INTERNATIONAL MONETARY FUND

VANUATU

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY AND PURCHASE UNDER THE RAPID FINANCING INSTRUMENT—DEBT SUSTAINABILITY ANALYSIS

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This joint IMF-WB debt sustainability analysis (DSA) updates the 2013 DSA. The results indicate that Vanuatu has shifted from low to moderate risk of debt distress. This escalation of debt distress risk largely reflects the expected high levels of fiscal deficits induced by post-cyclone reconstruction expenditures as well as the planned scaling-up of public investment, which will elevate the level of public debt over the next few years. The increase is expected to be manageable provided that financing terms are concessional and the surge in financing needs is temporary. Moreover, to the extent that grants are made available to fund the government's recovery plan, debt accumulation will be lower. Still, the authorities should be strategic in their choice of future infrastructure projects, reprioritize spending, and seek ways to increase revenues to ensure debt sustainability over the medium term.

BACKGROUND

1.   Vanuatu is coping with the consequences of Cyclone Pam that hit the country on March 13. Together with previously planned infrastructure investment spending, this is expected to increase both public and external debt in relation to GDP. The damage from Cyclone Pam will have a significant short-term effect on growth as important sectors of the economy including agriculture and tourism have been impaired.[1] GDP is expected to contract by 2 percent in 2015, in contrast to the pre-cyclone forecast of 3.5 percent growth. The investment projects are expected to foster growth in the future as they aim to build and modernize the country's infrastructure. However, concerns regarding the efficiency of investment, implementation capacity, and resulting debt burden suggest a prudent approach.

2.   The needs for post-cyclone reconstruction are large and will require external assistance to fill the financing gap. In line with the preliminary Post-Disaster Needs Assessment (PDNA), the recovery and reconstruction expenditures on the part of the public sector are expected on the scale of 20 percent of GDP spread over 3 years. Taking into account the estimated loss of revenue and grants committed so far, the fiscal deficit is projected to reach about 12 percent of GDP in 2015–16 and 10 percent in 2017. About 6 percent of GDP per year will be financed by project-related concessional loans. This leaves a financing gap of about 15 percent of GDP over 2015–17. In the absence of specific commitment of grants from development partners for reconstruction, the baseline scenario assumes that the gap will be filled with concessional loans.

3.   In 2014, the face values of external public and total external debt were low and declined from the 2013 levels in relation to GDP. The external public debt was estimated at 11.7 percent of GDP while total external debt stood at 22.5 percent of GDP. However, the total public and publicly guaranteed debt increased to 24 percent of GDP owing to increases in both domestic debt by the central government and the government-guaranteed debt extended to Government Business Enterprises (GBEs).[2] Due to data limitations, external liabilities of commercial banks are used as a proxy for private external debt.

4.   At the end of 2014 domestic debt of the central government stood at 7.8 percent of GDP. It constituted 40 percent of total central government debt and consisted of government

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[1] The Post-Disaster Needs Assessment (PDNA) estimated the total damage and losses to the economy caused by Cyclone Pam at 61 percent of GDP, of which the damage to physical assets accounts for 37 percent of GDP and production losses account for 24 percent of GDP. The highest levels of damage were to the housing stock (32 percent of total damage), the tourism sector (20 percent), the education sector (13 percent), and the transport sector (10 percent). As for production losses, agriculture and tourism are expected to sustain the largest levels at 33 and 26 percent of the total, respectively. Sixty nine percent of the impact falls within private enterprises and individual ownership, while the remaining 31 percent is in the public sector.

[2] Government-guaranteed GBE debt amounted to 4.6 percent of GDP at end-2014. All GBE debt is domestic, although some of it is owed to foreign-owned banks and is denominated in foreign currency. Comprehensive information on non-guaranteed GBE debt is not available.

bonds placed with the Reserve Bank of Vanuatu, commercial banks and other financial institutions (primarily the Vanuatu National Provident Fund).

5.   Most of Vanuatu's external debt is concessional. It has been contracted from multilateral lenders (ADB, EIB, and IDA) and via bilateral agreements (China Ex-Im Bank). The interest rates on debt are fairly low and loan maturities are long. This is reflected in a relatively high grant element of the debt and a low debt service, even though the degree of concessionality varies considerably by lender.

UNDERLYING ASSUMPTIONS

6.   The DSA is produced using updated data provided by the authorities and estimates from IMF and World Bank staff. [3] The impact of Cyclone Pam on the economy is drawn from the PDNA estimates. The DSA framework uses a discount rate of 5 percent. Total public debt includes central government debt, publicly guaranteed GBE debt, and RCF/RFI on the books of the Reserve Bank of Vanuatu.

7.   Major infrastructure projects are assumed to proceed as planned, although at a more protracted implementation schedule. Despite the unexpected economic disruption caused by the cyclone, the government intends to proceed with previously planned scaling-up of public infrastructure investment. In line with past experience and limited implementation capacity, the DSA assumes a somewhat lower rate of project implementation than envisaged by the government. Public capital expenditures are estimated to peak at 12.2 percent of GDP in 2016 and decline to a historic norm of about 2.3 percent of GDP in 2021. After the current plans are implemented, project borrowing is assumed to fall to the historical level of about 1 percent of GDP, setting the public debt ratio on a declining path.

Key assumptions underlying the baseline DSA are consistent with the post-cyclone scenario for the macroeconomic framework developed during the 2015 mission (Box 1). Differences from the 2013 DSA are mainly caused by the impact of the cyclone and the scaling-up of public investment.

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[3] Vanuatu's Country Policy and Institutional Assessment (CPIA) score average for years 2011–13 is 3.44. Accordingly, it is considered to have medium policies and institutions.

