



VANUATU

October 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR VANUATU

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Vanuatu, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its October 21, 2016 consideration of the staff report that concluded the Article IV consultation with Vanuatu.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on October 21, 2016, following discussions that ended on July 26, 2016, 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 September 22, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Vanuatu.

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IMF Executive Board Concludes 2016 Article IV Consultation with Vanuatu

On October 21, the Executive Board of the International Monetary Fund (IMF) concluded the 2016 Article IV consultation with Vanuatu.¹

Vanuatu's economy is gradually recovering from the extensive damages caused by Cyclone Pam, which hit the country in March 2015, and reconstruction efforts have started to yield positive results. In June 2015, the IMF Board approved a disbursement of about USD23.8 million under [the Rapid Credit Facility and the Rapid Financing Instrument](#). The IMF's financial assistance helped Vanuatu cope with its immediate balance of payments needs and played a key role in catalyzing critical donor support for the recovery.

The cyclone led to a decline in GDP of about 0.8 percent in 2015, relative to pre-cyclone projections of 3.5 percent. Reconstruction activity and infrastructure investment pushed inflation up to 2.5 percent in 2015 from about 1 percent in 2014. The current account deficit widened to 11 percent of GDP in 2015 from an average of 3 percent of GDP in the previous three years with sharply increased imports and depressed exports due to severe damages to tourism facilities and agricultural production.

Near-term prospects are favorable but risks to the outlook are tilted to the downside. Real GDP growth is expected to reach 4 percent in 2016 and 4.5 percent in 2017 driven by the recovery in tourism and agriculture, and further ramping-up of infrastructure projects. The risks to this favorable outlook stem mainly from the uncertainty in the rate of implementation of the public infrastructure projects. The danger of natural disasters is ever-present, aggravated by the cyclical effects of El Niño's droughts and La Niña's heavy rainfall.

In 2016 government spending is projected to increase by 16 percent of GDP, including unspent cyclone-related grants received in 2015, resulting in a fiscal deficit of about 10

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.

percent of GDP. Major infrastructure projects have recently started or are in the pipeline under an ambitious infrastructure investment program. These will be partly financed through external borrowing, raising central government debt sharply to 33.5 percent of GDP in 2016 and higher over the medium term. The government aims to cover the resulting fiscal gap with additional grant financing, in particular earmarked for public infrastructure projects.

The current account deficit is projected to widen further to around 20 percent of GDP in 2016 due to cyclone-related spending and the high import content of the major infrastructure projects. This deficit is envisaged to be financed by donor grants and loans, and foreign direct investment. Foreign reserves stood at USD 273 million (7.1 months of imports) by end-2015 bolstered by cyclone-related grants and loans from international partners.

The monetary policy stance has been accommodative in an effort to support growth in the aftermath of Cyclone Pam and the peg to a basket of currencies has served Vanuatu well in promoting stability and confidence. Inflation is projected to remain below 3 percent in the medium term owing to low commodity prices, even though expanding domestic demand will provide some upward pressure. Banks have fully recovered from the cyclone and are adequately capitalized and liquid. The financial system is sound, but further progress on financial inclusion is needed especially in the outer islands.

Executive Board Assessment²

Executive Directors noted that Vanuatu's economy is gradually recovering from the extensive damages caused by Cyclone Pam, and commended the authorities for their effective response and reconstruction efforts, which are yielding positive results. Directors noted that growth is expected to rebound in 2016 owing to the recovery of tourism and agriculture, and the scaling up of public investment. They concurred, however, that risks are mostly tilted to the downside given uncertainty in the rate of implementation of public infrastructure projects and the country's vulnerability to natural disasters.

Directors agreed that the immediate response to Cyclone Pam has been effective in alleviating human suffering and restoring economic activity. They emphasized, however, the importance of improving the country's resilience to natural disasters by building domestic and external buffers, promoting resilient infrastructure, and establishing more effective contingency plans.

Directors noted that major infrastructure projects, which have recently started or are in the pipeline, may challenge debt and fiscal sustainability. They stressed that a careful selection of investment projects, revenue mobilization, and fiscal discipline are essential to reduce the

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

pressure on fiscal accounts. Directors commended the authorities for launching a comprehensive tax reform initiative, including the introduction of a corporate and personal income tax. They agreed that additional financing should continue to be sought on grant and concessional terms.

Directors agreed that the financial sector has been recovering well from the adverse impacts of Cyclone Pam, and that the Reserve Bank of Vanuatu must take action to secure financial and price stability by gradually normalizing regulatory requirements for banks and non-banking financial institutions. They welcomed the authorities' recent initiatives to address shortcomings regarding anti-money laundering and combating the financing of terrorism (AML/CFT) and emphasized the need to accelerate the implementation of the AML/CFT action plan, including by drawing on technical assistance from international partners.

Directors viewed the accommodative monetary stance and the continuation of the exchange rate peg as appropriate in supporting economic recovery after the cyclone, while ensuring price and financial stability. They noted that, considering the weak transmission mechanism, vigilance is needed to check inflation pressures, and ensure monetary policy remains consistent with the exchange rate peg and reserve cover goals. Directors encouraged the authorities to enhance the effectiveness of monetary policy by streamlining policy objectives and instruments and by deepening financial markets.

Directors noted that a concerted effort to promote private sector investment by further implementing land reforms and enhancing quality upgrading in the tourism and agricultural sectors are key to ensure poverty is reduced and prosperity shared. They stressed that improving access to employment opportunities and financial inclusion should remain a priority to strengthen households' resilience to external shocks, especially in the outer islands.

Vanuatu: Selected Economic Indicators, 2011–17

Population (2014): 262,559

Per capita GDP (2014): \$3,104

IMF quota: SDR 23.8 million (0.01 percent of total)

Literacy rate (2012): 83.4 percent

Key export markets: New Zealand, Australia, Japan

	2011	2012	2013	2014	2015 Est.	2016 Proj.	2017 Proj.
Output							
Real GDP growth (%)	1.2	1.8	2.0	2.3	-0.8	4.0	4.5
Employment							
Unemployment (%) 1/	...	...	...	...	...	...	...
Price							
Inflation (%; period average)	0.9	1.3	1.5	0.8	2.5	2.2	2.6
General government finance							
Revenue and grants (% of GDP)	22.3	21.8	21.4	23.5	32.1	29.1	27.8
Expenditure (% of GDP)	24.4	23.4	21.7	22.7	24.9	39.7	45.1
Fiscal balance (% of GDP)	-2.1	-1.6	-0.2	0.8	7.2	-10.6	-17.3
Public debt (% of GDP)	20.7	21.7	20.6	19.3	25.6	33.5	44.8
Money and credit							
Broad money (% change)	1.3	-0.6	-5.5	8.6	11.4	0.2	...
Credit to private sector (% change)	8.8	6.9	2.0	9.0	1.8	6.7	...
Balance of payments							
Current account (% of GDP)	-8.1	-6.5	-3.3	-0.3	-11.1	-16.6	-21.1
Trade balance	-24.4	-25.4	-27.8	-24.2	-36.5	-32.4	-34.1
Exports of goods 2/	8.5	7.0	5.6	7.7	5.3	7.8	8.3
Imports of goods	-32.9	-32.4	-33.4	-31.9	-41.7	-40.2	-42.4
Tourism receipts	28.1	30.9	35.9	31.6	23.7	25.5	27.1
Capital and financial account	14.7	6.1	7.2	6.1	21.3	13.6	20.7
Of which: Foreign direct investment	7.5	4.9	4.2	2.6	4.4	5.4	5.8
Gross international reserves (in millions of U.S. dollars)	175.1	183.6	179.2	184.0	273.4	250.0	246.5
FDI (% of GDP)	7.5	4.9	4.2	2.6	4.4	5.4	5.8
Reserves (months of imports)	5.3	5.4	5.4	4.8	7.1	5.8	5.6
External debt service (in percent of GNFS exports)	1.4	1.4	1.8	2.1	2.5	2.5	2.7
External debt (% of GDP)	14.7	14.0	12.7	11.5	17.9	24.8	35.7
Exchange rates 2/							
Real effective exchange rate (average, 2005=100)	99.6	100.2	98.9	98.1	99.3	...	...
Memorandum items:							
Nominal GDP (in billions of vatu)	70.9	72.4	75.8	79.1	80.4	85.5	91.6
Nominal GDP (in millions of U.S. dollars)	792.1	781.7	801.8	815.0	737.9	773.4	829.0
Per capita GDP (in U.S. dollars)	3230	3116	3124	3104	2747	2815	2949
Population growth (annual percentage change)	...	...	...	...	...	...	...

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

1/ Data source: The World Bank Development Indicators.

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



VANUATU

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

September 22, 2016

KEY ISSUES

Context. Eighteen months after Cyclone Pam struck Vanuatu, the economy continues to recover from the cyclone's extensive damages. Reconstruction efforts are beginning to yield positive results, allowing increasing use of Port Vila's international airport, the reopening of damaged hotels, and the return of tourists to the islands. These encouraging developments augur well for a full recovery in the near future.

Outlook and risks. While damage to infrastructure and production was extensive, the cyclone led to a decline in real GDP estimated at about 0.8 percent in 2015, relative to pre-cyclone projections of 3.5 percent. The recovery in tourism and agriculture, combined with further ramping-up of infrastructure projects, is expected to propel real GDP growth to 4.0 percent in 2016 and 4.5 percent in 2017. Risks to the outlook are tilted to the downside. The largest uncertainty is the rate of implementation of public infrastructure projects.

Key policy recommendations:

- Build resilience to environmental shocks by creating fiscal buffers, promoting disaster-resistant infrastructure, and putting in place simple but effective disaster-response mechanisms, drawing lessons from Cyclone Pam.
- Implement the government's development agenda while safeguarding debt and fiscal sustainability. This will require careful project selection for public investment, spending discipline (including by state-owned enterprises), and mobilizing additional revenues (including by introducing an income tax).
- Maintain an accommodative monetary stance, but be ready to tighten if inflationary pressures emerge. Despite a mild appreciation, the real effective exchange rate remains broadly in line with fundamentals and the peg should be kept at its current level.
- Ensure financial stability by gradually normalizing regulatory requirements for the banking and non-banking financial sectors. Address shortcomings regarding anti-money laundering and countering the financing of terrorism (AML/CFT), leveraging support from international partners.
- Support private sector investment by further implementation of land reforms and by promoting quality upgrading in the tourism and agricultural sectors. At the same time reinforce social and economic inclusion by improving educational attainment and enhancing access to banking especially in the outer islands.

Approved By
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Discussions took place in Port Vila during July 13–26, 2016. The staff comprised Mr. Papageorgiou (head), Mr. Lee and Ms. Dao (both APD) and Mr. Marto (RES). Messrs. Feridhanusetyawan (ResRep), Stewart (OED), Edwards and Orton (both World Bank), and Rajah (ADB) participated in selected policy discussions. The mission met with Prime Minister Salwai, Minister of Finance Pikioune, Governor of Reserve Bank Athy, as well as other senior national, provincial, and municipal officials, private sector representatives, and development partners. Mr. Alvim provided editorial assistance for this report.

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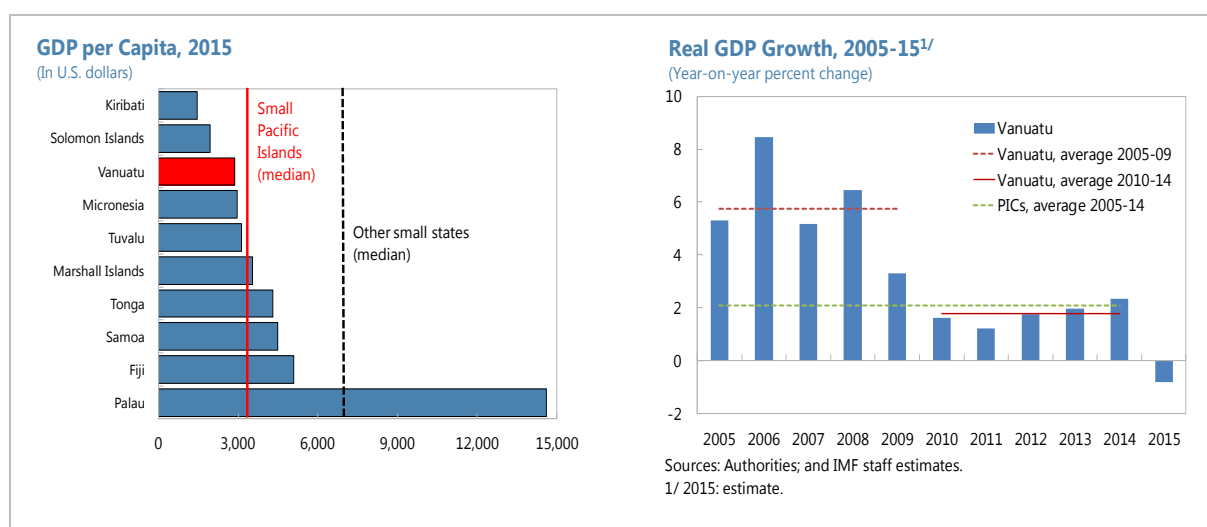
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BACKGROUND: RECOVERING FROM CYCLONE PAM

1. Vanuatu is a small island developing state and a low-income country recovering from Cyclone Pam's devastating damages. Its income per capita is about USD3,000, with tourism and agriculture the leading drivers of economic activity. Real GDP growth has floundered since 2010 with the average of the last 5 years declining below 2 percent per year from above 5 percent in the previous 5 years. At end-2015, Vanuatu experienced moderate public debt (25.6 percent of GDP), adequate reserves (7.1 months of imports), low inflation (2.5 percent), and relatively high private sector credit (around 70 percent of GDP).



2. Cyclone Pam struck Vanuatu in March 2015, causing damages estimated at around 60 percent of GDP. The extent of the damages appears to exceed that of any natural disaster experienced in the region in recent memory. In June 2015, the IMF Board approved a disbursement of about USD11.9 million under the *Rapid Credit Facility* (RCF, at zero interest rate) and an equal disbursement under the *Rapid Financing Instrument* (RFI; IMF Country Report No. 15/149). This financial assistance was intended to help Vanuatu cope with its immediate balance of payments needs and to catalyze critical donor support for the recovery.

3. At the same time the country was facing major political challenges which contributed to slowing down reconstruction. In October 2015, several members of parliament, including 5 ministers, were accused of bribery (11 were convicted). As a result, 14 seats in the 52-member Parliament were vacated and President Lonsdale dissolved the Parliament and called for early elections. The last Parliamentary elections in January 2016 produced a fractious legislature with 17 parties.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

4. Recent economic developments are marked by the damages of Cyclone Pam, the political turmoil that ensued, and the recovery process. Real GDP growth is estimated to have accelerated from 2 percent in 2013 to 2.3 percent in 2014 with the commencement of several infrastructure investment projects (Figure 1 and Table 1). However, the impact of the cyclone induced an estimated decline in real GDP of 0.8 percent in 2015. Inflation had been low and stable prior to the cyclone, dipping below 1 percent due to falling oil prices and service-related items. Cyclone-induced shortages, reconstruction activity, and infrastructure projects pushed it up to 2.5 percent in 2015. The current account deficit widened to 11 percent of GDP in 2015 from an average of 3 percent of GDP in the three years before, with imports increasing sharply on account of reconstruction efforts and exports depressed due to severe damages to tourism facilities and agricultural production (Figure 2 and Table 4). The deficit was comfortably financed by grants, borrowing, and foreign direct investment (FDI). Foreign reserves rose to USD273 million (7.1 months of imports) by end-2015, with reserves excluding Pam-related grants and loans at about USD215 million (5.6 months of imports). The fiscal balance recorded a surplus of about 7 percent in 2015 due to cyclone-related grants received that remained unspent during the fiscal year (Figure 3 and Table 2).

5. The outlook for Vanuatu is favorable owing to the momentum around reconstruction activities and infrastructure investments. A recovery in tourism and agriculture combined with further ramping-up of infrastructure projects is expected to propel real GDP growth to 4 percent in 2016 and 4.5 percent in 2017 (Table 5). Inflation is projected to remain below 3 percent in 2017 owing to low commodity prices, even though expanding domestic demand will provide some upward pressure. The current account deficit is projected to widen to around 20 percent of GDP in 2016 and 2017 due to cyclone-related spending and the high import content of the major infrastructure projects. This deficit is envisaged to be financed by donor grants and loans, and foreign direct investment. Fiscal accounts are likely to record large deficits (above 10 percent of GDP) in 2016 and 2017 due to the rise in spending related to reconstruction and infrastructure projects, and the clearing of past due legal commitments.

6. Risks to the outlook are tilted to the downside with recurring environmental shocks posing a constant threat. The largest uncertainty is the rate of implementation of public infrastructure projects, while the pace of the recovery—in particular, in tourism activities and agriculture—is difficult to predict (Appendix I). The scale and pace of reconstruction efforts may fall short of needs if external financing is not sufficient or if implementation capacity disappoints. On the external front, weaker-than-expected growth in emerging and advanced economies would have a direct impact on Vanuatu's agricultural sector via weaker commodity prices and a knock-on effect on tourism via a slowdown in Australia. A persistent appreciation of the vatu against the Australian dollar—despite an offsetting depreciation against the U.S. dollar—would reduce the attractiveness of Vanuatu as a tourist destination for Australians and lower the real

value of Australian aid. The danger of natural disasters is ever-present, aggravated by the cyclical effects of El Niño's droughts and La Niña's heavy rainfall.

	Sources of Risk	Likelihood	Impact
Downside	1. Weaker-than-expected global growth slowdown	Medium	Medium
	2. Sharp rise in risk premia with flight to safety (US dollar appreciation)	Medium	Medium
	3. Natural disasters and climate change	High	High
	4. Delays in implementation of infrastructure projects	High	High

Source: Staff assessment

Authorities' Views

7. The authorities concurred with the staff's assessment but saw stronger GDP growth over the medium term. In light of the positive economic momentum generated by the stable political environment of the last few months, the authorities are expecting a steadfast implementation of major infrastructure projects. They also noted that spillover effects of the construction boom to other sectors could further boost real GDP growth over the next few years.

POLICY FRAMEWORK TO SUPPORT RESILIENCE AND FOSTER GROWTH

Key areas of policy discussion during the Article IV consultation focused on (i) building resilience to and coping with natural disasters; (ii) scaling up infrastructure investment while preserving fiscal space and debt sustainability; (iii) maintaining prudent monetary policy and reserve management along with exchange rate stability; (iv) securing financial stability and improving the financial system; and (v) ensuring inclusive growth through diversification and quality upgrading.

A. Building Resilience to and Coping with Natural Disasters

8. Vanuatu is one of the countries in the world most vulnerable to natural disasters. The 2015 UN World Risk Index, which measures exposure to natural hazards and the capacity to cope with these events across 171 countries, continues to place Vanuatu at the top of its ranking.¹ Vanuatu's limited landmass—aggravated by the double insularity of outer islands—and high population and infrastructure densities in coastal areas, make it particularly prone to natural disasters. The cumulative impacts of non-extreme but prolonged weather events, such as the El Niño's droughts and La Niña's heavy rainfall put the country further at risk. As a result, Vanuatu's key economic sectors are disproportionately affected by extreme weather events.

¹ The index relates the exposure to natural hazards (earthquakes, cyclones, floods, droughts, and sea level rise) with the likelihood of suffering harm from the disaster and the capacity to reduce its immediate negative consequences (coping capacity) and to establish long-term strategies for societal change (adaptive capacity). See <http://www.worldriskreport.org/> and <http://www.uni-stuttgart.de/ireus/Internationales/WorldRiskIndex/>.

9. Natural disasters happen frequently and when they do, they are very costly. The probability of a natural disaster happening in Vanuatu in any given year is 65 percent and more than 99 percent in a five-year period. According to EM-DAT,² which provides estimates of human and economic costs by type of disaster, natural disasters caused annual damages equivalent to 2.4 percent of GDP over the 1950–2014 period.³ Cyclone Pam caused damages estimated at around 35 percent of GDP in physical capital and it affected more than 188,000 inhabitants (in the most affected southern islands, where some 30,000 inhabitants reside, schools and health centers are still being held in temporary facilities provided by UNICEF). The main productive sectors were highly affected, with damages to tourism and transport infrastructure estimated at 11 percent of GDP, and production losses in agriculture and tourism equivalent to 10 percent of GDP.⁴

10. Recovery from Cyclone Pam’s extensive damages has been slower than originally anticipated but reconstruction activities are now picking up steam (Box 1). Although the immediate response was quite effective in alleviating human suffering and restoring economic activity, some of the procedures put in place on project proposals were burdensome and delayed the implementation of key initiatives. Political instability and capacity constraints likely hindered reconstruction efforts: political unrest limited the disbursement of donors’ grants and, at the same time, the country’s capacity constraints to manage the post-disaster phase deferred actual implementation of reconstruction activities.

Staff’s Policy Recommendations

11. Staff welcomes the authorities’ strong commitment to make disaster readiness central to their macroeconomic and development agenda. Responding effectively to natural disaster risk entails different layers of preparedness:

- *Strengthening risk assessment and planning.* Lessons from Cyclone Pam show a need to improve on the existing disaster-response plan by making it simpler and more agile, and by establishing a stronger monitoring and evaluation framework. Understanding the main sources of vulnerability and the potential costs linked to extreme weather events is a first step in addressing disaster risk.
- *Building domestic fiscal buffers.* Staff recommends incorporating disaster costs into national budget planning and making the Response Fund, an ex post provision made when an emergency is declared, a more proactive rather than reactive instrument. The

² The EM-DAT database covers natural disasters that meet at least one of the following criteria: (i) 10 or more people reported killed; (ii) 100 or more people reported affected; (iii) a declaration of a state of emergency; or (iv) a call for international assistance. See <http://www.emdat.be/>.

³ Staff calculations suggest that the impact on underlying growth is modest, at around 0.12 percent per annum. Medium-term growth projections of 3 percent (around $\frac{3}{4}$ percent in per capita terms) reflect this as well as the positive impact from prospective infrastructure investments. Medium-term spending projections include an implicit small annual provision for disaster relief.

⁴ Estimates are based on Vanuatu’s Post-Disaster Needs Assessment led by the government.

introduction of a corporate and personal income tax is an opportunity to constitute an additional buffer.

- *Securing external buffers.* The authorities should complement domestic buffers with externally financed instruments, such as contingent credit lines with multilateral partners. Also, the existing strong engagement with key donors, whose financial support in the aftermath of Cyclone Pam had an immediate humanitarian and economic impact, must continue and be further enhanced.
- *Promoting resilient infrastructure and adequate maintenance.* Although more expensive, investing in adaptation (either infrastructure such as seawalls, breakwater reefs, that can withstand stronger weather events; or through relocating key infrastructure and conducting disaster mapping) can have positive spillovers. Ensuring the maintenance of critical infrastructure is adequately funded and part of a medium-term expenditure framework is critical (e.g., stable allocations for the Infrastructure Maintenance Fund, and including donor support).

Authorities' Views

12. The authorities welcomed staff's detailed assessment of the experience with Cyclone Pam and stressed that response delays in the early months were in part due to development partners' process requirements. Coordinating the support offered by donors and civil society organizations posed additional managerial challenges, with competing requests, deadlines, and procedures. Although cumbersome, the authorities acknowledged that some of the early hurdles faced helped improve the ultimate allocation of funds to more productive uses. The authorities are committed to simplify and improve the Recovery Plan established in August 2015.

13. The authorities argued that while enhancing domestic buffers to combat natural disasters must be a policy priority, in practice it is challenging to implement given other competing needs. In particular, the authorities highlighted that the funding needed to pursue their development agenda, notably via infrastructure investments, is likely to make preparedness to natural disasters a more challenging task. They reiterated the need for external buffers through continued support by donors and development partners.

14. The authorities agreed with the need for additional provisions related to infrastructure maintenance. The budget for operation and maintenance of infrastructure was increased by Vt200 million in 2016 (0.25 percent of GDP) and an Infrastructure Maintenance Fund is being set up with an expected budget of Vt1 billion by 2020 (about 1 percent of GDP).

Box 1. Vanuatu: Lessons from Cyclone Pam¹

Eighteen months after Cyclone Pam struck Vanuatu, the economy continues to recover from the cyclone's extensive damages. With the benefit of hindsight, we draw some lessons from the experience.

Institutions

Although the immediate response was effective, the recovery and reconstruction plan was overly complex with some coordination issues with development partners. Since 2013, Vanuatu has a Ministry dealing exclusively with climate change issues, which houses the National Disaster Management Office (NDMO) in charge of coordinating preparedness and recovery initiatives. Thanks to a cluster system in place (spanning water and sanitation, education, agriculture, to name a few) the immediate response was quite effective in alleviating human suffering, ensuring the population's access to food items and shelters. The medium- to long-term recovery is coordinated by the Prime Minister's Office. The government established a Recovery Committee in August 2015 to coordinate reconstruction efforts. Composed by high-level officials, the committee in charge of reviewing project proposals and allocating funds lacked a dedicated technical unit. Some of the procedures put in place were burdensome and delayed the implementation of key initiatives even if these might have improved the ultimate allocation of funds.²

	Response
Immediate response	High
Reconstruction activities	Low-Medium

Fiscal buffers

Fiscal buffers were very limited. The authorities had established two domestic financing mechanisms in response to natural disasters. Managed by the Ministry of Finance, the Emergency Fund has an allocation of Vt25 million (about USD230,000) and the Response Fund can provide up to 1.5 percent of the government's budget for that particular fiscal year (about USD2.5 million or 0.3 percent of GDP). The government spent in total Vt390 million with Pam-related relief and recovery in 2015 (about USD3.6 million or 0.5 percent of GDP), with additional resources diverted from other priority programs. The Response Fund, which is only triggered in case of a major natural disaster, cannot adequately facilitate the large needs from such an extreme event. Given the frequent recurrence of environmental events in Vanuatu, the authorities could consider establishing a preemptive fund that would reduce the fiscal pressures from higher frequency and lower intensity events, for example, by providing funding for resilient infrastructure and adaptation activities.

	Response
Fiscal buffers	Low

Donor financing

Financial assistance, in particular from bilateral partners, was swift and sizeable though disbursements are low. In the aftermath of Cyclone Pam, development partners contributed significant amounts of aid-in-kind, grants, and loans for immediate support and medium-term reconstruction-related projects. The IMF's financial assistance via RCF/RFI of about USD23.8 million for balance of payments needs played a key role in catalyzing critical donor support and was the first to be disbursed among IFIs. The World Bank committed USD50 million and the Asian Development Bank USD22 million for the reconstruction of roads, schools, and public buildings. At the bilateral level, the more significant contributions were AUD15 million for immediate response and AUD35 for recovery from Australia, NZD3.5 million for immediate response and NZD6 million for recovery from New Zealand, and EUR10.5 million from the E.U. While about USD72 million in grants were received in 2015 and disbursements are picking up in 2016, absorption capacity is being stretched.

	Response
Bilateral partners commitments and disbursements	High
Multilateral partners commitments and disbursements	Medium

Box 1. Vanuatu: Lessons from Cyclone Pam¹ (continued)

Insurance

Although timely, insurance was not sufficient to cover major disasters. Vanuatu received USD1.9 million from the Pacific Catastrophe Risk and Financial Insurance (PCRFI). While the authorities acknowledged the fast disbursement, the payout was insignificant (covering less than 1 percent of damages) for meeting the needs resulting from Cyclone Pam. Private sector insurance, primarily available to large and established businesses (resorts, in particular) and in urban areas, covered Vt5.7 billion of Pam-related damages (or about USD52 million). Despite the adequate payout, there is a risk that insurance premia may rise in the future.

	Response/ Magnitude
Pacific Catastrophe Risk and Financial Insurance (PCRFI)	High/Low
Private sector insurance payouts	Medium/High

Social safety net

The authorities' response supported households' reconstruction needs. The government suspended VAT and import duties on construction materials for two months after the cyclone, deferred the payments of vehicle registration fees and VAT payments to the next quarter, and provided subsidies for agricultural seedlings to affected households. The Vanuatu National Provident Fund (VNPF) allowed its 40,000 active members (mostly civil servants) to withdraw up to 20 percent of their retirement savings to cover expenses related to Cyclone Pam, with total withdrawals amounting to Vt1.7 billion (2.1 percent of GDP) for three months following the disaster. The VNPF was able to withdraw Vt2.1 billion in the domestic banking sector to fund its members' needs, with limited financial impact on its books. While the most considerable damages were recorded in the southern islands of Vanuatu, most VNPF members are located in the three major (and less affected) islands—limiting the reach of the policy.

