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January 3, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Vanuatu - Staff Report for the 1982 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with Vanuatu.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

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Department Heads

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INTERNATIONAL MONETARY FUND

VANUATU

Staff Report for the 1982 Article IV Consultation

Prepared by the Staff Representatives for the 1982 Article IV Consultation with Vanuatu

Approved by Tun Thin and Donald K. Palmer

December 30, 1982

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I. Introduction

The first Article IV consultation discussions with Vanuatu were held in Port Vila during November 1-12, 1982. The representatives of Vanuatu included: Mr. Walter Lini, Prime Minister; Mr. Kalpokor Kalsakau, Minister of Finance, Commerce, Industry and Tourism; other Ministers; senior officials of various government departments; and Mr. John A. Howard, Chief Executive Officer of the Central Bank of Vanuatu. The mission also benefited from discussions with leaders of the private sector. The staff representatives comprised Messrs. Ichiro Otani (Head), Luc De Wulf, Xan Vongsathorn (all ASD), Peter L. Joyce (STAT), and Miss Joan Pugh (ASD, secretary). Previously the Anglo-French Condominium 1/ of the New Hebrides, Vanuatu became independent in July 1980 and a member of the Fund in September 1981.

Vanuatu accepted, with effect from December 1, 1982, the obligations of Article VIII, Sections 2, 3, and 4.

II. Background: Socio-Economic Conditions

The economy of Vanuatu is open, dualistic, and heavily dependent on foreign assistance. The openness of the economy is characterized by a relatively large and free external sector: in recent years, combined exports and imports are estimated to have been about 70 per cent of GDP; only minor quantitative controls are applied to trade, and tariff rates are low; and no taxes or administrative controls are imposed on payments related to international transactions. In the absence of an income tax, estate tax, or death duties, Vanuatu is a tax haven, particularly for foreign companies and a financial center engaging in offshore banking activities. The Finance Center of Vanuatu, which started up in the early 1970s, has expanded rapidly over the past decade, and now comprises a number of law firms, accountants and trust companies which provide services for more than 1,000 registered companies. Among these companies are included 70 "exempted" 2/ banks whose external liabilities amount probably to some US$2.5-3 billion. The total amount of outstanding offshore liabilities could be substantialy more than that. The center provides about 300 jobs, over 200 of which are held by ni-Vanuatu, 3/ and is estimated to have contributed about 10 per cent of GDP in recent years.

The economy is dualistic in both an institutional and a geographic sense. Institutionally, relatively large-scale businesses (such as plantations, trade, shipping, banking, and tourism), dominated by expatriates, are operated in a monetized sector within an organized financial system, while small-scale agricultural operations, largely

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

2/ The accounts of exempted companies, as supplied to the authorities each year, are not available for public inspection. Exempted companies are not permitted (with some exceptions) to carry on business in Vanuatu.

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

family-oriented and run by the ni-Vanuatu, are carried out in a nonmonetized sector (Chart 1). Geographically, the commercial sector is located mainly in two cities--Port Vila (the capital) on the island of Efate, and Luganville on the island of Espiritu Santo--with an estimated combined population of about 20,000 (about 16 per cent of the total population of 126,000). The subsistence sector, which is largely self-sufficient, is located in the rural areas of the islands stretched over more than 850 kilometers, with the nonurban population living in many hundreds of small villages on these islands. The villagers on these islands are engaged in growing coconuts and other produce.

The economy has traditionally been heavily dependent on foreign assistance. In recent years, cash grants from France and the United Kingdom have financed a large portion (over 40 per cent in 1981 and about 30 per cent in 1982) of the Government's current expenditure, while all of its capital expenditures are financed by foreign development grants, mainly from these two countries, and also, since independence, from Australia and others. Such grant aid financed more than 50 per cent of total government expenditure; as a result, the budget had until recently realized surpluses. Official transfers, together with surpluses in the services account, have more than offset the large trade deficits, resulting in a surplus in the external current account and the overall balance of payments.

The period immediately preceding and following mid-1980 when Vanuatu gained its independence was characterized by political and social disruption. Though political stability is now restored, the country is faced with two important social issues, both with economic implications. The first of these is the land issue, which involves the disposition of the considerable amount of land that was appropriated from indigenous inhabitants during the colonial period and used by foreign settlers for relatively large-scale agricultural activities. The Government is now in the process of resolving such issues as land tenure, registrations, and leases. However, uncertainty over the outcome of the land legislation that is now before Parliament has continued to cloud the investment climate. The second issue--the localization of jobs--relates to the policy of filling key posts, in both Government and private business, with indigenous people, which has aggravated the shortage of skilled manpower.

