



VANUATU

June 2015

2015 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY AND PURCHASE UNDER THE RAPID FINANCING INSTRUMENT—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR VANUATU

In the context of the 2015 Article IV Consultation and Request for Disbursement Under the Rapid Credit Facility and Purchase Under the Rapid Financing Instrument, the following documents have been released and are included in this package:

- **Press Releases** including a statement by the Chair of the Executive Board and summarizing the views of the Executive Board as expressed during its June 5, 2015 consideration of the staff report on issues related to the Article IV Consultation and the IMF arrangements.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 5, 2015, following discussions that ended on April 28, 2015 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 May 20, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Vanuatu.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Vanuatu*

*Also included in Staff Report

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Press Release No. 15/264
FOR IMMEDIATE RELEASE
June 8, 2015

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Approves US\$23.8 Million in Financial Support for Vanuatu

On June 5, 2015, the Executive Board of the International Monetary Fund (IMF) approved financial support for Vanuatu as it rebuilds its economy after a devastating cyclone hit the country last March. The Board approved a disbursement of the equivalent of SDR8.5 million (about US\$11.9 million or 50 percent of quota) under the Rapid Credit Facility (RCF)¹ and a purchase in the equivalent of SDR8.5 million under the Rapid Financing Instrument (RFI).²

Category-five Cyclone Pam struck Vanuatu on March 13, 2015. It took eleven lives, displaced a quarter of the population, and destroyed a large share of Vanuatu's housing stock, infrastructure, tourist facilities, crops, and livestock. Estimated damage and losses to the economy exceed 60 percent of GDP.

At the conclusion of the Executive Board's discussion, Mr. Min Zhu, Acting Chair and Deputy Managing Director issued the following Statement:

“The macroeconomic impact of Cyclone Pam on Vanuatu is estimated to be severe. The economy is likely to contract this year, and the trade deficit is expected to widen substantially.

“The main challenge in the short run is to secure sufficient resources from donors and international aid agencies for reconstruction and rehabilitation. The government should seek grant financing to the extent possible and seek synergies between the existing infrastructure pipeline and reconstruction needs. Once the recovery takes hold, the government should rebuild fiscal buffers.

¹ The [RCF](#) provides rapid financial support in a single, up-front payout for low-income countries facing urgent financing needs. Financial assistance under the RCF is provided as an outright disbursement to Poverty Reduction and Growth Trust (PRGT)-eligible members that face an urgent balance of payments need, and where a full-fledged economic program is either not necessary or not feasible. Financing under the RCF carries a zero interest rate through 2016, has a grace period of 5½ years, and a final maturity of 10 years.

² The RFI is similar to the RCF and designed for situations where a full-fledged economic program is either not necessary or not feasible. Financial assistance provided under the RFI is subject to the same financing terms as the [Flexible Credit Line](#) (FCL), the [Precautionary and Liquidity Line](#) (PLL) and [Stand-By Arrangements](#) (SBA), and should be repaid within 3¼ to 5 years

“The disbursement under the Fund’s Rapid Credit Facility and the purchase under the Rapid Financing Instrument are intended to help Vanuatu cope with its immediate balance-of-payments needs and to catalyze critical donor support for the recovery.”



INTERNATIONAL MONETARY FUND



Press Release No. 15/279
FOR IMMEDIATE RELEASE
June 17, 2015

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes Article IV Consultation with Vanuatu

On June 5, the Executive Board of the International Monetary Fund (IMF) concluded the 2015 Article IV consultation¹ with Vanuatu.

Real GDP is expected to decline by 2 percent this year because of the cyclone damage to Vanuatu's main export sectors—tourism and agriculture—which will be only partially offset by reconstruction activities and infrastructure investment. Risks to the outlook are biased to the downside since reconstruction may be constrained by availability of funding and by implementation capacity. In 2016, a recovery in tourism and agriculture combined with further ramping-up of infrastructure projects is expected to propel growth to 5 percent.

With exports of goods and services depressed by cyclone damage and with imports boosted by domestic shortages and reconstruction needs, the current account balance is projected to deteriorate by 28 percent of GDP. This will put considerable pressure on Vanuatu's international reserves, which are likely to decline below prudent levels in the absence of substantial external financing. To strengthen the reserves position, the authorities have requested financial assistance from the IMF in the form an SDR8.5 million (about US\$11.9 million) disbursement from the Rapid Credit Facility (RCF) and a purchase of SDR8.5 million under the Rapid Financing Instrument (RFI).²

Public sector recovery needs are estimated at about 20 percent of GDP. This combined with the negative impact of economic disruption on government revenue and the public infrastructure investment plans will exert significant pressures on the budget. As a result, fiscal deficits in the order of 12 percent of GDP are expected in 2015 and 2016. The government plans to seek grant financing as much as possible to close the fiscal gap. At the same time, the relatively low public debt level (20 percent of GDP at end-2014) gives it room for concessional borrowing. Once the

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 approved the RCF and RFI for Vanuatu on June 5, 2015 (see Press Release No. 15/264).

recovery phase is over, the government should start rebuilding fiscal buffers through a combination of revenue mobilization and expenditure control.

Executive Board Assessment³

Executive Directors expressed sympathy with the people of Vanuatu for the devastation inflicted by Cyclone Pam, and noted the resulting pressures on the fiscal position and the balance of payments. While reconstruction activity will partly offset the adverse impact of the cyclone on tourism and agriculture, the economy is likely to contract this year, and risks are tilted to the downside. Nonetheless, Directors were encouraged by Vanuatu's track record of prudent economic management, the resilience of the population, and the swift humanitarian response. They expressed hope that the Fund's financial assistance would catalyze additional donor support.

Directors stressed the importance of a sound recovery plan and welcomed the work on the National Recovery and Economic Strengthening Program. Noting the large cost of reconstruction and rehabilitation, Directors supported the authorities' intention to seek grant financing to the extent possible before resorting to concessional debt. They recommended that the government's infrastructure investment priorities be aligned with absorptive capacity and, where feasible, with the reconstruction efforts. They also advised strengthening the social safety nets.

Directors welcomed the authorities' commitment to rebuild fiscal buffers once reconstruction is completed, and to put public debt on a declining path over the medium term. This will require efforts to improve revenue mobilization, strengthen spending discipline, rationalize and raise the efficiency of public investment, and enhance public financial management. It would also be prudent to establish a contingency fund.

Directors viewed the measures taken by the Reserve Bank of Vanuatu to support the economy and the banking system as broadly appropriate. They noted the need to continue to adhere to prudential norms during the recovery period and to undertake a thorough bank balance sheet assessment once pressures subside.

Directors agreed that Vanuatu would benefit from reforms to improve the business environment and promote economic diversification, alongside investments in infrastructure and human capital. Reform of government business enterprises is also needed, and Directors encouraged the authorities to submit a law based on the new Government Business Enterprise Policy to parliament without delay.

³ At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.



VANUATU

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

May 20, 2015

KEY ISSUES

Context. Devastating Cyclone Pam hit Vanuatu on March 13, destroying a large share of housing, infrastructure, tourist facilities, crops, and livestock. Estimated damage and losses to the economy exceed 60 percent of GDP.

Outlook. GDP is projected to decline by 2 percent in 2015, and risks are to the downside. A wide trade deficit in goods and services—driven by cyclone damage to export facilities and a boost to imports from domestic shortages and reconstruction needs—will put pressure on international reserves. Reconstruction spending is also expected to give rise to large fiscal deficits. For 2015, staff projects a current account deficit of 27 percent of GDP and a budget deficit of 12 percent of GDP.

Financial assistance. In view of the urgent balance-of-payments need, the authorities have requested emergency assistance from the IMF under RCF and RFI in the amount equivalent to SDR17 million (100 percent of the quota). Staff supports the request for Fund assistance, which would help ease the pressure on the balance of payments and catalyze financing from development partners to support the recovery and reconstruction efforts.

Key policy recommendations:

- Seek grants to finance reconstruction to the maximum extent; for the balance, use concessional borrowing. Going forward, rebuild fiscal buffers and create room for important social and development expenditures by reprioritizing spending, strengthening public financial management, and increasing tax and non-tax revenues. Also in the medium term, establish a contingency fund for natural disasters.
- Support the economy and the banking system by providing liquidity to banks with appropriate safeguards, and be ready to withdraw the liquidity once the situation is stabilized.
- Maintain the exchange rate basket peg at the current level for now but be ready to review and adjust the level to support the external sector and rebuild buffers if balance of payments pressures were to persist after the reconstruction phase.

Official commitments. The authorities' policies for the near term are broadly in line with staff recommendations. The authorities are committed to preserving macroeconomic stability and debt sustainability in the medium term.

Approved By
**Hoe Ee Khor and Peter
Allum**

Discussions took place in Port Vila and Luganville during April 15–28, 2015. The staff comprised Mr. Klyuev (head), Ms. Ananchotikul, and Ms. Dao (all APD). Messrs. Feridhanusetyawan (ResRep), Stewart (OED), and Edwards (World Bank) joined part of the mission. Executive Director Mr. Sterland participated in the Concluding Meeting. The mission met with Prime Minister Natuman, Minister of Finance Simelum, Minister of Lands Regenvanu, Deputy Reserve Bank Governor Tari, as well as other senior national, provincial, and municipal officials, private sector representatives, and development partners.

CONTENTS

BACKGROUND	4
IMPACT OF THE CYCLONE—OUTLOOK AND RISKS	5
FINANCING NEEDS AND ROLE FOR FUND SUPPORT	8
POLICIES FOR RECONSTRUCTION AND DEVELOPMENT	9
A. Fiscal Policy	9
B. External Sector	15
C. Monetary and Financial Policies	17
D. Structural Policies	18
STAFF APPRAISAL	19
BOXES	
1. Cyclone Pam and Economic Impact of Natural Disasters in Vanuatu	6
2. Infrastructure Projects	11
3. External Sector Assessment	16
FIGURES	
1. Recent Developments and Prospects	22
2. External Sector Developments	23
3. Public Finance and Monetary Indicators	24
4. Financial Sector Developments	25
TABLES	
1. Selected Economic and Financial Indicators, 2009–15	26
2. Balance of Payments, 2010–20	27
3. Central Government Budgetary Operations, 2010–20	28
4. Monetary Survey, 2009–2015	29
5. Medium-Term Baseline Scenario, 2010–20	30

6. Banks' Financial Soundness Indicators, 2009–14	31
7. Millennium Development Goals, 1990–2013	32
8. Financial Access/Inclusion Indicators	33
9. Indicators of Capacity to Repay the Fund, 2014–2025	34

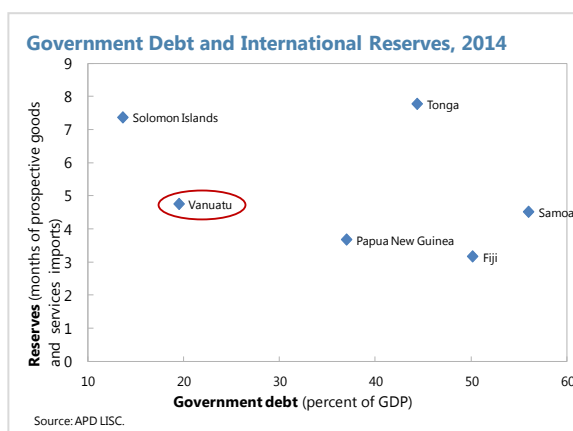
APPENDICES

I. Letter of Intent	35
II. Staff Policy Advice from the 2013 Article IV Consultation	38
III. Economic Citizenship Programs in Vanuatu and around the World	39
IV. Risk Assessment Matrix	43
V. Overview of Government Business Enterprises in Vanuatu	44
VI. Offshore Financial Sector in Vanuatu	48

BACKGROUND

1. Cyclone Pam. A devastating cyclone struck Vanuatu on March 13, leaving in its wake massive destruction and loss of life (Box 1). The Post-Disaster Needs Assessment (PDNA) estimated the damage to physical assets at 29.3 billion vatu (36.7 percent of the 2014 GDP) and production losses at 19.3 billion vatu (24.2 percent of GDP), for a combined 60.8 percent of GDP.

2. Context. Due to prudent macroeconomic policies in the years before the cyclone, Vanuatu had moderate public debt, adequate reserves, and low inflation. At the same time, growth has been disappointingly low over the last 5 years. The previous government sought to reinvigorate the economy through an ambitious program of infrastructure investment, much of it debt-financed. However, many projects faced considerable delays, and the government lost a no confidence vote in May 2014, partly because of a controversial public-private airport expansion deal that would have created a substantial contingent liability. The new government canceled the deal and professed commitment to fiscal prudence in line with staff advice (Appendix II). At the same time, it has kept public investment plans largely unchanged.



3. Pre-cyclone economic developments. Real GDP rose 2.3 percent in 2014—a slight acceleration from the 2013 pace of 2.0 percent. Agricultural production and exports boomed in response to rising prices of copra, coconut oil, kava, and beef, but tourist arrivals declined from the 2013 peak, reflecting a slowdown in the Australian economy, Australian dollar weakness, and a reduction in tourism promotion. Public infrastructure projects—which had been expected to boost growth—were slow to get off the ground, but a submarine cable connection completed in January 2014 spurred growth in the ICT sector. Inflation dropped to 1 percent due to a deceleration in the prices of food and household and electronic items. The current account balance recorded a surplus of 0.5 percent of GDP after a deficit in the previous year on account of an improvement in the terms of trade and increased official transfers. The basket-pegged vatu depreciated against the U.S. dollar but appreciated against the Australian dollar over the course of 2014. The fiscal balance strengthened to a surplus of 1 percent of GDP, reflecting improved tax compliance, high proceeds from “commercial diplomacy” programs (Appendix III), and underspending on grant-financed development projects.

IMPACT OF THE CYCLONE—OUTLOOK AND RISKS

4. Outlook. Because of cyclone damage, tourism and agricultural output are expected to sustain a big drop in 2015. Reconstruction activity and commencement of several large infrastructure projects should provide a partial offset. On balance, real GDP is projected to decline by 2 percent this year, in contrast to the pre-cyclone forecast of about 3½ percent growth.¹ In 2016, a recovery in tourism and agriculture combined with further ramping-up of infrastructure projects is expected to propel growth to 5 percent. Cyclone-induced shortages, reconstruction activity, and infrastructure projects are likely to raise inflation to about 2 percent in 2015, with a temporary suspension of VAT on construction materials, tools and seedlings and a decline in oil prices guarding against a more pronounced acceleration.

5. Risks. The outlook is subject to considerable uncertainty, and risks are biased to the downside (Appendix IV). The timing of agriculture and tourism recovery is difficult to predict. It partly depends on the speed and size of insurance payments, which are still being assessed.² Moreover, the scale and pace of reconstruction efforts may fall short of needs and expectations if external financing is not sufficient or because of constraints on implementation capacity. Further delays in infrastructure projects remain a possibility. From the external side, a larger-than-expected slowdown in major advanced or emerging economies or a persistent appreciation of the U.S. dollar would be a drag on Vanuatu, although their impact would likely be moderate given that Vanuatu's export sectors are currently supply-constrained. Finally, the danger of new natural disasters remains ever-present. On the upside, the impact of post-cyclone monetary stimulus may prove larger than expected.

6. Authorities' views. The authorities broadly agreed with staff on the outlook. They emphasized that 2015 will be a challenging year. At the same time, they noted the resilience of the people and the economy.

¹ For a variety of reasons, including non-market production and the difference between gross output and value added, output losses in PDNA do not translate directly into the impact on GDP. The projected impact of the cyclone is broadly in line with Cabazon and others (forthcoming), *Strengthening Macro-Fiscal Resilience to Natural Disasters and Climate Change in the Small States of the Pacific*, which relates GDP decline to the share of the population affected by a natural disaster.

² Insurance assessment is still ongoing. Insurance companies have reported 614 claims with an estimated total loss of US\$101 million. The actual payout is expected to be considerably lower.

Box 1. Cyclone Pam and Economic Impact of Natural Disasters in Vanuatu¹

Devastating category-5 Cyclone Pam made a direct hit on Vanuatu on March 13, 2015. With wind speed of up to 250 km per hour, it is one of the strongest storms ever and one of the worst natural disasters in the Pacific region. All of the country's provinces were affected including the capital city of Port Vila, with the islands in the southern region struck particularly hard. Eleven fatalities were confirmed. According to the OCHA reports, 188,000 people were affected across the country (out of a total population of 265,000), including 60,000 school-age children.² An estimated 65,000 residents were displaced from their homes and several thousands were sheltered in evacuation centers. Approximately 15,000 buildings were damaged or destroyed, including houses, schools, and medical facilities. Large-scale destruction of crops as well as agricultural infrastructure was reported, and the livelihoods of at least 80 percent of Vanuatu's rural population were negatively impacted. With food and water supply compromised, the spread of disease was a threat, although the worst fears had not materialized.

International humanitarian response was swift. It included in-kind assistance and pledges of financial aid totaling US\$50 million. Particularly large amounts of support were received from Australia (US\$12 million), the United Kingdom (US\$5.5 million), China (US\$4.9 million), New Zealand (US\$3.5 million), Netherlands (US\$2.9 million), and the United States (US\$2 million). The UN Central Emergency Response Fund has spent US\$5 million through various agencies. The Asian Development Bank has provided US\$1 million from its Asia Pacific Disaster Response Fund. In addition, Vanuatu has received a payout of US\$1.9 million under the Pacific Catastrophe Risk Insurance Pilot for the Pacific Islands.³

A preliminary Post-Disaster Needs Assessment (PDNA) led by the government and assisted by development partners estimated the total damage and loss at 48.6 billion vatu, equivalent to 60.8 percent of GDP, of which 36.7 percentage points was attributed to damages and 24.2 percentage points to production losses (Table 1). The sector that sustained the most damages was housing, which accounted for 32 percent of the total damages, followed by tourism (20 percent), education (13 percent), and transportation (10 percent). The largest production losses were estimated in the agriculture and tourism sectors at 33 and 26 percent of total losses, respectively. The public sector accounted for 31 percent of the total damages and losses, while the remainder was borne by the private sector. Recovery needs, at 42.0 percent of GDP, are nearly equally split between the public and the private sector.

¹ Prepared by Nasha Ananchotikul.

² The United Nations Office for the Coordination of Humanitarian Affairs Situation Report on Vanuatu: Tropical Cyclone Pam (No. 18 as of April 15, 2015).

³ The Pacific Catastrophe Risk Insurance Pilot is a joint initiative between the Secretariat of the Pacific Community, the World Bank, and the ADB. The pilot covers Cook Islands, Marshall Islands, Samoa, Solomon Islands, Tonga, and Vanuatu.

Box 1. Cyclone Pam and Economic Impact of Natural Disasters in Vanuatu (Concluded)

Vanuatu is the world’s most exposed country to natural disasters according to the World Risk Index, which measures exposure to natural hazards and the capacity to cope with and adapt to these events.⁴ Sixty four percent of Vanuatu’s citizens are believed to be exposed to natural hazards every year. These include earthquakes, volcano eruptions, tsunamis, flooding, and tropical cyclones (Table 2). Relative to economic size, the average annual losses due to natural disasters in Vanuatu are estimated at around 6–7 percent of GDP, the highest among the PICs (Figure 1). Only a year ago Cyclone Lusi ripped through several provinces in Vanuatu and took 12 lives. With the estimated total damages and losses of over 60 percent of GDP, Cyclone Pam appears more destructive than any other event in Vanuatu’s recent history. It was also more catastrophic than Cyclone Evan, which cost Samoa roughly 30 percent of GDP in 2013.

**Table 1: Impact by Cyclone Pam
(in percent of GDP)**

Sector	Damages and Losses			Recovery Needs		
	Damage	Losses	Total	Private	Public	Total
Productive	10.7	13.0	23.7	5.7	1.6	7.3
Agriculture	1.8	5.8	7.6	1.7	0.6	2.3
Commerce and industry	1.5	2.7	4.2	2.8	0.1	2.9
Tourism	7.4	4.5	11.9	1.3	0.9	2.2
Social	18.0	0.8	18.8	13.8	13.1	26.9
Housing (Private)	11.8	0.6	12.4	13.2	2.1	15.4
Health	1.1	0.1	1.2	-	1.0	1.0
Education	4.9	0.1	5.0	-	8.6	8.6
Culture	0.1	0.0	0.1	0.0	0.1	0.1
Other	-	-	-	0.6	1.3	1.9
Infrastructure	8.0	3.7	11.7	1.0	6.7	7.7
Transport	3.8	2.7	6.5	1.0	3.9	4.9
Public buildings	0.7	0.0	0.7	-	0.7	0.7
Water	0.5	0.4	0.9	-	1.2	1.2
Energy	0.2	0.1	0.4	0.0	-	0.0
Communication	2.8	0.5	3.3	-	0.9	0.9
Cross-cutting	-	6.7	6.7	-	0.8	0.8
Environment	-	6.7	6.7	-	0.2	0.2
Disaster risk management	-	-	-	-	0.6	0.6
Total	36.7	24.2	60.8	20.6	21.4	42.0
Memorandum:						
Total (in millions of vatu)	29,268	19,286	48,554	16,415	17,708	34,124
Total (in millions of US dollars)	282.7	186.3	469.0	158.6	171.1	329.6

Source: Vanuatu Post-Disaster Needs Assessment (as of May 11, 2015)

Figure 1: Annual average damage (in percent)

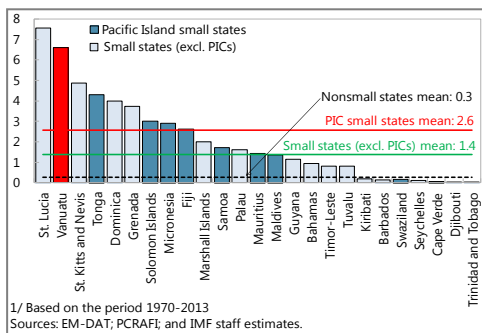


Table 2: Natural disasters in Vanuatu, 1980–2014

Disaster type	Event count	Total deaths	Total affected (approx.)	Total damage (USD million)
Storm - Tropical cyclone	16	79	290,000	205
Earthquake	8	12	15,000	n.a.
Volcano	5	0	19,000	n.a.
Flood	2	0	4,000	n.a.
Storm - Other	1	32	n.a.	n.a.
Tsunami	1	100	n.a.	n.a.
Landslide	1	1	3,000	n.a.
Average per year	1	6	9,500	> 5.9

Source: Center for Research on Epidemiology for Disasters, International Disaster Database.

