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May 22, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Vanuatu - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Vanuatu.

It is proposed to bring this subject to the agenda for discussion on Wednesday, June 27, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Otani (ext. (5)7305).

Att: (1)

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INTERNATIONAL MONETARY FUND

VANUATU

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Article IV Consultation with Vanuatu

Approved by P.R. Narvekar and Donald K. Palmer

May 21, 1984

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I. Introduction

The second Article IV consultation discussions with Vanuatu were held in Port Vila during March 19-30, 1984. The Vanuatu representatives included: Mr. Kalpokor Kalsakau, Minister of Finance, Commerce, Industry and Tourism; senior officials of government departments; and Mr. Patrick Noel, Chief Executive Officer of the Central Bank of Vanuatu and its senior staff members. The mission also met Father Walter Lini, Prime Minister. The staff representatives included Messrs. Ichiro Otani (Head), Xan Vongsathorn (both ASD), Christian Schiller (FAD), Louis Dicks-Mireaux (EP, STAT), and Mrs. Clementina Colliflower (ASD).

Vanuatu has accepted the obligations of Article VIII Sections 2, 3, and 4.

II. Background

Vanuatu, previously the Anglo-French Condominium 1/ of the New Hebrides, became independent in July 1980. Following a period of civil disturbances associated with independence, the country has enjoyed socio-political stability. In November 1983, general elections were held, and the ruling party, headed by Prime Minister Lini, again won a comfortable majority.

The economy of Vanuatu is highly open, with an unrestricted and relatively large external sector; in 1983, combined exports and imports are estimated to have been nearly 80 percent of GDP. The economy is dualistic; a large agricultural sector accounts for the bulk of production and employment, with about four fifths of the population living in rural areas, while a small monetized sector is concentrated in two urban areas.

In the absence of income, corporate, and estate taxes, Vanuatu is a tax haven. The Finance Centre of Vanuatu, which started in the early 1970s, has expanded significantly over the past decade, and now includes a number of commercial banks, trust companies, law and accounting firms, and exempt banks engaging in offshore banking activities. 2/ The Finance Centre, which, in the Government's view, makes an important contribution to the economy of Vanuatu, receives continuing official support and cooperation. The Centre provides approximately 320 jobs for expatriates, as well as ni-Vanuatu, 3/ and is the major source of management training for ni-Vanuatu. It is also an important source of

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1/ The joint administrative service of the British and French Governments in the New Hebrides.

2/ Exempt banks are banks that are registered in Vanuatu and are exempted from opening their accounts and documents to public inspection; they are prohibited from conducting business in Vanuatu.

3/ This term is used for the indigenous inhabitants of Vanuatu.

foreign exchange and government revenue (mainly in the form of company registration fees and other charges). Approximately 10 percent of GDP is estimated to have been contributed by the Finance Centre in recent years. At end-1982, the total assets of the exempt banks and other financial institutions were an estimated US$1.8 billion, or about 20 times the total assets of the domestic banking system.

Vanuatu continues to be heavily dependent on foreign assistance, although such assistance, particularly in support of the recurrent budget, has been declining significantly. The proportion of total public expenditure financed by foreign aid declined from over 80 percent in 1980-81 to slightly more than 50 percent in 1983.

III. Report on Discussions

The Vanuatu economy has performed well in recent years, and the outlook for 1984 is favorable. Key current and future policy issues facing the Government include (i) the substitution of domestic savings and revenue for the external grants that still predominate in the budget and the balance of payments; and (ii) establishment of a full-fledged monetary system.

1. Recent economic developments

After a considerable setback in 1980, economic activity recovered steadily during 1981-83. Real GDP is estimated by the staff to have increased at an annual rate of 1-2 percent in 1981 and 2-3 percent in 1982. In 1983, output expanded further, probably increasing at an annual rate of about 3-4 percent. Production of copra (a major export) increased by 8 percent, and export volume, by 11 percent, against a background of large increases in world market prices (quoted in U.S. dollars). The price of copra increased by 60 percent during 1983. An improvement in quality, mainly resulting from a better method of drying, also contributed to higher copra export prices. Reflecting these significant price increases, the Vanuatu Commodities Marketing Board (VCMB), which was set up in 1982 for the purpose of insulating domestic copra producers from wide fluctuations in international prices and is presently the sole purchaser of copra for export, made large profits in 1983 and raised procurement prices for copra producers on three occasions during the second half of the year.

In 1983, personal consumption expenditure appears to have increased substantially, while activities in construction, tourism, and investment have picked up considerably as confidence in the Vanuatu economy has grown and considerable progress has been made in resolving land tenure issues. However, private investment activities in the agricultural sector continue to be hampered by slow progress in the establishment of the legal and administrative framework for registering rural land leases, as well as by relatively high real interest rates.

Consumer prices in Vanuatu are largely determined by import prices, which are in turn significantly influenced by prices in the main trading partner countries (particularly Australia, the major supplier of Vanuatu's imports) and by the exchange rate of the vatu. More recently, domestic prices are being increasingly influenced by movements in tariff rates.

Inflation, as measured by consumer price indices, declined sharply in 1982, and prices increased only slightly in the first three quarters of 1983 over the corresponding period of 1982. But in the fourth quarter, inflation increased to an annual rate of 5 percent (Table 1). This increase reflected, to a large extent, a considerable depreciation of the vatu vis-a-vis the Australian dollar, and to a lesser extent, the shift forward of the increases in tariff duties that were introduced in 1983. Nevertheless, for the year as a whole, inflation declined to 2 percent, from 6 percent in 1982.

Vanuatu's external transactions in recent years have continued to be characterized by persistently large trade deficits but even larger surpluses on the account of services (particularly tourism) and transfers, resulting in sizable surpluses in the current account and the overall balance (Chart 1 and Table 2).

Following a sharp drop in exports in 1982, largely reflecting depressed copra prices in the world market, exports increased by 73 percent to SDR 17 million in 1983. Most of this increase was attributable to a sharp rise in copra prices and, to a lesser extent, an increase in volume; copra exports accounted for about 70 percent of total exports. Cocoa exports also rose significantly as both volume and prices rose substantially.

Imports have continued to grow in recent years; in 1983, they rose by 14 percent to SDR 45 million, with machinery, transport equipment, construction materials, and consumer goods showing significant gains. Contributing factors include generally buoyant investment activity in the urban area, and strong tourist and other consumer demand.

