

Vanuatu: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Vanuatu

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Vanuatu, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **August 29, 2002**, 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 November 7, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **November 21, 2002** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its November 22, 2002 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Vanuatu.

The document(s) listed below have been or will be separately released.

Selected Issues and Statistical Appendix Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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VANUATU

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Vanuatu

Approved by Daniel Citrin and Shigeo Kashiwagi

November 7, 2002

- The 2002 Article IV consultation discussions were held in Port Vila during August 20–29. The staff team comprised David Cowen (head), Alexander Wolfson, and Jian Ming Ni (all APD). Vanuatu is on a 24-month cycle.
- The mission met with Minister of Finance and Economic Management Molisa, Reserve Bank of Vanuatu Governor Kausiama, and other senior government officials, and with representatives from the private sector and major donors.
- At the conclusion of the last Article IV consultation in August 2000, Directors commended the authorities for maintaining macroeconomic stability, but recognized the need for strengthening the fiscal and external positions. They welcomed the progress made under the government’s Comprehensive Reform Program, which aimed at raising public sector efficiency and improving economic management. However, Directors noted that broader and deeper reforms in fiscal and structural areas were necessary for sustained growth. They supported the steps taken to strengthen oversight of the onshore and offshore financial sectors, but cautioned that efforts to combat money laundering needed to be brought up to international standards.
- Vanuatu has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.
- Data quality and coverage still impede effective surveillance of policies and developments in Vanuatu, but improvements have been made since the last consultation.
- The principal author of this report is David Cowen.

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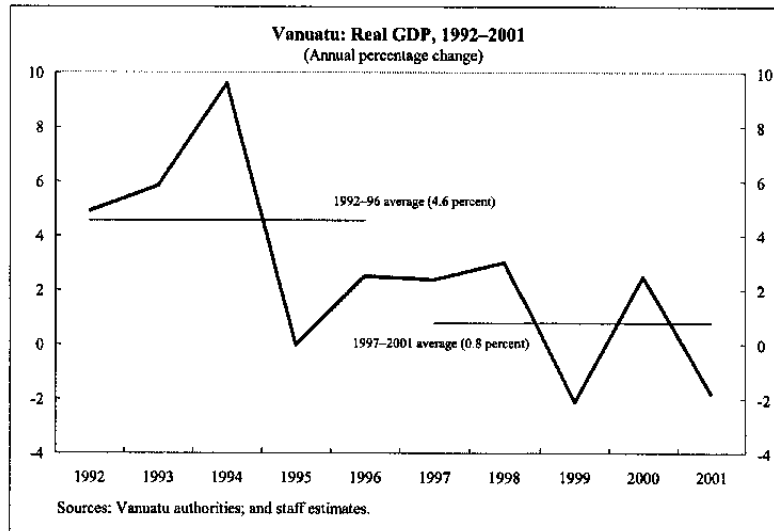
Executive Summary

- **Economic growth in Vanuatu has slowed considerably since the mid-1990s**, owing to persistent fiscal and structural weaknesses, which limit competitiveness. Combined with the effects from several cyclones and a weak external environment in 2001, real GDP contracted by 2 percent. Macroeconomic management has been reasonably sound. As a result, inflation has stayed low, but reserves have declined in recent years, in part reflecting poor export performance.
- **With little sign of recovery, real GDP growth is expected to be slightly negative again in 2002.** Growth would be expected to pick up over the medium term, absent major shocks and with a renewed reform effort, as well as sufficient resources to support outer island development.
- **Risks to medium-term growth prospects primarily arise from difficulties in reaching political consensus on addressing policy weaknesses.** Frequent changes in government over the past three years have slowed reforms in some key areas, but recent progress on bank supervision is a positive sign. A coalition government in place since April 2001 strengthened its hold on Parliament in a national election in May 2002, which could yield a more stable and reform-oriented policy environment.
- **The authorities and staff agreed that the underlying fiscal situation, while showing signs of improvement in 2001 and 2002, still required corrective actions.** To safeguard revenue performance and fund key social and infrastructure needs, tax compliance needs to be strengthened and expenditure priorities shifted away from wage outlays.
- **In view of the deterioration in the external position, the staff also underscored the need to ensure the exchange rate regime is consistent with maintaining a comfortable reserve cushion and protecting external competitiveness.** Given Vanuatu's high cost structure, competition gains could accrue from a sounder fiscal stance and a deepening of structural reforms.
- **The authorities and staff agreed that forceful action was required to regulate and supervise the offshore financial center (OFC).** A rapid alignment of the onshore and offshore supervisory regimes and strict enforcement of financial regulations would act to safeguard the domestic financial system and reduce the reputational harm from hosting an OFC that is largely noncompliant with Basel Core Principles. The OECD designated Vanuatu as an uncooperative tax haven in April 2002, in part because of a lack of transparency and information sharing.

I. RECENT ECONOMIC AND POLITICAL DEVELOPMENTS

1. **This year's consultation discussions took place against the backdrop of a continued slump in economic activity.** A trend slowdown in real GDP growth since the mid 1990s appears rooted in a persistence of fiscal and structural weaknesses. As a result, Vanuatu has a relatively high cost structure and poor basic infrastructure vis-à-vis the region, which has eroded

competitiveness (Box 1). This is compounded by a narrow production base, leaving it more susceptible to economic shocks.¹ Like other countries in the region, business activity is hindered by a small population, which limits economies of scale. Formal sector employment remains very limited, with 80 percent of the labor force tied to subsistence activity. As a result, Vanuatu rates low on regional human development indicators.



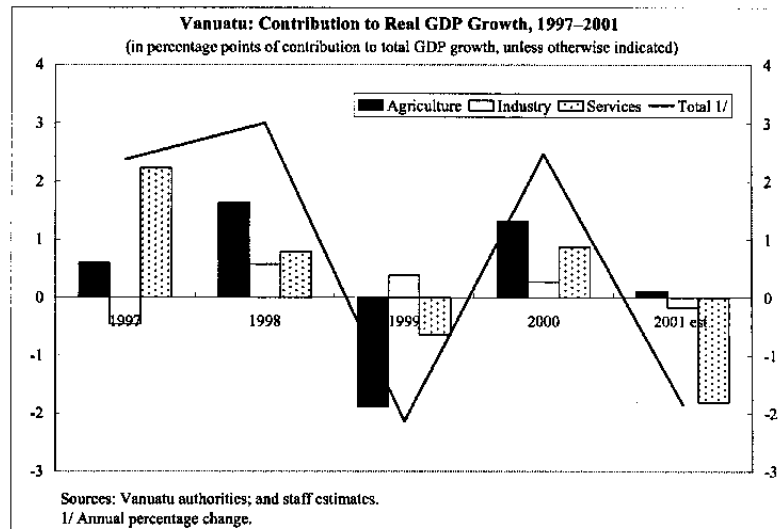
2. **In recent years, macroeconomic stability has generally prevailed, but structural reforms have slowed with several recent changes in government.** The government's reform agenda has been guided, in part, by the Comprehensive Reform Program (CRP), which was initiated in 1998 with assistance from the Asian Development Bank (AsDB) and other donors. The CRP provides a framework for raising public sector efficiency; strengthening economic and financial management; and improving parliamentary, judiciary, and legal procedures. Progress was initially good, but waned in 2000 and 2001 owing to a lack of consensus in policy direction. At the same time, poor growth performance continues to highlight the need for further reforms to the state-owned enterprise (SOE) and financial sectors and trade and investment regimes.

3. **Despite frequent changes in government, Vanuatu so far has managed to avoid the political and social unrest experienced by other Melanesian countries.** A coalition government comprising Vanuatu's two largest parties—the Vanuaaku Pati (VP) and Union of Moderate Parties (UMP)—came to power in April 2001, after the latter defected from the

¹ A selected issues paper contains background notes on recent growth performance and a regional comparison of competitiveness.

previous ruling coalition.³ The new coalition strengthened its hold on Parliament in a national election in May 2002. The VP retained the prime minister's post, despite the UMP's achievement of a one-seat edge over the VP in the Parliament, which has necessitated considerable power sharing. The government's most immediate challenge was containing a police insurrection in July 2002. The incident, which involved the temporary detention of several senior government officials, is being resolved in the courts.

4. **Economic activity contracted in 2001**, with real GDP falling by 2 percent due to the impact on the agricultural and tourism sectors of several major cyclones and a weak external environment (Table 1). Inflation increased from 2½ percent in 2000 to 3¾ percent in 2001, mainly on account of oil prices (Figure 1). The current account surplus declined from 2 percent of GDP in 2000 to ¾ percent in 2001, reflecting the impact of shocks to copra exports and tourism receipts (Table 2 and Figure 2). With the capital account remaining in deficit, gross official reserves fell slightly to \$38 million at end-2001 (3 months of next year's imports of goods and nonfactor services). Under the adjustable peg exchange rate arrangement, the vatu depreciated by 2¾ percent against the U.S. dollar in 2001, but appreciated by 5¾ percent in the first nine months of 2002.⁴ Since early 2001, the exchange rate has stayed broadly unchanged in real effective terms.



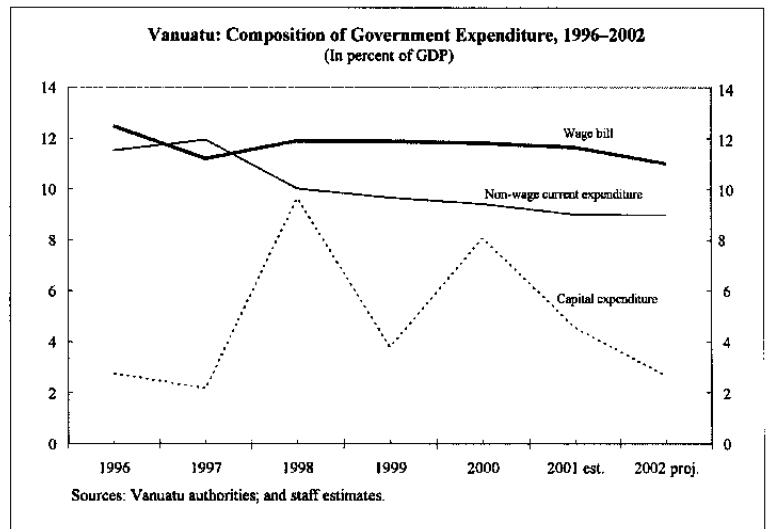
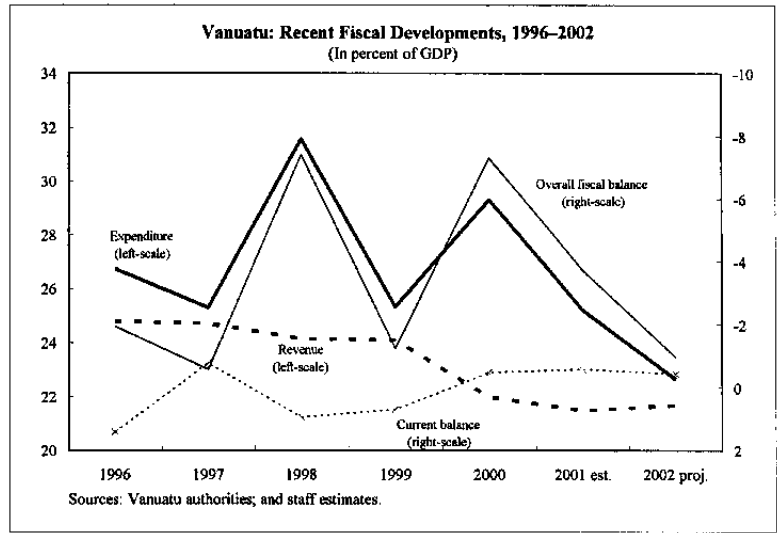
5. **The fiscal situation improved in 2001**, but the adjustment came mostly from a reduction in capital expenditure as a result of the completion of several large transport projects.⁵ The overall budget deficit (excluding net lending) declined from 7¼ percent of

³ The previous government lasted only 18 months. Its leadership became mired in mismanagement, culminating with the conviction and imprisonment of the prime minister in July 2002 on charges of illegally granting government guarantees to a private businessman.

⁴ The vatu is pegged against a (undisclosed) basket of currencies. The composition and weights of currencies in the basket are adjusted periodically (most recently in January 2002).

⁵ However, capital expenditure was larger than budgeted in 2001, mainly because of a supplementary appropriation to the Vanuatu National Provident Fund of VT 325 million (1 percent of GDP) to strengthen its finances. Excluding this, capital expenditure was ¾ percentage points of GDP below budget.

GDP in 2000 to 3¾ percent in 2001 (Table 3). Despite this, problems persisted with tax compliance and expenditure prioritization, which impeded effective budget execution in both 2000 and 2001. Revenue shortfalls stemmed from problems with VAT arrears and customs compliance and also reflected the economic slowdown. Expenditure priorities were skewed toward the wage bill, which continued to account for more than one-half of total recurrent expenditure, despite some expected savings under the CRP (Box 2). Education and health outlays grew slightly as a share of total spending, but service delivery to the outer islands and rural areas continued to lag due to resource shortfalls and capacity constraints. Starting in mid-2001, the government instructed the Vanuatu Commodity Marketing Board (VCMB) to pay subsidies to copra farmers.⁶ The cash-strapped VCMB, in turn, relied on direct advances from the Reserve Bank of Vanuatu (RBV) to make these payments, as none were budgeted. For the year ending June 2002, the total cost of subsidy payments made by the VCMB was estimated at VT 350 million (1 percent of GDP).



6. **Monetary policy has been generally restrained.** Broad money grew by 6 percent in 2000 and 2001, fueled by foreign currency deposits (FCDs) arising from a relatively strong current account (Table 4 and Figure 3). In view of the slowdown in the economy in 2001, the repo rate was reduced at mid-year (by 50 basis points), which contributed to a rebound in

⁶ The VCMB has traditionally bought copra and cocoa for export. In mid-2001, the price paid by VCMB to copra farmers was raised by 67 percent to VT 25,000 per ton (the prevailing world price was VT 19,000 per ton). In addition to this, the VCMB incurred operating costs (mainly for domestic transport) of about VT 12,000 per ton.

private sector credit growth (to 6½ percent in 2001).⁷ Domestic liquidity conditions were allowed to further ease in the first half of 2002, reflecting a switch from foreign currency to local currency deposits as a result of reduced market tension following the election and an appreciation of the vatu vis-à-vis the U.S. dollar (given its depreciation against other currencies in the basket). However, bank interest rate spreads continued to widen, reflecting the high operating costs, prospective credit risk, and uncertain policy environment.

II. OUTLOOK AND RISKS

7. **Performance so far this year suggests that real GDP growth will be slightly negative in 2002** (by about ¼ percent). A moderate rise in agricultural output, led by copra production (up 21 percent in the first half of 2002), is expected to be offset by slumps in tourism and construction activity. Tourist arrivals were down 14 percent in the first half of the year, affected in part by a strong recovery in Fiji—the major competitor in the region. Inflation is expected to stay below 3 percent (at 2 percent for the year ending June 2002), in view of prudent monetary management and despite a further increase in oil prices. A current account deficit of 2½ percent of GDP is projected, with a further softening in tourism receipts, but reserves should be unchanged at \$38 million by year-end (3 months of imports) on account of a slowing of capital outflows. External vulnerability appears to remain moderately low at this juncture, despite the weaknesses in economic performance in recent years, given a relatively small external debt and cautious monetary stance (Table 5).

8. **Over the medium term, sustained growth depends on tackling fiscal and structural weaknesses** in order to improve external competitiveness and expand productive opportunities (Box 3). Fiscal policy should be geared to providing adequate resources to meet key social and infrastructure needs, while maintaining prudent debt levels. In the structural areas, the focus remains on ensuring a well-supervised onshore and offshore financial sector, an open trade system, a transparent legal and regulatory framework, and a more limited government role in commercial activity. These policies would be expected to reduce high operating costs, build business confidence, and stimulate private investment, as necessary for sustained growth. Without these improvements, growth prospects would dim considerably, raising the risk of macroeconomic instability and social unrest, given rapid population increases and limited employment opportunities.

III. POLICY DISCUSSIONS

9. **In view of recent growth performance, policy discussions focused on fiscal and structural issues**, as did the 2000 Article IV consultation. The authorities and staff noted some progress had been made in addressing policy challenges highlighted during the last consultation (as summarized in Box 4), but agreed more progress was needed to lay a better

⁷ Despite relatively large foreign-currency deposits (70 percent of the total deposit base), 80 percent of total bank loans were denominated in local currency at end 2001. Banks mostly place foreign currency deposits in short-term liquid foreign currency assets.

foundation for sustained economic growth and a viable external position. The appropriateness of exchange rate policy was also discussed extensively, in view of concerns about competitiveness. In addition, financial sector policy featured prominently, including the risks posed by offshore financial center (OFC) activity.