	Response
Social safety nets	High

Monetary policy

The RBV's comfortable level of reserves helped alleviate liquidity constraints. The RBV's policy helped smooth the impact of Cyclone Pam with measures facilitating the financial sector's access to liquidity and supporting the government's rehabilitation efforts. The RBV took swift action and agreed to tie its policy rate to the 91-day RBV Note (variable) rate, which implied a decrease from 5.25 percent to about 1.85 percent, and to reduce the Statutory Reserve Deposit (SRD) requirement, which comprises reserve deposits of commercial banks held as reserves at the RBV, from 7 to 5 percent. Additional measures were taken, including the activation of an additional credit facility for commercial banks, an interest rate decrease on the RBV's Secured Advance Facility and the inclusion of SRD holdings as eligible collateral as well as the provision of financial assistance relief of Vt40 million to the government and provinces.

	Response
Monetary policy	High

Banking sector

Banks fostered the continuity of the payments system with well-targeted business continuity plans. Banks implemented their business continuity plan to ensure most households and businesses had enough physical currency to proceed with their daily activities when banks were closed, ATM machines were down, and the only means of payment available was notes and coins. The largest food and petrol retailers were visited twice daily to facilitate cash holdings and deposits. A few days after the cyclone hit, banks provided an immediate waiver on their retail customers' loan repayments for 2 to 3 months. Banks also delayed loan repayments for 6 to 12 months to some corporate customers pending an insurance payout and provided additional lending to commence repair

Box 1. Vanuatu: Lessons from Cyclone Pam¹ (concluded)

work. The impact on arrears and non-performing loans (NPLs) was not significant, but a few banks seized the opportunity to clear their books and write off several NPLs.

	Response
Banking sector	High

Communications and energy

Early warning systems were instrumental. The authorities sent early warning messages through radio and mobile phones, which helped reach communities prior to the cyclone. Telecommunication services were restored a few days after the cyclone, once electricity was reestablished (3 days after for hospitals and major services, and 95 percent of the service was restored after 4 weeks in Efate island and after 8 weeks in Tanna island). Damages were assumed by the government but the pass-through to consumers was limited (electricity prices are regulated by the government and updated monthly). The price of fuel dropped Vt10 per liter on all products a month after the cyclone.

	Response
Key services to the real sector	Medium

¹ Prepared by Ricardo Marto (RES).

² Response ratings are staff's normative assessment where "Low" means insufficient, "High" means sufficient and "Medium" means somewhere in the middle range between "Low" and "High".

B. Scaling Up Infrastructure Investment while Preserving Fiscal Space and Debt Sustainability

15. In 2015, the government budget recorded an unexpectedly large surplus of 7.2 percent of GDP due to unspent cyclone-related grants received from the international community. In addition, duties' collection improved considerably thanks to increased imports. As a result, domestic revenue was stable, broadly unaffected by the government's decision to suspend VAT on construction materials in the aftermath of Cyclone Pam. Government expenses rose to 23.6 percent of GDP due to immediate relief needs and early election expenses (Table 2). Capacity constraints and political uncertainties kept reconstruction spending and public investment low in 2015.

16. However, in 2016, the fiscal balance is projected to record deficits of about 10 percent of GDP due to large cyclone-related current and capital spending, and overdue severance payments. The government expects domestic revenue to increase by 2.3 percent compared to the 2015 budget (19.2 percent of GDP), supported by receipts from the Citizenship Program and the recently established Vanuatu Economic Rehabilitation Program (launched in late 2015). Non-donor-related expenses were initially projected at 19.2 percent of GDP, as provisions for Cyclone Pam's recovery activities were accounted for. However, a supplementary budget of 1.6 percent of GDP was passed in July to fulfill part of the overdue severance payments to civil servants (2.6 percent of GDP). Capital expenditure is projected to rise sharply

starting this year on account of the country's ambitious infrastructure scale up. Although much of the spending is financed by grants, external concessional loans, and deposits, long-term domestic bonds (1.4 percent of GDP) were issued to close the financing gap.

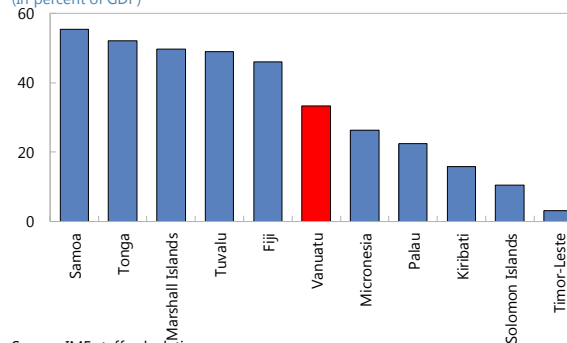
17. Major infrastructure projects, including the building of international wharfs and inter-island shipping facilities, roads, schools, and health centers, have recently started or are in the pipeline. The 2016 budget reported these projects for a combined value of 57 percent of the country's 2015 GDP spread over the next 7 years, with the bulk of the construction to be undertaken during the 2016-18 period. Five major infrastructure projects started and will be implemented over the next few years. In addition, agreements have been signed with the Asian Development Bank and the World Bank to finance, through grants and loans, the reconstruction of schools and roads damaged by Cyclone Pam.

18. The ambitious infrastructure investment program will be partly financed through external borrowing, raising central government debt sharply to 33.5 percent of GDP in 2016 and higher over the medium term. The significant increase of public debt in 2016 is mainly due to the rise in spending related to reconstruction and infrastructure projects and the clearing of significant past due government legal commitments. With two domestic issuances so far in 2016, government debt outstanding held by domestic financial institutions

was raised by 18.2 percent from end-2015 level. The RBV's recent purchase of a Vt1.1 billion 10 year-maturity bond has pushed its credit to the government to the limit. While the new external debt is highly concessional, repayment obligations may put pressure on fiscal accounts as debt service is projected to reach USD18 million by 2020.

Total Public Debt, 2015

(In percent of GDP)



Source: IMF staff calculations.
1/ Estimates.

19. An updated Debt Sustainability Analysis (DSA) suggests that Vanuatu continues to face a moderate risk of debt distress, a move-up from the low rating in 2013 due to post-Cyclone Pam reconstruction and planned infrastructure projects. While the evolution of debt indicators remains similar to that obtained in the 2015 DSA, the sizeable infrastructure projects pose threats to debt and fiscal sustainability when grants and concessional financing are delayed or become insufficient to cover the investment program. A model-based analysis reaffirms the need for a concerted effort with the private sector and international financial institutions to more clearly advocate for careful selection of projects and the need to develop contingency plans in case expected returns do not materialize, and that financing at concessional terms—in particular through grants—is available (Appendix III). In addition, another extreme weather event in the medium term is likely to raise the country's risk of debt distress, which further reinforces the need to rely on grant financing. Repeated large-scale borrowing to rebuild from disasters is not a viable long-term strategy and more emphasis is needed on risk reduction investments.

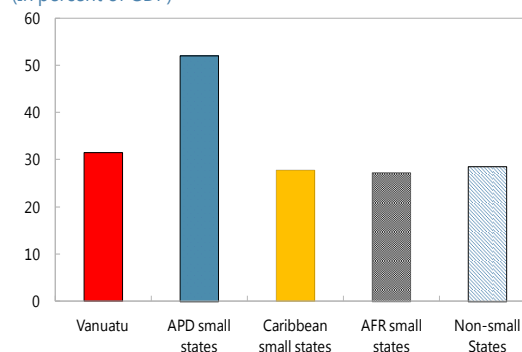
20. Revenue mobilization, including by launching an income tax, is essential to finance the country's development and create fiscal buffers.

Government revenues are low by regional standards and unlike other PICs Vanuatu does not have a personal or corporate income tax. The government has committed to launching a comprehensive tax reform to improve revenue collection, while maintaining a competitive business environment (Appendix IV). The tax reform initiative includes the introduction of personal and corporate income tax by 2018, which

would generate additional revenue of about 1 percent of GDP. A Tax Review Committee, supported by a AusAid-funded resident tax advisor, was formed within the Ministry of Economic Development and Finance and is expected to start the consultation process with the public soon.

General Government Revenue, 2015

(In percent of GDP)



Sources: IMF, World Economic Outlook; and IMF staff calculations.

21. Government Business Enterprises (GBEs) continue to operate under unclear regulatory framework raising concerns for their transparency and effectiveness.

They represent a significant ongoing fiscal cost to the government including by adding burden to public debt—government-guaranteed GBE debt amounted to 4.6 percent of GDP at the end of 2015). In comparison with other small island economies the performance of Vanuatu GBEs does not fare well (Appendix V). The authorities are working closely with ADB to assess their financial situation and to improve governance.

Staff's Policy Recommendations

22. Staff welcomes the authorities' tax reform initiatives, which are expected to raise tax revenue, but securing debt sustainability will require efforts in several respects:

- *Slowing down debt accumulation.* With public debt ratios rising sharply in the next few years, staff urges the authorities to exercise restraint in contracting additional borrowing in the near future, which would risk debt distress. Therefore, a clear policy priority for the authorities is to set the debt-to-GDP ratios on a declining path by 2021 and seek grant financing for the majority of any additional development projects. Staff sees the need for a concerted effort with the private sector and international financial institutions to ensure the public investment program yields the expected returns and that financing at concessional terms—in particular through grants—is available.
- *Exercising fiscal discipline.* Fiscal pressures are compounded by reconstruction efforts and the authorities' ambitious infrastructure investment agenda. At this critical juncture, prudent fiscal policy is key to Vanuatu's fiscal sustainability and macro stability. To reduce the need for supplementary budgets and more borrowing, it is important to reprioritize expenditure and seek synergies between pre-planned infrastructure projects and

reconstruction activities. It is also important to incorporate the cost of maintenance in the recurrent budget to minimize public infrastructure depreciation.

- *Implementing the tax reform in a timely and orderly manner.* Staff commends the authorities for launching a review of the tax system in 2016. Nonetheless, caution should be exercised in the planning and implementation stages of the tax reform to ensure the public and the tax administration are fully prepared to secure the expected revenue returns and fairness of the system. Close collaboration with the Fund’s tax policy and administration experts is highly recommended.
- *Reforming GBEs.* The GBEs play an important role in the economy and improving their efficiency would help safeguard fiscal sustainability and reduce the risk of contingent liabilities. In this context, staff welcomes the authorities’ plan to submit the GBE law to Parliament as its adoption would help improve fiscal discipline, accountability, and the financial viability of GBEs.

Authorities’ Views

23. The authorities recognized that the ambitious development plan and reform agenda may cause pressure on debt sustainability. While they view the “big push” in infrastructure investment as a necessary element of Vanuatu’s development strategy, they are also mindful of the risks involved, including to debt sustainability. They conveyed their intention to seek financing at concessional terms for new projects—in particular through grants.

24. The authorities concurred with the mission’s recommendations for further fiscal discipline. Given the current juncture of reconstruction efforts along with the scaling up of public investment, the authorities agreed that prudent fiscal policy should be a priority to ensure ample fiscal space and macroeconomic stability. They indicated that reducing the need for supplementary budgets and other unplanned expenditure will be an important fiscal objective.

25. The authorities expressed their strong commitment to push ahead with comprehensive tax reforms starting with the introduction of income tax by early 2018. The authorities emphasized the need to ensure that the reforms result in a tax system that is effective (yielding sizable additional revenues) but also socially fair especially to the poor. The authorities requested Fund’s technical assistance (TA) on policy and legislation and providing guidance in the implementation stage of the reforms.

C. Maintaining Prudent Monetary Policy and Reserve Management, along with Exchange Rate Stability

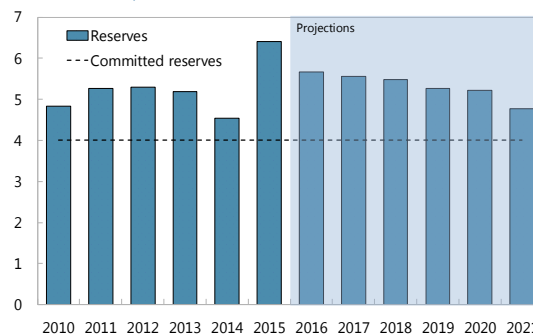
26. The accommodative monetary policy remains appropriate in an effort to support economic recovery and financial stability after the cyclone. In the aftermath of the cyclone, the RBV moved swiftly to support economic recovery and financial stability by lowering its policy rate to be tied to the RBV’s 91-day bill rate, reducing the required reserve ratio, and activating the RBV’s credit facilities. However, the monetary policy transmission mechanism in Vanuatu

remains obscure owing to unclear monetary policy objectives and inconsistencies in the use of monetary policy instruments as well as shallow financial markets (Appendix VI). In addition, credit provision to the business sector remains limited in spite of sufficient liquidity in the financial sector. This is partly due to the large uncertainty around business prospects and stringent collateral requirements.

27. Vanuatu has maintained considerable foreign exchange reserves.

Covering an estimated 5.8 months of imports of goods and services by end-2016, well above the authorities' committed level of 4 months of imports, reserves provide the first line of defense against external shocks. Considerable foreign exchange reserves are expected to remain over the next several years despite spending on Pam-related recovery efforts. These reserves will be needed by 2020 to provide foreign currency for the government's debt repayment obligations. It should be noted that downside risks to the import coverage of reserves are present as the materialized imports during the period of the country's ambitious infrastructure scaling up can be larger than projected.

Gross International Reserves
(In months of imports)

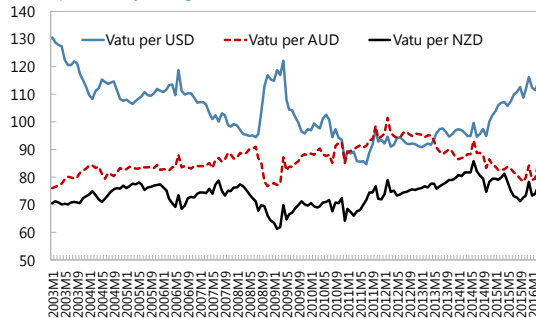


Sources: Vanuatu authorities; and IMF staff estimates.

28. Staff analysis suggests that the real effective exchange rate remains broadly in line with fundamentals and policy settings.

Despite recent nominal fluctuations, the analysis finds no significant misalignment of the vatu (pegged to a basket of currencies). The diverging paths between Vanuatu's major trading partners' currencies—the Australian dollar (AUD) and the U.S. dollar (USD)—have contributed to the vatu's nominal appreciation against the AUD and depreciation against the USD over the last months. The dissonant bilateral exchange rate fluctuations imply that different sectors may be affected differently (Box 2 and Appendix VIII).

Monthly Nominal Exchange Rates
(Vatu per currency, average)



Sources: Authorities and IMF staff estimates.

Note: An increase indicates a depreciation.

Staff's Policy Recommendations

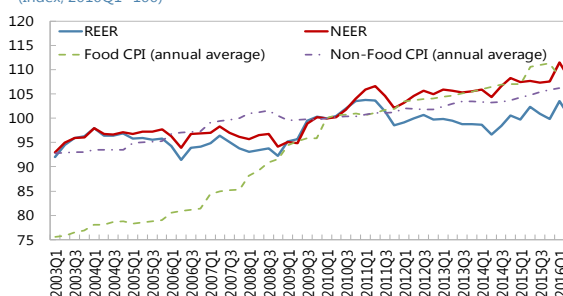
29. To make the monetary policy transmission mechanism more effective, staff encourages the RBV to clarify further its monetary policy objectives and instruments. Staff also encourages the RBV to maintain a conservative approach to reserve management as foreign reserves will be needed to provide foreign currency for debt repayment. It is therefore important to maintain foreign reserves at above 4 months of imports to provide a necessary buffer against external shocks.

Box 2. Vanuatu: External Balance Assessment¹

Vanuatu’s real exchange rate remains broadly in line with fundamentals, despite a mild real appreciation in the aftermath of Cyclone Pam. Cyclone-related inflows boosted reserves, which adequately remain above 5 months of imports. Business competitiveness remains relatively high, but with ample room for improvement.

Dissonant bilateral nominal exchange rate fluctuations have contributed to a mild real effective exchange rate (REER) appreciation. Over the recent period, the diverging paths between Vanuatu’s major trading partners’ currencies—the Australian dollar (AUD) and the U.S. dollar (USD)—have contributed to the vatu’s appreciation against the AUD and depreciation against the USD (both around 20 percent since 2013), most of which materializing over the last 12 months. Sectors are being affected differently depending on the predominant foreign currency in use and some may experience a price competitiveness loss. Since Australia accounts for about 55 percent of tourist arrivals and the majority of foreign aid, the vatu’s appreciation against the AUD could adversely affect the tourism sector and the value of aid flows. So far, the price elasticity of demand for tourism suggests a low sensitivity to nominal fluctuations with tourist arrivals steadily bouncing back after the airport’s runway repairs and the reopening of hotels and resorts. The months following Cyclone Pam saw a mild real appreciation of the vatu with food prices being concurrently pressured upward (despite stable inflation differentials with main trading partners).

Exchange Rates and Consumer Prices
(Index, 2010Q1=100)



Sources: Authorities and IMF staff estimates.
Note: An increase indicates an appreciation.

Vanuatu has been running moderately high current account deficits, yet reserves remain at an adequate level. Current account imbalances are likely to persist (well above 10 percent of GDP over the medium term) given post-cyclone reconstruction needs, the high import-content of the major infrastructure projects, and a piecemeal recovery of tourism receipts—with the external deficit being predominantly financed by external grants, concessional borrowing, and FDI which is expected to remain at high levels in the medium term due to post-cyclone reconstruction activities and infrastructure projects. International reserves, which support the currency peg, have recently experienced a significant boost and should remain adequately above five months of imports over the medium term.

Vanuatu enjoys a lower cost of doing business relative to its neighbors and other small developing states but there is ample room for improvement to boost competitiveness. Vanuatu ranked 94 (of 189) in the WB’s Ease of Doing Business index, below only two other Pacific Island countries. However, the country lags in several key aspects: (i) time and cost of starting a business; (ii) cost of dealing with construction permits; and (iii) enforcing contracts. Land titling was repeatedly referred to as a major hurdle by the private sector. Structural reforms to remove these bottlenecks and to stimulate investment should be considered, in particular if Vanuatu wants to expand its production of beef and other agricultural products.

Staff’s exchange rate assessments suggest that the external position is broadly consistent with fundamentals and desirable policy settings. The External Balance Assessment (EBA-lite) suggests a real overvaluation ranging from 6.7 to 7.9 percent, highlighting that the real exchange rate may be somewhat stronger than the level consistent with the external current account benchmark (around 8 percent of GDP). While robustness checks underline a mild degree of overvaluation, the baseline scenario confirms that overall there is no strong indication of misalignment.

External Balance Assessment

Method	CA (% of GDP)			REER gap (%)
	Underlying	Norm	Gap	
CA approach	-11.1	-8.7	-2.4	6.7
External stability approach	-11.1	-8.4	-2.7	7.9

Note: Results are based on the latest projections for Vanuatu, and the April 2016 WEO for all other countries used in calculations.

¹ Prepared by Ricardo Marto (RES). Appendix VIII provides further analysis on exchange rate issues.

30. Staff recommends maintaining the peg at its current level. Despite a mild real appreciation in the aftermath of Cyclone Pam, the peg to an undisclosed basket of currencies continues to serve Vanuatu well in promoting stability and confidence. In the future, the authorities should nonetheless be ready to adjust the level and composition of the peg if Vanuatu's external position worsens significantly.

Authorities' Views

31. The authorities concurred with the staff's assessment on the monetary policy transmission mechanism and on the need to develop policy tools to improve it. The authorities noted that capacity constraints and shallow financial markets were restricting their monetary policy options. The authorities agreed to maintain accommodative monetary policy, but stand ready to tighten should inflationary pressures emerge.

32. The authorities agreed with the staff's external balance assessment and on the need to maintain sufficient reserves to face future commitments. Despite concerns over the recent Australian dollar fluctuations, the authorities intend to maintain the current peg and consult with the IMF on any changes. If deemed necessary by new developments in the economy, the authorities will reassess its level to ensure external stability over the medium term.

D. Securing Financial Stability and Improving the Financial System

33. The financial sector has recovered well from the adverse impact of the cyclone, but vigilance is still needed. Since the last quarter of 2015 financial soundness of banks, weakened after the cyclone, has been improving with the rise of capital and liquid asset ratios, and the decline of the ratio of non-performing loans (NPLs). Nonetheless, the longer-term financial soundness of banks has been on a deteriorating trend since 2010 (Figure 4 and Table 6). The recent improvement of the banking sector's capital and liquidity position is attributed to the RBV's accommodative stance in the aftermath of

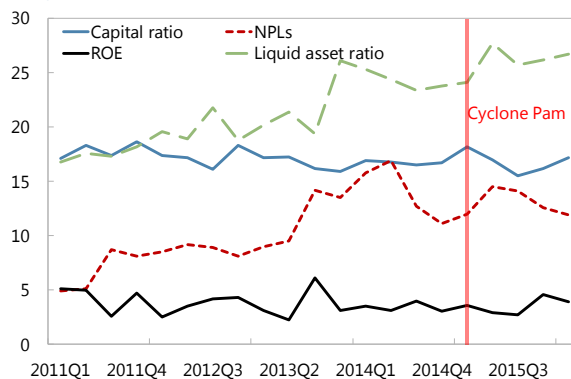
the cyclone, lowering the Statutory Reserve Deposit (SRD) requirement and the Liquid Asset Requirement (LAR) to alleviate potential liquidity pressures on banks. The non-bank financial sector remains, on the other hand, small and not sufficiently supervised.

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34. Despite a swift recovery of the payments system the role of banking sector in the post-cyclone recovery has remained somewhat limited. The growth of corporate lending has declined during the post-cyclone recovery period even though liquidity has been plentiful (Figure

Financial Soundness of Domestic Banks

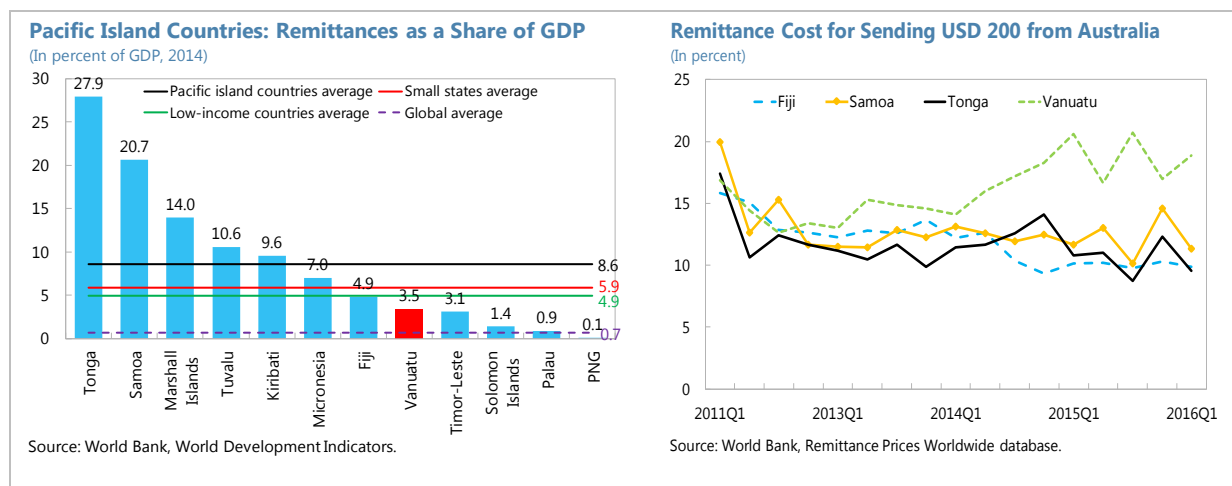
(In percent)



Source: Vanuatu Authorities

4 and Table 3). Large interest rate spreads and high lending rates have persisted even after the RBV’s lowering of the rediscount rate.⁵

35. The authorities are taking steps to address shortcomings regarding anti-money laundering and the countering the financing of terrorism (AML/CFT). Vanuatu was included in the Financial Action Task Force’s (FATF) gray list in February 2016 after the authorities agreed to an action plan to address significant AML/CFT deficiencies. Several measures, including amendments to the legal framework on AML/CFT and the international companies sector are being pursued. Though the loss of correspondent banking relationships (CBRs) has not emerged as a serious issue in Vanuatu, the inclusion in the FATF list and the selloff of Westpac (Australian bank) to PNG’s Bank South Pacific in July 2016 may pose some difficulties in cross-border payments, trade finance, and remittances. The cost of transferring funds to Vanuatu has been trending up since 2014 and is substantially higher than in other PICs.



Staff’s Policy Recommendations

36. The RBV must take action to secure financial stability by gradually normalizing regulatory requirements for the banking and non-bank financial sectors. First, the RBV needs to undertake a diagnostic assessment of banks’ financial situation to be prepared for the risks stemming from potential tightening of reserve and liquid asset requirements. Staff also recommends PFTAC’s assistance in reviewing a current credit union act and drafting the amendments to ensure the effectiveness of supervision on credit unions and to promote credit unions’ role in financial inclusion.

⁵ According to staff analysis, large interest rate spreads, which are commonly observed in PICs, result from high cost and high risk of credit potentially arising from small scale, vulnerability to shocks, and geographic dispersion in the region (Jamaludin, Klyuev, and Serechetapongse, *IMF WP/15/96*).

(continued)

37. Staff welcomes the authorities' recent initiatives to resolve the AML/CFT issue and encourage them to seek further international support. Vanuatu needs to accelerate the implementation of the AML/CFT action plan and ensure its legal framework is in line with international standards (e.g., secrecy obligations, bearer shares and share warrants, and transparency of beneficial ownership information of offshore companies and trusts).⁶ Several partners have expressed interest in supporting the authorities on this issue. Benefiting from Papua New Guinea and Australia's collaboration, the authorities should leverage this support to make bold steps to ensure its exit from the FATF monitoring.

Authorities' Views

38. The authorities emphasized that the RBV's prompt policy response after the cyclone significantly enhanced overall bank liquidity in the domestic financial system. They further acknowledged that caution is needed to ensure financial stability with the tightening of reserve and liquid asset requirements when deemed appropriate.

39. The authorities are proceeding with AML regulations and expect a steady implementation of the action plan put in place in line with international standards. In addition to FATF and the Asia-Pacific Group support, the authorities are engaging with other development partners for technical and legal support, and are committed to enhancing the overall effectiveness of the AML/CFT regime.

E. Ensuring Inclusive Growth through Diversification and Quality Upgrading

40. Vanuatu's ongoing development strategy pays particular attention to poverty and inclusion. A recent study by the World Bank⁷ finds that poverty is widespread in most Pacific islands with many households living in deprived conditions. To eliminate absolute poverty and achieve shared prosperity in Vanuatu, in accordance with Sustainable Development Goals (SDGs) 1 and 2, three key conditions must be in place: higher growth, employment and financial services, and a resilient social safety net against external shocks.

SDGs on poverty and respective targets

Goal 1. End poverty in all its forms everywhere

T1.5. By 2030, build the resilience of the poor and those in vulnerable situations and reduce their exposure and vulnerability to climate-related extreme events and other economic, social and environmental shocks and disasters.

Goal 2. End hunger, achieve food security and improved nutrition and promote sustainable agriculture

T2.4. By 2030, ensure sustainable food production systems and implement resilient agricultural practices that increase productivity and production, that help maintain ecosystems, that strengthen capacity for adaptation to climate change, extreme weather, drought, flooding and other disasters and that progressively improve land and soil quality.

Source: UN (2015). "Transforming Our World - the 2030 Agenda for

⁶ Key deficiencies identified by the FATF's latest assessment can be found here: <http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/fatf-compliance-june-2016.html>.

⁷ "Growing Challenges," *East Asia and Pacific Outlook* (World Bank, April 2016).

