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May 13, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Vanuatu - Staff Report for the 1987 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1987 Article IV consultation with Vanuatu, which will be brought to the agenda for discussion on a date to be announced.

Mr. Evers (ext. 7611) or Ms. Le Gall (ext. 7334) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

VANUATU

Staff Report for the 1987 Article IV Consultation

Prepared by the Asian Department

(In consultation with the Exchange and Trade Relations,
Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by W.M. Tilakaratna and Eduard Brau

May 12, 1987

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I. Introduction

The 1987 Article IV consultation discussions with Vanuatu were held in Port Vila during March 7-21, 1987. The staff team met with Mr. Kalpokor Kalsakau, Minister of Finance, Commerce, Industry, and Tourism; Mr. Edward Fillingham, General Manager of the Central Bank of Vanuatu; and senior officials from various government departments and offices. The staff team consisted of Mr. Willem G.L. Evers (Head), Ms. Francoise Le Gall, Mr. Reza Kibria, Mr. Robert Corker, and Ms. Glenys Murrell (secretary) (all ASD).

Vanuatu has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on current international transactions.

II. Background and Recent Economic Developments

Vanuatu consists of about 80 small islands in the South Pacific, 500 miles west of Fiji, and has a population of about 140,000. The country is endowed with abundant and fertile land and with rainfall sufficient for a wide variety of crops. The surrounding seas are rich in fish and there have been promising discoveries of gold. Subsistence agriculture is the principal means of livelihood for about 80 percent of the population. The modern sector of the economy consists mainly of government services, tourism, and plantation agriculture. Offshore financial services, which are provided by four commercial banks and about 90 financial institutions, contribute about 10 percent of gross domestic product. The main foreign exchange earners are tourism and exports of copra, cocoa, and beef. Vanuatu also offers flag-of-convenience registration of ships. Imports consist mainly of consumer goods, equipment, and construction materials. Because of the large expatriate population, the import propensity is relatively high and about 60 percent of total liquidity is held in foreign denominations. The country receives substantial amounts of foreign aid, in particular from the two former Condominium powers, France and the United Kingdom. English and French are in common use, along with Bislama, the main indigenous language. ^{1/}

A number of adverse developments have struck the economy during the last two years. Two cyclones caused a decline in agricultural output in 1985, while a downturn in the Australian economy and a depreciation of the Australian dollar led to a fall in tourist arrivals. Although agricultural production rebounded in 1986, tourism continued to decline, among other things, because Air Vanuatu ceased operations following the

^{1/} Vanuatu has over 100 indigenous languages.

termination of its management contract with a foreign airline. ^{1/} In addition, uncertainty regarding foreign policies affected offshore banking. GDP, which had grown by about 5 percent in 1984, remained more or less unchanged in 1985 and 1986. A favorable development was the continued expansion of manufacturing output which, from a low base, grew by 9 percent in 1985 and 15 percent in 1986.

Budgetary developments also took a turn for the worse in 1985 and 1986, as a decline in foreign grants and a rise in expenditures were only partly offset by increased revenues from higher import duties. From a surplus equivalent to 4 percent of GDP in 1984, the budget moved to deficits equivalent to 1 percent of GDP in 1985 and 7 percent of GDP in 1986 (Table 1). About 60 percent of the rise in current expenditures was on account of wages and salaries.

Total liquidity grew by 8 percent in 1985 and by 22 percent in 1986, largely because devaluations in both years increased the value of deposits held in foreign denominations (Table 2). Price support operations of the Vanuatu Commodities Marketing Board (VCMB) contributed to the growth in liquidity. Despite its rapid rise as the result of increased borrowing by the Government, domestic credit accounted for only one third of the expansion of liquidity in 1986. Inflation rose from almost 1 percent in 1985 to about 7 percent in 1986, mainly as the result of higher import prices.

In addition to the decline in tourism, the balance of payments was affected by a sharp drop in the price of copra and by declining official grants. Merchandise exports fell from SDR 32 million in 1984 to SDR 18 million in 1985 and to SDR 8 million in 1986, almost exclusively on account of lower copra prices (Table 3). Imports remained unchanged in 1985, but declined by 20 percent in 1986 as a result of lower oil prices, declining demand in the tourist sector, and the effect of higher import duties. After surpluses totaling SDR 71 million during the previous three years, the overall balance of payments incurred deficits of SDR 3 million in 1985 and SDR 11 million in 1986. These deficits were entirely financed by a decline in net foreign assets of the commercial banks. Gross official reserves rose from SDR 15 million, or four months of imports, at the end of 1984 to SDR 20 million, or six months of imports, at the end of 1986. ^{2/}

The vatu, which is pegged to the SDR, was devalued in April 1985, February 1986, and October 1986 by a total of 29 percent. The depreciation in real terms against currencies of Vanuatu's major trading partners was less pronounced, and there was an appreciation of the vatu against the Australian dollar. In December 1986, the real effective

^{1/} Vanuatu continues to be served by two other airlines, one from Australia and one from Fiji.

^{2/} At the end of February 1987, gross reserves stood at SDR 25 million.