The deficit in the total trade account declined marginally to SDR 27 million, compared with SDR 28 million in 1982, while the surplus in the services and transfers accounts is estimated to have fallen only slightly to SDR 45 million, despite a significant decline in foreign aid. Thus the current account fell slightly to a surplus of about SDR 18 million. Identified long-term capital recorded a small net inflow, reflecting disbursements of foreign long-term loans. Unidentified capital and errors and omissions recorded a net outflow of SDR 8 million, compared with a surplus of SDR 6 million in 1982, reflecting interest differentials moving against Vanuatu. According to monetary survey statistics, the overall balance is estimated to have

Table 1. Vanuatu: Indicators of Inflation and Related Variables, 1980-83 1/

	Inflation in Trading Partners 3/	Percentage Change in Effective Exchange Rate 4/	Inflation in Vanuatu		
			Import Prices 5/	Consumer Prices 2/ Food (0.465) 6/	Consumer Prices 2/ Overall
1980	15.6	-0.6	14.8	13.0	11.2
1981	3.6	22.7	26.8	35.7	27.4
1982	4.9	-3.7	0.3	0.9	6.2
Qtr. I	0.8	5.8	6.2	16.5	16.8
Qtr. II	5.5	-2.3	2.5	4.5	8.8
Qtr. III	6.5	-9.6	-3.6	-4.8	2.1
Qtr. IV	6.7	-9.5	-3.2	-9.4	-1.2
1983	6.3	-5.9	-0.3	-2.6	1.7
Qtr. I	6.4	-7.0	-1.3	-5.4	0.9
Qtr. II	9.1	-10.0	-1.4	-3.4	0.7
Qtr. III	5.4	-5.5	-0.1	-4.4	0.2
Qtr. IV	4.7	-1.7	2.3	3.1	4.8

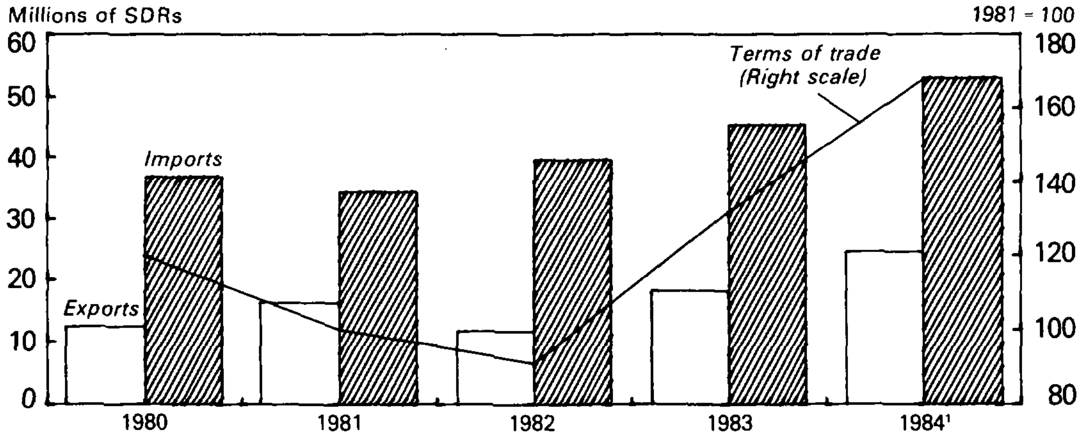
Sources: IMF, IFS; data provided by the Vanuatu authorities; and staff estimates.

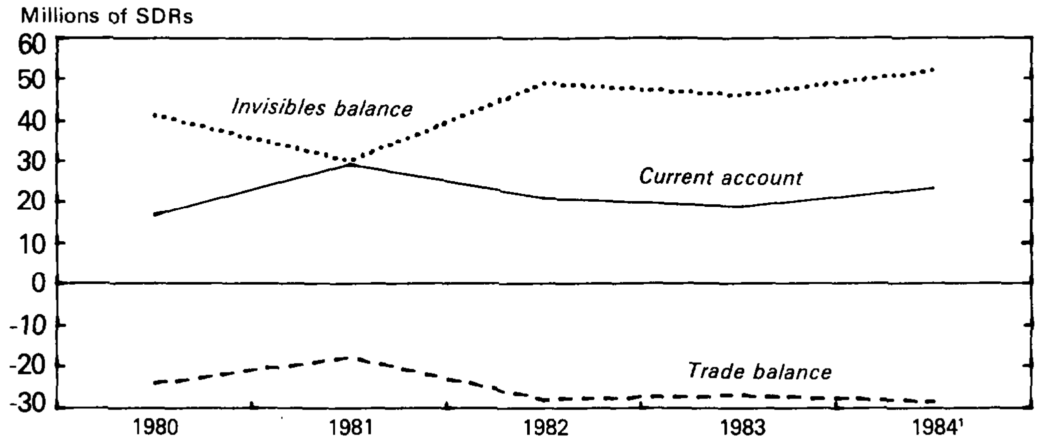
1/ Quarterly data indicate percentage change from the corresponding period of the preceding year.
2/ Refer to Port Vila low income group.
3/ Measured by changes in the import-weighted average of their export prices.
4/ Weighted by import shares in 1981 (appreciation -, depreciation +).
5/ Based on estimates obtained from export prices of major exporting countries for Vanuatu and the exchange rate of the vatu against their currencies.
6/ The weight in the overall index.

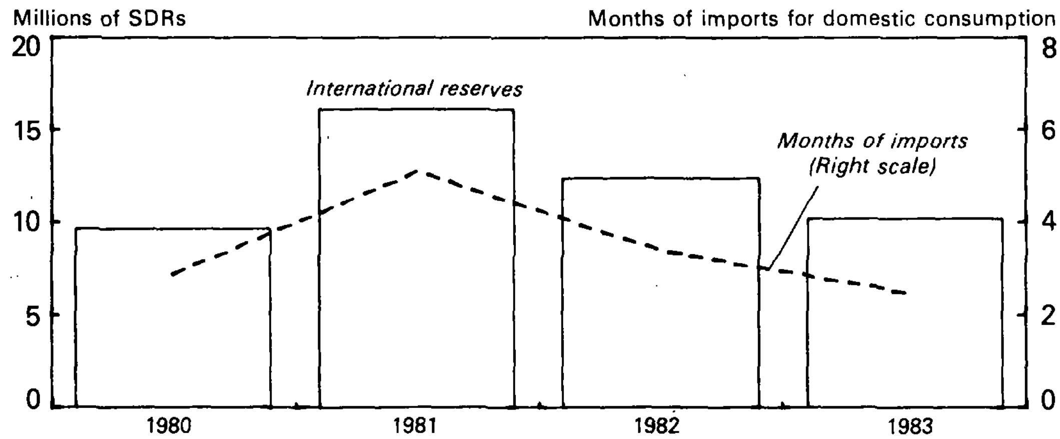
CHART 1

VANUATU

INDICATORS OF BALANCE OF PAYMENTS, 1980-84







Sources: Data provided by the Vanuatu authorities and staff estimates.

