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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/46-3

3:10 p.m., June 5, 2019

3. Vanuatu—2019 Article IV Consultation

Documents: SM/19/113 and Correction 1; and Supplement 1, and Supplement 2

Staff: Muir, APD; Gonzalez Miranda, SPR

Length: 23 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	G. Gasasira-Manzi (AE), Temporary
	L. Nankunda (AF), Temporary
	E. Rojas Ulo (AG), Temporary
N. Ray (AP)	
	P. Fachada (BR)
	P. Sun (CC)
	A. Guerra (CE)
	M. Sylvester (CO), Temporary
	S. Benk (EC)
	A. Castets (FF)
	I. Fragin (GR), Temporary
	P. Dhillon (IN), Temporary
	T. Persico (IT), Temporary
	T. Ozaki (JA), Temporary
	M. Saadaoui (MD), Temporary
	P. Al-Riffai (MI), Temporary
	T. Manchev (NE), Temporary
	J. Sigurgeirsson (NO)
	A. Tolstikov (RU), Temporary
	W. Al Hafedh (SA), Temporary
A. Mahasandana (ST)	
	Y. Danenov (SZ), Temporary
	J. Stockill (UK), Temporary
	M. Svenstrup (US), Temporary

G. Bauche, Acting Secretary
K. Hviding, Summing Up Officer
M. Gislen, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: O. Brekk, A. Di Bello, D. Muir, H. Nishizawa, C. Sandoz-dit-Bragard, A. Stuart. Legal Department: J. Ams. Strategy, Policy, and Review Department: M. Gonzalez Miranda. World Bank Group: A. Tully. Advisors to Executive Directors: S. David (AP), M. Kikiolo (AP), U. Latu (ST), R. Pandit (ST), A. Park (AP), K. Lok (CC), A. Sode (FF).

3. VANUATU—2019 ARTICLE IV CONSULTATION

Mr. Ray and Ms. Park submitted the following statement:

Vanuatu is a small developing state, consisting of 83 volcanic islands in the South Pacific. Tourism and agriculture are key drivers of economic activity, but distance from major markets and vulnerability to external shocks pose challenges to growth and development. Located on the earthquake-prone "ring of fire" and sitting at the center of the Pacific cyclone belt, Vanuatu experiences frequent natural disasters, including tropical cyclones, active volcanos and earthquakes, and is ranked as the most at-risk country in the world by the UN World Risk Index.

The economy has been growing strongly, boosted by spending on infrastructure and reconstruction projects following extensive damage caused by Cyclone Pam in 2015. The government has an ambitious development agenda aimed at developing urban and rural areas, improving living standards and delivering community services. As major infrastructure projects are completed, there is an increased focus on other drivers of medium-term growth, including initiatives to diversify and increase value added in agriculture and a cross-sector plan to develop air transport and tourism, the Shared Vision 2030.

The authorities largely agree with staff's analysis and near-term outlook, and with the broad thrust of the advice. They thank staff for their thoughtful analysis and the open and collaborative approach taken by the team. Staff from the World Bank and Asian Development Bank were also invited to join relevant meetings, which allowed all involved to draw on each other's expertise and make best use of the authorities' time. The authorities value highly the advice and technical assistance received from the Fund and look forward to further constructive engagement in future.

Prudent and sustainable fiscal management

The authorities are committed to maintaining fiscal discipline while making necessary investments in productive and social sectors to build economic growth. Spending on projects to address infrastructure gaps and post-disaster reconstruction has increased in recent years. While this has been largely funded through grants and loans with a high concessional element, public and publicly guaranteed debt has increased to an elevated level. The government's long-term fiscal objectives include maintaining a recurrent budget that is in surplus over the medium term and keeping nominal public and publicly guaranteed debt below 60 percent of GDP (consistent with staff's recommendation in 2018). The authorities note that staff projections show debt rising above this target in the medium term even with the domestic recurrent budget in surplus. They noted the need for additional revenue mobilization in the future, along with continued expenditure restraint and careful debt management. The authorities have taken the opportunity provided by strong growth in revenues from the economic citizenship program in 2019 to reduce debt where possible.

Increasing revenues to fund essential services is a priority for the government. A review of current taxes, non-tax revenues and revenue administration has been conducted to identify areas where tax policy, law and revenue administration may be reformed or modernized to support sustainable economic development. An updated Tax Administration Act came into force in 2019. The introduction of an income tax at a future date also remains a possibility.

Significant process has been made in strengthening the debt management framework. Under the debt management strategy introduced in 2015, new loans must have a grant element of at least 35 percent. The authorities are conscious of the need to plan and sequence projects, and new projects are required to have thorough and feasible plans to generate economic and financial returns in the medium term. Further improvements are being made to the debt management strategy, on-lending and guarantee policies and related financial regulations, drawing on assistance from development partners including the World Bank and Asian Development Bank.

Vanuatu continues to build resilience to natural disasters and climate change. This includes building fiscal policy buffers, ensuring an adequate level of international reserves, spending on resilient infrastructure and adequate maintenance. Between 2006 and 2016, Vanuatu developed a Disaster Risk Reduction and Disaster Management National Action Plan, as well as being the first Pacific Island country to have adopted both a National Adaptation Program of Action (2007) and National Action Plan for Climate Change Adaptation and Disaster Risk Reduction (2015). The new Disaster Risk Management Act 2018 aims to enhance engagement with provincial and municipal governments, support access to donor-funded disaster assistance and set up a national disaster fund. Securing access to donor-funded assistance is also needed. The authorities are discussing a development policy grant with a Catastrophe-Deferred Drawdown Option (CAT-DDO) with the World Bank which would provide immediate liquidity to the country in the aftermath of a natural disaster.

Supportive monetary and financial sector policies

The Reserve Bank of Vanuatu’s (RBV) actions have continued to contain inflationary pressures. The exchange rate regime has worked well, providing the economy with the useful nominal anchor, while statutory reserve requirements and open market operations have been used to address domestic pressures. The RBV stands ready to adjust policy as economic conditions evolve. Excess liquidity in the banking sector poses a medium-term challenge for monetary policy implementation. A review of monetary policy instruments is underway and the staff team’s analysis of excess liquidity in the banking sector is useful in this context. As this is not a problem unique to Vanuatu, the authorities would see value in a regional analysis of drivers and policy responses for the next Article IV consultation.

Broadening access to credit is a priority, and the authorities look forward to further engagement with the Fund on this issue. The RBV is carefully monitoring the banking sector and welcomes the IMF banking sector diagnostic currently underway. Financial sector development is also being supported through stronger supervision, including the introduction of a new legal framework for credit unions and work underway with PFTAC assistance to review the RBV’s approach to risk-based supervision. The authorities are also progressing financial inclusion initiatives under the National Financial Inclusion Strategy 2018-23. While noting that fintech applications have a role in strengthening financial inclusion, the authorities are also conscious of the need to ensure that appropriate regulatory frameworks are in place.

Significant progress has been made in improving Vanuatu’s AML/CFT framework, resulting in Vanuatu’s removal from the FATF AML/CFT grey list in June 2018. While banks have been able to maintain correspondent banking relationships, these remain under pressures and compliance activities have increased costs. A substantial amount of work was needed to prepare and implement new AML/CFT legislation to enable Vanuatu’s removal from the grey list. In this context, the authorities expressed concern that Vanuatu’s recent inclusion on the European Union list of non-cooperative tax jurisdictions could undermine some of the work that has been done to support correspondent banking relationships. Work is underway to ensure that Vanuatu fulfils its international obligations in the area of taxation. Technical assistance is also valuable in this area given resource constraints; the authorities have engaged additional technical assistance under the Australian Governance for Growth project.

Enhancing governance

The authorities are committed to strong governance. Efforts underway include improving public financial management, through the Tax Administration Act, and the authorities are working with the ADB to improve the operation of Government Business Enterprises. Progress has been made in implementing the IMF Safeguards Assessment recommendations including strengthening the corporate governance structure, internal audit function and overall structure of the RBV. Ongoing IMF technical assistance in this area is appreciated.

Mr. Fachada and Ms. Mohammed submitted the following statement:

We thank staff for the report and Mr. Ray and Ms. Park for their statement. We welcome the near-full recovery of Vanuatu from the devastation caused by Cyclone Pam in 2015. This small island developing nation remains highly vulnerable to natural disasters and climate change and this underscores the need for building financial buffers, prioritizing spending, and safeguarding public debt sustainability. We encourage the authorities to continue taking the necessary steps to maintain Vanuatu’s economy on a sustainable path.

Enhanced revenue measures and expenditure rationalization are needed to safeguard public debt sustainability. We take note that the Debt Sustainability Analysis (DSA) suggests that Vanuatu’s external and overall risk of debt distress is moderate, but the country has limited space to absorb shocks. Stronger revenue mobilization with the implementation of the 2017 tax reforms, including the introduction of personal and corporate income taxes, complemented with technical assistance would help secure enhanced government revenues. Also, greater expenditure rationalization for development projects and prioritization of grants and loans with higher concessionality for these projects could help reduce the debt burden and rebuild fiscal buffers. We note that strong revenues from the Economic Citizenship Program (ECP) could motivate delays in the tax reform. Could staff indicate whether there is an estimated timeframe to complete the implementation of the tax reform measures?

The financial sector remains broadly stable, but vigilance is warranted. We take note that although the banking sector has strong capital and liquidity positions, non-performing loans remain high. In this regard, we encourage the continued strengthening of the Reserve Bank of Vanuatu (RBV) supervision and regulatory framework and welcome the recent banking sector diagnostic assessment. We commend the authorities’ efforts in improving the AML/CFT framework and encourage them to sustain momentum and seek further support from development partners to maintain correspondent banking relationships and allow further progress on financial inclusion.

While we underscore the development made on strengthening RBV governance, further progress is needed to ensure the continuation of effective monetary and financial policies. We support staff's call to amend the RBV Act to allow greater central bank autonomy. We also concur with the need to implement strong internal controls, in accordance with best international practices.