⁴WorldRiskReport, 2011–2014, the United Nations University’s Institute for Environment and Human Security.

FINANCING NEEDS AND ROLE FOR FUND SUPPORT

7. Balance-of-payments

need. Even before the cyclone, Vanuatu's current account was expected to record a significant deficit, as an increase in project-related imports would outweigh the impact of lower oil prices.³ Now with severe damage to tourism facilities and agriculture, Vanuatu's exports are expected to be depressed this year, while imports will be boosted further on account of the reconstruction effort. Humanitarian response has been swift, but existing pledges of aid (about US\$50 million) are much smaller than preliminary damage estimates. As a result, the current account deficit is projected to be 27 percent of GDP, compared with 8 percent in

the pre-cyclone baseline. Insurance payments and foreign direct investment are expected to cover a relatively small part of the shortfall.⁴ Without additional external financing, international reserves would decline to US\$87 million (1.8 months of imports) by the end of 2015. Such levels would clearly be inadequate, particularly for a country subject to large and frequent shocks. Even if the fiscal gap (see the next section) is fully covered with external grants and loans, reserves would still be expected to decline to 2.7 months of imports.

8. Request for Fund assistance.

In view of the urgent balance-of-payments need, the authorities have requested IMF emergency assistance in the amount of SDR17 million

(100 percent of the quota). The assistance would be provided in equal shares as a one-off disbursement under the shocks window of the Rapid Credit Facility (RCF) and a one-off purchase under the Rapid Financing Instrument (RFI), both of which provide an appropriate response to the

Balance of Payments Impact			
(in US\$ million, unless otherwise indicated)			
	Pre-Cyclone 2015	Post-Cyclone 2015	Difference
Current account balance	-62	-211	-149
Exports of goods (f.o.b.)	58	41	-17
Imports of goods (f.o.b.)	-318	-461	-144
Services balance	182	115	-67
Cyclone-related humanitarian aid and grants	0	50	50
Insurance receipt	0	2	2
Capital and financial account	94	114	20
Foreign direct investment	33	53	20
Overall balance	32	-97	-129
Financing:	-	97	-
Change in international reserves (-, increase)	-	31	-
IMF's RCF/RFI	-	23	-
Financing gap ^{1/}	-	44	-
Memorandum items, assuming financing gap is closed:			
Gross international reserves			
Without RCF/RFI	216	130	-86
With RCF/RFI	-	153	-
<i>In months of prospective imports</i>			
Without RCF/RFI	5.4	2.7	-
With RCF/RFI	-	3.2	-

1/ The gap is expected to be closed by donors considering support in light of the recently finalized PDNA. Source: IMF staff estimates.

³ Vanuatu's imports of petroleum products equaled 7.2 percent of GDP in 2014.

⁴ US\$1.9 million has been received from the Pacific Catastrophe Risk Insurance Pilot. Private claims are still being assessed. Government property was not insured.

immediate economic, social, and humanitarian needs of Vanuatu. The RCF/RFI financing would increase the reserve cushion to 3.2 months of imports at end-2015. This cushion is still too low given high uncertainty about balance-of-payments flows this year, and the government continues to seek additional external support with the RCF/RFI playing a catalytic role. Vanuatu has adequate capacity to repay the Fund as the bulk of its public debt is concessional and the debt service is low relative to projected export earnings and foreign reserves. With the RCF/RFI, Vanuatu's repayments to the Fund are projected to peak in 2019 at a low level of 0.6 percent of GDP, or 1.2 percent of exports of goods and services (See Table 9 on Capacity to Repay the Fund).

9. Policy commitments. The authorities are committed to implementing sound policies to ensure macroeconomic stability and inclusive growth. As outlined in the Letter of Intent (Annex I), the authorities' agenda is broadly in line with staff's recommendations presented in this report (see below). Staff believes that the RCF/RFI will help achieve stable macroeconomic conditions and encourage development partners to be more forthcoming in their assistance. The authorities welcome a safeguards assessment as an opportunity to strengthen the Reserve Bank of Vanuatu's (RBV) governance and control framework.

POLICIES FOR RECONSTRUCTION AND DEVELOPMENT

A. Fiscal Policy

10. 2014 outturn. Last year the government recorded a surplus of 1 percent of GDP because of improved tax compliance, strong performance of the Hong Kong Permanent Residency Visa Program (HKPR) and Capital Investment Immigration Program (CIIP), and underspending on grant-financed projects. Due to enhanced enforcement, VAT receipts exceeded budget expectations by 4 percent. Revenue was also boosted by the success of HKPR and CIIP, which brought in a higher-than-expected 1.3 percent of GDP. In addition, by year-end the government spent less than two thirds of 4.1 percent of GDP it received in grants for several development programs and technical assistance on infrastructure projects. At the same time, budget overruns by government offices and programs remained a concern. Total expenditures exceeded the budget by more than 1 percent of GDP, leading to two supplementary budgets. One of the triggers for the supplementary budgets was a health care crisis, where payment delays and disputes had led to a temporary suspension of services. Other major items in the supplementary budgets included payments to the submarine cable company, covering a shortfall in the tertiary scholarship program, and a contribution to electrification of Malampa, Penama, and Torba provinces.

11. Pre-cyclone budget plans. In its 2015 budget, the government expected to increase domestic revenue by 5.5 percent compared to the 2014 Budget, to 18.1 percent of GDP, mainly due to higher VAT and HKPR receipts. Donor cash grants for social projects and productive sectors were projected to almost double from the 2014 Budget. Expenses were projected at 20.5 percent of GDP, including 1.2 percent of GDP allocated toward outstanding government obligations and severance payments. Capital expenditures were expected to rise sharply as several major infrastructure projects were ready to commence this year (Box 2). Even though two major projects (Luganville Wharf and Bauerfield Airport Rehabilitation) were not included in the budget, it envisaged a deficit of

5.9 percent of GDP. With the infrastructure projects financed mostly with external grants and concessional loans, the stock of external debt was projected to rise by 50 percent to reach 19 percent of GDP at year-end. In addition, the suspension of HKPR in January created a shortfall of 1.1 percent of GDP in projected revenues. In an effort to close that gap, the government expanded the excise tax list, broadened the scope of CIIP, and introduced some expenditure control measures. It also received 0.4 percent of GDP in budget support from the European Union.

12. Fiscal impact of the cyclone. Addressing post-cyclone needs will require a large, temporary increase in public spending to rehabilitate the economy, provide relief to vulnerable groups, and build up resilience against potential future disasters. With PDNA completed on May 11, the government intends to formulate its recovery plan by the end of May. The authorities have indicated that reconstruction expenditures will be on the scale of 20 percent of GDP—in line with public sector needs assessment in PDNA—spread over 3 years and partly offset by reducing expenses in other areas. Staff projects government spending based on this assumption. Future expenditures also reflect the government’s intention to proceed with earlier-planned infrastructure projects, although in line with past experience and limited implementation capacity staff expects implementation to take longer than planned. Moreover, cost savings of about 4 percent of GDP are assumed because of complementarities between infrastructure projects and reconstruction activities and because of reallocation of spending. About 3 percent of GDP is expected to be lost in tax revenues over the next 3 years because of a lower tax base and also, in 2015, because of general disruption and a three-month suspension of VAT on construction materials, tools and seedlings.

Impact of Cyclone Pam on Fiscal Position over 2015-17	
<i>(Percent of 2014 GDP)</i>	
CG debt at end-2014	19.5
CG debt at end-2017 (pre-cyclone)	41.7
Cyclone impact	13.4
Reconstruction expenditures	20.0
Revenue loss	3.0
<i>Minus :</i>	
Grants	3.3
Insurance receipt	2.4
Synergies/reallocation	4.0
CG debt at end-2017	55.0
Financing requirement	35.6
Identified financing	20.7
<u>Financing gap</u>	<u>14.9</u>

Box 2. Infrastructure Projects¹

The Vanuatu government has been working with development partners in the last few years on setting up several major investment projects to address the country's infrastructure bottlenecks and boost growth. Although the preparation took longer than expected, seven major projects are due to begin the construction stage in 2015 with total investment of US\$397 million (49 percent of 2014 GDP). The government plans to implement them over the next five years.

List of projects (only the first five were included in the 2015 Budget):

1. Port Vila Urban Infrastructure (grant from Australia and loan from ADB);
2. Interisland Shipping Project (grant from New Zealand and loan from ADB);
3. International Wharf (loan from JICA);
4. Vanuatu Tourism Infrastructure (grant from New Zealand);
5. Tanna and Malekula Road (loan from China Ex-Im Bank);
6. Luganville Wharf (loan from China Ex-Im Bank);
7. Bauerfield International Airport Rehabilitation (loan from the World Bank).

Location: Most of the projects are aimed at improving wharves, airports and other infrastructure in Port Vila and Luganville, which are the main urban areas. The Interisland Shipping Project and the Tanna and Malekula roads are two projects aiming at improving transportation to and within outer islands and at facilitating market access for the population living in those areas.

Delays: Arose mostly because of constrained implementation capacity. Initial design problems also increased project costs and lengthened the preparation, as additional funding negotiations were needed.

Financing: These projects are mainly financed externally by grants and loans. Australia and New Zealand provide together US\$67 million for the urban and tourist infrastructure in Port Vila and for the Interisland Shipping Project. The Asian Development Bank provides over US\$34 million in loans for these projects with the interest rate of 1.5 percent, 8-year grace period, and 36-year maturity (grant element of 45 percent). The government will contribute US\$8 million for the Port Vila Urban Infrastructure Project and the Vanuatu Tourist Infrastructure Project. The other 4 projects are financed exclusively by loans. JICA signed a loan agreement in 2012 and expects to agree this year on a second loan to finance the International Wharf in Port Vila, totaling US\$84 million with less than 1 percent interest rate, 10-year grace period, and 30-year maturity (grant element of 53 percent). Two loan agreements were signed with China Ex-Im Bank in 2014 for US\$57 million and US\$87 million for the Tanna and Malekula Roads and the Luganville Wharf projects, respectively. These loans have an interest rate of 2 percent, grace periods of 5 and 7 years, and 20-year maturity (grant element of 30 percent). The grace period starts from the moment the loan agreement is signed rather than from actual disbursements. The World Bank has just finalized a US\$59 million loan to improve the runway at the Bauerfield International Airport with no interest, 10-year grace period, and 40-year maturity (grant element of 61 percent).

Current situation: In the aftermath of cyclone Pam, the government expressed its intention to keep the momentum and continue these infrastructure projects as planned.

	Infrastructure Projects Government Plan (in millions of U.S. dollars)						
	2015	2016	2017	2018	2019	2020	Total
Grants	125	25.5	21.0	6.3	0.5	1.2	66.9
Loans	61.2	72.4	73.4	46.9	33.5	34.9	322.4
Government contribution	1.2	3.5	2.2	0.8	0.0	0.0	7.7
Total amount	74.9	101.4	96.6	54.0	34.0	36.1	397.0
(in percent of GDP)	9.7	12.2	10.8	5.7	3.4	3.4	

¹ Prepared by To-Nhu Dao

13. Financing and resource mobilization. With revenue and expenditure projections as outlined above, and counting only grants that have already been committed,⁵ the central government's operating budget would remain close to balanced, providing a fiscal anchor, even as the overall deficit rises to nearly 12 percent of GDP in 2015 and 2016 and 10 percent in 2017 to cover reconstruction-related investments. The government has about 6 percent of GDP per year lined up in project financing. Thus the government is facing a gap of about 15 percent of GDP over 2015–17 between its projected deficits and identified financing sources. If that gap is not filled, the government could borrow a limited additional amount from domestic banks and further reprioritize expenditures, but it would also have to scale down its reconstruction efforts and support for vulnerable groups. The authorities should seek further support from the international community building on a solid recovery plan, with IMF financing playing a catalytic role. Development partners have indicated their commitment to support Vanuatu, with specifics to be determined after the recovery plan is unveiled.⁶ Still it is unlikely that all reconstruction needs can be financed with grants. The government has ample fiscal space to access concessional lending to meet the recovery and development needs in the context of a medium-term fiscal plan. In the baseline it is assumed that the fiscal gap is filled with external concessional loans from multilateral and bilateral donors on terms equivalent to a blend of IDA, ADB, and China Ex-Im Bank terms.

14. Rebuilding fiscal buffers. Following the reconstruction and rehabilitation of the economy, the authorities should embark on a consolidation plan to rebuild fiscal buffers over the medium term. Under the baseline of unchanged policies, central government debt is projected to continue rising for several years after the cyclone, reaching 58 percent of GDP in 2020, largely because of the government's plans to ratchet up infrastructure investment (to a large extent debt-financed). According to the Debt Sustainability Analysis, this trajectory elevates Vanuatu from low to moderate risk of debt distress. Staff recommends the following policy priorities to set the public debt ratio on a declining trend after 2017 (with a text table below quantifying the impact):

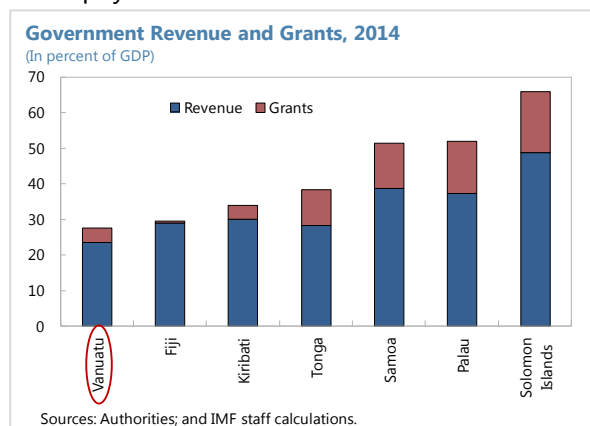
- *Infrastructure projects.* Staff supports the government's policy to improve infrastructure in order to raise Vanuatu's growth potential, but the challenge is to do it in an efficient and sustainable manner. Steps to increase absorptive capacity through adequate resource allocation are essential for raising return on that investment. The country would benefit from formulating an infrastructure investment plan that is aligned with the country's development

⁵ In fiscal accounts, cash grants to the government are included under grants, while in-kind aid is classified as non-tax revenue (which explains the projected increase in this item in 2015). Aid that does not go through the government is recorded in the balance of payments, but not in fiscal accounts. The insurance payout from the Pacific Catastrophe Risk Insurance Pilot is recorded as non-tax revenue in fiscal accounts and as a current transfer in external accounts.

⁶ The macroeconomic projections reflect an expected financing contribution from multilateral institutions of around US\$90 million to Vanuatu's recovery. Additional support from bilateral donors would help close the remaining financing gap.

agenda, implementation capacity, and fiscal space. It is also important to incorporate the cost of maintenance in the recurrent budget.

- Spending discipline.* The fiscal room for priority development and social expenditures could be expanded by controlling spending growth in other areas, including tertiary scholarships. The Public Finance and Economic Management Act constrains expenditure commitments in the budget, but frequent overruns have led to payment arrears and necessitated supplementary budgets. Regular monitoring and reporting during the year by ministries of their budget execution including commitments and arrears appear to be lacking. Technical assistance in the area of public financial management (PFM) scheduled to be delivered by PFTAC this year will help strengthen internal audit and other control procedures. Savings can be reallocated toward underfunded areas, including healthcare, stronger protection for vulnerable groups, and the contingency fund (see below).



- Revenue mobilization.* Vanuatu government's revenues are low in the regional context, and staff recommends raising them starting in 2017 or after the recovery takes hold.⁷ The government has recently initiated two programs that offer Vanuatu citizenship or residency in exchange for a fee and an investment in the country—the HKPR and the CIIP. However, the HKPR suffered a setback when the actions by Hong Kong, SAR authorities undermined the incentive for Chinese citizens to seek Vanuatu resident status. While potentially lucrative, “commercial diplomacy” programs carry integrity risks, and the revenues they generate are temporary and unpredictable. Staff welcomes the government's plan to raise non-tax revenue (NTR) supported by PFTAC technical assistance. However, the necessary expansion of the budget envelope would require additional measures, and the government should consider introducing an income tax at moderate coverage and rates, which, according to PFTAC analysis, could yield 3–4 percent of GDP.

⁷ The ratio of grants to GDP is projected to decline over the medium term reflecting expected slow growth in Australia's aid budget.

- *Contingencies.* Given the prevalence of natural disasters in the region, staff recommends setting up a natural disaster contingency fund, which can be funded over the medium term from the budget and by development partners. Subscription to catastrophic insurance—which has paid off this year—is a way to complement contingency planning, although specifics of coverage may need to be reviewed with development partners in light of the experience.

	Proj.					
	2015	2016	2017	2018	2019	2020
<i>Baseline</i>						
Net lending	-11.7	-11.7	-9.7	-7.2	-7.0	-5.2
Central government debt	31.2	40.7	47.5	51.7	55.9	58.2
<i>Adjustments</i>						
Revenue	0.0	0.0	0.5	3.0	4.0	4.0
Acquisition of non-financial assets	0.0	0.0	-1.0	-1.5	-1.0	0.0
<i>Adjustment scenario</i>						
Net lending	-11.7	-11.7	-8.2	-2.7	-2.0	-1.2
Public debt	31.2	40.7	45.9	45.7	45.3	44.2

15. Government Business Enterprises (GBEs). GBEs operations remain opaque, and the government is working with ADB to assess their financial situation and to improve governance and performance (Appendix V). According to the latest data, government-guaranteed GBE debt amounted to 4.6 percent of GDP at the end of 2014, adding to the burden of public debt.⁸ Staff welcomes the GBE Policy approved by the Cabinet in October 2013. The implementation of these reform proposals will help improve discipline, accountability and financial viability of GBEs. The government should submit the new GBE law to Parliament without delay. The new law would also allow it to proceed with rationalization plans developed for several commercial GBEs.

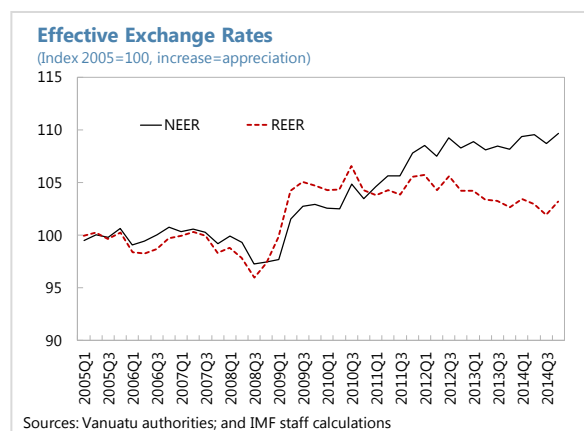
16. Authorities' views. The authorities noted that seeking grant financing for the recovery plan was crucial, but additional borrowing was also contemplated. They emphasized the significance of infrastructure projects for increasing the country's production potential. They agreed that spending discipline and revenue-raising measures are important for rebuilding fiscal buffers in the medium term. The authorities expressed their appreciation for technical assistance in the areas of PFM and NTR. They signaled their openness to introducing an income tax, perhaps gradually, and indicated that they would welcome technical assistance on practical aspects of that measure. They noted that the new GBE law is in final stages of review and will be submitted to Parliament in June. Overall, their commitments expressed in the LOI are in line with staff views.

⁸ All GBE debt is domestic, although some of it is owed to foreign-owned banks and is denominated in foreign currency. The numbers for non-guaranteed GBE debt are not available.

B. External Sector

17. Recent developments. In 2014, the trade balance improved noticeably due to favorable terms of trade including a decline in oil prices and rising prices of key agricultural products, namely copra, coconut oil, kava and beef, which stimulated their production and exports. Service income remained robust despite a decline in tourism receipts compared to their peak in 2013. Improvement in the trade balance together with inflows of foreign aid and income of ni-Vanuatu workers participating in the Recognised Seasonal Employer (RSE) and Pacific Seasonal Employer (PSE) schemes in New Zealand and Australia contributed to a current account surplus of 0.5 percent in 2014. Foreign direct investment was relatively small in 2014, partly reflecting a “wait and see” attitude of private sector investors toward the government’s infrastructure projects. As for the exchange rate, from January 2013 to end-2014, the vatu depreciated by 13 percent against the U.S. dollar while appreciating by 11 percent against the Australian dollar. The value of international reserves in U.S. dollars increased considerably less than would have been expected from the current, capital and financial account surpluses, indicating large errors and omissions in the balance of payments and valuation losses due to U.S. dollar appreciation. At end-2014 the reserves stood at a healthy level of US\$184 million (5 months of pre-cyclone import projection).

