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VANUATU

2013 ARTICLE IV CONSULTATION

June 2013

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV consultation with Vanuatu, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 20, 2013, with the officials of Vanuatu on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 16, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its June 7, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Vanuatu.

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

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

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VANUATU

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

May 16, 2013

KEY ISSUES

Macroeconomic situation and outlook: The economy is gradually turning around after weak growth in 2010–11 on the back of increasing tourism income. Inflation remains low, and the balance of payment stable. The fiscal position is sound, with fiscal deficits on the decline. Credit growth has slowed significantly. In the medium term, growth is expected to be driven by rising public investment, in part financed by external loans.

Buffers: Macroeconomic and prudential buffers are strong. Net international reserves are high, and public and external debt low. The risk of debt distress is low, and expected to remain so. While credit, foreign exchange and liquidity risks have increased in the financial sector, capitalization is high and banks are profitable.

Longer-term prospects: Maintaining strong fiscal and external buffers should be a macroeconomic policy priority in light of the economy's exposure to shocks. The authorities should also further improve supervision to contain emerging risks in the financial sector. In the longer run, financing continued investment while preserving low debt will require additional revenue measures. At the same time, structural reforms to improve the functioning of markets and institutions and to create a more business-friendly environment are needed to boost the growth potential.

Exchange regime: The vatu is pegged to an undisclosed basket of currencies. Vanuatu is an Article VIII member and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

Approved By
Luis Breuer and Peter Allum

Discussions took place in Port Vila during April 1–10, 2013. The staff team comprised Mr. Pitt (head), Ms. Choi (all APD), and Ms. Mowatt (SEC). Mr. Yang (Resident Representative) participated in the mission for some days. The team was joined by staff from the World Bank and the Asian Development Bank.

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INTRODUCTION

1. Vanuatu is a small island economy in the Pacific. It consists of around 80 islands, and has about 250,000 inhabitants. Situated about 1,200 miles northeast of Brisbane and 600 miles west of Fiji, it is relatively close (by Pacific standards) to Australia and New Zealand, but far from the Asian mainland. Vanuatu's income per capita is around $3,000.

2. Vanuatu is well-placed to improve the living standards of its population. Macro-economic and prudential buffers are strong, and the potential for growth is considerable. However, to seize growth opportunities, the authorities need to remove obstacles to private sector activity and pursue reforms in the public sector. At the same time, to manage risks, macroeconomic buffers need to be preserved and the financial sector vigilantly supervised.

3. Vanuatu's economy compares favorably to those of its Pacific island peers (Figure 1). Even as aid and public investment have been lower in the last decade compared to other Pacific islands, per-capita growth has been higher on average. Prudent fiscal and monetary policies have kept fiscal deficits, public debt, and inflation lower than in the region. Net international reserve (NIR) levels are high. The government is relatively small, and credit to the private sector, at 70 percent of GDP, is the highest among Pacific islands. Earlier deregulation in the telecom and aviation sectors has boosted growth and improved the business climate, which remains better than in most other Pacific islands, although its relative global position has deteriorated.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

A. Recent Developments

4. The political situation remains fractious and parliamentary coalitions have in the past changed frequently. In October 2012 elections, 17 parties gained representation in the parliament. While the recently replaced prime minister was reelected then, he resigned in March 2013 ahead of a no-confidence vote, and was succeeded by the current prime minister, Moana Carcasses Kalosil.

5. The economy is gradually turning around (Figure 2). After slowing growth due to a decline in construction and tourism in 2010/11, output growth in 2012 is estimated to have accelerated to around 2¼ percent, as tourism has recovered strongly. Inflation remains low (0.8 percent y/y in December). The current account deficit has narrowed to 6¼ percent of GDP in 2012 after having risen to over 8 percent of GDP in 2011, and was more than covered by direct investment inflows and capital grants, slightly raising international reserve coverage to 7 months of prospective imports. The fiscal deficit is estimated at 1½ percent of GDP in 2012, down from 2¼ percent in 2011, largely due to the authorities' efforts at controlling expenditure. Private sector credit growth slowed to 6.4 percent y/y in January 2013.

6. The authorities' policies have been broadly in line with past Fund advice. They have maintained external and fiscal policy buffers, as well as macroeconomic stability, and have stepped up supervision of the banking system. Furthermore, they have made efforts to raise additional revenue through administrative improvements, though the revenue-to-GDP ratio remains low compared to other Pacific islands. The authorities are now considering tax policy measures that could create additional fiscal space in the medium term.

B. Outlook and Risks

Staff Views

7. **The outlook is broadly favorable.** In 2013, continued growth in tourism and some private sector investment projects are forecast to raise output growth to 3¼ percent. At the same time, inflation is expected to pick up moderately to 1¾ percent y/y, as demand pressures increase. The current account is projected to decline somewhat further, and the overall balance of payments to remain in surplus. The budget (delayed due to the 2012 election) targets a small overall surplus, with zero net domestic financing and net repayments of external debt. It also envisages rising revenues on account of higher growth and improved compliance, and a significant increase in grants. Staff projections, which assume slower revenue growth and less external assistance, imply a modest deficit of 1 percent of GDP.

8. **Medium-term prospects are favorable.** Several donor-supported investment projects (including construction of a new wharf in Port Vila and investments in inter-island shipping) are scheduled to start over the next few years, boosting output growth to 4¾ percent by 2015. However, thereafter, growth is expected to gradually decline to 3½ percent in the long term. To sustain growth at higher rates, sufficient resources, both external and domestic, will need to be mobilized for continued public investment. Also, reviving the momentum for structural reforms to strengthen markets and institutions and improve the business climate more broadly is critical.

9. **Risks are tilted to the downside** (Box 1). Domestically, political fragmentation and limited capacity, in particular in line ministries, could affect the execution of planned projects and undermine donor confidence. External risks arise from possibly weaker-than-anticipated activity in the region which might adversely affect tourism, the mainstay of the economy, as well as a possible oil price shock. In addition, the danger of earthquakes and cyclones is ever-present, though such events have had only a small impact on the economy in past years. On the upside, a decisive push for further structural reforms could boost confidence and investment.

Authorities' Views

10. **The authorities broadly concurred with staff's views.** They considered, however, that growth in the next few years could be higher than staff projections given the implementation of donor-funded investment projects. They also stressed the importance of the agricultural sector, and explained that they were aiming to expand market access, improve product quality, and increase the value added of agricultural products in the next few years. They agreed with staff's assessment of the risks, but noted that implementation capacity at the Vanuatu Project Management Unit (VPMU) had been strengthened.

Box 1: Risk Assessment Matrix

Shock	Likelihood	Transmission channel	Potential Impact
Global/external risks			
Deeper than expected slowdown in EMs	Medium	A slowdown in Australia due to lower commodity prices could trigger decline in tourism	*Medium* : Growth slowdown, but cushioned by continued aid flows
Global oil shock triggered by geopolitical events	Low	Higher import prices would reduce BOP surplus, and fuel inflation	*Low/medium:* Large reserves can absorb BOP shock, and inflation is low
Severe natural disasters	Low	Earthquakes or cyclones could damage the capital stock in the transport, utilities, and tourism sectors	*Medium:* Relatively low capital intensity
Domestic risks			
Political instability	Medium/high	Delay in structural reforms and investment projects could lower growth and trigger donor fatigue	*Medium:* Lower growth
Lower-than-expected implementation	Medium	Lower public investment could lower growth and trigger donor fatigue	*Medium:* Lower growth
Upside domestic risks			
Decisive push for structural reforms	Low	Private sector and donor confidence could be boosted, raising private and public investment	*High:* Permanent increase in growth potential

POLICY DISCUSSIONS

A. Securing Stability

Background

Vanuatu has solid macroeconomic and prudential buffers, and the balance of payments remains stable. The authorities' fiscal and monetary policies have been prudent, with the government borrowing cautiously and the Reserve Bank of Vanuatu (RBV) controlling the level of liquidity in the financial system through open market operations and continuing to accumulate NIR.

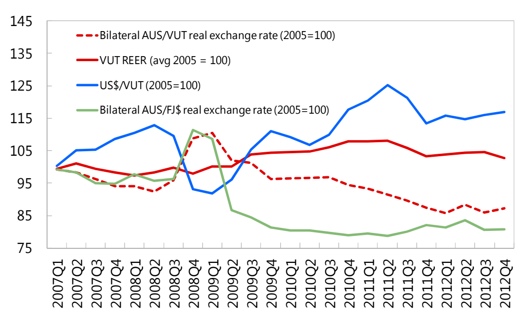
11. External sector. Current account deficits remain sizable, but are being comfortably financed by foreign direct investment inflows and capital grants. As a result, the rise in NIR has exceeded the pace of import growth. Other reserve adequacy metrics also suggest that Vanuatu could withstand a number of potential shocks: at end-2012, coverage of NIR of foreign-currency deposits stood at 96 percent, and at 29 percent of broad money. This provides adequate buffers against a potential withdrawal of foreign-currency deposits, which could be triggered by external factors, and permits the RBV to meet requests for foreign currency in the unlikely event of a loss of confidence. At the same time, the level of the exchange rate is broadly appropriate (Box 2).

12. Public finances. The debt sustainability analysis indicates that the risk of debt distress remains low, although contingent liabilities pose some risks. At end-2012, total public and public external debt remained low at 21½ and 14 percent of GDP, respectively. The projected pipeline of loans would lead to an increase in public debt by 2017, but the levels remain low and manageable, and are expected to broadly stabilize thereafter. The net present value-to-GDP ratios would remain 1–2 percentage points lower. However, these projections, which are consistent with the authorities' cautious approach to borrowing, assume strict public expenditure restraint, especially in investment, in the absence of higher revenues. Finally, significant contingent liabilities have accumulated from legal proceedings (about 10¾ percent of GDP) and loan guarantees (3 percent of GDP).

Box 2: Exchange Rate Assessment

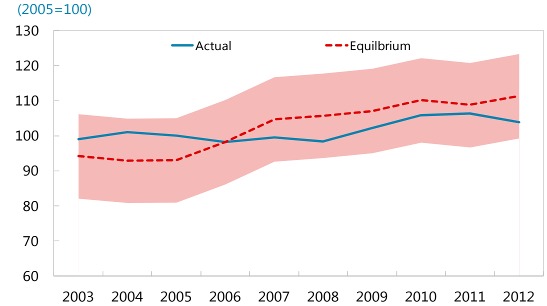
The exchange rate is broadly in line with fundamentals. While the REER has appreciated by about 3¼ percent since 2007, the bilateral real exchange rate with the A$, which is underweighted in the standard trade-based analyses (with a weight of 19 percent in the REER) but important for the key tourism sector (with about two-thirds of tourists from Australia, and the tourism industry providing 70 percent of exports of goods and nonfactor services), has depreciated by 14 percent over the same time frame. Compared to Fiji, a key competitor in the tourism market, the difference in the bilateral RER with Australia that arose after Fiji's devaluation has narrowed significantly. At the same time, CGER-type assessments are inconclusive: the equilibrium real exchange rate approach suggests that the vatu is 7½ percent below the estimated equilibrium value but within the 95 percent confidence interval. The macroeconomic balance and external sustainability approaches suggest an overvaluation of 12 and 25 percent, respectively, but the current account norms used in these approaches are unrealistic, as they are about 4 and 8 percentage points of GDP lower, respectively, than the average of actual current account deficits in the past 10 years.

Exchange Rates



Sources: Vanuatu Athorities; and staff calculations.

Equilibrium Real Exchange Rate 1/
(2005=100)



1/ The shaded area represents the 95 percent confidence interval oaround the equilibrium level.

13. Financial system. The onshore financial system consists of four banks, three of which are foreign-owned branches and subsidiaries, and four insurance companies, two of which are local. Credit growth, in part boosted by the entry of a new bank in 2007 and several large commercial and tourism projects, has slowed gradually. Banks remain well capitalized and profitable, and Vanuatu is attractive as a retirement and investment destination for Australian citizens due to its low-tax regime (and no income tax). Risks in the financial system have risen recently, however, due to the weak economic environment (including a decline in house prices), and structural change stemming from enhanced oversight by the Australian Tax Office (ATO) of Australian citizens' financial assets in Vanuatu, which has led to the repatriation of some foreign-currency deposits.

- *Nonperforming loans (NPLs) have remained high, peaking at 9 percent of total loans in mid-2012, driven by a few large loans.* While this is in part due to legacy loans for which collateral is difficult to seize or monetize, write-offs have been slow, and the NPL ratio remains at 8 percent in December. The RBV conducted a special onsite credit review at all banks in late 2011, has increased the frequency of required reporting by banks on asset quality, and is introducing new reporting requirements. The beginning of operations of a credit registry in mid-2012 should, over time, help improve access to credit while reducing risks.

- *The credit-to-deposit ratio has reached almost 100 percent.* This creates liquidity risks, potentially exacerbated by the operations of the Vanuatu National Provident Fund (VNPF), which is one of the largest depositors and has recently withdrawn significant amounts from the system to fund other investments.

- *Foreign-currency credit faces downside risks.* Growth of foreign-currency credit (which amounts to about one-quarter of total credit) has continued unabated in recent years, even as foreign-currency deposits have declined (from over one-half of total deposits in 2008 to one-third in 2012). Lending was financed by a drawdown of commercial banks' net foreign assets (NFA). However, with NFA now significantly reduced, a resumed repatriation of foreign-currency deposits would constrain foreign exchange lending more severely than in the past. Since the latter loans are extended to a significant extent to resident foreigners with foreign-currency incomes to purchase real estate (generally priced in foreign currency), this could exacerbate the current weakness in property prices. While borrowers appear hedged, to some extent, against foreign exchange risks, banks could be exposed to credit risks in the event of a broader property market downturn.

Staff Views

Maintaining buffers to sustain confidence and be able to respond to adverse shocks should be a policy priority. The authorities should continue to pursue their cautious macroeconomic policies, while strengthening prudential supervision where needed.

14. Monetary and exchange rate policies. The peg to an undisclosed basket of currencies has served Vanuatu well, and remains an appropriate anchor for monetary policy. Monetary policy should aim to maintain high NIR and contain inflation within the RBV's target range of 0–4 percent. In this context, the RBV's lowering of the rediscount rate from 6 to 5.5 percent in April, largely for signaling purposes, is appropriate. However, the authorities will need to carefully monitor credit developments to avoid a buildup of risks as economic growth picks up.

15. Fiscal policies. The authorities should maintain their cautious borrowing policies to protect strong fiscal cushions, in particular given significant fiscal contingencies. They need to carefully assess financing of new projects with a view of debt sustainability, notably the upgrading of the airport system currently under consideration, since their tax productivity is uncertain. At the same time, risks arising from other possible financing models (e.g., public-private partnerships) need to be carefully evaluated as well. Phasing large projects should also be considered. To the largest extent possible, the authorities should rely on grants and raise additional domestic revenue (see below).

16. Financial sector policies. While all but one bank are foreign-owned, care will need to be taken to preserve financial sector soundness. In this regard, the planned requirement for assigned capital for foreign bank branches (of which there is one) is welcome. The shift toward risk-based supervision provides an opportunity for systematically addressing risks in the financial system.

- The RBV should soon conduct a follow-up onsite review of NPLs, focusing on implementation of its previous recommendations to prevent the emergence of future NPLs, as well as on writing off existing NPLs more aggressively.

- The RBV should also carefully monitor individual banks' as well as systemic exposure to foreign exchange risk and to developments in the property market. While banks' net open positions remain modest, the RBV should consider introducing regulations to limit foreign currency risks. Also, the authorities should consider introducing formal regulations to ensure that the risk of unhedged foreign currency borrowers is reflected in banks' balance sheets, either through additional provisioning requirements or a higher risk weight.

