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VANUATU

April 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Vanuatu, the following documents have been released and are included in this package:

- A **Press Release.**
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on February 8, 2018, with the officials of Vanuatu on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 22, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association (IDA).

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April 26, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation with Vanuatu

On April 6, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Vanuatu,[1] and considered and endorsed the staff appraisal without a meeting.[2]

Vanuatu is poised to fully recover from the extensive damages caused by Cyclone Pam in 2015, with several large infrastructure projects near completion and growth bouncing back. Real GDP growth rebounded to 3.5 percent in 2016 from 0.2 percent in 2015, driven by recovery in tourism and agriculture combined with scaling-up of infrastructure. Inflation dipped below 1 percent in 2016 from 2.5 percent in 2015, due to low commodity prices. The current account deficit declined to about 4 percent of GDP in 2016 from 10.5 percent of GDP in 2015, due to rebounding exports and tourism activities.

A recovery in tourism and agriculture combined with further ramping-up of infrastructure projects is expected to propel real GDP growth to around 4 percent in 2017 and 2018. Inflation is estimated to pick up to 3.1 percent in 2017 driven by domestic demand, and rise further to 4.8 percent in 2018 mainly due to a temporary VAT increase, from 12.5 to 15 percent, before gradually reverting to modest levels in the medium term. The current account deficit is expected to widen to around 9 percent of GDP in 2017 and 2018, due to the high import content of infrastructure projects. The downside risks to this favorable outlook stem mainly from uncertainty in the rate of implementation of the public infrastructure projects and the ever-present danger of natural disasters.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

The public and publicly-guaranteed debt increased sharply since 2014 mainly due to disbursements for reconstruction and infrastructure projects, though the new external borrowing was highly concessional. The fiscal deficit is expected to remain high at around 7 to 8 percent of GDP in 2017 and 2018, again reflecting elevated spending on reconstruction and infrastructure.

The accommodative monetary policy stance has played a crucial role in supporting economic recovery and financial stability after the cyclone. Over the past year, however, excess liquidity in the banking system has been associated with building up of inflation pressure. Financial sector remains sound, but there exists ample room to support financial inclusion. Private access to financial services for small and medium-sized enterprises (SMEs) and households in rural areas and outer islands has remained limited.

Executive Board Assessment

Reconstruction efforts from Cyclone Pam are near completion and full recovery is in sight. A recovery in tourism and agriculture combined with further ramping-up of infrastructure projects is expected to propel real GDP growth to around 4 percent in 2017 and 2018. The main risks facing the economy relate to the rate of implementation of public infrastructure projects, and the ever-present danger of major natural disasters.

Although tourism remains the center of economic activity, diversification of economic activity is vital to boost growth and help protect against the constant threat of major natural disasters. To this end, Vanuatu needs to segment the tourism sector strategically across locations and intensify efforts to diversify the economy out of tourism into the agricultural sector. For the diversification strategy to work, supporting the private sector by improving the ease of doing business is necessary. Improving access to employment opportunities and financial inclusion should remain priorities, including in the outer islands.

Internalizing the risks to growth associated with natural disasters and boosting the readiness to respond and manage their destructive force is critical to Vanuatu’s development strategy. Lessons from Cyclone Pam highlight that while the ex-post response was satisfactory, more ex-ante measures could be undertaken, including in the areas of resilient infrastructure, and improving coordination with development partners.

Vanuatu’s public debt acceleration in the wake of the Cyclone Pam reconstruction should be followed by well anchored medium-term fiscal adjustment. Once the reconstruction phase is over, the authorities should consider embarking on fiscal adjustment measures to address the rising debt and to rebuild fiscal buffers. These measures should include effective management of recurrent spending, prioritization and careful selection of infrastructure projects, and the mobilization of domestic revenue. The authorities should consider a medium-term fiscal anchor, defined in terms of a fiscal deficit target and debt ceiling, to provide guidance for policy choices.

Excess liquidity in the banking system and a buildup of inflation pressure over the past year call for monetary policy tightening. The RBV should tighten its monetary policy stance through a gradual increase of reserve requirements. The peg to an undisclosed basket of currencies continues to serve Vanuatu well in promoting stability and confidence. The external position remains broadly consistent with the medium-term fundamentals and desirable policies.

Increasing access to financial services should be a priority, focused on addressing the difficulties faced by SMEs and households in rural areas and outer islands in obtaining credit. Staff fully supports the authorities' "financial sector architecture" initiative to address financial inclusion. While the financial sector remains sound, the RBV should stand ready to take action to secure financial stability by gradually normalizing regulatory requirements. Staff also welcomes authorities' recent efforts to exit the FATF gray list and encourages them to ensure effective implementation of the AML/CFT framework to mitigate CBR pressures.

Table 1. Vanuatu: Selected Economic and Financial Indicators, 2013–18

Population (2016): 274,775
IMF quota: SDR 23.8 million (0.01 percent of total)
Main products and exports: Coconut oil, copra, kava, beef
Key export markets: New Zealand, Australia, Japan

Per capita GDP (2016): $2,923
Literacy rate (2012): 83.4

					Est.	Proj.
	2013	2014	2015	2016	2017	2018
Output and prices (annual percentage change)						
Real GDP	2.0	2.3	0.2	3.5	4.2	3.8
Consumer prices (period average)	1.5	0.8	2.5	0.8	3.1	4.8
Consumer prices (end period)	1.5	1.1	1.5	2.1	3.8	4.6
Government finance (in percent of GDP)						
Total revenue	21.4	23.5	31.9	30.8	31.5	31.6
Taxes	17.2	17.4	16.3	16.3	17.4	17.8
Other revenue	2.0	2.0	5.5	5.3	5.2	5.2
Grants	2.2	4.1	11.8	8.3	8.3	8.2
Expenditure	21.7	28.5	41.5	36.9	38.9	39.5
Expense	20.7	21.8	23.1	24.8	27.0	28.6
Net acquisition of non-financial assets	1.0	6.6	18.3	12.1	11.9	11.0
Net lending (+)/borrowing (-)	-0.2	-5.0	-9.6	-6.1	-7.5	-8.0
Public and publicly-guaranteed debt (end of period)	23.1	28.7	42.4	48.8	51.0	53.7
Domestic	7.8	7.8	7.5	8.5	8.0	7.6
External	12.6	16.3	30.5	37.6	40.4	43.7
Publicly guaranteed debt	2.8	4.6	4.4	2.8	2.6	2.4
Money and credit (annual percentage change)						
Broad money (M2)	-6.4	8.5	23.1	10.6	2.4	11.3
Net foreign assets	-14.8	-14.5	71.6	46.5	-6.6	12.7
Domestic credit	2.7	9.3	-7.4	-10.2	10.9	10.1
Of which: Credit to private sector	2.0	9.0	1.4	1.3	4.3	4.1
Interest rates (in percent, end of period) 1/						
Deposit rate (vatu deposits)	1.9	2.6	2.3	1.6	…	…
Lending rate (vatu loans)	10.5	10.3	10.0	9.9	…	…
Balance of payments (in percent of GDP)						
Current account	-3.3	-0.3	-10.6	-4.1	-9.0	-9.2
Trade balance	-27.8	-24.2	-34.8	-33.1	-36.8	-27.6
Exports of goods	5.6	7.7	5.0	6.2	6.0	6.3
Imports of goods	-33.4	-31.9	-39.8	-39.3	-42.8	-33.9
Tourism receipts	35.9	31.6	23.7	25.5	25.5	26.2
Capital and financial account	7.2	5.2	15.3	11.8	14.2	8.5
Gross international reserves (in months of prospective G&S imports)	5.4	4.8	6.9	6.4	8.6	8.2
External debt service (in percent of GNFS exports)	1.9	2.1	2.6	2.1	2.3	3.3
Exchange rates 2/						
Vatu per U.S. dollar (period average)	94.5	97.1	107.0	109.3	107.8	…
Vatu per U.S. dollar (end of period)	97.3	102.7	109.6	113.1	106.5	…
Real effective exchange rate (average)	98.9	98.1	100.3	102.3	102.2	…
Memorandum items:						
Nominal GDP (in billions of vatu)	75.8	79.1	82.8	87.3	93.7	101.9
Nominal GDP (in millions of U.S. dollars)	802	815	774	798	870	957

Sources: Vanuatu authorities; and IMF staff estimates and projections.

1/ Weighted average rate of interest for total bank deposits and loans.
2/ The vatu is officially pegged to an undisclosed basket of currencies.

VANUATU

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

March 22, 2018

KEY ISSUES

Context: Three years after Cyclone Pam struck Vanuatu causing extensive damages, reconstruction efforts are near completion with full recovery in sight. However, capacity constraints and coordination issues have hampered the use of committed funds by donors and development partners, thereby slowing down recovery. Meanwhile, the government's ambitious development agenda is making good progress with several major infrastructure projects completed or projected to be completed in the next year.

Outlook and Risks: Following 0.2 percent growth in 2015, real GDP is expected to grow around 4 percent annually in 2016–18, driven by recovery in tourism and agriculture combined with scaling-up of infrastructure. The fiscal deficit is expected to remain high (6-8 percent) through 2016 to 2018 reflecting elevated spending on reconstruction and infrastructure projects. The largest uncertainties facing the economy relate to the rate of implementation of public infrastructure projects, and the ever-present danger of natural disasters.

Main Policy Recommendations:

- Develop and implement a medium-term strategy aiming at strong and durable growth. Diversifying to efficient production activities beyond tourism by further improving the business environment, fostering resilience to environmental shocks by building fiscal buffers, and promoting resilient infrastructure, are key components of this strategy.
- Safeguard fiscal sustainability, by embarking on medium-term fiscal adjustment once the post-cyclone reconstruction is over, to address the rising debt and rebuild fiscal buffers. An appropriate medium-term fiscal anchor should be considered, in terms of fiscal target and debt ceiling, to guide policy choices.
- Tighten the monetary policy stance through an adjustment of the reserve requirement ratio, supplemented by a change in the rediscount rate, and take steps towards strengthening the transmission mechanism.
- Secure financial stability by gradually normalizing regulatory requirements for both banking and non-banking financial sectors. Increasing private access to financial services should continue to be a priority.

Approved By
Odd Per Brekk (APD) and Johannes Wiegand (SPR)

Discussions took place in Port Vila during January 29–February 8, 2018. The staff team comprised Chris Papageorgiou (head), Dongyeol Lee, Hidetaka Nishizawa (both APD), and Nitya Aasaavari (RES). Heenam Choi and Anna Park (OED) participated in selected policy discussions. The mission met with Prime Minister Charlot Salwai Tabimasmas, Minister of Finance Gaetan Pikinoune, and Governor of Reserve Bank of Vanuatu (RBV) Simeon Malachi Athy, as well as other senior officials, representatives from the private sector and civil society organizations, and development partners. To-Nhu Dao and Antoinette Kanyabutembo assisted in preparing this report.

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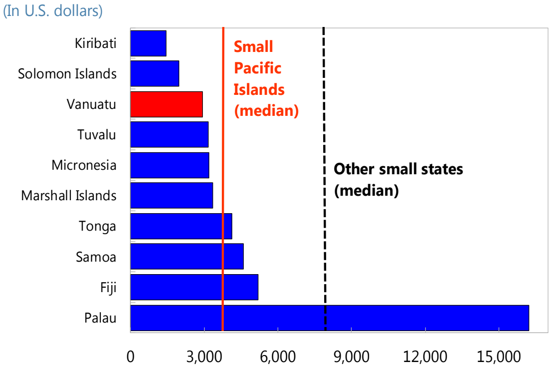
BACKGROUND

Vanuatu is a small island and a low-income country…

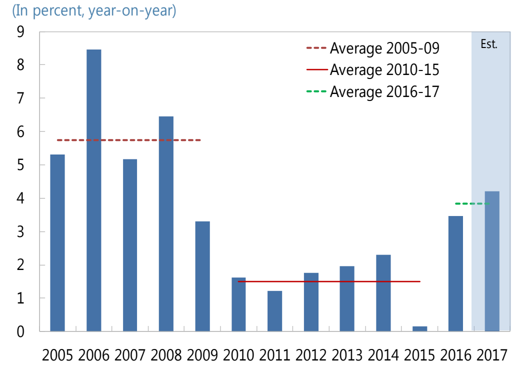
1. Setting. Vanuatu is a small island developing state and a low-income country. Its income per capita is about USD 3,000, with tourism and agriculture as the key drivers of economic activity. GDP growth has stagnated to average 1.5 percent from 2010 to 2015, from 5.7 percent over the previous 5-year period. Following Cyclone Pam, which struck in March 2015, growth has rebounded to around 4 percent on the back of substantial public investment.

GDP per Capita, 2016
(In U.S. dollars)



Sources: Country authorities; and IMF staff calculations

Real GDP Growth, 2005-17[1/]
(In percent, year-on-year)



Sources: Authorities; and IMF staff estimates.
1/ 2017: estimate.

…facing a constant threat of natural disasters…

2. Cyclone Pam. Vanuatu is the world's most at-risk country for natural disasters according to the UN World Risk Index, which measures exposure to natural hazards and the capacity to cope with and adapt to these events. Cyclone Pam struck Vanuatu three years ago causing extensive damages. The swift disbursement by the Fund of about USD 23.8 million under RCF/RFI helped Vanuatu cope with its immediate balance-of-payments needs and catalyzed critical donor support for the recovery.

…while at the same time implementing an ambitious development agenda

3. Public investment boom. In August 2015, the government launched the Vanuatu Infrastructure Strategic Investment Plan 2015-2024 (VISIP 2015), aimed at developing urban and rural areas, improving living standards, and delivering community services. The plan outlined the country's priorities for both economic and social infrastructure, and laid out how to fund and implement these investments. In addition to the projects envisaged in the plan, reconstruction supported by the IDA and the ADB started in 2017.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

Growth is bouncing back from the extensive damages caused by the cyclone

4. Recent developments. Real GDP growth rebounded to 3.5 percent in 2016 from 0.2 percent in 2015, driven by recovery in tourism and agriculture combined with scaling-up of infrastructure. Inflation dipped below 1 percent in 2016 from 2.5 percent in 2015, due to low commodity prices. The current account deficit declined to about 4 percent of GDP in 2016 from 10.6 percent of GDP in 2015, due to recovery in exports and tourism activities. The deficit was comfortably financed by grants, borrowing, and foreign direct investment (FDI). Foreign reserves stood at USD 267 million (6.4 months of imports) at end-2016, bolstered by cyclone-related grants and loans from international partners. The fiscal deficit stood at 6.1 percent of GDP in 2016 due to an increase in expenditure related to reconstruction and infrastructure projects. The deficit was mostly financed by external concessional borrowing.

Full recovery is in sight with several large infrastructure projects near completion…

5. Outlook. A recovery in tourism and agriculture combined with further ramping-up of infrastructure projects is expected to propel real GDP growth to around 4 percent in 2017 and 2018. Inflation is estimated to pick up to 3.1 percent in 2017 driven by domestic demand, and rise further to 4.8 percent in 2018 mainly due to a temporary VAT increase from 12.5 to 15 percent, before gradually reverting to modest levels in the medium term. The current account deficit is expected to widen to around 9 percent of GDP in 2017 and 2018, due to the high import content of the projects to scale-up infrastructure. This deficit would continue to be financed by donor grants and loans, as well as FDI. The fiscal deficit is expected to remain high at around 7 to 8 percent of GDP in 2017 and 2018 reflecting reconstruction and infrastructure expenditure. Elevated recurrent spending, including meeting past due legal commitments and a rise in pay for government officials, would be offset by the temporary increase in VAT rate, and proceeds from the citizenship program (Vanuatu Development Support Program (VDSP) and Vanuatu Contribution Program (VCP)).

…but risks remain on the downside.

6. Risks. The largest uncertainty facing the economy relates to the rate of implementation of public reconstruction and infrastructure projects (Appendix I). Their scale and pace may fall short of needs if external financing is not sufficient or if implementation capacity disappoints. The delayed implementation of revenue mobilization measures such as the introduction of the income tax could put a strain on fiscal accounts. On the external front, while the withdrawal of correspondent banking and the negative impact of weaker-than-expected global growth have so far been limited, they pose non-negligible risks. The danger of natural disasters is ever-present. On the upside, the authorities' infrastructure projects may result in positive spillovers to the overall economy.

Vanuatu: Summary Risk Assessment

	High Vulnerability, Risks to the Downside Dominate	Likelihood	Impact
Upside	1. Positive spillovers from large infrastructure projects	Medium	High
	2. Lower energy prices	Low	Medium
Downside	1. Implementation of infrastructure projects	High	High
	2. Natural disasters and climate change	High	High
	3. Delays in implementation of tax reform	Medium	High
	4. Weaker-than-expected global growth	Medium	Medium
	5. Reduced financial services by correspondent banks (globally)	High	Medium

Authorities' Views

7. The authorities concurred with staff's assessment on economic developments, outlook, and risks. They noted that a modest slowdown of GDP growth is expected after the completion of major infrastructure projects and construction production subsides. They also expressed their commitment to look for new growth engines to reduce the risk from outside shocks and boost productivity in the long-term. The authorities raised some concerns about possible unanticipated effects of graduation from the UN's Least Developed Country (LDC) status in 2020.

A DEVELOPMENT STRATEGY TO SUPPORT STRONG AND DURABLE GROWTH

Main areas of policy discussion. The mission focused on the following policy issues aiming at fostering high, sustainable, and resilient medium-term growth:

- Fostering strong and durable medium-term growth, given the risk of natural disasters;
- Preserving fiscal space and safeguarding debt sustainability in the face of growing development needs; and
- Maintaining prudent monetary policy while pursuing financial inclusion and stability.

A. Fostering Strong and Durable Medium-Term Growth Under the Risk of Natural Disasters

8. Context. A development strategy for Vanuatu must have at its core the capacity to bolster sustainable growth resilient to natural disasters. As shown previously (right panel; text figure in paragraph 1), growth has been unstable and not sufficiently strong. While growth since 2005 averaged 3.4 percent (2005–15 average), since 2010 it has plummeted to around 1.5 percent (2010–15 average). With mean population growth being one of the highest among Pacific Islands at 2.3 percent in 2016, per capita GDP growth since 2005 stands at 1.0 percent. There are two main causes for the low and volatile growth facing the country: first, the concentration of the island's economic activity in tourism; second, the ever-present danger of natural disasters.

9. Diversification within and outside tourism, and strengthening linkages of tourism with agriculture can play a critical role in boosting and stabilizing growth (Appendix III).[1] Tourism remains the center of economic activity benefiting from markets such as Australia and New Zealand, and more recently East Asia (China, Japan) and Europe. Improvements in connectivity—owing to the recently completed submarine cable, planned investments in transport infrastructure, and lower fuel prices—are attracting more tourists. However, lessons from past experiences with natural disasters (paragraph 10) point to segmenting the tourism space in Vanuatu into several distinct locations, for example by marketing Espiritu Santo and Port Vila separately. Such a strategy has proven to be successful in the Caribbean, Latin America and Southern Europe. Further, diversification towards

[1] "Sustaining Long-Run Growth and Macroeconomic Stability in Low-Income Countries–The Role of Structural Transformation and Diversification" (*IMF Policy Papers, March 2014*); and "Structural Reforms and Macroeconomic Performance–Initial Considerations for the Fund," (*IMF Policy Papers, November 2015*).

agricultural activities, for example by efforts to increase the production of Vanuatu's internationally recognized beef, would provide an additional defense against external shocks. Strengthening linkages of tourism with agriculture, and promoting agri-tourism can foster inclusive growth by enhancing domestic value-addition in tourism, and creating incentives for farmers in the outer islands to move away from subsistence agriculture.

10. **Natural disaster preparedness—lessons from Cyclone Pam**. Internalizing the risks to growth associated with natural disasters, and boosting the readiness to respond and manage their destructive force is critical to Vanuatu's development strategy (Appendix IV). Cyclone Pam highlighted that while the ex-post response was satisfactory, more ex-ante measures could be undertaken. Some examples of successful response include the authorities' support of households' reconstruction needs by suspending VAT and import duties on construction materials, steps taken by Reserve Bank of Vanuatu (RBV) to alleviate liquidity constraints by reducing the Statutory Reserve Deposit (SRD) requirement, and implementation of business continuity plan by banks to ensure that most households and businesses had enough physical currency. The government's Tropical Cyclone Pam Recovery program is set to continue in 2018, and the RBV's Natural Disaster Reconstruction Credit Facility keeps on providing funds to businesses. Coordination issues have led to delays in crucial projects such as upgrade of the runway at the Bauerfield International Airport. The pace of recovery in outer islands appears to be slower. The table below highlights some of the key internal and external weaknesses and threats identified by the Ministry of Climate Change & Adaptation.

Weaknesses		***Threats***	
Internal	*External*	*Internal*	*External*
• Lack of reliable and accessible scientific data • Deficiencies in current Disaster Management legislation • Expertise from Technical Assistance exercises under-utilized	• No budget (National Government) for the implementation of Disaster Risk Management and Climate Change Adaptation activities and programs • High number of activities and stakeholders to manage • Impact of natural disasters on delivery timelines and budget	• Overlaps and duplication in Climate Change and Disaster Risk Reduction roles • Lengthy processes to access emergency funds • Weaknesses in project selection and management	• High expectations from donors, community and government • Outside influence from regional/international institutions demanding specific conditions (one size fits all) • Competition for resources from donors, reduction in their support
Source: 2016-18 Corporate Plan, Ministry of Climate Change & Adaptation			

11. **Disaster resilience fund and climate financing.** The authorities have increased contingent provisioning for emergency purposes titled Emergency Fund, from VUV 25 million in the 2017 budget to VUV 50 million in 2018. The fiscal framework allows the authorities to swiftly withdraw up to 1.5 percent of a given year's total appropriation (around VUV 330 million), which later requires Parliamentary approval. In fact, VUV 200 million was spent via the supplementary budget to cope with the volcano eruption at Ambae Island in September 2017, rather than drawing on the Emergency Fund. While after Cyclone Pam the Pacific Catastrophe Risk and Financial Insurance (PCRFI) mechanism by the World Bank has been modified and is expected to lead to a larger payout when the next major disaster strikes, the amounts would remain small relative to rapid response needs. On the issue of climate financing, the existing flows via UNFCC mechanisms, multilateral and

bilateral support, and private investment can fulfill only a part of Vanuatu's resilient development needs. Green Climate Fund providing a grant of USD 18.1 million in February 2018 would, therefore, prove to be highly beneficial.[2]

Staff's Policy Recommendations

12. Promote diversification of economic activity to boost growth and help protect against the constant threat of natural disaster shocks:

- *Development strategy*. For the diversification strategy to work, supporting the private sector by improving the ease of doing business is necessary—specifically removing key bottlenecks on registering property and land titling would help address the high cost of doing business. The recent reforms to the leasing regime for customary land should be reassessed as they create further inefficiencies in the system. Improving access to employment opportunities and financial inclusion should remain priorities, especially in the outer islands.
- *Natural disasters*. The authorities are to be commended for their ex-post handling of Cyclone Pam and for maintaining outstanding relations with bilateral donors. Their assistance in the wake of volcano eruption at Ambae Island is a recent example of the continuing close engagement. However, more ex-ante measures could be undertaken requiring different layers of preparedness, including: i) strengthening risk assessment and planning; ii) building domestic fiscal buffers; iii) securing external buffers; and iv) promoting resilient infrastructure and adequate maintenance. Presenting a fiscal risk statement with the budget to identify and disclose fiscal risks including from natural disaster and climate change would help guide budget discussions.[3] In the medium term, the authorities may consider setting up a disaster resilience fund to tackle higher frequency and lower intensity events, and reduce recourse to the supplementary budget.

Authorities' Views

13. The authorities recognize that economic activity needs to become broad-based, and growth emanating from tourism needs to be more inclusive. They well appreciate that agriculture is macro-critical, and have come up with initiatives to combine agriculture-related education at the school level with financial inclusion. They acknowledge that the current system of land leasing, high cost of capital, non-tariff barriers for agricultural exports, and data gaps hinder scaling-up of production. A legislation which aims to promote farmers' associations is to be tabled during the first session of the Parliament in 2018.

14. The authorities remain committed to improving frameworks to foster disaster-resilient development, and mitigate the impact of climate change. Given fiscal considerations, concessional financing remains crucial. Implementation can be improved by closer coordination with donors, improving absorptive capacity, and sustained efforts to build human capital. Mindful of the intensified climate-related risks in the region, the authorities reiterated their plea for financial

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[2] This project will expand the use of Climate Information Services (CIS) in five targeted sectors: tourism, agriculture, infrastructure, water management and fisheries.

[3] "Small States' Resilience to Natural Disasters and Climate Change - Role of the IMF," (*IMF Policy Papers, December 2016*).

assistance to all development partners, including the Fund, when the next large natural disaster hits the island.