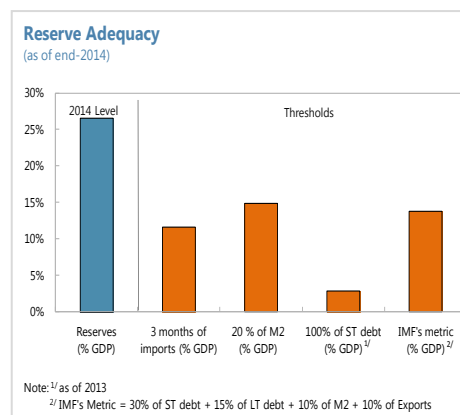
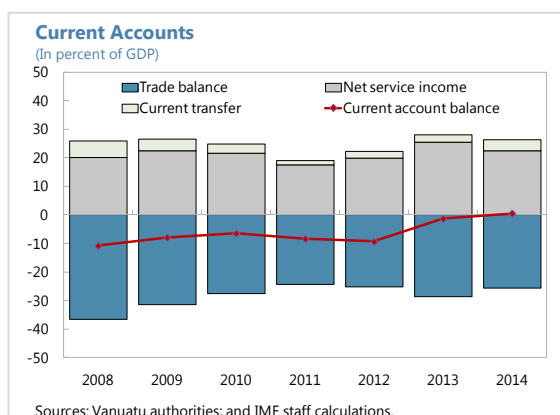
18. Exchange rate. The vatu peg to an undisclosed basket is an important nominal anchor. The real effective exchange rate has been broadly stable in the last two years. Staff analysis suggests that the value of the vatu is broadly in line with fundamentals (Box 3). As discussed above, the impact of the cyclone on Vanuatu’s external position is large, but temporary. Staff recommends maintaining the peg at the current level, since exchange rate stability is important for preserving confidence, while the effectiveness of a devaluation would be blunted by supply constraints. At the same time, the authorities should review Vanuatu’s external position once the reconstruction stage is over and be ready to adjust the level of the peg in the future if the balance of payments remains under pressure.



19. Authorities’ views. The authorities agreed that maintaining the value of the vatu at the current juncture is important for preserving confidence. They noted that they conduct annual reviews of the composition of their basket. They agreed that it will be important to appraise the balance-of-payments position and reassess the peg level once the recovery is complete to ensure external stability over the medium term.

Box 3. External Sector Assessment¹

Prior to the cyclone, Vanuatu was typically running moderate current account deficits, with a surplus recorded in 2014. Generally, current account deficits in the past had been more than fully financed by stable inflows of FDI as well as foreign capital grants and concessional loans. As a result, international reserves increased gradually over time, providing buffers to external shocks. Under normal circumstances, the end-2014 level of international reserves—at 23 percent of GDP, about 5 months of import cover (using pre-cyclone import forecast), and 165 percent of the Fund’s adequacy metric—would be deemed adequate by standard thresholds.



The catastrophic cyclone will cause the current account deficit to widen substantially in 2015. Given that cash crops and farming facilities were severely damaged by the cyclone, export receipts from the agricultural sector are likely to plummet over 2015–16. Tourism earnings are expected to be dramatically affected this year, as it will take time for tourists to return to Vanuatu following the cyclone and many major hotels will remain closed for 3–6 months. Imports are poised to rise significantly due to increased demand for food supplies, building materials and related items for reconstruction, as well as planned implementation of major infrastructure projects. An increase in remittances is likely to be small since ni-Vanuatu diasporas abroad are considerably smaller than those of some other Pacific nations, such as Samoa and Tonga. FDI and insurance inflows are likely to increase and provide some financing for private sector recovery. Foreign aid from development partners is anticipated to finance a portion of the BOP need. However, a large drawdown of foreign exchange reserves would still be expected, which could bring the reserves below prudent norms. At the same time, the impact of the cyclone is temporary, and reserves are expected to recover to adequate levels in a few years.

The exchange rate appears to be broadly in line with fundamentals. Standard exchange rate assessment methodologies produce mixed results. The EBA-lite and the macroeconomic balance approaches suggest an undervaluation of 5 and 7 percent, respectively, while the other approaches indicate an overvaluation ranging from 6 to 14 percent.² Overall, there is no clear indication of misalignment. Since these methodologies are subject to limitations and are sensitive to assumptions, caution should be exercised in interpreting the results.

Method	CA/GDP (%)			REER Gap (%)
	Underlying	Norm	Gap	
EBA Lite	-8.0	-9.0	1.0	-5.0
MB	-7.7	-9.7	2.0	-7.1
ES	-7.7	-3.8	-3.9	14.1
ERER	...	...	...	6.1
PPP	...	...	...	7.5

Note: Results are based on the latest estimates/projections for Vanuatu, and the October 2014 WEO for all other countries used in calculations.

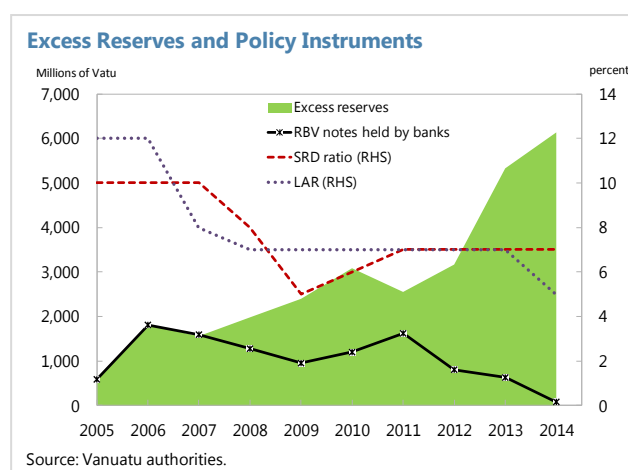
¹Prepared by Nasha Ananchotikul

²The underlying current account used in the calculation of the EBA-lite estimates has been adjusted to reflect a prospective current account in the medium term rather than using the projected current account in 2015, which is distorted by the cyclone impact.

C. Monetary and Financial Policies

20. Background. The onshore financial system consists of commercial banks, one credit institution, four insurance companies, and a national provident fund. Three of the four major commercial banks are foreign-owned. National Bank of Vanuatu is majority-owned by the government and is the only bank that has significant presence outside the urban areas. The financial system in Vanuatu is relatively shallow and dominated by commercial banks. Non-bank financial institutions generally play a limited role in Vanuatu's financial system, with the exception of the Vanuatu National Provident Fund (VNPF) given its relatively large asset size (20 percent of total banking system assets) and its importance as a source of liquidity for commercial banks. Commercial banks are well-capitalized and profitable. Banking system's liquidity is high in the aggregate, but is unevenly distributed, with some banks experiencing occasional shortages.

21. Recent developments. Before the cyclone, the RBV lowered the liquid assets requirement (LAR) from 7 to 5 percent in July 2014 to provide relief to less liquid institutions despite a high overall level of excess reserves. At the same time, bank capital ratios, while high, have been trending down. Non-performing loans (NPLs) have remained high, peaking at nearly 17 percent of total loans in mid-2014 driven by a few large loans, before



declining to 11 percent at end-2014 due to significant loan write-offs. Credit growth remained slow in line with anemic economic activity. To provide stimulus to the economy, RBV lowered its policy rate from 5½ to 5¼ percent in November 2014. However, the pass-through from the policy rate to lending rates is rather limited. Soon after Cyclone Pam, the government allowed contributors to the VNPF to withdraw up to 20 percent of their retirement savings—a figure expected to reach 2 billion vatu. This action was expected to put pressure on bank liquidity, as VNPF would have to liquidate some of its term deposits in the banking system to fund the withdrawals.

22. Monetary policy. After the cyclone, RBV moved swiftly to support economic recovery and financial stability by lowering its policy rate, reducing the required reserve ratio, and activating RBV's credit facilities. The policy rate was tied to the rate on RBV's 91-day bill (currently 1.8 percent). The Statutory Reserve Deposit (SRD) requirement was lowered from 7 to 5 percent to alleviate a potential liquidity pressure on banks after the VNPF withdrawals. The Secured Advance Facility was reactivated, allowing banks to borrow at a rate 250 basis points higher than the policy rate. The collateral requirement for this facility was relaxed and banks could now use their required reserves—in addition to their holdings of government bonds and RBV notes—as collateral. RBV also activated its new Import Substitution and Export Financing facility, allowing commercial banks to borrow at 1 percent under the condition that the funds will

be on-lent to private firms in specific sectors at a rate capped at 5 percent.⁹ In staff's view, the liquidity measures provide immediate relief to banks and will support post-cyclone recovery in the private sector. At the same time, liquidity support should be provided only to solvent banks and against adequate collateral. The authorities should be ready to withdraw liquidity once the situation is stabilized.

23. Financial stability. Liquidity pressures may still emerge, and NPLs are likely to rise because of cyclone damage. Commercial banks have voluntarily allowed their customers to suspend debt service for 2 or 3 months after the cyclone. Hence the impact of the disaster on loan performance has not yet crystallized. Staff emphasized that to safeguard against financial stability risks in the face of an anticipated pickup in credit demand, supervisory policies should ensure that banks continue to follow prudential norms for loan quality assessment with adequate risk management. Once the recovery takes hold and the situation improves, RBV should undertake a diagnostic assessment of bank balance sheets. If necessary, bank capital would need to be replenished by the government for the government-owned commercial bank or the parent banks in the case of foreign bank subsidiaries. Removing solvency concerns should also alleviate liquidity pressures in individual institutions, allowing monetary and macro-prudential policies to be driven by the overall economic and financial conditions.

24. Authorities' views. The authorities agreed with the importance of maintaining prudential standards. In the current conditions, the focus of monetary and financial policies is on supporting the economy and the banks. The authorities agreed with the necessity to evaluate the situation in individual banks after the recovery takes hold and to take corrective measures if necessary. They appreciated an offer to enlist PFTAC assistance with the diagnostic. The authorities noted their continued efforts to strengthen the financial sector regulatory framework through a number of measures. These include (i) implementing new prudential returns, which are more comprehensive than the previous ones; and (ii) adopting new prudential guidelines in several areas—such as asset classification, minimum provisioning, capital adequacy, and foreign currency open positions—in line with international regulatory standards.

D. Structural Policies

25. Challenges. Even before the cyclone struck, Vanuatu's growth was disappointingly low in the last 5 years. Infrastructure bottlenecks hindered economic activity, including tourism and agriculture. The business environment is good overall relative to most other PICs, but there is room for improvement



⁹ The spread of 4 percentage points accounts for associated costs and credit risk that banks take on under this lending scheme. It is smaller than the average interest rate spread in Vanuatu. Certain details of this facility are still being finalized.

in several categories. Similarly to other small islands, the economy is not very diversified. These challenges have been exacerbated by the cyclone.

26. Business environment. Infrastructure investment should be complemented with broad reforms aimed at enhancing the business environment. There is room to improve Vanuatu's ranking on the ease of starting a business and registering property.¹⁰ The cost of electricity is among the highest in the region. Land issues remain a challenge to business development, although to a lesser degree than in many other Pacific islands. The recent reforms to dispute resolution and leasing regime for customary land can be expected to improve transparency and fairness, but their impact on the ease of doing business remains to be seen.

27. Diversification. Vanuatu's export base is narrow, concentrated in tourism (primarily from Australia) and a few cash crops. Improvements in connectivity—thanks to the recently completed submarine cable connection, planned investment in transport infrastructure, and lower fuel prices—should facilitate introduction of new activities (e.g., call centers), robust growth beyond the capital, and expansion into new markets. In particular, the growing middle class in emerging Asia could be a major source of tourists, but tourism promotion in new countries is needed. On the other hand, Vanuatu's offshore financial sector has been under pressure from various Anti-money Laundering – Counter-terrorism Financing (AML-CTF) initiatives, and has shrunk further after the Global Financial Crisis (Appendix VI). The government may wish to consider whether the benefits of hosting the offshore financial sector outweigh the costs, including reputational risks.

28. Inclusiveness. Staff welcomes the authorities' commitment to inclusive growth aimed at fulfilling the National Vision of "A Just, Educated, Healthy and Wealthy Vanuatu" as elaborated in the government's *Priorities and Action Agenda*. Infrastructure development will improve both inter-island connectivity and access to export markets. Staff supports the government's commitment to bringing financial services to remote areas of the country, including via mobile banking and micro-credit. The authorities' plan to improve access to electricity in rural areas as well as in and around Port Vila is also welcome.

29. Authorities' views. The authorities emphasized their commitment to inclusive growth and poverty reduction. They are developing strategies for providing low-cost housing to the needy. The authorities agreed with the importance of diversifying the economy and shared their plans for extending the submarine cable to other islands and private sector ideas for making Vanuatu a business hub utilizing the high-speed internet connection. They expressed interest in conducting a cost-benefit analysis in regard to hosting an offshore financial sector.

STAFF APPRAISAL

30. Outlook. Vanuatu's economy is projected to decline by 2 percent this year, primarily because of massive damage to tourism and agriculture by Cyclone Pam, which is only partially offset by reconstruction. As export sectors start to recover, 5 percent growth is expected in 2016.

¹⁰ These indicators should be interpreted with caution owing to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

Risks are biased to the downside, particularly because of the uncertainty over the scale and timing of the government's reconstruction plans.

31. Balance-of-payments pressures and the exchange rate. With plunging exports and surging imports, RBV's international reserves will decline below prudent levels unless substantial assistance is provided by development partners. Staff therefore supports the authorities' request for balance-of-payments support in the amount of SDR17 million (100 percent of the quota) under combined RCF/RFI. The Fund's support would shore up reserves and catalyze aid from other development partners. The exchange rate is broadly in line with medium-term fundamentals and the peg should be maintained at its current level during the recovery period.

32. Fiscal challenges. Reconstruction cost in the order of 20 percent of GDP and some loss of tax revenue will put considerable pressures on the budget. The government should seek grants assistance as much as possible, formulating a sound recovery plan and building on the catalytic role of RCF/RFI. However, some recourse to concessional debt is unavoidable given the large size of the reconstruction cost. This borrowing, combined with that from the government's infrastructure investment plans, will cause the public debt to increase sharply in the next several years, and debt sustainability analysis indicates a shift from low to moderate risk of debt distress. Where feasible, the infrastructure investment pipeline should be used to support the current reconstruction effort and mitigate risks from possible future disasters.

33. Fiscal adjustments. The government should initiate steps to ensure that fiscal buffers are rebuilt once the reconstruction phase is over. Fiscal consolidation measures needed to put the public debt ratio on a downward trajectory include (i) revenue mobilization, with income tax introduction emerging as a viable option; (ii) spending discipline, including via strengthening public financial management; and (iii) rationalization of public investment in the context of a comprehensive infrastructure development plan aligned with national priorities, implementation capacity, and fiscal space. Steps in these areas should be taken as a high priority.

34. Government business enterprises. The authorities' efforts to ascertain the financial position and improve transparency and governance of GBEs are timely. The government should submit the new GBE law to Parliament without delay and proceed with its rationalization plans for commercial GBEs.

35. Monetary policy. RBV's measures to support the economy and the banking system are welcome. Liquidity should be provided to solvent banks against adequate collateral. Supervisory policies should ensure that banks continue to follow prudential norms in their loan assessment, with adequate risk management.

36. Financial sector. The banking system appears well-capitalized. However, the high level of NPLs is a source of concern, and liquidity, while high overall, is distributed unevenly. Liquidity support for the banking system is essential at the moment. However, once the pressures subside, a thorough assessment of bank balance sheets should be conducted and, if necessary, bank capital should be replenished.

37. Structural policies. Vanuatu would benefit from reforms aimed at enhancing the business environment, including by making it easier to start a business, register property, and lease land. The recently established high-speed internet connection should facilitate diversification of the economy. The authorities' commitment to economic and financial inclusion is welcome.

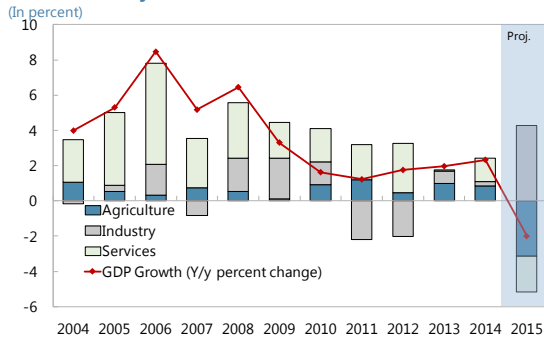
38. Consultation cycle. Given the devastation to the economy and the need for close monitoring and consultation with the authorities in the coming year, it is recommended that the next Article IV consultation be held on the 12-month cycle.

Figure 1. Recent Developments and Prospects

Tropical Cyclone Pam inflicted damage on Vanuatu's agriculture and tourism sector...

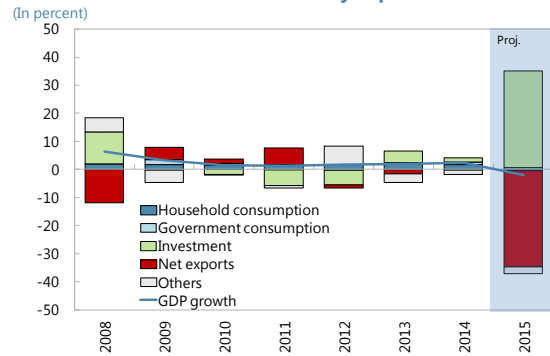
...crimping exports.

Real Growth by Sector 1/



Sources: Authorities; and IMF staff calculations. 1/ 2014 : estimate.

Contribution to Real GDP Growth by Expenditure

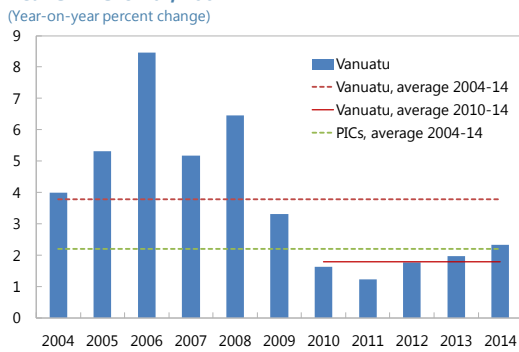


Sources: Vanuatu authorities; and IMF staff estimations.

Growth has been low in the last 5 years.

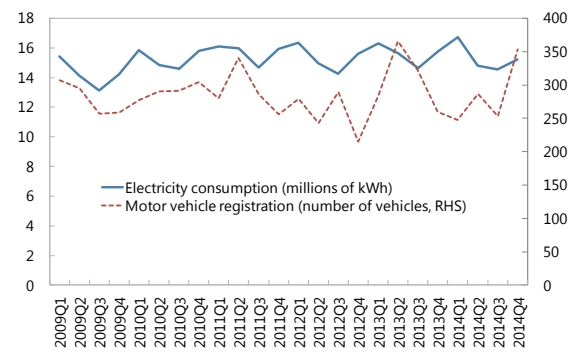
Indicators of private demand remained broadly flat.

Real GDP Growth, 2004-14^{1/}



Sources: Authorities; and IMF staff estimates. 1/ 2014: estimate.

Electricity Consumption and Motor Vehicle Registration

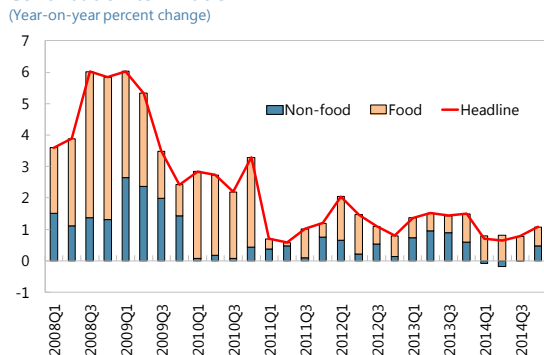


Source: Reserve Bank of Vanuatu.

Inflation moderated in 2014 as non-food prices weakened.

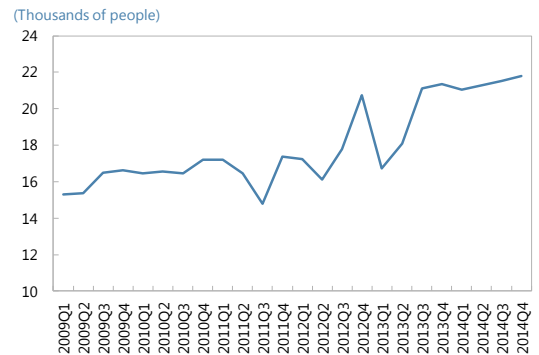
Formal employment continued to increase.

Contribution to Inflation



Sources: Vanuatu authorities; and IMF staff calculations.

Contributors to Vanuatu National Provident Fund

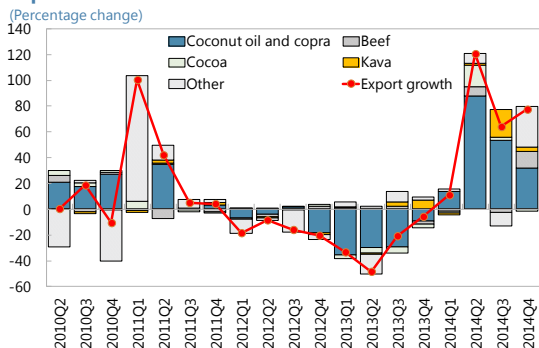


Source: Reserve Bank of Vanuatu.

Figure 2. External Sector Developments

Export growth was strong in 2014 due to favorable international prices.

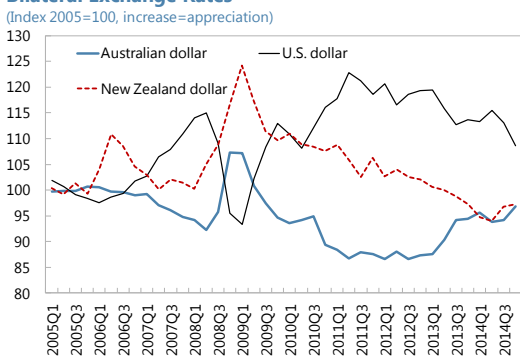
Export Growth



Source: Vanuatu authorities.