A. Fiscal Policy

10. **The staff noted recent improvements in the fiscal situation, but cautioned that a stronger revenue effort and expenditure prioritization were required**, in order to address critical spending needs while maintaining a sustainable debt situation. An overall budget deficit of 1¼ percent of GDP was initially targeted in 2002, but it is now projected to be 1 percent of GDP largely on account of delays in implementing externally-financed capital projects.⁸ Despite the continued economic slump, revenue shortfalls are expected to moderate as a result of higher specific duties on select imports and increased business licensing fees. Some improvements have also been made in VAT and customs administration through the introduction of automated systems aimed at strengthening tax audit and compliance procedures and recording tax arrears. Notwithstanding lower capital spending, expenditure is expected to be close to budget. However, spending priorities have remained skewed towards unproductive outlays, putting a squeeze on operations and maintenance and other critical needs. In particular, unbudgeted savings achieved on the wage bill, in part through controls over new hires (Box 2), are largely being offset by spending associated with salary arrears and the national election. In addition, supplementary budget support has been provided to the Asset Management Unit (AMU) (paragraph 18). In view of this, a tight cash situation persists in 2002, with the government still using a system of monthly warrants to control spending units.⁹ Moreover, it has continued to resort to advances from the RBV to fill a financing gap.

11. **Some further actions to safeguard the fiscal position in 2002 were discussed.** In the revenue area, despite expected shortfalls, the authorities did not favor new tax measures in 2002 on account of the weak economy. However, the staff recommended that excises on alcohol and tobacco products originally proposed in the 2002 budget be approved without further delay. On the expenditure side, the authorities agreed with staff on the need for strict limits on supplemental appropriations to avoid further compressing nonwage spending and incurring domestic payment arrears. The staff encouraged the use of treasury bill auctions rather than central bank advances to meet financing needs, in order to protect inflation

⁸ The 2002 budget contained \$5 million (2 percent of GDP) for an AsDB-supported outer island infrastructure project, which is being delayed as the government reconsiders its own contribution to funding and maintaining the project.

⁹ With the introduction of the Financial Management Information System in mid 2002, improved budget monitoring should allow the government to move from monthly to quarterly expenditure warrants by 2003, to give spending units greater flexibility in budget implementation.

performance and improve fiscal discipline. However, the authorities were reluctant, citing the need first to strengthen debt management. The authorities and staff did concur that copra subsidies should be rolled back in order to contain fiscal risks and avoid market distortions, but no official decision has been taken yet. In this regard, the staff urged an unwinding of the advances to the VCMB and a limitation on future support to farmers to that which was well targeted, small in scope, and fully budgeted, as well as a restriction of the VCMB to at most promotional activities.

12. **The staff also noted that additional actions were needed in the context of the 2003 budget to promote lasting fiscal consolidation.** To this end, the staff welcomed the cautious approach being taken by the authorities in formulating budget deficit targets in 2003, including a current budget balance. On the revenue side, in addition to new excises, further increases in specific duties on select imports are being considered. The staff cautioned against excessive reliance on trade taxes in view of future trade commitments (paragraph 19), which would require collapsing the number of tariff bands and lowering rates over the medium term. To safeguard revenue, the staff also urged limits on tax exemptions, including those that serve as implicit subsidies for SOEs, by strictly specifying their availability and use in the Foreign Investment Act and other relevant laws. In the expenditure area, the authorities acknowledged the need for further cuts in the wage bill in relation to GDP, given comparatively low spending on operations and maintenance and in social areas, and indicated that plans were being formulated to consolidate some ministerial tasks. The staff noted that higher capital spending was also appropriate in context of a well-designed public investment program and with donor coordination.

B. Monetary and Exchange Rate Policy

13. **A cautious monetary stance remains a priority,** to safeguard inflation performance and support the external position. The authorities and staff agreed that strict limits were needed on RBV advances for the remainder of 2002, as supported by fiscal restraint, to contain any further relaxation of domestic liquidity conditions. However, even with a seasonal pick up in domestic demand, broad money growth in 2002 will be very modest, with private sector credit expected to expand by 4 percent.

14. **The staff stressed the need to monitor exchange rate movements closely,** owing to poor export performance and steady reserve losses since the late 1990s, which signal low external competitiveness. In consideration of this, the staff acknowledged that given the structure of Vanuatu's economy, most notably the large share of imports to GDP (68 percent in 2001), a depreciation might have a limited initial impact on relative prices. At the same time, it could prove unavoidable in the absence of a concerted effort to raise productivity, foremost being through the maintenance of a sound fiscal stance and acceleration of structural reforms. The authorities recognized the need to address Vanuatu's competitive disadvantage vis-à-vis the region, but were cautious in their support for a more flexible exchange rate management.

15. **The staff also encouraged a deepening of the interbank market and greater transparency about the exchange rate peg in order to improve reserves management.** In the past, the RBV relied on copra export proceeds from the VCMB to build up reserves, but low world prices and domestic copra sales have dried up this source of foreign exchange.¹⁰ At the same time, banks still look to the RBV to meet some foreign exchange needs, in particular for large importers.¹¹ The staff encouraged the RBV to (i) widen its trading band (currently 0.3 percent around the RBV's daily announced mid rate) to give it more latitude in entering the interbank market and acquiring foreign exchange, and (ii) allow greater transparency about the nature of the exchange rate peg to reduce uncertainty about policy direction, including through public disclosure of the current composition and weights of the currency basket. The authorities indicated they would consider widening the band, but were reluctant to disclose details of the basket for fear of encouraging destabilizing speculation on exchange rate movements.

C. Financial Sector Policy

16. **The authorities have taken steps to strengthen the regulatory and supervisory regime for domestic banks.** The OFC Module II Assessment conducted by the Fund's Monetary and Exchange Affairs Department in May 2002 found the RBV's supervisory regime for domestic banks to be mostly compliant with the Basel Core Principles (BCP). In keeping with this assessment, the overall financial health of the domestic banking sector, dominated by three commercial banks, is viewed as generally sound. To address deficiencies identified in the OFC assessment, customer due diligence guidelines were approved in July 2002, and the Financial Institutions Act is being amended to improve oversight of banks' anti-money laundering systems and controls and introduce a more rigorous "fit and proper" regime.

17. **The staff noted that decisive actions were needed to strengthen the supervisory regime for offshore banks,** which the Fund's OFC assessment found to be mostly noncompliant with the BCP. Otherwise, domestic banks would continue to be exposed to reputational harm inflicted by the prevalence of "shell" institutions (Box 5). The authorities shared this concern in weighing the potential gains from a sounder financial system against the losses from a smaller offshore sector, which at present makes a very limited contribution to macroeconomic activity and government revenue.¹² In addition, the global focus on combating money laundering and terrorist financing since 2001 had given further impetus to

¹⁰ The VCMB, as a statutory body, typically sold foreign exchange from copra exports to the RBV. However, coconut oil mill operators, which now process the bulk of domestic copra production for export, tend to sell foreign exchange directly to the commercial banks.

¹¹ In early 2002, the RBV lowered its minimum limit on sales of foreign exchange to commercial banks from \$1 million to \$250,000 per transaction.

¹² A background note contains an assessment of the role and prospects of the OFC.

strengthening OFC oversight. In view of this, a new law is being finalized, so as to bring the regulatory and supervisory framework for offshore banks in line with domestic banks and under the control of the RBV. This law is also expected to clarify financial regulators' on-site supervisory powers against existing secrecy provisions, which have constrained effective oversight. Consistent with these moves, steps are being considered to achieve the removal of OECD designation of Vanuatu as an uncooperative tax haven, which occurred in April 2002.

18. **The authorities have completed the financial and operational restructurings of the state-owned National Bank of Vanuatu (NBV) and Vanuatu National Provident Fund (VNPF),** but acknowledged that the AMU set up to handle nonperforming loans (NPLs) transferred from the NBV and VNPF had underperformed. In view of low NPL recoveries, government budget support was provided to the AMU in April 2002 to repay the NBV, effectively recapitalizing the bank.¹³ Prospects for future recoveries remain low, owing to the poor quality and depressed value of the assets transferred to the AMU. The staff recommended that the government formulate a clear and timebound strategy for quickly resolving bad loans by selling foreclosed properties and writing off NPLs with no prospect for recovery to limit fiscal risks.¹⁴

D. Other Issues

19. **Progress in other structural areas has been slow since the last consultation, limiting long-term growth prospects.**

- **On SOE reform,** the process of privatizing and commercializing SOEs as envisaged in the original CRP framework is yet to be completed. Since 2000, the government has sold or liquidated ten small and medium-sized SOEs (namely in fishery and livestock activity and wholesale and retail trade). In addition, its remaining shares in the electricity company were divested in early 2002. However, no action has been taken on Air Vanuatu, which was to be partially privatized in 2001.¹⁵ This and additional privatizations originally envisaged in 2002 (most notably NBV and Telecom Vanuatu) are being delayed until the authorities complete a review of their divestment strategy, which is expected by year-end. In particular, the authorities cited

¹³ Specifically, as a result of an external audit at the NBV, the bank was required to provision for an overdue claim on the AMU arising from NBV loans transferred to the AMU in 2000. Lacking sufficient resources at the AMU for repayment or at the NBV for writing down the loans, the government transferred VT 288 million (0.9 percent of GDP) to the AMU to settle its balance with the NBV.

¹⁴ Based on discussions, the staff estimates the potential cost to the government of writing off nonrecoverable NPLs at the AMU to be VT 1 billion (3 percent of GDP).

¹⁵ Instead, the government merged and subsequently de-merged Air Vanuatu with Vanair (an inter-island carrier) in 2001, which further weakened the airline's financial condition.

the need to find ways to counter an expected fall in government revenue from further divestment. As most of the 20 wholly or partially-owned SOEs are loss-making, the staff urged a more aggressive approach to downsizing the public sector, noting a loss in government revenue could be offset by limits on tax exemptions extended to new owners.

- On **trade reform**, WTO accession stalled just prior to completion in late 2001 because of requests for wider sector openings and lower binding rates—mainly from the United States.¹⁶ The authorities cited the need to build internal political support to reconcile these differences, which the staff encouraged be done quickly to build on the progress so far. The authorities are also pursuing commitments under the Melanesian Spearhead Group (MSG) trade agreement¹⁷ and seeking ratification of the Pacific Island Countries Trade Agreement (PICTA), which the staff welcomed. The MSG is seen as a stepping stone to the PICTA, under which the maximum tariff rate with the 13 other Pacific Island Forum countries is expected to fall from the current 30 percent to 25 percent by January 2004 and gradually to zero by 2012.
- In the areas of **private sector development and FDI**, the authorities recognized that prospects depended on swift and effective actions to reduce administrative constraints, including streamlining land procurement and business licensing procedures. They also noted concerns about the effect of Vanuatu's cost structure on new business development, citing plans to establish a body to regulate utility prices, which are high by regional standards. The staff cautioned against the use of direct price controls on general commodities, in light of the reactivation of the Price Control Board in 2001, which at this stage is only monitoring price developments.

20. **The authorities have made a number of improvements recently in statistical methods and reporting**, which should assist in policy formulation and monitoring (Annex V). In two of the weaker statistical areas—national income accounts and the balance of payments—work is ongoing to improve accuracy and coverage with donor technical assistance. Surveillance is expected to be enhanced by the authorities' commitment to provide regular and timely updates of key economic and financial data. The staff also encouraged Vanuatu's timely participation in the Fund's General Data Dissemination System (GDSS).

¹⁶ Vanuatu rates a 4 on the Fund's index of trade restrictiveness, with a 10 being the most restrictive. The basic tariff structure consists of seven bands ranging from 0–30 percent. In addition, selected items, such as some prepared foods, attract up to a 55 percent rate. Alcohol and tobacco products, fuel, and paint have specific duties, which currently are as high as 125 percent on an *ad valorem* basis.

¹⁷ The MSG comprises Fiji, Papua New Guinea, Solomon Islands, and Vanuatu. Currently, it is aimed at facilitating duty-free import of manufactured products from other member states.

IV. STAFF APPRAISAL

21. **Vanuatu faces a number of challenges to address recent poor growth performance and a weakened external situation.** To its credit, macroeconomic stability has been maintained and external vulnerability is still manageable, despite frequent shocks and an uncertain policy environment. However, growth continues to trend downward, which points to the need to bolster external competitiveness and, in turn, expand productive opportunities. Medium-term prospects hinge on further actions on the fiscal and structural front. Given the low and declining level of per capita income, decisive steps are needed to deepen the reform agenda. Otherwise, Vanuatu risks further eroded competitiveness and diminished growth prospects, which could act to undermine macroeconomic stability and increase political and social tensions as a result of limited employment opportunities and rising urban drift.
22. **The overall fiscal situation has improved, but substantial additional actions are needed to achieve lasting fiscal consolidation.** A sound fiscal policy requires a further strengthening of VAT and customs administration and improvements to expenditure control and debt management. To this end, most immediately, passage of the excise act by end 2002 is essential for revenue performance. The government wage bill must also be reduced as a share of GDP to ensure sufficient resources for key social and infrastructure needs. Government subsidies should be limited, as their recent use points to wider problems arising from a lack of export diversification and narrowness of the production base, which require far reaching solutions. Close coordination is needed with donors on a public investment program that promotes more broad-based growth with continued caution in incurring new public debt.
23. **Monetary conditions eased in the first half of 2002, but a cautious stance is expected for the year as a whole and beyond.** This will require close monitoring of the current situation by the RBV to ensure domestic liquidity conditions are consistent with the inflation prospects and the external position. In line with this, the use of central bank advances to finance the budget should be strictly limited, as it also carries the risk of undermining fiscal discipline. Additionally, steps should be taken to restrict outside interference in central bank operations to ensure sound monetary management.
24. **The external position warrants close attention to exchange rate policy and reserves management.** While the adjustable peg exchange rate arrangement is broadly appropriate, the weakening of the external position remains a source of concern. Sound macroeconomic policies and additional structural reforms would be expected to strengthen overall competitiveness and the external position. However, in the event of a further deterioration, exchange rate adjustment may be necessary. As an immediate step to maintaining reserve levels, measures to deepen the interbank foreign exchange market should be adopted, including by publicly disclosing the nature of the currency basket.
25. **Progress has been made in strengthening the regulation and supervision of the onshore banks, but more stringent oversight of the offshore banks is needed to safeguard the domestic system.** Passage of legislation aligning the onshore and offshore

supervisory regimes will serve as an important first step. There is little justification for not acting quickly and decisively in this area, when weighing the OFC's limited overall economic contribution to the domestic economy against its potential reputational harm. However, the RBV will need adequate resources and support for proper enforcement, including technical assistance.

26. **Further steps have been taken to strengthen the NBV and VNPF, but close supervision is necessary to ensure continued sound finances in order to minimize fiscal risk.** Consistent with this, a more aggressive approach should be taken by the AMU on NPL recoveries, given delays so far and limited budget resources.

27. **In other structural areas, additional reforms are needed in view of recent growth performance and the high cost structure.** SOE reform should continue without further delay, given the SOEs' poor performance and small budget contribution and the government's limited management capacity. Trade commitments need to be implemented in a timely way, including WTO accession, to improve market access and reduce costly barriers, and with a view to attracting FDI. Private investment could also benefit from a more transparent legal and regulatory framework. However, with a narrow tax base and low tax take, tax exemptions to investors should be limited in scope and applied uniformly.

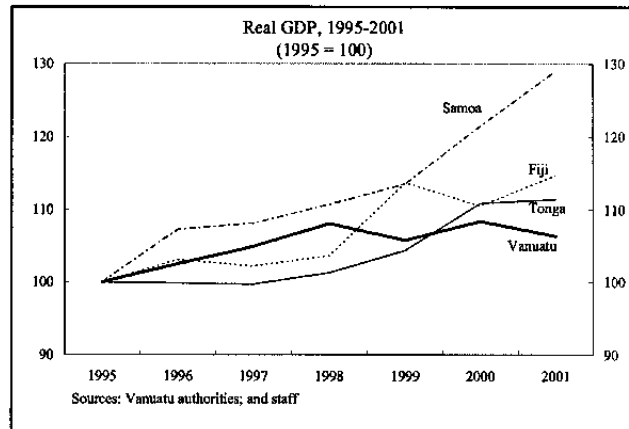
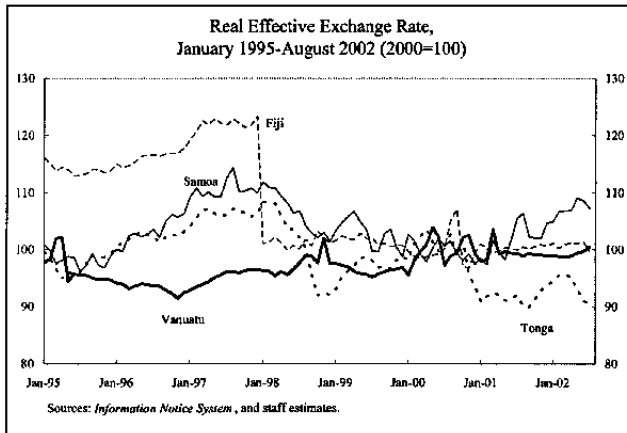
28. **Statistical reporting and coverage in Vanuatu have improved in recent years, and further changes are being made to allow more effective surveillance.** Participation in the GDDS would provide a useful foundation for setting out future commitments in statistical areas.