41. Improving access to employment opportunities and to basic social services is a priority, especially in the outer islands. Enhancing the educational attainment and skills of the poor deserve particular emphasis (Table 7). The ability to access external labor markets is a window of opportunity for poverty reduction and inclusion. Several PICs, including Vanuatu, have had labor mobility agreements with Australia, New Zealand, or the United States. Expanding these agreements will prove critical in addressing the country's unemployment challenges. Seasonal workers in Australia and New Zealand have increased, raising their living standards and those of their families at home. However, workers could be marketed more effectively and their skills enhanced with appropriate training policies. A recent study by the World Bank is assessing potential benefits for Vanuatu and other PICs from modifying existing labor migration policies by both sending and receiving countries (Appendix VII).

42. The authorities are making efforts to promote financial inclusion, but meeting lending needs by many small and medium-sized enterprises (SMEs) remains challenging. The National Bank of Vanuatu (NBV), the only domestic bank in Vanuatu, has played an important role in providing financial services to the outer islands, including via microfinance and financial literacy education programs. NBV recorded a 35 percent growth of microfinance lending in 2015 after introducing the *Rural Land and Seasonal Labour Loans* to rural residents and seasonal workers. The financial literacy education program was also very successful in helping open bank accounts in rural areas. Credit unions have played a complementary role in providing financial services to rural residents unable to access banking services. Nonetheless, many SMEs still find it challenging to obtain credit because of stringent collateral requirements, suggesting that there exists ample room for further financial development (Figure 5).

43. Quality upgrading and diversification are expected to play a critical role in promoting inclusive growth. Improvements in connectivity—thanks to the recently completed submarine cable connection, planned investments in transport infrastructure, and lower fuel prices—are attracting more and higher quality tourism. Exploring niche markets and tapping on Vanuatu's agricultural resources as in input for the tourism industry—agrotourism—will be beneficial for poverty reduction and inclusion. Efforts to increase agricultural production, including beef production, provide diversification in domestic activities that can serve the economy well and provide an additional buffer against external shocks.⁸

44. Improving the ease of doing business is an important complement in promoting quality upgrading and diversification. Enhanced competition would help address the high cost of doing business in Vanuatu that hinders entry into new lines of economic activity, which in turn limits opportunities for quality upgrading and productivity boosts. There is room to improve the country's standing on the ease of starting a business, registering property, or land titling.⁹ The

⁸ "Sustaining Long-Run Growth and Macroeconomic Stability in Low-Income Countries – The Role of Structural Transformation and Diversification," (IMF, March 2014).

⁹ Vanuatu ranks 94 (of 189) in the WB's *Ease of Doing Business* index.

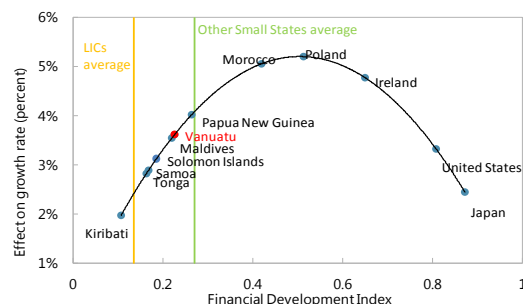
recent reforms to the leasing regime for customary land have caused unexpected delays in the process of registering land due to some inefficient procedures aimed at improving transparency.

Staff's Policy Recommendations

45. Staff encourages the authorities' efforts to bolster inclusive growth and emphasizes the following:

- *Poverty alleviation.* Particular emphasis should be placed on preparing the vulnerable populations for the recurrence of climatic events. The authorities' commitment to incorporate these efforts in the new medium-term development strategy is very welcome.
- *Financial inclusion.* Staff analytical work shows a strong link between financial deepening and growth. Therefore, increasing private access to finance should continue to be an important priority in Vanuatu's development strategy. At the same time, the authorities need to secure the soundness of non-bank financial institutions, which play a crucial role in promoting financial inclusion especially in the outer islands.
- *Quality upgrading.* Staff commends the authorities' efforts to improve quality upgrading in the agricultural sector, which accounts for about 70 percent of the labor force. New initiatives by bilateral and multilateral donors to expand opportunities in the agricultural sector is an encouraging step towards this direction.

Financial Development Effect on Growth



Source: IMF staff estimates, based on the methodology in SDN/15/08 (Table A1), and Čihák and others (2012).

Authorities' Views

46. **The authorities agreed with staff's view on the importance of financial inclusion for the long-term development of the country.** They expressed their intention to continue their efforts in promoting access to financial services in rural areas.

47. **The authorities concurred with the staff's recommendations on poverty reduction, diversification, and quality upgrading.** They noted ongoing efforts to introduce structural competitiveness measures to reduce the cost of doing business in Vanuatu. The authorities reinforced the intention of promoting more economic activities in the outer islands, with a particular focus on agricultural production supported by development partners. The authorities also agreed to improve the business environment by removing key bottlenecks and focusing on complementary structural competitiveness measures to stimulate private investment.

OTHER ISSUES

48. Engagement with donors. Staff held discussions with international partners on their engagement with the authorities, especially with regard to the disbursements of grants and loans for reconstruction efforts and infrastructure projects. The mission emphasized the importance of making grant financing available to Vanuatu in order to maintain debt sustainability and stressed the need to support the achievements of the SDGs, in particular goals related to eliminating poverty and combating climate change.

49. Safeguard assessment. The first-time RBV's safeguards assessment has been conducted. It identified several weaknesses in its governance arrangements, autonomy, transparency, and audit mechanisms. While the RBV has a recognized accounting framework and an external audit in place, these could be strengthened. The central bank requires recapitalization. The authorities are planning to seek assistance in drafting the amendments to the RBV Act and formulating a recapitalization plan through technical assistance from the IMF.

50. Statistical issues. While broadly adequate for surveillance purposes, quality and timeliness remain a concern for some data (see the Statistical Issues in the Informational Annex). Staff encouraged the authorities to seek further support from PFTAC on compilation, analysis, and dissemination of national accounts statistics.

STAFF APPRAISAL

51. Reconstruction efforts are beginning to yield positive results, suggesting that a full recovery from Cyclone Pam is within reach. Growth is expected to rebound in 2016 thanks to the recovery of tourism and agriculture, and the construction activity from major public infrastructure projects. Risks to the outlook are nonetheless tilted to the downside with the main uncertainty being the rate of implementation of public infrastructure projects.

52. Although the immediate response to Cyclone Pam was effective in alleviating human suffering and restoring economic activity, Vanuatu needs to improve its resilience to natural disasters. Responding effectively to natural disaster risk entails different layers of preparedness and response: (i) building domestic fiscal buffers and securing reliable external financial support; (ii) promoting resilient infrastructure and adequate maintenance; and (iii) establishing a simple but actionable contingency plan.

53. Major infrastructure projects have recently started or are in the pipeline posing sizeable threats to debt and fiscal sustainability. With public debt rising fast, fiscal discipline and revenue mobilization will be essential. The authorities are commended for launching a comprehensive tax reform initiative which will help raise additional revenue and reduce the pressure on fiscal accounts.

54. The financial sector has been recovering well from the adverse impacts of Cyclone Pam, but challenges remain. The RBV must take action to secure financial stability by gradually normalizing regulatory requirements for banks and non-banking financial institutions. Staff welcomes the authorities' recent initiatives to address shortcomings regarding AML/CFT and encourages them to draw on technical assistance from international partners.

55. The accommodative monetary stance and exchange rate peg remain appropriate in an effort to support economic recovery, as well as price and financial stability after the cyclone. Despite the weak transmission mechanism, vigilance is needed in order to tame inflation pressures if those emerge and ensure monetary policy remains consistent with the exchange rate and reserve cover goals. To make the monetary transmission mechanism more effective, the RBV is encouraged to clarify further its objectives and instruments. The real effective exchange rate remains broadly in line with fundamentals and the peg should be maintained at its current level.

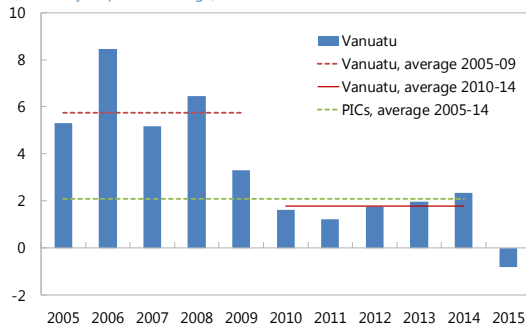
56. Higher growth, job availability, and resilience to external shocks are three key factors to ensure poverty is reduced and prosperity is shared. A concerted effort by the authorities to promote private sector investment by further implementing land reforms and enhancing quality upgrading in the tourism and agricultural sectors is required. Improving access to employment opportunities and financial inclusion should continue to be a priority to strengthen households' resilience to external shocks, especially in the outer islands.

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

Figure 1. Vanuatu: Recent Developments and Prospects

Growth slowed since 2010 and turned negative in 2015 due to Cyclone Pam.

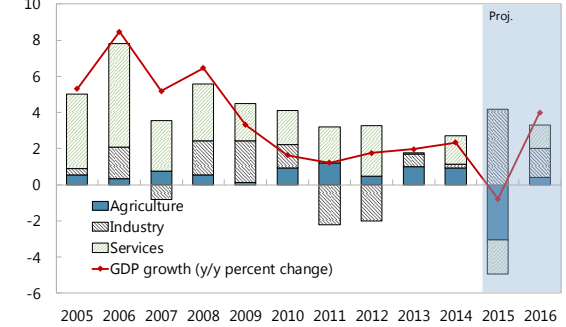
Real GDP Growth, 2005-15^{1/}
(Year-on-year percent change)



Sources: Authorities; and IMF staff estimates.
1/ 2015: estimate.

Growth is projected to rebound driven by infrastructure projects and reconstruction activities...

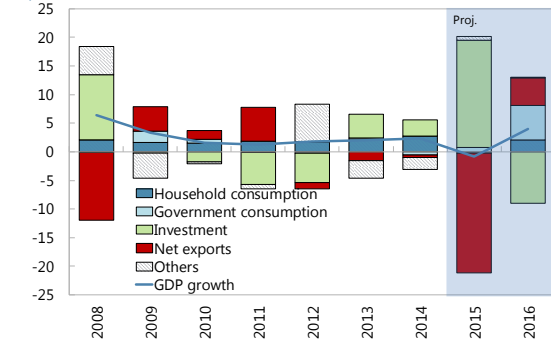
Real GDP Growth by Sector
(In percent)



Sources: Authorities; and IMF staff calculations.

...and government consumption growth.

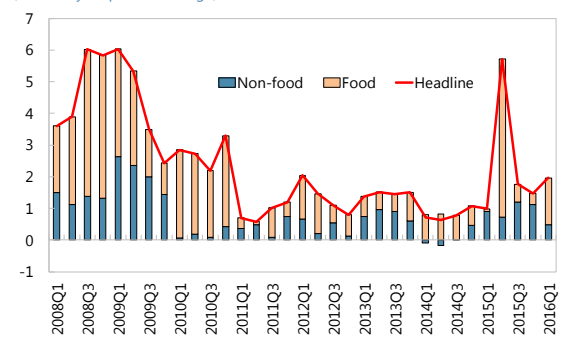
Contribution to Real GDP Growth by Expenditure
(In percent)



Sources: Vanuatu authorities; and IMF staff estimations.

Inflation picked up right after the cyclone and moderated since the second half of 2015.

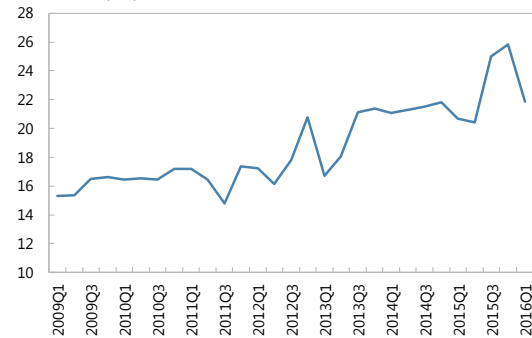
Contribution to Inflation
(Year-on-year percent change)



Sources: Vanuatu authorities; and IMF staff calculations.

Formal employment picked up after the cyclone and returned to pre-cyclone trend in the first quarter of 2016.

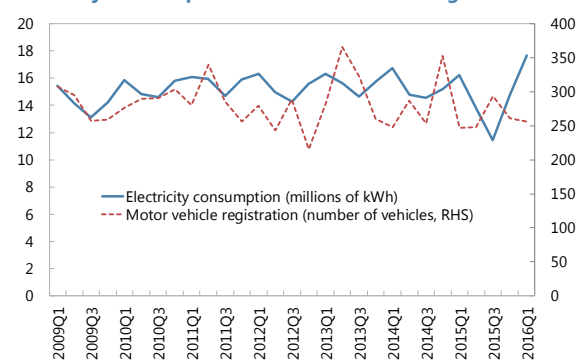
Contributors to Vanuatu National Provident Fund
(Thousands of people)



Source: Reserve Bank of Vanuatu.

Indicators of private demand declined after the cyclone and rebounded since the last quarter of 2015.

Electricity Consumption and Motor Vehicle Registration



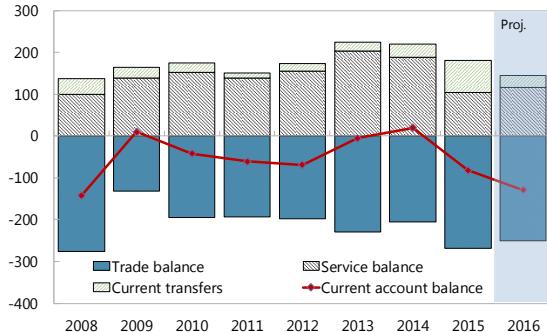
Source: Reserve Bank of Vanuatu.

Figure 2. Vanuatu: External Sector Developments

Current account balance is expected to drop sharply in 2016 due to higher imports.

Current Account

(In millions of US dollars)

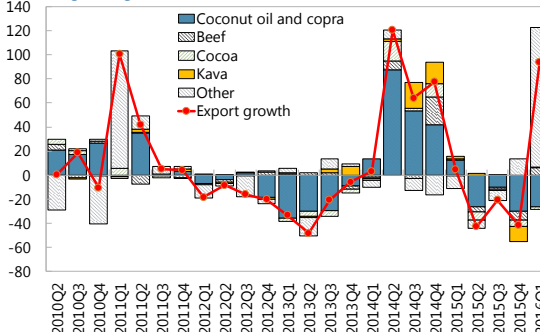


Sources: Vanuatu authorities; and IMF staff calculations.

Export growth was negative in 2015 due to the cyclone's damages and started to rebound in 2016.

Export Growth

(Percentage change)

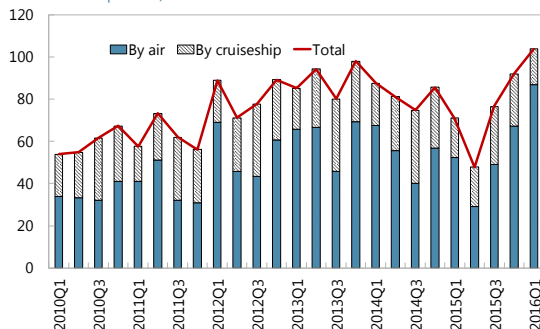


Source: Vanuatu authorities.

Tourist arrivals declined right after the cyclone but are recovering since the second half of 2015.

Tourist Arrivals

(In thousands of persons)

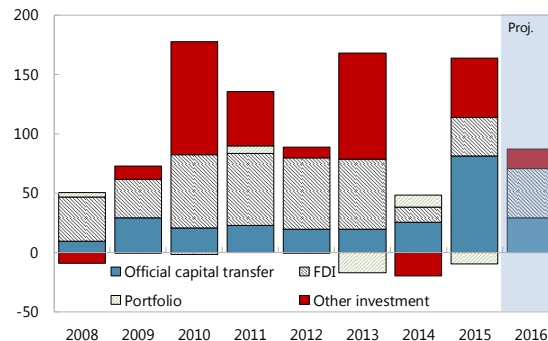


Source: Vanuatu authorities.

FDI and other investment will only cover part of the current account deficit.

Capital and Financial Accounts

(In millions of US dollars)

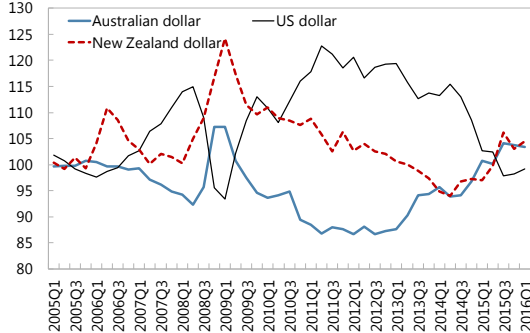


Sources: Vanuatu authorities; and IMF staff calculations.

The nominal exchange rate has been appreciating against the Australian dollar but weakening against the U.S. dollar.

Bilateral Exchange Rates

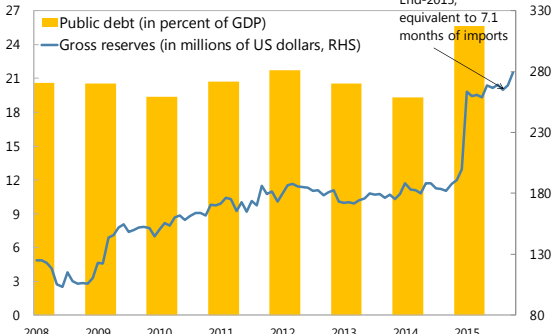
(Index 2005=100, increase=appreciation)



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

Reserves rose to comfortable levels while public debt increased significantly in 2015.

Public Debt and International Reserves



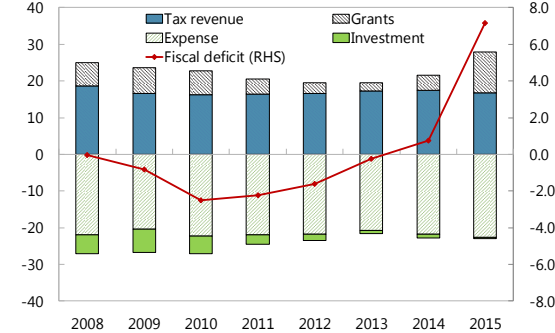
Sources: Vanuatu authorities; and IMF staff calculations.

Figure 3. Vanuatu: Public Finance and Monetary Indicators

Fiscal balances improved in recent years.

Fiscal Revenue and Expenditure

(In percent of GDP)

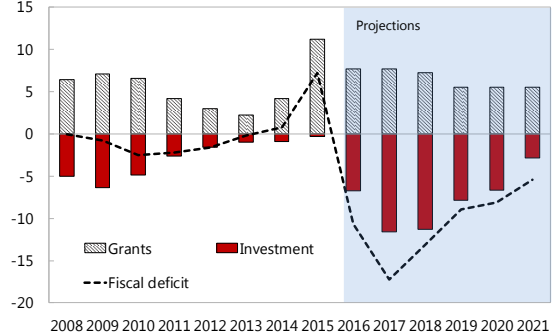


Sources: Vanuatu authorities; and IMF staff calculations.

However, reconstruction and new investment needs will likely lead to high fiscal deficits...

Fiscal Balance

(In percent of GDP)

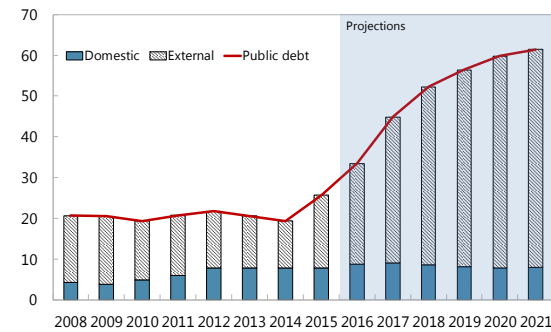


Sources: Vanuatu authorities; and IMF staff estimates.

...and drive up public debt.

Public Debt

(In percent of GDP)

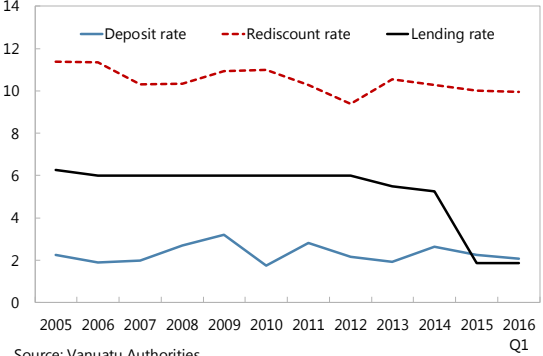


Sources: Authorities; and IMF staff estimates.

Large interest rate spreads have persisted and transmission from policy rate to commercial banks' interest rates appears limited.

Interest Rates

(In Percent)

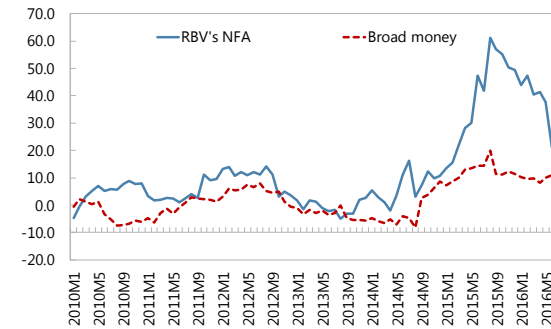


Source: Vanuatu Authorities

Money supply expanded strongly in the second half of 2014 through the third quarter of 2015 in tandem with increasing net foreign assets of the central bank.

RBV's NFA and Money Supply

(Year-on-year percentage change)

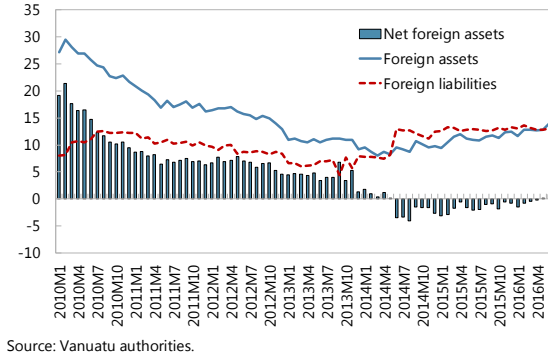


Source: Vanuatu authorities.

However, net foreign asset of the commercial banks continued to be negative since mid-2014 until it turned positive in May 2016.

Banks' Foreign Assets and Liabilities

(In billions of vatu)



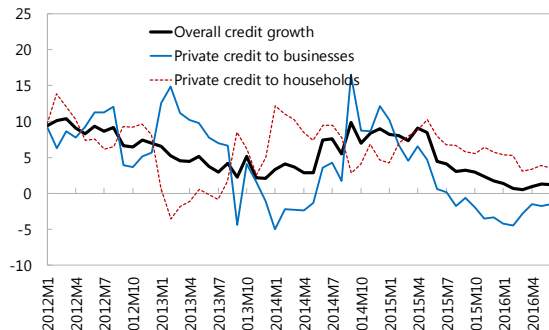
Source: Vanuatu authorities.

Figure 4. Vanuatu: Financial Sector Developments

Private credit growth declined sharply from the second half of 2015 in tandem with a large drop in credit to business sector.

Private Credit Growth

(Year-on-year percentage change)

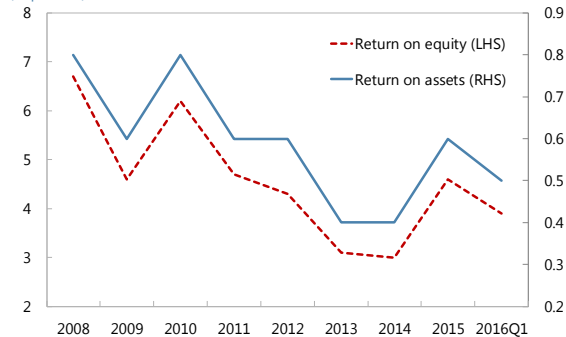


Source: Vanuatu authorities.

Bank profitability appears to have improved in 2015 and started to deteriorate slightly in 2016.

Bank Profitability

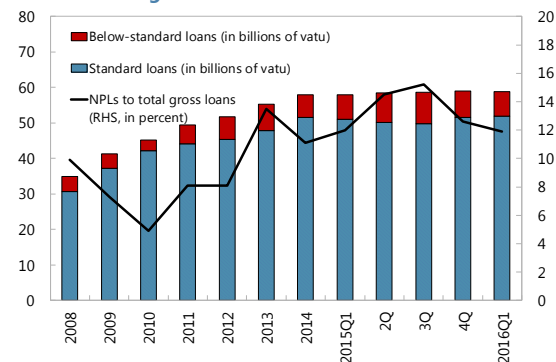
(In percent)



Source: Vanuatu authorities.

NPLs increased temporarily after the cyclone and started to decrease since the last quarter of 2015.

Non-Performing Loans

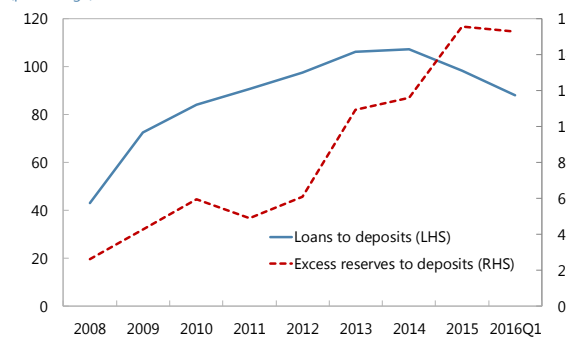


Source: Vanuatu authorities.

Despite the high loan-to-deposit ratio, overall bank liquidity remained ample.

Loan-to-Deposit and Excess Reserve Ratio

(percentage)

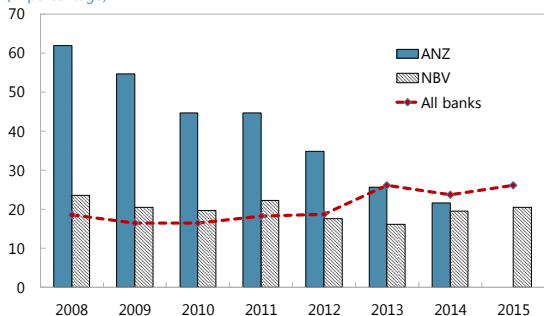


Source: Vanuatu authorities.

At the same time, liquidity has become more evenly distributed across banks...

Liquid Assets to Total Assets

(In percentage)

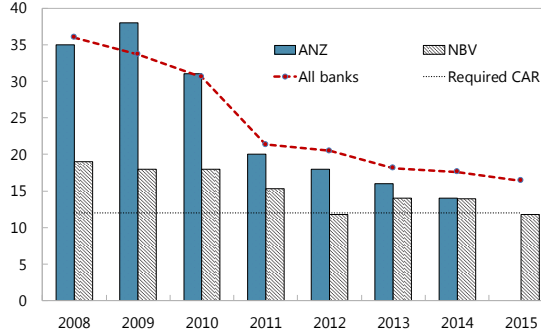


Sources: Vanuatu authorities; Bankscope; and IMF staff calculations.

...and the capital ratio has been on a declining trend, although still above the required level.

Total Capital Ratio

(Total capital in percent of risk-weighted assets)

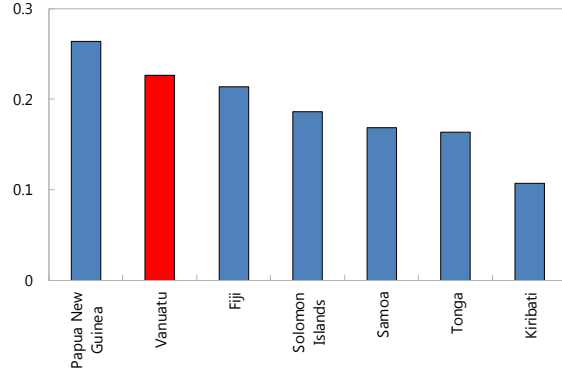


Sources: Vanuatu authorities; and Bankscope.

Figure 5. Vanuatu: Financial Access and Inclusion

Overall financial development is relatively high in Vanuatu compared to other PICs.

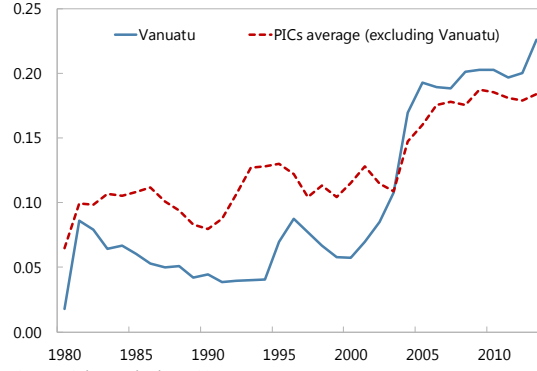
Financial Development Index, 2013



Source: Sahay and others (2015).

