2	50.6	51.9	53.0	57.2	54.0	19.8	52.5
Change in public sector debt	10.5	6.8	-0.7	0.5	1.0	1.4	1.3	1.2	1.1	1.1	0.8		
Identified debt-creating flows	2.9	-4.8	-5.6	0.5	1.0	1.4	1.3	1.2	1.1	1.1	0.8	0.5	1.2
Primary deficit	2.9	-0.1	-5.8	2.3	2.7	3.1	3.2	3.2	3.1	3.2	2.6	1.1	3.1
Revenue and grants	30.8	34.8	35.5	27.9	28.0	28.0	27.8	27.7	27.6	26.8	26.2	27.3	27.5
of which: grants	8.3	8.4	5.6	5.8	5.8	5.7	5.6	5.6	5.5	5.6	5.6		
Primary (noninterest) expenditure	33.7	34.7	29.7	30.2	30.7	31.1	31.0	30.9	30.7	30.0	28.7	28.3	30.5
Automatic debt dynamics	0.0	-4.6	0.2	-1.8	-1.7	-1.7	-1.8	-1.9	-2.0	-2.0	-1.8		
Contribution from interest rate/growth differential	-0.8	-1.7	-1.4	-1.7	-1.5	-1.6	-1.5	-1.6	-1.7	-1.7	-1.5		
of which: contribution from average real interest rate	0.4	0.3	0.2	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.1	0.3		
of which: contribution from real GDP growth	-1.2	-2.0	-1.6	-1.7	-1.5	-1.5	-1.5	-1.6	-1.6	-1.6	-1.9		
Contribution from real exchange rate depreciation	0.8	-3.0	1.6	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	7.6	11.6	4.9	-0.1	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	4.7	-0.2
Sustainability indicators													
PV of public debt-to-GDP ratio 2/	...	...	35.1	35.4	36.0	36.7	37.4	38.0	38.7	43.6	54.8		
PV of public debt-to-revenue and grants ratio	...	...	99.0	126.8	128.6	131.2	134.4	137.2	140.4	162.4	209.4		
Debt service-to-revenue and grants ratio 3/	9.9	9.8	12.4	10.8	12.2	10.9	11.7	11.7	8.6	11.7	16.7		
Gross financing need 4/	6.0	3.3	-1.4	5.3	6.1	6.2	6.4	6.4	5.5	6.3	7.0		
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	3.5	4.4	3.2	3.4	3.0	2.8	2.8	2.9	2.9	2.6	2.6	2.3	2.8
Average nominal interest rate on external debt (in percent)	1.2	1.2	1.2	1.1	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.4	1.2
Average real interest rate on domestic debt (in percent)	7.0	2.5	3.2	4.7	4.7	4.8	4.7	4.8	4.8	4.4	4.1	3.8	4.7
Real exchange rate depreciation (in percent, + indicates depreciation)	3.1	-8.6	3.8	...	...	...	...	...	...	...	...	-0.9	...
Inflation rate (GDP deflator, in percent)	1.8	4.2	2.9	2.1	2.3	2.5	2.6	2.6	2.6	2.6	2.6	2.6	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	-9.2	7.5	-11.7	5.3	4.6	4.3	2.4	2.5	2.2	2.1	2.1	4.9	2.9
Primary deficit that stabilizes the debt-to-GDP ratio 5/	-7.6	-7.0	-5.1	1.8	1.7	1.7	1.8	1.9	2.0	2.0	1.8	-6.5	1.9
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**No**

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central government, central bank, government-guaranteed debt. Definition of external debt is Residency-based.

