INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/208

VANUATU

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR VANUATU

September 2021

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 2021 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 August 31, 2021 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 August 31, 2021, following discussions that ended on July 22, 2021, 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 August 16, 2021.
- 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.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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PRESS RELEASE

PR21/263

IMF Executive Board Concludes 2021 Article IV Consultation with Vanuatu

FOR IMMEDIATE RELEASE

Washington, DC – September 14, 2021: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Vanuatu.

The COVID-19 pandemic and major natural disasters hit the Vanuatu economy severely in 2020. Due to the authorities' decisive measures, Vanuatu has had no domestic transmission of COVID-19. However, the border closure dealt a heavy blow to tourism. Infrastructure projects have also been delayed. In addition, Tropical Cyclone Harold and a volcanic eruption in Tanna Island caused extensive damage the first half of 2020. Notwithstanding the authorities' policy responses, the reduction in travel receipts led to severe economic contraction. Strong receipts of the Economic Citizenship Programs (ECP) and donor support have helped mitigate the impact of the pandemic on fiscal and external balances.

After a severe contraction in 2020, real GDP growth is expected to rise to 1.2 percent in 2021. Agricultural production and remittance income from seasonal workers will help to support a return to positive growth in 2021. Growth will also be supported by construction activity, despite delays which will push several large infrastructure projects into 2022. Tourism related sectors are expected to contract further in 2021 due to the extended border closure and are expected to start a gradual recovery beginning in 2022.

Risks to the outlook are substantial and tilted to the downside. A worsening of the pandemic requiring longer border closure would adversely impact economic activity. ECP revenues could fall sharply amid growing concerns on AML/CFT risks to ECP under the recent loss of the key correspondent banking relationship. Further deterioration of banks' asset quality could erode the soundness of Vanuatu's financial system. Lack of transparency and effective supervision framework for state enterprises could negatively affect the business environment and fiscal management. Issues concerning AML/CFT and EU blacklisting related to tax transparency could accelerate de-risking by foreign firms and impede foreign direct investment (FDI). An ever-present downside risk relates to further natural disasters.

Executive Board Assessment[2]

Executive Directors commended the authorities for their decisive actions to prevent a local outbreak of the pandemic, and for prudent policy management which has helped maintain macro-financial stability despite the challenges from the pandemic and natural disasters.

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[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.

[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.

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Directors emphasized that front-loading the vaccination strategy with support of development partners should be a priority to help support the recovery.

Directors concurred with the need for maintaining fiscal support over the near term, anchored on a credible medium-term fiscal consolidation strategy. They stressed that the support should be well targeted and complemented by improvements in public expenditure and investment management. Directors underscored that a fiscal strategy based on domestic revenue mobilization, including the introduction of personal and corporate income taxes, would both allow the authorities to reduce the reliance on revenues from the Economic Citizenship Program (ECP) and provide resources for investment in climate resilient infrastructure and other development needs. Directors urged the authorities to further manage fiscal risks by minimizing the contingent liabilities of SOEs, including of the state-owned airline.

Directors agreed that monetary policy should remain accommodative until the recovery is entrenched. Close monitoring of inflationary pressures is warranted. Directors emphasized that the authorities should remain vigilant of developments in the banking sector and continue to strengthen supervisory frameworks. They encouraged the authorities to establish crisis management and resolution frameworks and to improve the collateral asset recovery environment for liquidation of non-performing loans. Directors noted that digitalization could advance financial inclusion, but challenges remain.

Directors underscored the importance of improving governance, reducing corruption, and bolstering Vanuatu's risk profile, to mitigate risks stemming from weak due diligence of the ECP and the loss of correspondent banking relationships (CBRs). Directors urged the authorities to further strengthen legal frameworks and the institutional capacity pertaining to AML/CFT, tax transparency, and central bank autonomy and governance. They also underscored the need for the authorities to establish supervisory frameworks for the state-owned enterprises and enhance their transparency.

Directors agreed that economic diversification and development of quality infrastructure is essential for sustained and inclusive growth. They also underscored the need for improving Vanuatu's resilience to natural disasters and climate change and welcomed the operationalization of the Disaster Risk Management Act and the ongoing review of the National Adaptation Plan for Action. Noting Vanuatu's limited capacity, Directors encouraged the authorities to continue to benefit from technical assistance by the Fund and development partners.

Table 1. Vanuatu: Selected Economic Indicators, 2018–23

Population (2020): 301,695
Per Capita GDP (2020): US$ 3,090
IMF quota: SDR 23.8 million (0.01 percent of total)
Literacy rate (2018): 87.5 percent
Main products and exports: Kava, coconut oil, copra, cocoa, beef
Key export markets: New Caledonia, Australia, New Zealand

	2018	2019	2020	2021	2022	2023
	Estimates			Projections		
Output and prices (annual percent change)						
Real GDP	2.9	3.9	-6.8	1.2	3.0	4.1
Consumer prices (period average)	2.4	2.7	5.7	5.4	2.6	2.3
Consumer prices (end period)	1.9	3.5	7.0	3.9	2.3	2.2
Government finance (in percent of GDP)						
Total revenue	39.5	38.5	44.2	40.6	34.2	32.1
Taxes	18.4	17.6	14.6	16.1	16.5	17.0
Other revenue	12.0	13.9	16.0	11.2	9.7	8.7
Grants	9.2	7.0	13.6	13.2	8.0	6.4
Expenditure	33.3	31.8	44.4	44.0	38.3	36.1
Expense	26.9	28.5	37.8	36.4	29.6	29.0
Net acquisition of non financial assets	6.4	3.3	6.6	7.6	8.7	7.1
Net lending (+)/borrowing (-)	6.3	6.7	-0.1	-3.5	-4.1	-4.0
Public and publicly-guaranteed debt (end of period)	49.2	46.1	50.1	47.5	50.2	51.4
Domestic	7.3	6.1	9.3	8.0	6.7	5.7
External	41.9	40.1	40.8	39.4	43.5	45.8
Money and credit (annual percentage change)						
Broad money (M2)	-0.5	9.2	5.3	-3.0	3.8	6.0
Net foreign assets	39.0	24.2	16.9	0.0	5.2	6.3
Domestic credit	-4.4	-6.4	-9.5	-6.8	-1.3	1.6
Of which: Credit to private sector	1.2	0.4	1.5	-3.2	0.8	1.8
Interest rates (in percent, end of period) 1/						
Deposit rate (vatu deposits)	1.2	0.8	0.7	...	...	...
Lending rate (vatu loans)	0.0	0.0	0.0	...	...	...
Balance of payments (in percent of GDP)						
Current account	12.2	16.0	3.3	-6.9	-8.0	-5.7
Trade balance	-26.2	-29.5	-23.5	-23.3	-24.3	-26.1
Exports of goods	6.9	4.9	5.2	5.3	5.4	5.4
Imports of goods	-33.1	-34.4	-28.7	-28.5	-29.7	-31.5
Travel receipts	32.3	29.8	7.2	0.6	4.4	11.3
Capital and financial account	-16.0	-6.5	3.5	11.4	9.4	7.9
Of which: Foreign direct investment	3.9	2.7	2.6	2.9	3.0	2.9
Overall balance	2.7	9.8	10.9	4.5	1.4	2.2
Gross international reserves (in millions of U.S. dollars)	420.6	511.6	613.6	658.2	673.0	697.7
Gross international reserves (in months of prospective G&S imports)	9.6	13.3	15.3	14.7	13.3	11.8
External debt service (in percent of GNFS exports)	4.0	6.7	18.7	31.5	11.1	7.8
Exchange rates 2/						
Vatu per U.S. dollar (period average)	108.5	115.6	109.1	...	...	...
Vatu per U.S. dollar (end of period)	112.3	114.3	108.0	...	...	...
Memorandum items:						
Nominal GDP (in billions of vatu)	100.8	107.2	101.7	107.0	112.6	119.8
Nominal GDP (in millions of U.S. dollars)	928	928	932	999	1,060	1,127

Sources: Vanuatu authorities; and IMF staff estimates and projections.
1/ Weighted average rate of interest for total bank deposits and loans.
2/ The vatu is officially pegged to an undisclosed basket of currencies.

INTERNATIONAL MONETARY FUND

VANUATU

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

August 16, 2021

KEY ISSUES

Context: Border closures and other pandemic containment measures have kept Vanuatu free from COVID-19. However, they have dealt a heavy blow to economic activity as tourism has come to a virtual halt. On top of the pandemic, Tropical Cyclone Harold and a volcanic eruption in Tanna Island caused extensive economic damage in 2020. In the context of a continued loss of correspondent banking relationships (CBRs) in the Pacific, Vanuatu also lost a key CBR at end-June 2021. Air Vanuatu, one of the state-owned enterprises (SOEs), is in the process of being restructured.

Outlook and Risks: Following a severe contraction in 2020, real GDP is expected to grow by 1.2 percent in 2021, supported by agricultural production, remittance income, and construction activity. Tourism and related sectors are expected to contract further this year. Risks to the outlook are substantial and tilted to the downside. They include a potential worsening of the pandemic; a sharp fall in revenues from the Economic Citizenship Program (ECP) that offers passports in return for investment; an acceleration of de-risking by foreign firms concerning AML/CFT and tax transparency; further deterioration of banks' asset quality; and vulnerability to natural disasters.

Main Policy Recommendations:

- Maintain accommodative macroeconomic and financial policies in the near term to support the recovery. Given Vanuatu's limited fiscal space, fiscal support should continue to be well targeted while its phasing out being state-contingent. Front-load the vaccination strategy as feasible with support of development partners.
- Formulate a medium-term fiscal strategy based on gradual fiscal consolidation, including the introduction of personal and corporate income taxes. Integrate financing plans consistent with the fiscal strategy for the climate change adaptation plan and building resilience to natural disasters. Properly manage fiscal risks by minimizing the contingent liabilities of Air Vanuatu.
- Closely monitor the banking sector, establish crisis management and resolution frameworks, and improve collateral asset recovery environment for NPL liquidation.
- Establish effective supervision and transparency of SOEs and strengthen further legal frameworks and institutional capacities on AML/CFT, tax transparency, central bank autonomy and governance, leading to reduce corruption vulnerabilities.

Approved By
Krishna Srinivasan (APD) and Maria Gonzalez (SPR)

Mission dates: June 28–July 22, 2021
Mission team: Koki Harada (Head), Seruwaia Cagilaba, Gabriela Cugat, Leni Hunter (resident representative) and Yinqiu Lu (all APD). Kathleen Kao (LEG), Chris Becker (OED), Lodewijk Smets (WB), David Richard Fay and Nancy Wells (both ADB) participated in some of the meetings. Vybhavi Balasundharam (FAD) contributed to the preparations for the mission and background papers. The mission met with Minister of Finance and Economic Management Johnny Koanapo Rasou, Governor of Reserve Bank of Vanuatu (RBV) Simeon Malachi Athy, other senior officials from the government and RBV, and representatives from the private sector and civil society organization, and development partners. Yadian Chen, Francis Landicho, and Kristine Laluces (all APD) assisted in preparing this report.

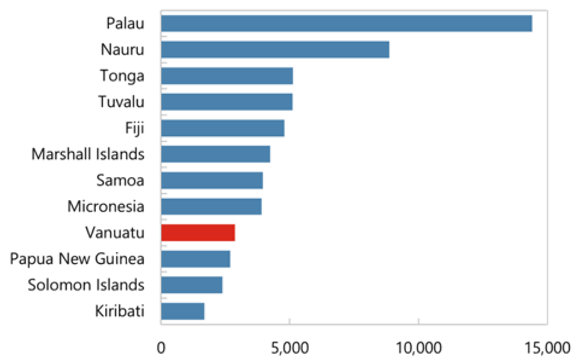
CONTENTS

ANNEXES

PRE-PANDEMIC LANDSCAPE AND CHALLENGES

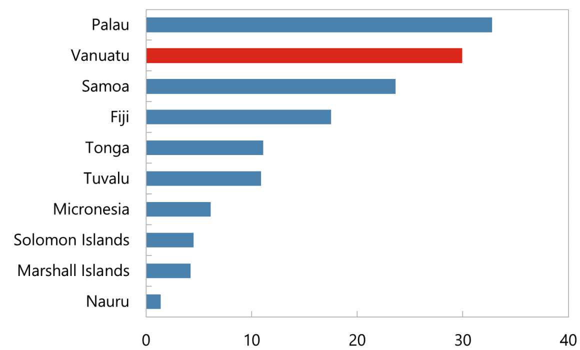
1. **Vanuatu graduated in 2020 from the United Nation's list of least developed countries, but its development needs remain high.**[1] Consisting of 83 islands with a population of about three hundred thousand, Vanuatu's GDP per capita remains below that of most of its peers in the Pacific. Accelerating economic development in an archipelago that is far removed from the closest continent will require infrastructure investment in various areas, including transportation, energy, and information and communications technology. While the tourism sector remains integral to Vanuatu's economy, further economic diversification is needed to enhance sustainable and inclusive growth and resilience.

GDP Per Capita of Pacific Island Countries, 2020
(In U.S. dollars)



Source: World Economic Outlook.

Balance of Payment, Travel Receipts, 2019
(In percent of GDP)



Sources: Authorities; IMF staff estimate.

2. **Vanuatu's economy was expanding prior to the Covid-19 pandemic.** Annual real GDP growth averaged 4.5 percent in 2016–19, underpinned by large public investments following Tropical Cyclone Pam in 2015, rising agricultural exports, and an increase in tourism receipts and remittances, which *inter alia* also helped strengthen the external position.[2] Windfall revenues in recent years from the Economic Citizenship Program (ECP)[3] that offers passports in return for investment helped the government maintain a prudent fiscal stance and reduce public debt. Inflation has generally been within the Reserve Bank of Vanuatu's (RBV) target range of 0 to 4 percent, and the financial system has remained sound.

3. **Key structural vulnerabilities relate to climate change, limited cross border financial linkages, and weak governance.** Vanuatu remains extremely vulnerable to climate change. It

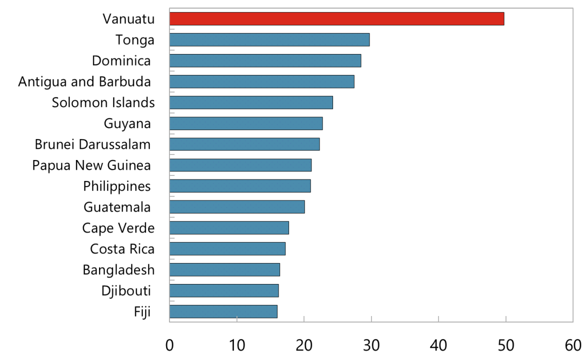
[1] Vanuatu was recommended for graduation from the least developed countries (LDC) category by the Committee for Development Policy (CDP) at the 2012 triennial review. Following cyclone Pam in 2015 a three-year extension was granted by the UN General Assembly, with graduation postponed to 4 December 2020.

[2] Vanuatu is the largest labor supplier to the seasonal worker program (SWP) of Australia and the Recognized Seasonal Employer (RSE) program in New Zealand.

[3] See Annex II.

ranked first in the 2020 World Risk Index[4] for vulnerability to natural disasters—highlighting the need for public investment in resilient infrastructure. Concerns relating to AML/CFT and financial integrity risks, particularly in the context of weak due diligence with regard to the ECP, put Vanuatu's limited financial links at risk. This is reflected in Vanuatu's recent loss of a key correspondent banking relationship (CBR)—a vital channel for ECP payments—and what will likely be a significant drop in ECP revenues. The loss of the CBR highlights underlying financial integrity risks, notably pertaining to AML/CFT and tax transparency.

2020 World Risk Index



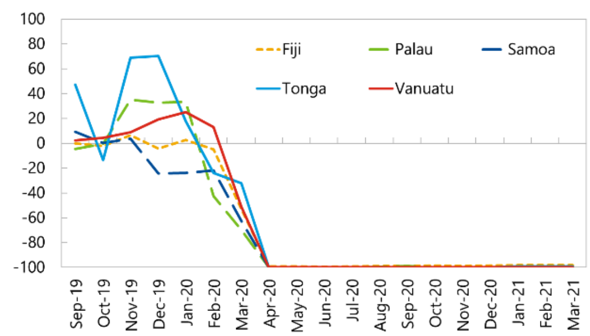
Source: World Risk Report 2020.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

4. The authorities' decisive pandemic containment measures prevented a local outbreak of COVID-19 but have entailed a high economic cost. Borders have been closed under a state of emergency since March 2020[5], and to date only three confirmed cases of COVID-19 have been identified at Vanuatu's borders. However, the closure dealt a severe blow to tourism, with spillovers to other sectors. Infrastructure projects have been delayed due to the border closure and lack of domestic capacity.

Selected PICs: Visitor Arrivals

(12-month percent change, includes tracking estimates)



Sources: National sources; and IMF staff estimates.

5. Vanuatu has also been hit by major natural disasters in 2020. In the first half of the year, Tropical Cyclone Harold and a volcanic eruption in Tanna Island caused extensive damage and severely affected crop production and food supply.[6] However, favorable weather after the natural

[4] Bündnis Entwicklung Hilft and Ruhr University Bochum, Institute for International Law of Peace and Armed Conflict (IFHV) publishes the World Risk Index based on countries' exposure, vulnerability, susceptibility, lack of coping capacities and lack of adaptive capacities.

[5] The state of emergency has been extended to the end of 2021.

[6] Category 5 TC Harold caused significant damage to shelter, schools, health infrastructure and supplies, agricultural crops, power and telecommunications; affecting an estimated 43 percent of the population (United Nations, UNSDG | UN in Action - Vanuatu). Damages by TC Harold are estimated at VUV 56.0 billion (damages to infrastructure and assets are estimated at VUV 27.7 billion), accounting for over 50 percent of GDP (July 2020, Vanuatu Recovery Strategy 2020-2023, Government of Vanuatu).

disasters and a reallocation of workers from tourism to agriculture have helped alleviate the damage to agricultural output, but the border closure has delayed rebuilding activities.

6. The authorities responded with a comprehensive policy package to mitigate the socio-economic impact of the pandemic and natural disasters. Policy measures included the following:

- The government announced a fiscal stimulus package in April 2020, amounting to over 4 percent of GDP, targeted at mitigating economic and social hardship. A major component (almost a quarter of this package) included emergency support to employment in the tourism sector. However, actual disbursements of support and fee exemptions have only amounted to about 2.5 percent of GDP, owing in part to limited implementation capacity. The Vanuatu National Provident Fund (VNPF) also supported members by providing short-term loans. In May 2021, the government announced the second fiscal stimulus package, again targeted at households and firms most affected by the pandemic. The government is also developing a scheme to provide further financial support of around 1.8 percent of GDP through commercial banks and the Vanuatu Agricultural Development Bank (VADB).

Vanuatu: Policy Response to the COVID-19 Shock and Twin Natural Disasters

Policy Measures	Size (Percent of GDP)	Expiration Date
Fiscal		
Economic Stimulus Package in 2020		
Employment Stabilisation Payment	0.94	Sep-20
Small and Medium Enterprise Grant	0.25	Nov-20
School Fee Subsidy	0.36	
Commodity Subsidy	0.16	
Shipping Subsidy	0.01	
Cancellation business fees and charges	0.78	
Second Economic Stimulus Package in 2021		
Wage Subsidy Scheme	0.52	Sep-21
Small Business Grant	0.65	Sep-21
Monetary		
Policy rate cut from 2.9% to 2.25%		
Reactivated the Disaster Reconstruction and Credit Facility		
Reactivated the Import Substitution and Export Finance Facility		
TC Harold Relief Assistance Initiative	0.03	
Financial		
Suspension of onsite examinations but focus more on offsite monitoring.		
Reduced regulatory Capital Adequacy Ratio threshold from 12.0% to 10.0%		
Loan repayment deferrals		Sep-21
Temporary suspension of prudential requirement on asset quality		Sep-21

Source: Vanuatu authorities.
(Note) If no "expiration" date is indicated, the policy measure is ongoing as of July 2021.

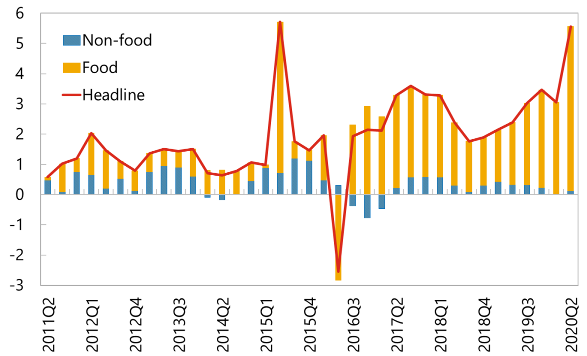
- In March 2020, the RBV cut its policy rate by 65 bps to 2.25 percent and increased liquidity support to banks.[7] The RBV also allowed a loan repayment deferral and relaxed loan classification requirements until end-September 2021 to provide banks additional time to restructure loans. The regulatory threshold for banks' Capital Adequacy Ratio (CAR) was reduced from 12 percent to 10 percent.

7. Notwithstanding support measures, economic activity contracted sharply, with attendant implications for the financial sector. Real GDP is estimated to have contracted by 6.8 percent in 2020, led by a collapse of activity in tourism and related sectors, including

[7] Open market operations rose from 600 million Vatu per week at the beginning of 2020 to 800 million Vatu per week at the end of the year. Excess reserves are over 31 billion Vatu at end-2020 while the target level is 3 billion Vatu. Since the reactivation of Imports Substitution and Export Finance Facility (ISEFF) and the Disaster Reconstruction Credit Facility (DRCF), 500 million Vatu has been made available to commercial banks under each of the facilities. The ISEFF is a back- to-back lending facility to businesses offered through commercial banks and DRCF is offered to businesses through commercial banks for the purpose of rehabilitation and reconstruction post disasters.

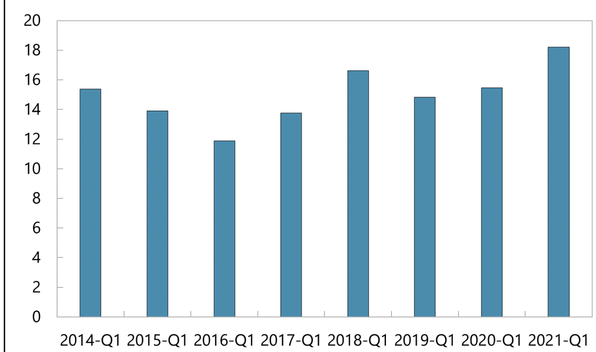
accommodation and food services. Headline inflation spiked to 5.6 percent in 2020Q2[8] and is expected to persist because of the longer-than-expected food supply shock caused by natural disasters and higher international food prices particularly for rice. In the financial sector, the system-wide NPL ratio increased from 14.4 percent at end-2019 to 19.0 percent at end-2020.[9] The CAR has remained well above the regulatory threshold at 20 percent as of end-2020.

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



Sources: Vanuatu authorities; and IMF staff calculations.

System-wide NPL ratio
(In percent)



Source: Vanuatu authorities.

8. Strong ECP receipts and donor support have helped mitigate the impact of the pandemic on fiscal and external balances.

- Despite a surge in expenditures and a decline in tax revenues, the overall fiscal position was near balance in 2020, owing to delays in infrastructure spending, windfall ECP receipts (about one third of total revenues) and donor support. The ECP receipts represent both a benefit and a drawback for Vanuatu. On the one hand, they have provided the country with financing to help address challenges posed by the pandemic and natural disasters. Conversely, owing to AML/CFT concerns and governance issues (see paragraph 29), ECP transactions pose risks to CBRs.

- Similarly, despite a sharp decline in tourist arrivals, the current account registered a surplus of 3.3 percent of GDP in 2020, and international reserves increased to U$613.6 million (about 15 months of prospective import cover). Vanuatu's external position in 2020 is assessed to be stronger than fundamentals and desirable policy settings (Appendix III).

9. The authorities have initiated their vaccination rollout, but challenges are expected. The authorities currently plan to vaccinate 20 percent of the population under COVID-19 Vaccines Global Access (COVAX) in 2021 and 40 percent of the population by June 2022.[10] The authorities

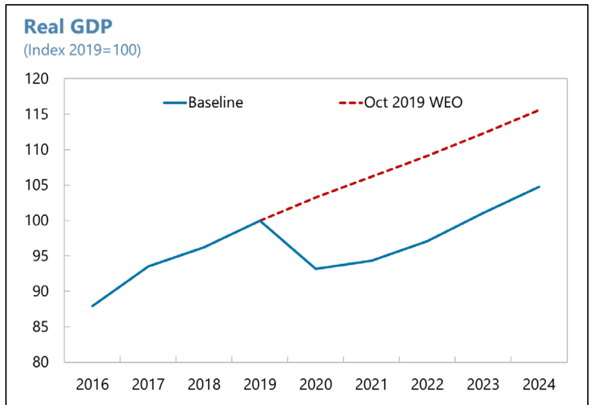
[8] The average inflation rate of 2019Q3-2020Q2 is 3.8 percent.

[9] The financial sector in Vanuatu has assets of about 155 percent of GDP and is dominated by five commercial banks that account for 131 percent of GDP. Of the five banks, four are foreign-owned and one is National Bank of Vanuatu (NBV) which is owned by the VNPF and the government.

[10] According to the Vanuatu National Deployment and Vaccination Plan, in 2021, targeted people include health workers and border staff (1 percent of the population), persons over 55 years of age (11.3 percent of the population) and persons aged over 35 with co-morbidities (7.1 percent of the population).

received 20,000 doses (AstraZeneca) through COVAX, 20,000 doses (AstraZeneca) from Australia, and 24,000 doses from China (Sinopharm). The authorities also expect to receive 48,000 doses (AstraZeneca) from Japan in August 2021 and additional 28,000 doses (AstraZeneca) from Australia soon. Sufficient vaccine doses for the entire population are expected to be secured through COVAX and donor support in the near term, but the rollout faces logistical difficulties and vaccination hesitancy in some areas.

10. Real GDP growth is expected to increase to 1.2 percent in 2021, led by an uptick in agriculture output, remittances, and construction activity. Rising agricultural production is expected to bolster growth. Remittances are projected to remain resilient due to the resumption of seasonal worker programs and should support private consumption. Growth will also be supported by construction activity, notwithstanding delays that may push several infrastructure projects into 2022.[11] Tourism related sectors are expected to contract further in 2021 due to the extension of border closures to end-2021 and are expected to begin a gradual recovery from 2022. Staff project the economy to recover to pre-pandemic output level by end-2023. Non-food inflationary pressures are expected to remain low. The current account deficit is projected to widen to 6.9 percent of GDP in 2021.



Sources: Vanuatu authorities and IMF staff projection.

11. Risks to the outlook are substantial and tilted to the downside. A worsening of the global pandemic requiring longer border closure would adversely impact economic activity, while faster vaccination rollout and subsequent border reopening would be an upside risk. ECP revenues could fall sharply amid growing concerns regarding AML/CFT risks, amplified by the recent loss of a key CBR. Issues concerning AML/CFT and EU blacklisting related to tax transparency could accelerate de-risking by foreign firms, leading to further loss of CBRs and impeding foreign direct investment (FDI). Further deterioration of banks' asset quality could erode the soundness of Vanuatu's financial system. Lack of transparency and an effective supervision framework for SOEs could increase government contingent liabilities and negatively affect the business environment. An ever-present downside risk relates to further natural disasters (Annex IV).

Authorities' Views

12. The authorities broadly concurred with staff's assessment on economic developments, outlook, and risks. The authorities' GDP growth forecasts were more optimistic than those of staff, based on a lower estimate of tourism's share of overall contribution to GDP. Inflation is expected to remain high in the first half of 2021 due to the temporary food supply shock and the increase in global fuel prices while non-food inflation is projected to remain under control. The authorities

[11] Vanuatu started to issue special visa allowing experts of infrastructure projects to enter the country during the border closure.

expected ongoing agricultural support programs to stabilize supply and prices over the medium term. They viewed the exchange rate regime as having served them well, including in the context of the ongoing pandemic, and foreign reserves to be at a comfortable level. The authorities emphasized the importance of supporting the agriculture sector because of labor shifts from the tourism sector to the agriculture sector at this juncture. Supporting the agriculture sector also contributes to fostering economic diversification of Vanuatu. The rollout of the Electronic Single Window has helped reduce trading costs. The authorities expressed strong concern over the loss of CBRs, which they attributed to global de-risking, and called for coordinated action from the international community to reverse the trend.

SUSTAINING RECOVERY AND GROWTH

Given heightened uncertainty, macroeconomic and financial policies should remain accommodative in the near term to support the recovery, while securing sufficient buffers to safeguard against near- and medium-term risks. To this end, short-term accommodation and support should be embedded in a medium-term framework to anchor sustained and inclusive growth while ensuring fiscal and debt sustainability.

A. Fiscal Policy

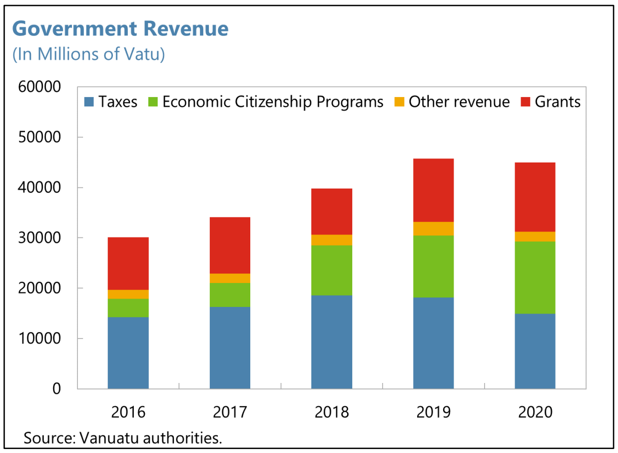
13. Continued fiscal support should remain in place over the near term. Based on the authorities' 2021 budget,[12] staff projects the fiscal deficit to widen to 3.5 percent of GDP in 2021 from 0.1 percent of GDP in 2020.[13] Given the spending needs for recovery and support to the vulnerable, and the current balance of risks, staff recommended that the phasing-out of COVID-related support should be state-contingent and supports the planned short-term expansion of the fiscal deficit. However, Vanuatu's limited fiscal space poses constraints for continued fiscal support if the pandemic is protracted. In this context, it is critical to ensure that support continues to be well targeted at households and firms most affected by the pandemic. Government support for loans made by commercial banks and the VADB should aim at supporting companies that are most affected by the pandemic but remain viable to minimize fiscal risks. It would also be important to strengthen public expenditure and investment management for a more efficient use of public resources.[14] Further, while logistical difficulties and vaccination hesitancy are serious challenges to tackle, front-loading the vaccination strategy as feasible with support of development partners should remain a priority to help secure Vanuatu's economic recovery.

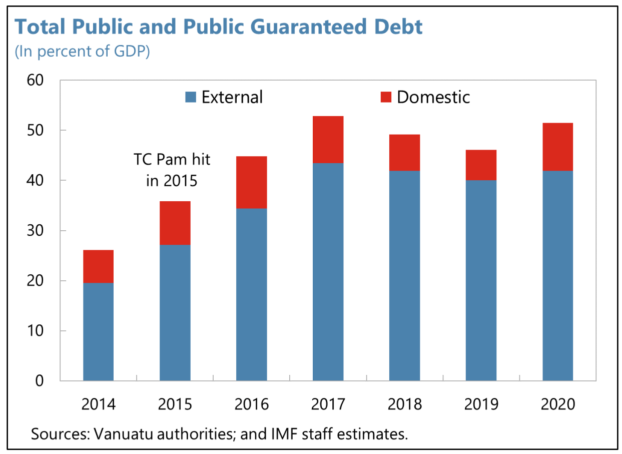
[12] The 2021 budget aims to achieve the objectives of the National Sustainable Development Plan (NSDP) 2030 and address challenges from the pandemic and natural disasters.