Financial development index has surpassed the PICs average since 2004.

Financial Development Index

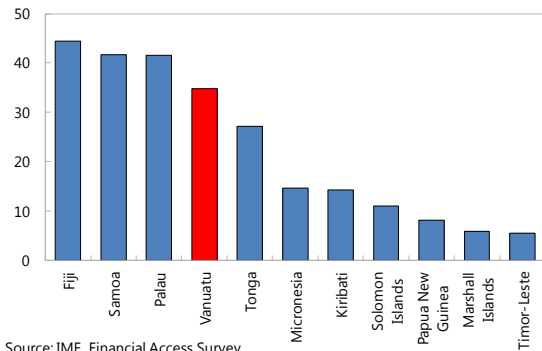


Source: Sahay and others (2015).

Financial access of households is appropriate compared to other PIC peers in the provision of ATM...

Number of ATM, 2014

(Per 100,000 adults)

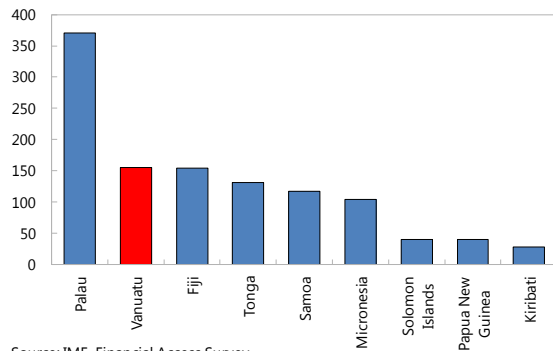


Source: IMF, Financial Access Survey.

...and in the number of bank loans.

Commercial Bank Loan Accounts, 2014

(Per 100,000 adults)

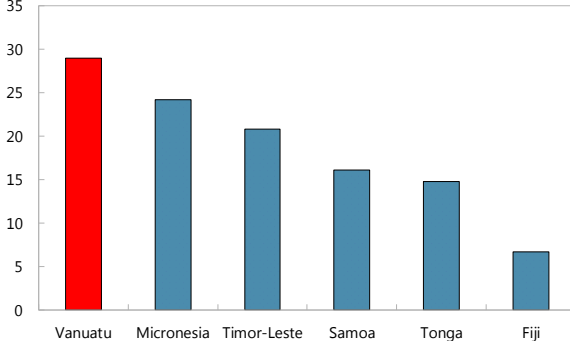


Source: IMF, Financial Access Survey.

However, financial access by the business sector is constrained...

Firms Identifying Access to Finance as Major Constraint, 2009

(In percent)

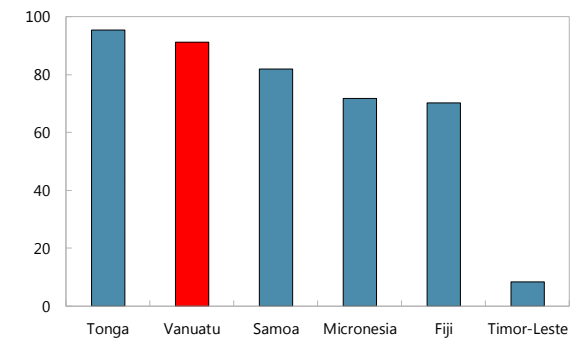


Source: World Bank, Enterprise Surveys.

...by higher collateral requirements.

Loans Requiring Collateral, 2009

(In percent)



Source: World Bank, Enterprise Surveys.

Table 1. Vanuatu: Selected Economic and Financial Indicators, 2011-16

	2011	2012	2013	2014	Est.	Proj.
					2015	2016
Output and prices (annual percentage change)						
Real GDP	1.2	1.8	2.0	2.3	-0.8	4.0
Consumer prices (period average)	0.9	1.3	1.5	0.8	2.5	2.2
Consumer prices (end period)	1.2	0.8	1.5	1.1	1.5	2.5
Government finance (in percent of GDP)						
Total revenue	22.3	21.8	21.4	23.5	32.1	29.1
Taxes	16.4	16.5	17.2	17.4	16.7	18.0
Other revenue	1.7	2.2	2.0	2.0	3.4	3.4
Grants	4.2	3.0	2.2	4.1	11.2	7.7
Expenditure	24.4	23.4	21.7	22.7	24.9	39.7
Expense	21.9	21.8	20.7	21.8	23.6	32.0
Net acquisition of non financial assets	2.7	1.6	1.0	0.9	1.3	7.7
Net lending (+)/borrowing (-)	-2.1	-1.6	-0.2	0.8	7.2	-10.6
Central government debt (end of period)	20.7	21.7	20.6	19.3	25.6	33.5
Domestic	6.0	7.8	7.8	7.8	7.7	8.7
External	14.7	14.0	12.7	11.5	17.9	24.8
Money and credit (annual percentage change)						
Broad money (M2)	1.3	-0.6	-5.5	8.6	11.4	0.2
Net foreign assets	-8.5	-6.3	-14.8	-14.5	71.6	-19.3
Domestic credit	10.9	5.7	2.7	9.4	-7.6	9.0
<i>Of which:</i> Credit to private sector	8.8	6.9	2.0	9.0	1.8	6.7
Interest rates (in percent, end of period) 1/						
Deposit rate (vatu deposits)	2.8	2.2	1.9	2.6	2.3	...
Lending rate (vatu loans)	10.3	9.4	10.5	10.3	10.0	...
Balance of payments (in percent of GDP)						
Current account	-8.1	-6.5	-3.3	-0.3	-11.1	-16.6
Trade balance	-24.4	-25.4	-27.8	-24.2	-36.5	-32.4
Exports of goods	8.5	7.0	5.6	7.7	5.3	7.8
Imports of goods	-32.9	-32.4	-33.4	-31.9	-41.7	-40.2
Tourism receipts	28.1	30.9	35.9	31.6	23.7	25.5
Capital and financial account	14.7	6.1	7.2	6.1	21.3	13.6
Gross international reserves (in months of prospective G&S imports)	5.3	5.4	5.4	4.8	7.1	5.8
External debt service (in percent of GNFS exports)	1.4	1.4	1.8	2.1	2.5	2.5
Exchange rates 2/						
Vatu per U.S. dollar (period average)	89.5	92.6	94.5	97.1	109.0	...
Vatu per U.S. dollar (end of period)	93.6	91.7	97.3	102.7	110.5	...
Real effective exchange rate (average)	99.6	100.2	98.9	98.1	99.3	...
Memorandum items:						
Nominal GDP (in billions of vatu)	70.9	72.4	75.8	79.1	80.4	85.5
Nominal GDP (in millions of U.S. dollars)	792	782	802	815	738	773

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

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

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

Table 2. Vanuatu: Central Government Budgetary Operations, 2011-21^{1/}

	2011	2012	2013	2014	Est.	Proj.	2017	2018	2019	2020	2021
					2015	2016					
(In millions of vatu)											
Total revenue	15,804	15,764	16,247	18,581	25,786	24,837	25,498	27,993	28,206	29,719	31,058
Taxes	11,630	11,982	13,069	13,743	13,469	15,373	15,339	17,573	18,893	19,850	20,598
Other revenue	1,220	1,608	1,514	1,561	3,300	2,892	3,100	3,313	3,529	3,740	3,964
Grants	2,954	2,174	1,664	3,277	9,018	6,573	7,059	7,107	5,784	6,129	6,495
Expenditure	17,315	16,942	16,423	17,987	20,017	33,925	41,306	40,855	37,555	38,658	37,447
Expense	15,505	15,803	15,694	17,259	18,950	27,315	29,768	28,783	28,346	30,218	32,945
<i>Of which:</i> Compensation of employees	7,862	8,412	8,438	8,583	8,893	10,090	10,815	10,491	11,176	11,843	12,197
Interest payment	398	463	555	573	700	777	1,007	1,207	1,308	1,570	1,207
Net acquisition of nonfinancial assets	1,881	1,139	729	729	1,067	6,610	11,537	12,072	9,210	8,440	4,502
Gross operating balance	299	-39	553	1,322	6,836	-2,478	-4,271	-790	-140	-499	-1,888
Net lending (+)/borrowing (-)	-1,511	-1,178	-176	594	5,769	-9,088	-15,808	-12,862	-9,349	-8,939	-6,389
Net acquisition of financial assets	-349	-124	-335	464	11,101	-1,110	-3,330	-2,775	-1,665	-1,665	-555
Net incurrence of liabilities	1,233	1,054	-159	-310	5,333	7,978	12,477	10,087	7,684	7,274	5,834
Domestic	950	1,389	306	263	32	1,200	900	100	84	170	693
Foreign	282	-335	-465	-573	5,301	6,778	11,577	9,987	7,600	7,103	5,141
(In percent of GDP)											
Total revenue	22.3	21.8	21.4	23.5	32.1	29.1	27.8	28.6	27.0	26.9	26.5
Taxes	16.4	16.5	17.2	17.4	16.7	18.0	16.7	17.9	18.1	18.0	17.6
Other revenue	1.7	2.2	2.0	2.0	4.1	3.4	3.4	3.4	3.4	3.4	3.4
Grants	4.2	3.0	2.2	4.1	11.2	7.7	7.7	7.3	5.5	5.5	5.5
Expenditure	24.4	23.4	21.7	22.7	24.9	39.7	45.1	41.7	36.0	35.0	32.0
Expense	21.9	21.8	20.7	21.8	23.6	32.0	32.5	29.4	27.2	27.3	28.1
<i>Of which:</i> Compensation of employees	11.1	11.6	11.1	10.8	11.1	11.8	11.8	10.7	10.7	10.7	10.4
Interest payment	0.6	0.6	0.7	0.7	0.9	0.9	1.1	1.2	1.3	1.4	1.0
Net acquisition of nonfinancial assets	2.7	1.6	1.0	0.9	1.3	7.7	12.6	12.3	8.8	7.6	3.8
Gross operating balance	0.4	-0.1	0.7	1.7	8.5	-2.9	-4.7	-0.8	-0.1	-0.5	-1.6
Net lending (+)/borrowing (-)	-2.1	-1.6	-0.2	0.8	7.2	-10.6	-17.3	-13.1	-9.0	-8.1	-5.5
Net acquisition of financial assets	-0.5	-0.2	-0.4	0.6	13.8	-1.3	-3.6	-2.8	-1.6	-1.5	-0.5
Net incurrence of liabilities	1.7	1.5	-0.2	-0.4	6.6	9.3	13.6	10.3	7.4	6.6	5.0
Domestic	1.3	1.9	0.4	0.3	0.0	1.4	1.0	0.1	0.1	0.2	0.6
Foreign	0.4	-0.5	-0.6	-0.7	6.6	7.9	12.6	10.2	7.3	6.4	4.4
Memorandum items:											
Public and publicly-guaranteed debt	23.7	24.6	23.3	23.9	33.4	38.6	49.7	56.4	59.7	62.5	63.7
Central government debt	20.7	21.7	20.6	19.3	25.6	33.5	44.8	52.2	56.4	59.8	61.4
Domestic	6.0	7.8	7.8	7.8	7.7	8.7	9.1	8.6	8.2	7.9	8.0
External	14.7	14.0	12.7	11.5	17.9	24.8	35.7	43.6	48.3	52.0	53.4
Guaranteed GBE debt	2.9	2.9	2.8	4.6	4.5	2.1	2.0	1.9	1.7	1.7	1.6
RCF/RFI					3.2	3.0	2.8	2.3	1.5	1.0	0.8
Debt service	1.0	1.9	2.4	2.2	2.5	3.1	3.1	3.4	3.5	3.8	3.4
Primary balance	-1.7	-1.0	0.5	1.5	8.0	-9.7	-16.2	-11.9	-7.7	-6.7	-4.2
Nominal GDP (millions of vatu) ^{2/}	70,873	72,415	75,803	79,109	80,425	85,472	91,616	97,923	104,312	110,543	117,145

1/ Fiscal year corresponds to the calendar year.

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

Table 3. Vanuatu: Monetary Survey, 2011-16

	2011	2012	2013	2014	2015	2016 Proj.
(In millions of vatu; end of period)						
Net foreign assets	20,367	19,091	16,272	13,908	23,867	19,275
Monetary authorities	14,035	14,537	14,932	16,533	24,693	22,110
Commercial banks	6,332	4,554	1,340	-2,625	-826	-2,834
Net domestic assets	36,921	37,839	37,500	44,483	41,193	46,637
Domestic credit	47,959	50,697	52,081	56,988	52,636	58,080
Claims on government (net)	-273	-774	-715	-1,153	-6,368	-5,168
Claims on municipalities	34	36	85	91	74	74
Claims on other sectors	48,199	51,435	52,711	58,050	58,931	63,175
Claims on nonfinancial public enterprises	410	371	648	1,303	1,177	1,527
Claims on private sector	47,788	51,064	52,063	56,747	57,753	61,647
Other items (net)	-11,039	-12,858	-14,580	-12,505	-11,443	-11,443
Total broad money	57,288	56,930	53,772	58,391	65,061	65,912
Narrow money	22,413	22,634	26,476	28,202	35,468	36,934
Currency outside banks	4,886	4,889	5,054	5,532	6,284	6,050
Demand deposits	17,528	17,745	21,422	22,669	29,184	30,884
Quasi-money	34,874	34,296	27,296	30,189	29,593	28,978
(Annual percentage change, unless otherwise indicated)						
Net foreign assets	-8.5	-6.3	-14.8	-14.5	71.6	-19.2
Net domestic assets	7.7	2.5	-0.9	18.6	-7.4	13.2
Domestic credit	10.9	5.7	2.7	9.4	-7.6	10.3
Private sector credit	8.8	6.9	2.0	9.0	1.8	6.7
Total broad money	1.3	-0.6	-5.5	8.6	11.4	1.3
Vatu broad money	5.4	-0.5	-3.0	8.3	10.4	1.9
Memorandum items:						
Vatu broad money multiplier	2.1	2.1	1.7	1.8	1.6	1.5
Total broad money multiplier	2.6	2.5	2.0	2.1	1.8	1.8
Velocity						
Narrow money	3.3	3.4	3.1	2.9	2.5	2.4
Vatu broad money	1.5	1.5	1.6	1.6	1.5	1.5
Total broad money	1.2	1.3	1.4	1.4	1.3	1.3
Reserve money (in millions of vatu)	11,881	12,992	15,328	16,851	20,287	17,976
Reserve money (annual percentage change)	6.5	9.4	18.0	9.9	20.4	-11.4
Credit to private sector (in percent of GDP)	67.4	70.5	68.7	71.7	71.8	72.1
Foreign currency deposits (annual percentage change)	-10.1	0.4	-18.5	10.6	17.5	-2.1
Foreign currency deposits/total deposits (percent)	33.2	33.5	15.8	16.1	17.0	16.3
Foreign currency credit/total credit (percent)	21.6	23.1	24.8	26.5	26.0	27.0
Net foreign assets of banks (in millions of U.S. dollars)	67.7	49.6	13.8	-25.6	-7.5	-25.6
Net foreign assets (in percent of GDP)	28.7	26.4	21.5	17.6	29.7	22.6
Nominal GDP (in millions of vatu)	70,873	72,415	75,803	79,109	80,425	85,472

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

Table 4. Vanuatu: Balance of Payments, 2011-21

(In millions of U.S. dollars)

	2011	2012	2013	2014	Est.		Proj.				
					2015	2016	2017	2018	2019	2020	2021
Current account balance	-64	-51	-26	-2	-82	-129	-175	-168	-113	-95	-59
Trade balance	-193	-198	-223	-197	-269	-250	-283	-276	-229	-224	-196
Exports of goods (f.o.b.)	67	55	45	63	39	60	69	77	87	94	103
Imports of goods (f.o.b.)	-260	-253	-268	-260	-308	-311	-352	-353	-315	-318	-300
Services balance	141	176	190	166	104	116	108	110	120	135	144
Receipts	286	322	331	307	284	269	272	286	307	333	354
<i>Of which:</i> travel	223	241	288	257	175	197	225	254	286	319	345
Payments	-145	-146	-142	-141	-179	-153	-164	-175	-187	-198	-210
Primary income	-24	-45	-11	4	7	-23	-24	-21	-23	-24	-26
Receipts	42	37	33	36	36	36	39	41	44	47	49
Payments	-65	-82	-45	-33	-29	-59	-63	-63	-67	-71	-75
Secondary income	12	17	18	26	76	28	23	19	19	19	19
Official	10	14	17	22	39	20	20	16	16	16	16
Private	2	3	1	3	37	8	3	3	3	3	3
Capital and financial account	117	47	58	50	157	105	172	155	103	97	66
Capital account	24	23	21	32	84	31	44	41	27	28	23
<i>Of which:</i> Official capital transfers (net)	23	20	20	25	81	29	42	39	25	26	21
Financial account	93	25	37	18	73	74	128	114	76	69	43
Foreign direct investment	59	38	33	21	33	41	48	49	40	39	36
Portfolio investment	-1	-4	7	-9	-10	0	0	0	0	0	0
Other investment	34	-10	-3	6	50	16	40	32	18	15	4
Net errors and omissions	-41	12	-36	-41	10	0	0	0	0	0	0
Overall balance	12	8	-5	6	85	-23	-4	-13	-9	3	6
Memorandum items:											
Gross international reserves	175	184	179	184	273	250	246	234	224	227	233
In months of prospective imports	5.3	5.4	5.4	4.5	7.1	5.8	5.6	5.6	5.2	5.3	5.2
Current account balance (in percent of GDP)	-8.1	-6.5	-3.3	-0.3	-11.1	-16.6	-21.1	-19.0	-11.9	-9.5	-5.6
Exports of goods (annual percentage change)	31.8	-18.6	-18.1	40.0	-37.8	54.1	14.7	12.2	11.9	9.2	3.0
Imports of goods (annual percentage change)	7.2	-2.7	5.7	-2.9	18.5	0.8	13.2	0.5	-10.8	1.0	1.0
Exchange rate (vatu per U.S. dollar, period average)	89.5	92.6	94.5	97.1	110.5	...	...	...	...	...	...
Exchange rate (vatu per U.S. dollar, end of period)	93.6	91.7	97.3	102.7	110.5	...	...	...	...	...	...
Public external debt (in percent of GDP)	14.7	14.0	12.7	11.5	17.9	24.8	35.7	43.6	48.3	52.0	53.4
Public external debt service (in percent of GNFS exports)	1.4	1.4	1.8	2.1	2.5	2.5	2.7	2.9	3.9	4.1	4.2
Nominal GDP	792	782	802	815	738	773	829	886	944	1000	1060

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

Table 5. Vanuatu: Medium-Term Baseline Scenario, 2011-21

	2011	2012	2013	2014	Est.	Proj.		2018	2019	2020	2021
					2015	2016	2017				
Output and prices (annual percentage change)											
Real GDP	1.2	1.8	2.0	2.3	-0.8	4.0	4.5	4.0	3.5	3.0	3.0
Consumer prices (period average)	0.9	1.3	1.5	0.8	2.5	2.2	2.6	2.8	2.9	3.0	3.0
Consumer prices (end of period)	1.2	0.8	1.5	1.1	1.5	2.5	2.7	2.9	3.0	3.0	3.0
Government finances (in percent of GDP)											
Total revenue	22.3	21.8	21.4	23.5	32.1	29.1	27.8	28.6	27.0	26.9	26.5
Revenue	18.1	18.8	19.2	19.3	20.8	21.4	20.1	21.3	21.5	21.3	21.0
Taxes	16.4	16.5	17.2	17.4	16.7	18.0	16.7	17.9	18.1	18.0	17.6
Other revenue	1.7	2.2	2.0	2.0	4.1	3.4	3.4	3.4	3.4	3.4	3.4
Grants	4.2	3.0	2.2	4.1	11.2	7.7	7.7	7.3	5.5	5.5	5.5
Expenditure	24.4	23.4	21.7	22.7	24.9	39.7	45.1	41.7	36.0	35.0	32.0
Expense	21.9	21.8	20.7	21.8	23.6	32.0	32.5	29.4	27.2	27.3	28.1
Net acquisition of non-financial assets	2.7	1.6	1.0	0.9	1.3	7.7	12.6	12.3	8.8	7.6	3.8
Net lending (+)/borrowing (-)	-2.1	-1.6	-0.2	0.8	7.2	-10.6	-17.3	-13.1	-9.0	-8.1	-5.5
Public and publicly guaranteed debt	23.7	24.6	23.3	23.9	33.4	38.6	49.7	56.4	59.7	62.5	63.7
Central government debt (end of period)	20.7	21.7	20.6	19.3	25.6	33.5	44.8	52.2	56.4	59.8	61.4
Domestic	6.0	7.8	7.8	7.8	7.7	8.7	9.1	8.6	8.2	7.9	8.0
External	14.7	14.0	12.7	11.5	17.9	24.8	35.7	43.6	48.3	52.0	53.4
Guaranteed GBE debt	2.9	2.9	2.8	4.6	4.5	2.1	2.0	1.9	1.7	1.7	1.6
Balance of payments (in percent of GDP)											
Current account	-8.1	-6.5	-3.3	-0.3	-11.1	-16.6	-21.1	-19.0	-11.9	-9.5	-5.6
Trade balance	-24.4	-25.4	-27.8	-24.2	-36.5	-32.4	-34.1	-31.2	-24.2	-22.4	-18.5
Exports of goods	8.5	7.0	5.6	7.7	5.3	7.8	8.3	8.7	9.2	9.4	9.7
Imports of goods	-32.9	-32.4	-33.4	-31.9	-41.7	-40.2	-42.4	-39.9	-33.4	-31.8	-28.3
Tourism receipts	28.1	30.9	35.9	31.6	23.7	25.5	27.1	28.7	30.3	31.9	32.5
Capital and financial account	14.7	6.1	7.2	6.1	21.3	13.6	20.7	17.5	11.0	9.7	6.2
Of which: Foreign direct investment	7.5	4.9	4.2	2.6	4.4	5.4	5.8	5.6	4.3	3.9	3.4
Overall balance	1.5	1.1	-0.6	0.8	11.6	-3.0	-0.4	-1.5	-1.0	0.3	0.6
Gross international reserves (in millions of U.S. dollars)	175	184	179	184	273	250	246	234	224	227	233
In months of prospective imports	5.3	5.4	5.4	4.5	7.1	5.8	5.6	5.6	5.2	5.3	5.2
External debt service (in percent of GNFS exports)	1.4	1.4	1.8	2.1	2.5	2.5	2.7	2.9	3.9	4.1	4.2
Memorandum items:											
Nominal GDP (in billions of vatu)	70.9	72.4	75.8	79.1	80.4	85.5	91.6	97.9	104.3	110.5	117.1
Nominal GDP (in millions of U.S. dollars)	792	782	802	815	738	773	829	886	944	1,000	1,060

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

Table 6. Vanuatu: Banks' Financial Soundness Indicators, 2010-15

	2010	2011	2012	2013	2014	2015
Capital adequacy						
Regulatory capital to risk-weighted assets	30.6	21.3	20.5	18.1	17.6	16.4
Regulatory Tier 1 capital to risk-weighted assets	29.5	18.7	18.3	15.9	16.7	16.2
Asset quality						
Nonperforming loans net of provisions to capital	14.7	16.8	12.0	37.4	49.4	69.3
Nonperforming loans to total gross loans	4.9	8.1	8.1	13.5	11.1	12.6
Earnings and profitability						
Return on assets	0.8	0.6	0.6	0.4	0.4	0.6
Return on equity	6.2	4.7	4.3	3.1	3.0	4.6
Interest margin to gross income	41.9	43.1	46.5	50.1	54.3	49.7
Noninterest expenses to gross income	37.8	46.4	52.4	46.9	55.2	51.4
Liquidity						
Liquid assets to total assets (liquid asset ratio)	16.5	18.2	18.8	26.1	23.8	26.2

Source: Reserve Bank of Vanuatu.

Table 7. Vanuatu: Millennium Development Goals, 1990-2014^{1/}

	1990	1995	2000	2005	2007	2009	2010	2011	2012	2013	2014	Status 1/
Goal 1: Eradicate extreme poverty and hunger												Mixed
Employment to population ratio, 15+, total (percent)	0	0	0	0	0	68	0	0	0	0	0	
Malnutrition prevalence, weight for age (percent of children under 5)	..	..	..	..	..	..	..	..	..	..	..
Poverty gap at \$1.25 a day (PPP) (percent)	..	..	..	..	..	..	..	..	..	..	..
Poverty headcount ratio at \$1.25 a day (PPP) (percent of population)	..	..	..	..	..	..	..	..	..	..	..
Prevalence of undernourishment (percent of population)	0	12	8	7	7	6	6	6	6	6	6	
Vulnerable employment, total (percent of total employment)	0	0	0	0	0	70	0	0	0	0	0	
Goal 2: Achieve universal primary education												Mixed
Literacy rate, youth female (percent of females ages 15-24)	0	0	0	0	0	0	0	0	0	95	0	
Literacy rate, youth male (percent of males ages 15-24)	0	0	0	0	0	0	0	0	0	95	0	
Persistence to last grade of primary, total (percent of cohort)	0	0	0	0	77	0	0	0	0	0	0	
Primary completion rate, total (percent of relevant age group)	0	0	92	0	84	84	84	0	0	94	0	
Total enrollment, primary (percent net)	0	0	99	99	0	0	0	0	0	0	0	
Goal 3: Promote gender equality and empower women												Mixed
Proportion of seats held by women in national parliaments (percent)	4	0	0	4	4	4	4	2	0	0	0	
Ratio of female to male enrollments in tertiary education (percent)	0	0	0	0	0	0	0	0	0	0	0	
Ratio of female to male primary enrollment (percent)	1	0	1	1	1	1	1	0	0	1	0	
Ratio of female to male secondary enrollment (percent)	0	0	1	0	0	0	1	0	0	0	0	
Share of women employed in the nonagricultural sector (percent of total nonagricultural employment)	0.0	0.0	0.0	37.9	37.8	37.2	0.0	0.0	0.0	0.0	0.0	
Goal 4: Reduce child mortality												Mixed
Immunization, measles (percent of children ages 12-23 months)	76	73	71	68	67	66	65	65	64	64	64	
Mortality rate, infant (per 1,000 live births)	29	25	24	23	24	24	24	24	24	24	24	
Mortality rate, under-5 (per 1,000)	36	30	29	28	28	28	29	29	29	28	28	
Goal 5: Improve maternal health												Mixed
Adolescent fertility rate (births per 1,000 women ages 15-19)	73	65	58	51	48	47	46	45	45	44	43	
Births attended by skilled health staff (percent of total)	0	89	0	0	74	0	0	0	0	89	0	
Contraceptive prevalence (percent of women ages 15-49)	0	39	0	0	38	0	0	0	0	49	0	
Maternal mortality ratio (national estimate, per 100,000 live births)	0	0	0	0	86	0	0	0	0	0	0	
Goal 6: Combat HIV/AIDS, malaria, and other diseases												On Track
Children with fever receiving antimalarial drugs (percent of children under age 15)	0	0	0	0	53	0	0	0	0	5	0	
Incidence of tuberculosis (per 100,000 people)	127	102	110	83	77	72	69	67	65	62	63	
Tuberculosis case detection rate (percent, all forms)	75	46	75	44	72	81	71	68	78	78	69	
Goal 7: Ensure environmental sustainability												Off Track
CO2 emissions (kg per PPP \$ of GDP)	0.3	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.0	0.0	0.0	
CO2 emissions (metric tons per capita)	0.5	0.4	0.4	0.3	0.4	0.5	0.5	0.6	0.0	0.0	0.0	
Forest area (percent of land area)	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	
Improved sanitation facilities (percent of population with access)	0	36	42	49	52	55	56	58	58	58	58	
Improved water source (percent of population with access)	62	69	76	82	85	87	88	90	91	92	93	
Marine protected areas, (percent of territorial water)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Goal 8: Develop a global partnership for development												
Internet users (per 100 people)	0.0	0.0	2.1	5.1	6.8	7.5	8.0	9.2	10.6	11.3	18.8	
Mobile cellular subscriptions (per 100 people)	0.0	0.1	0.2	6.1	11.8	57.0	71.9	56.6	59.1	50.3	60.4	
Telephone lines (per 100 people)	1.8	2.5	3.6	3.3	4.0	3.1	3.0	2.4	2.0	2.2	2.2	
Other												
Fertility rate, total (births per woman)	4.9	4.7	4.4	3.9	3.7	3.5	3.5	3.5	3.4	3.4	3.3	
GNI per capita, Atlas method (current US\$)	1,200	1,270	1,430	1,780	2,130	2,620	2,690	2,860	2,950	3,200	3,160	
GNI, Atlas method (current US\$) (billions)	0.2	0.2	0.3	0.4	0.5	0.6	0.6	0.7	0.7	0.8	0.8	
Gross capital formation (percent of GDP)	33	23	20	24	32	40	35	27	23	26	26	
Life expectancy at birth, total (years)	63	65	68	69	70	71	71	71	71	72	72	
Literacy rate, adult total (percent of people ages 15 and above)	0	0	0	0	0	0	0	0	0	84	0	
Population, total (millions)	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	
Trade (percent of GDP)	120	98	87	100	88	105	99	94	100	99	97	

Source: World Bank, *World Development Indicators* database.^{1/} According to Pacific Islands Forum Secretariat *2015 Pacific Regional MDGs Tracking Report*.