Table 1. Vanuatu: Summary of Central Government Budget, 1983-87

	1983	1984	1985	1986	1987	
					Budget	Recent estimate
(In billions of vatu)						
Total revenue and grants	4.5	5.6	5.6	5.1	6.4	6.4
Revenue	1.9	2.5	2.8	2.8	3.3	3.2
Tax revenue	1.5	2.0	2.3	2.2	2.8	2.5
Import duties	(1.0)	(1.2)	(1.5)	(1.5)	(2.0)	(1.8)
Other tax revenue	(0.5)	(0.8)	(0.8)	(0.7)	(0.8)	(0.7)
Nontax revenue	0.4	0.5	0.5	0.5	0.5	0.7
Foreign grants	2.6	3.1	2.8	2.3	3.1	3.2
Of which: Budget subsidies	(0.6)	(0.4)	(0.3)	(0.1)	(0.2)	(0.2)
Receipts from STABEX	(--)	(0.4)	(--)	(--)	(0.6)	(0.6)
Cyclone relief	(--)	(--)	(--)	(--)	(--)	(0.1)
Current expenditures	3.5	4.2	4.4	4.8	5.2	5.5
Wages and salaries	1.4	1.5	1.7	1.9	1.8	1.8
Transfer of STABEX funds	--	0.2	0.1	--	0.5	0.5
Cyclone-related expenditures	--	--	0.1	--	--	0.2
Expenditures for Air Vanuatu	--	--	--	--	--	0.1
Other expenditures	2.1	2.5	2.5	2.9	2.9	2.9
Development expenditures	1.1	0.9	1.3	1.2	1.2	1.2
Overall surplus or deficit (-)	-0.1	0.5	-0.1	-0.9	--	-0.3
Foreign borrowing (net)	--	--	0.1	0.1	...	0.1
Domestic borrowing	0.2	-0.5	--	0.8	...	0.2
Bank 1/	(0.2)	(-0.5)	(--)	(0.75)	(...)	(0.15)
Nonbank	(--)	(--)	(--)	(0.05)	(0.2)	(0.05)
(In percent of GDP)						
Memorandum items:						
Domestic revenue	19	20	22	21	23	22
Import duties	(10)	(10)	(12)	(11)	(14)	(12)
Foreign grants	25	26	21	18	21	22
Current expenditures	34	34	34	36	36	39
Wages :	(13)	(13)	(14)	(14)	(13)	(13)
Public savings	-15	-14	-12	-15	-13	-17
Development expenditures	11	8	10	9	8	8
Overall surplus or deficit (-)	-1	4	-1	-7	--	-2
(In percent)						
Import duties/total imports	15	18	20	25	31	28
Import duties/dutiable imports	18	22	30	35	44	40
Dutiable imports/total imports	86	83	66	70	70	68

Sources: Based on data provided by the Vanuatu authorities.

1/ Because of timing and recording differences, borrowing from the banking system in this table does not correspond to that of the monetary survey in Table 2.

Table 2. Vanuatu: Monetary Survey, 1983-87 ^{1/}

	1983	1984	1985	1986	1987 Est.
(In billions of vatu)					
Net foreign assets	5.8	9.3	9.9	11.2	11.5
Monetary authorities	0.6	0.8	1.0	2.5	...
Commercial banks	5.2	8.5	8.9	8.7	...
Assets	(17.4)	(20.6)	(29.2)	(32.3)	(...)
Liabilities	(12.2)	(12.1)	(20.3)	(23.6)	(...)
Domestic credit	2.9	2.2	1.9	2.7	3.2
Government (net)	-0.7	-1.3	-1.4	-0.9	-0.7
Private sector and public enterprises	3.6	3.5	3.3	3.6	3.9
Other items (net)	-0.9	-1.0	-0.7	-1.2	-1.2
Deposits of Commodities Marketing Board ^{2/}	0.5	1.4	1.2	0.7	0.8
Total liquidity ^{3/}	7.3	9.2	9.9	12.1	12.6
Money	1.8	2.1	2.2	2.2	...
Quasi-money in vatu	1.9	2.2	1.7	2.8	...
Quasi-money in foreign currencies	3.6	4.9	6.0	7.1	...
(Changes in percent of liquidity outstanding at the beginning of the period)					
Net foreign assets	28	48	7	13	2
Domestic credit	8	-8	-4	8	4
Of which: Government (net)	-3	-8	-1	5	2
Other items	-5	-1	3	-5	--
Deposits of the Commodities Marketing Board	-7	-12	2	5	-1
Total liquidity	24	26	8	22	4
In vatu	11	8	-4	11	...
In foreign currencies	13	18	12	11	...
(In percent)					
Memorandum items:					
Loan/deposit ratio (total)	46	34	30	31	...
Loan/deposit ratio (vatu)	73	69	82	77	...
Ratio of foreign to total liquidity	49	53	60	60	...
SDR appreciation against the vatu	--	--	9	29	...

Source: Based on data provided by the Vanuatu authorities.

^{1/} The data in this table differ from those published in IFS in that deposits from and claims on offshore financial institutions are recorded under net foreign assets rather than under total liquidity and domestic credit, respectively.

^{2/} These deposits are held in SDRs.

^{3/} Excluding deposits held by the Vanuatu Commodities Marketing Board.

Table 3. Vanuatu: Balance of Payments, 1982-86

(In millions of SDRs)

	1982	1983	1984	1985	1986
Trade balance	-29.5	-26.1	-18.6	-33.0	-32.4
Exports, f.o.b.	9.7	16.8	31.7	18.4	7.5
Of which: Copra	(6.7)	(12.3)	(26.9)	(12.9)	(3.6)
Imports	-39.2	-42.9	-50.3	-51.4	-39.9
Services and private transfers (net)	11.3	10.8	12.1	9.2	6.4
Inward travel receipts	19.3	20.7	23.2	18.6	12.2
Investment income	-7.3	-10.5	-12.0	-12.3	-10.0
Private transfers (net)	7.4	5.6	6.8	6.6	6.0
Other	-8.1	-5.0	-5.8	-3.8	-1.8
Official transfers	31.8	24.5	30.9	25.5	19.1
Of which: STABEX	(0.3)	--	(3.6)	--	--
Current account	13.6	9.2	24.4	1.7	-6.9
Nonmonetary capital (net)	7.8	5.9	8.3	5.4	5.1
Official	1.5	0.4	0.8	0.8	0.6
Private	4.5	10.0	7.3	4.6	5.0
Short-term capital	1.8	-4.5	0.2	--	-0.5
Errors and omissions	-4.7	1.4	5.4	-10.1	-9.4
Overall balance	16.7	16.5	38.1	-3.0	-11.2
Monetary authorities	(1.4)	(-0.3)	(-2.0)	(-1.3)	(-7.9)
Commercial banks	(-18.1)	(-16.2)	(-36.1)	(4.3)	(19.1)
Memorandum items:					
Official reserves	12.0	10.2	15.1	20.0	20.0
Total official debt	3.7	3.5	4.0	4.6	5.4
Debt service ratio (percent)	1.7	1.3	0.9	1.9	3.6
Current account/GDP ratio (percent)	15.4	9.6	20.3	1.4	-6.5
Tourist arrivals ('000)	26.8	27.4	26.2	18.9	13.5
Copra prices (SDRs/ton)	192	319	576	333	88

Source: Based on data provided by the Vanuatu authorities.

exchange rate stood at 16 percent below the average for 1983-84 (Chart 1).