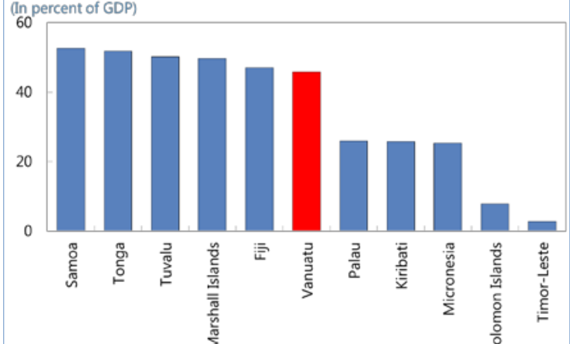
B. Preserving Fiscal Space and Safeguarding Debt Sustainability in the Face of Rising Development Needs

15. Staff projections envisage a fiscal deficit of 7.5 and 8.0 percent of GDP in 2017 and 2018, respectively. Tax collection in 2017 has turned out to be stronger compared to 2016 underpinned by the economic recovery. Also, non-tax revenue, including from citizenship programs, remains high. However, expenditure in 2017 has been higher than in 2016, due mainly to spending on severance payments, and the Pacific Mini Games held in Port Vila in December 2017. Thus, the fiscal deficit has deteriorated from 6.1 percent of GDP in 2016 to 7.5 percent in 2017. The deficit is expected to widen further to 8.0 percent of GDP in 2018 owing to an increase (7–8 percent on average) in the government wage bill, despite the increase in the VAT rate from 12.5 to 15 percent, starting January 1, 2018. The government will present the tax administration bill to the Parliament in mid-2018 followed by the income tax bill later in the year. The implementation of these bills in early 2019 combined with lower committed capital spending owning to the completion of large infrastructure projects, is expected to reduce the deficit to 4.3 percent in 2019.

16. Several infrastructure projects that had started in 2015 and accelerated in 2016 and 2017, are nearing completion in 2018 and 2019. Among them are the Luganville International Wharf and Tanna & Malekula Road Rehabilitation & Upgrade Program, both financed by the Export-Import Bank of China (China EXIM Bank) and the Port Vila Lapetasi International Multi-Purpose Wharf Development Project, financed by the Japan International Cooperation Agency (JICA). Cyclone Pam road and school reconstruction projects supported by the ADB, and Vanuatu Infrastructure Reconstruction and Improvement Project supported by the IDA started in 2017, and are making satisfactory progress. IDA has also supported the rehabilitation of Bauerfield International Airport and runway repairs for Santo and Tanna airports. However, persistent coordination issues related to contractors' implementation plans have resulted in major delays that could hurt tourist arrivals.

17. Public and publicly-guaranteed debt has increased sharply since 2014. The stock of public and public guaranteed debt increased sharply from 28.7 percent of GDP in 2014 to 48.8 percent in 2016. This is mainly due to disbursements for infrastructure and reconstruction activities, though the new external borrowing was highly concessional. Vanuatu's public debt is now at the higher end, compared to other Pacific Island countries (PICs). An updated Debt Sustainability Analysis (DSA) suggests that the risk of external debt distress in Vanuatu remains moderate, consistent with the 2016 assessment, but the debt service pressure would be on the rise over the medium term.

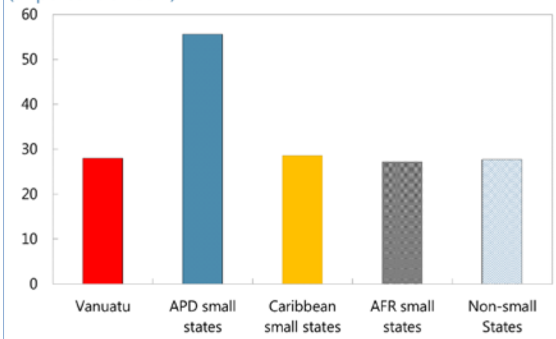
Total Public Debt, 2016 1/
(In percent of GDP)



Source: IMF staff calculations.
1/ Estimates.

18. Government revenues remain low, compared to peers in the region. The government aims at introducing corporate and personal income taxes as early as 2019 with technical assistance from the IMF HQ, PFTAC and Australia (Appendix V). In the meantime, the government has raised the VAT rate, and continues to employ economic citizenship programs for additional revenue (Box 1). Collections from these programs have substantially increased in the last few years. However, these programs may lead to reputational risks, which in turn could have a potentially adverse impact on correspondent banking relationships (CBRs).

General Government Revenue, 2016
(In percent of GDP)



Sources: IMF, World Economic Outlook; and IMF staff calculations.

Box 1. Economic Citizenship Program[1]

After failed attempts to establish passport selling schemes in the 1990s, the Vanuatu government revived the new economic citizenship programs to boost revenue. Vanuatu Economic Rehabilitation Program (VERP) was introduced after Cyclone Pam to raise additional fund for recovery activities. The Capital Investment Immigration Plan (CIIP), which was originally introduced in 2014, was replaced by Vanuatu Real Estate Option Program (REO Program) in November 2016, and VERP by Vanuatu Development Support Program (VDSP) and Vanuatu Contribution Program (VCP) in March 2017.

VDSP offers citizenship to foreign investors against one-time contribution, ranging from USD 200,000 for a single person application to USD 280,000 for a family with elderly parents. The offered "honorary citizenship" has most ni-Vanuatu rights except voting and political involvement. The application process requires a background check, including financial resources and criminal record, and takes between 1 to 2 months, making it one of the most fast-track citizenship programs in the world. However, citizens of North Korea, Yemen, Syria, Iraq, and Iran are not allowed to apply.

REO Program requires applicants to invest USD 230,000 in real estate related investments to obtain Vanuatu citizenship. The government expects the program to help raise substantial revenue, and that the associated private investments would directly provide employment and expand commercial facilities for a long-term growth**.**

These latest economic citizenship programs are successful in generating solid revenue in recent years. In 2017, revenue collection from the programs is estimated to around VUV 3.5 billion (around 3.7 percent of GDP), which accounts for 16.1 percent of total revenue, excluding grants. In October 2017, the government reportedly accepted Bitcoin payments for VDSP, making Vanuatu the first country in the world recognize the cryptocurrency as a legal form of payments. However, the Reserve Bank of Vanuatu reversed the decision after considering the associated transaction and reputation risks.

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[1] Prepared by To-Nhu Dao and Hidetaka Nishizawa.

19. With the intention to increase revenues, the authorities have started to review the policy framework on non-tax revenues. Based on a guided PEFA self-assessment in 2015, a medium-term PFM Reform Roadmap was formulated. These reforms include improving capacity for internal audit, as well as accounting and reporting. PFTAC has supported these reforms. Other possible areas of TA from PFTAC in the medium-term comprise public investment management, medium-term budgeting, and analysis of fiscal risks arising from Government Business Enterprises (GBEs).

Staff's Policy Recommendations

20. Staff recommends implementing fiscal consolidation measures in the medium term, updating the debt management strategy on an annual basis, and considering a medium term fiscal anchor, defined in terms of a fiscal deficit target and debt ceiling:

- *Fiscal Adjustment*. Staff supports the authorities' ongoing efforts—reconstruction and public investment with the help of international donors, and the mobilization of domestic revenues, including the VAT tax increase and introduction of income tax. Staff recommends moving swiftly, after the introduction of payroll tax for public servants in January 2019, to implement the remaining personal and corporate taxes to avoid further uncertainty. The authorities should consider restraining spending if the introduction of income tax is delayed or other revenues, such as those from the economic citizenship program, do not materialize as expected. As the phase of reconstruction and infrastructure scale-up would soon come to a closure, the authorities should consider embarking on fiscal adjustment measures to address the rising debt and to rebuild fiscal buffers. Measures should include (i) restraining recurrent spending, including effective and sustainable management of the public wage bill and severance payments; (ii) prioritization and careful selection of public infrastructure projects with due consideration of the county's absorptive capacity and expected returns from each project; and (iii) continued revenue mobilization, including through enhancements in tax administration (Appendix V).
- *Debt Management*. Given the recent rapid debt accumulation, the authorities should consider updating the debt management strategy (DMS) on an annual basis to safeguard debt sustainability. External financing should continue to be contracted as much as possible in the form of grants, or on concessional terms.
- *Fiscal Anchor*. The authorities should consider adopting a medium-term fiscal anchor, defined in terms of a fiscal deficit target and debt ceiling, as the current fiscal objectives[4] do not provide adequate guidance for policy choices. Staff assessment suggests that a reasonable medium-term debt ceiling for Vanuatu would be in the range of 50–60 percent for the nominal public and

[4] Two long-term fiscal objectives are described in the authorities' 2018 budget policy statement. First, recurrent balance, which is defined as recurrent revenue minus recurrent expenditure, is to be positive over the medium term. Second, the present value (PV) of public external debt-to-GDP is to be maintained at a prudent level below 40 percent of GDP.

publicly-guaranteed debt-to-GDP ratio[5], stricter than the authorities' current NPV target. [6] The proposed range takes into account the significant vulnerability to natural disaster shocks, high infrastructure needs, and planned financial support from bilateral and multilateral donors. The debt ceiling would be consistent with a fiscal deficit target of 3–4 percent of GDP, which would help ensure that the ceiling is not breached, and that debt ratios fall over time.

Authorities' Views

21. The authorities agreed on the need for fiscal adjustment, including effective and sustainable management of public wage bill and severance payments, over the medium-term, and to update the debt management strategy (DMS) annually. The authorities recognized the importance of putting in place a medium-term fiscal anchor, but raised some concerns that this may unduly limit required infrastructure investment. They also reiterated their commitment to introducing payroll tax for public servants in early 2019 followed by the remaining personal and corporate taxes in the middle of 2019, and reversing the temporary increase in the VAT rate. They agreed with staff on the risk associated with heavy reliance on revenue from the Economic Citizenship Program, which is not deemed to be a sustainable source of income. The authorities concurred with the staff's recommendations to update the DMS this year, seek grant financing as much as possible to reduce debt burden, and maintain a grant-element target of at least 35 percent on new loans.

C. Monetary Policy and Exchange Rate Stability

22. The basket peg regime is working well in Vanuatu, and the external position remains broadly consistent with the medium-term fundamentals and desirable policies. The basket peg remains the most reliable nominal anchor for monetary policy, given excess liquidity and weak monetary policy transmission. Staff assessment suggests that the external position is broadly in line with the level consistent with the external current account benchmark (a current account gap of -1.9 to 1.8 percent of GDP and REER gap of -4.7 to 5.0 percent) (Box 2).

23. Vanuatu has maintained considerable foreign exchange reserves. The reserves covered an estimated 6.4 months of imports of goods and services by end-2016, well above the level committed by the authorities (4 months of imports) and the reserve adequacy benchmarks (3.9–5.2 months of imports) (Box 2). The level of reserves is expected to remain comfortable over the next several years, despite spending on Pam-related recovery efforts and the infrastructure scaling-up. It should be noted that downside risks to the import coverage are present, as the actual imports required for infrastructure projects can be larger than projected.

[5] Staff suggests the nominal target instead of the current NPV target, as the former allows easier monitoring of the debt situation, eliminates the possibility of using discretion for discount rates, and provides discipline to avoid excessive indebtedness with concessional debt.

[6] The authorities' 40 percent NPV target, which only covers external PPG debts, corresponds to nominal debt of around 55-60 percent of GDP. The inclusion of public domestic debt leads public debt to rise to around 65-70 percent. Therefore, the proposed public debt ceiling (50–60 percent) is tighter than the authorities' current NPV target.

Box 2. External Sector Assessment[1]

Staff assessment suggests that Vanuatu's external position remains broadly consistent with the medium-term fundamentals and desirable policies, despite a mild appreciation of real effective exchange rate (REER) and a widening of current account deficit since 2015. This assessment is based on REER developments, the international reserves adequacy, the EBA-Lite CA approach, and the external sustainability approach.

The REER has been on a mild appreciation trend since 2014. Dissonant bilateral nominal exchange rate fluctuations have contributed to this. Since 2016, Vanuatu vatu has experienced nominal depreciation against the Australian dollar and appreciation against the U.S. dollar.

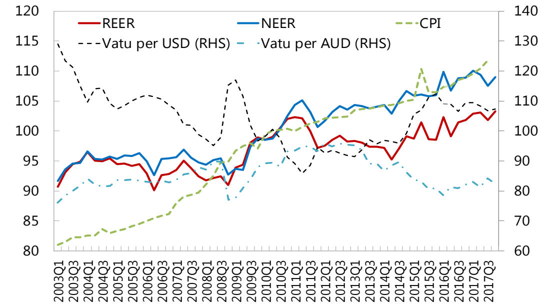
Net international reserves remain comfortable and in line with reserve adequacy benchmarks. Applying the staff's reserve adequacy framework for credit-constrained economies and small states, the adequate level of reserves for Vanuatu is estimated to lie in the range of 3.9 to 5.2 months of imports, depending on the probability of large shock event—i.e., sample average (50 percent) and vulnerability to natural disasters (75 percent)—somewhat lower than the actual level of 6.9 months. However, staff expects the reserve cover to fall back to around 5.4 months by 2023, slightly above the stringent benchmark as current account deficit would likely persist (7–9 percent of GDP over the medium term).

The EBA-Lite suggests that the external position is broadly consistent with fundamentals and desirable policies. Though the current account deficit has widened since 2015 driven by the high import content of infrastructure projects, overall there is no strong indication of misalignment.

- The CA approach finds that the REER gap stands at -4.7 percent, suggesting that the external position is broadly in line with fundamentals. However, EBA-Lite does not always capture fully the characteristics of small states, hence there is significant uncertainty around the estimates.
- The external sustainability approach shows that the REER gap ranges from 1.3 to 5.0 percent, indicating that the external position is broadly in line with the level consistent with the external current account benchmark.

Exchange Rates and Consumer Prices

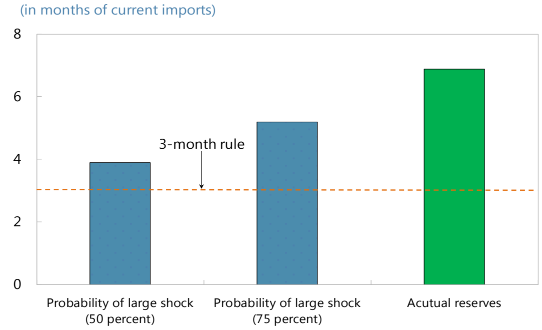
(Index, 2010 = 100) (Vatu per currency)



Sources: Authorities and IMF staff estimates.

Reserve Adequacy Benchmarks

(in months of current imports)



Sources: IMF staff calculations

CA Approach

CA-Actual	**-9.0%**
Cyclical Contributions (from model)	0.1%
additional temporary/statistical factors	0
Cyclically adjusted CA	**-9.1%**
CA-Norm	**-10.8%**
additional adjustments to the norm	0
Cyclically adjusted CA Norm	**-10.9%**
CA-Gap	1.8%
o/w Policy gap	1.5%
Elasticity	-0.38
REER Gap	-4.7%

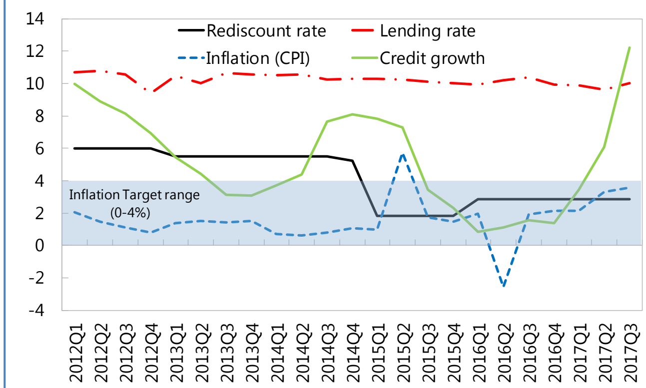
External Sustainability Approach

	CA norm (% of GDP)	Underlying CA (% of GDP)	CA gap (%)	REER gap (%)
Scenario 1: Stabilizing net IIP at -75 % of GDP	-7.3	-7.8	-0.5	1.3
Scenario 2: Stabilizing net IIP at -50 % of GDP	-5.9	-7.8	-1.9	5.0

[1] Prepared by Dongyeol Lee.

24. Excess liquidity in the banking system has been associated with the building up of inflation pressure over the past year. The accommodative policy stance has played a crucial role in supporting economic recovery and financial stability after the cyclone, though the monetary policy transmission mechanism remains weak—high lending rates of around 10 percent have continued during the post-cyclone period.[7] However, some signs of inflation pressure have begun to materialize recently. Inflation stood above 3 percent (year-on-year) in the second and third quarter of 2017, mainly driven by the price increase of food, transport, and education. Inflation is projected to pick up to 4.8 percent in 2018 due to a VAT increase by 2.5 percent (from 12.5 percent to 15 percent). At the same time, the subdued credit growth after the cyclone (2015Q3–2016 average: 1.8 percent) has recovered to the pre-cyclone level (2012–14 average: 6.2 percent) in 2017.

Policy Rate, Lending Rate, Inflation and Credit Growth
(In percent)



Sources: Vanuatu authorities.

Staff's Policy Recommendations

25. Staff recommends maintaining the peg at its current level, securing a comfortable level of reserves, and tightening monetary policy:

- *Exchange rate policy*. The peg to an undisclosed basket of currencies continues to serve Vanuatu well in promoting stability and confidence. In the future, if Vanuatu's external position worsens significantly, the authorities should nonetheless be ready to adjust the level and composition of the peg—the Fund stands ready to provide TA in this area as needed.
- *Reserve management*. Vanuatu's comfortable level of international reserves should be maintained, at above 5 months of imports, to provide foreign currency for government's debt repayment obligations, to serve as a buffer against external economic and natural disaster shocks.
- *Monetary policy*. Given signs of excess liquidity in the system and inflation pressures building up, the RBV should tighten its monetary policy stance through a gradual increase of reserve requirements. Given the limited monetary policy transmission and the basket peg exchange regime, normalizing its policy rate (rediscount rate) could also be used, albeit mainly for signaling purposes.

Authorities' Views

26. The authorities were in full agreement with the staff's view on tightening the monetary policy stance via a gradual increase of reserve requirements. The RBV emphasized that its prompt response by adopting accommodative monetary policy in the aftermath of Cyclone Pam played a pivotal role in supporting economic recovery and financial stability. They further

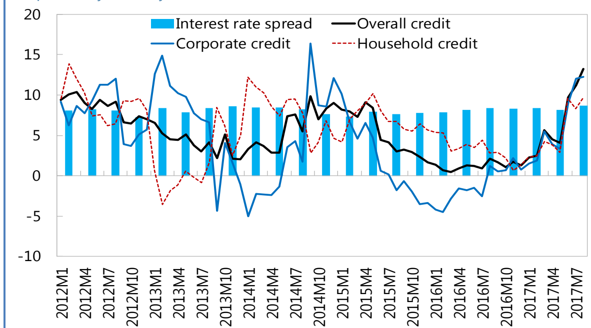
[7] In the aftermath of the cyclone, the RBV moved swiftly to support economic recovery and financial stability by lowering its policy rate to be tied to the RBV's 91-day bill rate, reducing the required reserve ratio, and activating its credit facilities.

acknowledged that tightening of reserve requirements must be carried out cautiously. Authorities concurred with the staff's exchange rate assessment and policy advice of maintaining comfortable reserve levels.

D. Financial Inclusion and Stability

27. Access to financial services is limited for both households and small and medium-sized enterprises (SMEs). Although the overall credit-to-GDP ratio is relatively high, credit is not evenly distributed between large firms and SMEs or between urban areas and rural areas. Vanuatu has three foreign commercial banks, one domestic bank (National Bank of Vanuatu), micro credit unions, and Vanuatu National Pension Fund (VNPF). The financial sector, with a small domestic market, a significant informal sector, and stringent collateral requirements, is inefficient; interest rate spreads, like other Pacific Island countries (PICs), are high.[8] This, in turn, results in relatively low financial access of households and SMEs. During the post-cyclone recovery, the credit provisions to the corporate and household sectors remained limited. Only recently have they begun to pick up owing to an improvement in business prospects, and infrastructure scaling-up.

Credit Growth and Interest Rate Spread
(In percent, year-on-year)



Source: Vanuatu authorities.

28. There exists ample room to support financial inclusion. Despite the growing role of National Bank of Vanuatu (NBV) and credit unions, a more active role of the financial sector in general is needed to provide financial services, including to rural areas and outer islands. Financial Services Demand Side Survey Vanuatu (2016) shows that only 37 percent of adults have a bank account—45 percent including those with an insurance policy or a microfinance, credit union, or a mobile money account—which is lower than other Pacific islands such as Fiji (60 percent), Tonga (41 percent), and Samoa (39 percent), but higher than Solomon Islands (26 percent).[9] In addition, business start-ups mainly rely on informal financing services (Micro, Small & Medium Enterprise Survey, 2016). The non-bank financial sector remains small and not sufficiently supervised. Financial sector reforms including the new Credit Unions Act would fill important gaps in prudential standards, and provide the basis for the RBV to strengthen its supervisory framework.

29. The financial sector remains sound, but vigilance is still needed. The banking sector has maintained adequate capital and liquidity positions. Nonetheless, it is of concern that the ratio of non-performing loans (NPLs) increased significantly in 2017 (2016Q4: 11.2 percent → 2017Q3: 17.5 percent). Banks' conservative balance sheet management (e.g., proactive recognition of impaired assets) as well as unfavorable business conditions (e.g., delays in airport runway rehabilitation) may

[8] Large interest rate spreads in PICs mainly result from high cost and high risk of credit potentially arising from small scale, vulnerability to shocks, and geographic dispersion in the region (*IMF WP/15/96*).

[9] Since 2014, Bankable Frontier Associates has worked with the Alliance for Financial Inclusion's (AFI) Pacific Islands Regional Initiative (PIRI) and the Pacific Financial Inclusion Programme (PFIP) to collect baseline data on access to financial services in five PIRI member countries: Fiji, Samoa, the Solomon Islands, Tonga, and Vanuatu.

have contributed to the recent rise of recorded NPLs in some banks. In addition, VNPF—which has a sizeable footprint in the financial system—has maintained sufficient liquidity despite significant withdrawals after Cyclone Pam (VUV 1,721 million).[10]

30. Vanuatu continues to address the deficiencies in its anti-money laundering/combating the financing of terrorism (AML/CFT) framework to facilitate its exit from the Financial Action Task Force (FATF) gray list and prevent further pressures on CBRs. Since its inclusion in the FATF gray list in 2016, Vanuatu has taken steps towards improving its AML/CFT regime by the enactment of several key laws,[11] and the completion of the offshore sector and terrorist financing risk assessment. Secrecy provisions under the International Companies Act have been repealed to allow key law enforcement agencies to obtain enhanced access to basic and beneficial ownership information. Efforts to ensure effective AML/CFT supervision are ongoing (e.g., licensing, fit and proper requirements, off-site and on-site supervision, sanctions). Mechanisms for international cooperation and exchange of information have also been widened. Continuous and effective implementation of these measures should contribute to Vanuatu's exit from the FATF gray list. The FATF listing has led to increased CBR pressures for some banks. However, the impact has not reached a critical level, as banks have found replacement CBRs and re-assessed their high-risk customers, in addition to government's efforts to strengthen AML/CFT compliance.

Staff's Policy Recommendations

31. Staff fully supports the authorities' recent efforts to address financial inclusion and to resolve AML/CFT issues:

- *Financial inclusion.* Staff's analytical work shows a strong linkage between financial deepening and growth.[12] Increasing private access to financial services should continue to be a priority, with a focus on addressing the difficulties faced in obtaining credit by SMEs and households in rural areas and outer islands. In this regard, staff welcomes the authorities' initiative on a financial sector architecture to address financial inclusion, supported by ADB experts.
- *Financial stability.* The RBV should be ready to take actions to secure financial stability by gradually normalizing regulatory requirements for both banking and non-banking financial sectors. The rise of SRD and LAR would be complementary in securing financial stability by containing excess liquidity in the financial sector while maintaining sufficient liquid assets. However, the authorities should continue to closely monitor individual banks' liquidity situation to secure the stability of financial system. Considering the recent rise of NPLs in some banks, banking supervision frameworks should be strengthened to ensure more accurate assessment of loan quality and secure sufficient loss provisions, and foster sound risk management practices in banks in general.

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[10] One week after Cyclone Pam, the government allowed VNPF contributors to withdraw up to 20 percent from their retirement accounts.

[11] Related legislations were passed in the Parliament in November 2017 (e.g., Financial Institutions Amendment Act, Charitable Associations Amendment Act, and Foundation Amendment Act).

[12] "Rethinking Financial Deepening: Stability and Growth in Emerging Markets" (*IMF SDN/15/08*).

- *AML/CFT*. Staff welcomes the authorities' recent successful efforts to resolve the AML/CFT issues, and encourages them to accelerate the implementation of AML/CFT action plan to exit the FATF monitoring by summer 2018.

Authorities' Views

32. The authorities were in full agreement with the staff's recommendation about making financial access a priority, gradually increasing LAR, and addressing remaining AML/CFT issues. They emphasized that the review on financial sector architecture is expected to promote access to financial services for SMEs and households in rural areas and outer islands. They also noted the importance of closely monitoring individual banks' financial situation to maintain financial stability, especially in view of the uneven distribution of liquidity among banks. Monetary tightening may result in some banks facing liquidity constraints. The authorities also noted that they completed the required legislations on AML/CFT issues, and are proceeding with implementation of the action plan to address remaining deficiencies. They emphasized that continued support by international institutions would be instrumental for Vanuatu to succeed in exiting the FATF monitoring list by Summer 2018.