[13] Staff estimates that the cyclically adjusted fiscal balance in 2021 is -2.5 percent compared to 1.1 percent in 2020.

[14] Ministry of Finance and Economic Management (MFEM) publishes monthly report of overall budget execution and quarterly expenditure report about expenditure of each ministry, while the publishment tends to be delayed. The Central Tender Board (CTB) is responsible to coordinate and manage the government's tender process for higher value procurement that the value of purchase exceeds VUV 10,000,000 threshold. Tender results are publicly available.

14. The fiscal trajectory remains uncertain, and Vanuatu's fiscal space is limited. The Debt Sustainability Analysis (DSA) indicates that the risk of debt distress in Vanuatu is moderate with limited space to absorb shocks and remains unchanged from the previous DSA. However, the risk of losing ECP revenues is increasing due to elevated concern about ECP due diligence with respect to AML/CFT together with the recent loss of a key CBR. A sudden stop in ECP revenues could undermine fiscal sustainability and require more rapid fiscal consolidation. Further, Vanuatu's development needs and vulnerabilities to climate change will likely require a scaling up of infrastructure spending over the medium-term. As grants are expected to shrink as the economy develops, and given the small domestic financial market, Vanuatu will need to rely on external concessional financing (see 2021 DSA).





15. Near-term support needs to be embedded in a credible medium-term fiscal strategy. A key fiscal anchor in Vanuatu is to maintain nominal public and publicly guaranteed (PPG) debt below 60 percent of GDP.[15] Vanuatu faces a dilemma. In the context of the pandemic and recent natural disasters, adhering to this target could be a significant challenge, especially if ECP revenues are lost. At the same time, to build additional buffers against shocks (particularly frequent natural disasters and climate change), Vanuatu would benefit from aspiring to a more stringent debt anchor, such as a 50 percent PPG debt-to-GDP target, as recommended in the 2019 Article IV consultation. These trade-offs inform staff's reform scenario and policy recommendations (see below). The fiscal deficit under staff's baseline scenario[16] is projected to be around 4 percent of GDP over the medium-term, leading to a breach of the authorities' PPG fiscal anchor in 2028 as shown in DSA—which suggests that further action on revenue mobilization will be necessary to maintain debt sustainability. The authorities should formulate a medium-term fiscal strategy that also ensures proper use of ECP revenues. Staff recommends the following key measures:

[15] Prudent debt management is embedded in Vanuatu's legal framework. Additional anchors in this framework include allowing only concessional borrowing and positive recurrent balance over the medium term.

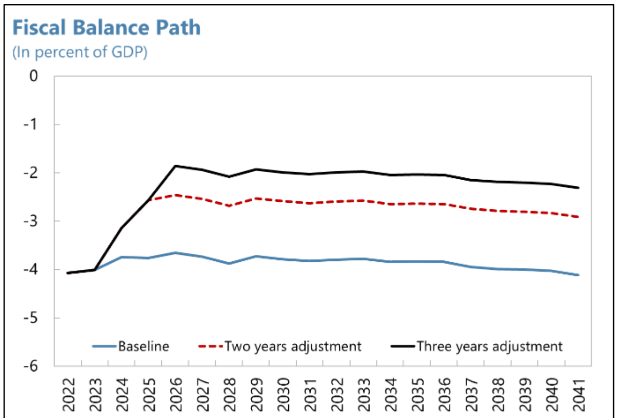
[16] The baseline scenario assumes the authorities' current fiscal rules, namely allowing only concessional borrowing and positive recurrent balance over the medium term.

- **Complete the proposed 2017 tax reforms.**[17] The introduction of personal and corporate income taxes (with reduction in less efficient taxes) could increase government revenues by 2.5 percent of GDP.[18] A phased introduction of personal and corporate income taxes could be considered.

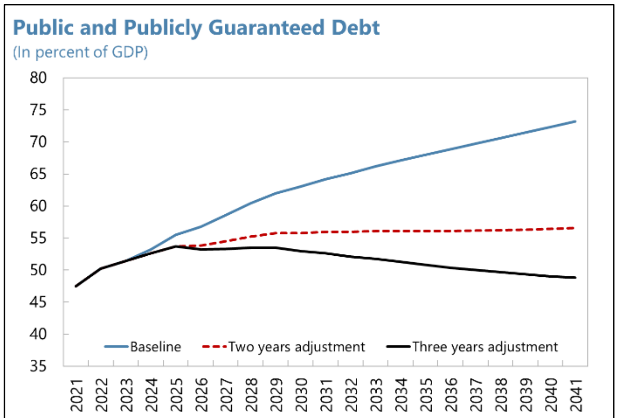
- **Stabilize expenditures as a share of GDP.** Expenditures under the domestically financed budget are expected to be stable. In order to maintain the expected expenditure path, keeping the wage bill in check[19] and maintaining a positive recurrent spending balance together with conservative ECP revenue projections will be key.

- **Limit and prioritize external borrowings by SOEs.** Preventing a breach of the debt target should be a key objective.[20] The authorities should strengthen monitoring and control of the fiscal risks posed by SOEs, including by introducing a governmental approval system of their external borrowing as well as improving their governance.

16. Staff recommends a gradual fiscal adjustment once the recovery is entrenched. Staff's reform scenario assumes a gradual fiscal consolidation of 0.6 percent of GDP annually starting in 2024. Two cases are presented under this scenario, one with 2-year adjustment (from 2024 to 2025) and the other with 3-year adjustment (from 2024 to 2026). The nominal PPG-debt-to-GDP ratio would remain below 60 percent of GDP in the medium- to long-term under the first adjustment case while the ratio would decline below 50 percent of GDP in the second case. This suggests that a 2-year fiscal consolidation could achieve the authorities' current debt target and that the additional one-year adjustment could provide additional fiscal buffers. While the initiation of fiscal adjustment should remain state-contingent, a credible forward-looking fiscal strategy should be put in place.



Source: IMF staff estimates.



Source: IMF staff estimates.

[17] In 2017, the Council of Ministers endorsed the Revenue Review Committee's proposals focusing on the introduction of progressive personal and corporate income taxes for higher-income households and larger businesses. The corporate income tax was proposed at a flat rate of 17 percent.

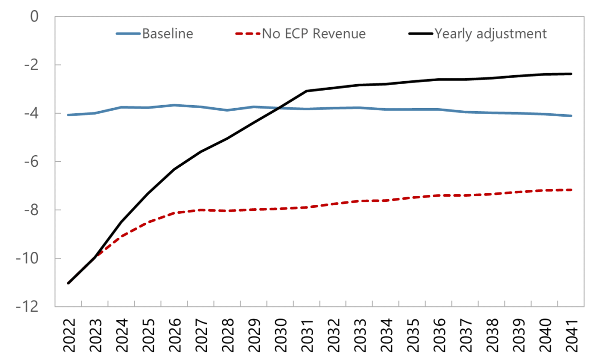
[18] See footnote 9 in the Staff Report for the 2019 Article IV Consultation.

[19] The compensation increased from 12.7 percent of GDP in 2018 to 15.4 percent in 2020, partly reflecting a supreme court order for proper adjustment of inflation on wages.

[20] Government-guaranteed debts for GBE such as Air Vanuatu, accounted for 4 percent of total public debt at end-2020. In addition, GBEs, including Air Vanuatu, hold non-publicly guaranteed liabilities.

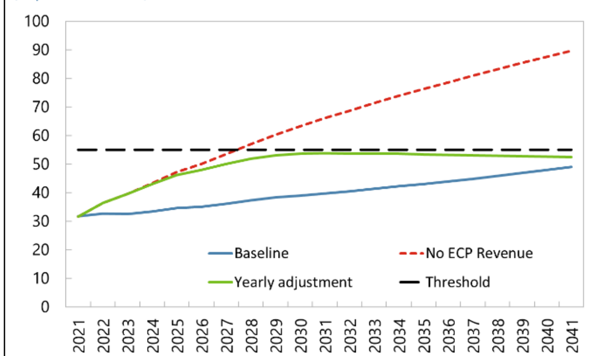
17. Further fiscal consolidation would allow the authorities to reduce reliance on ECP revenues and to use the revenues for investing in climate-resilient infrastructure. Implementing an annual fiscal consolidation of 0.6 percent of GDP through 2031, to compensate for the potential loss of all ECP revenues from 2022 onwards, would keep the present value of PPG debt to GDP below the DSA threshold of 55 percent.

Fiscal Balance Path
(In percent of GDP)



Source: IMF staff estimates.

Present Value of Public and Publicly Guaranteed Debt
(In percent of GDP)



Source: IMF staff estimates.

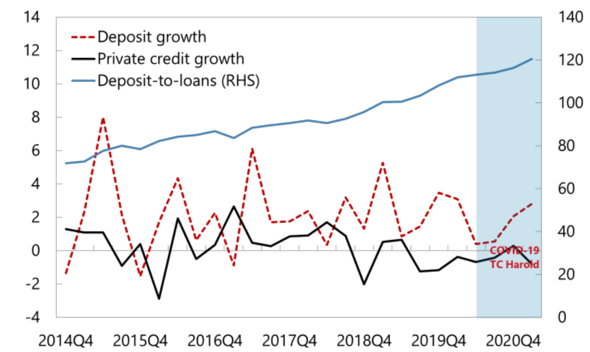
Authorities' Views

18. The authorities stressed their strong commitment to maintaining a positive recurrent balance and to prepayments to contain debt accumulation when the fiscal condition is favorable. The authorities recognized that there would be an upward pressure on maintenance costs for infrastructure going forward on the domestically funded budget. They also recognized that revenue mobilization may be needed in the future, as ECP proceeds were not a stable and sustainable source of revenues. In this context, the authorities appreciated the 2021 DSA scenario analysis, which assumed the loss of all ECP revenues. While seeking alternative administrative measures to ensure ECP transactions can continue to be processed, the authorities underscored that their strong cash reserves could provide some breathing space in the event of a sudden stop of ECP revenues in the short term. If necessary, they could resort to domestic bond issuance. However, there was no plan to introduce personal and corporate income taxes. They agreed with the staff's recommendations to strengthen monitoring and control of fiscal risks posed by SOEs.

B. Monetary and Financial Sector Policy

19. The authorities should maintain the current accommodative monetary policy stance with a low policy rate and ample liquidity support until the recovery is entrenched. The authorities' support measures have functioned well given ample liquidity in commercial banks. Headline CPI inflation has been higher than the RBV's target range of 0 to 4 percent partly due to TC Harold related food supply shock and rising global food prices but is expected to return to the target range.[21] The RBV has successfully stabilized non-food inflation between 0 and 1 percent over the past years. These suggest that the authorities' monetary policy stance is ap propriate. However, the authorities should continue to closely monitor and periodically reassess the policy stance —particularly in the event of unexpected shocks or persistent inflationary pressures. The authorities confirmed that they have not introduced any changes to Vanuatu's foreign exchange system since the last Article IV consultation.

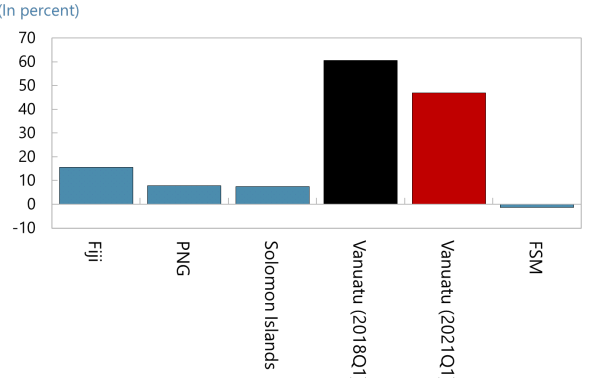
Deposit and Private Credit Growth
(In percent, Quarter-onQuarter)



Source: Vanuatu authorities.

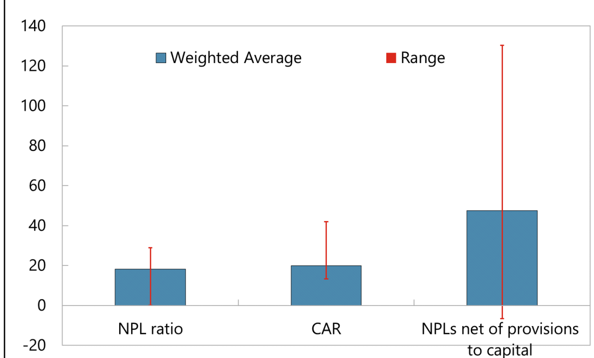
20. The authorities should carefully monitor individual banks and continue to strengthen supervision. As of end-2020, CARs of all banks were above the regulatory threshold while individual banks' financial positions varied. However, Vanuatu's NPLs net of provisions to capital are higher than in other Pacific Island Countries, and rising NPLs in the wake of the pandemic could pose challenges to financial sector soundness. The relaxation of loan classification requirements (extended to end-September 2021) may mask vulnerabilities in bank balance sheets. Stress testing is recommended to highlight potential weaknesses. If there are cases where capital and liquidity buffers fall below regulatory minima, the RBV should agree with banks on plans to bring capital and liquidity above the minimum threshold. The RBV should guide banks to accumulate further general provisioning early and restructure the debt of temporarily illiquid but otherwise solvent borrowers. It is important to establish crisis management and resolution frameworks.

Ratio of NPL net of provisions to capital
(In percent)



Source: IMF, Financial Soundness Indicators database.

Banks' Asset Quality as of 2020
(In percent)



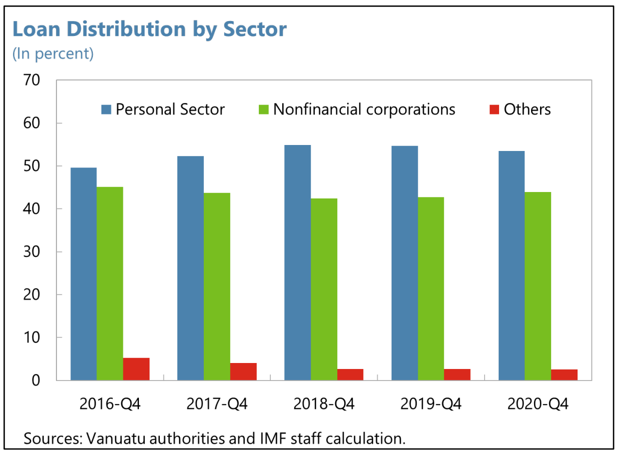
Sources: Vanuatu authorities; and IMF staff calculation.

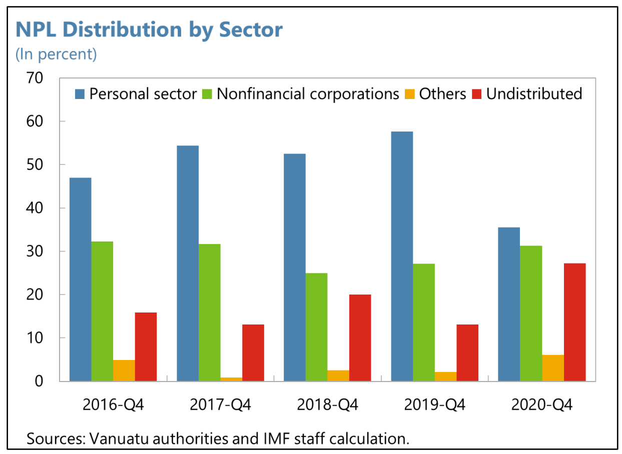
21. NBV lost its only CBR of USD at end-June 2021. While NBV is the only domestic bank holding multiple branches in rural areas, the impact of the loss on export businesses is limited as exporters can access other domestic banks' USD clearing services. On the other hand, NBV faces a

[21] The RBV's policy framework for containing inflation is (i) defense of exchange rate peg which allows it to import low inflation from Australia and New Zealand; (ii) bank's statutory reserve deposit requirements; (iii) open market operations; and (iv) rediscount rates.

potential loss of customers needing USD clearing services. This would adversely affect NBV's profitability. The authorities should closely monitor NBV's financial position and appropriately manage any fiscal risks given that NBV is owned by the VNPF and the government.

22. It would be crucial to improve the credit system for quicker reduction in existing NPLs and for healthier bank lending. The high NPL ratio in the personal credit sector over the years arose from poor credit standards of banks amid efforts to promote financial inclusion, and the situation has remained broadly unchanged (except for 2020-Q4 affected by relaxation of loan classification). The authorities need further efforts to reduce NPLs, including reforming judicial process for swifter collateral asset recovery. To avoid accumulation of NPLs, it would be important to improve accessibility to usable credit information. Staff welcome the authorities' efforts to improve Vanuatu's credit bureau to enrich credit information and make it usable with digital technology.





23. Digitalization could advance financial inclusion, but there are challenges ahead. The pandemic and natural disasters in 2020 have led to increased use of digital technologies for financial services. Digital money with blockchain technology was used to deliver aid to households affected by natural disasters (Box 1). However, the lack of a personal identification system prevents the widespread adoption of digital money. The current AML/CFT legal framework does not cover digital money activities. The authorities should focus their efforts on establishing a personal identification registration system and a legal framework to supervise digital money activities.

Authorities' Views

24. The authorities considered the current monetary policy stance as appropriate. While inflation is expected to remain within target over the medium-term, the authorities acknowledged that risks remain. The authorities committed to close monitoring and periodic reassessment of the monetary policy stance.

25. The authorities committed to carefully monitoring of the banking sector and strengthening supervision. The RBV was closely monitoring individual banks' financial situation to safeguard financial stability. The authorities are eager to establish crisis management and resolution frameworks.

26. The authorities highlighted that they are conducting a holistic review of financial sector regulatory frameworks. New legislation of national payment system will improve cross border payment activities in the region, facilitating business activities. Improving credit reporting will also contribute to business environment. The authorities concurred that new legislation on AML/CFT may be needed to accelerate digital money activities in Vanuatu. The amendment of Financial Dealers Licensing Act to allow digital asset trading and require physical presence of all license holders in Vanuatu was gazetted in July 2021.

Box 1. Oxfam's Blockchain-Powered Aid Program in Vanuatu

The program, namely UnBlocked Cash Project, is designed to deliver aid using blockchain technology to households affected by natural disasters. This was in response to the twin effects of Tropical Cyclone Harold and Covid-19 that severely impacted incomes and livelihoods of vulnerable households. The blockchain cash transfer solution could help Pacific Island Countries overcome capacity and financial infrastructural constraints by digitizing the delivery of aid to remote, rural, at risk populations.

The program uses an open-sourced blockchain-enabled system for quick and transparent financial aid. The system was developed by Oxfam in partnership with Sempo and ConsenSys. Each beneficiary and vendor are registered on the developed digital platform to manage their own accounts and use cashless transactions. Beneficiaries are given prepaid Near Field Communication (NFC) cards to purchase items at pre-approved vendors. The vendors' account balance in the platform is instantly updated whenever a purchase is made. The vendors can easily cash out to their bank accounts. To avoid the high cost of bank transfers, super vendors were created by Oxfam to allow businesses with sufficient liquidity to cash out smaller vendors. Compared to other aid delivery methods, the blockchain-based solution has several advantages: quick cash transfers (within a few hours); efficient reconciliation process (automatically linking all transactions with a unique 6-digit code); and high transparency (a running ledger of live, traceable transactions and real time monitoring by multiple parties).

Personal identification is a key challenge for wider adoption of digital money. Before launching the program, Oxfam conducted a feasibility study to identify households requiring cash transfers (beneficiaries) and the shops that these households use frequently (vendors). Oxfam collected personal identifiable information of all beneficiaries such as resident's location, age, and gender. Vendors also provided additional Know Your Customer (KYC) requirements including bank account details, photo ID, full name, phone number, business name and location. Those businesses that did not meet the requirements were removed from the program. The identification process was time-consuming and complicated—some beneficiaries did not have a birth certificate. This suggests that established personal identification system would be needed to better facilitate widespread adoption of digital money activities.

There is no legal framework and financial supervision policy in place to govern the use of digital money or e-commerce. The RBV gave approval for the Oxfam's program through a time bound no-objection letter outlining certain compliance safeguards (e.g. restricted use of the blockchain platform and banks' KYC and AML requirements for participants) that Oxfam needs to meet. Oxfam needs to maintain the safeguards throughout the program and provide reports to the RBV on a quarterly basis. To further develop e-commerce and digital money activities, the authorities would need to establish relevant legal frameworks. The authorities consider a regulatory sandbox to help develop regulations around the use of e-commerce and digital money.

C. Macro-Structural and Governance Issues

27. Economic diversification and development of quality infrastructure are essential for sustained and inclusive growth and resilience to shocks. The authorities are making progress towards agricultural diversification, with large growth in the fisheries industry (although the scale is still low). Vanuatu has also recently begun to supply some agricultural products, such as passionfruit and cassava, to Australia and New Zealand. In the context of economic diversification, promoting FDI is vital. Smooth ratification of the Pacific Agreement on Closer Economic Relations (PACER) Plus and improving FDI regulations could help facilitate higher levels of investment. Infrastructure projects to reduce gaps and improve connectivity to key markets could support economic development.[22] The authorities should continue to promote agricultural diversification and prioritize infrastructure projects, complemented by improvements in the business environment such as streamlining FDI regulations (Annexes VI and VII).

Vanuatu: Major Development-Partner-Financed Infrastructure Projects 2013-2021

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 Rural Electrification Project	2015	2020	All islands	WBG (IDA)	Grant
Vanuatu Cyclone Pam School Reconstruction Project	2016	2019	Tafea province	ADB, JPN	Grants
Vanuatu Infrastructure Reconstruction & Improvement Project	2016		All islands	WBG (IDA)	Grants, Loans
Vanuatu Rural Electrification Project Stage II	2017		All islands	WBG (IDA)	Grants, Loans
Energy Access Project	2017		Malekula, Santo	ADB	Grants, Loans
Vanuatu Pam Road Reconstruction Project	2017	2020	Efate	ADB	Grants, Loans
Vanuatu Cyclone Pam School Reconstruction Project	2017	2019	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
Vanuatu Pentecost Road and Wharf Project Phase I	2021		Pentecost	China EXIM	Grants, Loans

Sources: Vanuatu authorities, World Bank and ADB.
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 July, 2021.

28. Enhancing climate resilience is essential. The government formulated the National Adaptation Plan for Action in 2006, but it has not been updated. The adaptation plan is granular but lacks estimated fiscal costs and a financing roadmap. It will be crucial to clearly articulate a medium-term expenditure and financing roadmap for the adaptation plan. Introduction of a climate change expenditure tagging system would help the government identify financial gaps and facilitate donor financing. In terms of natural disaster response, the Disaster Risk Management Act came to effect in February 2020 and its operationalization is underway. Staff recommends integrating financing plans, consistent with a medium-term fiscal strategy, for the adaptation plan and disaster response to support resilience-building in a more efficient and effective manner (Annex VIII).

[22] Planned infrastructure projects include development of a submarine cable, electricity generation plants and roads.

29. Improving governance, reducing vulnerabilities to corruption, and bolstering Vanuatu's risk profile is essential.

- **ECP and AML/CFT concerns.** Despite improvements to its AML/CFT framework, Vanuatu still faces financial integrity risks.[23] Most critically, the authorities need to address financial integrity and reputational risks associated with the ECP. The current vetting process of applicants does not appear to be adequate and several individuals who obtained passports through the ECP have been linked to criminal activity. The authorities should strengthen AML/CFT framework as well as institutional capacity to ensure proper and rigorous oversight of the ECP. In particular, it would be crucial to establish more stringent process of vetting applicants and detecting criminal activities by existing ECP passport holders and new applicants.

- **SOE Governance.** The reform for SOEs has not seen progress since the last Article IV consultation. It is critical to quickly bolster management and transparency of SOEs—particularly with respect to Air Vanuatu. The authorities should be able to scrutinize SOE's business strategy and budget while ensuring managerial autonomy, and regularly monitor their financial conditions. Timely publication of financial statements would contribute to improving the business environment. Staff recommends that the SOE legal framework establish supervisory frameworks for SOEs to enhance their transparency. The authorities should properly manage fiscal risks by minimizing the contingent liabilities of Air Vanuatu, which is under restructuring.[24]

- **Tax Transparency.** The legislative amendment to meet the international standard on tax information exchange, which could contribute to delisting from EU's blacklist, is still under discussion of the parliament. Staff recommends that the amendment be implemented and made effective as early as possible.

- **Central Bank Autonomy and Governance.** The RBV's autonomy and governance arrangements should be strengthened as per the recommendations of the 2016 Safeguard Assessment.[25] While staff welcome the recent appointment of a Chief Risk Officer, the drafting of relevant amendments to the RBV Act is still incomplete. Further, the absence of an effective audit committee and an internal audit function presents additional risks for the RBV's governance.

Authorities' Views

30. The authorities concurred on the importance of economic diversification for Vanuatu. One of the policy objectives of the *Vanuatu 2030 The People's Plan* is to promote broad-based growth by strengthening linkages between tourism, infrastructure, agriculture, and industry in rural areas and diversify the rural economy. The authorities explained their policies in agriculture focus on

[23] Vanuatu's AML/CFT regime and its effectiveness were last assessed by the Asia/Pacific Group on Money Laundering (APG) in 2015. The next review by APG is likely to be postponed to 2023.

[24] The government took direct control of financial distressed Air Vanuatu in March 2021, which was in the process of purchasing four new aircrafts from Airbus estimated at USD 185 million—around 20 percent of GDP.

[25] See the Informational Annex for more details.

diversifying the production chain, supported by donors. The authorities also highlighted their policies to incentivize fishery manufacturing locally in Vanuatu. The authorities mentioned that the FDI related regulation is currently under review to be in line with PACER Plus.

31. **The authorities acknowledged the importance of a financing roadmap.** The authorities underscored the importance of investing in resilient infrastructure. They expressed their interest in introducing climate change expenditure tagging system. The authorities explained that the National Adaptation Plan for Action is currently under review for revision in 2021. In terms of natural disaster response, due to capacity constraints, they focused on COVID-19 related response such as supporting vaccination rollout, and their operationalization of the Disaster Risk Management Act is under consideration toward swifter response to natural disasters.

32. **The authorities committed to strengthening the AML/CFT framework and institutional capacity.** They were deeply concerned with the risk of losing CBRs and were considering strengthening ECP due diligence. This year, the authorities expected to complete several pieces of legislation on administration and governance reforms, including amending Tax Administration Act. The authorities highlighted the progress in central bank governance, notably appointment of Chief Risk Officer. The authorities planned to complete the amendment to the RBV Act along with the recommendations of the 2016 safeguard assessment in the broader context of financial sector reforms.

CAPACITY DEVELOPMENT INTEGRATION

33. **Vanuatu needs further technical assistance (TA) in the following priority areas:**

- **Statistical issues.** While broadly adequate for surveillance purposes, large revisions, quality, and timeliness remain a concern for some national data (Informational Annex). Staff recommend that the authorities seek further support from the Pacific Financial Technical Assistance Centre (PFTAC) and Statistics Department on the compilation and development of national accounts statistics. TA on macro-frameworks could also contribute to improving the forecasting capacities.

- **Public financial management.** Given Vanuatu's large infrastructure needs, TA on public infrastructure management could further contribute to improving the quality of infrastructure management.

- **Banking supervision.** TA on risk-based supervision from PFTAC is ongoing, although the pandemic has hindered progress. There is urgent need for TA on the crisis management and resolution frameworks, following the recommendations of the 2019 banking diagnostic assessment.

- **AML/CFT.** Given the recent loss of a vital CBR, Vanuatu has clear need to further improve the AML/CFT framework and institutional capacity.

Authorities' Views

34. The authorities expressed their appreciation for the support received from the Fund and PFTAC and requested that this support be continued. The authorities reiterated their commitment to push ahead with reforms supported by capacity building, especially strengthening AML/CFT due diligence, financial sector supervision, and statistics.

STAFF APPRAISAL

35. After a severe contraction in 2020, real GDP is expected to return to positive territory in 2021, supported by agricultural production and remittance income. Growth will also be supported by construction activity, notwithstanding delays that may push several infrastructure projects into 2022. Tourism related sectors are expected to contract further in 2021 due to the extended border closure and are expected to start a gradual recovery beginning in 2022. The current strength of the external position is temporary, driven by strong revenues from the ECP. Vanuatu's external position is assessed to be stronger than implied by fundamentals and desirable policy settings. Going forward, it is expected that current account balances will narrow, owing to a moderation in ECP-related flows and only a gradual recovery in tourism receipts.

36. Risks to the outlook are substantial and tilted to the downside. A worsening of the global pandemic requiring longer border closure would adversely impact economic activity, while a faster vaccination rollout and subsequent border reopening would be an upside risk. ECP revenues could fall sharply amid growing concerns on AML/CFT risks, amplified by the recent loss of a key CBR. Further deterioration of banks' asset quality could erode the soundness of Vanuatu's financial system. Lack of transparency and effective supervision framework for state enterprises could increase government contingent liabilities and negatively affect the business environment. Issues concerning AML/CFT and EU blacklisting related to tax transparency could accelerate de-risking by foreign firms, leading to further loss of CBRs, and impeding FDI. An ever-present downside risk relates to further natural disasters.

37. Continued fiscal support over the near term is necessary. The phasing-out of COVID-related support should be state-contingent. However, given Vanuatu's limited fiscal space, it is critical to ensure that support continues to be well targeted at households and firms most affected by the pandemic. It would be also important to strengthen public expenditure and investment management for a more efficient use of public resources. Properly managing fiscal risks by minimizing the contingent liabilities of Air Vanuatu would also be key. Front-loading the vaccination strategy as feasible with support of development partners should be a priority to help support the recovery.

38. Near-term support needs to be embedded in a credible medium-term fiscal strategy that brings about a gradual fiscal adjustment once recovery is firmly entrenched. The medium-term fiscal trajectory remains uncertain, and Vanuatu's fiscal space is limited. In the medium-term, Vanuatu's development needs and vulnerabilities to climate change would require a scaling up of infrastructure spending. While the initiation of fiscal adjustment should remain state-contingent, a credible forward-looking fiscal strategy, including an introduction of personal and corporate income taxes, should be put in place. Further fiscal consolidation would allow the authorities to reduce the reliance on ECP revenues and to use the revenues for resilient infrastructure.

39. The current accommodative monetary policy stance is appropriate. The RBV should maintain the current accommodative stance until the recovery is entrenched and continue to closely monitor and periodically reassess the policy stance —particularly in the event of unexpected shocks or persistent inflationary pressures.

40. The financial sector is broadly stable but should be carefully monitored. As of end-2020, CARs of all banks were above the regulatory threshold while individual banks' financial positions varied. However, rising NPLs in the wake of the pandemic could pose some challenges to financial sector soundness.

41. Economic diversification and development of quality infrastructure will be essential for sustained and inclusive growth and resilience to shocks. Smooth ratification of PACER Plus and improving the regulatory framework could promote vital foreign investment.

42. Further enhancing climate resilience is necessary. Introduction of a climate change expenditure tagging system would help government identify financial gaps and facilitate donor financing. Staff recommends integrating financing plans, consistent with a medium-term fiscal strategy, for the adaptation plan and disaster response to support resilience-building in a more efficient and effective manner.

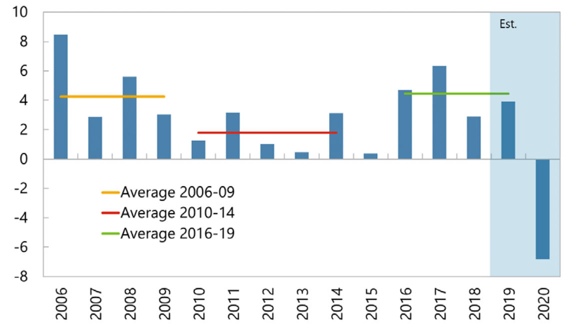
43. Improving governance, reducing vulnerabilities to corruption, and bolstering Vanuatu's risk profile is essential. It is critical to quickly bolster management and transparency of the SOEs—particularly with respect to Air Vanuatu. The authorities should establish supervisory frameworks for SOEs and enhance their transparency as soon as possible. The authorities should strengthen further legal frameworks and institutional capacities on AML/CFT (especially ECP due diligence), tax transparency, central bank autonomy and governance. These measures should also reduce corruption vulnerabilities.