[1]Projections

Table 2. Vanuatu: Balance of Payments, 1980-84

(In millions of SDRs)

	1980	1981	1982	1983	1984 (Proj.)
Domestic exports (f.o.b.)	9.9	13.5	9.7	16.8	22.9
Domestic imports (f.o.b.)	36.8	34.3	39.6	45.2	53.0
Balance on re-exports less imports for re-export	2.5	2.9	1.9	1.4	1.6
Total trade balance	-24.4	-17.9	-28.0	-27.0	-28.5
Net services	-0.5	8.5	17.3	20.6	23.9
Of which: tourism	(9.4)	(11.1)	(17.8)	(18.0)	(19.8)
Net official transfers	42.3	38.2	31.7	24.6	27.1
Current balance	17.4	28.8	21.0	18.2	22.5
Identified long-term capital	0.0	0.0	-0.1	0.8	1.9
Basic balance	17.4	28.8	20.9	19.0	24.4
Unidentified long and short-term capital, errors and omissions 1/	...	...	5.5	-7.7	...
Overall balance 2/	...	...	26.4	11.3	...
Exchange rate: vatu per SDR	88.9	104.2	106.2	106.2	...
Terms of trade (1981 = 100)	120.1	100.0	90.8	131.7	167.5

Sources: Central Bank of Vanuatu; and staff estimates.

1/ Residual.
2/ Based on the net foreign asset position of the banking system.

recorded a surplus of SDR 11 million in 1983. 1/ The net foreign asset position of the monetary authorities (including foreign exchange deposits with domestic commercial banks) fell by SDR 2 million, and the net foreign assets of the commercial banks (excluding onlending of the monetary authorities' foreign exchange deposits) rose by SDR 13 million.

The vatu has been pegged to the SDR since September 10, 1981. By February 1984 the effective exchange rate index for the vatu had appreciated by 15 percent in nominal (trade-weighted) terms, and by 3 percent in real terms (Chart 2). On March 12, 1984, the vatu was revalued by 5.6 percent to SDR 1 = VT 100.6. 2/ Between September 1981 and March 1984, the vatu in nominal effective terms appreciated by 17 percent, and in real terms, by 5 percent.

Outstanding external debt, which was incurred largely by the Condominium Government, amounted to about SDR 3.5 million at end-1983, and debt service payments were about 3 percent of receipts from exports in 1983. Official gross international reserves, held with both overseas and domestic commercial banks, declined by SDR 2 million to SDR 10 million at end-1983 (equivalent to about three months' imports); if foreign currency deposits held with domestic commercial banks are excluded, official international reserves remained virtually unchanged in 1983, and stood at SDR 6 million at year end.

2. Economic outlook for 1984

Assuming continued confidence in the economy and further progress in resolving land tenure issues, activity in construction, particularly of residential houses, and tourism is expected to expand further. However, the outlook for investment activity in the manufacturing sector is uncertain, due mainly to the limited capacity to implement industrial projects and the high costs of energy. Although the long-term potential for investment in the agricultural sector is bright, the lengthy process involved in rural land registration is likely to continue to retard private investment in agricultural projects in 1984. Recent increases in procurement prices for copra producers should lead to a further increase in the production of copra.

Inflation is not expected to accelerate significantly in 1984 because of the generally declining trend in world inflation and the March 12 revaluation of the vatu, which would offset a substantial portion of the shift forward of recent increases in import duties. The average inflation rate is projected to be around 5 percent in 1984.

1/ Statistical information on the invisible and capital accounts of the balance of payments is poor. The authorities have made efforts to improve this information, but are constrained by lack of manpower.

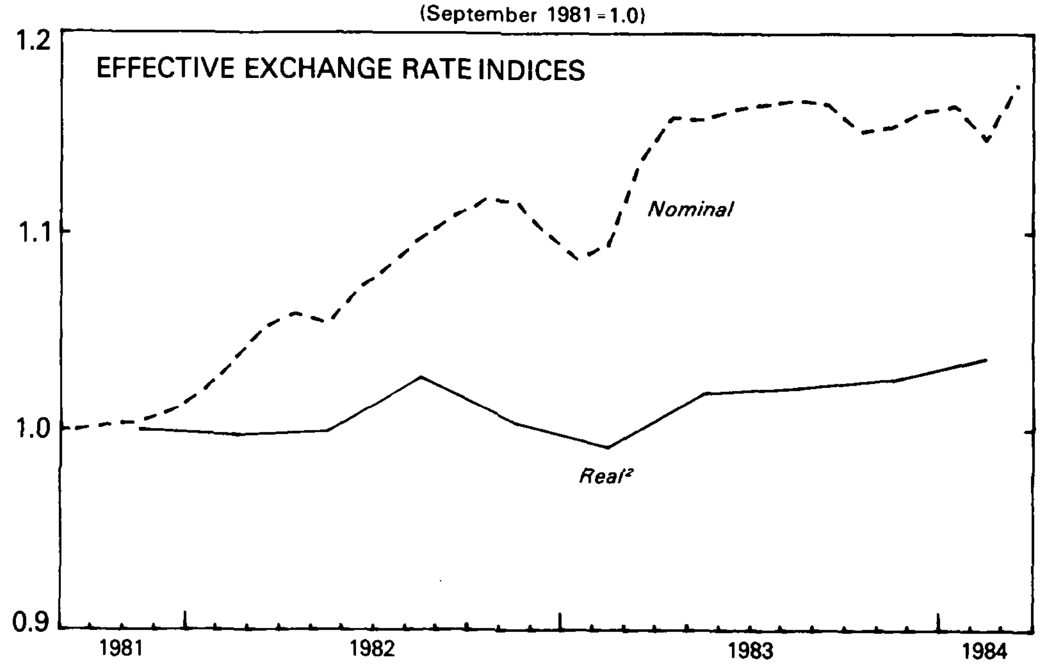
2/ A more detailed discussion on the policy aspects of this revaluation is presented in Section 3.c below.