29. It is proposed that the next Article IV consultation with Vanuatu take place on the current 24-month cycle.

Box 1. Vanuatu—Regional Comparison of Competitiveness

Vanuatu's competitiveness vis-à-vis other countries in the region is relatively low, when considering a broad range of indicators (see table below). In real effective terms, Vanuatu's exchange rate has stayed largely unchanged since the mid 1990s. This contrasts with Fiji—the South Pacific region's largest overall economy and tourism market, which has experienced a real effective depreciation equivalent to 15 percent.

Real GDP growth in Vanuatu since the mid 1990s has also been lower than in neighboring countries. The selected issues paper for this consultation contains background notes on recent growth performance and regional competitiveness, suggesting that despite similar structures of and shocks faced by the region's economies, low growth in Vanuatu can be partly attributed to competitive disadvantages.



Other Competitiveness Indicators 1/

| | Fiji | Samoa | Tonga | Vanuatu |
|--|--------|--------|--------|---------|
| Paved roads (in percent of total roads) 2/ | 49.2 | 42.0 | 27.0 | 23.9 |
| Aircraft departures 2/ | 57,500 | 10,800 | 3,800 | 1,400 |
| Telephone mainlines per 100 residents | 10.9 | 5.6 | 9.6 | 3.5 |
| Cost of a three-minute local call (in U.S. dollars) 3/ | 0.06 | 0.11 | 0.05 | 0.20 |
| Government wage bill (in percent of total expenditure) | 38.4 | 25.3 | 51.6 | 46.2 |
| Government capital expenditure (in percent of total expenditure) | 17.6 | 38.5 | 3.8 | 18.1 |
| Domestic interest rate spread (end of year) | 7.6 | 4.4 | 4.2 | 11.3 |
| Prevailing import tariff rates (in percent) 4/ | 0 - 27 | 0 - 20 | 0 - 25 | 0 - 55 |

Sources: National authorities and telecommunications providers; World Bank, *World Development Indicators*, 2002; International Telecommunication Union, *World Telecommunication Development Report 2002*; IFS and Fund staff estimates.

1/ For 2001, unless otherwise indicated.

2/ For 2000.

3/ As of September 2002.

4/ Excludes effective rates from specific import duties and ad valorem rates on selected luxury items.

Box 2. Vanuatu—Fiscal Management and the Comprehensive Reform Program

Since the last consultation, the government has taken some further steps to improve fiscal management in the context of its Comprehensive Reform Program (CRP). At the time, the CRP was entering its final (i.e., third) phase, which among its major remaining tasks looked to put into practice the principles of sound fiscal management laid out in legal and administrative measures taken in the earlier phases. The centerpiece of these actions was the Public Financial and Expenditure Management (PFEM) Act of 1998. It, along with several other acts, requires the government to take steps to strengthen budget preparation and monitoring and fiscal reporting and information systems. To improve budget transparency, the PFEM Act also necessitates the government prepare and implement a program-based budget. In addition, the act stipulates a prudent debt management.

In the area of budget preparation and fiscal reporting, some positive steps have been taken. The government has published an annual fiscal strategy report since 1999, which reviews recent economic performance and sets out main budget objectives in the forthcoming year. Included in this is a budget policy statement, summarizing prospective policy initiatives. In keeping with the PFEM Act, the government also prepares a monthly budget report and half yearly financial and economic update for budget monitoring and control purposes, but these reports are not published. Budget estimates still tend to overinflate wage requirements, based on the use of unapproved plans by certain line ministries to expand administrative structures. As a result, operational expenditure tends to go underbudgeted. Budget execution could also improve by ensuring fiscal reports are used to provide timely feedback to ministerial departments (i.e., the spending units). A financial management information system was also introduced in mid 2002 to improve program budgeting and expenditure tracking.

Budget implementation still remains a problem owing to a tight cash situation, which has led the government to use a system of monthly warrants based on the cash plans of spending units. In addition, problems with cash management have forced the government to rely on central bank advances (limited to VT 400 million and repayable up to six months). While this has allowed the government to address temporarily the problems faced by revenue shortfalls, at times it restricts proper budget execution, owing to a lack of certainty about prospective budget releases and the lumpiness of certain budget outlays (the problem is mainly in operational expenditures of line ministries, as wages are managed centrally and capital expenditure is mostly tied to external financing). In 2002, the situation has improved, in part due to better revenue planning.

Despite steps taken under the CRP to contain the number of government personnel and reduce the government wage bill as a share of total spending, limited additional progress has been made. In the first two phases of the CRP, the number of ministries was cut from 34 to 9 (but subsequently raised to 13), and the size of the civil service was reduced by 7 percent. However, the number of government departments stayed relatively constant, and there is still some substantial overlap in tasks. In addition, the wage bill has remained generally unchanged as a share of GDP and risen as a share of total recurrent expenditure. As of end-2000, there were approximately 4,500 public workers (30 percent of formal sector employment). Concerns also remain over the hiring of advisory and contractual (i.e., temporary) personnel. To address the latter, the Ministry of Finance and Economic Management implemented system of financial visas in 2002, under which it must authorize all new hires.

The government has also set limits on borrowing in its recent budget statements, but not directly on domestic debt. Currently, the ceiling on the total stock of external public debt stands at 40 percent of GDP and on annual public debt service payments (defined as domestic and foreign interest payments and external amortization payments) at 8 percent of government revenue. Based on 2001 budget estimates, external public debt was 31 percent of GDP at end-2001 and public debt service payments (excluding debt forgiveness) were 5 percent of revenue that year.

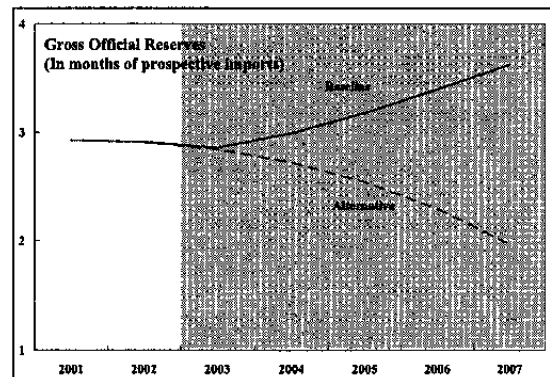
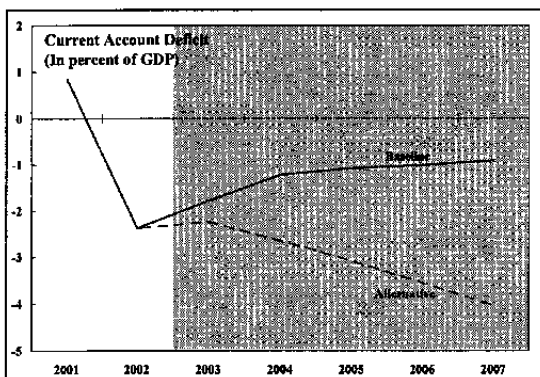
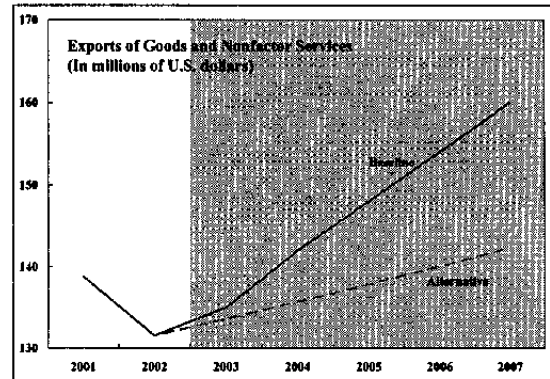
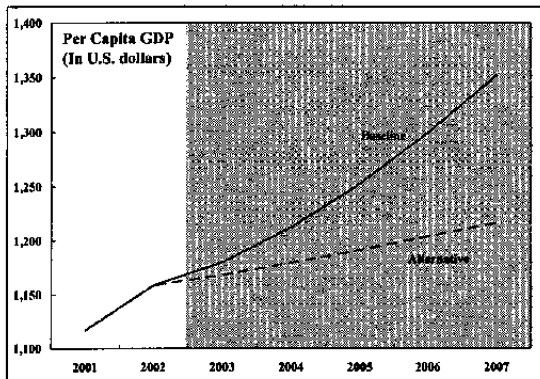
Box 3. Vanuatu—Medium-Term Outlook and Risks

Under an illustrative reform scenario and assuming no major shocks, real GDP growth in Vanuatu is envisaged to pick up to about 3 percent a year during 2003–07, rising to 4 percent by 2007 (Table 6). This would be based on an increase in productivity growth and investment activity resulting from the reforms. However, with population growth of 2½ percent a year, per capita GDP (in U.S. dollar terms) in 2007 would only be at the same level as in the mid-1990s. Inflation would be expected to stay in the range of 3–4 percent a year, reflecting prudent monetary management and declining oil prices over the medium term. Fiscal policy would be geared to maintaining low single-digit budget deficits and refocusing spending on key social and infrastructure needs, including in outer island and rural areas, in support of growth. In the event, government debt would remain sustainable, peaking at 40 percent of GDP in 2002, and slowly declining to 35 percent of GDP by 2007.

Higher sustained growth would be underpinned by an improved external position.

- The current account deficit would be expected to narrow to around 1 percent of GDP by 2005. The effects on external demand of productivity gains from structural reforms would be expected to more than offset a pick up in domestic demand, including from some impact of trade liberalization on imports.
- Official inflows would rise gradually in line with improved fiscal management, but external debt would remain at manageable levels, especially given the move to grant financing among donors. FDI inflows would also be expected to pick up in response to a more favorable investment climate, in particular in the tourism-related sectors, and also possibly in agro-processing, fisheries and livestock, and light manufacturing.
- Under these circumstances, the improved external position would allow an increase in the gross reserve cover to 3½ months of prospective imports by 2007.

The main downside risks to this scenario would arise from a lack of progress in addressing key fiscal and structural challenges. Steady implementation of a reform agenda would likely require maintenance of a stable political situation. Under a low case scenario, GDP growth would stay in the very low single digits, with the high cost structure (including real interest rates) persisting, and public spending staying oriented towards low priority outlays. The current account deficit would widen to 3–4 percent of GDP due to continued weaknesses in external demand. Official and FDI inflows would also be considerably lower. In this case, the reserve cover would continue decrease to 2 months of imports by 2007. Public external debt would stay manageable, but domestic debt would likely rise owing to a lack of revenue buoyancy and spending discipline. Pressure would weigh heavily on the exchange rate to adjust for external imbalances.



Box 4. Vanuatu—Policy Challenges and Responses

The staff noted several major policy challenges during the 2000 Article IV consultation, which are summarized in the table below. Also described are (i) the authorities' policy actions since 2000, and (ii) the staff's assessment of remaining challenges in each area made during the 2002 Article IV consultation.

| Past Policy Challenges | Authorities' Actions | Remaining Policy Challenges |
|---|---|---|
| <i>Fiscal policy</i> | | |
| Use an appropriate mix of revenue measures and spending restraint sufficient to contain the overall budget deficit and boost health and education expenditure. | The overall budget deficit fell sharply in 2001, but mainly due to lower capital spending. Some new tax sources have been tapped, but revenue continues to decline as a share of GDP, and spending restraint has been biased towards nonwage outlays. Health and education spending has risen as a share of total expenditure, but not as a share of GDP (Table 3). | The authorities shared the view that the underlying fiscal position was weak and that further decisive steps were needed to strengthen the tax system, with approval of new excises, and to redirect spending priorities, away from wages towards outlays in health and education and for other island and rural area infrastructure (see paragraph 12). |
| <i>Transparency of exchange rate policy</i> | | |
| Increase transparency about the adjustable peg exchange rate arrangement to avoid the risk of triggering speculation about policy direction. | The currency basket was adjusted in January 2002, but no details about the basket's composition and weights have been publicly disclosed. | The authorities resisted disclosure because of concerns about destabilizing speculation. The staff gave assurances this was very unlikely, and recommended periodic review and publication of the currency basket's weights and composition (see paragraph 15). |
| <i>Bank supervision</i> | | |
| Obtain a resident advisor to work closely with the Reserve Bank of Vanuatu (RBV) to enforce existing regulations on bank supervision. | An advisor from the Fund's Monetary and Exchange Affairs Department has been at the RBV since January 2002, focusing on strengthening bank supervision and bringing it in line with the Basel Core Principles. | In view of the recommendations made during Fund's Module II OFC Assessment in May 2002, the authorities will likely need follow up assistance for 2003, in particular if a new international banking act is passed giving the RBV regulatory and supervisory authority over the offshore banks (see paragraph 17 and Box 5). |
| <i>OFC and anti-money laundering (AML) activity</i> | | |
| Strengthen anti-money laundering controls by (i) improving coordination between the RBV and the Vanuatu Financial Services Commission (VFSC), and (ii) upgrading laws and administration in this area to international standards. | The Financial Transactions Report Act was approved in September 2000 setting out procedures for customer identification, record keeping, and suspicious transaction reporting. In addition, the Financial Intelligence Unit (FIU) was set up in the State Law Office in part to investigate suspicious transactions. To strengthen customer identification, the RBV also issued a "know-your-customer" regulation for domestic banks in July 2002, replacing an FIU guideline that was seen as largely ineffective. | The authorities were encouraged to adopt the remaining recommendations in the Module II OFC Assessment, including those pertaining to strengthening and enforcing anti-money laundering requirements. In addition, swift passage of the new international banking act is needed, as RBV was seen as more capable than the VFSC of regulating and supervising the offshore banks (see paragraphs 16 and 17 and Box 5). |
| <i>Statistical areas</i> | | |
| Seek technical assistance on the balance of payments and national accounts to address major shortcomings in statistical methods and reporting. | Since 2000, the authorities have received technical assistance from PFTAC (Annexes I and II) and several donors, and currently have a resident donor advisor on the national accounts. | The authorities will continue to need technical assistance in both areas, in particular as it pertains to capital and financial accounts in the balance of payments and business and informal sector surveys for the national accounts (Annex V). |

Box 5. Vanuatu—Offshore Financial Center

Background

- **Vanuatu's offshore financial center (OFC) consists of 34 banks, 15 insurance companies, and about 4,300 international companies on the corporate register.** Very few of these institutions maintain a physical presence in Vanuatu beyond the appointment of a local agent for legal purposes. The functions of the offshore banks are largely unknown, but some appear to provide in-house treasury operations for foreign firms. The offshore banks are prohibited from conducting transactions with Vanuatu residents. Domestic banks provide payments services to select offshore entities.
- **The OFC's overall contribution to the economy is small, and growth is likely to be curtailed by pending legal changes.** Originally established as a means of diversifying the economy, the offshore sector currently employs at most 150 residents (1 percent of formal sector employment). Other direct benefits (e.g., the payment of rent) are negligible. In 2001, the sector is estimated to have contributed 2 percent of total government revenue, mainly from Internet gaming and corporate registration fees.

OFC supervision

- **The legislation governing the OFC is outdated and enforcement of existing regulations is weak.** Current laws require only nominal reporting of offshore activity to the Vanuatu Financial Services Commission (VFSC), a small statutory authority charged with OFC oversight. The Module II OFC Assessment conducted by the Fund's Monetary and Exchange Affairs Department in May 2002 confirmed that the VFSC had little information on offshore banks and failed to comply with most of the Basel Core Principles in regulating and supervising the OFC. The Financial Stability Forum has included Vanuatu in Group III on OFC supervision, comprising jurisdictions falling significantly short of standards adopted by countries in Groups I and II.
- **As a result, the OFC goes largely unsupervised.** The VFSC currently lacks sufficient operational resources, independent authority, or legal support for doing this. At present, the VFSC has only 13 employees. Moreover, its board contains a number of industry representatives. Even though all offshore entities are required to register under the Companies Act, the same law contains tight secrecy provisions, which limit effective oversight. Also, as all but three offshore banks are shell operations, their supervision is nearly impossible.

Anti-money laundering requirements

- **Vanuatu has taken some steps in recent years to strengthen its anti-money laundering (AML) regulations.** The Financial Transactions Reporting Act, which was approved in September 2000, requires the reporting and investigation of suspicious transactions by the Financial Intelligence Unit of the State Law Office. As a result, Vanuatu has managed to stay of the FATF's list of noncooperative countries on money laundering.
- **Initial enforcement of AML requirements has been lax,** despite the filing of a number of suspicious transactions reports. This work has been constrained by a lack of coordination among financial regulators and inconsistency between supervisory powers and secrecy provisions. Some refinements are being made to the system to bring it into full compliance with FATF standards. A "know-your-customer" guideline issued to domestic banks in July 2002 requires domestic banks to seek greater disclosure on offshore client activities. The RBV also began on-site examination of domestic banks' AML framework recently.