Table 8. Vanuatu: Indicators of Capacity to Repay the Fund, 2016-26

	Proj.										
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Fund obligations based on existing and prospective credit											
(In millions of SDRs)											
Principal	0.0	0.0	2.1	4.3	3.0	1.7	1.7	1.7	1.7	0.9	0.0
Charges and interest	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations based on existing and prospective credit											
In millions of SDRs											
In millions of U.S. dollars	0.1	0.1	2.2	4.3	3.0	1.7	1.7	1.7	1.7	0.9	0.0
In percent of gross international reserves	0.0	0.1	1.3	2.7	1.9	1.0	1.0	1.0	0.9	0.4	0.0
In percent of government revenue	0.0	0.1	1.2	2.4	1.6	0.9	0.8	0.8	0.7	0.3	0.0
In percent of exports of goods and services	0.0	0.0	0.8	1.4	0.9	0.5	0.5	0.4	0.4	0.2	0.0
In percent of debt service 1/	0.2	0.2	4.4	7.4	5.0	2.7	2.5	2.4	2.2	1.0	0.0
In percent of GDP	0.0	0.0	0.4	0.6	0.4	0.2	0.2	0.2	0.2	0.1	0.0
In percent of quota	0.4	0.6	13.1	25.4	17.6	10.1	10.1	10.1	10.1	5.1	0.1
Outstanding Fund credit											
In millions of SDRs											
In millions of U.S. dollars	17.0	17.0	14.9	10.6	7.7	6.0	4.3	2.6	0.9	0.0	0.0
In percent of gross international reserves	9.4	9.6	8.9	6.6	4.7	3.6	2.5	1.4	0.5	0.0	0.0
In percent of government revenue	10.5	10.3	8.2	5.8	4.0	3.0	2.0	1.1	0.4	0.0	0.0
In percent of exports of goods and services	6.9	6.5	5.3	3.5	2.4	1.7	1.1	0.6	0.2	0.0	0.0
In percent of debt service 1/	37.1	34.9	29.3	18.2	12.8	9.5	6.2	3.5	1.1	0.0	0.0
In percent of GDP	3.0	2.9	2.3	1.6	1.1	0.8	0.5	0.3	0.1	0.0	0.0
In percent of quota	100.0	100.0	87.5	62.5	45.0	35.0	25.0	15.0	5.0	0.0	0.0
Net use of Fund credit (in millions of SDRs)											
Disbursements	0.0	0.0	-2.1	-4.3	-3.0	-1.7	-1.7	-1.7	-1.7	-0.9	0.0
Repayments and repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Nominal GDP (in millions of U.S. dollars)	773	829	886	944	1000	1060	1123	1190	1261	1337	1417
Exports of goods and services (in millions of U.S. dollars)	341	363	393	427	457	491	529	570	615	658	700
Gross international reserves (in millions of U.S. dollars)	250	246	234	224	227	233	242	249	264	290	334
Government revenue (in millions of U.S. dollars)	225	231	253	255	269	281	298	316	334	354	376
Debt service (in millions of U.S. dollars)	64	68	71	82	84	89	97	103	108	117	124
U.S. dollars/SDR (period average)	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Source: IMF staff estimates and projections.											
1/ Total debt service includes IMF repurchases and repayments.											

Appendix I. Vanuatu: Risk Assessment Matrix

Sources of Risks	Likelihood	Impact	Policies to Minimize Impact
Global risks			
Weaker-than-expected global growth slowdown	<p>Low/Medium Significant growth slowdown in China</p> <p>High/Medium Structurally weak growth in key advanced /emerging economies</p>	<p>Medium A decline in exports and tourism receipts would worsen the current account balance. It would also reduce fiscal revenue and weaken the reserves buffer.</p>	Facilitate diversification by introduction of new activities and expansion into new markets. Accelerate infrastructure investment to stimulate domestic demand in the short-term and improve competitiveness in the long-term.
Sharp rise in risk premia with flight to safety	Medium	<p>Medium A large U.S. dollar appreciation against the Australian dollar will result in the vatu's sizable appreciation against the Australian dollar. This may create problems for Vanuatu since Australia is Vanuatu's largest trading partner, tourist source, and grant provider.</p>	While in the short term the authorities should continue the implementation of the basket currency peg, some intervention to basket currencies and weights may be considered in the medium term if the underlying fundamentals worsen. Strengthen reserve management in line with IMF TA.
Reduced financial services by global/regional banks ("withdrawal of corresponding banking relationships")	High	<p>Medium Though the loss of CBRs has not emerged as a serious issue, the inclusion in the FATF list may pose some difficulties in cross-border payments, trade finance, and remittances. The closure of MTOs could potentially increase the cost of remittances.</p>	Ensure transparency and improve banking regulation and supervision to mitigate the risk. Strengthen the AML/CFT framework in line with the international standard through TA from various stakeholders (e.g., IMF, World Bank, and Australian government).

Appendix I. Vanuatu: Risk Assessment Matrix (concluded)

Domestic risks			
Natural disasters and climate change	High	High Damages to agriculture and infrastructure, potentially leading to a reduction in fiscal space, can have significant impacts on potential growth. Climate change is likely to increase the intensity and frequency of natural disasters, alter weather and precipitation patterns, and raise sea levels.	Build greater ex-ante resilience to natural disasters by enhancing adaptation measures (with better infrastructure, territorial planning, and fiscal buffers), improve disaster response planning (with more swift coping mechanisms), and seek global/regional climate financing opportunities.
Delays in implementation of infrastructure projects	High	High/Medium Short- and medium-term growth would be adversely affected.	Promote public investment by prioritizing in project selection and implementation. Stimulate private sector investment by improving business environment and facilitating credit provision.
Earlier-than-desired implementation of tax reform	Medium	High/Medium Introduction of income tax and corporate tax without proper preparation would cause disturbances in the economy with contractions in household consumption and business investment.	Seek TA from the IMF on the implementation of tax reforms to secure the expected revenue return and fairness of tax system.

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

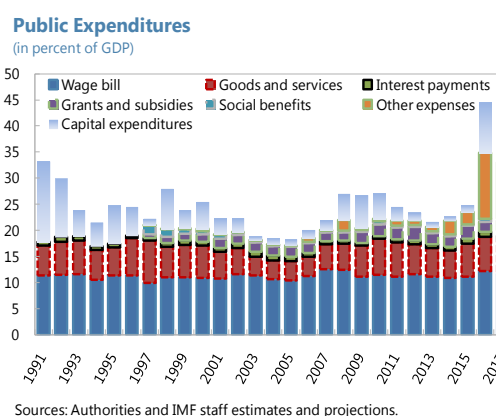
Appendix II. Vanuatu: Authorities' Response to Past Fund Policy Advice

Fund Recommendation	Policy Actions
<p>Fiscal Policy To the extent possible, seek grants to finance reconstruction activities and infrastructure projects.</p>	<p>The authorities obtained sizable grant financing from donors for reconstruction efforts in the aftermath of Cyclone Pam. They are committed to seeking financing at concessional terms—in particular through grants—for new projects.</p>
<p>Rebuild fiscal buffers and create room for important social and development expenditures by reprioritizing spending, strengthening public financial management, and increasing tax and non-tax revenues.</p>	<p>The authorities released the <i>Vanuatu Infrastructure Strategic Investment Plan (2015-2024)</i> which includes prioritization, funding, and implementation of infrastructure projects. The authorities launched a review of <i>Revenue Modernization and Reform—Building an Effective Tax System / Regime</i> in 2016 and issued a press release on the approval of personal income and corporate tax. They plan to seek TA from the Fund on the implementation stage of the tax reforms.</p>
<p>Establish ex-ante contingency planning and financing for natural disasters in the medium term.</p>	<p>The government established a Recovery Committee in August 2015 to more effectively plan for natural disasters and coordinate reconstruction efforts. The authorities still need to complement domestic buffers with externally financed instruments, such as contingent credit lines with multilateral partners.</p>
<p>Monetary and Financial Sector Policy Continue to support the economy and the banking system by providing liquidity to banks with appropriate safeguards. Be ready to withdraw the liquidity once the situation is stabilized and inflationary pressures emerge.</p>	<p>The accommodative monetary policy swiftly imposed in the aftermath of the cyclone played an important role in supporting economic recovery and financial stability. Balance sheets of banks have become stronger in 2016 thanks to sufficient liquidity provision to the financial sector. The RBV stands ready to assess banks' financial situation to ensure financial stability, and to tighten capital requirements if deemed necessary.</p>
<p>Exchange Rate Policy Maintain the exchange rate basket peg at the current level for now but be ready to review and adjust the level to support the external sector.</p>	<p>The vatu peg to an undisclosed basket has been an important nominal anchor during the recovery period. Despite a mild appreciation in recent months, the real effective exchange rate remains broadly in line with fundamentals.</p>
<p>Structural Policies Submit the new government business enterprises (GBEs) law to Parliament and proceed with its rationalization plans for commercial GBEs.</p>	<p>Though a new GBE law was not passed in Parliament last year, the authorities are planning to submit the GBE law to Parliament during 2016.</p>
<p>Boost competitiveness in the private sector by diversifying the economy and improving the business climate</p>	<p>The authorities along with strong support by donors and development partners aim at improvements in product quality especially in the agricultural sector that accounts for around 70 percent of the labor share.</p>

Appendix III. Public Investment, Debt Sustainability, and Natural Disasters in Vanuatu¹

Scaling up public infrastructure investment

Vanuatu's ambitious public investment plan helps foster recovery from cyclone Pam with key infrastructure. The government recently launched its 2015-2024 strategic infrastructure investment plan, prioritizing projects and suggesting financing sources. Short-listed priority projects add US\$407 million infrastructure (mainly in transport, energy, and telecommunications) to ongoing infrastructure projects estimated at US\$307 million. Representing more than 96 percent of 2015 GDP (55 percent of GDP in new projects), the 10-year investment plan is expected to be mostly financed with the support of bi- and multilateral partners (US\$273 million) and through private sector partnerships (US\$133 million). In order to cope with damages provoked by cyclone Pam and revamp infrastructure, capital expenditures are expected to sextuple from an average of 1.5 percent of GDP (2011-2015) over the following five years before returning to historical levels by 2022. The authorities expect the investment plan to raise related current expenditures by 5 percentage points of GDP over the medium term.



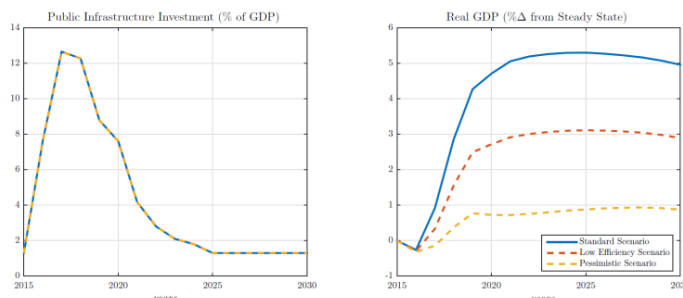
Risks linked to poor implementation capacity and limited availability of concessional financing to sustain high levels of capital spending demand a closer look at the macroeconomic implications of the investment program. To that end, we use the dynamic small open economy model developed by Buffie et al. (2012; called the Debt, Investment, and Growth or DIG model) to explore the effects of the planned scaling up of public investment on GDP growth and debt sustainability. The model is calibrated to fit Vanuatu's specificities with projected public investment and concessional debt financing provided exogenously. In addition to making explicit the nexus between public investment and growth, the model-based approach allows to compare the dynamic response of key macroeconomic aggregates contrasting alternative assumptions about the return on public infrastructure, the persistence of absorptive capacity constraints and inefficiencies in the investment process, and the financing mechanisms available (taxes, transfers, external concessional, external commercial, and domestic debt).

Reaping the benefits of public investment depends on several factors with competing macroeconomic effects. Sensitivity analyses show the importance of investing in key infrastructure projects while minimizing stringent bottlenecks.² The greater the inefficiencies and absorptive capacity constraints, the lower are the gains for the economy. By slowing the accumulation of public capital, more inefficient public investment translates into lower GDP, while lower returns on public infrastructure suggest a lesser crowding-in effect of private investment. Furthermore, although the authorities expect the public investment program to be mostly financed by concessional debt and grants, the timing of external inflows implies some fiscal adjustment. The steep increase in taxes (or decrease in current expenditures) needed when the government faces stringent inefficiencies and absorptive limitations (red and yellow curves in

figure) have a pervasive effect on private consumption and private investment. The wasted resources have a clear tradeoff by compelling the government to leverage additional resources for much lower benefits.

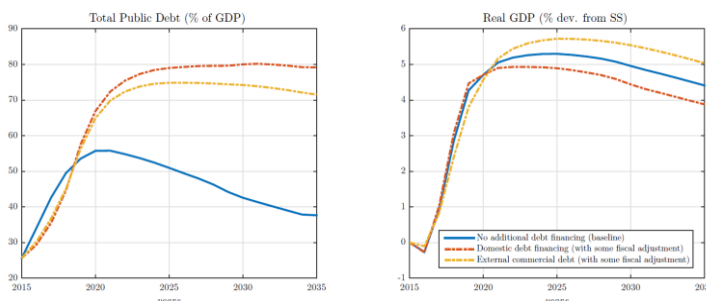
Efforts are therefore needed to enhance public investment management. As Lee et al. (2016) show, Pacific Island Countries (PICs), and Vanuatu in particular, have substantial scope to improve public investment efficiency.³ Through improved public financial management systems, adequate planning, and better implementation, Vanuatu’s ambitious investment program would yield a more favorable macroeconomic outcome.

Public Investment and Real GDP under Alternative Returns, Efficiency, and Absorptive Capacity Constraints



Debt financing mechanisms transfer the burden to future generations with a positive impact on growth; however, debt sustainability considerations are now key.⁴ Reliance on domestic debt financing (red curve in figure below) crowds out private investment by competing for finite resources in the economy, which in turn leads to lower growth. On the other hand, external commercial borrowing (yellow curve) yields the greatest level of growth contributing the lower real interest rate these operations carry—with the caveat of assuming a relatively constant country risk premium—and the non-crowding out effect on private consumption and private investment. In these scenarios, public debt is expected to remain well above 70 percent of GDP (from 26 percent in 2015) over the following decades. The risk of debt distress under these alternative scenarios shows the importance of securing (mostly) grant-based financing of the public investment program.

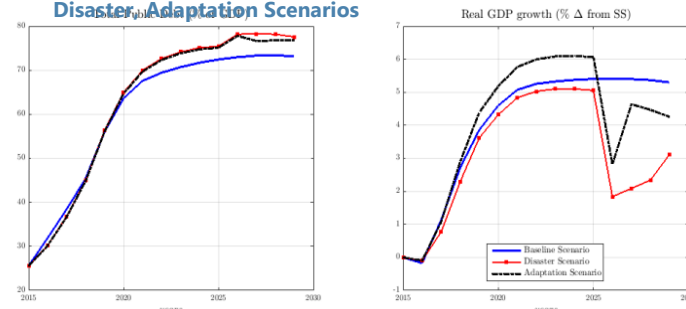
Total Public Debt and Real GDP under the Baseline Scenario with Alternative Financing Mechanisms



Building resilience to natural disasters⁵

As one of the most vulnerable countries in the world, Vanuatu is at risk of damaging natural disasters. Introducing a natural disaster shock of the magnitude of Cyclone Pam allows to explore the dynamic adjustment of Vanuatu and study debt sustainability risks following years of intensive public investment spending. The shock hits Vanuatu in 2026, causing sizeable damages and losses (2 percent of current output is destroyed and permanent damages to the country’s capital stock (private tradable and nontradable sectors, and public capital) amounts to 9 percent of GDP and lead to a temporary decrease in productivity in the following three years). Under this scenario, Vanuatu’s public debt sustainability is under considerable pressure, with external debt increasing rapidly and total public debt

Total Public Debt and Real GDP under the Baseline, Natural Disaster, Adaptation Scenarios



reaching 80 percent of GDP (i.e. an additional 5 percentage points) in the years following the disaster.⁶

Building resilience to natural disasters is key. An extension of the previous model incorporates public investment in adaptation and accounts for a faster recovery of productivity as a result of fully functional institutions in coping with the damages of the disaster. Private consumption and private investment are able to recover at a faster pace thanks to reduced productivity losses, while real GDP tends to be less affected by the disaster when adaptation investments are deployed. The authorities should seek to anchor their investment program on an adaptation approach to natural disasters and climate change, enhancing the resilience of major infrastructure and services.

Concluding remarks

The simulations therefore present the following lessons:

- Public investment efficiency, coupled with an enhanced public financial management and a careful selection of infrastructure projects are key to achieve higher growth and debt sustainability.
- An aggressive scaling up of public investment increases the level of GDP but poses sizeable threats to debt and fiscal sustainability when grants and concessional financing are not enough to cover the investment program.
- A concerted effort with the private sector and international financial institutions is therefore needed to ensure the public investment program yields the expected returns and that financing at concessional terms is available.
- Given the recurrence of natural disasters and the extent of damages these cause, authorities should seek to:
 - Incorporate disaster costs into the budget planning (accounting for the average impact on growth, destruction of productive capital, and loss of productivity) and make adequate allocations for operation and maintenance.
 - Invest in building ex ante resilience (appropriate adaptation measures, infrastructure, urban planning and coastal zone management) and build fiscal buffers.
 - Develop a simple but actionable framework for coping with natural disasters (plan, institutions, and responsibilities) to accelerate the recovery process.

¹ Prepared by Ricardo Marto (RES).

² Given the post-disaster reconstruction phase Vanuatu finds itself in, the baseline scenario assumes a high gross rate of return on public infrastructure (30%)—congruent with a low stock of public capital—and inefficiencies in the investment process implying that for every dollar invested only half of it is transformed into public capital. The alternative scenarios assume lower returns, higher inefficiencies, and more severe absorptive capacity constraints.

³ D. Lee, P. Tumbarello, K. Washimi and T. Zeinullayev, “Mind the Gap: Public Investment, Growth and Natural Disaster Risk in the Small States of the Pacific,” IMF WP (forthcoming).

⁴ A combination of fiscal adjustment and nonconcessional borrowing (domestic or external) is introduced to analyze the shortcomings of smaller than expected bi- and multilateral funding.

⁵ Ongoing analytical work.

⁶ Authorities resort to external nonconcessional debt to cover part of the damages.

Appendix IV. Revenue Modernization in Vanuatu: Building an Effective Tax System¹

Public expenditure is an important tool governments have to achieve economic and social and objectives. Taxes and other revenue are needed to finance quality government expenditure and support the authorities' ambitious development plans that aim to create jobs, raise standards of living and encourage sustainable economic development in Vanuatu.

To provide appropriate government revenues to deliver services that meet the community's needs the Council of Ministers launched a review of Revenue Modernization and Reform—Building an Effective Tax System, in March 2016. Further objectives of the review are to improve the efficiency and fairness of revenue collections and modernize the tax administration. Currently the value added tax (VAT) provides almost 40 percent of total revenues excluding grants. A range of fees and charges are also levied, which are costly to comply with and collect. Tax reform options are being developed by a Revenue Review Project Team with the Director of Finance and Treasury as project team leader and members from the Department of Finance and Treasury, the Prime Minister's Office, the Department of Customs and Inland Revenue, the Vanuatu Chamber of Commerce, the State Law Office and the Law Commission. The tax reform scenarios build on previous IMF advice.

Options for building an effective tax system are evaluated by five guiding principles: (i) appropriate government revenues; (ii) support of economic growth and efficiency; (iii) fairness; (iv) simplicity, certainty and convenience; and (v) transparency and visibility.

In August 2016 the Government issued a press release that Vanuatu will consider the introduction of a personal and corporate income tax. The tax reform proposal also includes:

- Abolishing fees and charges that are costly to collect and comply with to reduce the cost of doing business in Vanuatu; and
- Bringing forward the PACER Plus reductions in import duties over five years to lower the cost of living and the cost of capital to support investment and economic growth.

The top personal marginal income tax rate is proposed to be aligned with the company income tax rate and the recommendation is to have a company income tax rate that is below the rate of neighboring countries. Among comparator countries Fiji has the lowest rate at 20 percent for resident companies and 17 percent for multinational headquarters.

Determining a tax-free threshold, which is the level of annual income below which people do not pay income tax, is important. Vanuatu has a large number of people with home produced and consumed goods, about 70 percent of working people. The tax free threshold should ensure subsistence living is not subject to income tax. However, small changes in the tax-free threshold have large revenue impacts. For example: a tax-free threshold of VT 700,000 annual income would exempt about 84 percent of working people from income taxation; a threshold of VT 600,000 would exempt about 73 percent; and a VT 1 million threshold about 90 percent. Other design issues to consider are the treatment of small businesses,

the level and mechanism for taxing capital income (such as interest, dividends and rent) and the taxation of non-residents.

The modernization of the tax administration is being supported by the development of a risk based compliance improvement strategy and a Strategic and Business Plan. Moreover, a new organizational structure, a governance framework and an overall modernization strategy linked to the implementation of an income tax are being designed. These administration reforms are important, as the administrative challenges in implementing an income tax should not be underestimated.

The introduction of an income tax will have a number of advantages for Vanuatu. It will provide valuable revenue to improve Vanuatu's prospects for sustainable development and better living standards. This revenue should offset any revenue loss from abolishing other small nuisance taxes and import duties. The income tax will also capture income not currently taxed, including ensuring a share of income sourced in Vanuatu but taxed in other countries. An income tax will also align Vanuatu's tax system with standard international practice. While there may be some impact on investment and jobs, it is unlikely to be significant as the proposed low rates will still make Vanuatu internationally competitive.

While an income tax will provide a secure source of funding for quality government expenditure, it will be important to demonstrate accountability and integrity in the use of taxpayer funds to gain public support for the introduction of the tax. Current and planned government programs should be reviewed, and the quality of all government spending should be assessed by three criteria: (i) the effects of government spending programs on economic efficiency, (ii) on equity, and (iii) the provision of safety nets. The focus should be on the provision of essential public services that support sustainable development.

Finally, tax reform is an integral part of the proposed Public Financial Management (PFM) reform. Developing alternative sources of revenue generation was identified as a key priority in a Public Expenditure and Financial Accountability (PEFA) assessment conducted in 2015 as well as integrated and medium-term planning and budgeting processes.

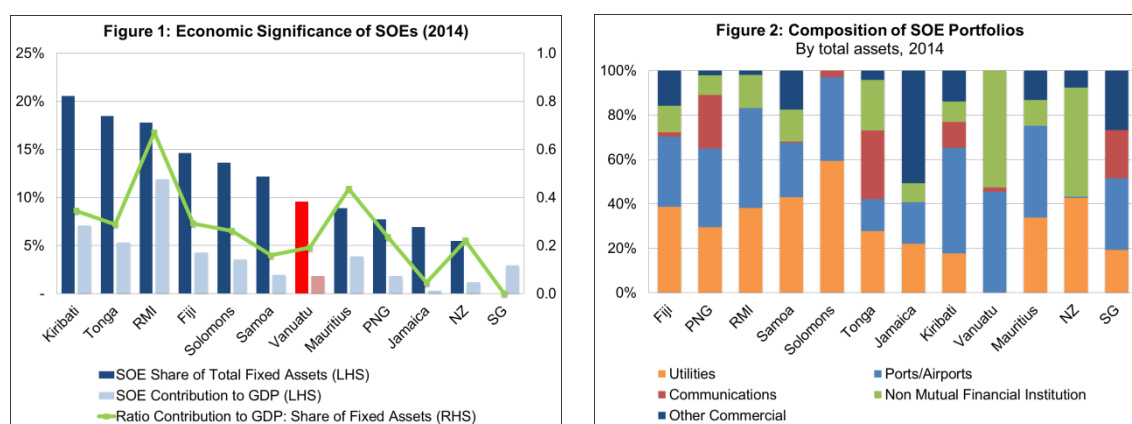
¹ Prepared by Iris Claus, Ron Hackett, Chita Marzan, and Stan Shrosbree (PFTAC).

Appendix V. Benchmarking Government Business Enterprise Performance in Vanuatu¹

Government Business Enterprises (GBEs), referred to locally as commercial government business enterprises, play an important role in the Vanuatu economy. GBEs account for about 8 percent of the total stock of fixed capital and dominate several sectors including banking, broadcasting, postal operations and transport. The GBE portfolio has historically performed poorly and financial performance has been declining in recent years.

Comparison with other small island economies provides a useful benchmark for understanding performance issues and the need for reform. This appendix compares key indicators for Vanuatu's GBE portfolio with other small island economies in the region as well as Jamaica, Mauritius, New Zealand and Singapore.² The analysis focuses on the period 2010-2014. Vanuatu has 11 GBEs. However, only eight are active and regularly producing audited financial accounts.³ The three largest – National Bank of Vanuatu (NBV), Air Vanuatu (Operations) Limited, and Airports Vanuatu Limited (AVL) – accounted for 96 percent of total GBE assets.

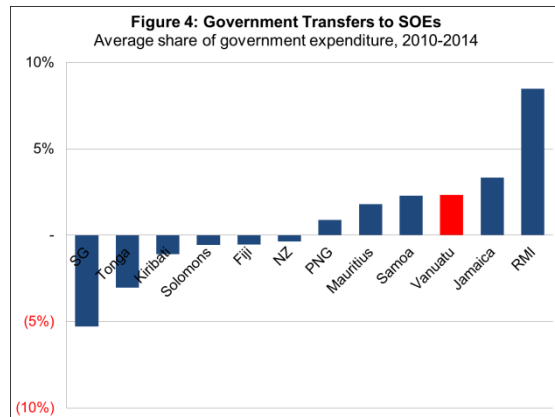
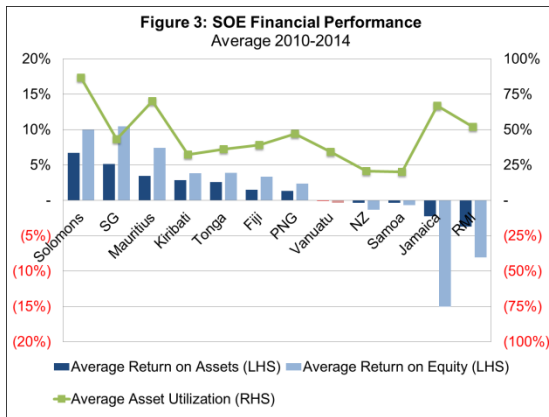
Vanuatu's GBE portfolio is relatively small compared to other countries in the region (Figure 1). This is largely because it has successfully contracted out the provision of water and power services to the private sector. However, the portfolio is relatively concentrated in non-infrastructure, commercially-oriented activities, in particular financial services (Figure 2). This includes the NBV and the Vanuatu Agriculture Development Bank (VADB). Such activities have less strategic justification than infrastructure services and risk crowding-out the private sector and distorting markets. As GBE financial performance tends to compare poorly to the private sector, this suggests a significant productivity cost for the economy. Indeed, GBEs add only 0.24 percent to Vanuatu's GDP for every 1 percent share of the total fixed capital stock they hold.