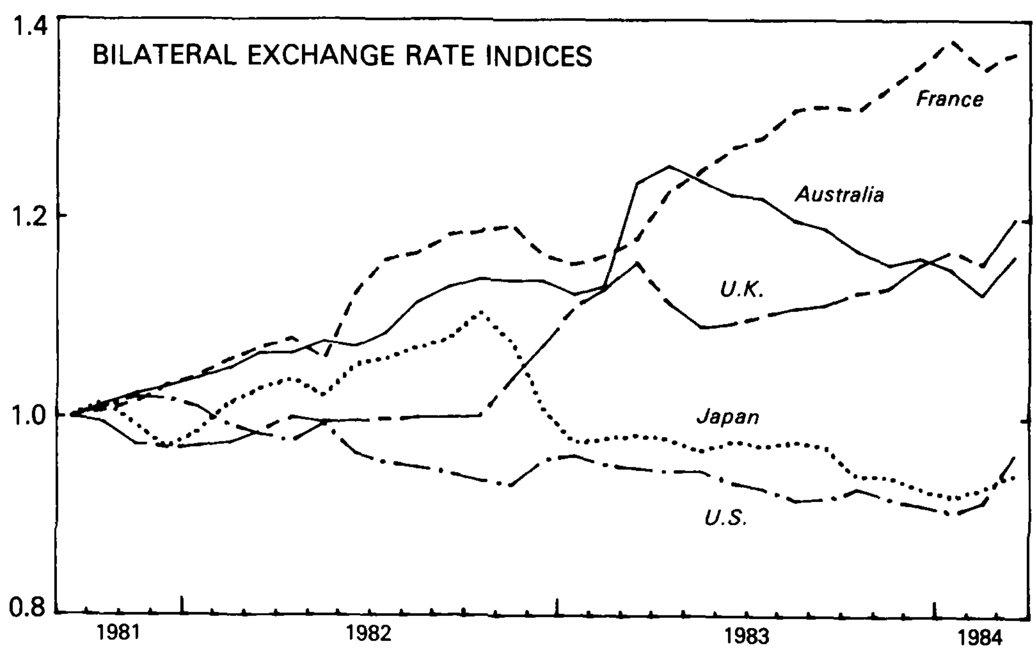
CHART 2

VANUATU

INDICATORS OF THE VATU EXCHANGE RATE[1], 1981-84

(September 1981 = 1.0)





Source: IMF, *IFS*.

[1]An increase represents an appreciation.

[2]The fourth quarter 1981=1.0.

The external sector is again expected to perform well, with exports increasing by 36 percent to SDR 23 million, due largely to a further increase in copra exports, and imports rising by 17 percent to SDR 53 million. The deficit in the trade balance (including the balance on re-exports less imports for re-export) is likely to increase slightly to SDR 29 million. However, the surplus in the invisibles account is expected to rise by SDR 6 million to SDR 51 million, reflecting a further expansion of tourism as well as a large disbursement of funds from the European Community's system for the Stabilization of Export Earnings (STABEX). The current account surplus is projected to increase by SDR 5 million to SDR 23 million in 1984.

Outstanding external public debt is expected to rise considerably in 1984 and beyond, reflecting expected disbursements of concessionary loans from international organizations. However, debt service payments are projected to remain at 3 percent of exports, and the profile of debt service payments is not likely to change significantly over the medium term (Table 3).

3. Policy issues

The generally favorable economic developments in recent years have reflected in part large inflows of foreign grant aid. However, foreign grants provided by the United Kingdom and France to finance recurrent budgetary expenditures are expected to continue to decline sharply in the years ahead; the last payment of these grants is expected to be made in 1988. It is thus extremely important that the Government formulate and implement adjustment policies for the period ahead. Against this background, discussions with the authorities on both short- and medium-term policy issues focused on fiscal, industrial and external trade, exchange rate policy, and the role of the Central Bank.

a. Fiscal policy

From independence up until 1983, total government expenditure has been about one half of GDP. The budget has, on average, been in surplus despite the considerable decline in foreign grants. In 1983, the budget recorded a small overall deficit of VT 49 million (about one half of 1 percent of GDP), reflecting a capital account deficit, financed by a drawdown on the Development Fund's deposits which had been built up in previous years, that more than offset a surplus in the recurrent budget (Table 4). In the recurrent budget, expenditure grew by 4 percent, somewhat faster than inflation. While the growth of recurrent expenditure was modest, it would have been even less had the spending agencies adhered to their originally budgeted spending limits. Revenue rose by 18 percent. This sharp increase was due mainly to buoyant economic activity, particularly in the external sector and also to a number of new revenue measures, including increases in customs duties, work permit fees, license and company registration fees, and in the airport departure tax. Foreign grants dropped significantly as in previous years.

Table 3. Vanuatu: Medium-Term External Public Debt Profile, 1982-88 1/

(In millions of SDRs)

	1982	1983	1984	1985	1986	1987	1988
Total debt outstanding (end-period)	3.7	3.5	4.8	7.2	10.7	15.4	21.1
Debt service on debt contracted prior to 1984							
Principal Interest	0.28	0.29	0.39	0.41	0.40	0.39	0.38
Interest	0.15	0.16	0.18	0.15	0.13	0.10	0.08
Debt service on debt contracted in 1984 and after							
Principal	--	--	--	--	--	--	--
Interest	--	--	0.07	0.11	0.16	0.22	0.28
Total debt service							
Principal	0.28	0.29	0.39	0.41	0.40	0.39	0.38
Interest	0.15	0.16	0.25	0.26	0.29	0.32	0.36
Exports	9.7	16.8	22.9	19.2	19.1	21.0	22.9
Debt service ratio (as percent of exports)	4.4	2.7	2.8	3.5	3.6	3.4	3.2

Sources: Data provided by the Vanuatu authorities and staff estimates.
1/ Includes external debts of the Government and the Development Bank of Vanuatu.

Table 4. Vanuatu: Summary of Central Government Fiscal Operations, 1980-84 1/

	1980	1981	1982	1983	1984 Budget	1984 Staff est.
			(In millions of vatu)			
Total revenue and grants	4,907	5,261	4,888	4,445	4,964	4,895
Recurrent revenue	1,268	1,370	1,607	1,893	2,208	2,174
Foreign grants	3,639	3,891	3,281	2,552	2,756	2,721
Recurrent budget	(1,033)	(924)	(743)	(559)	(490)	(455)
Other 2/	(2,606)	(2,967)	(2,538)	(1,993)	(2,266)	(2,266)
Total expenditure	4,597	4,647	5,210	4,493	4,781	4,717
Recurrent budget	2,025	2,043	2,327	2,419	2,649	2,585
Other 3/	2,572	2,604	2,883	2,074	2,132	2,132
Overall surplus or deficit (-)	309	614	-322	-49	183	178
Of which: recurrent surplus	(276)	(251)	(23)	(33)	(49)	(44)
Financing	-309	614	322	49	-183	-178
Foreign (net)	-21	-23	-26	-21	-33	-33
Domestic (net) 4/	-288	-591	348	70	-153	-145
Banks 5/	(...)	(...)	(491)	(200)	(...)	...
Others 6/	(...)	(...)	(-143)	(-130)	(...)	...
			(Percentage changes)			
Recurrent revenue		8.0	17.3	17.8	16.6	14.8
Recurrent grants		-10.6	-19.6	-24.8	-12.3	-18.6
Recurrent expenditure		0.9	13.9	4.0	9.5	6.9

Sources: Data provided by the Vanuatu authorities and staff estimates.