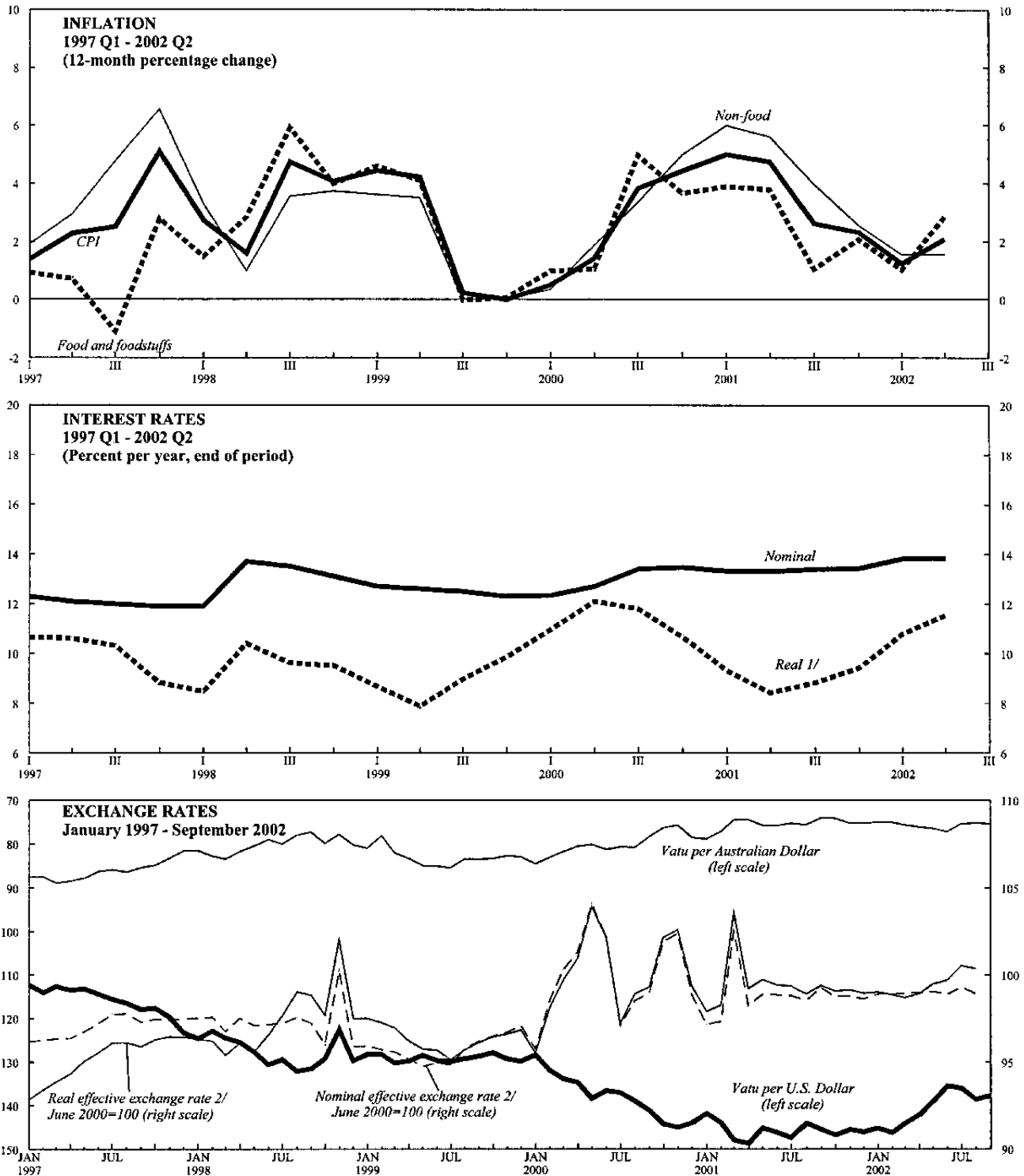
Tax haven status

- **The OECD designated Vanuatu as an uncooperative tax haven in April 2002,** along with the Marshall Islands, Nauru, and four other jurisdictions (from an original list of 35 in 2000). Removal from the list would require a commitment to improve the transparency of offshore activities and the effective exchange of information with the OECD member countries. Otherwise, Vanuatu could face OECD sanctions if no agreement is reached.

Prospects for the OFC

- **The long-term prospects for the OFC are uncertain.** The reputational damage to the banking system and to investor sentiment of promoting an offshore financial sector limits the potential benefits from its further development. Already, as a result of the U.S. Patriot Act passed in October 2001, domestic banks are experiencing greater scrutiny from foreign correspondent banks, owing to the former's proximity to and dealings with offshore entities. As a result, some recent disruption in payments clearance has been experienced, at times necessitating establishment of new correspondent relations.

Figure 1. Vanuatu: Selected Economic Indicators, 1997-2002

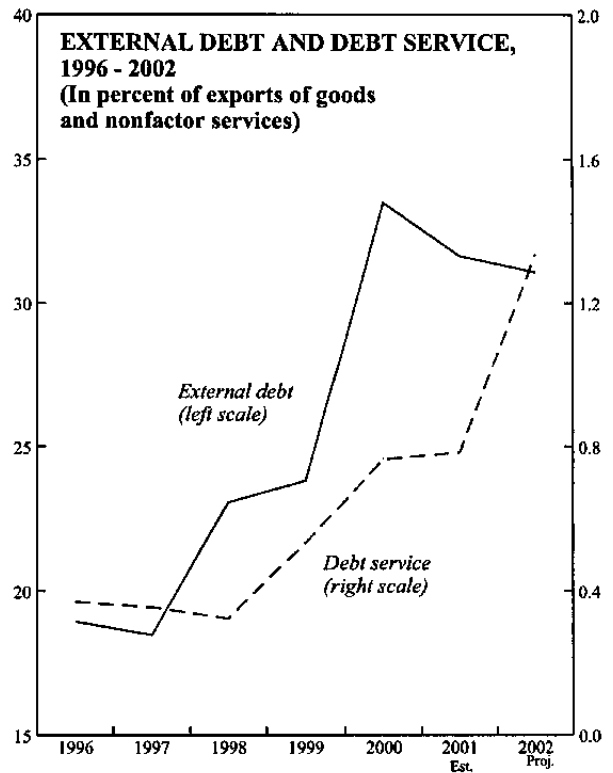
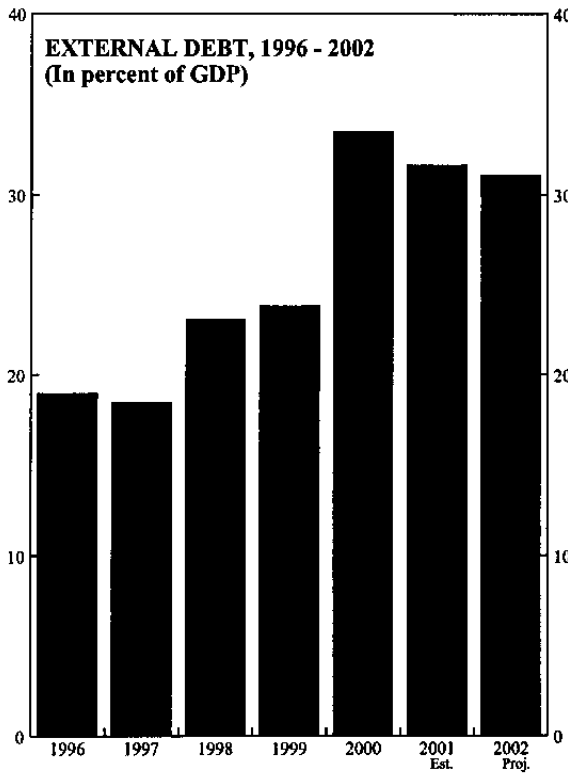
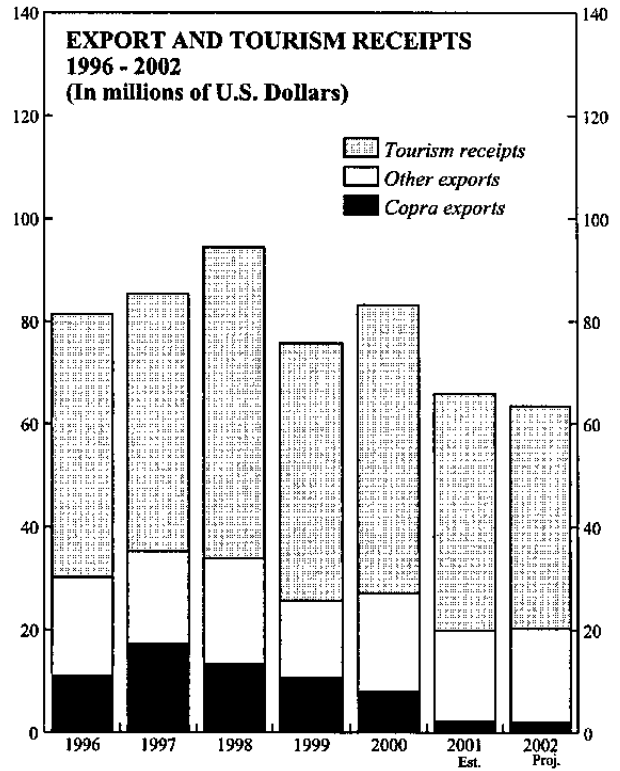
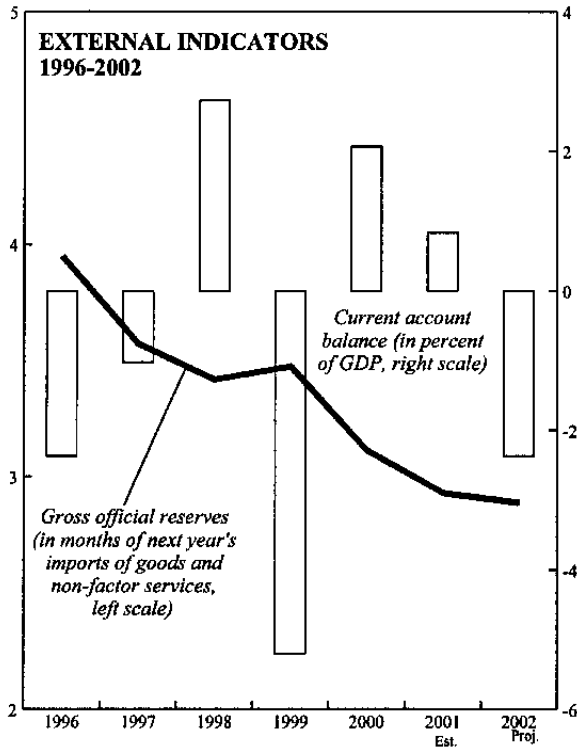


Sources: Vanuatu authorities, and Fund staff estimates.

1/ Measured with respect to a weighted average lending rate on bank loans and the four-quarter average inflation rate.

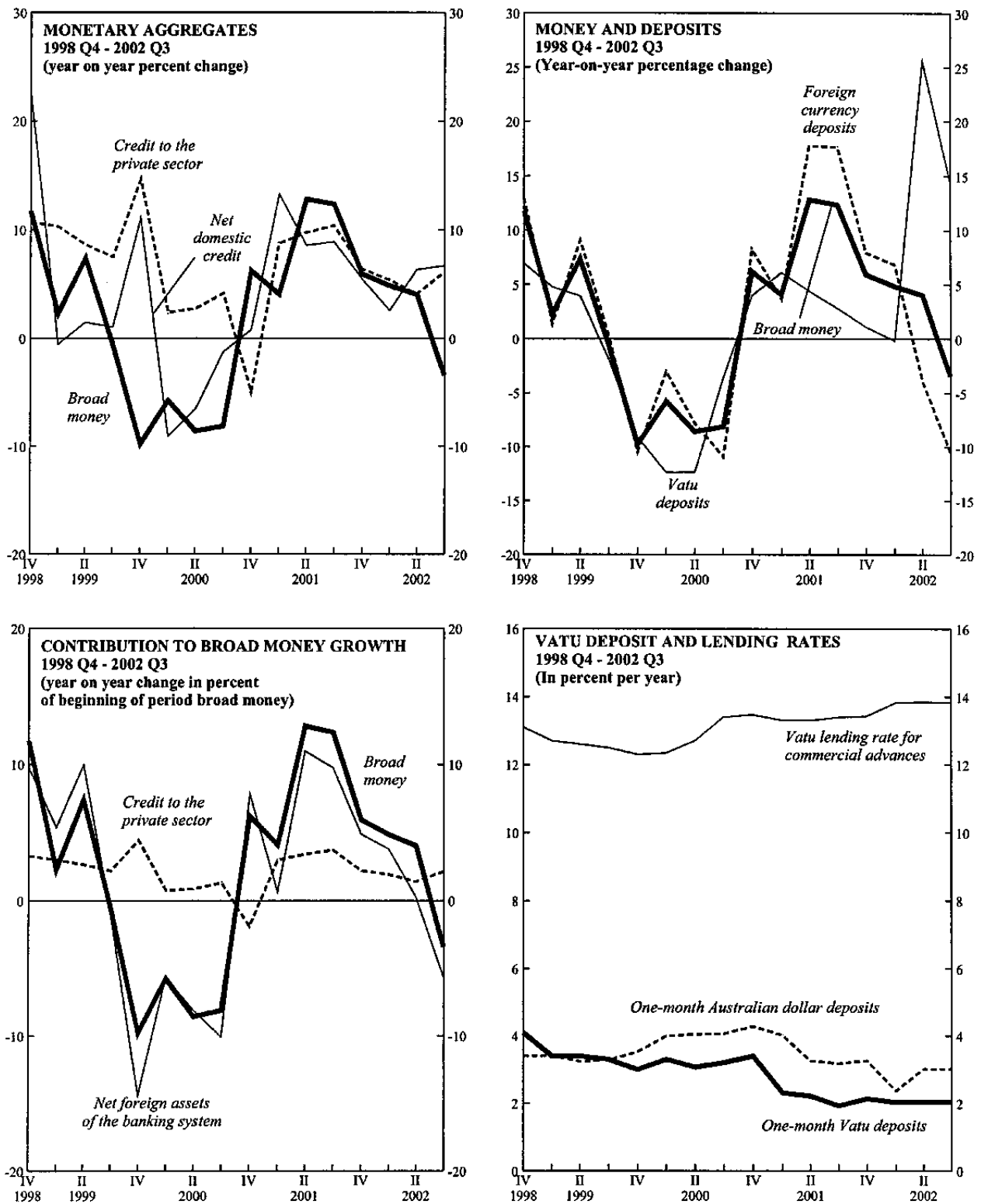
2/ Available to August 2002 and based on a transactions-weighted basket of currencies.

Figure 2. Vanuatu: External Sector Developments, 1996-2002



Sources: Vanuatu authorities, and Fund staff estimates.

Figure 3. Vanuatu: Monetary and Financial Indicators, 1998-2002 1/



Sources: Vanuatu authorities, and Fund staff estimates.

1/ Data for 2002 Q3 as of end August.

Table 1. Vanuatu: Selected Economic and Financial Indicators, 1998–2003

Nominal GDP (2001): US\$220 million
 Population (2001) 196,900
 GDP per capita (2001): US\$1,117
 Quota: SDR 17.0 million

| | 1998 | 1999 | 2000 | 2001 Est. | 2002 Staff proj. | 2002 H1 Est. 1/ | 2003 Staff proj. |
|---|-------|-------|-------|--------------|---------------------|--------------------|---------------------|
| Output and prices (annual percentage change) | | | | | | | |
| Real GDP | 3.0 | -2.1 | 2.5 | -1.9 | -0.3 | ... | 2.0 |
| Nominal GDP | 5.2 | 3.4 | 5.3 | 0.7 | 1.8 | ... | 6.1 |
| Consumer prices (period average) | 3.3 | 2.2 | 2.5 | 3.7 | 2.2 | 2.1 | 4.0 |
| Government finance (in percent of GDP) | | | | | | | |
| Total revenue and grants | 24.2 | 24.1 | 22.0 | 21.5 | 21.7 | 9.7 | 21.8 |
| Total expenditure | 31.6 | 25.3 | 29.3 | 25.2 | 22.6 | 11.9 | 23.3 |
| Overall balance (excluding onlending) | -7.4 | -1.2 | -7.3 | -3.7 | -1.0 | -2.2 | -1.5 |
| Money and credit (twelve-month change) 2/ | | | | | | | |
| Broad money (M2) | 11.7 | -9.8 | 6.2 | 5.9 | 1.5 | -3.4 3/ | 5.5 |
| Net foreign assets | 9.7 | -14.4 | 7.8 | 4.9 | -0.7 | -5.6 3/ | 4.3 |
| Domestic credit | 6.6 | 3.6 | 0.3 | 2.1 | 2.2 | 2.6 3/ | 1.2 |
| Credit to private sector | 3.3 | 4.4 | -1.9 | 2.2 | 1.5 | 2.1 3/ | 2.0 |
| (annual percentage change) | 10.7 | 14.6 | -4.9 | 6.4 | 4.2 | 6.1 3/ | 5.7 |
| Interest rates (in percent, end of period) 4/ | | | | | | | |
| Deposit rate (Australian dollar) 5/ | 3.4 | 3.6 | 4.3 | 3.3 | ... | 3.0 | ... |
| Deposit rate (vatu) | 4.1 | 3.0 | 3.4 | 2.1 | ... | 2.0 | ... |
| Lending rate (vatu) | 13.1 | 12.3 | 13.5 | 13.4 | ... | 13.8 | ... |
| Current account (in millions of U.S. dollars) | | | | | | | |
| (in percent of GDP) | 6.2 | -12.2 | 4.7 | 1.8 | -5.6 | ... | -4.4 |
| Exports, f.o.b. (in millions of U.S. dollars) | 2.7 | -5.2 | 2.1 | 0.8 | -2.4 | ... | -1.8 |
| (annual percentage change) | 33.9 | 25.7 | 27.1 | 19.9 | 20.3 | 8.9 | 21.0 |
| Imports, f.o.b. (in millions of U.S. dollars) | -3.9 | -24.3 | 5.6 | -26.7 | 2.0 | 5.7 | 3.5 |
| (annual percentage change) | 76.4 | 83.5 | 77.2 | 77.8 | 79.2 | 42.3 | 82.3 |
| | -6.6 | 11.1 | -9.1 | 1.1 | 2.0 | -10.3 | 4.0 |
| Gross official reserves (end of period) | | | | | | | |
| In millions of U.S. dollars | 44.3 | 42.7 | 39.1 | 37.7 | 37.9 | 36.7 6/ | 39.2 |
| In months of prospective imports 7/ | 3.4 | 3.5 | 3.1 | 2.9 | 2.9 | 2.9 | 2.9 |
| External debt | | | | | | | |
| External debt (in percent of GDP) 8/ | 23.1 | 23.8 | 33.5 | 31.6 | 31.1 | ... | 30.1 |
| External debt service 9/ | 0.3 | 0.5 | 0.8 | 0.8 | 1.3 | ... | 1.7 |
| Exchange rates (period average) | | | | | | | |
| Exchange rate regime: Pegged to an undisclosed basket of currencies | | | | | | | |
| Vatu per U.S. dollar (period average) | 127.5 | 129.1 | 138.3 | 145.7 | ... | 138.2 10/ | ... |
| Real effective exchange rate (12-month average, 1990=100) | 97.4 | 96.4 | 100.0 | 99.4 | ... | 100.4 3/ | ... |
| (annual percentage change) | 2.3 | -1.1 | 3.8 | -0.6 | ... | -0.6 | ... |
| Memorandum items: | | | | | | | |
| GDP (nominal, in billions of vatu) | 29.2 | 30.2 | 31.8 | 32.1 | 32.6 | ... | 34.6 |
| Per capita GDP (in U.S. dollars) | 1,258 | 1,254 | 1,200 | 1,117 | 1,159 | ... | 1,180 |
| Population growth (annual percentage change) | 2.6 | 2.6 | 2.7 | 2.7 | 2.7 | ... | 2.6 |

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

1/ Official estimate of performance in the first half of 2002, unless otherwise indicated.