2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

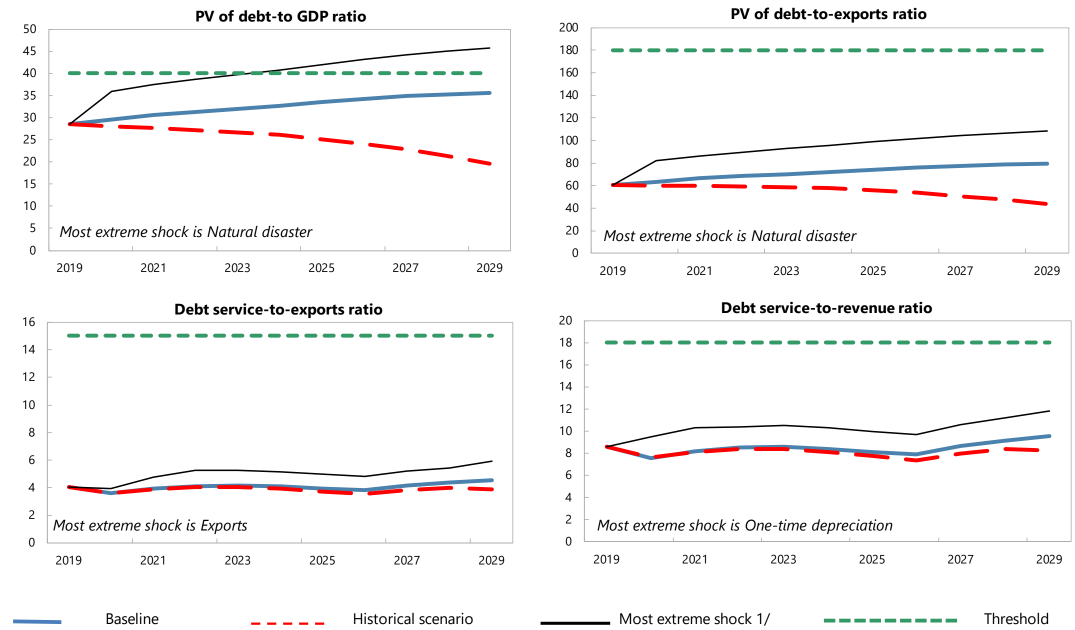
3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

4/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.

5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.

6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Figure 1. Vanuatu: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2019–29 1/



Customization of Default Settings	Size	Interactions
Tailored Tests		
Combined CLs	Yes	
Natural Disasters	No	Yes
Commodity Prices 2/	n.a.	n.a.
Market Financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing Assumptions for Stress Tests*	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.3%	1.3%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	31	31
Avg. grace period	8	8

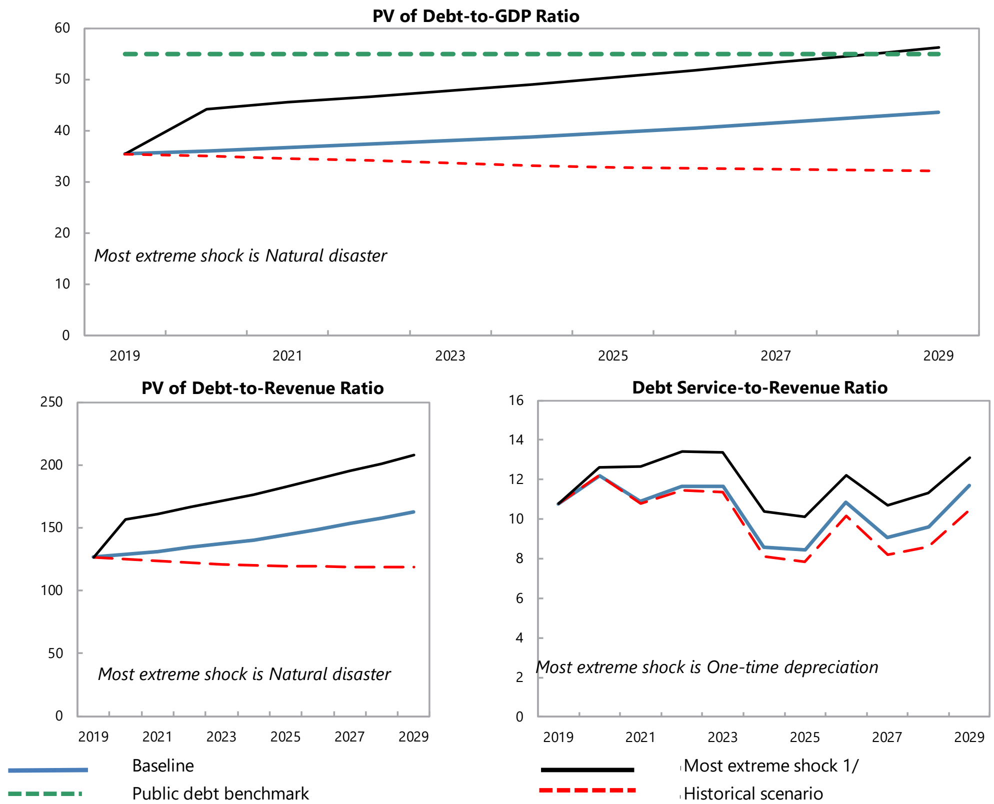
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2029. Stress tests with one-off breaches are also presented (if any), while these one-off breaches are deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Vanuatu: Indicators of Public Debt Under Alternative Scenarios, 2019–29 1/