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

Figure 1. Vanuatu: Real Sector Developments

Growth fell severely in 2020....

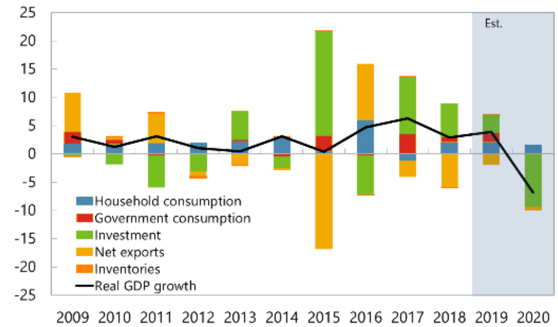
Real GDP Growth, 2006-20
(In percent, year-on-year)



Sources: Authorities; and IMF staff estimates.

...as the pandemic weakened private sector investment and government infrastructure investment.

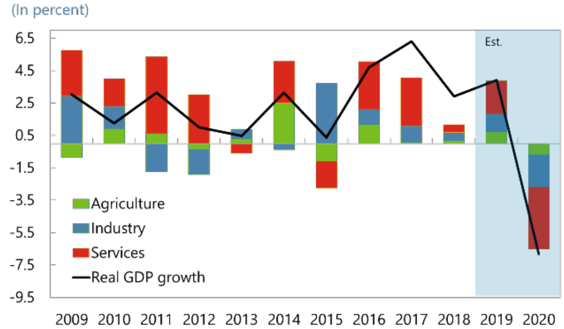
Contribution to Real GDP Growth by Expenditure
(In percent)



Sources: Vanuatu authorities; and IMF staff calculations..

On the production side, services (led by tourism) led the decline in growth.

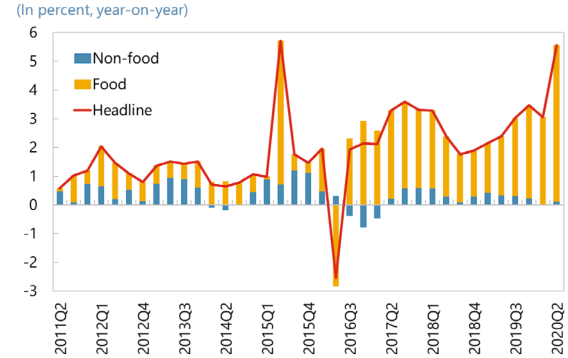
Contribution to Real GDP Growth by Sector
(In percent)



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

Food inflation temporary spiked in 2020 following TC Harold.

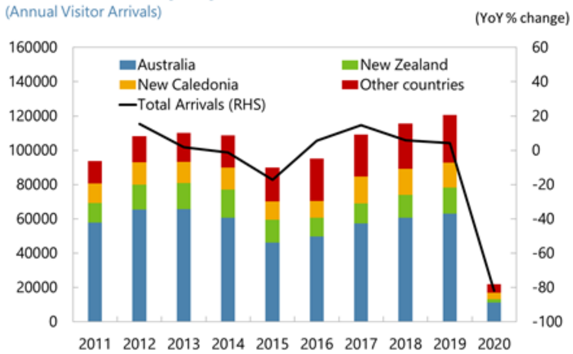
Contribution to Inflation
(In percent, year-on-year)



Sources: Vanuatu authorities; and IMF staff calculations.

Recent economic activity largely reflected tourism which collapsed in 2020 due to the pandemic.

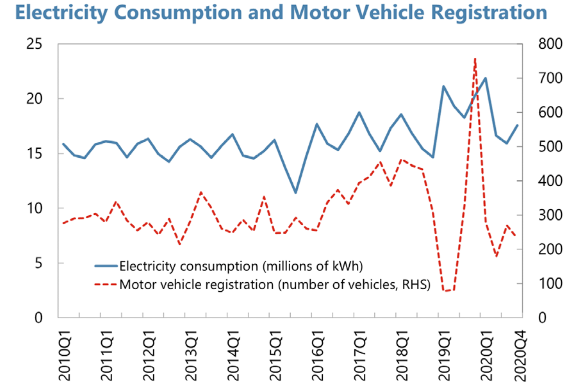
Tourist Arrivals by Key Source Markets
(Annual Visitor Arrivals)



Source: Vanuatu Authorities.

Private demand weakened due to the pandemic.

Electricity Consumption and Motor Vehicle Registration



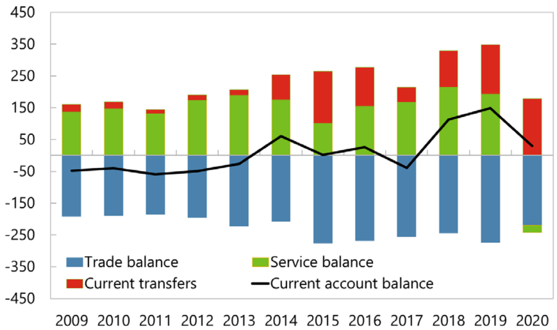
Source: Vanuatu authorities.

Figure 2. Vanuatu: External Sector Developments

The current account surplus reduced in 2020 due to the loss of services credit.

Current Account

(In millions of US dollars)

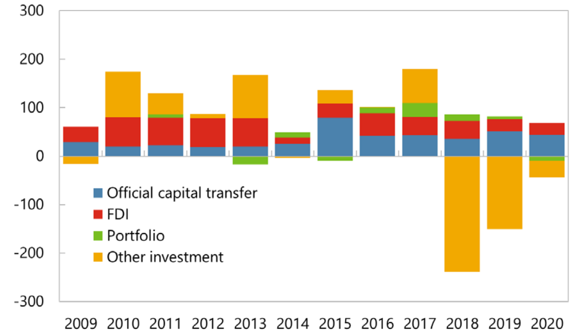


Sources: Vanuatu authorities; and IMF staff calculations.

FDI has weakened while capital grants remained strong.

Capital and Financial Accounts

(In millions of US dollars)

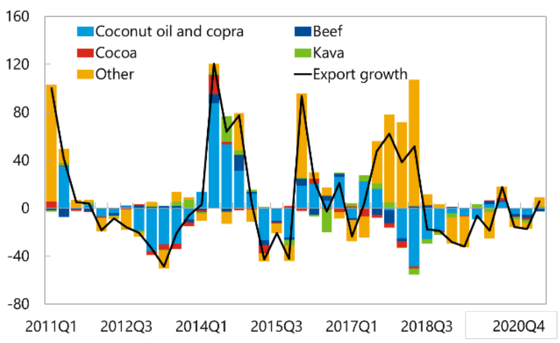


Sources: Vanuatu authorities; and IMF staff calculations.

Exports, mainly agricultural products, remained weak.

Export Growth

(In percent, year-on-year)

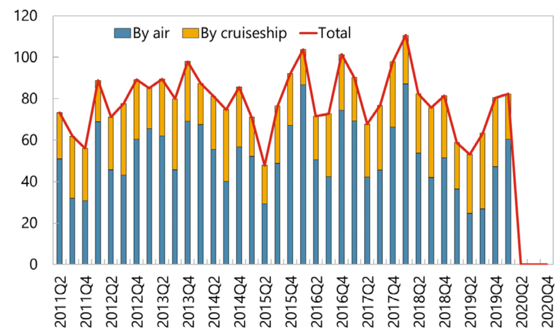


Source: Vanuatu authorities.

The fall in tourist arrivals was sharp and sudden.

Tourist Arrivals

(In thousands of persons)

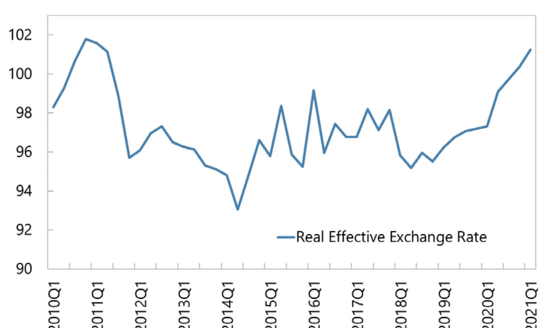


Source: Vanuatu authorities.

The real effective exchange rate appreciated, mainly due to its higher headline inflation relative to its trading partners.

Real Effective Exchange Rate

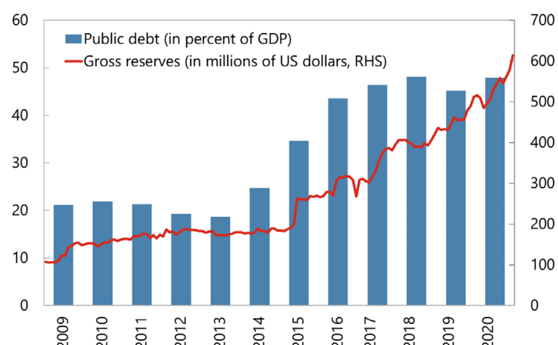
(Index 2010=100)



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

Reserves have increased and public debt has stabilized recently.

Public Debt and International Reserves

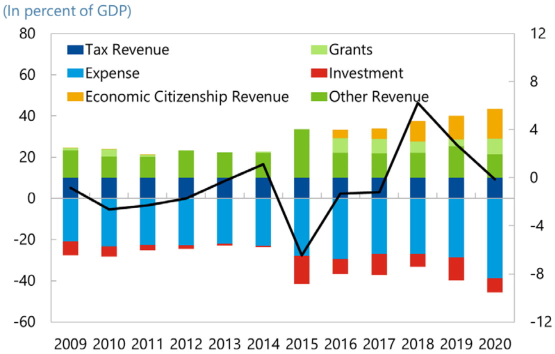


Sources: Vanuatu authorities; and IMF staff calculations.

Figure 3. Vanuatu: Fiscal and Monetary Sector Developments

Fiscal balance has improved, but with increasing reliance on revenues from the Economic Citizenship Program.

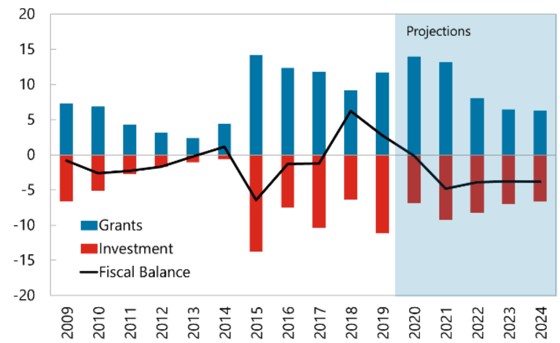
Fiscal Revenue and Expenditure
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff calculations.

...but the deficits remain, as ECP revenues and grant support moderate while infrastructure needs remain large.

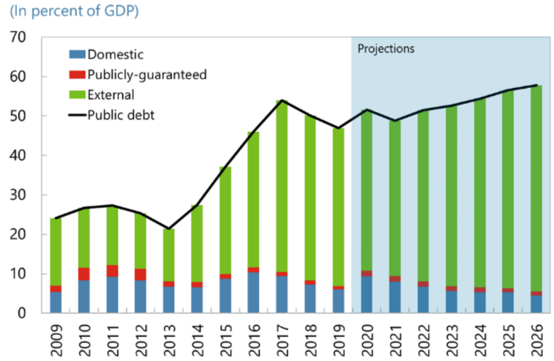
Fiscal Balance
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff estimates.

Debt accumulation in the upcoming years is expected to revert to an increasing trend.

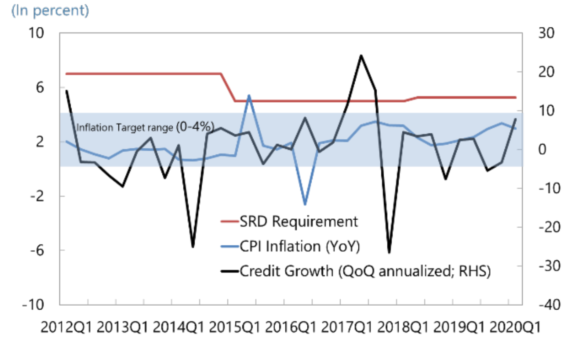
Public and Publicly-guaranteed Debt
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff estimates.

The RBV maintained the SRD at 5.25 percent in 2020 as inflation is estimated to return to the RBV's target range.

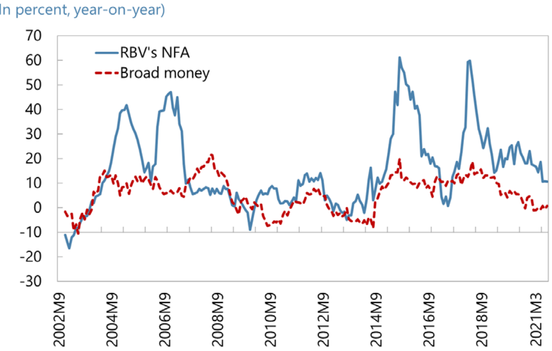
SRD Requirement, Inflation and Credit Growth
(In percent)



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

Money supply growth remains stable amid the pandemic.

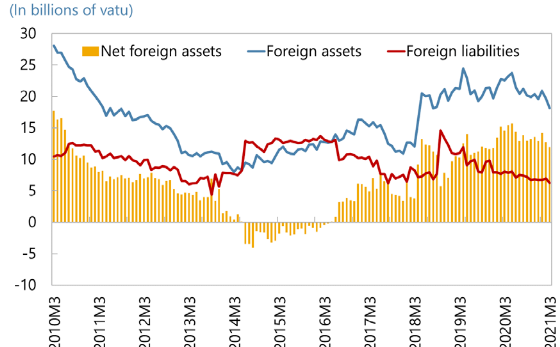
RBV's NFA and Money Supply Growth
(In percent, year-on-year)



Source: Vanuatu authorities.

Net foreign assets of commercial banks continued to build up.

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



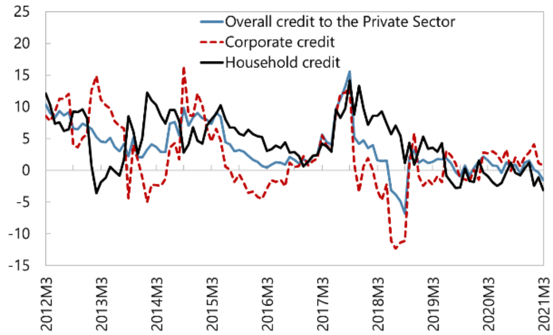
Source: Vanuatu authorities.

Figure 4. Vanuatu: Financial Sector Developments

Private credit growth remains stable amid the pandemic, while household credit growth somewhat weakened.

Private Credit Growth

(Year-on-year percentage change)

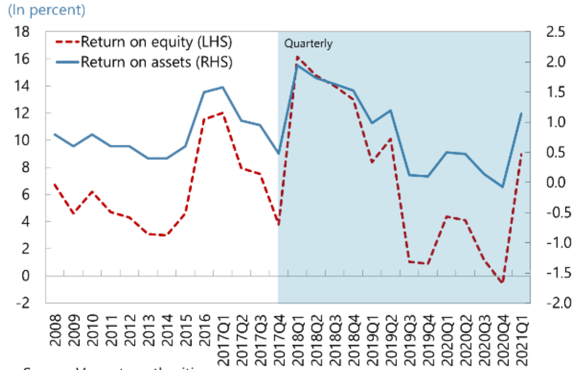


Source: Vanuatu authorities.

Bank profitability has weakened significantly since 2019, but recently improved.

Bank Profitability

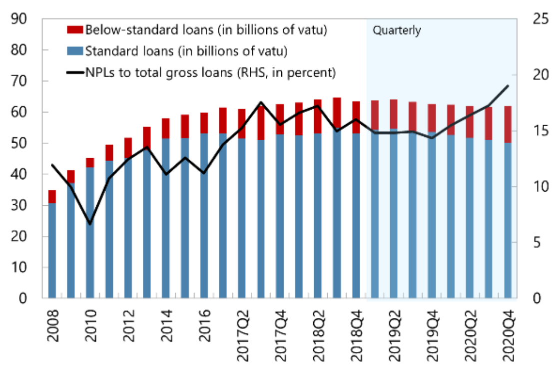
(In percent)



Source: Vanuatu authorities.

NPLs have increased in 2020.

Non-Performing Loans

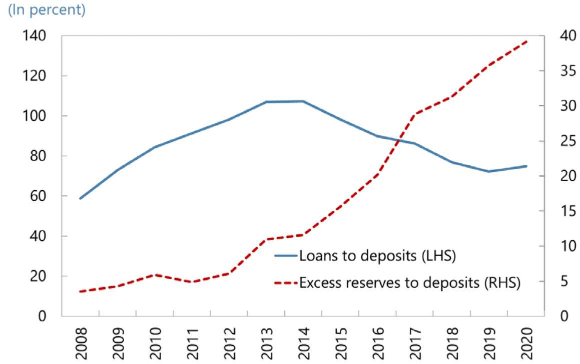


Source: Vanuatu authorities.

Bank reserves continue to build up, while loan to deposit ratio stabilized.

Loan-to-Deposit and Excess Reserve Ratio

(In percent)

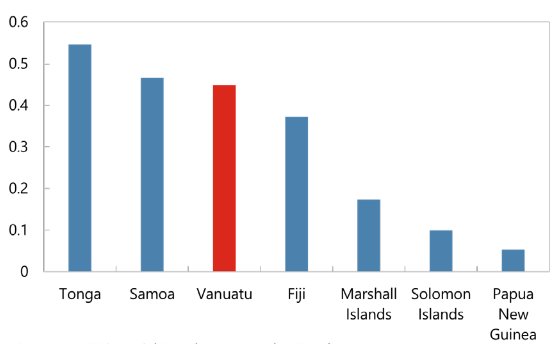


Source: Vanuatu authorities.

Financial access of households is moderately high compared to its Pacific peers...

Financial Institutions Access Index, 2019

(Bank branches and ATMs per 100,000 adults)

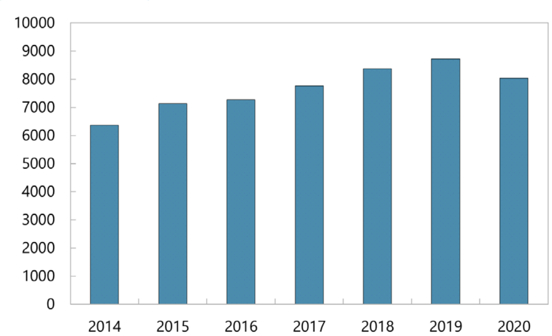


Source: IMF Financial Development Index Database.

...access to bank loans for households has also improved.

Household Borrowers with Commercial Banks

(Number of borrowers)



Sources: IMF Financial Access Survey, Vanuatu Authorities.

Table 1. Vanuatu: Selected Economic Indicators, 2018-2023

Population (2020): 301,695
IMF quota: SDR 23.8 million (0.01 percent of total)
Main products and exports: Kava, coconut oil, copra, cocoa, beef
Key export markets: New Caledonia, Australia, New Zealand

Per Capita GDP (2020): US$ 3,090
Literacy rate (2018): 87.5 percent

	2018	2019	2020	2021	2022	2023
		Estimates		Projections		
Output and prices (annual percent change)						
Real GDP	2.9	3.9	-6.8	1.2	3.0	4.1
Consumer prices (period average)	2.4	2.7	5.7	5.4	2.6	2.3
Consumer prices (end period)	1.9	3.5	7.0	3.9	2.3	2.2
Government finance (in percent of GDP)						
Total revenue	39.5	38.5	44.2	40.6	34.2	32.1
Taxes	18.4	17.6	14.6	16.1	16.5	17.0
Other revenue	12.0	13.9	16.0	11.2	9.7	8.7
Grants	9.2	7.0	13.6	13.2	8.0	6.4
Expenditure	33.3	31.8	44.4	44.0	38.3	36.1
Expense	26.9	28.5	37.8	36.4	29.6	29.0
Net acquisition of non financial assets	6.4	3.3	6.6	7.6	8.7	7.1
Net lending (+)/borrowing (-)	6.3	6.7	-0.1	-3.5	-4.1	-4.0
Public and publicly-guaranteed debt (end of period)	49.2	46.1	50.1	47.5	50.2	51.4
Domestic	7.3	6.1	9.3	8.0	6.7	5.7
External	41.9	40.1	40.8	39.4	43.5	45.8
Money and credit (annual percentage change)						
Broad money (M2)	-0.5	9.2	5.3	-3.0	3.8	6.0
Net foreign assets	39.0	24.2	16.9	0.0	5.2	6.3
Domestic credit	-4.4	-6.4	-9.5	-6.8	-1.3	1.6
Of which: Credit to private sector	1.2	0.4	1.5	-3.2	0.8	1.8
Interest rates (in percent, end of period) 1/						
Deposit rate (vatu deposits)	1.2	0.8	0.7	…	…	…
Lending rate (vatu loans)	0.0	0.0	0.0	…	…	…
Balance of payments (in percent of GDP)						
Current account	12.2	16.0	3.3	-6.9	-8.0	-5.7
Trade balance	-26.2	-29.5	-23.5	-23.3	-24.3	-26.1
Exports of goods	6.9	4.9	5.2	5.3	5.4	5.4
Imports of goods	-33.1	-34.4	-28.7	-28.5	-29.7	-31.5
Travel receipts	32.3	29.8	7.2	0.6	4.4	11.3
Capital and financial account	-16.0	-6.5	3.5	11.4	9.4	7.9
Of which: Foreign direct investment	3.9	2.7	2.6	2.9	3.0	2.9
Overall balance	2.7	9.8	10.9	4.5	1.4	2.2
Gross international reserves (in millions of U.S. dollars)	420.6	511.6	613.6	658.2	673.0	697.7
Gross international reserves (in months of prospective G&S imports)	9.6	13.3	15.3	14.7	13.3	11.8
External debt service (in percent of GNFS exports)	4.0	6.7	18.7	31.5	11.1	7.8
Exchange rates 2/						
Vatu per U.S. dollar (period average)	108.5	115.6	109.1	…	…	…
Vatu per U.S. dollar (end of period)	112.3	114.3	108.0	…	…	…
Memorandum items:						
Nominal GDP (in billions of vatu)	100.8	107.2	101.7	107.0	112.6	119.8
Nominal GDP (in millions of U.S. dollars)	928	928	932	999	1,060	1,127

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

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

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

Table 2. Vanuatu: Central Government Budgetary Operations, 2018-2023[1/]

	2018	2019	2020	2021	2022	2023
			Estimates		Projections	
			(In millions of vatu)			
Total revenue	39,813	41,250	45,000	43,382	38,557	38,460
Domestic revenue	30,591	33,753	31,186	29,214	29,519	30,788
Taxes	18,541	18,836	14,896	17,272	18,635	20,413
Taxes on property	582	648	602	633	667	709
Taxes on goods and services	13,919	14,565	11,161	13,023	14,049	15,416
Taxes on international trade	4,039	3,623	3,133	3,616	3,920	4,288
Other revenue	12,050	14,917	16,290	11,942	10,884	10,375
Of which: Economic citizenship programs	9,954	12,558	14,352	9,048	7,837	7,135
Grants from development partners [2/]	9,223	7,497	13,814	14,168	9,038	7,672
Expenditure	33,510	34,111	45,138	47,104	43,141	43,260
Expense [3/]	27,109	30,537	38,405	38,936	33,349	34,741
Compensation of employees	12,838	14,036	15,659	16,507	16,939	17,332
Use of goods and services	7,695	9,488	10,144	9,813	9,769	10,387
Interest payment	921	971	888	1,001	989	1,013
Subsidies	116	194	1,501	1,622	130	139
Grants by central government	2,621	2,499	3,996	3,507	2,679	2,848
Social benefits	1,049	733	940	881	928	987
Other expense [2/]	1,870	2,616	5,277	5,605	1,915	2,036
Acquisition of nonfinancial assets [3/]	6,401	3,574	6,733	8,168	9,792	8,519
Gross operating balance [4/]	12,704	10,713	6,595	4,446	5,208	3,720
Domestic fiscal balance [5/]	7,741	7,172	658	-1,691	138	258
Net lending (+)/borrowing (-))	6,303	7,139	-138	-3,722	-4,584	-4,800
Net acquisition of financial assets	8,502	7,238	1,720	-3,011	1,435	461
Net incurrence of liabilities	3,509	-154	1,536	710	6,019	5,260
Domestic	-1,616	-673	2,419	-908	-984	-829
Foreign	5,124	519	-883	1,619	7,003	6,090
Amortization	1,463	2,460	2,886	3,307	1,390	1,473
Borrowing	6,587	2,979	2,003	4,926	8,393	7,563
Memorandum items:						
Public debt	49,542	49,448	50,979	50,767	56,543	61,560
Domestic	6,267	5,594	8,013	7,104	6,120	5,291
External	42,236	42,956	41,489	42,185	48,945	54,792
Publicly guaranteed	1,040	898	1,477	1,477	1,477	1,477
Debt service	4,000	4,104	5,231	5,217	3,491	3,601
External debt service	1,900	2,933	3,383	3,748	1,882	2,058
Primary balance	7,225	8,110	750	-2,720	-3,595	-3,787
			(In percent of GDP)			
Total revenue	39.5	38.5	44.2	40.6	34.2	32.1
Domestic revenue	30.4	31.5	30.7	27.3	26.2	25.7
Taxes	18.4	17.6	14.6	16.1	16.5	17.0
Other revenue	12.0	13.9	16.0	11.2	9.7	8.7
Of which: Economic citizenship programs	9.9	11.7	14.1	8.5	7.0	6.0
Grants from development partners	9.2	7.0	13.6	13.2	8.0	6.4
Expenditure	33.3	31.8	44.4	44.0	38.3	36.1
Expense [3/]	26.9	28.5	37.8	36.4	29.6	29.0
Compensation of employees	12.7	13.1	15.4	15.4	15.0	14.5
Use of goods and services	7.6	8.8	10.0	9.2	8.7	8.7
Interest payment	0.9	0.9	0.9	0.9	0.9	0.8
Subsidies	0.1	0.2	1.5	1.5	0.1	0.1
Grants by central government	2.6	2.3	3.9	3.3	2.4	2.4
Social benefits	1.0	0.7	0.9	0.8	0.8	0.8
Other expense	1.9	2.4	5.2	5.2	1.7	1.7
Acquisition of nonfinancial assets [3/]	6.4	3.3	6.6	7.6	8.7	7.1
Gross operating balance [4/]	12.6	10.0	6.5	4.2	4.6	3.1
Domestic fiscal balance [5/]	7.7	6.7	0.6	-1.6	0.1	0.2
Net lending (+)/borrowing (-)	6.3	6.7	-0.1	-3.5	-4.1	-4.0
Net acquisition of financial assets	8.4	6.8	1.7	-2.8	1.3	0.4
Net incurrence of liabilities	3.5	-0.1	1.5	0.7	5.3	4.4
Memorandum items:						
Public and publicly-guaranteed debt	49.2	46.1	50.1	47.5	50.2	51.4
Domestic	7.3	6.1	9.3	8.0	6.7	5.7
External	41.9	40.1	40.8	39.4	43.5	45.8
Of which: RCF/RFI	1.6	1.1	0.9	0.6	0.4	0.2
Debt service	4.0	3.8	5.1	4.9	3.1	3.0
Of which: External debt service	1.9	2.7	3.3	3.5	1.7	1.7
Primary balance	7.2	7.6	0.7	-2.5	-3.2	-3.2
Nominal GDP (millions of vatu)	100,771	107,220	101,713	106,979	112,632	119,758

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

Table 3. Vanuatu: Reconciling the Domestic Budget with the IMF Presentation, 2018-2023[1/]

	2018	2019	2020	2021	2022	2023
			Est.		Projections	
Domestic budget (excluding development partners)						
			(In millions of vatu)			
Revenue (excluding development partner grants)	30,591	33,753	31,186	29,214	29,519	30,788
- Expense (excluding development partners)	22,227	25,580	30,225	30,051	28,482	29,574
= Gross operating balance (excluding development partners)	**8,364**	**8,173**	**961**	**-837**	**1,037**	**1,214**
- Acquisition of non-financial assets (excluding development partners)	622	1,001	303	854	899	956
= Net lending/borrowing (excluding development partners)	**7,741**	**7,172**	**658**	**-1,691**	**138**	**258**
			(In percent of GDP)			
Revenue (excluding development partner grants)	30.4	31.5	30.7	27.3	26.2	25.7
- Expenses (excluding development partners)	22.1	23.9	29.7	28.1	25.3	24.7
= Gross operating balance (excluding development partners)	**8.3**	**7.6**	**0.9**	**-0.8**	**0.9**	**1.0**
- Fixed assets (excluding development partners)	0.6	0.9	0.3	0.8	0.8	0.8
= Net lending/borrowing (excluding development partners)	**7.7**	**6.7**	**0.6**	**-1.6**	**0.1**	**0.2**
Consolidated budget (including development partners)						
			(In millions of vatu)			
Gross operating balance (excluding development partners)	**8,364**	**8,173**	**961**	**-837**	**1,037**	**1,214**
+ Additional revenues (development partners grants)	9,223	7,497	13,814	14,168	9,038	7,672
- Additional expenses (using development partner grants and/or loans)	4,882	4,957	8,180	8,885	4,867	5,166
= Gross operating balance (overall)	**12,704**	**10,713**	**6,595**	**4,446**	**5,208**	**3,720**
- Fixed assets (excluding development partners)	622	1,001	303	854	899	956
- Fixed assets (using development partner loans)	5,779	2,573	6,430	7,314	8,893	7,563
= Net lending/borrowing (overall)	**6,303**	**7,139**	**-138**	**-3,722**	**-4,584**	**-4,800**
			(In percent of GDP)			
Gross operating balance (excluding development partners)	**8.3**	**7.6**	**0.9**	**-0.8**	**0.9**	**1.0**
+ Additional revenues (development partners grants)	9.2	7.0	13.6	13.2	8.0	6.4
- Additional expenses (using development partner grants and/or loans)	4.8	4.6	8.0	8.3	4.3	4.3
= Gross operating balance (overall)	**12.6**	**10.0**	**6.5**	**4.2**	**4.6**	**3.1**
- Acquisition of non-financial assets (excluding development partners)	0.6	0.9	0.3	0.8	0.8	0.8
- Acquisition of non-financial assets (using development partners' loans)	5.7	2.4	6.3	6.8	7.9	6.3
= Net lending/borrowing (overall)	**6.3**	**6.7**	**-0.1**	**-3.5**	**-4.1**	**-4.0**
Memorandum items:						
Nominal GDP (millions of vatu)	100,771	107,220	101,713	106,979	112,632	119,758

Sources: Vanuatu authorities; and IMF staff estimates and projections.
1/ Fiscal year corresponds to the calendar year.