- To forestall liquidity risks, the RBV should review liquidity requirements from a prudential viewpoint. While the current accommodative monetary policy stance is appropriate, the high credit-to-deposit ratio warrants close prudential attention, and liquidity cushions may need to be strengthened.

- The operations of the VNPF should be reviewed, and its mandate clarified. While the desire to tap its resources for national development is understandable, its primary function is to ensure adequate returns for its members, requiring a focus on the safety of its assets.

Authorities' Views

17. The authorities broadly concurred with the staff's views. They stressed their commitment to continue prudent fiscal policies to maintain fiscal buffers, including in the light of fiscal contingencies. While they viewed infrastructure investment, in particular in the airport system, as critical for future growth, they were conscious of the risks involved in debt financing of such projects, and were considering a number of options, including private sector involvement. They considered their exchange rate regime a key anchor for maintaining stability, and were determined to maintain it. At the same time, they considered that there was room for higher credit growth to support economic activity. They also emphasized their conservative approach to financial sector supervision, pointing to the revocation of several licenses of offshore banks, and requested further technical assistance (TA) to help improve supervision along the lines suggested by staff.

B. Reigniting Sustainable Growth

Background

After the slowdown in recent years, growth is expected to rise in 2013–15 on the back of a recovery in tourism and investment. However, in the longer term, a broader foundation needs to be built to support sustainable growth.

18. Low investment poses risks to future growth. New projects in the next few years will provide a boost to the economy, but continued investment in key infrastructure is required. In particular, the upgrading of the main airport is critical to expand tourism and tap into the potential of the Asian market. Investments to deliver public services to remote islands are also needed. However, government revenues are low compared with other Pacific islands, even as a significant share of recurrent spending—the wage bill—is comparable.

19. The authorities are making efforts to increase revenue. They are strengthening the audit function in the Department of Customs and Inland Revenue, including by introducing risk-based auditing. Also, discussions are underway in the Melanesian Spearhead Group (MSG) to amend the rules of origin with the aim of reducing revenue losses arising from the MSG free trade agreement, and new legislation is being discussed in the parliament to improve customs enforcement and compliance. The government is also exploring tax policy measures.

20. Capacity constraints weigh on public investment. After a number of donor-supported investments were completed in 2010–11, new projects have only gradually been launched, despite significant needs and the availability of donor financing. While the VPMU has been strengthened, the strain on the administration of planning, coordinating, and executing investment projects, as well as complying with donor requirements, is significant.

21. The business environment has deteriorated in relative terms. After a number of reforms in key sectors in the early 2000s—which have helped Vanuatu's economy weather the global crisis in 2009 relatively well—the reform momentum appears to have slowed, and Vanuatu has slipped in the World Bank's Doing Business ranking.

Staff Views

Vanuatu's cautious approach to external borrowing and its low debt level have established an important buffer against fiscal shocks. To preserve this, any efforts to widen the fiscal space to finance infrastructure spending and improved delivery of public services should come primarily through raising additional domestic revenue. At the same time, reforms to improve the institutional and business environment are needed to support a more dynamic private sector.

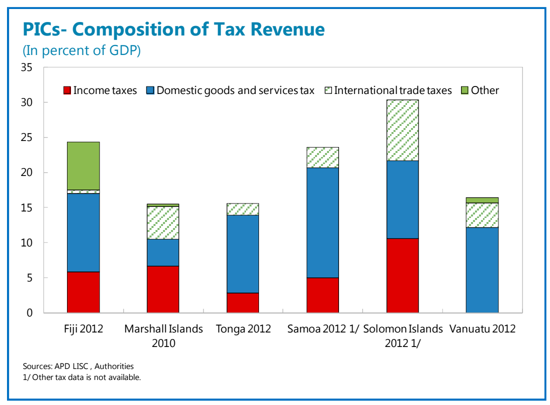
22. In addition to revenue-increasing efforts already underway, further administrative measures could produce gains. Tax enforcement would be strengthened with the hiring and training of more staff, especially in the large taxpayers office, the establishment of a VAT tribunal, and prosecution of non-payers. Any revenue losses arising from new trade agreements should be offset through higher excise taxes. In this context, opportunities for streamlining the tax system and reducing exemptions further should be explored.

23. However, these measures, while welcome, cannot yield additional revenue on the scale needed to finance future investment as well as needed maintenance and social spending. More decisive tax policy measures will be required to boost revenue by amounts sufficient to provide the government with the resources needed (Box 3). On balance, staff recommend the introduction of an income tax, as other Pacific islands have done. However, this requires significant administrative preparation—additional staff would have to be hired and comprehensively trained and equipped, and taxpayers educated. Therefore, an early decision will lead to higher revenue yields only in the medium term. To alleviate the impact on businesses, structural reforms to lower the costs of doing business should be implemented simultaneously (see below).

Box 3: Financing Public Investment over the Longer Term

Capital spending in Vanuatu has been among the lowest of the Pacific islands over the past decade. As a result, the road network is inadequate and poorly maintained, commercial ports have the highest cost in the Pacific, and limited capacity at airports constrains tourism growth. At the same time, a rapidly growing population is increasing pressure on the existing physical and social infrastructure.

The fiscal space for scaling up public investment or for higher spending on maintenance and social services is constrained. Vanuatu has been relying on a mix of grants and concessional borrowing to finance public investment, including the current pipeline of projects scheduled for implementation during 2013–2017, which would raise public debt by around 4¼ percentage points by 2017. Maintaining the debt-to-GDP ratio broadly constant over the long term without tax policy measures would result in public investment declining to below 1 percent of GDP. To sustain higher levels of capital spending without raising the debt-to-GDP ratio further, new non debt-creating sources of revenue will be needed to supplement aid flows.



Vanuatu's domestic revenue, at 18½ percent of GDP, is low relative to its Pacific island peers, suggesting scope to increase revenue. There are various options for domestic revenue mobilization:

- Strengthening compliance should result in continued improvements in VAT collection, but the scope for further improvements is relatively narrow.
- Raising the VAT rate from the current 12.5 percent to 15 percent could yield additional revenue relatively quickly, but would disproportionately hit the poorer segments of the population and would likely generate lower revenue than an income tax (some 1–1½ percent of GDP).
- Conversely, the introduction of an income tax, levied on both wage earners and corporates, could yield between 3 and 4 percent of GDP at modest tax rates, and bring greater equity to the tax system. Staff estimates suggest that additional revenue of this magnitude would allow for sustaining the rate of public investment at a level consistent with higher growth, as well as finance a modest increase in current expenditure.

24. Broader structural reforms are needed to complement public investment and boost the underlying potential of the economy. This requires a broad-based strengthening of markets and institutions. Reforms should be focused on and designed around achieving clear goals, with agencies receiving political support and held accountable for results. Key areas are:

- *Reforming government business enterprises (GBEs).* Enhancing accountability, strengthening governance, and clarifying objectives are important to control risks and improve financial performance (Box 4). In this regard, the introduction of a new policy framework for GBEs is a key prerequisite. Consideration should also be given to privatizing some GBEs, and entities slated for liquidation should be closed expeditiously.

Box 4: Government Business Enterprises

Scope: There are 21 Government Business Enterprises (GBEs), of which 5 are regulatory entities, and 16 fully or partially state-owned enterprises. Many of these have mandates which are both commercial and public service-related.

Accountability and governance: Controls to ensure that GBEs are efficiently managed and accountable are inadequate. Accounting standards in many GBEs are weak and several have not produced financial statements for many years. Indeed, many do not employ any qualified accountants, while their boards are often staffed by political appointees without the requisite technical knowledge. More generally, political interference in GBEs' operations can result in poor financial decisions.

Financial relations with the government: Transfers to GBEs from the central government budget are limited to regulatory entities. While GBEs are managed at arm's length, the government's ultimate ownership exposes it to financial risks, which are difficult to assess due to weak reporting. While borrowing by GBEs requires government approval, this process may bypass the Ministry of Finance. A change to the Public Financial Management Act is expected be gazetted soon to limit the liabilities of the government with respect to the corporatized entities it owns.

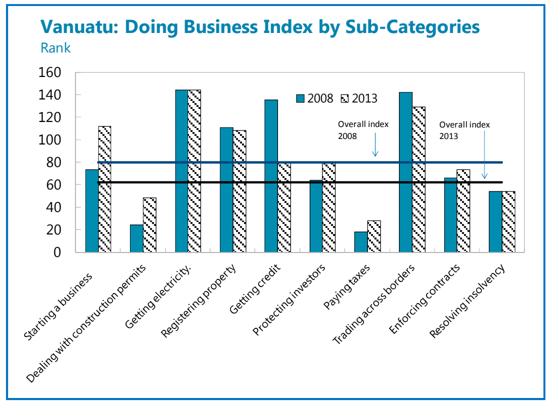
Reform plans: The government has embarked on a reform program for GBEs, but progress has been slow. Some GBEs have been moribund for several years and have been marked for liquidation. A GBE unit has been created in the Ministry of Finance and Economic Management and a draft policy framework providing for stronger governance arrangements has been prepared with the assistance of the Asian Development Bank. The framework is currently awaiting approval by the Council of Ministers.

- *Civil service reform.* The strengthening of the VPMU should help ensure a smooth execution of donor-supported investment projects. However, more broadly, the government will need to ensure that the civil service is well-educated, well-staffed, and well-paid, while avoiding unproductive employment. This will require focusing scarce resources on key areas, including investment promotion and business service delivery. While every effort should be made to contain costs, this may require some additional spending, reinforcing the argument for higher revenue. Consideration should also be given to involving private sector associations more in some activities.

- *Improving the business climate.* To reverse Vanuatu's slide in global competitiveness rankings, and create a business-friendly environment to attract domestic and foreign investors, reforms are needed to (i) lower costs, especially of key inputs such as energy, as well as of trading; (ii) streamline procedures; and (iii) improve the land market (Box 5).

- *A concerted effort, in cooperation with the private sector, should be made to develop new markets for tourism* (both geographically and in enhancing the value added of the tourism industry). This would require additional resources for sustained promotional campaigns, and collaboration with external partners (operators and airlines) and investors.

Box 5: The Business Climate



Background: Vanuatu is ranked 80th in the World Bank's 2013 Doing Business index. This remains higher than the average of Pacific islands, but represents a slide from rank 62 in 2008. In the index's subcategories, Vanuatu's rank improved in getting credit (due to a broadening of collateral and better creditor protection) but deteriorated in starting a business and dealing with construction permits (mainly due to the introduction of an environmental assessment requirement). In addition, energy and transport costs remain high. Even if the business environment has not deteriorated in absolute terms, or some new procedures (such the environmental assessment) are warranted, action needs to be taken to improve Vanuatu's relative standing to keep up with competitors and realize growth opportunities.

Reforms should concentrate on:

- *Lowering costs:* While fostering competition in small economies is often difficult, every effort should be made to introduce or enhance competition wherever possible to lower prices, in particular in the key energy (fuel imports and electricity generation) and transport sectors. Where natural monopolies are inevitable, expanding the remit and strengthening the capacity of regulators are critical. The planned expansion of the wharf in Port Vila and an inter-island shipping project should help reduce trading costs.
- *Streamlining administration:* Eliminating redundant procedures (as Tonga and Timor-Leste have done) and regulations, and reducing the time required (e.g., through an electronic system for business registration, as in Solomon Islands) should help reduce start-up and compliance costs and save time. In addition, comprehensive one-stop shop support for foreign and domestic investors should be made available.
- *Further improving accessibility of land.* The land market, while better developed than in most Pacific islands, could be improved further through completion of data in the land registry and strengthening of dispute resolution mechanisms.

Authorities' Views

25. The authorities concurred with staff that boosting revenue was critical, as they wanted to preserve low debt, and reduce reliance on donors. At the same time, they pointed to the administrative and political difficulties of introducing an income tax, and thought that ultimately consumers would bear the burden of such a tax, as this would be passed on in an environment of limited competition. They were also concerned about the impact of an income tax on the business environment. They seemed more inclined to rely on a combination of a VAT increase and administrative efficiency gains, and possibly the reintroduction of a turnover tax (which had been abolished earlier when the VAT was introduced) and increases in business licensing fees. However, they stressed that they were exploring all options, and requested Fund TA to this end.

26. The authorities also agreed that the business climate needed to be enhanced. They shared staff's views on GBE reform, but noted the considerable political challenges to reform in this area. They also considered a streamlining of the administration and improving governance as critical, including to boost Vanuatu's reputation abroad. They explained their intention to strengthen the Public Service Commission to introduce reforms in the civil service, as well as their plan to promote the Chamber of Commerce as the single interlocutor of business with government, and to increase the capacity of the public prosecutor's office. They agreed with the need to strengthen competition, but pointed to the difficulties facing a small economy in this regard. With regard to business promotion, they affirmed their intention to facilitate business, including foreign direct investment, but indicated that some activities—including in the tourism sector—would remain reserved for businesses which were majority-owned by locals.

OTHER ISSUES

27. AML/CFT issues. The most recent mutual evaluation by the Asia Pacific Group on Money Laundering (APG) took place in 2006, which assessed Vanuatu as not passing 11 out of 16 core/key recommendations. In 2011, Vanuatu was placed under the "Enhanced Mutual Evaluation Follow-Up" process and subject to close monitoring by the APG. Since then, Vanuatu has enacted more comprehensive AML/CFT legislation and has established a Financial Intelligence Unit (FIU), but effective implementation and enforcement still need to be demonstrated. Personnel and financial resources of the FIU need to be significantly increased. The FIU, though severely understaffed, has prepared several cases for prosecution. A detailed report by Vanuatu on its AML/CFT progress will be analyzed and discussed by the APG membership at its annual meeting in July 2013.

STAFF APPRAISAL

28. Cautious macroeconomic policies have been instrumental in maintaining stability and confidence. The authorities should continue with their conservative approach to debt financing. While public and external debt is low, fiscal contingencies pose some risks. Monetary policy should remain geared toward maintaining high international reserves and low inflation. The RBV will need to monitor monetary conditions as economic growth is expected to pick up, and tighten policies if needed.

29. Financial sector policies have been appropriately cautious. Supervision of the financial sector has been tight, and banks remain well capitalized despite a rise in NPLs. At the same time, foreign exchange risks have increased, and the authorities should strengthen supervision further through introduction of regulations limiting net open foreign exchange positions. Liquidity and credit risks also warrant attention.

30. To maintain low debt in the longer term while funding needed spending on infrastructure, maintenance and social services, new revenue measures are needed. The authorities' consideration of options in this regard is welcome. While recognizing the benefits of a low-tax environment (though, on the other hand, the reputational costs of being considered a "tax haven" can be significant), staff recommend the introduction of an income tax, because it alone among the options is expected to yield sufficient resources to adequately fund future spending needs while supporting a more equal after-tax income distribution. However, a decision will need to be made soon, since extensive and careful preparations are needed before a new tax can be expected to yield substantial revenue.

31. While higher revenues are needed, these should be used to strengthen, not broaden, the state. Along with public investments and maintenance of the public capital stock, a well-educated, well-paid, and well-staffed civil service is critical to provide public services and support private sector activity. However, with limited resources, the state should carefully consider its activities, and concentrate on those where its impact is highest, while holding government agencies accountable. In other areas, the government may be able to reduce its role.

32. Vanuatu's growth potential is considerable, especially in the tourism sector but also in agriculture. To realize this potential, as well as the full benefits arising from infrastructure investments, reforms are needed to increase the effectiveness of the civil service, enhance competition in key sectors, and improve the accessibility to land. Such measures would lower business costs and limit or at least partially offset the pass-through of higher taxes on consumers, and thus help reduce the impact of higher taxation. Expediting reforms in these areas would also help mitigate external risks.

