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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/182

3:00 p.m., December 16, 1988

R. D. Erb, Acting Chairman

Executive Directors

Alternate Executive Directors

- J. Heywood, Temporary
- Di W., Temporary
- D. C. Templeman, Temporary
- J.-P. Schoder, Temporary
- P. E. Archibong, Temporary
- M. Hepp, Temporary
- R. Marino, Temporary
- A. M. Othman
- S. Rouai, Temporary
- R. Wenzel, Temporary
- E. Kiriwat
- L. E. N. Fernando
- J. E. Zeas, Temporary
- C. L. Haynes, Temporary
- A. R. Ismael, Temporary
- B. R. Fuleihan, Temporary
- M. Pétursson, Temporary
- G. Serre, Temporary
- P. Kapetanović, Temporary
- C.-Y. Lim
- T. Morita, Temporary
- S. Appetiti, Temporary

C. Brachet, Acting Secretary  
S. B. Woolls, Assistant

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Also Present

Asian Department: H. Neiss, Deputy Director; P. Gotur,  
J. R. Marquez-Ruarte, H. Vittas. European Department: R. P. Hicks.  
Exchange and Trade Relations Department: H. B. Junz, Deputy Director.  
Legal Department: P. L. Francotte. Assistant to Executive Director:  
M. J. Shaffrey.

1. VANUATU - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Vanuatu (SM/88/256, 11/23/88). They also had before them a background paper on recent economic developments in Vanuatu (SM/88/263, 12/2/88).

Mr. Lim made the following statement:

My Vanuatu authorities are in broad agreement with the general tenor of the staff report. The report highlights quite clearly the major constraints facing Vanuatu as a small developing island nation.

Vanuatu experienced relatively favorable growth and balance of payments performance from the time of its independence in 1980 up to the end of 1984. Various shocks in the period from 1985 to 1987 resulted in a virtually stagnant economy over those three years. This was largely caused by severe cyclones in 1985 and 1987, very depressed copra prices, and a dramatic decline in tourism receipts. There was some resumption of growth in 1987 due to the recovery in world copra prices and the reconstruction following the cyclones, and this has continued into 1988.

Although the outlook over the medium term is more encouraging than in previous years, the Vanuatu authorities agree with the staff report that there is little room for complacency and that there are major challenges to be met and some significant downside risks.

The events of recent years underline the structural vulnerability of a small island nation such as Vanuatu and emphasize its dependence on foreign aid, its small internal market and distance from foreign markets, its narrow production base, and exposure to natural disasters such as cyclones.

The Board discussion for the 1987 Article IV consultation with Vanuatu (EBM/87/83, 6/5/87) centered on some of the constraints or structural bottlenecks facing Vanuatu, and I would like to comment on the policy action that has been taken over the past year to alleviate these constraints on growth.

The financial constraints facing Vanuatu are severe and my Vanuatu authorities are committed to achieving meaningful reductions in the fiscal deficit. In 1987, Executive Directors stressed the need for reforms in the tax system, and the authorities intend to introduce a turnover tax in mid-1989, and they have reduced import duty exemptions. On the expenditure side, the Government has taken steps to restrain current spending, particularly with respect to the government payroll. Success in this critical area will help meet the demands for development

expenditure. To assess the implications of development expenditure on external debt servicing and the future cost of operating and maintaining projects, Vanuatu officials have developed a proposal to be put to the Government for establishing a system of multiyear financial programming, which will be of great assistance in assessing the resource claims of development projects.

I would like Directors to note that the Vanuatu Government, for reasons of fiscal prudence, does not borrow from the Central Bank to finance its expenditure. On the question of monetary policy, the Government has an essentially noninterventionist policy, and interest rates are largely market determined.

With respect to the lack of skilled labor facing the Vanuatu economy, the Government is seeking to improve technical, managerial, and marketing skills. Recently an IDA credit of SDR 6.3 million has been approved, and that will improve greatly access to secondary education and provide funding for curriculum development and teacher training.

The authorities attach great importance to export diversification and view with great concern the prospect of the loss of the copra market if the European Communities' (EC) regulations on aflatoxin levels are not met, as the earnings from copra exports continue to constitute about 60 percent of total export receipts. The Government is making a major effort to improve the processing and storage of copra, and it is hoped that the EC will show some flexibility on this issue.