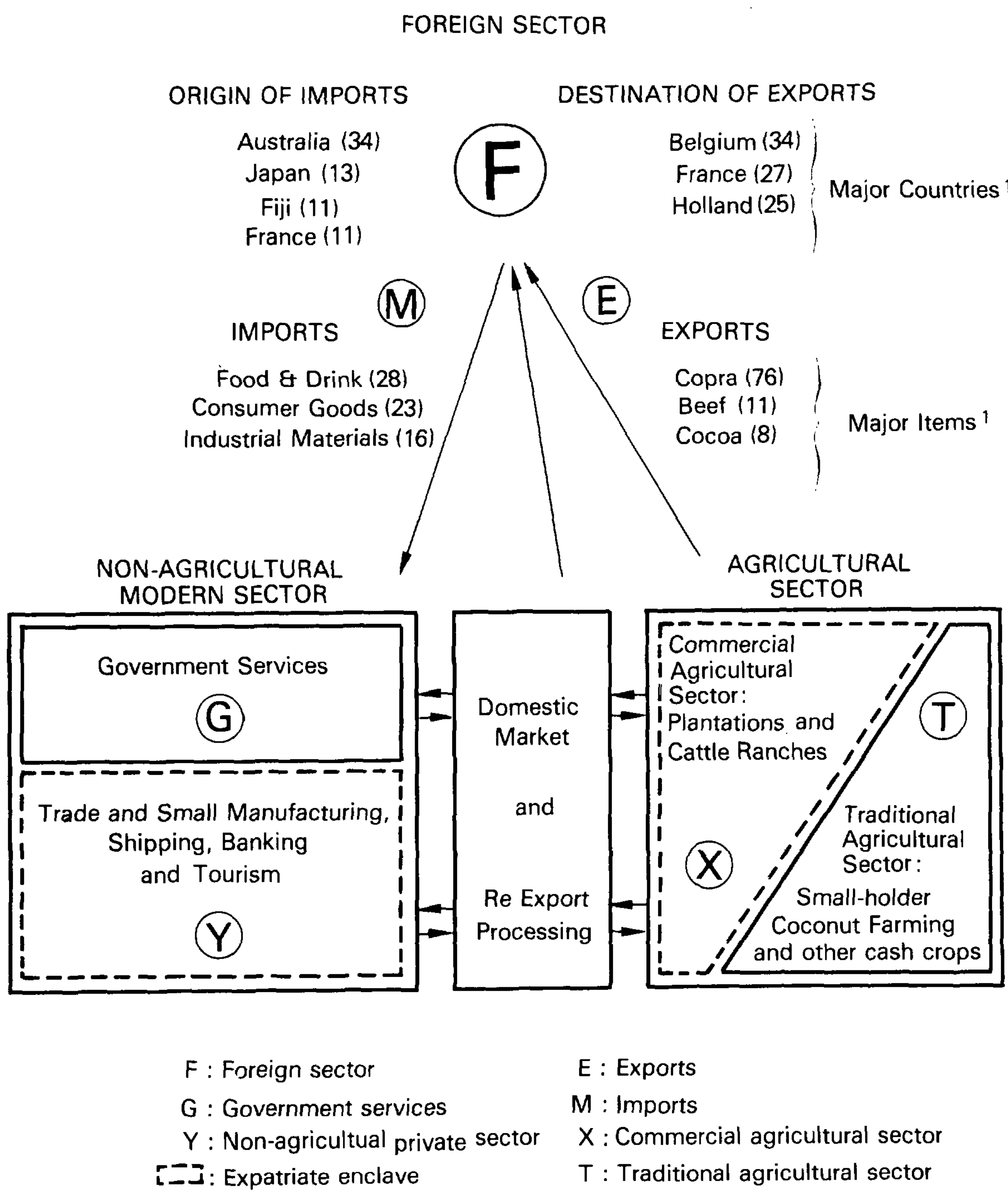
III. Recent Developments and Outlook

Following independence in 1980, Vanuatu's fragile economy suffered severe economic disruptions: output fell; the currency depreciated; prices increased sharply in 1980 and 1981; and the external terms of trade worsened significantly. On balance, the economy has weathered these disruptions remarkably well, and is presently on its way to a gradual recovery. The outlook for 1983 may be characterized as cautiously optimistic.

CHART 1

VANUATU

ECONOMIC STRUCTURE



[1]Figures in parentheses are percentage shares in 1981.

1. Recent developments

The country's attainment of political independence led to the abrupt departure of many expatriates who had held managerial positions, mainly in the plantation and cattle-raising sectors. In 1980, the coconut plantation sector was particularly disrupted by the sudden departure of expatriates; copra production fell by over 26 per cent; and copra exports (which account for about three fourths of total exports of domestic products) declined by about 33 per cent. Furthermore, against the background of political and social uncertainty as well as the unresolved land issue, investment fell significantly, while the number of tourists visiting Vanuatu dropped by about 28 per cent. Reflecting these factors, real GDP is estimated to have declined by about 10 per cent in 1980.

Since then, overall economic activity has recovered somewhat, with real GDP growing at an estimated annual rate of 1 or 2 per cent in 1981 and 1982. The speed of the recovery, however, varied significantly from one sector to another. Activities in the construction, housing, tourism, and offshore banking sectors have expanded significantly, but recovery in the copra industry and the agricultural sector in general has not been steady. Also, the uncertainty over the land issue and, to a smaller extent, relatively high real interest rates from mid-1982 (hovering over 10 per cent on loans) have continued to hamper the expansion of investment demand.

Consumer prices in Vanuatu are largely determined by import prices (Chart 2), which are in turn determined by prices in Vanuatu's main trading partner countries (particularly in Australia from which Vanuatu obtains the largest proportion of its essential imports, including food) and by the exchange rate of the vatu (the New Hebrides franc before January 1, 1981). During the few years prior to independence, the annual rate of inflation measured by consumer prices fluctuated narrowly between 4 and 7 per cent, reflecting the relative exchange rate stability of the vatu (which had been pegged to the French franc through September 9, 1981) and the moderate rate of world inflation. However, inflation increased from 4 per cent in 1979 to over 11 per cent in 1980 and reached about 30 per cent in the third quarter of 1981 (Table 1). This rapid increase was due essentially to the increase in the prices of imported commodities, which in turn was caused by the rapid depreciation of the vatu against trading partner currencies.

The annual rate of inflation declined to 17 per cent in early 1982, and to 2 per cent in the third quarter of 1982, due mainly to the significant appreciation of the vatu against the currencies of Vanuatu's major trading partners and partly to a slowdown in inflation in these countries. A salutary effect of this deceleration was that it greatly diminished the pressure for large wage increases in the public sector in early 1982.

Vanuatu's external transactions are characterized by persistent deficits in the trade account and surpluses in the services and transfer accounts, resulting in current account and overall surpluses.

Table 1. Vanuatu: Indicators of Inflation, 1980-82 1/

	Inflation in Trading Partners 2/	Percentage Change in Effective Exchange Rate 3/	Inflation in Vanuatu		
				Consumer Prices 5/	
			Import prices 4/	Food (0.465)6/	Overall
1980	16.9	-0.4	16.6	13.0	11.2
1981	2.3	22.0	24.0	35.7	27.5
Qtr. I	6.6	21.9	28.9	24.4	25.0
Qtr. II	1.4	24.8	25.4	37.4	27.8
Qtr. III	0.5	27.4	27.7	39.3	30.3
Qtr. IV	1.0	14.4	15.1	31.8	26.7
1982					
Qtr. I	0.7	3.2	4.8	16.5	16.8
Qtr. II	5.5	-4.3	0.4	4.5	8.8
Qtr. III	8.3	-10.1	-3.5	-4.9	2.1

Sources: IMF, IFS, the Vanuatu authorities and staff estimates.