Box 1: Key Macroeconomic Assumptions

	Baseline		Historical	2013 DSA	
	2015-20	2021-35	Avg. (2005-14)	2013-18	2019-33
Real GDP growth (percent)	2.7	3.0	3.8	4.2	3.6
Growth of exports of goods and services (US dollar terms)	6.6	6.0	9.7	3.6	7.0
Non-interest current account balance (in percent of GDP)	-14.5	-4.0	-6.0	-6.4	-5.0
GDP deflator growth (U.S. dollar terms; percent)	1.7	2.9	4.7	1.2	2.8
Primary balance (in percent of GDP)	-7.5	0.0	-0.7	-1.4	-0.6

- *GDP growth*. GDP is projected to decline by 2 percent in 2015, mainly because of the cyclone impact on agricultural output and tourism, and then increase 5 percent in 2016 as economic recovery takes hold. Growth is expected to average 2.7 percent during 2015–2020, with the negative impact of the cyclone offset by reconstruction and project investment. In the long run, the economy is assumed to grow at the rate of 3 percent—below the average of the past 10 years, but above the average of the last 5 years.

- *Fiscal balance*. The fiscal deficit is projected at 10.7 and 10.6 percent of GDP in 2015 and 2016, respectively, reflecting recovery and reconstruction expenditures and the planned increase in infrastructure investment. The DSA assumes a gradual improvement in the fiscal balance over time and its stabilization at near-balance levels in the long run.

- *Reconstruction efforts and financing*. Based on the PDNA's public sector needs assessment, reconstruction expenditures are assumed to be 20 percent of GDP spread over 2015–17. Part of reconstruction activities are assumed to overlap with infrastructure projects. Any additional external borrowing needed to fill the financing gap is assumed to be made on concessional terms at the average of the terms on the ADB, the World Bank, and the China ExIm Bank loans.

- *Imports and exports*. Imports of goods and services are assumed to increase to about 76 percent of GDP in 2015 and 69 percent in 2016 driven by humanitarian needs, local supply constraints, reconstruction and project-related materials. Exports of goods and services in 2015-16 are expected to remain lower than the 2013 levels due to a contraction in tourism and agricultural exports, but to pick up gradually thereafter. The non-interest current account deficit is projected at about 4 percent of GDP in the long run.

- *FDI* is assumed to increase substantially over 2015-16 due to reconstruction needs, and remain relatively high in the medium term reflecting the crowding-in effects of the government's infrastructure projects. It is then projected to stabilize at around 4 percent of GDP in the long run.

- *Inflation*. Supply constraints caused by Cyclone Pam are expected to give rise to some inflationary pressures in 2015, but this should be partially offset by the recent decline in oil prices. Thus, the DSA assumes a slight increase in inflation to 2 percent in 2015. Higher rate of inflation is expected during 2016-18 due to potential economic stimulus induced by project implementation.

EXTERNAL DEBT SUSTAINABILITY

8.   Under the baseline scenario, the external debt of Vanuatu remains sustainable. Public and publicly-guaranteed (PPG) external debt increases significantly over the medium term compared to the 2013 DSA, primarily due to an increase in borrowing for reconstruction and project investments. As these temporary factors fall out of the picture, the debt ratio then starts declining. The face value of external PPG peaks in 2020 at 52.5 percent of GDP. Its present value

(PV) remains well below the DSA threshold, peaking at 32.4 percent of GDP in 2020. Other indicators also remain below the relevant thresholds in the baseline scenario**.**

9. **One threshold for public external debt is breached under standard tests, suggesting a moderate risk rating.** The PV of the debt-to-GDP ratio breaches the threshold of 40 percent under four out of eight standardized stress tests. The most extreme scenario corresponds to a combination shock with lower nominal GDP and export growth and lower net non-debt-creating flows than assumed in the baseline, which would set off the PV of the debt-to-GDP ratio to peak at 49 percent in 2020. The PV of the debt-to-exports ratio and the PV of the debt-to-revenue ratio are close to breaching their thresholds in the most extreme scenarios. On the other hand, the ratios of debt service to exports and to revenue remain well below the respective thresholds under standard stress tests.

10. **It is important to keep in mind the refinancing risk**. The baseline does not assume that fiscal policy will be tightened in the medium term to an extent sufficient to generate surpluses that would fully cover planned amortization. Thus public debt is expected to be rolled over at sufficiently concessional terms. However, in an alternative scenario with the cost of borrowing 200 basis points higher than in the baseline, the present discounted value of external public debt service increases noticeably relative to the measures of repayment capacity and PV of the debt-to-GDP ratio breaches the applicable threshold. Moreover, it should be kept in mind that the terms of new borrowing might be considerably harsher than in this alternative scenario.

11. **The historical scenario yields debt ratios that are below the projections in the baseline case**. Macroeconomic assumptions in the baseline are less favorable than the average economic outcomes over the last ten years. This reflects the deterioration of macroeconomic prospects brought about by Cyclone Pam and a temporary widening of deficits over the next few years caused by infrastructure projects.

PUBLIC DEBT SUSTAINABILITY

12. Under the baseline scenario the PV of total public debt is projected to increase from 30.9 percent of GDP in 2015 to 43.7 percent of GDP by 2020. Although this is a significant increase from 21.5 percent of GDP in 2014, it remains below the benchmark of 56 percent. A gradual decline is expected over the long run to bring the public debt level lower at 25.6 percent of GDP by 2035. About 4.6 percent of GDP in total public debt in 2015 is due to contingent liabilities pertaining to GBE borrowing. The PV of public debt is expected to rise to 218.4 percent of budget revenue in 2020 and then decline to 128.1 percent by 2035. Debt service on the total public debt absorbs about 18 percent of government revenue and grants in the long run.