OTHER ISSUES

33. Safeguards assessment. A safeguards assessment of the RBV was conducted in 2016. Several areas were found to be in need of significant strengthening. These include the following: (i) amendments to the RBV Act to strengthen the bank's autonomy; (ii) the establishment of Audit Committee to support governance and oversight arrangements; (iii) formulating an effective recapitalization strategy to improve financial position of the bank; and (iv) setting up of an internal audit function the absence of which presents additional risks for the RBV's control environment. While the RBV received technical assistance on recapitalization framework, capacity constraints have hindered progress in addressing key safeguards recommendations.

34. Statistical issues. While broadly adequate for surveillance purposes, quality and timeliness remain a concern for some data (Statistical Issues in the Informational Annex). Staff encouraged the authorities to seek further support from PFTAC on the compilation and development of national accounts statistics, and improvements to local technical capacity. Staff also recommends the authorities to ensure the allocation of adequate resources to prevent further delays in improving National Account Statistics, including their timeliness and quality.

35. Graduation from Least Developed Countries (LDC). Vanuatu was included in the LDC list in 1985, and it is scheduled for graduation in 2020.[13] The graduation implies that it will no longer benefit from LDC-specific differential treatment in the fulfillment of WTO commitments. Though Vanuatu would lose access to LDC-specific instruments of development cooperation, it has been observed that development partners do not base their cooperation exclusively on LDC status. The UN recognizes the importance of a smooth transition mechanism to avoid reversal of the progress made by the graduating countries.

[13] The Committee for Development Policy (CDP) reviews the list of LDCs and makes recommendations for inclusion in and graduation from the category every three years. Vanuatu was recommended for graduation by the CDP in 2012 which was endorsed by the United Nations Economic and Social Council (ECOSOC).

STAFF APPRAISAL

36. Reconstruction efforts from Cyclone Pam are near completion and full recovery is in sight. A recovery in tourism and agriculture combined with further ramping-up of infrastructure projects is expected to propel real GDP growth to around 4 percent in 2017 and 2018. The main risks facing the economy relate to the rate of implementation of public infrastructure projects, and the ever-present danger of major natural disasters.

37. Although tourism remains the center of economic activity, diversification of economic activity is vital to boost growth and help protect against the constant threat of major natural disasters. To this end, Vanuatu needs to segment the tourism sector strategically across locations and intensify efforts to diversify the economy out of tourism into the agricultural sector. For the diversification strategy to work, supporting the private sector by improving the ease of doing business is necessary. Improving access to employment opportunities and financial inclusion should remain priorities, including in the outer islands.

38. Internalizing the risks to growth associated with natural disasters and boosting the readiness to respond and manage their destructive force is critical to Vanuatu's development strategy. Lessons from Cyclone Pam highlight that while the ex-post response was satisfactory, more ex-ante measures could be undertaken, including in the areas of resilient infrastructure, and improving coordination with development partners.

39. Vanuatu's public debt acceleration in the wake of the Cyclone Pam reconstruction should be followed by well anchored medium-term fiscal adjustment. Once the reconstruction phase is over, the authorities should consider embarking on fiscal adjustment measures to address the rising debt and to rebuild fiscal buffers. These measures should include effective management of recurrent spending, prioritization and careful selection of infrastructure projects, and the mobilization of domestic revenue. The authorities should consider a medium-term fiscal anchor, defined in terms of a fiscal deficit target and debt ceiling, to provide guidance for policy choices.

40. Excess liquidity in the banking system and a buildup of inflation pressure over the past year call for monetary policy tightening. The RBV should tighten its monetary policy stance through a gradual increase of reserve requirements. The peg to an undisclosed basket of currencies continues to serve Vanuatu well in promoting stability and confidence. The external position remains broadly consistent with the medium-term fundamentals and desirable policies.

41. Increasing access to financial services should be a priority, focused on addressing the difficulties faced by SMEs and households in rural areas and outer islands in obtaining credit. Staff fully supports the authorities' "financial sector architecture" initiative to address financial inclusion. While the financial sector remains sound, the RBV should stand ready to take action to secure financial stability by gradually normalizing regulatory requirements. Staff also welcomes authorities' recent efforts to exit the FATF gray list and encourages them to ensure effective implementation of the AML/CFT framework to mitigate CBR pressures.

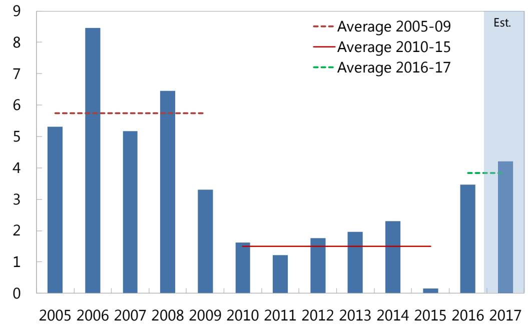
42. It is recommended that the next Article IV Consultation takes place on the standard 12-month cycle.

Figure 1. Vanuatu: Recent Developments and Prospects

After the adverse impact of Cyclone Pam in 2015, growth is estimated to have rebounded in 2016 and 2017…

Real GDP Growth, 2005-17[1/]

(In percent, year-on-year)

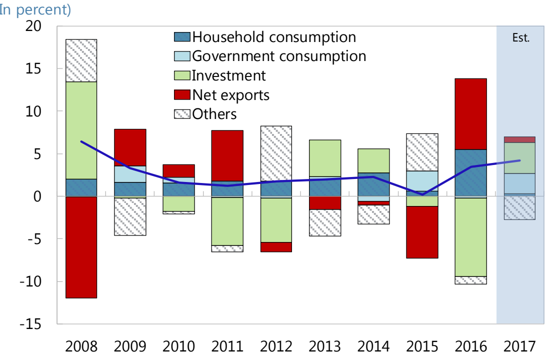


Sources: Authorities; and IMF staff estimates.
1/ 2017: estimate.

Growth is estimated to continue to be strong, driven by infrastructure projects and reconstruction activities

Contribution to Real GDP Growth by Expenditure

(In percent)

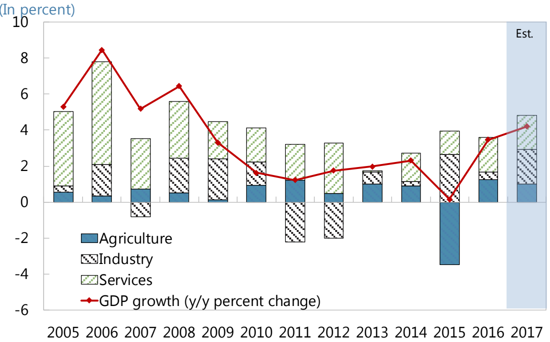


Sources: Vanuatu authorities; and IMF staff estimations.

… driven by investment growth and service sector recovery.

Real GDP Growth by Sector

(In percent)

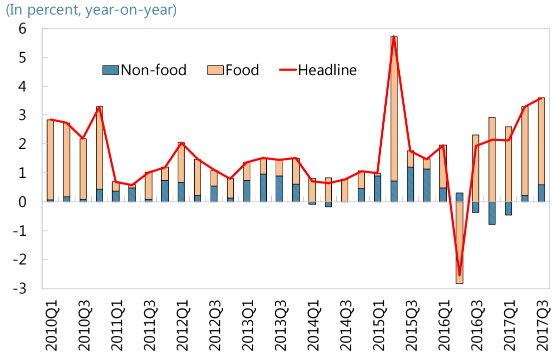


Sources: Authorities; and IMF staff calculations.

Inflation has been risen above 3 percent since the second quarter of 2017.

Contribution to Inflation

(In percent, year-on-year)

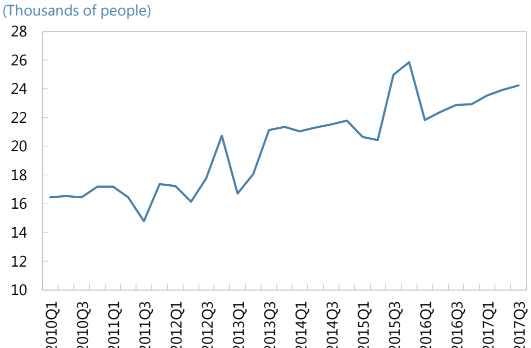


Sources: Vanuatu authorities; and IMF staff calculations.

Since 2016, formal employment has also returned to the increasing trend seen before the cyclone.

Contributors to Vanuatu National Provident Fund

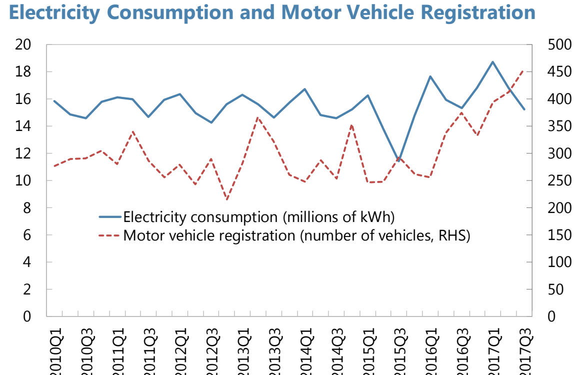
(Thousands of people)



Source: Vanuatu authorities.

Indicators of private demand are also recovering.

Electricity Consumption and Motor Vehicle Registration

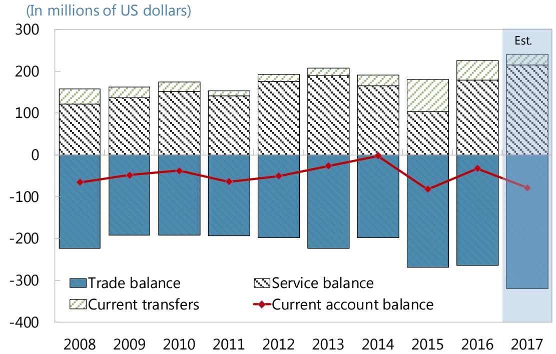


Source: Vanuatu authorities.

Figure 2. Vanuatu: External Sector Developments

Current account deficit is estimated to increase in 2017 due to higher imports.

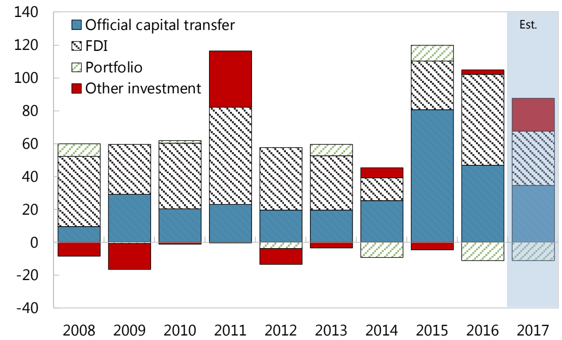
Current Account
(In millions of US dollars)



Sources: Vanuatu authorities; and IMF staff calculations.

FDI and other investment is expected to fund only a part of the current account deficit.

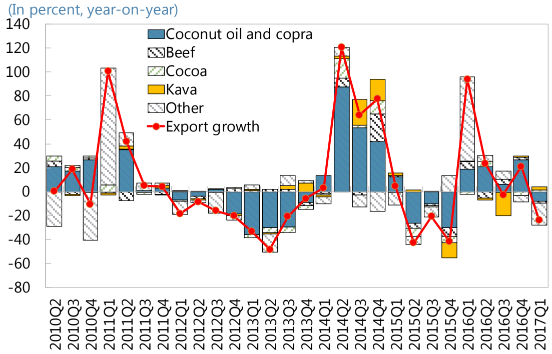
Capital and Financial Accounts
(In millions of US dollars)



Sources: Vanuatu authorities; and IMF staff calculations.

On the other hand, export growth is recovering at a slow pace.

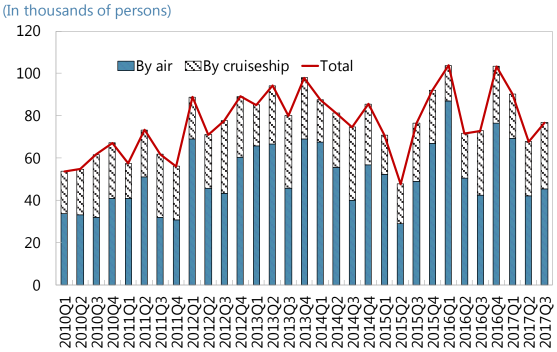
Export Growth
(In percent, year-on-year)



Source: Vanuatu authorities.

Tourist arrivals are recovering mainly driven by the recovery in airline visitors.

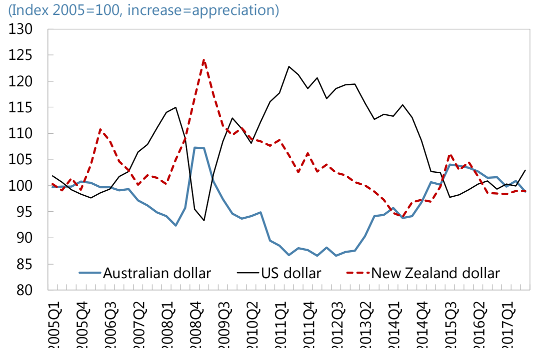
Tourist Arrivals
(In thousands of persons)



Source: Vanuatu authorities.

Since the second half of 2015, the nominal exchange rate has been mildly appreciating against the U.S. dollar but moderately weakening against the Australian dollar.

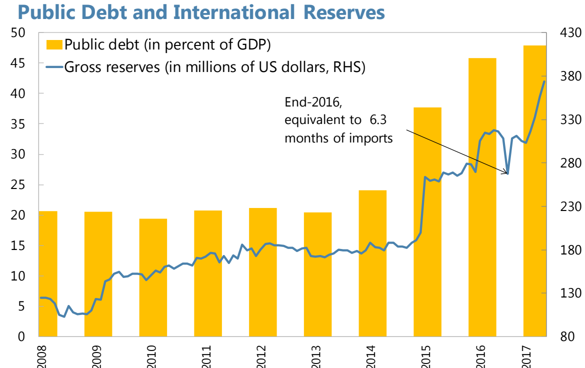
Bilateral Exchange Rates
(Index 2005=100, increase=appreciation)



Sources: Vanuatu authorities; Bloomberg LP; and IMF staff calculations.

Reserves are being maintained at a comfortable level while public debt has increased significantly since 2015.

Public Debt and International Reserves

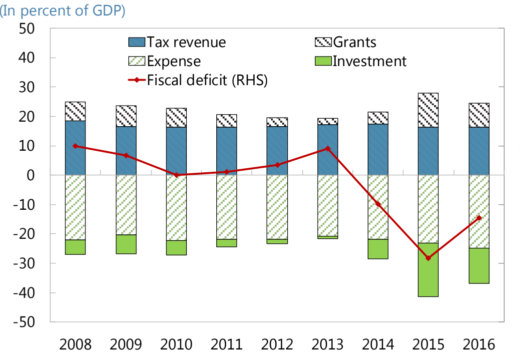


Sources: Vanuatu authorities; and IMF staff calculations.

Figure 3. Vanuatu: Public Finance and Monetary Indicators

Fiscal balance has deteriorated in recent years…

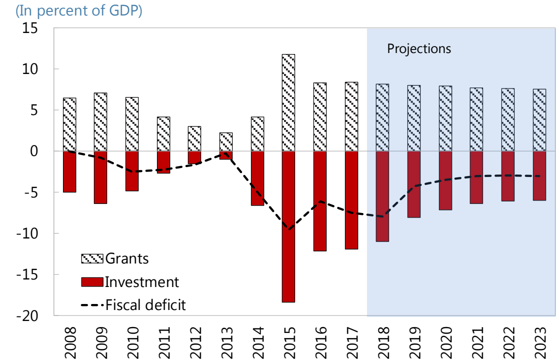
Fiscal Revenue and Expenditure
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff calculations.

High fiscal deficits will likely continue until 2018 due to reconstruction and new investment needs.

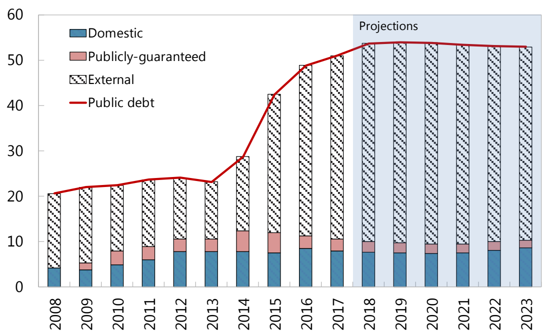
Fiscal Balance
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff estimates.

…and driven up public and publicly-guaranteed debt.

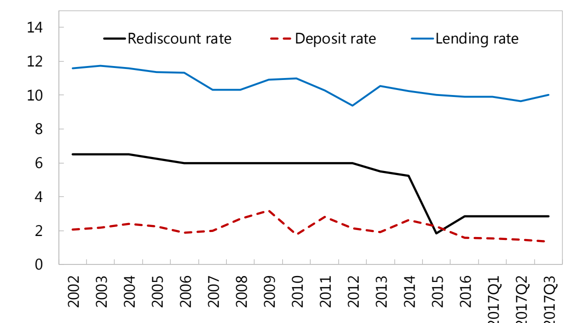
Public and Publicly-guaranteed Debt
(In percent of GDP)



Sources: Authorities; and IMF staff estimates.

Large interest rate spreads have persisted, and transmission from policy rate to commercial banks' interest rates appears limited.

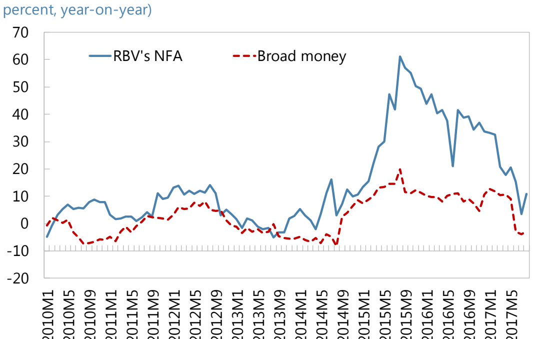
Interest Rates
(In percent)



Source: Vanuatu authorities.

Money supply is stabilizing since the second half of 2015 in tandem with decreasing net foreign assets of the central bank.

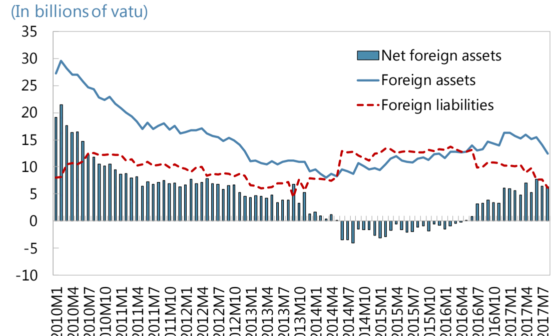
RBV's NFA and Money Supply Growth
(In percent, year-on-year)



Source: Vanuatu authorities.

Net foreign asset of commercial banks turned positive in May 2016 and continued to increase afterwards.

Banks' Foreign Assets and Liabilities
(In billions of vatu)



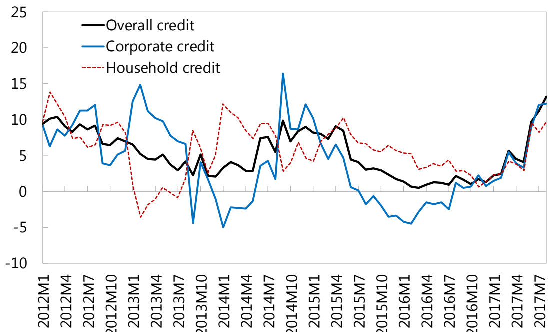
Source: Vanuatu authorities.

Figure 4. Vanuatu: Financial Sector Developments and Financial Inclusion

Private credit growth recovered in 2017, driven by a large increase in credit to both corporate and household sectors.

Private Credit Growth

(In percent, year-on-year)

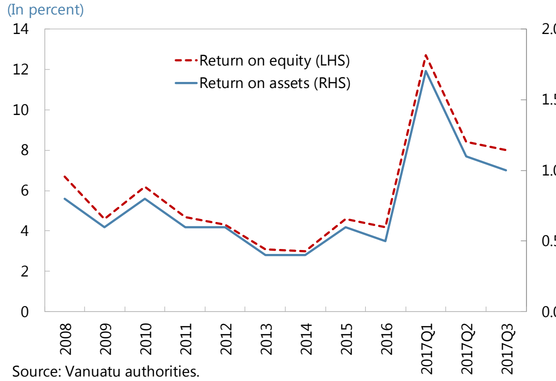


Source: Vanuatu authorities.

Bank profitability has improved in 2017 due to an improvement in earnings.

Bank Profitability

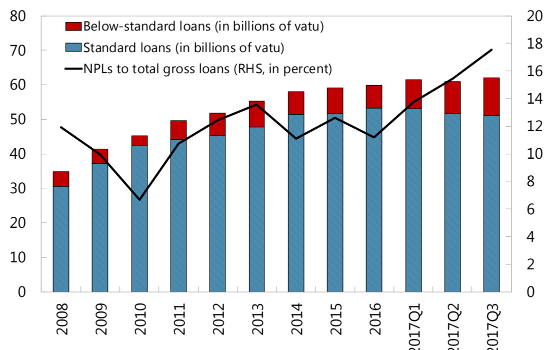
(In percent)



Source: Vanuatu authorities.

However, NPLs also increased driven by an increase in substandard and doubtful assets.

Non-Performing Loans

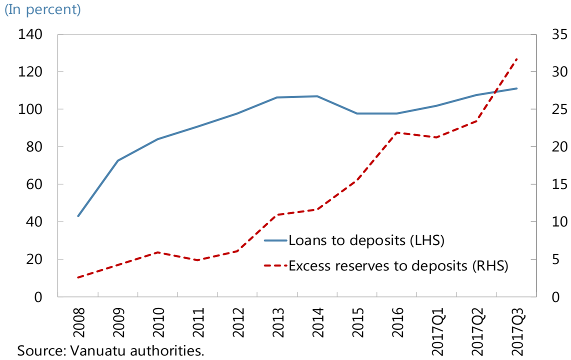


Source: Vanuatu authorities.

Despite the high loan-to-deposit ratio, overall bank liquidity has increased significantly in 2017.

Loan-to-Deposit and Excess Reserve Ratio

(In percent)

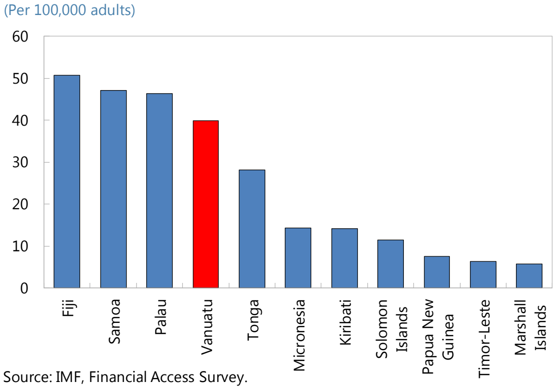


Source: Vanuatu authorities.

Financial access of households with respect to provision of ATMs is moderately high compared to other PIC peers…

Number of ATM, 2016

(Per 100,000 adults)

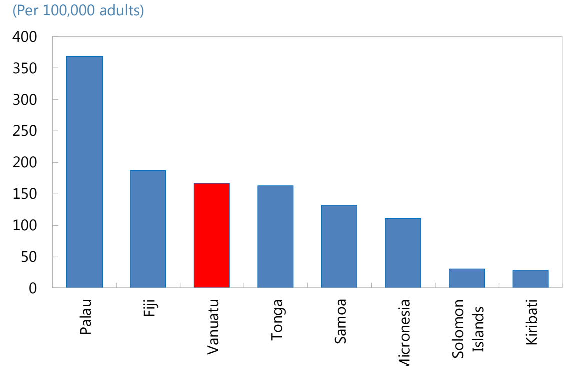


Source: IMF, Financial Access Survey.

… and also with respect to the number of bank loans.

Commercial Bank Loan Accounts, 2014

(Per 100,000 adults)



Source: IMF, Financial Access Survey.