Vanuatu is highly vulnerable to natural disasters and climate change. We commend the authorities on their efforts in addressing risks from natural disasters and encourage that the Disaster Risk Management Act 2018 bill be passed, and the emergency fund be established. We take note that Vanuatu is the world's most at-risk country for natural disasters, according to the UN World Risk Index. Given the country's susceptibility to natural disasters and the importance of effective insurance schemes, could staff elaborate about Vanuatu's withdrawal from the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI)?

Mr. Merk and Mr. Fragin submitted the following statement:

We thank staff for an insightful report and Mr. Ray and Ms. Park for their helpful buff statement.

We take positive note of Vanuatu's progressing recovery from the extensive damage caused by Cyclone Pam in 2015. Supported by solid growth, the authorities' efforts to push ahead with their broader development agenda are welcome. We broadly concur with staff's recommendations, in particular with a view to limiting fiscal risks and building buffers. The latter is all the more important given that Vanuatu is ranked as the most at-risk country in the world by the UN World Risk Index, as highlighted by Mr. Ray and Ms. Park.

Moreover, we encourage the authorities to continue their efforts to strengthen institutional governance, including through greater autonomy of the RBV. Important progress has been achieved in addressing gaps in the AML/CFT framework, resulting in Vanuatu's removal from the FATF grey list last year. However, we also encourage the authorities to improve the taxation framework in line with international tax good governance principles, as emphasized in the revised EU list of non-cooperative jurisdictions for tax purposes published in March 2019.

In addition, we would welcome if staff could further elaborate on the possible factors behind the recently strong revenue inflows from economic citizenship programs (which are estimated having more than doubled in 2018 relative to 2017, according to Table 2).

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for the comprehensive reports and Mr. Ray and Ms. Park for their insightful buff statement. It is encouraging to see that the reconstruction in Vanuatu is nearing completion following the devastating damage caused by Cyclone Pam four years ago. The recovery has been strong as reflected by many indicators, including growth, inflation, current account, foreign reserves and fiscal balance. We commend the authorities for this achievement and positively note that they are now concentrating on broader development plans. Going forward, a prudent mix of fiscal, monetary and external policies is required to maintain the macro-economic stability. As the world's most at-risk country for natural disasters, continued efforts are essential to improve disaster resilience with the support of donors and development partners, given the domestic resource constraints. We broadly concur with the staff's assessment and wish to make following remarks for emphasis.

The risk rating for debt distress remains moderate in Vanuatu as per the DSA. However, fiscal discipline is required to strengthen policy buffers and reduce the debt burden over the medium-term. For reducing the reliance on Vanuatu's economic citizenship programs (ECP) and building buffers in advance of potential natural disasters, buttressing the tax base by completing the tax reforms is vital. Authorities are rightly focusing on financing projects to address infrastructure gaps. We reiterate the importance of concessional and grant financing for such projects to support debt sustainability and encourage the authorities to continue their engagement with development partners in this regard. Could staff comment on the capacity issues that could delay infrastructure projects? Further improvements in governance, including public financial management, is also important to improve fiscal performance.

The current accommodative monetary policy and fixed exchange rate regime are considered appropriate. We positively note that authorities stand ready to adjust policy as economic conditions evolve, as elaborated in the buff statement. Excess liquidity is an area that need effective measures as proposed in Annex VI. We see the scope for improving monetary policy effectiveness through further financial deepening and improved monetary policy transmission.

Vanuatu's banks are well capitalized and liquid, with declining non-performing loans and without a major risk in financial system. Increasing competitiveness in the banking sector is important which will also help safeguard the effectiveness of monetary policy. We commend the authorities for successfully exiting from the FATF grey list in June 2018 reflecting the progress achieved in strengthening the AML/CFT framework. However, this needs continuation to address remaining shortcomings.

Addressing structural impediments is important to encourage other economic activities, given the high reliance on agriculture and tourism. Providing financial services in the rural areas, enhancing labor skills and lowering cost of doing business are essential towards this direction. Could staff elaborate on other potential areas of diversification in Vanuatu? We noted that the Shared Vision 2030 plan is expected to play a key role in bolstering tourism growth. However, as elaborated in Box 1, the total cost and financing for this is uncertain. Staff's comments are welcome on this along with alternatives if required financing is not secured over the medium-term.

The expected graduation of Vanuatu from LDC status in 2020 is anticipated to have no significant impact on its growth path. However, the expected reduction of preferential market access for exports due to this graduation will need specific attention. Hence, we encourage the authorities to continue their efforts to find alternative means of preferential access. Could staff comment on the avenues available for this, in addition to the PACER plus free trade agreement?

Vanuatu's progress in improving natural disaster preparedness is commendable. While continued efforts are important to build buffers in advance of potential natural disasters, we stress the need for continued donor engagement and support to Vanuatu for undertaking ex-ante preparedness to better face such disasters, going forward.

We commend the authorities for their engagement with the Fund on TA and capacity requirements. Also, we positively note the staff's collaborative approach with other development partners in the Article IV consultation process and encourage the increased use of this approach by other Fund missions as well, particularly on small states as well as countries vulnerable to natural disasters. Could staff comment?

With these remarks, we wish the authorities all success in their future endeavors.

Mr. Inderbinen and Mr. Danenov submitted the following statement:

We thank staff for a comprehensive set of papers and Mr. Ray and Ms. Park for their informative buff statement. Vanuatu is on its way to a full recovery from Cyclone Pam's extensive damages. The economy is growing strongly, supporting the forthcoming graduation from LDC status. In order to ensure further progress, Vanuatu's authorities should seek to maintain debt sustainability, strengthen governance and improve the management of natural disaster risks.

We welcome the authorities' commitment to maintain fiscal discipline and keep the public debt level below 60 percent of GDP. Increasing revenues, in particular, through the introduction of personal and corporate income taxes, as well as prioritizing grants and loans with higher concessionality should contribute to rebuild fiscal buffers.

We encourage the authorities to continue building resilience to natural disasters. In addition to securing fiscal buffers and spending on resilient infrastructure, we support the initiative to set up a national disaster fund, envisaged in the new Disaster Risk Management Act 2018. In that regard, we agree with staff that this fund should be approached as a long-term, self-replenishing vehicle with consistent funding from the government and, to the extent possible, Vanuatu's development partners. Ensuring robust governance will be key in the set-up of the national disaster fund. More broadly, we encourage the authorities to sustain their efforts in strengthening governance.

Mr. Doornbosch and Mr. Manchev submitted the following statement:

We thank staff for their candid report and Mr. Ray and Ms. Park for a very informative buff statement. Vanuatu's economic recovery from the damaging 2015 Cyclone Pam is underway with the strong support by their development partners. We welcome the authorities' ambitious implementation of the Infrastructure Strategic Investment Plan 2015-24 as well as their recent progress with improving governance. These actions will increase growth potential and economic diversification. Although Vanuatu is scheduled to graduate next year from the World bank's Least Developed Country Category list, the authorities face the challenging task of balancing the financing needs and execution of the large public infrastructure projects and putting debt on a sustainable path, building buffers against future shocks, and strengthening the AML/CFT framework. Since we agree with the thrust of staff's appraisal, the following comments are provided for emphasis.

Fiscal policy and debt management

Further fiscal consolidation is warranted to build buffers against potential natural disasters and preserve debt sustainability. Although the risk of debt distress is moderate, we agree with staff's arguments that Vanuatu should build additional fiscal space to absorb shocks. The authorities' firm commitment to a balanced budget outside of the development partners' operations is welcome. In a medium-term perspective, however, volatile revenues from the Economic Citizenship Programs do not provide enough cushion to justify any further delay in the 2017 Tax Reform. It should be expeditiously completed and, together with further rationalization of government spending, ensure stable domestic financing for achieving the ambitious goals of the National Sustainable Development Plan (NSDP, 2015-30).

We welcome the updated debt management strategy with stronger rules regarding the concessional financing. The envisaged larger grants or grant components for concessional financing would help ease the path of the PPG-debt-to-GDP ratio, but it should also be complemented by regulations to prevent a breach of the debt targets by the Vanuatu National Provident Fund and other SOEs.

Monetary and financial sector policies

The monetary policy framework should be better calibrated, and the financial stability framework needs to be further strengthened. The existing exchange rate regime has served Vanuatu well and foreign reserves are at a comfortable level. We agree with staff that the Reserve Bank of Vanuatu (RBV) has successfully maintained inflation within the target range and its short-term monetary policy stance is appropriate. However, the combination of persistent excess liquidity in the banking sector, high bank lending rates, and elevated NPLs, together with the observed fintech penetration, pose challenges to financial stability. Going forward to the next consultation, we encourage staff to provide more in-depth analyses and tailored recommendations. We also believe that a greater autonomy for the RBV would help ensure continued policy effectiveness.

We welcome the recent progress with strengthening the AML/CFT framework and encourage its swift implementation. Vanuatu's removal from the FATF's "grey list" of jurisdictions with strategic AML/CFT deficiencies in 2018 and the recent establishment of a Distributed Ledger Technology taskforce comprising relevant financial regulators should alleviate pressures on corresponding banking relations and increase access to external financing. These, together with the newly launched National Financial Inclusion Strategy (NFIS, 2018–23) and strong engagement of the NBV, will have a positive effect on financial deepening and growth in the medium-term.

Management of climate change and natural disasters

We welcome the authorities' proactive stance to enhance resilience to natural disasters and increase economic diversification. The introduction of the 2018 Disaster Risk Management Act will better involve the provincial and municipal participation in the process, facilitate donor-funded disaster assistance and humanitarian aid, and establish a National Emergency Fund (NEF). Recent improvements to the national disaster planning framework, as well as induction of a "shared vision for tourism", have also been important steps in the right direction. However, staff has identified several deficiencies in the authorities' approaches, like lacking clarity of the governance structure to promote transparency, avoid the misuse of the NEF and missing guidelines for the use of these funds, including procedures for the urgent request of funds and types of emergencies or disasters for which the funds could be utilized. They also recommend the authorities to consider establishing a multi-year contingency fund and criticized uncertainty surrounding cost and financing of the "shared vision for tourism". Going forward to the next consultation with Vanuatu, we would welcome more clarity on staff's plan for a closer engagement in these areas. Staff comments are sought.

Finally, we commend Vanuatu's adherence to the enhanced General Data Dissemination System (e-GDDS). It will increase data transparency and help create stronger synergies between data dissemination and surveillance.