1/ Figures may not add up due to rounding.

2/ Consists of development grants, technical assistance, and grants received from the European Community's system for the Stablization of Export Earnings (STABEX).

3/ Consists of development expenditure, technical assistance, and transfers of funds received from STABEX to the Vanuatu Commodities Marketing Board.

4/ Residual.

5/ Changes in the net claim on the Government as defined in the monetary survey tables.

6/ Increases in deposits of special funds including the Water Supply Deposit Fund.

Virtually all of the expenditure on development projects, technical assistance, and other related services is financed by foreign grants from the United Kingdom, France, Australia, and other countries, and expenditure execution is essentially not controlled by the Vanuatu authorities. Such expenditure declined considerably, the main contributing factor being a sizable reduction in technical assistance. Development grants fell by about 10 percent, and, unlike in the previous two years, no grants were received from STABEX in 1983. 1/

For 1984, despite a further sharp decline in foreign cash grants, the recurrent budget allowed for a significant increase in expenditure--10 percent according to the original budget. To a large extent, this increase reflects a 7 percent rise in the number of civil servants and a 4 percent salary increase for them, and a more than doubling of the allowances for daily workers; these increases in salaries and allowances were the first in two years. The Government has not formulated an explicit incomes policy. However, restraint in granting wage and salary increases in the public sector has been an important element in the overall stance of policies to moderate growth in fiscal expenditure. The budgeted expansion in total expenditure in 1984 appears somewhat at variance with the Government's stated intention of containing expenditure, which was supported by the Fund at the time of the 1982 consultation with Vanuatu, and represents a reversal of the trends judiciously set by the Government in 1981. However, recognizing the need to contain the growth in expenditure, the Government has imposed a ban on recruitment of new employees for the period February-June 1984. Taking account of the effect of this ban, the staff estimates that the Government should be able to contain the growth in expenditure at 7 percent in 1984, a rate somewhat higher than the expected rate of inflation.

The budget envisages a 17 percent increase in revenue for 1984, to a large extent reflecting plans to introduce, with effect from January 1, 1984, increases in tariff rates, the airport departure tax, business license fees, and the extension of registration fees to companies registered under the French law. However, most of the new measures have been implemented with delays, and some are yet to be implemented. In addition, revenue will be adversely affected by the recent revaluation of the vatu vis-a-vis the SDR. The revaluation will also reduce the vatu value of grants from France, which are denominated in French francs. As a result, the possible savings in the wage bill, reflecting the recruitment freeze, are expected to be offset by shortfalls in revenue and grants, so that the initial estimate of a small surplus in the recurrent budget is likely to remain unaffected.

1/ Grants from STABEX are to be passed on to the VCMB, which in turn is expected to use them for the operation of the VCMB and the development of the copra sector.

The authorities are in the process of reviewing the 1984 recurrent budget and intend to present a revised budget to Parliament by this summer, taking into account the developments in the first half of 1984. While they do not yet have any revised estimates, they plan to maintain a small surplus in the recurrent budget.

As for the medium-term perspective, it is clear that in the absence of any action on the expenditure or revenue side, a large deficit will emerge in the overall as well as the recurrent budget with the continued decline in foreign grants. Therefore, significant action needs to be taken if deficit financing is to be avoided. As for the recurrent budget, if the Government's services in real terms were to grow at the same rate as the overall economy (3-4 percent), then additional revenue of VT 200 million (or about 10 percent of present revenue) must be raised each year. Alternatively, without new revenue measures, government recurrent expenditure in nominal terms would have to be reduced by 1 percent each year. The reduction in expenditure would be needed mainly because of the low elasticity of the present tax system which would bring about only a limited amount of additional tax revenue, insufficient to offset the expected declines in foreign aid. Thus, the staff team stressed the need to raise new revenue and/or economize expenditure; the authorities shared the staff team's views.

The Government has indicated that, for the 1985 budget, it intends to introduce new revenue-raising measures, such as increases in the rents for the government housing facility and in public utililty charges. Duty exemptions on government imports are also to be removed, mainly to improve the allocation of resources. The staff team also encouraged the authorities to consider the introduction of a tax on domestic production and to make further progress toward improving tax administration.

The Government has not yet been able to prepare the capital budget. However, in response to a recent recommendation made by the Auditor General, the authorities are presently preparing such a budget for 1984 and hope to prepare a similar one later this year for 1985. Expenditure on development projects is estimated to increase substantially in 1984, although that on technical assistance is projected to drop further, because of a sizable reduction in foreign aid.

b. Industrial and external trade policy

Vanuatu's external trade and industrial policy centers on the development of export industries based on agricultural products and of import-substitution industries. Some progress has been made in these areas.

In the export sector, considerable improvement has been made in the quality of copra. The installation of hot-air dryers for copra was a significant step which has resulted in a premium on the export price of about 2 percent, as opposed to a discount of about 10 percent prior to the improvement. The authorities intend to accelerate the use of these dryers with financial support provided mainly by foreign aid donor countries. Other export-oriented projects that have been promoted by the authorities include cocoa and coffee plantations, but the immediate future for the latter is somewhat uncertain because of the lack of a firm commitment by foreign aid donor countries interested in the project.

The scope for developing import-substitution industries is limited. However, given relatively high wages and salaries in the manufacturing sector (an average annual salary of about US$2,000 per worker, according to the 1983 survey) and relatively high labor mobility, the authorities have aimed at the development of such industries with labor-saving technology. In this context, the recent establishment of a cement factory is noteworthy; this factory, which will be using substantial amounts of local materials, is expected to begin production in mid-1984. A textile-clothing factory was also established recently. These two factories together should provide about 90 jobs for ni-Vanuatu, or about a 10 percent increase in employment in the manufacturing sector. Other import-substitution industries that have been established in recent years include chicken and pig farms, ice-cream and soft drinks factories, and a small-scale fish marketing company.