The exchange rate recently appreciated against the Australian dollar but weakened against the U.S. dollar.

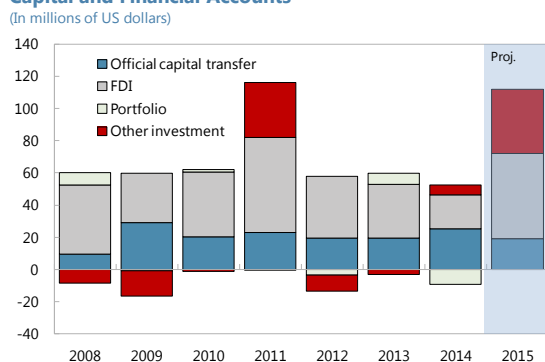
Bilateral Exchange Rates



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

FDI and other investment will only cover part of the gap...

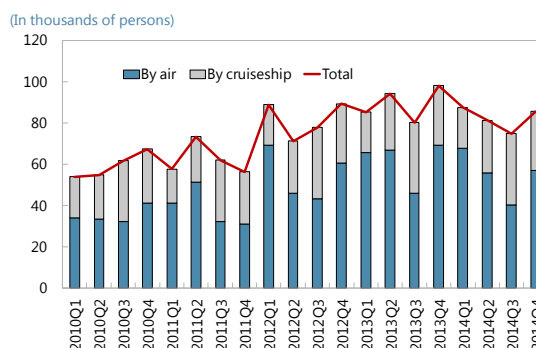
Capital and Financial Accounts



Sources: Vanuatu authorities; and IMF staff calculations.

Tourist arrivals declined somewhat.

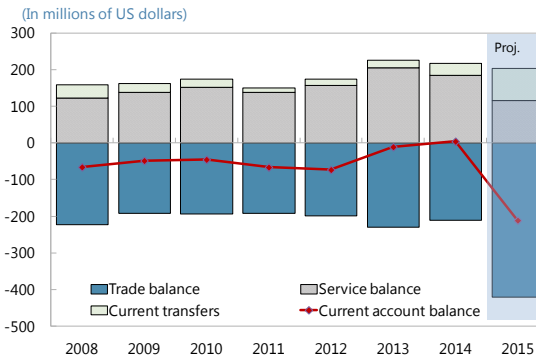
Tourist Arrivals



Source: Vanuatu authorities

Current account balance is expected to drop sharply in 2015 due to lower exports and higher imports.

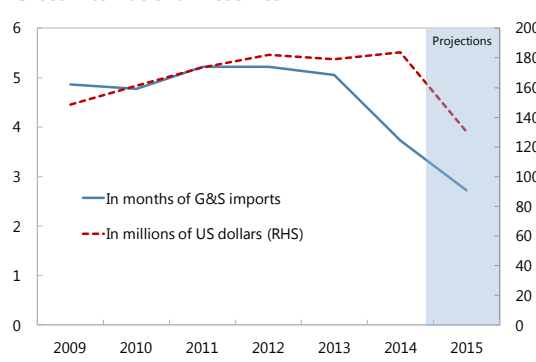
Current Account



Sources: Vanuatu authorities; and IMF staff calculations.

...leading to a drain on international reserves.

Gross International Reserves

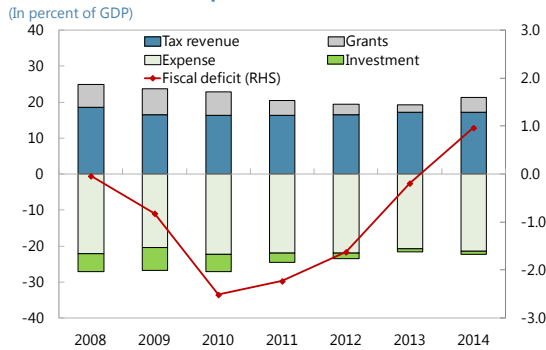


Sources: Vanuatu authorities; and IMF staff estimates.

Figure 3. Public Finance and Monetary Indicators

Fiscal balances improved in recent years.

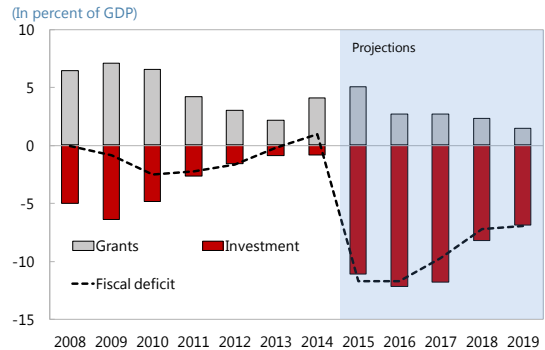
Fiscal Revenue and Expenditure



Sources: Vanuatu authorities; and IMF staff calculations.

However, reconstruction and new investment needs will likely lead to high fiscal deficits...

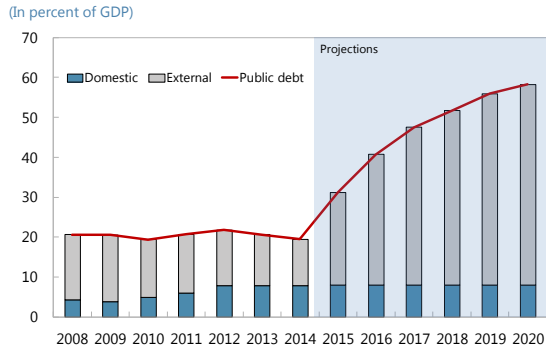
Fiscal Balance



Sources: Vanuatu authorities; and IMF staff estimates.

...and drive up public debt.

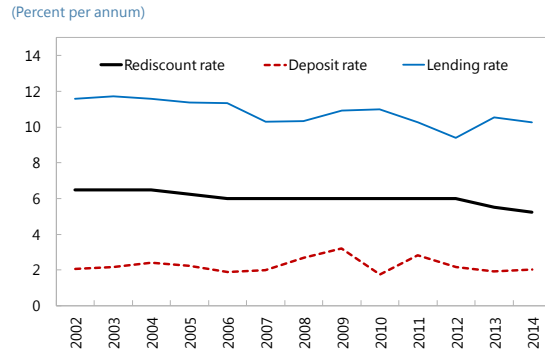
Public Debt



Sources: Authorities; and IMF staff estimates.

Transmission from policy rate to commercial banks' interest rates appears limited.

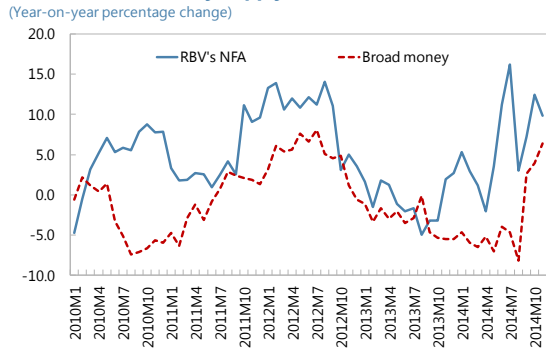
Interest Rates



Source: Vanuatu authorities.

Money supply expanded strongly in the second half of 2014 in tandem with increasing net foreign assets of the central bank.

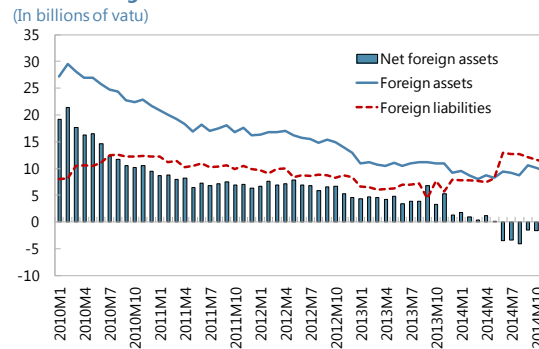
RBV's NFA and Money Supply



Source: Vanuatu authorities.

However, net foreign assets of the commercial banks continued to decline and turned negative in mid-2014.

Banks' Foreign Assets and Liabilities



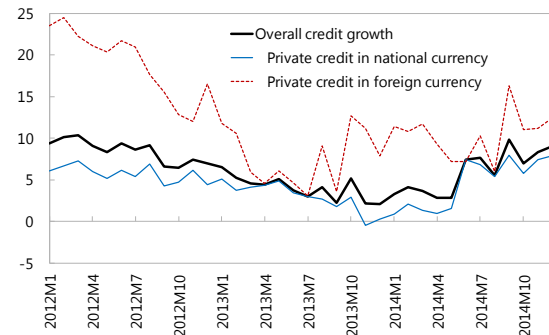
Source: Vanuatu authorities.

Figure 4. Financial Sector Developments

Private credit growth started to turn around after having been on a decline during the past years.

Private Credit Growth

(Year-on-year percentage change)

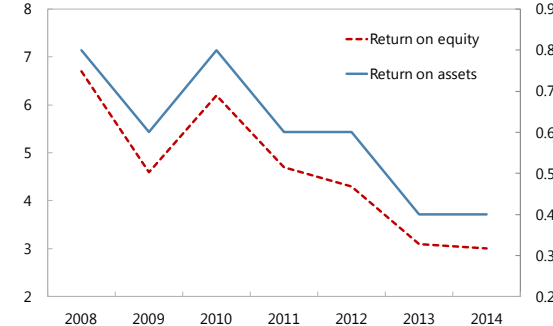


Source: Vanuatu authorities.

At the same time, bank profitability appears to have improved.

Bank Profitability

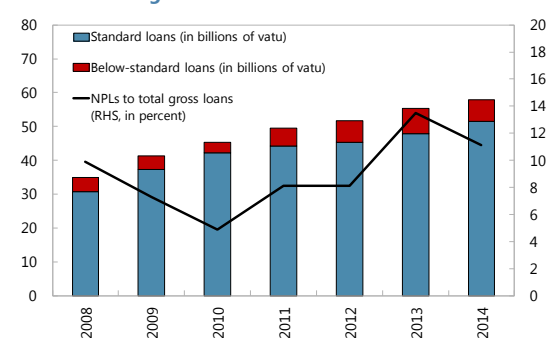
(In percent)



Source: Vanuatu authorities.

NPLs were on the rise until late 2014.

Non-Performing Loans

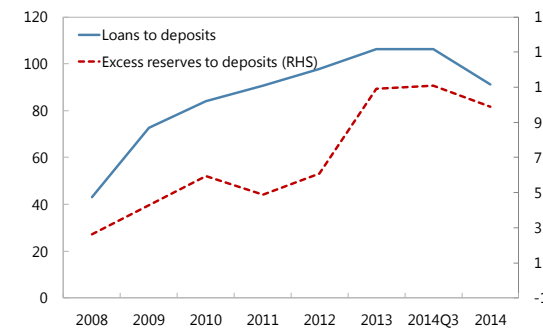


Source: Vanuatu authorities.

Despite the high loan-to-deposit ratio, overall bank liquidity remained ample.

Loan-to-Deposit and Excess Reserve Ratio

(percentage)

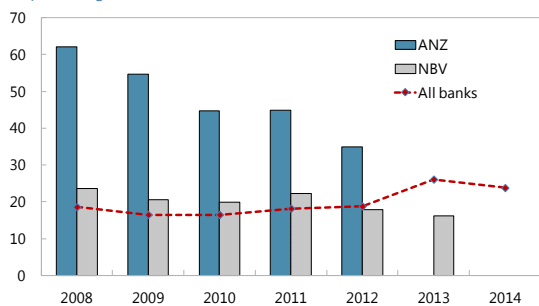


Source: Vanuatu authorities.

However, liquidity is distributed unevenly across banks.

Liquid Assets to Total Assets

(In percentage)

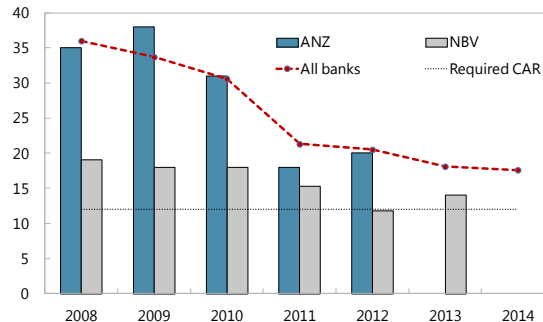


Sources: Vanuatu authorities; Bankscope; and IMF staff calculations.

The capital ratio has been on a declining trend, although still well above the required level.

Total Capital Ratio

(Total capital in percent of risk-weighted assets)



Sources: Vanuatu authorities; and Bankscope.

Table 1. Vanuatu: Selected Economic and Financial Indicators, 2009–15

	2009	2010	2011	2012	2013	Est.	Proj.	
						2014	2015	
Output and prices (annual percentage change)								
Real GDP	3.3	1.6	1.2	1.8	2.0	2.3	-2.0	3.5
Consumer prices (period average)	5.2	2.7	0.7	1.4	1.3	1.0	2.0	0.5
Consumer prices (end period)	2.4	3.3	1.2	0.8	1.5	1.1	2.2	1.0
Government finance (in percent of GDP)								
Revenue	26.0	24.6	22.3	21.8	21.3	23.3	26.0	21.8
Taxes	16.6	16.3	16.4	16.5	17.2	17.2	16.7	17.0
Other revenue	2.2	1.7	1.7	2.2	2.0	2.0	4.2	1.9
Grants	7.1	6.5	4.2	3.0	2.2	4.1	5.1	2.4
Expenditure	26.8	27.1	24.4	23.4	21.5	22.3	37.7	29.4
Expense	20.4	22.2	21.9	21.8	20.6	21.4	26.5	22.0
Net acquisition of non financial assets	6.4	4.9	2.7	1.6	0.9	0.9	11.1	7.4
Net lending (+)/borrowing (-)	-0.8	-2.5	-2.1	-1.6	-0.2	1.0	-11.7	-7.6
Central government debt (end of period)	20.5	19.4	20.7	21.7	20.6	19.5	31.2	26.1
Domestic	3.8	4.8	6.0	7.8	7.8	7.8	8.0	7.6
External	16.7	14.5	14.7	14.0	12.7	11.7	23.2	18.5
Money and credit (annual percentage change)								
Broad money (M2)	0.5	-6.0	1.3	-0.6	-5.5	8.6	3.1	...
Net foreign assets	-18.3	-34.5	-8.1	-6.3	-25.0	13.1	-41.9	...
Domestic credit	4.6	4.6	4.6	5.8	2.6	4.1	15.8	...
Of which: Credit to private sector	19.9	11.6	9.4	6.9	1.7	3.8	15.0	...
Interest rates (in percent, end of period) 1/								
Deposit rate (vatu deposits)	3.2	1.8	2.8	2.2	1.9	2.0	...	...
Lending rate (vatu loans)	10.9	11.0	10.3	9.4	10.7	10.3	...	...
Balance of payments (in percent of GDP)								
Current account	-7.9	-6.5	-8.4	-9.4	-1.4	0.5	-27.4	-7.7
Trade balance	-31.5	-27.7	-24.4	-25.4	-28.8	-25.8	-54.5	-32.3
Exports of goods	9.0	6.9	8.5	7.0	4.8	7.7	5.4	7.3
Imports of goods	-40.5	-34.6	-32.9	-32.4	-33.6	-33.5	-59.8	-39.6
Tourism receipts	30.6	30.9	28.1	30.9	35.9	31.3	22.0	31.0
Capital and financial account	7.1	9.1	13.1	5.4	8.4	6.3	17.8	14.7
Without RCF/RFI							14.7	
RCF/RFI							3.0	
Gross international reserves (in months of prospective G&S imports) - without RCF/RFI	4.9	4.8	5.2	5.2	5.1	4.8	2.7	5.4
Gross international reserves (in months of prospective G&S imports) - with RCF/RFI							3.2	
External debt service (in percent of GNFS exports)	1.6	1.4	1.5	1.4	1.7	2.0	3.0	2.2
Exchange rates 2/								
Vatu per U.S. dollar (period average)	106.7	96.9	89.5	92.6	94.5	97.1	...	...
Vatu per U.S. dollar (end of period)	97.9	93.2	93.6	91.7	97.3	102.7	...	...
Real effective exchange rate (average)	96.5	100.0	100.4	103.1	104.0	105.0	...	...
Memorandum items:								
Nominal GDP (in billions of vatu)	65.1	67.9	70.9	72.4	75.8	79.8	79.8	83.0
Nominal GDP (in millions of U.S. dollars)	610	701	792	782	802	822	771	802

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

1/ Weighted average rate of interest for total bank deposits and loans. September data for 2014.

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

Table 2. Vanuatu: Balance of Payments, 2010–20
(in millions of U.S. dollars)

	2010	2011	2012	2013	Est.		Proj.				
					2014	2015	2016	2017	2018	2019	2020
Current account balance	-45	-66	-73	-11	4	-211	-155	-128	-112	-114	-104
Trade balance	-194	-193	-198	-231	-212	-420	-382	-365	-344	-351	-349
Exports of goods (f.o.b.)	48	67	55	39	63	41	56	60	67	71	74
Imports of goods (f.o.b.)	-243	-260	-253	-270	-275	-461	-437	-425	-411	-422	-423
Services balance	152	138	156	204	184	115	183	243	239	243	247
Receipts	276	283	302	353	334	246	319	395	409	432	456
<i>Of which: travel</i>	216	223	241	288	257	169	237	306	315	332	350
Payments	-124	-145	-146	-149	-149	-131	-136	-152	-170	-189	-209
Primary income	-25	-23	-48	-5	0	7	11	-26	-28	-27	-29
Receipts	37	41	36	33	36	34	38	41	44	48	51
Payments	-62	-65	-84	-37	-35	-27	-27	-67	-71	-75	-80
Secondary income	22	12	17	21	32	87	33	20	21	21	26
Official	21	10	14	20	28	51	18	17	18	18	23
Private	1	2	3	1	3	36	15	3	3	3	3
Capital and financial account	64	104	42	67	52	114	120	128	141	136	117
Capital account	21	24	23	21	32	21	28	31	29	22	18
<i>Of which: Official capital transfers (net)</i>	20	23	20	20	25	19	26	29	27	20	16
Financial account	43	80	19	46	20	92	91	96	112	114	99
Foreign direct investment	40	59	38	33	21	53	48	48	48	48	48
Portfolio investment	2	-1	-4	7	-9	0	0	0	0	0	0
Other investment	-1	34	-10	-3	6	40	44	49	64	66	51
Net errors and omissions	-6	-25	40	-59	-51	0	0	0	0	0	0
Overall balance	13	12	8	-3	5	-97	-35	0	29	22	13
Financing:	-13	-12	-8	3	-5	97	35	0	-29	-22	-13
Change in international reserves (- = increase)	-13	-12	-8	3	-5	31	-8	-28	-26	-16	-8
IMF's RCF/RFI						23	0	0	-3	-6	-4
Financing gap ^{1/}						44	43	28	0	0	0
Memorandum items:											
Gross international reserves (without RCF/RFI)	161	174	182	179	184	130	138	166	195	217	230
In months of prospective imports	4.8	5.2	5.2	5.1	3.7	2.7	2.9	3.4	3.8	4.1	4.5
Gross international reserves (with RCF/RFI)						153	162	189	215	231	240
In months of prospective imports						3.2	3.4	3.9	4.2	4.4	4.7
Current account balance (in percent of GDP)	-6.5	-8.4	-9.4	-1.4	0.5	-27.4	-18.7	-14.3	-11.7	-11.3	-9.8
Exports of goods (annual percentage change)	-12.2	38.7	-18.5	-29.4	64.2	-35.0	35.0	7.0	12.0	6.0	5.0
Imports of goods (annual percentage change)	-1.7	7.2	-2.7	6.5	2.2	67.5	-5.2	-2.9	-3.3	2.8	0.2
Exchange rate (vatu per U.S. dollar, period average)	96.9	89.5	92.6	94.5	97.1	...	...	...	...	...	...
Exchange rate (vatu per U.S. dollar, end of period)	93.2	93.6	91.7	97.3	102.7	...	...	...	...	...	...
Public external debt (in percent of GDP)	14.5	14.7	14.0	12.7	11.7	23.2	32.7	39.5	43.7	47.9	50.2
Public external debt service (in percent of GNFS exports)	1.4	1.5	1.4	1.7	2.0	3.0	2.6	2.5	3.2	4.5	4.5
Nominal GDP	701	792	782	802	822	771	828	893	953	1006	1062

1/ The gap is expected to be closed by donors considering support in light of the recently finalized PDNA.