Table 1. Vanuatu: Selected Economic and Financial Indicators, 2013-18

Population (2016): 274,775
IMF quota: SDR 23.8 million (0.01 percent of total)
Main products and exports: Coconut oil, copra, kava, beef
Key export markets: New Zealand, Australia, Japan

Per capita GDP (2016): $2,923
Literacy rate (2012): 83.4 percent

					Est.	Proj.
	2013	2014	2015	2016	2017	2018
Output and prices (annual percentage change)						
Real GDP	2.0	2.3	0.2	3.5	4.2	3.8
Consumer prices (period average)	1.5	0.8	2.5	0.8	3.1	4.8
Consumer prices (end period)	1.5	1.1	1.5	2.1	3.8	4.6
Government finance (in percent of GDP)						
Total revenue	21.4	23.5	31.9	30.8	31.5	31.6
Taxes	17.2	17.4	16.3	16.3	17.4	17.8
Other revenue	2.0	2.0	5.5	5.3	5.2	5.2
Grants	2.2	4.1	11.8	8.3	8.3	8.2
Expenditure	21.7	28.5	41.5	36.9	38.9	39.5
Expense	20.7	21.8	23.1	24.8	27.0	28.6
Net acquisition of non financial assets	1.0	6.6	18.3	12.1	11.9	11.0
Net lending (+)/borrowing (-)	-0.2	-5.0	-9.6	-6.1	-7.5	-8.0
Public and publicly-guaranteed debt (end of period)	23.1	28.7	42.4	48.8	51.0	53.7
Domestic	7.8	7.8	7.5	8.5	8.0	7.6
External	12.6	16.3	30.5	37.6	40.4	43.7
Publicly guaranteed debt	2.8	4.6	4.4	2.8	2.6	2.4
Money and credit (annual percentage change)						
Broad money (M2)	-6.4	8.5	23.1	10.6	2.4	11.3
Net foreign assets	-14.8	-14.5	71.6	46.5	-6.6	12.7
Domestic credit	2.7	9.3	-7.4	-10.2	10.9	10.1
Of which: Credit to private sector	2.0	9.0	1.4	1.3	4.3	4.1
Interest rates (in percent, end of period) 1/						
Deposit rate (vatu deposits)	1.9	2.6	2.3	1.6	…	…
Lending rate (vatu loans)	10.5	10.3	10.0	9.9	…	…
Balance of payments (in percent of GDP)						
Current account	-3.3	-0.3	-10.6	-4.1	-9.0	-9.2
Trade balance	-27.8	-24.2	-34.8	-33.1	-36.8	-27.6
Exports of goods	5.6	7.7	5.0	6.2	6.0	6.3
Imports of goods	-33.4	-31.9	-39.8	-39.3	-42.8	-33.9
Tourism receipts	35.9	31.6	23.7	25.5	25.5	26.2
Capital and financial account	7.2	5.2	15.3	11.8	14.2	8.5
Gross international reserves (in months of prospective G&S imports)	5.4	4.8	6.9	6.4	8.6	8.2
External debt service (in percent of GNFS exports)	1.9	2.1	2.6	2.1	2.3	3.3
Exchange rates 2/						
Vatu per U.S. dollar (period average)	94.5	97.1	107.0	109.3	107.8	…
Vatu per U.S. dollar (end of period)	97.3	102.7	109.6	113.1	106.5	…
Real effective exchange rate (average)	98.9	98.1	100.3	102.3	102.2	…
Memorandum items:						
Nominal GDP (in billions of vatu)	75.8	79.1	82.8	87.3	93.7	101.9
Nominal GDP (in millions of U.S. dollars)	802	815	774	798	870	957

Sources: Vanuatu authorities; and IMF staff estimates and projections.

1/ Weighted average rate of interest for total bank deposits and loans.

2/ The vatu is officially pegged to an undisclosed basket of currencies.

Table 2. Vanuatu: Central Government Budgetary Operations, 2013-23 [1/]

						Proj.					
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
					(In millions of vatu)						
Total revenue	16,247	18,585	26,424	26,872	29,514	32,184	35,470	37,826	39,869	42,161	44,767
Taxes	13,069	13,747	13,467	14,231	16,276	18,158	20,736	22,416	23,855	25,387	27,017
Other revenue	1,514	1,561	3,209	5,403	5,417	5,687	5,976	6,244	6,521	6,808	7,245
Grants	1,664	3,277	9,748	7,238	7,821	8,339	8,758	9,167	9,492	9,966	10,505
Expenditure	18,339	22,518	34,344	32,207	36,509	40,298	40,163	41,907	43,587	46,090	48,972
Expense	15,694	17,268	19,152	21,629	25,317	29,112	31,367	33,604	35,744	38,091	40,565
Compensation of employees	8,438	8,582	8,893	9,107	9,967	12,368	13,233	14,083	14,987	15,949	16,973
Use of goods and services	4,144	5,185	5,843	5,995	8,131	8,842	9,678	10,532	11,208	11,927	12,693
Interest payment	555	573	700	908	949	1,084	1,161	1,226	1,287	1,422	1,541
Subsidies	0	0	0	0	0	0	0	0	0	0	0
Grants	1,600	2,035	2,530	3,217	2,408	2,618	2,801	2,981	3,173	3,376	3,593
Social benefits	346	241	476	1,542	2,664	2,897	3,100	3,299	3,510	3,736	3,976
Other expense	612	652	710	860	1,198	1,303	1,394	1,484	1,579	1,680	1,788
Net acquisition of nonfinancial assets	2,644	5,250	15,191	10,578	11,192	11,186	8,796	8,303	7,843	7,999	8,408
Gross operating balance	553	1,317	7,272	5,243	4,197	3,072	4,103	4,222	4,125	4,070	4,202
Net lending (+)/borrowing (-)	-2,092	-3,933	-7,919	-5,335	-6,995	-8,114	-4,692	-4,081	-3,718	-3,929	-4,205
Net acquisition of financial assets	-343	460	5,682	3,050	1,470	-1,200	-600	-400	-300	0	0
Net incurrence of liabilities	1,428	3,607	12,425	9,002	7,173	6,913	4,092	3,681	3,418	3,929	4,205
Domestic	306	263	32	1,453	105	286	439	391	777	1,311	1,404
Foreign	1,121	3,344	12,393	7,549	7,068	6,627	3,653	3,290	2,640	2,618	2,802
					(In percent of GDP)						
Total revenue	21.4	23.5	31.9	30.8	31.5	31.6	32.5	32.6	32.3	32.1	32.0
Taxes	17.2	17.4	16.3	16.3	17.4	17.8	19.0	19.3	19.3	19.3	19.3
Other revenue	2.0	2.0	3.9	6.2	5.8	5.6	5.5	5.4	5.3	5.2	5.2
Grants	2.2	4.1	11.8	8.3	8.3	8.2	8.0	7.9	7.7	7.6	7.5
Expenditure	24.2	28.5	41.5	36.9	38.9	39.5	36.8	36.1	35.3	35.1	35.0
Expense	20.7	21.8	23.1	24.8	27.0	28.6	28.8	29.0	28.9	29.0	29.0
Compensation of employees	11.1	10.8	10.7	10.4	10.6	12.1	12.1	12.1	12.1	12.1	12.1
Use of goods and services	5.5	6.6	7.1	6.9	8.7	8.7	8.9	9.1	9.1	9.1	9.1
Interest payment	0.7	0.7	0.8	1.0	1.0	1.1	1.1	1.1	1.0	1.1	1.1
Subsidies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	2.1	2.6	3.1	3.7	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Social benefits	0.5	0.3	0.6	1.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Other expense	0.8	0.8	0.9	1.0	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Net acquisition of nonfinancial assets	3.5	6.6	18.3	12.1	11.9	11.0	8.1	7.2	6.3	6.1	6.0
Gross operating balance	0.7	1.7	8.8	6.0	4.5	3.0	3.8	3.6	3.3	3.1	3.0
Recurrent budget balance	-1.7	-0.4	6.9	3.6	1.7	0.4	1.3	1.3	1.2	1.1	1.1
Net lending (+)/borrowing (-)	-2.8	-5.0	-9.6	-6.1	-7.5	-8.0	-4.3	-3.5	-3.0	-3.0	-3.0
Net acquisition of financial assets	-0.5	0.6	6.9	3.5	1.6	-1.2	-0.6	-0.3	-0.2	0.0	0.0
Net incurrence of liabilities	1.9	4.6	15.0	10.3	7.7	6.8	3.8	3.2	2.8	3.0	3.0
Domestic	0.4	0.3	0.0	1.7	0.1	0.3	0.4	0.3	0.6	1.0	1.0
Foreign	1.5	4.2	15.0	8.7	7.5	6.5	3.3	2.8	2.1	2.0	2.0
Memorandum items:											
Public and publicly-guaranteed debt	23.1	28.7	42.4	48.8	51.0	53.7	53.9	53.8	53.3	53.1	52.9
Central government public debt	20.4	24.1	38.0	46.1	48.4	51.3	51.7	51.8	51.4	51.3	51.2
Domestic	7.8	7.8	7.5	8.5	8.0	7.6	7.5	7.4	7.6	8.1	8.6
External	12.6	16.3	30.5	37.6	40.4	43.7	44.2	44.3	43.8	43.2	42.6
Of which: RCF/RFI			3.0	2.9	2.4	1.6	1.1	0.9	0.6	0.4	0.2
Guaranteed GBE debt	2.8	4.6	4.4	2.8	2.6	2.4	2.2	2.1	1.9	1.8	1.7
Debt service	2.4	2.9	3.0	3.0	3.1	3.3	3.8	3.5	3.6	3.7	3.8
Primary balance	0.5	-4.2	-8.7	-5.8	-6.5	-6.9	-3.2	-2.5	-2.0	-1.9	-1.9
Nominal GDP (millions of vatu)	75,803	79,109	82,798	87,250	93,733	101,932	109,060	116,062	123,514	131,444	139,884

1/ Fiscal year corresponds to the calendar year.

Sources: Vanuatu authorities; and IMF staff estimates and projections.

Table 3. Vanuatu: Monetary Survey, 2013-18

	2013	2014	2015	2016	2017	2018
					Est.	Proj.
	(In millions of vatu; end of period)					
Net foreign assets	16,272	13,908	23,867	34,976	39,029	38,785
Monetary authorities	14,932	16,533	24,693	28,876	32,742	32,079
Commercial banks	1,340	-2,625	-826	6,100	6,287	6,707
Net domestic assets	37,500	44,483	41,193	36,993	38,370	41,659
Domestic credit	52,081	56,988	52,415	51,728	56,898	60,187
Claims on government (net)	-715	-1,153	-6,368	-7,913	-9,176	-8,890
Claims on municipalities	85	91	74	129	108	108
Claims on other sectors	52,711	58,050	58,710	59,513	65,966	68,969
Claims on nonfinancial public enterprises	648	1,303	1,177	1,245	1,176	1,526
Claims on private sector	52,063	56,747	57,532	58,268	64,790	67,443
Other items (net)	-14,580	-12,505	-11,222	-14,735	-18,528	-18,528
Total broad money	53,772	58,391	65,061	71,969	77,399	80,444
Narrow money	26,476	28,202	35,468	42,658	47,230	51,011
Currency outside banks	5,054	5,532	6,284	7,151	7,471	9,552
Demand deposits	21,422	22,669	29,184	35,506	39,759	41,459
Quasi-money	27,296	30,189	29,593	29,311	30,169	29,433
	(Annual percentage change, unless otherwise indicated)					
Net foreign assets	-14.8	-14.5	71.6	46.5	11.6	-0.6
Net domestic assets	-0.9	18.6	-7.4	-10.2	3.7	8.6
Domestic credit	2.7	9.4	-8.0	-1.3	10.0	5.8
Private sector credit	2.0	9.0	1.4	1.3	11.2	4.1
Total broad money	-5.5	8.6	11.4	10.6	7.5	3.9
Vatu broad money	-3.0	5.3	15.0	12.3	7.6	4.9
Memorandum items:						
Vatu broad money multiplier	1.7	1.7	1.6	1.5	1.4	1.4
Total broad money multiplier	2.0	2.1	1.8	1.7	1.6	1.6
Velocity						
Narrow money	3.1	2.9	2.6	2.2	2.1	2.1
Vatu broad money	1.6	1.7	1.6	1.5	1.4	1.5
Total broad money	1.4	1.4	1.3	1.3	1.3	1.3
Reserve money (in millions of vatu)	8,392	9,359	11,756	15,922	21,976	21,477
Reserve money (annual percentage change)	39.2	11.5	25.6	35.4	38.0	-2.3
Credit to private sector (in percent of GDP)	68.7	71.7	69.5	66.8	69.1	66.2
Foreign currency deposits (annual percentage change)	-18.5	-0.1	20.4	0.7	7.2	-2.4
Foreign currency deposits/total deposits (percent)	15.8	14.5	15.7	14.3	14.2	13.7
Foreign currency credit/total credit (percent)	24.8	26.5	26.0	27.0	27.0	28.0
Net foreign assets of banks (in millions of U.S. dollars)	13.8	-25.6	-7.5	54.0	59.0	63.0
Net foreign assets (in percent of GDP)	21.5	17.6	28.8	40.1	41.6	38.1
Nominal GDP (in millions of vatu)	75,803	79,109	82,798	87,250	93,733	101,932

Source: Vanuatu authorities, and IMF staff estimates and projections.

Table 4. Vanuatu: Balance of Payments, 2013-23

(In millions of U.S. dollars)

					Est.	Proj.					
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Current account balance	**-26**	**-2**	**-82**	**-32**	**-78**	**-88**	**-88**	**-87**	**-90**	**-94**	**-97**
Trade balance	-223	-197	-269	-264	-320	-264	-266	-270	-276	-286	-301
Exports of goods (f.o.b.)	45	63	39	50	52	60	66	73	80	87	96
Imports of goods (f.o.b.)	-268	-260	-308	-314	-373	-324	-332	-343	-356	-374	-397
Services balance	190	166	104	179	215	151	153	160	163	170	183
Receipts	331	307	283	330	347	337	348	367	384	404	433
Of which: travel	288	257	183	204	222	250	274	306	333	362	398
Payments	-142	-141	-179	-152	-132	-186	-195	-207	-221	-235	-250
Primary income	-11	4	7	7	2	2	2	2	2	2	3
Receipts	33	36	36	36	39	43	46	49	52	55	59
Payments	-45	-33	-29	-30	-37	-41	-44	-47	-50	-53	-56
Secondary income	18	26	76	46	25	24	23	22	21	20	19
Official	17	22	39	38	23	22	21	20	19	18	17
Private	1	3	37	8	2	2	2	2	2	2	2
Capital and financial account	**58**	**43**	**118**	**95**	**124**	**81**	**78**	**80**	**78**	**82**	**85**
Capital account	21	32	84	48	82	36	37	38	38	39	40
Of which : Official capital transfers (net)	20	25	81	47	35	34	35	36	36	37	38
Financial account	37	11	35	47	42	45	40	42	40	43	45
Foreign direct investment	33	14	30	55	33	38	41	44	44	47	48
Portfolio investment	7	-9	10	-11	-11	-11	-11	-11	-11	-11	-11
Other investment	-3	6	-5	3	20	19	10	9	7	7	8
Net errors and omissions	-36	-34	51	-61	55	0	0	0	0	0	0
Overall balance	**-5**	**6**	**87**	**1**	**100**	**-6**	**-11**	**-7**	**-12**	**-13**	**-12**
Financing:	**5**	**-6**	**-64**	**-1**	**-100**	**3**	**5**	**3**	**9**	**10**	**9**
Change in international reserves (- = increase)	5	-6	-87	-1	-100	6	11	7	12	13	12
IMF's RCF/RFI			23	0	0	-3	-6	-4	-2	-2	-2
Memorandum items:											
Gross international reserves	179	184	269	267	368	361	350	344	332	319	307
In months of prospective imports	5.4	4.5	6.9	6.4	8.6	8.2	7.6	7.2	6.5	5.9	5.4
Current account balance (in percent of GDP)	-3.3	-0.3	-10.6	-4.1	-9.0	-9.2	-8.6	-8.0	-7.7	-7.6	-7.4
Exports of goods (annual percentage change)	-18.1	40.0	-38.0	28.2	4.7	15.5	10.2	9.6	3.0	3.0	3.0
Imports of goods (annual percentage change)	5.7	-2.9	18.5	2.0	18.6	-12.9	2.4	3.3	3.3	3.3	3.3
Exchange rate (vatu per U.S. dollar, period average)	94.5	97.1	107.0	109.3	107.8	…	…	…	…	…	…
Exchange rate (vatu per U.S. dollar, end of period)	97.3	102.7	109.6	113.1	106.5	…	…	…	…	…	…
Public external debt (in percent of GDP)	12.6	16.3	30.5	37.6	40.4	43.7	44.2	44.3	43.8	43.2	42.6
Public external debt service (in percent of GNFS exports)	1.9	2.1	2.6	2.1	2.3	3.3	4.6	4.0	4.4	4.4	4.3
Nominal GDP	802	815	774	798	870	957	1024	1090	1160	1234	1313

Sources: Vanuatu authorities; and IMF staff estimates and projections.

Table 5. Vanuatu: Medium-Term Baseline Scenario, 2013-23

					Est.	Proj.					
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Output and prices (annual percentage change)											
Real GDP	2.0	2.3	0.2	3.5	4.2	3.8	3.5	3.0	3.0	3.0	3.0
Consumer prices (period average)	1.5	0.8	2.5	0.8	3.1	4.8	3.4	3.0	3.0	3.0	3.0
Consumer prices (end of period)	1.5	1.1	1.5	2.1	3.8	4.6	3.4	3.0	3.0	3.0	3.0
Government finances (in percent of GDP)											
Total revenue	21.4	23.5	31.9	30.8	31.5	31.6	32.5	32.6	32.3	32.1	32.0
Revenue	19.2	19.4	20.1	22.5	23.1	23.4	24.5	24.7	24.6	24.5	24.5
Taxes	17.2	17.4	16.3	16.3	17.4	17.8	19.0	19.3	19.3	19.3	19.3
Other revenue	2.0	2.0	3.9	6.2	5.8	5.6	5.5	5.4	5.3	5.2	5.2
Grants	2.2	4.1	11.8	8.3	8.3	8.2	8.0	7.9	7.7	7.6	7.5
Expenditure	21.7	28.5	41.5	36.9	38.9	39.5	36.8	36.1	35.3	35.1	35.0
Expense	20.7	21.8	23.1	24.8	27.0	28.6	28.8	29.0	28.9	29.0	29.0
Net acquisition of non-financial assets	1.0	6.6	18.3	12.1	11.9	11.0	8.1	7.2	6.3	6.1	6.0
Net lending (+)/borrowing (-)	-0.2	-5.0	-9.6	-6.1	-7.5	-8.0	-4.3	-3.5	-3.0	-3.0	-3.0
Public and publicly guaranteed debt	23.1	28.7	42.4	48.8	51.0	53.7	53.9	53.8	53.3	53.1	52.9
Central government debt (end of period)	20.4	24.1	38.0	46.1	48.4	51.3	51.7	51.8	51.4	51.3	51.2
Domestic	7.8	7.8	7.5	8.5	8.0	7.6	7.5	7.4	7.6	8.1	8.6
External	12.6	16.3	30.5	37.6	40.4	43.7	44.2	44.3	43.8	43.2	42.6
Of which: RCF/RFI			3.0	2.9	2.4	1.6	1.1	0.9	0.6	0.6	0.4
Guaranteed GBE debt	2.8	4.6	4.4	2.8	2.6	2.4	2.2	2.1	1.9	1.8	1.7
Balance of payments (in percent of GDP)											
Current account	-3.3	-0.3	-10.6	-4.1	-9.0	-9.2	-8.6	-8.0	-7.7	-7.6	-7.4
Trade balance	-27.8	-24.2	-34.8	-33.1	-36.8	-27.6	-26.0	-24.8	-23.8	-23.2	-22.9
Exports of goods	5.6	7.7	5.0	6.2	6.0	6.3	6.5	6.7	6.9	7.1	7.3
Imports of goods	-33.4	-31.9	-39.8	-39.3	-42.8	-33.9	-32.4	-31.5	-30.7	-30.3	-30.2
Tourism receipts	35.9	31.6	23.7	25.5	25.5	26.2	26.8	28.1	28.7	29.4	30.3
Capital and financial account	7.2	5.2	15.3	11.8	14.2	8.5	7.6	7.3	6.7	6.6	6.5
Of which : Foreign direct investment	4.2	1.7	3.8	6.9	3.8	3.9	4.0	4.0	3.8	3.8	3.7
Overall balance	-0.6	0.8	11.3	0.1	11.5	-0.7	-1.1	-0.6	-1.0	-1.0	-0.9
Gross international reserves (in millions of U.S. dollars)	179	184	269	267	368	361	350	344	332	319	307
In months of prospective imports	5.4	4.5	6.9	6.4	8.6	8.2	7.6	7.2	6.5	5.9	5.4
External debt service (in percent of GNFS exports)	1.9	2.1	2.6	2.1	2.3	3.3	4.6	4.0	4.4	4.4	4.3
Memorandum items:											
Nominal GDP (in billions of vatu)	75.8	79.1	82.8	87.3	93.7	101.9	109.1	116.1	123.5	131.4	139.9
Nominal GDP (in millions of U.S. dollars)	802	815	774	798	870	957	1,024	1,090	1,160	1,234	1,313

Sources: Vanuatu authorities; and IMF staff estimates and projections.

Table 6. Vanuatu: Banks' Financial Soundness Indicators, 2012-17

	2012	2013	2014	2015	2016	2017Q3
Capital adequacy						
Regulatory capital to risk-weighted assets	20.5	18.1	17.6	16.4	19.3	17.1
Regulatory Tier 1 capital to risk-weighted assets	18.3	15.9	16.7	16.2	16.4	15.3
Asset quality						
Nonperforming loans net of provisions to capital	12.0	37.4	49.4	69.3	36.5	62.3
Nonperforming loans to total gross loans	8.1	13.5	11.1	12.6	11.2	17.5
Earnings and profitability						
Return on assets	0.6	0.4	0.4	0.6	0.5	1.0
Return on equity	4.3	3.1	3.0	4.6	4.2	8.0
Interest margin to gross income	46.5	50.1	54.3	49.7	55.3	54.4
Noninterest expenses to gross income	52.4	46.9	55.2	51.4	54.0	50.1
Liquidity						
Liquid assets to total assets (liquid asset ratio)	18.8	26.1	23.8	26.2	32.3	34.1

Source: Reserve Bank of Vanuatu.

Table 7. Vanuatu: SDGs Identified in National Sustainable Development Plan 2016 to 2030 (Vanuatu 2030)

Key elements identified by the Vanuatu 2030	Corresponding SDGs 1/	Role of the IMF
I. Society Pillar		>TA on PFM with a particular focus on increased fiscal resilience, transparency and accountability > TA on financial supervision to support financial deepening and inclusion
1. Vibrant cultural identity		
2. Quality Education	4 Quality Education	
3. Quality Health Care	3 Good Health and Well Being	
4. Social Inclusion	5 Gender Equality; 10 Reduced Inequality	
5. Security, Peace and Justice	16 Peace, Justice, and Strong Institution	
6. Strong and Effective Institutions		
II. Environmental Pillar		> Provide analytical and policy framework on how to incorporate the cost of natural disasters and climate change > Coordination with the World Bank Group and development partners
1. Food and Nutrition Security	2 Zero Hunger	
2. Blue-Green Economic Growth	7 Affordable and Clean Energy	
3. Climate and Disaster Resilience	13 Climate Action	
4. Natural Resource Management	6 Clean Water & Sanitation; 14 Sustainable Use of Oceans	
5. Ecosystems and Biodiversity	12 Responsible Consumption; 15 Protect Forests & Ecosystem	
III. Economy Pillar		> Surveillance and policy advice on macro-economic policies > TA on tax administration reform and domestic revenue mobilization > Coordination with the World Bank Group and development partners > Capacity development
1. Stable and Equitable Growth	8 Inclusive Economic Growth & Decent Work	
2. Improve Infrastructure	9 Resilient Infrastructure & Innovation	
3. Strengthen Rural Communities	11 Sustainable Cities & Communities	
4. Create jobs and business opportunities	1 No Poverty; 17 Partnerships for the Goals	

1/ Staff compilation.

Table 8. Vanuatu: Indicators of Capacity to Repay the Fund, 2017-27

		Proj.									
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Fund obligations based on existing and prospective credit											
(In milions of SDRs)											
Principal	0.0	2.1	4.3	3.0	1.7	1.7	1.7	1.7	0.9	0.0	0.0
Charges and interest	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations based on existing and prospective credit											
In millions of SDRs	0.1	2.2	4.3	3.0	1.7	1.7	1.7	1.7	0.9	0.0	0.0
In millions of U.S. dollars	0.1	3.1	6.1	4.2	2.4	2.4	2.4	2.4	1.2	0.0	0.0
In percent of gross international reserves	0.0	0.9	1.7	1.2	0.7	0.8	0.8	0.8	0.4	0.0	0.0
In percent of government revenue	0.1	1.0	1.8	1.2	0.6	0.6	0.6	0.5	0.3	0.0	0.0
In percent of exports of goods and services	0.0	0.8	1.4	0.9	0.5	0.5	0.4	0.4	0.2	0.0	0.0
In percent of debt service 1/	0.3	6.0	9.6	6.8	3.6	3.4	3.2	3.1	1.5	0.0	0.0
In percent of GDP	0.0	0.3	0.6	0.4	0.2	0.2	0.2	0.2	0.1	0.0	0.0
In percent of quota	0.6	13.1	25.4	17.6	10.1	10.1	10.1	10.1	5.1	0.1	0.1
Outstanding Fund credit											
In millions of SDRs	17.0	14.9	10.6	7.7	6.0	4.3	2.6	0.9	0.0	0.0	0.0
In millions of U.S. dollars	23.5	21.0	15.0	10.8	8.4	6.0	3.6	1.2	0.0	0.0	0.0
In percent of gross international reserves	6.4	5.8	4.3	3.1	2.5	1.9	1.2	0.4	0.0	0.0	0.0
In percent of government revenue	8.6	6.9	4.5	3.0	2.2	1.5	0.9	0.3	0.0	0.0	0.0
In percent of exports of goods and services	5.9	5.1	3.4	2.3	1.7	1.1	0.7	0.2	0.0	0.0	0.0
In percent of debt service 1/	55.6	40.2	23.6	17.2	12.7	8.5	4.8	1.5	0.0	0.0	0.0
In percent of GDP	2.7	2.2	1.5	1.0	0.7	0.5	0.3	0.1	0.0	0.0	0.0
In percent of quota	100.0	87.5	62.5	45.0	35.0	25.0	15.0	5.0	0.0	0.0	0.0
Net use of Fund credit (in millions of SDRs)	0.0	-2.1	-4.3	-3.0	-1.7	-1.7	-1.7	-1.7	-0.9	0.0	0.0
Disbursements	0	0	0	0	0	0	0	0	0	0	0
Repayments and repurchases	0.0	-2.1	-4.3	-3.0	-1.7	-1.7	-1.7	-1.7	-0.9	0.0	0.0
Memorandum items:											
Nominal GDP (in millions of U.S. dollars)	870	957	1024	1090	1160	1234	1313	1398	1487	1583	1684
Exports of goods and services (in millions of U.S. dollars)	397	414	440	464	492	528	542	577	623	676	736
Gross international reserves (in millions of U.S. dollars)	368	361	350	344	332	319	307	297	286	285	299
Government revenue (in millions of U.S. dollars)	274	302	333	355	374	396	420	446	474	505	537
Debt service (in millions of U.S. dollars)	42	52	63	63	66	70	74	78	83	88	92
U.S. dollars/SDR (period average)	1.4	…	…	…	…	…	…	…	…	…	…

Source: IMF staff estimates and projections.