In February 1987, a severe cyclone struck Vanuatu causing extensive damage to the capital, Port Vila, but leaving the agricultural sector more or less unharmed. The damage to buildings, equipment and stocks is tentatively estimated at SDR 80 million, of which about SDR 8 million was sustained by government-owned property. The Government is currently formulating a comprehensive program of reconstruction and intends to convene a meeting of donor countries in June 1987 to discuss possible reconstruction aid.

On the occasion of the 1985 Article IV consultation, 1/ Executive Directors expressed concern over mounting pressures to increase expenditures and, citing the heavy dependence on foreign aid, urged the authorities to exercise expenditure restraint and broaden the tax base. Directors also observed that diversification and expansion of the productive base of the economy was required in order to strengthen the balance of payments.

III. Report on the Discussions

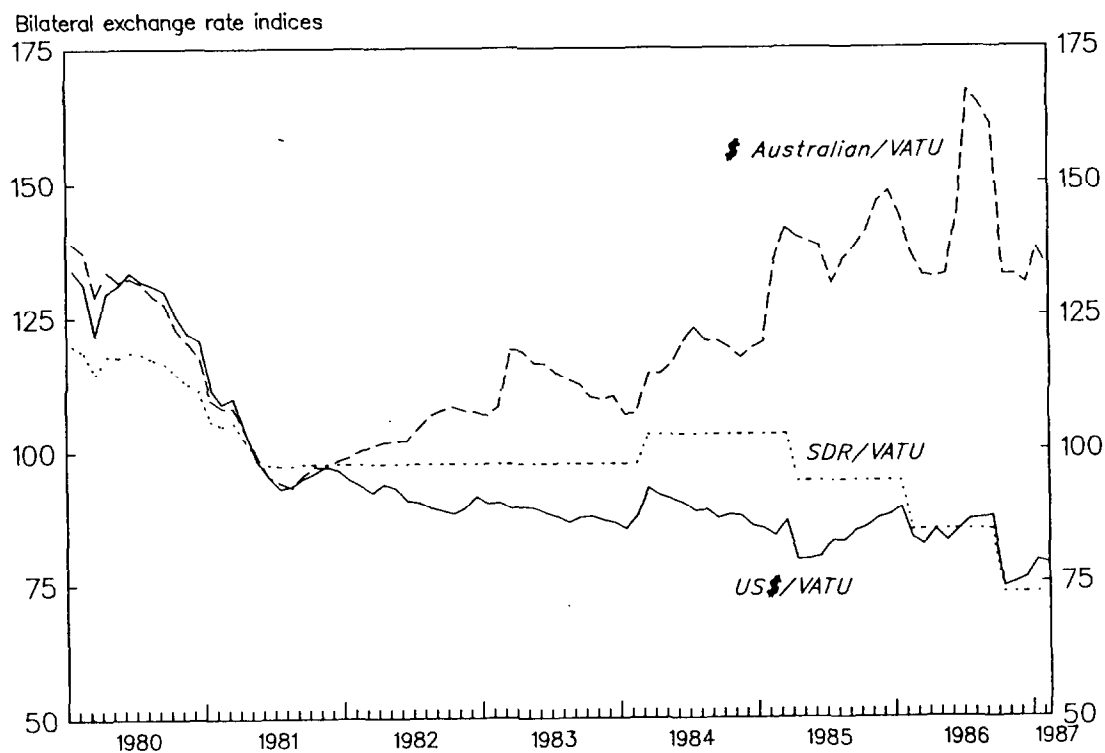
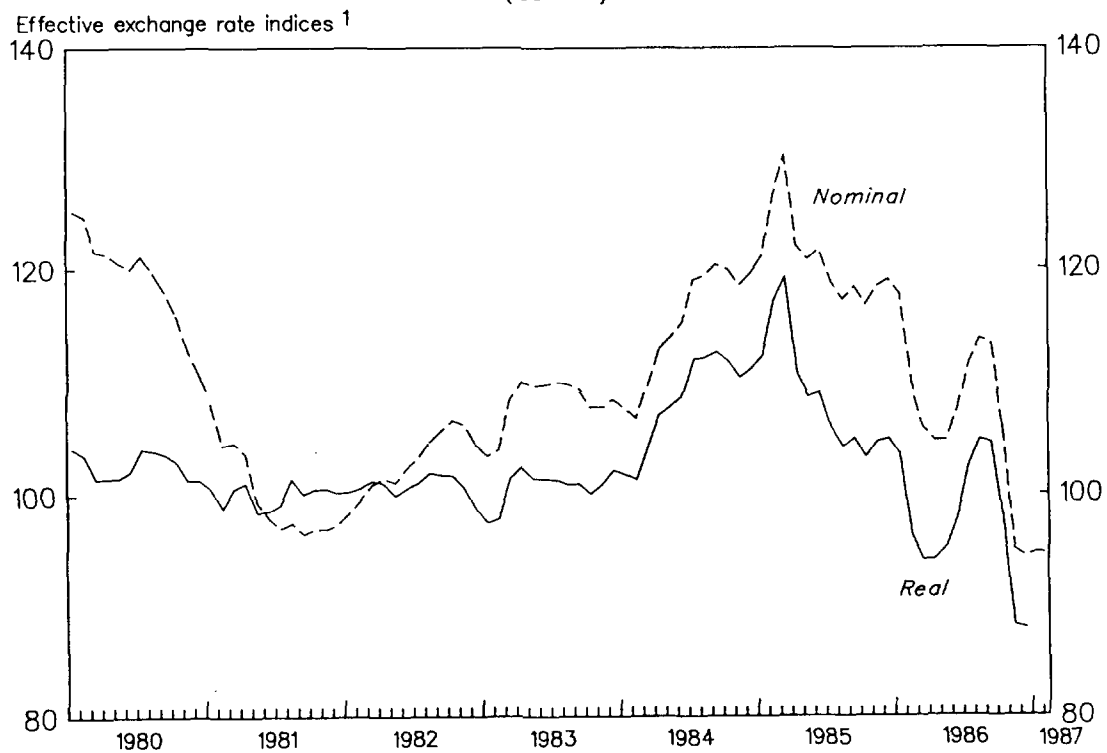
Although Vanuatu is well endowed with natural resources and receives generous aid from foreign donors, its development prospects are constrained by a number of structural bottlenecks. Foremost among these are the lack of trained workers to identify and implement new projects; rigidities in the land tenure system; and remoteness from external markets. Other impediments include a tax system that is unlikely to yield sufficient revenue to offset declining budgetary support from abroad, and meet the rising outlays associated with development; a banking system that is insufficiently geared to the needs of the domestic economy; and a narrow production base that is subject to wide cyclical fluctuations in world demand. The discussions focused in particular on production and investment policies, fiscal and monetary policies, and balance of payments policies.