In 1983, the Government continued its ban on imports of frozen chicken to Efate Island, and pressures for protection of other import-substitution industries have increased. The staff team argued that these pressures should be vigorously resisted; if protection is provided for infant industries, it must be made clear that it will remain in effect only for a limited period of time. The authorities agreed with this policy suggestion.

c. Exchange rate policy

The authorities' decision to revalue the vatu vis-a-vis the SDR by 5.6 percent on March 12, 1984 was influenced by two central concerns: the potential threat of rapid increases in domestic prices following the increase in import duties; and the authorities' perception of a likely increase in inflation in Australia and of the possibility of a further strengthening of the Australian dollar in the near future. The authorities felt that without the revaluation, the rise in the consumer price index would have been about 11 percent in 1984. The staff team noted that the revaluation would probably have a favorable impact on inflation only in the short run.

As for the impact of the revaluation on the balance of payments, the authorities argued that the adverse impact in 1984 would be small and would be cushioned by the continued expansion of copra exports and tourism. The staff team shared the authorities' view that in the short run the balance of payments would not be significantly affected by the recent revaluation for several reasons: (1) The growth of receipts in

SDR terms from copra exports was not expected to be affected by this revaluation. (2) The revaluation was expected to increase the growth of imports in SDR terms somewhat. (3) The number of tourists from Australia will remain unaffected since the prices of most package tours from Australia had been set for 1984 before the revaluation; the possible adverse impact on tourists from countries other than Australia is likely to be minimal. The authorities also felt that a strong vatu would increase confidence in the Vanuatu economy and would be conducive to investment from abroad.

The staff team emphasized, however, that over the medium term the recent revaluation would have a noticeably adverse impact on the balance of payments and that the prospective reduction in foreign grants is an important factor in the assessment of the appropriateness of the exchange rate policy. In this context, the authorities need to watch developments in the external sector carefully, particularly their implications over the medium term, and to make more active use of the exchange rate as a policy instrument for external adjustment as circumstances warrant.

At the time of the last Article IV consultation with Vanuatu, some Executive Directors suggested that the vatu be pegged to a trade-weighted basket of currencies, rather than the SDR. After a careful review of the exchange rate arrangement, both the authorities and the staff team considered that the vatu's link to the SDR could well be maintained for the time being, mainly because of advantages in clarity and operational simplicity, and that the performance of this exchange rate arrangement should be evaluated frequently in terms of both nominal and real effective rates as well as developments in the external sector.

d. The role of the Central Bank

In late 1980, the Central Bank of Vanuatu was established, with technical assistance from the Fund, under the Central Bank Act of 1980. The principal objectives of the Central Bank, as defined by the Act, are: (a) to regulate the issue and availability of the local currency; (b) to engage in foreign exchange operations; (c) to advise the Government on financial matters; (d) to promote monetary stability and a sound financial structure; and (e) to foster financial conditions conducive to the orderly and balanced economic development of Vanuatu.

The monetary authorities have continued to make further progress toward the fulfillment of these objectives. The Central Bank has successfully completed the bank note exchange operation, by which New Hebrides franc (FNH) notes ceased to be legal tender at the end of March 1983. Nevertheless, the Central Bank will continue to honor FNH notes for five years. Also, from April 1, 1983, Australian currency is no longer considered a co-circulating currency in Vanuatu and is treated as any other foreign currency. The Central Bank has also embarked on a program to substitute vatu coins for FNH coins from the second half of 1983.

Three technical experts have been provided by the Fund to the Central Bank since its inception. However, because the upgrading of the technical and managerial skill of ni-Vanuatu staff has been a slow process, the Central Bank continues to suffer from a shortage of skilled manpower. This has hampered its assumption of the responsibilities of banker to the Government and commercial banks and its development of effective monetary policy instruments. The Central Bank does not buy or sell foreign exchange at present.

Movements in monetary aggregates, statistical information on which has improved substantially in recent years, continue to be influenced largely by the behavior of the commercial banks and the nonbanking sector of the economy, as well as nonresident financial and other institutions. Several characteristics of monetary developments in 1983 are noteworthy: (1) Against the background of buoyant economic activity largely supported by the favorable performance of exports and tourism, deposit liabilities of the banking system to residents expanded rapidly. (2) Partly because of a significant increase in liquidity and high real interest rates, residents' demand for loans was weak. (3) The absence of high quality short-term vatu-denominated assets has caused the commercial banking sector to invest excess liquidity in short-term foreign assets. In 1983, the commercial banking sector again experienced a further increase in the excess position of vatu liabilities over vatu assets, and, hence in that of foreign currency assets over liabilities (Table 5). (4) The commercial banks continue to receive foreign currency deposits from residents and to extend foreign currency loans and advances to residents. The share of foreign currency deposits in total resident deposits increased slightly in 1982 and 1983 to 57 percent at end-1983, while the share of foreign currency loans and advances in the total outstanding to residents declined by 14 percentage points in these two years to 31 percent at end-1983.

From mid-1983, interest rates on deposits and loans tended to decline, but spreads between the rates remained high. In view of these developments, the Central Bank, in August 1983, issued informal guidelines requesting the commercial banks to reduce interest rates on loans and to narrow spreads to 4.5 percentage points or less. In recent months, loan rates have tended to decline somewhat, partly in response to the Central Bank guidelines, and interest rate spreads have narrowed.

In the conduct of foreign exchange operations, the Banque Indosuez Vanuatu, which is presently the main government depository and holds part of the national foreign exchange reserves, acts as a clearing house for the other commercial banks under a transitional arrangement. In September 1981, when the arrangement to peg the vatu to the SDR was established, the Central Bank and the Banque Indosuez established a joint understanding that: during the period that the Banque Indosuez holds the reserves and deals in foreign exchange on behalf of the Central Bank, any loss to the Banque Indosuez resulting from a change in the parity of the vatu vis-a-vis the SDR would be covered by the Central

Table 5. Vanuatu: Selected Monetary Indicators, 1981-83 1/

	At the End of:			Changes in:	
	1981	1982	1983	1982	1983
			Monetary Survey (In billions of vatu)		
Net foreign assets 2/	2.6	5.4	6.6	2.8	1.2
Of which: Commercial banks	1.8	4.8	6.0	3.0	1.2
Total domestic credit	3.1	3.1	2.9	--	-0.2
Of which: Claims on Govt. (net)	-1.4	-0.9	-0.7	0.5	0.2
Total liquidity	5.3	7.9	8.6	2.6	0.7
Of which:					
Money	1.3	1.5	1.8	0.2	0.4
Quasi-money	4.0	6.5	6.8	2.5	0.3
(Offshore institutions' holdings) 3/	(1.6)	(2.2)	(0.9)	(0.6)	(-1.3)
Other liabilities (net)	0.4	0.6	0.9	0.2	0.4
Memorandum item:					
Net position in foreign currency denominated assets 4/	0.6	1.0	1.1	0.4	0.1

Selected Interest Rates
(In percent per annum at end of period)

	1981	1982		1983	
	Dec.	June	Dec.	June	Dec.
Deposits (1 month)					
Vatu	9.4	9.5	8.5-10.0	7.7-8.8	8.3-8.6
Australian dollar	8.7-9.2	8.7-9.2	8.1-11.0	7.0-12.0	6.0-8.8
Euro-dollar 5/	13.8	15.7	9.5	9.7	10.1
Commercial loans					
Vatu	14.0-16.0	14.0-16.0	13.7-16.2	13.3-16.4	12.2-15.6
Australian dollar	15.0-16.8	16.5-16.8	17.3-18.4	16.1-18.1	13.0-16.4
Spread 6/	...	6.0	6.6	7.2	5.7

Sources: Central Bank of Vanuatu; and staff estimates.