Table 4. Vanuatu: Monetary Survey, 2018-2023

	2018	2019	2020	2021	2022	2023
				Projections		
	(In millions of vatu; end of period)					
Net foreign assets	53,975	67,017	78,334	78,353	82,465	87,675
Monetary authorities	46,896	55,212	65,477	70,208	71,785	74,409
Commercial banks	7,080	11,805	12,858	8,145	10,680	13,265
Net domestic assets	30,498	25,265	18,819	15,896	15,378	16,026
Domestic credit	50,607	47,349	42,842	39,920	39,401	40,049
Claims on government (net)	-12,291	-15,803	-21,116	-22,024	-23,009	-23,838
Claims on municipalities	76	67	37	59	59	59
Claims on other sectors	62,822	63,085	63,921	61,884	62,350	63,828
Claims on nonfinancial public enterprises	1,034	1,067	949	906	862	1,212
Claims on private sector	61,788	62,017	62,972	60,979	61,488	62,615
Other items (net)	-20,109	-22,084	-24,023	-24,023	-24,023	-24,023
Total broad money (M2)	84,473	92,282	97,154	94,249	97,843	103,701
Narrow money	55,063	62,949	67,667	61,780	68,169	76,697
Currency outside banks	8,582	9,345	10,384	-2,900	-4,862	-5,763
Demand deposits	46,481	53,603	57,284	64,680	73,031	82,461
Quasi-money	29,410	29,334	29,486	32,469	29,673	27,004
	(Annual percentage change, unless otherwise indicated)					
Net foreign assets	39.0	24.2	16.9	0.0	5.2	6.3
Net domestic assets	-33.8	-17.2	-25.5	-15.5	-3.3	4.2
Domestic credit	-4.4	-6.4	-9.5	-6.8	-1.3	1.6
Credit to the economy	0.8	0.4	1.3	-3.2	0.8	2.4
Private sector credit	1.2	0.4	1.5	-3.2	0.8	1.8
Total broad money	-0.5	9.2	5.3	-3.0	3.8	6.0
Vatu broad money	0.8	9.4	5.2	-4.5	5.4	7.7
Memorandum items:						
Vatu broad money multiplier	1.4	1.3	1.3	1.4	1.3	1.2
Total broad money multiplier	1.5	1.5	1.4	1.5	1.4	1.4
Velocity						
Narrow money	2.1	1.7	1.6	1.7	1.7	1.7
Vatu broad money	1.3	1.3	1.2	1.3	1.3	1.3
Total broad money	1.2	1.2	1.1	1.1	1.2	1.2
Reserve money (in millions of vatu)	45,913	45,886	47,681	51,682	53,129	55,916
Reserve money (annual percentage change)	8.7	-0.1	3.9	8.4	2.8	5.2
Credit to private sector (in percent of GDP)	61.3	57.8	61.9	57.0	54.6	52.3
Foreign currency deposits (annual percentage change)	11.7	4.7	5.8	10.1	-8.6	-9.0
Foreign currency deposits/total deposits (percent)	11.3	11.1	11.3	11.1	9.6	8.2
Foreign currency credit/total credit (percent)	31.9	29.8	28.4	28.4	28.4	28.4
Net foreign assets of banks (in millions of U.S. dollars)	63.1	103.3	119.1	76.7	100.5	124.9
Net foreign assets (in percent of GDP)	53.6	62.5	77.0	73.2	73.2	73.2
Nominal GDP (in millions of vatu)	100,771	107,220	101,713	106,979	112,632	119,758

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

Table 5. Vanuatu: Balance of Payments, 2018-2023
(In percent of GDP, unless otherwise stated)

	2018	2019	2020	2021	2022	2023
			Est.	Projections		
Current account balance	**12.2**	**16.0**	**3.3**	**-6.9**	**-8.0**	**-5.7**
Trade balance	**-26.2**	**-29.5**	**-23.5**	**-23.3**	**-24.3**	**-26.1**
Exports of goods (f.o.b.)	6.9	4.9	5.2	5.3	5.4	5.4
Domestic exports	4.8	4.7	4.6	4.8	4.9	4.9
Re-exports	2.1	0.2	0.7	0.5	0.5	0.5
Imports of goods (f.o.b.)	-33.1	-34.4	-28.7	-28.5	-29.7	-31.5
Services balance	**23.1**	**20.7**	**-2.6**	**-8.3**	**-5.3**	**0.5**
Receipts	40.3	36.2	12.6	5.9	9.7	16.5
Of which: travel	32.3	29.8	7.2	0.6	4.4	11.3
Payments	-17.2	-15.5	-15.2	-14.2	-15.0	-16.0
Primary income	**3.0**	**7.9**	**10.2**	**9.4**	**10.9**	**11.0**
Receipts	7.1	11.1	12.4	11.5	13.1	13.1
Payments	-4.1	-3.2	-2.2	-2.2	-2.1	-2.1
Secondary income	**12.3**	**16.9**	**19.2**	**15.3**	**10.7**	**8.9**
Official	12.0	15.3	18.3	14.4	9.9	8.1
Private	0.3	1.6	0.8	0.8	0.8	0.8
Capital and financial accounts	**-16.0**	**-6.5**	**3.5**	**11.4**	**9.4**	**7.9**
Capital account	**4.3**	**6.5**	**5.7**	**4.2**	**4.0**	**3.5**
Of which: Official capital transfers (net)	3.8	5.5	4.7	3.3	3.1	2.7
Financial account	**-20.3**	**-13.0**	**-2.2**	**7.2**	**5.4**	**4.3**
Foreign direct investment	3.9	2.7	2.6	2.9	3.0	2.9
Portfolio investment	1.5	0.6	-1.0	-0.7	-0.7	-0.6
Other investment	-25.7	-16.3	-3.8	5.0	3.1	2.0
Net errors and omissions	**6.5**	**0.3**	**4.2**	**0.0**	**0.0**	**0.0**
Overall balance	**2.7**	**9.8**	**10.9**	**4.5**	**1.4**	**2.2**
Financing:	**-3.1**	**-10.4**	**-11.4**	**-4.7**	**-1.6**	**-2.4**
Change in international reserves (- = increase)	-2.7	-9.8	-10.9	-4.5	-1.4	-2.2
IMF's RCF/RFI	-0.3	-0.6	-0.4	-0.2	-0.2	-0.2
Memorandum items:						
Gross international reserves	45.3	55.1	65.8	65.9	63.5	61.9
In months of prospective imports	9.6	13.3	15.3	14.7	13.3	11.8
Net official reserves	45.9	52.5	64.9	…	…	…
Exports of goods (annual percentage change)	5.9	-29.4	7.9	7.9	8.9	6.3
Imports of goods (annual percentage change)	-2.8	3.8	-16.1	6.4	10.5	12.8
Exchange rate (vatu per U.S. dollar, period average)	108.5	115.6	109.1	…	…	…
Exchange rate (vatu per U.S. dollar, end of period)	112.3	114.3	108.0	…	…	…
Public external debt	41.9	40.1	40.8	39.4	43.5	45.8
Public external debt service (in percent of GNFS exports)	4.0	6.7	18.7	31.5	11.1	7.8
Nominal GDP	928	928	932	999	1060	1127

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

Table 6. Vanuatu: Medium-Term Baseline Scenario, 2018-2026

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Estimates				Projections			
Output and prices (annual percentage change)									
Real GDP	2.9	3.9	-6.8	1.2	3.0	4.1	3.7	2.7	2.7
Consumer prices (period average)	2.4	2.7	5.7	5.4	2.6	2.3	2.2	2.2	2.2
Consumer prices (end period)	1.9	3.5	7.0	3.9	2.3	2.2	2.2	2.2	2.2
Government finances (in percent of GDP)									
Total revenue	39.5	38.5	44.2	40.6	34.2	32.1	31.6	31.0	30.6
Taxes	18.4	17.6	14.6	16.1	16.5	17.0	17.3	17.3	17.3
Other revenue	12.0	13.9	16.0	11.2	9.7	8.7	8.1	7.5	7.2
Grants	9.2	7.0	13.6	13.2	8.0	6.4	6.2	6.2	6.1
Expenditure	33.3	31.8	44.4	44.0	38.3	36.1	35.4	34.8	34.3
Expense 1/	26.9	28.5	37.8	36.4	29.6	29.0	28.5	28.2	27.8
Acquisition of nonfinancial assets 1/	6.4	3.3	6.6	7.6	8.7	7.1	6.9	6.6	6.4
Net lending (+)/borrowing (-)	6.3	6.7	-0.1	-3.5	-4.1	-4.0	-3.7	-3.8	-3.7
Public and publicly-guaranteed debt (end of period)	49.2	46.1	50.1	47.5	50.2	51.4	53.2	55.5	56.8
Domestic	7.3	6.1	9.3	8.0	6.7	5.7	5.3	5.3	4.4
External	41.9	40.1	40.8	39.4	43.5	45.8	47.9	50.2	52.3
Of which: RCF/RFI	1.6	1.1	0.9	0.6	0.4	0.2	0.1	0.1	0.1
Balance of payments (in percent of GDP)									
Current account	12.2	16.0	3.3	-6.9	-8.0	-5.7	-4.4	-3.6	-4.1
Trade balance	-26.2	-29.5	-23.5	-23.3	-24.3	-26.1	-29.3	-30.8	-30.7
Exports of goods	6.9	4.9	5.2	5.3	5.4	5.4	5.4	5.4	5.4
Imports of goods	-33.1	-34.4	-28.7	-28.5	-29.7	-31.5	-34.7	-36.2	-36.2
Travel receipts	32.3	29.8	7.2	0.6	4.4	11.3	18.5	22.3	21.7
Capital and financial account	-16.0	-6.5	3.5	11.4	9.4	7.9	6.6	6.6	6.5
Of which: Foreign direct investment	3.9	2.7	2.6	2.9	3.0	2.9	2.9	3.1	3.2
Overall balance	2.7	9.8	10.9	4.5	1.4	2.2	2.2	3.0	2.4
Gross international reserves (in millions of U.S. dollars)	421	512	614	658	673	698	724	761	792
(in months of prospective G&S imports)	9.6	13.3	15.3	14.7	13.3	11.8	11.1	11.1	11.0
External debt service (in percent of GNFS exports)	4.0	6.7	18.7	31.5	11.1	7.8	5.8	5.3	5.5
Memorandum items:									
Nominal GDP (in billions of vatu)	100.8	107.2	101.7	107.0	112.6	119.8	126.8	133.1	139.7
Nominal GDP (in millions of U.S. dollars)	928	928	932	999	1,060	1,127	1,194	1,253	1,315

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, 2016-2021

	2016	2017	2018	2019	2020	2021Q1
Capital adequacy						
Regulatory capital to risk-weighted assets	19.3	18.0	20.1	19.2	20.0	21.8
Regulatory Tier 1 capital to risk-weighted assets	16.4	15.6	16.3	17.9	18.9	20.3
Asset quality						
Nonperforming loans net of provisions to capital	42.2	57.1	52.2	42.5	57.5	57.5
Nonperforming loans to total gross loans	11.2	15.6	16.0	14.4	19.0	18.2
Earnings and profitability						
Return on assets[1/]	1.5	0.5	1.5	0.1	-0.1	1.1
Return on equity[1/]	11.5	3.8	13.0	0.9	-0.6	9.0
Interest margin to gross income	64.3	63.6	65.3	65.1	68.0	69.0
Noninterest expenses to gross income	64.4	63.2	63.3	70.4	78.1	78.8
Liquidity						
Liquid assets to total assets (liquid asset ratio)	32.9	35.5	45.2	43.6	44.0	43.4

Source: Reserve Bank of Vanuatu.

[1/] There are seasonal effects explaining the quarterly trend in the return on assets and return on equity as banks pay some non-interest expenses and overhead costs towards year end. Provisioning expenses also tend to be higher by year end.

Table 8. Vanuatu: Indicators of Capacity to Repay the Fund, 2020-2029

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
	Est.					Projections				
Total obligations based on existing and prospective credit										
In millions of SDRs	3.2	1.7	1.7	1.7	1.7	0.9	0.0	0.0	0.0	0.0
Principal	3.0	1.7	1.7	1.7	1.7	0.9	0.0	0.0	0.0	0.0
Charges and interest	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
In millions of U.S. dollars	4.4	2.5	2.5	2.5	2.5	1.3	0.0	0.0	0.0	0.0
In percent of gross international reserves	0.7	0.4	0.4	0.4	0.3	0.2	0.0	0.0	0.0	0.0
In percent of government revenue	1.1	0.6	0.7	0.7	0.7	0.3	0.0	0.0	0.0	0.0
In percent of exports of goods and services	4.0	1.5	1.0	0.7	0.6	0.3	0.0	0.0	0.0	0.0
In percent of debt service 1/	8.6	4.5	6.5	6.2	6.1	3.0	0.0	0.0	0.0	0.0
In percent of GDP	0.5	0.2	0.2	0.2	0.2	0.1	0.0	0.0	0.0	0.0
In percent of quota	18.6	10.1	10.1	10.1	10.1	5.1	0.1	0.1	0.1	0.1
Outstanding Fund credit										
In millions of SDRs	7.7	6.0	4.3	2.6	0.9	0.0	0.0	0.0	0.0	0.0
In millions of U.S. dollars	10.7	8.6	6.2	3.7	1.2	0.0	0.0	0.0	0.0	0.0
In percent of gross international reserves	1.7	1.3	0.9	0.5	0.2	0.0	0.0	0.0	0.0	0.0
In percent of government revenue	2.6	2.1	1.7	1.0	0.3	0.0	0.0	0.0	0.0	0.0
In percent of exports of goods and services	9.6	5.4	2.5	1.1	0.3	0.0	0.0	0.0	0.0	0.0
In percent of debt service 1/	20.7	15.7	16.2	9.2	3.0	0.0	0.0	0.0	0.0	0.0
In percent of GDP	1.1	0.9	0.6	0.3	0.1	0.0	0.0	0.0	0.0	0.0
In percent of quota	45.0	35.0	25.0	15.0	5.0	0.0	0.0	0.0	0.0	0.0
Net use of Fund credit (in millions of SDRs)	-3.0	-1.7	-1.7	-1.7	-1.7	-0.9	0.0	0.0	0.0	0.0
Disbursements	0	0	0	0	0	0	0	0	0	0
Repayments and repurchases	-3.0	-1.7	-1.7	-1.7	-1.7	-0.9	0.0	0.0	0.0	0.0
Memorandum items:										
Nominal GDP (in millions of U.S. dollars)	932	999	1060	1127	1194	1253	1315	1377	1442	1510
Exports of goods and services (in millions of U.S. dollars)	111	160	247	348	413	425	448	472	497	520
Gross international reserves (in millions of U.S. dollars)	614	658	673	698	724	761	792	825	861	898
Government revenue (in millions of U.S. dollars)	413	405	363	362	378	389	402	416	432	451
Debt service (in millions of U.S. dollars)	51	55	38	41	41	42	43	46	47	50
U.S. dollars/SDR (period average)	1.39	1.45	1.46	1.46	1.47	1.47	1.48	1.48	1.48	1.48

Source: IMF staff estimates and projections.

1/ Total debt service includes IMF repurchases and repayments.

Table 9. Vanuatu: Integration Matrix of Surveillance Issues and Capacity Building

Surveillance issues	IMF			Asian Development Bank		World Bank	
	Past	2021[1/]	Planned/ ongoing	Past	Planned/ ongoing	Past	Planned/ ongoing
Fiscal sector:							
Public financial management	√	√	√			√	√
Expenditure framework			√				
Revenue framework	√	√	√				
Macro-financial issues:							
Financial supervision and regulation	√	√	√	√	√		
Financial market development				√	√		
Correspondent banking relationships		√	√		√		
Macro-structural issues:							
Infrastructure				√	√	√	√
Private sector development				√	√		
Governance issues				√	√		
Poverty/gender/inequality							
Climate change							
Natural disaster management						√	√
Financial inclusion				√	√		
Statistics:							
Data enhancement	√	√	√				

1/ IMF Fiscal year.

Annex I. Authorities Response to Fund Policy Advice

Fund Recommendation	Policy Actions
Fiscal Policy	
Continue with revenue mobilization and expenditure prioritization to maintain debt sustainability. Proposed measures include i. Complete the proposed 2017 tax reforms to increase revenues. ii. Stabilize expenditure as a share of GDP. iii. Focus on grants and loans with higher concessionality. iv. Limit and prioritize loans, especially less concessional lending.	• The authorities did not introduce income tax and pass the Tax administration Act. • Established a national revenue governance committee to oversee the government's efforts in expanding its revenue base. • ECP revenue windfall used for debt repayments and signed new concessional loan and grant agreement for Climate Change Resilient Transport Project with World Bank IDA.
Strengthen the debt management framework.	• The new national debt management strategy was passed through parliament in 2019 and are in place till 2022.
The authorities should 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 2018 Article IV consultation.	• 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.
Monetary Policy/Exchange Rate Policy	
RBV should maintain an accommodative monetary policy stance but be ready to ease if necessary. Monetary policy should hold the course to maintain stable exchange rate and low inflation. 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.	• In March 2020, the RBV reduced the policy rate from 2.9% to 2.25% and implemented liquidity provision. International reserves remained about 15 months of prospective import in 2020. Non-food inflation is expected to remain stable. The basket peg regime has been working well, and the REER has remained roughly stable.
Financial Sector Policy	
Work on financial inclusion should help further development of the financial sector.	• In 2020, slow progress toward key financial inclusion goals due to the pandemic. In 2021, the RBV will undertake a mid-term review of the National Financial Inclusion Strategy 2018-2023.
Strengthen the financial sector's regulatory and legal frameworks to support fintech use.	• Legislation and supervisory framework to monitor the use of fintech and distributed ledger technology is being developed. The amendment to Financial Dealers Licensing Act became effective in July 2021, allowing the trade of digital assets and requiring physical presence of all license holders in Vanuatu.
Given elevated NPLs and low profitability, the RBV needs to monitor the banking sector carefully and continue strengthening its supervisory framework.	• The RBV continued monitoring developments in banking system, including profitability and NPLs. The commercial banks' loan repayment holiday and the temporary relaxation of loan classification were extended by September 2021.
Ongoing improvements to AML/CFT regime are needed to strengthen financial sector stability and ease potential pressures on correspondent banking relationships.	• AML/CFT related bills were passed in Parliament in 2020. Review of current AML/CFT framework by APG/FATF is expected in 2023.
Strengthen RBV's governance to help ensure the continuation of effective monetary and financial policies that support	• 2016 Safeguards assessment recommendations is still incomplete.
Structural Policy	
Structural policy should focus on diversification to foster stable growth and resilience. Diversification strategy should be complemented by further improvements in the business environment.	• Economic Development Zone (EDZ) legislation is in progress. • The Vanuatu Electronic Single Window (VESW) project, aiming to reduce the cost and time of trading, was completed.
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. Set up a carefully designed national emergency fund with stable and substantial funding.	• Disaster Risk Management Act 2019 was passed by parliament in November 2019, and gazetted in February 2020. • The government is setting up a trust account in 2021. The government allocated VUV 300 million to its emergency fund. • The PFEM Act also provides avenues for additional funding of 1.5% of the budget appropriation in emergency.

Annex II. Economic Citizenship Program: An Update[1]

1. **Vanuatu is the only country in the Asia and Pacific region to have an Economic Citizenship Program (ECP) – whereby one can pay a set amount of dollars and acquire citizenship quickly**. ECPs have become increasingly popular in small state developing economies over the last decade. Such a commodified citizenship invariably entails limited or no residency requirements, restricts the scope for income taxation and increases mobility of recipients through visa free access to over a hundred countries. ECPs are generally the primary source of quick liquid revenue for small states like Vanuatu, but it is highly volatile and requires prudent management.

2. **After failed attempts to establish schemes that offer passports in return for investment in the 1990s, the Vanuatu government revived the new ECP in 2016**.[2] This was primarily to boost revenues and support the recovery activities post the devasting Tropical Cyclone Pam in March 2015. After experimenting with a real estate option (REO) program (that is used in some countries), the government settled on Vanuatu Development Support Program (VDSP) and Vanuatu Contribution Program (VCP) from 2017 onwards for interested candidates to obtain Vanuatu citizenship.[3] These schemes offer "honorary citizenship" that includes most ni-Vanuatu rights except voting and political involvement, in exchange for a one-time contribution. The application process requires a background check, including of financial resources and criminal record, and takes between 1 to 2 months, making it one of the most fast-track citizenship programs in the world.[4]

3. **The required investment amount through their schemes have declined over time.** Initially, both schemes offered citizenship to foreign investors for USD 220,000 for a single person application to USD 280,000 for a family with elderly parents. Application amount has since been lowered twice. There were reduced USD 150,000 for a single applicant in May 2018, then to USD 130,000 for a single applicant and USD 180,000 for a family of four in November 2019. Of this amount, the government fee is USD 80,000 (USD 130,000 for a family of four). The rest is retained by agents, who must be a born or naturalized Vanuatu citizen, and who pays a 15 percent tax on their revenues. The number of agents licensed for the ECP transaction have more than doubled in 2020, to over 100.

4. **Revenues from the ECP have accelerated over the past five years**. The ECP funds collected in 2020 increased by 16.7 percent compared to 2019, which itself was 23.6 percent higher than revenues in 2018. ECP revenue accounted for a third of government revenue in 2020 and have been higher than foreign aid since 2018. They are now the largest source of revenue, higher than VAT, the primary tool for domestic revenue collections. As a result of the buoyant ECP revenues,

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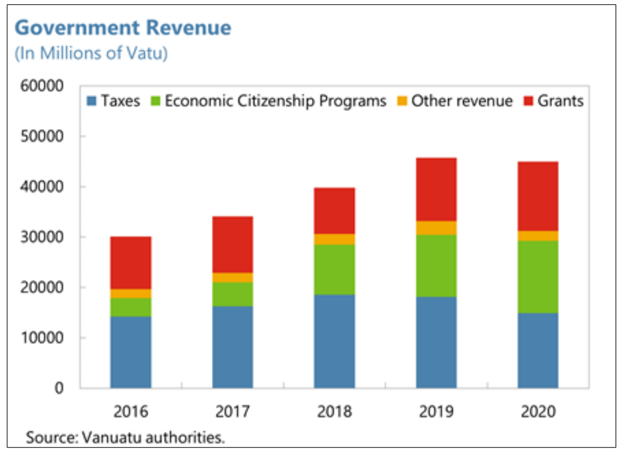
[1] Prepared by Vybhavi Balasundharam.

[2] See Box 1 in 2018 Vanuatu Article IV report for more details.

[3] REO Program required applicants to invest USD 230,000 in real estate related investments to obtain Vanuatu citizenship.

[4] Citizens of North Korea, Yemen, Syria, Iraq, and Iran are not allowed to apply.

Vanuatu has run a large fiscal surplus in 2018 and 2019 and only a small deficit in 2020, despite the severe economic impact from the COVID-19 pandemic and natural disasters in 2020.



5. The government has so far used the ECP revenues prudently. The government has used the surplus ECP revenues for early repayments of debt, fund one-off expenditures like the COVID-19 stimulus package, natural disaster relief and the mandated restoration of wage levels of public officials. It has also built and maintained large cash reserves. Any additional surplus should be carefully managed given the threat of sudden stop. Recent evidence suggests that spending on public consumption would be the riskiest while spending toward public investment and debt consolidation would be a safer use of these revenues (Dominica IMF Selected Issues Paper, 2017). The government should not increase its recurrent spending further, particularly on wage bill and use of goods and services. Vanuatu could potentially pool surplus revenues in a trust fund to cope with the high vulnerability to natural disasters and focus on building climate resilience.[5]

6. Citizenship-by-investment schemes are generally recognized as being associated with financial integrity and corruption risks. They have been linked to money laundering, tax evasion, and other crimes. If these risks are not properly managed, they can result in reputational damage to offering countries that could be detrimental to their financial sector and broader economy. Risks arising from Vanuatu's ECP have been flagged. In 2019, questions on the effectiveness of its AML/CFT regime were raised after international criminals were found holding Vanuatu passports through its ECP.

7. There is an urgent need to mitigate the financial integrity risks and reduce the growing reliance on ECP revenues. Financial integrity risks associated with the ECP may be one cause of difficulty in attempts to establish new CBRs. There is insufficient transparency and concerns about the stringency of the application review process.[6] The government should strengthen its AML/CFT regime and its implementation. Given the unpredictability of ECP revenues, the government should actively consider revenue mobilization and further expenditure rationalization. As it now stands, the revenue base is limited – VAT, tariffs on imported goods and a variety of minor business taxes and fees. Vanuatu has no income or corporate taxes.

[5] See examples in St. Lucia, the sustainable growth fund in St. Kitts and Nevis.

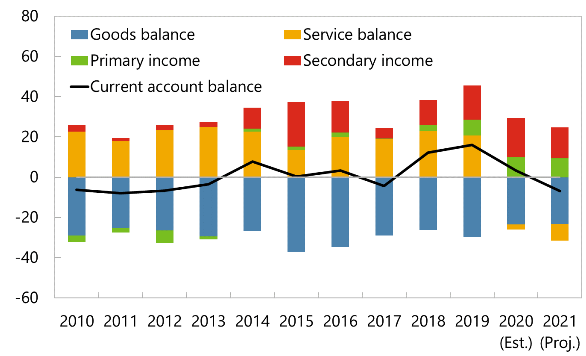
[6] No information on the citizenship of the applicants, acceptance rate and number of approved applications is publicly available. In the current vetting system, Vanuatu's Financial Intelligence Unit is tasked with conducting only a criminal background check and no further due diligence is performed by the Citizenship Office.

Annex III. External Sector Assessment[1]

The external position for 2020 is stronger than the level implied by fundamentals and desirable policy setting. The current account balance is estimated to remain in surplus in 2020 mainly due to the windfall revenues from the Economic Citizenship Program (ECP) despite a sharp drop in tourism receipts. The real effective exchange rate has appreciated slightly in 2020 while international reserves have increased largely reflecting the windfall ECP receipts.

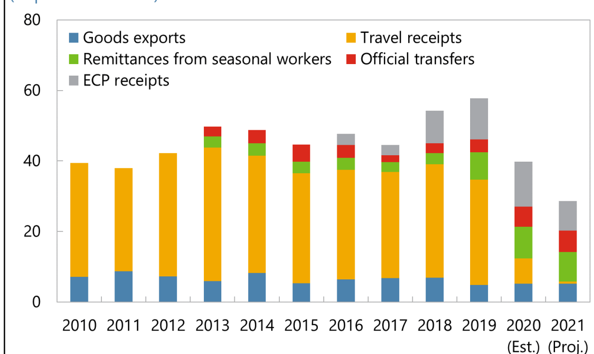
1. **Current account balance.** Vanuatu's current account (CA) surplus is estimated to decline to 3.3 percent of GDP in 2020 from a record surplus of 16 percent of GDP in 2019, largely due to a sharp drop in travel receipts. These receipts (about 30 percent of GDP on average over 2015–19) are estimated to drop by about 75 percent in 2020 due to the border closure measures preemptively imposed by the authorities to prevent a local transmission of COVID-19. The larger-than-expected windfall revenues from the ECP, increased donor support as a response to the COVID-19 pandemic and 2020 Tropical Cyclone (TC) Harold, and resilience of remittances from seasonal workers had prevented CA from turning into deficit in 2020. The CA balance is expected to deteriorate in 2021, mainly due to lower ECP and travel receipts.

Current Account
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff estimates.

Select Credit Items of the Current Account
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff estimates.

2. **The EBA-lite CA model results indicate a positive gap of 3.5 percent of GDP in 2020, consistent with an estimated cyclically adjusted CA surplus of 1.5 percent and a model-based CA norm of -2 percent of GDP.** Thus, the CA in 2020 is assessed to be stronger than the level implied by fundamentals and desirable policy setting. The cyclical adjustments incorporate the temporary impact of the pandemic on the tourism and the excess revenue windfall from the ECP (measured

Vanuatu: Model Estimates for 2020 (in percent of GDP)

	CA model
CA-Actual	**3.3**
Cyclical contributions (from model) (-)	0.6
COVID-19 adjustor (+) 1/	8.5
Additional temporary/statistical factors (+) 2/	-9.7
Adjusted CA	**1.5**
CA Norm (from model) 3/	**-2.0**
Adjustments to the norm (+)	0.0
Adjusted CA Norm	**-2.0**
CA Gap	**3.5**
o/w Relative policy gap	8.1
Elasticity	-0.32
REER Gap (in percent)	**-11.1**

Source: IMF staff estimates.
1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism (8.5 percent of GDP).
2/ Adjustment to the extraordinary revenue windfall from the ECP (7.8 percent of GDP), and the higher current transfers received by the government (1.9 percent of GDP).
3/ Cyclically adjusted, including multilateral consistency adjustments.

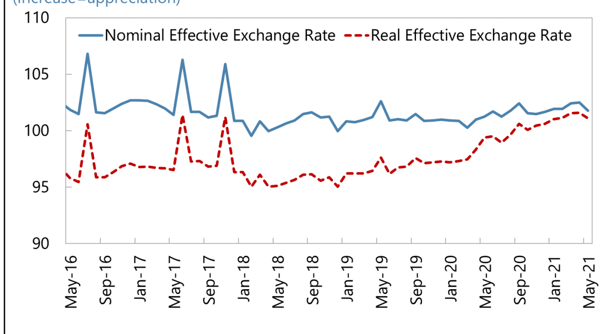
[1] Prepared by Yinqiu Lu.

against the forecast ECP revenues over 2021–2026) and increased donor support. The main contributors of the positive policy gap are the stronger than desirable fiscal balance largely due to the ECP revenues, lower than desirable public health spending, and reserve accumulation.

3. Exchange rate and competitiveness. The exchange rate of the vatu is linked to a transaction-weighted (trade and tourism receipts) basket of currencies with weights adjusted periodically. The real effective exchange rate (REER) appreciated by 1.7 percent on average in 2020, mainly due to its higher headline inflation relative to its trading partners.

Nominal Effective Exchange Rate and Real Effective Exchange Rate

(Increase=appreciation)



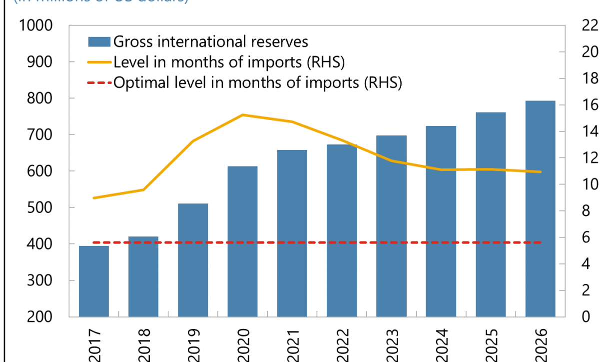
Sources: Vanuatu authorities; and IMF staff estimates.

4. Capital and financial accounts. Vanuatu's capital and financial accounts inflows recorded a surplus in 2020, mainly driven by donor project-related capital grants and net FDI inflows. Net FDI inflows (about 4.2 percent of GDP on average over 2015–19) remained weak at 2.6 percent of GDP in 2020 due to the pandemic. Net errors and omissions were about 4.2 percent of GDP in 2020.

5. International reserves and adequacy. Vanuatu's gross official reserves increased to US$613.6 million (about 15 months of imports) in 2020 from US$511.6 million in 2019, largely reflecting the windfall ECP receipts and increased donor support. A reserve adequacy methodology for credit-constrained economies is used to estimate an optimal level of reserves by comparing the costs and benefits of holding reserves. When measured against Vanuatu's vulnerability to external shocks, the adequate level of reserves is estimated to lie in the range of 4.2 to 5.6 months of imports, depending on the probability of a large shock, 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. Overtime, reserve coverage is expected to remain adequate to finance imports and loan repayments, despite the slow recovery of tourism and moderating ECP revenues. Vanuatu needs buffers to cover its imports needs for reconstruction and losses in domestic production in the event of natural disasters. For example, the Cyclone Pam in 2015 destroyed between 70 and 80 percent of GDP and led to large reconstruction and imports needs.

Official Foreign Exchange Reserves

(In millions of US dollars)



Sources: Vanuatu authorities; and IMF staff estimates.