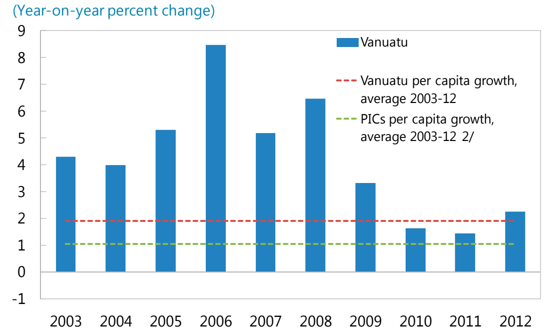
33. The authorities should carefully assess financing options for new large infrastructure projects, in particular the upgrading of the airport system. Staff recognize that these investments are important for future growth, but they also carry risks, and it is critical that Vanuatu's strong debt position not be jeopardized. Consideration should be given to phasing investments, and involving the private sector (though this requires a careful assessment of risks to public finances as well).

34. It is recommended that the next Article IV consultation be held on the 24-month cycle.

Figure 1: Vanuatu in the Pacific

Growth on average has been faster than in other PICS …

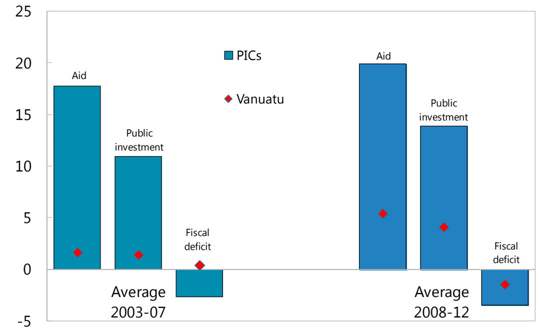
Real GDP Growth, 2003-12[1]
(Year-on-year percent change)



Source: APD LISC.
1/ 2012: estimate.
2/ 2012 PICs average does not include Marshall Islands.

… with lower aid, public investment, and deficits.

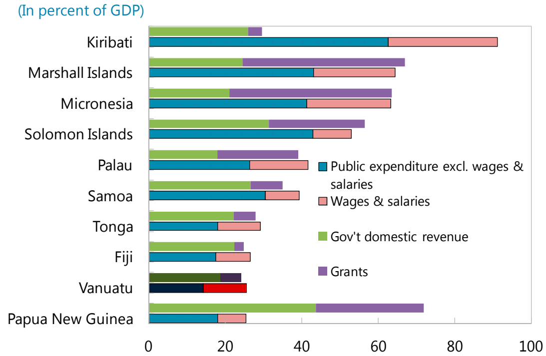
Fiscal Indicators, Average 2003-07, 2008-12[1/]
(In percent of GDP)



Source: APD LISC.
1/ 2012: estimate.

The government is relatively small, but the wage bill is comparable to other PICs …

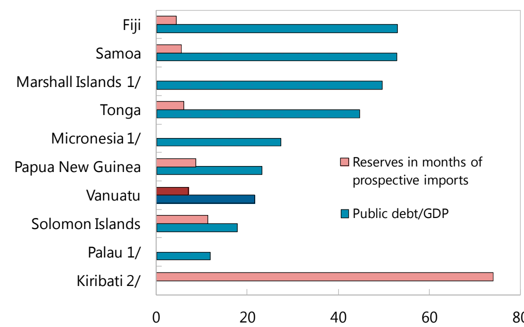
Government Finances, Average 2008-12[1/]
(In percent of GDP)



Source: APD LISC.
1/ 2012: estimate.

… while policy buffers are strong.

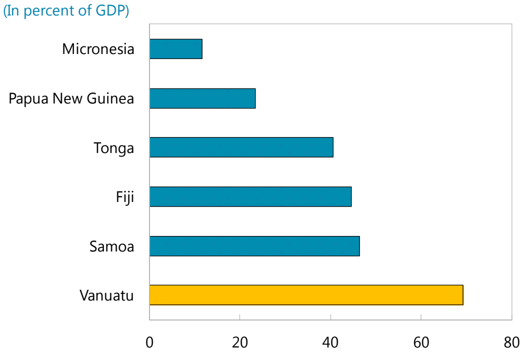
Public Debt and Reserves, 2012



Source: APD LISC.
1/ Reserves to prospective imports ratio is not available.
2/ Public debt to GDP ratio is not available.

Credit to the private sector is high …

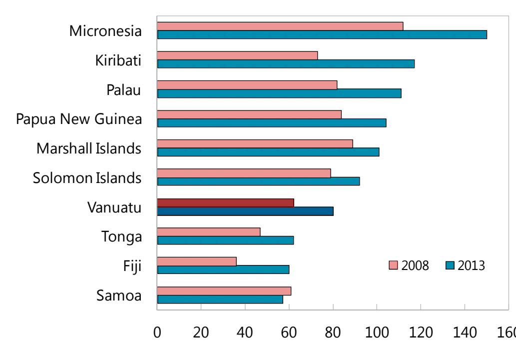
Credit to Private Sector, 2012
(In percent of GDP)



Source: ADP LISC.

… even though Vanuatu has slipped in business rankings (though not relative to other PICs)

Ease of Doing Business Rank [1/], 2008 and 2013



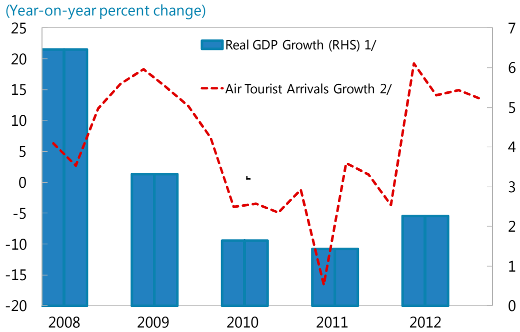
Source: World Bank, Doing Business 2008, 2013.
1/ A lower rank indicates a more friendly business climate.

Figure 2: Recent Developments

Tourist arrivals have hit GDP growth, but are recovering …

Real GDP and Air Tourist Arrivals

(Year-on-year percent change)

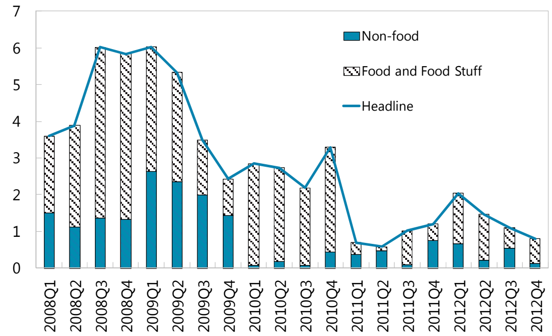


Sources Vanuatu Authorities.
1/ 2012: estimate.
2/ Arrivals from Australia are about two-thirds of the total.

… while inflation has declined.

Contribution to Inflation

(Year-on-year percent change)

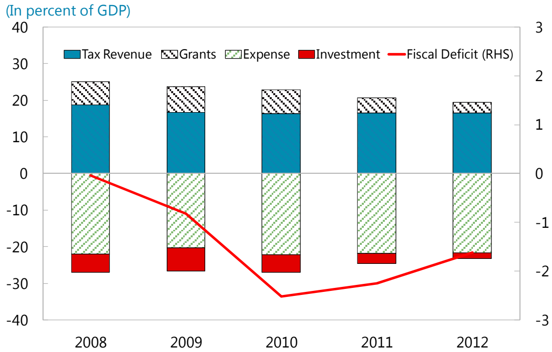


Sources: Vanuatu authorities; and IMF staff calculations.

Declining investment has also undermined growth.

Fiscal Revenue and Expenditure

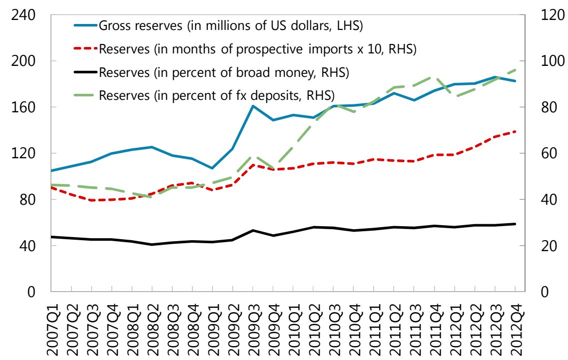
(In percent of GDP)



Source: Vanuatu Authorities, and IMF staff calculations.

International reserves have increased.

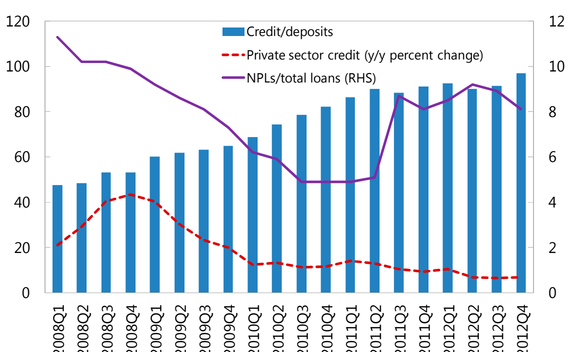
Gross Reserves



Sources: Vanuatu authorities; and IMF staff calculations.

While credit growth has slowed, NPLs have risen …

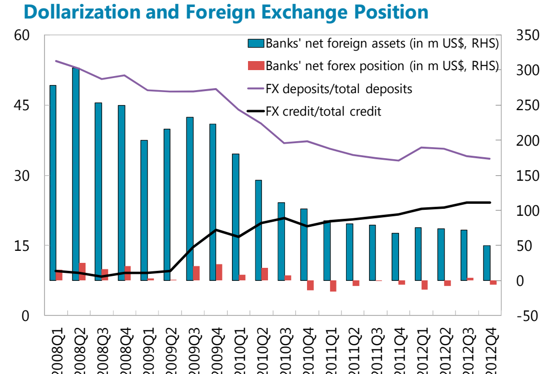
Domestic Credit Indicators



Source: Vanuatu Authorities, and IMF staff calculations.

… and domestic credit, including in FX, has been financed by a decline in NFA.

Dollarization and Foreign Exchange Position



Source: Vanuatu Authorities and IMF staff calculations.

Table 1. Vanuatu: Selected Economic and Financial Indicators, 2008–14

	2008	2009	2010	2011	Est. 2012	Proj. 2013	Proj. 2014
Output and prices (annual percentage change)							
Real GDP	6.5	3.3	1.6	1.4	2.3	3.3	4.2
Consumer prices (period average)	4.2	5.2	2.7	0.7	1.4	1.4	1.9
Consumer prices (end period)	5.8	2.4	3.3	1.2	0.8	1.8	2.0
Government finance (in percent of GDP)							
Revenue	27.0	26.0	24.6	22.4	21.7	22.7	23.9
Domestic Revenue	20.5	18.9	18.1	18.3	18.7	18.4	18.5
Grants	6.4	7.1	6.5	4.1	3.0	4.3	5.3
Expenditure	27.0	26.8	27.1	24.6	23.3	23.7	26.0
Expense	22.0	20.4	22.2	21.9	21.7	23.2	22.8
Net acquisition of non-financial assets	5.0	6.4	4.9	2.7	1.6	0.6	3.2
Net lending (+)/borrowing (-)	0.0	-0.8	-2.5	-2.2	-1.6	-1.0	-2.1
Public debt (end of period)	20.6	20.5	19.4	20.9	21.6	21.6	22.5
Domestic	4.2	3.8	4.8	6.0	7.7	8.8	10.5
External 1/	16.4	16.7	14.5	14.8	13.9	12.8	12.0
Money and credit (annual percentage change)							
Broad money (M2)	13.2	0.5	-6.0	1.3	-0.6	...	...
Net foreign assets	9.0	-18.3	-34.5	-8.1	-6.3	...	...
Domestic credit	4.6	4.6	4.6	4.6	5.8	...	...
Of which: Credit to private sector	43.3	19.9	11.6	9.4	6.9	...	...
Interest rates (in percent, end of period) 2/							
Deposit rate (vatu deposits)	2.7	3.2	1.8	2.8	2.4	...	...
Lending rate (vatu loans)	10.3	10.9	11.0	10.3	9.5	...	...
Balance of payments (in percent of GDP)							
Current account	-7.9	-6.1	-5.4	-8.1	-6.3	-5.9	-6.4
Trade balance	-33.0	-29.6	-27.4	-24.6	-25.2	-24.6	-25.3
Exports of goods 3/	6.9	9.0	7.3	8.6	7.0	7.0	6.9
Imports of goods	-39.9	-38.7	-34.6	-33.1	-32.2	-31.6	-32.2
Tourism receipts	28.1	30.6	30.9	28.7	33.2	32.7	32.5
Capital and financial account	8.5	7.2	7.4	10.9	6.8	7.8	9.1
Of which: Foreign direct investment	7.0	5.0	5.7	7.3	4.7	4.2	4.3
Gross international reserves (in millions of U.S. dollars)	115	149	161	174	182	198	221
In months of prospective imports of goods	4.9	6.1	6.2	6.9	7.0	7.1	7.4
External debt service (in percent of GNFS exports)	1.3	1.6	1.4	1.4	-0.6	1.9	1.8
Exchange rates 4/							
Vatu per U.S. dollar (period average)	101.3	106.7	96.9	89.5	92.6	...	...
Vatu per U.S. dollar (end of period)	112.6	97.9	93.2	93.6	91.7	...	...
Real effective exchange rate (average)	98.2	102.0	105.8	106.2	103.8	...	...
Memorandum items:							
Nominal GDP (in billions of vatu)	61.6	65.1	67.9	70.3	72.9	76.4	81.1
Nominal GDP (in millions of U.S. dollars)	608	610	701	786	787	827	865

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

1/ Includes publicly guaranteed external debt.

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

3/ Main exports: copra, beef.