1/ Total may not add up due to rounding.
2/ Includes the Treasury's foreign exchange holdings. Excludes the monetary authorities' foreign currency balances with domestic commercial banks.
3/ Exempt banks and other financial institutions' vatu and foreign currency deposits with commercial banks.
4/ The net position of commercial banks, the Vanuatu savings banks, and one merchant bank; the latter two institutions are excluded from the monetary survey.
5/ Three-month deposit rates in London.
6/ Lending rates minus one-month deposit rates; weighted average.

Bank; if a change were to result in a profit, the Banque Indosuez would pay that profit to the Central Bank. Thus, the Banque Indosuez was assured of avoiding any exchange risk from an official change in the vatu-SDR rate while holding the reserves.

The March 1984 revaluation of the vatu vis-a-vis the SDR brought about a considerable loss to the Banque Indosuez. At the time of the consultation discussions in Port Vila, the Central Bank had not compensated the Banque Indosuez for this loss. As a result of this delay in implementing the joint understanding, considerable uncertainty had arisen over who was responsible for bearing the exchange risk of holding the foreign exchange reserves. The staff team noted that a more active use of exchange rate policy for both internal and external adjustments, as envisaged by the authorities, would necessitate a greater role for the Central Bank as a banker in international exchange operations in order to provide commercial banks with a facility to adjust their foreign currency positions. Until such time that the Central Bank can assume management of the country's foreign exchange reserves, it should continue to delegate that responsiblity to a commercial bank. In return, any exchange gain or loss that may be incurred by that commercial bank when the vatu exchange rate vis-a-vis the SDR is changed by the authorities should be transferred to the Central Bank.

Because of the excessive imbalance in the currency composition of assets and liabilities, the commercial banking sector is exposed to undesired exchange risks. The recent appreciation of the vatu has intensified concern over exchange risks, and the lack of means to avoid such risks could reduce commercial banks' willingness to accept additional vatu deposits and, hence, could hamper the sound development of commercial banking and financial intermediation. In these circumstances, the Central Bank could encourage commercial banks to phase out the present practice of extending loans in foreign currency when a loan in vatu would be appropriate finance. Also, steps could be taken to introduce interest-bearing liquid claims on the Central Bank, such as certificates of deposit, which would further broaden opportunities for commercial banks to invest in interest-bearing vatu assets. Such changes would be important steps toward expanding the acceptance of the vatu as liquid tender and helping commercial banks adjust their vatu and foreign currency positions.

IV. Staff Appraisal

The performance of Vanuatu's economy has been satisfactory in recent years. Economic activity has continued to expand, to a large extent reflecting the continued success in improving the quality of copra and in increasing confidence in the economy. Progress made in resolving land tenure issues has also contributed to buoyant activity in construction and tourism. The budget has generally been in surplus, and the balance of payments has recorded considerable surpluses. Inflation has remained relatively low. The satisfactory economic performance is attributable not only to significant amounts of foreign assistance, but also to the authorities' prudent efforts in implementing adjustment policies in fiscal and other areas.

Given the generally favorable outlook for economic activity and the balance of payments for 1984, the authorities' recent economic policies have been aimed at avoiding budget deficits in the face of continued further declines in grants from abroad and at keeping inflation from rising.

The staff notes with satisfaction that the Government's budget has, on average, been in surplus in the recent past. However, the fiscal situation has not been entirely free from problems. In 1983, the growth of recurrent expenditure was faster than initially envisaged, and a further acceleration is expected in 1984. While the ban on recruitment of new employees that has been imposed for February-June 1984 is commendable, the hiring of additional civil servants following the lifting of the ban should also be avoided. Also, there seems to be scope for further rationalization of staffing requirements.

With a view to covering an expansion of budgetary expenditure and a significant decline in foreign grants, the authorities have introduced several revenue-raising measures in the recent past, and they intend to implement further measures to raise revenue in the future. The staff welcomes these efforts. In this context, the authorities should take steps to broaden the tax base and to increase the elasticity of the tax system.

In the area of industrial and external trade policy, the staff welcomes the recent progress made in improving the quality of copra and the authorities' plan to provide continued support to the promotion of exports based on agricultural products. The staff also commends the authorities' maintenance of Vanuatu's exchange system free of restrictions. However, the staff notes with concern that some pressures for protection of import-substituting industries have emerged recently and urges the authorities not to yield to such pressures.

The authorities appreciated the vatu by 5.6 percent in March 1984 to mitigate inflationary pressures. The staff shares the authorities' view that in the short run possible gains in containing price increase would be significantly greater than the adverse impact on the balance of payments. In the longer term, however, the adverse impact of the appreciation on the balance of payments would be noticeable. Therefore, it is essential that the longer-term impact on the balance of payments be counteracted by improving the potential of traditional and new exports, promoting the substitution of domestic products for imports without resorting to uneconomic protective measures, and containing the expansion of aggregate demand through the moderation of salary increases for civil servants.

The staff notes the authorities' intention to monitor developments closely in the external sector and to use exchange rate policy actively in order to bring about balance of payments adjustment if required. In view of these and other practical considerations, the vatu's link to the SDR appears a viable option, provided it is administered with appropriate flexibility.

The Central Bank's assumption of responsibilities as a banker to the Government and the commercial banks has been hampered by a shortage of skilled manpower. Nevertheless, in view of the authorities' intention to make more active use of exchange rate policy, the Central Bank should play a greater role in providing the commerical banking sector with facilities to adjust foreign exchange positions. The Central Bank should move as soon as possible to undertake the management of the national foreign reserves and to engage in foreign exchange operations. At the same time, it should improve financial intermediation in the money market by issuing interest-bearing vatu-denominated instruments, and by encouraging the banks to reduce the further use of foreign currency-denominated loans when a loan in vatu is appropriate finance.