1/ Total debt service includes IMF repurchases and repayments.

Appendix I. Risk Assessment Matrix 1/

Likelihood	Impact		Policy Recommendation
Medium	**High** **1. Positive spillovers from large infrastructure projects** The implementation of major infrastructure projects, including the building of international wharfs and inter-island shipping facilities, could have positive spillovers to the economy from 2018 onwards.	Upside	• Consider ways to use some of the gains to invest in resilient infrastructure.
Low	**Medium** **2. Lower energy prices** Persistently lower oil prices could keep production costs low and inflationary pressures in check.	Upside	• Take advantage of favorable conditions to push ahead with the medium-term development and diversification strategies.
High	**High** **1. Implementation of infrastructure projects** The delays in implementation of major infrastructure projects could have negative spillovers to the economy.	Downside	• Public investment should be guided by careful project selection and implementation. • Stimulate private sector investment by improving business environment and facilitating credit provision.
High	**High** **2. Natural disasters and climate change** Vanuatu faces many natural disasters, including tropical cyclones, earthquakes, floods, and volcanic activity. Climate change is likely to increase the intensity and frequency of natural disasters, alter weather and precipitation patterns, and raise sea levels.	Downside	• Build greater ex-ante resilience to natural disasters by enhancing adaptation measures (with better infrastructure, spatial planning, and fiscal buffers). • Maintain financial support from development partners and seek global/regional climate financing opportunities.
Medium	**High** **3. Delays in implementation of tax reform** Further delays in revenue mobilization would put a strain on fiscal policy, more so with the pay rise for government employees being effective from 2018.	Downside	• Seek TA from the IMF on the implementation of tax reforms to secure the expected revenue return and achieve fairness in the tax system. • Continue improving the implementation of Compliance Improvement Strategy to raise the efficiency of VAT collections.
Medium	**Medium** **4. Weaker-than-expected global growth, especially significant China slowdown and its spillovers** A decline in exports and tourism receipts by a severe economic slowdown in China and its spillovers to regional economies (e.g., Australia) would worsen the current account balance further. It would also reduce fiscal revenue and weaken the reserves buffer.	Downside	• Accelerate infrastructure investment to stimulate domestic demand in the short-term and improve competitiveness in the long-term. • Facilitate diversification by introduction of new activities and expansion into new markets.
High	**Medium** **5. Reduced financial services by correspondent banks** The global risk of loss of correspondent banking relationships is high. Though the loss of CBRs has not emerged as a serious issue, the inclusion in the FATF grey list may pose some difficulties in cross-border payments, trade finance, and remittances. The closure of money transfer operators (MTOs) could potentially increase the cost of remittances.	Downside	• Ensure transparency and improve banking regulation and supervision to mitigate the risk. • Continue to strengthen the AML/CFT framework and tax transparency in line with the international standard through TA from various stakeholders (e.g., IMF, World Bank, and Australian government).

1/The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern at the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Appendix II. Authorities' Response to Past Fund Policy Advice

Fund Recommendation	Policy Actions
Fiscal Policy Reduce debt accumulation and exercise fiscal discipline.	• Debt accumulation has slowed from 2015 to 2016. Public debt rose by 13.7 percent in 2015 due to sizable disbursements for infrastructure projects, decelerating to 6.4 percent in 2016. • Fiscal deficit remains high due to increase in expenditure related to reconstruction and infrastructure projects, though they were largely financed by highly concessional external borrowing.
Implement the tax reform in a timely and orderly manner.	• The government increased the VAT rate from 12.5 to 15 percent in January 2018 and is committed to introducing income tax and implementing the revised tax administration bill from January 2019.
Monetary Policy Clarify further the RBV's monetary policy objectives and instruments.	• The authorities maintained the accommodative policy stance to support economic recovery and financial stability after the cyclone; though the monetary policy transmission mechanism remains weak.
Maintain a conservative approach to reserve management and maintain foreign reserves at above 4 months of imports to provide a necessary buffer against external shocks.	• Foreign exchange reserves have remained above 5 months of imports throughout 2016 and 2017. • The RBV has improved its reserve management system significantly benefiting from IMF TA on reserve management in 2015 and 2017.
Financial Sector Policy Secure financial stability by gradually normalizing regulatory requirements for the banking and non-banking financial sectors.	• The RBV maintained accommodative regulatory requirements to alleviate potential liquidity pressures on banks and to support the post-cyclone economic recovery. • The RBV is reviewing overall financial sector architecture to address financial inclusion.
Accelerate the implementation of the AML/CFT action plan and ensure its legal framework is in line with international standards.	• The authorities have taken successful steps towards improving its AML/CFT regime by allocating significant resources to major policy reformulation, legislative drafting work, and the completion of the offshore sector and terrorist financing risk assessment.
Increase access to financial services and ensure inclusive growth.	• The RBV hosted a symposium on financial inclusion to better shape the future strategy of financial deepening and intends to set up the National Financial Inclusion Strategy.
Exchange Rate Policy Maintain the exchange rate basket peg at the current level. Be ready to review and adjust the level and composition of the basket if external position worsens significantly.	• The basket peg regime has been working well, and the REER remains broadly in line with fundamentals and desirable policies.
Structural Policies Reform Government Business Enterprises (GBEs).	• The authorities plan to submit the GBE law to the Parliament in March 2018, which is expected to provide a solid foundation for improving GBE governance, accountability, and performance.
Enhance preparedness to natural disaster risk by strengthening risk assessment and planning, building domestic fiscal buffers, securing external buffers, and promoting resilient infrastructure and adequate maintenance.	• There have been many well-documented examples of successful ex-post response in the aftermath of Cyclone Pam by the government, the RBV, and the banks. • Further steps are required to strengthen ex-ante preparedness, including a simpler and more effective response action plan.
Improve quality upgrading in the agriculture sector.	• The authorities recognize the importance of diversification and quality upgrading in the agricultural sector. The authorities are committed to passing legislation this year which aims at tapping Vanuatu's agricultural resources, including serving as an input for the tourism industry—agri-tourism.

Appendix III. Export Diversification in Vanuatu: Some Considerations[1]

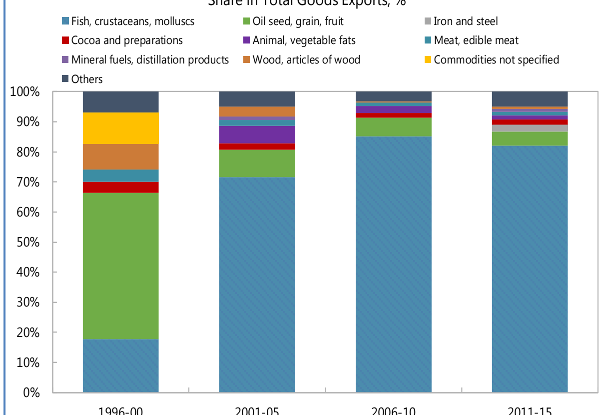
Many developing countries have aimed at export diversification to guard against sharp, and often unanticipated, changes in their terms of trade, which in turn have been associated with instability in growth. Specifically, island economies are characterized by high levels of trade openness with their exports being usually concentrated within a narrow range of goods and services. They also tend to experience higher volatility in growth.[2] Therefore, incorporating diversification into the overall growth strategy acquires greater importance for these economies.

Vanuatu's goods exports as a ratio to GDP stood at 6.8 percent over 2011–15. An analysis at the HS 2-digit shows concentration in primary products (Figure 1).[3] After 2000, the share of "fish, crustaceans, molluscs" in total goods exports rose to 70 percent or more and persisted over time. For 2011–15 on an average, other exports which together accounted for 7 percent share included "cocoa and preparations", "animal, vegetable fats", and "meat, edible meat".

The above facts find resonance in the Concentration Index computed by the United Nations Conference on Trade and Development (UNCTAD). The index suggests that the degree of concentration of Vanuatu's goods exports has been higher compared to its peers for most of the period under consideration, though it has begun to reduce after 2013 (Figure 2).

Figure 1. Vanuatu's Goods Exports

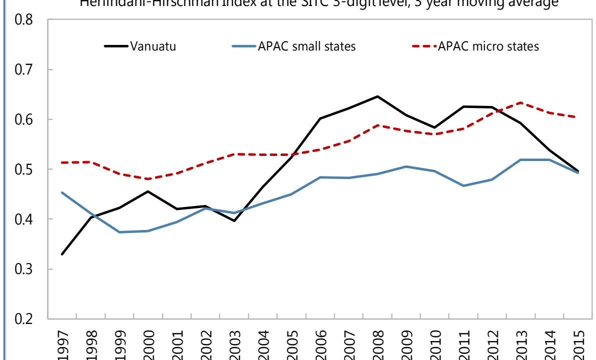
Share in Total Goods Exports, %



Sources: UN Comtrade Database, authors' calculations

Figure 2. Concentration Index of Goods Exports

Herfindahl-Hirschman Index at the SITC 3-digit level, 3 year moving average



Sources: UNCTAD, authors' calculations.
Small states include Fiji, Solomon Islands, and Timor Leste;
Micro states include Kiribati, Marshall Islands, Palau, Samoa, Tonga, and Tuvalu.

A country can diversify its exports by entering new product lines, exporting to new partners, or by upgrading the quality of existing products. From 2000 to 2010, around 95 percent of Vanuatu's fish exports by value were being sent to Japan and Thailand. Their share reduced over 2011–15, with the emergence of Vietnam, China and Korea which together accounted for 8 percent of Vanuatu's fish exports. The markets in Mexico, Ecuador, Singapore, Hong Kong SAR, with

[1] Prepared by Nitya Aasaavari (RES) and Ke Wang (SPR).

[2] "Macroeconomic Issues in Small States and Implications for Fund Engagement", IMF (2013).

[3] Vanuatu has reported its exports in the UN Comtrade database till 2011 only; exports here refer to the imports reported by Vanuatu's partner countries. Using the former, commodities such as "ships, boats", "nuclear reactors, boilers", and "electrical, electronic equipment" which appear to be re-exports have been dropped from exports.

a combined share of 2.5 percent over the same period, could possibly be tapped further. Further, diversification and quality upgradation tend to be complementary. The quality of Vanuatu's fish exports has remained relatively low with an index value of 0.6 over 1998 to 2010; value 1 reflects the 90th percentile among all exporters of that commodity.[4]

A possible opportunity to diversify within primary products lies in increasing beef production. Over 2013–15, Vanuatu exported beef to Japan, Solomon Islands and New Zealand, their respective shares being 55 percent, 40 percent and 5 percent.[5] However, over 2006–10, there were additional destinations—Australia, New Caledonia, Tonga, Fiji, and Kiribati accounted for 16 percent share. Examining the export demand at HS-6 level and the penetration of competitors may reveal if Vanuatu can again export beef to these countries.

Turning to services exports, tourism can be made more inclusive by strengthening its linkages with agriculture, and promoting agri-tourism. A study by FAO shows that developing domestic supply chains in agriculture can increase domestic value-added from the tourism sector, by reducing its dependence on food imports.[6] Recent initiatives, for example, by Vanuatu Chamber of Commerce and Industry to celebrate Vanuatu Agri-Tourism Week are also useful. Further, tourism expansion can be made more sustainable by offering niche options such as eco-tourism, a strategy which is being adopted by Kiribati, Marshall Islands, and Micronesia.[7] However, it remains important to attempt to diversify to other services, given that tourism revenues represent one of the main channels of spillover from a global downturn. In fact, widening the spread of financial services, especially in the outer islands, would facilitate shared prosperity in Vanuatu.

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[4] Based on the quality index compiled by the IMF, for SITC 2-digit product “Fish, fresh, chilled or frozen”, available at - https://www.imf.org/external/np/res/dfidimf/diversification.htm.

[5] Beef exports in the UN Comtrade data have been identified as HS-4 “0201”, “0202” (more than 90% of exports) and HS-6 “020621”, “020629”.

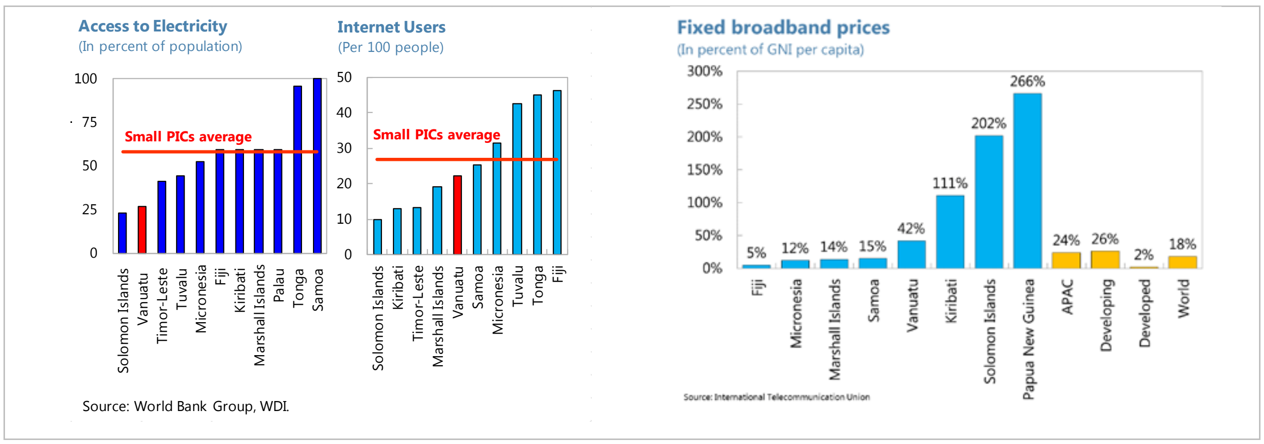
[6] “Linking Farmers to Markets: Improving Opportunities for Locally Produced Food on Domestic and Tourist Markets in Vanuatu”, FAO (2014).

[7] “Asia and Pacific Small States: Raising Potential Growth and Enhancing Resilience to Shocks”, IMF (2013).

Appendix IV. Public Investment, Debt Sustainability, and Natural Disasters in Vanuatu[1]

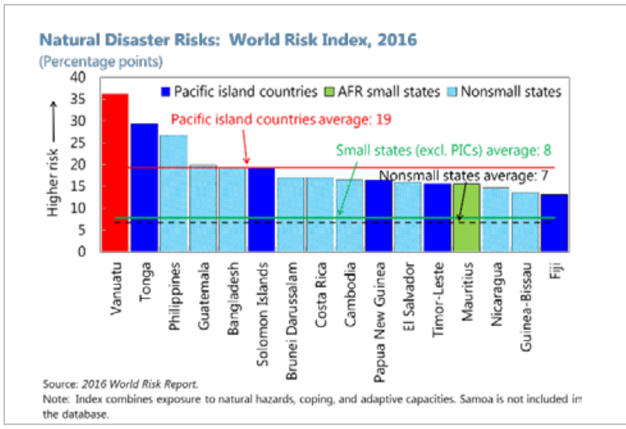
The infrastructure needs in Vanuatu are relatively high, compared with other small states. Vanuatu lags its peers in the access to infrastructure, especially electricity. The number of internet users per 100 people in Vanuatu is lower than the average in other small Pacific Islands countries, while the cost of broadband is higher than the average in developing countries. To address the infrastructure gap, the government launched the Vanuatu Infrastructure Strategic Investment Plan 2015–2024 (VISIP 2015) in August 2015. The plan recognized infrastructure as the foundation for developing urban and rural areas and sustaining industries and commerce. Better infrastructure will help improve living standards and delivering essential community services, and thus expected to drive future economic growth. The plan outlined the country's priorities and suggested how to fund and implement economic and social infrastructure investments. In line with VISIP 2015, the government has accelerated the implementation of the infrastructure projects by borrowing from external creditors, mostly bilateral and multilateral partners. As a result, public and publicly guaranteed debt has increased from 28.7 percent of GDP in 2014 to 48.8 percent in 2016.

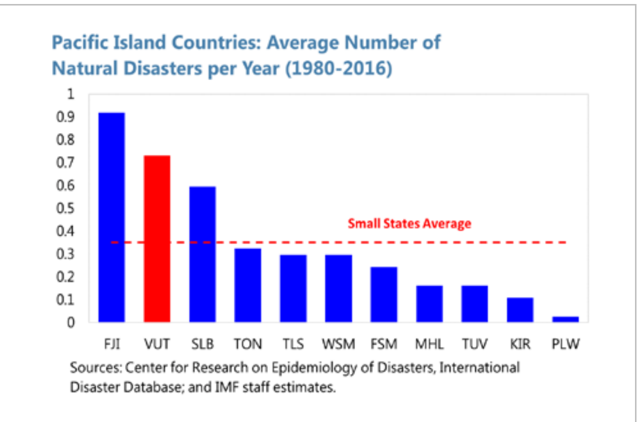
Title



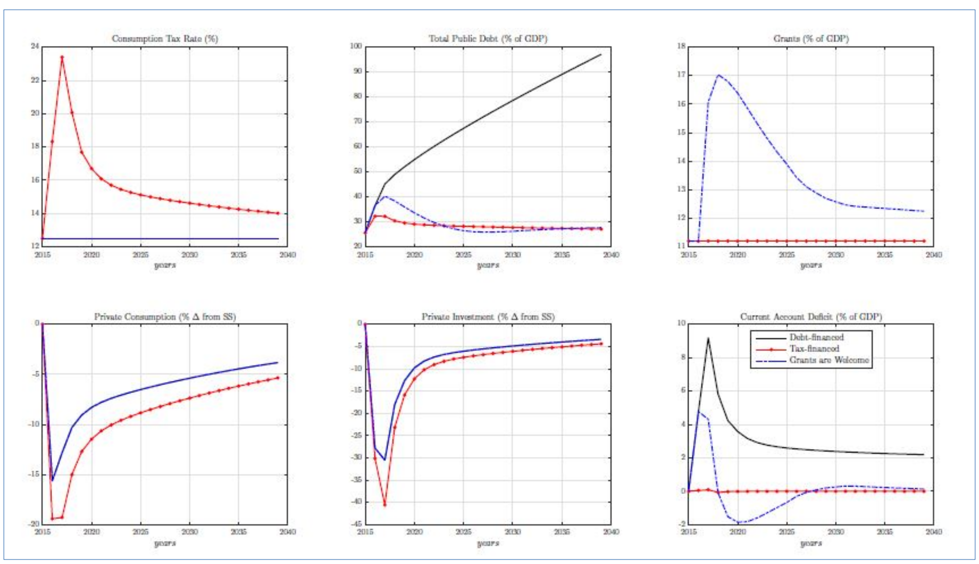
Vanuatu is the one of the most vulnerable countries to natural disasters. According to the UN World Risk Index, the country is ranked first as the country most at risk of natural disasters. In March 2015, it was hit by a category five cyclone— Cyclone Pam—one of the most devastating natural disasters in the Pacific region's history, inflicting damages and losses of about 60 percent of GDP and affecting more than 70 percent of the population. The damages to tourism and transport infrastructure were expected to be at 11 percent of GDP. The international community, such as the IDA and the ADB, has supported reconstruction projects for school and road by providing loans and grants to the country.

[1] Prepared by Hidetaka Nishizawa and Ricardo Marto (University of Pennsylvania).





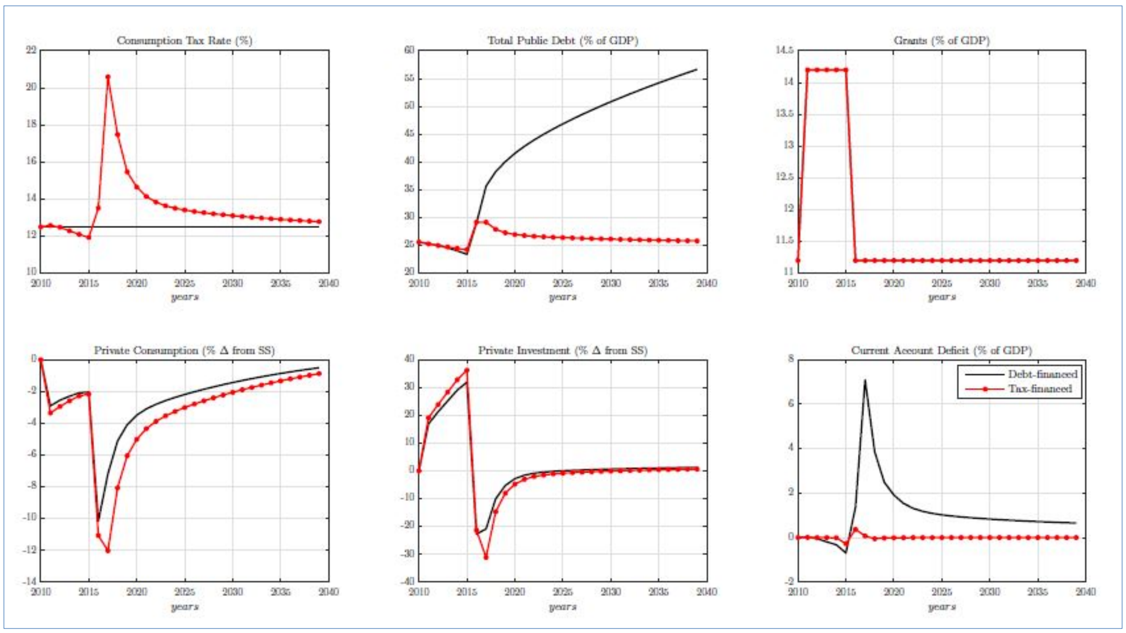
As much as possible, Vanuatu should receive financial support for reconstruction in the form of grants, to safeguard fiscal and debt sustainability over the medium term. The recent IMF working paper[2] uses a dynamic small open economy model to study the debt sustainability concerns that arise from the need to rebuild public infrastructure over the medium term. The figure below presents the trajectory of endogenous variables for three scenarios, where the fiscal gap is entirely financed by (1) an increase in consumption taxes, (2) external borrowing, or (3) external grants, which are provided exogenously, mimicking the large inflow of grants needed to sustain the accelerated reconstruction program. Under scenario (1), the government would have to raise the consumption tax rate from 12.5 percent to close to 23 percent in the short term and to about 14 percent over the medium term, adversely affecting private consumption and private investment by 20 percent and 40 percent, respectively, relative to its pre-Pam level. Under scenario (2), public debt would exceed 90 percent of GDP in the medium term. Scenario (3) preserves both debt sustainability and macroeconomic stability. Also, external grants often come with substantial technical assistance, enforcing stricter rules regarding procurement as well as enhancing the functioning of institutions to help cope with the disaster's consequences.



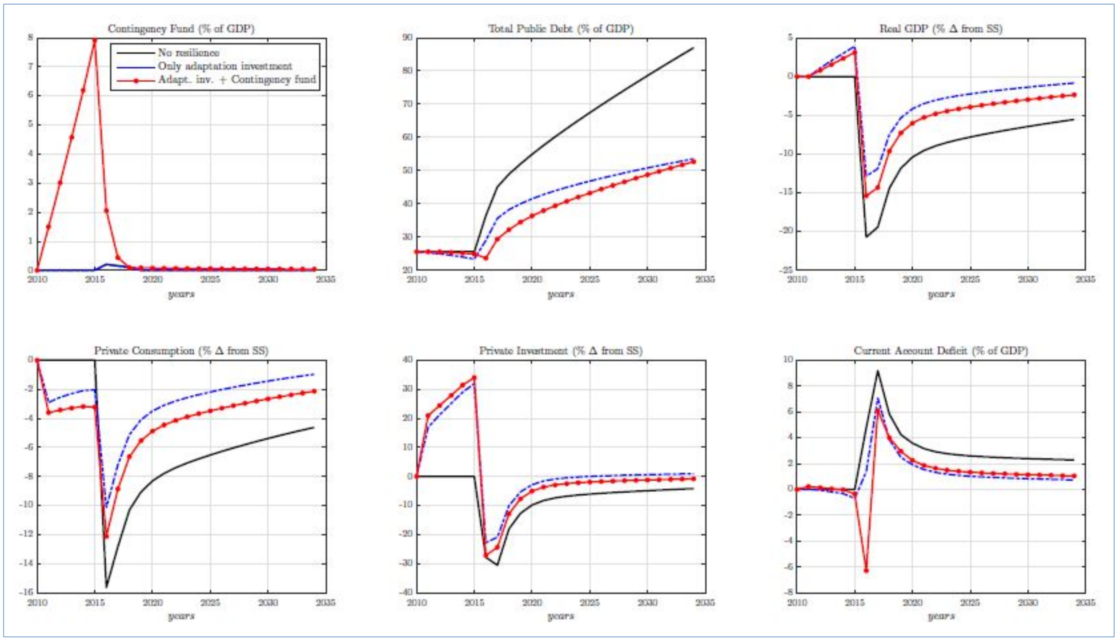
[2] "Building Resilience to Natural Disasters: An Application to Small Developing States ", IMF Working Paper (2017) by Ricardo Marto, Chris Papageorgiou, and Vladimir Klyuev.