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

Table 2. Vanuatu: Balance of Payments, 2008–14

(In millions of U.S. dollars)

						Proj.	
	2008	2009	2010	2011	2012	2013	2014
Current account balance	**-48**	**-37**	**-38**	**-63**	**-50**	**-49**	**-55**
Trade balance	-201	-181	-192	-193	-198	-203	-218
Exports of goods (f.o.b.)	42	55	51	67	55	58	60
Imports of goods (f.o.b.)	-242	-236	-243	-260	-253	-261	-278
Services balance	122	137	152	141	172	173	182
Receipts	233	244	276	286	319	331	345
Of which: travel	171	187	216	226	261	270	281
Payments	-111	-107	-124	-145	-147	-158	-163
Primary income	-5	-19	-20	-23	-40	-40	-38
Receipts	37	31	36	42	41	44	47
Payments	-42	-49	-57	-65	-82	-84	-86
Secondary income	36	25	22	12	17	21	19
Official	32	22	21	10	14	18	16
Private	3	3	1	2	3	3	3
Capital and financial account	**52**	**44**	**52**	**86**	**54**	**64**	**79**
Capital account	10	29	21	24	24	31	43
Of which : Official capital transfers (net)	10	29	20	23	19	27	40
Financial account	42	14	31	62	30	33	36
Foreign direct investment	43	30	40	57	37	35	37
Portfolio investment	8	-1	0	-1	-4	0	0
Other investment	-8	-16	-10	5	-4	-2	-1
Government	14	7	3	3	4	-4	-1
Other	-22	-23	-12	2	-7	2	0
Net errors and omissions	-8	27	-1	-10	4	0	0
Overall balance	**-4**	**33**	**13**	**12**	**8**	**15**	**24**
Memorandum items:							
Gross international reserves	115	149	161	174	182	198	221
In months of prospective imports	4.9	6.1	6.2	6.9	7.0	7.1	7.4
Current account balance (in percent of GDP)	-7.9	-6.1	-5.4	-8.1	-6.3	-5.9	-6.4
Exports of goods (annual percentage change)	40.7	32.1	-7.4	31.8	-18.6	6.0	3.5
Imports of goods (annual percentage change)	37.9	-2.6	2.9	7.2	-2.7	3.2	6.6
Exchange rate (vatu per U.S. dollar, period average)	101.3	106.7	96.9	89.5	92.6	...	...
Exchange rate (vatu per U.S. dollar, end of period)	112.6	97.9	93.2	93.6	91.7	...	...
Public external debt (in percent of GDP)	16.4	16.7	14.5	14.8	13.9	12.8	12.0
Public external debt service (in percent of GNFS exports)	1.3	1.6	1.4	1.4	-0.6	1.9	1.8
Nominal GDP	608	610	701	786	787	827	865

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

Table 3. Vanuatu: Central Government Budgetary Operations, 2008–14 [1/]

					Est.	Budget	Proj.	
	2008	2009	2010	2011	2012	2013	2013	2014
					(In millions of vatu)			
Revenue	16,618	16,900	16,708	15,733	15,792	18,940	17,365	19,355
Taxes	11,457	10,825	11,089	11,630	12,000	13,166	12,649	13,525
Other revenue	1,202	1,465	1,187	1,220	1,616	1,464	1,405	1,492
Grants	3,959	4,610	4,431	2,883	2,176	4,311	3,311	4,338
Expenditure	16,644	17,435	18,416	17,315	16,961	18,616	18,136	21,081
Expense	13,562	13,272	15,109	15,434	15,821	18,195	17,715	18,484
Of which: Compensation of employees	7,651	7,236	7,831	7,870	8,412	8,559	8,409	8,796
Net acquisition of nonfinancial assets	3,082	4,163	3,307	1,881	1,140	421	421	2,597
Gross operating balance	3,056	3,628	1,599	299	-30	745	-350	872
Net lending (+)/borrowing (-)	-26	-535	-1,708	-1,582	-1,169	325	-770	-1,726
Of which: Net incurrence of liabilities	1,023	664	1,064	1,233	1,052	-325	770	1,726
Domestic	-400	-98	800	950	1,389	0	1,095	1,803
Foreign	1,423	762	264	282	-336	-325	-325	-77
					(In percent of GDP)			
Revenue	27.0	26.0	24.6	22.4	21.7	24.8	22.7	23.9
Taxes	18.6	16.6	16.3	16.5	16.5	17.2	16.6	16.7
Other revenue	2.0	2.2	1.7	1.7	2.2	1.9	1.8	1.8
Grants	6.4	7.1	6.5	4.1	3.0	5.6	4.3	5.3
Expenditure	27.0	26.8	27.1	24.6	23.3	24.4	23.7	26.0
Expense	22.0	20.4	22.2	21.9	21.7	23.8	23.2	22.8
Of which: Compensation of employees	12.4	11.1	11.5	11.2	11.5	11.2	11.0	10.8
Net acquisition of nonfinancial assets	5.0	6.4	4.9	2.7	1.6	0.6	0.6	3.2
Gross operating balance	5.0	5.6	2.4	0.4	0.0	1.0	-0.5	1.1
Net lending (+)/borrowing (-)	0.0	-0.8	-2.5	-2.2	-1.6	0.4	-1.0	-2.1
Of which: Net incurrence of liabilities	1.7	1.0	1.6	1.8	1.4	-0.4	1.0	2.1
Domestic	-0.6	-0.2	1.2	1.4	1.9	0.0	1.4	2.2
Foreign	2.3	1.2	0.4	0.4	-0.5	-0.4	-0.4	-0.1
Memorandum items:								
Public debt	20.6	20.5	19.4	20.9	21.6	20.2	21.6	22.5
Domestic	4.2	3.8	4.8	6.0	7.7	7.4	8.8	10.5
External	16.4	16.7	14.5	14.8	13.9	12.8	12.8	12.0
Debt service	0.9	1.1	0.9	1.0	1.0	1.4	2.2	1.8
Primary balance	0.5	-0.3	-2.0	-1.7	-1.0	1.2	-0.2	-1.4
Nominal GDP (millions of vatu)	61,607	65,117	67,911	70,347	72,911	76,406	76,406	81,112

1/ Fiscal year corresponds to the calendar year

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

Table 4. Vanuatu: Monetary Survey, 2008–January 2013

	2008	2009	2010	2011	2012	2013 Jan.
	(In millions of vatu; end of period)					
Net foreign assets	40,878	33,409	21,876	20,113	18,847	18,613
Monetary Authorities	12,814	11,600	12,321	13,781	14,293	14,206
Commercial banks	28,063	21,809	9,555	6,332	4,554	4,408
Net domestic assets	18,995	26,737	34,677	37,174	38,084	38,024
Domestic credit	29,843	36,435	42,786	47,695	50,469	50,271
Claims on government (net)	-3,010	-2,971	-1,183	-713	-1,200	-1,537
Claims on municipalities	13	16	16	34	36	38
Claims on the economy	32,840	39,390	43,953	48,374	51,633	51,770
Claims on nonfinancial public enterprises	72	107	95	410	371	491
Claims on private sector	32,768	39,283	43,857	47,963	51,262	51,280
Other items (net)	-10,848	-9,699	-8,109	-10,520	-12,385	-12,247
Total broad money	59,873	60,146	56,552	57,287	56,930	56,637
Narrow money	11,447	11,542	14,048	14,586	14,604	13,927
Currency outside banks	3,756	3,917	4,553	4,886	4,889	4,550
Demand deposits	7,691	7,625	9,494	9,700	9,715	9,377
Quasi-money	48,425	48,604	42,504	42,701	42,327	42,710
Time and savings deposits	19,617	21,379	23,162	25,317	24,876	25,258
Foreign currency deposits	28,809	27,225	19,342	17,384	17,451	17,452
	(Annual percentage change, unless otherwise indicated)					
Net foreign assets	9.0	-18.3	-34.5	-8.1	-6.3	-9.9
Net domestic assets	23.3	40.8	29.7	7.2	2.4	3.8
Domestic credit	36.7	22.1	17.4	11.5	5.8	5.0
Credit to the economy	43.2	19.9	11.6	10.1	6.7	6.4
Private sector credit	43.3	19.9	11.6	9.4	6.9	6.4
Total broad money	13.2	0.5	-6.0	1.3	-0.6	-1.1
Vatu broad money	18.7	6.0	13.0	7.2	0.1	-2.7
Foreign currency deposits	7.7	-5.5	-29.0	-10.1	-0.9	-1.1
Memorandum items:						
Vatu broad money multiplier	2.7	2.9	2.6	2.7	2.7	2.8
Total broad money multiplier	5.2	5.2	4.0	3.9	3.9	4.1
Velocity						
Narrow money	5.5	5.7	5.3	5.1	5.2	5.2
Vatu broad money	2.2	2.0	1.9	1.8	1.8	1.9
Total broad money	1.1	1.1	1.2	1.2	1.3	1.3
Reserve money (in million vatu)	11,447	11,542	14,048	14,586	14,604	13,927
Reserve money (annual percentage change)	6.2	0.8	21.7	3.8	0.1	-1.4
Credit to private sector (in percent of GDP)	53.2	60.3	64.6	68.2	70.3	70.1
Foreign currency deposits/total deposits	51.3	48.4	37.2	33.2	33.5	33.5
Foreign currency credit/total credit	9.1	18.4	19.1	21.6	23.1	..
Net foreign assets of banks (in millions of U.S. dollars)	249.2	222.7	102.6	67.7	49.6	49.3
Net foreign assets (in percent of GDP)	66.4	51.3	32.2	28.6	25.8	25.4
Nominal GDP (in millions of vatu)	61,607	65,117	67,911	70,347	72,911	73,202

Source: Vanuatu authorities.

Table 5. Vanuatu: Medium-Term Baseline Scenario, 2011–18

		Est.	Proj.					
	2011	2012	2013	2014	2015	2016	2017	2018
Output and prices (annual percentage change)								
Real GDP	1.4	2.3	3.3	4.2	4.8	4.5	4.3	4.0
Consumer prices (period average)	0.7	1.4	1.4	1.9	2.3	2.8	3.0	3.0
Consumer prices (end of period)	1.2	0.8	1.8	2.0	2.6	3.0	3.0	3.0
Food prices (end of period)	0.9	1.4	0.9	1.0	2.0	2.5	2.5	2.5
Government finances (in percent of GDP)								
Revenue	22.4	21.7	22.7	23.9	23.6	23.1	22.5	21.9
Domestic Revenue	18.3	18.7	18.4	18.5	18.6	18.7	18.8	18.8
Grants	4.1	3.0	4.3	5.3	5.0	4.4	3.7	3.1
Expenditure	24.6	23.3	23.7	26.0	26.6	26.7	24.8	24.0
Expense	21.9	21.7	23.2	22.8	22.5	22.4	22.1	21.9
Net acquisition of non-financial assets	2.7	1.6	0.6	3.2	4.2	4.3	2.7	2.1
Net lending (+)/borrowing (-)	-2.2	-1.6	-1.0	-2.1	-3.0	-3.6	-2.3	-2.0
Public debt (end of period)	20.9	21.6	21.6	22.5	24.0	25.9	26.4	26.7
Domestic	6.0	7.7	8.8	10.5	10.6	10.4	11.2	12.5
External	14.8	13.9	12.8	12.0	13.4	15.5	15.2	14.2
Balance of payments (in percent of GDP)								
Current account	-8.1	-6.3	-5.9	-6.4	-7.3	-7.5	-6.5	-6.2
Trade balance	-24.6	-25.2	-24.6	-25.3	-25.9	-25.9	-23.8	-23.0
Exports of goods	8.6	7.0	7.0	6.9	6.7	6.5	6.3	6.1
Imports of goods	-33.1	-32.2	-31.6	-32.2	-32.6	-32.4	-30.0	-29.0
Tourism receipts	28.7	33.2	32.7	32.5	31.9	31.3	29.7	28.8
Capital and financial account	10.9	6.8	7.8	9.1	11.2	11.0	7.8	6.3
Of which : Foreign direct investment	7.3	4.7	4.2	4.3	4.0	3.7	3.5	3.3
Gross international reserves (in millions of U.S. dollars)	174	182	198	221	257	290	304	305
In months of prospective imports	6.9	7.0	7.1	7.4	8.2	9.5	9.7	9.2
External debt service (in percent of GNFS exports)	1.4	-0.6	1.9	1.8	1.7	1.6	1.6	1.6
Memorandum items:								
Nominal GDP (in billions of vatu)	70	73	76	81	87	93	100	107
Nominal GDP (in millions of U.S. dollars)	786	787	827	865	913	966	1,022	1,079

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

Table 6. Vanuatu: Vulnerability Indicators, 2008–12

	2008	2009	2010	2011	2012
Financial sector indicators					
Public debt	20.6	20.5	19.4	20.9	21.6
Broad money (percent change, 12-month basis)	13.2	0.5	-6.0	1.3	-0.6
Share of deposits in broad money (percent)	93.7	93.5	91.9	91.5	91.4
Share of foreign currency deposits in total deposits (percent)	51.3	48.4	37.2	33.2	33.5
Private sector credit (percent change, 12-month basis)	43.3	19.9	11.6	9.4	6.9
Nonperforming loans (as share of total loans)	9.9	7.3	4.9	8.1	8.1
Nonperforming loans net of provisions to capital	20.5	15.7	14.7	16.8	12.0
Regulatory capital to risk-weighted assets	36.0	33.7	30.6	21.3	20.5
Regulatory tier 1 capital to risk-weighted assets	35.0	32.5	29.5	18.7	18.3
External indicators					
Exports of goods (annual percentage change, in U.S. dollars)	40.7	32.1	-7.4	31.8	-18.6
Imports of goods (annual percentage change, in U.S. dollars) 1/	-37.9	2.6	-2.9	-7.2	-3.8
Current account balance, excl. official transfers (in percent of GDP)	-13.2	-9.7	-8.5	-9.3	-8.1
Capital and financial account balance (in percent of GDP)	8.5	7.2	7.4	10.9	6.8
Of which: Inward foreign direct investment	7.0	5.0	5.7	7.3	4.7
Gross official reserves (in millions of U.S. dollars)	115.3	148.6	161.4	173.8	182.2
(In months of corresponding imports of goods on c.i.f. basis)	4.8	6.3	6.7	6.7	7.2
(In months of prospective imports of goods)	4.9	6.1	6.2	6.9	7.0
(In percent of broad money)	21.7	24.2	26.6	28.4	29.4
Foreign liabilities of Reserve Bank of Vanuatu (in millions of U.S. dollars)	1.5	30.2	29.1	26.5	26.4
Foreign exposure of Reserve Bank of Vanuatu 2/	1.3	21.2	18.8	15.8	15.0
Foreign assets of commercial banks (in millions of U.S. dollars)	325.9	309.9	233.8	173.1	141.3
Foreign liabilities of commercial banks (in millions of U.S. dollars)	76.7	87.2	131.3	105.5	91.6
Foreign exposure of commercial banks 2/	23.5	28.1	56.1	60.9	64.9
Total external debt (in percent of GDP)	16.4	16.7	14.5	14.8	13.9
(In percent of exports of goods and nonfactor services)	32.7	37.1	32.4	31.6	29.5
External debt-service (in percent of exports of GNFS)	1.3	1.6	1.4	1.4	-0.6
Exchange rate (vatu per U.S. dollar, end of period)	112.6	97.9	93.2	93.6	91.7

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

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

2/ Foreign liabilities as a percentage of foreign assets.

VANUATU

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 16, 2013

Prepared By

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

CONTENTS

FUND RELATIONS

(As of March 31, 2013)

Membership Status

Joined: September 28, 1981; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	17.00	100.00
Fund holdings of currency	14.51	85.33
Reserves tranche position	2.50	14.68

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocations	16.27	100.00
Holdings	1.52	9.37

Outstanding Purchases and Loans

None

Latest Financial Arrangements

None

Projected Payments to Fund [1]

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

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.01	0.01	0.01	0.01	0.01
Total	0.01	0.01	0.01	0.01	0.01

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

Implementation of HIPC Initiative

Not applicable

Implementation of Multilateral Debt Relief Initiative

Not applicable

Implementation of Post-Catastrophe Debt Relief

Not applicable

Exchange Arrangements

Since 1988, Vanuatu has officially maintained an adjustable peg exchange rate arrangement. Currently, the exchange rate of the vatu is linked to a transactions weighted (trade and tourism receipts) basket of currencies. The weights and composition of the basket, which are not publicly disclosed, are adjusted periodically. The Reserve Bank of Vanuatu (RBV) quotes daily buying and selling rates for the vatu against the U.S., Australian, and New Zealand dollars; the euro; the U.K. pound; and the Japanese yen. The rate in terms of the U.S. dollar as of March 31, 2013 was VT 91.65 per U.S. dollar. The de facto classification is "other managed," as the composite weights are not disclosed and cannot be confirmed. Vanuatu has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

Article IV Consultation

Vanuatu is on a 24-month cycle. The previous Article IV consultation took place during March 2–10, 2011, and was concluded on April 22, 2011 (Country Report No. 11/120).

OFC Assessments

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

Technical Assistance

LEG, MCM, PFTAC, and STA have provided technical assistance on anti-money laundering, banking supervision and regulation, reserve management, tax and fiscal accounts, tax administration and policy, balance of payments, and national accounts.

Resident Representative

The resident representative office for the Pacific Islands, including Vanuatu, was opened in September 2010 in Suva, Fiji. Mr. Yongzheng Yang is the Resident Representative.