2/ Change in percent of beginning of period broad money.

3/ August 2002.

4/ Weighted average rate of interest.

5/ Unweighted rate of interest on one-month bank deposits.

6/ As of end-August 2002.

7/ Imports of goods (for domestic consumption) and nonfactor services.

8/ Medium- and long-term public debt only.

9/ In percent of exports of goods and nonfactor services.

10/ As of September 30, 2002.

Table 2. Vanuatu: Balance of Payments, 2000–2007 1/
(In millions of U.S. dollars, unless otherwise indicated)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|--|-------|-------|-------|-------|-------|-------|-------|-------|
| | | Est. | | | Proj. | | | |
| Current account balance | 4.7 | 1.8 | -5.6 | -4.4 | -3.1 | -2.9 | -2.9 | -2.8 |
| (excluding official transfers) | -13.4 | -11.6 | -22.2 | -21.4 | -21.1 | -22.2 | -23.4 | -24.8 |
| Trade balance | -50.0 | -58.0 | -58.9 | -61.4 | -64.6 | -68.7 | -73.4 | -78.8 |
| Exports (f.o.b.) | 27.1 | 19.9 | 20.3 | 21.0 | 21.8 | 22.9 | 24.2 | 25.6 |
| Domestic exports | 24.2 | 15.8 | 15.9 | 16.5 | 17.1 | 18.0 | 19.0 | 20.1 |
| Re-exports | 3.0 | 4.1 | 4.3 | 4.5 | 4.7 | 4.9 | 5.2 | 5.5 |
| Imports (f.o.b.) | 77.2 | 77.8 | 79.2 | 82.3 | 86.5 | 91.6 | 97.6 | 104.4 |
| Domestic consumption | 75.0 | 74.9 | 76.1 | 79.1 | 83.1 | 88.1 | 93.8 | 100.4 |
| Imports for re-exports | 2.2 | 2.9 | 3.1 | 3.2 | 3.4 | 3.6 | 3.8 | 4.1 |
| Services balance | 58.8 | 46.1 | 44.4 | 48.0 | 52.0 | 55.0 | 58.0 | 61.0 |
| Receipts | 129.3 | 118.9 | 119.5 | 123.0 | 130.0 | 136.0 | 142.0 | 148.0 |
| Of which: travel | 56.0 | 46.0 | 43.2 | 47.0 | 50.8 | 55.3 | 60.3 | 65.7 |
| Payments | 70.4 | 72.8 | 75.2 | 75.0 | 78.0 | 81.0 | 84.0 | 87.0 |
| Income | -12.9 | -4.0 | -3.1 | -4.0 | -4.0 | -3.5 | -3.0 | -2.0 |
| Receipts | 18.7 | 17.2 | 19.1 | 19.0 | 20.0 | 21.5 | 23.0 | 25.0 |
| Payments | 31.6 | 21.1 | 22.1 | 23.0 | 24.0 | 25.0 | 26.0 | 27.0 |
| Current transfers (net) | 8.9 | 17.7 | 12.1 | 13.0 | 13.5 | 14.3 | 15.5 | 17.0 |
| Official current transfers (net) | 18.1 | 13.5 | 16.6 | 17.0 | 18.0 | 19.3 | 20.5 | 22.0 |
| Private current transfers (net) | -9.2 | 4.2 | -4.6 | -4.0 | -4.5 | -5.0 | -5.0 | -5.0 |
| Capital and financial account | -2.6 | -10.4 | 5.8 | 5.7 | 7.0 | 8.0 | 9.0 | 10.5 |
| Capital account | -20.0 | -15.9 | -6.5 | -1.3 | -2.0 | -3.0 | -4.0 | -4.5 |
| Official capital transfers (net) | 10.6 | 11.8 | 12.2 | 13.0 | 13.5 | 14.0 | 14.5 | 15.0 |
| Private capital transfers (net) | -30.6 | -27.7 | -18.7 | -14.3 | -15.5 | -17.0 | -18.5 | -19.5 |
| Financial account | 17.4 | 5.5 | 12.2 | 7.0 | 9.0 | 11.0 | 13.0 | 15.0 |
| Foreign direct investment | 20.2 | 17.9 | 15.1 | 18.6 | 22.1 | 25.6 | 29.1 | 32.6 |
| Portfolio investment (net) | 0.7 | -4.3 | -1.4 | 0.0 | 0.5 | 1.0 | 1.5 | 2.0 |
| Government | 15.9 | -3.4 | 0.0 | 1.9 | 2.3 | 2.3 | 2.2 | 2.0 |
| Disbursements | 16.6 | 3.2 | 1.1 | 3.5 | 4.0 | 4.0 | 4.0 | 4.0 |
| Amortization | -0.8 | -6.6 | -1.1 | -1.6 | -1.7 | -1.7 | -1.8 | -2.0 |
| Other investment (net) | -19.4 | -4.7 | -1.4 | -11.6 | -13.6 | -15.6 | -17.6 | -19.6 |
| Of which: commercial banks | -19.4 | -11.9 | 0.1 | -14.2 | -16.6 | -19.0 | -21.5 | -23.9 |
| Net errors and omissions | -7.4 | 1.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Overall balance | -5.3 | -7.2 | 0.2 | 1.3 | 3.9 | 5.1 | 6.1 | 7.7 |
| Financing | 5.3 | 7.2 | -0.2 | -1.3 | -3.9 | -5.1 | -6.1 | -7.7 |
| Change in net official reserves of the Reserve Bank of Vanuatu (-, increase) | 5.3 | 1.2 | -0.2 | -1.3 | -3.9 | -5.1 | -6.1 | -7.7 |
| Debt forgiveness 2/ | 0.0 | 6.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Memorandum items: | | | | | | | | |
| Gross official reserves (in million U.S. dollars) | 39.1 | 37.7 | 37.9 | 39.2 | 43.1 | 48.1 | 54.2 | 61.9 |
| (in months of prospective imports) | 6.0 | 5.7 | 5.5 | 5.4 | 5.6 | 5.9 | 6.2 | 6.6 |
| (in months of prospective imports of goods and nonfactor services) | 3.1 | 2.9 | 2.9 | 2.9 | 3.0 | 3.2 | 3.4 | 3.6 |
| Exports (annual percentage change) | 5.6 | -26.7 | 2.0 | 3.5 | 4.0 | 5.0 | 5.5 | 6.0 |
| Imports (annual percentage change) | -9.1 | 1.1 | 2.0 | 4.0 | 5.0 | 6.0 | 6.5 | 7.0 |
| Current account balance (in percent of GDP) | 2.1 | 0.8 | -2.4 | -1.8 | -1.3 | -1.1 | -1.1 | -1.0 |
| (excluding official transfers) | -5.8 | -5.3 | -9.5 | -8.8 | -8.4 | -8.6 | -8.7 | -8.9 |

Source: Vanuatu authorities; and Fund staff estimates and projections.

1/ Data for 2000 and 2001 are converted from vatu to U.S. dollars using annual average exchange rate.

2/ In 2001, the outstanding balance on a loan from China for construction of the University of the South Pacific Law School was forgiven.

Table 3. Vanuatu: Central Government Fiscal Operations, 1998–2002

(In millions of vatu)

| | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|---|--------|-------|--------|--------|--------|--------|-------------|
| | | | | Budget | Est. | Budget | Staff proj. |
| Total revenue and grants | 7,054 | 7,278 | 6,996 | 7,700 | 6,887 | 7,477 | 7,077 |
| Revenue | 6,683 | 6,753 | 6,623 | 6,889 | 6,446 | 7,020 | 6,652 |
| Tax | 5,932 | 5,925 | 5,919 | 6,257 | 5,786 | 6,380 | 5,850 |
| Income and profits | 113 | 64 | 64 | 67 | 61 | 72 | 72 |
| Goods and services | 2,669 | 3,371 | 3,366 | 3,600 | 3,336 | 3,589 | 3,505 |
| <i>Of which</i> : VAT | 861 | 2,285 | 2,462 | 2,460 | 2,361 | 2,506 | 2,233 |
| International trade 1/ | 3,100 | 2,436 | 2,406 | 2,543 | 2,292 | 2,669 | 2,223 |
| Other | 50 | 55 | 83 | 47 | 97 | 50 | 50 |
| Nontax | 744 | 797 | 682 | 483 | 648 | 473 | 536 |
| Capital revenue | 7 | 31 | 22 | 149 | 12 | 167 | 267 |
| Grants 2/ | 371 | 525 | 373 | 811 | 440 | 457 | 424 |
| Total expenditure and net lending | 10,111 | 7,652 | 9,372 | 8,001 | 8,082 | 8,073 | 7,393 |
| (excluding net lending) | 9,220 | 7,654 | 9,323 | 8,001 | 8,082 | 8,073 | 7,393 |
| Current expenditure | 6,402 | 6,509 | 6,755 | 6,622 | 6,622 | 6,896 | 6,528 |
| Wages and salaries | 3,478 | 3,592 | 3,757 | 3,797 | 3,734 | 4,078 | 3,594 |
| Purchases of goods and services | 1,857 | 1,909 | 2,022 | 1,729 | 1,840 | 1,717 | 1,807 |
| Transfers 3/ | 863 | 762 | 738 | 827 | 800 | 820 | 820 |
| Interest payments | 204 | 247 | 239 | 269 | 248 | 282 | 308 |
| Capital expenditure 4/ | 2,818 | 1,145 | 2,567 | 1,379 | 1,460 | 1,177 | 865 |
| Net lending | 891 | -2 | 50 | 0 | 0 | 0 | 0 |
| Overall balance (excluding net lending) | -2,166 | -376 | -2,327 | -301 | -1,196 | -596 | -316 |
| (including net lending) | -3,057 | -375 | -2,376 | -301 | -1,196 | -596 | -316 |
| Financing | 3,057 | 375 | 2,376 | 301 | 1,196 | 596 | 316 |
| Foreign (net) | 1,373 | 643 | 2,198 | 301 | 388 | 597 | 3 |
| Borrowing | 1,374 | 680 | 2,301 | 445 | 468 | 750 | 150 |
| Amortization | 1 | 37 | 104 | 144 | 80 | 153 | 147 |
| Domestic (net) | 1,684 | -268 | 179 | 0 | 808 | 0 | 313 |
| Banking system (net) | 1,292 | -241 | 630 | 0 | -215 | 0 | 295 |
| Nonbank (net) 5/ | 392 | -27 | -451 | 0 | 1,023 | 0 | 18 |
| Memorandum items: | | | | | | | |
| Social expenditure | 2,651 | 2,658 | 2,811 | ... | 2,906 | 2,999 | ... |
| <i>Of which</i> : education | 1,582 | 1,732 | 1,843 | ... | 1,925 | 2,018 | ... |
| health | 819 | 842 | 878 | ... | 902 | 900 | ... |
| Current balance | 274 | 212 | -154 | 118 | -188 | -43 | -142 |
| Central government debt | 8,896 | 9,657 | 13,081 | 12,509 | 12,847 | 12,753 | 13,164 |
| Domestic | 2,157 | 2,461 | 2,431 | 2,515 | 2,706 | 2,706 | 3,019 |
| External | 6,739 | 7,197 | 10,650 | 9,995 | 10,141 | 10,046 | 10,144 |

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

1/ Net of tax rebate for import duties.

2/ Cash grants only.

3/ Excludes transfers to the Development Fund.

4/ For 2001 estimate and 2002 projection, includes capital transfers to the Vanuatu National Provident Fund of VT 325 million and to the Asset Management Unit of VT 288 million, respectively.

5/ Includes statistical discrepancy.

Table 3. Vanuatu: Central Government Fiscal Operations, 1998–2002 (concluded)

(In percent of GDP)

| | 1998 | 1999 | 2000 | 2001 | | 2002 | |
|--|-------|------|------|--------|------|--------|-------------|
| | | | | Budget | Est. | Budget | Staff proj. |
| Total revenue and grants | 24.2 | 24.1 | 22.0 | 24.2 | 21.5 | 22.0 | 21.7 |
| Revenue | 22.9 | 22.3 | 20.8 | 21.6 | 20.1 | 20.7 | 20.4 |
| Tax | 20.3 | 19.6 | 18.6 | 19.7 | 18.1 | 18.8 | 17.9 |
| Income and profits | 0.4 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Goods and services | 9.1 | 11.2 | 10.6 | 11.3 | 10.4 | 10.6 | 10.7 |
| Of which : VAT | 2.9 | 7.6 | 7.7 | 7.7 | 7.4 | 7.4 | 6.8 |
| International trade 1/ | 10.6 | 8.1 | 7.6 | 8.0 | 7.2 | 7.9 | 6.8 |
| Other | 0.2 | 0.2 | 0.3 | 0.1 | 0.3 | 0.1 | 0.2 |
| Nontax | 2.5 | 2.6 | 2.1 | 1.5 | 2.0 | 1.4 | 1.6 |
| Capital revenue | 0.0 | 0.1 | 0.1 | 0.5 | 0.0 | 0.5 | 0.8 |
| Grants 2/ | 1.3 | 1.7 | 1.2 | 2.5 | 1.4 | 1.3 | 1.3 |
| Total expenditure and net lending (excluding net lending) | 34.6 | 25.3 | 29.5 | 25.1 | 25.2 | 23.8 | 22.6 |
| Current expenditure | 31.6 | 25.3 | 29.3 | 25.1 | 25.2 | 23.8 | 22.6 |
| Wages and salaries | 21.9 | 21.5 | 21.2 | 20.8 | 20.7 | 20.3 | 20.0 |
| Purchases of goods and services | 11.9 | 11.9 | 11.8 | 11.9 | 11.6 | 12.0 | 11.0 |
| Transfers 3/ | 6.4 | 6.3 | 6.4 | 5.4 | 5.7 | 5.1 | 5.5 |
| Interest payments | 3.0 | 2.5 | 2.3 | 2.6 | 2.5 | 2.4 | 2.5 |
| Capital expenditure 4/ | 0.7 | 0.8 | 0.7 | 0.8 | 0.8 | 0.8 | 0.9 |
| Net lending | 9.6 | 3.8 | 8.1 | 4.3 | 4.6 | 3.5 | 2.6 |
| Overall balance (excluding net lending) | 3.1 | 0.0 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| (including net lending) | -7.4 | -1.2 | -7.3 | -0.9 | -3.7 | -1.8 | -1.0 |
| | -10.5 | -1.2 | -7.5 | -0.9 | -3.7 | -1.8 | -1.0 |
| Financing | 10.5 | 1.2 | 7.5 | 0.9 | 3.7 | 1.8 | 1.0 |
| Foreign (net) | 4.7 | 2.1 | 6.9 | 0.9 | 1.2 | 1.8 | 0.0 |
| Borrowing | 4.7 | 2.3 | 7.2 | 1.4 | 1.5 | 2.2 | 0.5 |
| Amortization | 0.0 | 0.1 | 0.3 | 0.5 | 0.2 | 0.5 | 0.4 |
| Domestic (net) | 5.8 | -0.9 | 0.6 | 0.0 | 2.5 | 0.0 | 1.0 |
| Banking system (net) | 4.4 | -0.8 | 2.0 | -2.0 | -0.7 | 0.0 | 0.9 |
| Nonbank (net) 5/ | 1.3 | -0.1 | -1.4 | 1.4 | 3.2 | 0.0 | 0.1 |
| Memorandum items: | | | | | | | |
| Social expenditure | 9.1 | 8.8 | 8.8 | ... | 9.1 | 8.8 | ... |
| Of which : education | 5.4 | 5.7 | 5.8 | ... | 6.0 | 5.9 | ... |
| health | 2.8 | 2.8 | 2.8 | ... | 2.8 | 2.6 | ... |
| Current balance | 0.9 | 0.7 | -0.5 | 0.4 | -0.6 | -0.1 | -0.4 |
| Central government debt | 30.5 | 32.0 | 41.1 | 39.3 | 40.1 | 37.5 | 40.3 |
| Domestic | 7.4 | 8.1 | 7.6 | 7.9 | 8.4 | 8.0 | 9.2 |
| External | 23.1 | 23.8 | 33.5 | 31.4 | 31.6 | 29.6 | 31.1 |
| Debt service-to-revenue | 3.1 | 4.2 | 5.2 | 6.0 | 5.1 | 6.2 | 6.8 |

Sources: Vanuatu authorities; and Fund staff estimates and projection.