Borrowing Assumptions for Stress Tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	85%	85%
Domestic medium and long-term	15%	15%
Domestic short-term	2%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.3%	1.3%
Avg. maturity (incl. grace period)	31	31
Avg. grace period	8	8
Domestic MLT debt		
Avg. real interest rate on new borrowing	4.7%	4.7%
Avg. maturity (incl. grace period)	10	10
Avg. grace period	9	9
Domestic short-term debt		
Avg. real interest rate	-2.5%	-2.5%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2029. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Table 3. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2019–29

(In percent)

	Projections 1/										
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
PV of debt-to GDP ratio											
Baseline	28	30	31	31	32	33	33	34	35	35	36
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2029 2/	28	28	28	27	27	26	25	24	23	21	20
B. Bound Tests											
B1. Real GDP growth	28	30	32	33	34	35	35	36	37	37	38
B2. Primary balance	28	31	34	34	35	36	36	37	38	38	38
B3. Exports	28	32	38	38	39	40	**40**	**41**	**42**	**42**	**42**
B4. Other flows 3/	28	34	**40**	**41**	**41**	**42**	**42**	**43**	**44**	**44**	**44**
B5. Depreciation	28	37	35	36	37	38	39	**40**	**41**	**42**	**42**
B6. Combination of B1-B5	28	35	39	39	40	**41**	**41**	**42**	**43**	**43**	**43**
C. Tailored Tests											
C1. Combined contingent liabilities	28	34	35	36	36	37	38	38	39	39	40
C2. Natural disaster	28	36	37	39	40	**41**	**42**	**43**	**44**	**45**	**46**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	40	40	40	40	40	40	40	40	40	40	40
PV of debt-to-exports ratio											
Baseline	61	64	66	68	70	72	74	76	77	79	80
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2029 2/	61	60	60	59	59	58	56	54	51	47	44
B. Bound Tests											
B1. Real GDP growth	61	64	66	68	70	72	74	76	77	79	80
B2. Primary balance	61	67	73	75	77	79	81	82	84	85	86
B3. Exports	61	74	94	97	99	101	103	105	106	108	108
B4. Other flows 3/	61	74	87	89	90	92	94	96	97	98	98
B5. Depreciation	61	64	61	63	65	67	69	71	72	74	75
B6. Combination of B1-B5	61	74	77	86	88	90	92	93	95	96	97
C. Tailored Tests											
C1. Combined contingent liabilities	61	73	76	78	80	81	83	85	87	88	89
C2. Natural disaster	61	82	86	90	93	96	99	102	104	107	109
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	180	180	180	180	180	180	180	180	180	180	180
Debt service-to-exports ratio											
Baseline	4	4	4	4	4	4	4	4	4	4	5
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2029 2/	4	4	4	4	4	4	4	4	4	4	4
B. Bound Tests											
B1. Real GDP growth	4	4	4	4	4	4	4	4	4	4	5
B2. Primary balance	4	4	4	4	4	4	4	4	4	4	5
B3. Exports	4	4	5	5	5	5	5	5	5	5	6
B4. Other flows 3/	4	4	4	5	5	5	4	4	5	5	5
B5. Depreciation	4	4	4	4	4	4	4	4	4	4	4
B6. Combination of B1-B5	4	4	4	5	5	5	5	4	5	5	6
C. Tailored Tests											
C1. Combined contingent liabilities	4	4	4	4	4	4	4	4	4	5	5
C2. Natural disaster	4	4	5	5	5	5	5	5	5	5	5
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	15	15	15	15	15	15	15	15	15	15	15
Debt service-to-revenue ratio											
Baseline	9	8	8	9	9	8	8	8	9	9	10
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2029 2/	9	8	8	8	8	8	8	7	8	8	8
B. Bound Tests											
B1. Real GDP growth	9	8	9	9	9	9	9	8	9	10	10
B2. Primary balance	9	8	8	9	9	9	8	8	9	9	10
B3. Exports	9	8	9	9	9	9	9	9	9	10	11
B4. Other flows 3/	9	8	9	9	10	9	9	9	9	10	11
B5. Depreciation	9	9	10	10	10	10	10	10	11	11	12
B6. Combination of B1-B5	9	8	9	10	10	10	9	9	10	10	12
C. Tailored Tests											
C1. Combined contingent liabilities	9	8	9	9	9	9	9	8	9	9	10
C2. Natural disaster	9	8	9	9	9	9	9	9	9	10	10
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	18	18	18	18	18	18	18	18	18	18	18