13. Standard stress tests do not pose sustainability concerns, even in the most extreme shock scenario. The PV of debt to GDP breaches the benchmark of 56 percent of GDP only in a scenario in which the primary balance is held fixed at its 2015 level. However, that scenario is unrealistic since the large primary deficit this year is caused by Cyclone Pam and is clearly temporary.
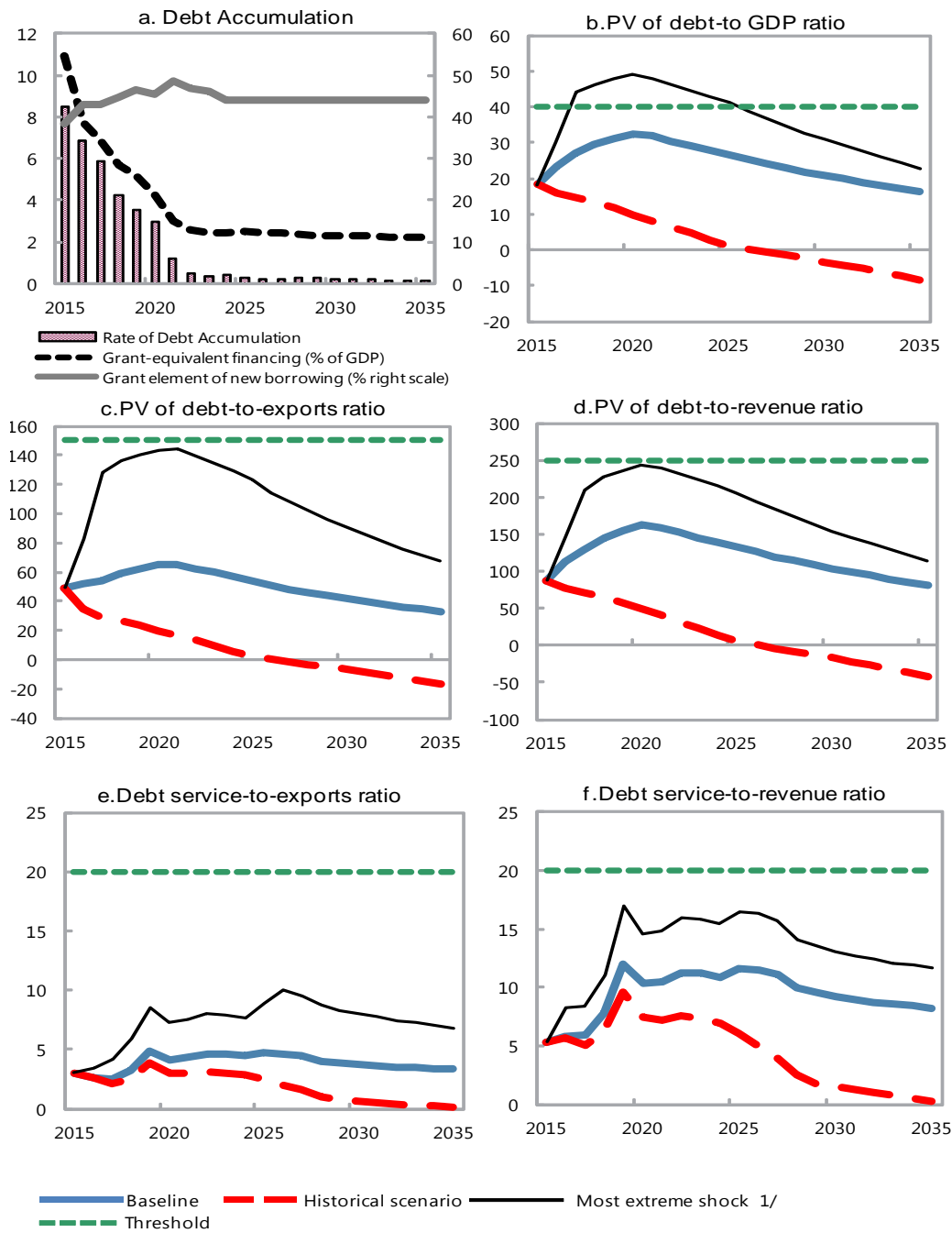
CONCLUSION AND STAFF ASSESSMENT

14. Vanuatu is currently at a moderate risk of debt distress and the planned trajectory of debt accumulation should be managed prudently. External and public debt levels are currently low. However, they are projected to rise steeply over the next few years and peak at substantially higher levels before starting to decline. While remaining below applicable thresholds in the baseline scenario, debt burden indicators show some breaches under standard stress tests.

15. To maintain public and external debt at manageable levels, the authorities will need to continue with prudent borrowing strategy and rebuild fiscal buffers over the medium term. This requires the authorities to be strategic in the choice of future public investment projects, ensuring that they are in line with national priorities, implementation capacity, and available fiscal room. The recent experience of the massive cyclone also highlights the importance of building adequate policy buffers in good times, which help cushion unexpected shocks. To set the public debt ratio on a downward trajectory while making room for priority social and developmental expenditures, the authorities should mobilize new revenue sources and strengthen public finance management processes.

AUTHORITIES' VIEWS

16. **The authorities broadly concurred with the implications of debt sustainability analysis.** They viewed the projected debt accumulation over the next few years as temporary and agreed with the importance of rebuilding fiscal buffers over the medium term. They noted that seeking grant financing for the recovery plan was crucial before resorting to additional borrowing. Investment project prioritization was also important given the projected increases in debt burden. They welcomed staff recommendations regarding spending discipline and increasing revenues and would appreciate technical assistance on these aspects. Overall, the authorities are committed to preserving debt sustainability in the medium term.

Figure 1. Vanuatu: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2015–2035 [1/]

a. Debt Accumulation

b.PV of debt-to GDP ratio

Rate of Debt Accumulation

Grant-equivalent financing (% of GDP)

Grant element of new borrowing (% right scale)

c.PV of debt-to-exports ratio

d.PV of debt-to-revenue ratio

e.Debt service-to-exports ratio

f.Debt service-to-revenue ratio

Baseline   Historical scenario   Most extreme shock 1/

Threshold

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a Combination shock; in c. to a Exports shock; in d. to a Combination shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Table 1. Vanuatu: External Debt Sustainability Framework, Baseline Scenario, 2012-2035 [1]
(In percent of GDP, unless otherwise indicated)