1. Production and investment policies

Although preparations for the Second National Development Plan (1987-91) have not yet been completed, its policy objectives are likely to be the same as those of the previous plan: (1) better utilization of resources through diversification of production and more balanced regional development; (2) greater contributions to the development effort from the modern sector of the economy; and (3) less dependency on foreign aid. Agricultural extension services will in particular concentrate on plantation agriculture where, in contrast to cultivation by

1/ Vanuatu is on an 18-month consultation cycle.

CHART 1
VANUATU
EXCHANGE RATE INDICES, 1980-87
(1981=100)



Source: *International Financial Statistics*, IMF.

¹ Trade weights include tourism.



smallholders, production has declined in recent years. The rehabilitation of plantations is not only expected to increase the production of copra, but will also permit the raising of cattle at relatively low cost. Vanuatu's beef is of good quality and promising markets for it exist in Japan, Singapore, Papua New Guinea, and the Philippines. The Government also plans to promote the cultivation of fruits and spices in order to diversify the agricultural base. In industry, it will continue to provide tax concessions to foreign investors, particularly in agro-processing and in industries with export potential. Although a Foreign Investment Law is still under preparation, several foreign investments, including one for the production of television circuitry, have recently been made.

Uncertainty regarding ownership of the land is one of the more important obstacles to further development, particularly of the agricultural sector, where ownership questions have led to long delays in the implementation of a program to replace overaged coconut trees with high-yielding varieties. The uncertainty arises because of disputes in determining the original owners, to whom most of the land held by expatriates reverted upon independence. Most claims on disputed land are submitted to the courts, but owing to lack of sufficient legal staff, adjudication has been slow and there is a large backlog of unresolved cases. In addition, although the Government has the authority to lease disputed land for up to 75 years, the number of new leases has declined from 1,037 in 1985 to 755 in 1986. In view of the importance of the land issue for economic development, the staff team suggested that the Government take a more active role in solving this issue. The Second National Development Plan would provide a good opportunity to bring land policies into clearer focus, and to establish benchmarks toward the eventual solution of this problem.

2. Fiscal policies

With the introduction of the 1987 budget, the authorities took a number of measures to redress the deteriorating fiscal situation. Import duties were raised by 25 percent, on average, and following several years of rapid increases, expenditures for goods and services were budgeted to remain at the same level as in 1986, while outlays for wages and salaries were slated to decline. In order to achieve the reduction in expenditures for wages and salaries, it was decided to lay off redundant workers and to limit raises to those resulting from grade increases. In addition, civil servants would not be compensated for the contribution that they will have to make to the National Provident Fund starting in 1987 (3 percent of salary), and as in 1986, they would receive no cost of living increase. Other fiscal measures include an increase in secondary school fees and, in an effort to reduce costs, the transfer of implementation responsibility for some public works projects to the private sector. There are also plans to privatize other government activities, such as those of the Marine Department and the Government Car Pool. Taking into account the compensation that

Vanuatu will receive from STABEX for the shortfall in export earnings, the overall budget for 1987 was expected to be in balance. 1/

In early 1987, it became clear that the projected increase in customs receipts from VT 1.5 billion to VT 2.0 billion would not be realized, as import demand declined--especially of items on which import duties had been greatly increased. In addition, following the cyclone in February, the Government decided to temporarily exempt from import duties all materials needed for reconstruction. Because of these factors, and taking into account imports to replenish stocks lost during the cyclone, the estimate of customs duties has been revised to VT 1.8 billion. As a result of the cyclone, revenue from export duties and domestic taxes is projected to fall short of the budget target by VT 0.1 billion. However, reflecting the receipt of US\$1.8 million in royalty payments from the Soviet Union and the United States in connection with recently concluded fishing agreements, nontax revenue will rise by about VT 0.2 billion. With additional expenditures projected at VT 0.2 billion for cyclone relief, and VT 0.1 billion for a new management contract for Air Vanuatu, the 1987 budget is now estimated to incur a deficit of VT 0.3 billion, or 2 percent of GDP. The deficit will be financed largely by a further drawdown of Government deposits with the banking system.

Despite recent measures to raise more revenue and stem the growth of expenditures, the underlying fiscal position remains weak. With the effective duty rate having almost doubled in recent years, customs receipts now account for more than 70 percent of total tax revenue, and as demonstrated by recent experience, further increases in import duties may result in only marginally higher yields. Rates of other taxes and levies, such as the business license tax and the tax on tourism, are already relatively high so that scope for additional revenue from these sources is also rather limited. Furthermore, both France and the United Kingdom have indicated that they will gradually phase out budgetary subsidies, and with development expenditures continuing at about 8-10 percent of GDP, current expenditures may be expected to rise over the medium term.

Although the Government intends to introduce a 3 percent sales tax in 1988, it is not expected that this tax will yield enough revenue to bridge the emerging gap between revenues and expenditures. The staff team observed that, as a result of exemptions, dutiable imports as a proportion of total imports had declined in recent years, and that rationalization of the system of exemptions could lead to substantial revenue within a relatively short time. In addition, medium-term fiscal viability will probably not be achieved without broadening the tax base and making the tax system more responsive to the growth of incomes. The introduction of an income tax, with proper safeguards to protect

1/ The Government is expected to retain 30 percent of these disbursements and to pass on the remaining 70 percent to the VCMB.

Vanuatu's attractiveness as a tax haven and a center for offshore banking, would therefore have to be seriously considered. The soon-to-be-inaugurated National Provident Fund could be instrumental in overcoming one of the difficulties in establishing the tax, namely the registration of employment and incomes.