Considerable progress has been made in the compilation of basic economic data, especially monetary statistics. The authorities' interest in the publication of a Vanuatu country page in IFS in the near future is welcome. However, much improvement is needed in the availability of data on invisible and capital transactions for the balance of payments, national income and expenditure accounts, and the capital account of the budget.

It is recommended that the next Article IV consultation with Vanuatu take place on an 18-month cycle.

Vanuatu--Fund Relations
(As of April 30, 1984)

I. Membership status

(a)	Date of membership:	September 28, 1981
(b)	Status:	Article VIII

A. Financial Relations
(Amounts in millions of SDRs, unless otherwise indicated)

II. General Department

(a)	Quota:	9.0
(b)	Fund holdings of vatu:	7.43 (82.5 percent of
(c)	Fund holdings of currency subject to repurchases:	--
	Of which: Credit tranches:	--
	Special facilities:	--
(d)	Reserve tranche positions:	1.57 (17.5 percent of
(e)	Current operational budget (maximum use of currency):	--

		Limit	Outstanding	Uncalled
(f)	Lending to the Fund:	--	--	--
	GAB)	--	--	--
	SFF)	--	--	--
	Enlarged access)	--	--	--
	Total)	--	--	--

III. Current Stand-by or Extended Arrangement and Special Facilities

(a)	Current stand-by or extended arrangement:	None
(b)	Previous stand-by or extended arrangement:	None
(c)	Special facilities (the current and past two years):	None

IV. SDR Department

(a)	Net cumulative allocation:	None
(b)	Holdings:	SDR 33,672
(c)	Current Designation Plan (amount of maximum designation):	None

V. Administered Accounts

(a)	Trust Fund loans:	None
	(i) Disbursed:	None
	(ii) Outstanding:	None
(b)	SFF Subsidy Account:	None
	(i) Donations:	None
	(ii) Loans to Fund:	None
	(iii) Payments to Fund:	None

VI. Overdue Obligations to the Fund:

(a)	General Department:	Repurchases	- None
		Charges	- None
(b)	SDR Department:	Charges	- None
(c)	Trust Fund:	Repayments	- None
		Interest	- None

VII. Vanuatu has not used Fund resources from its membership to date

B. Nonfinancial Relations

VIII. Exchange rate arrangement:

From September 10, 1981 to March 11, 1984 the vatu was pegged to the SDR at the rate of VT 106.20 = SDR 1. Since March 12, 1984, the vatu has been pegged to the SDR at the rate of VT 100.60 = SDR 1. At present the Central Bank of Vanuatu does not buy or sell foreign exchange. As a transitional arrangement, the Banque Indosuez Vanuatu, which is presently the main government depository, quotes daily the rates of the vatu against 11 currencies on the basis of their respective SDR values. A spread of up to 0.8 percent is maintained by the Banque Indosuez Vanuatu on the international commercial buying and selling rates of those currencies in terms of the SDR for its purchases and sales of vatu. There are no taxes or subsidies on purchases or sales of foreign exchange.

IX. Last Article IV consultation:

Held in Port Vila during November 1-12, 1982; Executive Board discussed the staff report (SM/83/3) on February 3, 1983.

X. Technical assistance:

(a) CBD: Three CBD technical experts have been provided to the Central Bank of Vanuatu since its inception in 1980; they occupy the positions of Chief Executive Officer, Deputy General Manager, and Research Manager.

(Continued)

(b) FAD: In July 1983, a member from the panel of fiscal exp assigned for a period of six months to the Ministry Finance to provide technical assistance in the fiel budgetary control.

(c) Other: None.

XI. Resident Representative/Advisor: None

Vanuatu--Relations with the World Bank Group
(As of April 30, 1984)

On August 2, 1983, the World Bank approved the first credit on standard IDA terms to the Republic of Vanuatu for the equivalent of SDR 1.9 million (US$2.0 million) to help finance an agricultural extension and training project. The project would be cofinanced with the Asian Development Bank (AsDB) as the lead institution; the AsDB would provide SDR 1.0 million (US$1.1 million) from its Special Fund resources, plus a technical assistance grant of US$265,000. No disbursements have yet been made.

A World Bank economic mission visited Vanuatu during November-December 1982. The Country Economic Memorandum--Vanuatu, Selected Development Issues (Report No.4489-VA)--was issued on July 29, 1983.

Vanuatu

Basic Data

Area, population, and GDP

Area:	12,189 sq.kms.
Population (June 1983):	123,900
Population growth rate (1980-83):	2.5 percent per annum
GDP, 1983: 1/	SDR 79 million
GDP per capita (1983): 1/	SDR 640

	1981	1982	1983	Proj. 1984
Consumer prices: (Percentage change during the year) 2/	26.7	-1.2	4.8	5
Budget: (Vatu mn.)				
Revenue and grants	5,261	4,888	4,445	4,964
Of which: Current grants	(924)	(743)	(559)	(490)
Total expenditure	4,647	5,210	4,493	4,781
Surplus or deficit (-)	614	-322	-49	183
Money and credit: (Vatu bn.) 3/				
Domestic credit	3.1	3.1	2.9	...
Of which: Private sector	(3.1)	(3.3)	(3.3)	...
Money	1.3	1.5	1.8	...
Quasi-money	4.0	6.5	6.8	...
	(In millions of SDRs)			
Balance of payments:				
Exports, f.o.b.	13.5	9.7	16.8	22.9
Imports, f.o.b.	34.3	39.6	45.2	53.0
Balance on re-exports less imports for re-exports	2.9	1.9	1.4	1.6
Total trade balance	-17.9	-28.0	-27.0	-28.5
Net services	8.5	17.3	20.6	23.9
Net official transfers	38.2	31.7	24.6	27.1
Current account	28.8	21.0	18.2	22.5
Long-term capital	--	-0.1	0.8	1.9
Overall balance 4/	...	26.4	11.3	...
External debt: (end of period) 5/	3.5	3.7	3.5	4.8
Gross official reserves: 6/ (end of period)	16.1	12.4	10.2	...
In months of imports for domestic consumption	5.1	3.4	2.5	...
Terms of trade: (1981 = 100)	100.0	90.8	131.7	167.5
Exchange rate: (VT/SDR) 7/	104.2	106.2	106.2	...

1/ Rough estimates.
2/ During one-year period ending in the fourth quarter.
3/ End-of-year.
4/ Based on the net foreign asset position of the banking system.
5/ Staff estimates.
6/ Foreign exchange holdings of the Central Bank of Vanuatu and the Treasury with both overseas and domestic commercial banks.
7/ Average exchange rate.