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)[1]

Economic Statistics

During 2010 and 2011 PFTAC assisted with the upgrading of government finance statistics to the 2001 GFS Manual. Support is now being provided by a regional GFS project managed by STA and the authorities are now reporting data regularly to STA. PFTAC has provided ongoing assistance with peer review of annual GDP estimates, helped finalize and publish for the first time GDP by expenditure approach and is assisting with rebasing the constant price GDP measures to a 2010 base year. Future plans include the development of a quarterly measure of GDP.

Public Financial Management

In 2009 PFTAC was asked to assess the FMIS system (as part of PFTAC's regional review of FMIS implementation issues). Vanuatu has regularly sent officials to PFTAC-sponsored regional training events. No direct PFM interventions have been recorded since the April 2009 FMIS review.

Macroeconomics

In the macroeconomic area, PFTAC provided assistance to the Ministry of Finance and Economic Management (MFEM) in constructing a financial programming framework for Vanuatu and provided training in its use. This assistance included a number of missions that focused on improving the framework developed by MFEM, building together with MFEM and the Reserve Bank of Vanuatu (RBV) a small empirical-based inflation model that was later integrated into the framework, and holding a workshop to provide training in how to use the framework. In addition, staff members from MFEM and RBV participated in a regional financial programming workshop in Fiji held jointly by PFTAC and the Singapore Regional Training Institute using a Fiji case study specifically developed for this workshop.

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

BANK-FUND COUNTRY TEAM CONSULTATIONS

As of April 10, 2013

1. A representative of the World Bank accompanied the IMF Article IV team on their visit to Vanuatu on April 2–10, 2013 and participated in discussions with the team and the Government of Vanuatu. The Bank and Fund country teams exchanged views on key macroeconomic prospects, fiscal policy priorities, and fiscal sustainability, and agreed to coordinate the two teams' work over the period April 2013 to March 2014.

2. The teams agreed on the main macroeconomic issues for Vanuatu. These are the near and medium term growth outlook, appropriate fiscal and monetary policies over the near term, maintaining a sound fiscal course over the medium term, and addressing structural issues to sustain economic growth over the longer term.

More specifically:

- Near-term growth outlook
  - Key determinants of growth: Continued growth in the tourism sector of the economy and the role played by donor-financed construction activities.
- Fiscal policy
  - Appropriate fiscal stance in 2013 and 2014.
  - Revenue mobilization to support improvements in key service delivery areas such as health and education and to enhance growth prospects, including via the introduction of an income tax in the medium term and near-term policies such as increased compliance and enforcement, and a continued reduction in exemptions.
- Monetary policy
  - Effectiveness of monetary policy in managing economic activity.
- Financial policy
  - The implications of declining net foreign assets for bank soundness.
  - Continuing efforts to strengthen financial supervision and regulation.
- Structural issues
  - Improving basic infrastructure including transport, electricity, telecommunications and urban amenities.
  - Strengthening the investment climate, including through enhanced competition.
  - Improving investor services, including through a one-stop shop.
  - Improving education and health services.

3. Based on this shared assessment, the teams identified four areas as macro-critical, in view of their central role in achieving a sound macro-financial policy framework and sustained growth: (i) continuing efforts to strengthen the medium-term fiscal framework and explore options to generate more revenues to counter the decline in collections due to trade liberalization and to mobilize more funds to finance social and physical infrastructure, including through the introduction of income taxation; (ii) continuing efforts to safeguard financial stability by further strengthening financial supervision and regulation; (iii) improving basic infrastructure such as seaports, airports and urban amenities to support reduced costs and increased economic activity; and (iv) structural reforms to strengthen competition and improve business service delivery to bolster the underlying growth potential of the economy. Table 1 details the specific activities planned by the two country teams over the period April 2013 to March 2014, along with their expected deliveries.

4. The teams have the following requests for information and collaboration from their counterparts:

- The Fund team requests to be kept informed of progress in various projects and analytical work undertaken by the Bank in order to use resources efficiently and avoid work overlaps.

- The Bank team requests the Fund to make available to the Bank its latest macroeconomic assessment and macroeconomic data from time to time as inputs to the Bank's lending and non-lending operations.

5. No disagreements among the two teams emerged on either the key issues, challenges, or on the division of tasks to tackle these. It was agreed that further details on collaboration, as necessary, will be agreed at the technical level as work progresses.

Table 1	Vanuatu: Bank and Fund Planned Activities in Macro-critical Structural Reform Areas, April 2013–March 2014	
	Products	Expected Delivery Date
Bank Work Program	• Support to Department of Energy, Mines and Mineral Resources to extend electricity connections to lower income households • Support to regulatory reform in telecoms • Support to Government in identifying appropriate level and mix of financing in the health sector • Institutional strengthening to support labor migration schemes	Ongoing Ongoing Ongoing Ongoing
Fund Work Program	• Surveillance (Article IV consultation concluded), including a joint debt sustainability analysis • Technical assistance: strengthening supervision (PFTAC) • Technical assistance: revenue options (PFTAC)	June 2013 December 2013 December 2013

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

As of April 19, 2013

Operational Strategy

Asian Development Bank's (AsDB) Country Partnership Strategy for 2010–2014 is aligned with the government's poverty reduction strategy and aims to assist the government to address constraints in (i) transport—by providing support for improved connectivity to markets and social services; (ii) urban development—by improving access to sanitation and drainage facilities and improve urban infrastructure with a particular focus on Port Vila; and (iii) energy—by supporting greater energy efficiency, rural electrification, and renewable energy sources. Consistent with the government's strategy of fostering private sector-led growth, AsDB also focuses on improving the enabling environment for the private sector through updating the legal and regulatory environment, better access to finance, and the reform and restructuring of state-owned enterprises (SOEs).

Subject to the annual country performance assessment exercise, AsDB envisions support from 2013 to 2014 of about $10.56 million in loans from the Asian Development Fund as well as $300,000 per annum in technical assistance (TA) grant support. To leverage AsDB's impact and reduce borrowing costs, cofinancing opportunities will be pursued with other development partners.

Lending Trends/ADF Grants/Portfolio Status

Since joining AsDB in 1981, 11 loans have been provided to Vanuatu for a total amount of $67.07 million and 60 TA projects for $21.82 million. More than 50 percent of the loans were for infrastructure rehabilitation and more than 40 percent of the TAs were for institutional support and capacity building. ADB resumed its lending operations in Vanuatu with the approval of two projects in the last quarter of 2011. These were for the Vanuatu Interisland Shipping Project ($26.82 million), cofinanced by the New Zealand Government and Port Villa Urban Development Project ($39.16 million), cofinanced by the Australian Government.

There are four ongoing TA projects amounting to $3.96 million: TA7288-VAN: Interisland Shipping Support Project; TA 7345-VAN: Port Vila Urban Development Project; TA 7588-VAN: State-Owned Enterprise Rationalization Program; and TA 8285-VAN: Energy Access Project.

Private Sector Development. AsDB's country strategy in Vanuatu aims for rapid, inclusive, and private sector-led economic growth. AsDB's capacity development and advisory support focuses on (i) improving the business regulatory environment; (ii) expanding access to finance; and (iii) reforming SOEs and public-private partnerships which is provided through the Pacific Private Sector Development Initiative II and II. The Private Sector Operations Department continues to explore investment opportunities in energy, trade, information and communication technology, and financial sectors to support small and medium-sized enterprises.

- **Improving the business regulatory environment.** Recent AsDB assistance has been focused on drafting a new Companies Act, a new Insolvency Act and a new Trustee Act. Advisory support will continue for the implementation of these new laws and for establishing an electronic companies' registry.

- **Expanding Access to Financial Services.** AsDB provides ongoing assistance for improving access to finance opportunities in Vanuatu. AsDB has supported the National Bank of Vanuatu to implement a rural outreach program to expand access to financial services in several of Vanuatu's islands using new technologies and communications equipment. A diagnostic was also prepared for the Reserve Bank of Vanuatu and the Vanuatu Financial Services Commission on the current framework for the regulation and supervision of microfinance institutions (including the Vanuatu Women's Development Scheme) that are taking deposits. It is providing further support to improve outreach of financial services in rural areas.

- **State-Owned Enterprise Program.** SOE reform is central to the improved economic governance supported through the Japan Fund for Poverty Reduction. AsDB approved a stand-alone TA in 2010 to support the government's SOE reform efforts. The reform of the government's SOEs will be focused on assisting the government to improve the governance, transparency, and efficiency of the SOEs. This could also include closure or divestiture as appropriate.

Interisland Shipping Support Project. AsDB is cooperating closely with the government and New Zealand to implement a package of investments and technical assistance to improve interisland shipping services, capacity, and regulation. The main outcomes of the project includes (i) better access to markets and social services in the outer island target areas by 2014; (ii) stronger safety regulations and more compliance; and (iii) better shipping infrastructure. AsDB provides a loan of $10.82 million, the New Zealand government a parallel grant of $12.60 million, and the Vanuatu government $3.40 million. Implementation started in the beginning of 2013.

Port Vila Urban Development Project. AsDB's support for urban development will contribute to social development by improving access to sustainable basic services in urban areas. AsDB, through a concessionary loan of $5.0 million equivalent and administering of the corresponding grant of $31.0 million equivalent from the Australian government, will provide assistance focused on urban planning and the provision of affordable, sustainable, and effective sanitation and drainage services to the residents of Port Vila and its surrounds, particularly to those living in informal settlements. Specific results targeted include (i) preparation of robust planning, legislative and policy documents for implementation in cooperation with the government, (ii) preparation of an integrated storm water drainage and sanitation master plan; (iii) institutional strengthening and capacity development; and (iv) provision of high priority drainage and sanitation infrastructure.

Energy Sector Initiatives. Overall access to energy is estimated at 33 percent and power generation is heavily dependent on diesel generation, which results in high power tariffs. RETA-7329

Promotion of Renewable Energy in the Pacific assessed alternative renewable energy options and concluded that hydropower is the least cost expansion option. The $11 million *Energy Access Project* (EAP), proposed for 2014, will support increased energy access to households and businesses in the provincial centers of Vanuatu thus contributing to inclusive economic growth. This will be achieved through expansion of existing distribution grids and the development of low-cost renewable energy generation from hydropower. In addition, ADB will support the transition to renewable energy through a pilot grid-connected solar project in Luganville and will assist consumers to use energy more efficiently under regional technical assistance.

Regional Cooperation Initiatives. Regional support will continue to be provided for renewable energy and energy efficiency, climate change, coastal and marine resources management, private sector development, management of civil aviation and information and communications technology. Under the Pacific Alliance for Sustainability, funded by the Global Environment Facility, AsDB is helping to build climate change adaptation capacity through regional TA aimed at strengthening management of coastal and marine resources. The regional TA for Statistical Capacity Building in the Asia and Pacific Region will continue. AsDB will continue to support Vanuatu's participation in regional forums. AsDB will continue to work closely with the Pacific Islands Forum in a variety of areas, including on economic monitoring and formulation and implementation of economic policy.

AsDB–World Bank joint Development Coordination Office

AsDB has strengthened its assistance to Vanuatu through closer collaboration with the government and other development partners. An AsDB–World Bank joint Development Coordination Office was opened in June 2010 in Port Vila. The shared field presence is increasing AsDB's responsiveness to the development needs of Vanuatu and supports aid coordination and aid effectiveness.

STATISTICAL ISSUES

As of April 30, 2013

I. Assessment of Data Adequacy for Surveillance	
General: Data provision has some shortcomings, but is broadly adequate for surveillance. In particular, national accounts and external sector statistics need to be further improved, while the coverage of government finance statistics could be expanded.	
National Accounts: While there have been improvements in methodology and the development of additional data sources, the accuracy of the recently-released, experimental expenditure-based GDP estimates could be further improved. Also, data are compiled only on an annual basis. Work is underway on rebasing the constant price GDP estimates using 2010 as the new base year. PFTAC is providing technical assistance in this work, and also in the improvement of the experimental expenditure-based GDP and the development of estimates of GDP on a quarterly basis. **Price statistics:** The CPI weights are based on 1998 household surveys, and only cover the two urban centers of Port Vila and Luganville. Work on rebasing the CPI is underway, using data from the 2010 Household Income and Expenditure Survey.	
Government finance statistics: Budget classification is broadly consistent with the *2001 GFSM*. Government operations data are compiled for the central government. However, they exclude public enterprises and operations of provincial governments and the two municipalities, as well as grant bodies and other central government extra-budgetary units. The operations of the budget are recorded on a cash plus invoice basis.	
Monetary statistics: The Reserve Bank of Vanuatu reports monthly monetary data, including the accounts of the monetary authorities, commercial banks, and interest rates in its monthly bulletin posted on its website. The RBV also publishes a quarterly report with wider coverage of financial data including fiscal transactions and financial soundness indicators.	
External sector statistics: An external sector statistics mission visited Vanuatu during March 2013 and made the following key recommendations: (1) Review and improve the compilation of offshore banking data in the balance of payments and international investment position using information from the Financial Institutions Supervision Department; (2) Improve the coverage and classification of the public external debt; and (3) Propose to the Vanuatu Investment Promotion Authority improvements to the different application forms for foreign direct investment approvals, which would allow for the identification of new investments in Vanuatu.	
II. Data Standards and Quality	
Participant in the General Data Dissemination System (GDDS) since April 2004.	No data ROSC is available.
III. Reporting to STA	
Exchange rate and reserves data have been reported only through October 2012. Monthly monetary statistics data have been reported through August 2012. Annual balance of payments data have been published through 2011, but are inconsistent with data provided to the mission. Quarterly consumer price data are available through Q3 2012. Annual trade figures are available only through 2011. Both the trade and price data are gathered from other sources; no data is sent by the authorities. Annual GFS data through 1990 have been reported intermittently in the 2001 GFS format. No sub-annual fiscal data have been reported for publication in the *IFS*.	

Vanuatu: Table of Common Indicators Required for Surveillance

As of May 15, 2013

	Date of latest observation	Date received	Frequency of Data 1/	Frequency of Reporting 1/	Frequency of Publication 1/
Exchange Rates	31/03/13	20/04/13	M	M	M
International reserve assets and reserve liabilities of the monetary authorities 2/	31/1/13	1/4/2013	M	M	M
Reserve/base money	31/1/13	1/4/2013	M	M	M
Broad money	31/1/13	1/4/2013	M	M	M
Central bank balance sheet	31/1/13	1/4/2013	M	M	M
Consolidated balance sheet of the banking system	31/1/13	1/4/2013	M	M	M
Interest rates 3/	31/1/13	1/4/2013	Q	Q	Q
Consumer price index	31/12/12	1/4/2013	Q	Q	Q
Revenue, expenditure, balance and composition of financing - General Government 4/ 5/	NA	NA	NA	NA	NA
Revenue, expenditure, balance and composition of financing - Central Government 4/ 5/	31/12/12	25/2/13	Q	Q	Q
Stocks of central government and central government-guaranteed debt	31/12/12	25/2/13	A	A	A
External current account balance	31/12/12	1/4/2013	Q	Q	Q
Exports and imports of goods and services	31/12/12	1/4/2013	Q	Q	Q
GDP/GNP	31/12/11	15/01/13	A	A	A
Gross external debt	31/12/12	1/4/2013	Q	Q	Q
International Investment Position	31/12/12	1/4/2013	Q	Q	Q

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

VANUATU

May 16, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS[1]

Approved By
Luis Breuer and Peter Allum (IMF)
Jeffrey D. Lewis and Sudhir Shetty (IDA)

Prepared by the staffs of the International Monetary Fund and the International Development Association.