The Vanuatu Commodities Marketing Board accumulated substantial reserves prior to 1985, but with export prices below domestic prices, reserves have fallen rapidly since then (Chart 2). It is the policy of the VCMB to determine the domestic procurement prices for copra on the basis of expected trends in international prices and the level of its reserves. With the STABEX funds that the VCMB has received from the Government, this policy has resulted in higher domestic copra prices than would otherwise have been possible. The staff team observed that the use of STABEX funds for income supplements was tantamount to providing a government subsidy to what should be one of Vanuatu's most competitive sectors, and suggested that the Government review its policy of passing on a large proportion of the STABEX funds to the VCMB. These funds may be put to better use for promoting agricultural diversification and improving transportation in remote areas. The VCMB could support the domestic price of copra during times of low international prices with funds it obtained from the levies imposed on copra growers during times of high international prices; supplementary income payments from STABEX are not necessary for this purpose.

3. Monetary policies

The four commercial banks are either subsidiaries or branches of foreign-owned banks, and a preponderant share of their activities is derived from Vanuatu's status as a tax haven and a center for offshore banking. Nonresident deposits account for nearly 65 percent of total deposit liabilities, and reflecting mainly the large expatriate community, foreign currency deposits of residents account for another 22 percent. It is the policy of the banks to balance their liabilities in foreign exchange with matching foreign assets. Because of the shortage of qualified technical and managerial staff, and also because loans for smaller, especially rural, projects are not considered worth the servicing costs, commercial banks have been reluctant to lend domestically. This has resulted in ample bank liquidity in vatu which in turn has had a depressing effect on deposit rates. The average deposit rate fell from 8.8 percent in 1984 to 6.9 percent in 1986, but largely because of the perceived risks, bank lending rates have remained at about 14 percent. ^{1/}

Both the Vanuatu Savings Bank and the Vanuatu Development Bank hold sizable deposits with the commercial banks. The Vanuatu Savings Bank

^{1/} About 50 percent of outstanding bank loans to the productive sector are at interest rates above 14 percent, despite guidelines from the Central Bank that lending rates should not exceed that level.

has been successful in mobilizing deposits in rural areas through its many branch offices, but its charter does not permit it to make loans. The Vanuatu Development Bank derives its resources from foreign grants and lines of credit it has with the Asian Development Bank and the European Investment Bank, but owing to lack of trained personnel to evaluate projects, as well as a regulation limiting its lending to ni-Vanuatu, ^{1/} the Vanuatu Development Bank has been unable to lend all its resources. In order to permit better use of the savings and foreign aid, the staff team suggested: (1) elimination or softening of the restriction on lending to non ni-Vanuatu borrowers; (2) the provision of more trained personnel to the Vanuatu Development Bank; and (3) an arrangement whereby the Vanuatu Development Bank could use the network of branch offices of the Vanuatu Savings Bank to facilitate the extension of credit to rural areas. Improvements in the lending mechanism will not only provide much needed capital for rural development, but will also permit higher interest rates on deposits, which will encourage savings.

The rapid buildup of liquidity in recent years was largely associated with balance of payments surpluses and the effect of devaluations on the value of deposits held in foreign exchange. The impact of the monetary expansion on domestic prices has been marginal as demand for liquidity, particularly for quasi-money which largely represents savings, has increased. Total liquidity is expected to rise slightly in 1987, and to decline thereafter, as the cost of reconstruction and replacement of stocks and equipment will largely be met by a drawdown of deposits, particularly those held in foreign exchange. With the government deficit declining and credit to the private sector restricted by the cautious attitude of the commercial banks, the authorities do not see a need for regulating liquidity at the present time. However, they will resort to reserve requirements and other instruments of monetary policy if credit expansion were to put pressure on prices or the external reserve position.