Vanuatu needs to consider two policy options to prepare for natural disasters in the future: (i) investing in adaptation infrastructure and (ii) saving proceeds in an external contingency fund.

(i) **Investing in Resilient Infrastructure:** The paper considers the case in which the government to decides to spend 3 percent of GDP per year in adaptation infrastructure in the five years prior to Cyclone Pam—expenditures being entirely funded by donors. The result shows that investing in adaptation would have reduced damages to public and private infrastructure. Thus, fiscal and debt sustainability concerns are attenuated owing to the buildup of resilient capital. Investing in adaptation helps reduce the risks of debt distress, with public debt reaching less than 60 percent of GDP over the medium term (as opposed to 100 percent of GDP in the previous section), while the tax-financed reconstruction program requires a less demanding fiscal adjustment.



(ii) **Building Fiscal Buffers:** The paper also considers the case in which the government decides to allocate annually half of the 3 percent of GDP to adaptation investments and the other half saved in a contingency fund reaching about 8 percent of GDP at the time of the disaster. The availability of financial resources allows the government to start reconstruction without the need for additional borrowing in the short term. Building fiscal buffers allows the government to live with lower debt-to-GDP levels compared with only investing in resilient infrastructure over the medium term. However, GDP is more affected in the former case than in the latter since the infrastructure is not as resilient as with full adaptation investments.



Policy Implications:

(1) Given the high level of public debt, external disbursements should be contracted as much as possible on concessional terms or in the form of grants to keep the debt burden contained.

(2) The government should consider prioritizing public spending towards developing resilient infrastructure and/or better support the maintenance of existing infrastructure.

(3) Given Vanuatu's vulnerability to natural disasters, the government should rebuild fiscal buffers over the medium term through reprioritizing spending and mobilizing new revenue resources. This self-insurance mechanism would allow the government to respond swiftly to relatively frequent but small size (in damages) natural disasters by establishing a contingency fund or any other financial mechanism.

Appendix V. Revenue Modernization and Reforms in Vanuatu[1]

To provide the appropriate level of government revenues to deliver services that meet the community's needs, the Vanuatu Council of Ministers launched a review of *Revenue Modernization and Reform—Building an Effective Tax System/Regime* in March 2016. Further objectives of the review were to improve the efficiency, effectiveness and fairness of revenue collections and modernize the tax administration. Currently, the Value-Added Tax (VAT) provides almost 40 percent of total revenues excluding grants; a range of fees and charges, which are costly to collect and comply with, are levied. Tax reform options were developed by a Revenue Review Project Team (RRPT) with the Director of Finance and Treasury as the project leader, and members drawn from the Department of Finance and Treasury, the Prime Minister's Office, the Department of Customs and Inland Revenue, the Vanuatu Chamber of Commerce, the State Law Office and the Law Commission. Tax reform scenarios were built based on previous IMF advice.

Model of the Vanuatu Economy (MOVE), an empirical analysis using a macroeconomic and fiscal framework, played an important part in supporting the authorities to develop a methodology to enhance revenue forecasts, and tools to evaluate the impact of tax reform options. The MOVE was developed by the Reserve Bank of Vanuatu, the Ministry of Finance and Economic Management (MFEM) with inputs from the Vanuatu Statistics Office (VNSO) and the Department of Customs and Inland Revenue (DCIR), and supported by the IMF's Pacific Financial Technical Assistance Centre (PFTAC).

A tax reform proposal report and recommendations were presented to the Governance Committee in late May-June 2017. The committee is chaired by the Honorable Minister of Finance and Economic Management and comprises the Directors General of the Ministry of Finance and Economic Management, the Prime Minister's Office, the Ministry of Trade, Tourism, Commerce, Industry and Ni-Vanuatu Business, the Ministry of Infrastructure and Public Works Utilities, the Attorney General, the Parliamentary Secretary and the Parliamentary Committee. The proposal included: (i) abolishing fees and charges that are costly to collect and comply with, to reduce the cost of doing business in Vanuatu; (ii) bringing forward the PACER Plus reductions in import duties over five years, to lower the cost of living as well as the cost of capital, and to support investment and economic growth; and (iii) introducing an income tax for individuals (with a tax-free threshold) and companies, to shift the tax burden to higher income earners.

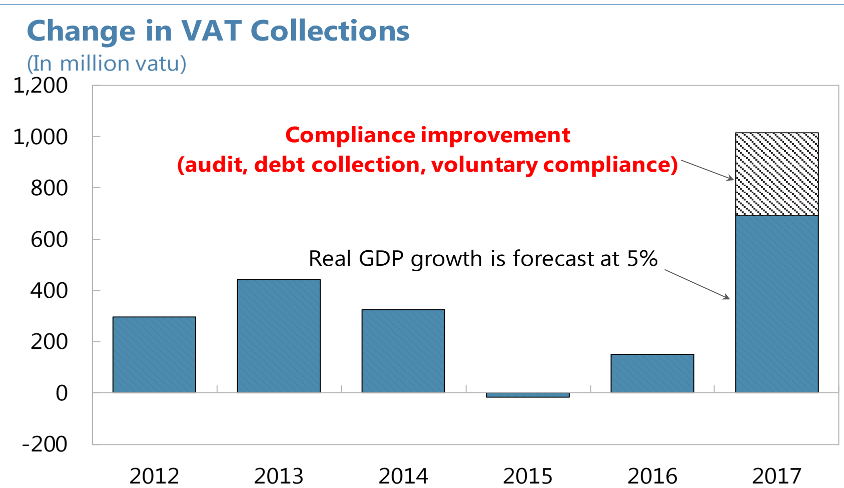
As part of these reforms, Vanuatu requested PFTAC technical assistance to support administrative improvements. These included:

- Developing a risk-based approach to compliance management;
- Detailed plans and guidance to facilitate the transition to a new functional operating model in line with the Government's tax reform agenda;
- Setting up a Reforms and Modernization Project Team, with appropriate reporting lines and overall governance arrangements to ensure that high-quality objectives are achieved;

[1] Prepared by Stan Shrosbree (PFTAC).

- Hands-on assistance in setting up new core tax and support functions—the new functional business model was successfully introduced on 11th July 2017 with the Inland Revenue Division, and creating management/staff awareness of new ways of work and administrative benefits from the functional approach;
- Guidance on absorbing and Income Tax into the new functional model, its impact across core tax functions and necessary alignment to DCIR IT systems.

Numerous PFTAC/IMF missions also assisted in facilitating the drafting of new Laws, Tax Administration Act and Regulations, reviews of the Value-Added Tax Act and Rent Tax Act, a new corporate strategy (5 years), and synchronizing the roll-out of modernized IT systems. A recent analysis of increased tax revenues shows that Vanuatu's Compliance Improvement Strategy is delivering results (see Figure). Although the Compliance Risk Management approach is still in its infancy, inroads have been made into increasing the number of audits, and reducing the number of outstanding tax returns. Through greater public awareness of tax obligations, the levels of voluntary compliance have increased as reflected below. This new risk-based approach to managing compliance and developing treatment strategies for non-compliers is in its second year. A recent PFTAC review highlighted potential areas of improvement, which will be considered in a renewed 2018-2019 Compliance Improvement Plan currently under development.



Notes: 2017 GDP is estimated from data to July and past VAT collection trends. VAT collections are those reported in the Government Finance Statistics (i.e. they net out VAT paid by government).
Source: PFTAC using the Model Of the Vanuatu Economy (MOVE).

INTERNATIONAL MONETARY FUND

VANUATU

March 22, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION —INFORMATIONAL ANNEX

Prepared By	The Asia and Pacific Department (In consultation with other departments)

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FUND RELATIONS

(As of February 28, 2018)

Membership Status: joined September 28, 1981; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	23.80	100.00
Fund holdings of currency	28.11	118.09
Reserves tranche position	4.20	17.63

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocations	16.27	100.00
Holdings	1.09	6.68

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	8.50	35.71
Emergency Assistance [1/]	8.50	35.71

[1/] Emergency Assistance may include ENDA, EPCA, and RFI.

Latest Financial Arrangements: None

Projected Payments to the Fund [2/]
(SDR million; based on existing use of resources and presenting holdings of SDRs);

	Forthcoming 2018	2019	2020	2021	2022
Principal	2.13	4.25	2.98	1.70	1.70
Charges/Interest	0.21	0.22	0.15	0.12	0.12
Total	2.33	4.47	3.12	1.82	1.82

[2/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative: Not applicable

Implementation of Post-Catastrophe Debt Relief: Not applicable

Exchange Arrangements

Since 1988, Vanuatu has officially maintained an adjustable peg exchange rate arrangement. Currently, the exchange rate of the vatu is linked to a transactions-weighted (trade and tourism receipts) basket of currencies. The weights and composition of the basket, which are not publicly disclosed, are adjusted periodically. The Reserve Bank of Vanuatu (RBV) quotes daily buying and selling rates for the vatu against the U.S., Australian, and New Zealand dollars; the euro; the U.K. pound; and the Japanese yen. The rate in terms of the U.S. dollar as of March 9, 2018 was VT 107.01 per U.S. dollar. The de facto classification is "other managed," as the composite weights are not disclosed and cannot be confirmed. Vanuatu has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

Article IV Consultation

Vanuatu is on a 12–month consultation cycle. The previous Article IV consultation mission took place during July 13–26, 2016 and the consultation was concluded on October 21, 2016 (Country Report No. 16/336).

OFC Assessments

The most recent Offshore Financial Center Module II Assessment, conducted by MFD, was concluded in May 2006.

Safeguards Assessments

The first safeguards assessment of the RBV was completed in October 2016. The assessment found that the RBV has a recognized accounting framework and publishes annual financial statements, albeit with some delay. It also identified several weaknesses in its governance arrangements, autonomy, transparency, and audit mechanisms. Recommendations included: (i) drafting amendments to the RBV Act to align it with leading practices for central banks; (ii) establishing an Audit Committee; (iii) outsourcing internal audit services to an independent international audit firm; and (iv) formulating a recapitalization plan. Progress on the implementation of the recommendations has been slow.

Technical Assistance

LEG, MCM, and PFTAC have provided more than 20 technical assistance missions between August 2016 and February 2018 including fiscal tax law, national accounts statistics, government finance statistics, reserve management, RBV recapitalization, internal audit, and public financial management.

Purpose	Date	Department
National Accounts	Aug. 15-19, 2016	PFTAC
Credit Union Program and Capacity Building	Oct. 10-19, 2016	PFTAC
Review of PFM Roadmap	Oct. 17-21, 2016	PFTAC
Fiscal Tax Law	Oct. 24-Nov. 4, 2016	LEG
Upgrade of the Revenue Management System	Nov. 17-25, 2016	PFTAC
Internal Audit	Nov. 2-15, 2016	PFTAC
Fiscal Tax Law	Jan. 4-18, 2017	LEG
Fiscal Tax Law	Mar. 6-10, 2017	LEG
Supervision Framework Enhancement Program	May 1-7, 2017	PFTAC
Reserve Bank of Vanuatu on Supervision Framework Enhancement	May 1–9, 2017	PFTAC
Reserve Management	May 23–Jun. 6, 2017	MCM
Reserve Bank of Vanuatu Recapitalization	May 31-Jun. 13, 2017	MCM
Capacity-Development on Accounting and Reporting Scoping Mission	Jul. 3-14, 2017	PFTAC
Compliance Risk Management	Jul. 3-12, 2017	PFTAC
Fiscal Tax Law – Income Tax	Jul. 20-27, 2017	LEG
National Accounts	Aug. 7-18, 2017	PFTAC
Strengthen Organization Structure	Aug. 14-Sep. 1, 2017	PFTAC
Using the National Framework for Revenue Forecasting in Budget Preparations	Aug. 20-Sep. 2, 2017	PFTAC
Development of Accounting Regulation and Manual	Oct. 23-Nov. 3, 2017	PFTAC
Government Finance Statistics	Nov. 6-17, 2017	PFTAC
Strengthening Internal Audit	Nov. 15-Dec. 5, 2017	PFTAC
Development of Accounting Regulation and Manual	Nov. 27-Dec. 5, 2017	PFTAC

Resident Representative

The resident representative office for the Pacific Islands, including Vanuatu, was opened in September 2010 in Suva, Fiji and Mr. Tubagus Feridhanusetyawan was the Resident Representative until February 5, 2018. Ms. Leni Hunter is the incoming Resident Representative.

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)

(As of February 2018)

Economic Statistics

Vanuatu received technical assistance (TA) as part of the three-year Government Finance Statistics (GFS) capacity-building project for selected Asian and Pacific Island Countries, funded by the Japan Administered Account for Selected IMF Activities (JSA1) till late 2015. PFTAC conducted a mission in November 2017, focusing on expanding coverage to the rest of the general government and reconciling GFS data publications between the Department of Finance and Treasury, National Statistics Office and the Reserve Bank. The mission further assisted in the compilation and dissemination of the Budgetary Central Government GFS data (2012–2016) for the annual *Government Finance Statistics Yearbook*.

The Vanuatu National Statistics Office (VNSO) has benefited from five national accounts TA missions since 2012 (most recently in August 2017) and attendance at annual sub-regional workshops. TA had focused on developing quarterly GDP estimates as well as an intended rebase, but staff losses caused delays in GDP publication, and forced TA to refocus on support for basic functionality. By August 2017 however, capacity had improved, and the last mission improved the use of administrative data, estimated the impact of Cyclone Pam and set out a new plan to rebase in 2019/2020. The next mission should take place in the first half of FY2019.

Public Financial Management (PFM)

Vanuatu has regularly sent officials to PFTAC-sponsored regional training events. During FY2017 and FY2018, several missions were conducted to: (i) develop a PFM Reform Roadmap following on from a PEFA self-assessment; (ii) formulate a medium-term accounting and reporting reform plan leading to orientation of government accountants on the basic principles and features of IPSAS and developing accounting policies/regulations; and (iii) building capacity in internal audit and the development of strategic and annual plans and development of an internal audit manual.

Follow-up TA is planned in FY2019 to meet the requests of the Ministry of Finance including: (i) improving the 2019 Vanuatu Budget; (ii) payroll systems and procurement audit; (iii) progress review of the recommendations to improve accounting internal control; and (iv) capacity-development in adopting the new accounting regulations.

Macroeconomics

In the macroeconomic area, PFTAC has provided assistance to the Reserve Bank of Vanuatu (RBV) in developing a Model Of the Vanuatu Economy (MOVE). The MOVE, which generates medium-term projections within an internally consistent macroeconomic and fiscal framework, has been used by the Ministry of Finance and Economic Management (MFEM) to inform a review of Vanuatu's tax system. MFEM has also implemented revenue forecasting by industries which is possible because of the consistent use of industry classification by the Department of Customs and Inland Revenue

(DCIR) and the VNSO. In addition, staff members from the Office of the Prime Minister, MFEM, the RBV, and the VNSO participated in regional workshops on GDP compilation and forecasting and medium-term expenditure planning for national sustainable development.

Tax Administration

Supported by PFTAC, Vanuatu has made steady progress over the last few years which has included: (a) implementation of a new strategic and business plan; (b) a risk-based compliance improvement strategy; (c) implementation of performance standards; and (d) the development of an IT strategy followed by the implementation of an IT system that has facilitated taxpayer compliance. A Revenue Review Governance Committee and a Project Team have made recommendations for modernizing Vanuatu's tax system including introduction of Income Tax (as previously recommended by the IMF), and an enhanced organizational structure and governance arrangements which PFTAC supported through technical assistance missions.

Financial Supervision

In 2017, PFTAC assisted the Reserve Bank of Vanuatu with developing its regulatory framework for credit unions, and will continue that work with a mission in April 2018, to assist the Reserve Bank in finalizing drafting of the Credit Union law and prudential standards. In 2018, PFTAC will also assist the Reserve Bank in enhancing its risk-based supervision framework by developing an effective risk-rating and supervisory action planning process.

RELATIONS WITH THE WORLD BANK

(As of February 2018)

The Bank and Fund country teams have exchanged views on the main macroeconomic issues facing Vanuatu and appropriate policy responses.

Fiscal Issues
The teams agree that careful fiscal planning will be required to finance necessary development expenditure (including Cyclone Pam-related reconstruction spending) while at the same time ensuring debt sustainability. Where possible, the authorities should seek external financing on grant or highly concessional credit terms. The authorities should also aim to rebuild fiscal buffers over the medium term, including by taking steps to increase domestic revenues through the introduction of income and corporate taxes. The teams agree that formulating an infrastructure investment plan in line with national priorities, and ensuring discipline and allocative efficiency in public expenditure more generally, will be important in responding to fiscal challenges.

Public Investment
The scaling up of investments in infrastructure should be complemented with broad reforms aimed at enhancing the business environment, promoting tourism (including in newer long-haul markets), and improving the resilience, consistency and quality of agricultural output. The teams welcome efforts to strengthen institutions for climate change adaptation and disaster risk management, including the recently-established early warning systems. Both teams noted the importance of promoting inclusive growth, which will be supported by government strategies to ensure the widespread provision of basic services and employment opportunities, particularly in the less-populated islands.

Exchange Rate and AML/CFT Issues
The teams agree that the vatu peg to a basket of currencies has served Vanuatu well and should be maintained, given the importance of exchange rate stability for maintaining confidence. Both the IMF and the Bank welcome the government's commitment to address current deficiencies in controls on anti-money laundering and combating the financing of terrorism, noting considerable progress in technical compliance with a number of legislative amendments,

Collaboration
The teams have the following requests for information and collaboration from their counterparts:

- The Fund team requests to be kept informed of progress in various projects and analytical work undertaken by the Bank in order to use resources efficiently and avoid work overlaps.
- The Bank team requests that the Fund make available to the Bank its latest macroeconomic assessments and macroeconomic data from time to time, as inputs to the Bank's lending and non-lending operations.

- Further details on collaboration, as necessary, will be agreed at the technical level as work progresses. Table 1 details the specific activities planned by the two country teams over the next year, along with their expected deliverables.

Table 1. Vanuatu: Bank and Fund Planned Activities in Macro-critical Structural Reform Areas
(March 2018–April 2019)

	Products	Expected Delivery Date
Bank Work Program	• Support improvements in the operational safety and oversight of international air transport and associated infrastructure in Vanuatu, including rehabilitation and works at Bauerfield International Airport. Support for emergency reconstruction to repair cyclone-related damage to airports. • Support the reconstruction and improved disaster resilience of selected public-sector assets in provinces affected by TC Pam, including roads, schools, and other public buildings. • Support increased access to electricity services in and around Port Vila, as well as for rural and lower-income households. Technical assistance on the government's energy sector work program. • Assist in increasing the resilience of communities in Vanuatu to the impacts of climate change and natural hazards on food and water security, including through strengthened disaster risk management and preparedness. • Support regulatory reform in telecoms and ICT. • Technical assistance to improve public financial management and identify the appropriate level and mix of financing in the health sector. • Technical assistance for public debt management (building on the Debt Management and Performance Assessment conducted in 2014, and the Medium-Term Debt Strategy supported in 2015). • Technical assistance to develop a strategy and technical options for piloting affordable and resilient housing settlements in selected areas exposed to natural hazards.	Ongoing (FY18) Ongoing (FY18) Ongoing (FY18) Ongoing (FY18) Completed (FY17) Ongoing (FY18) Ongoing (FY18) Ongoing (FY18)
Fund Work Program	• Surveillance (Article IV consultation mission), including a joint debt sustainability analysis • Technical assistance on improvement of national accounts statistics and rebasing (PFTAC). • Technical assistance on developing comprehensive tax reform strategy, legislation, and implementation.	April 2018 2018-2019 2018-2019

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of February 2018)

Operational Strategy

The Pacific Approach, 2016–2020 serves as the operational framework of the Asian Development Bank (ADB) for the Pacific region. The ADB program in Vanuatu contributes to the objectives of the Pacific Approach by: reducing costs; managing risk; and enabling value creation. ADB's country operations business plan for 2018–2020 is aligned with the government's priorities and continues ADB's support in (i) transport; (ii) urban development; and (iii) energy. Consistent with the government's strategy of fostering private sector-led growth, ADB has also focused on improving access to financial services, reforming business laws, and supporting state-owned enterprise (SOE) reform.

ADB's indicative allocation to Vanuatu of Asian Development Fund loan and grant resources is USD37.29 million for 2017–19, including USD9.73 million in disaster risk reduction financing. To leverage ADB's impact and reduce borrowing costs, co-financing opportunities will be pursued with other development partners.

Portfolio Status

Since joining ADB in 1981, Vanuatu has received 16 loans amounting to USD95.96 million, 14 grants totaling USD83.40 million, and 69 TA projects totaling USD23.05 million. More than 50 percent of the loans and TA projects were for the transport sector. There are six ongoing projects totaling USD128.80 million, including a grant provided by the Asia Pacific Disaster Response Fund after the September 2017 Manaro volcano eruption. There are two ongoing TA projects amounting to USD1.87 million: TA 7938-VAN: Establishment of the Maritime Safety Administration; and TA 9263-VAN: Supporting the Vanuatu Project Management Unit and the Ministry of Infrastructure and Public Utilities.

Interisland Shipping Support Project

The project aims to improve the efficiency and effectiveness of interisland shipping services. It comprises: (i) infrastructure investments in Port Vila and five outer islands, and (ii) establishment of a shipping support scheme to catalyze the provision of services to remote noncommercial destinations. The project is complemented by TA to improve sector governance. ADB is providing a loan of USD29.30 million, the Government of New Zealand a parallel grant of USD17.25 million, and the Government of Vanuatu USD5.57 million.

Port Vila Urban Development Project

The project aims to support affordable and effective drainage, roads, and sanitation systems that are climate resilient and sustainable in and around Port Vila. ADB is providing a loan of USD5.00 million and administering the corresponding grant of USD31.00 million from the Government of Australia. The Government of Vanuatu is providing a contribution of USD3.10 million. An additional grant of USD2.87 million from the Global Environment Facility was approved in December 2016.

Energy Access Project

The project aims to increase energy access and renewable energy generation on the islands of Espiritu Santo and Malekula, which are the second and third largest population centers after Efate.

The project will assist Vanuatu install hydropower generation to replace diesel generation in Malekula and will extend the distribution grid in both Malekula and Espiritu Santo. The project was approved in December 2017. ADB is providing a USD2.50 million loan, a USD2.50 million grant, and is administering a USD12.00 million grant from the Strategic Climate Fund.

Private Sector Development

The Pacific Private Sector Development Initiative (PSDI) is a regional technical assistance facility co-financed by the Government of Australia, the Government of New Zealand, and ADB. PSDI works with Pacific developing member countries to improve the enabling environment for business and support inclusive, private sector-led economic growth. ADB's support under PSDI focuses on (i) improving access to financial services; (ii) business law reform; and (iii) state-owned enterprise reform.

- **Improving Access to Financial Services.** ADB supported the secured transactions framework reform through the drafting and passage of the Personal Property Securities Act, and the installation, and later upgrade, of an electronic registry to record the filing of security interests.
- **Business Law Reform.** ADB assistance has focused on drafting a new Companies Act, a new Companies (Insolvency and Receiverships) Act, and a new Insolvency (Cross Border) Act. Support was also provided for online companies, business names, and charitable associations registry.
- **State-Owned Enterprise Reform.** ADB supported preparation of an SOE reform policy, approved by Cabinet in October 2013, and the subsequent drafting of SOE legislation. ADB has also been working with several SOEs on reform and rationalization strategies, including recommending liquidation where appropriate.

Cyclone Response

Following Tropical Cyclone Pam in March 2015, ADB's immediate support to the government comprised (i) the approval of USD1.0 million grant financing from the Asia Pacific Disaster Response Fund, and (ii) deployment of urban and infrastructure specialists to Port Vila. This was followed by approval of the: Cyclone Pam School Reconstruction Project (USD5.00 million), co-financed by the Government of Japan; and the Cyclone Pam Road Reconstruction Project (USD24.50 million).

Proposed Pipeline Projects

ADB's forward pipeline includes a proposed urban development project for Luganville and a second phase of the Port Vila Urban Development Project. A Project Development Facility is also proposed to support project design and implementation readiness of infrastructure projects. Vanuatu's participation in regional projects relating to the finance sector is being discussed with the government.

