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March 2007
IMF Country Report No. 07/92

Vanuatu: 2006 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the2006 Article IV consultation with Vanuatu, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 5, 2006, 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 February 9, 2007. 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; and

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 26, 2007 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

VANUATU

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the
2006 Consultation with Vanuatu

Approved by Masahiko Takeda and Anthony Boote

February 9, 2007

- **This report is based on discussions held by the team in Port Vila** during November 27–December 5, 2006. The team comprised Messrs. Aitken (Head), Chensavasdijai, Nakabayashi, and Ms. Mitra (all APD), and Mr. Andrew Blazey (OED).
- **Counterparts:** The team met with Minister of Finance and Economic Management Willie Jimmy, Governor of the Reserve Bank of Vanuatu Odo Tevi, and other senior officials.
- **Outreach:** The mission's outreach included meetings with commercial banks, donors, and embassies.
- **Context of past surveillance:** In the 2004 Article IV consultation, the authorities and the Fund agreed on the broad policy priorities—fiscal consolidation through tax reforms and expenditure cuts, structural reforms to support private sector development, and continued progress in strengthening banking supervision. However, expenditure reforms have been hindered by the large wage bill while structural reforms have been slow.
- **Exchange rate:** Vanuatu maintains an adjustable peg exchange rate arrangement linked to a transactions-weighted basket of currencies with undisclosed weights. 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.
- **Statistical issues:** Vanuatu's data are sufficient for surveillance purposes, although shortcomings remain. Vanuatu began participating in the GDDS in 2003. Core economic data are updated in a regular and timely manner, which has enhanced surveillance. Two of the key statistical areas—national accounts and balance of payments—remain weak. Data are not available for public enterprise operations and the labor market.
- **Technical assistance:** Vanuatu continues to receive assistance from the Pacific Financial Technical Assistance Center (PFTAC) to improve the quality of bank supervision, reserve management, and other areas.

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Executive Summary

Background

- **Macroeconomic conditions have improved over the last several years.** Output growth has rebounded, private capital inflows have increased, and inflation remains low. Since the formation of the present government in December 2004, donor pledges have increased sharply.

- **If good macroeconomic policies and political stability are maintained, near-term prospects are positive,** boosted by the direct impact of aid and private capital inflows on investment and growing tourism. Inflation is expected to increase modestly but remain subdued.

- **However, progress on structural reforms has been limited.** On the positive side, financial sector reforms have been impressive. At the same time, fiscal structural reforms have not advanced, and the recent increase in civil service wages will further add to the already high wage bill. Little progress has been made on reforms to improve the private sector environment.

Key Policy Issues

- **Stronger policy action to reduce private sector barriers is needed** to enhance Vanuatu's external competitiveness and would lead to higher, sustained private sector-led growth than experienced in the past.

- **In the near term, there is a risk that recent civil service wage increase could add to already strong demand and lead to a more pronounced pick-up in inflation.**

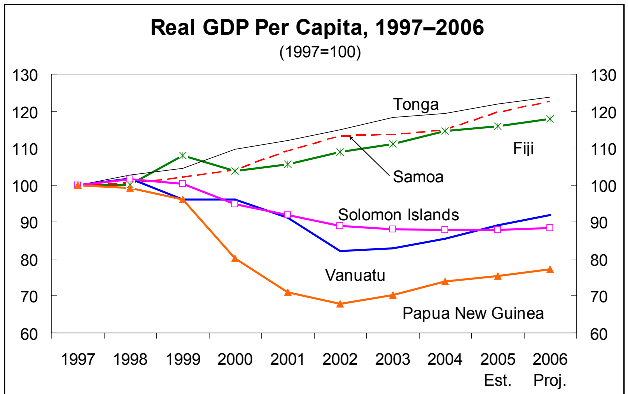
- **The present economic situation provides an opportune time to begin undertaking long overdue fiscal restructuring.** Reforms should focus on improving the delivery and efficiency of government services, reducing the size of the wage bill, and removing numerous tax exemptions. Loss-making state-owned enterprises should be restructured, including through privatization.

- **Recent financial sector reforms are commendable, but additional efforts are needed to ensure this sector remains sound.** In particular, the proposed agriculture development bank should be placed under strict central bank supervision from its inception to prevent the mismanagement and loan losses experienced by the previous development bank.

I. Economic Developments and Outlook

A. Background

1. **Vanuatu has recently emerged from a long period of low growth and falling per capita incomes.** The historically poor growth performance reflects a number of deep-seated structural problems. A weak environment for private activity and rapid population growth have added to the difficulties that come from a narrow output and export base, with per capita incomes falling since 1999. Infrastructure spending is low compared to most Pacific island and Caribbean countries, and inter-island travel and communications are a particular problem. The weak education system has resulted in shortages of skilled workers, matched only by Papua New Guinea and the Solomon Islands. Vanuatu experiences almost no emigration and few remittances, in marked contrast to Samoa and Tonga. Vanuatu is also particularly vulnerable to natural disasters. Human development indicators are among the lowest of the Pacific island countries, with about 80 percent of the labor force employed in subsistence farming in rural areas.



Sources: Vanuatu authorities; IMF, WEO database; and IMF staff estimates.

Gross Domestic Product (GDP) Per Capita and Human Development Index (HDI) in Vanuatu and Comparator Countries

	HDI Rank[1]	GDP Per Capita in US$ (2004)	Real GDP Per Capita Annual Growth Average 1995-2004
Caribbean Average[2]	68	6,082	2.2
Samoa	75	1,706	2.7
Fiji	90	3,093	1.8
Vanuatu	119	1,557	-1.1
Solomon Islands	128	566	-2.3
Papua New Guinea	139	659	-3.0

Sources: UN, Human Development Report (2006); and IMF, WEO database.

[1] Rank out of 177 countries.
[2] Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

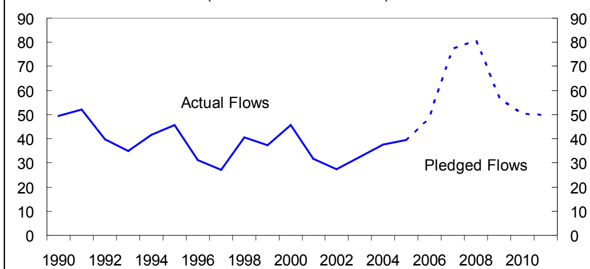
2. **Persistent political uncertainties have added to macroeconomic instability and retarded structural reform.** Vanuatu's fragmented political party structure has led to a series of fragile coalition governments which survived for only short periods as political unions were created and dissolved with frequency. Although not subject to the unrest seen in some of the neighboring Pacific island countries, the political instability distracts from needed action on reforms, and the private sector regularly lists this instability among its major concerns inhibiting investment. The current coalition government led by Prime

Minister Lini has been in place since December 2004 when the previous government was dissolved in a no confidence vote. Most of the major structural reform initiatives proposed by the staff, in particular civil service reform and measures to improve the private sector environment, could continue to prove politically difficult in the run-up to the next general election, due in July 2008.

3. **Since the formation of the present government, donor pledges have increased sharply.** Reflecting sound macroeconomic management and improved relations with traditional bilateral aid donors in the last two years, Vanuatu now faces the possibility of receiving significantly higher aid flows over the near and medium term. In addition, Vanuatu has become the first Pacific island country to receive funds from the U.S. Millennium Challenge Account, which could amount to as much as US$66 million in grant aid (17 percent of 2006 GDP) over the next five years to support infrastructure projects (discussed below).

Official Development Assistance to Vanuatu

(In millions of U.S. dollars)



Sources: AusAID; Millennium Challenge Corporation; NZAID; OECD; and IMF staff estimates.

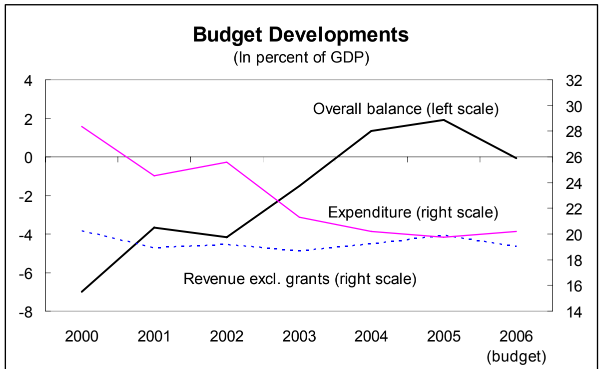
4. **In these circumstances, the country has the opportunity to place itself on a higher growth path.** Vanuatu fulfills many of the theoretical conditions for higher growth, in particular a wealth of natural resources, and growth opportunities in agriculture, fisheries, and tourism. The society is more homogeneous than in Papua New Guinea, Solomon Islands, and Fiji. There is currently less urban poverty and its associated problems than in many other island countries. Donor aid, if used effectively, could help reduce some of the barriers to development that Vanuatu faces.

B. Economic Developments

5. **Macroeconomic conditions have improved over the last several years.** Following two years of contraction, output growth recovered beginning in 2003, spurred by stronger performance in construction and a pickup in tourist arrivals following an expansion of airline capacity to Vanuatu (Table 1). Growth reached 7 percent in 2005 and an estimated 5½ percent in 2006, well above the average for Pacific island countries.[1] After peaking at 3 percent in 2003, inflation has since declined to 1½ percent in 2006 (Figures 1-4).

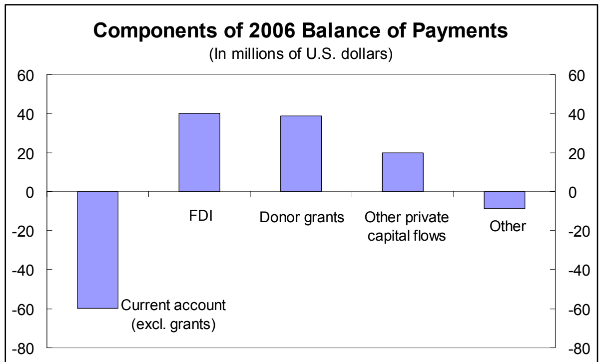
[1] Vanuatu's national accounts estimates have undergone frequent revisions, making it difficult to draw any firm conclusions about the growth rate solely based on national accounts data. The latest revisions, following external technical assistance, are particularly large, and produce GDP growth rates for 2004-05 that are unusually high relative to Vanuatu's historical growth experience. At the same time, the staff regard the direction of the revisions as broadly correct—all other indicators support a recent rebound in the economy.

6. **Budget performance has also improved**. With cuts in capital spending and improved tax collection—led by higher VAT collection, increased revenue from property taxes, and larger payments by hotels and retail operations—the budget moved from a deficit of 4 percent of GDP in 2002 to a surplus of nearly 2 percent of GDP in 2005 (Table 2). The 20-25 percent increase in civil servants' wages from July 2006, the first increase in some ten years, has led to an erosion of the budget position, with an expected deficit in 2006 of around ½ percent of GDP. However, the public debt-to-GDP ratio continued to decline to about 30 percent, from nearly 45 percent in 2002.



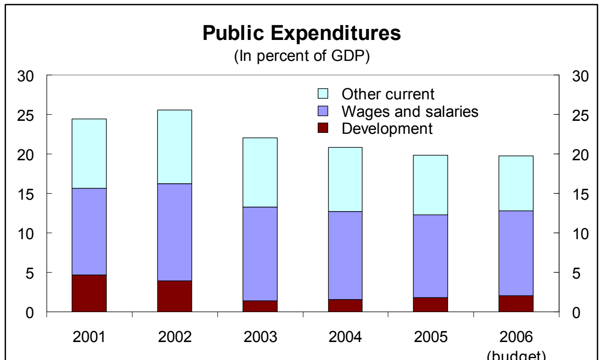
Sources: Vanuatu authorities; and IMF staff estimates.

7. **The overall external balance has strengthened.** The current account deficit remains in the range of 8-10 percent of GDP, but has been more than offset by FDI, aid, and private capital inflows (Table 3). Reserves have increased to over 7 months of import cover, well above the official target of 4 months. The real exchange rate has appreciated slightly relative to 2002.



Sources: Vanuatu authorities; and IMF staff estimates.