1/ Net of tax rebate for import duties.

2/ Cash grants only.

3/ Excludes transfers to the Development Fund.

4/ For 2001 estimate and 2002 projection, includes capital transfers to the Vanuatu National Provident Fund of VT 325 million and to the Asset Management Unit of VT 288 million, respectively.

5/ Includes statistical discrepancy.

Table 4. Vanuatu: Monetary Survey, 1999–2002

| | 1999 | 2000 | 2001 | | | | 2002 | | | |
|---|--------|--------|--------|--------|--------|--------|--------|--------|-----------|------------|
| | | | March | June | Sept. | Dec. | March | June | Aug. Est. | Dec. Proj. |
| (In millions of vatu; end of period) | | | | | | | | | | |
| Net foreign assets | 22,205 | 24,677 | 24,318 | 26,753 | 25,739 | 26,312 | 25,581 | 26,834 | 23,673 | 26,058 |
| Monetary Authorities 1/ | 5,406 | 5,471 | 5,072 | 4,850 | 5,098 | 5,375 | 5,168 | 5,008 | 4,770 | 5,125 |
| Commercial banks | 16,799 | 19,206 | 19,246 | 21,904 | 20,641 | 20,937 | 20,413 | 21,826 | 18,903 | 20,933 |
| Net domestic assets | 9,405 | 8,895 | 9,142 | 8,522 | 9,366 | 9,246 | 9,500 | 9,867 | 10,276 | 10,033 |
| Domestic credit | 12,536 | 12,638 | 13,367 | 13,041 | 13,894 | 13,327 | 13,710 | 13,867 | 14,330 | 14,107 |
| Claims on government (net) | 290 | 920 | 1,290 | 839 | 1,299 | 705 | 820 | 1,023 | 1,223 | 1,000 |
| Claims on municipalities | 4 | 3 | 5 | 4 | 4 | 5 | 0 | 0 | 0 | 0 |
| Claims on nonfinancial public enterprises | 85 | 158 | 184 | 179 | 277 | 322 | 362 | 334 | 340 | 300 |
| Claims on private sector | 12,158 | 11,556 | 11,889 | 12,019 | 12,315 | 12,295 | 12,528 | 12,510 | 12,767 | 12,808 |
| Other items (net) | -3,131 | -3,743 | -4,225 | -4,520 | -4,528 | -4,081 | -4,210 | -4,000 | -4,054 | -4,074 |
| Total broad money | 31,610 | 33,571 | 33,459 | 35,275 | 35,105 | 35,558 | 35,081 | 36,701 | 33,949 | 36,092 |
| Narrow money | 4,543 | 4,769 | 4,741 | 4,559 | 4,772 | 5,036 | 4,908 | 5,717 | 6,499 | ... |
| Currency outside banks | 1,936 | 1,834 | 1,718 | 1,716 | 1,834 | 1,941 | 1,826 | 1,837 | 2,150 | ... |
| Demand deposits (vatu) | 2,607 | 2,935 | 3,023 | 2,843 | 2,938 | 3,095 | 3,082 | 3,880 | 4,348 | ... |
| Quasi-money | 27,067 | 28,802 | 28,718 | 30,716 | 30,333 | 30,523 | 30,173 | 30,984 | 27,450 | ... |
| Time and savings deposits (vatu) | 6,371 | 6,401 | 6,374 | 6,021 | 6,226 | 6,344 | 6,299 | 7,255 | 6,089 | ... |
| Demand deposits in foreign currency | 2,689 | 3,116 | 3,335 | 4,219 | 3,203 | 2,880 | 3,363 | 5,498 | 5,038 | ... |
| Time and savings deposits in foreign currency | 18,006 | 19,286 | 19,010 | 20,477 | 20,904 | 21,299 | 20,511 | 18,232 | 16,323 | ... |
| (Annual percentage change) | | | | | | | | | | |
| Total broad money | -9.8 | 6.2 | 4.1 | 12.8 | 12.4 | 5.9 | 4.8 | 4.0 | -3.4 | 1.5 |
| Narrow money | -5.4 | 5.0 | 10.7 | 6.7 | 5.1 | 5.6 | 3.5 | 25.4 | 43.2 | 35.6 |
| Quasi-money | -10.5 | 6.4 | 3.1 | 13.8 | 13.6 | 6.0 | 5.1 | 0.9 | -17.0 | -4.1 |
| Foreign currency deposits | -10.5 | 8.2 | 3.7 | 17.8 | 17.6 | 7.9 | 6.8 | -3.9 | -10.5 | ... |
| Vatu broad money | -8.4 | 2.3 | 4.9 | 2.8 | 2.3 | 1.9 | 0.8 | 22.6 | 14.4 | ... |
| Net domestic assets | 21.2 | -5.4 | 13.7 | 7.3 | 9.5 | 4.0 | 3.9 | 15.8 | 8.6 | 8.5 |
| Domestic credit | 11.1 | 0.8 | 13.3 | 8.6 | 8.9 | 5.4 | 2.6 | 6.3 | 6.7 | 5.9 |
| Private sector credit | 14.6 | -4.9 | 8.7 | 9.7 | 10.4 | 6.4 | 5.4 | 4.1 | 6.1 | 4.2 |
| Memorandum items: | | | | | | | | | | |
| Foreign currency deposits (in millions of vatu) | 20,696 | 22,401 | 22,345 | 24,695 | 24,107 | 24,179 | 23,874 | 23,729 | 21,361 | ... |
| (in millions of U.S. dollars) | 160.6 | 156.9 | 149.2 | 168.2 | 162.0 | 164.8 | 166.3 | 175.3 | 155.7 | ... |
| (in percent of of total deposits) | 69.7 | 70.6 | 70.4 | 73.6 | 72.5 | 71.9 | 71.8 | 68.1 | 67.2 | ... |
| GDP/narrow money | 6.7 | 6.7 | ... | ... | ... | 6.4 | ... | ... | ... | ... |
| GDP/vatu broad money | 2.8 | 2.8 | ... | ... | ... | 2.8 | ... | ... | ... | ... |
| GDP/total broad money | 1.0 | 0.9 | ... | ... | ... | 0.9 | ... | ... | ... | 1.0 |

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

1/ Reserve Bank of Vanuatu and small Treasury foreign exchange operations.

Table 5. Vanuatu: Vulnerability Indicators, 1998-2002
(In percent of GDP, unless otherwise indicated)

| | 1998 | 1999 | 2000 | 2001 | 2002 Staff proj. |
|--|-------|-------|-------|-------|---------------------|
| Financial sector risk indicators | | | | | |
| Public debt 1/ | 30.5 | 32.0 | 41.1 | 40.1 | 40.3 |
| Broad money (percent change, 12-month basis) | 11.7 | -9.8 | 6.2 | 5.9 | 1.5 |
| Private sector credit (percent change, 12-month basis) | 10.7 | 14.6 | -4.9 | 6.4 | 4.2 |
| Share of deposits in broad money (in percent, end of period) | 94.2 | 93.9 | 94.5 | 94.5 | ... |
| Share of foreign currency deposits in total deposits (in percent, end of period) | 70.1 | 69.7 | 70.6 | 71.9 | ... |
| External indicators | | | | | |
| Exports (percent change, 12-month basis in U.S. dollars) | -3.9 | -24.3 | 5.6 | -26.7 | 2.0 |
| Imports (percent change, 12-month basis in U.S. dollars) | -6.5 | 11.1 | -9.1 | 1.1 | 2.0 |
| Current account balance | 2.7 | -5.2 | 2.1 | 0.8 | -2.4 |
| Capital and financial account balance (in millions of U.S. dollars) | -7.3 | 6.0 | -2.6 | -10.4 | 5.8 |
| <i>Of which: inward foreign direct investment</i> | 20.4 | 13.4 | 20.2 | 17.9 | 15.1 |
| Gross official reserves (in millions of U.S. dollars) | 44.3 | 42.7 | 39.1 | 37.7 | 37.9 |
| (in months of prospective imports) 2/ | 3.4 | 3.5 | 3.1 | 2.9 | 2.9 |
| (in percent of broad money) | 16.4 | 17.4 | 16.6 | 15.6 | 15.0 |
| Central bank foreign liabilities (in millions of U.S. dollars) | 0.2 | 1.7 | 1.6 | 1.8 | ... |
| Central bank foreign currency exposure 3/ | 0.4 | 4.0 | 4.1 | 4.9 | ... |
| Foreign assets of commercial banks (in millions of U.S. dollars) | 190.0 | 164.3 | 160.6 | 177.2 | ... |
| Foreign liabilities of commercial banks (in millions of U.S. dollars) | 25.0 | 33.9 | 26.2 | 29.5 | ... |
| Foreign currency exposure of commercial banks 3/ | 13.2 | 20.7 | 16.3 | 16.6 | ... |
| Total external debt (in percent of GDP) 4/ | 23.1 | 23.8 | 33.5 | 31.6 | 31.1 |
| Total external debt (as percent of exports of goods and services) 4/ | 35.0 | 39.7 | 47.7 | 50.1 | 52.1 |
| External debt-service payments (as percent of exports of goods and services) 5/ | 0.3 | 0.5 | 0.9 | 5.1 | 1.3 |
| Exchange rate (vatu per U.S. dollar, end of period) | 129.8 | 128.9 | 142.8 | 146.7 | ... |

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

1/ Central government only.

2/ Imports of goods (for domestic consumption) and nonfactor services.

3/ Foreign currency exposure is defined as foreign currency liabilities as a percentage of foreign currency assets.

4/ Medium- and long-term public debt only.

5/ For 2001, includes debt forgiveness.

Table 6. Vanuatu: Medium-Term Scenario, 2000–2007 1/

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|--|----------|-------|------------|-------|-------|-------|-------|-------|
| | Estimate | | Projection | | | | | |
| Output and prices (annual percentage change) | | | | | | | | |
| Real GDP | 2.5 | -1.9 | -0.3 | 2.0 | 2.8 | 3.3 | 3.7 | 4.0 |
| Nominal GDP | 5.3 | 0.7 | 1.8 | 6.1 | 6.1 | 6.4 | 6.8 | 7.1 |
| Consumer prices (period average) | 2.5 | 3.7 | 2.2 | 4.0 | 3.2 | 3.0 | 3.0 | 3.0 |
| Current account balance (in millions of U.S. dollars) 2/ | 4.7 | 1.8 | -5.6 | -4.4 | -3.1 | -2.9 | -2.9 | -2.8 |
| (in percent of GDP) | 2.1 | 0.8 | -2.4 | -1.8 | -1.3 | -1.1 | -1.1 | -1.0 |
| Trade balance | -50.0 | -58.0 | -58.9 | -61.4 | -64.6 | -68.7 | -73.4 | -78.8 |
| Exports, f.o.b. | 27.1 | 19.9 | 20.3 | 21.0 | 21.8 | 22.9 | 24.2 | 25.6 |
| (annual percentage change) | 5.6 | -26.7 | 2.0 | 3.5 | 4.0 | 5.0 | 5.5 | 6.0 |
| Imports, f.o.b. | 77.2 | 77.8 | 79.2 | 82.3 | 86.5 | 91.6 | 97.6 | 104.4 |
| (annual percentage change) | -9.1 | 1.1 | 2.0 | 4.0 | 5.0 | 6.0 | 6.5 | 7.0 |
| Gross official reserves (end of period) | | | | | | | | |
| In millions of U.S. dollars | 39.1 | 37.7 | 37.9 | 39.2 | 43.1 | 48.1 | 54.2 | 61.9 |
| In months of prospective imports | 3.1 | 2.9 | 2.9 | 2.9 | 3.0 | 3.2 | 3.4 | 3.6 |
| Central government budget (in percent of GDP) | | | | | | | | |
| Revenue and grants | 22.0 | 21.5 | 21.7 | 21.8 | 22.2 | 22.6 | 23.0 | 23.3 |
| Total expenditure | 29.3 | 25.2 | 22.6 | 23.3 | 23.6 | 23.9 | 24.2 | 24.5 |
| Overall balance | -7.3 | -3.7 | -1.0 | -1.5 | -1.4 | -1.3 | -1.2 | -1.2 |
| Central government debt | 41.1 | 40.1 | 40.3 | 39.5 | 38.6 | 37.5 | 36.4 | 35.1 |
| Broad money (M2) (annual percentage change) | 6.2 | 5.9 | 1.5 | 5.5 | 6.7 | 7.0 | 7.4 | 7.7 |
| External debt | | | | | | | | |
| External debt (in percent of GDP) 3/ | 33.5 | 31.6 | 31.1 | 30.1 | 29.2 | 28.3 | 27.3 | 26.1 |
| External debt service 4/ 5/ | 0.9 | 5.1 | 1.3 | 1.7 | 1.6 | 1.6 | 1.6 | 1.6 |
| GDP in current prices (in billions of vatu) | 31.8 | 32.1 | 32.6 | 34.6 | 36.8 | 39.1 | 41.8 | 44.7 |

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

1/ This medium-term outlook represents a reform scenario, as discussed in Box 3.

2/ Including official transfers.

3/ Medium- and long-term public debt only.

4/ In percent of exports of goods and nonfactor services.

5/ For 2001, includes debt forgiveness.

Vanuatu—Fund Relations

(As of October 31, 2002)

I. Membership Status: Joined 9/28/81; Article VIII

| II. General Resources Account: | SDR Million | % Quota |
|---------------------------------------|--------------------|----------------|
| Quota | 17.00 | 100.0 |
| Fund holdings of currency | 14.51 | 85.3 |
| Reserve position in Fund | 2.50 | 14.7 |

| III. SDR Department: | SDR Million | % Allocation |
|-----------------------------|--------------------|---------------------|
| Holdings | 0.83 | N/A |

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Arrangements:

Since 1988, Vanuatu has 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 (most recently in January 2002). 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 October 31, 2002 was VT 136.7 per U.S. dollar.

Vanuatu has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions. However, effective February 23, 2000, the RBV indicated it would cease honoring requests for forward exchange contracts and assuring the availability of foreign exchange for capital transactions.

VIII. Article IV Consultation:

The last Article IV consultation discussions with the authorities were held in Port Vila during May 2000. The Executive Board discussed the staff report and concluded the consultation on August 1, 2000.

| | Department | Date |
|--|--------------------|---|
| IX. OFC Assessments: | | |
| Offshore Financial Center Module II assessment | MAE | May 2002 |
| X. Technical Assistance (2000–present): | | |
| Short-term: | | |
| Exchange rate policy and reserve management | MAE | November 2001 |
| Banking supervision and monetary management | PFTAC ¹ | June 2000 |
| Tax administration | PFTAC | June and November 2000 |
| Public expenditure management | | September 2000 and November 2001 |
| Statistical assessment | PFTAC | March 2000 |
| Balance of payments | PFTAC | August 2000, September and December 2001, and July 2002 |
| National accounts | PFTAC | March 2001 |
| Long-term: | | |
| General Advisor, RBV | MAE | January 1999–July 2000 |
| Banking Supervision | MAE | January 2002–present |
| XI. Resident Representative: None | | |

¹ Pacific Financial Technical Assistance Centre.

Vanuatu—Relations with the Pacific Financial Technical Assistance Centre¹

The Centre's assistance to Vanuatu since 1996 has included 32 advisory missions, with the primary focus on banking regulation and supervision, public financial management and tax administration, and economic statistics. During 1996–2001, Vanuatu sent 33 officials to the Centre's regional seminars, workshops, and training courses.

Banking Regulation and Supervision

Since 1996, the Centre has provided extensive assistance in establishing a bank supervisory regime at the Reserve Bank of Vanuatu. This work culminated in the Financial Institutions Act of 1999, the main empowering legislation for regulation and supervision of the domestic banking sector. The Centre has also assisted the Vanuatu Financial Services Commission in developing a supervisory framework for the offshore financial center (OFC), but changes in banking legislation needed for meaningful oversight of this activity are still pending.