ADB Extended Mission in Vanuatu

An ADB–World Bank joint Development Coordination Office was opened in Port Vila in June 2010. In 2017, ADB upgraded the Development Coordination Office to an Extended Mission (EM-VAN), further strengthening ADB's presence on the ground.

The ADB's Pacific Liaison and Coordination Office in Sydney is responsible for country programming in Vanuatu, supported by the Pacific Operations Division in Manila.

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance	
General: Data provision has shortcomings, but is broadly adequate for surveillance. In particular, national accounts and external sector statistics need to be further improved, while the coverage of government finance statistics could be expanded. Reporting lags could be shortened.	
National accounts: While there have been improvements in the methodology and the development of additional data sources, the accuracy of expenditure-based GDP estimates could be further improved. Data are compiled only on an annual basis and timeliness have been negatively impacted by limited staffing resources. Recent staff unsettling in 2016 resulted in a 10-month delay in releasing the 2015 GDP estimates and set back plans to rebase GDP to 2010 and develop a new quarterly measure. Due to supplementary work by PFTAC, preliminary 2016 estimates have now been published and the timeline for new benchmark estimates have been shifted to FY2019. PFTAC continues to provide interim supplementation in national accounts compilation and has set out a plan to revive rebasing plans and other development work during FY2019 and FY2020. **Price statistics:** The CPI weights are based on 2006 household surveys, and only cover the two urban centers of Port Vila and Luganville. Rebasing the CPI to a more recent base year may start after a new Household Income and Expenditure Survey in 2018.	
Government finance statistics: Budget classification is broadly consistent with the *GFSM2001*. Work is underway to migrate budget classification to the *GFSM2014*. The November 2017 mission assisted the authorities to expand coverage to the rest of the general government by investigating data sources and including extrabudgetary units of the central government, and provincial and local governments. Budgetary central government (BCG) data compiled and disseminated by the Department of Finance and Treasury (DoFT), National Statistics Office and the Reserve Bank produce statistical discrepancies and should be reconciled. GFS data is published monthly by the DoFT but not reported to STA for inclusion in the International Financial Statistics (*IFS*). A process should be initiated to reconcile financial balance sheet transactions (financial and nonfinancial assets and liabilities) causing imbalances between the net lending borrowing and financing requirement. BCG data for 2012–2016 was submitted for the annual *Government Finance Statistics Yearbook* by the end of the November 2017 mission.	
Monetary statistics: Monetary statistics are compiled broadly in line with the *Monetary and Financial Statistics Manual*. The Reserve Bank of Vanuatu (RBV) reports monthly monetary data, using Standardized Report Forms (SRFs) for the central bank and other depository corporations, which are published in the *International Financial Statistics*. Following a regional workshop in 2016, the RBV also reports Financial Soundness Indicators (FSIs) on a quarterly basis which include all 12 core and 7 encouraged indicators for deposit takers. While reported on an annual basis, information on the Financial Access Survey is sparse and reported with long lags.	
External sector statistics: The RBV releases quarterly BOP data in its Quarterly Economic Review. A special Debt Unit has been created within the Ministry of Finance in 2015 for public debt management and recording; however, the recording and management of public debt needs further improvement. Two external sector statistics missions visited Vanuatu in the second half of 2015 to assist the authorities in improving the collection and reporting of external debt and external sector statistics.	
II. Data Standards and Quality	
Participant in the General Data Dissemination System (GDDS) since April 2004.	No data ROSC is available.

Vanuatu: Table of Common Indicators Required for Surveillance

(As of February 2018)

	Date of latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]
Exchange Rates	9/2017	2/2018	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	9/2017	2/2018	M	M	M
Reserve/Base Money	9/2017	2/2018	M	M	M
Broad Money	9/2017	2/2018	M	M	M
Central Bank Balance Sheet	9/2017	2/2018	M	M	M
Consolidated Balance Sheet of the Banking System	9/2017	2/2018	M	M	M
Interest Rates[3]	9/2017	2/2018	Q	Q	Q
Consumer Price Index	9/2017	2/2018	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government	N/A	N/A	N/A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing[4]—Central Government	9/2017	2/2018	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2016	10/2017	A	A	A
External Current Account Balance	9/2017	2/2018	Q	Q	Q
Exports and Imports of Goods and Services	3/2017	2/2018	Q	Q	Q
GDP/GNP	2016	2/2018	A	A	A
Gross External Debt	12/2016	10/2017	Q	Q	Q
International Investment Position	9/2017	2/2018	Q	Q	Q

[1] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), and Not Available (N/A).

[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[3] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[4] Foreign and domestic financing.

[5] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

INTERNATIONAL MONETARY FUND

VANUATU

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

March 22, 2018

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Prepared by the Staffs of the International Monetary Fund and the International Development Association (IDA).

This update of the debt sustainability analysis (DSA) for Vanuatu shows that external risk of debt distress remains moderate. External PPG debt to GDP began to rise in 2014, increasing sharply through end-2016. An upward trend in this measure is anticipated to continue over the next few years due to the planned implementation of public infrastructure projects and reconstruction activities. This increase in indebtedness is expected to be manageable, provided the financing terms are concessional, and the surge in financing needs is temporary. However, given the country's high vulnerability to natural disaster shocks and increased debt service burdens in the medium term, the authorities should be vigilant about rapid debt accumulation. They should take into account the country's absorptive capacity when considering the pace and scale of new borrowing. Also, such borrowing should continue to be on concessional terms to reduce the debt burden. Furthermore, the authorities should consider updating the debt management strategy annually, stand ready to reprioritize spending, and seek ways to increase revenues (including by introducing an income tax) to rebuild fiscal buffers against shocks, including natural disaster shocks.[1].

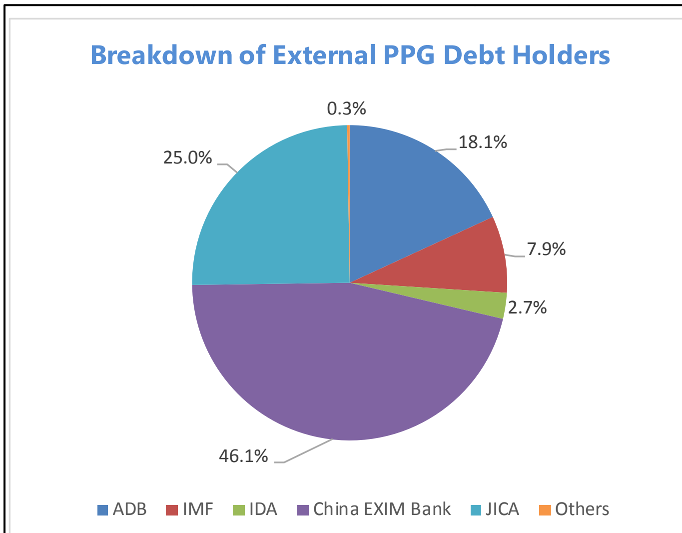
[1] This DSA was prepared jointly with the World Bank, in accordance with the standard Debt Sustainability Framework for Low-income Countries (LIC DSF) approved by the Executive Boards of the IMF and the IDA. Debt sustainability is assessed in relation to policy-dependent debt burden thresholds. Vanuatu, with an average Country Policy and Institutional Assessment (CPIA) score of 3.40 over the last three years, is considered to have moderate policy and institutional capacity for the purposes of the DSA framework. Thus, the external debt burden thresholds for the FSM are (i) PV of debt-to-GDP ratio: 40 percent; (ii) PV of debt-to-exports ratio: 150 percent; (iii) PV of debt-to-revenue ratio: 250 percent; (iv) debt service-to-exports ratio: 20 percent: and (v) debt service-to-revenue ratio: 20 percent.

BACKGROUND

1. **Vanuatu's external public debt has risen sharply since 2015 when Cyclone Pam hit the country**—external public and publicly guaranteed (PPG) debt increased from 16.3 percent of GDP in 2014 to 30.5 percent in 2015 and then rose further to 37.6 percent in 2016. This was mainly driven by disbursements for infrastructure projects from bilateral creditors, which kickstarted construction in 2015 despite Cyclone Pam's disruption, and accelerated it in 2016. The IMF's quick RCF/RFI disbursement of USD 23.8 million in June 2015 catalyzed the international community's efforts to support Vanuatu's recovery from Cyclone Pam. The IDA and ADB also have supported the country's reconstruction efforts by providing loans and grants. Vanuatu has received loans from bilateral and multilateral donors for both development and reconstruction.

2. **The government prepared its first debt management strategy (DMS) 2015–2017 in August 2015.** The overall objective of the DMS is to minimize the cost of public debt, consistent with the government's tolerance for financial risk of the existing public debt portfolio. To achieve this, the government set six specific objectives for the 2015–2017 period. One of these is to maintain the present value (PV) of public external debt below 40 percent of GDP. Another is to minimize the cost of public debt by contracting external loans with a grant element of at least 35 percent. The government will update the strategy in 2018.

3. **External PPG debt stood at US$290 million[2] (37.6 percent of GDP) as of end-2016, and bilateral creditors have emerged as a greater source of funding than multilateral creditors.** China EXIM Bank and JICA accounted for 46.1 and 25.0 percent of total external PPG debt respectively, while the share of multilateral creditors—the IMF, ADB and IDA—amounted to 28.7 percent. Loans were contracted on concessional terms, with the interest rates on debt fairly low (0-2 percent), and loan maturity long (20-40 years). This is due to a relatively high grant element of debt resulting in a low debt service burden. Due to data limitations, external liabilities of commercial banks have been used as a proxy for private external debt.



Sources: Vanuatu authorities and IMF staff estimates.

[2] The revision to the debt stock was made due to higher-than-expected disbursements in 2015 for donor-funded projects.

4. Public domestic debt, comprised of central government bonds, stood at VUV 7.4 billion as of end-2016 (about USD 65.2 million, or 8.5 percent of GDP). The bonds were largely held by public corporations (primarily the Vanuatu National Provident Fund), followed by the Reserve Bank of Vanuatu and commercial banks. The government provides guarantees for Government Business Enterprises (GBEs), such as Air Vanuatu. Publicly guaranteed debt is estimated to stand near VUV 2.4 billion (about USD 21.3 million, or 2.8 percent of GDP).

Stock of public debt (external and domestic) at end-2016

	In million of Vatu	In million of US dollars	As a share of total debt	In percent of GDP
Total public debt	42,593	377	100	48.8
External	32,810	290	77.0	37.6
Multilateral	9,411	83	22.1	10.8
ADB	5,952	53	14.0	6.8
IDA	875	8	2.1	1.0
IMF	2,584	23	6.1	3.0
Bilateral	23,399	207	54.9	26.8
China EXIM Bank	15,124	134	35.5	17.3
JICA	8,192	72	19.2	9.4
Others	83	1	0.2	0.1
Domestic	9,784	87	23.0	11.2
Government bonds	7,377	65	17.3	8.5
Publicly guaranteed debt	2,407	21	5.7	2.8

Source: Vanuatu authorities and IMF staff estimates.

METHODOLOGY AND ASSUMPTIONS

5. The macroeconomic assumptions in the DSA incorporate long-term effects of natural disasters and climate change from 2023 onwards. The baseline scenario, which is based on current policies and consistent with the macroeconomic framework presented in the policy note, assumes no disaster from 2017 to 2022 to avoid complicating policy discussion of the medium-term outlook. However, from 2023 onwards, the baseline assumptions adjust GDP growth, the current account balance and primary balance to incorporate the effects of natural disasters and climate change. The annual effects on two balances are calculated by spreading the impact of a large natural disaster, like Cyclone Pam, over the fifteen-year period from 2023 to 2037. The DSA framework uses a discount rate of 5 percent to calculate the net PV of external debt. The following are the key macroeconomic assumptions under the baseline scenario:

- ***GDP growth.*** Real GDP growth is expected to remain high, 4.2 percent in 2017 and 3.8 percent in 2018, due to the implementation of infrastructure projects, and reconstruction after Cyclone Pam. In the medium term (2017–2022), growth is expected to average 3.4 percent, supported mainly by public investment, tourism, and agriculture. In the long term (2023-2037), growth is projected to be 3.0 percent on average, after netting out 0.5 percentage point[3] as the impact of natural disasters and climate change.
- ***Inflation. T***he inflation rate (GDP deflator) is expected to rise to 3.1 percent in 2017 and further to 4.8 percent in 2018 due to the increase in VAT rate, the public wage bill, and the minimum wage rate. In the long run, it is projected to average 3.3 percent.
- ***Balance of payments.*** The non-interest current account deficit in 2017 and 2018 is expected to remain high due mainly to elevated imports driven by reconstruction and project

[3] Please see "The Economic Impact of Natural Disaster in Pacific Island Countries: Adaptation and Preparedness" by Dongyeol Lee, Irene Zhang, and Chau Nguyen (IMF Working Paper, forthcoming).

implementation. In the long term, the deficit is expected to narrow to 4.4 percent of GDP on average, as imports likely decrease with the completion of the reconstruction projects and major agricultural exports recover. After 2023, the long-term effect of natural disasters and climate change are projected to widen the deficit by 0.7 percentage points annually.

- ***FDI inflows.*** FDI inflows are expected to average about 3.9 percent over the medium term and 2.8 percent over the longer term.
- ***Fiscal balance.*** The primary balance is expected to be negative at 6.5 and 6.9 percent of GDP in 2017 and 2018 respectively, reflecting increases in expenditures due to Cyclone Pam and infrastructure projects. The primary deficit is expected to decrease to 3.8 percent of GDP on average in the medium term and 1.8 percent in the long term, owing to the completion of reconstruction projects, the value-added tax hike and the introduction of the income tax. The effects of natural disasters and climate change are expected to deteriorate the fiscal balance by 0.3 percent of GDP annually.
- ***External borrowing and grants.*** In addition to the ongoing projects supported by JICA and China EXIM Bank, disbursements for other projects are expected to materialize in the next three to seven years. These include road, school reconstruction and energy access projects financed by the ADB, and infrastructure reconstruction and improvement projects supported by IDA. New external borrowing is projected to average 3.9 percent of GDP over the longer term, while the grant-element of the borrowing is gradually declining. Grants are expected to gradually decline to 5.5 percent of GDP, as the economy grows.

Vanuatu: Baseline Macroeconomic Assumptions
(In percent of GDP, unless otherwise stated)

	2017	2018	2019	2020	2021	2022	2017-22 average	2023-37 average	Effect of ND and CC	Historical average (2007-16)
Real GDP growth	4.2	3.8	3.5	3.0	3.0	3.0	3.4	3.0	0.5	2.7
Inflation rate (GDP deflator, in percent)	3.1	4.8	3.4	3.3	3.3	3.3	3.5	3.3		3.2
Non-interest current account deficit	8.1	8.2	7.7	7.0	6.8	6.7	7.4	4.4	0.7	5.8
Net FDI (negative = inflow)	-3.8	-3.9	-4.0	-4.0	-3.8	-3.8	-3.9	-2.8		-5.7
Primary deficit	6.5	6.9	3.2	2.5	2.0	1.9	3.8	1.8	0.3	2.1
Grants	8.3	8.2	8.0	7.9	7.7	7.6	8.0	7.4		5.5

Source: IMF staff projections

CUSTOMIZED SCENARIO OF ANOTHER MAJOR NATURAL DISASTER EVENT

6. **The extreme natural disaster shock is based on the experiences during Cyclone Pam.** The shock's impact resulted in the reduction of real GDP growth by roughly 5 percentage points[4] and a sharp increase in external borrowing—external debt increased by about 14 percent of GDP in 2015. The

[4] This is also broadly consistent with the one-time GDP growth adjustment for Vanuatu under a large natural disaster shock scenario (4.2–4.4 percentage points) suggested by "The Economic Impact of Natural Disaster in Pacific Island Countries: Adaptation and Preparedness".

customized scenario assumes that another extreme natural disaster shock hits in 2020, leading to an increase in debt-to-GDP ratio by 14 percentage points in that year.

EXTERNAL DEBT SUSTAINABILITY

7. The baseline scenario indicates that the external debt of Vanuatu remains sustainable. All indicators capturing the PV of external PPG debt remain below the thresholds over the projection period (Figure 1.1). The nominal external PPG debt peaks in 2020 at 44.3 percent of GDP, from 37.6 percent of GDP in 2016, due to the disbursement of infrastructure projects and reconstruction projects for road and school. Vanuatu's public external debt service ratios are also relatively low, reflecting the fact that most of its public external debt is highly concessional.

8. Standard stress tests indicate that one threshold for public external debt is breached (Figure 1.1). In the most extreme shock scenario[5], namely a one-time depreciation shock, the PV of debt to GDP ratio breaches the threshold of 40 percent, indicating moderate risk of external debt distress. However, this case is regarded as 'borderline' under the DSA framework, where the largest breach of a threshold falls within a ±5 percent band around threshold. To address the borderline case, the framework introduces the probability approach. The main difference is that the probability approach incorporates a country's individual CPIA score and average GDP growth rate, whereas the traditional approach uses one of three discrete CPIA values (3.25 for weak, 3.50 for medium, and 3.75 for strong) and an average growth rate across LICs. The probability approach indicates a more substantial breach of the threshold for the PV of debt-to-GDP ratio, reinforcing the initial assessment of moderate risk (Figure 1.2).

9. The stress test also indicates that a shock to financing terms—a rise in interest rates on new borrowing by 2 percentage points compared to the baseline—is also an important risk to sustainability during the projection period (2017-2037) (Table 2). This suggests that external borrowing should be contracted on concessional terms as much as possible.

10. The customized scenario with another major natural disaster event is expected to adversely affect debt trajectories—solvency as well as liquidity indicators— though scenario measures continue to remain below thresholds. However, it should be noted that severe natural disasters could occur several times within a twenty-year horizon, which could have a large cumulative effect on debt sustainability.

PUBLIC DEBT SUSTAINABILITY

11. The PV of public sector debt in percent of GDP remains below the benchmark under the baseline scenario (Figure 2). Nominal public debt (external plus domestic) is expected to increase from 48.8 percent of GDP in 2016 to 53.9 percent in 2019 and then decline to 50.8 percent in 2037. The debt service-to-revenue ratio is expected to rise from 9.9 percent in 2017 to 13.5 percent in 2037.

[5] The most extreme stress test is the test that yields the highest ratio on or before 2027.

12. The standard stress tests show one breach of public benchmark. The PV of debt-to-GDP breaches the threshold of 58 percent of GDP significantly in a scenario in which the primary balance is held fixed at its 2017 level (6.5 percent of GDP). This scenario, however, is not fully applicable, as the heightened deficit of 2017 is mainly caused by increases in spending on Cyclone Pam reconstruction and infrastructure projects which are financed by external creditors. However, the breach suggests that prudent selection of future public investments should be made in line with not only the country's development strategy, but also its debt-carrying and implementation capacity.

CONCLUSION

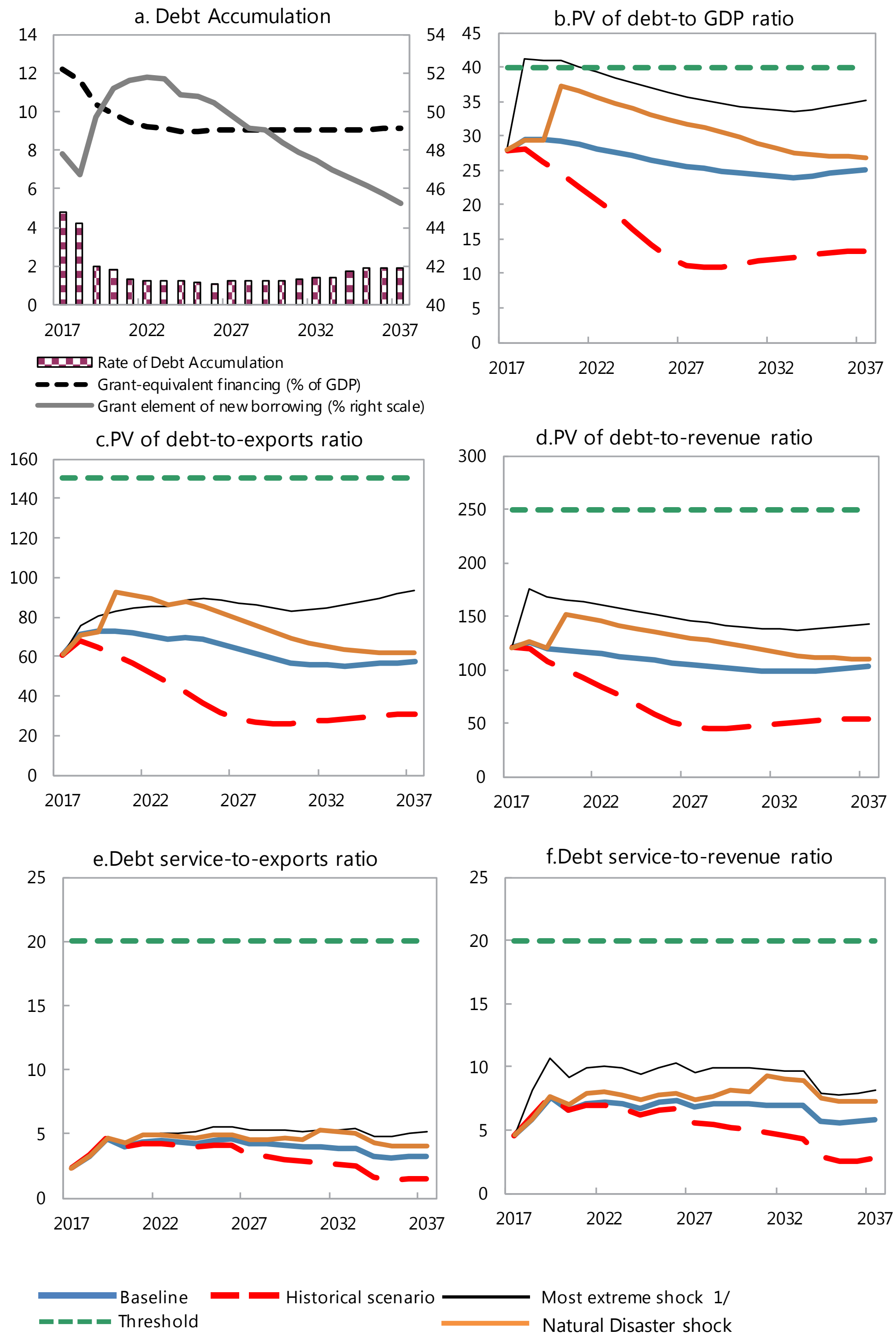
13. The updated DSA suggests that Vanuatu's risk of external debt distress continues to be moderate. In the baseline scenario, which considers the long-term effects of natural disasters and climate change, there is no breach of indicative threshold for each external debt sustainability indicator. However, the stress tests suggest that a one-off 30 percent depreciation shock and a shock to financing terms will negatively affect debt dynamics, causing breach of the PV of debt-to-GDP ratio threshold. External disbursements should be contracted as much as possible on concessional terms or in the form of grants to keep the debt burden contained. Given the recent sharp debt accumulation and increased debt service burden in the medium term, the authorities should consider updating the debt management strategy annually.

14. The customized scenario with a one-off severe natural disaster shock indicates that this shock has large adverse cumulative effects on the country's fiscal position and debt sustainability. Given Vanuatu's vulnerability to natural disasters, the authorities should be vigilant about rapid debt accumulation and rebuild fiscal buffers over the medium term through strengthening public finance management, reprioritizing spending, and mobilizing new revenue resources.

AUTHORITIES' VIEWS

15. The authorities broadly concurred with the assessment of the debt sustainability analysis. Given high infrastructure needs, the authorities underscored the need for financial support from bilateral and multilateral donors for new projects. At the same time, they intended to maintain a grant-element target of at least 35 percent under the upcoming debt management strategy, and seek grant financing as much as possible to reduce debt burden. With debt-servicing for key projects commencing in 2019, the authorities recognized the importance of rebuilding fiscal buffers over the medium term through revenue mobilization efforts, especially the introduction of personal and corporate income taxes.