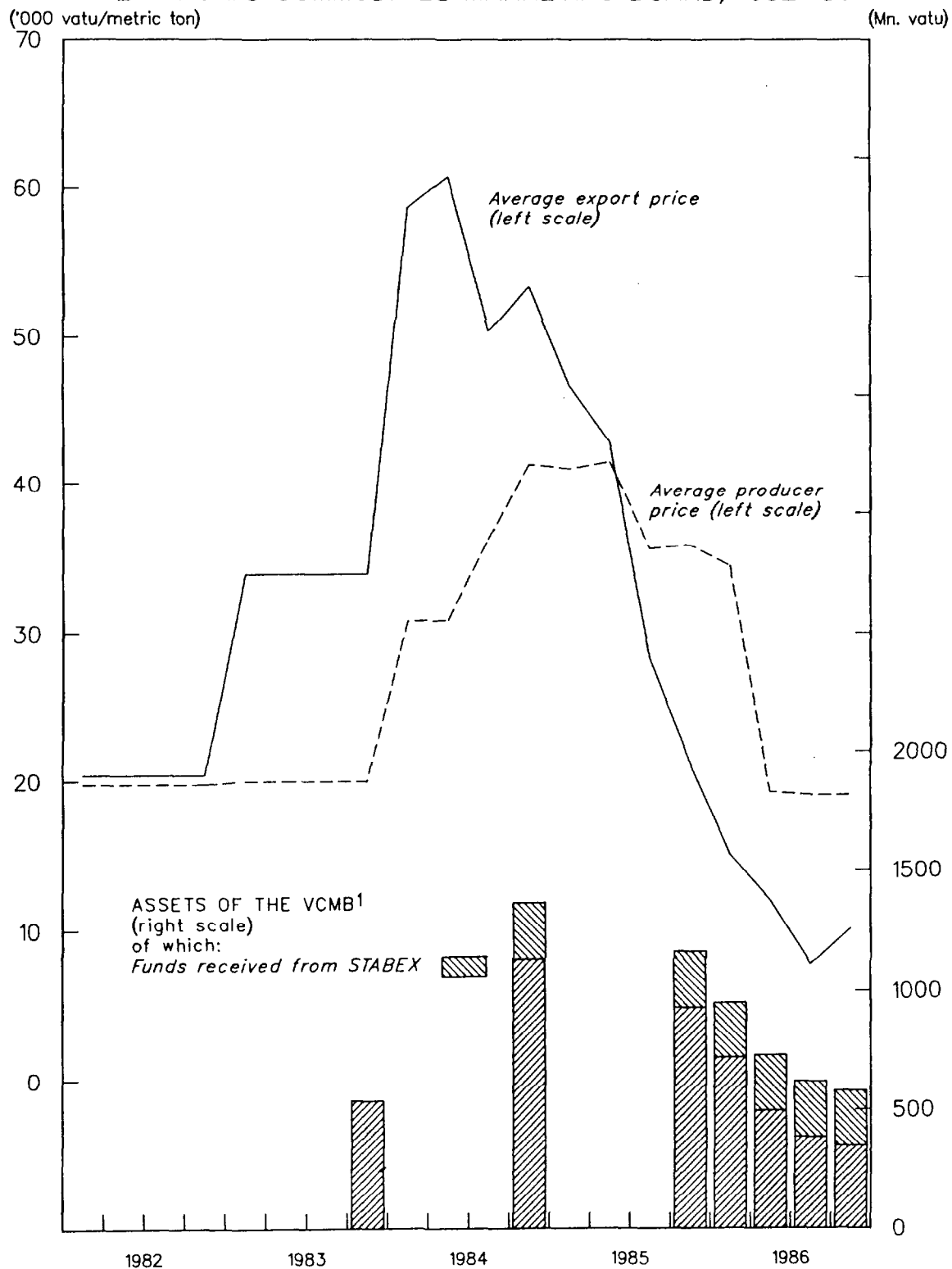
4. External policies

Although the recent cyclone only marginally affected Vanuatu's capacity to earn foreign exchange from tourism and copra exports, the restoration of property damaged by the cyclone will pose a heavy burden on the balance of payments over the medium term. The authorities estimate that about 80 percent of the damaged property will be repaired or replaced, and that about two thirds of the expected cost (SDR 42 million) will give rise to imports during the next four years. In addition, as a result of the cyclone damage, several enterprises may suspend operations, which may result in repatriation of capital of about SDR 2 million. Receipts from insurance claims are estimated at about SDR 17 million, and the authorities hope to receive about SDR 8 million in official reconstruction aid.

^{1/} Ni-Vanuatu are the indigenous inhabitants of Vanuatu.

CHART 2
VANUATU

COPRA PRICES AND THE ASSETS OF
THE VANUATU COMMODITIES MARKETING BOARD, 1982-86



Source: Data provided by the Vanuatu authorities.

¹ Information for several quarters in 1984 and 1985 is not available.

Earnings from copra are projected to rise gradually over the medium term as a result of higher prices, and tourist earnings are expected to benefit from a rebound in the Australian economy, the resumption of operations of Air Vanuatu, and improvements in airport facilities that will make it possible to service Vanuatu with larger and more economical aircraft. Disbursements from STABEX in compensation of export shortfalls of copra are estimated at SDR 6.3 million, of which SDR 4.2 million will be disbursed in 1987 (Table 4). Largely because of the STABEX disbursement, the overall balance of payments is expected to show a small surplus in 1987, but a cumulative deficit of about SDR 24 million is projected for 1988-90. The authorities expect most of this deficit to be financed by the foreign reserves held by the commercial banks (net foreign exchange holdings of the commercial banks amounted to SDR 62 million at the end of 1986). In addition, the authorities would not view with alarm a modest drawdown of official reserves which, at the end of 1986, amounted to SDR 20 million.

The authorities have followed a flexible exchange rate policy, giving due weight to the importance of the Australian dollar. In fact, the three devaluations of the vatu implemented since early 1985 were specifically aimed at reducing the impact of the Australian dollar's decline against the SDR. At end-March 1987, the exchange rate vis-a-vis the Australian dollar was about 13 percent above the average for 1983-84, compared with a peak of 45 percent in July 1986. The authorities indicated that, at this level, Vanuatu could compete with tourist facilities in Fiji and Australia. They viewed the current slump in tourism mainly as a result of the recessionary conditions in Australia, the interruption of operations by Air Vanuatu, and bad publicity following political upheavals in a neighboring territory.

Because most foreign aid has been received in grant form, foreign debt is relatively small, amounting to SDR 5.4 million at the end of 1986. Owing to the rapid fall of exports and earnings from tourism, the debt service ratio rose from 1 percent in 1984 to 4 percent in 1986, but with foreign exchange earnings expected to rebound, the debt service ratio is projected to fall to about 2 percent by 1990. The authorities indicated that it was their policy to refrain from borrowing on commercial terms, particularly as, with a gradual shift in foreign aid from grants to loans, the debt service ratio is expected to rise during the 1990s.

IV. Staff Appraisal

During the last two years, the economy was struck by a number of adverse developments. Severe cyclones affected agricultural output; the world market price of copra, Vanuatu's major export, fell by about 80 percent; and owing mainly to an economic downturn in the major tourist markets, tourist arrivals decreased precipitously. Despite a

Table 4. Vanuatu: Balance of Payments and External Public
Debt Projections, 1987-90

(In millions of SDRs)

	1986 Actual	1987 Estimate	1988	1989 Projections	1990
Trade balance	-32.4	-43.4	-55.4	-52.6	-47.1
Exports	7.5	8.2	10.0	11.2	12.5
Of which: Copra	(3.6)	(3.6)	(4.6)	(5.3)	(6.0)
Imports	-39.9	-51.6	-65.4	-63.8	-59.6
Of which: Related to cyclone reconstruction	(--)	(8.0)	(18.0)	(12.0)	(4.0)
Services and private transfers (net)	6.4	14.8	16.3	8.4	9.9
Of which: Inward travel receipts	(12.2)	(13.7)	(17.1)	(19.8)	(22.9)
Investment income	(-10.0)	(-8.8)	(-9.2)	(-9.6)	(-10.0)
Private transfers (net)	(6.0)	(6.6)	(7.0)	(7.4)	(8.0)
Settlement of insurance claims	(--)	(8.0)	(9.0)	(--)	(--)
Official transfers	19.1	26.9	26.5	25.3	23.7
Of which: STABEX	(--)	(4.2)	(1.4)	(0.7)	--
Cyclone reconstruction aid	(--)	(--)	(3.0)	(3.0)	(2.0)
Current account	-6.9	-1.7	-12.6	-18.9	-13.6
Nonmonetary capital	5.1	3.5	4.9	7.5	8.9
Official	0.6	1.2	2.3	3.8	5.0
Private	5.0	2.3	2.5	3.7	3.9
Of which: Cyclone-related repatria- tion of capital	(--)	(-1.0)	(-1.0)	(--)	(--)
Short-term	-0.5	--	--	--	--
Errors and omissions	-9.4	--	--	--	--
Overall balance	-11.2	1.8	-7.7	-11.4	-4.7
Memorandum items:					
External debt	5.4	7.0	9.3	13.1	18.1
Debt service	0.7	0.7	0.7	0.9	0.8
Debt service ratio ^{1/}	3.6	3.2	2.6	2.9	2.3

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

^{1/} Debt service as a percentage of receipts from exports and tourism.

continued expansion of the small manufacturing sector, GDP remained more or less unchanged and, following sizable surpluses in earlier years, the balance of payments registered deficits in both 1985 and 1986. Reflecting a decline in foreign grants and higher expenditures for wages and salaries, the budget moved from a surplus to a substantial deficit, in spite of sharply higher import duties. Inflation has started to accelerate, mainly as a result of higher import costs.