Annex IV. Risk Assessment Matrix[1]

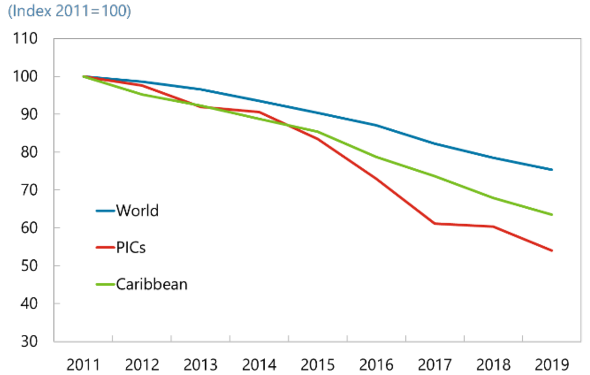
Likelihood	Risks	Expected Impact	Main Policy Recommendation
	Unexpected shifts in the Covid-19 pandemic.		
Medium	• **Asynchronous progress.** Limited access to, and longer-than-expected deployment of, vaccines in some countries—combined with dwindling policy space—prompt a reassessment of their growth prospects (for some Emerging and Frontier Markets triggering capital outflows, depreciation and inflation pressures, and debt defaults).	***High*** Prolonged border closure to contain COVID-19 could invite associated disruptions to tourism and delays of infrastructure projects. A slower recovery or a renewed downturn would increase risks of economic scarring: productivity of tourism related sector would decrease by loss of skilled labor and closure of prospective firms.	Continue targeted fiscal measures to affected households and businesses. Maintain current accommodative monetary policy stance.
Medium	• **Prolonged pandemic.** The disease proves harder to eradicate (e.g., due to new virus strains, short effectiveness of vaccines, or widespread unwillingness to take them), requiring costly containment efforts and prompting persistent behavioral changes rendering many activities unviable. For countries with policy space, prolonged support—while needed to cushion the economy—exacerbates stretched asset valuations, fueling financial vulnerabilities. For those with limited space, especially EMs, policy support is insufficient.		
Medium	• **Faster containment.** Pandemic is contained faster than expected due to the rapid production and distribution of vaccines, boosting confidence and economic activity.	***High*** Resumption of economic activity could normalize quicker if the pandemic is contained faster.	
High	**Potential drop of ECP revenues.** ECP revenues could fall sharply amid growing concerns regarding AML/CFT risks, amplified by the recent loss of a key correspondent banking relationship (CBR). AML/CFT capacity constraint could lead to lessening Vanuatu's passport attractiveness (e.g. by EU's delisting from the visa-free country list), leading to revenue drop.	***High*** ECP revenue drop might jeopardize medium-term fiscal sustainability. The cash reserve buffer can mitigate the shock, if the decline is temporary.	Formulate a medium-term fiscal strategy. Continue to commit to the current fiscal rules such as positive recurrent balance and concessional borrowing.
High	**Growing NPLs.** Financial institutions' asset quality could deteriorate with a spike in NPL ratios once the policy support measures expire.	***Medium*** Banks could deleverage to rebuild capital buffers and subsequently credit conditions could tighten. Structurally high NPL ratio in the personal sector could hinder promoting financial inclusion.	Guide banks to accumulate further general provisioning early. Establish crisis management and resolution frameworks.
High	**Weak Governance.** Lack of transparency and supervising framework for state-owned enterprises (SOE) could deteriorate their business soundness and negatively affect business environment and fiscal management. Issues on AML/CFT and EU blacklisting related to tax transparency could undermine business appetite of foreign companies in a de-risking context, leading to further loss of CBRs and hindering promotion of foreign direct investment (FDI). Insufficient autonomy of the central bank could also affect their business appetite.	***High*** Promoting FDI is a key for Vanuatu's economic growth. Weak FDI could lead to slow economic growth and deterioration of external fiscal sustainability.	Establish the governance structure of the SOEs. Strengthen AML/CFT institutional capacity. Amend the tax bill consistent with the international standard of tax transparency. Complete the 2016 safeguard assessment.
Medium/Low	**Higher frequency and severity of natural disasters related to climate change** cause severe economic damage to smaller economies susceptible to disruptions and accelerate emigration from these economies (medium probability). A sequence of severe events in large economies reduces global GDP and prompts a recalculation of risk and growth prospects. Disasters hitting key infrastructure or disrupting trade raise commodity price levels and volatility (low probability).	***High*** Vanuatu faces high natural disaster risk, 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.	Integrate financing plans, consistent with the medium-term fiscal strategy, for the adaptation plan and disaster response to support resilience-building.

[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. Non-mutually exclusive risks may interact and materialize jointly.

Annex V. Recent Developments in Correspondent Banking Relationships in the Pacific Island Countries[1]

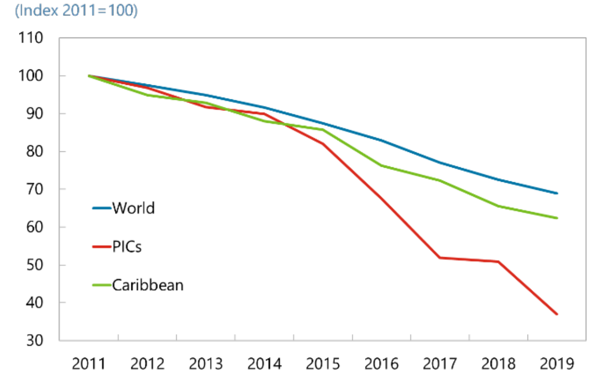
1. The number of active correspondents has continued to decline globally over a decade, but at a much slower pace and some regions are more affected than others.[2] Such decline is generally attributed to correspondent banks' concerns about risks and weak profitability. International rules on tax transparency and anti-money laundering and combating of financing of terrorism (AML/CFT) have become more stringent following the Global Financial Crisis of 2008. Consequently, international correspondent banks were finding it less attractive to hold correspondent banking relationships (CBRs) with banks in Pacific island countries (PICs) due to the high costs of AML/CFT compliance and low profitability of transactions. In 2019, the Pacific region saw the largest yearly decline (about 6 percent) in CBRs compared to other regions, including the Caribbean. The number of active correspondents of USD account has more severely fallen in PICs. In 2021, the recent termination of CBRs by an Australian bank with several domestic banks in PICs including Samoa and Vanuatu revealed that loss of CBR could invite more serious economic consequences than ever, given that the economies have relied on fewer and fewer CBRs.

Number of Active Correspondents
(Index 2011=100)



Sources: BIS; and IMF staff calculation.

Number of Active USD Correspondents
(Index 2011=100)



Sources: BIS; and IMF staff calculation.

2. CBR is essential financial infrastructure for PICs. Traditionally, CBR involves a financial institution (correspondent bank) in a foreign country facilitating cross border payment services on behalf of a financial institution (respondent bank) in another country. Financial institutions in PICs are typically too small to have operations in other countries and therefore rely on CBR to conduct cross border payments. Maintaining CBRs with international banks allows PICs to engage in international trade and develop their exporting industries such as agriculture which is vital for their development. Furthermore, CBR allows for the transmission of remittances which are important income sources for PICs.

[1] Prepared by Seruwaia Cagilaba.

[2] A report of the Committee on Payments and Market Infrastructures (CPMI) published in 2020 based on SWIFT data estimated that the decline in number of active correspondent banks worldwide has been around 22% between 2011 and 2019.

3. The escalation of CBR issues in PICs could have severe macroeconomic consequences. Losing CBR could hinder export activities, especially in case of USD account, which is one of major trade clearing currencies. This could lead to inadequate level of foreign reserves to pay for future imports. Fiscal sustainability issues could also occur when the loss of CBR leads to a material reduction in government revenues. In Solomon Islands, CBR issues threatened to disrupt the exports of logs, the main source of foreign reserves and government revenues. The loss of CBR could harm remittances, which is another source of foreign reserves and a key driver of household consumption in PICs. Samoa's recent loss of USD CBR with an Australian Bank could potentially harm future personal remittance inflows.[3] Given that currency trading is a source of banks' income, the withdrawal of CBR could deteriorate banks' profitability. In Vanuatu, the recent loss of USD CBR in one of the major domestic banks could have material implications on its profitability given that its export clearing service of USD, a major trading currency, is no longer available. Moreover, reduction in CBR leads to concentration of CBR in fewer banks, increasing systemic instability risk.

4. CBR issues in PICs are commonly associated with AML/CFT related concerns. Financial integrity risks have been cited by banks as one reason for the termination of CBRs. All of the PICs facing CBR issues previously have been found by the Asia Pacific Group on Money Laundering (APG) to have important deficiencies in their AML/CFT regimes. International financial centers often have to contend with heightened ML/TF risks (including inadequate entity transparency and inaccurate beneficial ownership information), which make them vulnerable to illicit financial flows (due to their frequent exploitation by criminal elements). These concerns, along with other factors, such as negative reputational implications of high-risk activities (e.g., economic citizenship programs) and low profitability, often lead to CBR pressures. Recently there have been elevated reports raising concerns on the strength of due diligence checks being linked with criminal activities for Vanuatu's economic citizenship program, that likely contributed to its major domestic bank losing its only USD CBR. In addition, non-compliance with international standard of tax transparency (e.g., as reflected in the EU list of non-cooperative tax jurisdictions) also can contribute to CBR pressures in the context of de-risking.

5. It is therefore imperative that PICs actively pursue reforms to strengthen their AML/CFT regimes and mitigate the financial integrity risks as well as the risk of losing CBR. PICs should ensure that their AML/CFT regimes remain resilient to any perceived or actual risks to financial integrity and good governance. To this end, the Fund has assisted PICs to deal with CBR issues through the provision of technical assistance and by facilitating regional dialogue among key stakeholders. Regional dialogue on CBR issues can help to identify the main drivers behind CBR pressures as well as solutions. The Fund has dedicated externally financed thematic fund that supports Fund-delivered technical assistance to targeted PICs to strengthen AML/CFT supervision. PFTAC is also providing secretarial support for a regional KYC facility, contributing to addressing CBR issues in PICs.

[3] It accounts for 17.2% of GDP in 2019. Source: World Bank World Development Indicators on Personal Remittances https://data.worldbank.org/indicator/BX.TRF.PWKR.DT.GD.ZS

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World Bank World Development Indicators on Personal Remittances. Available via the Internet: https://data.worldbank.org/indicator/BX.TRF.PWKR.DT.GD.ZS

Annex VI. Promoting Economic Diversification in the Post-COVID Era[1]

1. The Vanuatu economy is heavily reliant on tourism and exports have remain limited. Vanuatu has a narrow export base with economic activity largely concentrating on tourism and agriculture.[2] Historically the tourism industry has been the main driver of economic growth accounting for almost a third of GDP before the COVID crisis. Economic growth has also been influenced by industrial construction activity (which averaged a 10-year growth of 12.8 percent in the pre-COVID period) reflecting infrastructure projects. In contrast, the agriculture, fisheries, and forestry sector has faced weak and volatile growth, as production continued to be hampered by natural disasters including two major cyclones[3] in the last 5 years. An eighty percent share of agriculture production is for crops including export commodities kava, copra, and cocoa. Fish production has been negligible until recently when commercial fishing growth improved exponentially following the opening of Vanuatu's first Tuna canning company.[4] Forestry and livestock production are mainly for the domestic market and export (sawn timber and beef) only on a small scale.

2. There is potential to strengthen future long-term growth through economic diversification. The pandemic emphasized the need to diversify growth, after the country suffered its worst economic recession in history following the collapse of tourism. The authorities' post-COVID growth strategy[5] is focused on developing the productive and social sectors to achieve stable and inclusive economic growth. Moreover, the authorities' long-term economic development goals as per the Vanuatu 2030: The People's Plan, include economic diversification and production of more niche value added processed commodities. There are three potential industries that can be considered to diversify growth in Vanuatu, which include:

- **Fisheries.** The authorities aim to establish fisheries as one of the top 10 GDP sectors by 2030. Given its large Exclusive Economic Zone (EEZ), the government could earn revenues from fishing licenses given to purse seiners and longline fishing vessels that fish in Vanuatu waters. Commercial fishing in Vanuatu is mainly for Tuna which has steadily increased since 2017. According to the authorities, Vanuatu receives about $3 million Vatu per year in revenues from fishing licenses given to foreign Tuna fishing vessels. There is huge potential to raise domestic

[1] Prepared by Seruwaia Cagilaba.

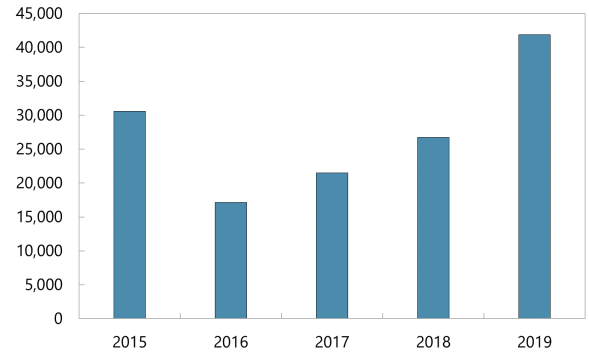
[2] The top foreign exchange earners in Vanuatu is tourism followed by sales revenues from the Economic Citizenship Program, personal remittances (from Seasonal Workers Program and Recognised Seasonal Employer scheme), and export earnings from kava, coconut oil, copra, and cocoa.

[3] Tropical Cyclone Pam in 2015 and Tropical Cyclone Harold in 2020.

[4] In October 2019, the Vanuatu government opened Sino Van, the country's first fish canning company since Palekula Fishing Base operations closed in 1987. See more information in: https://dailypost.vu/news/sino-van-launches-after-15-years/article_9093579c-f6a1-11e9-b77a-734bc171a910.html

[5] For more details see page 3 of the Government of the Republic of Vanuatu, 2021, "Budget 2021 Volume 1 Fiscal Strategy Report Incorporating the Economic and Fiscal Update and the Budget Policy Statement"

Total Tuna Caught by Vanuatu Fishing Vessels
(In Tonnes)



Source: Western & Central Pacific Fisheries Commission: Tuna Fishery Yearbook 2019.

fish production and exports through investment in better offloading, storage, and processing facilities in Vanuatu. This was clearly illustrated in 2020, when there was exponential increase in domestic fish production and fish exports a year after Sino Van fish processing plant began operations. Authorities have plans to develop better infrastructure to allow more tuna and fish species to be processed domestically. However, authorities need to exercise caution to ensure that policies that develop the fisheries sector are environmentally sustainable.

- **Manufacturing for agribusiness.** Commercial agriculture in Vanuatu is relatively underdeveloped, with exports largely concentrated in unprocessed crops. Agribusiness is mostly related to the processing of kava, coconut oil, beef, and sawn timber. The manufacturing sector is still small and can be better linked to agriculture production to create more value-added agriculture exports that are niche to Vanuatu. European Development Fund 11's (EDF-11) Value Chain program is already providing support for agriculture value chains in Vanuatu, to help mechanize as well as improve quality of production and storage facilities for agriculture produce. However, business environment constraints related to the high cost of doing business in Vanuatu is a key barrier that will need to be addressed to encourage private sector investment in the manufacturing industry. This can be enhanced with investment in better quality transport networks such as roads and wharves to facilitate greater market access for farmers.

- **ICT enabled outsourcing services**. Given its high literacy rate[6], fluency in English and French, and cheap labour costs compared to advanced economies, Vanuatu has the potential to provide outsourcing services such as call centers to its neighbors Australia and New Zealand and French speaking countries in Europe. The authorities are currently developing an Economic Development Zone (EDZ) legislation which can help attract foreign direct investment (FDI) into both manufacturing and ICT enabled outsourcing services sectors. Infrastructure developments that improve access to ICT and energy can also support the development of an outsourcing services industry in Vanuatu, by reducing the cost of doing business.

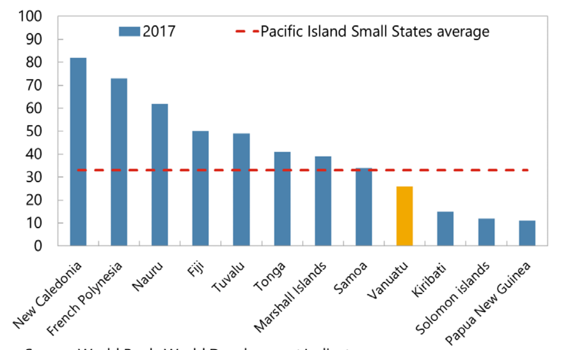
3. **Several barriers limit the country's ability to diversify growth.** In order to fully harness its growth potential and diversify its economic sectors, Vanuatu must address existing macro critical issues that are hindering private sector investment and development.

- **High cost of doing business due to gaps in key infrastructure.** Authorities mentioned that the key barrier to diversifying the agriculture sector was the high cost of doing business, largely

[6] Vanuatu's Literacy Rate (among the population aged 15 years and older) was 87.5% in 2018 according to the UNESCO Institute of Statistics. http://uis.unesco.org/en/country/vu

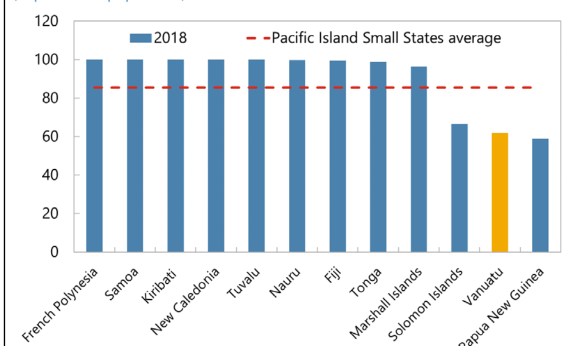
due to utility costs that were higher than most Pacific Island Countries (PICs). Vanuatu will need to address key infrastructure gaps constraining access to electricity, transport services, and internet. In Vanuatu, only 61.9 percent of the population had access to electricity in 2018, with urban areas having higher access (93.7 percent) compared to rural areas (51.1 percent). Energy access in Vanuatu is also well below most other PICs. Electricity in Vanuatu is largely solar driven, as grid electricity is only accessible in the main urban centers Port Villa and Luganville. The rural areas in Vanuatu particularly the outer islands are isolated from main urban centers with limited access to markets and essential services, which requires good transport infrastructure. Internet is only accessible by a quarter of the population (26 percent), comparably lower than other PICs like New Caledonia (82 percent), French Polynesia (73 percent), Nauru (62 percent) and Fiji (50 percent).

Individuals Using the Internet
(In percent of population)



Source: World Bank, World Development Indicators.

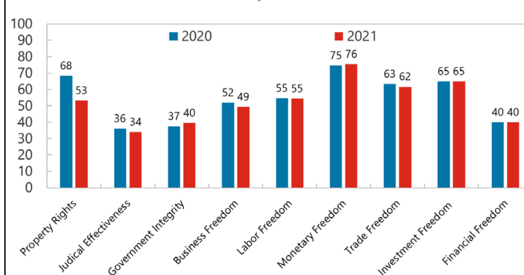
Access to Electricity
(In percent of population)



Source: World Bank, World Development Indicators.

- **Weak business environment.** Structural gaps in the business environment will also need to be addressed. The Index of Economic Freedom,[7] showed that relative to previous assessment in 2020, Vanuatu's business climate had worsened in terms of property rights, judicial effectiveness, business freedom, and trade freedom. The country was found to be economically repressed in the area of judicial effectiveness, government integrity, business freedom[8], and financial freedom[9].

Index of Economic Freedom, Vanuatu



The Index of Economic Freedom is a perception based measure of a country's property rights and freedom from government regulation. This is measured on a scale of 0 (minimum freedom) to 100 (maximum freedom). The index uses official data and expert judgement covering 186 economies. For more details please refer to footnote 7.

Source: The Heritage Foundation, 2021.

[7] A country's economic freedom is assessed based on twelve factors which include property rights, judicial effectiveness, government integrity, government spending, tax burden, fiscal health, business freedom, labor freedom, monetary freedom, trade freedom, investment freedom, and financial freedom. A score of 50 or below in any of these twelve areas suggests economic repression. It should be noted that there is uncertainty around the point estimates for each aspect measured by the index and uncertainty bands are not provided by the compiler.

[8] Business freedom is a measure of how efficient a country's regulations are and whether business operations are being restricted by regulations and the infrastructure environment.

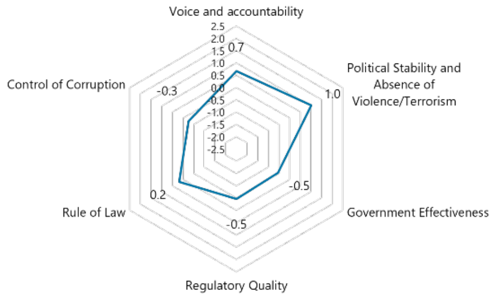
[9] Financial freedom is a measure of banking sector efficiency and whether the banking sector is free of government control and interference. Vanuatu scored 40 on the financial freedom index which indicates there is strong

(continued)

- **Governance issues** dampen investor confidence and deter quality private sector investment including FDI. In 2019, the Worldwide governance indicators rated Vanuatu poorly in terms of government effectiveness, regulatory quality, and control of corruption. Additionally, the country ranked below most other countries in the world in these same areas of governance. The 2016 Safeguards Assessment[10] highlighted the need to strengthen the autonomy and governance of RBV. There is also lack of transparent information on Government Business Enterprises. In addition, Vanuatu has been blacklisted by the European Union because it was not compliant with the international standard of tax transparency. AML/CFT gaps related to Know Your Customer requirements also restrict quality FDI.

Vanuatu: Estimates of Governance, 2019

(Scale of -2.5 to 2.5; higher values represent stronger governance)

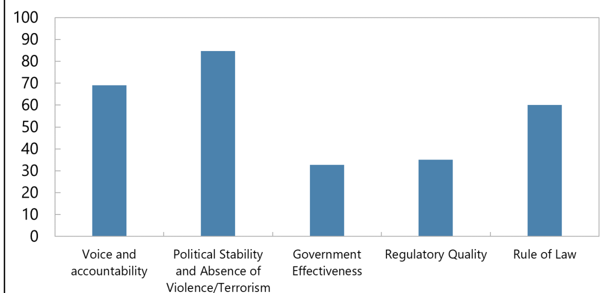


The Worldwide Governance Indicators are perception based and summarizes the views of many enterprises, citizens and expert survey respondents on the quality of governance in a country. There is a degree of uncertainty around the point estimates. Caution is needed as the quality of underlying data can vary across countries and data sources.

Source: Worldwide Governance Indicators, Daniel Kaufmann and Aart Kraay.

Vanuatu: Governance Rank, 2019

Percentile rank among all countries (ranges from 0 (lowest) to 100 (highest) rank)



The Worldwide Governance Indicators are perception based and summarizes the views of many enterprises, citizens and expert survey respondents on the quality of governance in a country. Caution is needed as the quality of underlying data can vary across countries and data sources.

Source: Worldwide Governance Indicators, Daniel Kaufmann and Aart Kraay.

4. **Continuing structural reforms and infrastructure development are crucial for diversifying growth in Vanuatu.** The authorities need to fast track reforms that pre-dated the pandemic and align structural reforms to ensure it achieves the Sustainable Development Goals (see Vanuatu SDG table). In particular, authorities are encouraged to avoid widespread tax exemptions when implementing the EDZ and to focus on reforms that:

- **Promote better connectivity through investment in quality climate resilient infrastructure.** Access to key transport infrastructure like roads, wharves, and ports are essential for development and growth, because it facilitates trade through connecting buyers to sellers. The authorities are encouraged to continue investment in quality transport infrastructure that enables better interisland connectivity and access to markets. It is also vital that transport infrastructure is climate change resilient given Vanuatu's high vulnerability to natural disasters.

- **Encourage digitization of payments and services.** Digitization requires improvement in energy access. Since 2015, there has been progress on improving access to energy in rural areas through donor support from the World Bank's Vanuatu Rural Electrification Project. Access to

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government interference in the financial sector. This means the central bank is not independent, there is significant control and restrictions on financial institutions, and the central bank has weak control on contract enforcement and fraud prevention in the financial sector. It suggests that government owns and controls financial institutions with a large minority share of overall financial sector assets.

[10] For more details pls. see p.22 of the IMF, 2018, *Vanuatu: 2018 Article IV Consultation*, IMF Country Report No. 18/10

energy is expected to further improve through additional donor support from the World Bank[11] and the Asian Development Bank.[12] With better energy access, more households and businesses will be able to access the internet. Government is committed to improve internet coverage to 98 percent by 2022 under its Universal Access Policy and is actively demonopolizing the ICT sector in Vanuatu to encourage competition and more private sector investment. The authorities also plan to undertake a Submarine Cable project that will allow for better internet connection and coverage across Vanuatu. The Interchange Cable Network 2 (ICN2) project[13] is also expected to enhance internet coverage and connectivity. Improvements in ICT infrastructure and de-monopolization will facilitate access to cheaper internet services. Recently, the authorities launched the Vanuatu Electronic Single Window (VESW) a donor funded project[14] that aims to reduce the cost and time of trading across borders through digitization.

- **Strengthen governance and transparency.** Improving the business environment through better institutions that support governance and transparency will encourage private sector investment and growth. The authorities will need to fast track the implementation of key recommendations from the 2016 Safeguards Assessment on improving RBV governance. Structural reforms to improve reporting on GBEs, enhance KYC and strengthen AML/CFT will also need to be implemented quickly to encourage more better quality FDI.

[11] World Bank's Rural Electrification Project Stage 2 started in 2017 and is expected to provide better access to solar energy in rural areas across Vanuatu.

[12] ADB's Energy Access Project started in 2017 is expected to provide better access to renewable energy on the island of Santo.

[13] Interchange Limited, a major telecommunications company in Vanuatu has invested Vatu 550M to date on its Interchange Cable Network 2 (ICN2) project.

[14] The Project was funded by the Enhanced Integrated Framework (EIF) and the Australian Government. The Vanuatu Government provided in-kind contribution, in terms of personnel and ICT support. The main implementing partner was the United Nations for Trade and Development, UNCTAD.

Table 1. Vanuatu: SDGs Identified in the National Sustainable Development Plan 2016 to 2030 (Vanuatu 2030)[1/]

Key elements identified by the Vanuatu 2030	Corresponding SDGs [2/]	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/ Cited from p.32 of IMF, 2019, Vanuatu: 2019 Article IV Consultation, IMF Country Report No. 19/162.
2/ Staff compilation.

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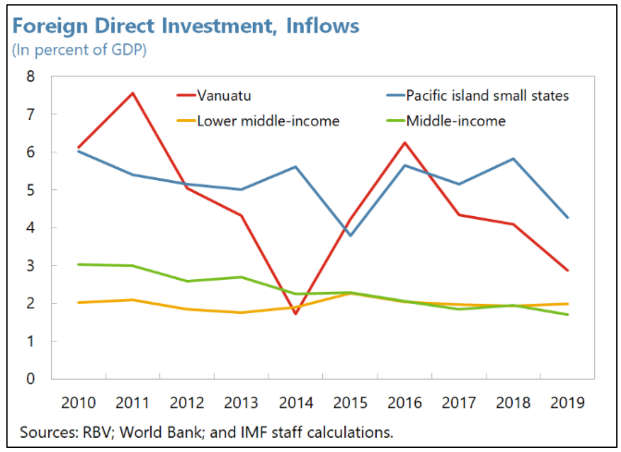
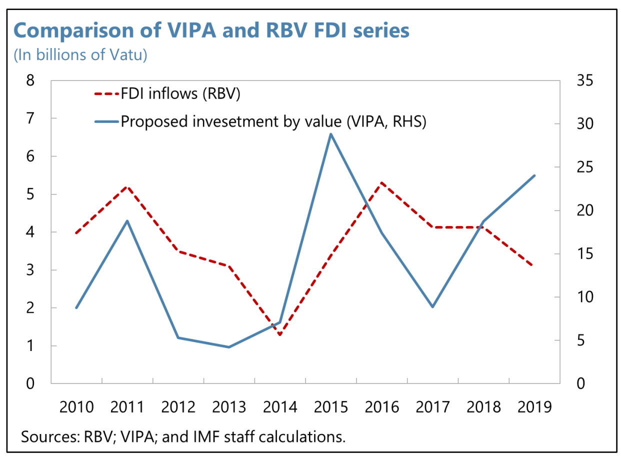
Annex VII. Foreign Direct Investment in Vanuatu[1]

Foreign direct investment (FDI) is an important catalyst for raising growth prospects for developing economies. FDI can increase productivity, generate employment, and increase capital stock. FDI can also help diversify domestic economy and promote regional and global integration. Nevertheless, attracting and reaping the benefits of FDI will largely depend on business operating environments, including regulations and labor skills. Improving Vanuatu's business environment would be a key to attracting foreign investment.

1. **FDI inflows to Vanuatu, relatively high among its peers, have declined recently.** FDI inflows to Vanuatu averaged 4.7 percent of GDP in 2010–19, compared to 2.0 percent of GDP in lower middle-income countries and 2.3 percent in middle-income countries. However, FDI inflows dropped from the peak of 7.6 percent of GDP in 2011 to 2.9 percent of GDP in 2019, below the average of a group of Pacific island small states.[2] Despite the decline, Vanuatu's FDI inflows as a percent of GDP are still twice those of lower middle-income and middle-income countries.



2. **As disaggregated FDI inflows data[3] are unavailable, data on proposed investment approved by the Vanuatu Investment Promotion Agency (VIPA) are used to analyze the allocation of foreign investment inflows**. The two sets of data have similar trends though the proposed value of investment in the VIPA data is on average four times larger than the size of FDI inflows in the balance of payments data.[4] Although the proposed value of investment may not



[1] Prepared by Yinqiu Lu.

[2] Pacific islands small states include Fiji, Kiribati, Marshall Islands, Micronesia, Nauru, Palau, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.

[3] The FDI inflows data are compiled by RBV in line with the *Balance of Payments Manual 6*.

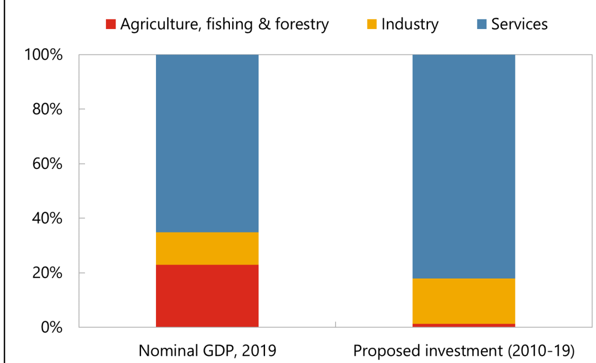
[4] Two reasons could explain the size difference. First, the RBV FDI data capture the realized FDI while the VIPA data record the proposed value of approved foreign investment, which may differ from what is materialized. Second, as the RBV FDI data capture the net change in domestic residents' FDI liabilities to foreigners, an exit of foreign

(continued)

necessarily become realized, it could point to foreign investors' appetite for Vanuatu. Given the similar trends of these two data sets, the VIPA data are used as a proxy for FDI inflows data for more detailed analysis.

3. **Among the three main economic sectors, Vanuatu's service sector attracted most foreign investment while the agriculture sector the least**. The share of proposed investment going into the services sector was larger than the sector's share in the economy. Among the services sector, accommodation and food services sector (proxies for the tourism sector) attracted most investment, followed by the financial sector, and wholesale and retail trade. In contrast, the agriculture sector, which accounted for about 20 percent of nominal GDP in 2019, only attracted 1.3 percent of the total proposed foreign investment in 2010–19. This low ratio is likely one of the main reasons for the low real growth rate in the agriculture sector, i.e., 1.6 percent on average in 2010–19 versus the overall real GDP growth rate of 2.7 percent over the same period.

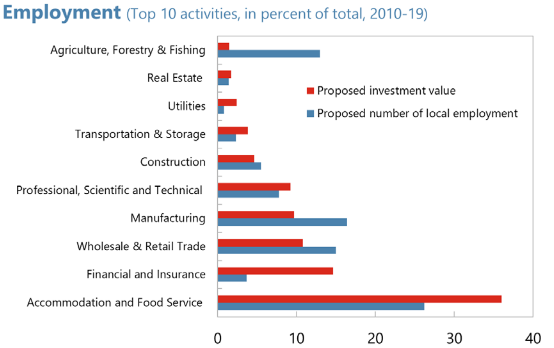
Economic Activity and Proposed Foreign Investment



Sources: RBV; VIPA; and IMF staff calculations.