8. **However, progress on structural reforms has been limited.** On the positive side, financial sector reforms have been impressive, with the government taking steps over the last several years to substantially improve supervision of domestic banks and the offshore financial sector. At the same time, fiscal structural reforms have not advanced. The wage bill in 2006 reached over half of total expenditures (at around 12½ percent of GDP, high by regional standards), despite the government's own reform agenda to allow for more development-oriented public spending. The increase in civil service wages will boost these figures further beginning in 2007, underscoring the need for reforms. Numerous exemptions on VAT and duties have not been streamlined. In addition, little progress has been made on reforms to improve the private sector environment (discussed below), which are key to placing Vanuatu on a higher sustainable growth path.



Sources: Vanuatu authorities; and IMF staff estimates.

9. **The proposed agriculture development bank raises concerns.** In June 2006 a law was passed allowing for a new development bank, although it has not yet been established. Previously, a similar bank dominated by politically-motivated lending and mismanagement resulted in bankruptcy in 1998 and a corresponding increase in public debt.

C. Outlook and Risks

10. **If good macroeconomic policies continue and political stability is maintained, near-term prospects are positive.** Baseline projections show growth being maintained at about 4-5 percent over the next two-three years, boosted by the direct impact of aid and private capital inflows on investment and growing tourism following the launching of new flights to Vanuatu in 2006. Inflation is expected to increase modestly but remain subdued. There is, however, a risk that a loosening of fiscal policy and increased capital inflows could put upward pressure on private sector wages and prices.

11. **However, without structural reforms to improve the private sector environment, aid flows may be, as in the past, insufficient to deliver sustained growth over the medium term.** Although Vanuatu has been among the highest donor recipients of the Pacific island nations, aid has been relatively ineffective thus far in improving its growth performance. Barriers to private sector development remain substantial, and key structural and financial sector reforms are needed to render aid more effective. Without much stronger efforts to undertake these reforms, the positive growth projected in the near term could prove temporary. In this case, growth over the medium term is unlikely to exceed Vanuatu's historical performance of 2-2½ percent, with per capita income growth remaining stagnant.

II. Policies to Improve Growth Prospects

The discussions focused on the policies required to promote sustainable economic growth over the medium term. The authorities and staff team agreed on the importance of maintaining macroeconomic stability, and the need to avoid inflationary pressures that might begin to emerge as the result of the recent civil service wage increase. The staff team emphasized the need to accelerate structural reforms, focusing on improving the framework for fiscal policy formation, improving the efficiency and effectiveness of spending in health and education, facilitating the redirection of spending toward development-related priorities,
and strengthening the private sector environment. Staff and authorities agreed on the importance of subjecting the newly proposed agriculture development bank to strict central bank supervision.

Donor Aid Flows Per Capita
(U.S. dollars)

	1990-94	1995-99	2000-05
Fiji	70	53	53
Samoa	314	196	203
Tonga	287	293	230
Vanuatu	286	206	175

Sources: Vanuatu authorities; OECD; IMF, IFS database; and IMF staff estimates.

A. Maintaining the Favorable Macroeconomic Environment

Monetary and Exchange Rate Issues

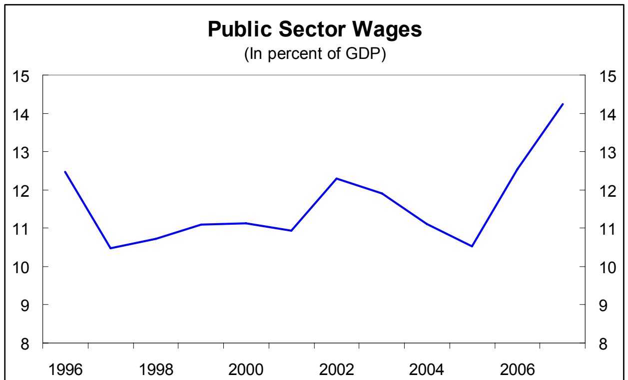
12. **The monetary conditions have eased somewhat in the last two years, with little sign of inflation.** Capital inflows from FDI, donor aid, and private nonresidents have resulted in an increase in reserves and domestic liquidity. Correspondingly, domestic credit has increased, reflecting lending related to property purchases, construction, and investment in the tourist sector. At the same time, there are few signs of inflationary pressures, suggesting growing money demand with the deepening of the financial sector.

13. **The staff team regards the transactions-weighted, basket pegged exchange rate regime as appropriate for Vanuatu's stage of development***,* given the country's small open economy with a narrow export base, its generally sound fiscal policy stance, and its limited institutional capacity to conduct monetary policy. Although it comes at the price of less monetary policy independence, and prevents the nominal exchange rate from playing a role in absorbing external shocks, the regime has served as an anchor to help keep inflation subdued. The current account deficit mainly corresponds to higher imports related to FDI and donor inflows, which are likely to continue over the medium term (Annex I, Table 4). With a stronger reserve position and good prospects for exports of many goods and tourism, there appears to be little sign of exchange rate misalignment at present. As such, staff regards resolving structural problems as the key to improving Vanuatu's competitiveness. The team reiterated the desirability of disclosing the weights of currencies in the basket and outlining the policy with regard to implementing changes in the weights.

14. **The staff team and authorities agreed that the prospect of continued capital inflows, particularly if accompanied by a loosening in fiscal policy, could pose a challenge to near-term macroeconomic management.** Increased donor inflows and a weakening of the budget position could add to domestic demand, increase imports, and put upward pressure on Vanuatu's real exchange rate. At the same time, other capital inflows, which may already be contributing to the reported increase in urban property prices, could remain substantial. Given Vanuatu's basket pegged exchange rate regime, monetary conditions are determined by balance of payments developments, and the role of monetary policy in offsetting these pressures remains limited. The authorities considered sterilization as an option, but argued it would be a costly and potentially counterproductive policy beyond the short run. With the budget parameters largely set in the short run, the staff and authorities saw the risk that demand growth could outpace supply capacity over the next several years, with few policy tools available to prevent a possible overheating of the economy. The staff urged that these developments be closely monitored in the future, particularly with the aim of protecting the external position and, if necessary, preventing an excessive increase in credit growth. The Reserve Bank of Vanuatu agreed with this assessment, emphasizing the role for strong bank supervision in the current environment. The authorities were confident that recent steps to improve supervision (discussed in Section C) and the prevalence of foreign-owned banks would help to limit any buildup of nonperforming loans.

Fiscal Issues

15. **The staff team emphasized that the current economic situation provided an opportune platform to restructure the government budget and improve fiscal policy formulation.** Improving the efficiency of government service delivery and reorienting the structure of expenditures toward development is a key priority. As part of this effort, the staff strongly supported the establishment of a medium-term expenditure framework. The authorities agreed that public service delivery could be improved, but emphasized that Vanuatu's large geographic spread necessitated a larger civil service than in many other Pacific island countries. The staff stated that the public sector wage bill reaching 14 percent of GDP in 2007, with levels of public employment similar to that in other countries, suggests that public sector wages are among the highest in the region. The authorities maintained that the recent wage increase was justified given the differential between civil service and private sector wages, while at the same time agreeing with staff that large *ad hoc* increases in wages are potentially damaging to macroeconomic management and recognizing the need to develop a more rational mechanism for civil service wage increases going forward.



Sources: Vanuatu authorities; and IMF staff estimates.

Regional Comparison of Wage and Salary Expenditures[1]

	Vanuatu	PNG	Samoa	Solomon Islands	Fiji
Public wage bill (in percent of GDP)	12.1	9.2	8.3	9.7	11.5
(percent of total expenditure)	53.0	29.4	24.5	24.5	40.6
Public employment (percent of total employment)	26.9	...	...	27.9	28.2

Sources: Authorities of Vanuatu, PNG, Samoa, Solomon Islands, and Fiji; and IMF staff estimates.
[1] The latest data for wages with corresponding employment data are 2003 figures.

16. **If these issues are not addressed, much of the improvement in the overall budget position to date is likely to unwind going forward.** Expenditure heavily directed toward the wage bill crowds out much needed development-related spending and could reduce Vanuatu's competitiveness by limiting the supply of labor available to the private sector, putting pressure on wages in growing export-oriented sectors including tourism. Added to this is the risk that some of the outstanding registered legal claims on land disputes against the government will materialize.

17. **Staff reiterated the considerable scope for improving the structure of revenues and widening the tax base.** Tax rates are high, variable, and with numerous exemptions. In addition to needed further improvements in tax administration, the staff encouraged a streamlining of the VAT and duty collections, which could increase budget revenue considerably. The authorities are beginning to recognize this more explicitly; the 2007 budget includes for the first time, an estimate of revenue lost to tax and duty exemptions. According to this estimate, the lost revenue in 2006 was over 3½ percent of GDP.

18. **The structure of the 2007 budget only partially addresses these concerns.** The authorities are projecting a balanced budget in 2007, although staff estimate that higher-than-budgeted expenditure needs could produce a deficit of ½ percent of GDP.

- *Tax revenue* is expected to increase by 2 percent of GDP. While the budget includes some commendable, albeit limited, measures to improve tax collection and limit VAT and duty exemptions, increased revenue mainly reflects the strong economic outlook and an expected increase in tax receipts associated with higher consumer spending following the civil service wage increase.

- Some import duties have been adjusted to increase revenue slightly, with the result that *import duty spreads* may increase, in contrast to the goal of streamlining the structure of import duties (duty rates range from 0 to 55 percent). Prior to the 2007 budget, the number of duty rates has been sharply reduced. However, the 2007 budget increases import duties on some items and reduces them on others, with the possible result that duty spreads will increase.

- Current expenditures are to increase by 2½ percent of GDP. This is almost entirely accounted for by the wage increase, with the *public sector wage bill* expected to approach nearly two-thirds of current expenditures.

- *Maintenance spending* will rise in line with the increase in donor-related capital spending, particularly that associated with the MCA (Box 1).

- *Capital expenditures* related to development needs are budgeted to rise by nearly 4 percent of GDP, although this increase is more than financed by donor grants, raising the question of sustainability of development spending if grants were to decline.

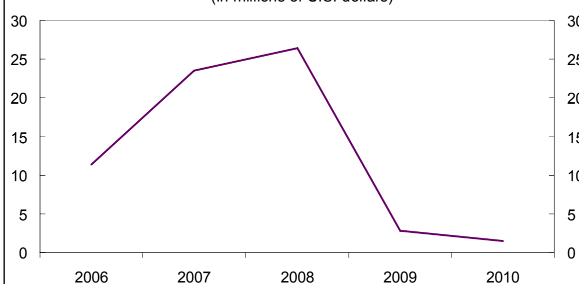
Box 1. The U.S. Millennium Challenge Account Program in Vanuatu

Vanuatu is the first Pacific island country to receive funding from the Millennium Challenge Account (MCA). The MCA was established in 2002 by the United States government for provision of foreign aid to countries meeting a set of established criteria (www.mcc.gov/about/index.php). In 2006, Vanuatu reached an agreement with the MCA for a grant of nearly $66 million over a five-year period (2006-10), with the objectives of benefiting poor, rural agricultural areas and spurring tourist-related goods and services by reducing transportation costs and improving access to transportation services. Eleven projects over eight islands have already been identified for funding in consultation with the Vanuatu government. The MCA's long-run program goals include increasing average income per capita by $200, providing market and social service access to rural inhabitants, and expanding tourism by 15 percent.

Vanuatu's MCA program is focused on a specific set of projects required to be completed within five years. Some 83 percent of total funds will be allocated towards engineering and construction, 9 percent to institutional strengthening for sustainability and maintenance, 6 percent for program administration and audits, and 2 percent for monitoring and evaluation. The program's projects include roads, bridges, and other infrastructure. Engineering and construction for all eleven projects will be tendered to a single external contractor as a design-build contract. After a competitive bidding process, the contract is expected to be finalized in early 2007 with the bulk of the construction occurring from end-2007 through 2009.

MCA Disbursement Schedule

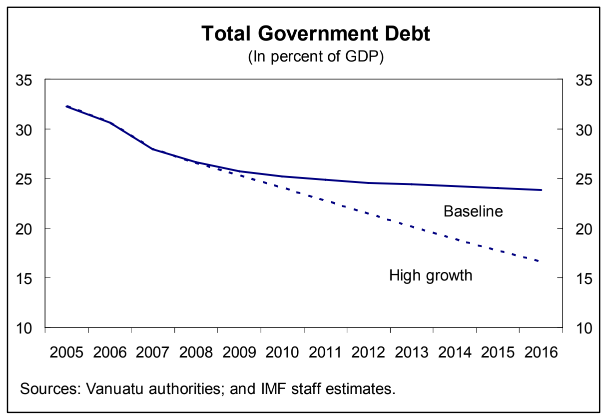
(In millions of U.S. dollars)



Source: Millennium Challenge Corporation, http://www.mcc.gov/countries/vanuatu/Vanuatu_Compact_Summary.pdf

The MCA is projected to have a significant impact on the local economy. Most contracted employees will be living in Vanuatu, boosting local housing and consumer markets. Depending on the external contractor, the projects' local content of labor, goods and services could be as much as 20 percent. The program also requires the government to budget annually funds for maintenance of program-related roads. Similarly, the government will be required to develop and implement wharf user fees for wharf maintenance.