Although copra will be Vanuatu's major export commodity in the foreseeable future, efforts at export diversification are projected to gradually reduce the proportion of copra exports to total receipts. Beef from Vanuatu enjoys a high reputation for quality in world markets, and exports in 1987 reached the highest figure yet recorded, and the Government is making considerable efforts to assist small producers. Cocoa is another commodity for which new markets can be tapped with improvements in quality standards.

Tourism is an important source of foreign exchange for Vanuatu, but it has been affected greatly by difficulties with air transportation to Vanuatu and cyclone damage. However, a gradual recovery is apparent and should be assisted by prospects of improved air services, the planned runway extensions, and expansion of facilities at the main airport.

The authorities wish to stimulate direct foreign investment in the Vanuatu economy. In this respect, the Government is putting extra resources into resolving the question of land

ownership disputes--one of the important obstacles to investment and growth--to enable the expeditious granting of leases as a basis for commercial and investment activity.

More generally, my Vanuatu authorities attach considerable importance to continuing with appropriate external policies. The staff report, for example, stresses the need for Vanuatu to maintain a prudent approach to external debt management, and my Vanuatu authorities are in complete agreement, given Vanuatu's vulnerability to external shocks and natural disasters and to heavy reliance on official transfers. Also my authorities are determined to maintain flexibility in exchange rate management not only for monetary policy considerations, but also for the broader aim of ensuring international competitiveness. The vatu was pegged to the SDR from September 10, 1981 to February 5, 1988 when the link was changed to an undisclosed basket of currencies. This change was made to counteract speculation in the foreign exchange market and in no way represents a change toward more rigidity in exchange rate management policy by the Vanuatu authorities.

I would like to express my Vanuatu authorities' deep appreciation for the continued international support for the economy and particularly the support that was readily forthcoming in the aftermath of the 1987 cyclone. They also wish to record their appreciation of the technical assistance provided by the Fund.

My authorities have reaffirmed their determination to continue with their program of prudent economic management in line with the views contained in the staff paper. Finally, my authorities concur with the recommendation that future Board discussion of the Article IV consultations be held every 24 months, following the bicyclic procedure.

Mr. Heywood made the following statement:

Over the past few years, Vanuatu has had to contend with a devastating catalog of events that have jeopardized macro-economic stability and hampered further growth and development. Notwithstanding the stagnation in real output over the period 1985-87, the economy has fared reasonably well under external buffeting--foreign reserves have been steadily increased, Vanuatu's debt/service and debt/GDP ratios have remained fairly comfortable, and inflation has been kept within tolerable bounds.

As the staff pointed out, the most worrying feature of the past few years has been a sharp weakening in the fiscal position, which has forced the authorities to borrow heavily from

the domestic financial sector. It is clear that the authorities are fully apprised of the need to bring the fiscal deficit under control, and some progress has been made in 1988. In addition, given the narrowness of the existing tax base and its overwhelming reliance on international trade, the authorities' intention to introduce a turnover tax in 1989 is particularly welcome.

We agree that the main challenge under the current circumstances is the need to control spending, particularly expenditures of a recurrent nature. With the wage bill accounting for over half of total expenditure, the authorities' Manpower Committee will need to examine carefully the scope for further cuts in real wages combined with tighter control over government employment. In addition, the authorities should be extremely cautious about backdating to 1980 public sector contributions to the National Provident Fund. I would be interested to know from the staff how serious the prospect of this backdating is and what the budgetary implications of it would be.

Also with respect to the budget, we were very pleased to note that the authorities transferred only a portion of the STABEX grants received in 1987 and 1988 over to the Vanuatu Commodities Marketing Board. However, Table 4 of SM/88/263 clearly shows that over the past few years average copra producer prices have been held at uneconomic levels, to the detriment of the Marketing Board's finances. Given the projected fall in STABEX receipts after 1989, the importance of restoring realistic domestic copra prices is obvious. I wonder whether the staff has any further information on price developments in 1988.

The re-establishment of financial stability and close control over recurrent expenditures are essential preconditions for the successful attainment of the authorities' development goals. Vanuatu's development is severely hampered by geographic, climatic, and institutional constraints. However, the country's economic potential should not be underestimated, and progress has been made on a number of fronts in recent years, as Mr. Lim described in his opening statement. In particular, certain impediments to growth have been reduced, and the foundations for greater economic diversification have been laid.