Ms. Pollard and Ms. Svenstrup submitted the following statement:

We thank staff for an insightful report and Mr. Ray and Ms. Park for their helpful buff Statement.

The authorities have nearly completed the recovery from the destruction caused by Cyclone Pam in 2015. They can now turn their focus back to the broader development agenda, which will require fiscal discipline and new revenue generation to fund social priorities and maintain debt sustainability, efforts to rebuild financial buffers, and further progress on the broader structural reform agenda. We broadly agree with staff's recommendations and offer two comments for emphasis.

We welcome the authorities' efforts to address gaps in the AML/CFT framework, which resulted in Vanuatu's removal from the FATF gray list last year. Further improvements and steadfast implementation of the framework will now be important, supported by technical assistance when needed. We fully support staff's call to strengthen the financial sector's regulatory and legal frameworks prior to expanding into new fintech technologies, products, and services. The mandate and responsibilities of the Distributed Ledger Technology taskforce should also be clarified, and its work made transparent.

We appreciate staff's detailed discussion of Vanuatu's external debt, including the table detailing major development partner-financed infrastructure projects. This is a good example of the level of detail that should be routinely included in staff reports. We agree with staff's fiscal advice and welcome the Fund's technical assistance, including support to strengthen public debt management. We support the authorities' efforts to continue strengthening capacity to plan and sequence projects, and to ensure that new projects are subject to feasibility and financial assessments. Could staff comment on the robustness of Vanuatu's current project selection and public investment management processes?

Mr. Sigurgeirsson and Mr. Gade submitted the following statement:

We thank staff for their reports and their work on Vanuatu. Vanuatu is a small state exposed to natural disasters and ranked the most-at-risk country in the world according to the United Nations World Risk Index. The 2016 Article IV staff report, which was written in the immediate aftermath of the devastating cyclone Pam, offered a set of clear recommendations to increase Vanuatu's resilience to natural disasters. In addition, it was recommended to strengthen governance and transparency. We note in this report and the informative BUFF statement by Mr. Ray and Ms. Park that the authorities have continued developing their strategy to enhance resilience to natural disasters, continue to work towards strengthening the AML/CFT framework, and that work is underway to ensure that Vanuatu fulfils its international obligations in the area of taxation. We broadly agree with the staff appraisal and key policy recommendations and offer the following points for emphasis.

Strengthening resilience to natural disasters remains a key priority and disaster planning needs to be accompanied by staffing and funding. We take positive note that the national disaster planning framework has improved in recent years, and that it is a key priority area for the authorities. To ensure stable funding and adequate buffers, we support staff's recommendation of fiscal discipline and further reform of public financial management, while continuing to explore insurance and externally financed instruments in a cost-effective way. We welcome that the authorities have increased the contingency provisions for responding to a series of natural disasters. Much of the reconstruction following the devastating cyclone Pam is now completed. While acknowledging the difficulty in quantifying the effect, does staff have an estimate of how this reconstruction has translated into greater resilience to future natural disasters and the future expected fiscal costs of natural disasters?

We welcome further work to strengthen governance and tax administration. We take positive note that significant progress was made to strengthen the AML/CFT resulting in Vanuatu being removed from the FATF AML/CFT grey list in June 2018. We encourage completion of the Tax Administration Act and the Government Business Enterprise Act to continue strengthening governance and transparency. We acknowledge that Vanuatu has limited administrative capacity and support ongoing technical assistance in these areas.

We would urge caution on drawing too strong conclusions from the assessment of the external sector position given the uncertainty and the context of the exchange rate policy. Given the windfall revenues from the economic citizen program (ECP), the current account gap is assessed to be 6.7 percent of GDP in 2018, which somewhat automatically translates into a REER undervaluation of 18.5 percent. Without those extraordinary revenues, the external position would have been moderately weaker than fundamentals, corresponding to a slight overvaluation of the REER. Looking ahead, lower ECP revenue and imports related to public and private infrastructure projects are assessed to lead towards a stabilization of the current account deficit around 5 percent of GDP. Given the extraordinary flows, future projections, and the inherent uncertainty in the EBA-lite methodology, we would suggest greater caution in interpreting and communicating the results of the External balance Assessment. In addition, we find it more appropriate to use ranges and not point estimates.

Finally, we take positive note of Vanuatu’s likely graduation from LDC status in 2020.

Mr. Sylla, Mr. N’Sonde and Ms. Nankunda submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Ray and Ms. Park for their insightful buff statement.

Vanuatu's macroeconomic performance and reform efforts are a solid basis to nurture a transformational agenda. Progress in economic diversification which should help the economy grow by an average annual rate above 3 percent going forward. While the outlook remains stable, the authorities should intensify their domestic revenue mobilization efforts to finance their economic diversification agenda and depart from overly reliance on development partner funding. Downside risks stem from natural disasters and global tensions. Against this backdrop, the authorities should harness resilience building. We concur with the thrust of staff's appraisal and would like to emphasize the following points.

We commend the authorities for their fiscal reform actions. The introduction of a broader tax regime and enhanced prioritization of expenditures should help maintain the debt target well below the benchmark while preserving extra fiscal buffers to mitigate risks from natural disasters. The authorities should also focus on strengthening fiscal governance by completing the Tax Administration and the Government Business Enterprises to reinforce SOE governance. These measures would also help reduce over reliance on the volatile revenues from the economic citizenship program.

The monetary policy stance remains suitable to fundamentals, and the exchange rate broadly steady in a context of low inflation. We take positive note of the inflation targeting regime and encourage the authorities to enhance the monetary policy framework, including through increasing the CBA 's independence and transparency.

The financial sector is broadly stable but should be closely monitored against excess liquidity, increase of NPLs, and capital adequacy vulnerabilities. We take positive note of the authorities' National Financial Inclusion strategy and the NBV's efforts to expand the scope of FinTech services to rural areas. While these developments represent a welcome opportunity to promote financial inclusion, we wonder whether the Central bank has put in place the adequate regulation to mitigate potential risks? We also encourage the authorities to continue strengthening the AML/CFT framework in line with international standards while boosting financial integrity and minimizing the risks of correspondence banking relationship (CBR) withdrawals. Further efforts are needed to effectively implement the AML/CFT standards and increase transparency in the offshore sector.

Current actions to promote inclusive growth go in the right direction. The authorities' Shared Vision 2030 carries a great potential for the development of the transportation and tourism sectors. We invite the authorities to also pursue enhancements in structural areas that would improve the business environment, notably in customs procedures, property registry, and red tape.

With these remarks, we wish the authorities of Vanuatu success in their endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written report and Mr. Ray and Ms. Park for their informative buff statement. We are encouraged to note that following extensive damages caused by Cyclone Pam in 2015, Vanuatu's economy has been growing strongly, supported by spending on construction. We also welcome the authorities' commitment to foster economic diversification, especially in agriculture and tourism. Since we broadly support staff's analysis and policy recommendations, we would limit our remarks to a few issues.

Since Vanuatu is the world's most at-risk country for natural disasters, as measured by the UN World Risk Index, building resilience to natural disasters will be key. In paragraphs 40-43 of the staff report on addressing risks from natural disasters, we note the steps being taken by the authorities as well as staff's recommendations to enhance preparedness and invest in resilient infrastructure. In this context, we wonder whether the development of a national disaster resilience strategy (DRS), as envisaged in the recent Board paper on "Building Resilience in Developing Countries Vulnerable to Large Natural Disasters" will be useful for Vanuatu considering the ever-present danger of natural disasters. Staff comments would be appreciated.

We commend the authorities for the significant progress in improving the AML/CFT framework that led to removal in 2018 from FATF's grey list of jurisdictions with strategic AML/CFT deficiencies. At the same time, we echo staff recommendation on the need for continued improvements to the AML/CFT regime as well as its effective implementation to strengthen financial sector stability and ease potential pressures on correspondent banking relationships.

Finally, we note that the 2016 safeguards assessment of the Reserve Bank of Vanuatu (RBV) identified several weaknesses in its governance arrangements, autonomy, transparency, and audit mechanisms and made several recommendations to address the weaknesses. In this context, while we take positive note of the progress made so far, we encourage the authorities to continue their engagement with staff to implement the outstanding recommendations.

With these remarks, we wish the authorities further success.

Mr. Ronicle and Ms. Freeman submitted the following statement:

We thank staff for their informative report and Mr. Ray and Ms. Park for their helpful buff statement. We welcome the positive reconstruction programme that has occurred since Cyclone Pam struck four years ago and the stable economic growth path. Given Vanuatu's high risk of further natural disasters, we welcome the focus on this in Staff's recommendations, and, in particular, those around further strengthening debt sustainability and climate resilience.

On debt sustainability, we welcome the Debt Sustainability Analysis, the insight it provides to debt and macro stability, and the recommendations to further build fiscal buffers and resilience against shocks. It is important that there are strong debt management functions and a firm commitment to transparency. We would welcome Staff's assessment of the commitment of Vanuatu to debt transparency, including the availability of data. In addition, given the vulnerability of Vanuatu to external factors, can Staff comment on any work to further explore how resilient debt instruments can reduce risks from natural disaster shocks?

As the world's most as risk country, we welcome the recent efforts of the Government to enhance its approach to disaster risk management and infrastructure resilience. However, we would have welcomed further information and data on climate risk awareness: could staff comment on whether there are plans to mainstream disaster risk awareness throughout Government planning and the banking sector? We also support Staff's recommendation to update the Vanuatu National Adaptation Plan from 2006, and note the development of a CAT-DDO with the World Bank. Could Staff update on: 1). progress and timelines for the development of the CAT-DDO and 2). plans for a Climate Change Policy Assessment? Lastly, we noted that Vanuatu has withdrawn from the Pacific Catastrophe Risk Assessment and Financing Initiative due to the high costs associated with it. We invite staff to reflect on whether there is any further multilateral support that can be provided to ensure that the cost burden is proportionate.