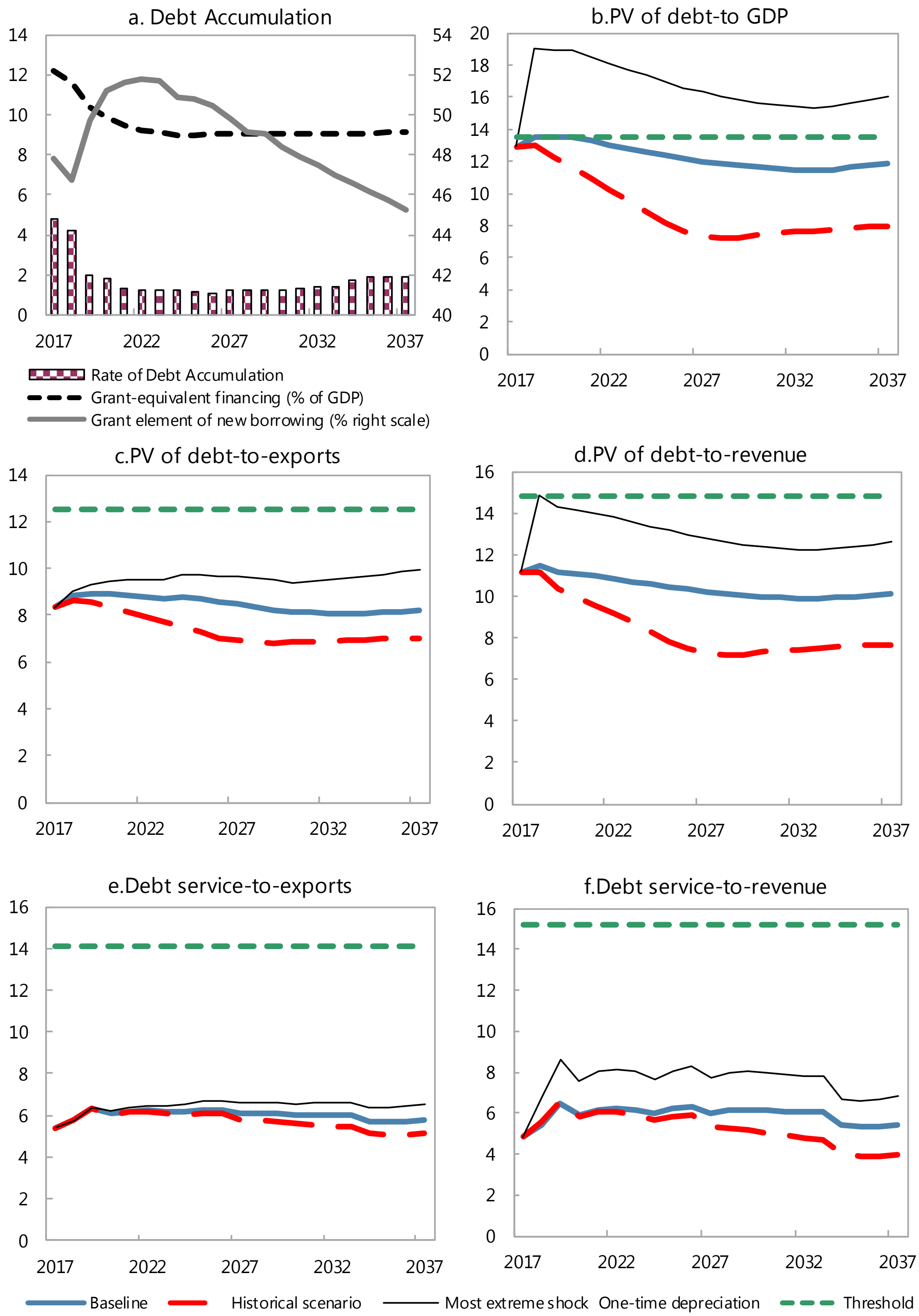
Figure 1.1. Vanuatu: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios 2017–37 1/



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 2027. In figure b. it corresponds to a One-time depreciation shock; in c. to a Terms shock; in d. to a One-time depreciation shock; in e. to a Terms shock and in figure f. to a One-time depreciation shock

Figure 1.2. Vanuatu: Probability of Debt Distress of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2017–37 1/



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 2027. In figure b. it corresponds to a One-time depreciation shock; in c. to a Terms shock; in d. to a One-time depreciation shock; in e. to a Terms shock and in figure f. to a One-time depreciation shock

Table 1. Vanuatu: External Debt Sustainability Framework, Baseline Scenario, 2017–37[1/]

(In percent of GDP, unless otherwise indicated)

	Actual			Historical [6/] Average	Standard [6/] Deviation	Projections									
	2014	2015	2016			2017	2018	2019	2020	2021	2022	2017-2022 Average	2027	2037	2023-2037 Average
External debt (nominal) 1/	**31.1**	**46.1**	**53.2**			**56.7**	**59.6**	**60.1**	**60.2**	**59.6**	**58.9**		**55.8**	**55.4**	
of which: public and publicly guaranteed (PPG)	16.3	30.5	37.6			40.4	43.7	44.2	44.3	43.8	43.2		40.4	40.5	
Change in external debt	8.4	15.0	7.0			3.6	2.86	0.5	0.1	-0.6	-0.7		-0.5	0.3	
Identified net debt-creating flows	-1.8	8.5	-4.2			3.2	3.27	2.7	2.3	2.3	2.2		1.4	1.4	
Non-interest current account deficit	**-0.3**	**9.7**	**3.3**	**5.8**	**3.3**	**8.1**	**8.2**	**7.7**	**7.0**	**6.8**	**6.7**	7.4	**5.2**	**4.2**	4.4
Deficit in balance of goods and services	3.9	21.4	10.7			12.1	11.8	11.0	10.1	9.7	9.4		7.6	6.5	
Exports	45.4	41.6	47.6			45.9	41.5	40.4	40.4	40.0	39.9		40.1	43.6	
Imports	49.2	62.9	58.3			58.0	53.3	51.5	50.5	49.7	49.3		47.8	50.2	
Net current transfers (negative = inflow)	-3.1	-9.8	-5.8	-4.2	2.5	-2.9	-2.5	-2.2	-2.0	-1.8	-1.6	-2.2	-1.3	-1.3	-1.3
of which: official	-2.7	-5.0	-4.8			-2.6	-2.3	-2.0	-1.8	-1.6	-1.4		-1.2	-1.2	
Other current account flows (negative = net inflow)	-1.1	-1.8	-1.6			-1.1	-1.1	-1.1	-1.1	-1.1	-1.2		-1.1	-1.0	
Net FDI (negative = inflow)	**-1.7**	**-3.8**	**-6.9**	**-5.7**	**2.4**	**-3.8**	**-3.9**	**-4.0**	**-4.0**	**-3.8**	**-3.8**	-3.9	**-3.2**	**-2.1**	-2.8
Endogenous debt dynamics 2/	**0.2**	**2.5**	**-0.6**			**-1.1**	**-1.1**	**-1.0**	**-0.8**	**-0.8**	**-0.7**		**-0.7**	**-0.8**	
Contribution from nominal interest rate	0.6	0.9	0.8			0.9	0.9	0.9	0.9	0.9	1.0		0.9	0.8	
Contribution from real GDP growth	-0.5	-0.1	-1.5			-2.0	-2.0	-1.9	-1.7	-1.7	-1.7		-1.6	-1.6	
Contribution from price and exchange rate changes	0.1	1.7	0.1			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**10.2**	**6.6**	**11.3**			**0.4**	**-0.4**	**-2.2**	**-2.1**	**-2.9**	**-2.9**		**-1.8**	**-1.0**	
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/	...	...	42.4			44.2	45.4	45.3	45.1	44.5	43.9		41.0	40.0	
In percent of exports	...	...	88.9			96.2	109.4	112.0	111.7	111.3	110.1		102.2	91.6	
PV of PPG external debt	**...**	**...**	**26.8**			**27.9**	**29.5**	**29.4**	**29.3**	**28.8**	**28.2**		**25.6**	**25.1**	
In percent of exports	**...**	**...**	**56.3**			**60.7**	**71.0**	**72.7**	**72.5**	**71.9**	**70.6**		**63.7**	**57.6**	
In percent of government revenues	**...**	**...**	**119.1**			**120.4**	**125.9**	**120.0**	**118.6**	**116.9**	**114.9**		**104.4**	**102.6**	
Debt service-to-exports ratio (in percent)	**7.4**	**8.8**	**7.3**			**8.0**	**9.5**	**11.0**	**10.3**	**10.7**	**10.8**		**10.3**	**8.7**	
PPG debt service-to-exports ratio (in percent)	**2.1**	**2.6**	**2.1**			**2.3**	**3.3**	**4.6**	**4.0**	**4.4**	**4.4**		**4.2**	**3.3**	
PPG debt service-to-revenue ratio (in percent)	**4.9**	**5.5**	**4.5**			**4.6**	**5.8**	**7.6**	**6.6**	**7.1**	**7.2**		**6.8**	**5.8**	
Total gross financing need (Millions of U.S. dollars)	10.7	74.2	-0.9			69.5	78.8	82.9	78.4	85.0	89.0		105.0	185.6	
Non-interest current account deficit that stabilizes debt ratio	-8.8	-5.3	-3.8			4.5	5.4	7.2	6.9	7.4	7.4		5.7	3.9	
Key macroeconomic assumptions															
Real GDP growth (in percent)	2.3	0.2	3.5	2.7	1.9	4.2	3.8	3.5	3.0	3.0	3.0	3.4	3.0	3.0	3.0
GDP deflator in US dollar terms (change in percent)	-0.6	-5.2	-0.3	3.6	7.4	4.6	6.0	3.4	3.3	3.3	3.3	4.0	3.3	3.3	3.3
Effective interest rate (percent) 5/	2.7	2.7	1.8	2.2	0.4	1.9	1.8	1.7	1.6	1.6	1.7	1.7	1.6	1.5	1.6
Growth of exports of G&S (US dollar terms, in percent)	-1.6	-13.0	18.1	8.2	11.6	5.1	-0.6	4.3	6.3	5.4	6.0	4.4	8.5	6.6	7.1
Growth of imports of G&S (US dollar terms, in percent)	-1.9	21.4	-4.4	9.1	15.5	8.3	1.1	3.3	4.5	4.7	5.6	4.6	5.8	7.1	6.5
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	47.8	46.7	49.7	51.2	51.6	51.8	49.8	49.8	45.2	48.4
Government revenues (excluding grants, in percent of GDP)	19.4	20.1	22.5			23.1	23.4	24.5	24.7	24.6	24.5		24.5	24.5	24.5
Aid flows (in Millions of US dollars) 7/	74.3	212.1	140.1			122.2	146.4	129.9	128.8	128.0	133.0		179.3	351.1	
of which: Grants	33.8	91.1	66.2			72.6	78.3	82.2	86.1	89.1	93.6		124.5	232.0	
of which: Concessional loans	40.6	121.0	73.9			49.7	68.1	47.7	42.7	38.9	39.4		54.8	119.1	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			12.2	11.6	10.4	9.9	9.4	9.2		9.0	9.1	9.1
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			74.3	74.8	81.5	83.8	85.3	85.7		84.7	81.4	83.7
Memorandum items:															
Nominal GDP (Millions of US dollars)	815.0	773.8	798.2			869.7	956.9	1023.8	1089.6	1159.5	1234.0		1684.4	3138.3	
Nominal dollar GDP growth	1.6	-5.0	3.1			9.0	10.0	7.0	6.4	6.4	6.4	7.5	6.4	6.4	6.4
PV of PPG external debt (in Millions of US dollars)			206.9			245.2	281.8	300.8	319.0	333.5	347.4		430.9	788.3	
(PVt-PVt-1)/GDPt-1 (in percent)						4.8	4.2	2.0	1.8	1.3	1.2	2.6	1.3	1.9	1.4
Gross workers' remittances (Millions of US dollars)	3.5	37.3	8.0			2.0	2.0	2.1	2.1	2.2	2.2		2.4	3.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	26.5			27.8	29.4	29.3	29.2	28.7	28.1		25.5	25.1	
PV of PPG external debt (in percent of exports + remittances)	...	...	55.1			60.4	70.6	72.3	72.1	71.6	70.3		63.5	57.4	
Debt service of PPG external debt (in percent of exports + remittanc	...	...	2.1			2.3	3.3	4.6	4.0	4.4	4.4		4.2	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

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, 2017–2037

(In percent)

	Projections							
	2017	2018	2019	2020	2021	2022	**2027**	2037
PV of debt-to GDP ratio								
Baseline	28	29	29	29	29	28	**26**	25
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	28	28	26	25	23	21	**11**	13
A2. New public sector loans on less favorable terms in 2017-2037 2	28	31	33	33	34	34	**35**	41
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	28	30	31	31	30	30	**27**	27
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	28	30	32	32	31	31	**28**	26
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	28	32	35	35	34	33	**30**	30
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	28	30	31	31	30	29	**27**	26
B5. Combination of B1-B4 using one-half standard deviation shocks	28	31	32	32	31	31	**28**	28
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	28	41	41	41	40	39	**36**	35
PV of debt-to-exports ratio								
Baseline	61	71	73	72	72	71	**64**	58
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	61	68	65	61	57	52	**28**	30
A2. New public sector loans on less favorable terms in 2017-2037 2	61	76	80	83	84	85	**87**	93
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	61	71	73	73	72	71	**64**	58
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	61	75	88	88	87	86	**77**	66
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	61	71	73	73	72	71	**64**	58
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	61	73	76	76	75	74	**66**	59
B5. Combination of B1-B4 using one-half standard deviation shocks	61	67	69	68	68	67	**60**	56
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	61	71	73	73	72	71	**64**	58
PV of debt-to-revenue ratio								
Baseline	120	126	120	119	117	115	**104**	103
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	120	120	107	100	92	84	**46**	54
A2. New public sector loans on less favorable terms in 2017-2037 2	120	134	133	136	137	139	**143**	166
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	120	130	127	125	124	121	**110**	108
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	120	129	131	129	128	125	**114**	106
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	120	139	142	140	139	136	**124**	121
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	120	129	125	124	122	120	**109**	104
B5. Combination of B1-B4 using one-half standard deviation shocks	120	132	130	129	127	125	**114**	115
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	120	176	167	165	163	160	**146**	143

Table 2. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2017–2037 (concluded)

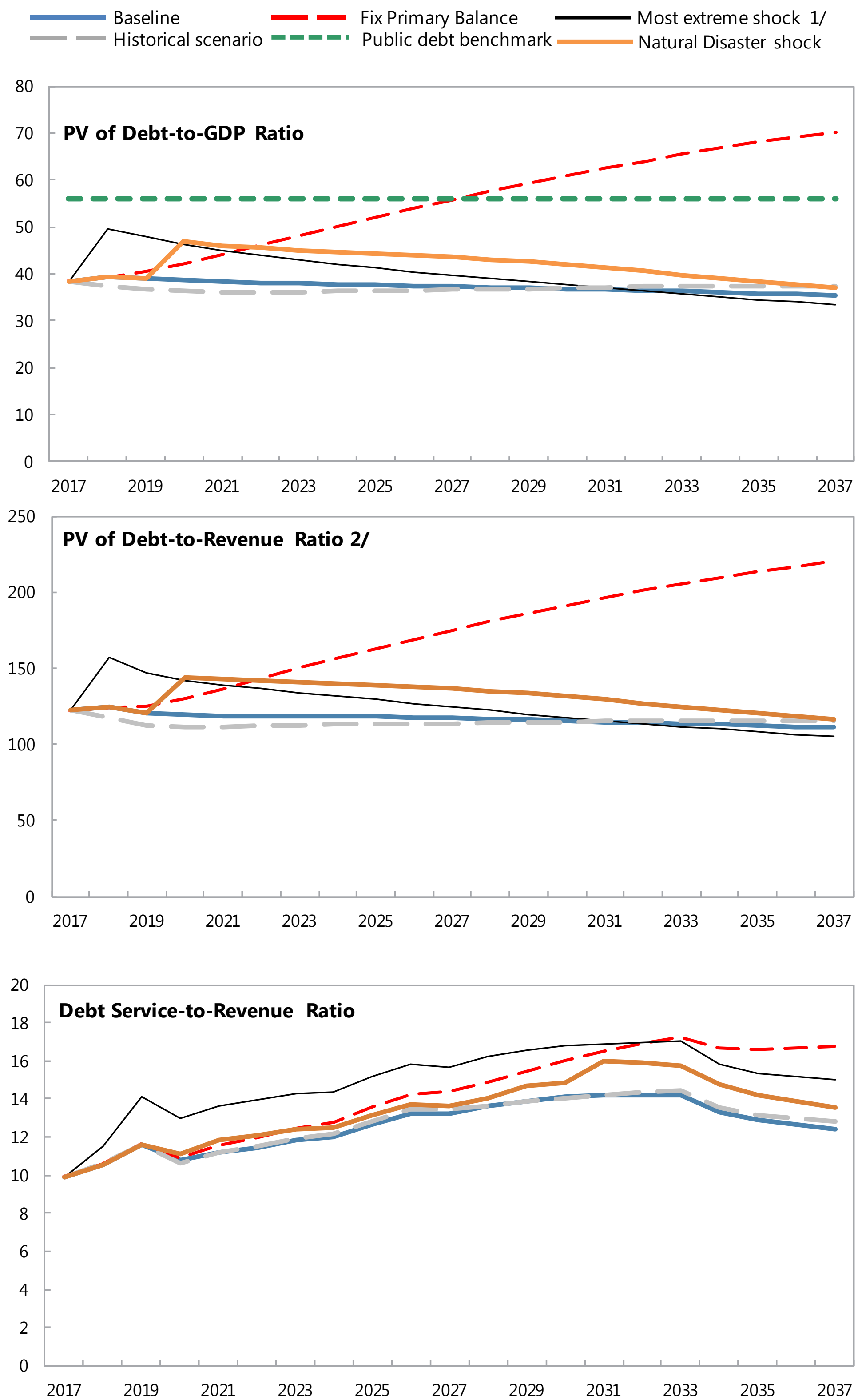
(In percent)

	Projections							
	2017	2018	2019	2020	2021	2022	2027	2037
Debt service-to-exports ratio								
Baseline	2	3	5	4	4	4	**4**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	2	3	5	4	4	4	**3**	2
A2. New public sector loans on less favorable terms in 2017-2037 2	2	3	5	4	5	5	**5**	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	2	3	5	4	4	4	**4**	3
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	2	3	5	5	5	5	**5**	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	2	3	5	4	4	4	**4**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	2	3	5	4	4	4	**4**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	2	3	5	4	4	4	**4**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	2	3	5	4	4	4	**4**	3
Debt service-to-revenue ratio								
Baseline	5	6	8	7	7	7	**7**	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	5	6	8	7	7	7	**6**	3
A2. New public sector loans on less favorable terms in 2017-2037 2	5	6	8	7	8	8	**9**	9
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	5	6	8	7	8	8	**7**	6
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	5	6	8	7	7	7	**7**	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	5	6	9	8	8	9	**8**	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	5	6	8	7	7	7	**7**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	5	6	9	7	8	8	**8**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	5	8	11	9	10	10	**10**	8
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	47	47	47	47	47	47	**47**	47

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
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 Alternatives Scenarios 2017–2037 1/



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 2027.
2/ Revenues are defined inclusive of grants.

Table 3. Vanuatu: Public Sector Debt Sustainability Framework, Baseline Scenario, 2017–2037

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate				Projections					
	2014	2015	2016	Average 5/	Standard Deviation 5/	2017	2018	2019	2020	2021	2022	2017-22 Average	2027	2037	2023-37 Average
Public sector debt 1/	28.7	42.4	48.8			51.0	53.7	53.9	53.8	53.3	53.1		52.1	50.8	
of which: foreign-currency denominated	16.3	30.5	37.6			40.4	43.7	44.2	44.3	43.8	43.2		40.4	40.5	
Change in public sector debt	5.6	13.7	6.4			2.2	2.7	0.2	-0.1	-0.5	-0.2		-0.2	-0.1	
Identified debt-creating flows	4.7	9.3	4.9			2.1	3.9	0.8	0.3	-0.2	-0.2		-0.2	-0.1	
Primary deficit	4.2	8.7	5.1	2.1	3.1	6.5	6.9	3.2	2.5	2.0	1.9	3.8	1.8	1.8	1.8
Revenue and grants	23.5	31.9	30.8			31.5	31.6	32.5	32.6	32.3	32.1		31.9	31.9	
of which: grants	4.1	11.8	8.3			8.3	8.2	8.0	7.9	7.7	7.6		7.4	7.4	
Primary (noninterest) expenditure	27.7	40.6	35.9			37.9	38.5	35.8	35.1	34.2	34.0		33.7	33.7	
Automatic debt dynamics	0.4	0.6	-0.2			-4.4	-3.0	-2.4	-2.2	-2.2	-2.1		-2.0	-1.9	
Contribution from interest rate/growth differential	-0.4	-0.2	-1.3			-1.8	-2.0	-1.8	-1.6	-1.6	-1.6		-1.4	-1.4	
of which: contribution from average real interest rate	0.1	-0.2	0.1			0.2	-0.1	0.0	0.0	0.0	0.0		0.1	0.1	
of which: contribution from real GDP growth	-0.5	0.0	-1.4			-2.0	-1.9	-1.8	-1.6	-1.6	-1.6		-1.5	-1.5	
Contribution from real exchange rate depreciation	0.8	0.9	1.1			-2.6	-1.1	-0.6	-0.6	-0.6	-0.6		-0.5	-0.5	
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	0.9	4.4	1.5			0.1	-1.2	-0.6	-0.3	-0.2	0.0		0.0	0.0	
Other Sustainability Indicators															
PV of public sector debt	...	...	38.0			38.4	39.4	39.1	38.8	38.3	38.1		37.3	35.4	
of which: foreign-currency denominated	...	...	26.8			27.9	29.5	29.4	29.3	28.8	28.2		25.6	25.1	
of which: external	...	...	26.8			27.9	29.5	29.4	29.3	28.8	28.2		25.6	25.1	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	7.2	11.7	8.1			9.6	10.2	7.0	6.0	5.6	5.6		6.0	5.8	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	123.4			122.0	124.9	120.3	118.9	118.7	118.8		117.0	110.9	
PV of public sector debt-to-revenue ratio (in percent)	...	...	169.0			166.0	168.6	159.7	157.0	155.7	155.6		152.3	144.4	
of which: external 3/	...	...	119.1			120.4	125.9	120.0	118.6	116.9	114.9		104.4	102.6	
Debt service-to-revenue and grants ratio (in percent) 4/	12.5	9.3	9.9			9.9	10.6	11.6	10.8	11.2	11.5		13.2	12.4	
Debt service-to-revenue ratio (in percent) 4/	15.2	14.8	13.5			13.5	14.2	15.4	14.3	14.7	15.0		17.2	16.1	
Primary deficit that stabilizes the debt-to-GDP ratio	-1.3	-5.0	-1.3			4.3	4.2	3.0	2.5	2.4	2.1		2.0	1.9	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	2.3	0.2	3.5	2.7	1.9	4.2	3.8	3.5	3.0	3.0	3.0	3.4	3.0	3.0	3.0
Average nominal interest rate on forex debt (in percent)	1.7	2.6	1.4	1.6	0.4	1.5	1.4	1.3	1.3	1.3	1.4	1.4	1.3	1.2	1.2
Average real interest rate on domestic debt (in percent)	3.1	-0.9	3.6	2.4	1.8	1.8	0.7	2.1	2.2	2.3	2.4	1.9	3.0	3.3	3.1
Real exchange rate depreciation (in percent, + indicates depreciation)	6.8	5.4	3.8	-0.1	7.3	-7.2	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.0	4.5	1.8	3.2	2.0	3.1	4.8	3.4	3.3	3.3	3.3	3.5	3.3	3.3	3.3
Growth of real primary spending (deflated by GDP deflator, in percent)	35.6	46.7	-8.7	7.4	18.2	10.2	5.3	-3.8	1.0	0.6	2.2	2.6	2.9	3.1	2.9
Grant element of new external borrowing (in percent)	...	...	...	...	...	47.8	46.7	49.7	51.2	51.6	51.8	49.8	49.8	45.2	...

Sources: Country authorities; and staff estimates and projections.
1/ Coverage of public sector is central government and 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 for Public Debt, 2017–2037

	Projections							
	2017	2018	2019	2020	2021	2022	2027	2037
PV of Debt-to-GDP Ratio								
Baseline	38	39	39	39	38	38	37	35
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	38	37	37	36	36	36	37	37
A2. Primary balance is unchanged from 2017	38	39	41	42	44	46	56	70
A3. Permanently lower GDP growth 1/	38	40	40	40	39	40	42	48
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	38	41	42	43	43	43	46	48
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	38	39	39	39	38	38	37	35
B3. Combination of B1-B2 using one half standard deviation shocks	38	38	39	39	39	39	41	43
B4. One-time 30 percent real depreciation in 2018	38	49	48	46	45	44	40	33
B5. 10 percent of GDP increase in other debt-creating flows in 2018	38	45	44	44	43	43	41	38
PV of Debt-to-Revenue Ratio 2/								
Baseline	122	125	120	119	119	119	117	111
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	122	118	112	111	111	112	114	116
A2. Primary balance is unchanged from 2017	122	124	125	130	136	144	175	220
A3. Permanently lower GDP growth 1/	122	125	121	121	122	123	129	147
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	122	129	129	129	131	133	141	149
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	122	122	121	119	119	119	117	111
B3. Combination of B1-B2 using one half standard deviation shocks	122	121	119	119	120	122	127	132
B4. One-time 30 percent real depreciation in 2018	122	157	147	142	139	137	124	105
B5. 10 percent of GDP increase in other debt-creating flows in 2018	122	141	136	134	133	133	130	119
Debt Service-to-Revenue Ratio 2/								
Baseline	10	11	12	11	11	11	13	12
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	10	11	12	11	11	11	13	13
A2. Primary balance is unchanged from 2017	10	11	12	11	12	12	14	17
A3. Permanently lower GDP growth 1/	10	11	12	11	11	12	14	14
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	10	11	12	11	12	12	14	14
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	10	11	12	11	11	11	13	12
B3. Combination of B1-B2 using one half standard deviation shocks	10	11	12	11	11	12	14	13
B4. One-time 30 percent real depreciation in 2018	10	11	14	13	14	14	16	15
B5. 10 percent of GDP increase in other debt-creating flows in 2018	10	11	12	11	12	12	13	13

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.