In previous Board discussions on Vanuatu, Directors have emphasized the importance of resolving the question of land ownership disputes as a prerequisite to stimulating private sector investment, particularly from overseas. Therefore, that the authorities have given priority to this issue by launching a major project designed to speed up the granting of leases is welcome. With less than 20 percent of Vanuatu's potentially arable land currently in use, it is clear that there is substantial scope for further development.

Equally important have been the measures taken over recent years to promote economic diversification. While the authorities' strenuous efforts to meet the EC's aflatoxin regulations are clearly appropriate, it is apparent that, over the medium term, the economy's dependence on copra needs to be reduced. The background paper on recent economic developments outlines an impressive array of measures that have been taken to improve the quality and quantity of cocoa production, develop the coffee and beef sectors, and promote tourism. If these measures can be carried out, the doubling of noncopra exports over the next five years envisaged in the staff's medium-term projections might not be unrealistic. In this context, the authorities' continued commitment to a flexible exchange rate policy is especially welcome.

As the economy emerges from a period of considerable external challenges, the prospects for a resumption in real per capita growth in Vanuatu will be more promising. However, as the authorities are aware, the attainment of a stable growth path will require difficult decisions in the short term, a clear tightening of the fiscal position, and further structural adjustment. We support the use of the bicyclic procedure in Vanuatu's case.

Mr. Morita said that, in light of its structural weakness, Vanuatu's economy needed a considerable degree of economic development. However, caution was required with respect to the pace at which the Second Development Plan was implemented, because, as was often the case with developing countries with weak fiscal positions, a too rapid implementation of reforms could risk the sound external position and arouse inflationary pressure. That consideration might apply particularly to the case under discussion, because the scope for monetary policy was limited, and the STABEX grant was expected to be abated gradually. His authorities hoped that, at the current stage, the Vanuatu authorities would also take that consideration into account in implementing the multiyear financial program.

Strengthening the fiscal position would be an important, but time-consuming task for Vanuatu, Mr. Morita considered. Current expenditures should be restrained, in particular those related to wages and salaries should be monitored closely. On the revenue side, many small island economies such as Vanuatu had a natural disadvantage, because tax collection was more difficult or costly. Therefore, the introduction of a turnover tax or a reduction of the import duty exemption would be very helpful. In that connection, the authorities' intention to take action in mid-1989 was welcome. Further efforts to broaden the tax base would also be desirable.

Land tenure reform was very important in the medium- to long-term perspective, as the current land tenure system might impede foreign direct

investment or bank lending in the future, Mr. Morita noted. It might be helpful, at the current stage, to establish a committee to work on land reform and to make a reform timetable. If such a reform was not economical, a strengthening of the island court system could be considered.

A diversification of exports was desirable, Mr. Morita remarked. As the staff had clearly pointed out, tourism was one of the most promising sectors in Vanuatu, although there was a structural weakness in that area, as suggested in the staff paper. In addition, he wondered whether a further cultivation of the cash agricultural crop could not be sought, given Vanuatu's abundant supply of fertile, arable land. In that connection, Table 5 of SM/88/256, on the balance of payments projections, showed that the ratio of copra to total exports was expected to be virtually unchanged from 1988 to 1993. There might be scope for further efforts in that area.

He generally endorsed the staff appraisal, and supported the application of the 24-month consultation cycle to Vanuatu, Mr. Morita concluded.

Mr. Haynes stated that his authorities endorsed the appraisal in the staff report for the 1988 Article IV consultation with Vanuatu. Vanuatu's problems were similar to those of many small island economies in that its structural constraints were combined with a susceptibility to natural disasters. Given the downside risks associated with the medium term, it was important for the authorities to maintain a long-term perspective together with sound macroeconomic policies designed to reduce external and internal imbalances. In a recent Board discussion on Aruba (EBM/88/180, 12/14/88), the staff had suggested that it might be useful to create a contingency fund for Aruba to prepare for potential adverse circumstances. Although the objective economic situations of Aruba and Vanuatu differed, it was important for the authorities to take such forward-looking financial planning into consideration in order to cope with shocks that could affect them in the future.