Vanuatu remains at a low risk of debt distress based on the Low-Income Country Debt Sustainability Assessment (LIC DSA). Vanuatu's overall public debt level is low and should remain manageable, provided fiscal deficits remain small. Under the baseline scenario, all external debt sustainability indicators are projected to remain well below their applicable thresholds.[2] *Public debt is also projected to remain low, consistent with the authorities' conservative borrowing policies. Contingent liabilities arising from lawsuits (all domestic) pose a moderate risk.*

BACKGROUND

1. **Public and external debt levels remain comfortable.** In 2012, public debt rose slightly to 21.6 percent of GDP. A fiscal deficit of 1.6 percent of GDP was domestically financed. Total external debt declined to 25.5 percent of GDP, mainly reflecting lower private external debt, but also net repayments of public and publicly guaranteed (PPG) external debt, which declined to slightly below 14 percent of GDP.[3] Publicly guaranteed domestic debt (not included in the DSA baseline) amounts to 3 percent of GDP. Contingent liabilities arising from potential court-imposed damages in lawsuits amount to 10¾ percent of GDP. There are no other known contingent liabilities.

2. **The analysis is based on the standard LIC DSA framework.** The key assumptions are conservative (Box 1), and differ somewhat from those in the last DSA. Growth is higher in the medium term and lower in the longer run as investment rises and then declines. At the same

[1] This DSA was prepared jointly with the World Bank, in accordance with the Debt Sustainability Framework for low-income countries approved by the Executive Boards of the IMF and IDA. The debt data underlying this exercise were provided by the Vanuatu authorities.

[2] Vanuatu's policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessment, averaged 3.4 over the past three years, placing it as a medium performer.

[3] Due to data limitations, external liabilities of banks are used as a proxy for private external debt.

time, the fiscal projections envisage a small primary deficit, in line with recent outcomes, and consistent with a stable public debt-to-GDP ratio. In addition, the non-interest current account deficit is projected to be slightly higher. Contingent liabilities are entirely domestic. PPG external debt has broadly evolved as forecast in the last DSA, while total external debt has declined faster as banks' foreign liabilities have fallen. On the other hand, total public debt has risen instead of declined as forecast at the time of the last DSA, as government deficits have not declined as forecast then.

Box 1: Key Assumptions

	Baseline		Historical	2011 DSA	
	2013-18	2019-33	Avg. (10 yrs)	2010-15	2016-30
Real GDP (percent change)	4.2	3.6	4.3	3.7	4.0
GNFS exports (US$ terms; percent change)	3.6	7.0	12.7	7.3	7.3
Non-interest current account balance (percent of GDF	-6.4	-5.0	-6.4	-5.4	-4.7
GDP deflator in US$ terms (percent change)	1.2	2.8	6.3	5.7	3.0
Primary balance (percent of GDP)	-1.4	-0.6	0.2	-0.4	0.0

- *GDP growth* is projected to recover to a peak of 4¾ percent in 2015 as new largely donor-financed investment projects are implemented. This is, however, well below previous investment-driven growth spurts. In the long run, growth is assumed to gradually decline to 3½ percent, below the average of the past 10 years.

- The *GDP deflator* in US$ terms is projected to rise gradually to 2¾ percent in the long run, in line with an inflation rate within the Reserve Bank of Vanuatu's target band.

- The *primary fiscal deficit* is assumed to stabilize at about ½ percent of GDP (and the overall deficit at about 1½ percent of GDP), slightly lower than the average of the past five years and consistent with the authorities' conservative borrowing policies and a stabilization of the public debt-to-GDP ratio. Critically, maintaining the modest deficits envisaged in the baseline scenario would compress public investment in the absence of domestic revenue measures.

- *Foreign aid* is projected to increase significantly in the next few years, before declining gradually as a percentage of GDP. Roughly 9 percent of total aid in the long run is assumed to be concessional loans, higher than the historical average but lower than in 2013–18 when a large, highly concessional loan is being disbursed.

- The *current account deficit* is projected around 5 percent in the longer run and assumed to be financed by foreign direct investment inflows and capital grants, reflecting the structure of the economy. Tourism, the main earner of foreign exchange, has significant upside potential.

EXTERNAL DEBT SUSTAINABILITY

3. **Under the baseline scenario, Vanuatu's external debt remains sustainable.** Total and PPG external debt are projected to increase to 26¾ and 15¼ percent of GDP, respectively, by 2016 before declining again to levels similar to those at end-2012. Other key indicators of sustainability—the present value of PPG external debt, the ratio of PPG debt service to exports, and the ratio of PPG debt service to revenue—all remain well below the indicative thresholds.

4. **Stress tests indicate no breaching of the applicable thresholds for PPG external debt.**[4] However, if the authorities were to increase their external borrowing significantly beyond the amounts assumed in the baseline scenario, for example to finance large infrastructure projects with uncertain tax productivity, external debt levels could quickly rise, particularly if the terms of this borrowing were to be less favorable than the baseline borrowing mix.

PUBLIC DEBT SUSTAINABILITY

5. **Under the baseline scenario, public sector debt increases to 26 percent of GDP in 2018, and then broadly stabilizes at that level.** This contrasts somewhat with the external DSA, where PPG external debt falls back to 2012 levels, due to amortization of old debt and a sharp slowdown in new external borrowing from 2017. All other indicators point in the same direction.

6. **Stress tests suggest that a realization of contingent liabilities equal to 10 percent of GDP, would result an equivalent increase in the debt-to-GDP ratio over the longer term.** A growth shock or lower long run growth, however, poses a bigger risk to public debt sustainability over the longer term. However, as with external debt, should the government debt-finance large infrastructure projects, public debt levels would rise commensurately.

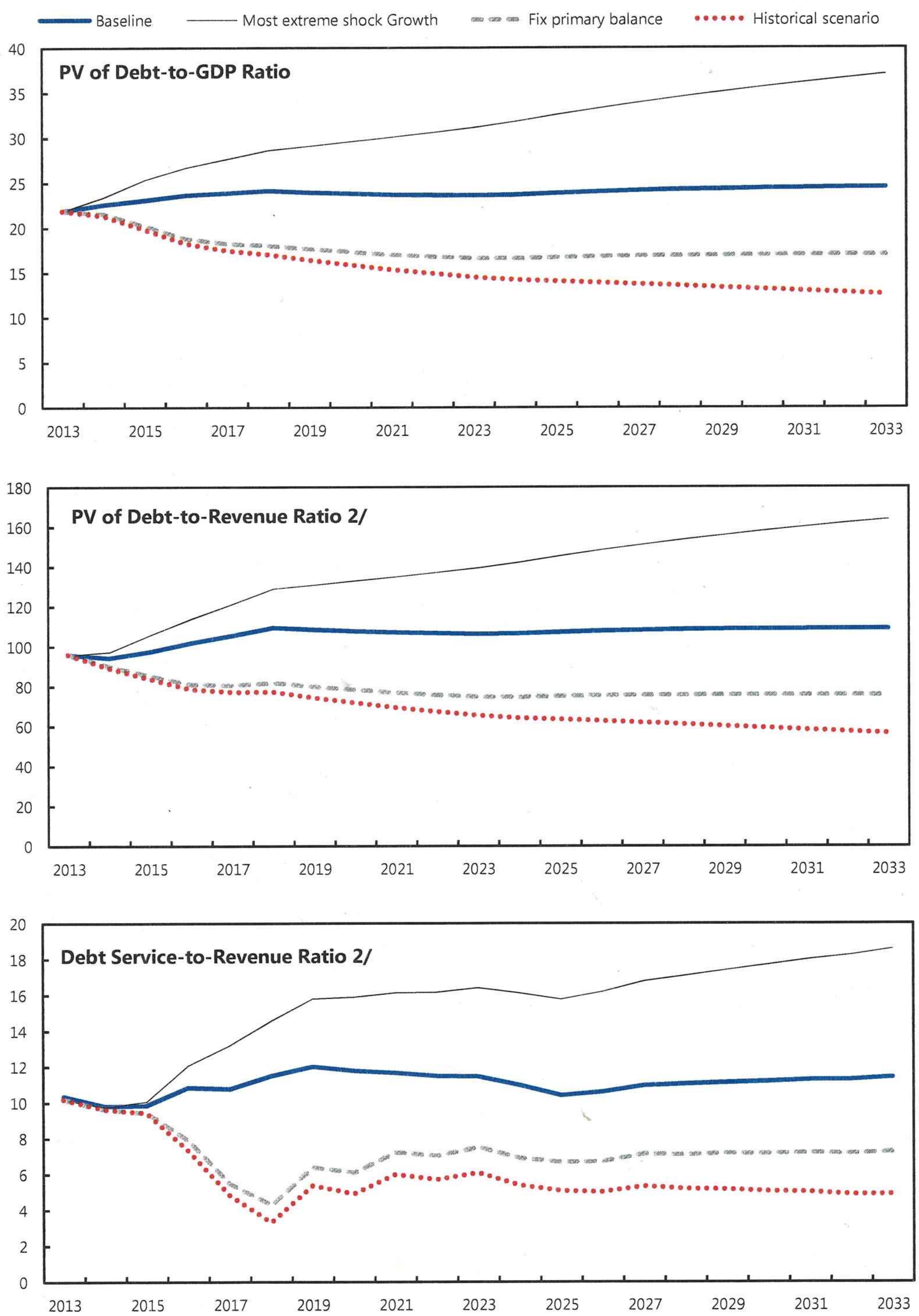
STAFF ASSESSMENT

7. **Vanuatu is at a low risk of debt distress; external and public debt levels are low.** While they are projected to rise in the next few years, they remain manageable, and all indicators of vulnerability remain well below the applicable thresholds, even under stress tests.

8. **However, to contain public and external debt at prudent levels, the authorities will need to continue the cautious borrowing strategy of the past.** Combined with significant spending needs for infrastructure investment and maintenance, as well as in social sectors, this requires that domestic revenues be increased significantly.

[4] The historical scenario, which assumes that key variables such as export growth and the US$ GDP deflator remain at the average levels of the past 10 years, was eliminated from the analysis, as it presents an unrealistically favorable view of conditions going forward (GDP growth was boosted by high levels of grant-financed investment while primary balances were positive).

Figure 1. Vanuatu: Indicators of Public Debt Under Alternative Scenarios, 2013–2033 1/

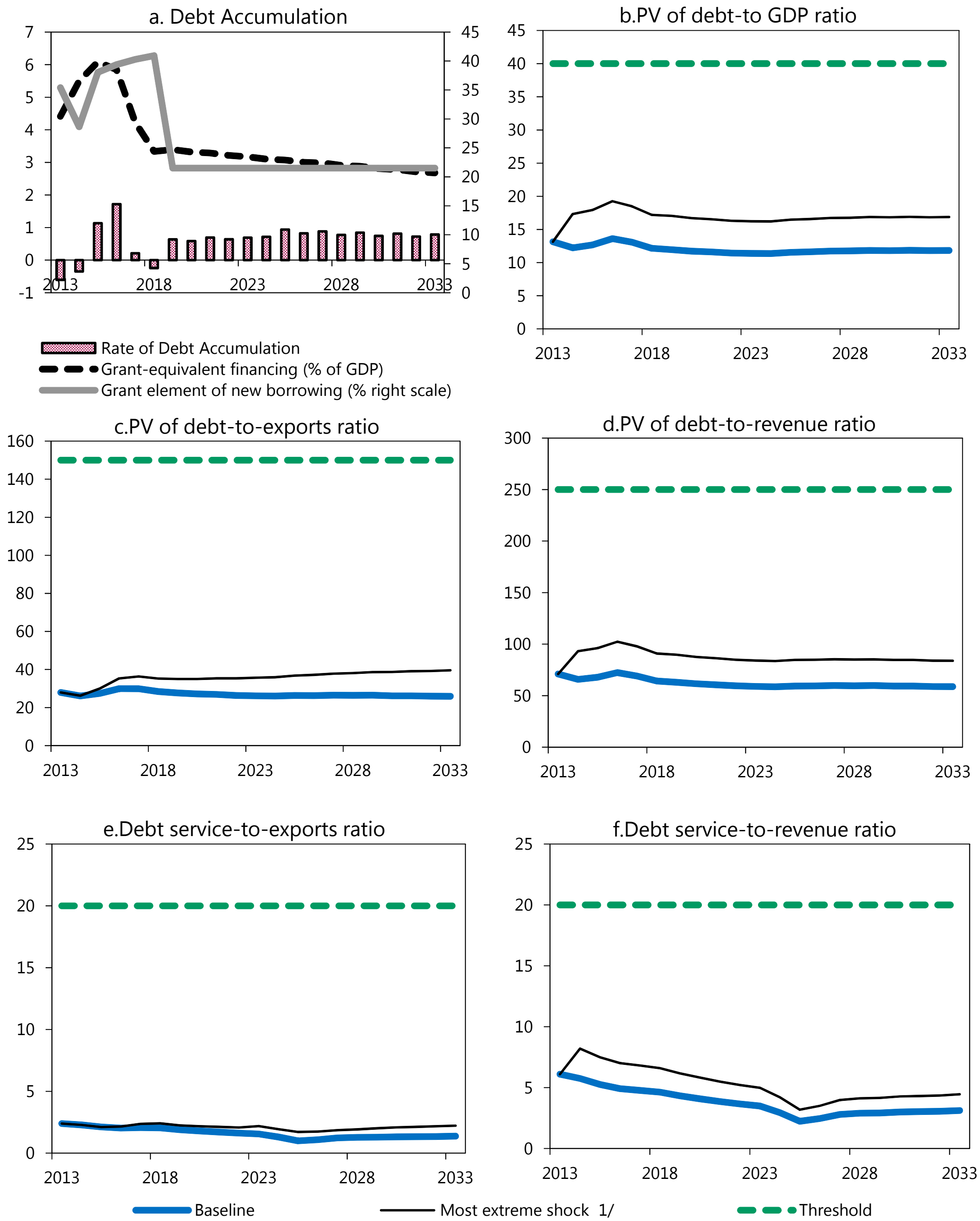


Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2023.

2/ Revenues are defined inclusive of grants.