	Actual 2012	Actual 2013	Actual 2014	Historical [6] Average	Standard [6] Deviation	2015	2016	2017	2018	2019	2020	2015-2020 Average	2025	2035	2021-2035 Average
External debt (nominal) 1/	**25.7**	**24.0**	**22.5**			**37.6**	**46.8**	**53.4**	**57.4**	**61.5**	**63.7**		**54.5**	**39.8**	
of which: public and publicly guaranteed (PPG)	14.0	12.7	11.7			26.4	35.6	42.2	46.2	50.3	52.5		43.2	28.2	
Change in external debt	-2.3	-1.7	-1.5			15.0	9.2	6.6	4.0	4.1	2.2		-1.9	-1.1	
Identified net debt-creating flows	4.9	-3.4	-3.7			21.1	11.2	7.0	5.0	5.2	3.9		0.5	1.8	
Non-interest current account deficit	**8.8**	**0.7**	**-1.1**	**6.0**	**3.6**	**26.6**	**17.7**	**13.3**	**10.6**	**10.0**	**8.7**		**4.1**	**3.8**	**3.8**
Deficit in balance of goods and services	5.5	3.3	3.4			39.6	23.9	13.7	11.0	10.7	9.6		5.1	4.1	
Exports	45.6	48.9	48.3			37.2	45.2	50.9	49.9	50.0	49.9		48.9	49.9	
Imports	51.0	52.2	51.7			76.8	69.1	64.6	60.9	60.7	59.5		54.0	54.0	
Net current transfers (negative = inflow)	-2.2	-2.6	-3.9	-3.8	1.4	-11.3	-3.9	-2.3	-2.2	-2.1	-2.5		-2.7	-2.2	-2.5
of which: official	-1.8	-2.5	-3.4			-6.7	-2.1	-2.0	-1.9	-1.8	-2.2		-2.4	-2.0	
Other current account flows (negative = net inflow)	5.6	0.0	-0.6			-1.7	-2.3	1.9	1.8	1.4	1.6		1.7	1.9	
Net FDI (negative = inflow)	**-4.9**	**-4.2**	**-2.6**	**-7.0**	**3.8**	**-6.8**	**-5.8**	**-5.3**	**-5.0**	**-4.7**	**-4.5**		**-3.0**	**-1.7**	**-2.6**
Endogenous debt dynamics 2/	**0.9**	**0.0**	**0.0**			**1.3**	**-0.8**	**-0.9**	**-0.7**	**0.0**	**-0.3**		**-0.6**	**-0.4**	
Contribution from nominal interest rate	0.5	0.6	0.6			0.8	0.9	1.0	1.1	1.3	1.1		1.0	0.8	
Contribution from real GDP growth	-0.5	-0.5	-0.5			0.5	-1.7	-2.0	-1.7	-1.4	-1.5		-1.6	-1.2	
Contribution from price and exchange rate changes	0.9	-0.2	-0.1			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	-7.2	1.8	2.2			-6.0	-2.0	-0.5	-0.9	-1.1	-1.7		-2.4	-2.9	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	20.0			29.5	34.6	38.3	40.6	42.4	43.6		37.8	27.8	
In percent of exports	...	...	41.4			79.3	76.5	75.4	81.3	84.9	87.4		77.3	55.7	
PV of PPG external debt	**...**	**...**	**9.2**			**18.3**	**23.4**	**27.2**	**29.4**	**31.2**	**32.4**		**26.5**	**16.3**	
In percent of exports	**...**	**...**	**19.0**			49.2	51.8	53.4	59.0	62.5	64.9		54.2	32.6	
In percent of government revenues	**...**	**...**	**48.0**			87.7	113.9	129.4	144.7	154.3	161.9		132.4	81.2	
Debt service-to-exports ratio (in percent)	**3.7**	**3.9**	**5.0**			**5.5**	**4.3**	**3.8**	**4.7**	**7.0**	**5.9**		**7.3**	**6.0**	
PPG debt service-to-exports ratio (in percent)	**1.4**	**1.4**	**1.7**			**3.0**	**2.6**	**2.5**	**3.2**	**4.9**	**4.1**		**4.8**	**3.3**	
PPG debt service-to-revenue ratio (in percent)	**3.4**	**3.5**	**4.3**			**5.3**	**5.8**	**5.9**	**7.8**	**12.0**	**10.3**		**11.7**	**8.2**	
Total gross financing need (Millions of U.S. dollars)	44.1	-12.3	-10.4			168.1	115.4	88.1	76.2	88.3	76.2		65.6	130.6	
Non-interest current account deficit that stabilizes debt ratio	11.2	2.4	0.4			11.5	8.5	6.7	6.6	5.9	6.5		6.0	5.0	
Key macroeconomic assumptions															
Real GDP growth (in percent)	1.8	2.0	2.3	3.8	2.5	-2.0	5.0	4.5	3.5	2.5	2.5	2.7	3.0	3.0	3.0
GDP deflator in US dollar terms (change in percent)	-3.0	0.6	0.2	4.7	6.5	-4.3	2.3	3.2	3.1	3.0	2.9	1.7	2.9	2.9	2.9
Effective interest rate (percent) 5/	1.8	2.6	2.6	2.1	0.4	3.5	2.7	2.4	2.2	2.5	1.9	2.5	1.9	2.0	1.9
Growth of exports of G&S (US dollar terms, in percent)	1.8	10.0	1.3	9.7	8.0	-27.7	30.5	21.3	4.8	5.6	5.4	6.6	6.0	6.0	6.0
Growth of imports of G&S (US dollar terms, in percent)	-1.6	4.9	1.5	9.8	14.1	39.3	-3.2	0.7	0.7	5.2	3.5	7.7	6.0	6.0	5.3
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	37.8	42.6	42.1	43.3	45.7	43.9	42.6	44.1	44.1	44.4
Government revenues (excluding grants, in percent of GDP)	18.8	19.2	19.2			20.9	20.5	21.0	20.3	20.2	20.0		20.0	20.0	20.0
Aid flows (in Millions of US dollars) 7/	23.5	17.5	311.8			106.3	94.0	83.1	68.5	76.6	63.5		53.1	81.2	
of which: Grants	23.5	17.5	33.8			39.1	22.4	24.3	22.3	14.9	15.7		20.9	37.4	
of which: Concessional loans	0.0	0.0	278.1			67.2	71.6	58.8	46.3	61.7	47.8		32.2	43.8	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			10.8	7.7	6.8	5.6	5.2	4.2		2.5	2.2	2.4
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			53.4	53.4	54.8	56.7	54.1	54.9		66.1	69.9	67.8
Memorandum items:															
Nominal GDP (Millions of US dollars)	781.7	801.8	822.3			770.9	828.4	892.9	953.3	1006.4	1061.8		1415.5	2535.0	
Nominal dollar GDP growth	-1.3	2.6	2.6			-6.2	7.5	7.8	6.8	5.6	5.5	4.5	6.0	6.0	6.0
PV of PPG external debt (in Millions of US dollars)			71.4			141.0	193.9	242.8	280.6	314.1	344.2		375.3	412.0	
(PVt-PVt-1)/GDPt-1 (in percent)						8.5	6.9	5.9	4.2	3.5	3.0	5.3	0.3	0.1	0.3
Gross workers' remittances (Millions of US dollars)	3.0	1.0	3.5			36.0	15.0	3.0	3.0	3.0	3.0		3.3	4.1	
PV of PPG external debt (in percent of GDP + remittances)	...	...	9.1			17.5	23.0	27.1	29.3	31.1	32.3		26.4	16.2	
PV of PPG external debt (in percent of exports + remittances)	...	...	18.9			43.7	49.8	53.1	58.6	62.1	64.6		53.9	32.4	
Debt service of PPG external debt (in percent of exports + remittance	...	...	1.7			2.7	2.5	2.4	3.2	4.8	4.1		4.7	3.3	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate cha