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private transfers and FDI.

Table 4. Vanuatu: Sensitivity Analysis for Key Indicators of Public Debt 2019–29

	Projections 1/										
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
PV of Debt-to-GDP Ratio											
Baseline	35	36	37	37	38	39	40	41	42	43	44
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2029 2/	35	35	35	34	34	33	33	33	32	32	32
B. Bound Tests											
B1. Real GDP growth	35	37	40	42	43	45	46	48	50	52	53
B2. Primary balance	35	38	41	41	42	42	43	44	45	46	47
B3. Exports	35	38	43	43	44	45	45	46	47	48	49
B4. Other flows 3/	35	41	46	47	47	48	49	49	50	51	52
B5. Depreciation	35	43	41	40	38	37	37	36	35	35	34
B6. Combination of B1-B5	35	37	38	36	37	37	38	39	40	41	42
C. Tailored Tests											
C1. Combined contingent liabilities	35	42	42	43	43	44	45	46	47	48	49
C2. Natural disaster	35	44	45	47	48	49	50	52	53	55	**56**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public debt benchmark	55	55	55	55	55	55	55	55	55	55	55
PV of Debt-to-Revenue Ratio											
Baseline	127	129	131	134	137	140	145	149	153	158	162
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2029 2/	127	125	123	122	121	120	120	119	119	119	119
B. Bound Tests											
B1. Real GDP growth	127	133	142	148	154	160	167	174	182	189	197
B2. Primary balance	127	136	145	148	151	154	158	163	167	171	176
B3. Exports	127	136	153	156	159	162	166	170	174	178	182
B4. Other flows 3/	127	146	165	168	170	173	177	181	186	190	193
B5. Depreciation	127	155	150	145	141	138	136	134	132	131	130
B6. Combination of B1-B5	127	131	135	131	133	137	141	145	149	154	158
C. Tailored Tests											
C1. Combined contingent liabilities	127	149	151	154	157	160	164	168	173	177	181
C2. Natural disaster	127	157	161	166	171	176	182	189	195	201	208
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio											
Baseline	11	12	11	12	12	9	8	11	9	10	12
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2029 2/	11	12	11	11	11	8	8	10	8	9	10
B. Bound Tests											
B1. Real GDP growth	11	12	11	12	12	9	9	12	10	11	13
B2. Primary balance	11	12	11	12	12	9	9	11	10	10	12
B3. Exports	11	12	11	12	12	9	9	11	9	10	12
B4. Other flows 3/	11	12	11	12	12	9	9	12	10	10	13
B5. Depreciation	11	13	13	13	13	10	10	12	11	11	13
B6. Combination of B1-B5	11	12	11	11	11	8	8	11	9	9	12
C. Tailored Tests											
C1. Combined contingent liabilities	11	12	12	12	12	9	9	11	10	10	12
C2. Natural disaster	11	13	12	13	13	10	10	12	10	11	13
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