Although the cyclone of February 1987 caused extensive damage in Port Vila, it appears that the agricultural sector was relatively unharmed and that tourist facilities sustained only minor damage. The economy is therefore expected to benefit fully from the gradual recovery in copra prices and tourist arrivals that is projected in the years ahead. Agricultural diversification remains an important policy objective, and current plans to revitalize cultivation on plantations and to introduce new crops should reduce the dependence on copra and tourism as major foreign exchange earners. Land tenure problems continue to be a major obstacle to agricultural development and it will therefore be important that the Government take a more active role in resolving this issue. The formulation of the next National Development Plan will be an opportune occasion for the authorities to focus attention on this problem and to allocate appropriate resources for its solution.

Although a number of measures have been taken to redress the deteriorating outlook for the budget, the underlying fiscal position remains weak. In view of the heavy dependence on customs duties, prospects are not favorable for domestic revenue to keep pace with national income, even if some import duty rates are increased further. As budgetary assistance from abroad is likely to be reduced, and current expenditures will rise as a result of the coming on stream of development projects, the staff urges the authorities to give early consideration to the introduction of an income tax, with proper safeguards to protect Vanuatu's attractiveness as a tax haven and center for offshore banking. The fiscal position would also improve if the Government were to retain a much larger share of the funds received from STABEX in compensation for export shortfalls. Instead of income supplements, these funds should be used for much needed improvements of the infrastructure in rural areas.

The rapid expansion of total liquidity in recent years, which resulted mainly from balance of payments surpluses and the effect of devaluations of the vatu on deposits held in foreign denominations, has had only a marginal effect on domestic prices. This situation could change, of course, if domestic credit expansion were to accelerate rapidly, but in the event of such a development, the authorities are prepared to adopt a more active monetary policy, including the use of reserve requirements. An increase in more qualified personnel in the

Vanuatu Development Bank, and the removal of other restrictions on its lending, would go a long way in facilitating the provision of adequate credit to the domestic economy. The productive use of credit would, in turn, permit the payment of more remunerative interest rates on deposits, which would encourage savings.

Repairs of buildings damaged by the cyclone and the replacement of stocks and equipment will add substantially to imports, and the balance of payments is expected to be in deficit during the years to come. However, given the relatively high level of reserves, the projected magnitude of these deficits is within the limits of what Vanuatu could finance from its own resources. The authorities have been following a flexible exchange rate policy and recent devaluations have restored the competitive position of the tourist sector. However, as there are still *uncertainties in the outlook for tourism, and competition from neighboring countries* is increasing, the authorities will need to keep the exchange rate under active review.

It is proposed that Vanuatu remain on an 18-month consultation cycle.

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VANUATU

Basic Data

<u>Area:</u>	12,000 square kilometers				
<u>Population (mid-1986):</u>	140,154				
<u>Population growth:</u>	3.2 percent per annum				
<u>GDP per capita (1986):</u>	SDR 761				
	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987 Proj.</u>
Output and prices (change in percent)					
Real GDP	3.0	4.6	0.4	-0.1	-1.2
Consumer prices (end-period)	1.7	3.2	0.9	6.5	9.0
Government budget (VT bn.)					
Revenue and grants	4.5	5.6	5.6	5.1	6.4
Foreign grants	(2.6)	(3.1)	(2.8)	(2.3)	(3.2)
Expenditures	4.6	5.1	5.7	6.0	6.7
Current expenditures	(3.5)	(4.2)	(4.4)	(4.7)	(5.5)
Overall surplus or deficit (-)	-0.1	0.5	-0.1	-0.9	-0.3
Money and credit (VT bn.)					
Net foreign assets	5.8	9.3	9.9	11.2	11.5
Domestic credit	2.9	2.2	1.9	2.7	3.2
Government (net)	(-0.7)	(-1.3)	(-1.4)	(-0.9)	(-0.7)
Private sector <u>1/</u>	(3.6)	(3.5)	(3.3)	(3.6)	(3.9)
Total liquidity	7.3	9.2	9.9	12.1	12.6
In vatu	(3.7)	(4.3)	(4.0)	(4.9)	(...)
In foreign currencies	(3.6)	(4.9)	(6.0)	(7.1)	(...)
Balance of payments (SDR mn.)					
Exports (f.o.b.) <u>2/</u>	16.8	31.7	18.4	7.5	8.2
Imports (f.o.b.)	42.9	50.3	51.4	39.9	51.6
Trade balance	-26.1	-18.6	-33.0	-32.4	-43.4
Current account balance <u>3/</u>	9.2	24.4	1.7	-6.9	-1.7
Overall balance	16.5	38.1	-3.0	-11.2	1.8
Gross official reserves (end of period)					
In millions of SDRs	10.2	15.1	20.0	20.0	...
In months of imports for domestic consumption	3.0	3.8	4.9	6.2	...
Net reserves of commercial banks (SDR mn.)	48.8	84.9	80.6	61.5	...
Exchange rates					
Vatu/SDR <u>4/</u>	106.2	100.6	110.0	142.0	142.0 <u>5/</u>
Nominal effective exchange rate <u>6/</u>	108.2	115.3	120.9	107.0	...
Real effective exchange rate <u>6/</u>	100.7	108.4	108.8	97.2	...
Selected financial ratios (in percent)					
Overall budget balance/GDP	-0.6	4.0	-0.6	-6.5	-2.4
Foreign grants/GDP <u>7/</u>	25.5	25.6	21.4	17.6	21.9
Current account balance/GDP	9.6	20.3	1.4	-6.5	-1.6
External debt/GDP	3.6	3.3	4.0	5.8	7.0
External debt service ratio <u>8/</u>	1.3	0.9	1.9	3.6	3.2

1/ Including public enterprises.2/ Domestic exports.3/ Including official transfers.4/ End of period.5/ End-March 1987.6/ Period averages; 1981=100.7/ Inclusive of technical assistance and development grants.8/ As a percentage of export and tourist receipts.