1/ Quarterly data indicate percentage change from the corresponding period of the preceding year.

2/ Measured by changes in the import-weighted average of their export prices.

3/ Weighted by import shares in 1981.

4/ Based on estimates obtained from export prices of major exporting countries for Vanuatu and the exchange rate of the vatu against their currencies.

5/ Refer to a low income group.

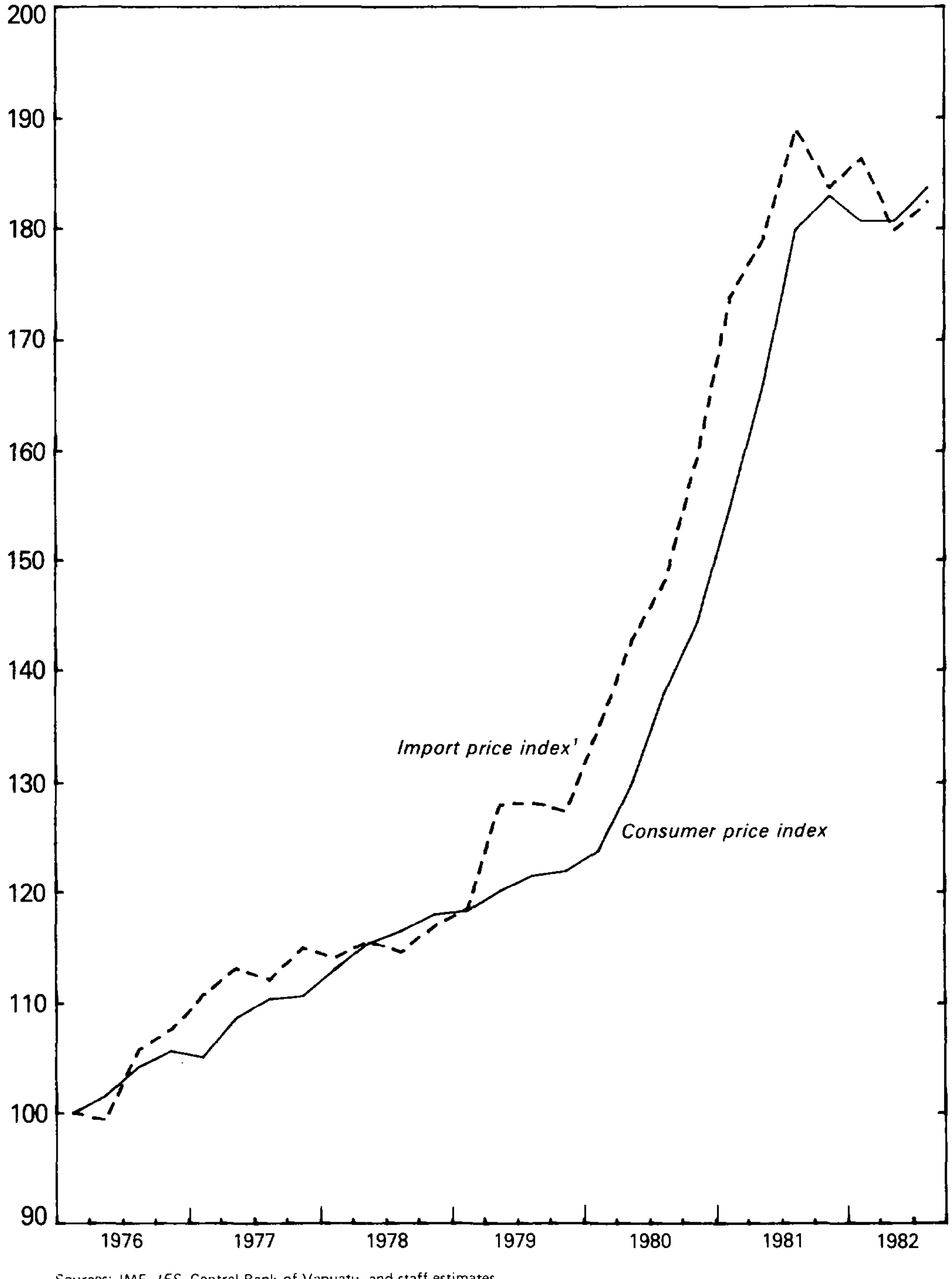
6/ The weight in the overall index.

CHART 2

VANUATU

INDICATORS OF PRICES, 1976-82

(1976 first quarter=100)



Sources: IMF, *IFS*, Central Bank of Vanuatu, and staff estimates.

[1] Import price index is estimate on the basis of export prices of Vanuatu's trading partners and the exchange rates of the vatu vis-a-vis currencies of these countries.

Following the setback in 1980, the export sector recovered significantly in 1981, as copra that was stockpiled during 1980 was exported along with 1981's crop; but in 1982, exports leveled off as Vanuatu's export products suffered from continuing depressed prices in the world market, world recession, and the lagged impact of adverse weather on the volume of copra exports. Imports declined in 1980, reflecting the departure of expatriates and the decline in the number of tourists, and remained depressed through the first half of 1981. This trend was reversed in 1982 with the recovery of the Vanuatu economy and the return of expatriates and tourists. Despite a surplus in the balance on re-exports less imports for re-exports, the total trade balance remained in large deficit in 1982, amounting to 70 per cent of imports (f.o.b.). Owing to substantial surpluses in services and transfers, the current account is estimated to record a surplus of under SDR 25 million in 1982, somewhat less than in 1981. With a small inflow on long-term capital, the overall surplus will total about SDR 25 million in 1982, again somewhat reduced from 1981 (Table 2).