We also noted the progress that Vanuatu has made to comply with FATF standards on AML/CFT and its removal from the FATF Grey List. Given this positive progress, we understand the Authorities concerns with their inclusion in the EU's list of non-cooperative tax jurisdictions and encourage them to continue to collaborate closely with the EU to understand the steps needed for removal. We also support Staff's recommendations of technical assistance for financial supervision and capacity building at the Vanuatu Financial Services Commission and Financial Intelligence Unit. We strongly welcome the efforts of the Authorities to focus on fostering financial inclusion, including as they look to grow their FinTech sector.

Lastly, we noted that the Article IV meetings were conducted jointly with the Asian Development Bank and World Bank and invite Staff's comments and reflections on this approach.

Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Mr. Ray and Ms. Park for an insightful buff statement. We welcome the economic recovery of Vanuatu and commend the authorities for the reconstruction efforts, 4 years after the Cyclone Pam. Given, the ever-present danger of natural catastrophes, Vanuatu policy priority is to strengthen investment in disaster preparedness and in resilient infrastructure. While we agree with the thrust of staff analysis, we would like to make the following comments for emphasis:

We agree with staff that the authorities should look for further domestic revenue mobilization outside the economic citizenship program, notably to build fiscal buffers for natural disasters. At this stage of development and given the needs for fiscal buffer and public investment in resilience, creating a personal income tax and a corporate income tax seems fully warranted. Building tax capacity is even more important in the context of decreasing access to concessional financing and uncertain receipts of the economic citizenship program. More broadly, we remain skeptical of the use of economic citizenship program since they pose significant risks in terms of AML/CFT.

We encourage the authorities to strengthen their debt and investment management frameworks and avoid the potential pitfalls of excessive external debt accumulation. We agree with staff that concessional financing should be prioritized and that management of external financing projects should be extended to SOEs. Debt transparency, through timely and accurate debt recording is key. Could staff elaborate on the DSA consequences or potential of the November 2018 loan agreement with China?

We thank staff for its interesting analysis of excess liquidity in the banking sector. We encourage the authorities to monitor more closely these liquidity developments and to implement the suggested measures to mop up excessive liquidity if deem appropriate. A strategy to reduce non-performing loans should also help to reduce banks' reserves held for precautionary motives.

While we commend the authorities for their efforts to design measures to strengthen the AML/CFT framework, we encourage them to swiftly and effectively implement these reforms and to take advantage of the development partners' technical assistance in this field. Could staff elaborate of the potential risks of the economic citizenship program on ML/FT? We also strongly support staff call for prudent approach regarding fintech.

Ms. Mahasandana and Ms. Pandit submitted the following statement:

We thank staff for a well-written report and Mr. Ray and Ms. Park for their informative buff statement. The Vanuatu economy has made significant recovery after the devasting Cyclone Pam, with growth at 3.2 percent in 2018, while reconstruction is closer to the completion. Moreover, the economy continues to experience low inflation, adequate reserves and a well-capitalized banking sector. However, challenges remain particularly in managing the vulnerability to natural disasters, promoting debt sustainability and improving institutional governance. We commend the authorities' focus on a broad development plan aimed at urban and rural development, improvement of living standards and effective delivery of the community services, as noted in the buff. We broadly agree with the thrust of staff's appraisal and would like to raise the following comments for emphasis.

Fiscal reform is vital to safeguarding debt sustainability and disaster preparedness. We take positive note of authorities' efforts to maintain fiscal discipline based on the National Sustainable Development Plan 2015 to 2030 and the finalization of the debt management strategy. Nonetheless we see some concerns over the trajectory of the public debt. The DSA analysis indicates that the PPG debt-to-GDP is forecasted to be above 60 percent in 2025 due to ailment of concessional loans instead of grants. Furthermore, increasing resilience against frequent natural disasters by building a fiscal buffer remains a key challenge. We therefore see merit in staffs' view that implementation of revenue reforms, modernizing the income as well as corporate tax and expenditure prioritization are critical priorities. We underscore the importance of debt stabilization through overall fiscal reforms to create fiscal space. We welcome the authorities' strong commitment to maintain the target level for the grant element at least 35 percent of development partners financing.

We are encouraged that the banking sector generally remains sound and well-capitalized, but note that high NPLs, further financial inclusion and promotion of use of fintech remain challenges for the financial sector. We appreciate the IMF/PFTAC assistance in conducting the banking diagnostic assessment to help safeguard the financial stability and promote the financial inclusion. We commend the authorities for establishing the new National Financial Inclusion Strategy (NFIS) and the efforts of the National Bank of Vanuatu (NBV) in promoting financial inclusion through the financial literacy, SMEs financing and electronic banking. In addition, the introduction of a legal framework for credit unions is a welcome step to securing the soundness of non-bank financial institution sector and fostering financial deepening. We concur with staff that there is a need to strengthen the regulatory and legal framework, especially to mitigate the possible risks with the greater use of fintech in the system. Furthermore, we welcome the progress made in AML/CFT regime to facilitate the exit Vanuatu from the FATF gray list. This will also help mitigate the impact of potential correspondent banking relationships (CBR) pressure on the financial system.

We concur with staff assessment that the current monetary policy stance is appropriate given contained inflationary pressures. Nevertheless, the contradictory situation of an excess liquidity in the banking sector alongside high lending rates of commercial banks amid restrained credit could reflect weak policy effectiveness. Staff comments are welcome on this matter. In addition, the autonomy of the central bank is crucial to enhance its credibility that leads to the effectiveness of monetary policy.

We commend the authorities' policy initiatives to enhance agricultural diversification through modernization and tourism development. We support the policy initiatives to promote the agricultural diversification through the introduction of modern agricultural method, and to improve access by the farm sector to markets. We likewise see merit in formation of an integrated air travel and tourism plan to boost tourist arrivals. Stepped-up investments in disaster-resistant infrastructure and increase natural disaster crisis preparedness are also vital to boost competitiveness and private investment. In this vein, a national emergency fund as proposed in the Disaster Risk Management Act 2018 is an important step going forward. Similarly, we encourage the authorities to strengthen its governance to address corruption.

We support the ongoing capacity building effort to build resilience in the economy and encourage authorities to continue its constructive engagement with the Fund and development partners in capacity building.

With these comments, we wish Vanuatu authorities and its people success in their future endeavors.

Mr. Sun and Ms. Lok submitted the following statement:

We thank staff for the comprehensive report and Mr. Ray and Ms. Park for their useful buff statement. As recovery from the extensive damage caused by Cyclone Pam reaches near completion, the priority of the small island state of Vanuatu has shifted to broader development to improve living standards and foster longer-term growth. Doing so requires the authorities' prudent macroeconomic management and continued support from development partners including the Fund. We broadly share staff's appraisal and would confine our comments to the following.

Facing strong development needs and significant risks of natural disasters, sound policy management is needed to balance between growth-enhancing investments and building buffers to ensure resilience in times of shock, while preserving debt sustainability. We welcome the authorities' commitment in this regard and their notable efforts in raising revenues and strengthening the debt management framework. As the authorities continue to fill Vanuatu's infrastructure gaps, effective prioritization and sequencing of projects would be critical for ensuring efficient use of resources. To this end, we encourage staff to continue to provide strong support for the authorities in developing their public financial management capacity going forward.

Although Vanuatu's banking sector remains liquid and well-capitalized, elevated non-performing loans and low profitability call for close monitoring and continued strengthening of the supervisory framework. We take positive note that efforts are being made on both fronts by the Reserve Bank of Vanuatu (RBV) with the Fund's assistance. We also support a careful approach towards fintech, such that the benefits from technological innovation can be harnessed without posing additional risks to the financial system. Meanwhile, we commend the authorities' efforts in strengthening the AML/CFT framework, which have resulted in Vanuatu's removal from the FATF grey list in 2018 and in turn contributed to maintaining correspondent banking relationships (CBRs). Nevertheless, we note from the buff statement that the inclusion of Vanuatu on the EU list of non-cooperative tax jurisdictions could potentially undermine the work done on supporting CBRs.

Could staff comment on the potential impact of the EU listing on CBRs and the possible ways by which the Fund could provide support to the authorities to address the EU's concerns?

Stronger institutions and good governance are key to sound policymaking and effective policy implementation. We take positive note of the related efforts underway by the authorities, including in enhancing tax administration and the operation of Government Business Enterprises. Progress is also being made to implement the 2016 IMF Safeguards Assessment recommendations for enhancing RBV's governance and internal controls. On the RBV, we note staff's suggestion that "greater autonomy would help ensure continued policy effectiveness and formally guard against political influence," while it appears that the RBV has been quite effective in keeping inflation within the target range. Could staff elaborate on the specific factors underlying their concern over the RBV's autonomy? What is staff's assessment on the RBV's operational autonomy at present?

With these remarks, we wish the authorities every success with their policy endeavors.

Ms. Levonian, Ms. McKiernan and Mr. Sylvester submitted the following statement:

We thank staff for their well-written report and Mr. Ray and Ms. Park for their helpful buff statement. We commend the Vanuatu authorities for their noteworthy progress in rebuilding the economy following the devastating impact of Tropical Cyclone Pam four years ago. With the rebuilding process largely completed, the authorities can now focus their attention on their broader development objectives, including to build resilience to shocks, to maintain debt sustainability, and to improve governance. In this regard, we note that staff and the authorities are in broad agreement on the main policy priorities going forward, and thus, we limit our comments to issues related to building resilience to natural disasters, strengthening fiscal and financial policies, and improving governance.

On building resilience to natural disasters, we are encouraged by the authorities' continued strong commitment to developing an integrated disaster resilience framework. The authorities have rightfully prioritized building resilience to natural disasters and economic diversification over the years. We commend them for the progress made thus far. They have also recognized that further efforts are required, and, in this context, we welcome recent initiatives through the Disaster Management Act to further strengthen their framework in support ex ante preparation. In this context, we would welcome staff views on the withdrawal of Vanuatu from the Pacific Catastrophe Risks Assessment and Financing Initiative (PCRAFI) and implications, if any, for their disaster resilience framework. Finally, the continued engagement of IFIs and donors, is essential to support Vanuatu's resilience building efforts, as well as those of other countries facing similar disaster-related risks, and, in this regard, we wish to reiterate our call to the Fund and other partners to remain engaged on this important issue.