19. **State-owned enterprise (SOE) reform is a key priority.** Many of Vanuatu's SOEs are heavily subsidized, depleting budget resources and distorting price-setting mechanisms that would encourage private sector development. Most SOEs operate without adequate oversight or accountability. The staff underscored the need to take quick action to restructure the national airline, Air Vanuatu, and the Vanuatu Commodities Marketing Board, two of the largest recipients of budget subsidies. The authorities recognize these problems, although they emphasized that SOE restructuring is particularly difficult in the current political environment. They nevertheless agreed that at a minimum attention should be given to establishing plans to restructure Air Vanuatu as soon as feasible. The staff strongly supported the government's initiative to establish a framework, with the objective of improving accountability and performance, to require all government business enterprises to provide regular financial reports to the Ministry of Finance.



20. **Overall, the authorities agreed that the medium-term fiscal strategy should focus on maintaining Vanuatu's debt sustainability.** While the projected deterioration in the budget balance is unlikely to produce a sharply rising debt-to-GDP ratio (Appendix I), the budget is currently overly reliant on donor grants. A strong fiscal position would reduce this reliance and create a cushion against lower revenue if growth slows or if unforeseen expenditure needs arise, such as in the event of a natural disaster.[2] The staff estimate that a fiscal deficit of less than 1½ percent of GDP would be sufficient to stabilize the debt-to-GDP ratio at its current level under the baseline scenario.

B. Promoting Private Sector Growth and Improving Competitiveness

21. **A key factor inhibiting Vanuatu's growth performance has been considerable barriers to private sector development,** including poor and expensive infrastructure and shortcomings in the legal framework, particularly for land use. These barriers have limited Vanuatu's external competitiveness and prevented sustained private sector-led growth (Box 2). The structural policies needed to reduce these barriers are well mapped out. The staff agrees with the list of policy measures that are needed and incorporated in the government's development plan focusing on improving the physical and legal infrastructure and strengthening the regulation of utility monopolies. While addressing these barriers is a

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[2] Vanuatu is now eligible for graduation from LDC status, which while welcome, could have an impact on future aid and trade preferences over the medium term. The possible loss of preferential trade status and reduced aid after graduation reinforce the need to increase competitiveness and reduce reliance on donor grants.

Box 2. Reasons for Vanuatu's Historically Poor Growth Performance

Until recently, Vanuatu has witnessed low growth and falling per capita income. In the past decade, real GDP growth averaged only 2 percent, while relatively rapid population growth led to a decline in per capita terms. Vanuatu's GDP per capita of $1,557 in 2004 was below many of its neighbors and one-fourth of the Caribbean average.

Vanuatu's economy continues to be plagued by barriers to private sector development. Key impediments include:

- *Political instability.* Policy uncertainty arising from a series of short-lived coalition governments has stifled key economic reforms and deterred foreign investment.

- *High costs of doing business.* According to the World Bank, Vanuatu's ease of doing business index ranked 58th out of 175 in 2006, below Fiji, Samoa and Tonga. Compared to its neighbors, Vanuatu ranks particularly low in the ease of obtaining credit, registering property, and trading.

- *Poor and expensive infrastructure.* The cost of electricity, telecommunication, and transportation remains high by regional standards, while sanitation and water supply are inadequate.

- *Insecure transactions framework.* The legal framework for securing transactions is incomplete, in particular with regard to the use of collateral and debt collection.

- *Weak property and land rights.* Land-sharing arrangements enshrined in the Constitution make it difficult to use land as security for loans and for productive investment purposes, and often give rise to land ownership disputes.

Structural Indicators

	Fiji	Samoa	Tonga	Vanuatu
Paved roads (in percent of total roads) (2000)	49	42	27	24
Aircraft departures (2004)	45,669	10,538	1,336	1,477
Telephone mainlines per 100 residents (2005)	12	7	11	3
Mobile phone subscribers per 100 residents (2005)	17	13	16	6
Cost of three-minute call to U.S., U.S. dollars (2004)	3	1	1	7
Electricity costs, U.S. dollars per kwh (2003)	0.16	0.18	0.31	0.26
Electricity consumption per capita, kwh (2004)	904	547	374	189
Improved sanitation facilities (percent of population with access)	72	100	96	50
Improved water facilities (percent of population with access)	47	88	100	60

Sources: Vanuatu authorities; Energy Information Administration; International Telecommunication Union, *World Telecommunication Development Report* (2006); and World Bank, *World Development Indicators* (2006).

Moving forward, there is a need to push ahead with policies to improve the climate for private investment. Measures should focus on reducing the high costs of doing business; upgrading and maintaining infrastructure; strengthening the regulation of utility monopolies; improving the legal framework to allow for a wider range of securitization and more efficient debt collection; reforming the land tenure system to ensure transparent, fair and enforced property rights; and restructuring loss-making SOEs including through privatization.

difficult and ongoing challenge, important steps can be taken now to lay the basis for future policy actions. In this regard the staff strongly supported the authorities initiative to establish a secured transactions system for the use of moveable assets as collateral, and to put in place a utilities regulatory authority to exercise oversight over monopolies in telecommunications, energy, and other utilities.

22. **With Vanuatu's relatively open trade regime, reducing these barriers could contribute directly to the country's external competitiveness.** Beginning in 2004 the country expanded its regional trade links, participating in the Pacific Island Countries Trade Agreement, and the Pacific Agreement on Closer Economic Relations, and it intends to participate in the prospective Economic Partnership Agreement with the EU. Prior to the 2007 budget, Vanuatu had sharply reduced the number of tariff rates, although the average rate is still high by regional standards. The authorities have taken some steps to liberalize exports of copra, cocoa, and kava by reducing the role of the Vanuatu Commodities Marketing Board, although these steps can be easily reversed, creating uncertainty which continues to hinder agricultural development. In addition, the structural weaknesses discussed above prevent Vanuatu from being more competitive relative to other Pacific island nations.

C. Strengthening the Financial Sector

23. **Staff commended the authorities on the substantial strengthening of financial sector supervision, emphasizing that additional steps are needed in certain areas.**

- *Domestic bank supervision* has been brought to international standards. Vanuatu's banking supervision is now largely compliant with all of the Basel Core Principles. Nevertheless, staff training is required both for further development and to address the current lack of supervisory skills. The banking system, comprising two Australian-owned commercial banks and one domestically-owned bank, is generally sound and profitable, although problems related to a few large loans have led to a recent increase in the nonperforming loan ratio. Some loans were resolved last year through collateral sales, and the remaining loans are adequately provisioned for.

- *The supervision of the offshore financial center* has seen a dramatic improvement since the last assessment in 2002, a result of the authorities' desire to improve Vanuatu's reputation as a financial center. With the elimination of licenses for shell banks (those lacking a physical presence in Vanuatu), the number of offshore banks fell from some 100 in the early 1990s to 7 by end-2006.

- *Improving supervision of insurance companies* remains a key priority. While a regulatory framework for insurance oversight is now in place, a lack of skilled staff remains a shortcoming. Staff encouraged a timely transfer of insurance supervision to the Reserve Bank of Vanuatu.

- *AML/CFT* legislation has been put in place, but awareness of legislative obligations needs to be increased. The staff urged the authorities to take steps to bring the Financial Intelligence Unit to full operational capacity, and in this regard, reexamine the current institutional setting for the unit with the aim of increasing its effectiveness.

24. **Staff and the authorities agreed that the establishment of the state-owned Vanuatu Agriculture Development Bank (VADB), if not carried out carefully, could pose risks to the financial system and public sector debt.** According to the legislation, the VADB is intended to facilitate economic development with special regard to agriculture, forestry, fisheries, livestock, manufacturing, and tourism. The bank may issue bonds and borrow money, but is not allowed to take deposits. Under the current law, the bank would not be subject to central bank supervision, but would be required to provide information to the Ministry of Finance. The authorities agreed that the Ministry of Finance lacks the capacity to supervise such a bank, and recognized that Vanuatu's previous experience with a development bank did not end well. Given this, the authorities agreed that the VADB should be required, from its inception, to operate under central bank supervision. The authorities also expressed awareness that preventing political interference in lending decisions would require a board which included independent members skilled in commercial banking operations.

III. Staff Appraisal

25. **Vanuatu is now in a position to capitalize on recent favorable developments to maintain strong economic growth over the next several years.** Output growth has rebounded, private capital inflows have increased, and near term growth prospects are good. Macroeconomic conditions are sound, and improved relations with donors have led to a significant increase in donor pledges. This aid, if used effectively, could help reduce some of the barriers to development Vanuatu faces.

26. **Although growth is strong at present, aid flows alone cannot maintain this performance over the medium term without a more concerted effort to address structural weaknesses.** Vanuatu's economy continues to be plagued by barriers to private sector development, including poor and expensive infrastructure and shortcomings in the legal framework, particularly for land use. Policies to reduce these barriers would enhance Vanuatu's external competitiveness and lead to sustained private sector-led growth.

27. **In the near term, there is a risk that recent civil service wage increases could add to already strong demand and lead to a more pronounced pickup in inflation.** Given Vanuatu's basket exchange rate peg system, the role of monetary policy in offsetting these and other pressures is limited. The central bank should nevertheless monitor the situation carefully with an eye to preventing credit growth from adding to demand pressures as well as leading to an increase in nonperforming loans. Strong bank supervision will be important in this regard.

28. **The present economic situation provides an opportune time to begin undertaking long overdue fiscal restructuring.** Reforms should focus on improving the delivery and efficiency of government services, reducing the size of the wage bill, and removing numerous tax exemptions. Loss-making state-owned enterprises should be restructured, including through privatization.

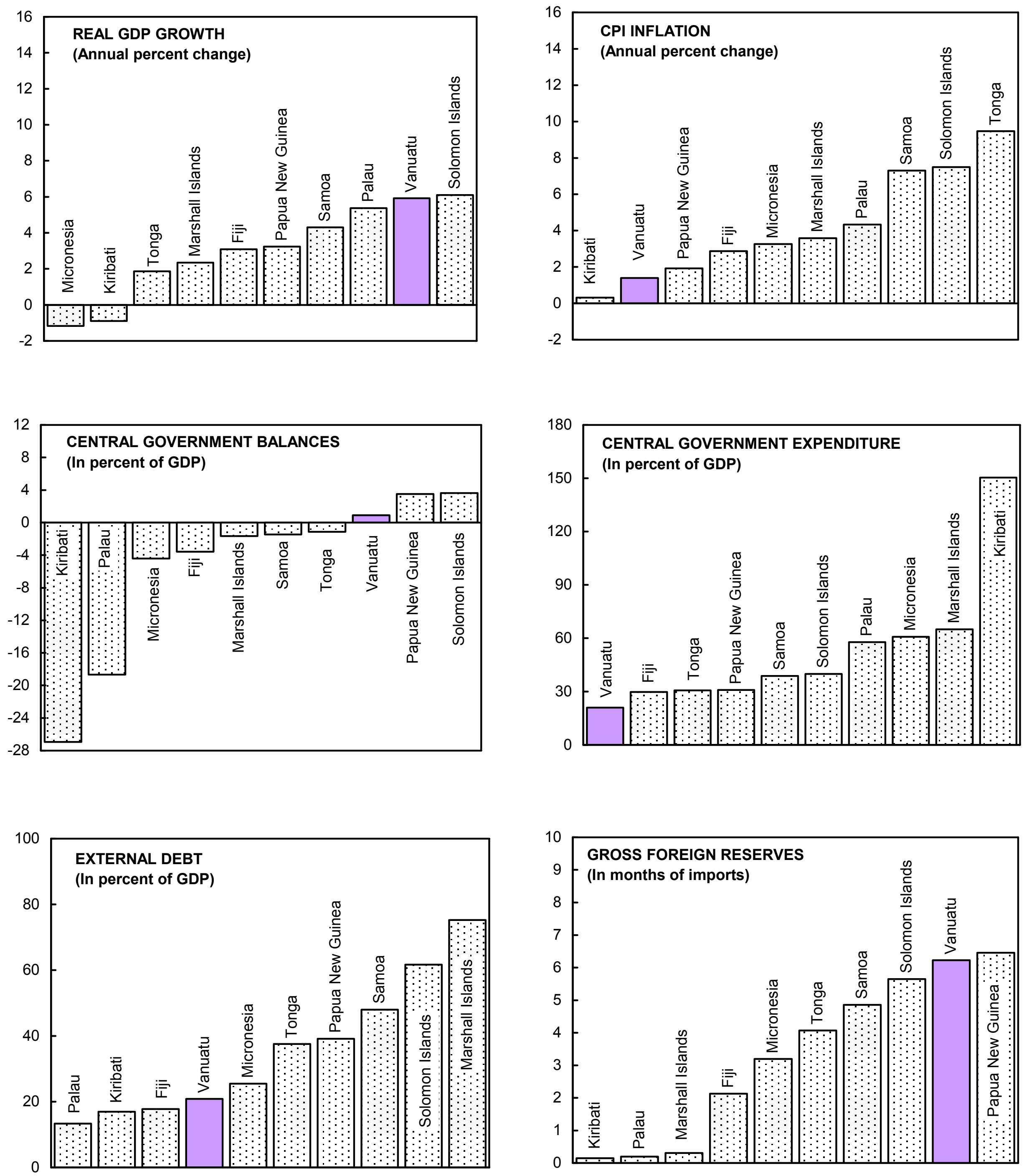
29. **The transactions-weighted, basket pegged exchange rate regime is appropriate for Vanuatu's stage of development.** With a stronger reserve position and good prospects for exports of many goods and tourism, there appears to be little sign of exchange rate misalignment at present. As such, staff regards resolving structural problems as the key to improving Vanuatu's competitiveness.