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015-2035
(In percent)

				Projections				
	2015	2016	2017	2018	2019	2020	**2025**	2035
PV of debt-to GDP ratio								
Baseline	18	23	27	29	31	32	**27**	16
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	18	16	15	13	12	10	**1**	-9
A2. New public sector loans on less favorable terms in 2015-2035 2/	18	26	33	37	41	43	**40**	33
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	18	24	29	31	33	35	**28**	17
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	18	29	43	44	46	47	**40**	22
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	18	24	30	32	34	35	**29**	18
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	18	26	31	33	34	36	**29**	17
B5. Combination of B1-B4 using one-half standard deviation shocks	18	30	44	46	48	49	**41**	23
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	18	33	38	42	44	46	**38**	23
PV of debt-to-exports ratio								
Baseline	49	52	53	59	62	65	**54**	33
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	49	35	29	27	23	20	**2**	-17
A2. New public sector loans on less favorable terms in 2015-2035 2/	49	58	64	73	81	87	**83**	66
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	49	52	53	59	62	65	**54**	33
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	49	82	128	136	141	144	**124**	67
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	49	52	53	59	62	65	**54**	33
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	49	57	60	66	69	71	**60**	35
B5. Combination of B1-B4 using one-half standard deviation shocks	49	80	115	122	127	130	**111**	61
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	49	52	53	59	62	65	**54**	33
PV of debt-to-revenue ratio								
Baseline	88	114	129	145	154	162	**132**	81
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	88	77	70	66	57	49	**6**	-42
A2. New public sector loans on less favorable terms in 2015-2035 2/	88	128	155	180	201	217	**202**	164
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	88	118	138	155	165	173	**142**	87
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	88	141	202	218	227	234	**197**	109
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	88	119	142	158	169	177	**145**	89
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	88	125	146	161	170	178	**147**	87
B5. Combination of B1-B4 using one-half standard deviation shocks	88	147	210	227	236	244	**205**	114
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	88	161	183	205	218	229	**187**	115

Table 2. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015-2035 (continued)
(In percent)

	2015	2016	2017	2018	2019	2020	**2025**	2035
Debt service-to-exports ratio								
Baseline	3	3	2	3	5	4	**5**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	3	3	2	3	4	3	**2**	0
A2. New public sector loans on less favorable terms in 2015-2035 2/	3	3	2	3	3	3	**5**	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	3	3	2	3	5	4	**5**	3
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	3	3	4	6	8	7	**9**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	3	3	2	3	5	4	**5**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	3	3	3	3	5	4	**5**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	3	3	4	5	8	7	**8**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	3	3	2	3	5	4	**5**	3
Debt service-to-revenue ratio								
Baseline	5	6	6	8	12	10	**12**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	5	6	5	6	10	7	**6**	0
A2. New public sector loans on less favorable terms in 2015-2035 2/	5	6	5	7	8	8	**11**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	5	6	6	8	13	11	**12**	9
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	5	6	7	10	14	12	**14**	11
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	5	6	6	9	13	11	**13**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	5	6	6	8	12	11	**12**	9
B5. Combination of B1-B4 using one-half standard deviation shocks	5	6	7	10	14	13	**15**	12
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	5	8	8	11	17	15	**16**	12
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	44	44	44	44	44	44	**44**	44