On fiscal policy, we note positively the authorities' commitment to further fiscal reforms in line with staff's recommendations. Fiscal consolidation will be needed to place debt on a downward trajectory and to restore fiscal buffers. We support the authorities' fiscal reform plans aimed at mobilizing domestic revenues, including through greater reliance on more permanent revenue sources, increasing the efficiency of spending, and strengthening debt management. Further, we welcome the commitment by the authorities to use proceeds from the economic citizenship program to reduce debts, where possible.

On financial sector policy, we urge further efforts to reduce remaining vulnerabilities and protect against emerging risks. As staff notes, the financial sector is broadly stable, but pockets of risks and vulnerabilities exist. We look forward to the results of IMF-led banking sector diagnostic assessment. We note positively ongoing steps to strengthen the AML/CFT framework and, like staff, we urge the authorities to ensure that risks associated with increasing fintech use are properly mitigated. Taken together, these efforts should help reduce risks to corresponding banking relationships (CBRs) and allow for continued progress on financial inclusion.

Finally, on governance, we welcome the progress made thus far and urge continued efforts to further strengthen the governance framework. We note positively ongoing efforts to improve governance in revenue administration, central bank operations, and the AMF/CFT framework. We particularly note the legislative and administrative effort aimed at improving the oversight and management of SOEs. We share the authorities' call for continued support to strengthen governance.

Ms. Mannathoko and Ms. Gasasira-Manzi submitted the following statement:

We thank staff for the comprehensive report and Mr. Ray and Ms. Park for their insightful buff statement. As a a small developing state, vulnerable to frequent natural disasters, including climate-related disasters, volcanoes and earthquakes, Vanuatu faces significant downside risks and is ranked as the most-at-risk country in the world by the UN World Risk Index. The authorities have however managed to adopt policies to support growth, including spending on infrastructure and reconstruction projects after extensive damage caused by cyclone Pam in 2015. Despite more favorable economic performance in recent years, external uncertainties remain with possible adverse impacts from slower than expected global growth, rising protectionism and retreat from multilateralism, tightening global financial conditions, volatility of energy prices and unstable revenues. We therefore welcome the authorities' focus on advancing drivers of medium-term growth - including fostering economic diversification as major infrastructure projects are completed, in order to generate higher, more resilient and inclusive growth, as embedded in the country's development agenda. We also commend the authorities for their commitment to enhancing disaster preparedness and for the progress made so far in improving the disaster planning framework.

Fiscal Policy

The authorities' commitment to maintaining fiscal discipline alongside essential investments in productive and social sectors (as mentioned in the buff statement) is noted. Going forward, sustained fiscal discipline alongside revenue mobilization will be needed to build buffers and maintain debt at sustainable levels. We find the authorities' criteria for accepting loans, focusing on their intended use and their concessionally appropriate, while noting that the risk of debt distress is moderate (attributed to a perceived shift in the rate of accumulation). Nevertheless, vulnerability to natural disasters remains high necessitating additional measures. In this regard, we welcome the progress made on strengthening the debt management framework and the improvements being made to the debt management strategy, drawing on assistance from development partners. In addition, continued expenditure restraint and project planning and prioritization remain important. We also see merit in measures geared towards additional revenue mobilization, including efforts to broaden the revenue base and reduce reliance on Economic Citizenship Program (ECP) revenues. We note the introduction of an updated Tax Administration Act that came into force in 2019, following a review of current taxes, non-tax revenues and revenue administration. Could staff provide further information on the new policies and how much they expect them to impact the fiscal position?

Monetary and Financial Policies

We concur that the monetary policy framework has worked well to contain inflationary pressures and that the Reserve Bank of Vanuatu (RBV) should stand ready to adjust the policy stance in line with economic conditions. However, excess liquidity in the banking sector poses some challenges for monetary policy implementation. Could staff elaborate on why OMOs are not effective in mopping up the additional excess liquidity? Is there a sterilization cost issue (due to the need for larger of more frequent issuance) or is excess liquidity that is mopped up in one period subsequently replaced necessitating further OMOs? Are there no other investment instruments that banks can use? Although staff proposes tightening the monetary policy stance through a gradual increase of banks' Statutory Reserve Deposit (SRD) requirement over the medium term, this also poses some financial stability risks in light of high non-performing loan (NPL) ratios in some banks. In this regard, we agree that there is need for a banking diagnostic to analyze excess liquidity and would appreciate staff's comments on the request for a regional analysis of this issue. That said, there is also a need to strengthen the supervisory and regulatory framework of the financial sector, given elevated NPLs over half of which are in the household sector, in addition to the low profitability of banks. At the same time, competition in the banking sector should be facilitated to avoid monopolistic tendencies and the associated impact on monetary policy transmission, that could negatively impact credit to the private sector.

We commend the authorities for their progress with the AML/CFT framework and their exit from the FATF "grey list" in 2018. We encourage continued reform implementation. The progress made by the authorities to strengthen financial inclusion, including the new National Financial Inclusion Strategy 2018-23, is welcome. We also note the authorities' concerns regarding fintech risks and their desire to better understand the possibilities and regulatory requirements. We therefore encourage support to ensure the appropriate regulatory and legal framework is put in place to harness the opportunities of fintech while protecting against risks. The regulatory framework should strike the right balance between safeguarding the financial sector and promoting innovation, inclusion and efficiency in the financial sector.

Structural Policies

We support the authorities' plans to continue strengthening economic diversification, including through policies to diversify agriculture along the production chain and to promote tourism. This should be supported by policies that promote a favorable business environment and encourage private sector development. Simplifying and removing bottlenecks in the regulatory environment should support increased FDI and boost employment opportunities. The authorities' commitment to strengthening governance, is also welcome. It will contribute to the strengthening of institutions, making them more efficient and improving Vanuatu's competitiveness, which will in turn help to trigger private investment.

With these comments we wish the Vanuatu authorities success.

Mr. Guerra and Ms. Arevalo Arroyo submitted the following statement:

We thank staff for the paper and Mr. Ray and Ms. Park for their helpful buff statement.

We find the forthcoming completion of the reconstruction efforts in Vanuatu encouraging after the catastrophic damages by Cyclone Pam in 2015. This will allow the authorities to focus on a broader development agenda to boost growth and improve governance in hand with development partners. Going forward, Vanuatu's distinctive geographical characteristics, as described by Mr. Ray and Ms. Park in their statement, pose significant challenges for its development and resilience.

On fiscal policy, fiscal discipline and reforms will be required to secure sustainability in the medium term. We note from the DSA analysis that government debt will breach its 60 percent of GDP target in half a decade under the current scenario. This calls for further action beyond the recent improvement in the fiscal policy framework by the authorities. In particular, we support staff's view on the need to complete the proposed 2017 tax reform and give priority to project financing using grants and loans with higher concessionality. The authorities should prioritize loans on the basis of preventing the breach of the debt target and limit the loans made available to SOEs. In this regard, we note the commitment of the authorities, as stated in the buff, to continue with fiscal discipline by maintaining a recurrent surplus budget over the medium term and keeping public debt below 60 percent of GDP, including publicly guaranteed debt.

While inflationary pressures have been contained, we take note of the effects of excess liquidity in the banking sector on the monetary policy transmission mechanism in the medium term. We thank staff for the analysis in Annex VI, but as noted in Mr. Ray's and Ms. Park's buff, we consider that a regional analysis of drivers and policy responses in the next Article IV consultation would be useful as this is an issue that several Pacific island states experience.

Notwithstanding a broadly stable financial sector and recent progress in some fronts, further efforts to address vulnerabilities and enhance financial inclusion is encouraged. The use of fintech could be a good avenue to boost financial inclusion, but a prudent approach is warranted. Strengthening the supervisory framework in this regard will be necessary to ensure financial stability and avoid AML/CFT risks.

We welcome improvements in strengthening the AML/CFT regime and look forward to its implementation. We commend the authorities for the work that led to Vanuatu's removal of the FATF's "grey list". We also agree with staff that technical assistance could be beneficial in the enforcement efforts. We take note that improvement to this regime could alleviate pressures on correspondent banking relationships.

Continued progress on the governance front will allow to foster growth as institutions are strengthened and gaps are closed. We welcome the ongoing commitment from the authorities to improve public financial management and strengthening fiscal governance, among other initiatives.

Moreover, to enhance both monetary and financial policy effectiveness, bolstering the autonomy of the RBV is of the essence. In this regard we welcome initial progress in the implementation of the IMF's 2016 Safeguards Assessment recommendations.

The Acting Chair (Mr. Zhang) made the following statement:

When we talk about Vanuatu, one thing that stands out immediately is the country's vulnerability to natural disasters and climate change. The country is measured by the U.N. World Risk Index as one of the world's most at-risk countries for natural disasters and climate change. Consequently, it is natural that all gray statements highlight these vulnerabilities and risks. The gray statements also highlighted the need for fiscal discipline, including broadening the tax base to reduce the reliance on the economic citizenship programs, and to try to put debt sustainability back on track.

Other important issues include strengthening governance and making continued progress in enforcing the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework and dealing with the issues of correspondent banking relationships (CBRs). All of these are crucial to the country.

Mr. Ozaki made the following statement:

We are pleased to see that following Cyclone Pam in 2015, reconstruction is near completion, with a full recovery in sight, and the economy has been growing strongly, supported by infrastructure projects. At the same time, the country faces important challenges, such as safeguarding debt sustainability and fostering stable growth and resilience. Since we broadly concur with the thrust of the staff appraisal, we will provide three comments.

First, on fiscal policy, we note that public sector debt has increased sharply. Under these circumstances, while new loans must have a grant element of at least 35 percent under the debt management strategy introduced in 2015, as in Mr. Ray and Ms. Park's buff statement, we take note that the grant element of the recent loan was lower than the authorities' commitment.

While we observe that the government has an ambitious development agenda, we urge the authorities to focus on grants and highly concessional loans to fund projects, and to strengthen the debt management framework.

We also note that the total cost of financing the Shared Vision 2030 is uncertain. The government is at risk of being required to guarantee any debt financing to Air Vanuatu. The authorities need to be mindful of the risk from state-owned enterprises (SOEs) and closely monitor the situation. In order to safeguard debt sustainability over the medium term, we encourage the authorities to engage in further fiscal reform, including tax reform, reducing their reliance on revenues from the economic citizenship program, and prioritizing the reduction of future borrowing for infrastructure, as the Acting Chair emphasized in his initial statement.