30. **Recent financial sector reforms are commendable, but additional efforts are needed to ensure this sector remains sound.** In particular, the proposed agriculture development bank should be placed under strict central bank supervision from its inception to prevent the mismanagement and loan losses experienced by the previous development bank.

31. **Improving domestic capacity to compile statistics is necessary to strengthen monitoring and policy analysis.** Fund staff, including through PFTAC, will continue to assist in this area.

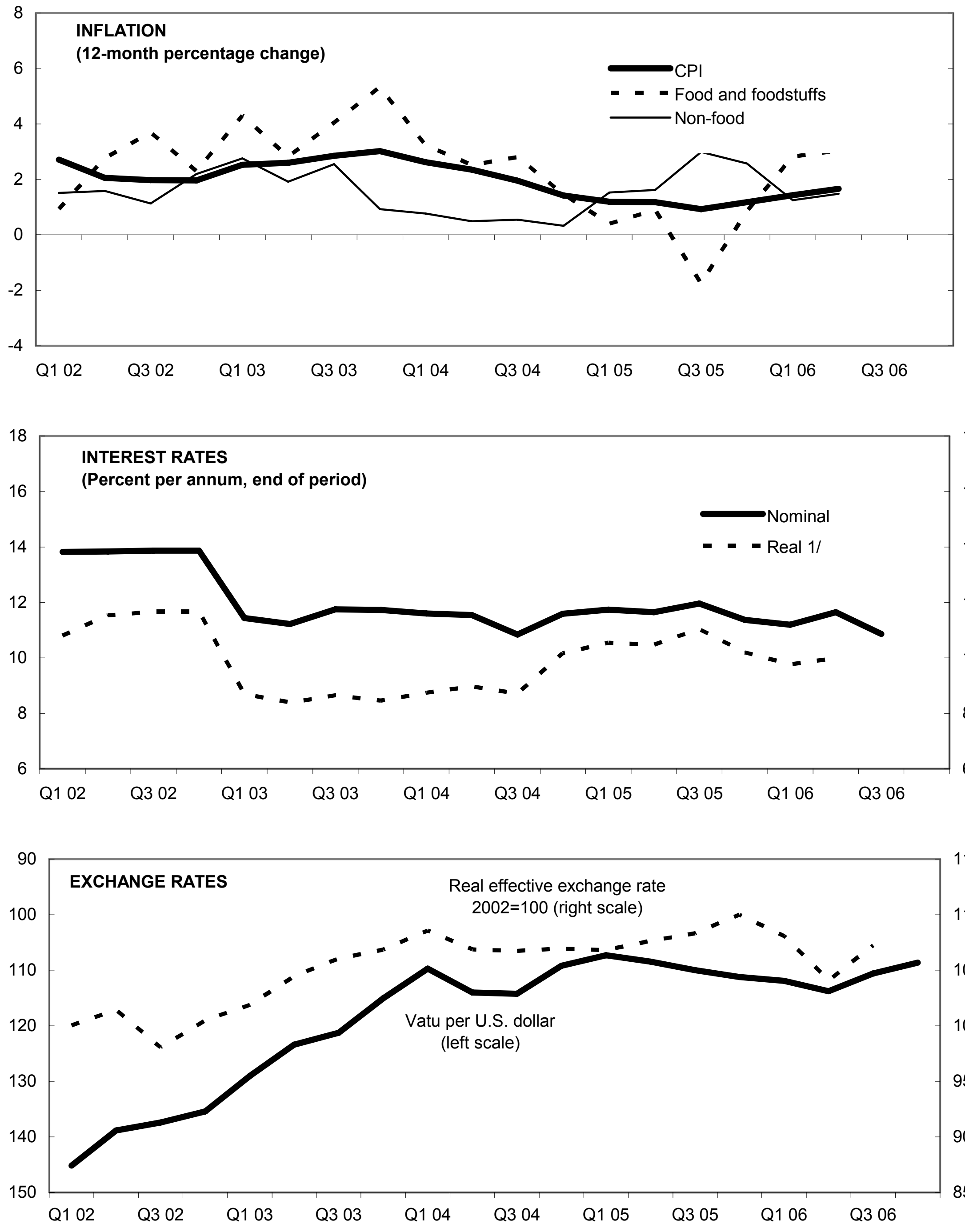
32. **It is recommended that the next Article IV consultation take place on the 24-month cycle.** The authorities welcomed a proposed interim staff visit during 2007.

Figure 1. Vanuatu: Regional Comparators
(Averages, 2004–06)



Sources: Vanuatu authorities; and Fund staff estimates.

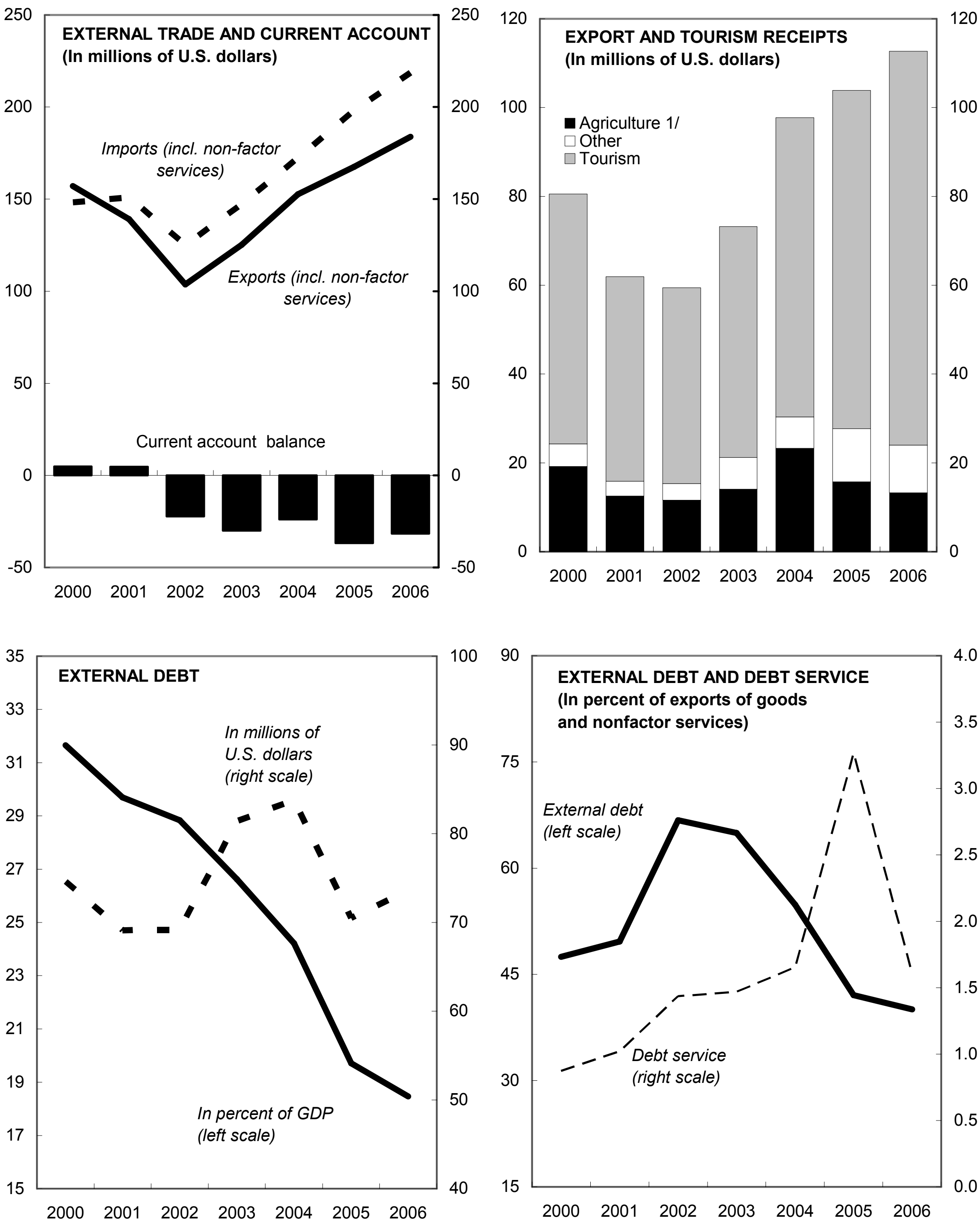
Figure 2. Vanuatu: Selected Economic Indicators, 2002–06



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.

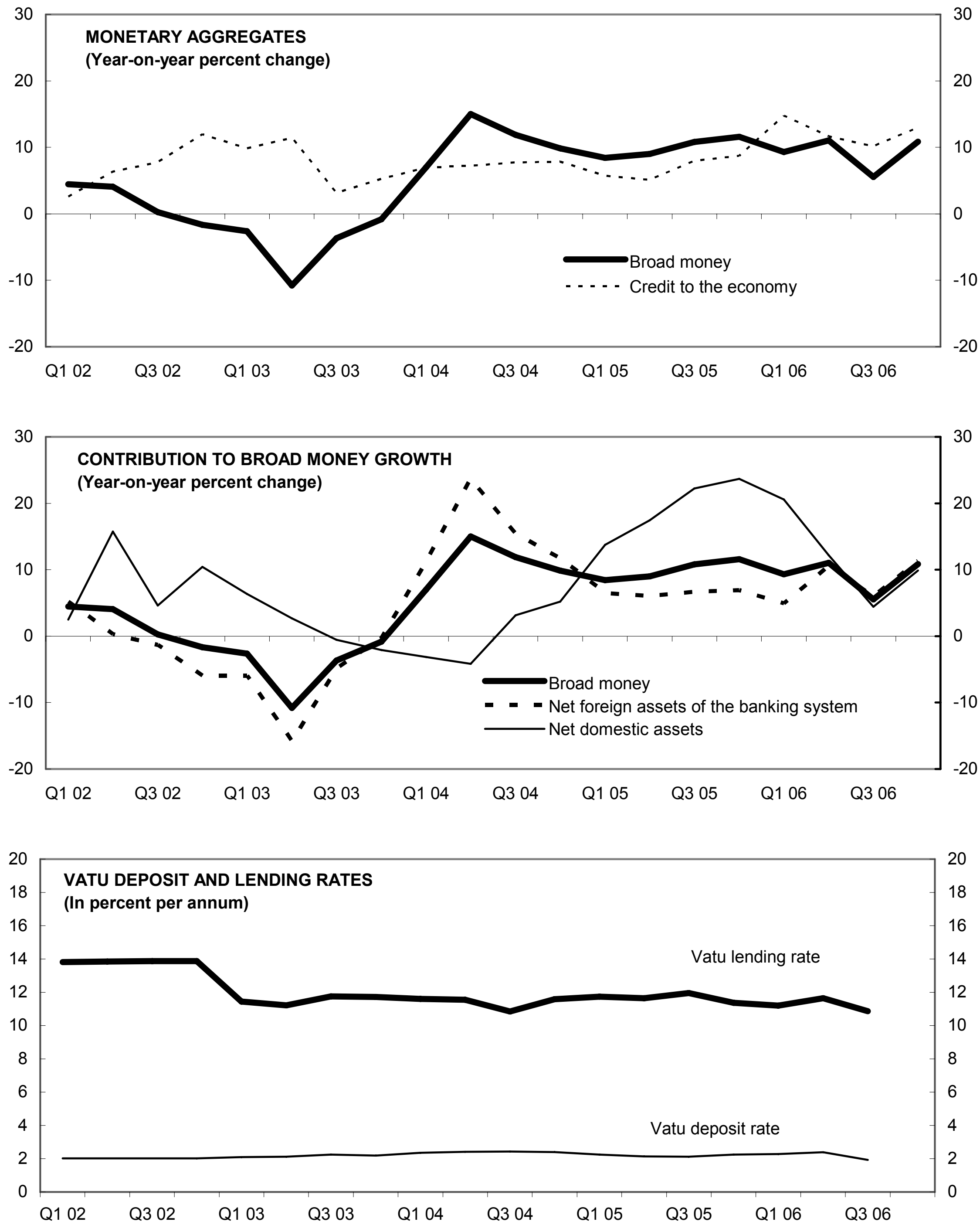
Figure 3. Vanuatu: External Sector Developments, 2000–06



Sources: Vanuatu authorities, and Fund staff estimates.