Figure 2. Vanuatu: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2013–2033 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2023. In figure b. it corresponds to a One-time depreciation shock; in c. to a Terms shock; in d. to a One-time depreciation shock; in e. to a Terms shock and in figure f. to a One-time depreciation shock

Table 1. Vanuatu: Public Sector Debt Sustainability Framework, Baseline Scenario, 2010–2033

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2010	2011	2012	Average 5/	Standard Deviation 5/	2013	2014	2015	2016	2017	2018	2013-18 Average	2023	2033	2019-33 Average
Public sector debt 1/	19.4	20.9	21.6			21.4	22.1	23.5	25.4	25.8	26.0		25.5	26.6	
of which: foreign-currency denominated	14.5	14.8	13.9			12.7	11.8	13.2	15.3	15.0	14.0		13.4	14.0	
Change in public sector debt	-1.2	1.5	0.7			-0.2	0.7	1.4	1.8	0.4	0.2		0.0	0.0	
Identified debt-creating flows	0.9	1.6	0.6			0.1	0.9	1.6	2.0	0.6	0.4		0.0	0.0	
Primary deficit	2.0	1.7	1.0	-0.2	1.5	0.1	1.3	2.2	2.5	1.2	0.9	1.4	0.5	0.5	0.5
Revenue and grants	24.6	22.4	21.6			22.8	24.0	23.7	23.2	22.6	22.0		22.2	22.5	
of which: grants	6.5	4.1	3.0			4.3	5.3	5.0	4.4	3.7	3.1		2.9	2.4	
Primary (noninterest) expenditure	26.6	24.0	22.6			22.9	25.2	25.9	25.7	23.9	23.0		22.7	23.0	
Automatic debt dynamics	-1.1	0.0	-0.4			0.0	-0.4	-0.6	-0.5	-0.6	-0.5		-0.5	-0.5	
Contribution from interest rate/growth differential	-0.1	-0.1	-0.2			-0.2	-0.5	-0.8	-0.6	-0.7	-0.6		-0.4	-0.4	
of which: contribution from average real interest rate	0.2	0.2	0.3			0.5	0.4	0.2	0.4	0.3	0.4		0.5	0.5	
of which: contribution from real GDP growth	-0.3	-0.3	-0.5			-0.7	-0.9	-1.0	-1.0	-1.0	-1.0		-0.9	-0.9	
Contribution from real exchange rate depreciation	-1.0	0.1	-0.2			0.2	0.1	0.1	0.1	0.1	0.1		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-2.0	-0.1	0.1			-0.3	-0.2	-0.2	-0.2	-0.2	-0.2		-0.1	0.1	
Other Sustainability Indicators															
PV of public sector debt	...	...	21.9			21.8	22.6	23.0	23.6	23.8	24.1		23.5	24.5	
of which: foreign-currency denominated	...	...	14.2			13.1	12.2	12.7	13.6	13.1	12.1		11.4	11.8	
of which: external	...	...	14.2			13.1	12.2	12.7	13.6	13.1	12.1		11.4	11.8	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	3.5	3.1	2.6			2.5	3.6	4.6	5.0	3.7	3.4		3.1	3.0	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	101.2			95.7	94.2	97.3	101.7	105.4	109.3		106.1	108.7	
PV of public sector debt-to-revenue ratio (in percent)	...	...	117.4			118.1	121.2	123.5	125.6	126.2	127.5		122.0	121.6	
of which: external 3/	...	...	76.0			71.1	65.8	67.9	72.3	69.2	64.3		59.0	58.8	
Debt service-to-revenue and grants ratio (in percent) 4/	6.2	6.4	7.6			10.3	9.8	9.8	10.8	10.7	11.5		11.4	11.4	
Debt service-to-revenue ratio (in percent) 4/	8.4	7.8	8.8			12.8	12.6	12.5	13.4	12.9	13.4		13.2	12.8	
Primary deficit that stabilizes the debt-to-GDP ratio	3.2	0.2	0.2			0.3	0.6	0.8	0.7	0.8	0.7		0.6	0.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	1.6	1.4	2.3	4.2	2.2	3.3	4.2	4.7	4.5	4.3	4.0	4.2	3.5	3.5	3.6
Average nominal interest rate on forex debt (in percent)	1.3	1.6	1.4	1.3	0.2	1.5	1.5	1.6	1.6	1.5	1.5	1.5	1.5	1.6	1.5
Average real interest rate on domestic debt (in percent)	5.1	5.4	6.2	4.1	2.1	6.0	4.3	2.7	4.7	4.5	4.5	4.4	4.6	4.6	4.6
Real exchange rate depreciation (in percent, + indicates depreciation)	-6.1	0.4	-1.6	-3.9	7.9	1.4	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.6	2.1	1.4	2.8	2.2	1.4	1.9	2.3	2.8	3.0	3.0	2.4	2.9	2.9	2.9
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	-0.1	0.0	0.1	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	35.4	28.6	38.1	39.4	40.3	40.9	37.1	21.5	21.5	...

Sources: Country authorities; and staff estimates and projections.

1/ Budgetary central government, gross debt

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

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

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2. Vanuatu: Sensitivity Analysis for Key Indicators of Public Debt, 2013–2033

	Projections							
	2013	2014	2015	2016	2017	2018	2023	2033
PV of Debt-to-GDP Ratio								
Baseline	22	23	23	24	24	24	24	24
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	22	21	20	18	17	17	14	13
A2. Primary balance is unchanged from 2013	22	22	20	19	18	18	17	17
A3. Permanently lower GDP growth 1/	22	23	24	24	25	26	29	41
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	22	23	25	27	28	29	31	37
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	22	23	22	23	23	23	23	24
B3. Combination of B1-B2 using one half standard deviation shocks	22	22	22	23	23	24	26	30
B4. One-time 30 percent real depreciation in 2014	22	28	28	28	28	28	26	26
B5. 10 percent of GDP increase in other debt-creating flows in 2014	22	31	32	32	32	32	30	28
PV of Debt-to-Revenue Ratio 2/								
Baseline	96	94	97	102	105	109	106	109
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	96	89	83	78	77	77	65	56
A2. Primary balance is unchanged from 2013	96	90	85	81	81	82	75	76
A3. Permanently lower GDP growth 1/	96	95	99	105	110	117	128	180
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	96	97	106	114	121	129	139	164
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	96	94	94	99	102	106	104	107
B3. Combination of B1-B2 using one half standard deviation shocks	96	92	90	97	103	109	115	133
B4. One-time 30 percent real depreciation in 2014	96	118	118	120	123	127	119	117
B5. 10 percent of GDP increase in other debt-creating flows in 2014	96	131	134	136	140	143	133	126
Debt Service-to-Revenue Ratio 2/								
Baseline	10	10	10	11	11	11	11	11
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	10	10	9	7	5	3	6	5
A2. Primary balance is unchanged from 2013	10	10	9	8	5	4	7	7
A3. Permanently lower GDP growth 1/	10	10	10	11	11	12	15	21
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	10	10	10	12	13	15	16	19
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	10	10	10	11	9	11	11	11
B3. Combination of B1-B2 using one half standard deviation shocks	10	10	10	9	7	12	13	15
B4. One-time 30 percent real depreciation in 2014	10	11	11	13	13	14	14	15
B5. 10 percent of GDP increase in other debt-creating flows in 2014	10	10	11	31	13	22	13	13

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

Table 3. External Debt Sustainability Framework, Baseline Scenario, 2010–2033 1/

(In percent GDP unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2010	2011	2012			2013	2014	2015	2016	2017	2018	2013-2018 Average	2023	2033	2019-2033 Average
External debt (nominal) 1/	**33.2**	**28.3**	**25.5**			**24.2**	**23.2**	**24.6**	**26.8**	**26.5**	**25.5**		**24.9**	**25.5**	
of which: public and publicly guaranteed (PPG)	14.5	14.8	13.9			12.7	11.8	13.2	15.3	15.0	14.0		13.4	14.0	
Change in external debt	2.2	-5.0	-2.7			-1.4	-0.9	1.4	2.2	-0.3	-1.0		0.0	0.0	
Identified net debt-creating flows	-4.3	-2.9	1.6			1.1	1.3	2.5	3.0	2.1	2.0		1.6	1.2	
Non-interest current account deficit	**4.7**	**7.4**	**5.8**	**6.4**	**1.1**	**5.6**	**6.0**	**7.0**	**7.2**	**6.2**	**5.8**	6.3	**5.1**	**4.5**	5.0
Deficit in balance of goods and services	5.7	6.7	3.3			3.7	4.3	5.1	5.5	4.7	4.6		4.1	3.6	
Exports	46.6	44.9	47.5			47.1	46.9	46.2	45.5	43.7	42.7		43.5	45.6	
Imports	52.4	51.6	50.8			50.8	51.1	51.3	51.0	48.5	47.4		47.7	49.2	
Net current transfers (negative = inflow)	-3.2	-1.6	-2.1	-3.8	1.4	-2.5	-2.1	-1.7	-1.6	-1.6	-1.5	-1.8	-1.1	-0.6	-1.0
of which: official	-3.0	-1.3	-1.8			-2.1	-1.8	-1.3	-1.3	-1.2	-1.1		-0.8	-0.4	
Other current account flows (negative = net inflow)	2.2	2.4	4.6			4.3	3.9	3.6	3.3	3.0	2.6		2.1	1.6	
Net FDI (negative = inflow)	**-5.7**	**-7.3**	**-4.7**	**-7.4**	**3.5**	**-4.2**	**-4.3**	**-4.0**	**-3.7**	**-3.5**	**-3.3**	-3.8	**-3.2**	**-3.0**	-3.1
Endogenous debt dynamics 2/	**-3.3**	**-3.0**	**0.5**			**-0.3**	**-0.4**	**-0.5**	**-0.6**	**-0.5**	**-0.5**		**-0.3**	**-0.3**	
Contribution from nominal interest rate	0.7	0.6	0.5			0.6	0.5	0.5	0.5	0.5	0.6		0.5	0.5	
Contribution from real GDP growth	-0.4	-0.4	-0.6			-0.8	-1.0	-1.0	-1.0	-1.1	-1.0		-0.8	-0.8	
Contribution from price and exchange rate changes	-3.6	-3.2	0.6			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**6.6**	**-2.1**	**-4.3**			**-2.5**	**-2.3**	**-1.2**	**-0.8**	**-2.4**	**-3.0**		**-1.6**	**-1.2**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		-0.3	-0.5	
PV of external debt 4/	...	...	25.8			24.6	23.7	24.1	25.1	24.5	23.6		22.9	23.4	
In percent of exports	...	...	54.3			52.2	50.5	52.2	55.1	56.0	55.2		52.7	51.2	
PV of PPG external debt	**...**	**...**	**14.2**			**13.1**	**12.2**	**12.7**	**13.6**	**13.1**	**12.1**		**11.4**	**11.8**	
In percent of exports	**...**	**...**	**29.8**			**27.9**	**26.1**	**27.4**	**29.9**	**29.9**	**28.4**		**26.2**	**25.9**	
In percent of government revenues	**...**	**...**	**76.0**			**71.1**	**65.8**	**67.9**	**72.3**	**69.2**	**64.3**		**59.0**	**58.8**	
Debt service-to-exports ratio (in percent)	**4.8**	**4.2**	**3.6**			**6.7**	**6.7**	**5.8**	**5.1**	**5.2**	**5.4**		**4.2**	**3.6**	
PPG debt service-to-exports ratio (in percent)	**1.4**	**1.4**	**1.4**			**2.4**	**2.3**	**2.1**	**2.0**	**2.1**	**2.0**		**1.6**	**1.4**	
PPG debt service-to-revenue ratio (in percent)	**3.6**	**3.5**	**3.5**			**6.1**	**5.8**	**5.3**	**4.9**	**4.8**	**4.6**		**3.5**	**3.1**	
Total gross financing need (Millions of U.S. dollars)	8.9	16.0	22.0			37.6	42.6	52.8	56.6	50.3	51.7		55.8	88.7	
Non-interest current account deficit that stabilizes debt ratio	2.5	12.4	8.5			6.9	7.0	5.7	5.0	6.5	6.8		5.2	4.4	
Key macroeconomic assumptions															
Real GDP growth (in percent)	1.6	1.4	2.3	4.2	2.2	3.3	4.2	4.7	4.5	4.3	4.0	4.2	3.5	3.5	3.6
GDP deflator in US dollar terms (change in percent)	13.0	10.6	-2.1	7.3	6.7	1.7	0.4	0.8	1.3	1.5	1.5	1.2	2.9	2.9	2.8
Effective interest rate (percent) 5/	2.5	2.0	1.9	1.9	0.3	2.3	2.3	2.3	2.1	2.1	2.2	2.2	2.2	2.3	2.2
Growth of exports of G&S (US dollar terms, in percent)	9.1	8.0	6.0	13.1	8.1	4.1	4.1	4.1	4.1	1.8	3.1	3.6	6.9	6.9	7.0
Growth of imports of G&S (US dollar terms, in percent)	6.9	10.4	-1.3	12.3	11.4	5.0	5.2	6.0	5.1	0.6	3.1	4.2	6.7	6.7	6.8
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	35.4	28.6	38.1	39.4	40.3	40.9	37.1	21.5	21.5	21.5
Government revenues (excluding grants, in percent of GDP)	18.1	18.3	18.6			18.5	18.6	18.7	18.8	18.9	18.9		19.3	20.1	19.5
Aid flows (in Millions of US dollars) 7/	51.5	38.8	23.5			37.0	47.6	65.8	72.6	49.6	39.0		47.1	74.6	
of which: Grants	45.7	32.2	23.5			35.8	46.2	45.9	42.7	38.2	33.9		43.3	67.2	
of which: Concessional loans	5.8	6.6	0.0			1.2	1.4	19.8	29.9	11.4	5.0		3.8	7.4	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			4.4	5.5	6.1	5.8	4.2	3.3		3.2	2.7	3.0
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			96.9	93.7	78.1	72.7	85.4	92.4		76.0	72.1	75.1
Memorandum items:															
Nominal GDP (Millions of US dollars)	700.8	786.3	787.0			826.7	864.7	912.9	966.3	1022.2	1078.8		1494.9	2806.1	
Nominal dollar GDP growth	14.9	12.2	0.1			5.1	4.6	5.6	5.8	5.8	5.5	5.4	6.5	6.5	6.6
PV of PPG external debt (in Millions of US dollars)			112.7			107.9	105.0	114.9	130.5	132.6	130.1		170.3	331.9	
(PVt-PVt-1)/GDPt-1 (in percent)						-0.6	-0.3	1.1	1.7	0.2	-0.2	0.3	0.7	0.8	0.8
Gross workers' remittances (Millions of US dollars)	1.1	2.3	3.0			3.1	3.2	3.4	3.6	3.7	3.8		4.3	5.2	
PV of PPG external debt (in percent of GDP + remittances)	...	...	14.1			13.1	12.2	12.6	13.6	13.0	12.1		11.4	11.8	
PV of PPG external debt (in percent of exports + remittances)	...	...	29.6			27.7	25.9	27.2	29.7	29.6	28.2		26.0	25.8	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	1.4			2.4	2.3	2.1	2.0	2.0	2.0		1.5	1.4	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

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

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

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

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

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

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

Table 4. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2013–2033

(In percent)

	Projections							
	2013	2014	2015	2016	2017	2018	**2023**	2033
PV of debt-to GDP ratio								
Baseline	13	12	13	14	13	12	**11**	12
A. Alternative Scenarios								
A1. New public sector loans on less favorable terms in 2013-2033 2	13	12	14	16	16	15	**16**	18
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	13	12	13	14	14	13	**12**	12
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	13	12	12	13	12	11	**11**	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	13	12	13	13	13	12	**11**	12
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	13	12	12	13	13	12	**11**	12
B5. Combination of B1-B4 using one-half standard deviation shocks	13	8	3	4	4	3	**4**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	13	17	18	19	18	17	**16**	17
PV of debt-to-exports ratio								
Baseline	28	26	27	30	30	28	**26**	26
A. Alternative Scenarios								
A1. New public sector loans on less favorable terms in 2013-2033 2	28	26	30	35	36	35	**36**	40
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	28	26	27	30	30	28	**26**	26
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	28	25	25	27	27	26	**24**	25
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	28	26	27	30	30	28	**26**	26
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	28	26	26	29	29	27	**25**	26
B5. Combination of B1-B4 using one-half standard deviation shocks	28	17	6	8	8	7	**10**	19
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	28	26	27	30	30	28	**26**	26
PV of debt-to-revenue ratio								
Baseline	71	66	68	72	69	64	**59**	59
A. Alternative Scenarios								
A1. New public sector loans on less favorable terms in 2013-2033 2	71	66	74	85	84	80	**80**	90
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	71	67	71	75	72	67	**62**	62
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	71	64	63	67	64	59	**56**	58
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	71	65	67	72	69	64	**59**	59
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	71	66	65	70	66	62	**57**	58
B5. Combination of B1-B4 using one-half standard deviation shocks	71	44	15	21	20	16	**23**	44
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	71	93	96	102	98	91	**84**	84

Table 4. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2013–2033 (Continued)

(In percent)

Debt service-to-exports ratio								
Baseline	2	2	2	2	2	2	**2**	1
A. Alternative Scenarios								
A1. New public sector loans on less favorable terms in 2013-2033 2	2	2	2	2	2	2	**2**	2
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	2	2	2	2	2	2	**2**	1
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	2	2	2	2	2	2	**1**	1
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	2	2	2	2	2	2	**2**	1
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	2	2	2	2	2	2	**2**	1
B5. Combination of B1-B4 using one-half standard deviation shocks	2	2	2	2	2	2	**0**	1
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	2	2	2	2	2	2	**2**	1
Debt service-to-revenue ratio								
Baseline	6	6	5	5	5	5	**3**	3
A. Alternative Scenarios								
A1. New public sector loans on less favorable terms in 2013-2033 2	6	6	5	5	5	5	**5**	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	6	6	6	5	5	5	**4**	3
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	6	6	5	5	5	5	**3**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	6	6	5	5	5	5	**3**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	6	6	5	5	5	5	**3**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	6	6	5	4	4	4	**1**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	6	8	7	7	7	7	**5**	4
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	23	23	23	23	23	23	**23**	23

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

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IMF Executive Board Concludes 2013 Article IV Consultation with Vanuatu

On June 7, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Vanuatu.[1]

Background

Economic activity is gradually turning around after slowing growth mainly due to a decline in construction and tourism in 2011. Output growth in 2012 is estimated at around 2¼ percent on the back of a recovery in tourism. Inflation remained low, at 0.8 percent year on year in December 2012. The balance of payments remains sound. The current account deficit has narrowed to 6¼ percent of GDP in 2012, and was more than covered by foreign direct investment inflows and official grants. Official reserves continued to rise to $182 million, with coverage of prospective imports rising to 7 months. The fiscal deficit is estimated at 1½ percent of GDP in 2012, largely due to the authorities' efforts at controlling expenditure. Public debt remains low, at 21½ percent of GDP.