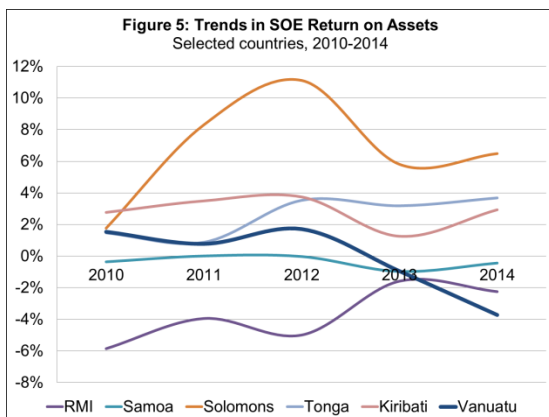
The financial performance of Vanuatu's GBE portfolio, more generally, compares poorly with other countries in the region (Figure 3). During 2010-2014 available financial statements indicate that the portfolio's Return on Assets (ROA) averaged -0.13 percent and Return on Equity averaged -0.39 percent – the second worst performance in the region and far lower than the best performing portfolio, Solomon Islands, which averaged a ROA of 6.7 percent and ROE of 10.0%. Asset utilization, which measures the

efficiency of assets in generating sales, also shows that Vanuatu’s GBE portfolio is amongst the weaker performers.

Reflecting poor financial performance, GBEs represent a significant and ongoing fiscal cost for government. Government transfers to GBEs averaged 2.3 percent of general government expenditure during 2010-2014 (Figure 4). This is the third highest amongst the comparator group, although significantly lower than that in the Republic of Marshall Islands and Jamaica, with large GBE losses in the latter having contributed to macroeconomic concerns. By contrast, a number of countries in the region have been able to realize negative government transfers to GBEs (i.e. dividends).



Unfunded Community Service Obligations (CSOs) are a significant burden for Vanuatu’s GBEs. CSOs involve activities operating on non-commercial or subsidized terms. If not properly contracted and funded, CSOs reduce profitability and undermine efficient management by the GBEs themselves as well as government in pursuing its policy objectives. Air Vanuatu contributed 94 percent of GBE losses during 2008 to 2014, reflecting unfunded CSOs estimated at Vt176 million in 2013 alone and resulting in a Vt1.4 billion loan and a Vt2.2 billion guarantee from the government. In 2016 the government is providing another financing package for Air Vanuatu, to be disbursed in two tranches valued at a total of Vt423 million. The financial performance of NBV has also been declining in recent years due in part to unfunded CSOs for rural outreach, estimated to cost about \$1.7 million in 2014.



Experience in the region shows that reforms to strengthen commercial-orientation and accountability can improve GBE performance, though political will must be sustained through time. Countries that have undertaken the most substantive reforms such as Solomon Islands and Tonga are seeing improvements in financial performance (Figure 5). Moreover, GBE productivity in these countries also appears to have been rising. By contrast, the financial performance of Vanuatu’s GBE portfolio has been declining.

Vanuatu adopted a broad-based GBE reform policy in October 2013 under the Cabinet at the time however implementation has been weak. For instance, an GBE Monitoring Unit has been formally established but remains under-resourced. An GBE minister is yet to be appointed and sector ministers continue to be responsible for GBEs in their portfolio. In 2011 parliament passed a bill to liquidate the Vanuatu Commodities Marketing Board but so far there has been no action. An GBE Bill based on the 2013 policy has been prepared and is planned to be submitted to government during 2016. Passage and implementation of the GBE Bill would provide a solid foundation for improving GBE performance, in particular by requiring GBEs to generate profits to cover their cost of capital, putting in place a framework for funding CSOs, and prohibiting the appointment of civil servants and elected officials to GBE boards.

¹ Prepared by Roland Rajah (Asian Development Bank). Based on *Finding Balance: Benchmarking the Performance of State-Owned Enterprises in Island Countries* (ADB, forthcoming).

² These countries are included in the analysis for comparative purposes: Jamaica and Mauritius as developing small island economies from outside the region and New Zealand and Singapore as developed country benchmarks.

³ Vanuatu Post Limited is included in the analysis however it has not produced accounts for 2014 and its 2013 statements remain unaudited. Vanuatu Post Limited accounted for 8% of total GBE assets in 2013. Available financial statements show it recorded positive profits from 2008 to 2013.

Appendix VI. Monetary Policy Framework in Vanuatu¹

The primary monetary policy objectives of the Reserve Bank of Vanuatu (RBV) is to promote monetary stability (Reserve Bank Act (1980)). Monetary stability is defined as a stable value of money both at the domestic level (price stability) and at the external level (exchange rate stability). The RBV aims to achieve this ultimate objective by: (i) maintaining low and stable inflation rate with CPI-based headline inflation within 0 to 4 percent per annum, and (ii) maintaining a sufficient level of official foreign exchange reserves at a minimum of 4 months of import cover.

The monetary policy instruments of the RBV have evolved from rule-based instruments (reserve requirements and standing facilities) to a more market-based instrument (money market operations). Since 1998, monetary policy has been mainly conducted by open market operations in RBV notes, supplemented by the Statutory Reserve Deposit (SRD) and two standing facilities:

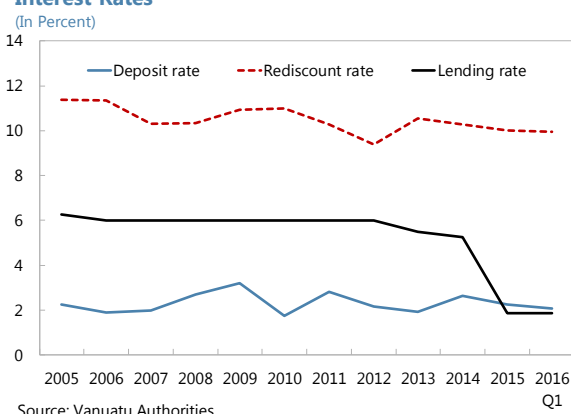
- **RBV Notes through Open Market Operations (OMO).** The Reserve Bank issues RBV notes with various maturities up to 91 days and auctions them regularly through a variable-rate tender system to absorb excess liquidity that is not bound by SRD requirements. The amount of RBV notes to be issued at each auction is determined to achieve a desired level of money supply consistent with the projected demand for liquidity in the financial system.
- **Statutory Reserve Deposit (SRD).** The SRD, or reserve requirements, requires banks to maintain currently 5 percent of deposits at the central bank which was reduced from 7 percent after Cyclone Pam in March 2015. The SRD is calculated on a monthly average basis and applies to all demand, time, and saving deposits in domestic currency as well as to 50 percent of demand deposits in foreign currency. The RBV does not use the SRD (but rather, OMO) for short-term liquidity management.
- **Standing Facilities.** The RBV can provide temporary liquidity to banks through the Rediscount Facility and Repurchase Facility. The rediscount rate applies to these operations.
- **Rediscount Rate.** The rediscount rate is the RBV's official or policy rate. However, under the monetary aggregate targeting, the RBV does not conduct OMO to influence market rates to move towards the rediscount rate. In addition, given the high structural excess liquidity in the financial system, the rediscount window has been rarely used in the past. Hence, the rediscount rate—and similarly the interbank rate—has not changed much over time and it may only serve as a signaling device regarding the RBV's monetary policy stance. However, after Cyclone Pam the rediscount rate was reduced from 5.5 percent to be tied to RBV's 91-day bill rate (1.85 percent in March 2015). In May 2016, the rediscount rate was adjusted to "RBV's 91-day bill rate (1.85 percent in May 2016) + 1 percent".

The operational policy target for OMO is the volume of banks' excess reserves based on short-term liquidity projections. The implementation of monetary policy is carried out by the Financial Markets Department of the RBV. As discussed above, the RBV relies largely on OMO as a main instrument to fine tune the level of liquidity in the domestic financial system. Since its introduction, the RBV's OMO has been partially successful in absorbing excess liquidity from the system (IMF, 2004).² Although participation has been broadened by allowing nonbanks to participate in the auctions of RBV notes, there has not been

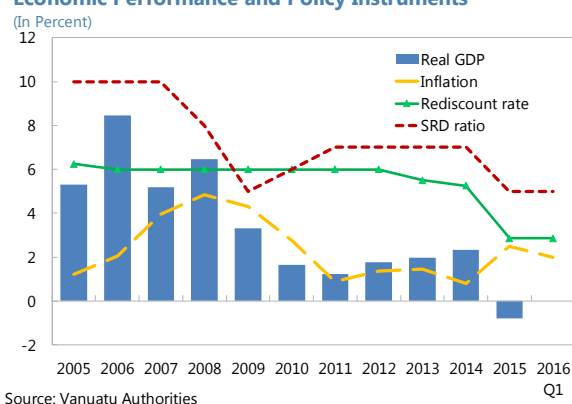
actual participation of nonbanks yet because the payment system is not ready to settle the transactions by nonbanks.

The ability of monetary policy to effectively control domestic monetary conditions is limited in Vanuatu due to its highly open economy and fixed exchange rate regime, shallow financial markets, and limited financial access in the overall economy. Movements in the policy rate hardly have an effect on interest rates in the economy, and no policy instruments seem to play an important role in output and inflation dynamics. Recent studies find that monetary policy transmission in Vanuatu is generally weak especially through traditional interest rate and credit channels (Hililan, 2013, Yang et. al, 2011, and Jayaraman, 2009).³ The existing policy instruments do not seem to operate coherently or to be consistent with any objective, partly reflecting the multiple objectives including price stability and financial system stability that the RBV aims to achieve with monetary policy tools. Although the current framework has served the country well by delivering low inflation and adequate foreign exchange reserves, it has been evident that monetary policy transmission is generally weak and monetary policy has limited ability to control domestic monetary conditions. Further financial deepening, more clear description of the monetary policy objectives, a coherent usage of the existing monetary instruments with a clear understanding of the transmission mechanism, would allow for more flexible monetary policy framework and to enhance the effectiveness of monetary policy in responding to liquidity shocks.

Interest Rates



Economic Performance and Policy Instruments



¹ Prepared by Dongyeol Lee (APD) and Nasha Ananchotikul (Bank of Thailand).

² IMF (2004), "Monetary Policy Implementation at Different Stages of Market Development," IMF Occasional Paper No. 244.

³ Hililan, Michael Samuel (2013), "Monetary Policy Transmission Mechanism in Vanuatu," University of Wollongong; Yang, Yongzheng, Matt Davies, Shengzu Wang, Jonathan Dunn, and Yiqun Wu (2011), "Monetary Policy Transmission Mechanisms in Pacific Island Countries," IMF Working Paper No. 11/96; Jayaraman, T.K. and Chee-Keong Choong (2009), "Monetary Policy Transmission Mechanism in Vanuatu," University of the South Pacific.

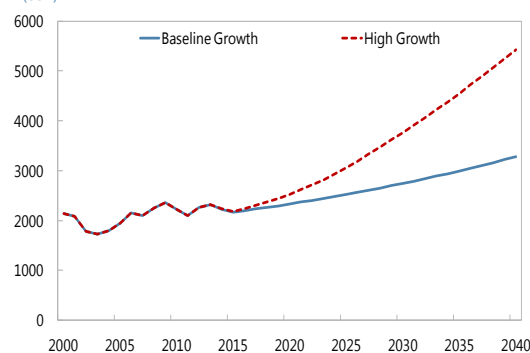
Appendix VII. Possible Benefits from Increased Labor Mobility¹

The ability to access external labor markets varies significantly across the Pacific. Some countries in the Pacific have free labor market access to the United States and New Zealand. Others have historically had high levels of labor mobility. Vanuatu, along with its Melanesian neighbors, Papua New Guinea and Solomon Islands, has among the lowest rates of outward migration in the world. These three 'low mobility' countries account for just 5 percent of the stock of Pacific migrants living in OECD countries, despite making up approximately 85 percent of the region's population.

As a part of its Pacific Possible report, the World Bank is examining what possible benefits could be obtained by Vanuatu and other Pacific countries over the next 25 years if both sending and receiving countries were to significantly alter their existing policies and practices on labor migration. Key reforms for receiving countries proposed in Pacific Possible include: expanding access through existing migration pathways, such as the seasonal worker schemes and the working holiday maker programs; opening up access to new labor markets, such as Korea via its Employment Permit System; providing access to new sectors, like aged care, through programs tailored for the Pacific; and expanding opportunities for permanent migration, especially for the 'low mobility' countries and atoll island states most impacted by climate change. Expanding access to the lower-skilled entry pathways in Australia and New Zealand is likely to prove most promising in the immediate term, and would allow Vanuatu to build on its current strong performance in the seasonal worker schemes. Vanuatu itself could also do more to develop appropriate education and training policies, which will help manage the risks from 'brain drain'; market its workers more effectively; and introduce measures to manage the negative social impacts of labor mobility.

If Vanuatu and the receiving countries were able to implement these reforms, the potential gains are significant. Estimates indicate that the stock of ni-Vanuatu migrants could increase from 2,280 in 2013 to 23,000 by 2040. This would generate an additional USD43 million in remittances. Evidence from a multi-year impact evaluation of seasonal workers in Vanuatu suggests that these remittances will have sizeable poverty impacts for those that remain at home, with participating households experiencing a 34 to 38 percent increase in per capita income (Gibson & McKenzie 2010). However, the largest gains would be for the migrants themselves who would benefit from critical employment opportunities and increase their incomes. To capture these benefits, a new measure for the economic impacts of migration has been developed, Gross National Income Plus (GNI+), which includes GNI as well as the income earned by longer-term migrants living abroad. Using this indicator, the per capita gains for Vanuatu through to 2040 could be around USD2,000, relative to a business-as-usual baseline. The findings suggest that labor mobility will prove critical in addressing Vanuatu's unemployment challenge and raising living standards in the face of limited domestic growth.

Vanuatu GNI+ Per Capita, 2000-2040
(USD)

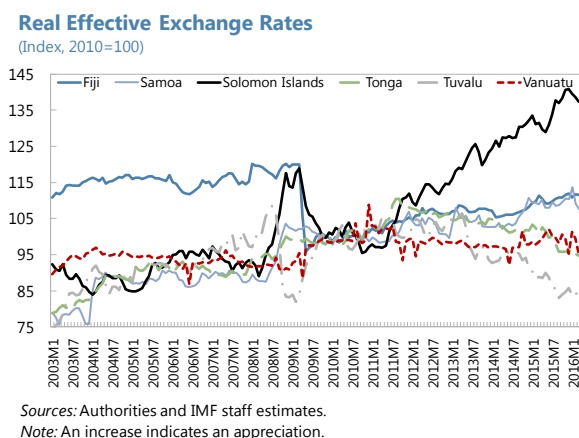
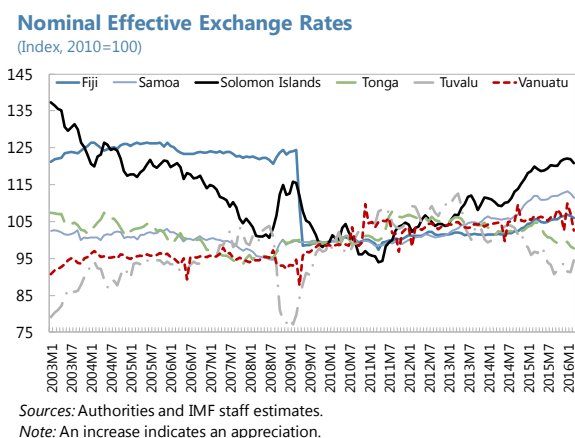
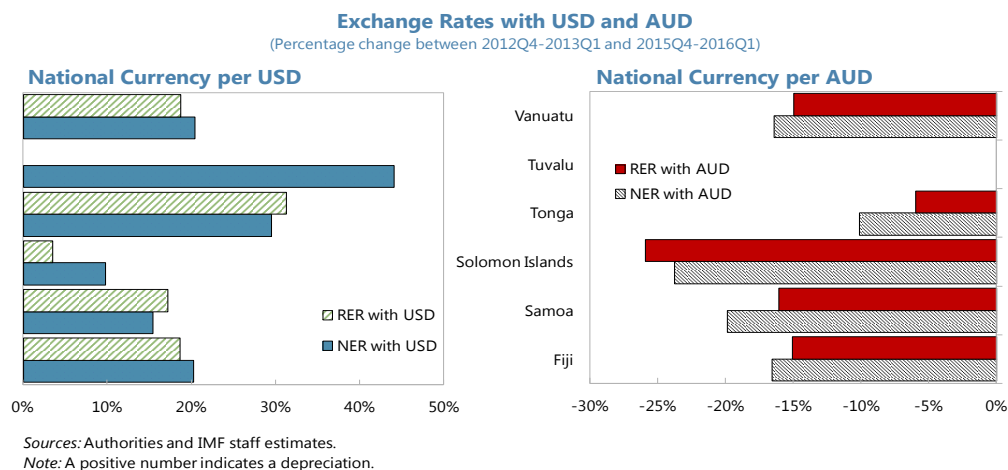


Source: World Bank and Australian National University (2016)

¹ Prepared by Jesse Doyle (World Bank), based on *Pacific Possible: Labour Mobility* (World Bank and Australian National University, 2016).

Appendix VIII. Exchange Rate Issues: Competitors and Sectors¹

Diverging exchange rate fluctuations with main trading partners' currencies is not exclusive to Vanuatu. Most other Pacific Island Countries (PICs), which are key competitors in the tourism industry, have also experienced some appreciation of their currency against the AUD and some depreciation against to USD—thus relative price competitiveness of Vanuatu as a tourist destination should still be preserved. Despite its cyclical volatility and as opposed to some of its neighbors, Vanuatu's REER seems to be broadly consistent across time.

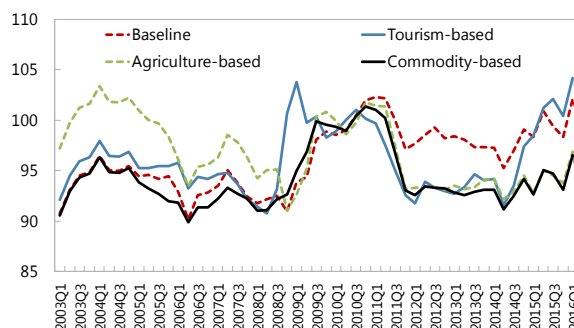


Sectors are being affected differently depending on the predominant foreign currency in use and some may experience a price competitiveness loss. Since Australia accounts for about 59 percent of tourist arrivals (over the 2005–2015 period) and the majority of foreign aid, the vatu's appreciation against the AUD could adversely affect the tourism sector and the value of aid flows. So far, the price elasticity of demand for tourism suggests a low sensitivity to nominal fluctuations with tourist arrivals steadily bouncing back after the airport's runway repairs and the reopening of hotels and resorts.² Agricultural exports, on the other hand, are spread across Australia (18 percent, over the 2010–2015 period) and several other Asian countries (Philippines, Malaysia, Japan, New Caledonia, Fiji, and Papua New Guinea accounted for an additional 56 percent) and may be more insulated against the recent nominal fluctuations.

A sectoral decomposition of the REER can help understand some of the discrepancies and competitiveness challenges faced by certain sectors.³ To assess price competitiveness in a specific sector, weights of the REER can reflect sectoral trade flows and inflation can be expressed in terms of a subset of its components. With data availability as a constraint, we compute alternative specifications of the REER assuming weights are implied by tourism receipts, agriculture exports, and commodity (oil and agriculture) imports. The tourism sector has faced the largest price competitiveness loss since 2014, while agriculture producers were less concerned by exchange rate fluctuations than what the baseline REER suggests. The high import content of production and consumption in a small island state like Vanuatu implies, however, that import prices matter. The commodity-based REER suggests that the recent nominal fluctuations have not affected producers and consumers alike with no major price competitiveness loss.⁴

Real effective exchange rates

(Index, 2010 = 100)



Sources: Authorities and IMF staff estimates.
Notes: An increase indicates an appreciation.

¹ Prepared by Ricardo Marto (RES).

² Tourist arrivals from Australia and New Zealand have had an historical seasonality, peaking in the third quarter of the year and dipping in the first quarter.

³ The REER is a function of a weighted average of indexed nominal bilateral exchange rates and inflation differentials. There are several measures of aggregate price fluctuations, such as the consumer price index, wholesale or producer price index, GDP deflator, or unit labor costs, and weights can be underpinned by trade flows in goods or goods and services. For the baseline scenario, inflation differentials are based on consumer price indices and weights in Vanuatu's effective exchange rates are based on the 2004-2006 trade flows.

⁴ After abandoning its peg to the SDR in 1988, the Reserve Bank of Vanuatu determines the value of the vatu on the basis of an undisclosed transaction-weighted basket of currencies. Solomon Islands does not disclose the basket composition of its pegged exchange rate regime, while the currencies of Samoa and Tonga are anchored on announced foreign exchange (U.S. dollar, Australian dollar, New Zealand dollar, Euro (Only Samoa), Fiji dollar (only Tonga)).



VANUATU

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION —INFORMATIONAL ANNEX

September 22, 2016

Prepared By

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

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FUND RELATIONS

(As of August 31, 2016)

Membership Status: joined September 28, 1981; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	23.80	100.00
Fund holdings of currency	28.11	118.09
Reserves tranche position	4.20	17.63

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	16.27	100.00
Holdings	1.37	8.43

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	8.50	35.71
Emergency Assistance ^{1/}	8.50	35.71

^{1/} Emergency Assistance may include ENDA, EPCA, and RFI.

Latest Financial Arrangements: None

Projected Payments to the Fund ^{2/}

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

	Forthcoming				
	2016	2017	2018	2019	2020
Principal			2.13	4.25	2.98
Charges/Interest	0.05	0.10	0.01	0.01	0.01
Total	0.05	0.10	0.01	0.01	0.01

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

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative: Not applicable

Implementation of 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 August 31, 2016 was VT 108.72 per U.S. dollar. The de facto classification is “other managed,” as the composite weights are not disclosed and cannot be confirmed. Vanuatu has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

Article IV Consultation

Vanuatu is on a 12-month consultation cycle. The previous Article IV consultation mission took place during April 15-28, 2015 and the consultation was concluded on June 5, 2015 (Country Report No. 15/149).

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 11 technical assistance missions between May 2015 and June 2016 on the financial programming framework, national accounts for revenue forecasting, anti-money laundering, post natural disaster banking supervision strategy, reserve management, external sector statistics, public financial management, PEFA self-assessment, and national accounts monitoring and forecasting.

Purpose	Date	Department
Workshop on Practical Applications of the Financial Programming Framework	May 21-Jun. 3, 2015	PFTAC
PEFA Self-Assessment	Jun. 1-12, 2015	PFTAC
Post-Natural Disaster Banking Sector Supervision Strategy	Jun. 9-12, 2015	PFTAC
External Sector Statistics	Jul. 27-Aug. 7, 2015	STA
Government Finance Statistics	Oct. 5-16, 2015	STA
External Sector Statistics	Oct. 26-Nov. 6, 2015	STA
Develop GDP forecasting and Monitoring Methodology	Oct. 26-30, 2015	PFTAC
Reserve Management	Oct. 28–Nov. 10, 2015	MCM
PFM Reform Roadmap	Apr. 1-8, 2016	PFTAC
Vanuatu Financial Programming Framework and a National Framework for Revenue Forecasting	Mar. 7-18, 2016	PFTAC
Empirical Analysis of Tax Reform Options Using the Model of the Vanuatu Economy	May 8-22, 2016	PFTAC

Resident Representative

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

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)

(As of August 2016)

Economic Statistics

During 2010 and 2011 PFTAC assisted with the upgrading of government finance statistics to the 2001 GFS Manual and the authorities have been supplying data regularly to STA. A GFS mission is scheduled for September 2016. The Vanuatu National Statistics Office has benefited from four national accounts TA missions since 2012 (most recently in August 2016) and attendance at annual sub-regional workshops. TA has particularly focused on rebasing GDP to 2010 and the development of quarterly GDP estimates, though both remain incomplete due capacity issues. Rebasing is the priority and work is expected to resume in early 2017.

Public Financial Management

Vanuatu has regularly sent officials to PFTAC-sponsored regional training events. During FY2015 and 2016, missions were conducted to prepare authorities for a review of non-tax revenues; assist with risk-based planning and other business processes for internal audit, including on the use of the audit software TeamMate, a guided PEFA self-assessment and development of a framework for formulating a PFM Reform Roadmap. Follow-up TA is planned in FY17 to continue the internal audit reform and formulation of a PFM Reform Roadmap.

Macroeconomics

In the macroeconomic area, PFTAC has provided assistance to the Reserve Bank of Vanuatu (RBV) in developing a Model Of the Vanuatu Economy (MOVE). The MOVE, which generates medium-term projections within an internally consistent macroeconomic and fiscal framework, is being used by the Ministry of Finance and Economic Management (MFEM) to inform a review of Vanuatu's tax system. In addition, staff members from the Office of the Prime Minister and MFEM participated in regional workshops, co-hosted by the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) Pacific Office and the Pacific Islands Tax Administrators Association (PITAA), on government expenditure and revenue forecasting.

Tax Administration

Supported by PFTAC, Vanuatu has made steady progress over the last few years which has included: (a) the development of a new strategic and business plan; (b) a risk-based compliance improvement strategy; (c) implementation of performance standards; and (d) the development of an IT strategy followed by the implementation of an IT system that has facilitated taxpayer compliance. A Revenue Review Governance Committee and Project Team, recently appointed by Vanuatu's MFEM, has been tasked with drafting a framework for modernizing Vanuatu's tax system and includes two main deliverables: (a) a review of the current tax policy regime and exploration of the possibility of introducing an Income Tax (as previously recommended by the IMF); and (b) a review of the current

organizational structure and governance arrangements which PFTAC supported through a recent technical assistance mission.

Financial Supervision

In FY2016 PFTAC conducted a series of technical assistance missions involving on-site examination of banks and revisions of the Credit Union Act and oversight capacity building. The Reserve Bank of Vanuatu indicated that those sectors were a priority for technical support. In addition, in June 2015, the PFTAC Financial Supervision advisor visited Vanuatu to advise on implementation of a post-natural disaster (Cyclone Pam) banking sector recovery strategy, as well as to draw lessons from Vanuatu's experience for other PFTAC members.

BANK–FUND COUNTRY TEAM CONSULTATIONS

(As of August 2016)

Representatives of the World Bank accompanied the IMF team on the Article IV mission to Vanuatu (July 13-26, 2016) and participated in discussions with the Government of Vanuatu. The Bank and Fund country teams also exchanged views on the main macroeconomic issues facing Vanuatu and appropriate policy responses.

Fiscal Issues

The teams agreed that careful fiscal planning will be required to finance necessary development expenditure (including Cyclone Pam-related reconstruction spending) while at the same time ensuring debt sustainability. Where possible, the authorities should seek external financing on grant or highly concessional credit terms. The authorities should also aim to rebuild fiscal buffers over the medium term, including by taking steps to increase domestic revenues through the introduction of income and corporate taxes. The teams agreed that formulating an infrastructure investment plan in line with national priorities, and ensuring discipline and allocative efficiency in public expenditure more generally, will be important in responding to fiscal challenges.

Public Investment

The scaling up of investments in infrastructure should be complemented with broad reforms aimed at enhancing the business environment, promoting tourism (including in newer long-haul markets), and improving the resilience, consistency and quality of agricultural output. The teams welcomed efforts to strengthen institutions for climate change adaptation and disaster risk management, including by strengthening early warning systems. Both teams noted the importance of promoting inclusive growth, which will be supported by government strategies to ensure the widespread provision of basic services and employment opportunities, particularly in the less-populated islands.

Exchange Rate and AML/CFT Issues

The teams agreed that the vatu peg to a basket of currencies has served Vanuatu well and should be maintained, given the importance of exchange rate stability for maintaining confidence. Both the IMF and the Bank welcomed the government commitment to address current deficiencies in controls on anti-money laundering and combating the financing of terrorism.

Collaboration

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 that the Fund make available to the Bank its latest macroeconomic assessments and macroeconomic data from time to time, as inputs to the Bank's lending and non-lending operations.

Further details on collaboration, as necessary, will be agreed at the technical level as work progresses. Table 1 details the specific activities planned by the two country teams over the next year, along with their expected deliverables.