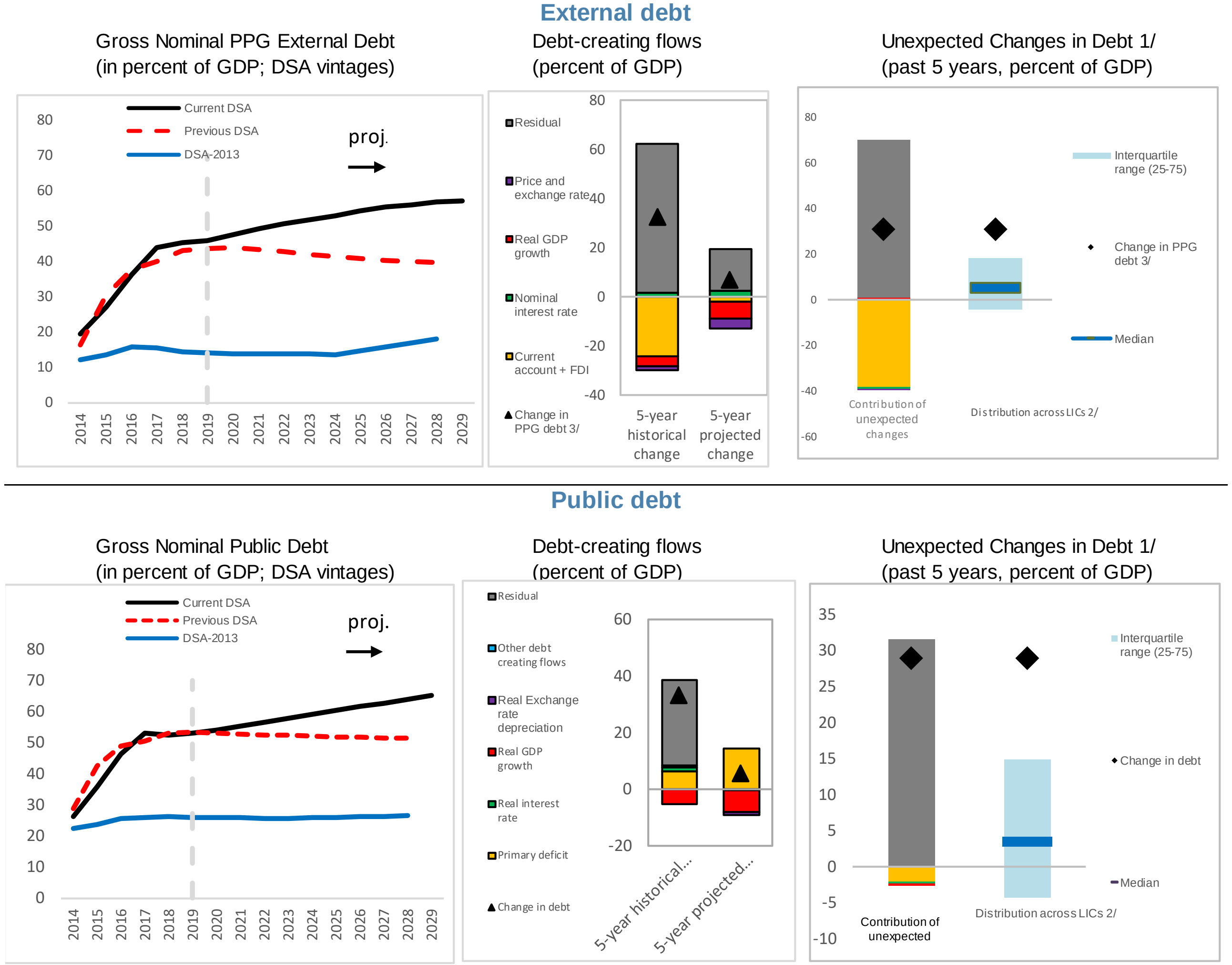
Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the benchmark.

2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

3/ Includes official and private transfers and FDI.

Figure 3. Vanuatu: Drivers of Debt Dynamics – Baseline Scenario



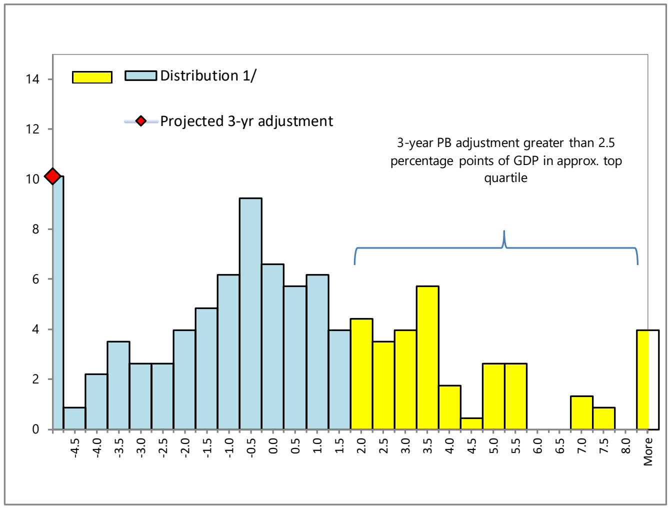
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