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
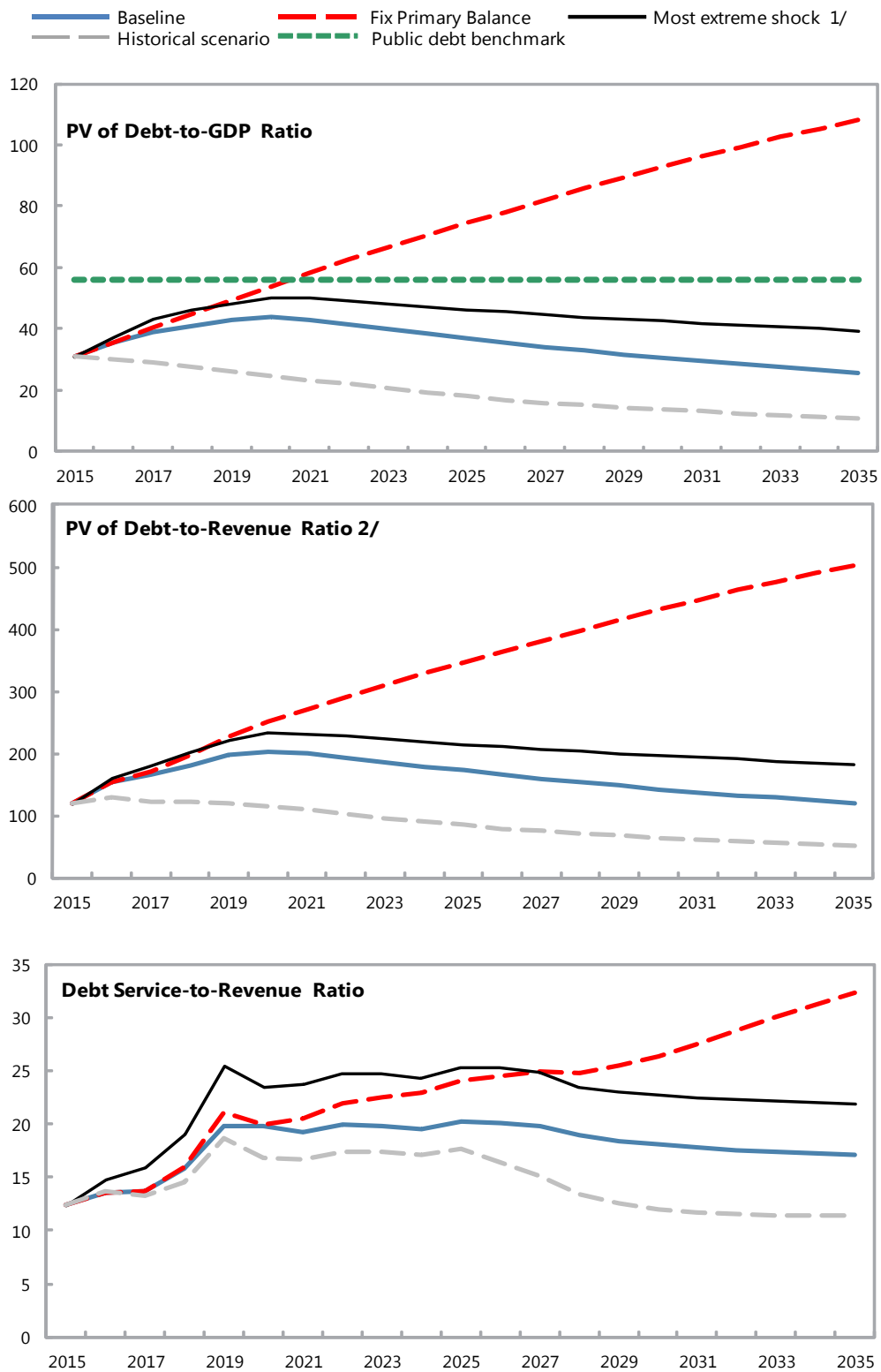
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 2. Vanuatu: Indicators of Public Debt Under Alternative Scenarios, 2015-2035 [1]

Legend:
— Baseline
- - Fix Primary Balance
— Most extreme shock [1]
- - Historical scenario
- - Public debt benchmark

PV of Debt-to-GDP Ratio

PV of Debt-to-Revenue Ratio [2]

Debt Service-to-Revenue Ratio

Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2025.
2/ Revenues are defined inclusive of grants.

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Table 3. Vanuatu: Public Sector Debt Sustainability Framework, Baseline Scenario, 2012-2035
(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections					2015-20 Average	2025	2035	2021-35 Average
	2012	2013	2014			2015	2016	2017	2018	2019	2020				
Public sector debt 1/	24.6	23.3	24.0			38.9	47.8	54.1	57.9	61.8	63.8		53.7	37.6	
of which: foreign-currency denominated	14.0	12.7	11.7			26.4	35.6	42.2	46.2	50.3	52.5		43.2	28.2	
Change in public sector debt	1.0	-1.3	0.7			14.9	8.9	6.3	3.8	3.9	2.0		-2.1	-1.3	
Identified debt-creating flows	0.8	-0.1	-1.5			11.8	8.9	6.3	3.8	4.1	1.9		-2.1	-1.3	
Primary deficit	1.0	-0.5	-1.7	-0.3	1.5	10.7	10.6	8.6	6.0	5.7	3.8	7.5	-0.1	0.0	0.0
Revenue and grants	21.8	21.3	23.3			26.0	23.3	23.7	22.7	21.7	21.5		21.5	21.5	
of which: grants	3.0	2.2	4.1			5.1	2.7	2.7	2.3	1.5	1.5		1.5	1.5	
Primary (noninterest) expenditure	22.8	20.8	21.6			36.6	33.9	32.3	28.6	27.4	25.3		21.4	21.5	
Automatic debt dynamics	-0.1	0.4	0.2			1.1	-1.7	-2.3	-2.2	-1.6	-1.9		-2.0	-1.3	
Contribution from interest rate/growth differential	-0.1	-0.3	-0.3			1.1	-1.5	-1.8	-1.8	-1.2	-1.5		-1.6	-1.0	
of which: contribution from average real interest rate	0.3	0.2	0.2			0.6	0.4	0.3	0.0	0.2	0.0		0.0	0.1	
of which: contribution from real GDP growth	-0.4	-0.5	-0.5			0.5	-1.9	-2.1	-1.8	-1.4	-1.5		-1.6	-1.1	
Contribution from real exchange rate depreciation	0.0	0.7	0.5			0.1	-0.2	-0.5	-0.3	-0.3	-0.4		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	0.1	-1.2	2.2			3.1	0.0	0.0	0.0	-0.2	0.2		0.0	0.0	
Other Sustainability Indicators															
PV of public sector debt	...	10.6	21.5			30.9	35.6	39.1	41.1	42.7	43.7		37.0	25.6	
of which: foreign-currency denominated	...	0.0	9.2			18.3	23.4	27.2	29.4	31.2	32.4		26.5	16.3	
of which: external	...	...	9.2			18.3	23.4	27.2	29.4	31.2	32.4		26.5	16.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	2.9	2.1	0.9			13.9	13.8	11.8	9.6	10.0	8.0		4.2	3.7	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	49.6	92.5			118.8	153.3	164.9	181.3	196.7	203.4		172.1	119.3	
PV of public sector debt-to-revenue ratio (in percent)	...	55.2	112.3			147.7	173.5	186.3	202.2	211.1	218.4		184.8	128.1	
of which: external 3/	...	...	48.0			87.7	113.9	129.4	144.7	154.3	161.9		132.4	81.2	
Debt service-to-revenue and grants ratio (in percent) 4/	8.8	12.4	11.1			12.4	13.6	13.6	15.9	19.8	19.8		20.3	17.1	
Debt service-to-revenue ratio (in percent) 4/	10.2	13.8	13.5			15.5	15.4	15.4	17.7	21.2	21.3		21.8	18.3	
Primary deficit that stabilizes the debt-to-GDP ratio	0.0	0.8	-2.4			-4.2	1.7	2.3	2.2	1.8	1.7		2.0	1.3	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	1.8	2.0	2.3	3.8	2.5	-2.0	5.0	4.5	3.5	2.5	2.5	2.7	3.0	3.0	3.0
Average nominal interest rate on forex debt (in percent)	1.3	1.7	1.7	1.4	0.3	3.7	2.3	2.0	1.9	2.1	1.7	2.3	1.6	1.5	1.5
Average real interest rate on domestic debt (in percent)	4.7	2.2	2.2	3.2	2.0	2.5	1.8	1.3	1.5	1.7	1.9	1.8	2.3	2.9	2.4
Real exchange rate depreciation (in percent, + indicates depreciation)	-0.3	5.2	4.1	-1.1	7.3	0.5	...	...	...	...	...		...	...	...
Inflation rate (GDP deflator, in percent)	0.4	2.7	2.9	3.1	2.1	2.0	2.5	3.2	3.1	3.0	2.9	2.8	2.9	2.9	2.9
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.0	-6.8	6.2	-0.3	3.2	66.4	-2.9	-0.4	-8.2	-2.0	-5.4	7.9	3.1	3.1	1.9
Grant element of new external borrowing (in percent)	...	...	...	...	...	38.6	43.0	42.9	44.8	46.7	45.4	43.6	44.1	44.1	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Vanuatu: Sensitivity Analysis for Key Indicators of Public Debt 2015–2035