Public Financial Management and Tax Administration

Starting with the government's 1997 budget, the Centre has assisted the authorities in strengthening annual budget preparation and reporting and improving cash management, as well as developing medium-term revenue and expenditure forecasts. In 2001, the Centre also aided in completing the questionnaire on the Fund's *Code of Good Practices on Fiscal Transparency*. Other recent assistance has begun to look at improving public enterprise management and reporting and at strengthening the role of the auditor-general. The Centre's assistance in tax administration has been fairly limited, mainly concentrated on strengthening customs administration and introducing select excises.

Economic Statistics

The focus of Centre's work has been on the balance of payments and national accounts. On the balance of payments, regular assistance has been given on adapting compilation procedures in line with the fifth edition of the Fund's *Balance of Payments Manual*. Recent work has looked at the recording of commercial bank and OFC activity; the Centre is also assisting the authorities in participating in the Fund's *Coordinated Portfolio Investment Survey*. On the national accounts, assistance commenced in 1997 to update annual estimates, which had gone largely uncompiled since 1993. Follow up work on improving compilation methods has been mostly coordinated by the Asian Development Bank.

¹ The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a multi-donor technical assistance institution, financed by the IMF, AsDB, AusAID, NZODA, and, until 2001, by the UNDP, with the IMF as Executing Agency. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu.

Vanuatu—Relations with the World Bank Group¹

(As of end-June 2002)

Since joining the World Bank Group in 1981, Vanuatu has received four IDA credits totaling US\$15.4 million (all fully disbursed) in the areas of agricultural extension and training (1983), transportation and education infrastructure (1986), primary and secondary education (1988), and affordable housing (1991). More recently, a Learning and Innovation Loan equivalent to US\$4.0 million was approved in June 2001.

The Bank has also supported utilities reform in Vanuatu through a series of policy-based workshops, which have yielded reform proposals for water, power, and telecommunications. The government has requested support from the Bank to implement these reforms. In addition, the Bank has provided analytical and advisory services to Pacific Island countries, including Vanuatu, through its biennial Regional Economic Reports (REPs). The report for 2002 analyzes trade liberalization and complementary reforms in the Pacific Island economies.

In other areas, the South Pacific Project Facility (SPPF), established in 1989 and managed by the International Finance Corporation (IFC), has provided small business advisory services for the Pacific Island member countries. The IFC approved its first investment loan in Vanuatu in January 1996 totaling US\$4.8 million (fully disbursed), which involved the purchase of an existing hotel property from receivership, and its refurbishment, expansion, and upgrading.

In addition, the Foreign Investment Advisory Service (FIAS) assisted the government in formulating a foreign investment code in 1995. Arising from this work was a second project on preparing legislative drafting guidelines for a new Foreign Investment Act (passed in 1997) and amendments to immigration, business licensing, and work permits legislation. The FIAS also assisted with preparing legislative drafting guidelines for the creation of a new investment promotion agency in 1998. Future policy initiatives are likely to focus on areas such as reducing administrative barriers to investment, issuing a national investment policy statement, and streamlining the investment approvals process.

Recent Reports (since 1998)

- Enhancing the Role of Government in the Pacific Island Economies, October 1998
- Pacific Islands Stakeholder Participation in Development: Vanuatu, May 1999
- Cities, Seas, and Storms: Managing Change in Pacific Island Economies, November 2000

¹ Prepared by the World Bank staff.

Vanuatu—Relations with the Asian Development Bank¹

(As of end-June 2002)

The Asian Development Bank's (AsDB) operations in Vanuatu started in 1981. As of end-June 2002, the AsDB had provided nine loans (a total of US\$51.3 million) and 50 technical assistance projects (US\$13.0 million). The loan projects include assistance for agriculture, cyclone damage rehabilitation, port facilities, urban infrastructure development, development financing, and the Comprehensive Reform Program (CRP). The technical assistance projects cover both project preparation and advise in the areas of agricultural and forestry development, agricultural support services, energy, industrial estate development, transport and communications, social infrastructure, population planning, economic and fiscal management, vocational training, and CRP support.

The pipeline for 2002 consists of a project loan to improve infrastructure on the outer islands and institutional capacity for transport infrastructure management at the central and provincial levels. Technical assistance is programmed for establishing a policy framework for and capacity building in agriculture sector development, capacity building in the National Statistic Office, and capacity building in infrastructure management.

The strategic thrust of the AsDB's operations for Vanuatu over the medium term will be to build local capacity for sound economic management and good governance and maintain its support for the CRP while (i) stimulating private sector development and GDP growth by dealing with the underlying constraints and policy issues; and (ii) supporting the provision of improved rural infrastructure and social services. There is a strong cross-cutting concern for addressing poverty, employment, environment, and other social issues, particularly in the rural areas.

Projections for 2002–05

The lending program is expected to amount to a maximum of US\$12 million over the next four years, with US\$6 million allocated in 2002 and US\$2 million allocated a year during 2003–05. The technical assistance program is expected to amount to around US\$2.8 million over the next four years.

Loans Commitment and Disbursement During 1998–2002
(In millions of U.S. dollars)

| Year | Contract Awards | Disbursements |
|--------------------|-----------------|---------------|
| 1998 | 10.8 | 11.4 |
| 1999 | 8.0 | 6.6 |
| 2000 | 9.5 | 10.6 |
| 2001 | 0.8 | 2.8 |
| 2002 ^{1/} | 0.0 | 0.2 |

1/ Through June 30, 2002.

¹ Prepared by AsDB staff.

Vanuatu—Statistical Issues

Some improvements have been made in Vanuatu's economic statistics, but deficiencies persist in methods and coverage, which impede effective surveillance. The Reserve Bank of Vanuatu (RBV) is responsible for balance of payments (BOP) and monetary statistics; the Ministry of Finance (MoF) for government finance and external debt statistics, and the National Statistics Office (NSO) for most other official statistics (including GDP, consumer prices, external trade, tourism activity, and labor and demographics). Available economic and financial data are published regularly in the RBV's monthly *Financial and Economic News* and *Quarterly Economic Review* and in the NSO's quarterly *Statistics Indicators (SI)*. Recent technical assistance on the BOP and national accounts has been provided by the Pacific Financial Technical Assistance Centre (PFTAC) (see Annex II).

National Accounts and Prices

The NSO has compiled annual estimates of GDP by type of economic activity (in current and constant prices) through 2001. Preliminary estimates have been published up to 1999 in the quarterly *SI*. Revised estimates, prepared with technical assistance from the PFTAC, Asian Development Bank, and AusAID, are expected to be published by end-2002. Estimates of GDP by expenditure also have been compiled annually through 1999, but not officially published. In support of this work, data from an annual business survey and an informal sector activity survey (last conducted in 2000) are being incorporated into national accounts estimates. A national census was conducted in 1999 and a labor market survey in 2000.

The CPI is compiled on a quarterly basis. The NSO has no plans to improve the frequency, timeliness, or coverage (which is largely urban-based) of the CPI owing to resource constraints.

Government Finance Statistics

Government finance statistics (GFS) are compiled on a monthly basis, but are not officially published. Final estimates of annual data are reported with a considerable lag. The latest annual data published in the *GFS Yearbook* is for 1999. The quality and timeliness of data have improved since a GFS mission visited Vanuatu in November 1998. Follow up assistance on expenditure data has been provided by PFTAC and AusAID as part of ongoing work in strengthening public financial management. As a result, government expenditure data on a functional basis were prepared starting in 1998, and are expected to be released for publication later this year. Some inconsistencies exist between the fiscal and monetary accounts in terms of reconciling data on domestic financing of the budget by the banking system reported by the RBV and the MoF.

Monetary Statistics

Monetary statistics are compiled on a monthly basis for the RBV and three domestic deposit money banks (DMBs). In reporting these data to the Fund for *IFS*, the RBV submits a breakdown of sundry income that allows STA to properly reclassify these accounts. However, a similar breakdown is not provided for the DMBs. Currently, the activity of Vanuatu's 34 offshore banks goes largely unrecorded. The RBV is attempting to correct for this deficiency by working with the Vanuatu Financial Services Commission (VFSC), which regulates the offshore financial sector, to develop a standard reporting system.

External Sector Statistics

The BOP is compiled on a quarterly basis. As a result of PFTAC technical assistance, extensive revisions have been made to annual BOP data since the 2000 Article IV consultation, especially to net investment income and current transfers and to the capital and financial accounts and various sub-items. This has reduced the size and variability of net errors and omissions as reported by the RBV. Coverage of private flows is expected to improve with the adoption of a revised enterprise survey by end-2002. Assistance is ongoing to refine methods for compiling the BOP to ensure its consistency with government budget and commercial bank data and to more fully incorporate activity of the offshore financial sector. The authorities also are working with PFTAC to complete the *Coordinated Portfolio Investment Survey*. Data on external debt and debt service (all official) are compiled annually by the MoF.

Vanuatu: Core Statistical Indicators
(As of October 31, 2002)

| | Exchange Rates | International Reserves | Central Bank Balance Sheet | Broad Money | Interest Rates | Consumer Price Index | Exports/Imports | Current Account Balance | Overall Government Balance | GDP/GNP | External Debt |
|----------------------------|----------------|------------------------|----------------------------|-------------|----------------|----------------------|-----------------|-------------------------|----------------------------|-----------|---------------|
| Date of Latest Observation | 10/31/02 | 8/2002 | 8/2002 | 8/2002 | 8/2002 | 2002 Q2 | 2002 Q2 | 2002 Q2 | 2002 Q2 | 2001 | 2001 |
| Date Received | 10/31/02 | 10/2002 | 10/2002 | 10/2002 | 10/2002 | 8/2002 | 8/2002 | 8/2002 | 8/2002 | 8/2002 | 8/2002 |
| Frequency of Data | Daily | Monthly | Monthly | Monthly | Monthly | Quarterly | Quarterly | Quarterly | Quarterly | Annually | Annually |
| Frequency of Reporting 1/ | Daily | Monthly | Monthly | Monthly | Monthly | Quarterly | Quarterly | Quarterly | O | O | Annually |
| Source of Update 2/ | C | A | A | A | A | A | A | N | N | N | N |
| Mode of Reporting 3/ | E | C | C | C | C | C | C | C | C | V | C |
| Confidentiality | No | No | No | No | No | No | No | No | No | No | No |
| Frequency of Publication | Monthly | Monthly | Monthly | Monthly | Monthly | Quarterly | Quarterly | Quarterly | Quarterly | Irregular | Annually |

1/ O-other irregular basis.

2/ A-direct reporting by the authority; C-commercial electronic data provider; N-official publication or press release.

3/ E-electronic data transfer; C-cable, facsimile, or mail; V-staff visits.

Vanuatu—Social and Demographic Indicators

| | 1990 | 2000 | Same Region/Income Group 1/ | |
|--|------|------|-----------------------------|---------------------|
| | | | East Asia and Pacific | Lower-Middle Income |
| Population | | | | |
| Total population (in thousands) | 150 | 192 | 1,855,200 | 2,047,600 |
| Growth rate | 2.6 | 2.7 | 1.0 | 1.0 |
| Urban population (in percent of total) | 18 | 20 | 35 | 42 |
| Public current expenditures | | | | |
| Health (in percent of GDP) | 2.6 | 3.0 | 5.0 | ... |
| Education (in percent of GDP) | 4.4 | 6.5 | 3.0 | 4.0 |
| Safe water (in percent of population with access) | | | | |
| Total | 72 | 88 | 75 | 80 |
| Urban | 95 | 100 | 93 | 95 |
| Rural | 67 | 85 | 66 | 69 |
| Immunization rate (in percent under 12 months) | | | | |
| Measles | 66 | 59 | 85 | 89 |
| Diphtheria/pertussis/tetanus (DPT) | 76 | 66 | 85 | 89 |
| Life expectancy at birth (in years) | | | | |
| Total | 61 | 69 | 69 | 70 |
| Male | 61 | 67 | 67 | 67 |
| Female | 62 | 70 | 71 | 72 |
| Adult literacy (in percent) | 32 | 34 | 86 | 76 |
| Infant mortality (live births per thousand) | 56 | 30 | 36 | 58 |

Source: World Bank, *World Development Indicators*; and Vanuatu authorities.

1/ Year 2000 or latest available prior to 2000.

**Statement by the IMF Staff Representative
November 22, 2002**

1. This statement contains information that has become available since the Staff Report for the 2002 Article IV consultation was circulated to the Executive Board on November 7, 2002. The information does not alter the thrust of the staff appraisal.
2. The government budget for 2003, currently being considered by Parliament and expected to receive final approval by early December, aims for a current budget balance. The overall budget deficit in 2003 is projected to be about 1 percentage point of GDP smaller than indicated in the staff report, mostly on account of lower capital expenditure.
3. Monetary developments through September 2002 are generally in line with staff projections. Broad money growth rose to 1 percent for the year ending September 2002, reflecting a reversal in the decline in foreign currency deposits observed in August. For the same period, credit to the private sector expanded by 4¾ percent. Net credit to government by the banking system increased by VT 464 million (1½ percent of GDP) from end-August, which staff understands has since been partially unwound. Inflation (period average) was at 2 percent for the year ending September 2002.
4. On November 11, Parliament approved the International Banking Act, which aims to strengthen oversight of offshore banks. Under the act, which takes effect from January 1, 2003, offshore banks will be supervised by the Reserve Bank of Vanuatu. They will face significantly tighter prudential regulations (in line with onshore banks), including in the areas of capital requirements, data provision, and audit procedures. Offshore banks can apply for a one-year interim license effective from January 1. To continue to operate beyond 2003, they must subsequently reapply for a regular license by end-August 2003, which will be granted only to those banks maintaining a physical presence in Vanuatu and meeting the minimum capital requirement, as well as all other provisions in the act.



INTERNATIONAL MONETARY FUND

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FOR IMMEDIATE RELEASE
December 11, 2002

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

IMF Concludes 2002 Article IV Consultation with Vanuatu

On November 22, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Vanuatu.¹

Background

Since the mid-1990s, Vanuatu has experienced a trend slowdown in growth, owing to persistent fiscal and structural weaknesses, which have led to a loss in external competitiveness. Despite frequent shocks and an uncertain policy environment, macroeconomic stability has been maintained, but structural reforms have slowed. A national election in May 2002 has cautiously bolstered reform prospects.

Real GDP growth was 2½ percent in 2000 owing to an agriculture-led recovery. However, the economy contracted by 2 percent in 2001, due to the effects of several major cyclones and a global downturn in agriculture and tourism. Inflation remained subdued, increasing from 2½ percent in 2000 to 3¾ percent in 2001. The current account surplus declined from 2 percent of GDP in 2000 to ¾ percent in 2001, reflecting the impact of shocks to copra exports and tourism receipts. As a result, gross official reserves fell to US\$38 million at end-2001 (three months of prospective imports).

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. 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.

Performance so far in 2002 suggests that real GDP will further contract by ¼ percent, because of a slump in tourism and construction. This would still require a moderate rise in agricultural output, buoyed by a strong recovery in copra production. Inflation should stay below 3 percent with prudent monetary management, despite an increase in oil prices. A current account deficit of 2½ percent of GDP is projected, with a further softening in tourism receipts, but reserves should be unchanged at US\$38 million by year end (three months of imports) on account of a slowing of capital outflows. External vulnerability appears to remain moderately low at this juncture, despite the weaknesses in economic performance in recent years, given a relatively small external debt and cautious monetary stance.

The fiscal situation improved in 2001, but most of the adjustment came from reduced capital spending. The overall budget deficit (excluding net lending) declined from 7¼ percent of GDP in 2000 to 3¼ percent of GDP in 2001. Despite this, problems persisted with tax compliance and expenditure prioritization. Revenue shortfalls stemmed from administrative problems and, in 2001, the economic slowdown. Expenditure priorities were skewed toward the wage bill, which remained in excess of one-half of the recurrent budget in each year. Education and health outlays grew slightly as a share of total spending, but stayed flat in terms of GDP, and service delivery to the outer islands and rural areas continued to lag due to resource shortfalls and capacity constraints.

Public finances have further improved in 2002, but the spending mix is still skewed towards unproductive outlays. An overall budget deficit of 1¼ percent of GDP was initially targeted in 2002, but it is now projected to be 1 percent of GDP, although this decline is largely attributable to delays in implementing externally-financed capital projects. Revenue shortfalls are expected to moderate, despite the continued economic slump, given some steps to broaden the tax base and improve VAT and customs administration. Problems continue to arise from unbudgeted appropriations, which given a tight cash situation act to squeeze spending on operations and maintenance and for key social and infrastructure needs. Starting in mid-2001, the government instructed the Vanuatu Commodity Marketing Board (VCMB) to pay subsidies to copra farmers, which have been financed through direct advances from the Reserve Bank of Vanuatu (RBV). These payments have continued in 2002, which given the poor financial state of the VCMB have potential budget implications.