The vatu's link to the French franc led to a substantial appreciation of the vatu against the Australian dollar in 1978 and 1979 (Chart 3). Thereafter, the movement was reversed, and between the end of 1979 and the third quarter of 1981, the vatu depreciated against the Australian dollar by about 47 per cent. With effect from September 10, 1981, the vatu was linked to the SDR at the rate of VT 106.2 = SDR 1. The new arrangement has led the vatu to appreciate against the currencies of Vanuatu's major trading partners. The appreciation since September 10, 1981 is estimated to be about 10 per cent in terms of the trade-weighted exchange rate.

Outstanding external debt, which was incurred entirely by the Condominium Government, amounted to about SDR 3 million at end-1981, and debt service payments are estimated to be about 7 per cent of exports in 1982. Official international reserves increased in 1982, partly reflecting the surplus position of the overall balance of payments. At the end of August 1982, official international reserves (including deposits with domestic commercial banks) amounted to SDR 16 million, equivalent to four to five months of imports for domestic consumption.

2. Economic outlook for 1983

Given political stability and an improved economic climate, certain sectors, such as construction, tourism, and the copra industry are expected to expand. Offshore banking activity is also expected to increase further. As domestic interest rates are likely to decline, reflecting the slowdown of inflation and declining interest rates abroad, increased borrowing from the banking sector could contribute to the economic recovery. Inflation is low at present, and prices of domestic output are expected to rise only moderately, while those of imported items are not likely to increase significantly if inflation in Vanuatu's trading partners continues to moderate.

Table 2. Vanuatu: Balance of Payments, 1980-83

(In millions of SDRs)

	1980	1981	1982 (Estimate)	1983 (Projection)
Domestic exports (f.o.b.)	9.9	13.5	9.6	10.4
Domestic imports (f.o.b.)	36.8	34.3	38.4	45.4
Balance on re-exports less imports for re-export	3.2	2.6	1.9	1.9
Total trade balance	-23.7	-18.2	-26.9	-33.1
Net services	6.5	9.4	20.9	23.2
Net transfers	37.0	37.7	30.5	32.0
Current balance	19.8	28.9	24.5	22.1
Long-term capital	0.3	0.4	0.2	2.8
Overall balance 1/	20.1	29.3	24.7	24.9
Exchange rate: vatu per SDR	88.9	104.2	106.2	106.2 2/
Terms of trade (1981=100)	117.5	100.0	91.2	86.1

Sources: Data provided by the Central Bank of Vanuatu and staff estimates.

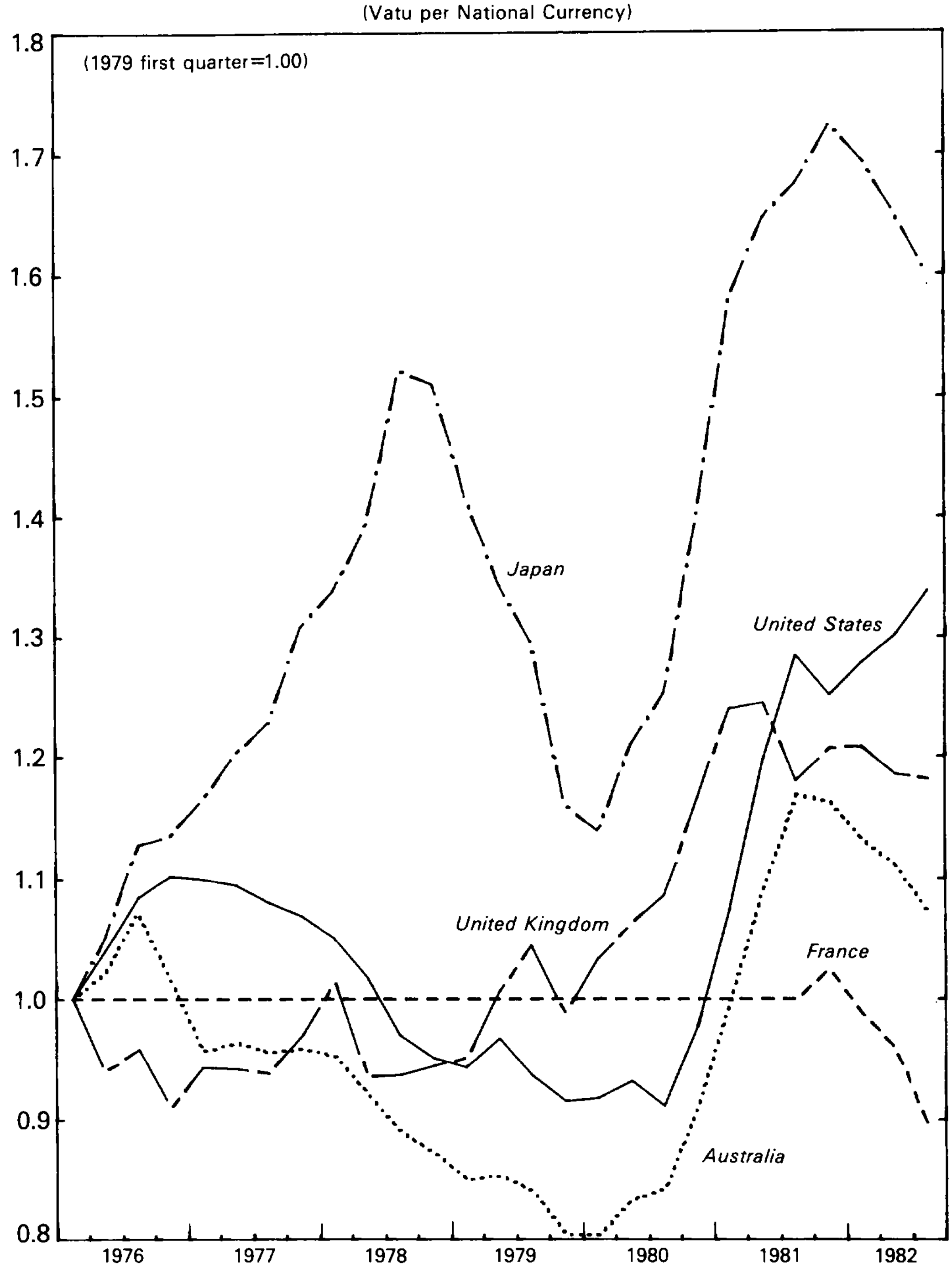
1/ Excludes nonmonetary short-term capital and errors and omissions.
2/ Assumption.