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

Table 3. Vanuatu: Central Government Budgetary Operations, 2010–20 ^{1/}

	2010	2011	2012	2013	Prel. Budget		Proj.					
					2014	2015	2015	2016	2017	2018	2019	2020
(In millions of vatu)												
Revenue	16,708	15,804	15,764	16,174	18,566	18,989	20,720	19,969	21,965	22,411	22,648	23,665
Taxes	11,089	11,630	11,982	13,027	13,730	14,069	13,330	15,971	17,640	18,174	19,070	19,890
Other revenue	1,187	1,220	1,608	1,490	1,558	2,029	3,344	1,676	1,807	1,929	2,037	2,149
Grants	4,431	2,954	2,174	1,657	3,278	2,892	4,046	2,322	2,518	2,308	1,541	1,626
Expenditure	18,416	17,315	16,942	16,320	17,797	24,233	30,056	30,007	30,987	29,534	29,922	29,439
Expense	15,109	15,505	15,803	15,637	17,113	18,163	21,182	19,534	20,067	21,433	22,753	24,205
<i>Of which:</i> Compensation of employees	7,831	7,862	8,412	8,440	8,455	8,844	8,540	8,893	9,357	9,936	10,574	11,155
Interest payment	334	398	463	555	573	684	812	918	1,097	1,239	1,351	1,626
Net acquisition of nonfinancial assets	3,307	1,881	1,139	684	684	6,071	8,874	10,473	10,920	8,101	7,169	5,234
Gross operating balance	1,599	299	-39	538	1,453	827	-462	435	1,898	978	-105	-540
Net lending (+)/borrowing (-)	-1,708	-1,511	-1,178	-146	769	5,245	-9,336	-10,038	-9,022	-7,123	-7,274	-5,774
<i>Of which:</i> Net incurrence of liabilities	1,064	1,233	1,054	-159	-51	5,245	4,823	5,567	6,123	7,123	7,274	5,774
Domestic	800	950	1,389	306	263	163	163	515	535	500	441	459
Foreign	264	282	-335	-465	-314	5,082	4,660	5,052	5,588	6,623	6,833	5,315
Financing gap							4,513	4,471	2,899			
(In percent of GDP)												
Revenue	24.6	22.3	21.8	21.3	23.3	21.4	26.0	23.3	23.7	22.7	21.7	21.5
Taxes	16.3	16.4	16.5	17.2	17.2	15.9	16.7	18.6	19.1	18.4	18.3	18.1
Other revenue	1.7	1.7	2.2	2.0	2.0	2.3	4.2	2.0	2.0	2.0	2.0	2.0
Grants	6.5	4.2	3.0	2.2	4.1	3.3	5.1	2.7	2.7	2.3	1.5	1.5
Expenditure	27.1	24.4	23.4	21.5	22.3	27.3	37.7	34.9	33.5	29.9	28.7	26.7
Expense	22.2	21.9	21.8	20.6	21.4	20.5	26.5	22.7	21.7	21.7	21.8	22.0
<i>Of which:</i> Compensation of employees	11.5	11.1	11.6	11.1	10.6	10.0	10.7	10.4	10.1	10.1	10.1	10.1
Interest payment	0.5	0.6	0.6	0.7	0.7	0.8	1.0	1.1	1.2	1.3	1.3	1.5
Net acquisition of nonfinancial assets	4.9	2.7	1.6	0.9	0.9	6.8	11.1	12.2	11.8	8.2	6.9	4.8
Gross operating balance	2.4	0.4	-0.1	0.7	1.8	0.9	-0.6	0.5	2.1	1.0	-0.1	-0.5
Net lending (+)/borrowing (-)	-2.5	-2.1	-1.6	-0.2	1.0	5.9	-11.7	-11.7	-9.7	-7.2	-7.0	-5.2
<i>Of which:</i> Net incurrence of liabilities	1.6	1.7	1.5	-0.2	-0.1	5.9	6.0	6.5	6.6	7.2	7.0	5.2
Domestic	1.2	1.3	1.9	0.4	0.3	0.2	0.2	0.6	0.6	0.5	0.4	0.4
Foreign	0.4	0.4	-0.5	-0.6	-0.4	5.7	5.8	5.9	6.0	6.7	6.5	4.8
Financing gap							5.7	5.2	3.1			
Memorandum items:												
Public and publicly-guaranteed debt	22.4	23.7	24.6	23.3	24.0	30.1	38.8	47.7	54.0	57.5	60.9	62.5
Central government debt	19.4	20.7	21.7	20.6	19.5	26.0	31.2	40.7	47.5	51.7	55.9	58.2
Domestic	4.8	6.0	7.8	7.8	7.8	7.0	8.0	8.0	8.0	8.0	8.0	8.0
External	14.5	14.7	14.0	12.7	11.7	19.0	23.2	32.7	39.5	43.7	47.9	50.2
Guaranteed GBE debt	3.1	2.9	2.9	2.8	4.6	4.1	4.6	4.2	3.9	3.7	3.5	3.3
RCF/RFI							3.0	2.8	2.6	2.2	1.5	1.0
Debt service	0.9	1.0	1.9	2.4	2.2		3.0	3.1	3.3	3.5	3.6	3.9
Primary balance	-2.0	-1.7	-1.0	0.5	1.7	-5.1	-10.7	-10.6	-8.6	-6.0	-5.7	-3.8
Nominal GDP (millions of vatu) ^{2/}	67,911	70,873	72,415	75,803	79,819	88,728	79,803	85,879	92,573	98,828	104,338	110,077

1/ Fiscal year corresponds to the calendar year.

2/ Authorities' pre-cyclone GDP projection is used for 2015 budget.

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

Table 4. Vanuatu: Monetary Survey, 2009–2015

	2009	2010	2011	2012	2013	2014 Est.	2015 Proj.
(In millions of vatu; end of period)							
Net foreign assets	33,409	21,876	20,113	18,847	14,131	15,975	9,284
Monetary authorities	11,600	12,321	13,781	14,293	14,822	16,342	10,762
Commercial banks	21,809	9,555	6,332	4,554	-691	-367	-1,479
Net domestic assets	26,737	34,677	37,174	38,084	39,654	42,416	50,945
Domestic credit	36,435	42,786	47,695	50,469	51,773	53,886	62,415
Claims on government (net)	-2,971	-1,183	-713	-1,200	-1,089	-1,618	-1,455
Claims on municipalities	16	16	34	36	85	91	141
Claims on other sectors	39,390	43,953	48,374	51,633	52,778	55,413	63,729
Claims on nonfinancial public enterprises	107	95	410	371	648	1,306	1,506
Claims on private sector	39,283	43,857	47,963	51,262	52,129	54,107	62,223
Other items (net)	-9,699	-8,109	-10,520	-12,385	-12,119	-11,471	-11,471
Total broad money	60,146	56,552	57,287	56,930	53,772	58,391	60,228
Narrow money	11,542	14,048	14,586	14,604	19,186	22,387	23,936
Currency outside banks	3,917	4,553	4,886	4,889	5,054	5,533	5,396
Demand deposits	7,625	9,494	9,700	9,714	14,132	16,854	18,540
Quasi-money	48,604	42,504	42,701	42,327	34,586	36,004	36,293
Time and savings deposits	21,379	23,162	25,317	24,876	19,617	22,261	23,374
Foreign currency deposits	27,225	19,342	17,384	17,451	14,969	13,743	12,919
(Annual percentage change, unless otherwise indicated)							
Net foreign assets	-18.3	-34.5	-8.1	-6.3	-25.0	13.1	-41.9
Net domestic assets	40.8	29.7	7.2	2.4	4.1	7.0	20.1
Domestic credit	22.1	17.4	11.5	5.8	2.6	4.1	15.8
Private sector credit	19.9	11.6	9.4	6.9	1.7	3.8	15.0
Total broad money	0.5	-6.0	1.3	-0.6	-5.5	8.6	3.1
Vatu broad money	6.0	13.0	7.2	-1.1	-1.7	15.1	6.0
Memorandum items:							
Vatu broad money multiplier	2.9	2.6	2.7	2.7	2.0	2.0	2.0
Total broad money multiplier	5.2	4.0	3.9	3.9	2.8	2.6	2.5
Velocity							
Narrow money	5.7	5.3	5.1	5.2	4.5	3.8	3.4
Vatu broad money	2.0	1.9	1.8	1.8	1.9	1.9	1.7
Total broad money	1.1	1.2	1.2	1.3	1.4	1.4	1.3
Reserve money (in millions of vatu)	9,421	11,157	11,881	12,992	15,328	16,851	11,698
Reserve money (annual percentage change)	1.5	18.4	6.5	9.4	18.0	9.9	-30.6
Credit to private sector (in percent of GDP)	60.3	64.6	67.7	70.8	68.8	67.8	78.0
Foreign currency deposits (annual percentage change)	-5.5	-29.0	-10.1	0.4	-14.2	-8.2	-6.0
Foreign currency deposits/total deposits (percent)	48.4	37.2	33.2	33.5	30.7	26.0	23.6
Foreign currency credit/total credit (percent)	18.4	19.1	21.6	23.1	24.8	26.5	26.0
Net foreign assets of banks (in millions of U.S. dollars)	222.7	102.6	67.7	49.6	-7.1	-3.6	-14.3
Net foreign assets (in percent of GDP)	51.3	32.2	28.4	26.0	18.6	20.0	11.6
Nominal GDP (in millions of vatu)	65,117	67,911	70,873	72,415	75,803	79,819	79,803

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

Table 5. Vanuatu: Medium-Term Baseline Scenario, 2010–20

	2010	2011	2012	2013	Est.	Proj.					
					2014	2015	2016	2017	2018	2019	2020
Output and prices (annual percentage change)											
Real GDP	1.6	1.2	1.8	2.0	2.3	-2.0	5.0	4.5	3.5	2.5	2.5
Consumer prices (period average)	2.7	0.7	1.4	1.3	1.0	2.0	2.5	3.2	3.1	3.0	3.0
Consumer prices (end of period)	3.3	1.2	0.8	1.5	1.1	2.2	3.0	3.3	3.0	3.0	3.0
Government finances (in percent of GDP)											
Revenue	24.6	22.3	21.8	21.3	23.3	26.0	23.3	23.7	22.7	21.7	21.5
Revenue	16.3	18.1	18.8	19.2	19.2	20.9	20.5	21.0	20.3	20.2	20.0
Taxes		16.4	16.5	17.2	17.2	16.7	18.6	19.1	18.4	18.3	18.1
Other revenue		1.7	2.2	2.0	2.0	4.2	2.0	2.0	2.0	2.0	2.0
Grants	6.5	4.2	3.0	2.2	4.1	5.1	2.7	2.7	2.3	1.5	1.5
Expenditure	27.1	24.4	23.4	21.5	22.3	37.7	34.9	33.5	29.9	28.7	26.7
Expense	22.2	21.9	21.8	20.6	21.4	26.5	22.7	21.7	21.7	21.8	22.0
Net acquisition of non-financial assets	4.9	2.7	1.6	0.9	0.9	11.1	12.2	11.8	8.2	6.9	4.8
Net lending (+)/borrowing (-)	-2.5	-2.1	-1.6	-0.2	1.0	-11.7	-11.7	-9.7	-7.2	-7.0	-5.2
Public and publicly guaranteed debt		23.7	24.6	23.3	24.0	38.8	47.7	54.0	57.5	60.9	62.5
Central government debt (end of period)	19.4	20.7	21.7	20.6	19.5	31.2	40.7	47.5	51.7	55.9	58.2
Domestic	4.8	6.0	7.8	7.8	7.8	8.0	8.0	8.0	8.0	8.0	8.0
External	14.5	14.7	14.0	12.7	11.7	23.2	32.7	39.5	43.7	47.9	50.2
Guaranteed GBE debt		2.9	2.9	2.8	4.6	4.6	4.2	3.9	3.7	3.5	3.3
RCF/RFI						3.0	2.8	2.6	2.2	1.5	1.0
Balance of payments (in percent of GDP)											
Current account	-6.5	-8.4	-9.4	-1.4	0.5	-27.4	-18.7	-14.3	-11.7	-11.3	-9.8
Trade balance	-27.7	-24.4	-25.4	-28.8	-25.8	-54.5	-46.1	-40.9	-36.1	-34.9	-32.9
Exports of goods	6.9	8.5	7.0	4.8	7.7	5.4	6.7	6.7	7.0	7.0	7.0
Imports of goods	-34.6	-32.9	-32.4	-33.6	-33.5	-59.8	-52.8	-47.6	-43.1	-41.9	-39.9
Tourism receipts	30.9	28.1	30.9	35.9	31.3	22.0	28.6	34.3	33.0	33.0	33.0
Capital and financial account	9.1	13.1	5.4	8.4	6.3	14.7	14.4	14.3	14.8	13.5	11.0
Of which: Foreign direct investment	5.7	7.5	4.9	4.2	2.6	6.8	5.8	5.3	5.0	4.7	4.5
Overall balance		1.6	1.1	-0.4	0.6	-12.6	-4.2	0.0	3.1	2.1	1.2
Gross international reserves (in millions of U.S. dollars)	161.4	174	182	179	184	130	138	166	195	217	230
In months of prospective imports	4.8	5.2	5.2	5.1	3.7	2.7	2.9	3.4	3.8	4.1	4.5
External debt service (in percent of GNFS exports)	1.4	1.5	1.4	1.7	2.0	3.0	2.6	2.5	3.2	4.5	4.5
Memorandum items:											
Nominal GDP (in billions of vatu)	67.9	70.9	72.4	75.8	79.8	79.8	85.9	92.6	98.8	104.3	110.1
Nominal GDP (in millions of U.S. dollars)	700.8	792	782	802	822	771	828	893	953	1,006	1,062

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

Table 6. Vanuatu: Banks' Financial Soundness Indicators, 2009–14
(In percent)

	2009	2010	2011	2012	2013	2014
Capital adequacy						
Regulatory capital to risk-weighted assets	33.7	30.6	21.3	20.5	18.1	17.6
Regulatory Tier 1 capital to risk-weighted assets	32.5	29.5	18.7	18.3	15.9	16.7
Asset quality						
Nonperforming loans net of provisions to capital	15.7	14.7	16.8	12.0	37.4	49.4
Nonperforming loans to total gross loans	7.3	4.9	8.1	8.1	13.5	11.1
Earnings and profitability						
Return on assets	0.6	0.8	0.6	0.6	0.4	0.4
Return on equity	4.6	6.2	4.7	4.3	3.1	3.0
Interest margin to gross income	42.5	41.9	43.1	46.5	50.1	54.3
Noninterest expenses to gross income	46.1	37.8	46.4	52.4	46.9	55.2
Liquidity						
Liquid assets to total assets (liquid asset ratio)	16.5	16.5	18.2	18.8	26.1	23.8

Source: Reserve Bank of Vanuatu.

Table 7. Vanuatu: Millennium Development Goals, 1990–2013 ^{1/}

	1990	1995	2000	2005	2007	2009	2010	2011	2012	2013	Status 1/
Goal 1: Eradicate extreme poverty and hunger											Mixed
Employment to population ratio, 15+, total (percent)	0	0	0	0	0	0	68	0	0	0	
Malnutrition prevalence, weight for age (percent of children under 5)	..	..	..	..	..	..	..	..	..	..
Poverty gap at \$1.25 a day (PPP) (percent)	..	..	..	..	..	..	..	..	..	..
Poverty headcount ratio at \$1.25 a day (PPP) (percent of population)	..	..	..	..	..	..	..	..	..	..
Prevalence of undernourishment (percent of population)	0	0	0	0	0	0	0	0	0	0	
Vulnerable employment, total (percent of total employment)	0	0	0	0	0	0	70	0	0	0	
Goal 2: Achieve universal primary education											Mixed
Literacy rate, youth female (percent of females ages 15-24)	0	0	0	0	0	0	0	0	0	95	
Literacy rate, youth male (percent of males ages 15-24)	0	0	0	0	0	0	0	0	0	95	
Persistence to last grade of primary, total (percent of cohort)	0	0	0	0	77	71	0	0	0	0	
Primary completion rate, total (percent of relevant age group)	0	0	0	0	0	0	0	0	0	0	
Total enrollment, primary (percent net)	0	0	99	99	0	0	0	0	0	0	
Goal 3: Promote gender equality and empower women											Mixed
Proportion of seats held by women in national parliaments (percent)	0	0	0	0	0	0	0	0	0	0	
Ratio of female to male enrollments in tertiary education (percent)	0	0	0	0	0	0	0	0	0	0	
Ratio of female to male primary enrollment (percent)	0	0	0	0	0	0	0	0	0	0	
Ratio of female to male secondary enrollment (percent)	0	0	0	0	0	0	0	0	0	0	
Share of women employed in the nonagricultural sector (percent of total nonagricultural employment)	0.0	0.0	0.0	37.9	37.8	38.9	0.0	0.0	0.0	0.0	
Goal 4: Reduce child mortality											On Track
Immunization, measles (percent of children ages 12-23 months)	76	73	71	68	68	68	68	68	68	68	
Mortality rate, infant (per 1,000 live births)	27	22	20	18	17	17	16	16	15	15	
Mortality rate, under-5 (per 1,000)	33	27	23	21	20	20	19	19	18	18	
Goal 5: Improve maternal health											Mixed
Adolescent fertility rate (births per 1,000 women ages 15-19)	73	65	58	51	48	47	47	46	45	45	
Births attended by skilled health staff (percent of total)	0	89	0	0	74	0	0	0	0	0	
Contraceptive prevalence (percent of women ages 15-49)	0	39	0	0	38	0	0	0	0	0	
Maternal mortality ratio (national estimate, per 100,000 live births)	0	0	0	0	86	0	0	0	0	0	
Goal 6: Combat HIV/AIDS, malaria, and other diseases											On Track
Children with fever receiving antimalarial drugs (percent of children under age 5 with fever)	0	0	0	0	53	0	0	0	0	0	
Incidence of tuberculosis (per 100,000 people)	127	63	110	83	77	74	72	69	67	65	
Prevalence of HIV, total (percent of population ages 15-49)	0	0	0	0	0	0	0	0	0	0	
Tuberculosis case detection rate (percent, all forms)	75	75	75	44	72	61	81	71	68	78	
Goal 7: Ensure environmental sustainability											Off Track
CO2 emissions (kg per PPP \$ of GDP)	0.3	0.2	0.2	0.1	0.2	0.1	0.2	0.2	0.0	0.0	
CO2 emissions (metric tons per capita)	0.5	0.4	0.4	0.3	0.4	0.4	0.5	0.5	0.0	0.0	
Forest area (percent of land area)	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	36.1	
Improved sanitation facilities (percent of population with access)	0	36	42	49	52	54	55	56	58	58	
Improved water source (percent of population with access)	62	69	76	83	85	87	88	89	91	91	
Marine protected areas, (percent of territorial water)	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.0	0.0	0	
Goal 8: Develop a global partnership for development											
Internet users (per 100 people)	0.0	0.0	2.1	5.1	6.8	7.3	7.5	8.0	9.2	10.6	
Mobile cellular subscriptions (per 100 people)	0.0	0.1	0.2	6.1	11.8	16.0	57.0	71.9	56.6	59.1	
Telephone lines (per 100 people)	1.8	2.5	3.6	3.3	4.0	4.6	3.1	3.0	2.4	2.0	
Other											
Fertility rate, total (births per woman)	4.9	4.7	4.4	3.9	3.7	3.6	3.5	3.5	3.5	3.4	
GNI per capita, Atlas method (current US\$)	1,200	1,270	1,430	1,780	2,120	2,510	2,590	2,700	2,850	3,010	
GNI, Atlas method (current US\$) (billions)	0.2	0.2	0.3	0.4	0.5	0.6	0.6	0.6	0.7	0.7	
Gross capital formation (percent of GDP)	33	23	20	24	32	41	40	35	27	23	
Life expectancy at birth, total (years)	63	65	68	69	70	70	71	71	71	71	
Literacy rate, adult total (percent of people ages 15 and above)	0	0	0	0	0	0	0	0	0.00	83	
Population, total (millions)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Trade (percent of GDP)	120	98	87	100	88	103	105	99	94	100	

Source: World Bank, *World Development Indicators* database.1/ According to Pacific Islands Forum Secretariat 2013 *Pacific Regional MDGs Tracking Report*.

Table 8. Financial Access/Inclusion Indicators

(as of end-2013 or otherwise specified)

	Vanuatu	Fiji	Papua New Guinea	Samoa	Solomon Islands	Tonga
Credit to private sector to GDP (percent)	69.2	61.4	28.7	38.7	18.4	27.8
Commercial banks: Number of branches	30	64	79	23	20	10
Commercial bank branches per 100,000 adults	23	11	2	23	7	21
ATMs per 100,000 adults	37	42	8	36	12	27
Firms with a checking or savings account (percent) ^{1/}	96	96.1	n.a.	97	n.a.	100
Firms with a bank loan/line of credit (percent) ^{1/}	45.8	37.8	n.a.	51.3	n.a.	54.4
Firms using banks to finance investments (percent) ^{1/}	41.1	37.1	n.a.	48.3	n.a.	33.9
Firms using banks to finance working capital (percent) ^{1/}	33.2	50.7	n.a.	68.7	n.a.	3

Source: IMF FAS database and World Bank's Global Financial Development Report (2014): Financial Inclusion.

^{1/} as of 2011.