Monetary policy has been generally restrained. Broad money grew by 6 percent in both 2000 and 2001, fueled by foreign currency deposits (FCDs) arising from a relatively strong current account. Exchange rate policy has also been generally appropriate, but declining exports and reserves continue to warrant a flexible exchange rate management. Domestic liquidity conditions were allowed to ease through the first half of 2002, although private sector credit growth slowed from 6½ percent at end-2001 to 4 percent at end-June 2002 reflecting weak overall growth. However, even with a seasonal pickup in domestic demand, broad money growth in 2002 is projected to be very modest, with private sector credit growth expected to stay at 4 percent.

In the financial sector, a number of steps have been taken since the last Article IV consultation to strengthen the RBV's oversight of domestic banks, in line with the Basel Core Principles (BCPs) for bank supervision. Most recently, "know-your-customer" guidelines were adopted in mid 2002, in part to improve anti-money laundering (AML) controls. Financial and operational restructurings of the state-owned National Bank of Vanuatu (NBV) and Vanuatu National Provident Fund (VNPF) have also been completed, but the Asset Management Unit set up to handle nonperforming loans transferred from the NBV and VNPF has underperformed.

The global focus on combating money laundering and terrorism financing has given further impetus to also strengthening oversight of Vanuatu's offshore financial sector. Initial steps were taken in this regard in late 2000, particularly in relation to the reporting of suspicious transactions, but enforcement continued to be constrained for legal, operational, and budgetary reasons. A new international banking act approved by Parliament in mid-November 2002 puts offshore banks under the direct supervision of the RBV starting in 2003. With proper enforcement, this act is expected to bring the supervisory regime for offshore banks into line with international standards, both in terms of the BCPs and AML requirements. The authorities also are currently developing proposals for a more effective supervisory response in the non-bank area.

Progress in other structural areas has been slow since the last consultation, which limits long-term growth potential. On state-owned enterprise (SOE) reform, the process of privatizing and commercializing SOEs is lagging due to a lack of political consensus. The government has sold or liquidated ten small and medium-sized SOEs since the beginning of 2001, but actions still need to be taken on another 20 enterprises, including Air Vanuatu. On trade reform, WTO accession stalled just prior to completion in late 2001. In the areas of private sector development and FDI, prospects still depend on swift and effective actions to reduce administrative constraints, including streamlining land procurement and business licensing procedures.

Statistical methods and reporting have improved in the past few years, which should assist in policy formulation and monitoring. In two of the weaker statistical areas—national income accounts and the balance of payments—work is ongoing to improve accuracy and coverage with donor technical assistance.

Executive Board Assessment

Directors commended Vanuatu for maintaining macroeconomic stability and making progress on structural reforms under difficult economic and political conditions. Inflation has remained subdued, the external debt is manageable, and the fiscal situation has improved. However, Directors observed that Vanuatu's recent economic growth performance has been lackluster—especially in view of the rapid population growth. They acknowledged that Vanuatu's susceptibility to external shocks and natural disasters, its fragmented geography and small size, and recent political developments have affected this performance. Nevertheless, they noted that persistent fiscal and structural weaknesses have led to a relatively high-cost

production structure and inadequate basic infrastructure, which have eroded Vanuatu's competitiveness vis-à-vis neighboring countries. They recommended that prompt action be taken to remove these weaknesses, including through continued implementation of the Comprehensive Reform Program. Noting that international donors play an active and important role in Vanuatu, Directors stressed the importance of better aid coordination and consistency of policy advice by the international community.

Directors welcomed the overall improvement in the fiscal situation, but emphasized that more needs to be done to boost revenue and redirect spending toward infrastructure and the provision of social services, with the objective of achieving a lasting fiscal consolidation. They therefore supported the authorities' cautious approach to formulating the 2003 budget, which aims for a current budget balance. On revenue, Directors encouraged a broadening of the tax base and strengthening of VAT and customs administration. They supported current plans to adopt new excises on alcohol and tobacco in the 2003 budget, which they viewed as essential to improving revenue performance. On expenditure, Directors suggested stepped-up efforts to improve expenditure control and debt management, including strict limits on supplemental appropriations. They emphasized the need to control the wage bill and to further shift spending to the social sectors and infrastructure development, but also to increase the effectiveness of spending on education. They supported higher capital spending within the framework of a well-designed public investment program with coordinated donor support.

Directors welcomed the progress that has been made in strengthening budget procedures under the government's Comprehensive Reform Program. However, Directors stressed that government subsidies, including those to copra farmers, need to be scaled back and better-targeted given more critical spending priorities and prevailing market conditions.

Directors considered that monetary policy has been generally restrained, and that it should continue to be so in order to keep inflation low and support the external position. They urged limits on the use of central bank advances to finance the public sector, in order to avoid undermining fiscal discipline, and called on the authorities to develop the capacity to use treasury bill auctions instead.

Directors viewed the adjustable peg exchange rate arrangement as broadly appropriate, but stressed that it needs to be backed up by sound macroeconomic and structural policies to enhance external competitiveness. Most Directors were of the view that any significant weakening in external performance would call for a more flexible exchange rate management, and, in this respect, were pleased to note that the authorities are willing to consider a widening of the trading band. Some Directors also recommended greater transparency regarding the composition of the currency basket. Others, however, expressed concern that this could lead to destabilizing speculation on the exchange rate. Directors supported the authorities' request for technical assistance in the area of foreign reserve management.

Directors welcomed the progress made in strengthening the regulation and supervision of onshore banks, as well as the recent passage of the International Banking Act to improve the oversight of offshore banks. They advised the authorities to strictly enforce the new legislation.

Directors stressed the need to effectively regulate non-bank activity as well in the offshore sector, to ensure effective controls against money laundering and terrorism financing in line with internationally agreed standards. Some Directors suggested that the authorities undertake a comprehensive study of the costs and benefits of the offshore financial center.

Directors commended the completion of restructuring of the National Bank of Vanuatu and the National Provident Fund, and cautioned that close supervision is needed to ensure that these two institutions remain financially sound. They called for a more aggressive approach by the Asset Management Unit on non-performing loan recoveries, given delays so far and limited budget resources.

Directors stressed that additional structural reforms are needed to bolster medium-term growth prospects and address the high-cost production structure. They encouraged the development of a strategy to commercialize and privatize remaining state-owned enterprises, as envisaged in the original Comprehensive Reform Program. Directors also urged timely implementation of trade commitments and a reinvigorated effort at WTO accession, to improve market access, reduce costly barriers, and attract foreign direct investment. In this regard, they expressed concern about the high share of trade taxes in government revenue, and suggested that the Fund might consider providing technical assistance to address these imbalances. Directors noted that private investment would also benefit from a more transparent legal and regulatory framework and fewer administrative barriers, and that tax exemptions to investors should be limited in scope and applied uniformly.

Directors welcomed the recent steps taken to improve the accuracy and coverage of the national income accounts and balance of payments statistics. They looked forward to a further strengthening in these areas, including through continued support from the Pacific Financial Technical Assistance Center. Directors also encouraged Vanuatu's timely participation in the Fund's General Data Dissemination System.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Vanuatu is also available.

Vanuatu: Selected Economic Indicators, 1998–2002

| | 1998 | 1999 | 2000 | Est. 2001 | Proj. 2002 |
|--|---|-------|------|--------------|---------------|
| | (Percent change) | | | | |
| Real GDP | 3.0 | -2.1 | 2.5 | -1.9 | -0.3 |
| Inflation (period average) | 3.3 | 2.2 | 2.5 | 3.7 | 2.2 |
| Money and credit | | | | | |
| Broad money | 11.7 | -9.8 | 6.2 | 5.9 | 1.5 |
| Credit to the private sector | 10.7 | 14.6 | -4.9 | 6.4 | 4.2 |
| Merchandise exports, f.o.b. | -3.9 | -24.3 | 5.6 | -26.7 | 2.0 |
| Merchandise imports, f.o.b. | -6.6 | 11.1 | -9.1 | 1.1 | 2.0 |
| Real effective exchange rate (Period average) | 2.3 | -1.1 | 3.8 | -0.6 | ... |
| | (In percent of GDP) | | | | |
| Government budget | | | | | |
| Total revenue | 22.9 | 22.3 | 20.8 | 20.1 | 20.4 |
| Grants | 1.3 | 1.7 | 1.2 | 1.4 | 1.3 |
| Total expenditure 1/ | 31.6 | 25.3 | 29.3 | 25.2 | 22.6 |
| Overall fiscal balance 1/ | -7.4 | -1.2 | -7.3 | -3.7 | -1.0 |
| External debt | 23.1 | 23.8 | 33.5 | 31.6 | 31.1 |
| | (In millions of U.S. dollars, unless otherwise indicated) | | | | |
| Current account balance 2/ | 6.2 | -12.2 | 4.7 | 1.8 | -5.6 |
| (In percent of GDP) | 2.7 | -5.2 | 2.1 | 0.8 | -2.4 |
| Gross official foreign exchange reserves | 44.3 | 42.7 | 39.1 | 37.7 | 37.9 |
| (In months of next year's imports) 3/ | 3.4 | 3.5 | 3.1 | 2.9 | 2.9 |

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

1/ Excludes onlending.

2/ Includes official transfers.

3/ Imports of goods (for domestic consumption) and nonfactor services.

**Statement by Michael Callaghan, Executive Director on Vanuatu
November 22, 2002**

Key Points

- Vanuatu faces many challenges, given its small size, high cost structure and cyclone-prone environment. It has faced a significant decline in the prices for its major export crops. Frequent changes in government have also been an impediment to advancing a comprehensive reform agenda.
- Notwithstanding these challenges and uncertainties, macroeconomic stability has been maintained - a testament to generally sound macroeconomic policies.
- The fiscal position is tight and the authorities have taken steps to control expenditures and boost revenue, particularly through improvements to VAT and customs administration. Capacity limitations hamper the introduction of more comprehensive reforms, including in the area of debt management.
- There have been improvements in budget monitoring and steps have been taken to control the growth in the government wage bill.
- A cautious approach has been taken with respect to the 2003 budget, which is generally in line with the staff recommendations. The 2003 budget which the government is to table in Parliament targets a recurrent deficit of 0.1 percent of GDP and an overall surplus of 0.4 percent of GDP.
- The authorities are conscious of the need to maintain healthy reserve levels and have requested technical assistance to examine some of the recommendations with respect to exchange rate and reserve management raised by the staff.
- There have been significant developments in strengthening the regulation and supervision of the offshore financial sector and the anti-money laundering regime.

A challenging environment

Vanuatu faces many challenges. Some of these are associated with its size and geography. With a population of around 197,000, like other small states it faces the problem of diseconomies of scale that result in a high cost of doing business. Adding to its cost structure is the fact that it consists of a dispersed group of islands which is a considerable distance from major population centers. There are also the pressures that come from a rapidly growing population. Then there is the weather. Vanuatu experiences an average of 2.6 cyclones each year, with only one year in seven or eight being cyclone-free. There is also the risk of volcanic eruptions and earthquakes. As noted in the selected issues paper, the

Commonwealth Secretariat has ranked Vanuatu as the most vulnerable country to natural disasters among 111 developing countries.

In recent years Vanuatu has experienced a degree of political uncertainty which has presented another challenge to pursuing reform. Over the past decade there have been ten changes of government, with three changes since 1999. Added to these uncertainties, the economy has had to contend with the effects of the weaker external environment and a significant decline in the prices of some of its major exports, particularly copra, cocoa and kava. Since 1997, the prices of copra, cocoa and kava have all fallen by more than 50 percent, although there was some improvement in cocoa prices in the first half of 2002.

The tourism sector is particularly important to Vanuatu and was adversely affected by the terrorist attacks on the United States in September 2001. More recently, there has been increased competition from Fiji which has seen a recovery in its tourist sector with greater political stability. The Vanuatu authorities have recently launched a new tourism marketing campaign.

Despite these many challenges, the authorities have maintained macroeconomic stability. Inflation is under control, external debts are manageable, and the fiscal situation has improved. In addition, the authorities have continued to make progress in addressing structural weaknesses in the economy under the Comprehensive Reform Program and are committed to making further progress in order to strengthen medium-term growth.

As noted, relatively frequent changes of government have not facilitated the implementation of reforms. The current government is a coalition and has a substantial majority in Parliament. This holds out the prospect for greater political stability, although all governing coalition arrangements pose particular challenges.

In terms of the future direction of policy, the government recognizes the importance of maintaining macroeconomic stability as well as the need to advance structural reform in order to enhance the competitiveness of the economy. Specifically, the Prime Minister is emphasizing 'Five Millennium Priorities', which are: achieving the goals of good governance; supporting and improving private sector led growth; improving the participation of all people in the economic, social and political development of Vanuatu; improving the standard of living for all ni-Vanuatu; reducing inequalities; and distributing equally all benefits of the services and resources of the government.

Fiscal policy

The authorities are aware of the need to address the fiscal situation and have taken a cautious approach in formulating the 2003 budget. The 2003 budget, which is ready to be tabled in Parliament, targeted a recurrent deficit of 0.1 percent of GDP and an overall surplus of 0.4 percent of GDP.

More broadly, there have been improvements in budget preparation and reporting. Since 1999 the government has published an annual fiscal strategy report. The cash position is very tight and expenditure has been kept under close control through the use of monthly

warrants. The introduction of the Financial Management Information System has improved budget monitoring and should allow the use of quarterly expenditure warrants by next year, thus making budget implementation more flexible. The authorities have taken note of the staff's recommendation for greater reliance on treasury bill auctions to meet government financing needs, although the authorities believe this needs to be addressed in the context of strengthening overall debt management.

Some important steps have been made towards strengthening revenue performance. VAT and customs administration have been improved with the introduction of automated systems which strengthen tax audit and compliance procedures. The Lands Department is in the process of improving the collection of land leases, which would have a positive impact on the 2003 fiscal position. Excises on tobacco and alcohol products are included in the 2003 budget and become effective as of January 2003. The authorities are also considering increasing duties on select imports, and are investigating ways of further improving customs and VAT compliance.

On the expenditure side, the authorities recognize the importance of reducing the wage bill to divert resources to health and education, rural infrastructure and development of the outer islands. In this regard, new arrangements have been introduced whereby additional recruitment by any agency must obtain approval from the Finance Ministry.

Copra is the main source of income in the outer islands, where a significant proportion of the population lives. Given the limited means available to provide support to the outer islands, the authorities have been using copra subsidies. The subsidies are aimed at reducing income disparities between rural and urban communities and to help support producers, given the volatility in international copra prices. Nevertheless, to ensure the subsidies achieve their intended objective and given the tightness of the fiscal position and the need to avoid market distortions, the authorities are looking to ensure that this support is well targeted. The Vanuatu Commodities Marketing Board is readjusting its marketing arrangements to reduce costs. Due to the tight fiscal situation, direct financial assistance by the government to the Vanuatu Commodity Marketing Board has been minimal.

Exchange rate regime

While reserves have declined since the late 1990s, the decline has been gradual. This year uncertainty about the elections has affected reserve levels.

The authorities are mindful of the need to maintain healthy reserve levels. In this vein, they have requested technical assistance to examine further staff's suggestions to improve reserves management. While the authorities are willing to consider deepening the interbank market through widening the Reserve Bank of Vanuatu's trading band, they have reservations about disclosing details of the basket. Based on previous experience, they are concerned that disclosure might encourage destabilizing speculation on exchange rate movements.

Financial sector issues

A key focus of the authorities' reform efforts has been on financial sector issues. Notwithstanding limited capacity, they have tackled vigorously identified weaknesses in the anti-money laundering regime and the regulation and supervision of the offshore financial sector (OFC). They have made good progress since the last consultation, including:

- approval of the Financial Transactions Report Act in September 2000, which sets out procedures for customer identification, record keeping and suspicious transaction reporting;
- establishing a Financial Intelligence Unit;
- issuing a 'know-your-customer' regulation for domestic banks; and
- conducting on-site examination of domestic banks' AML procedures.

The Offshore Financial Centre Module II Assessment conducted by MAE earlier this year made recommendations to strengthen the regulation and supervision of domestic banks and also the OFC. The authorities support MAE's recommendation and have acted rapidly to address weaknesses identified in both the domestic sector and the OFC.

While the domestic banking sector is generally sound, the Assessment did identify some areas for improvement. To address these issues, customer due diligence guidelines were approved in July. The Financial Institutions Act is being amended to improve oversight of banks' anti-money laundering systems and controls and introduce a more rigorous 'fit and proper' regime.

The weaknesses in the regulation and supervision of the OFC were more significant, but the authorities have moved to address the weaknesses as quickly as possible, with valuable technical assistance from the Fund. The Parliament recently passed the International Banking Act, which will strengthen the oversight of offshore banks. Under the Act, supervision of the OFC will be brought under the authority of the Reserve Bank of Vanuatu with effect from January 1, 2003. Parliament has also recently passed several bills related to combating terrorist financing.

Progress has been made on state-owned enterprise reform since the last Article IV consultation with the sale or liquidation of 10 enterprises. Further progress is expected to be made following the completion of the review of the divestment strategy at the end of this year.

In closing, we would like to thank staff for the well written report. The authorities value this opportunity to consult with the Fund on the broad economic and policy outlook, and also appreciate greatly the technical assistance being provided by the Fund and through PFTAC. This technical assistance has certainly had many benefits, particularly in terms of strengthening the financial sector and improving statistical methods and reporting.