CHART 3

VANUATU

INDICES OF EXCHANGE RATES, 1976-82

(Vatu per National Currency)



Source: IMF, *IFS*.

On the external side, the volume of exports may show some recovery but prices are likely to remain depressed. Imports are expected to accelerate. As a result, the trade deficit is expected to widen. However, earnings from tourism will continue to increase, while grant aid from abroad will rebound as declines in cash grant aid to the current budget will be more than offset by increases in foreign aid to the capital account. Therefore, both the current account and the overall balance of payments are expected to remain in surplus, and the size of the surplus is likely to remain broadly the same.

IV. Report on Discussions

While the economy has made substantial progress in overcoming many of its difficulties since independence and its prospects for 1983 are cautiously optimistic, the Government has yet to make further adjustments necessitated by the expected decline and eventual cessation of foreign cash grant aid to support the current budget and a possible further deterioration in the external terms of trade. The time profile of the required adjustment depends crucially on the timing of the decline in foreign grants to the budget as well as the performance of the export sector and the movement of the terms of trade in the future.

In the medium term (perhaps until 1985), the Government expects annual reductions of roughly 15 per cent in the amount of current budget support obtained through cash grants and does not envisage the emergence of serious budgetary problems. However, such support could stop completely by 1985. The authorities therefore intend gradually to reduce the gap between overall expenditure and domestic revenue. In addition, they plan to improve export performance and to promote the cautious development of the tourist sector, according import substitution a relatively low priority. They are also exploring the possibility of obtaining concessionary long-term loans from international and foreign organizations such as the Asian Development Bank, the World Bank, and the Caisse Centrale de Cooperation Economique.

1. Fiscal policy

Despite the expected drop in foreign grants to finance the current budget, the Government is committed to minimizing deficit financing. To implement this policy, the Government has introduced measures to restrain its budgetary expenditure and to raise revenue. Nevertheless, the overall government accounts in 1982 are likely to be in deficit, amounting to about 2 per cent of GDP, compared with a surplus of nearly 3 per cent of GDP in 1981.

Prior to independence, Vanuatu had three separate government administrations and a dual system of education and other public services. After independence, a unitary government service was introduced, but it was not feasible to streamline all government functions in a short period. The continued multiplicity of government agencies, combined with the high quality of some of the government services (e.g., education and health), has resulted in a very large public sector: in 1982, Central Government overall expenditure is estimated to have been about 46 per cent of GDP.

In their efforts to cope with the strain imposed on the unified Government of Vanuatu, the authorities exercised tight controls over government spending in both 1981 and 1982. In 1981, they abolished two ministries and combined several administrative services. In addition, they effected a freeze on employment in the Government from July 1981 to June 1982. When the freeze was lifted in June 1982, directives were issued by the Government to keep a strict control on recruitment; the cost of hiring junior officials was offset by the saving from retiring senior staff, whose positions were not filled. Some progress was also made in rationalizing the educational and health systems. Efforts to promote further streamlining of government services are being supported by assistance from the Commonwealth Fund for Technical Cooperation (CFTC) and the United Nations.

In April 1981 and January 1982, when inflation was increasing rapidly and the real wage rate declining sharply, the Government granted two salary supplements of VT 30,000 per annum to all but the top-ranking officials. These salary adjustments, the first in seven years, are estimated to be about 13 per cent of the 1982 wage bill, or 9 per cent of current expenditure for that year. The present level of wages in real terms is still substantially below their 1974 level. Despite these wage increases, total current expenditure in real terms probably declined substantially between 1980 and 1982, even though it increased by 10 per cent in nominal terms (Table 3).

Since independence, the authorities have sought to introduce revenue increasing measures, and in 1981 the Government requested that a Fund technical assistance mission visit Port Vila to advise on fiscal matters. Later in that year, the mission's report was presented to the authorities, and several of its recommendations were subsequently adopted. The revenue-enhancing measures introduced since independence include: (a) an increase in the company registration fee; (b) increases in the import duties on tobacco, alcoholic beverages, and spirits; (c) an increase in the customs service tax on imports by one percentage point; and (d) the introduction of a 10 per cent tax on services provided by hotels and restaurants.

While considerable progress has been made in containing expenditure and raising revenue, significant further efforts are needed if the authorities are to fulfill their objective of avoiding deficit financing in the face of declining foreign grants. If foreign grants to the current budget were to fall by 15 per cent annually and if current expenditure were to remain constant in real terms, domestic revenue would have to increase substantially faster than in the past. In view of the possibility of this faster decline and the low elasticity of the tax system in Vanuatu, the staff team discussed with the authorities various possibilities for improving the revenue performance of the economy.

Table 3. Vanuatu: Summary of Government Finance, 1980-83 1/

	1980	1981	1982 (Estimate)	1983 (Prel. budget)
		(In millions of vatu)		
Total revenue	3,061	3,257	3,152	3,457
Current revenue	1,268	1,370	1,492	1,757
Foreign grants	1,793	1,887	1,660	1,700
Of which: Current	1,033	924	740	600
Capital	760	963	920	1,100
Total expenditure 2/	2,895	3,060	3,302	3,450
Current	2,092	2,060	2,302	2,350
Capital	803	1,000	1,000	1,100
Surplus or deficit (-)	166	197	-150	8
Financing	-166	-197	150	-8
Foreign (net)	-21	-23	-26	-28
Domestic				
Increase (-), decrease (+) in government deposits	-145	-174	176	20
		(Percentage changes)		
Total revenue		6.7	-3.5	9.7
Total current expenditure		-1.5	11.8	2.1

Sources: Data provided by the authorities and staff estimates.

1/ Totals may not add due to rounding.
2/ This does not include the cost of technical assistance provided by foreign governments and international organizations. For 1982, such assistance is estimated at VT 1.5 billion.