1/ Agricultural exports include beef, cocoa, coconut oil, copra, kava, and timber.

Figure 4. Vanuatu: Monetary and Financial Indicators, 2002–06



Sources: Vanuatu authorities, and Fund staff estimates.

Table 1. Vanuatu: Selected Economic and Financial Indicators, 2002–07

Nominal GDP (2005): US$368 million
Main exports: Tourism, kava, beef
GDP per capita (2005): US$1,692
FDI (2005): US$12.6 million
Public debt (2005): 32.2 percent of GDP
Foreign public debt (2005): 61.1 percent of total public debt

	2002	2003	2004	2005	2006	2007
				Est.	Proj.	
Output and prices (annual percentage change)						
Real GDP	-7.4	3.2	5.5	6.8	5.5	5.0
Nominal GDP	-6.4	7.0	7.8	9.0	7.2	7.6
Consumer prices (period average)	2.0	3.0	1.4	1.2	1.6	2.5
Government finance (in percent of GDP)						
Total revenue and grants	21.5	19.8	21.5	21.7	22.5	28.8
Revenue	19.1	18.5	19.1	19.8	20.3	22.2
Tax	17.0	16.8	17.1	17.7	17.8	19.8
Nontax	2.1	1.8	1.9	2.1	2.5	2.4
Grants 1/	2.3	1.3	2.5	1.9	2.3	6.6
Total expenditure	25.6	21.3	20.2	19.8	23.1	29.3
Current expenditure 2/	21.7	20.0	18.6	18.0	20.3	22.7
Capital expenditure	3.9	1.4	1.6	1.8	2.8	6.6
Overall balance	-4.2	-1.5	1.3	1.9	-0.5	-0.5
Money and credit (annual percentage change)						
Broad money (M2)	-1.7	-0.8	9.8	11.6	11.1	...
Net foreign assets	-6.0	-0.3	11.7	6.9	12.2	...
Domestic credit	12.0	5.3	7.9	8.7	13.0	...
Credit to private sector	7.9	9.8	9.6	16.3	11.5	...
Interest rates (in percent, end of period) 3/						
Deposit rate (vatu deposits)	2.1	2.2	2.4	2.3	1.9	...
Lending rate (vatu loans)	11.6	11.7	11.6	11.4	10.9	...
Balance of payments						
Current account (in millions of U.S. dollars)	-22.2	-30.0	-23.9	-36.8	-30.9	-55.7
(in percent of GDP)	-9.7	-10.7	-7.3	-10.0	-8.0	-13.2
of which: tourism exports (in millions of U.S. dollars)	44.1	52.0	67.4	76.1	88.7	93.5
Merchandise exports, f.o.b. (in millions of U.S. dollars)	20.1	26.6	38.1	38.1	38.9	40.5
(annual percentage change)	0.7	32.5	43.4	0.0	2.0	4.0
Merchandise imports, f.o.b. (in millions of U.S. dollars)	74.6	86.8	106.8	124.7	140.3	170.9
(annual percentage change)	-4.5	16.4	23.1	16.7	12.5	21.8
of which: imports linked to donor-related projects	...	...	...	...	...	33.0
Gross official reserves (end of period)						
In millions of U.S. dollars	36.4	44.3	62.1	67.6	99.1	118.9
In months of corresponding imports of goods 4/	5.0	5.2	6.0	5.6	7.2	7.1
In months of corresponding imports of goods (excluding imports linked to donor-related projects) 4/	...	...	...	...	...	8.8
In months of prospective imports of goods 4/	4.3	4.3	5.1	4.9	5.9	6.8
External debt						
External debt (in percent of GDP) 5/	28.8	26.6	24.2	19.7	18.5	16.6
External debt service 6/	1.4	1.5	1.7	3.3	1.6	1.7
Exchange rates (period average)						
Exchange rate regime: pegged to an undisclosed basket of currencies						
Vatu per U.S. dollar (period average)	139.2	122.2	111.8	109.2	111.2	…
Real effective exchange rate (average, 2000=100)	106.5	111.5	113.6	114.5	…	…
(annual percentage change, - depreciation)	4.1	4.6	1.9	0.9	…	…
Memorandum items:						
Nominal GDP (in billions of vatu)	32.0	34.2	36.9	40.2	43.1	46.3
Per capita GDP (in U.S. dollars)	1,141	1,355	1,557	1,692	…	…
Population growth (annual percentage change)	2.6	2.6	2.6	2.6	…	…

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

1/ Includes Millennium Challenge Account (MCA) project grant which was launched in 2006.
2/ Assumes 20-25 percent civil service wage increase beginning July 2006.
3/ Weighted average rate of interest for total bank deposits and loans. 2006 data are as of September.
4/ Imports values are on c.i.f. basis.
5/ Medium- and long-term public debt only.
6/ In percent of exports of goods and nonfactor services.

Table 2. Vanuatu: Central Government Fiscal Operations, 2002-07

(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006		2007	
					Budget	Proj.	Budget	Proj.
Total revenue and grants	21.5	19.8	21.5	21.7	20.1	22.5	29.3	28.8
Revenue	19.2	18.7	19.2	19.9	19.0	20.3	22.8	22.3
Tax 1/	17.0	16.8	17.1	17.7	16.9	17.8	20.3	19.8
Taxes on properties	0.2	0.2	0.3	0.4	0.3	0.5	1.2	1.0
Goods and services	10.5	10.7	10.8	11.3	10.7	11.5	11.8	11.8
International trade	6.4	5.9	6.0	6.0	5.9	5.7	7.3	7.0
Nontax	2.1	1.8	1.9	2.1	2.2	2.5	2.4	2.4
Capital revenue	0.1	0.1	0.2	0.1	0.0	0.0	0.0	0.0
Grants 2/	2.3	1.1	2.3	1.8	1.1	2.3	6.6	6.6
Total expenditure and net lending	25.6	21.3	20.2	19.8	20.2	23.1	29.3	29.3
Total expenditure	25.6	21.3	20.2	19.8	20.2	23.1	29.3	29.3
Current expenditure	21.7	20.0	18.6	18.0	18.2	20.3	22.7	22.7
of which:								
Wages and salaries 3/	12.3	11.9	11.1	10.5	10.8	12.5	14.2	14.2
Purchases of goods and services	5.2	3.8	3.6	3.7	3.7	3.5	4.8	4.8
Interest payments	1.0	1.0	1.0	0.9	0.9	0.7	0.8	0.8
Transfers	2.4	2.4	2.3	2.2	2.2	3.0	2.4	2.4
Capital expenditure	3.9	1.4	1.6	1.8	2.0	2.8	6.6	6.6
Net lending	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**-4.2**	**-1.5**	**1.3**	**1.9**	**-0.1**	**-0.5**	**0.0**	**-0.5**
Financing	4.2	1.5	-1.3	-1.9	0.1	0.5	0.0	0.5
Foreign financing (net)	0.3	-0.3	-0.5	-1.3	0.1	0.1	-0.6	-0.5
Concessional borrowing	0.3	-0.3	-0.5	-1.3	0.1	0.1	-0.6	-0.5
Commercial borrowing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing (net)	3.9	1.8	-0.9	-0.6	0.0	0.5	0.6	1.0
Domestic market borrowing (net)	1.1	0.2	0.0	-0.4	0.0	0.0	0.0	0.0
Other domestic borrowing (net)	2.7	1.7	-0.9	-0.2	0.0	0.5	0.6	1.0
Memorandum items:								
Public debt	44.4	43.0	38.5	32.2	30.2	30.6	28.0	27.3
Domestic (in millions of vatu)	15.6	16.4	14.3	12.5	11.7	12.1	11.5	10.7
External (in millions of vatu) 4/	28.8	26.6	24.2	19.7	18.5	18.5	16.6	16.6
Debt service-to-revenue	6.9	7.3	7.7	10.9	7.6	6.2	6.1	5.9
Nominal GDP growth (annual percent change)	-6.4	7.0	7.8	9.0	7.2	7.2	7.6	7.6
Real GDP growth (annual percent change)	-7.4	3.2	5.5	6.8	5.5	5.5	5.0	5.0

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

1/ Net of tax rebate for import duties paid by UNELCO.
2/ Includes Millennium Challenge Account (MCA) project grant which was launched in 2006.
3/ Annual increases in wages and salaries generally reflect trends in public sector employment. Wages and salaries were increased by an additional 20 to 25 percent in July 2006.
4/ China provided VT 486 million of debt relief in 2005.

Table 3. Vanuatu: Balance of Payments, 2002–07
(In millions of U.S. dollars, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007
				Est.	Proj.	
Current account balance	**-22.2**	**-30.0**	**-23.9**	**-36.8**	**-30.9**	**-55.7**
Trade balance	-54.5	-60.2	-68.7	-86.6	-101.4	-130.4
Merchandise exports (f.o.b.)	20.1	26.6	38.1	38.1	38.9	40.5
Merchandise imports (f.o.b.)	-74.6	-86.8	-106.8	-124.7	-140.3	-170.9
Domestic consumption	-55.4	-65.3	-81.3	-106.9	-93.2	-109.6
Imports of capital goods (donor-related projects)						-33.0
Imports for re-exports	-1.2	-0.9	-1.8	-1.3	-1.3	-1.3
Services balance	33.1	38.1	49.0	55.9	67.4	71.1
Receipts	83.6	98.7	114.6	129.5	145.0	152.6
of which: travel	44.1	52.0	67.4	76.1	88.7	93.5
Payments	-50.4	-60.5	-65.5	-73.6	-77.6	-81.5
Income	-11.5	-15.2	-18.7	-25.9	-29.9	-31.4
Receipts	22.4	24.2	27.2	27.8	29.1	30.6
Payments	-33.9	-39.4	-45.8	-53.7	-59.0	-62.0
Current transfers (net)	10.7	7.3	14.4	19.9	33.0	35.0
Official current transfers (net)	15.9	14.8	20.6	19.8	28.0	30.0
Private current transfers (net)	-5.2	-7.5	-6.3	0.1	5.0	5.0
Capital and financial account	**26.1**	**35.1**	**50.8**	**35.9**	**62.4**	**75.5**
Capital account	-1.9	-3.9	-2.1	0.9	1.6	27.3
Official capital transfers (net)	6.4	5.6	7.2	10.2	10.9	36.6
Private capital transfers (net)	-8.3	-9.5	-9.4	-9.4	-9.4	-9.4
Financial account	28.0	39.0	52.9	35.1	60.8	48.3
Foreign direct investment	13.6	17.3	19.2	12.6	40.0	30.0
Portfolio investment	-0.3	2.0	0.9	-1.4	0.5	0.5
Government	0.7	-0.9	-1.5	-4.8	0.3	-2.2
Disbursements	1.5	0.0	0.0	0.0	2.4	0.0
Amortizations	-0.8	-0.9	-1.5	-4.8	-2.1	-2.2
Other investment	14.0	20.5	34.4	28.6	20.0	20.0
Net errors and omissions	-5.1	2.8	-9.1	11.1	0.0	0.0
Overall balance	**-1.2**	**7.9**	**17.7**	**10.3**	**31.5**	**19.8**
Financing	1.2	-7.9	-17.7	-10.3	-31.5	-19.8
Change in net official reserves of the RBV (-, increase)	1.2	-7.9	-17.7	-5.8	-31.5	-19.8
Change in gross reserves	-1.2	7.9	17.8	5.5	31.5	19.8
Change in liabilities of monetary authorities	0.0	0.1	0.0	0.3	0.0	0.0
Debt forgiveness (-, increase)	0.0	0.0	0.0	-4.4	0.0	0.0
Memorandum items:						
Gross official reserves (in millions of U.S. dollars)	36.4	44.3	62.1	67.6	99.1	118.9
(in months of corresponding imports of goods) 1/	5.0	5.2	6.0	5.6	7.2	7.1
(in months of prospective imports of goods)	4.3	4.3	5.1	4.9	5.9	6.8
Exports of goods (annual percentage change)	0.7	32.5	43.4	0.0	2.0	4.0
Imports of goods (annual percentage change)	-4.5	16.4	23.1	16.7	12.5	21.8
Current account balance (in percent of GDP)	-9.7	-10.7	-7.3	-10.0	-8.0	-13.2
Exchange rate (vatu per U.S. dollar, period average)	139.2	122.2	111.8	109.2	111.2	…

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

1/ Imports values are on c.i.f. basis.