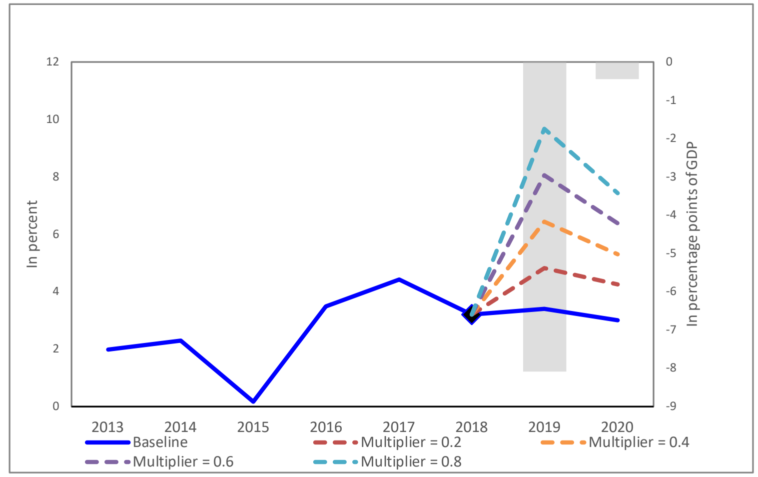
Figure 4. Vanuatu: Realism Tools

3-Year Adjustment in Primary Balance (Percentage points of GDP)



1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Figure 5. Vanuatu: Qualification of the Moderate Category, 2019–29 1/

Sources: Country authorities; and staff estimates and projections.

1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percent and y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

Statement by Nigel Ray, Executive Director of Vanuatu, and Anna Park, Advisor to the Executive Director of Vanuatu

Vanuatu is a small developing state, consisting of 83 volcanic islands in the South Pacific. Tourism and agriculture are key drivers of economic activity, but distance from major markets and vulnerability to external shocks pose challenges to growth and development. Located on the earthquake-prone “ring of fire” and sitting at the center of the Pacific cyclone belt, Vanuatu experiences frequent natural disasters, including tropical cyclones, active volcanos and earthquakes, and is ranked as the most at-risk country in the world by the UN World Risk Index.

The economy has been growing strongly, boosted by spending on infrastructure and reconstruction projects following extensive damage caused by Cyclone Pam in 2015. The government has an ambitious development agenda aimed at developing urban and rural areas, improving living standards and delivering community services. As major infrastructure projects are completed, there is an increased focus on other drivers of medium-term growth, including initiatives to diversify and increase value added in agriculture and a cross-sector plan to develop air transport and tourism, the *Shared Vision 2030*.

The authorities largely agree with staff’s analysis and near-term outlook, and with the broad thrust of the advice. They thank staff for their thoughtful analysis and the open and collaborative approach taken by the team. Staff from the World Bank and Asian Development Bank were also invited to join relevant meetings, which allowed all involved to draw on each other’s expertise and make best use of the authorities’ time. The authorities value highly the advice and technical assistance received from the Fund and look forward to further constructive engagement in future.

Prudent and sustainable fiscal management

The authorities are committed to maintaining fiscal discipline while making necessary investments in productive and social sectors to build economic growth. Spending on projects to address infrastructure gaps and post-disaster reconstruction has increased in recent years. While this has been largely funded through grants and loans with a high concessional element, public and publicly guaranteed debt has increased to an elevated level. The government’s long-term fiscal objectives include maintaining a recurrent budget that is in surplus over the medium term and keeping nominal public and publicly guaranteed debt below 60 per cent of GDP (consistent with staff’s recommendation in 2018). The authorities note that staff projections show debt rising above this target in the medium term even with the domestic recurrent budget in surplus. They noted the need for additional revenue mobilization in the future, along with continued expenditure restraint and careful debt management. The authorities have taken the opportunity provided by strong growth in revenues from the economic citizenship program in 2019 to reduce debt where possible.