In the short run, consumption taxes could be increased. Because the import tax is the only consumption tax in Vanuatu, and the rate at which the tax is levied is rather low by international standards, there should be scope for increasing this tax. To broaden the domestic tax base and also to prevent undesired protection induced by the increase in the import tax, the introduction of a tax on domestic production merits serious consideration. Once in place, it could be coordinated with the import tax and serve as the backbone of the future fiscal system. This new tax would be easy to administer, because only a few domestic manufactures would be subject to it at first, and it would not be expected that this new tax would raise large revenues immediately. However, combined with the eventual introduction of an income tax, such a system would permit a larger share of fiscal revenue to be obtained from domestic production and consumption.

On the expenditure side, the authorities stated their intention to enhance their present efforts to streamline the public service sector and to contain the level of nonwage expenditure. The staff team also encouraged the authorities to find a way to implement their policy of localizing government sector jobs without affecting the efficient operation of the public sector.

Capital expenditure has not yet been consolidated in the budget, which complicates the monitoring of such expenditure and attempts to analyze the role of public investment expenditure in the nation's economy. However, the Government has made significant progress in relating public sector investment to the financing requirement, as can be seen in the recently published First National Development Plan, 1982-1986. The staff team stressed the need to prepare an annual capital budget and to consolidate it with the current budget, so as to give both policy-makers and administrators an accurate picture of the Government's overall contribution to economic activity. The authorities agree with this view, but believe that the shortage of skilled manpower will hamper this consolidation for the foreseeable future.

2. Monetary policy

In December 1980, the Central Bank of Vanuatu was established with technical assistance from the Fund. Its formal establishment was provided for 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, supply, availability, and international exchange of currency; (b) to advise the Government on financial matters; (c) to promote monetary stability; (d) to promote a sound financial structure; and (e) to foster financial conditions conducive to the orderly and balanced economic development of Vanuatu.

The monetary authorities have made significant progress toward the fulfillment of these objectives. Following its establishment in December 1980, the Central Bank of Vanuatu initiated a currency exchange operation in order to substitute new vatu notes for both New Hebrides franc notes and the other co-circulating currencies (primarily Australian dollars). This operation has been carried out successfully. The authorities believe that very few, if any, foreign notes are now in circulation. The monetary authorities announced on November 30, 1982 that, with effect from April 1, 1983, the New Hebrides franc notes will cease to be legal tender in Vanuatu, and that the Australian currency will not be considered as co-circulating currency in Vanuatu and will be treated as foreign currency; New Hebrides franc coins will still be allowed to circulate.

The currency exchange operation siphoned off foreign currencies circulating outside of the banking system, thereby increasing the Central Bank's holdings of foreign assets, matched by the increase in its domestic liability. Since this operation covered both the banking and nonbanking sectors of the economy, it is difficult to estimate the exact proportion of the foreign currencies circulating outside of the banking system that was replaced by the new notes. However, the authorities are under the impression that the value of the replaced foreign currencies within the nonbanking sector was relatively small.

In mid-1981, the authorities started to compile monetary statistics, and their efforts have begun to bear fruit. According to these statistics, total liquidity expanded by VT 2.5 billion, or 59 per cent during the 12-month period ending in August 1982. Most of this is accounted for by an increase in quasi-money; about half of this increase was due to a rise in the foreign currency deposits held by offshore institutions, and the rest, to the vatu and foreign currency deposits held by residents. These increases reflected large inflows of short-term capital against a background of restored confidence in the economy. Domestic credit increased only slightly, reflecting stagnant investment demand. Mainly because of these developments, the net foreign assets of the banking system increased by VT 2.5 billion during that period (Table 4).

While the Central Bank has legally acquired many of the policy instruments that are usually available to well-established central banks, it has not yet started operations as banker to the Government and commercial banks; one of the five commercial banks in the country--Banque Indosuez Vanuatu--is presently the Government's main depository, and in extraordinary circumstances, acts as the lender of last resort.

Under the Central Bank Act of 1982, the Central Bank was given the power to impose the maximum maturities and interest rates chargeable in respect of loans, advances, overdrafts, and other forms of credit. In April 1982, the Act was amended to allow the Central Bank to prescribe both minimum and maximum deposit and lending rates.

In March 1981, against a background of political uncertainty, high domestic inflation, rising interest rates, and depressed economic activity, the Central Bank introduced a 15.5 per cent ceiling on interest rates on loans in vatu, with a view to promoting investment. However, investment remained stagnant. The imposition of the ceiling on loan rates induced commercial banks to protect their profit margins by introducing additional

Table 4. Vanuatu: Selected Monetary Indicators, 1980-82

	Monetary Survey 1/		
	Outstanding at end period		Change during the period
	August 1981	August 1982	
	(In billions of vatu)		
Net foreign assets	0.9	3.4	2.5
Domestic credit	3.6	3.8	0.2
Total liquidity	4.3	6.8	2.5
Of which:			
Narrow money	1.4	1.6	0.2
Quasi-money	2.9	5.2	2.3
(Offshore institution's holdings)	(1.0)	(2.1)	(1.1)
Other liabilities (net)	0.1	0.3	0.2

	Selected Interest Rates			
	1980	1981		1982
	Dec.	June	Dec.	June
	(In per cent per annum at end of period)			
Deposits (one to three months)				
Vatu	8.8- 9.3	9.5-10.3	9.4- 9.9	10.0
Australian dollar	9.9-10.9	11.5-12.5	8.7- 9.2	9.8
Euro-dollar 2/	17.8	17.7	13.8	15.7
Commercial loans				
Vatu	13.5-15.5	13.8-15.0	13.5-15.7	12.7-14.2
Australian dollar	14.0-16.0	16.3-18.3	15.0-16.8	16.5-16.8

Sources: Data provided by the Central Bank of Vanuatu and staff estimates.

1/ Figures are as yet provisional. Total may not add due to rounding.
2/ Three-month deposit rate in London.

fees and commissions. Thus, the effective interest rates on loans exceeded the quoted rates, leading to the loss of the stimulating effect that had been expected by the authorities. With vatu deposit rates remaining virtually unchanged at a time when interest rates abroad were rising, and with the declining confidence in the economy, vatu deposits fell sharply and capital outflows occurred. These outflows were also spurred by the rapid depreciation of the vatu against most of the currencies of the trading partners, particularly the Australian dollar. As a result, the commercial banks experienced a shortage in loanable funds denominated in vatu.