Table 4. Vanuatu: Balance of Payments, 2006–11

(In millions of U.S. dollars, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011
			Proj.			
Current account balance	**-30.9**	**-55.7**	**-62.0**	**-48.3**	**-43.2**	**-42.4**
Trade balance	-101.4	-130.4	-137.8	-125.2	-121.5	-122.2
Merchandise exports (f.o.b.)	38.9	40.5	42.9	45.5	48.2	51.1
Merchandise imports (f.o.b.)	-140.3	-170.9	-180.6	-170.6	-169.7	-173.2
of which: imports of capital goods (donor-related projects)		-33.0	-36.2	-15.1	-9.5	-9.0
Services balance	67.4	71.1	73.7	76.5	79.7	83.0
Receipts	145.0	152.6	158.5	164.2	169.6	175.2
of which: travel	88.7	93.5	97.0	100.6	104.4	108.3
Payments	-77.6	-81.5	-84.8	-87.8	-89.9	-92.2
Income	-29.9	-31.4	-33.0	-34.6	-36.4	-38.2
Receipts	29.1	30.6	32.1	33.7	35.4	37.2
Payments	-59.0	-62.0	-65.1	-68.4	-71.8	-75.4
Current transfers (net)	33.0	35.0	35.0	35.0	35.0	35.0
Official current transfers (net)	28.0	30.0	30.0	30.0	30.0	30.0
Private current transfers (net)	5.0	5.0	5.0	5.0	5.0	5.0
Capital and financial account	**62.4**	**75.5**	**73.7**	**49.9**	**38.6**	**36.1**
Capital account	1.6	27.3	30.8	7.5	1.2	0.6
Official capital transfers (net)	10.9	36.6	40.2	16.8	10.5	10.0
Private capital transfers (net)	-9.4	-9.4	-9.4	-9.4	-9.4	-9.4
Financial account	60.8	48.3	42.9	42.5	37.5	35.5
Foreign direct investment	40.0	30.0	25.0	25.0	20.0	18.0
Portfolio investment	0.5	0.5	0.5	0.5	0.5	0.5
Government	0.3	-2.2	-2.6	-3.1	-3.1	-3.1
Other investment	20.0	20.0	20.0	20.0	20.0	20.0
Net errors and omissions	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**31.5**	**19.8**	**11.6**	**1.6**	**-4.6**	**-6.3**
Financing	-31.5	-19.8	-11.6	-1.6	4.6	6.3
of which: Change in net official reserves of the RBV (-, increase)	-31.5	-19.8	-11.6	-1.6	4.6	6.3
Memorandum items:						
Gross official reserves (in millions of U.S. dollars)	99.1	118.9	130.5	132.1	127.5	121.2
(in months of corresponding imports of goods) 1/	7.2	7.1	7.4	7.9	7.7	7.2
Exports of goods (annual percentage change)	2.0	4.0	6.0	6.0	6.0	6.0
Imports of goods (annual percentage change)	12.5	21.8	5.7	-5.5	-0.5	2.1
Current account balance (in percent of GDP)	-8.0	-13.2	-13.7	-10.1	-8.6	-8.0

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

1/ Imports values are on c.i.f. basis.

Table 5. Vanuatu: Vulnerability Indicators, 2002–07

(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007
				Est.	Proj.	
Financial sector indicators						
Public debt	44.4	43.0	38.5	32.2	30.6	27.3
Broad money (percent change, 12-month basis) 1/	-1.7	-0.8	9.8	11.6	11.1	...
Private sector credit (percent change, 12-month basis) 1/	7.9	9.8	9.6	16.3	11.5	...
Nonperforming loans (as share of total loans) 2/	3.9	8.4	13.3	19.5	16.4	...
Share of deposits in broad money (percent)	94.5	93.9	93.5	93.7	93.3	92.0
Share of foreign currency deposits in total deposits (percent)	66.8	64.5	62.6	59.8	55.4	50.2
External indicators						
Exports of goods (annual percentage change, in U.S. dollars)	0.7	32.5	43.4	0.0	2.0	4.0
Imports of goods (annual percentage change, in U.S. dollars)	-4.5	16.4	23.1	16.7	12.5	21.8
Current account balance (excl. official transfers)	-16.6	-16.0	-13.5	-15.4	-15.2	-20.3
Capital and financial account balance	11.3	12.5	15.4	9.8	16.1	17.9
Of which: Inward foreign direct investment	5.9	6.2	5.8	3.4	10.3	7.1
Gross official reserves (in millions of U.S. dollars)	36.4	44.3	62.1	67.6	99.1	118.9
(in months of corresponding imports of goods) 3/	5.0	5.2	6.0	5.6	7.2	7.1
(in months of prospective imports of goods and services)	4.3	4.3	5.1	4.9	5.9	6.8
(in percent of broad money)	13.9	14.3	17.3	17.8	22.3	25.6
Foreign liabilities of Reserve Bank of Vanuatu (in millions of U.S. dollars) 2/	1.9	1.9	1.9	2.2	2.0	…
Foreign currency exposure of Reserve Bank of Vanuatu 4/ 5/	5.8	4.9	3.4	3.5	2.3	…
Foreign assets of commercial banks (in millions of U.S. dollars) 2/	215.7	243.4	263.4	260.7	287.8	…
Foreign liabilities of commercial banks (in millions of U.S. dollars) 2/	65.2	65.0	64.8	63.6	85.4	…
Foreign currency exposure of commercial banks 2/ 4/	30.2	26.7	24.6	24.4	29.7	…
Total external debt (in percent of GDP) 6/	28.8	26.6	24.2	19.7	18.5	16.6
(in percent of exports of goods and nonfactor services)	66.8	65.0	54.9	42.1	40.6	36.3
External debt-service (in percent of exports of goods and nonfactor services)	1.4	1.5	1.7	3.3	1.6	1.7
Exchange rate (vatu per U.S. dollar, end of period)	133.2	111.8	106.5	112.3	106.5	…

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

1/ Change in percent of end-of-period broad money.
2/ Through end-September 2006.
3/ Imports values are on c.i.f. basis.
4/ Foreign currency exposure is defined to be foreign currency liabilities as a percentage of foreign currency assets.
5/ Through end-August 2006.
6/ Medium- and long-term public debt only.

Table 6. Vanuatu: Social Indicators 1/

		Same Region/Income Group	
	Vanuatu	East Asia and Pacific	Lower-middle Income
Population			
Total population (millions)	0.22	1,885	2,475
Growth rate (percent annual)	2.6	0.9	1.0
Urban population (percent of population)	24.0	40.6	48.7
Total fertility rate (births per woman)	4.0	2.0	2.0
GNI per capita (in U.S. dollars)	1,579	1,627	1,918
Current public expenditure			
Health (in percent of GDP)	3	1.9	2.5
Education (in percent of GDP)	10	3.2	3.5
Gross primary enrollment			
(in percent of school age population)	118	115	108
Male	120	116	111
Female	116	114	105
Immunization rate (percent 12-23 months)			
Measles	48	82	86
Diptheria/Pertussis/Tetanus (DPT)	49	87	88
Life expectancy at birth (years)			
Total	69	70	70
Male	67	68	68
Female	71	72	73
Mortality			
Infant (per thousand live births)	32	29	32
Under 5 (per thousand live births)	40	37	40

Sources: World Bank, *World Development Indicators* (2006) and Millennium Development Goals.

1/ Figures represent latest single year of data over the years 2000-06.

APPENDIX I. VANUATU—MEDIUM-TERM OUTLOOK

This appendix describes the result of medium-term simulations under a baseline scenario and a scenario assuming an acceleration of structural reforms to improve the private sector environment and the structure of the public sector budget. The results indicate that under either scenario, Vanuatu's public debt appears sustainable, assuming no weakening of fiscal policy going forward. The results also show that Vanuatu's growth rate, external position, and public debt profile are substantially better under the reform scenario.

Baseline scenario

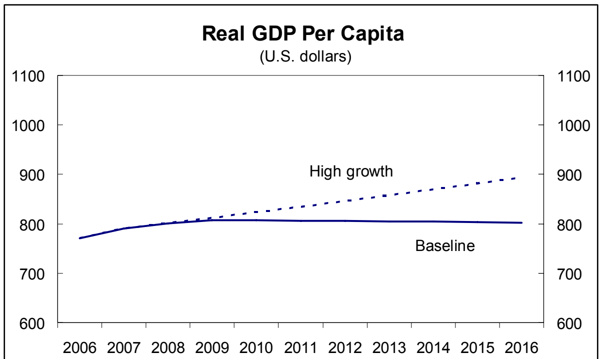
Policy assumptions. After rising initially, medium-term real GDP growth is assumed to fall to historic levels of about 2½ percent, reflecting poor and expensive infrastructure, as well as shortcomings in the legal framework, particularly for land use. Revenues rise in line with GDP, while expenditures increase in line with increasing needs for spending on maintenance and development-related investment, resulting in a worsening over time in the budget deficit.

Outcomes. Under this assumption, flows from the traditional bilateral donors and the MCA grant will raise GDP in the short term. In the medium term, as the MCA grant money fades, growth will decline to its historical trend. The current account deficit is sustainable as it is driven by imports that are related to donor flows, rising initially and declining in the medium term. Public debt declines gradually from 30 percent of GDP to 24 percent of GDP over a ten year period.

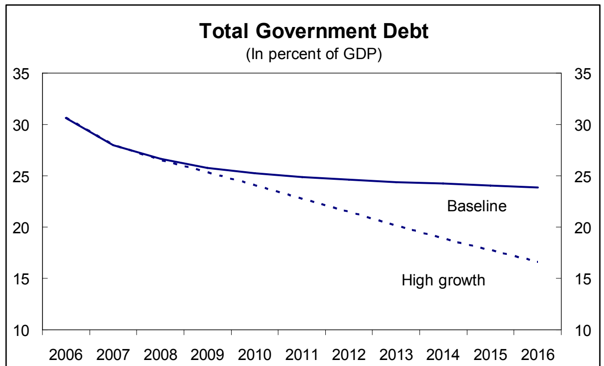
Comprehensive reform scenario

Policy assumptions. In this scenario, structural reforms are implemented expeditiously, with policies to reduce barriers to private sector development enhancing Vanuatu's external competitiveness and leading to higher sustained private sector-led growth than in the past. As a result, real annual GDP growth is assumed to be maintained at 4 percent over the medium term. With the widening of the tax base, revenues rise faster than GDP, while improvements in the efficiency of public sector services allow the budget to accommodate increasing needs for spending on maintenance and development-related investment with lower overall expenditures than in the baseline scenario. As a result, the budget remains at near balance over the medium term.