Table 9. Indicators of Capacity to Repay the Fund, 2014–2025

	2014	Proj.										
		2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Fund obligations based on existing credit												
(In millions of SDRs)												
Principal	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Charges and interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fund obligations based on existing and prospective credit 1/												
(In millions of SDRs)												
Principal	0.0	0.0	0.0	0.0	2.1	4.3	3.0	1.7	1.7	1.7	1.7	0.9
Charges and interest	0.0	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations based on existing and prospective credit 1/												
In millions of SDRs												
In millions of U.S. dollars	0.0	0.1	0.1	0.1	2.2	4.3	3.0	1.7	1.7	1.7	1.7	0.9
In percent of gross international reserves	0.0	0.1	0.1	0.1	1.6	2.9	1.9	1.1	1.0	1.0	1.0	0.5
In percent of government revenue	0.0	0.1	0.1	0.1	1.5	2.9	1.9	1.0	1.0	0.9	0.9	0.4
In percent of exports of goods and services	0.0	0.0	0.0	0.0	0.6	1.2	0.8	0.4	0.4	0.4	0.4	0.2
In percent of debt service 2/	0.0	0.4	0.4	0.2	3.9	6.5	4.5	2.5	2.3	2.2	2.0	1.0
In percent of GDP	0.0	0.0	0.0	0.0	0.3	0.6	0.4	0.2	0.2	0.2	0.2	0.1
In percent of quota	0.0	0.5	0.6	0.6	13.1	25.5	17.8	10.2	10.1	10.1	10.1	5.1
Outstanding Fund credit 1/												
In millions of SDRs												
In millions of U.S. dollars	0.0	17.0	17.0	17.0	14.9	10.6	7.7	6.0	4.3	2.6	0.9	0.0
In percent of gross international reserves	0.0	18.4	17.4	14.6	10.9	7.1	4.9	3.6	2.5	1.5	0.5	0.0
In percent of government revenue	0.0	12.0	12.5	11.4	9.9	7.0	4.9	3.6	2.4	1.4	0.4	0.0
In percent of exports of goods and services	0.0	6.4	5.3	5.1	4.2	2.9	2.0	1.5	1.0	0.6	0.2	0.0
In percent of debt service 2/	0.0	74.4	74.5	33.5	25.7	15.9	11.4	8.5	5.7	3.2	1.0	0.0
In percent of GDP	0.0	3.1	2.9	2.7	2.2	1.5	1.1	0.8	0.5	0.3	0.1	0.0
In percent of quota	0.0	100.0	100.0	100.0	87.5	62.5	45.0	35.0	25.0	15.0	5.0	0.0
Net use of Fund credit (in millions of SDRs) 1/												
Disbursements	0	17	0	0	0	0	0	0	0	0	0	0
Repayments and repurchases	0.0	0.0	0.0	0.0	-2.1	-4.3	-3.0	-1.7	-1.7	-1.7	-1.7	-0.9
Memorandum items:												
Nominal GDP (in millions of U.S. dollars)	822	771	828	893	953	1006	1062	1122	1189	1260	1335	1416
Exports of goods and services (in millions of U.S. dollars)	287	374	454	476	503	530	549	581	616	653	693	749
Gross international reserves (in millions of U.S. dollars)	184	130	138	166	195	217	230	240	248	250	249	244
Government revenue (in millions of U.S. dollars)	191	200	193	212	216	218	228	241	256	271	287	304
Debt service (in millions of U.S. dollars)	35	32	32	72	83	97	98	102	110	116	122	131
U.S. dollars/SDR (period average)	1.5	1.4	1.4	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.5	1.5

Source: IMF staff estimates and projections.

1/ Assuming a disbursement of the entire amount of requested Fund financing in 2015.

2/ Total debt service includes IMF repurchases and repayments.

Appendix I. Letter of Intent

May 20, 2015

Ms. Christine Lagarde
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, DC 20431, USA

Dear Ms. Lagarde:

On the 13th of March 2015, a category-five tropical cyclone, Pam, hit Vanuatu, resulting in the loss of eleven lives and in extensive damage to infrastructure, agriculture, housing, and tourist facilities. The cyclone undermined food security for more than 60 percent of the country's population, destroyed or severely damaged more than a quarter of the housing stock, and disrupted the provision of essential services such as water, electricity, and telecommunication. With many schools damaged and several used as shelters, education has been disrupted. Damage to hospitals and clinics has interfered with health service delivery just as the need has surged.

The Damage and Loss Assessment completed in April puts the total value of the damages to property at VT29.3 billion or US\$283 million. Together with estimated production losses of VT19.3 billion, or US\$186 million, the total estimated cost of the cyclone amounts to VT48.6 billion, or US\$469 million, equivalent to 61 percent of GDP.

The disaster has set back our efforts to develop the economy. It has damaged critical infrastructure such as bridges, roads, wharves, and airports. The tourism sector—Vanuatu's main source of foreign exchange—has been hit hard, with several major hotels closed for repairs. Agriculture has suffered even more, as this year's crop has been destroyed in many parts of the country, and some areas will take years to recover; moreover, much livestock perished in the cyclone and many fishing boats were damaged. We expect our economic growth to be considerably lower this year than the robust expansion anticipated prior to this sudden and exogenous shock, even after taking into account reconstruction activity.

With Vanuatu's main export sectors—tourism and agriculture—severely affected by the cyclone and with imports boosted by emergency response, recovery and reconstruction needs, and infrastructure investment, we project a sharp deterioration of our trade balance for 2015, in the order of 35 percent of GDP. While this deterioration will be partially offset by insurance receipts, external assistance, and private capital inflows, it will put pressure on our external position, and we are concerned that our international reserves may fall to a dangerously low level.

The deterioration of the current account balance will also reflect a worsening of our fiscal position. Supporting the vulnerable population and restoring public facilities and infrastructure will necessitate considerable expansion in government expenditures even as revenues will suffer with the weak economy. Public sector recovery and reconstruction needs estimated at VT17.7 billion, or 21 percent of GDP, will have to be accounted for as additional expenditures for

2015 and beyond. In mobilizing financial resources for recovery and reconstruction, we intend to remain prudent and avoid excessive debt accumulation. We will seek external grants as much as possible before resorting to concessional loans or domestic borrowing. So far, Vanuatu has received US\$50 million worth of emergency assistance in cash and in kind. We intend to seek synergies between our planned development projects and reconstruction work, as well as to reduce expenditures in other areas where possible. Despite these efforts and some insurance payments, we still have a fiscal financing gap of about 15 percent of GDP, over the period 2015–17.

Against this background, the Government of Vanuatu would like to request financial assistance from the International Monetary Fund to address Vanuatu's urgent balance-of-payments need and prevent an immediate and severe economic disruption. The assistance would be in the amount equivalent to SDR17 million (US\$23.5 million) as a disbursement of SDR8.5 million (50 percent of our quota) under the Rapid Credit Facility (RCF) and a purchase of SDR8.5 million under the Rapid Financing Instrument (RFI) to ease the pressure on our fiscal position and official foreign reserves. We have been holding extensive discussions with our key development partners on possible financial support and we expect that Fund assistance would help catalyze additional inflows of external resources.

While significant increases in budget deficits and public debt are inevitable as we rebuild our economy, we are committed to restoring our fiscal and financial buffers over time. We will embark on fiscal consolidation as soon as economic recovery takes hold and aim to put the ratio of public debt to GDP on a declining path. To this end, we will take the following steps: (i) strengthen spending discipline by stricter adherence to budget allocations, strengthening internal audit, and making other improvements in public financial management, with technical assistance from PFTAC; (ii) review our infrastructure investment program to ensure that debt-financed projects fit into our country's overall development strategy and are in line with our implementation capacity; (iii) mobilize additional fiscal revenues (which are currently low in comparison to regional peers) via further improving compliance, raising non-tax revenues, and other measures—possibly including introducing an income tax. Moreover, with technical assistance from the World Bank, we will enhance our debt management framework in order to lower borrowing costs and minimize debt risks. The government will finalize rationalization strategies for eight Government Business Enterprises (GBEs) and submit to Parliament a new GBE bill aimed at improving their discipline, accountability and financial viability. While enforcing expenditure control, we will make sure that vulnerable groups of the population are protected and sufficient funds are allocated for primary and secondary education and for health care.

We have lowered the policy interest rate and reduced the statutory reserve deposit requirement to support economic recovery and ensure that banks have sufficient liquidity. We will continue to support the economy and the banking system while maintaining adequate safeguards. In the same vein, our supervisory policies will make certain that banks continue to follow prudential norms for loan quality assessment with adequate risk management. Once the recovery takes hold and the situation normalizes, we will undertake a diagnostic assessment of bank balance sheets and, if necessary, seek to replenish bank capital. Building on several recent regulatory and

supervisory steps, we will further strengthen Vanuatu's Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF) regime. We will introduce amendments to the 2014 AML/CTF Act that will bring it in conformity with international standards.

Our exchange rate regime has served the country well, and we will maintain the value of the vatu against the currency basket to preserve private sector confidence. Once the reconstruction stage is over, we will review our balance-of-payments outlook and assess whether the current level of the peg is consistent with external sustainability or whether an adjustment is needed to restore competitiveness.

Vanuatu will promote inclusive growth through structural reforms. Private sector development and employment creation are top priorities in our Priorities and Action Agenda. As assessed by the World Bank, our business environment compares favorably with regional peers, but we will seek improvement in the few lagging areas, such as the ease of starting a business. Our infrastructure plans target development in several islands and will improve connectivity across the country. The recently established—via a public-private partnership—submarine cable connection will provide additional opportunities. The government will continue its efforts to bring financial services to remote areas of the country, including via mobile banking and micro-credit. We are developing strategies for providing low-cost housing to the needy. In cooperation with the World Bank, we are working on improving access to electricity in rural areas as well as in and around Port Vila.

The Government of Vanuatu values its cooperation with the IMF and takes its obligations seriously. We do not intend to introduce measures or policies that would compound the balance-of-payments difficulties. We do not intend to impose new or intensify existing restrictions on the making of payments and transfers for current international transactions, trade restrictions for balance-of-payments purposes, or multiple currency practices, or to enter into bilateral payments agreements which are inconsistent with Article VIII of the Fund's Articles of Agreement. Furthermore, we commit to undergoing a safeguards assessment, providing IMF staff with access to the Reserve Bank of Vanuatu's most recently completed external audit reports, and authorizing our external auditors to hold discussions with IMF staff. The Reserve Bank of Vanuatu will publish soon on its website the audited financial statements for the year ended December 31, 2013.

Sincerely yours,

/s/

The Hon. Maki Stanley Simelum
Minister of Finance and Economic Management
Government of Vanuatu

/s/

Simeon Athy
Governor
Reserve Bank of Vanuatu

Appendix II. Vanuatu—Staff Policy Advice from the 2013 Article IV Consultation

Staff Advice	Policy Action
Monetary policy should remain geared toward maintaining high international reserves and low inflation.	Low and stable inflation rate and maintaining a sufficient level of official foreign exchange reserves remain the main objectives of RBV's monetary policy. Over the last two years international reserves have risen to 5 months of imports, while inflation has remained low and stable.
Continue with conservative approach to debt financing.	Public debt declined in 2013 and 2014, and the new Prime Minister has pledged a cautious approach to external borrowing. However, the 2015 Budget envisaged large infrastructure investment, much of it debt-financed.
Assess carefully financing options for new large infrastructure projects, in particular the upgrading of the airport system.	The new government has canceled the controversial large-scale airport expansion plan and finalized a loan agreement with the World Bank to finance repairs and upgrading of the existing main international airport.
Seek new revenues; specifically, introduce an income tax.	The authorities have raised new revenues by improving VAT compliance and via economic citizenship programs. They are planning to increase non-tax revenue with PFTAC assistance. An income tax remains under consideration.
Concentrate public spending on areas where impact is highest while holding government agencies accountable.	Overspending in some areas (tertiary scholarships) and underfunding in others (health care) has led to recurring supplementary budgets.
Conduct reforms to increase the effectiveness of the civil service, enhance competition in key sectors, and improve the accessibility of land.	Vanuatu has made property transfers faster by digitizing its land registry system. The impact of recent changes to the regime for leasing customary land is not yet clear. Initiatives to promote renewable energy sources may increase competition in the electricity sector.
Reform government business enterprises (GBEs) to control risks and improve financial performance.	The Cabinet approved a new policy aimed at improving discipline, accountability and financial viability of GBEs in October 2013. However, no law based on that policy has yet been introduced in parliament. A workshop on GBE reform organized by ADB took place in Port Vila in September 2014.
Introduce regulations limiting net open foreign exchange positions.	Regulation limiting net open foreign exchange positions has been drafted, but not yet introduced.
Pay attention to liquidity and credit risks.	RBV has tightened prudential guidelines on loan classification and increased the amount of information it collects on banks' financial position.

Appendix III. Economic Citizenship Programs in Vanuatu and around the World¹

Economic citizenship programs have gained popularity over the last decade, particularly in smaller nations. Several Pacific island countries, including Vanuatu, have adopted or are considering variations of such programs. This note lays out (i) examples of economic citizenship programs from around the world, highlighting their benefits and drawbacks; (ii) the economic citizenship programs initiated recently in Vanuatu, and (iii) measures to mitigate the risks of such programs.

Programs in Other Countries

Economic citizenship programs—where a country’s citizenship or resident status is granted in exchange for a substantial investment in the national economy—have become increasingly popular in recent years.² The motivation for investors varies, but often includes acquiring a “passport of convenience” that would allow them to travel visa-free to a larger set of countries than their original passport. Tax considerations also play an important role. Most of the citizenship programs have been set up by relatively small nations (Table 1), and in case of a successful launch, the revenue they bring to the budget may be quite substantial. In one striking example, St. Kitts and Nevis’s Citizenship-by-Investment program collected 13 percent of GDP in budget revenue and similar amounts in contributions to the Sugar Industry Diversification Foundation and in real estate investments in 2013. The scale of most other programs is considerably more modest.

Almost everywhere, economic citizenship programs have given rise to various concerns. Often there are claims of irregularities in the process and of diversion of funds by agents or government officials for personal gain. Such problems marred a recent program in Comoros and several early experiments in Pacific island nations, leading to their suspension or discontinuation.³ There have also been allegations of passports being sold to terrorists and criminals, facilitating their travel and allowing them to avoid extradition. This has led to countermeasures, such as a recent imposition of visa requirements on citizens of St. Kitts and Nevis by Canada.

Thus, economic citizenship programs have the potential to supplement government revenues. However, their scale is difficult to predict, which complicates macroeconomic management. Very large inflows may be difficult to intermediate, and care needs to be taken to avoid overheating and loss of competitiveness by domestic producers. Even more perniciously, such programs inflict reputational risks. Thus the inflows are subject to sudden stops in response to internal or

¹ Prepared by Anuk Serechetapongse

² Xu and others, 2015, *Too Much of a Good Thing? Prudent Management of Inflows under Economic Citizenship Programs*, IMF Working Paper WP/15/93.

³ Van Fossen, 2007, “Citizenship for Sale: Passports of Convenience from Pacific Island Tax Havens,” *Commonwealth and Comparative Politics*, 45(2), pp. 138–163.

external concerns. They may also decline noticeably because of growing competition or because the demand from the target group falls.

	Country	Inception Year	Minimum Investment ^{1/}	Residency Requirements ^{2/}	Citizenship Qualifying Period ^{3/}
Citizenship Programs	Antigua and Barbuda	2013	USD 250,000	5 days within a 5-year period	Immediate
	Cyprus	2011	EUR 2.5 million	No (Under revision)	Immediate
	Dominica	1993	USD 100,000	No	Immediate
	Grenada	2014	USD 250,000	No	Immediate
	Malta	2014	EUR 1.15 million	6 Months	One year
	St. Kitts and Nevis	1984	USD 250,000	No	Immediate
	Vanuatu (CIIP)	2014	USD 260,000	No	10 years
Residency Programs	Australia	2012	AUD 5 million	40 days/year	5 years
	Bulgaria	2009	EUR 500,000	No	5 years
	Canada ^{4/}	Mid-1980s	CAD 800,000	730 days within a 5-year period	3 years
	Canada-Quebec	N.A.	CAD 800,000	730 days within a 5-year period	3 years
	France	2013	EUR 10 million	N.A.	5 years
	Greece	2013	EUR 250,000	No	7 years
	Hungary	2013	EUR 250,000	No	8 years
	Ireland	2012	EUR 500,000	No	N.A.
	Latvia	2010	EUR 35,000	No	10 years
	New Zealand	N.A.	NZD 1.5 million	146 days/year	5 years
	Portugal	2012	EUR 500,000	7 days/year	6 years
	Singapore	N.A.	SGD 2.5 million	No	2 years
	Spain	2013	EUR 500,000	No	10 years
	Switzerland	N.A.	CHF 250,000/year	No	12 years
	UK	1994	GBP 1 million	185 days/year	6 years
	US	1990	USD 500,000	180 days/year	7 years
Vanuatu (PR)	2011	USD 2,800	No	10 years	

Sources: Xu, El-Ashram, and Gold (2015) and Vanuatu authorities.
1/ Alternative investment options may be eligible.
2/ Explicit minimum residency requirements under immigrant investor schemes; residency criteria to qualify for citizenship may differ.
3/ Including the qualification period for permanent residency under residency programs.
4/ Program suspended since February 2014.

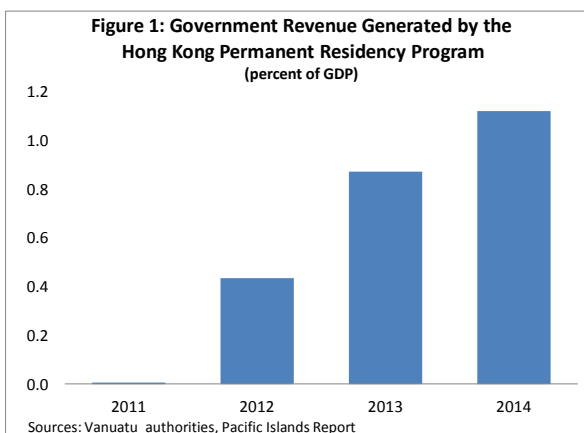
Vanuatu's "Commercial Diplomacy" Programs

In the 1990s, there had been attempts to establish passport selling schemes in Vanuatu, which required the state to waive its ten-year residency requirement for citizenship and lift its dual citizenship prohibition. Many of them failed after fraud was publicized. Nevertheless, in the period of 1996–1997, the country received 1.5 percent of GDP in revenue from selling 300 passports. But reports of illegal issuance of passports, some of which had been sold to criminals, damaged the country's international reputation. Some countries, such as Canada, dropped visa waivers for Vanuatu nationals.

Over a decade later, the country has started two new economic citizenship programs.

a. Hong Kong Permanent Residency (HKPR) Visa Program

The Hong Kong permanent residency visa program was launched in September 2011. It was targeted at investors from mainland



China who wanted to apply for Hong Kong permanent residency, particularly via the Hong Kong Capital Investment Entrant Scheme, and thus needed residency from a country or territory besides China and Hong Kong to be qualified to apply under this scheme. In order to obtain Vanuatu's permanent residency status, an investor had to apply via an agent based in Hong Kong and invest at least \$2,800 (300,000 vatu) in companies registered in Vanuatu. The Vanuatu visa is valid for 10 years, within which time the investors are expected to be granted Hong Kong permanent residency. So far the program has attracted about 1500 investors and generated close to 2½ percent of GDP in revenue since its inception. However, the Hong Kong Capital Investment Entrant Scheme was suspended in January 2015, eliminating the main incentive for the mainland Chinese to seek Vanuatu residency. Consequently, the Vanuatu government has suspended HKPR, which was projected to bring 1.1 percent of GDP to the budget in 2015. Still, the authorities hope that as a result of this program, Vanuatu would become better known in China as a destination for investment and tourism.

b. Capital Investment Immigration Plan (CIIP)

In addition to the Hong Kong Permanent Residency Visa Program, Vanuatu has recently established the Capital Investment Immigration Plan (CIIP), whose target group is not limited to the Chinese. In exchange for the Vanuatu citizenship, an investor has to pay a \$40,000 fee and invest \$260,000. The investment, which will be returned to the investor after 7 years, is allocated to deposits in partially-government-owned National Bank of Vanuatu (25 percent), Vanuatu long-term government bond (25 percent), and real investment in the country's various islands (50 percent). The authorities hope that the return from the real investment alone would be sufficient to fully repay investors. The program was launched in 2014 and brought in about 0.2 percent of GDP that year.

Measures to Mitigate the Risks of Economic Citizenship Programs

Drawing from the past experience of various countries, including that of Vanuatu, a number of measures can be implemented to mitigate the risks and address the drawbacks of the economic citizenship programs.

- a. Proper screening of applications:** To avoid abuses of the programs as channels to conceal criminal activities, adequate oversight and background checks, including screening criminal records from the country of origin and the sources of investment and fees, should be applied to all applications.
- b. Ensuring transparency of the identity of the new citizens, the investments made, and revenue management:** Publishing the identity of the new citizens would enable foreign authorities to identify potential misuse of the schemes and allow financial institutions to build more precise profiles of the new citizens. Revenues and spending related to the programs should be audited (to avoid mismanagement by government officials and agents) and published.

- c. *Saving revenues from the programs for future needs:*** In case of substantial inflows, it will be important to save a fair portion of the revenues to help address future financing needs and to ensure that sufficient safeguards are in place to prevent misuse of the revenues.

Appendix IV. Vanuatu—Risk Assessment Matrix

Nature/Source of Threat	Likelihood	Impact	Policies to Minimize Impact
Lower-than-expected investment in reconstruction or infrastructure	M	H: Lower public investment would reduce the offset to the decline in tourism and agriculture in the short run and decrease growth potential in the longer term.	Address the reasons for slow public investment (e.g., insufficient external support, implementation capacity). Stimulate private sector growth by improving business environment and facilitating credit provision.
Persistent U.S. dollar strength	H	M: A large U.S. dollar appreciation against the Australian dollar, given Vanuatu's basket peg, will result in the vatu's sizeable appreciation against the Australian dollar. This may create problems for Vanuatu since Australia is by far Vanuatu's largest trading partner, tourist source, and aid provider.	Review and adjust the value of the peg. Going forward, consider increasing the weight on the Australian dollar in the basket and introduce periodic review of the appropriateness of the level of the peg.
Protracted period of slower growth in key emerging economies	M	M: Given Vanuatu's dependence on tourism and agricultural commodity exports, if a slowdown in large emerging economies leads to a large reduction in commodity prices, this would have a considerable impact on Vanuatu both directly and indirectly via the effect on tourist arrivals from Australia and New Zealand.	Seek new markets and diversify into new activities. Accelerate infrastructure investment to stimulate domestic demand in the short run and improve competitiveness in the long run.
Another major natural disaster in the near future	L	H: Another natural disaster would cause widespread damage to infrastructure, agriculture, and tourism and set back the recovery.	Mobilize external support. Use available fiscal space to finance reconstruction efforts. Provide ample liquidity to banks to ensure smooth operation of the financial system. To prepare for future disasters, rebuild fiscal buffers and establish a contingency fund as soon as feasible.