Faced with the commercial banks' lack of loanable funds in vatu and the continued stagnant investment activity, combined with the announcement of vatu's link to the SDR, the monetary authorities in September 1981 raised the ceiling on interest rates on loans from 15.5 per cent to 18 per cent per annum. They hoped that this higher ceiling would permit commercial banks to raise deposit rates, thereby attracting vatu deposits. To reinforce the authorities' expectation, the Central Bank also asked commercial banks to raise deposit rates. However, very few banks acceded to this request, and deposit rates remained virtually the same. The only observable effect of these measures--the considerable increase in the vatu deposits after September 1981--was probably due mainly to the change in the expectation of the vatu exchange rates and the restoration of confidence in the economy. The staff team suggested that the ceiling on interest rates on loans in vatu be abolished; and further advised against any future introduction of ceilings or floors on interest rates in order to avoid distortion in the financial market. The authorities agreed that the ceiling was not fulfilling a useful function, and on November 30, 1982, they abolished the 18 per cent ceiling.

The absence of direct controls on interest rates may appear to diminish the role of the Central Bank at the very time when it is attempting to gain some control and to achieve independence in the area of monetary policy. However, in a highly open economy such as Vanuatu, with no controls over capital movements, a rapidly growing offshore financial center and a pegged currency, the scope of monetary policy is bound to be restricted. As the authorities agree, when the Central Bank acquires enough skilled manpower and eventually becomes a lender of last resort for the banking system and when commercial bills or other financial instruments become available in the system, the Central Bank may possess somewhat greater scope for exercising an "independent" monetary policy in the short run. However, even then, the influence of monetary policy may be largely limited to the capital account of the balance of payments.

3. Trade policy

Against a background of continuous trade deficits and expected declines in foreign grant aid, the promotion and diversification of exports is one of the authorities' key policies in reducing the trade deficit in the medium term. In this regard, more concerted efforts are required to revitalize the traditional export sector. This revitalization would involve improving the yield of coconut trees and the quality of copra, creating the necessary infrastructure (such as island feeder roads to the coast, wharves, and adequate land transport), and rationalizing the inter-island sea transport services. Several steps have already been taken in this direction, including the promotion of better methods to dry copra so as to increase its quality; support for a research project financed by France, which has resulted in the development of higher-yielding coconut trees; construction of infrastructure in the rural area; and the establishment of the Vanuatu Commodities Marketing Board. However, most of these measures are as yet in their early stages, and their beneficial impact on copra export performance is not expected to materialize for several years.

Various aspects of the import substitution strategy were also discussed. The staff team was in general agreement with the authorities view that, among others, the limited size of the domestic market seriously limits the effectiveness of such a policy. The authorities agreed that import substitution, if introduced, should be limited to products that can easily become competitive with imported goods and that incentives should be limited to a short period of time. In particular, the time limit should be announced at the onset. An international organization has been asked to prepare a study on investment guidelines appropriate to the Vanuatu economy.

The Government has introduced some restrictions on the import of certain agricultural products to protect local producers on a temporary basis--only during the harvest season or when an excess supply exists. The staff team hoped that these restrictions are indeed temporary, and will not cause an unduly large rise in prices.

4. Exchange rate policy

When the vatu was pegged to the SDR in September 1981, the Government's major objective was to cushion imported inflation. The appreciation of the vatu since then against most of the currencies of Vanuatu's major trading partners has certainly fulfilled this objective. Despite this appreciation, the balance of payments performance was not adversely affected. While the vatu appreciated vis-a-vis the currencies of Vanuatu's major trading partners, it depreciated against the U.S. dollar, and this proved to be beneficial to exporters of copra, since copra prices are quoted in U.S. dollars in the world market.

The implication of the present exchange rate arrangement on domestic inflation and the balance of payments in the future was discussed. The authorities emphasized their objective of keeping inflation relatively low, so as to avoid possible pressure for wage increases, particularly in the public sector. They recognized, however, that the scope for further appreciation is limited by its possible impact on the external balance. Further appreciation of the vatu might certainly be expected to discourage exports, encourage imports, and to have some adverse impact on tourism.

However, in the staff team's view, in the near future, such an impact may be limited. Copra exports have a low supply elasticity, and most imported items are consumed by tourists and expatriates who derive a large part of their income from abroad. Furthermore, the market for hotels is already tight, and, with continued political stability and the active publicity campaign being undertaken by the tourist industry, there is likely to be a further increase in demand.

While the present exchange rate policy was appropriate, the staff team suggested that the balance of payments developments be kept under constant review, and that the authorities be prepared to take the necessary exchange rate action when the situation so demands.

V. Staff Appraisal

Vanuatu's economic policies, particularly its fiscal and exchange rate polices, over the past two years, have been successful in meeting the challenges posed by independence and the generally difficult conditions in the world economy. By late 1982, prices stabilized significantly, owing to the appreciation of the vatu and the slowdown of world inflation. The present rate of inflation, at 2 to 3 per cent a year, is one of the lowest in the world. Furthermore, economic activity has been gradually recovering, even though the tempo of the recovery has varied somewhat from one sector to another. The Government budget, however, swung into deficit in 1982, owing to continued declines in grant aid from abroad and to two salary increases granted in 1981 and 1982. More serious deterioration was prevented by the implementation of commendable fiscal measures. The external position of the balance of payments continued to be in surplus.

As the general economic condition has improved and stabilized, the focus of economic policy has been shifting toward further adjustment of the economy in the face of the expected further declines in foreign grants, and the burden of the adjustment will fall largely on the Government sector. The principal policy issues in this regard are the authorities' commitment to avoid deficit financing and the additional fiscal measures needed to contain expenditure and raise domestic revenue.