Increasing revenues to fund essential services is a priority for the government. A review of current taxes, non-tax revenues and revenue administration has been conducted to identify areas where tax policy, law and revenue administration may be reformed or modernized to support sustainable economic development. An updated *Tax Administration Act* came into force in 2019. The introduction of an income tax at a future date also remains a possibility.

Significant process has been made in strengthening the debt management framework. Under the debt management strategy introduced in 2015, new loans must have a grant element of at least 35 per cent. The authorities are conscious of the need to plan and sequence projects, and new projects are required to have thorough and feasible plans to generate economic and financial returns in the medium term. Further improvements are being made to the debt management strategy, on-lending and guarantee policies and related financial regulations, drawing on assistance from development partners including the World Bank and Asian Development Bank.

Vanuatu continues to build resilience to natural disasters and climate change. This includes building fiscal policy buffers, ensuring an adequate level of international reserves, spending on resilient infrastructure and adequate maintenance. Between 2006 and 2016, Vanuatu developed a Disaster Risk Reduction and Disaster Management National Action Plan, as well as being the first Pacific Island country to have adopted both a National Adaptation Program of Action (2007) and National Action Plan for Climate Change Adaptation and Disaster Risk Reduction (2015). The new *Disaster Risk Management Act* 2018 aims to enhance engagement with provincial and municipal governments, support access to donor-funded disaster assistance and set up a national disaster fund. Securing access to donor-funded assistance is also needed. The authorities are discussing a development policy grant with a Catastrophe-Deferred Drawdown Option (CAT-DDO) with the World Bank which would provide immediate liquidity to the country in the aftermath of a natural disaster.

Supportive monetary and financial sector policies

The Reserve Bank of Vanuatu's (RBV) actions have continued to contain inflationary pressures. The exchange rate regime has worked well, providing the economy with the useful nominal anchor, while statutory reserve requirements and open market operations have been used to address domestic pressures. The RBV stands ready to adjust policy as economic conditions evolve. Excess liquidity in the banking sector poses a medium-term challenge for monetary policy implementation. A review of monetary policy instruments is underway and the staff team's analysis of excess liquidity in the banking sector is useful in this context. As this is not a problem unique to Vanuatu, the authorities would see value in a regional analysis of drivers and policy responses for the next Article IV consultation.

Broadening access to credit is a priority, and the authorities look forward to further engagement with the Fund on this issue. The RBV is carefully monitoring the banking sector and welcomes the IMF banking sector diagnostic currently underway. Financial sector development is also being supported through stronger supervision, including the introduction of a new legal framework for credit unions and work underway with PFTAC assistance to review the RBV's approach to risk-based supervision. The authorities are also progressing financial inclusion initiatives under the *National Financial Inclusion Strategy 2018-23*. While noting that fintech applications have a role in strengthening financial inclusion, the authorities are also conscious of the need to ensure that appropriate regulatory frameworks are in place.

Significant progress has been made in improving Vanuatu's AML/CFT framework, resulting in Vanuatu's removal from the FATF AML/CFT grey list in June 2018. While banks have been able to maintain correspondent banking relationships, these remain under pressures and compliance activities have increased costs. A substantial amount of work was needed to prepare and implement new AML/CFT legislation to enable Vanuatu's removal from the grey list. In this context, the authorities expressed concern that Vanuatu's recent inclusion on the European Union list of non-cooperative tax jurisdictions could undermine some of the work that has been done to support correspondent banking relationships. Work is underway to ensure that Vanuatu fulfils its international obligations in the area of taxation. Technical assistance is also valuable in this area given resource constraints; the authorities have engaged additional technical assistance under the Australian Governance for Growth project.

Enhancing governance

The authorities are committed to strong governance. Efforts underway include improving public financial management, through the *Tax Administration Act*, and the authorities are working with the ADB to improve the operation of Government Business Enterprises. Progress has been made in implementing the IMF *Safeguards Assessment* recommendations including strengthening the corporate governance structure, internal audit function and overall structure of the RBV. Ongoing IMF technical assistance in this area is appreciated.