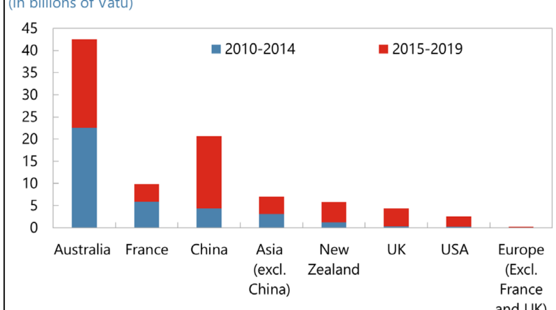
4. **Foreign investment has greatly contributed to job creation**. Local employees hired by foreign-owned business accounted for one third of Vanuatu's formal employment in 2018.[5] The sector that has created the most jobs is the accommodation and food service sector, followed by manufacturing, and wholesale and retail trade. The number of local employees that foreign financial companies proposed to hire is relatively small due to the sector's low labor intensity; while that of those hired by the foreign agricultural companies is disproportionately larger than the amount of proposed investment in the sector, attesting to the crucial role of foreign investment in generating relatively well-paid formal agricultural jobs.

Proposed Investment Value and Number of Local Employment (Top 10 activities, in percent of total, 2010-19)



Sources: VIPA; and IMF staff calculations.

Proposed Investment Value by Source Country
(In billions of Vatu)



Note: Korea and Singapore account for about 70 percent of the proposed investment value from Asia excluding China.
Sources: VIPA; and IMF staff calculations.

investment would lead to a decline in FDI inflows while the VIPA data do not record the exit of previous foreign investment.

[5] VIPA Corporate Report (2018).

5. Australia remains the largest source of foreign investment to Vanuatu while the presence of China has increased. Proposed investment from Australia accounted for 20 percent of total proposed investment in 2015–19 while this ratio used to be close to half in 2010–14. The share of proposed investment from China increased from 9 percent in 2010–14 to 16 percent in 2015–19. Accordingly, China has become the second largest source country in Vanuatu in line with its increased presence in the region.

6. The authorities have tried to strike a balance between promoting FDI and supporting Vanuatu citizens. A dedicated Vanuatu Investment Promotion Authority is mandated to regulate and promote foreign investment. The National Investment Policy Statement provides updates on policies, regulations, and fees related to undertaking investments in Vanuatu. A Foreign Investment Act was adopted in 2019 to replace the Foreign Investment Promotion Act. The market access limitation to FDI is guided by the Act through a list of 15 business activities that only Vanuatu citizens can operate (e.g., exports of kava and seeds, and commercial fishing in Vanuatu's inshore waters) and a list of activities that are open to foreign investors as long as the size of the operation is above certain thresholds (e.g., tour agent with annual sales turnover above vatu 20 million) to protect local business from foreign competition. Vanuatu also has a Reserved Occupations List under the Employment Act, which reserves 22 employment categories to Vanuatu citizens, mostly low and semi-skilled occupation. Non-citizen employees need to renew their work permits on an annual basis, up to a maximum period of four years, as a way to incentivize employers to train citizen workers to fill positions held by non-citizens within this timeframe.

7. Recent developments point to increased barriers to FDI. The Foreign Investment Act is currently under comprehensive review with one proposal specifically calling for a mandatory joint-venture between local and foreign investors after foreign investors renew the annual business licenses four times. In June 2020, 33 new employment categories were proposed to be added on top of the current 22 reserved occupations to address unemployment of Vanuatu citizens caused by the pandemic. The final number of the new categories has been reduced to ten. However, this expansion of the reserved occupations could potentially exacerbate the existing shortage of skilled workers, which business owners were most concerned according to a survey conducted in mid-2018.[6]

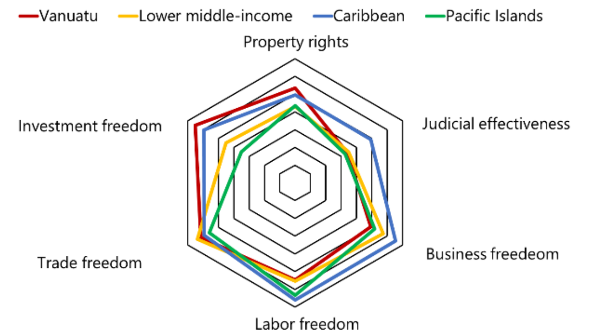
8. The authorities could take the opportunity of adopting PACER Plus to take a comprehensive review of the foreign investment policy. The lists of reserved activities and reserved occupations are to be reviewed to be in line with PACER Plus. Detailed criteria to guide the decisions on the reservation list and the thresholds of the restricted activities could be clarified and made public to improve the regulatory environment. The list of the expanded reserved occupation should be revisited to avoid creating labor shortage for both domestic and foreign investment, especially as seasonal worker programs are expected to pick up after the pandemic and the ratification of Pacer Plus. Improving domestic labor skills and enhancing skill match are generally more effective in creating local jobs than restricting the entry of foreign labor in generating skilled jobs. Given the authorities' policy in promoting the agricultural diversification and the role of FDI in

[6] Trade Policy Framework Update 2019–2025, Government of Vanuatu.

generating employment in the sector, restrictions in FDI in the agricultural business should be revisited.

9. Further improving other aspects in the business operating environments is critical in attracting FDIs. Vanuatu's track record in attracting FDIs was relatively good compared to the average lower middle-income countries, but there are areas for improvement. For example, the electricity and transportations costs are high in Vanuatu. In addition, the costs involved in starting a business are high and the bottlenecks on registering property and land titling remain. The judicial effectiveness is relatively low in Vanuatu, leading to weak enforcement of contracts. Improvement in these areas will further attract FDI inflows and gain from Pacer Plus.

Economic Freedom: Vanuatu vs. Comparators

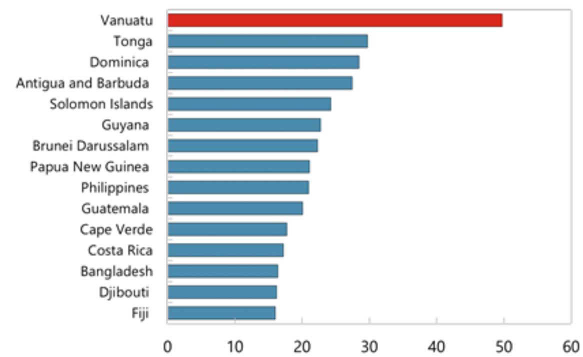


Note: The index of econmic freedom ranges from 0 (low) to 100 (high). There is uncertainty around point estimates when using indicator for ranking purposes and comparison with peers. Vanuatu is classified as a lower middle income country by the World Bank.
Source: Index of Economic Freedom (2021).

Annex VIII. Adaptation to Climate Change in Vanuatu[1]

1. Vanuatu is one of the most vulnerable countries to climate change. It already faces multiple natural disaster risks, including from tropical cyclones, earthquakes, volcanic eruptions, and droughts. Just in 2020, the country faced twin major natural disasters, namely Tropical Cyclone (TC) Harold and Yasur volcanic ash fall that resulted in destruction of farmlands and infrastructure. The economy had been recovering and rebuilding from TC Pam in 2015, one of the worst natural disasters in Vanuatu, before the COVID-19 crisis hit and significantly impacted the economy. Recovery from the COVID-19 crisis presents an opportunity to strengthen resilience to natural disasters and climate change.

2020 World Risk Index

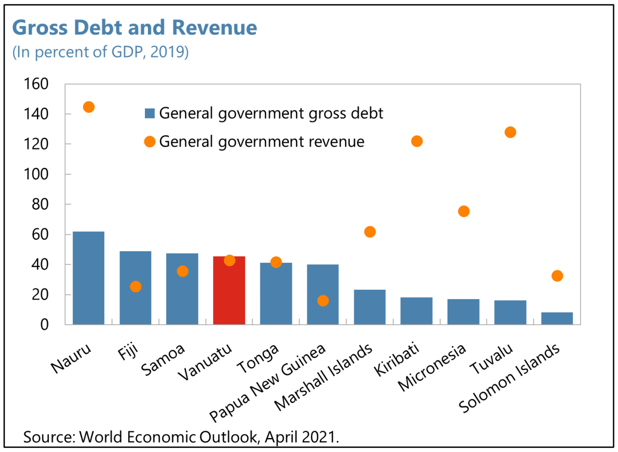


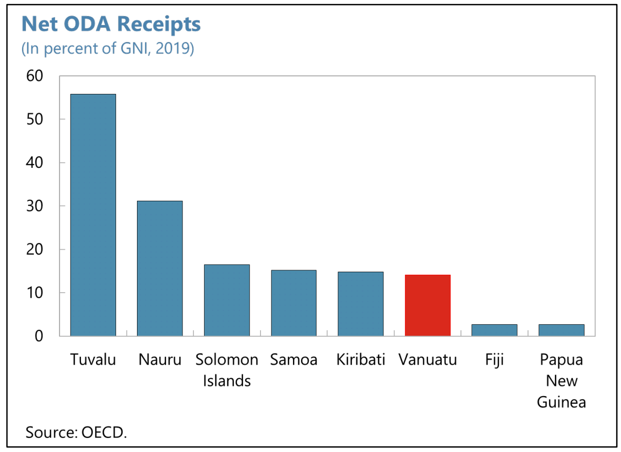
Source: World Risk Report 2020.

2. Climate change is likely to impact agriculture, water, coastal and marine resources, and infrastructure as well as tourism sectors in Vanuatu. Agricultural productivity could be impacted by the changes in rainfall distribution as agriculture in Vanuatu is entirely rain-fed. Intense and prolonged rainfall as well as drought combined with higher temperatures could reduce agriculture output and amplify food insecurity. Projected increases in sea surface temperatures combined with increased ocean acidification are likely to put pressures on the marine food chain and impact the fisheries industry. The incidence off vector-borne disease such as malaria and dengue fever, and water-borne diseases such as dysentery and diarrhea are likely to increase and shift in distribution.

3. Vanuatu has limited fiscal space to deal with climate change risks. It is under moderate risk of debt distress but has limited space to absorb shocks. In fact, Vanuatu is one of the most indebted countries amongst PICs with limited revenue mobilization. Given the high debt, the country targets grant financing and highly concessional loans for climate change adaptation. Until the start of 2016, it relied heavily on aid from development partners to cope with natural disasters. ECP revenues allowed the government to build strong cash buffers and support recovery from natural disasters. However, with uncertainty around the sustainability of ECP revenues, Vanuatu must adopt risk mitigation and risk management strategies to cope with the increasing intensity and frequency of natural disasters.

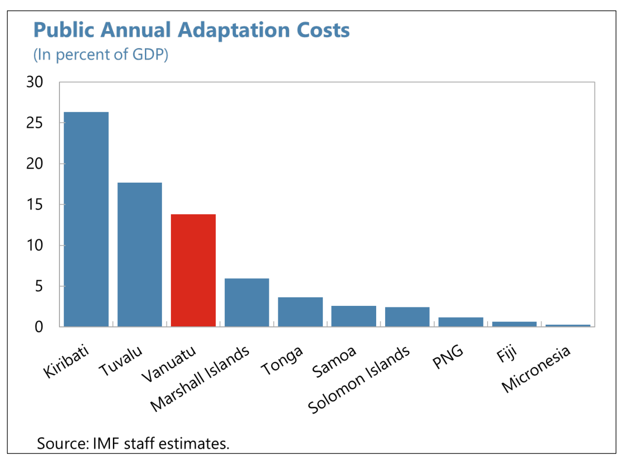
[1] Prepared by Vybhavi Balasundharam.





4. Given the exposure to climate change, Vanuatu is already taking steps to prepare. Vanuatu is the only Pacific Island Country to have completed both a National Adaptation Program of Action (NAPA) and a National Action Plan (NAP) for Disaster Risk Reduction. These non-structural interventions involve developing guidelines, operating frameworks, and action plans to help guide both ex-ante resilience building and post-disaster resilience. These plans are quite granular in nature, invariably containing sectoral action plans for each vulnerable sector. However, the NAPA was last updated in 2006 and would benefit from a revisit to press ahead with climate change adaptation measures. With regards to disaster risk management, Vanuatu only recently passed the Disaster Risk Management Act 2019 which was then gazetted in February 2020. The National Disaster Management Office (NDMO) coordinates disaster response using a cluster system. The goal is to decentralize the disaster response and strengthen local government response at the community or provincial levels given the limited capacity and localized nature of majority of the natural disasters. There has been some progress in decentralizing disaster management, but more needs to be done and technical assistance would be required for a more agile disaster risk management.

5. The government has also started to incorporate climate resilience into new infrastructure building and expanding adaptation capital, though it is limited by capacity constraints and high costs.[2] IMF (2021) estimates that Vanuatu would need to spend around 13 percent of GDP annually on public adaptation costs. This indicates that adaptation can be very costly in Vanuatu and therefore balanced combination between non-structural interventions such as mapping



[2] Adaptive capacity refers to physical, economic, natural, and human capital that is resilient to climate change risks (Carbon Disclosure Project, 2014). Examples include improving crop and livestock production practices for higher

(continued)

escaping routes and high-risk areas and structural measures, namely upgrading infrastructure, would be appropriate. Formulating a financing roadmap for their adaptation plan would help to meet the consistent spending needs over the next decades. However, Vanuatu does not have a cohesive and holistic climate risk financing.

6. **Fiscal policies could play a vital role in financing resilience building.** Vanuatu has established two instruments to deal with natural disasters. To cover natural disaster response, the finance ministry can disburse emergency funds up to VUV 300 million before the declaration of state of emergency. Once a state of emergency is declared, another 1.5 percent of appropriated budget of the year can be reallocated to respond to the shock. However, when natural disasters are large, these budget tools would not offer sufficient buffer. In these cases, the government relies on grants from development partners and taps into its reserves that have been accumulated from windfall ECP revenues. However, new loans and grants from the international community following a disaster is often inadequate in providing timely assistance and recovery.

7. Recent take up of contingent ex-ante financing arrangements like the Catastrophe Deferred Drawdown Option (Cat DDO) has boosted Vanuatu's post-disaster resilience. Instruments like Cat DDO ensure immediate liquidity in the aftermath of disasters, including health-related events, and are usually cheaper than the cost of maintaining reserve funds.[3] Vanuatu secured a Cat DDO facility of US$ 10 million contingent grant in January 2020 and received a payout of the whole amount in April 2020 to support the country's response to the combined impacts of the global COVID-19 pandemic and TC Harold. This experience highlights the important role that risk sharing instruments can play.

8. **While Vanuatu has built its post-disaster resilience over the recent years, it still lags in building ex-ante resilience that could substantially lower the costs of natural disasters**. Vanuatu currently does not have green fund for adaptation needs. Creating a trust fund with windfall revenues from the ECP and using the returns to finance adaptive capacity building is an option to consider. Alternatively, Vanuatu with its large tourism sector could follow the approach in Maldives and impose a green tax on visitors that can then be used for resilience building.[4] Finally, Vanuatu could also allocate a share of national budget specifically to resilient infrastructure building like in the case of Bangladesh's Climate Fiscal Framework (CFF) where about 2 percent of the national budget was allocated to resilient infrastructure building in 2017. It is critical that Vanuatu incorporate a climate change expenditure tagging system to monitor and track climate-related

food security and farmer income; safeguarding communities in coastal areas; enhancing early-warning systems, climate-resilient building measures and water management.

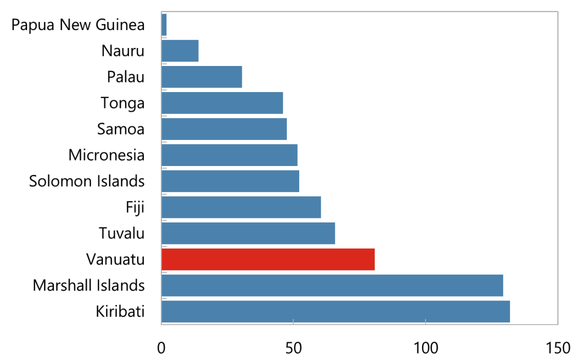
[3] CAT bonds provide a hedge against natural disaster liabilities by transferring risks to capital markets. They are ideal for covering low frequency, high severity events like tropical storms and hurricanes. Cat DDO is a risk retention instrument ideal for medium frequency, medium severity events like floods. Reserve funds are appropriate for covering high frequency, low severity events like local floods and landslides. See IMF (2019) and World Bank (2010) for discussion on options for financing different types of disaster risk.

[4] Maldives levied a green tax of six dollars per person per day from resorts, vessels, and hotels and three dollars per person per day from guest houses from 2016 and some of this revenue was planned to be used for resilience building.

expenditures in the national budget system like in Nepal. This public financial management (PFM) tool would help the governments identify financial gaps, effectively mobilize investment to attain the national action plans, evaluate the climate financing activities and improve accountability (CPI, 2018; GFLAC and UNDP, 2018).

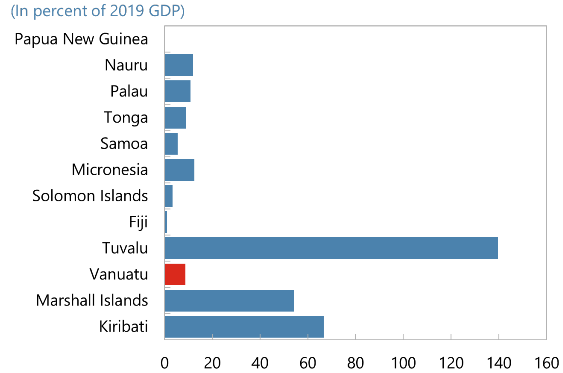
9. Vanuatu has an underinsurance problem whereby few people have adequate protection in the event of natural disasters. The VNPF has initiated an instrument to provide support of up to VUV 150,000 from the provident fund in the event of a tropical cyclone. However, this only caters to the small subset of formal sector employees. Vanuatu has actively engaged with development partners in the Climate risk insurance initiative, a micro-insurance scheme for farmers and rural households. Vanuatu does not have any sovereign national disaster risk insurance. Previous attempts at a regional risk pool such as the Pacific Catastrophe Risk Insurance Scheme (PCRIC) have failed to garner sufficient buy-in due to the high expenses and high barriers to access.[5]

Amount of Funding Approved
(In millions of US dollars)



Source: Climate Funds Update.

Amount of Funding Approved
(In percent of 2019 GDP)



Sources: Climate Funds Update; and WEO database.

10. Vanuatu faces severe challenges in securing financing for building adaptation capital despite the high vulnerability to climate change. Vanuatu is around the median amongst PICs in access to climate financing in terms of amount of funding approved to GDP while the absolute amount is the third largest in the region. Given the capacity constraints, meeting the stringent requirement for financing from multilateral climate funds like Green Climate Fund (GCF) results in lengthy timelines.[6] A large share of the bilateral donor assistance is also sourced through multilateral entities. Vanuatu currently relies on regional bodies like the Secretariat of the Pacific Regional Environment Programme (SPREP) to act as accreditation entities, exacerbating an already

[5] Only 5 of the 15 PICs signed up for the PCRIC scheme. In 2015, the pilot scheme paid $1.9 million to support Vanuatu's emergency response after it was hit by TC Pam. Vanuatu has since withdrawn from the PCRIC due to high expenses and low returns. Note that a similar scheme in the Caribbean - which is mostly comprised of small island nations facing similar threats - has had far more buy-in with 19 countries contribution to the regional risk pool.

[6] Apart from some regional projects, Vanuatu currently has only 1 project under GCF that focuses on resilience development planning and a few in pipeline. This one project under GCF required between three and four years of negotiation.

cumbersome coordination process.[7] Recent work by staff addresses the challenges faced by PICs and provides some recommendations to improve the accessibility of these funds. With a more developed capital markets and sustainable debt levels, Vanuatu could consider issuing sovereign green bonds like Fiji did in 2017. For now, given its economic position and limited market access, tapping into grant financing would be the most viable.

11. Vanuatu has made strides in adapting to climate change but there is scope for more action. Adapting to climate change is a multifaceted process and involves making physical infrastructure more resilient to climate shocks, making the processes for policy decision-making more agile in the face of these shocks, and educating the public about their role in adapting to climate change. Sufficient monitoring and tracking of their adaptation spending and improving the public investment management efficiency are essential. Finally, development partners have played an active role in helping Vanuatu build its adaptive capacity so far, but more resources need to be mobilized for small states like Vanuatu to effectively cope with climate change risks.

[7] Vanuatu is currently trying to get their DoFT to become an accreditation entity. The process is expected to take many years.

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INTERNATIONAL MONETARY FUND

VANUATU

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 16, 2021

Prepared By

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

CONTENTS

FUND RELATIONS

(As of June 30, 2021)

Membership Status: joined September 28, 1981; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	23.80	100.00
Fund holdings of currency	19.61	82.38
Reserves tranche position	4.20	17.63

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	16.27	100.00
Holdings	1.93	11.89

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	6.8	28.57
Emergency Assistance [1/]	0.0	0.0

[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				
	2021	2022	2023	2024	2025
Principal	0.85	1.70	1.70	1.70	0.85
Charges/Interest	0.00	0.01	0.01	0.01	0.01
Total	0.85	1.71	1.71	1.71	0.86

[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 July 21, 2021 was VT 109.95 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 making of payments and transfers for current international transactions and multiple currency practices.

Article IV Consultation

Vanuatu is on a 12–month consultation cycle. The previous Article IV consultation mission took place during March 26 -April 08, 2019 and the consultation was concluded on a lapse-of-time basis on June 05, 2019 (Country Report No. 19/162).

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 a Chief Risk Officer, the bank is yet to publish it's 2020 financial statements and progress in implementing the safeguards recommendations has been slow.

Technical Assistance

Technical assistance on public financial management, revenue administration, banking supervision, macroeconomic management and policy analysis, and statistics (GDP, external sector statistics and government finance) has been provided mainly through PFTAC.

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. The frequency and quality of national accounts could be further improved, while the coverage of government finance statistics and external sector statistics could be expanded, and data provision 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. Plans to rebase GDP and develop a new quarterly measure to at least 2022 have been delayed. 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 FY2022 and FY2023. **Price statistics:** A quarterly CPI covering the two urban centers of Port Vila and Luganville is produced. Dissemination is irregular, with the 2nd quarter of 2020 currently the most recent release. The CPI weights are based on 2010 household surveys. Rebasing the CPI to a more recent base year has been reprioritized due to delays in the 2019 Household Income and Expenditure Survey.	
Government finance statistics: The budget classification is broadly consistent with the *GFSM 2001*. Work is underway to migrate budget classification to the *GFSM 2014*. Discrepancies across fiscal data compiled and disseminated by the Department of Finance and Treasury (DoFT), the Vanuatu National Statistics Office (VNSO), and the Reserve Bank of Vanuatu (RBV) need to be reconciled; statistical discrepancies are also present in the balance sheet for transactions in assets and liabilities. Expanding coverage to the general government started but with significant time delays and source data gaps. Capacity constraints and the lack of a dedicated GFS compiler have slowed overall progress on GFS data compilation and dissemination. Central government debt and government guarantees are compiled on a quarterly basis but not publicly available.	
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*. Vanuatu reports data for some indicators to the Financial Access Survey (FAS) including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs). **Financial sector surveillance**: The RBV also reports Financial Soundness Indicators (FSIs) on a quarterly basis, including all 12 core and 7 encouraged indicators for deposit takers. The FSI data along with accompanying meta data are published in the IMF's FSI data portal. However, data has not been updated since 2018Q1.	
External sector statistics: The RBV releases quarterly BOP and IIP data in its Quarterly Economic Review and are in the process of disseminating the data in line with the *Balance of Payments and International Investment Position Manual* (BPM6) format. The dissemination lag of quarterly external sector data could be further shortened to so support surveillance. The RBV has collected sufficient information to participate in the IMF's Coordinated Direct Investment Survey (CDIS) and could start compiling external debt statistics. The coverage of external sector statistics could be further improved, for example, by addressing any incomplete coverage of positions of other financial corporations.	
II. Data Standards and Quality	
Since April 2019, Vanuatu has implemented the recommendations of the IMF's Enhanced General Data Dissemination System (e-GDDS) by publishing essential data through the National Summary Data Page (NSDP), an important achievement on data transparency.	No data ROSC is available.

Vanuatu: Table of Common Indicators Required for Surveillance
(As of July 2021)

	Date of latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	5/2021	6/2021	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	3/2021	6/2021	M	M	M
Reserve/Base Money	3/2021	6/2021	M	M	M
Broad Money	3/2021	6/2021	M	M	M
Central Bank Balance Sheet	3/2021	6/2021	M	M	M
Consolidated Balance Sheet of the Banking System	3/2021	6/2021	M	M	M
Interest Rates[3]	4/2021	7/2021	M	M	M
Consumer Price Index	6/2020	3/2021	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	05/2021	7/2021	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]	2020	7/2021	A	A	A
External Current Account Balance	12/2020	7/2021	Q	Q	Q
Exports and Imports of Goods and Services	12/2020	7/2021	Q	Q	Q
GDP/GNP	2018	7/2020	A	A	A
Gross External Debt	12/2020	7/2021	Q	Q	Q
International Investment Position	12/2020	7/2021	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 2018. 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.

INTERNATIONAL MONETARY FUND

VANUATU

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

August 16, 2021

Approved By
Krishna Srinivasan and Maria Gonzalez (IMF) and Hassan Zaman and Marcello Estevão (IDA)

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

Vanuatu: Join Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress:	Moderate
Overall risk of debt distress:	Moderate
Granularity in the risk rating:	Limited space to absorb shocks
Application of judgement:	No

The 2021 Debt Sustainability Analysis (DSA) indicates that the risk of debt distress rating for Vanuatu remains moderate with limited space to absorb shocks and has not changed from the 2019 DSA.[1] *Two tailored shocks and an alternative scenario are presented, all leading to a significant deterioration in debt sustainability. A natural disaster shock would cause the PV of the public and publicly guaranteed (PPG) external debt-to-GDP ratio to breach the threshold from 2027 onwards. A contingent liability shock based on the fact that the government took over the control of Air Vanuatu would cause the PV of the PPG external debt-to-GDP ratio to breach the threshold from 2022 onwards. The most extreme shock in terms of the PV of the PPG external debt-to-GDP ratio is the combined contingent liabilities. An alternative scenario of a sudden fall of the Economic Citizenship Program (ECP) revenues indicates that the PV of the external debt-to-GDP ratio would breach the 40 percent threshold in 2028 onwards and that the PV of the public debt-to-GDP ratio would breach the 55 percent benchmark from 2028 onwards. The most extreme shock in terms of the public debt-to-GDP ratio is growth. The DSA results indicate the need for rebuilding fiscal buffers and enhancing resilience against shocks, including from natural disasters. Such needs would require early formulating a medium-term fiscal strategy, particularly revenue mobilization measures. When financing the rebuilding costs or investing in new infrastructure, the authorities are encouraged to continue seeking grants or concessional loans.*

[1] Vanuatu's Composite Indicator (CI) index, calculated on the basis of the April 2021 World Economic Outlook (WEO) and the 2019 Country Policy and Institutional Assessment (CPIA) released in July 2020, is at 2.93, indicating that Vanuatu's debt-carrying capacity is medium.

PUBLIC DEBT COVERAGE

1. **The coverage of public sector debt for this DSA is central government debt, central government guaranteed debt, and central bank debt, which has been borrowed on behalf of the government.** The debt of Air Vanuatu is not included due to the lack of concrete information and the fact that the government has neither assumed nor guaranteed debt of Air Vanuatu (see paragraph 11). Because of data limitations, other elements in the general government, non-guaranteed state-owned enterprise (SOE) debt and private external debt are not included in the analysis. 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. The PFTAC is providing technical assistance to help the authorities expand the coverage of government financial statistics (GFS) from budgetary central government to general government and SOEs.

Coverage of Public Sector Debt

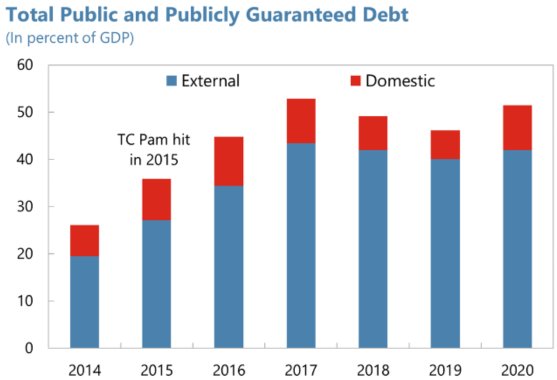
	Subsectors of the public sector	Sub-sectors covered
1	Central government	X
2	State and local government	
3	Other elements in the general government	
4	o/w: Social security fund	
5	o/w: Extra budgetary funds (EBFs)	
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X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

BACKGROUND ON DEBT

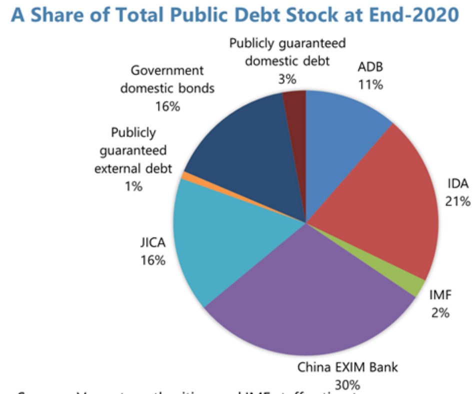
2. **Public sector debt, 51.5 percent of GDP as of end-2020, has remained stable after 2018.** Public sector debt had increased from 26.1 percent of GDP in 2014 to 52.8 percent of GDP in 2017. The sharp increase was mainly caused by the new disbursement for the post-Tropical Cyclone (TC) Pam reconstruction and infrastructure development support by bilateral partners, including the Export-Import Bank of China (China Eximbank) and the Japan International Cooperation Agency (JICA), and multilateral development partners, including the ADB, IDA, and IMF. The public debt stock has stabilized after 2018. The policy response to the pandemic and natural disasters in 2020 was financed by stronger-than-expected revenues from the Economic Citizenship Program (ECP)[2], grants from donors, financial assets, and domestic debt issuance. Its debt obligations are largely external, accounting for 81 percent of its total public debt as of end-2020. The China Eximbank is the largest external creditor, accounting for 30 percent of its total public debt. Of public domestic debt, central government bonds were largely held by public corporations (primarily the Vanuatu National Provident Fund, VNPF), Reserve Bank of Vanuatu (RBV), and commercial banks.

[2] ECP offers passports in return for investment. ECP consists of Vanuatu Development Support Program (VDSP) and Vanuatu Contribution Program (VCP). These schemes offer "honorary citizenship" that includes most ni-Vanuatu rights except voting and political involvement, in exchange for a one-time contribution. Application amount is USD 130,000 for a single applicant and USD 180,000 for a family of four. Of this amount, the government fee is USD 80,000. These schemes started from 2017. See Appendix II of the staff report for the 2021 Article IV Consultation.

Government-guaranteed debts for SOEs, such as Air Vanuatu[3], accounted for 4 percent of total public debt.



Sources: Vanuatu authorities; and IMF staff estimates.



Sources: Vanuatu authorities; and IMF staff estimates.

3. Stronger-than-expected revenues from the ECP have allowed early repayments on China's lower concessionality loans. VUV1.5 billion (1.5 percent of GDP) in 2019 and VUV2 billion (2 percent of GDP) in 2020 were repaid in advance to China. Further early repayment to China of VUV 2 billion is planned in 2021. The revenues also enabled Vanuatu to opt not to participate in the Debt Service Suspension Initiative.

