FOR AGENDA

SM/84/116
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

June 22, 1984

To: Members of the Executive Board

From: The Secretary

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

The following corrections have been made in SM/84/116 (5/22/84):

Page 8, Table 3, line 5: for "Principal Interest" read "Principal"

Page 9, Table 4, column 3, line 14: for "(491)" read "(489)"

line 15: for "(-143)" read "(-141)"

column 4, line 14: for "(200)" read "(202)"

line 15: for "(-130)" read "(-133)"

Page 14, para. 2, line 19: for "57 percent" read "56 percent"

Page 16, 2nd full para., penultimate line: for "liquid tender" read "legal tender"

Page 23, Basic Data, under money and credit: for "Of which: Private sector" read "Of which: Nonfinancial private sector"

column 3: for "(3.3)" read "(3.5)"

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

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	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	-155	-145
Banks 5/	(...)	(...)	(489)	(202)	(...)	...
Others 6/	(...)	(...)	(-141)	(-133)	(...)	...
			(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.

SM/84/116
Corrected: 6/21/84

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.

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 56 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 legal 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 legal 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,

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: Nonfinancial private sector	(3.1)	(3.3)	(3.5)	...
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.