Vanuatu - Social and Demographic Indicators

<u>Population characteristics</u>		<u>Access to health care</u>	
Life expectancy at birth (1983)	58	Percentage of population (1983)	
Infant mortality (1984; per 1,000 live births)	75	Local health care	80
		Prenatal care	90
		Population per physician (1979)	3,725
		Population per hospital bed (1979)	160
<u>Access to safe water (1981-85)</u>		<u>Access to adequate sanitary facilities (1981-85)</u>	
Percentage of population	45	Percentage of population	30
<u>Education</u>		<u>Income distribution in urban areas (1985)</u>	
Literacy rate (1979; percent)	13	Percentage of ni-Vanuatu household income	
Percentage of ni-Vanuatu in urban areas (1986)		Highest decile	28
No schooling	7	Lowest decile	2
Primary schooling	61		
Secondary schooling	32		

Vanuatu: Fund Relations
(As of April 30, 1987)

I. Membership status

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

A. Financial Relations

II. General Department
(General Resources Account)

- | | | |
|-----|----------------------------------|----------------------------------------------|
| (a) | Quota: | SDR 9.0 million |
| (b) | Total Fund holdings of currency: | SDR 7.413 million
(82.4 percent of quota) |
| (c) | Fund credit: | None |
| | Of which: Credit tranches: | None |
| | Special facilities: | None |
| (d) | Reserve tranche position: | SDR 1.587 million
(17.6 percent of quota) |
| (e) | Current operational budget: | None |
| (f) | Lending to the Fund: | None |

III. Stand-by or extended arrangements
and special facilities

- | | | |
|-----|------------------------------------|------|
| (a) | Stand-by or extended arrangements: | None |
| (b) | Special facilities: | None |

Vanuatu has not used Fund resources since becoming a member.

IV. SDR Department

- | | | |
|-----|----------------------------|-------------|
| (a) | Net cumulative allocation: | None |
| (b) | Holdings: | SDR 217,634 |
| (c) | Current Designation Plan: | None |

V. Administered Accounts

- | | | |
|-----|----------------------|------|
| (a) | Trust Fund loans: | |
| | (i) Disbursed: | None |
| | (ii) Outstanding: | None |
| (b) | SFF Subsidy Account: | None |

VI. Overdue obligations to the Fund: None

Vanuatu: Fund Relations (concluded)
(As of April 30, 1987)

B. Nonfinancial Relations

VII. Exchange rate arrangement

Between April 1, 1985 and October 23, 1986, the vatu was devalued by a total of 29.2 percent and the rate is currently VT 142.00 = SDR 1. The Central Bank quotes rates on a daily basis for the vatu against the U.S. dollar, the pound sterling, the French franc, the Australian dollar, the deutsche mark, the Japanese yen and the New Zealand dollar. However, it only buys and sells U.S. dollars, pounds sterling, French francs, and Australian dollars.

VIII. Last Article IV consultation

The staff held consultations with the authorities in Port Vila during July 22-August 5, 1985. The Executive Board discussed the Staff Report (SM/85/278) on November 4, 1985.

IX. 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 General Manager, Deputy General Manager, and Research Manager. |
| (b) FAD: | In July 1983, a member from the panel of fiscal experts was assigned for a period of six months to the Ministry of Finance to provide technical assistance in the field of budgetary control. |

X. Resident Representative/Advisor

None.

Vanuatu: Relations With the World Bank Group

Vanuatu joined the World Bank group in 1981. A credit for SDR 1.9 million was approved in May 1983 for an Agricultural Extension and Training project. A second credit, also for SDR 1.9 million, was approved in March 1986. This credit will finance several projects in transportation and port development. Both credits were cofinanced with the Asian Development Bank. A third credit, for expansion of access to secondary education, curriculum development, and teacher training, has been appraised and will be negotiated with the Government soon. While the International Development Association has taken the lead, the Australian Development Assistance Bureau is an important cofinancier of this project.

The staff of the International Development Association is cooperating closely with the United Nations Development Programme and with the Asian Development Bank in their efforts to assist Vanuatu with the post-cyclone reconstruction.

Vanuatu--Statistical Issues

1. Outstanding Statistical Issues

a. Real sector

National accounts statistics for the period 1983-86 have recently been received and are being reviewed prior to publication in IFS. The weights underlying the construction of the CPI are somewhat outdated (first quarter, 1976) and will be revised soon.

b. Government finance

No data were published for Vanuatu in the 1986 Government Finance Statistics Yearbook or in IFS. However, annual government finance data for the years 1981 through 1984, preliminary data for 1985, and budget data for 1986 have been received recently. These data will be reviewed shortly for publication in the GFS Yearbook and in IFS.

c. Monetary accounts

The Bureau of Statistics has obtained data for the Government Savings Bank and the Development Bank of Vanuatu for July 1982 and July 1984. Additional historical data for these institutions would permit the preparation of a banking survey and a financial survey for publication in IFS.

d. Balance of payments

The authorities began reporting balance of payments data to the Bureau of Statistics in August 1985. The latest annual issue (Volume 37) of the Balance of Payments Statistics Yearbook contains a section for Vanuatu, incorporating data for 1982-85 as well as explanatory notes.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Vanuatu in the May 1987 issue of IFS. The data are based on reports sent to the Bureau of Statistics by the Central Bank of Vanuatu, which during the past year have been provided on a timely basis.

Vanuatu--Statistical Issues (concluded)

Status of IFS Data

Latest Data in
May 1987 IFS

Real Sector	- National Accounts	n.a.
	- Prices: CPI	Q2 1986
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	n.a.
	- Financing	n.a.
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	Jan. 1987 (partial)
	- Deposit Money Banks	Dec. 1986
	- Other Financial Institutions	n.a.
Interest Rates	- Discount Rate	n.a.
	- Bank Lending Rate	August 1986
	- Bank Deposit Rate	August 1986
	- Bond Yields	August 1986
External Sector	- Merchandise Trade:	
	Values (exports)	November 1986
	Values (imports)	September 1986
	Prices	n.a.
	- Balance of Payments	1985
	- International Reserves	March 1987
	- Exchange Rates	March 1987