Table 1 Vanuatu: Bank and Fund Planned Activities in Macro-critical Structural Reform Areas (August 2016–July 2017)		
	Products	Expected Delivery Date
Bank Work Program	<ul style="list-style-type: none"> • Support improvements in the operational safety and oversight of international air transport and associated infrastructure in Vanuatu, including rehabilitation and works at Bauerfield International Airport. Support for emergency reconstruction to repair cyclone-related damage to airports. • Support the reconstruction and improved disaster resilience of selected public sector assets in provinces affected by TC Pam, including roads, schools, and other public buildings. • Support increased access to electricity services in and around Port Vila, as well as for rural and lower-income households. Technical assistance on the government's energy sector work program. • Assist in increasing the resilience of communities in Vanuatu to the impacts of climate change and natural hazards on food and water security, including through strengthened disaster risk management and preparedness. • Support regulatory reform in telecoms and ICT. • Technical assistance to improve public financial management and identify the appropriate level and mix of financing in the health sector. • Technical assistance for public debt management (building on the Debt Management and Performance Assessment conducted in 2014, and the Medium Term Debt Strategy supported in 2015). 	Ongoing From mid-2016 Ongoing Ongoing Ongoing Ongoing From late-2016
Fund Work Program	<ul style="list-style-type: none"> • Surveillance (Article IV consultation mission), including a joint debt sustainability analysis • Technical assistance on improvement of national accounts statistics and rebasing (PFTAC). • Technical assistance on developing comprehensive tax reform strategy, legislation, and implementation. 	October 2016 August 2016-2017 Late 2016

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of August 2016)

Operational Strategy

The Asian Development Bank's (ADB's) Country Operations Business Plan for 2016–2018 is aligned with the government's Priorities and Action Agenda and aims to assist the government 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 improving urban infrastructure with a particular focus on Port Vila; and (iii) energy—by rural electrification and renewable energy sources. Consistent with the government's strategy of fostering private sector-led growth, ADB also focuses on improving the enabling environment for the private sector through improving access to financial services, reforming business laws, and supporting state-owned enterprise (SOE) reform.

ADB's indicative allocation to Vanuatu of Asian Development Fund loan and grant resources for 2017–2019 has been set at USD37.29 million, including USD9.73 million in disaster risk reduction financing. In addition to this, ADB will also provide on average approximately USD500,000 per annum in technical assistance (TA) grant support. To leverage ADB's impact and reduce borrowing costs, co-financing opportunities will be pursued with other development partners.

Portfolio Status

Since joining ADB in 1981, 14 loans have been provided to Vanuatu for a total amount of USD89.36 million, 9 grants totaling USD66.74 million, and 62 TA projects totaling USD22.45 million. More than 50 percent of the loans and TA projects were for the transport sector. 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 (USD52.12 million), co-financed by the Government of New Zealand, and the Port Villa Urban Development Project (USD39.10 million), co-financed by the Government of Australia.

There are three ongoing TA projects amounting to USD1.13 million: TA 8724-VAN: Supporting the Preparation of the National Sustainable Development Plan; TA 7938-VAN: Establishment of the Maritime Safety Administration; and TA 9073-VAN: Institutional Strengthening for Environmental Safeguards in Vanuatu.

Interisland Shipping Support Project

The aim of this project is to improve the efficiency and effectiveness of interisland shipping services through provision of an integrated package of assistance. It comprises two major components: (i) infrastructure investments in the capital of Port Vila and five outer islands, and (ii) establishment of a shipping support scheme to catalyze the provision of services to remote noncommercial destinations. The project is complemented by associated TA to improve sector governance through institutional strengthening and legal and regulatory reforms, and by project management services. ADB is providing a loan of USD29.30 million, the Government of New Zealand a parallel grant of USD17.25 million, and the Government of Vanuatu USD5.57 million.

Port Vila Urban Development Project

The aim of this project is to improve drainage, roads, and sanitation systems in greater Port Vila municipality and adjacent urban and peri-urban areas in the Shefa province. The project is implementing the recommendations of the drainage and sanitation master plan prepared through a project preparatory TA, which identified priority interventions for improved access to, and delivery of drainage and sanitation services to the residents of Port Vila. It is supporting affordable, sustainable, and effective sanitation, roads, and storm water drainage services, and is contributing to climate resilient and sustainable urban development in and around Port Vila. ADB is providing a loan of USD5.0 million and administering the corresponding grant of USD31.0 million from the Government of Australia. The Government of Vanuatu is providing a contribution of USD3.1 million.

Private Sector Development

Private sector development in Vanuatu is supported through the Pacific Private Sector Development Initiative (PSDI). PSDI is a regional technical assistance facility cofinanced by the Government of Australia, the Government of New Zealand, and ADB. PSDI works with Pacific developing member countries to improve the enabling environment for business and support inclusive, private sector-led economic growth. ADB's support under PSDI focuses on (i) improving access to financial services; (ii) business law reform; and (iii) state-owned enterprise reform.

- **Improving Access to Financial Services.** ADB supported the secured transactions framework reform through the drafting and passage of the Personal Property Securities Act, and the installation, and later upgrade, of an electronic registry to record the filing of security interests.
- **Business Law Reform.** ADB assistance has focused on drafting a new Companies Act, a new Companies (Insolvency and Receiverships) Act, and a new Insolvency (Cross Border) Act. Support was also provided for online companies, business names, and charitable associations registry.
- **State-Owned Enterprise Reform.** ADB supported preparation of an SOE reform policy, approved by Cabinet in October 2013, and the subsequent drafting of SOE legislation. ADB has also been working with several SOEs on reform and rationalization strategies, including recommending liquidation where appropriate.

Cyclone Response

Following Tropical Cyclone Pam in March 2015, ADB's immediate support to the government consisted of (i) the approval of USD1.0 million grant financing from the Asia Pacific Disaster Response Fund, and (ii) deployment of urban and infrastructure specialists to Port Vila to provide assistance. This was followed by the approval of two cyclone recovery projects for the reconstruction of Vanuatu's roads and schools.

Proposed Pipeline Projects

ADB's forward pipeline includes a proposed Energy Access Project that will support increased energy access to households and businesses in the provincial centers of Vanuatu through expansion of existing distribution grids and the development of low-cost renewable energy generation from hydropower.

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An urban development project for Luganville and a second phase of the Port Vila Urban Development Project are also proposed. Vanuatu's participation in regional projects for tourism and agribusiness financing are being discussed with the government.

ADB–World Bank Joint Development Coordination Office

An ADB–World Bank joint Development Coordination Office was opened in June 2010 in Port Vila. The shared field presence has improved ADB's responsiveness to the development needs of Vanuatu and supports aid coordination and aid effectiveness. In 2016, the office will be upgraded to become the Vanuatu Extended Mission, strengthening ADB's presence on the ground.

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

General: Data provision has shortcomings, but is broadly adequate for surveillance. In particular, national accounts and external sector statistics need to be further improved, while the coverage of government finance statistics could be expanded. Reporting lags could be shortened.

National accounts: While there have been improvements in methodology and the development of additional data sources, the accuracy of the recently-released, experimental expenditure-based GDP estimates could be further improved. Data are compiled only on an annual basis. Due to recent staff changes in Vanuatu National Statistics Office, there may be delays in 2015 GDP release. PFTAC is providing technical assistance in national accounts compilation, including rebasing the constant price GDP estimates using 2010 as the new base year, 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. Rebasing the CPI to a more recent base year may start after a new Household Income and Expenditure Survey in 2017.

Government finance statistics: Budget classification is broadly consistent with the *GFSM2001*. Work is underway to migrate budget classification to *GFSM2014*. Government operations data are compiled for the central government only and 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 (RBV) reports monthly monetary data, including the accounts of the monetary authorities and commercial banks (only in aggregate), and the distribution of loans by sector 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 key financial soundness indicators. Information on financial access is sparse, and could be usefully expanded to allow for better assessment of financial inclusiveness and monetary policy transmission.

External sector statistics: The RBV releases quarterly BOP data in its Quarterly Economic Review. A special Debt Unit has been created within the Ministry of Finance for public debt management and recording in 2015; however, the recording and management of public debt needs further improvement. Two external sector statistics missions visited Vanuatu in the second half of 2015 to assist the authorities in improving the collection and reporting of external debt and external sector statistics.

II. Data Standards and Quality

Participant in the General Data Dissemination System (GDDS) since April 2004.

No data ROSC is available.

Vanuatu: Table of Common Indicators Required for Surveillance

(As of August 2016)

	Date of latest Observation	Date Received	Frequency of Data ¹	Frequency of Reporting ¹	Frequency of Publication ¹
Exchange Rates	4/2016	8/2016	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary ²	3/2016	6/2016	M	M	M
Reserve/Base Money	3/2016	6/2016	M	M	M
Broad Money	3/2016	6/2016	M	M	M
Central Bank Balance Sheet	3/2016	6/2016	M	M	M
Consolidated Balance Sheet of the Banking System	3/2016	6/2016	M	M	M
Interest Rates ³	3/2016	6/2016	Q	Q	Q
Consumer Price Index	3/2016	5/2016	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing ⁴ —General	N/A	N/A	N/A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing ⁴ —Central	5/2016	7/2016	M	M	M
Stocks of Central Government and Central Government-Guaranteed ⁵	2015	5/2016	A	A	A
External Current Account Balance	3/2016	6/2016	Q	Q	Q
Exports and Imports of Goods and Services	3/2016	6/2016	Q	Q	Q
GDP/GNP	2014	3/2015	A	A	A
Gross External Debt	12/2015	4/2016	Q	Q	Q
International Investment Position	3/2016	6/2016	Q	Q	Q

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

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

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

⁴ Foreign and domestic financing.

⁵ Includes external gross financial asset and liability positions vis-à-vis nonresidents.



VANUATU

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION —DEBT SUSTAINABILITY ANALYSIS

September 22, 2016

Approved By
**Luc Everaert and Peter
Allum (IMF) and John
Panzer (IDA)**

Prepared by the Staff of the International Monetary Fund and the International Development Association (IDA).

This update of the debt sustainability analysis (DSA) shows that Vanuatu's risk rating for debt distress remains moderate, since the evolution of debt indicators remains similar to that obtained in the 2015 DSA. The level of public debt began to rise in 2015 and will continue to increase over the next few years due to the implementation of major public infrastructure projects and reconstruction activities. This is expected to be manageable provided that the financing terms are concessional and the surge in financing needs is temporary. Nonetheless, repayment obligations will likely put pressure on the economy and will require fiscal adjustment over the medium term. The DSA has been extended to include an alternative scenario of a Cyclone Pam-like natural disaster within 5 years, under which debt sustainability deteriorates in the aftermath of the event. The authorities are recommended to pursue prudent fiscal policies, including spending reprioritization and tax reform implementation, and seek grant financing for infrastructure investments in the next few years to ensure debt sustainability over the medium term.

BACKGROUND

1. **Vanuatu is recovering from Cyclone Pam that hit the country in March 2015.** The damages from Cyclone Pam had a smaller-than-expected effect on growth, thanks to the resilience of Vanuatu's economy and the swift response from the international community. A number of infrastructure projects started their construction phase after Cyclone Pam, with the bulk of spending boosting public external debt.
2. **In 2015, the face values of external and total public debt, as well as total (public and private) external debt increased steeply.** The country's rapid debt accumulation was attributed to disbursements for infrastructure projects and the IMF's funding support through the Rapid Credit Facility (RCF) and Rapid Financing Instrument (RFI). Total central government debt rose to 25.6 percent of GDP and external public debt increased to 17.9 percent of GDP. Total external debt stood at 34.1 percent of GDP. Due to data limitations, external liabilities of commercial banks are used as a proxy for private external debt.
3. **At the end of 2015, central government domestic debt was estimated at 7.7 percent of GDP.** It constitutes 23.2 percent of total debt and consists of government bonds placed with the Reserve Bank of Vanuatu, commercial banks and other financial institutions (primarily the Vanuatu National Provident Fund).
4. **Vanuatu's public external debt is mostly concessional (17.9 percent of GDP).** It has been contracted from multilateral lenders (IMF, EIB, WB-IDA and ADB) and via bilateral agreements (China Ex-Im Bank). Typically, the nominal interest rates on these instruments (except for China Ex-Im Bank) are fairly low (0-2 percent) and loan maturity is long (20-40 years), which reflects a relatively high grant element of the debt and a low debt service.

METHODOLOGY AND ASSUMPTIONS

5. **The DSA is produced using data provided by the authorities and estimates from IMF and World Bank staff.** The DSA framework uses a discount rate of 5 percent. Total public debt includes central government debt, publicly guaranteed debt by Government Business Enterprises (GBEs), and the Fund's RCF/RFI to Reserve Bank of Vanuatu.
6. **The following are the key macroeconomic assumptions under the baseline scenario:**
 - *GDP growth.* The economy continues to recover from Cyclone Pam despite some delays due to political uncertainty in the second half of 2015 and airport runway safety issues in early 2016. GDP is projected to increase by 4 percent in 2016, and accelerate to 4.5 percent in 2017 as infrastructure projects and reconstruction gain speed. In the period 2016–2021, growth is expected to average 3.3 percent, supported mainly by public investment, tourism, and agricultural exports. Long-term growth is maintained at 3 percent.

- *Fiscal balance.* The primary balance is projected to be negative at 9.7 percent of GDP in 2016 before widening to -16.2 percent of GDP in 2017, reflecting increases in expenditures due to Cyclone Pam reconstruction and infrastructure projects. We assume a gradual improvement of the fiscal balance to -4.2 percent of GDP in 2021.
- *Capital expenditures.* Many planned public investment projects began in 2015. The road and school reconstruction projects financed by the ADB and the WB are expected to start in 2017. Public capital expenditures are estimated to peak at 12.6 percent of GDP in 2017 and decline to 2.6 percent (close to historical values) in 2021. New external borrowing is expected from the ADB, WB, JICA (with concessional terms), and the China Ex-Im Bank.
- *Imports and exports.* We assume that imports-to-GDP ratio continues above 40 percent of GDP through 2015 to 2017 driven by the high import content of reconstruction and projects (around 30 percent before the cyclone). At the same time, we expect exports to increase to 7.8 percent of GDP in 2016 and to 8.3 percent of GDP in 2017 as recovery is underway for tourism and major agricultural exports.
- *Inflation.* Inflation is projected at 2.2 percent in 2016. We assume a further increase to 2.5 percent in 2017 due to demand pressures from reconstruction activities and infrastructure projects, and a gradual increase to 3 percent by 2019.

Key Assumptions

	Baseline		Historical Avg. (2005-14)	2015 DSA	
	2016-21	2022-36		2015-2020	2021-2035
Real GDP growth (percent)	3.7	3.0	3.2	2.7	3.0
Growth of exports of goods and services (US dollar terms)	6.0	6.6	6.7	6.6	6.0
Non-interest current account balance (in percent of GDP)	-12.8	-1.0	-6.0	-14.5	-4.0
GDP deflator growth (U.S. dollar terms; percent)	2.5	2.9	3.5	1.7	2.9
Primary balance (in percent of GDP)	-9.4	-0.1	-0.2	-7.5	0.0

EXTERNAL DEBT SUSTAINABILITY

7. The baseline scenario indicates that the external debt of Vanuatu remains sustainable. All external debt ratios stay below the thresholds over the projection periods. Under the baseline, the face value of external public and publicly-guaranteed (PPG) debt peaks in 2021 at 51.6 percent of GDP. Its present value (PV) remains below the DSA threshold, peaking at 29 percent in 2021. Vanuatu's public external debt service ratios are also relatively low, reflecting that most of its public external debt is highly concessional.

8. One threshold for public external debt is breached under standard tests. In the most extreme shock scenario ("Terms-of-trade shock"), the PV of debt-to-GDP ratio breaches the threshold of 40 percent. However, the breach is temporary, as the effects of the shock wind down. Other indicators of debt sustainability—the PV of debt-to-exports ratio, the PV of debt-to-revenue ratio, the debt service-to-export ratio, and the debt service-to-revenue ratio—remain below their respective thresholds.

9. The historical scenario yields debt ratios that are below the projections in the baseline case, reflecting the deterioration of macroeconomic prospects and a widening of

medium-term deficits caused by Cyclone Pam and on-going public investments. This historical scenario is produced using the average of the past 10 years for key macroeconomic variables and shows a decline in the PV of the debt-to-GDP ratio compared to the baseline, while all other indicators have the same path.

PUBLIC DEBT SUSTAINABILITY

10. Public debt ratios are likely to be sustainable provided that the government continues to seek a mix of grant and highly concessional financing. Under the baseline scenario, the PV of total public debt is projected to increase from 23.8 percent of GDP to 38.5 percent of GDP by 2021. By 2036 it is expected to decline to 22.4 percent of GDP. Thus the PV of public debt remains significantly below the benchmark. The PV of debt-to-revenue ratio is expected to increase to 230.7 in 2022 and then decline gradually to 136.9 percent by 2035.

11. The standard tests show one breach of thresholds. The PV of debt-to-GDP breaches the benchmark of 58 percent of GDP in a scenario in which the primary balance is held fixed at its 2016 level, reflecting risks of maintaining high level of fiscal deficits from debt-financed public investments. This scenario is less realistic as fiscal space is expected to improve in the medium term after infrastructure projects' completion. However, this suggests that prudent selection of future public investment should be made in line with not only the country's development strategy, but also its debt-carrying and implementation capacity.

ALTERNATIVE SCENARIO OF ANOTHER MAJOR NATURAL DISASTER EVENT

12. The extreme natural disaster shock replicates Cyclone Pam's estimated impact on the economy.¹ The shock results in the reduction of real GDP growth by roughly 4 percentage points, a deterioration of fiscal balance of about 4 percent of GDP, and about 6 percent of GDP of additional external public debt in the year of the disaster. Under this scenario, the external and public debt sustainability deteriorates significantly right after the event. Two of the thresholds, the PV of debt-to-GDP ratio and PV of debt service-to-revenue ratio, are breached, suggesting substantial pressures from a major natural disaster on the economy.

¹ In addition to the extreme natural disaster shock scenario we have considered adjusting macro projections to reflect the average impact of natural disasters by calculating the historical annual average damage to the economy as reported by EM-DAT for the period 1990-2014. This was found to be modest at 0.12% of GDP growth – despite Vanuatu's high rate of natural disasters. Given the small magnitude of the average effect, we chose not to incorporate it in the medium-term growth projections.

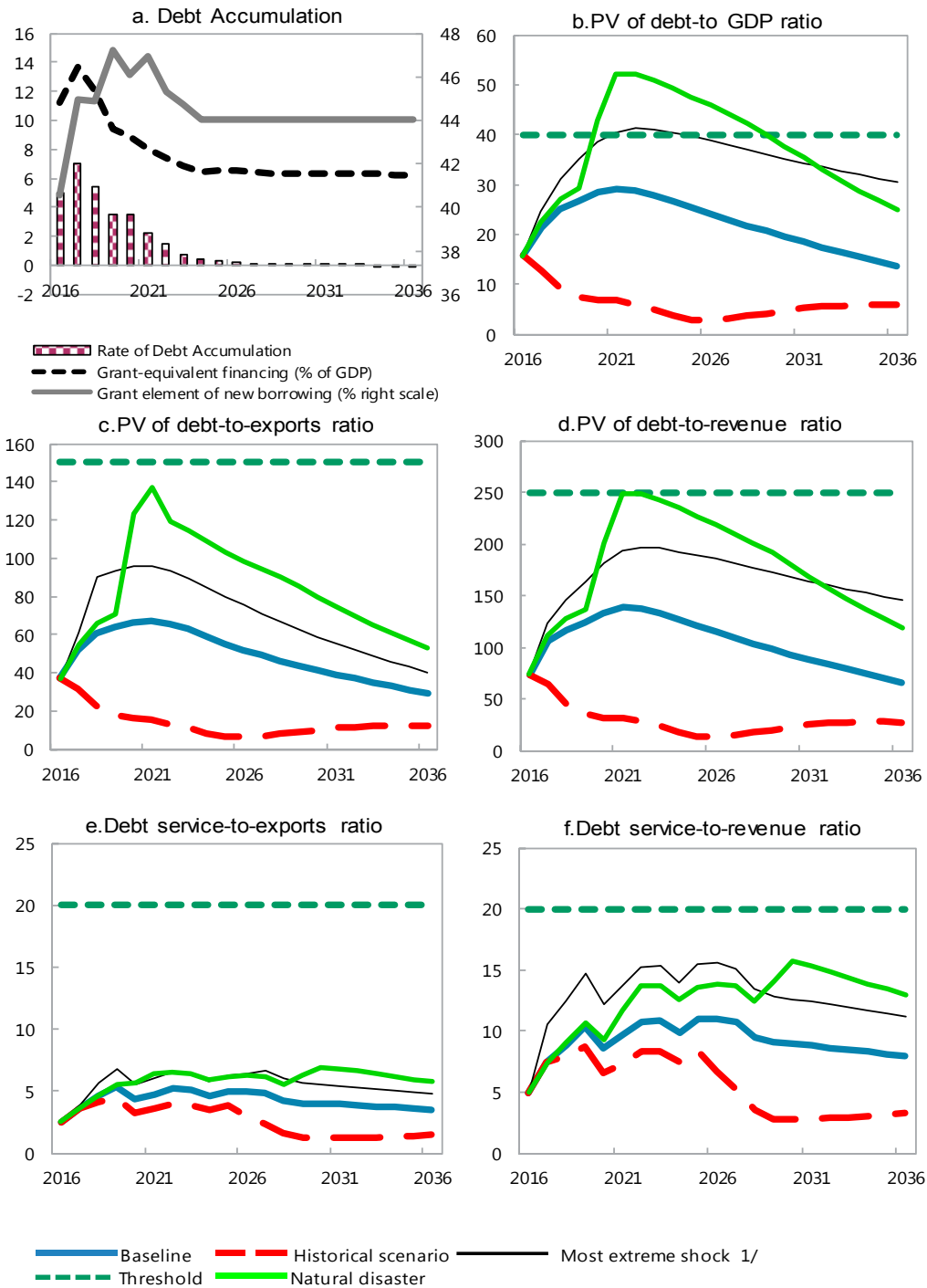
CONCLUSION

13. Vanuatu's risk of debt distress remains moderate and the planned trajectory of debt accumulation is similar to that obtained in the 2015 DSA. The country's debt rating was elevated from "low risk" in 2013 to "moderate risk" as a result of the 2015 cyclone and planned infrastructure spending. In the baseline scenario, external and public debt levels are projected to rise steeply over the next few years and peak at substantially higher levels before starting to decline. In order to set public debt ratios on a downward trajectory while making room for priority social and developmental expenditures, the authorities must continue their cautious borrowing strategy and rebuild fiscal buffers over the medium term through strengthening public finance management, reprioritizing spending, and mobilizing new revenue resources (including with the introduction of income taxes within a comprehensive tax reform). Given Vanuatu's vulnerability to natural disasters, additional extreme weather events are likely to have large adverse cumulative effects on the country's fiscal position and debt sustainability (as indicated by the alternative shock scenario), reinforcing the case for seeking grant financing with bi and multilateral partners for post-disaster reconstruction while pursuing risk reduction investments, and ensuring public investment is efficient.

AUTHORITIES' VIEWS

14. The authorities broadly concurred with the assessment of debt sustainability analysis. They noted that the ambitious development plan and reform agenda may cause more pressure on debt sustainability and agreed with the importance of rebuilding fiscal buffers over the medium term. They conveyed their intention of seeking grant financing for new projects and expected the comprehensive tax reform to yield additional revenues.

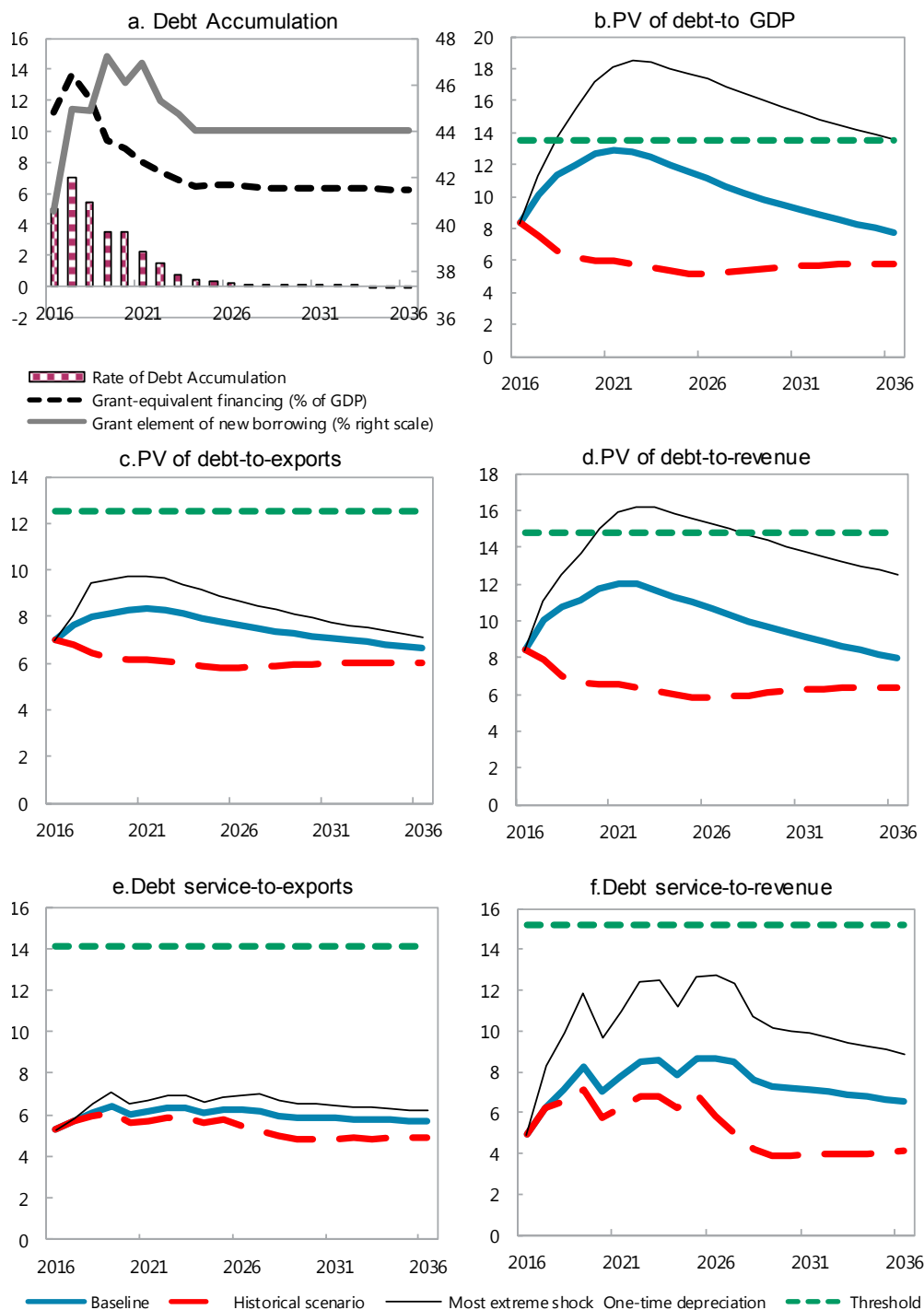
Figure 1. Vanuatu: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios 2016–2036 ^{1/}



Sources: Country authorities; and staff estimates and projections.

^{1/} The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b. it corresponds to a Terms shock; in c. to a Exports shock; in d. to a Terms shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure 2. Vanuatu: Probability of Debt Distress of Public and Publicly Guaranteed External Debt under Alternatives Scenarios 2016–2036 ^{1/}



Sources: Country authorities; and staff estimates and projections.