Outcomes. Structural reforms in combination with Vanuatu's relatively open trade regime improve external competitiveness resulting in a strong export-driven economy, particularly for tourism. Relative to the baseline scenario, export growth increases by 4 percent. The resulting improvement in the current account leaves Vanuatu in a stronger reserve position, with reserves increasing by 2 months of import cover (relative to baseline scenario). Public debt declines more rapidly, from 30 percent of GDP to 18 percent of GDP.



Sources: Vanuatu authorities; and IMF staff estimates.



Sources: Vanuatu authorities; and IMF staff estimates.

Baseline Scenario

	2006	2007	2008	2009	2010	2011	2012	Average 2013-16
Public debt (in percent of GDP)	30.6	27.9	26.6	25.7	25.2	24.9	24.6	24.1
Fiscal balance (in percent of GDP)	-0.5	-0.5	-0.5	-0.6	-0.7	-0.8	-0.9	-1.0
Current account (in percent of GDP)	-8.0	-13.2	-13.7	-10.1	-8.6	-8.0	-7.3	-6.1
Export growth of goods and nonfactor services (percent)	9.7	5.0	4.3	4.1	3.9	3.9	3.9	3.9
Import growth of goods and nonfactor services (percent)	9.9	15.8	5.2	-2.6	0.5	2.2	1.8	2.4
Gross official reserves (in months of imports)	7.2	7.1	7.4	7.9	7.7	7.2	6.6	5.5

Sources: Vanuatu authorities; and IMF staff estimates.

Reform Scenario

	2006	2007	2008	2009	2010	2011	2012	Average 2013-16
Public debt (in percent of GDP)	30.6	27.9	26.5	25.3	24.0	22.7	21.4	18.3
Fiscal balance (in percent of GDP)	-0.5	-0.5	-0.5	-0.4	-0.3	-0.2	-0.1	0.0
Current account (in percent of GDP)	-8.0	-13.2	-13.7	-9.0	-7.6	-7.1	-6.5	-5.3
Export growth of goods and nonfactor services (percent)	9.7	5.0	4.3	6.9	6.9	7.4	7.5	7.6
Import growth of goods and nonfactor services (percent)	9.9	15.8	5.2	-2.5	3.6	5.5	5.6	6.1
Gross official reserves (in months of imports)	7.2	7.1	7.4	8.2	8.2	8.0	7.8	7.3

Sources: Vanuatu authorities; and IMF staff estimates.

INTERNATIONAL MONETARY FUND

VANUATU

Staff Report for the 2006 Article IV Consultation—Informational Annexes

Prepared by the Asia and Pacific Department

February 9, 2007

ANNEX I. VANUATU—FUND RELATIONS
(As of December 31, 2006)

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	1.08	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. 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 December 31, 2006 was 106.5 vatu 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.

VIII. Article IV Consultation:

The last Article IV consultation discussions with the authorities were held in Port Vila during November 2004. The Executive Board discussed the staff report and concluded the consultation on February 25, 2005.

IX. OFC Assessments:

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

X. Technical Assistance from Headquarters (2000–present):

LEG, MCM, PFTAC, and STA have provided technical assistance on anti-money laundering, banking supervision, reserve management, and balance of payments.

XI. Resident Representative: None

ANNEX II. VANUATU—RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)[1]

Since 1998, the Center's assistance to Vanuatu has included 31 advisory missions, with a primary focus in banking supervision and statistics. In addition, Vanuatu has sent 28 officials to the Center's regional seminars, workshops, and training courses.

Financial Sector Supervision

PFTAC has provided assistance to the Reserve Bank of Vanuatu (RBV) to assist with the continued strengthening of its supervision of domestic and offshore banks and the provident fund. In addition, the advisor responds to ad-hoc requests for assistance. PFTAC also organized peripatetic advisors to assist the Vanuatu Financial Services Commission with the development of a supervisory framework for domestic and offshore insurance companies. PFTAC has also assisted the RBV arrange technical assistance to strengthen the functions of the central bank.

Public Financial Management

AusAid has funded an extensive technical assistance program in budget management. PFTAC has complemented that assistance through advice on prioritization and sequencing of needed reforms, and, in 2003, by training of staff on moving budget reporting to a GFS basis (see below). PFTAC is also currently providing advice and assistance through a peripatetic advisor on macroeconomic forecasting and analysis.

Tax Administration and Policy

PFTAC assistance has been limited to short diagnostic missions on strengthening customs administration and introducing select excises.

Economic Statistics

Following a PFTAC review, technical assistance provided by STA in the context of the GDDS/PFTAC project for Pacific island countries resulted in Vanuatu producing quarterly balance of payments and international investment position statistics consistent with the *BPM5*. The Center

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[1] The Pacific Financial Technical Assistance Center (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 Center'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.

trained staff and developed plans for presenting government finance statistics on the basis of the 2001 GFS Manual and for integration of GFS classifications with the budget and accounting systems. Data based on the new standards is nearing completion. PFTAC also undertook a mid-term review of the statistics element of an AusAID/AsDB funded institutional strengthening project. PFTAC has provided some ad hoc peer review of national accounts compilation.

ANNEX III. VANUATU—RELATIONS WITH THE WORLD BANK GROUP[2]

(As of January 2007)

Since joining the World Bank Group in 1981, Vanuatu has received five IDA credits totaling $18.9 million (all fully disbursed) in the areas of agricultural extension and training (1983), transportation and education infrastructure (1986), primary and secondary education (1988), affordable housing (1991), and a Learning and Innovation Loan (2001). Vanuatu is eligible for an IDA14 allocation of SDR 5.0 million (indicative only) over FY2006-08, of which SDR 1.7 million is for FY07.

The Bank's program of assistance to Vanuatu supports the Government's own development priorities as articulated in the Comprehensive Reform Program and is guided by the Bank's broader *Pacific Regional Strategy FY06-09*. The Bank's program targets a few key areas that have the potential to promote private sector growth and access to regional labor markets.

Promoting private sector growth

- **Utilities**. The Bank has supported the Government's initiatives to reduce high utilities costs through a series of policy-based workshops as well as provided funding through the *Developing a Multi-sector Utilities Regulatory Body* (US$227,500 PPIAF Grant, approved 12/01/2003) for a performance and regulatory review of the utilities sector. The Bank is also providing assistance on the draft National Energy Policy Framework and National Rural Electrification Master Plan, and on options for new rural initiatives or existing concession contracts.

- **Telecoms**. The Bank is supporting the Government's initiatives to reform the telecoms sector and improve the coverage and quality of services in the country through providing assistance in the preparation of a sector reform road map. It will include detailed goals to improve the telecoms market (structure and its evolution) and a subsequent implementation plan.

- **Investment**. The Foreign Investment Advisory Service (FIAS) has assisted the Vanuatu Investment Promotion Authority (VIPA) with the drafting of a National Investment Policy Statement, which was posted on VIPA's website in April 2005. Draft investment policy statements at the provincial level are being prepared and may be the subject of a further request for assistance by the Government to FIAS.

- **IFC technical assistance**. The Pacific Enterprise Partnership (formerly known as Pacific Enterprise Development Facility) has been providing support to individuals and intermediaries to allow them to on-deliver quality services in country. Two initiatives are underway in Vanuatu; one is working with the Melanesian Savings and Loans, and another with a tourism association. Vanuatu will be included in the joint Bank/IFC regional sustainable energy program.

[2] Prepared on the basis of inputs from the World Bank staff.

Enhancing access to regional labor markets

- **Labor mobility report**. The Bank has recently completed a migration report to understand the opportunities and address the constraints to labor market integration in the Pacific region. The report found that seasonal labor schemes targeting unskilled workers could offer new opportunities to Pacific Islanders, with empirical evidence showing that remittances have had a direct impact on improving the welfare of the poor. Drawing on global experience, the report concludes that with due attention to design and oversight, bilateral migration programs for temporary unskilled workers can be beneficial for both labor sending and receiving countries.

- **Seasonal workers pilot scheme**. The New Zealand Government has recently announced a new Pacific Seasonal Labor scheme that is expected to commence in April 2007. Vanuatu, the only country in Melanesia, has been selected as one of the first six countries to kick-start the scheme. The Bank has been requested by both governments of New Zealand and Vanuatu to play a key facilitation role in the design and evaluation of a pilot scheme which will see small numbers of ni-Vanuatu working in selected horticulture farms in New Zealand. In coordination with stakeholders, the Bank is providing implementation advice to ensure that both countries' needs and concerns will be considered and carefully addressed in the design of the pilot. The Bank will also help to strengthen the capacity of institutions to regulate, manage and benefit from the export of labor in Vanuatu in the same way the Bank designs technical assistance for trade facilitation in the goods market.

Recent reports:

- East Asia and Pacific Update: Managing through a Global Downturn, November 2006
- An East Asian Renaissance: Ideas for Growth, September 2006
- At Home and Away—Expanding Job Opportunities for Pacific Islanders through Labor Mobility, August 2006
- Opportunities to Improve Social Services: Human Development in the Pacific Islands, 2006
- The Pacific Infrastructure Challenge, 2006
- Not If, But When: Adapting to Natural Hazards in the Pacific Islands Region, 2006
- Pacific Regional Strategy FY2006-2009, May 2005

ANNEX IV. VANUATU—RELATIONS WITH THE ASIAN DEVELOPMENT BANK[3]

(As of end-December 2006)

The Asian Development Bank's (AsDB) operations in Vanuatu started in 1981. As of end-December 2006, the AsDB had provided nine loans (a total of $51.25 million) and 54 technical assistance (TA) projects ($15.77 million).

The loan projects included assistance for agriculture, cyclone damage rehabilitation, port facilities, urban infrastructure development, development financing, and the Comprehensive Reform Program. In line with Government policy, no loans were extended in 2006. In 2007, AsDB will continue the current strategy of not providing new loans to Vanuatu until there is sufficient demand for these loans.

The technical assistance projects cover both project preparation and advice 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, private sector development and access to affordable credit.

AsDB has recently successfully completed an advisory TA for development of a medium-term strategic framework which comprised the means for implementing the Priorities and Action Agenda (PAA) in a medium-term context, taking into account various planning and development modalities.[4] It became the integral part of the process ending with the Council of Ministers endorsing the PAA 2006-2015 and received a wide support among development partners for its potential to improve donor coordination.[5]

The ongoing TA includes secured transactions reform that was successfully initiated in November 2005.[6] Stakeholder consultations have been held in Port Vila and rural areas. A new secured transactions law is being drafted, and the supporting notice filing archive (registry) designed. The proactive approach by the Ministry of Finance in spearheading the reform process has been widely appreciated.

In the last quarter of 2006, technical assistance was approved to assist the Government in strengthening the framework for business transactions and thereby improve the reputation and commercial attractiveness of Vanuatu as an investment destination.[7] Specifically the TA will (i) reform the laws and regulations constituting the companies, bankruptcy and

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[3] Prepared on the basis of input provided by AsDB staff.

[4] AsDB. 2004. *Technical Assistance Development of Medium Term Strategic Framework*. Manila, approved in the amount of $500,000.

[5] A development partners meeting for "An Educated, Healthy and Wealthy Vanuatu" was held on 28 November 2006 in Port Vila.

[6] AsDB. 2004. *Technical Assistance to Vanuatu for Secured Transactions Reform*. Manila, approved in the amount of $600,000.

[7] AsDB. 2006. *Technical Assistance to Vanuatu Financial Services Commission: Institutional and Legal* reforms. Manila, approved in the amount of $800,000.

insolvency framework, (ii) develop companies' registry reform roadmap, and (iii) provide an assessment of Vanuatu Financial Services Commission to ensure high corporate governance standards and strong supervisory capabilities.

In 2007, AsDB will scale up a successful microfinance development project with the National Bank of Vanuatu.[8] In addition, assistance in 2008 will continue with the reforms focusing on the financial sector and private sector development reforms, especially improving the business environment. To complement the TA program and leverage scarce TA resources, AsDB will include Vanuatu in regional TA activities where feasible.

Given the country's development challenges and the Government's strategic development priorities, and taking into account AsDB's Pacific Strategy 2005–2009 and other donor programs, a Private Sector Development (PSD) focus for AsDB assistance is indicated. AsDB's approach in Vanuatu will (i) build upon the Private Sector Assessment[9] (ii) intensify support for recent successes in areas where there is a momentum for reform, (iii) focus on supporting institutions with sufficient absorptive capacity, and (iv) cover areas in which AsDB has comparative advantages and which are sparsely covered by other funding agencies. Dialogue with the Government and key stakeholders has underscored the need to remain focused on the PSD core areas of business law environment and access to finance, where AsDB has established a lead role throughout the Pacific.