The staff representative from the Asian Department said that the staff had received information on copra prices that was more recent than the data provided in the background paper on recent economic developments. The average domestic prices paid to producers were still higher than the f.o.b. prices received by Vanuatu, but the difference between the two prices had narrowed in the second quarter of 1988, compared with the first quarter.

The Vanuatu Commodities Marketing Board took several factors into account in setting prices: actual current prices; a projection of average long-term prices; the level of reserves, and the rate at which it was rising or falling; and, most important, expected STABEX grants, the staff representative explained. STABEX grants were considered as business income by the Marketing Board, because they helped compensate for price differentials between the EC markets and markets in Asia. The combination

of actual prices, reserves, and STABEX grants constituted an effective constraint on the extent to which domestic producer prices could differ from world prices at any given time.

In line with a recommendation made by the Board during the 1987 Article IV consultation with Vanuatu, the Government made that pricing constraint more stringent in 1988 by limiting its transfer of STABEX grants to the Marketing Board to a fraction of the total grants received, instead of transferring the total amount, as in previous years, the staff representative went on. The current policy was appropriate, because it helped to ensure that pricing in Vanuatu was realistic.

On page 27 of SM/88/263, the staff had noted that, in August 1987, the Prime Minister of Vanuatu had agreed with the Public Service Employees Union to backdate to 1980 all public sector contributions to the National Provident Fund for civil servants, the staff representative continued. However, no provision for that backdating was made in the 1988 budget. Directors would recall that the 1988 budget was not announced until April 1988, owing to the general elections that took place in late 1987. At the time of the staff's consultations with the authorities, it was uncertain whether or not that backdating would be made effective. Apparently, the Government's contributions to the National Provident Fund would not become due until civil servants retired, so that contribution was not an immediate claim on the Government's resources. However, as Mr. Heywood had pointed out, it did represent a contingent liability, and thus a further reason for the Government to exercise strict wage restraint.

Mr. Lim commented that, although the authorities recognized the importance of promoting private investment, political tensions in Vanuatu were constraining the implementation of land tenure reforms. Although the authorities were making substantial efforts in the direction of reforming the land tenure system, it would be difficult to solve problems in that area over the short term. The Government was fully aware of the need to curtail borrowing, and it would continue its efforts aimed at fiscal consolidation.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the appraisal in the staff report for the 1988 Article IV consultation with Vanuatu. As noted in the staff report, the Vanuatu economy was gradually recovering following a difficult period when economic performance had been adversely affected by severe shocks. Since late 1987, a recovery of copra prices and an intensive reconstruction effort, partly under the impetus of sizable aid flows, had resulted in an improvement in real incomes and export receipts, the balance of payments had reverted to an overall surplus position, and inflation had been kept at a reasonable level.

Directors observed that the fiscal situation remained difficult, and that fiscal pressures continued to pose a risk to monetary stability and strain the ability of the Government to pay for essential development projects. With respect to the pace of adjustment, caution was recommended in order to reduce the risk of inflationary pressures, particularly as the scope for monetary policy action was limited. The authorities' efforts to strengthen the public finances were commended, but it was suggested that additional measures could be considered, including a broadening of the revenue base and restraint on the growth of recurrent expenditure, including the wage bill.

Directors noted the staff's projection of a sustainable balance of payments position in the medium term, but expressed concern about the major uncertainties continuing to face the economy, including those associated with copra exports and tourism. They stressed the importance of the authorities' efforts to improve the quality of copra exports, to diversify and widen the export base, and to promote tourism through strengthened marketing efforts. Directors also welcomed the authorities' attempts to resolve land tenure issues and encouraged a continuation of those efforts.

Directors welcomed Vanuatu's flexible exchange rate policy. They noted the authorities' view that the present level of external competitiveness was appropriate, and welcomed their intention to remain flexible in their management of the exchange rate. Directors commended the authorities for their policies on external debt management and thought that Vanuatu's circumstances recommended continued prudence in that area.

Directors agreed to place Vanuatu on the bicyclical consultation schedule. It is expected, therefore, that the next full Article IV consultation with Vanuatu will take place in 24 months.

APPROVED: June 22, 1989

LEO VAN HOUTVEN  
Secretary