Second, on financial sector policy, it is encouraging that the banking sector has a strong capital and liquidity position. We commend the authorities' efforts that led to Vanuatu's removal in 2018 from the Financial Action Task Force's (FATF) gray list. At the same time, given the elevated nonperforming loans (NPLs) and the low profitability, we support the authorities' policy measures for stronger supervision, including the introduction of a new legal framework for credit unions and a review of the Reserve Bank of Vanuatu's approach to risk-based supervision.

Lastly, we commend the staff for allowing staff from the World Bank and the Asian Development Bank to join relevant meetings, which allowed all involved to draw on each other's expertise and to make the best use of the authorities' time, as the buff statement pointed out.

In response to Mr. Gokarn's and Mr. Ronicle's questions in their gray statement, the staff reiterated that the cooperation has enriched Fund staff's understanding of the issues in Vanuatu, which we also welcome.

Ms. Mahasandana made the following statement:

We thank the staff for the comprehensive report and Mr. Ray and Ms. Park for their buff statement. We have issued a gray statement and also would like to thank the staff for their responses, especially on our questions related to excess liquidity, high lending rate, and tight credit conditions in Vanuatu's banking system.

The situation is not only true for Vanuatu. Many countries in the Pacific region, as well as some countries in my constituency, are also experiencing this issue. It is also important because it results in a weak transmission mechanism.

We would like to echo what Mr. Doornbosch has mentioned in his gray statement and would encourage the staff's further work to provide an in-depth analysis and practical recommendations for the country's persistent excess liquidity, high lending rate, and tight credit markets.

Mr. Sylvester made the following statement:

We issued a gray statement, in which we commended the Vanuatu authorities for the meaningful progress made in rebuilding the economy following the devastating impact of Tropical Cyclone Pam some four years ago. We also broadly concurred with the staff's appraisal and recommendations. I want to use this intervention to underscore the need for the Fund to support building ex ante resilience to natural disasters and climate change, and to support the authorities' call for further work to support financial sector soundness.

We welcome the strong focus on building resilience to natural disasters and climate change in the report, and we appreciate the staff's response to our question regarding Vanuatu's withdrawal from the Pacific Catastrophe Risk Assessment and Finance Initiative.

Like many in our constituency, Vanuatu's vulnerability to natural disasters and climate change is a perennial risk. Like others, we also would be interested in hearing the staff's views on the relevance of the disaster resilience strategy (DRS) framework recently discussed at the Board for

Vanuatu and whether the DRS framework was discussed with the authorities. We also wish to reiterate our call for the Fund and other partners to continue to remain engaged on this important issue.

Finally, we would like to support the authorities' call for analysis and policy advice on reducing excess liquidity in the banking system.

The staff representative from the Asia and Pacific Department (Mr. Muir), in response to questions and comments from Executive Directors, made the following statement:[1]

I appreciate all the comments that we received and the questions from the gray statements. They are interesting to read, and we hope we have been able to answer them satisfactorily through the responses we gave.

At this time, I would like to answer Mr. Sylvester's question about the DRS paper. The relevance of that framework for Vanuatu is very high. To a large degree, they have engaged in that planning. They have several strategies in place that cover the main points of the DRS. We did not explicitly discuss it during the meetings this time, simply because it was not as available in this form. However, it is something we will discuss going forward.

One of the major features they have is a resilience strategy that was put in place last year. They also are in the process of passing the Disaster Risk Management Act this year, which basically codifies in law how they will treat the budgetary matters for dealing with natural disasters. They also have a strategy that they are updating currently that deals with resilient infrastructure. It is a strategy that was put in place before Cyclone Pam, and it is being updated now, as it has basically expired.

Furthermore, during the infrastructure building that has taken place in the last three or four years with the development partners, that has been one of the large concerns of the planning phase—that they are building infrastructure that is resilient and will withstand a natural disaster of the magnitude of Cyclone Pam. When we were in Port Vila, that was very visible to us as we saw the city.

Mr. Ray made the following concluding statement:

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

I thank colleagues for their statements and for their remarks. We will be sure to convey Directors' views, suggestions, and encouragement to our Vanuatu authorities.

I thought I would make a few additional remarks about the challenges in policy making in Vanuatu and how the Fund can best help, because that is probably of relatively broad interest.

Vanuatu is prone to natural disasters, which can add to an already large infrastructure need. The distance from major markets and the narrow economic base also pose challenges for development. Gathering a political consensus for major reforms can be quite difficult. In Vanuatu, there are 65 or so inhabited islands. There are 100 different language groups. Island loyalties and linkages are important to the Vanuatu people's sense of identity.

Politics in Melanesia can be robust, and governments in Vanuatu typically comprise fluid coalitions of small parties. Vanuatu has had even more prime ministers than Australia in the past 20 years. There have been 16. The authorities are navigating some difficult policy tradeoffs in a complicated political environment. They are conscious of the need to balance spending on needed infrastructure, with maintaining fiscal discipline. They agree that their revenue base needs to be broadened in the future. But on income tax, more time is needed to get political support for key measures, and there is an election coming up later this year.

The staff's analysis on risks to fiscal sustainability is useful to the authorities to build the case for reform. I would caution, however, against undercutting the message with too much fine-tuning of advice. For example, small tweaks to the advice on medium-term fiscal targets can, in the end, be a bit unhelpful and can undermine credibility for what is a generally very sound framework.

Broadening access to credit is a priority for the authorities and is enabled by a relatively healthy financial system. The staff's work on understanding the causes of excess liquidity has been useful. As colleagues have commented, my authorities would like some more work done in this area because it would help in identifying policy responses.

As this issue is not unique to Vanuatu, a point that Ms. Mahasandana stressed, perhaps the Fund could look for solutions that have worked elsewhere.

The Reserve Bank of Vanuatu undertook a safeguards assessment in 2016. It has made progress in addressing their recommendations. One area where work is still underway is on formal independence in the Reserve Bank Act, and a number of Directors commented on this. The Reserve Bank is working closely with Fund's legal experts on how to proceed. This assistance is also useful. The experts provide information on good practice from elsewhere in the world. I do wonder, though, about the emphasis on this form of independence. As the staff notes in their responses to questions, the Reserve Bank, in fact, has a fair degree of autonomy in practice. In my personal experience, the Governor is highly respected and influential. So potential gains from additional formal independence needs to be balanced against the Reserve Bank's concerns—it is the Reserve Bank that is worried about it, not the government—that opening up this act may lead to unhelpful changes that all of us around this table would not want to see. It is a question of ensuring operational independence and taking the opportunity at a politically opportune moment in order to formalize it.

Lastly, I thank Mr. Muir and his team for their hard work and acknowledge the collaborative approach, as staff from the World Bank and the Asian Development Bank did join relevant meetings. This is very helpful. The team also prepared a one-page summary of their findings for their minister to share with his colleagues. This is something we see as useful for building traction for the Fund, and we encourage the Asia and Pacific Department to continue doing so.

The Acting Chair (Mr. Zhang) noted that Vanuatu is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the recovery from Cyclone Pam and the authorities' focus on broader development objectives to improve living standards and long-term growth. The high exposure to natural disasters remains a key risk to the outlook, and Directors underscored the need for additional efforts to build adequate fiscal buffers, strengthen governance, and to enhance disaster resilience. The authorities should continue constructive engagement with their development partners for technical assistance, capacity development, and financing.

Directors stressed the need for continued fiscal discipline. They noted that the long pipeline of development projects is likely to put upward pressure on debt ratios. To safeguard debt sustainability, the government should prioritize infrastructure investment and engage in further fiscal reform, including introducing corporate and personal income taxes while removing inefficient taxes, reducing reliance on revenues for the economic citizenship programs. Directors noted that this would allow the authorities to lower the public-and-publicly-guaranteed-debt-to-GDP target to 50 percent.

Directors considered the monetary policy stance to be appropriate as inflation is expected to stay near the middle of the 0-4 percent target band. They recognized that excess liquidity in the system may be reducing monetary policy effectiveness and should be closely monitored.

Directors agreed that the authorities' strategy should be underpinned by diversification in agriculture and tourism. Directors noted that the diversification strategy should be complemented by improvements in the business environment to help trigger private investment and enhance competition and productivity.

Directors commended Vanuatu for its removal from the FATF grey list and recommended that the financial sector's regulatory and legal frameworks be further strengthened to account also for increasing fintech use. Together with ongoing progress in enforcing the AML/CFT framework, this should help maintain correspondent banking relationships. Directors also noted that the 2018-2023 National Financial Inclusion Strategy should help improve broaden access to finance and inclusion more generally.

Directors noted that the national disaster planning framework has been improved substantially in recent years. Directors viewed the proposed Disaster Risk Management Act with its national emergency fund as an opportunity to establish a multi-year fund with consistent government funding.

Directors recognized that, with limited administrative capacity, Vanuatu is vulnerable to corruption from gaps in governance. To address these vulnerabilities, they suggested further strengthening the Reserve Bank of Vanuatu's autonomy, in line with recommendations from the IMF's 2016 Safeguards Assessment and strengthening fiscal governance by completing the Government Business Enterprises Act and the Tax Administration Act.

It is expected that the next Article IV consultation with Vanuatu will be held on the standard 12-month cycle.

APPROVAL: April 21, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook, Fiscal, and Debt Policy

1. ***The expected gradation of Vanuatu from LDC status in 2020 is anticipated to have no significant impact on its growth path. However, the expected reduction of preferential market access for exports due to this graduation will need specific attention. Hence, we encourage the authorities to continue their efforts to find alternative means of preferential access. Could staff comment on the avenues available for this, in addition to the PACER plus free trade agreement?***

- Bilateral agreements can supplement multilateral ones, including the PACER Plus. In this regard, the authorities are currently discussing bilaterally with New Caledonia and Japan.

- In February 2019, Vanuatu has signed a trade agreement with New Caledonia to free up trade for about 50 products. Vanuatu can export agricultural products including coffee without duties or quantity restrictions. In return, New Caledonia can supply processed food and building materials. The agreement has been endorsed by the New Caledonia Congress in March 2019. Vanuatu is expected to approve it in the coming months. Solomon Islands and Fiji may join the trade deal.