The nonlending program focuses exclusively on creating an enabling environment for private sector growth through improved institutions and access to finance. Therefore, a key success determinant of this investment and its sustainability will be the Government's ability to manage the programs; and provide focused, stable leadership and counterparts. This will require a strong political consensus on the need for a stable and predictable business environment. A further key success determinant will be the private sector's ability to deliver the services. Thus, policy dialogue in support of the grant activities will be critical.

[8] The initial *Technical Assistance to Vanuatu for Rural and Microfinance Outreach* was approved in the amount of $250,000 in January 2004.

[9] AsDB. 2003. *Private Sector Assessment for Vanuatu: Issues, Challenges and Policy Options*, Manila.

Loans Commitment and Disbursement during 2000–06 (In millions of U.S. dollars)		
Year	Contract Awards	Disbursements
2000	9.5	10.6
2001	0.8	2.8
2002	0.0	0.2
2003	0.0	0.1
2004	0.0	0.0
2005	0.0	0.0
2006	0.0	0.0

Proposed Technical Assistance Projects for 2007–08 (In millions of U.S. dollars)		
Year	Project name	Amount
2007	Strengthening Rural and Microfinance	0.60
	Total	0.60
2008	Companies Registry Reform	0.60
	GBE Reform	0.50
	Total	1.10

ANNEX V. VANUATU: STATISTICAL ISSUES

Improvements have been made in economic statistics, but deficiencies persist in methods and coverage. 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 official statistics (including GDP, consumer prices, external trade, tourism activity, and labor and demography). 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 Indicator*s (*SI*). Recent technical assistance on the BOP and national accounts was provided by the Pacific Financial Technical Assistance Centre (PFTAC) in national accounts and, by STA in the context of the Fund's GDDS/PFTAC project for Pacific Island countries, and in BOP. Vanuatu began participating in the Fund's General Data Dissemination System (GDDS) in April 2004.

National Accounts and Prices

The NSO has compiled annual estimates of GDP by type of economic activity (in current and constant prices) and GDP by expenditure (in current prices) through 2005. The estimates, prepared with technical assistance from the PFTAC, Asian Development Bank, and AusAID, have been published in the quarterly *SI* and posted on the NSO's website. 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. Quarterly GFS data have been included in the RBV's *Quarterly Economic Review* and the NSO's quarterly *Statistics Indicator*s (*SI*) and posted on the website in a timely manner since 2001. The quality and timeliness of data have improved since a 1998 GFS mission. 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 have been released for publication since 2003. In recent years, Vanuatu has not reported statistics for publication in the *GFS Yearbook* and *IFS*. Some inconsistencies exist between the fiscal and monetary accounts concerning domestic financing of the budget by the banking system.

Monetary Statistics

Monetary statistics are compiled on a monthly basis for the RBV and three commercial banks. 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 commercial banks.

In March 2005, STA held a regional seminar at the STI to introduce the standardized report forms (SRFs) for monetary statistics. Vanuatu participated in the seminar and subsequently sent test data in the SRFs on several occasions. These data are being reviewed by STA and will be ready for publication in *IFS* once data issues are resolved.

The RBV has developed a standard reporting system for the offshore sector and the data on the activity of offshore banks are published quarterly.

External Sector Statistics

The BOP is compiled on a quarterly basis. As a result of PFTAC technical assistance, in the context of the GDDS/PFTAC project for Pacific island countries, extensive revisions have been made to annual BOP data, 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 has also improved with the adoption of a revised enterprise survey by end-2002. Assistance is ongoing to refine methods for compiling the BOP to ensure 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.

ANNEX V. VANUATU: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of January 31, 2007)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange Rates	Jan.2007	Jan.2007	D	D	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov.2006	Jan.2006	M	M	M
Reserve/Base Money	Nov.2006	Jan.2007	M	M	M
Broad Money	Nov.2006	Jan.2007	M	M	M
Central Bank Balance Sheet	Nov.2006	Jan.2007	M	M	M
Consolidated Balance Sheet of the Banking System	Nov.2006	Jan.2007	M	M	M
Interest Rates[2]	Nov.2006	Jan.2007	M	M	M
Consumer Price Index	Jun.2006	Nov.2006	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3] - General Government[4]	NA	NA	NA	NA	NA
Revenue, Expenditure, Balance and Composition of Financing[3] - Central Government	Nov.2006	Nov.2006	Q	Q	Q
Stocks of Central Government and Central Government - Guaranteed Debt	Nov.2006	Nov.2006	A	A	A
External Current Account Balance	Sept.2006	Nov.2006	Q	Q	Q
Exports and Imports of Goods and Services	Sept.2006	Nov.2006	Q	Q	Q
GDP/GNP	Nov.2006	Nov.2006	A	I	I
Gross External Debt[5]	Nov.2006	Nov.2006	A	A	A

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2]Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3]Foreign, domestic bank, and domestic nonbank financing.
[4]The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5]Does not include currency and maturity composition. For central government only.
[6]Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/27
FOR IMMEDIATE RELEASE
March 2, 2007

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

IMF Executive Board Concludes 2006 Article IV Consultation with Vanuatu

On February 26, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Vanuatu.[1]

Background

Vanuatu has recently emerged from a long period of low growth and falling per capita incomes. Following two years of contraction, output growth recovered beginning in 2003, spurred by stronger performance in construction and a pickup in tourist arrivals. Growth reached 7 percent in 2005 and an estimated 5½ percent in 2006, well above the average for Pacific island countries. After peaking at 3 percent in 2003, inflation has since declined to 1½ percent in 2006. The overall external balance has benefited from rising foreign direct investment, aid, and private capital inflows, with reserves increasing to over 7 months of imports.

Budget performance has also improved. With cuts in capital spending and improved tax collection, the budget moved from a deficit of 4 percent of GDP in 2002 to a surplus of nearly 2 percent of GDP in 2005. The increase in civil servants' wages from July 2006, the first in some ten years, has led to an erosion of the budget position, with an expected deficit in 2006 of around ½ percent of GDP. However, the public debt-to-GDP ratio continued to decline to about 30 percent from nearly 45 percent in 2002.

[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.

If good macroeconomic policies continue and political stability is maintained, near-term prospects are positive. Growth should be maintained at about 4-5 percent over the next two-three years, boosted by the direct impact of aid and private capital inflows on investment and growing tourism following the launching of new flights to Vanuatu in 2006. Inflation is expected to increase modestly but remain subdued. There is, however, a risk that a loosening of fiscal policy and increased capital inflows could put upward pressure on private sector wages and prices.

Medium-term prospects will depend on the pace of structural reforms, an area where progress has been limited. On the positive side, financial sector reforms have been impressive, with the government taking steps over the last several years to substantially improve supervision of domestic banks and the offshore financial sector. At the same time, fiscal structural reforms have not advanced. The wage bill remains high, crowding out development-related spending. Numerous exemptions on the value-added tax and duties have not been streamlined. In addition, little progress has been made on reforms to address the substantial barriers to private sector development, which are key to placing Vanuatu on a higher growth path. Without stronger efforts to undertake these reforms, the positive growth projected in the near term could prove temporary, with medium-term growth reverting to its historical performance and per capita income growth remaining stagnant.

Executive Board Assessment

Executive Directors commended the authorities for maintaining sound macroeconomic policies, which have strengthened the economic recovery, as well as for progress made in financial sector supervision. Directors encouraged the authorities to take advantage of the recent favorable developments to establish the foundations for maintaining strong economic growth over the next several years. Improved relations with donors have led to a significant increase in donor support that, if used effectively, could help reduce some of the deep-seated barriers to development that Vanuatu faces.

Directors stressed that although growth is strong at present, aid flows alone cannot maintain this performance over the medium term without a more concerted effort to address structural weaknesses. Directors urged the authorities to accelerate policies to reduce Vanuatu's impediments to private sector development, including poor and expensive infrastructure and shortcomings in the legal framework. This would enhance Vanuatu's external competitiveness and promote private sector activity.

Directors considered that the recent large civil service wage increases could add to demand pressure and a pickup in inflation. While recognizing that Vanuatu's basket exchange rate peg system limits the role of monetary policy, Directors nevertheless urged the central bank to monitor the situation carefully with an eye to preventing credit growth from adding to demand pressures as well as leading to an increase in nonperforming loans. Strong bank supervision will be important in this regard.

Directors emphasized that the present economic situation provides an opportune time for the authorities to begin undertaking long overdue fiscal restructuring. They urged the authorities to focus reforms on improving the delivery and efficiency of government services, restructuring the civil service and reducing the associated wage bill, and removing numerous tax exemptions and enhancing tax administration. Directors stated that loss-making state-owned enterprises should be restructured, including through privatization.

Directors considered the transactions-weighted, basket pegged exchange rate regime as appropriate for Vanuatu's stage of development, and stressed that progress on the structural agenda will be key to improving Vanuatu's competitiveness.

Directors welcomed the considerable progress in reforming the financial sector, but noted that additional steps are needed in certain areas. In particular, they urged the authorities to place the proposed agriculture development bank under strict central bank supervision from its inception to prevent the mismanagement and loan losses experienced by the previous development bank. Directors encouraged the authorities to promote commercial bank awareness of their responsibilities under the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) legislation.

Directors underscored the need to improve the domestic capacity to compile statistics for timely monitoring and policy analysis, and encouraged the authorities to intensify their efforts in this area.

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Vanuatu: Selected Economic and Financial Indicators, 2002–07

	2002	2003	2004	2005	2006	2007
				Est.	Proj.	
Output and price (annual percentage change)						
Real GDP	-7.4	3.2	5.5	6.8	5.5	5.0
Consumer prices (period average)	2.0	3.0	1.4	1.2	1.6	2.5
Government finance (in percent of GDP) 1/						
Total revenue and grants 2/	21.5	19.8	21.5	21.7	22.5	28.8
Total expenditure 3/	25.6	21.3	20.2	19.8	23.1	29.3
Current expenditure	21.7	20.0	18.6	18.0	20.3	22.7
Capital expenditure	3.9	1.4	1.6	1.8	2.8	6.6
Overall balance	-4.2	-1.5	1.3	1.9	-0.5	-0.5
Money and credit (annual percentage change)						
Broad money (M2)	-1.7	-0.8	9.8	11.6	11.1	…
Net foreign assets	-6.0	-0.3	11.7	6.9	12.2	…
Domestic credit	12.0	5.3	7.9	8.7	13.0	…
Balance of payments						
Current account (in millions of U.S. dollars)	-22.2	-30.0	-23.9	-36.8	-30.9	-55.7
(in percent of GDP)	-9.7	-10.7	-7.3	-10.0	-8.0	-13.2
Of which: tourism exports (in millions of U.S. dollars)	44.1	52.0	67.4	76.1	88.7	93.5
Merchandise exports, f.o.b. (in millions of U.S. dollars)	20.1	26.6	38.1	38.1	38.9	40.5
(annual percentage change)	0.7	32.5	43.4	0.0	2.0	4.0
Merchandise imports, f.o.b. (in millions of U.S. dollars)	74.6	86.8	106.8	124.7	140.3	170.9
(annual percentage change)	-4.5	16.4	23.1	16.7	12.5	21.8
Gross official reserves (end of period)						
In millions of U.S. dollars	36.4	44.3	62.1	67.6	99.1	118.9
In months of corresponding imports of goods 4/	5.0	5.2	6.0	5.6	7.2	7.1
Public Debt debt						
Total debt (in percent of GDP)	44.4	43.0	38.5	32.2	30.6	27.3
External debt (in percent of GDP) 5/	28.8	26.6	24.2	19.7	18.5	16.6
External debt service 6/	1.4	1.5	1.7	3.3	1.6	1.7

Sources: Vanuatu authorities, and IMF staff estimates and projections.
1/ Figures in 2006 and 2007 are staff projections.
2/ Includes Millennium Challenge Account (MCA) project grand which was launched in 2006.
3/ Assumes 20–25 percent civil service wage increase beginning July 2006.
4/ Imports values are on c.i.f. basis.
5/ Medium- and long-term public debt only.
6/ In percent of exports of goods and nonfactor services.