"L"=Low; "M"=Medium; "H"=High. 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 of risks listed 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 as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Appendix V. Overview of Government Business Enterprises in Vanuatu¹

State-owned enterprises are termed Government Business Enterprises (GBEs) in Vanuatu. While there are 22 GBEs, not all are engaged in commercial activities. Those GBEs that are majority owned by the government and operate under a commercial mandate are termed Commercial Government Business Enterprises (CGBEs), of which there are 11—Airports Vanuatu Limited (Airports), Air Vanuatu (Operations) Limited (AVL), Asset Management Unit (AMU), Metenesel Estates Limited (MEL), National Bank of Vanuatu (NBV), National Housing Corporation (NHC), Vanuatu Agriculture Development Bank (VADB), Vanuatu Broadcasting & Television Corporation (VBTC), Vanuatu Commodities Marketing Board (VCMB), Vanuatu Livestock Development Limited (VLDL), and Vanuatu Post Limited (VPL).

The remaining GBEs comprise six regulatory bodies,² four minority holdings,³ and one mutual financial institution.⁴ This appendix focuses mainly on the CGBEs.

Historically the entire GBE portfolio has performed poorly. While some entities demonstrate sound governance and financial management, such as AVL, Vanuatu Post, NBV and VNPF, many GBEs have poor governance and accountability as well as lax financial management. Some CGBEs have not produced audited financial statements since the 1990s.⁵

Poor governance compounds the weak financial management. Of the 64 directors serving on the 11 CGBE boards, 37 directors (or 58 percent) comprised public servants, a further three (5 percent) were GBE chief executives, and the remaining 24 positions (38 percent) were allocated to independent private sector members.⁶ In the main, the public servant directors were appointed by the relevant sector or line ministries, further compromising their ability to act in the best interests of the GBEs.

The GBE's poor financial reporting is demonstrated in the government's December 2013 account—the most recent available—where the financial data for the GBEs only covers financial year 2011 and 2012 financial years.⁷ The report indicates that total net investment in the GBEs was 7,120 million vatu (nearly 10 percent of GDP), of which the CGBEs comprised 5,493 million vatu (77 percent of the total). While the CGBEs are a significant investment, comprising 22.87 percent of the government's total net worth, the returns are poor, contributing negative 78 million vatu in the 2012 financial year. The only two CGBEs that provided the government shareholder with a positive return in 2012 were the National Bank of

¹ Prepared by Christopher Russel (ADB).

² Reserve Bank of Vanuatu; Vanuatu Financial Services Commission; Utilities Regulatory Authority; Vanuatu Telecommunications Regulator; Vanuatu Investment Promotion Authority; and National Tourism Office.

³ Ifira Wharf & Stevedoring Limited (government share 34 percent); Interchange Limited (12.5 percent); Northern Island Stevedoring Limited (10 percent); Vanuatu Abattoirs (33.9 percent).

⁴ Vanuatu National Provident Fund (includes Members Financial Services Limited).

⁵ Vanuatu Livestock Development Limited (1991) and National Housing Corporation (1998).

⁶ Survey undertaken in November 2014.

⁷ The Government consolidated the SOEs on an equity accounting basis in its financial reports, the Financial Statements of the Government of Vanuatu, December 2013.

Vanuatu (78 million vatu) and Vanuatu Post Limited (7 million vatu)⁸.

Government investment in CGBEs: December 2012 (in millions of vatu)				
CGBE	Opening Balance 2011	Net Surplus / Deficit	Government Contribution	Closing Balance 2012
Air Vanuatu	- 1,042	314	425	-303
Airports Vanuatu	3,197			3197
AMU	52	-52		0
MEL	110			110
NBV	977	78		1,055
NHC	278			278
VADB	393			393
VBTC	41			41
VCMB	0			0
VLDL	45			45
Vanuatu Post	670	7		677

Many of the CGBEs perform no useful service as indicted by the lack of active management and current financial accounts. Power generation and distribution and the provision of water and wastewater services have been contracted out to the private sector

Current and Future Developments

A. GBE Reform Policy

Recognizing that the status quo is not sustainable, the government has embarked upon a GBE reform program with the assistance of the Asian Development Bank (ADB). A GBE reform policy was drafted in 2012 and adopted by the Council of Ministers (COM) in October 2013. The key elements of the approved Policy include:

- A primary objective for all GBEs to operate as profitable businesses;
- Development of a robust community service obligation (CSO) framework requiring GBEs and the government to properly identify, cost, contract and fund CSOs;
- Enhanced governance, establishing basic director duties and requiring directors to be appointed on the basis of best skill and experience;
- The appointment of one minister responsible for all GBEs—the Responsible Minister;
- GBEs must develop forward-looking business plans and statements of corporate intent;

⁸ Air Vanuatu (Operations) Limited recorded a surplus of 314 million vatu, but received additional equity of 425 million vatu to cover prior period losses.

- Improved transparency and accountability by requiring audited accounts to be produced in a timely manner, tabled in Parliament and a summary published in local newspapers; and
- The formal establishment of a GBE monitoring unit in the Ministry of Finance and guidelines on how the Unit will operate and support the Responsible Minister.

B. GBE Legislation

Following the adoption of the Reform Policy, the government requested the ADB to draft a GBE Bill,⁹ which was done in 2014 after consultation with GBEs and relevant sector ministries. The bill follows the framework established by the GBE Reform Policy and all of the matters listed above have been incorporated into the bill. Other provisions to note are:

- The content of the statement of corporate intent (SCI) and business plan, as well as when they need to be prepared and delivered to the Responsible Minister and adopted by the board, are specified. The board must consult with the Minister on the content of the SCI and business plan and they must clearly demonstrate how the GBE will achieve the Primary Objective;
- SCIs must be tabled in Parliament after they have been adopted;
- Politicians may not be appointed to GBE boards and the number of public servants that can be appointed is limited;¹⁰
- General duties of GBE directors are clearly established in the bill as are board processes including management of meetings, quorums, etc.;
- There are provisions dealing with disclosure of interests, and GBEs must establish codes of conduct;
- Audited reports must be submitted to the Responsible Minister within 3 months from the end of a financial year and summary accounts published in local newspapers. The audited report must be tabled in Parliament; and
- The bill defines the role, powers and responsibilities of the Responsible Minister.

The bill represents best international practice. The government has indicated that it intends to submit the bill to Parliament in June 2015.

Reform and Rationalization

In 2014 the government identified eight CGBEs as reform priorities.¹¹ With assistance from ADB,

⁹ The bill deals only with Commercial Government Business Enterprises and does not cover the regulatory GBEs.

¹⁰ No more than two and never as chair. If the board has three members, no more than one.

¹¹ Air Vanuatu (Operations) Limited, Asset Management Unit, Metenesel Estates Limited, National Housing Corporation, Vanuatu Broadcasting & Television Corporation, Vanuatu Commodities Marketing Board, Vanuatu Livestock Development Limited, and Vanuatu Post Limited.

rationalization strategies were developed for seven of the targeted CGBEs. The Vanuatu Commodity Marketing Board, which had already been identified by the government as warranting liquidation, was excluded. However, the government is now considering a revised role for the Board. Reform strategies include:

- COM papers have been prepared recommending the liquidation of Asset Management Unit, Vanuatu Livestock Development Limited, and Metenesel Estates Limited;¹²
- Identification, costing and contracting community service obligations (CSOs) for the 24 unprofitable domestic air routes serviced by Air Vanuatu. Informal and unfunded CSOs undermine Air Vanuatu's financial performance. As of 31 December 2013, AVL had 1.4 billion vatu of outstanding loans from the government, up from 870 million four years earlier. In addition, government loan guarantees totaled 2.1 billion vatu,¹³ up from 900 million vatu at the end of 2009. Because of losses in most years—except for the 314 million vatu profit in 2012—Air Vanuatu's net worth decreased from *negative* 166 million vatu at the end of 2008 to *negative* 600 million vatu as of 31 December 2013.¹⁴
- Identification, costing and contracting CSOs for Vanuatu Post. CSOs are estimated to cost Vanuatu Post 28 million vatu per year.
- COM has approved using commercial assets—a quarry and development lands—owned by National Housing to repay 60 million vatu owed to the government. If additional cash is raised through this commercialization process, it will be returned to the government as shareholder.
- The separation of the commercial and regulatory functions undertaken by VBTC and an assessment of whether the commercial activities should be privatized.

Adoption of the reform strategies will improve the commercial performance of the CGBEs; release capital for the government through debt repayments and asset sales; and reduce potential future claims on the government's balance sheet.

Enacting the CGBE Bill and ensuring that it is fully implemented will support improved CGBE performance through mandating an unambiguous commercial objective and requiring greater transparency and accountability, improved governance, and effective ownership monitoring.

Government's Contingent Liabilities – CGBEs		
CGBE	2014 - Vatu	Nature of Liability
Air Vanuatu	3,604,946,452	Guarantees to Vanuatu National Provident Fund, BRED Bank & aircraft leasing firms.
National Housing	43,000,000	Guarantees for various development projects

Source: Ministry of Finance.

¹² The recommendation also included freeing development land for greater private sector participation.

¹³ Now 3.6 billion vatu (see table).

¹⁴ This does not include a conversion to equity of 900 million vatu in government debt reflected in the Air Vanuatu's 2013 accounts and approved by shareholding Ministries, but not yet formally approved by Parliament.

Appendix VI. Offshore Financial Sector in Vanuatu¹

A. Overview of the Offshore Sector in Vanuatu

Vanuatu's offshore financial sector was established under the 1970 Banking Act during the joint Anglo-French Condominium. The adoption of an offshore financial center (OFC)² was seen as a potential source of growth for a geographically-isolated and largely undiversified economy. By diversifying away from a declining agricultural sector, the OFC created a major boost for the country and helped transform Port Vila during the 1970s and 1980s. The offshore financial sector comprises offshore banks, non-bank entities including insurance companies, trust, company service providers, as well as shipping registry.

The size of the offshore banking sector has declined dramatically over the past two decades. After its peak at 120 in 1993, the number of offshore banks has fallen to only two at present (Table 1), which represents at most 10 percent of the overall offshore sector.³ Meanwhile, the number of international companies had steadily increased since the enactment of the International Companies Act in 1993 to currently over 5,000 companies at its peak in 2006.⁴ International companies have been the primary product of the OFC in Vanuatu, contributing up to 80 percent of the OFC's income (IMF, 2005). The rest of the OFC institutions are of minor importance to the overall offshore industry. The offshore industry's clients are mostly from Australia, New Zealand, and Asia, without a single area of concentration (in contrast with Samoa's concentration in China and Cook Islands' focus on the United States). There are very few clients from the United States and most of them would route their transactions via a third country rather than directly to Vanuatu.

¹ Prepared by Nasha Ananchotikul.

² "Offshore sector" and "offshore financial center (OFC)" are used interchangeably throughout this report.

³ The number of offshore banks in Vanuatu declined to 2 banks during the first quarter of 2015. According to RBV, 5 new offshore banks recently applied for new licenses. However, they have yet to conduct banking business as they face difficulty in establishing offshore correspondent banks.

⁴ The decline in the number of international companies since 2007 started with the downturn in the global financial markets and the subsequent Global Financial Crisis in 2008. However, the new registrations of international companies picked up again during 2011–2014 as Vanuatu's government actively promoted its international company sector by providing Vanuatu Registry Services in Hong Kong and Singapore, along with the Hong Kong Permanent Residency (HKPR) program launched in 2011. The number of international companies registered through Hong Kong reached 1,706 companies by 2013. However, this trend is likely to cease with the recent suspension of the HKPR program.

Table 1: Vanuatu: Number of Offshore Sector Entities

	1980	1985	1990	1995	2000	2005	2010	2014	Latest
Offshore banks	41	93	103	88	51	7	7	6	2
International companies	422	529	739	1,468	4,002	4,650	1,784	3,522	n/a
Trust companies	12	15	12	12	12	10	15	13	n/a
Insurance companies	n/a	n/a	n/a	9	12	15	28	0	n/a

Source: RBV's Quarterly Economic Review (December 2014), IMF (2005), and data provided by Vanuatu Financial Services Commission.

B. Offshore Banks

All offshore banks are prohibited from undertaking business with residents of Vanuatu, including making loans to them or accepting local deposits. The decline of the offshore banking sector during the late 1990s and early 2000s largely reflected the authorities' effort to improve the reputation of Vanuatu's OFC and withdrawal of private offshore clients in the wake of adverse publicity for the region and outside pressure for more transparency of OFCs, as well as increased foreign competition. Total reported assets of the remaining seven banks, as of November 2014, were approximately US\$73 million, roughly 10 percent of the domestic banks' assets. More than half of the assets were recorded as market-related instruments and investments, while only about 7 percent of the assets were recorded as loans and advances.

Before the adoption of the 2002 International Banking Act, there was no requirement for offshore entities to maintain a physical presence in Vanuatu, nor to prepare annual reports of their financial transactions or operation plans. Most of the offshore banks operated as "shell banks" with no presence and appeared to serve as in-house treasuries for foreign conglomerates and wealthy individuals. Following the International Banking Act, offshore banks are now required to maintain a physical presence in Vanuatu. The banks must have an office and records in Vanuatu, employ staff locally and have management responsible for day-to-day operations. In addition, the RBV has issued several prudential guidelines for offshore banks—including guidelines on customer due diligence ("know your customer"), fit-and-proper criteria for key management positions, and external audit requirements—which should enhance transparency and information sharing in line with those prevailing for domestic banks.

C. Contribution to the Economy

The main contribution of the offshore sector to the country is claimed to be in terms of registration fees,⁵ employment, expenditure including wages and salaries, and spending on office equipment and housekeeping. There exist some estimates on these figures, although they seem to vary substantially across different sources (Table 2). Based on the earlier estimates, it appears that the offshore sector contributes at least 5 percent of GDP and roughly 3–5 percent of government revenue.^{6,7}

⁵ Company registration fee is US\$150 for incorporation and US\$300 for annual renewal.

⁶ According to Sharman (2008), the discrepancy between the IMF's estimates and the larger figures on GDP contribution from other sources including the RBV is due to an assumption on the indirect effects of the OFC on the general economy. The Ministry of Finance has apparently estimated the multiplier on GDP to be 2.5. However, it can be argued that, since OFC institutions are prohibited from dealing with citizens and domestic financial sector, the 'spin off' effect on domestic economy should have been rather low, if any.

The sector employs no more than 200 staff, with about one forth believed to be foreign expatriates. This accounts for less than 2 percent of total formal sector employment in Vanuatu (IMF, 2002). Overall, it seems that the offshore sector makes only modest contribution to Vanuatu in terms of economic growth, employment and government revenue. A recent study by Jayaraman and Choong (2010) finds that OFC did not contribute to Vanuatu's economic growth, and hence the reliance on the OFC for growth is misplaced.

The offshore financial center in Vanuatu has been directly affected by the global financial crisis through the losses incurred on foreign investments. There seems to be a dramatic shrinkage of OFC's assets in the subsequent period, which mirrors a large withdrawal of deposit funding by corporate clients. However, the implications for the domestic economy are likely to be limited due to the small contribution of the OFC to the overall economy.⁸

Table 2: Vanuatu: Offshore Sector's Contribution to the Economy

Source	Economic Contribution (percent of GDP)	Revenue from OFC (percent of gov rev)	OFC Employment (persons)
IMF (2002)	-	1.8	200
IMF (2005)	4	3	-
PIF Secretariat (2004)	9.7	5.1	-
RBV	9	5.5	-
Sharman (2008)	-	-	111
Jayaraman & Choong (2010)	9 (avg 2000–07)	4.8 (avg 2000–07)	-

D. Impact of Global Regulatory Initiatives on Offshore Banking Activity

Major anti-OFC/anti-money laundering events or actions that may have significantly affected Vanuatu's OFC banking activity include the 1998 OECD Harmful Tax Competition initiative and the subsequent OECD's 2002 Blacklist, the 2000 Blacklist by the Financial Action Task Force (FATF), and the 2001 U.S. Patriot Act. The pressure became heightened after the 9/11 terrorist attacks in the United States in 2001. These events and their subsequent guidelines for tax havens to improve transparency and exchange of information, even though they did not create any obligations by law, damaged Vanuatu's reputation as an offshore center and led to a sharp decline of the OFC in 2002 due to loss of foreign investors and increased cost as access to international financial networks being cut off. In addition, domestic banks—especially NBV which does not have foreign parent linkages unlike the other foreign banks operating in Vanuatu—have experienced difficulties accessing the international banking system as many foreign counterparties, especially U.S. banks, have decided to suspend their relationship with Vanuatu banks, being concerned about their own reputations.

⁷ In comparison, OFC represents about 3 percent of GDP in Samoa, and up to 8 percent in the Cook Islands.

⁸ According to the authorities, the contribution of the offshore banks to the economy is slightly below 1 percent of GDP.

Banking businesses in Vanuatu recently experienced another shock when faced with the Australian Tax Office (ATO)'s crackdown on tax evasion by demanding banks in offshore jurisdictions—including Vanuatu, Samoa, Cook Islands, Singapore, and Hong Kong—to submit bank account information on their Australian customers for scrutiny. However, doing so would violate the secrecy provision of Vanuatu's International Companies Act. As a result, both commercial and offshore banks in Vanuatu were forced to close international companies' accounts.

Steps were taken by Vanuatu authorities, largely in a cooperative manner, to strengthen the oversight of the offshore sector in response to mounting outside pressure. In September 2000, Vanuatu's authorities adopted the Financial Transactions Reporting Act (FTRA), which required offshore entities to report suspicious transactions to the Financial Intelligence Unit (FIU). In 2003, Vanuatu's authorities endorsed the FATF 40 recommendations on money laundering as required by the U.S. Patriot Act.

In June 2014, the old Financial Transaction Reporting Act was repealed and replaced with the Anti-Money Laundering and Counter-Terrorism Financing (AML/CFT) Act, which imposes additional responsibilities and obligations on businesses and professions providing financial services in Vanuatu. Banks are in the process of updating their AML/CTF policies to reflect the changes.⁹ All banks have also registered and filed with the U.S. IRS in compliance with the Foreign Account Tax Compliance Act (FATCA) and are hence required to report foreign offshore assets of U.S. taxpayers. In January 2015, Vanuatu brought into force amendments to the Proceeds of Crime Act and the Counter Terrorism and Transnational and Organized Crime (CTTOC) Act.

In the latest public statement on Vanuatu in April 2015, the Asia/Pacific Group on Money Laundering (APG) welcomed the progress. At the same time, it noted that some of the deficiencies identified in its 2006 Mutual Evaluation Report, particularly those regarding the criminalization of money laundering and terrorist financing, have not been adequately addressed.

E. Concluding Remarks

Overall, it appears that the contribution of the OFC to the general economy has been limited, while the negative reputation impact from heightened OFC criticism has done considerable damage to Vanuatu's financial sector. The global pressure on tax havens has not only created problems for offshore banks, but also appears to have inflicted significant indirect costs on some domestic banks. These costs are in terms of the reluctance of foreign investors and international banks to do business with Vanuatu or in additional scrutiny on the clients on whose behalf the domestic banks are transacting. Given its concentrated domestic banking system, a disruption in the external operations of the domestic banks has been one of the key vulnerabilities of Vanuatu's economy. With the backdrop of increasing global pressure, the benefit of the OFC should thus be weighed against the spillover costs on the overall economy in considering the continuation of the OFC status.

⁹ RBV has conducted two AML/CTF onsite reviews in 2014—one on a commercial bank and one on an offshore banks.

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VANUATU

May 20, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION AND REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY AND PURCHASE UNDER THE RAPID FINANCING INSTRUMENT—INFORMATIONAL ANNEX

Prepared By

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

CONTENTS

FUND RELATIONS	2
RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)	3
BANK–FUND COUNTRY TEAM CONSULTATIONS	5
RELATIONS WITH THE ASIAN DEVELOPMENT BANK	7
STATISTICAL ISSUES	10

FUND RELATIONS

(As of April 30, 2015)

Membership Status: joined September 28, 1981; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	17.00	100.00
Fund holdings of currency	14.51	85.33
Reserves tranche position	2.50	14.68

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocations	16.27	100.00
Holdings	1.50	9.24

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to the Fund ^{1/}

(SDR million; based on existing use of resources and presenting holdings of SDRs);

	2015	2016	Forthcoming 2017	2018	2019
Principal					
Charges/Interest	0.01	0.01	0.01	0.01	0.01
Total	0.01	0.01	0.01	0.01	0.01

^{1/} 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 May 8, 2015 was VT 105.60 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 has been on a 24-month consultation cycle. The previous Article IV consultation mission took place during April 1–10, 2013, and the consultation was concluded on June 7, 2013 (Country Report No. 13/169).

OFC Assessments

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

Technical Assistance

LEG, MCM, PFTAC, and STA have provided technical assistance on anti-money laundering, banking supervision and regulation, reserve management, tax and fiscal accounts, tax administration and policy, non-tax revenue, public financial management, balance of payments, and national accounts.

Resident Representative

The resident representative office for the Pacific Islands, including Vanuatu, was opened in September 2010 in Suva, Fiji. Mr. Tubagus Feridhanusetyawan is the Resident Representative.