The authorities have maintained prudent macroeconomic and financial policies. They have protected external and fiscal policy buffers, as well as macroeconomic stability. Furthermore, they have made efforts to raise additional revenue through administrative

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

improvements. The Reserve Bank of Vanuatu (RBV) has also stepped up supervision of the banking system to address credit and foreign exchange risks.

In 2013, continued growth in tourism and some private sector investment projects are forecast to raise output growth to 3¼ percent, and inflation is expected to pick up moderately to 1¾ percent year on year, as demand pressures increase. The overall balance of payments is projected to remain in surplus. The budget targets zero net domestic financing and net repayments of external debt. It also envisages rising revenues on account of higher growth and improved compliance, and a significant increase in grants. In the medium term several donor-supported investment projects are scheduled to be implemented in the next few years, boosting output growth to 4¾ percent by 2015. Domestic risks arise from limited capacity, which could affect the execution of planned projects. A key external risk stems from possibly weaker-than-anticipated activity in the region which might adversely affect tourism. On the upside, a decisive push for further structural reforms could boost confidence and private sector investment.

Executive Board Assessment

They commended the authorities' prudent policies, which have fostered macroeconomic stability and resilience to shocks. Looking ahead, Directors considered that Vanuatu needs to maintain strong policy buffers while investing in infrastructure, enhancing public service delivery, and improving the business environment.

Directors agreed that spending needs, particularly in infrastructure and social services, will put pressure on the fiscal position. They welcomed the authorities' plans to strengthen tax administration and their consideration of new revenue measures, underscoring the advantages of an income tax, among the various options, in terms of revenue yield and distributional impact. Directors emphasized the need to accelerate the reform of government business enterprises, which is necessary to improve governance and reduce fiscal risks.

Directors noted that public and external debt remain low. They encouraged the authorities to maintain their conservative approach to debt management, supporting their intention to seek external financing only on concessional terms. Prospective financing pressures can be alleviated by appropriately phasing public projects and partnering with the private sector.

Directors concurred that the exchange rate peg has served Vanuatu well, and remains an appropriate anchor for monetary policy. They encouraged the Reserve Bank of Vanuatu to monitor monetary conditions closely as economic growth picks up, and tighten the policy stance if needed.

Directors commended the authorities' cautious financial sector policies and noted that banks remain well capitalized despite a rise in nonperforming loans. To address emerging risks, Directors saw merit in further strengthening supervision and introducing regulation to limit banks' open foreign exchange positions. Liquidity and credit risks also warrant close attention. Directors welcomed steps in establishing an anti money laundering framework, but encouraged the authorities to speed up progress to address gaps in implementation and enforcement.

Directors noted Vanuatu's considerable growth potential, especially in tourism and agriculture. Realizing this potential will require a new round of structural reforms, including increasing the effectiveness of the civil service, promoting competition in key sectors, and improving access to land. Such measures would lower business costs and help mitigate external risks.

Vanuatu: Selected Economic and Financial Indicators, 2008–14\

	2009	2010	2011	Est. 2012	Proj. 2013	Proj. 2014
Output and prices (annual percentage change)						
Real GDP	3.3	1.6	1.4	2.3	3.3	4.2
Consumer prices (period average)	5.2	2.7	0.7	1.4	1.4	1.9
Consumer prices (end period)	2.4	3.3	1.2	0.8	1.8	2.0
Government finance (in percent of GDP)						
Revenue	26.0	24.6	22.4	21.7	22.7	23.9
Domestic Revenue	18.9	18.1	18.3	18.7	18.4	18.5
Grants	7.1	6.5	4.1	3.0	4.3	5.3
Expenditure	26.8	27.1	24.6	23.3	23.7	26.0
Expense	20.4	22.2	21.9	21.7	23.2	22.8
Net acquisition of non-financial assets	6.4	4.9	2.7	1.6	0.6	3.2
Net lending (+)/borrowing (-)	-0.8	-2.5	-2.2	-1.6	-1.0	-2.1
Public debt (end of period)	20.5	19.4	20.9	21.6	21.6	22.5
Domestic	3.8	4.8	6.0	7.7	8.8	10.5
External	16.7	14.5	14.8	13.9	12.8	12.0
Money and credit (annual percentage change)						
Broad money (M2)	0.5	-6.0	1.3	-0.6	...	...
Net foreign assets	-18.3	-34.5	-8.1	-6.3	...	...
Domestic credit	4.6	4.6	4.6	5.8	...	...
Of which: Credit to private sector	19.9	11.6	9.4	6.9	...	...
Interest rates (in percent, end of period) 1/						
Deposit rate (vatu deposits)	3.2	1.8	2.8	2.4	...	...
Lending rate (vatu loans)	10.9	11.0	10.3	9.5	...	...
Balance of payments (in percent of GDP)						
Current account	-6.1	-5.4	-8.1	-6.3	-5.9	-6.4
Trade balance	-29.6	-27.4	-24.6	-25.2	-24.6	-25.3
Exports of goods	9.0	7.3	8.6	7.0	7.0	6.9
Imports of goods	-38.7	-34.6	-33.1	-32.2	-31.6	-32.2
Tourism receipts	30.6	30.9	28.7	33.2	32.7	32.5
Capital and financial account	7.2	7.4	10.9	6.8	7.8	9.1
Of which: Foreign direct investment	5.0	5.7	7.3	4.7	4.2	4.3
Gross international reserves (in millions of U.S. dollars)	148.6	161.4	173.8	182.2	197.7	221.3
In months of prospective imports of goods	6.1	6.2	6.9	7.0	7.1	7.4
External debt service (in percent of GNFS exports)	1.6	1.4	1.4	-0.6	1.9	1.8
Exchange rates 2/						
Real effective exchange rate (average)	102.0	105.8	106.2	103.8	…	…
Memorandum items:						
Nominal GDP (in billions of vatu)	65.1	67.9	70.3	72.9	76.4	81.1
Nominal GDP (in millions of U.S. dollars)	610	701	786	787	827	865

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

Statement by Joon-Won Yoon, Executive Director for the Vanuatu and Branan Karae, Advisor to Executive Director June 4, 2013

The Vanuatu authorities thank staff for the constructive policy dialogue and useful advice provided during the Article IV Consultation. The favorable 2013 economic assessment is a welcoming sign that the country is maturing further and heading in the right direction. Nonetheless, the authorities recognize that they face numerous challenges, including in infrastructure and tax reform, and, in this regard, reaffirm their full commitment to the economic growth agenda.

Economic Developments, Outlooks and Risks

Vanuatu is a highly open, small island economy in the Pacific, and remains significantly exposed to external uncertainties. The delay in the global economic recovery has put a strain on the economy over the past few years. The economy began to recover in 2012, with the tourism sector picking up strongly. Inflation is low at 0.8 percent and the current account deficit has narrowed to 6¼ percent of GDP, from 8 percent in 2011. Growth for 2013 is projected to continue, supported by a pickup in manufacturing and construction.

Downside risks to the growth forecast include: further delay in the global recovery, unexpected rise in global fuel prices, and a change of preference from tourism originating from Australia and New Zealand. At the domestic level, the frequent changes in the political arena present challenges to reform efforts. However, the new government, headed by Prime Minister Moana Carcasses Kalosil, is committed to ensuring political stability in order to promote economic growth and structural reform.

Fiscal Management

Fiscal management is sound and the authorities are committed to maintaining this position. Authorities intend to maintain debt at low levels, although they recognize that this will be a significant challenge, given projected infrastructure financing needs. Authorities agree with the Staff assessment that the government budget needs to be strengthened to support the financing of public capital investment projects. In this regard, the government will continue to work closely with the development partners and to seek external financing support on concessional terms only.

The fiscal revenue base must be strengthened over the longer term. The authorities are pleased to advise that discussions with the line ministries on the planned new revenue initiatives have started and the government is putting together the recommendations. While some recommendations can be implemented right away, such as increasing the VAT rates, others like the income tax proposal will require comprehensive analysis to be carried out first. As noted in the staff report, authorities are open to considering all tax options, and would welcome Fund assistance to this end.

Tax administration will be further strengthened by the recruitment of suitable personnel, appropriate training and improving enforcement capacity. On the expenditure side, the authorities will continue to improve expenditure management and strengthen the oversight of audit controls. The authorities recently amended the Public Finance and Economic Management Act to improve the control and disbursement of funds. The government's plan to address the financial health of state owned enterprises (SOEs) through the restructuring of these entities and liquidation of those that are no longer profitable will ease the pressure on the government budget.

Monetary Policy and Exchange Rate

The monetary policy framework of the Reserve Bank of Vanuatu (RBV) continued to be effective in achieving the monetary policy targets over the past two years. The peg to a basket of currencies has served the country well in providing stability and guiding expectations. While inflation is currently low, inflationary pressure is expected to increase over the coming years with the implementation of government projects and the expected increase in domestic demand. The RBV stands ready to tighten monetary policy and to take appropriate steps to protect net international reserves above the four months import cover threshold as demand for import rises in the near term.

Financial Sector

The financial sector is sound and domestic banks are well capitalized. However, growth of non-performing loans (NPLs) resulting from weak economic environment is a concern. The RBV has responded proactively, by conducting onsite reviews of NPLs, increasing their monitoring and instructing banks to adhere to prudent credit lending standards. The RBV strongly advised banks to ensure they had adequate provisioning to cover potential losses. As a result, specific provisions for the banking industry as a whole, increased by 159 percent from August 2011 to December 2012.

On the high credit to deposit ratio, the RBV is closely monitoring the situation, particularly in relation to the Vanuatu National Provident Fund's recent withdrawal of its significant deposits from the banking system to fund its huge investments. More broadly, while the industry's liquidity level is high, the distribution among individual banks is uneven. To this end, the RBV will continue to review the prudential liquidity requirements of commercial banks and ensure that banks continue to adhere to best liquidity management practices.

Authorities concur with the staff assessment that individual banks' systematic exposure to foreign exchange risk should be monitored carefully. Notably, the trend increase in demand for foreign-currency credit, against declining foreign-currency deposits, is of concern. At this stage, the RBV has drafted, but not yet implemented, a guideline on managing foreign currency risk. The guideline will also address the risk of exposure to unhedged foreign currency lending to ensure that it is reflected in the banks' balance sheet.

AML/CFT Issues

As an offshore center, Vanuatu's reputation has come under intense scrutiny over the years. However, Vanuatu is committed to complying with the international standards on anti-money laundering practice. Vanuatu has enacted more comprehensive AML/CFT legislations and has established the Financial Intelligence Unit (FIU) to oversee this function. The authorities agree, however, that effective enforcement of the legislation is an area of weakness and they will put more focus on this. More financial support will be provided to the FIU and the authorities will continue to recruit and upgrade the HR capacity of the Unit through its participation in domestic and international trainings.

Structural Reform

The government continues to pursue structural reform steadfastly in its efforts to improve government services to make basic services more affordable and reliable to the general public. The 2008 reform in the telecommunication sector brought greater competition with the entry of Digicel, bringing the total telecommunication service providers to two. The government also launched in 2012 its e-government network allowing it to run its own network, improving its services throughout the country. The government is also giving its full support behind a private-led joint venture project to deploy Vanuatu's first international submarine cable system linking Vanuatu to Fiji. This new set up, planned for completion this year, will deliver faster, more efficient and cost effective internet connectivity, replacing the current unstable satellite telecommunication set up.

On the energy sector, concerted effort has been made to increase power supply, improve reliability, and reduce the high costs of electricity. The government has opened up the energy sector and licensed a new electricity company, Vanuatu Utilities and Infrastructure, which operates in the second town, in the northern part of the country. The main power provider, Unelco Vanuatu Ltd., has also diversified its energy source to include coconut oil and wind energy. The government is also in the process of finalizing the setup of a geothermal plant venture with a reputable international energy company, Kuth Energy, on the northern side of the island of Efate. The project, once in operation, is expected to reduce the high cost of electricity in Port Vila (the capital) and reduce the high dependency on diesel based electricity generation.

The drop in the country's 2013 doing business ranking from 62 to 80 is unfortunate. The authorities are determined to improve the ranking by reducing the time it takes to start a new business and the time taken to obtain a construction permit. Authorities also see merit in eliminating redundant procedures to reduce start-up and compliance costs.

The government is committed to reforming Government Business Enterprises (GBEs) to achieve the combined goals of improved public service delivery, reduced fiscal transfers to the GBE sector and private sector development. A policy paper on reforming GBEs is currently being finalized for submission to the Council of Ministers. The GBE policy will form the basis of a new SOE legislation. While there are no current plans for privatizing any GBEs over the medium term, any restructuring and privatization of GBEs can only occur after the new SOE legislation is in place.

The future driver of growth will mainly come from the tourism sector. To reduce the heavy reliance on the Australia and New Zealand markets, the authorities are also looking to expand into the Asian market. Last year, the authorities conducted a number of big promotions in the Asian region and they intend to increase this further. The outcome of last year's promotion is already showing positive results. Given that the infrastructure capacity of the country is insufficient to support tourism targeted growth, the implementation of the donor funded projects to improve Port Vila's urban infrastructure, main wharf and shipping is a welcomed development. Short-term growth will be driven by the implementation of donor funded public infrastructure projects that have already been approved. To avoid delays and to smooth out the impact of donor funded large capital projects, the authorities will strengthen the role and capacity of the Vanuatu Project Management Unit. Over the longer term, the government is focused on soliciting financial support to fund the expansion of the country's main airports to accommodate larger aircrafts and increased capacity.

For the agriculture and fishery industries, the authorities will continue to exploit the comparative advantage of these industries and will more critically address the barriers to labor and investment. Plans are also under way to open up a government fishery processing plant (built with the assistance from China some years ago) on Efate in June this year. This processing plant will help facilitate private sector activities, increase the value-added in the production process, and provide local employment. Job opportunities have also increased with the opening up of the unskilled labor mobility scheme with the New Zealand Government in 2006 under the Recognized Seasonal Employee scheme. A similar scheme has just been established with Australia, although the scale is still small.