4. The authorities are strongly committed to their 2019–22 Debt Management Strategy (DMS). The DMS requires a 35 percent grant component for all new concessional borrowing. The authorities plan to prepay lower concessionality loans, where feasible.

BACKGROUND ON MACROECONOMIC FORECASTS

5. In 2020, Vanuatu was simultaneously hit by the COVID-19 pandemic as well as major natural disasters. The authorities have closed borders since March 2020. While Vanuatu has had no domestic transmission of COVID-19, the border closure dealt a severe blow to tourism, with spillovers to other sectors. Infrastructure projects have been delayed. TC Harold caused significant damage to shelter, schools, health infrastructure and supplies, agricultural crops, power and telecommunications; affecting an estimated 43 percent of the population.[4] Damages by TC Harold are estimated at VUV 56.0 billion (damages to infrastructure and assets are estimated at VUV 27.7 billion), accounting for over 50 percent of GDP. The government swiftly took fiscal stimulus measures targeted at mitigating economic and social hardship (actual disbursements of support and fee exemptions have only amounted to about 2.6 percent of GDP). Strong ECP receipts and donor support have helped mitigate the impact of the pandemic on fiscal and external balances. In 2020,

[3] The amounts are the current outstanding amount reported by the authorities.

[4] United Nations, UNSDG | UN in Action – Vanuatu, https://unsdg.un.org/un-in-action/vanuatu

the overall fiscal position was near balance and the current account registered a surplus of 3.3 percent of GDP.

6. The assumptions in the baseline scenario are consistent with the macroeconomic framework. The main assumptions are:

- ***Real GDP growth*** is projected at 2.7 percent on average during 2021–31[5]. This incorporates the gradual recovery from the severe economic downturn in 2020 due to the COVID-19 pandemic and TC Harold. The level of real GDP is expected to recover to the pre-pandemic level by 2023, and average growth rate during 2021-24 is projected at 3 percent. While implementing delayed infrastructure projects and agriculture production could boost economy, the tourism sector is expected to recover very gradually, as the restoration of tourist confidence would take time.[6]

- ***Inflation*** (measured by the GDP deflator) is projected to average 2.6 percent (in U.S. dollar terms, the relevant measure for external debt), and 2.3 percent (in domestic currency terms, the relevant measure for public debt) during 2021–31.[7] These are consistent with the CPI inflation rates, which are projected to remain stable over the medium- to the long-term within the RBV's target range 0 to 4 percent unless unexpected shock occurs.

- The ***non-interest current account deficit*** is projected to rise to 4.2 percent of GDP on average over 2021–31, relative to the historical average of a surplus of 2.3 percent. This increase reflects the high import content for key infrastructure projects and rebuilding from TC Harold, as well as the sharp fall in travel receipts due to the pandemic which only start to recover by 2022. Furthermore, the strong revenues from the ECPs over the past three years are not expected to be sustained going forward.

- ***Foreign direct investment inflows*** are expected to average 3.1 percent of GDP over 2021–31, lower than the historical average of 4.9 percent (reflecting the post TC Pam investment boom). Staff expect the reconstruction costs for TC Harold to be lower than TC Pam as the affected areas are more rural and do not have the same reconstruction needs as TC Pam that had damaged the capital city, Port Vila.

- The ***primary deficit*** is expected to average 2.9 percent of GDP over 2021–31, a deterioration from the historical average of a surplus of 0.9 percent. The projection reflects moderating ECP revenues and grants (see below) and increasing infrastructure spending going forward, including rebuilding associated with TC Harold, given Vanuatu's vulnerability to climate change and natural disasters.

[5] The historical growth is at 1.7 percent. This includes severe economic downturn in 2020.

[6] The authorities currently plan to vaccinate 20 percent of the population under COVID-19 Vaccines Global Access (COVAX) in 2021 and 40 percent of the population by June 2022. Faster vaccination rollout and subsequent border reopening would be an upside risk.

[7] The inflation in 2021 is projected to be 5.8 percent and 3.9 percent respectively, reflecting the longer-than-expected food supply shock caused by natural disasters and higher international food prices particularly for rice.

- ***External borrowing and grants*** will continue to be strong in the medium term because of the gradual recovery from the COVID-19 and TC Harold. Grants and borrowing from multilateral development partners are expected to increase over the medium term because of the planned scaling-up of IDA financing, and ADB financing (to follow the IDA growth path). Staff also expect that new loans from China will meet the grant component of 35 percent after the Tanna project disbursements under the old (lower concessionality) terms end in 2022. Overall, grants are expected to decline over the longer term, as the country's economy grows. Infrastructure projects will be financed by external borrowings in the medium-term. Small domestic financing is expected in the medium term, reflecting the authorities' Debt Management Strategy 2019-2022.[8]

- The ***government-guaranteed debts*** as of end-2020 will continue to remain stable for the projection period. Staff assumes that the government will not provide any guarantees for any new borrowing by SOEs, including Air Vanuatu.

- The **effects of natural disasters and climate change** over the longer term are incorporated into the baseline scenario. The years 2021–26 are assumed to be free from newly-occurring major, costly disasters to simplify the policy discussion of the near-term outlook—a standard practice in DSAs for other Pacific island small states with a similar risk profile. However, from 2027 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. The effect of natural disasters might become more persistent on GDP growth, current account and fiscal deficit in the future. This suggests that Vanuatu would benefit from aspiring to a more stringent debt anchor against these shocks, such as a 50 percent PPG-debt-to-GDP target.

- The ***discount rate*** used to calculate the net present value of external debt remains at 5 percent.

7. The major difference of assumptions between the previous DSA and the current DSA relates to the pandemic and natural disasters in 2020. The current DSA assumes; higher growth rates than the previous DSA, reflecting the recovery from the pandemic and natural disasters in 2020; lower nominal GDP, reflecting the economic contraction in 2020 and gradual recovery afterwards; higher revenue and grants and expenditure, reflecting the recovery needs and donor support as well as lower nominal GDP; and lower exports, reflecting slower recovery in tourism after the pandemic.

[8] According to the strategy, to ensure that there is still a market for domestic bonds in case the government has need of it in the future, the government should continue to issue a small number of bonds at low interest rates.

DSA Key Macroeconomic and Fiscal Assumptions						
	Previous DSA		Current DSA		Current vs Previous	
	2021-26	2021-31	2021-26	2021-31	2021-26	2021-31
Real GDP growth, percent	2.8	2.8	2.9	2.7	0.1	-0.1
Inflation (GDP deflator), percent	2.6	2.6	2.5	2.3	-0.1	-0.2
Nominal GDP (Millions of $US Doll	1205.8	1391.2	1158.0	1319.6	-47.8	-71.6
Revenue and grants	27.6	27.3	33.4	31.8	5.7	4.4
Primary expenditure	30.8	30.4	36.3	34.7	5.5	4.3
Primary balance	-3.1	-3.1	-2.9	-2.9	0.2	0.2
Exports of goods and services	45.5	45.1	23.8	27.9	-21.7	-17.2
Imports of goods and services	54.3	53.2	49.7	52.8	-4.6	-0.4
Current account balance	-4.3	-4.3	-5.4	-4.8	-1.1	-0.4

8. **The realism tool indicates that the primary balance projections are reasonable (Figure 4).** The fiscal forecasts between 2021 and 2023 are based on reasonable assumptions as the projected three-year adjustment lies in the left section of the distribution of past adjustments of the primary deficit. Real growth forecasts for 2021 and 2022 are higher than the projected growth path calculated by the model due to the growth rebound following the sharp economic contraction due to the COVID-19 pandemic and damages caused by the TC Harold. The realism of projections for public and private investment rates and their contribution to real GDP could not be calculated due to the unavailability of data.

COUNTRY CLASSIFICATION

9. **Vanuatu's debt-carrying capacity applied in the 2021 DSA is medium.** The debt carrying capacity has not changed since the 2019 DSA. Vanuatu's Composite Indicator (CI) index, calculated based on the April 2021 WEO and the 2019 CPIA released in July 2020, is 2.93, indicating that the county's debt-carrying capacity is medium according to the low-income country (LIC)-DSF framework. The relevant indicative thresholds for this category are: 40 percent for the 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 PPG external debt. The benchmark for the PV of the total public sector debt for medium debt-carrying capacity is 55 percent of GDP.

Debt Carrying Capacity	Medium		
Final	Classification based on current vintage	Classification based on the previous vintage	Classification based on the two previous vintage
Medium	Medium 2.93	Medium 2.94	Medium 2.99

Applicable thresholds

APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	180
GDP	40
Debt service in % of	
Exports	15
Revenue	18

APPLICABLE	
TOTAL public debt benchmark	
PV of total public debt in percent of GDP	55

SCENARIO STRESS TESTS

10. **Given Vanuatu's vulnerability to natural disasters, a tailored stress test for a natural disaster shock is conducted.** Vanuatu, a small developing natural-disaster-prone state, is automatically subject to the standard natural disaster shock in the DSA. The DSA assumes a one-off shock of 10 percentage points to the debt-to-GDP ratio in 2022. Real GDP growth and exports are lowered by 4 and 10 percentage points respectively in the year of the shock (same as the previous DSA).[9]

11. **Another key stress test for Vanuatu is the combined contingent liability shock.** The contingent liability risk mostly stems from the stressed Air Vanuatu. It was in the process of purchasing four new aircrafts, while facing substantial operational loss from the border closure because of the COVID-19 pandemic.[10] In March 2021, the government decided to take temporary control of Air Vanuatu for restructuring to reduce its reliance on state coffers. The restructuring process is ongoing, including reviewing the aircraft purchasing contract for its cancellation. A fiscal risk associated with the contract could materialize if the government assumes the payment obligation of the aircrafts on behalf of Air Vanuatu, i.e., USD 185 million (around 20 percent of GDP)

[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*.

[10] In February and April 2019, the government provided two loans to Air Vanuatu, totaling VUV 1,230 million. The money was used as deposits to purchase two new aircrafts. A further loan was made to bring the total to VUV 2 billion in 2019. In 2020, the government provided loans VUV 1625.6 million to Air Vanuatu.

based on publicly available information. In order to capture this fiscal risk, the magnitude of the shock of SOE debts has been adjusted from the default value of 2 percent to 22 percent. The default value of 5 percent for the financial market is used.

12. An alternative scenario reflecting a loss of ECP revenues is applied to both external and public debt sustainability analyses. The ECP revenues have become a significant source of government revenues (accounting for one-third of the total revenue in 2020). Given the uncertain and volatile nature of the ECP revenues, the scenario assumes a sudden drop of ECP revenues to zero from 2022 onwards to capture the risk of the loss, while our baseline projection reflects moderating ECP revenues.

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	22.0	Given its takeover of Air Vanuatu, the government could incur all costs for purchasing four aircrafts accounting for around 20 percent of GDP.
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)			27.0	

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%.

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

13. Under the baseline scenario, there are temporary breaches of two indicative thresholds. The external debt service-to-exports ratio and PV of the external debt-to-exports ratio in 2021 are expected to be breached due to the planned early repayment to China and low services exports because of the pandemic (Figure 1 and Table 1).[11] The PV of the external-debt-to GDP ratio is expected to increase gradually from 24.0 percent in 2021 to 35.6 percent in 2031 mainly because of the new loan disbursements for key infrastructure projects. As Figure 3 shows, the main driver for the debt dynamics during the projection period is the current account deficit.[12]

14. The stress tests confirm the vulnerability of debt dynamics to contingent liabilities, natural disasters, and macroeconomic shocks. The combined contingent liabilities shock has the largest impact on the external debt dynamics with a breach of the PV of the debt-to-GDP threshold from 2022 onwards. These dynamics suggest the need for the authorities to manage well the airplane purchase contract and build up fiscal buffers to restructure Air Vanuatu. Furthermore, the authorities need to establish a legal framework for proper supervision and oversight of the

[11] The cause of the temporary breaches is not warranted to use judgment for the purpose of determining risk rating.

[12] Large residual in debt accumulation of historical external and public debt could be associated with unexpected increase in external borrowing and capital grants for rebuilding infrastructure needs arising from TC Pam. The residual substantially reduces in projections.

government business enterprises to alleviate fiscal risk from contingent liabilities. The tailored natural disaster shock would elevate the PV of the debt-to-GDP ratio from 2022 onwards and cause a breach of the threshold starting in 2027, illustrating the importance of enhancing resilience to natural disasters. Shocks to real GDP growth, exports, and other flows would also lead to breaches of the threshold of the PV of the debt-to-GDP ratio (Table 3), illustrating the importance of expanding export base through economic diversification, and promoting foreign direct investment (FDI).

15. The alternative scenario of losing ECP revenues points to a deteriorating external debt sustainability (Figure 1 and Table 3). In this scenario, the PV of debt-to-GDP ratio is expected to reach the threshold of 40 percent in 2028. It highlights the need for formulating a medium-term fiscal strategy, particularly revenue mobilization, to reduce the reliance on ECP revenues.

B. Public Sector Debt Sustainability Analysis

16. The PV of the public debt-to-GDP ratio does not breach the 55 percent benchmark under the baseline scenario (Figure 2 and Table 2). However, the public nominal debt-to-GDP ratio is expected to rise from 47.5 percent in 2021 to breach the authorities' stated public debt-to-GDP target of 60 percent by 2028, driven mainly by the larger primary deficits (Table 2 and Figure 3).

17. The stress tests indicate that the growth shock has the largest impact on the debt dynamics, causing a breach of the PV of the public debt-to-GDP benchmark from 2027 onwards. This shock assumes a growth rate of -1.7 percentage points in 2022 and 2023 based on the 10-year historical average growth minus one standard deviation, contrary to the rebound that has been projected. This suggests the importance of entrenching recovery from the pandemic and TC Harold.

18. The alternative scenario regarding the loss of ECP revenues demonstrates the vulnerability of public debt sustainability to the loss (Figure 2 and Table 4). In this scenario, PV of the public debt-to-GDP ratio is expected to reach the threshold of 55 percent in 2028. It highlights the need for formulating a medium-term fiscal strategy, particularly revenue mobilization, to reduce the reliance on ECP revenues.

RISK RATING AND VULNERABILITIES

19. The debt sustainability analysis suggests that Vanuatu's risk of external debt distress remains moderate, with limited space to absorb shocks. Under the baseline, there is only a one-year breach in two of the debt burden indicators (debt service-to-exports ratio and the PV of the debt-to-exports ratio in 2021), which are automatically disregarded in line with the guidance note on the Debt Sustainability Framework for Low-Income Countries. The results of the stress tests indicate that the contingent liabilities shock would result in a breach of the threshold for the PV of the external debt-to-GDP ratio from 2022 and onwards. This indicates that the urgent need to restructure Air Vanuatu and establish a supervisory framework for the government business enterprises. The shocks to real GDP growth, exports, other flows, and natural disasters would result in breaches of the threshold for the PV of the external-debt-to-GDP ratio in later years, underscoring the importance of expanding export base through economic diversification, of promoting FDI, and 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 the debt service indicators remain well below their thresholds under the baseline scenario except the one-off breaches of debt service-to-exports ratio and the PV of the debt-to-exports ratio in 2021, grant support from development partners should be secured and loan-funded projects should be contracted on favorable concessional terms to help contain the debt service burden, following the authorities' stated goal of receiving a 35 percent grant element for such loans.

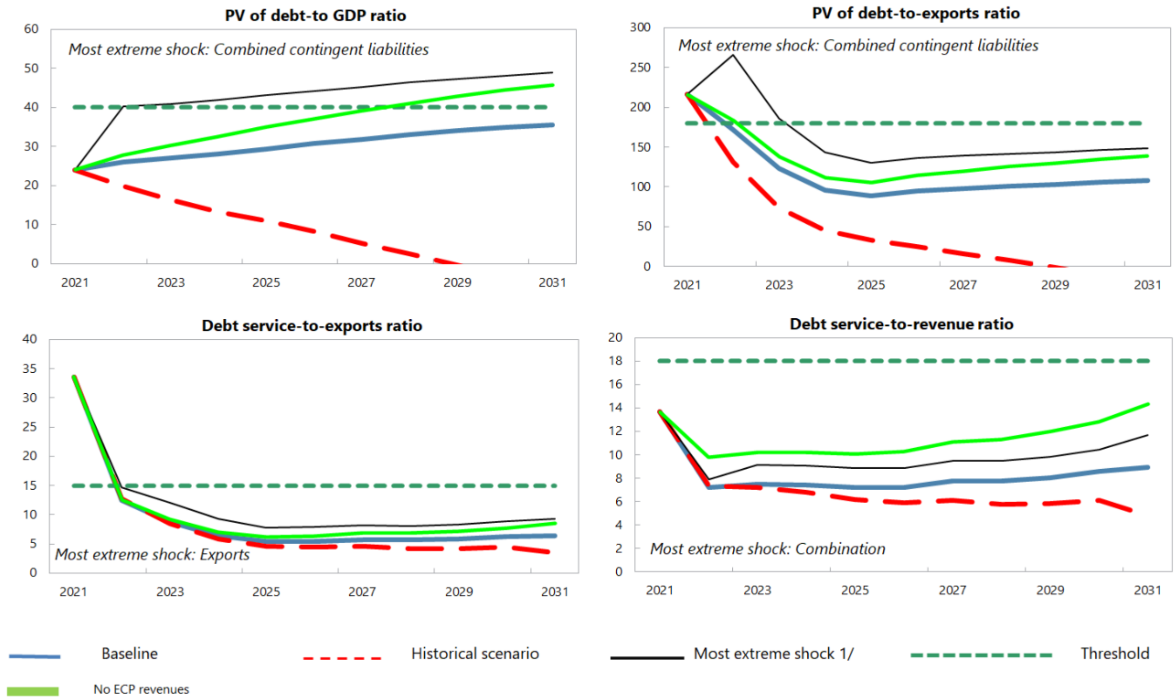
20. The DSA suggests that the overall risk of debt distress is moderate. Even though the 55 percent benchmark for the PV of the public debt-to-GDP ratio would not be breached under the baseline scenario, the public-debt-to-GDP ratio would breach the authorities' target of 60 percent of GDP by 2028. In addition, under the alternative scenario of a loss of ECP revenues, the benchmark of the public debt-to-GDP ratio would be breached from 2028 onwards, illustrating the need for formulating medium-term fiscal strategy, especially revenue mobilization to reduce the reliance on ECP revenues. Furthermore, given that the growth shock would lead to the breach from 2027 onwards, entrenching recovery from the pandemic and TC Harold would be important in safeguarding medium-term debt sustainability.

AUTHORITIES' VIEWS

21. The authorities broadly agreed with the staff analysis of Vanuatu's debt sustainability. They highly appreciated the analysis of the alternative scenario which assumes no ECP revenues from 2022 onwards. They acknowledged that the ECP revenues are not sustainable. They stressed that, even under the alternative scenario, strong cash reserves generated by the ECP revenues should be able to provide liquidity support in the short term. They underscored their strong commitment to maintaining positive recurrent balance over the medium term. Given high infrastructure needs, the authorities underscored their intention to only contract external loans with a grant-element of at least 35 percent.

22. The authorities also agreed with the assumptions used in the DSA. These include the assumptions on the positive recurrent balance over the medium term and the grant element of new loans, as they remained strongly committed to the fiscal rules. The DSA's assumption of 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.

Figure 1. Vanuatu: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2021-2031



Customization of Default Settings	Size	Interactions
Standardized Tests	Yes	
Tailored Stress		
Combined CL	Yes	
Natural disaster	No	Yes
Commodity price	n.a.	n.a.
Market financing	n.a.	n.a.

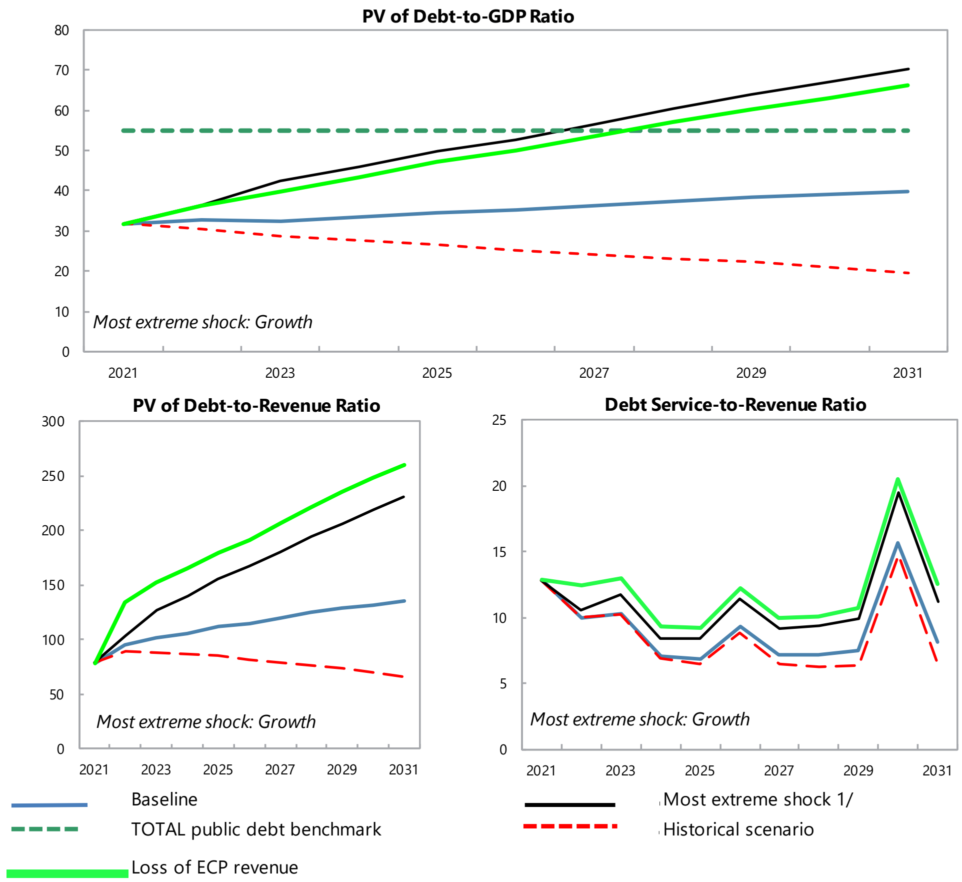
Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing assumptions on additional financing needs resulting from the 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	1.4%	1.4%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	33	33
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 2031. 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.

Figure 2. Vanuatu: Indicators of Public Debt under Alternative Scenarios, 2021-2031



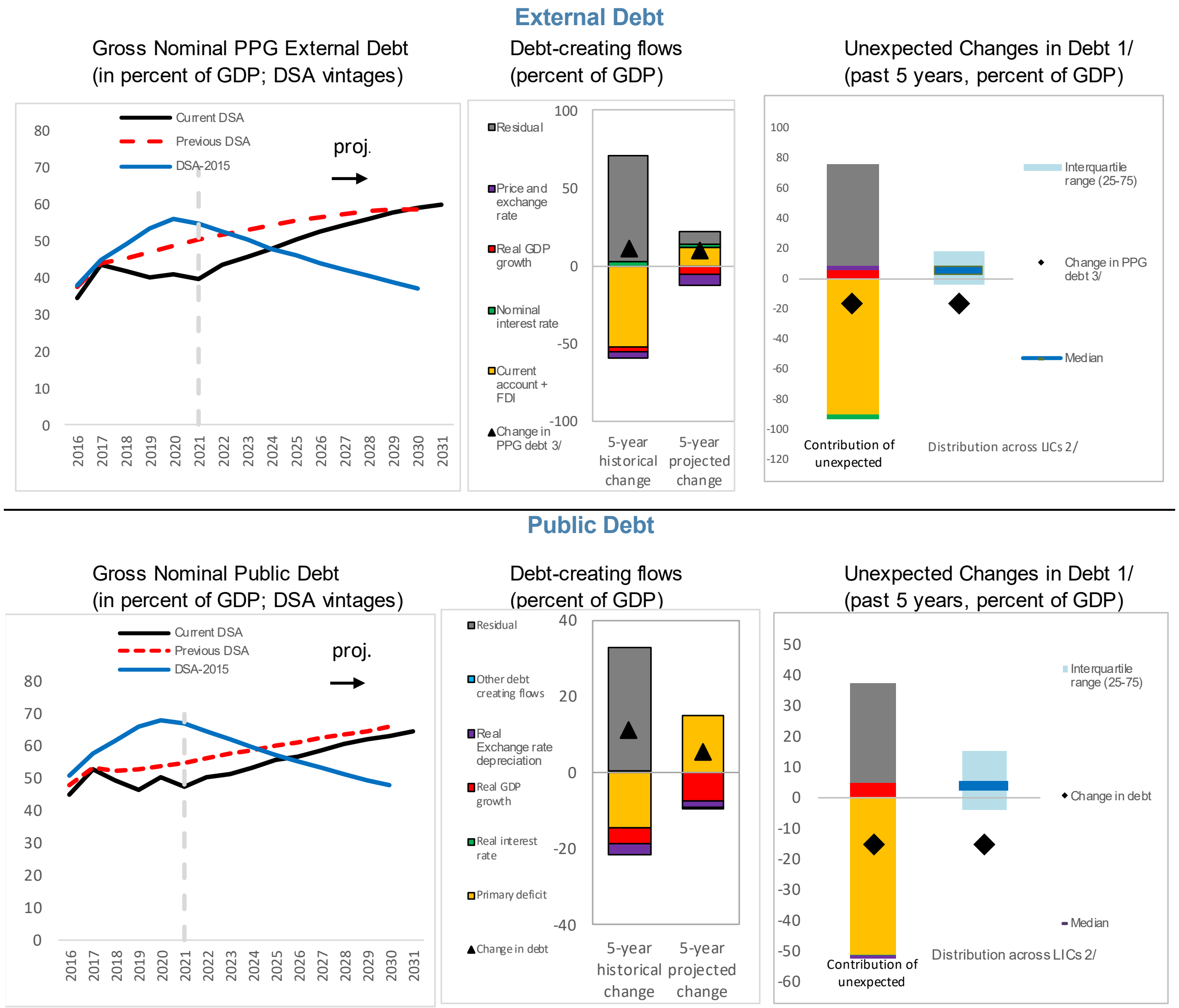
Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	95%	95%
Domestic medium and long-term	5%	5%
Domestic short-term	0%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.4%	1.4%
Avg. maturity (incl. grace period)	33	33
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	-2.3%	-2.3%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the

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 2031. 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.

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



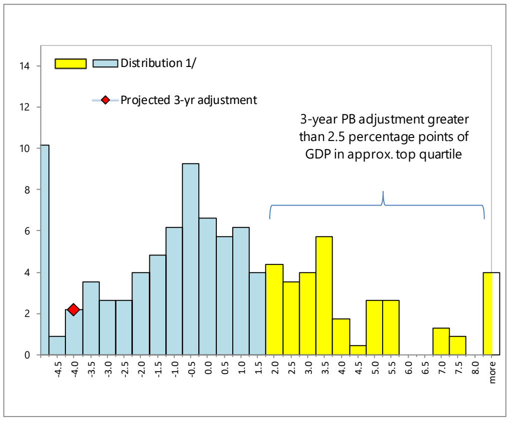
1/ Difference between anticipated and actual contributions on debt ratios.

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.

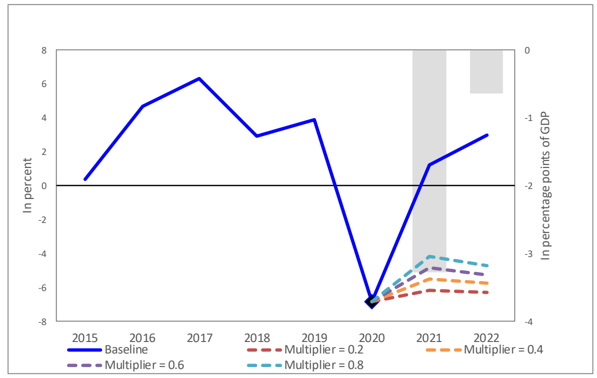
Figure 4. Vanuatu: Realism Tools

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



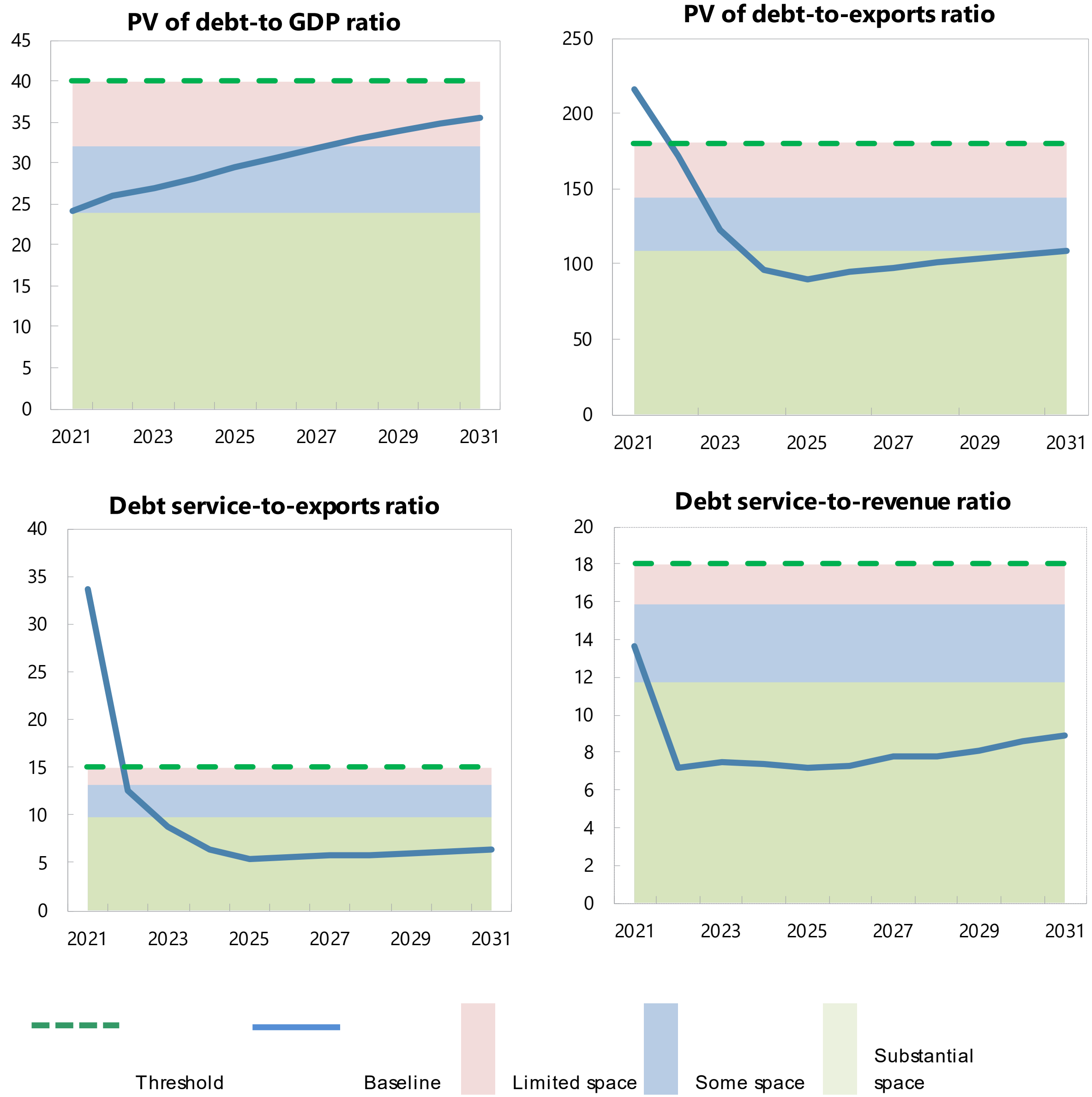
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

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, 2021-2031[1/]



Sources: Country authorities; and staff estimates and projections.