- Other potential avenues exist, such as discussions with China, given the closer relationship through the Belt and Road Initiative.

2. ***We would welcome if staff could further elaborate on the possible factors behind the recently strong revenue inflows from economic citizenship programs (which are estimated having more than doubled in 2018 relative to 2017, according to Table 2).***

- There are several factors, including successful replacement of Vanuatu Economic Rehabilitation Program (VERP) with Vanuatu Development Support Program (VDSP) and Vanuatu Contribution Program (VCP) in March 2017. There is also the increased realization on the part of foreign investors that when they join the program they face fewer restrictions and regulations to start businesses within Vanuatu that other investors would have to comply with through Vanuatu’s foreign investment regime.

3. ***We note that strong revenues from the Economic Citizenship Program (ECP) could motivate delays in the tax reform. Could staff indicate whether there is an estimated timeframe to complete the implementation of the tax reform measures?***

- The authorities plan to:
- Revise the tax administration bill first, which prescribes an introduction of a tax identification number. This underway
- complete a review of government spending and efficiency, also underway.
- Then, they plan to introduce the personal and corporate income taxes, the timing of which is very uncertain because of the political process. At this time, there is no set target, and it seems unlikely new taxes would be introduced before the next election in early 2020.

4. ***Could staff elaborate of the potential risks of the economic citizenship program on ML/TF?***

- Although there are legitimate reasons for seeking citizenship or residency through investment, countries need to be cognizant of all the motivations that might underpin such a decision. Economic citizenship programs (ECPs) may increase a country's exposure to illicit flows, particularly those stemming from foreign tax offenses.
- To that end, in Vanuatu, ECPs are not open to some countries (such as Iran, Iraq, Democratic People's Republic of Korea, Syria and Yemen). There is a vetting process for applications by the Financial Intelligence Unit using international databases. However, Vanuatu, needs to remain vigilant given their capacity constraints, to prevent the granting of economic citizenship to individuals linked to organized crime, corruption, or other financial crime (including tax evasion).
- Otherwise, ECPs:
- could allow foreigners to travel under a Vanuatu passport and avoid some degree of scrutiny in other countries.
- provides easier access to conducting business in Vanuatu and will not necessarily face the same degree of scrutiny as a foreign investor under Vanuatu's foreign investment regime.

5. ***Could staff comment on the robustness of Vanuatu's current project selection and public investment management processes?***

- The *Vanuatu Infrastructure Strategic Investment Plan* 2015-24 (VISIP) sets out the project selection methodology.

- The authorities can enhance coordination role of Vanuatu Project Management Unit (VPMU) and other ministries, including Ministry of Infrastructure and Public Unities and Ministry of Finance and Economy, in terms of selecting and managing projects.

- There has been some analysis underway in the VPMU to account for delays in projects such as the Interisland Shipping Project, and how to improve and strengthen contracts, regulations, and processes going forward.

- Given a limited funding for maintenance of public infrastructure, the authorities need to enhance capacity to plan and implement maintenance projects.

6. ***We would welcome Staff's assessment of the commitment of Vanuatu to debt transparency, including the availability of data. In addition, given the vulnerability of Vanuatu to external factors, can Staff comment on any work to further explore how resilient debt instruments can reduce risks from natural disaster shocks?***

- The authorities publish the statement of borrowing in the annual budget documents. They intend to publish quarterly reports of debt data, starting early 2019. This is a welcome step towards enhancing debt transparency.

- Staff are currently looking at the scale of fiscal buffers needed for disaster-prone Pacific island small states like Vanuatu and the range of different financial options available to them to build resilience to natural disasters, including aid and concessional loans.

- The recent draft Board Paper "Building Resilience in Developing Countries Vulnerable to Large Natural Disasters", also mentioned in question 18 below, discusses increasing the range of climate-resilient debt instruments available (with some suggestions as to types of instruments) and increasing access to them.

7. ***Could staff elaborate on the DSA consequences or potential of the November 2018 loan agreement with China?***

- Staff incorporates the November 2018 loan agreement with China into the baseline scenario under the DSA. The disbursement of this USD 51 million project is assumed to take place from 2019 to 2021.

- Relative to the last DSA, disbursements from China are assumed to be higher, given the November 2018 loan, following the rules for concessionality laid out by the Ministry of Finance and Economic Management.

8. ***We note the introduction of an updated Tax Administration Act that came into force in 2019, following a review of current taxes, non-tax revenues and revenue administration. Could staff provide further information on the new policies and how much they expect them to impact the fiscal position?***

- The Tax Administration Act (TAA) is still not fully implemented. Although it was passed in December 2018, the accompanying bills with consequential amendments to other legislation need to be passed for the TAA to be certified.

- The introduction of a tax identification number regime for individuals and firms would enhance the country's tax administration and could be used to help introduce personal and corporate income taxes.

Monetary Policy and Financial Sector

9. ***Could staff elaborate on the specific factors underlying their concern over the RBV's autonomy? What is staff's assessment on the RBV's operational autonomy at present?***

- Staff's concerns on the RBV's autonomy arise from the 2016 safeguards assessment, which found that the *RBV Act* ("Act") does not provide for sufficient institutional or personal autonomy. For example, the Governor, the Deputy Governor, and Board members do not have due process protection in the event of dismissal and the Act requires approval of the Minister of Finance for certain Board decisions. The Act needs to be amended to help ensure central bank autonomy and align with leading practices, but the authorities have been slow in addressing these issues including other safeguards recommendations notwithstanding staff's follow up.

- In practice, the RBV appears to have a fair degree of autonomy, which is evidenced by a gradual decrease in credit to government in the last three years, and recent retention of the 2016 and 2017 profits to build up the central bank's financial buffers.

10. ***We take positive note of the authorities' National Financial Inclusion strategy and the NBV's efforts to expand the scope of FinTech services to rural areas. While these developments represent a welcome opportunity to promote financial inclusion, we wonder whether the Central bank has put in place the adequate regulation to mitigate potential risks?***

- The RBV takes note of the potential risks, including credit risk, associated with promoting financial inclusion. It regularly monitors the state of non-performing loans (NPLs) and can take necessary measures to address NPL issues.

- The RBV is working on the drafting of the new Vanuatu Credit Union (VCU) Act to accommodate the large Cooperative Savings and Loans Societies (S&Ls) to a credit union under the VCU Act, with assistance from the IMF. This would enhance the supervision and regulation of S&Ls, which plays an important role in providing credit, especially in more remote locations.

11. ***The contradictory situation of an excess liquidity in the banking sector alongside high lending rates of commercial banks amid restrained credit could reflect weak policy effectiveness. Staff comments are welcome on this matter.***

- The banking sector in Vanuatu has large free reserves, but a significant portion is being hold for precautionary motives. Given the high number of nonperforming loans and the absence of an active inter-bank market, banks seem to hold higher-than-normal ratios of liquid assets at the central bank for self-insurance. More disaggregated data on commercial banks' reserves would be useful to assess the proportion of excess liquidity in free reserves.

- The underlying concern that the monetary policy transmission mechanism is weak or ineffective is well founded. However, the main concern is not excess liquidity by itself, but a weak interest rate transmission channel that largely reflects structural characteristics of financial markets. In Vanuatu, interest rate pass-through is mainly limited because of monopolistic competition of banks and credit market frictions.

12. ***Could staff comment on the potential impact of the EU listing on CBRs and the possible ways by which the Fund could provide support to the authorities to address the EU's concerns?***

- The EU listing is a bilateral matter between EU and Vanuatu. Vanuatu has begun bilateral discussions with the EU, as is appropriate. In principle, the current EU listing as a non-cooperative tax jurisdiction is based on a lack of follow-up on commitments made in 2017. List by the EU could have some bearing on the decision of foreign correspondent banks to enter, maintain or terminate a relationship if it is deemed as reflecting a heighted ML/TF risk with associated increased compliance costs. If Vanuatu were to request technical assistance from the IMF on matters relating to the outcomes of those discussions with the EU, the IMF would of course consider if we can provide the needed technical assistance.

13. ***Could staff elaborate on why OMOs are not effective in mopping up the additional excess liquidity? Is there a sterilization cost issue (due to the need for larger of more frequent issuance) or is excess liquidity that is mopped up in one period subsequently replaced necessitating further OMOs? Are there no other investment instruments that banks can use?***

- To reduce excess liquidity, RBV can use sterilized intervention to reduce the monetary base. For instance, OMOs would result in a reduction of central bank's net foreign assets and a contraction of the monetary base.

- OMOs may also be ineffective, since they only have a small market interested in buying its bonds. And they may drive up interest rates in the economy.

- Sterilizing large capital inflows is costly for a small central bank such as the RBV as a consequence of the need for larger and more frequent issuance of central bank bills or short-term government securities. Issuing a large stock of securities to mop up the capital inflow can place a heavy debt-service burden on the government or RBV. Moreover, operating losses for the RBV can occur when the funds it raises are invested in foreign assets, which earn prevailing global interest rates – often lower than rates the RBV must pay on the bills it has sold.

- The RBV could tighten its monetary stance through a gradual increase of banks' statutory reserve deposit (SRD) requirement over the medium term. This would increase the percentage of money held as deposits at the RBV and mechanically reduce free reserves of commercial banks. However, higher SRD requirements could also shrink voluntary reserves in some banks and increase financial stability risks as banks with higher NPLs tend to hold a larger share of liquidity for precautionary reasons.

14. ***In this regard, we agree that there is need for a banking diagnostic to analyze excess liquidity and would appreciate staff's comments on the request for a regional analysis of this issue.***

- The banking diagnostic is ongoing, conducted by MCM, with a two-week visit to Vanuatu in May after the Article IV consultation visit.

- In terms of regional analysis on this issue, the Small States has yet to discuss it, but this is a longstanding issue in the Pacific region for a number of states, that has also been prominent in the past.

- There has been work done in the past, highlighted in Chapter 14 by Jan Gottschalk, in the IMF volume published in 2016, *Resilience and Growth in the Small States of the Pacific* (edited by Khor, Kronenberg, and Tumbarello).