	Projections							
	2015	2016	2017	2018	2019	2020	2025	2035
PV of Debt-to-GDP Ratio								
Baseline	31	36	39	41	43	44	37	26
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	31	30	29	28	26	25	18	11
A2. Primary balance is unchanged from 2015	31	36	40	45	49	54	74	108
A3. Permanently lower GDP growth 1/	31	36	40	42	44	46	42	40
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-201	31	37	43	46	48	50	46	39
B2. Primary balance is at historical average minus one standard deviations in 2016-201	31	30	30	32	34	35	29	20
B3. Combination of B1-B2 using one half standard deviation shocks	31	31	30	33	36	37	33	28
B4. One-time 30 percent real depreciation in 2016	31	41	43	43	43	44	36	24
B5. 10 percent of GDP increase in other debt-creating flows in 2016	31	41	44	46	48	49	42	29
PV of Debt-to-Revenue Ratio 2/								
Baseline	119	153	165	181	197	203	172	119
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	119	129	122	122	119	115	84	50
A2. Primary balance is unchanged from 2015	119	153	170	198	226	251	346	503
A3. Permanently lower GDP growth 1/	119	154	167	185	203	212	195	183
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-201	119	160	180	201	221	232	215	182
B2. Primary balance is at historical average minus one standard deviations in 2016-201	119	131	127	142	157	164	136	95
B3. Combination of B1-B2 using one half standard deviation shocks	119	132	128	147	164	173	155	130
B4. One-time 30 percent real depreciation in 2016	119	177	180	191	200	203	168	113
B5. 10 percent of GDP increase in other debt-creating flows in 2016	119	177	187	204	220	227	193	133
Debt Service-to-Revenue Ratio 2/								
Baseline	12	14	14	16	20	20	20	17
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	12	14	13	15	19	17	18	11
A2. Primary balance is unchanged from 2015	12	14	14	16	21	20	24	32
A3. Permanently lower GDP growth 1/	12	14	14	16	21	20	22	21
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-201	12	14	15	17	22	21	22	21
B2. Primary balance is at historical average minus one standard deviations in 2016-201	12	14	13	15	19	18	20	15
B3. Combination of B1-B2 using one half standard deviation shocks	12	14	14	15	20	19	21	17
B4. One-time 30 percent real depreciation in 2016	12	15	16	19	25	23	25	22
B5. 10 percent of GDP increase in other debt-creating flows in 2016	12	14	14	17	21	20	21	18

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

**Statement by Barry Sterland, Executive Director for Vanuatu,
and Chris Stewart, Advisor to the Executive Director
June 5, 2015**

Vanuatu was devastated by Cyclone Pam in mid-March this year. The size of the storm – one of the strongest ever recorded globally – combined with Vanuatu's vulnerabilities to such natural disasters because of its small size and remoteness, resulted in extensive damage across the entire country. Eleven people lost their lives and the United Nations estimates that about 188,000 people, out of a population of just over 265,000, were directly affected. The fact that more residents were not killed or injured during the storm is testament to the authorities' efforts to prepare the population for such events.

The authorities strongly appreciate the many expressions of support received from the international community in response to this situation. This includes the prompt provision of humanitarian aid by a number of countries and organizations. The personal message of support by the Managing Director was greatly valued, as was the IMF's flexibility and responsiveness in quickly adapting the planned Article IV mission to the evolving situation in Vanuatu and working with authorities on the financing request.

The Government is determined to draw on the strength and resilience of the people of Vanuatu, as well as the cooperation of international partners, to move from the immediate recovery efforts to reconstruction, and ultimately return to a strong development pathway. Vanuatu requests the Board's approval for financing under a blended Rapid Credit Facility/Rapid Financing Instrument (RCF/RFI) facility to strengthen its reserves during this difficult time, and looks forward to close engagement with the IMF on policy advice and technical assistance.

Damage Assessment and Economic Outlook

The total value of damages and losses in production are estimated at over VT48 billion (about US$470 million), or just over 60 percent of GDP. This is an enormous relative impact. It reflects both damages and disruption across almost all areas of the community; the storm has destroyed people's homes and food production, damaged vital infrastructure, disrupted essential services and greatly impacted people's livelihoods through its effects on major sectors (including tourism and agriculture). As such, the disaster has set back efforts to develop the economy.