If the authorities aim at maintaining the level of current expenditure in real terms, a substantial increase in the revenue efforts will be needed. In the staff's view, the most efficient means of raising revenue immediately would be an increase in the consumption tax on imports, which is low by international standards. The import tax is the most important contributor to the Government's tax resources; and its revenue could be enhanced either by broadening the tax base or by increasing the rate, or both. To broaden the tax base further, and also to prevent undesired protective effects, the introduction of a sales tax on domestic production should be considered. In the absence of a tax system that increases the tax-GDP ratio over time and the prospective phasing out of grant aid, government expenditure will have to be tightly controlled in order to achieve the authorities' objective of maintaining a balanced budget. In this context, the present efforts to streamline the civil service and contain wages in the public sector are essential.

In the area of monetary policy, the staff welcomes their recent decision to remove the ceiling on interest rates on loans in vatu and believes that such ceilings should not be reintroduced. Any controls on the level of interest rates on loans or deposits would inevitably lead to distortions in the financial market, which would be particularly detrimental to a small open economy like Vanuatu, which has no controls on capital movements and maintains a pegged exchange rate system. In fact, there is little further that the authorities can do for the time being to make their monetary policy more effective in influencing the real sector of the economy.

The staff agrees with the authorities' emphasis on the promotion and revitalization of traditional exports and with their belief in the limited effectiveness of import substitution policy, and hopes that the efforts under way will be strengthened. The staff also agrees with the authorities' cautious policy toward industrialization and the rapid expansion of the tourist industry in order to protect the country from economic dislocation, the destruction of traditional values and culture, and the emergence of pollution and disequilibrium in the ecological balance.

The exchange rate policy pursued by the Government since September 1981 proved successful in insulating the economy against imported inflation. Despite the appreciation of the vatu since that time, the balance of payments has remained in surplus. Nevertheless, the present exchange rate policy should be kept under continuing review in the light of evolving external conditions.

Finally, the staff welcomes Vanuatu's recent decision to accept the obligations of Article VIII, Sections 2, 3, and 4.

Fund Relations with Vanuatu 1/

Date of membership:	September 28, 1981
Status:	Article VIII.
Quota:	SDR 6.9 million.
Fund holdings of vatu:	SDR 5.86 million or 85.0 per cent of quota.
SDR position:	Holdings (SDR 2,519); allocation (none).
Exchange system:	Since September 10, 1981, the vatu has been pegged to the SDR at the rate of VT 106.20 = SDR 1. At present the Central Bank of Vanuatu does not buy or sell foreign exchange. At the end of October 1982, the buying and selling rates for the vatu quoted by a leading commercial bank were VT 98.67 per U.S. dollar and VT 100.81 per U.S. dollar, respectively.
Fund technical assistance:	Provided through the Asian, Fiscal Affairs, and Central Banking Departments. There are three experts assigned to the Central Bank of Vanuatu under the CBD technical assistance program serving as Chief Executive Officer, Deputy General Manager, and Research Manager of the Bank. In addition, in July 1981, another CBD panel member was assigned for a period of six months to the Central Bank of Vanuatu as advisor on foreign exchange arrangements. The Fund has also provided two technical assistance missions in the fields of taxation and the exchange rate system (both in May 1981).

1/ As of December 15, 1982.

Vanuatu: Relations with the World Bank

Vanuatu joined the World Bank Group and the International Finance Corporation (IFC) on September 28, 1981. An acquaintance mission of the World Bank visited Vanuatu during December 1982.

Vanuatu

Basic Data

Area, population, and GDP

Area:	12,189 sq. kms.
Population (June 1982):	125,600
Population growth rate (1967-79):	3.2 per cent per annum
GDP, 1982: 1/	SDR 71.6 million
GDP per capita (1982): 1/	SDR 570

	1980	1981	1982	1983
Consumer prices				
(Percentage change during the year)	18.4	26.7	2.1 2/	...
Budget (in mn. of vatu) 3/				
Total revenue	3,061	3,257	3,152	3,457
Revenue	1,268	1,370	1,492	1,757
Foreign grants	1,793	1,887	1,660	1,700
Total expenditure	2,895	3,060	3,302	3,450
Current	2,092	2,060	2,302	2,350
Capital	803	1,000	1,000	1,100
Surplus or deficit (-)	166	197	-150	8
Financing	-166	-197	150	-8
Foreign (net)	-21	-23	-26	-28
Domestic				
Increase (-), decrease (+) in government deposits	-145	-174	176	20
Money and credit (in bn. of vatu) 4/				
Net foreign assets		2.6	3.4	
Domestic credit		3.1	3.8	
Net claims on Government		-1.4	-1.1	
Claims on private sector		3.1	3.5	
Claims on nonmonetary financial institutions		1.3	1.4	
Money		1.6	1.6	
Quasi-money		3.7	5.2	
Other liabilities (net)		0.4	0.3	

(Continued)

Vanuatu

Basic Data (Concluded)

	1981	1982	1983
	(In millions of SDRs)		
Balance of payments			
Exports, f.o.b.	13.5	9.6	10.4
Imports, f.o.b.	34.3	38.4	45.4
Balance on re-exports less imports for re-exports	2.6	1.9	1.9
Total trade balance	-18.2	-26.9	-33.1
Net services	9.4	20.9	23.2
Net transfers	37.7	30.5	32.0
Current account	28.9	24.5	22.1
Long-term capital	0.4	0.2	2.8
Overall balance 5/	29.3	24.7	24.9
External debt (end of period) 6/	3.3	1.8	...
Gross official reserves (end of period) 7/			
(a) Foreign exchange held with overseas banks	7.3	2.7	...
(b) (a) plus foreign exchange held with domestic commercial banks	16.1	16.3	...
In months of imports for domestic consumption			
(a) Foreign exchange held with overseas banks	2.4	0.8	...
(b) (a) plus foreign exchange held with domestic commercial banks	5.2	4.6	...
Terms of trade (1981 = 100)	100.0	91.2	86.1
Exchange rate (VT/SDR)	104.2	106.2	106.2 8/

1/ Rough estimates.
2/ During one-year period ending in the third quarter of 1982.
3/ Estimates for 1982 and preliminary budget for 1983.
4/ End of December for 1981 and end of August for 1982.
5/ Excluding short-term nonmonetary capital and errors and omissions.
6/ Staff estimates.
7/ End of August for 1982.
8/ Assumption.