- In the Vanuatu Staff Report, for example, Annex VI on excess liquidity uses the example of past policy actions in Fiji.

Structural

15. ***Could staff comment on the capacity issues that could delay infrastructure projects?***

- Coordination issues related to contractors' implementation plans have resulted in major delays in key projects such as upgrade of the runway at the Bauerfield International Airport.

- There is room for improvement in coordinating key stake holders, monitoring the project implementation, and providing sufficient funding for maintenance.

- With regards to projects by development partners supervised by the Vanuatu Project Management Unit (VPMU), there has been some analysis underway. This includes, for example, drawing on lessons learned from delays in projects such as the Interisland Shipping Project, to learn how to improve and strengthen contracts, regulations, and processes going forward.

16. ***Addressing structural impediments is important to encourage other economic activities, given the high reliance on agriculture and tourism. Providing financial services in the rural areas, enhancing labor skills and lowering cost of doing business are essential towards this direction. Could staff elaborate on other potential areas of diversification in Vanuatu?***

- Tourism remains the center of economic activity benefiting from markets such as Australia and New Zealand, and more recently East Asia (China, Japan) and Europe. Improvements in connectivity—owing to the recently completed submarine cable, planned investments in transport infrastructure —are attracting more tourists. However, lessons from past experiences with natural disasters point to segmenting the tourism space in Vanuatu into several distinct locations, for example by marketing Pentecost Island, Espiritu Santo and Port Vila separately. Such a strategy has proven to be successful in the Caribbean, Latin America and Southern Europe.

- Further, diversification towards agricultural activities, for example by efforts to increase the production of Vanuatu’s internationally recognized beef, would provide an additional defense against external shocks. Strengthening linkages of tourism with agriculture and promoting agri-tourism can foster inclusive growth by enhancing domestic value-addition in tourism and creating incentives for farmers in the outer islands to move away from subsistence agriculture.

- Another possibility, over the long term, is whether Vanuatu might become a transportation hub. Air Vanuatu sees strong opportunities in the growing inbound tourism market as it operates from an airport that is in the geographic center of South Pacific. Further investment would be needed to expand airport infrastructure (such as Bauerfield international airport) that is already operating close to, and sometimes beyond, capacity.

17. ***We noted that the Shared Vision 2030 plan is expected to play a key role in bolstering tourism growth. However, as elaborated in Box 1, the total cost and financing for this is uncertain. Staff's comments are welcome on this along with alternatives if required financing is not secured over the medium term [for Shared Vision 2030].***

- On one hand, the Vanuatu Tourism Office (VTO), Air Vanuatu and the Vanuatu airports may require further support from the government. On the other hand, the Vanuatu National Provident Fund (VNPF) or the private sector may be more involved as financiers.

- So far, the government has provided deposits for some airplanes and is at risk at being required to guarantee any debt financing, as Air Vanuatu is a SOE. This could also be the case if financing was to be provided by the VNPF, itself an SOE.

- Options that Air Vanuatu could also consider:

- negotiating leasing contracts for the new aircraft or continue negotiating aircraft prices with Airbus.

- a joint venture with a larger foreign airline, which could reduce the costs of expanding operations to Air Vanuatu.

- Vanuatu could seek support from other Pacific states, helping strengthen economic cooperation in the region. There could be a regional strategy for tourism to promote diversity and cultural richness of the Pacific and share marketing expenditure and risks among participating states.

Disaster Resilience

18. ***We wonder whether the development of a national disaster resilience strategy (DRS), as envisaged in the recent Board paper on "Building Resilience in Developing Countries Vulnerable to Large Natural Disasters" will be useful for Vanuatu considering the ever-present danger of natural disasters. Could the staff comment?***

- The authorities developed the *Climate Change and Disaster Risk Reduction Policy (2016-2030)* with support from the United Nations Development Programme, Secretariat of the Pacific Community, German Agency for International Cooperation (SPC/GIZ), and the Australian Government. The policy includes governance, finance, climate change adaptation, and disaster preparedness. It is similar in concept to the DRS proposed in the Board Paper.

- Given the withdrawal of from the Pacific Catastrophe Risks Assessment and Financing Initiative (PCRAFI), current Fund recommendations concerning the authorities' establishment of a national emergency fund, and discussions with the World Bank and ADB on contingent credit (CAT-DDO and Pacific Disaster Contingent Savings Facility respectively), the authorities should consider updating the policy's section on financing.

19. ***Much of the reconstruction following the devastating cyclone Pam is now completed. While acknowledging the difficulty in quantifying the effect, does staff have an estimate of how this reconstruction has translated into greater resilience to future natural disasters and the future expected fiscal costs of natural disasters?***

- The objective of reconstruction projects supported by development partners, such as World Bank, ADB, JICA, Australia, New Zealand (among others), is to reconstruct and/or improve the disaster and climate resilience of selected public sector assets (road and school) impacted by Cyclone Pam. Therefore, staff believes some reconstruction projects would contribute to enhancing resilience to natural disaster and reducing the expected fiscal costs of natural disasters. To assess the numerical reconstruction effect, staff needs to understand further the details of reconstruction projects. There is no work of which staff is aware, at this point, on quantifying the benefits of resilient construction in the Pacific islands.

20. ***Given the country's susceptibility to natural disasters and the importance of effective insurance schemes, could staff elaborate about Vanuatu's withdrawal from the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI)?***

21. ***In this context, we would welcome staff views on the withdrawal of Vanuatu from the Pacific Catastrophe Risks Assessment and Financing Initiative (PCRAFI) and implications, if any, for their disaster resilience framework.***

22. ***Lastly, we noted that Vanuatu has withdrawn from the Pacific Catastrophe Risk Assessment and Financing Initiative due to the high costs associated with it. We invite staff to reflect on whether there is any further multilateral support that can be provided to ensure that the cost burden is proportionate.***

- The PCRAFI allows its member countries to receive the immediate financial support in the aftermath of natural disaster. In fact, Vanuatu received a payout of US$ 1.9 million after the Cyclone Pam in 2015 under the Pacific catastrophe risk insurance pilot program, which formed an integral part of the PCRAFI.

- However, given the premiums, the payout for Vanuatu was perceived to be somewhat small, plus the requirements to receive pay-outs were perceived as relatively restrictive.

- The withdrawal itself does not affect the disaster resilience framework. Staff welcomes alternative efforts to enhance financial resilience, including the authorities' discussion with the World Bank on the CAT-DDO, a contingent financing line that provides immediate liquidity. We also make recommendations in the Staff to take advantage of the opportunity for making the national emergency fund a multi-year vehicle when establishing it, with development partner support, if possible.

- Staff notes there was a plan to establish a regional natural disaster fund, which was called Melanesian Emergency Stabilization Fund in 2015. However, thus far not much progress has been made in establishing a fund. According to 2017 annual report of Melanesian Spearhead Group (MSG) Secretariat, there was a lack of appetite for MSG members to pursue the initiative at the sub-regional level.

23. ***Could staff comment on whether there are plans to mainstream disaster risk awareness throughout Government planning and the banking sector?***

- The *Climate Change and Disaster Risk Reduction Policy (2016-2030)* discusses concrete measures to improve community awareness, given the remoteness of many islands and the diversity of languages. The policy is discussed above in response to question 18.

- The banks have put in place their business continuity plans to ensure that most households and business have enough physical currency to proceed with their daily activities, even when banks and ATM machines are closed. 3 of the 5 banks also have foreign parents that would likely assist in the event of a large-scale natural disaster.

24. ***Could Staff update on: 1). Progress and timelines for the development of the CAT-DDO and 2). plans for a Climate Change Policy Assessment (CCPA)?***

- 1) Although staff understand the World Bank is currently discussing the CAT-DDO with the authorities, we do not have any information on specific timelines.

- 2) CCPAs have been conducted for Belize, Grenada, St Lucia, and Seychelles, and one is going ahead for Micronesia. The last of the envisaged six pilot CCPAs is planned for Tonga in December. Following that a stocktaking will be undertaken in collaboration with the World Bank.

Procedural

25. ***We positively note the staff's collaborative approach with other development partners in the Article IV consultation process and encourage the increased use of this approach by other Fund missions as well, particularly on small states as well as countries vulnerable to natural disasters. Could staff comment?***

26. ***Lastly, we noted that the Article IV meetings were conducted jointly with the Asian Development Bank and World Bank and invite Staff's comments and reflections on this approach.***

- The ADB and World Bank asked to join our meetings, and we had preliminary communications on the topic well in advance of the mission. We consulted with the authorities, and they laid out the parameters of which meetings to attend – for example, the ADB did not attend meetings concerning the DSA, while neither attended meetings at the RBV or with the other development partners.

- The ADB and WB attended select meetings as observers. IMF staff led the discussion, but the ADB and WB staff also contributed.

- It has enriched IMF staff's understanding of issues in Vanuatu, in three ways:

- ADB and WB staff often had lines of inquiry that we had not thought to pursue in our meetings with the authorities.

- We informally discussed our concerns with our different types of country work in Vanuatu – whether analytical, technical assistance, the roles of our institutions, and our understanding of the economy.

- It allowed for some direct collaboration with the World Bank on the DSA in tandem with the authorities during the mission, instead of waiting as it often does until later in the process of finalizing the DSA draft.

27. ***Going forward to the next consultation with Vanuatu, we would welcome more clarity on staff's plan for a closer engagement in these areas [Shared Vision 2030, National Emergency Fund]. Staff comments are sought.***

- During this Article IV, staff did meet with the key stakeholders (current and potential) in each area – Vanuatu Tourism Office, Ministry of Tourism, Air Vanuatu, Vanuatu National Provident Fund, Ministry of Finance and Economic Management, Ministry of Climate Change and Natural Disasters, and others. Staff will follow up with these areas during if there is a Staff Visit in late 2018 to see if there are any issues regarding implementing *Shared Vision 2030* and prescribing the guidance of the National Emergency Fund. There will be follow-up in the 2020 Article IV. It may be possible at that time to hold some roundtables on these topics, with consent of the authorities, to bring together various stakeholders. Staff will stay alert to any technical assistance needs in these areas as well as part of the ongoing process to integrate surveillance and capacity development.