2015 will be a particularly difficult year. The economy is now forecast to contract this year, potentially by up to 2 percent, in contrast to the reasonably robust expansion that had been anticipated prior to this disaster. The trade deficit is expected to increase sharply during 2015 given the severe disruption caused to Vanuatu's main exports – tourism and agriculture – and the expected jump in imports in response to the recovery and reconstruction needs. This will

place reserves under pressure, even though they were maintained at prudent levels prior to the cyclone. A fiscal deficit will also arise as revenues decline and expenditures climb as the authorities provide relief to vulnerable groups in the short-term, support reconstruction efforts, and continue to address various infrastructure needs constraining development.

Request for Assistance

In order to strengthen reserve buffers in the wake of the cyclone, Vanuatu requests SDR17 million under a blended RCF/RFI facility which is intended for precautionary purposes. This will help to address the urgent balance-of-payments needs and thus mitigate the risk of economic disruption. The IMF's involvement is also expected to help catalyse further donor assistance.

Furthermore, in mobilizing additional resources, the authorities intend to remain prudent and avoid excessive debt accumulation. Authorities will seek external grants as much as possible before resorting to concessional loans or other borrowing. Authorities will also continue to hold discussions with their key development partners on additional financial support given the criticality of additional support and cooperation.

Fiscal policy

The authorities' track record of prudent fiscal management provided them with solid buffers preceding this crisis. Such an approach is particularly important given Vanuatu's high exposure to natural disasters. Once the immediate priority of supporting the recovery has been addressed, the authorities are committed to rebuilding these buffers. In particular, once the immediate needs have been addressed, the authorities intend to put public debt to GDP on a declining path and continue to follow their long-running strategy of only borrowing to invest in infrastructure projects. The authorities intend to achieve a stronger fiscal position in the medium term through a number of actions detailed in their Letter of Intent. These include strengthening expenditure discipline, reforming Government Business Enterprises, and improving public debt management. The authorities will consider infrastructure priorities and potentially consolidate the selection of projects of national importance, as well as explore other sources of revenue, such as the potential introduction of an income tax in the medium term.

To ensure that the recovery efforts are coherent and well prioritized, the Government is developing its 'National Recovery and Economic Strengthening Program' in close consultation with Vanuatu's largest donors. This plan highlights the importance of cooperation between these partners in identifying Vanuatu's recovery needs, monitoring progress and adjusting or cancelling projects where necessary. Indeed, even before the cyclone, the Government had delayed or downsized a number of transport projects to move resources to other priority areas. Such a consultative approach will help ensure that

immediate recovery needs are addressed, minimize sequencing problems and make sure that the investment plans are consistent with the authorities' already published national development aspirations. The plan also notes the complementarities between a number of the pre-cyclone infrastructure spending plans and post-cyclone recovery requirements.

Monetary Policy and the Financial Sector

The authorities are committed to operating monetary policy to support the economy while maintaining economic and financial stability. In the immediate aftermath of the storm, the Reserve Bank of Vanuatu (RBV) acted swiftly to support the economy and the financial system through lowering the policy rate, reducing the statutory reserve deposit requirement and introducing a number of facilities to ensure essential credit continued to flow. The Reserve Bank of Vanuatu is conscious of the need to monitor how the economy and financial system respond to these actions and broader developments in coming months, and stands ready to implement additional measures or adjust actions already taken as warranted. In a similar manner, in addition to implementing a range of measures to improve the banking system's prudential standing before the cyclone, the RBV will continue to make sure that banks follow prudential norms and will step up its reviews of banks' risk management. In this regard, they welcome the technical assistance planned from the IMF's Pacific Financial Technical Assistance Centre (PFTAC).

The authorities note that the pegged exchange rate has provided the economy with a useful nominal anchor and intend to maintain this peg to preserve private sector confidence. The blended RCF/RFI will provide additional resources to help ensure that reserves do not fall below prudent levels, despite their elevated pre-cyclone levels, given the substantial increase in the current account deficit expected in the short term. The authorities also acknowledge the staff's suggestion that it might be appropriate to re-evaluate the peg in the medium term.

Structural Reforms

The authorities are continuing to progress structural reforms to promote inclusive growth, recognising that sustained growth is key to their development ambitions. First, the forthcoming gazetting of new company laws should aid business incorporation, addressing one of the areas where Vanuatu lags other regional peers. Second, planned land reforms, should result in a more efficient and equitable system based on clearer and more predictable processes. Third, the authorities will further strengthen Vanuatu's Anti-Money Laundering and Counter-Terrorism Financing regime, are cooperating with the Global Forum on Transparency and Exchange of Information for Tax Purposes, and are open to considering the costs and benefits of hosting an offshore financial sector. Fourth, the authorities remain committed to implementing their National Financial Inclusion Strategy to bring financial services to more remote areas of the country. More generally, the authorities' focus on infrastructure investment will help address some of the bottlenecks hindering activity and,

through projects such as the recently completed submarine cable, provide new development opportunities to a wider range of the population.

International Response

The authorities are thankful for the generous initial pledges by donors announced in recent weeks. It is critical that international partners consider additional grant and concessional assistance in light of the soon-to-be-finalized recovery plan to assist Vanuatu respond to this devastation, and lay solid macroeconomic foundations for growth.

The authorities would like to reiterate their thanks to the IMF Staff for their productive engagement on policy and the speed and flexibility of their response. Within four weeks of the cyclone a mission was on the ground and within three months financial assistance is being considered by the Board. The Managing Director indicated that the IMF stood ready to assist the country in an unbureaucratic manner and this has been demonstrated by both HQ and PFTAC staff. The authorities have found the discussions exceptionally productive, are grateful for the large amount of insightful analysis provided by the staff team, and will closely consider all aspects of the IMF's policy advice. Authorities welcome the upcoming Safeguards Assessment as a valuable opportunity to further examine the governance and control framework of the RBV. The authorities are particularly appreciative of the offer of moving Vanuatu to a 12-month Article IV timetable as well as specific offers of technical assistance. This will assist Vanuatu in the critical transitions that it must manage in the near term, and assist it in laying the foundation for a durable recovery.

Finally, our Authorities very much look forward to the Board's feedback, and request its positive consideration of the proposed RCF/RFI request. This will assist the Government in the necessary task of catalysing further resources for reconstruction from its development partners.