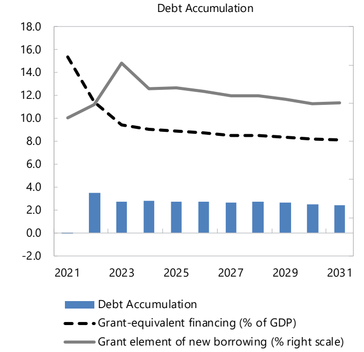
1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percent and y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

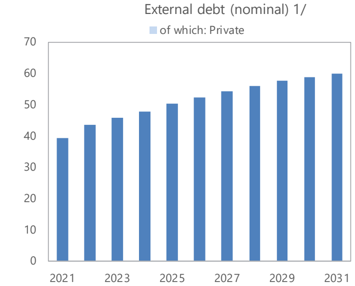
Table 1. Vanuatu: External Debt Sustainability Framework, Baseline Scenario, 2018–2041

(In percent of GDP, unless otherwise indicated)

	Actual			Projections												Average 8/	
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2041	Historical	Projections
External debt (nominal) 1/	41.9	40.1	40.8	39.4	43.5	45.8	47.9	50.2	52.3	54.2	56.0	57.5	58.8	59.9	64.1	27.2	51.4
of which: public and publicly guaranteed (PPG)	41.9	40.1	40.8	39.4	43.5	45.8	47.9	50.2	52.3	54.2	56.0	57.5	58.8	59.9	64.1	27.2	51.4
Change in external debt	-1.5	-1.8	0.7	-1.4	4.0	2.3	2.2	2.3	2.1	1.9	1.8	1.5	1.2	1.1	-0.2		
Identified net debt-creating flows	-18.4	-18.6	-6.0	3.5	3.9	1.1	0.0	-0.8	-0.4	-0.2	-0.4	-0.5	-0.5	-0.9	-2.4	-9.5	0.4
Non-interest current account deficit	-12.6	-16.5	-3.7	6.5	7.5	5.2	3.9	3.0	3.5	3.7	3.4	3.3	3.4	3.0	1.2	-2.3	4.2
Deficit in balance of goods and services	3.1	8.8	26.1	31.6	29.6	25.6	23.5	22.2	22.8	23.2	23.3	23.8	24.3	24.2	27.1	10.5	24.9
Exports	47.2	41.1	17.8	11.1	15.1	21.9	29.2	33.0	32.4	32.5	32.7	32.9	32.9	32.9	32.6		
Imports	50.3	49.9	43.9	42.7	44.7	47.5	52.7	55.2	55.2	55.8	56.0	56.7	57.2	57.1	59.7		
Net current transfers (negative = inflow)	-12.3	-16.9	-19.2	-15.3	-10.7	-8.9	-8.0	-7.4	-7.1	-6.9	-6.8	-6.9	-6.8	-6.7	-5.4	-10.8	-8.3
of which: official	-12.0	-15.3	-18.3	-14.4	-9.9	-8.1	-7.2	-6.6	-6.3	-6.1	-6.0	-6.1	-6.0	-5.8	-4.6		
Other current account flows (negative = net inflow)	-3.4	-8.4	-10.7	-9.8	-11.3	-11.5	-11.6	-11.8	-12.2	-12.7	-13.1	-13.6	-14.1	-14.6	-20.5	-2.0	-12.4
Net FDI (negative = inflow)	-3.9	-2.7	-2.6	-2.9	-3.0	-2.9	-2.9	-3.1	-3.2	-3.2	-3.2	-3.2	-3.2	-3.2	-2.8	-4.9	-3.1
Endogenous debt dynamics 2/	-1.8	0.5	0.3	-0.1	-0.7	-1.2	-1.1	-0.7	-0.7	-0.6	-0.6	-0.7	-0.7	-0.7	-0.7		
Contribution from nominal interest rate	0.4	0.4	0.5	0.4	0.4	0.5	0.5	0.6	0.6	0.6	0.6	0.7	0.7	0.7	0.8		
Contribution from real GDP growth	-1.2	-1.6	2.7	-0.5	-1.1	-1.7	-1.6	-1.2	-1.3	-1.3	-1.3	-1.3	-1.4	-1.4	-1.5		
Contribution from price and exchange rate changes	-1.1	1.7	-2.9	...	...	...	...	...	...	...	...	...	...	...	...		
Residual 3/	16.9	16.8	6.8	-4.9	0.1	1.2	2.2	3.1	2.5	2.0	2.3	2.1	1.7	2.1	2.2	12.8	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	0.0	0.0	0.0	0.0		
Sustainability indicators																	
PV of PPG external debt-to-GDP ratio	...	...	25.7	24.0	25.9	26.9	28.1	29.4	30.6	31.8	32.9	33.9	34.8	35.6	40.1		
PV of PPG external debt-to-exports ratio	...	...	144.6	216.1	171.3	122.8	96.1	89.0	94.6	97.6	100.6	103.1	105.8	108.2	122.8		
PPG debt service-to-exports ratio	4.7	8.2	21.1	33.6	12.5	8.8	6.4	5.4	5.5	5.8	5.7	5.9	6.2	6.4	7.5		
PPG debt service-to-revenue ratio	7.3	10.6	12.2	13.7	7.2	7.5	7.4	7.2	7.2	7.7	7.7	8.1	8.6	8.9	10.8		
Gross external financing need (Million of U.S. dollars)	-133.4	-146.4	-24.0	73.0	68.3	47.0	34.5	20.9	27.7	32.2	29.9	31.2	35.1	31.3	20.7		
Key macroeconomic assumptions																	
Real GDP growth (in percent)	2.9	3.9	-6.8	1.2	3.0	4.1	3.7	2.7	2.7	2.5	2.5	2.5	2.5	2.5	2.5	1.9	2.7
GDP deflator in US dollar terms (change in percent)	2.5	-3.8	7.8	5.8	3.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	1.9	2.6
Effective interest rate (percent) 4/	1.1	1.1	1.2	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.4	1.3	1.2
Growth of exports of G&S (US dollar terms, in percent)	14.7	-13.0	-56.5	-33.1	44.4	54.3	40.9	18.6	2.9	5.3	5.3	5.3	4.7	4.7	4.7	-3.3	13.9
Growth of imports of G&S (US dollar terms, in percent)	-0.7	-0.9	-11.6	4.2	11.2	13.0	17.5	9.9	4.8	5.9	5.2	6.1	5.5	4.6	4.5	1.7	8.0
Grant element of new public sector borrowing (in percent)	...	...	...	45.2	45.9	48.1	46.8	46.8	46.6	46.4	46.4	46.2	46.0	46.0	44.4	...	46.4
Government revenues (excluding grants, in percent of GDP)	30.4	31.5	30.7	27.3	26.2	25.7	25.4	24.8	24.5	24.2	24.0	24.0	23.8	23.7	22.7	24.0	24.9
Aid flows (in Million of US dollars) 5/	85.0	64.9	126.6	155.7	135.1	123.8	120.1	123.7	126.1	128.6	134.4	137.1	139.9	145.4	181.3		
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	15.3	11.4	9.4	9.1	8.9	8.7	8.5	8.5	8.3	8.2	8.1	6.6	...	9.5
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	85.9	74.0	74.2	73.8	74.3	74.4	74.4	74.3	74.4	74.5	74.3	73.4	...	75.3
Nominal GDP (Million of US dollars)	928	928	932	999	1,060	1,127	1,194	1,253	1,315	1,377	1,442	1,510	1,582	1,656	2,629		
Nominal dollar GDP growth	5.5	-0.1	0.5	7.1	6.1	6.3	5.9	5.0	4.9	4.7	4.7	4.7	4.7	4.7	4.7	3.8	5.4
Memorandum items:																	
PV of external debt 7/	...	...	25.7	24.0	25.9	26.9	28.1	29.4	30.6	31.8	32.9	33.9	34.8	35.6	40.1		
In percent of exports	...	...	144.6	216.1	171.3	122.8	96.1	89.0	94.6	97.6	100.6	103.1	105.8	108.2	122.8		
Total external debt service-to-exports ratio	4.7	8.2	21.1	33.6	12.5	8.8	6.4	5.4	5.5	5.8	5.7	5.9	6.2	6.4	7.5		
PV of PPG external debt (in Million of US dollars)			240.0	239.9	274.6	303.7	335.0	368.0	402.6	437.3	474.8	512.6	550.2	589.1	1053.4		
(PVt-PVt-1)/GDPt-1 (in percent)				0.0	3.5	2.7	2.8	2.8	2.8	2.6	2.7	2.6	2.5	2.5	1.9		
Non-interest current account deficit that stabilizes debt ratio	-11.1	-14.6	-4.5	7.8	3.5	2.9	1.7	0.7	1.4	1.8	1.5	1.8	2.1	1.8	1.4		

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.

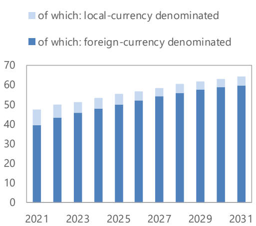
Table 2. Vanuatu: Public Sector Debt Sustainability Framework, Baseline Scenario, 2018-2041

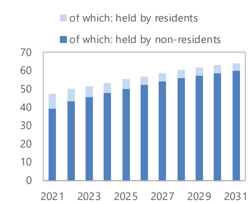
(In percent of GDP, unless otherwise indicated)

	Actual			Projections												Average 6/	
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2041	Historical	Projections
Public sector debt 1/	**49.2**	**46.1**	**50.1**	**47.5**	**50.2**	**51.4**	**53.2**	**55.5**	**56.8**	**58.6**	**60.4**	**62.0**	**63.0**	**64.2**	**73.2**	**35.5**	**56.6**
of which: external debt	**41.9**	**40.1**	**40.8**	**39.4**	**43.5**	**45.8**	**47.9**	**50.2**	**52.3**	**54.2**	**56.0**	**57.5**	**58.8**	**59.9**	**64.1**	**27.2**	**51.4**
Change in public sector debt	-3.7	-3.0	4.0	-2.7	2.7	1.2	1.8	2.2	1.3	1.8	1.8	1.6	1.1	1.1	0.9		
Identified debt-creating flows	**-7.1**	**-8.9**	**0.4**	**1.9**	**1.9**	**1.2**	**1.0**	**1.4**	**1.2**	**1.3**	**1.4**	**1.1**	**1.1**	**1.1**	**1.0**	**-2.0**	**1.3**
Primary deficit	**-7.2**	**-7.6**	**-0.7**	**2.5**	**3.2**	**3.2**	**2.9**	**2.9**	**2.8**	**2.9**	**3.0**	**2.8**	**2.9**	**2.9**	**2.8**	**-0.9**	**2.9**
Revenue and grants	39.5	38.5	44.2	40.6	34.2	32.1	31.6	31.0	30.6	30.2	30.0	29.9	29.6	29.4	27.4	**32.2**	**31.8**
of which: grants	9.2	7.0	13.6	13.2	8.0	6.4	6.2	6.2	6.1	6.0	6.0	5.9	5.8	5.7	4.7		
Primary (noninterest) expenditure	32.3	30.9	43.5	43.1	37.4	35.3	34.6	33.9	33.4	33.1	33.0	32.7	32.5	32.3	30.2	**31.3**	**34.7**
Automatic debt dynamics	**0.1**	**-1.4**	**1.1**	**-0.6**	**-1.3**	**-2.0**	**-1.9**	**-1.5**	**-1.6**	**-1.6**	**-1.6**	**-1.7**	**-1.7**	**-1.8**	**-1.8**		
Contribution from interest rate/growth differential	-1.3	-1.7	3.4	-0.6	-1.3	-2.0	-1.9	-1.5	-1.6	-1.6	-1.6	-1.7	-1.7	-1.8	-1.8		
of which: contribution from average real interest rate	0.2	0.2	0.1	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	0.0		
of which: contribution from real GDP growth	-1.5	-1.9	3.4	-0.6	-1.4	-2.0	-1.8	-1.4	-1.5	-1.4	-1.4	-1.5	-1.5	-1.5	-1.8		
Contribution from real exchange rate depreciation	1.4	0.3	-2.3	...	...	...	...	...	...	...	...	...	...	...	...		
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**	**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	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	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	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	0.0	0.0	0.0	0.0		
Residual	**3.4**	**5.9**	**3.7**	**-4.6**	**0.9**	**0.0**	**0.8**	**0.9**	**0.1**	**0.5**	**0.5**	**0.4**	**-0.1**	**0.0**	**-0.1**	**5.5**	**0.0**
Sustainability indicators																	
PV of public debt-to-GDP ratio 2/	**...**	**...**	**34.8**	**31.8**	**32.6**	**32.6**	**33.4**	**34.6**	**35.1**	**36.2**	**37.4**	**38.4**	**39.0**	**39.8**	**49.1**		
PV of public debt-to-revenue and grants ratio	**...**	**...**	**78.7**	**78.5**	**95.4**	**101.5**	**105.5**	**111.7**	**114.6**	**119.7**	**124.6**	**128.4**	**131.9**	**135.3**	**179.2**		
Debt service-to-revenue and grants ratio 3/	**10.9**	**11.4**	**12.7**	**12.8**	**10.0**	**10.3**	**7.1**	**6.9**	**9.4**	**7.2**	**7.2**	**7.5**	**15.7**	**8.2**	**11.4**		
Gross financing need 4/	-2.9	-3.2	4.9	7.7	6.6	6.5	5.2	5.1	5.7	5.1	5.2	5.1	7.5	5.3	5.9		
Key macroeconomic and fiscal assumptions																	
Real GDP growth (in percent)	2.9	3.9	-6.8	1.2	3.0	4.1	3.7	2.7	2.7	2.5	2.5	2.5	2.5	2.5	2.5	**1.9**	**2.7**
Average nominal interest rate on external debt (in percent)	1.1	1.1	1.2	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.4	**1.4**	**1.2**
Average real interest rate on domestic debt (in percent)	2.2	3.7	5.1	3.0	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	**3.4**	**4.6**
Real exchange rate depreciation (in percent, + indicates depreciation)	3.2	0.8	-5.5	...	...	...	...	...	...	...	...	...	...	...	...	**0.2**	**...**
Inflation rate (GDP deflator, in percent)	3.2	2.4	1.8	3.9	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	**2.7**	**2.3**
Growth of real primary spending (deflated by GDP deflator, in percent)	-9.3	-0.7	31.2	0.3	-10.6	-1.9	1.6	0.8	1.1	1.6	2.1	1.7	1.7	2.1	2.1	**9.0**	**0.0**
Primary deficit that stabilizes the debt-to-GDP ratio 5/	-3.5	-4.5	-4.7	5.2	0.4	2.0	1.1	0.7	1.5	1.1	1.2	1.3	1.8	1.7	1.9	**-4.2**	**1.6**
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	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.

Table 3. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2021-2031

(in percent)

	Projections 1/										
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
PV of debt-to GDP ratio											
Baseline	24	26	27	28	29	31	32	33	34	35	36
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2031 2/	24	20	16	13	11	8	5	2	0	-4	-6
A2. Alternative Scenario: [Loss of ECP revenues]	24	28	30	33	35	37	39	**41**	**43**	**44**	**46**
B. Bound Tests											
B1. Real GDP growth	24	28	32	33	35	36	37	39	**40**	**41**	**42**
B2. Primary balance	24	28	31	32	33	35	36	37	38	39	39
B3. Exports	24	28	33	34	35	36	37	39	40	**41**	**41**
B4. Other flows 3/	24	31	38	39	**40**	**41**	**42**	**43**	**44**	**45**	**45**
B5. Depreciation	24	33	29	30	32	33	35	36	38	39	40
B6. Combination of B1-B5	24	33	36	38	39	**40**	**42**	**43**	**44**	**45**	**46**
C. Tailored Tests											
C1. Combined contingent liabilities	24	**40**	**41**	**42**	**43**	**44**	**45**	**46**	**47**	**48**	**49**
C2. Natural disaster	24	33	34	36	38	40	**41**	**43**	**44**	**46**	**47**
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	**216**	171	123	96	89	95	98	101	103	106	108
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2031 2/	**216**	131	74	45	33	25	16	7	-1	-11	-19
A2. Alternative Scenario: [Loss of ECP revenues]	**216**	**183**	137	111	106	115	120	125	130	135	139
B. Bound Tests											
B1. Real GDP growth	**216**	171	123	96	89	95	98	101	103	106	108
B2. Primary balance	**216**	**185**	142	110	101	107	110	113	115	118	120
B3. Exports	**216**	**210**	**194**	151	139	146	150	154	157	161	164
B4. Other flows 3/	**216**	**208**	173	133	121	127	130	132	134	137	138
B5. Depreciation	**216**	171	104	82	77	82	85	89	91	94	96
B6. Combination of B1-B5	**216**	**212**	142	128	117	124	127	131	133	136	138
C. Tailored Tests											
C1. Combined contingent liabilities	**216**	**265**	**186**	143	130	136	139	142	144	146	148
C2. Natural disaster	**216**	**224**	161	127	118	126	131	135	139	144	148
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	**34**	12	9	6	5	5	6	6	6	6	6
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2031 2/	**34**	13	8	6	5	4	5	4	4	4	3
A2. Alternative Scenario: [Loss of ECP revenues]	**34**	12	9	7	6	6	7	7	7	8	9
B. Bound Tests											
B1. Real GDP growth	**34**	12	9	6	5	5	6	6	6	6	6
B2. Primary balance	**34**	12	9	7	6	6	6	6	6	6	7
B3. Exports	**34**	15	12	9	8	8	8	8	8	9	9
B4. Other flows 3/	**34**	12	9	7	6	6	6	6	7	7	8
B5. Depreciation	**34**	12	9	6	5	5	5	5	6	6	6
B6. Combination of B1-B5	**34**	13	11	8	7	7	7	7	7	7	8
C. Tailored Tests											
C1. Combined contingent liabilities	**34**	12	10	8	6	6	7	7	7	7	7
C2. Natural disaster	**34**	13	10	7	6	6	7	7	7	7	8
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	14	7	7	7	7	7	8	8	8	9	9
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2031 2/	14	7	7	7	6	6	6	6	6	6	5
A2. Alternative Scenario: [Loss of ECP revenues]	14	10	10	10	10	10	11	11	12	13	14
B. Bound Tests	14	10	10	10	10	10	11	11	12	13	14
B1. Real GDP growth	14	8	9	9	8	9	9	9	9	10	11
B2. Primary balance	14	7	8	8	8	8	8	8	8	9	10
B3. Exports	14	7	8	8	8	8	8	8	9	9	10
B4. Other flows 3/	14	7	8	8	8	8	9	9	9	9	11
B5. Depreciation	14	9	9	9	9	9	9	9	10	10	11
B6. Combination of B1-B5	14	8	9	9	9	9	9	9	10	10	12
C. Tailored Tests											
C1. Combined contingent liabilities	14	7	9	9	8	8	9	9	9	10	10
C2. Natural disaster	14	7	8	8	8	8	8	8	9	9	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, 2021-2031

	Projections 1/										
	2021	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**2031**
	PV of Debt-to-GDP Ratio										
Baseline	32	33	33	33	35	35	36	37	38	39	40
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2031 2/	32	30	29	28	27	25	24	23	22	21	20
A2. Alternative Scenario: [Loss of ECP revenue]	32	36	40	43	47	50	54	**57**	**60**	**63**	**66**
B. Bound Tests											
B1. Real GDP growth	32	36	42	46	50	53	**57**	**60**	**64**	**67**	**70**
B2. Primary balance	32	35	37	38	39	39	41	42	43	43	44
B3. Exports	32	34	37	38	39	39	40	42	43	43	44
B4. Other flows 3/	32	38	44	44	45	46	47	48	49	49	50
B5. Depreciation	32	37	35	33	32	31	30	30	29	28	27
B6. Combination of B1-B5	32	34	35	35	36	37	38	39	40	41	42
C. Tailored Tests											
C1. Combined contingent liabilities	32	48	48	48	49	50	51	52	53	53	54
C2. Natural disaster	32	40	41	42	44	45	46	48	50	51	52
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.
TOTAL public debt benchmark	55	55	55	55	55	55	55	55	55	55	55
	PV of Debt-to-Revenue Ratio										
Baseline	79	95	101	106	112	115	120	125	128	132	135
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2031 2/	79	89	89	87	86	82	79	77	74	70	66
A2. Alternative Scenario: [Loss of ECP revenue]	13	12	13	9	9	12	10	10	11	20	13
B. Bound Tests											
B1. Real GDP growth	79	104	127	140	155	167	181	194	207	219	231
B2. Primary balance	79	102	116	120	126	129	134	139	143	146	150
B3. Exports	79	99	115	119	126	128	134	139	142	146	149
B4. Other flows 3/	79	112	136	139	146	149	154	159	163	167	169
B5. Depreciation	79	111	110	107	106	103	102	101	99	96	95
B6. Combination of B1-B5	79	100	109	110	116	119	125	130	134	137	141
C. Tailored Tests											
C1. Combined contingent liabilities	79	141	149	153	160	163	168	173	177	180	184
C2. Natural disaster	79	117	126	132	140	145	153	160	165	171	176
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	13	10	10	7	7	9	7	7	7	16	8
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2021-2031 2/	13	10	10	7	7	9	6	6	6	15	6
A2. Alternative Scenario: [Loss of ECP revenue]	13	12	13	9	9	12	10	10	11	20	13
B. Bound Tests											
B1. Real GDP growth	13	11	12	8	8	11	9	9	10	19	11
B2. Primary balance	13	10	10	8	7	10	8	8	8	16	9
B3. Exports	13	10	10	7	7	10	8	7	8	16	9
B4. Other flows 3/	13	10	11	8	8	10	8	8	8	16	10
B5. Depreciation	13	10	12	9	8	11	9	9	9	17	10
B6. Combination of B1-B5	13	10	10	7	7	10	7	7	8	16	8
C. Tailored Tests											
C1. Combined contingent liabilities	13	10	12	8	8	11	8	8	9	17	9
C2. Natural disaster	13	10	11	8	8	10	8	8	8	17	9
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.

Statement by Chang Huh, Executive Director for Vanuatu and Christian Becker, Adviser to Executive Director August 31, 2021

Our authorities in Vanuatu appreciate the open and constructive engagement with the mission team during the 2021 Article IV virtual consultations. At this very difficult time for Vanuatu the advice of the Fund is needed more than ever. The authorities attach significant value to the high-quality policy advice and assistance received through their Fund membership. The authorities also broadly concur with staff's assessment, analysis, and tailored policy recommendations.

Vanuatu is a small archipelago of 80 islands scattered in the South Pacific Ocean, remotely located around 2,000 kilometers east of Australia. Vanuatu's land area is very limited, with most of the islands having steep hills, unstable soil, and little permanent fresh water. The country lies on a very active tectonic plate boundary (the "Ring of Fire") where the continental plates meet. Vanuatu is highly vulnerable to external economic shocks due to its narrow production base, lack of economies of scale, limited institutional capacity, as well as high dependence on imports and donor assistance.

At the beginning of 2020 Vanuatu had almost fully recovered from the devastation caused by a tropical cyclone four years prior. Since the beginning of last year, the country has concurrently suffered three major disasters. In March 2020 the COVID-related border closures precipitated a collapse in the tourism sector and cut Vanuatu off from key imports. The next month the islands were again severely impacted by another tropical cyclone which damaged homes, infrastructure, and crops. Reconstruction efforts have been hampered by the lack of available materials and engineering expertise due to border closures in Vanuatu and major trading partners. At the same time, there has been more than the usual volcanic activity. Poisonous gasses, acid rain, ash, and earthquakes have damaged crops, threatened livestock, and led to the evacuation of local villages. A comprehensive report was compiled that assesses the impact of these disasters and formulates detailed policy responses. Regional development partners are collaborating closely with the authorities in Vanuatu. The World Bank provided emergency funding through a Development Policy Grant with a Catastrophe- Deferred Drawdown Option. The Asian Development Bank has also supported the response to COVID-19 through grants for Vanuatu.

COVID-19 Response, Recent Developments and Outlook

According to the *COVID-19 Health Sector Preparedness and Response Plan*, Vanuatu is now in "Scenario 1 – No confirmed cases". Since the beginning of the pandemic, there have been only three active cases, all of which were detected in quarantine and there has been no community transmission. From over 23,000 tests conducted in Australia and New Zealand on people arriving from Vanuatu, none have detected the virus. No deaths have been recorded, in part because closing borders is very effective in small and remote island nations. Nonetheless, this has far reaching economic consequences.

Since late 2020, work has been ongoing by the Ministry of Health to plan and prepare for the roll-out of vaccines. In April 2021, Parliament approved the import of vaccines that had received a WHO Emergency Use Listing. The first batch of 24,000 doses of AstraZeneca vaccine were received through the COVAX Facility in May 2021 and a further 20,000 doses of Sinopharm COVID-19 vaccine were received in June 2021. Vaccination commenced in June 2021 for priority groups (frontline workers, the elderly, and people with pre-existing medical conditions) but vaccinations are now open to all adults over the age of 18.

The Ministry of Health is working to identify options to procure additional vaccines to enable full vaccination of the eligible population. The rollout is also constrained by the limited medical personnel and could be drawn out until the end of 2023. Delivery of vaccines to remote islands has been innovative, with some doses flown in by drones. This work is essential to enable reopening of the borders so that the economic recovery is faster and more sustainable.

Economic Outlook and Risks

The macroeconomic situation is dominated by COVID-19 and multiple natural disasters. The economy is forecast to recover in 2021 but projected growth is initially expected to be uneven before broadening. The major drivers are likely to be the industrial sector and growth in construction activities. Building activity will be related to implementations of delayed public infrastructure projects and resumption of reconstruction following the damage caused by Tropical Cyclone Harold. Both upside and downside risks make the outlook even more uncertain than usual.

Post-cyclone reconstruction efforts and re-opening of the tourism sector remain tied to developments in the pandemic and related border closures. The economy could rebound more solidly if tourism benefits from pent-up demand in the larger neighboring countries (Australia, China, and New Zealand) when borders re-open. The same is true if delayed investment in infrastructure benefits from the arrival of materials and engineering expertise from overseas. The authorities are more optimistic about this scenario than staff and hence have slightly higher projections for economic growth.

On the downside, evolution of the pandemic and effective vaccination both remain highly uncertain (as they do in all countries). The asynchronous recovery in trading partners could also be disruptive in terms of the composition of exports and imports.

Imminent adoption and ratification of requirements to join the Pacific Agreement on Closer Economic Relations (PACER Plus) will support a sustainable recovery by boosting trade and investment.

Monetary Policy and the Financial sector

In March 2020, the Reserve Bank of Vanuatu (RBV) reduced the policy rate from 2.90 per cent to 2.25 per cent and ensured that the financial system remained liquid. There is little scope for many of the unconventional monetary policy tools that were implemented in more advanced economies and the exchange rate remains pegged to a trade-based basket of currencies.

Over the forecast horizon, Vanuatu's annual headline inflation is expected to remain within the Reserve Bank's target range of 0.0 to 4.0 per cent. Inflation is projected to increase to the upper end of the target, reflecting high domestic food prices and lagged effects from the increase in international fuel prices. Fuel prices have a stronger direct link to transport and utility costs in Vanuatu than in advanced economies.

To support the corporate sector, and protect banks from non-performing loans, a loan guarantee program was put in place. Banks continue to make loans on their own books but are indemnified by the government from potential defaults.

The quality of loan portfolios at the four commercial banks has remained relatively robust. Standard performing loans make up the bulk of total loans, although some small business loans are edging toward becoming non-performing. The non-performing loans situation will become clearer after the loan moratorium period ends in September 2021.

Fiscal Policy

The economic support package amounted to almost US$30 million (around 3 per cent of GDP). The focus of the Vanuatu authorities was on a guarantee of bank loans, wage subsidies, small business grants, and additional funding for the Vanuatu Agricultural Development Bank. The government also lent its support to the national airline given curtailed international travel and tourism since the onset of the pandemic. The government has adequate liquidity buffers and is expecting to record a budget surplus.

Despite relatively high public and external indebtedness, staff judge the situation in Vanuatu to remain sustainable. However, there is an urgent need to broaden the government's revenue base (with currently no taxes on income, profits, or dividends).

One third of revenues are grants but these will begin to peter out as the country graduates to the next level of development.

Another third of revenue comes from the US dollar-denominated Economic Citizenship Program (ECP) which is increasingly coming under pressure from compliance with international money laundering legislation, de-risking and the withdrawal of Correspondent Banking Relationships. The authorities appreciated a scenario staff presented in the debt sustainability assessment that showed how the loss of ECP revenues would impact debt levels. The loss of ECP would place severe pressure on debt sustainability and the authorities generally concurred with staff that when the recovery is well entrenched, non-essential spending would have to be cautiously wound back and alternative sources of revenue would need to be mobilized.

Correspondent Banking Relationships (CBR)

Despite progress, ongoing improvements to the AML/CFT regime in Vanuatu are needed to strengthen financial sector stability and ease potential pressures on correspondent banking relationships. There is a danger that important US dollar CBRs could be terminated entirely. This is a complex issue that affects countries in the Pacific even more severely than in other developing regions, but is also at critical levels in the Caribbean, developing Europe, and Africa. Given the prominence of the US dollar in international trade and payments, the withdrawal of CBRs poses challenges for financial stability, banking in the outer islands, and channeling revenues from the Economic Citizenship Program. Remittances from overseas workers are an important source of income and foreign exchange that averages around 10 per cent of GDP. The decline in CBRs is now at a level where there is a serious risk that Vanuatu could be entirely cut off from the international payments system and face the associated risks to financial stability, the balance of payments, and foreign income.

The authorities noted that de-risking by international banks continued despite domestic efforts to improve compliance with international standards. It is appreciated that the Fund and PFTAC provide important research, technical assistance to improve compliance, build local capacity, and are actively engaged in the region with respect to CBRs.

Structural Reforms

Economic diversification from reliance on tourism and agriculture (for domestic consumption) could foster agricultural exports to regional trading partners, further value added in the fishing industry, as well as potential tertiary sector growth in English and French speaking call centers. Vanuatu has plans to address key infrastructure gaps that are constraining access to electricity, transport, and the internet. Only 26 per cent of the population has access to the internet, which is also inhibiting financial inclusion.

However, scope and options for diversification remain constrained by the size of the Vanuatu economy. With a population of just 300,000, limited natural resources, and geographic isolation, advice needs to remain tailored and realistic. Vulnerabilities cannot be entirely eliminated given the precarious economic, geographic, climate, and natural disaster situation.

Climate Change

The authorities in Vanuatu have plans in place to respond to natural disasters through the domestic budget, but recovery from significant unforeseeable events like tsunamis, cyclones, volcanic eruptions, and earthquakes remain very much dependent on donor support. In that respect, the authorities in Vanuatu will benefit from the APD-FAD departmental paper on access to climate finance by Pacific island countries.

The challenges from climate change can be broadly divided into two related but somewhat different areas:

Slow moving global warming is leading to rising sea levels and is threatening island nations in the Pacific. Given that there is little that can be done directly to address the existential threat from this phenomenon, additional considerations must be contemplated when advising Vanuatu on development needs.

The country is also experiencing more frequent natural disasters that are related to climate change, such as cyclones and king tides. These events are more discrete and require immediate support for reconstruction after the event, as well as ongoing investment in more resilient infrastructure.

Capacity constraints hamper the implementation of mitigating climate strategies in small island countries in the Pacific and elsewhere in the world. Given that there are many reforms needed to achieve sustainable development in addition to climate resilience, the prioritization of climate-related action needs to be prioritized within a much wider policy agenda. Capacity building in terms of up-skilling local authorities is a good start but remains constrained by the overarching smallness of Vanuatu.