^{1/} The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b. it corresponds to a Terms shock; in c. to a Exports shock; in d. to a Terms shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Table 1. Vanuatu: External Debt Sustainability Framework, Baseline Scenario, 2013–2036 ^{1/}
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average	Standard Deviation	Projections										
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-2021			2022-2036	
												Average	2026	2036	Average	
External debt (nominal) 1/	22.8	26.3	34.1			41.2	52.0	59.2	63.3	66.7	67.8			60.1	44.0	
<i>of which: public and publicly guaranteed (PPG)</i>	12.7	11.5	17.9			24.8	35.6	42.8	47.0	50.4	51.6			43.9	27.6	
Change in external debt	-2.9	3.5	7.8			7.1	10.8	7.2	4.2	3.4	1.1			-1.8	-1.2	
Identified net debt-creating flows	-1.5	-2.7	9.4			10.0	13.6	11.5	5.7	3.7	0.4			-2.3	-1.0	
Non-interest current account deficit	2.7	-0.5	9.8	6.0	3.2	15.6	20.1	17.8	10.5	8.3	4.4			0.6	0.7	1.1
Deficit in balance of goods and services	4.1	3.9	22.3			17.4	21.1	18.7	11.5	8.9	4.9			0.7	-0.1	
Exports	46.9	45.4	43.7			42.5	41.2	41.0	41.7	42.7	43.1			46.5	47.2	
Imports	51.0	49.2	66.0			60.0	62.2	59.7	53.2	51.6	48.1			47.2	47.2	
Net current transfers (negative = inflow)	-2.3	-3.1	-10.3	-4.2	2.5	-3.7	-2.8	-2.1	-2.0	-1.9	-1.8			-1.4	-0.8	-1.2
<i>of which: official</i>	-2.2	-2.7	-5.2			-2.6	-2.5	-1.8	-1.7	-1.6	-1.5			-1.1	-0.6	
Other current account flows (negative = net inflow)	0.8	-1.2	-2.2			1.9	1.9	1.3	1.0	1.2	1.2			1.3	1.5	
Net FDI (negative = inflow)	-4.2	-2.6	-4.4	-6.8	3.9	-5.4	-5.8	-5.6	-4.3	-3.9	-3.4			-2.3	-1.3	-2.0
Endogenous debt dynamics 2/	0.0	0.4	4.0			-0.3	-0.7	-0.8	-0.5	-0.6	-0.7			-0.6	-0.4	
Contribution from nominal interest rate	0.6	0.8	1.3			1.0	1.1	1.1	1.5	1.2	1.2			1.1	0.9	
Contribution from real GDP growth	-0.5	-0.5	0.2			-1.3	-1.7	-1.9	-1.9	-1.8	-1.9			-1.8	-1.3	
Contribution from price and exchange rate changes	-0.2	0.2	2.5			...	...	...	...	...	...			...	...
Residual (3-4) 3/	-1.4	6.2	-1.6			-2.9	-2.8	-4.3	-1.6	-0.4	0.8			0.4	-0.2	
<i>of which: exceptional financing</i>	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	
PV of external debt 4/	...	...	27.8			32.1	37.6	41.3	43.0	44.7	45.2			40.4	30.1	
In percent of exports	...	...	63.6			75.4	91.4	100.7	103.1	104.7	104.8			87.0	63.7	
PV of PPG external debt	...	...	11.6			15.7	21.3	24.9	26.7	28.4	29.0			24.2	13.7	
In percent of exports	...	...	26.5			36.9	51.6	60.8	64.0	66.6	67.2			52.1	29.1	
In percent of government revenues	...	...	55.5			73.5	105.6	116.8	124.1	133.3	138.2			115.4	65.4	
Debt service-to-exports ratio (in percent)	3.7	5.3	7.3			5.8	7.0	8.1	9.1	7.1	7.7			8.6	7.7	
PPG debt service-to-exports ratio (in percent)	1.4	1.4	2.6			2.5	3.6	4.6	5.4	4.3	4.7			5.0	3.5	
PPG debt service-to-revenue ratio (in percent)	3.4	3.3	5.4			5.0	7.4	8.8	10.4	8.6	9.7			11.0	7.9	
Total gross financing need (Millions of U.S. dollars)	2.1	-5.6	63.4			98.6	142.3	138.1	94.4	73.7	46.4			33.2	77.1	
Non-interest current account deficit that stabilizes debt ratio	5.6	-4.0	2.0			8.6	9.3	10.6	6.3	4.9	3.3			2.4	1.9	
Key macroeconomic assumptions																
Real GDP growth (in percent)	2.0	2.3	-0.8	3.2	2.8	4.0	4.5	4.0	3.5	3.0	3.0	3.7	3.0	3.0	3.0	3.0
GDP deflator in US dollar terms (change in percent)	0.6	-0.7	-8.7	3.5	7.8	0.8	2.6	2.8	2.9	2.9	2.9	2.5	2.9	2.9	2.9	2.9
Effective interest rate (percent) 5/	2.4	3.4	4.4	2.4	0.8	3.1	2.8	2.4	2.6	2.0	1.9	2.5	2.0	2.1	1.9	1.9
Growth of exports of G&S (US dollar terms, in percent)	-0.1	-1.6	-12.8	6.7	11.0	2.0	3.7	6.4	8.3	8.6	7.0	6.0	7.1	6.0	6.6	6.6
Growth of imports of G&S (US dollar terms, in percent)	2.6	-1.9	21.4	9.9	14.9	-4.9	11.2	2.5	-5.1	2.9	-1.4	0.9	4.0	6.0	5.8	5.8
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	40.5	44.9	44.9	47.2	46.1	46.9	45.1	44.1	44.1	44.2	44.2
Government revenues (excluding grants, in percent of GDP)	19.2	19.3	20.8			21.4	20.1	21.3	21.5	21.3	21.0			21.0	21.0	21.0
Aid flows (in Millions of US dollars) 7/	17.6	34.0	136.3			104.2	148.8	129.9	109.3	107.5	111.5			112.3	182.1	
<i>of which: Grants</i>	17.6	33.8	82.7			59.5	63.9	64.3	52.3	55.5	58.8			78.5	140.3	
<i>of which: Concessional loans</i>	0.0	0.2	53.6			44.7	84.9	65.6	56.9	52.0	52.8			33.7	41.8	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			11.2	13.7	12.1	9.4	8.8	8.1			6.6	6.3	6.5
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			68.6	65.1	67.1	68.5	69.6	74.0			83.2	87.2	85.0
Memorandum items:																
Nominal GDP (Millions of US dollars)	801.8	815.0	737.9			773.4	829.0	886.0	943.8	1000.2	1059.9			1416.6	2530.4	
Nominal dollar GDP growth	2.6	1.6	-9.5			4.8	7.2	6.9	6.5	6.0	6.0	6.2	6.0	6.0	6.0	6.0
PV of PPG external debt (in Millions of US dollars)	...	...	84.2			121.5	176.2	220.8	251.7	284.5	307.2			342.7	347.2	
(Pvt-Pvt-1)/GDPt-1 (in percent)	...	...	...			5.1	7.1	5.4	3.5	3.5	2.3	4.5	0.2	-0.1	0.2	0.2
Gross workers' remittances (Millions of US dollars)	1.0	3.5	37.3			8.0	3.0	3.0	3.0	3.0	3.1			3.4	4.1	
PV of PPG external debt (in percent of GDP + remittances)	...	...	11.0			15.5	21.2	24.8	26.6	28.4	28.9			24.1	13.7	
PV of PPG external debt (in percent of exports + remittances)	...	...	23.7			36.0	51.2	60.3	63.5	66.2	66.8			51.8	29.0	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	2.3			2.4	3.6	4.6	5.3	4.3	4.7			4.9	3.5	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - p(1+g)] / (1+g+p+gp)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and p = 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 2. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–2036
(In percent)

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
PV of debt-to GDP ratio								
Baseline	16	21	25	27	28	29	24	14
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	16	13	9	8	7	7	3	6
A2. New public sector loans on less favorable terms in 2016-2036 2/	16	25	31	35	39	41	39	30
A3. Alternative Scenario : Natural Disaster	16	23	27	29	43	52	46	25
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	16	22	27	29	31	31	26	15
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	16	23	31	32	34	34	29	16
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	16	23	29	31	33	33	28	16
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	16	24	29	31	32	33	28	15
B5. Combination of B1-B4 using one-half standard deviation shocks	16	24	32	33	35	36	30	17
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	16	30	35	38	40	41	34	19
PV of debt-to-exports ratio								
Baseline	37	52	61	64	67	67	52	29
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	37	31	23	18	16	15	6	12
A2. New public sector loans on less favorable terms in 2016-2036 2/	37	60	76	84	90	94	84	65
A3. Alternative Scenario : Natural Disaster	37	55	66	70	123	137	99	53
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	37	52	61	64	67	67	52	29
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	37	61	90	93	96	96	75	40
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	37	52	61	64	67	67	52	29
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	37	57	71	73	76	76	59	32
B5. Combination of B1-B4 using one-half standard deviation shocks	37	56	74	77	80	80	63	34
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	37	52	61	64	67	67	52	29
PV of debt-to-revenue ratio								
Baseline	74	106	117	124	133	138	115	65
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	74	64	44	35	32	32	14	27
A2. New public sector loans on less favorable terms in 2016-2036 2/	74	123	146	163	181	193	185	145
A3. Alternative Scenario : Natural Disaster	74	112	127	136	201	249	218	119
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	74	110	126	134	144	149	124	71
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	74	115	144	150	159	164	138	75
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	74	113	135	143	154	159	133	75
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	74	117	136	142	151	156	131	72
B5. Combination of B1-B4 using one-half standard deviation shocks	74	118	148	155	165	171	144	79
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	74	149	165	175	188	195	163	92

Table 2. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–2036 (continued)

(In percent)

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
Debt service-to-exports ratio								
Baseline	2	4	5	5	4	5	5	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	2	4	4	5	3	4	3	1
A2. New public sector loans on less favorable terms in 2016-2036 2/	2	4	4	5	4	4	5	5
A3. Alternative Scenario : Natural Disaster	2	4	5	5	6	6	6	6
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	2	4	5	5	4	5	5	4
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	2	4	6	7	6	6	6	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	2	4	5	5	4	5	5	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	2	4	5	6	5	5	5	4
B5. Combination of B1-B4 using one-half standard deviation shocks	2	4	5	6	5	5	6	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	2	4	5	5	4	5	5	4
Debt service-to-revenue ratio								
Baseline	5	7	9	10	9	10	11	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	5	7	8	9	7	7	7	3
A2. New public sector loans on less favorable terms in 2016-2036 2/	5	7	9	9	8	9	11	10
A3. Alternative Scenario : Natural Disaster	5	7	9	11	9	12	14	13
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	5	8	10	11	9	10	12	9
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	5	7	9	11	9	10	12	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	5	8	10	12	10	11	13	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	5	7	9	11	9	10	12	9
B5. Combination of B1-B4 using one-half standard deviation shocks	5	8	10	12	10	11	13	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	5	11	12	15	12	14	16	11
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	44	44	44	44	44	44	44	44

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.

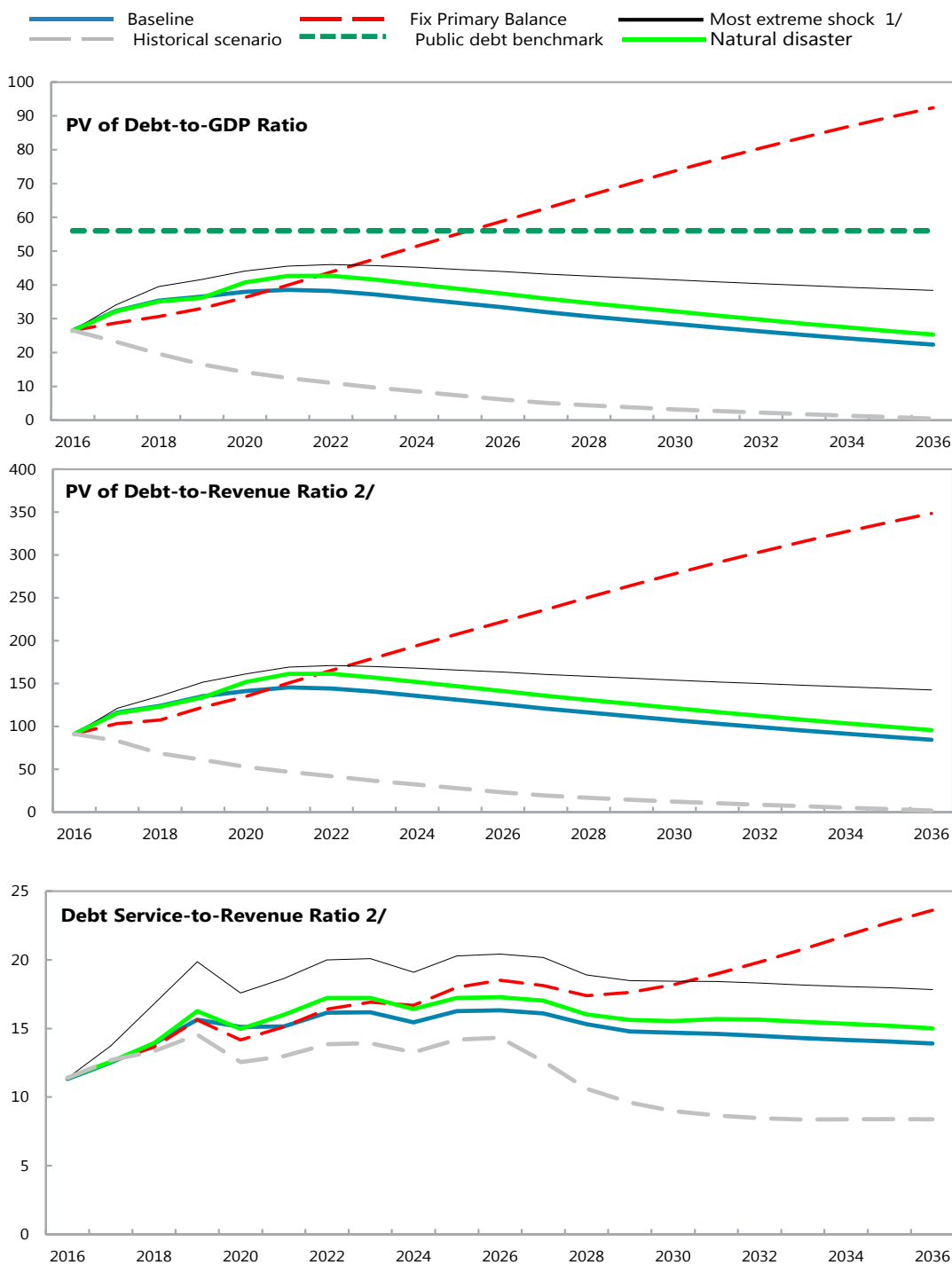
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

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.

Figure 3. Vanuatu: Indicators of Public Debt under Alternatives Scenarios 2016–2036^{1/}



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2026.

2/ Revenues are defined inclusive of grants.

Table 3. Vanuatu: Public Sector Debt Sustainability Framework, Baseline Scenario, 2016–2036
(In percent of GDP, unless otherwise indicated)

	Actual			Average ^{5/}	Standard Deviation ^{5/}	Estimate					Projections				
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-21 Average		2026	2036	2022-36 Average
Public sector debt 1/	23.3	23.9	30.2			35.6	46.6	53.3	56.9	59.9	61.2		53.0	36.3	
<i>of which: foreign-currency denominated</i>	12.7	11.5	17.9			24.8	35.6	42.8	47.0	50.4	51.6		43.9	27.6	
Change in public sector debt	-1.3	0.6	6.2			5.5	11.0	6.6	3.7	3.0	1.2		-1.9	-1.3	
Identified debt-creating flows	-0.1	-1.0	-6.7			8.9	14.9	10.1	5.9	4.7	2.1		-1.9	-1.3	
Primary deficit	-0.5	-1.5	-8.0	-0.8	2.8	9.7	16.2	11.9	7.7	6.7	4.2	9.4	0.0	-0.1	0.1
Revenue and grants	21.4	23.5	32.1			29.1	27.8	28.6	27.0	26.9	26.5		26.5	26.5	
<i>of which: grants</i>	2.2	4.1	11.2			7.7	7.7	7.3	5.5	5.5	5.5		5.5	5.5	
Primary (noninterest) expenditure	20.9	22.0	24.0			38.8	44.0	40.5	34.7	33.6	30.7		26.5	26.4	
Automatic debt dynamics	0.4	0.4	1.3			-0.9	-1.3	-1.8	-1.8	-1.9	-2.1		-1.9	-1.2	
Contribution from interest rate/growth differential	-0.2	-0.2	0.6			-0.6	-1.0	-1.5	-1.5	-1.6	-1.7		-1.6	-1.0	
<i>of which: contribution from average real interest rate</i>	0.2	0.3	0.4			0.5	0.5	0.3	0.3	0.1	0.0		0.0	0.1	
<i>of which: contribution from real GDP growth</i>	-0.5	-0.5	0.2			-1.2	-1.5	-1.8	-1.8	-1.7	-1.7		-1.6	-1.1	
Contribution from real exchange rate depreciation	0.7	0.6	0.7			-0.2	-0.3	-0.2	-0.3	-0.4	-0.4		...	...
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	-1.3	1.6	12.9			-3.4	-3.9	-3.5	-2.2	-1.7	-0.8		0.0	0.0	
Other Sustainability Indicators															
PV of public sector debt	...	12.4	23.8			26.5	32.3	35.4	36.6	37.9	38.5		33.4	22.4	
<i>of which: foreign-currency denominated</i>	...	0.0	11.6			15.7	21.3	24.9	26.7	28.4	29.0		24.2	13.7	
<i>of which: external</i>	...	...	11.6			15.7	21.3	24.9	26.7	28.4	29.0		24.2	13.7	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	2.1	1.0	-5.3			13.0	19.6	15.9	11.9	10.7	8.2		4.3	3.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	53.0	74.4			91.3	116.2	123.8	135.3	141.1	145.4		125.8	84.4	
PV of public sector debt-to-revenue ratio (in percent)	...	64.3	114.4			124.1	160.6	165.9	170.2	177.8	183.8		159.1	106.7	
<i>of which: external 3/</i>	...	...	55.5			73.5	105.6	116.8	124.1	133.3	138.2		115.4	65.4	
Debt service-to-revenue and grants ratio (in percent) 4/	12.3	10.3	8.5			11.3	12.5	13.9	15.6	15.1	15.2		16.3	13.9	
Debt service-to-revenue ratio (in percent) 4/	13.7	12.6	13.1			15.4	17.3	18.6	19.7	19.0	19.2		20.7	17.6	
Primary deficit that stabilizes the debt-to-GDP ratio	0.8	-2.1	-14.3			4.3	5.1	5.3	4.0	3.7	3.0		1.9	1.2	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	2.0	2.3	-0.8	3.2	2.8	4.0	4.5	4.0	3.5	3.0	3.0	3.7	3.0	3.0	3.0
Average nominal interest rate on forex debt (in percent)	1.7	1.7	3.7	1.7	0.7	2.6	2.4	2.0	2.1	1.6	1.5	2.0	1.5	1.5	1.5
Average real interest rate on domestic debt (in percent)	2.2	3.1	1.0	2.6	1.5	2.0	2.9	2.9	2.7	2.8	2.8	2.7	3.1	3.4	3.2
Real exchange rate depreciation (in percent, + indicates depreciation)	5.0	5.2	6.0	-1.3	7.3	-1.2	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.7	2.0	2.5	3.2	1.9	2.2	2.6	2.8	2.9	2.9	2.9	2.7	2.9	2.9	2.9
Growth of real primary spending (deflated by GDP deflator, in percent)	-6.2	7.6	8.2	1.0	4.1	67.9	18.5	-4.3	-11.2	-0.6	-5.7	10.8	3.1	3.1	2.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	40.5	44.9	44.9	47.2	46.1	46.9	45.1	44.1	44.1	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

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 4. Vanuatu: Sensitivity Analysis for Key Indicators for Public Debt, 2016–2036

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
PV of Debt-to-GDP Ratio								
Baseline	27	32	35	37	38	39	33	22
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	27	23	20	17	14	13	6	0
A2. Primary balance is unchanged from 2016	27	29	31	33	36	40	59	92
A3. Permanently lower GDP growth 1/	27	33	36	38	40	41	39	39
A4. Alternative Scenario : Natural Disaster	26	32	35	36	41	43	37	25
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	27	34	40	42	44	46	44	38
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	27	24	22	24	26	26	22	15
B3. Combination of B1-B2 using one half standard deviation shocks	27	24	22	24	26	28	26	23
B4. One-time 30 percent real depreciation in 2017	27	36	37	37	37	37	31	20
B5. 10 percent of GDP increase in other debt-creating flows in 2017	27	38	41	42	43	44	38	25
PV of Debt-to-Revenue Ratio 2/								
Baseline	91	116	124	135	141	145	126	84
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	91	83	68	61	53	47	23	2
A2. Primary balance is unchanged from 2016	91	103	107	122	135	151	222	349
A3. Permanently lower GDP growth 1/	91	117	126	138	146	153	145	142
A4. Alternative Scenario : Natural Disaster	91	115	123	134	152	161	141	96
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	91	121	136	152	161	169	163	142
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	91	88	78	88	95	99	84	57
B3. Combination of B1-B2 using one half standard deviation shocks	91	87	75	88	97	104	98	87
B4. One-time 30 percent real depreciation in 2017	91	131	130	135	137	138	116	75
B5. 10 percent of GDP increase in other debt-creating flows in 2017	91	136	143	154	160	164	143	96
Debt Service-to-Revenue Ratio 2/								
Baseline	11	13	14	16	15	15	16	14
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	11	13	13	15	13	13	14	8
A2. Primary balance is unchanged from 2016	11	13	14	16	14	15	19	24
A3. Permanently lower GDP growth 1/	11	13	14	17	15	16	17	17
A4. Alternative Scenario : Natural Disaster	11	13	14	16	15	16	17	15
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	11	13	15	17	16	16	18	17
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	11	13	13	15	13	14	15	12
B3. Combination of B1-B2 using one half standard deviation shocks	11	13	14	15	13	15	16	13
B4. One-time 30 percent real depreciation in 2017	11	14	17	20	18	19	20	18
B5. 10 percent of GDP increase in other debt-creating flows in 2017	11	13	14	17	15	16	17	15

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.

**Statement by Barry Sterland, Executive Director for Vanuatu, and Chris Stewart, Advisor to the Executive Director of Vanuatu
October 21, 2016**

The Vanuatu authorities thank staff for an open and frank set of discussions and useful policy advice during the Article IV consultation. There is a large amount of agreement on the challenges facing Vanuatu. In the immediate term, the country continues to recover from the devastation caused by Cyclone Pam in March 2015. In the longer term, the authorities recognize the need to undertake deeper reforms to bolster the country's resilience. Indeed, the authorities remain committed to strengthening their risk assessment and planning capabilities, as well as their economic and fiscal buffers. Particular importance is placed on sound and resilient infrastructure investment to further development goals, the modernization of the taxation system – including through the introduction of both household and corporate income taxation – and efforts to address AML/CFT concerns.

Recent Developments and the Outlook

Economic activity is continuing to strengthen following Cyclone Pam. Reconstruction activities are progressing and services have picked up as tourists return. The economy has gained further impetus from a number of infrastructure projects, many of which had been on hold. There are signs that business optimism and investment are lifting, including in response to political stability, the new Government's decisive actions to implement reforms, and confidence in the legal system.

The authorities generally agree with staff's outlook and assessment of the risks, although note that there are a number of important upside risks. In particular, successful implementation of the Government's infrastructure plans would directly boost economic activity and could catalyze further private sector activity. Authorities acknowledge that this will depend on successful and timely implementation.

Fiscal Policy

The authorities' infrastructure-focused fiscal policy will be implemented within Vanuatu's absorptive capacity. Indeed, even before the cyclone, a number of transport projects had been delayed or downsized to minimize sequencing problems. As such, the authorities are continuing to work closely with development partners. This will not only help ensure that stimulus remains appropriately timed, but will also improve project planning and implementation capabilities, maximizing the gains from public investment.

The Government is seeking to modernize the taxation system. This will introduce personal income and corporate tax arrangements and modernize the system's operation. This will help strengthen Government finances, improve public financial management and strengthen Vanuatu's ability to deal with external shocks. At the same time, the government is trying to support the poor through appropriately calibrating the personal income tax's tax-free threshold. These reforms will also make the business environment more attractive through reducing a number of minor fees and charges, and strengthen businesses through reducing import duties. It will be important to bed this system down smoothly. As such, the authorities are undertaking public consultations on the new system and will greatly appreciate the assistance of the IMF in its implementation.

Efforts are underway to improve public financial management. The Government agrees with the need to improve fiscal discipline, particularly around reducing the need for supplementary budgets, better accounting for maintenance costs and reducing the overall costs associated with government machinery. They also appreciate the benefits of enhancing domestic buffers to combat natural disasters noting, however, the challenge imposed by competing demands. The Government's actions to address the long-standing backlog of severance payments will not only improve public financial management but will also address a number of negative effects across the economy. In particular, uncertainty about severance payments for nurses, police and teachers has resulted in pension-eligible staff delaying their retirements. These sectors had curtailed the hiring of new staff and, in the case of the nursing, have had to close down the teaching college for two years given the lack of new positions.

The authorities remain committed to putting the public debt-to-GDP ratio on a declining path over the medium term and appreciate the importance of seeking grant financing for any new infrastructure projects. The authorities feel that their infrastructure investment agenda is needed to achieve critical development needs, but are also conscious of the need to carefully plan and sequence project. They appreciate the need to rebuild buffers in the medium term and maximize grant funding.

Monetary Policy

The Reserve Bank of Vanuatu's actions have continued to help Vanuatu achieve both low and stable inflation and a stable peg over the past year. The RBV stands ready to adjust policy as appropriate, noting the changing developments in economic activity and acknowledging the staff's analysis that the exchange rate is in line with fundamentals and that the pegged exchange rate has provided the economy with a useful nominal anchor.

Financial System

The banking system is well capitalized and very liquid. The decline in non-performing loans is a welcome development, particularly after Cyclone Pam interrupted businesses' and households' incomes. The authorities are considering ways in which they could improve access to credit, building on the establishment of a national Financial Inclusion Task Force in 2013, a separate Financial Inclusion Unit at the RBV in 2016, and financial literacy programs by the RBV and commercial banks. This includes pursuing, with the Ministry of Education, formalizing a financial education curriculum in schools, and the diagnostic assessment of banks' financial situations. Such work will be assisted by some of the lessons from the RBV's completion of a financial inclusion demand side survey in 2016 which identified gaps in the financial inclusion agenda, given the needs, access/barriers and usage of financial services and products. The RBV Board of Directors has proposed amendments to legislation to strengthen aspects of regulation around AML/CFT (see below). The RBV is also working with PFTAC on improving the RBV's prudential policies for credit unions that fall within the RBV's legal minimum threshold, and assisting in drafting a new Credit Union Act to improve supervision of this sector.

The authorities continue to focus on ways to further improve Vanuatu AML/CFT framework. A national committee has been established within the PM's Office to work on this issue. Recent actions include the RBV's work on a new risk-based manual on AML/CFT, assessing international banks' AML documents to assess their risk tolerances, and new requirements around registering money changers. At the same time the Financial Intelligence Unit is revising its guidelines and there have been changes to the automatic exchange of information. Furthermore, a number of amendments have been drafted and these will be discussed in Parliament towards the end of 2016 or early 2017. The authorities have received valuable assistance from FATF's Asia-Pacific Group and, most recently, authorities have begun to work with both the World Bank and the Australian Government to further this work. These actions will help Vanuatu remain connected to international financial markets. Vanuatu remains committed to rectifying the deficiencies identified in the mutual evaluation report and improving Vanuatu's effectiveness at combating money laundering and terrorist financing, so that Vanuatu can be removed from the FATF public statement.

Structural Reforms

The authorities are working closely with ADB to improve the operation of Government Business Enterprises (GBEs). The authorities have re-established the Public Accounts Committee, with the newly appointed members starting a review of one GBE providing stevedoring services. Beyond this, legislation on GBE to improve corporate governance of GBEs will be tabled in Parliament in November 2016. This will,

amongst other things, liquidate four of the remaining GBEs. The office of the Auditor General has completed audits and reports of the operations of GBEs in 2015. The Asian Development Bank and World Bank are also working with Air Vanuatu in reviewing its domestic and international routes (the airline is expected to make a small profit this year).

The authorities welcome the report's acknowledgement that their development strategy pays particular attention to poverty and inclusion. The authorities' focus on infrastructure will improve accessibility, reduce business costs and facilitate quality upgrading and diversification, including through attracting more and higher quality tourism. This will be complemented by other, more specific measures. The authorities are, for example, continuing to work with smaller farmers to improve both food security as well as these farmers' livelihoods. Likewise, the Council of Ministers is scheduled to endorse the completion of the trade agreement under the Pacific Agreement on Closer Economic Relations (Pacer-Plus) with other Pacific Island countries, Australia and New Zealand by December 2016. Trade negotiations with the EU will quickly follow. Finally, the authorities remain committed to improving the business environment and stimulating private investment by removing key bottlenecks and supporting reforms that will improve structural competitiveness.