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)

Economic Statistics

During 2010 and 2011 PFTAC assisted with the upgrading of government finance statistics to the 2001 GFS Manual. Support is now being provided by a regional GFS project managed by STA and the authorities are now reporting data regularly to STA. PFTAC has provided ongoing assistance with peer review of annual GDP estimates, helped finalize and publish for the first time GDP by expenditure approach, and is assisting with rebasing the constant price GDP measures to a 2010 base year. Future plans include the development of a quarterly measure of GDP.

Public Financial Management

Vanuatu has regularly sent officials to PFTAC-sponsored regional training events. During FY2015, missions were conducted to prepare authorities for a review of non-tax revenues and assist with business processes for internal audit, including technical assistance (TA) on the use of the audit software TeamMate. Anticipated activity during FY2016 includes coordinating a guided PEFA self-assessment and commencing work with Ministry of Finance officials on development of a PFM Reform Roadmap. In addition, further TA on internal audit is likely.

Macroeconomics

In the macroeconomic area, PFTAC provided assistance to the Reserve Bank of Vanuatu (RBV) in developing their monitoring and projection framework and in training staff on how to use the framework effectively. In addition, staff members from the Ministry of Finance and Economic Management and the RBV participated in a regional workshop on long-term fiscal planning conducted jointly by PFTAC and the Asian Development Bank.

Tax Administration

PFTAC and IMF Legal Department have provided technical assistance to Vanuatu that included a mission in June 2010 setting the foundation for introducing an income tax¹ and the development of a strategic and business plan² in 2011. More recently, two PFTAC missions were carried out. The first³ conducted an overall review of current reform progress. The second⁴ assisted the Department of Customs and Inland Revenue (DCIR) in the renewal of their strategic and business plan. A technical assistance plan to further strengthen compliance risk management has been agreed and will commence shortly.

DCIR has made steady revenue administration reform progress over the last few years which has included: (a) the development of a corporate strategy and business plan; (b) a risk-based compliance improvement strategy; (c) implementation of performance standards; and (d) the development of an IT strategy (supported by PFTAC) followed by the implementation of an IT system that has facilitated taxpayer compliance. The authorities recently submitted a request to PFTAC to review the current VAT and Rent Tax Legislation which needs to be modernized.

Financial Supervision

The PFTAC Resident Technical Advisor scheduled a series of technical missions involving on-site examination of banks and revisions of the Credit Union Act and oversight capacity building. The Reserve Bank of Vanuatu indicated that those sectors were a priority for technical support. The programs are expected to be delivered during FY2016.

¹ Margaret Cotton and Peter Mullins 2010 – Framework for an Income Tax and Review of the VAT threshold, June 2010.

² Carson McNeill - Tax Policy & Administration Reforms.

³ Stan Shrosbree – Evaluating Current Reform Progress and Determining Next Steps in Improving Taxpayer Compliance.

⁴ Carson McNeill – Review and Update Vanuatu’s Customs and Inland Revenue Corporate Strategy.

BANK–FUND COUNTRY TEAM CONSULTATIONS

(As of May 8, 2015)

A representative of the World Bank accompanied the IMF team on the Article IV mission to Vanuatu (April 15–28, 2015) and participated in discussions with the Government of Vanuatu. The Bank and Fund country teams also exchanged views on the main macroeconomic issues facing Vanuatu, the effects of Cyclone Pam, and appropriate policy responses.

The teams agreed that addressing post-cyclone needs will require a large, temporary increase in public spending to rehabilitate the economy and provide relief to vulnerable groups. To finance this temporary increase in spending, it is important that the authorities seek external financing at highly concessional terms. Moreover, after undertaking necessary recovery and reconstruction activities in the aftermath of the cyclone, the authorities should rebuild fiscal buffers over the medium term, including by taking steps to mobilize revenues. The teams agreed that formulating an infrastructure investment plan in line with national priorities, and ensuring discipline and allocative efficiency in public expenditure, will also be important in responding to fiscal challenges. Infrastructure investment should be complemented with broad reforms aimed at enhancing the business environment, improving connectivity and promoting tourism (including in new markets). Both teams welcomed the authorities' commitment to inclusive growth, which will be supported by government strategies to provide low-cost housing and improve access to electricity and financial services.

The teams broadly welcomed the RBV's measures to support the economy and banking system in the aftermath of the cyclone, while noting that the clarity and communication of these measures would be important determinants of their effectiveness. To safeguard against financial stability risks, the central bank should ensure that banks continue to follow prudent lending and risk management standards. The teams agreed that the vatu peg should be maintained in the short to medium term, given the importance of exchange rate stability for maintaining confidence, but that there is scope to adjust the peg over the longer term depending on the evolution of balance-of-payments pressures.

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.

It was agreed that 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
July 2015–June 2016

	Products	Expected Delivery Date
Bank Work Program	<ul style="list-style-type: none"> 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. 	Ongoing
	<ul style="list-style-type: none"> Assist in increasing the resilience of communities in Vanuatu to the impacts of climate change and natural hazards on food and water security. 	Ongoing
	<ul style="list-style-type: none"> Support strengthened disaster risk management and preparedness. 	Ongoing
	<ul style="list-style-type: none"> Support increased access to electricity services for rural and lower-income households. Technical assistance on the government's energy sector work program. 	Ongoing
	<ul style="list-style-type: none"> Support regulatory reform in telecoms and ICT. 	Ongoing
	<ul style="list-style-type: none"> Technical assistance to improve public financial management and identify the appropriate level and mix of financing in the health sector. 	Ongoing
	<ul style="list-style-type: none"> Technical assistance for public debt management (building on the Debt Management and Performance Assessment conducted in 2014). 	Ongoing
	<ul style="list-style-type: none"> Technical assistance for the development of a National Housing Policy and financial support for the construction of more disaster-resilient housing. 	From mid-2015
Fund Work Program	<ul style="list-style-type: none"> Surveillance (Article IV consultation concluded), including a joint debt sustainability analysis 	June 2015
	<ul style="list-style-type: none"> Technical assistance: coordinating a guided PEFA self-assessment (PFTAC) 	June 2016
	<ul style="list-style-type: none"> Technical assistance on developing a PFM Reform Roadmap (PFTAC) 	June 2016
	<ul style="list-style-type: none"> Technical assistance: non-tax revenues (PFTAC) 	June 2016

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of May 4, 2015)

Operational Strategy

Asian Development Bank's (ADB) Country Operations Business Plan for 2015–2017 is aligned with the government's Priorities and Action Agenda and aims to assist the government in (i) transport—by providing support for improved connectivity to markets and social services; (ii) urban development—by improving access to sanitation and drainage facilities and improving urban infrastructure with a particular focus on Port Vila; and (iii) energy—by supporting greater energy efficiency, rural electrification, and renewable energy sources. Consistent with the government's strategy of fostering private sector-led growth, ADB also focuses on improving the enabling environment for the private sector through improving access to financial services, reforming business laws, and supporting state-owned enterprise (SOE) reform.

ADB allocation to Vanuatu of Asian Development Fund loan resources for 2015–2016, determined based on the results of the 2014 Country Performance Assessment exercise, has been set at US\$14.46 million. In addition to this, ADB will also provide on average approximately US\$500,000 per annum in technical assistance (TA) grant support. To leverage ADB's impact and reduce borrowing costs, cofinancing opportunities will be pursued with other development partners.

Portfolio Status

Since joining ADB in 1981, 11 loans have been provided to Vanuatu for a total amount of US\$85.55 million and 62 TA projects for US\$22.45 million. More than 50 percent of the loans and technical assistance projects were for the transport sector. ADB resumed its lending operations in Vanuatu with the approval of two projects in the last quarter of 2011. These were for the Vanuatu Interisland Shipping Project (US\$52.12 million), cofinanced by the Government of New Zealand, and the Port Vila Urban Development Project (US\$39.10 million), cofinanced by the Government of Australia.

There are five ongoing TA projects amounting to US\$5.19 million (including cofinancing): TA 8724-VAN: Supporting the Preparation of the National Sustainable Development Plan; TA 8336-VAN: Expansion of Rural Financial Services; TA 8285-VAN: Energy Access Project; TA 7938-VAN: Interisland Shipping Support Project; and TA 7345-VAN: Port Vila Urban Development Project.

Interisland Shipping Support Project

The aim of this project is to improve the efficiency and effectiveness of interisland shipping services through provision of an integrated package of assistance. It comprises two major components: (i) infrastructure investments in the capital of 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 associated TA to improve sector governance through institutional strengthening and legal and regulatory reforms, and by project management services. ADB is providing a loan of US\$29.30 million, the Government of New Zealand a parallel grant of US\$17.25 million, and the Government of Vanuatu US\$5.57 million.

Port Vila Urban Development Project

The aim of this project is to improve drainage, roads, and sanitation systems in greater Port Vila (municipality and adjacent urban and peri-urban areas in the Shefa province). The project will implement the recommendations of the drainage and sanitation master plan prepared through a project preparatory TA, which identified priority interventions for improved access to, and delivery of drainage and sanitation services to the residents of Port Vila. It will support affordable, sustainable, and effective sanitation, roads, and storm water drainage services, and contribute to climate resilient and sustainable urban development in and around Port Vila. ADB is providing a loan of US\$5.0 million and administering the corresponding grant of US\$31.0 million from the Government of Australia. The Government of Vanuatu is providing a contribution of US\$3.1 million.

Private Sector Development

Private sector development in Vanuatu is supported through the Pacific Private Sector Development Initiative (PSDI). PSDI is a regional technical assistance facility cofinanced 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. A diagnostic was also prepared for the Reserve Bank of Vanuatu and the Vanuatu Financial Services Commission on the current framework for the regulation and supervision of microfinance institutions.
- **Business Law Reform.** ADB assistance has focused on drafting a new Companies Act, a new Insolvency Act, and a new Trustee Act. Support will continue for the implementation of these laws and for establishing an electronic registry to include company and business name registrations.
- **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 is also working with several SOE's 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 consisted of (i) the approval of US\$1.0 million grant financing from the Asia Pacific Disaster Response Fund, and (ii) deployment of urban and infrastructure specialists to Port Vila to provide assistance. ADB is currently consulting with the government on the provision of additional financing to support reconstruction needs.

Proposed Pipeline Projects

ADB's forward pipeline includes a proposed Energy Access Project that will support increased energy access to households and businesses in the provincial centers of Vanuatu through expansion of existing distribution grids and the development of low-cost renewable energy generation from hydropower.

An urban development project for Luganville and a second phase of the Port Vila Urban Development Project are also proposed.

ADB–World Bank Joint Development Coordination Office

An ADB–World Bank joint Development Coordination Office was opened in June 2010 in Port Vila. The shared field presence has improved ADB's responsiveness to the development needs of Vanuatu and supports aid coordination and aid effectiveness.

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance	
<p>General: Data provision has some 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.</p>	
<p>National accounts: While there have been improvements in methodology and the development of additional data sources, the accuracy of the recently-released, experimental expenditure-based GDP estimates could be further improved. Data are compiled only on an annual basis. Work is underway on rebasing the constant price GDP estimates using 2010 as the new base year. PFTAC is providing technical assistance in this work, and also in the improvement of the experimental expenditure-based GDP and the development of estimates of GDP on a quarterly basis.</p> <p>Price statistics: The CPI weights are based on 1998 household surveys, and only cover the two urban centers of Port Vila and Luganville. Work on rebasing the CPI is underway, using data from the 2010 Household Income and Expenditure Survey.</p>	
<p>Government finance statistics: Budget classification is broadly consistent with the <i>GFSM2001</i>. Work is underway to migrate budget classification to <i>GFSM2014</i>. Government operations data are compiled for the central government only and exclude public enterprises and operations of provincial governments and the two municipalities, as well as grant bodies and other central government extra-budgetary units. The operations of the budget are recorded on a cash plus invoice basis.</p>	
<p>Monetary statistics: The Reserve Bank of Vanuatu reports monthly monetary data, including the accounts of the monetary authorities and commercial banks (only in aggregate), and the distribution of loans by sector in its monthly bulletin posted on its website. The RBV also publishes a quarterly report with wider coverage of financial data including fiscal transactions and key financial soundness indicators. Information on financial access is sparse, and could be usefully expanded to allow for better assessment of financial inclusiveness and monetary policy transmission.</p>	
<p>External sector statistics: The Reserve Bank of Vanuatu releases quarterly BOP data in its Quarterly Economic Report. A special Debt Unit has been created within the Ministry of Finance for public debt management and recording. An external sector statistics mission visited Vanuatu during February 2015 to assist the authorities in concluding the review of quarterly balance of payments and international investment position (IIP) statistics.</p>	
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 May 2015)

	Date of latest Observation	Date Received	Frequency of Data ¹	Frequency of Reporting ¹	Frequency of Publication ¹
Exchange Rates	5/1/2015	5/1/2015	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary ² Authorities ²	3/1/2015	5/1/2015	M	M	M
Reserve/Base Money	3/1/2015	5/1/2015	M	M	M
Broad Money	3/1/2015	5/1/2015	M	M	M
Central Bank Balance Sheet	3/1/2015	5/1/2015	M	M	M
Consolidated Balance Sheet of the Banking System	3/1/2015	5/1/2015	M	M	M
Interest Rates ³	3/1/2015	5/1/2015	Q	Q	Q
Consumer Price Index	12/1/2014	3/1/2015	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	12/1/2014	3/1/2015	M	M	M
Stocks of Central Government and Central Government-Guaranteed ⁵ Debt ⁵	7/6/1905	4/1/2015	A	A	A
External Current Account Balance	12/1/2014	4/1/2015	Q	Q	Q
Exports and Imports of Goods and Services	12/1/2014	4/1/2015	Q	Q	Q
GDP/GNP	7/5/1905	11/1/2014	A	A	A
Gross External Debt	12/1/2014	4/1/2015	Q	Q	Q
International Investment Position	12/1/2014	4/1/2015	Q	Q	Q

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

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

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

⁴Foreign and domestic financing.

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



VANUATU

May 20, 2015

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

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Prepared by the Staff of the International
Monetary Fund and the International
Development Association.

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

BACKGROUND

1. Vanuatu is coping with the consequences of Cyclone Pam that hit the country on

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

2. The needs for post-cyclone reconstruction are large and will require external assistance to fill the financing gap.

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

3. In 2014, the face values of external public and total external debt were low and declined from the 2013 levels in relation to GDP.

The external public debt was estimated at 11.7 percent of GDP while total external debt stood at 22.5 percent of GDP. However, the total public and publicly guaranteed debt increased to 24 percent of GDP owing to increases in both domestic debt by the central government and the government-guaranteed debt extended to Government Business Enterprises (GBEs).² Due to data limitations, external liabilities of commercial banks are used as a proxy for private external debt.

4. At the end of 2014 domestic debt of the central government stood at 7.8 percent of GDP.

It constituted 40 percent of total central government debt and consisted of government

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

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

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

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

UNDERLYING ASSUMPTIONS

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

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

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

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

Box 1: Key Macroeconomic Assumptions

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

- GDP growth.** GDP is projected to decline by 2 percent in 2015, mainly because of the cyclone impact on agricultural output and tourism, and then increase 5 percent in 2016 as economic recovery takes hold. Growth is expected to average 2.7 percent during 2015–2020, with the negative impact of the cyclone offset by reconstruction and project investment. In the long run, the economy is assumed to grow at the rate of 3 percent—below the average of the past 10 years, but above the average of the last 5 years.
- Fiscal balance.** The fiscal deficit is projected at 10.7 and 10.6 percent of GDP in 2015 and 2016, respectively, reflecting recovery and reconstruction expenditures and the planned increase in infrastructure investment. The DSA assumes a gradual improvement in the fiscal balance over time and its stabilization at near-balance levels in the long run.
- Reconstruction efforts and financing.** Based on the PDNA's public sector needs assessment, reconstruction expenditures are assumed to be 20 percent of GDP spread over 2015–17. Part of reconstruction activities are assumed to overlap with infrastructure projects. Any additional external borrowing needed to fill the financing gap is assumed to be made on concessional terms at the average of the terms on the ADB, the World Bank, and the China ExIm Bank loans.
- Imports and exports.** Imports of goods and services are assumed to increase to about 76 percent of GDP in 2015 and 69 percent in 2016 driven by humanitarian needs, local supply constraints, reconstruction and project-related materials. Exports of goods and services in 2015-16 are expected to remain lower than the 2013 levels due to a contraction in tourism and agricultural exports, but to pick up gradually thereafter. The non-interest current account deficit is projected at about 4 percent of GDP in the long run.
- FDI** is assumed to increase substantially over 2015-16 due to reconstruction needs, and remain relatively high in the medium term reflecting the crowding-in effects of the government's infrastructure projects. It is then projected to stabilize at around 4 percent of GDP in the long run.
- Inflation.** Supply constraints caused by Cyclone Pam are expected to give rise to some inflationary pressures in 2015, but this should be partially offset by the recent decline in oil prices. Thus, the DSA assumes a slight increase in inflation to 2 percent in 2015. Higher rate of inflation is expected during 2016-18 due to potential economic stimulus induced by project implementation.

EXTERNAL DEBT SUSTAINABILITY

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

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

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

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

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

PUBLIC DEBT SUSTAINABILITY

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

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

CONCLUSION AND STAFF ASSESSMENT

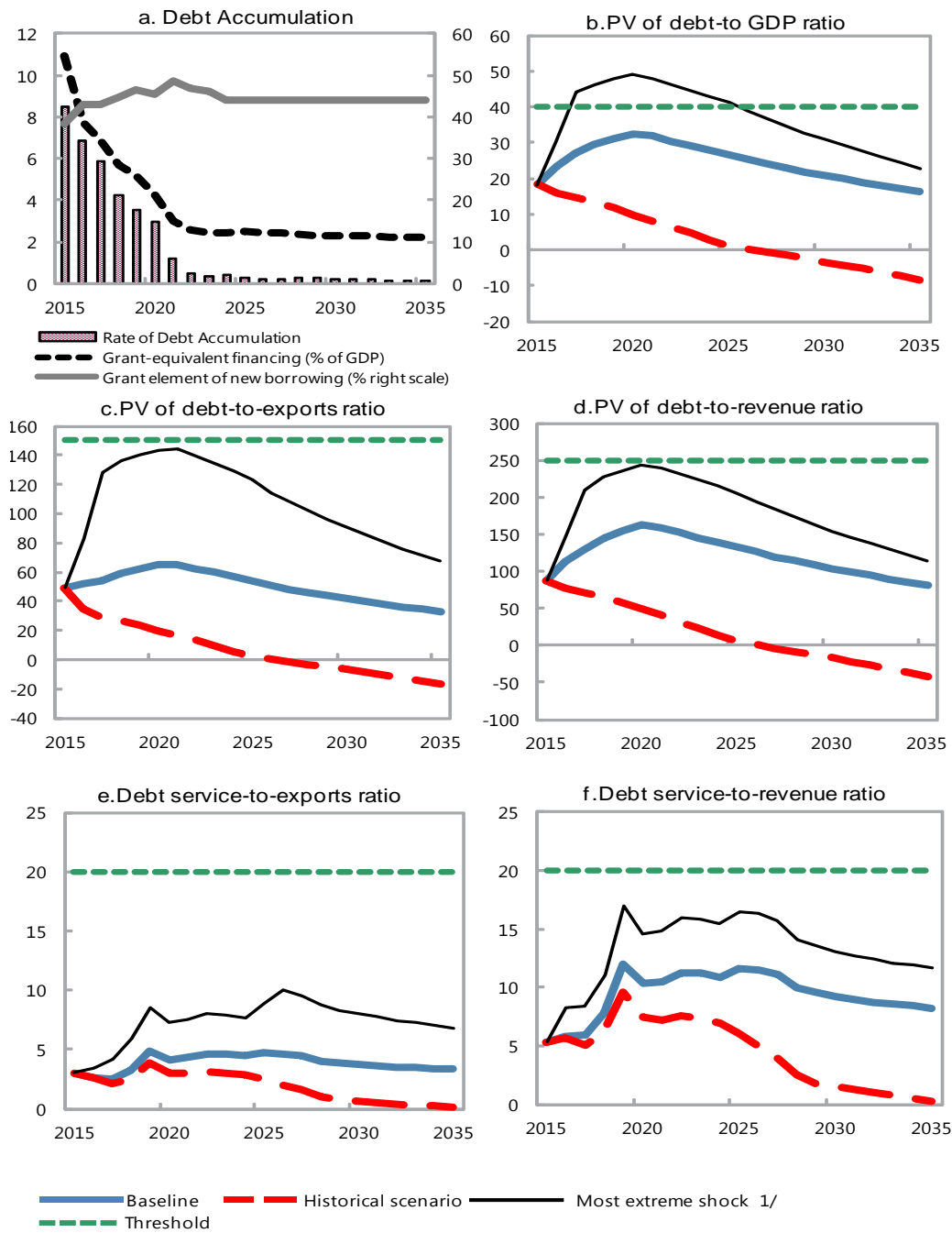
14. Vanuatu is currently at a moderate risk of debt distress and the planned trajectory of debt accumulation should be managed prudently. External and public debt levels are currently low. However, they are projected to rise steeply over the next few years and peak at substantially higher levels before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

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

AUTHORITIES' VIEWS

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

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



Sources: Country authorities; and staff estimates and projections.

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

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

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

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - \rho(1+g)] / (1+g + \rho + g\rho)$ 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 changes.

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

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

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

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

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

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

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

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

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

Sources: Country authorities; and staff estimates and projections.

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

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

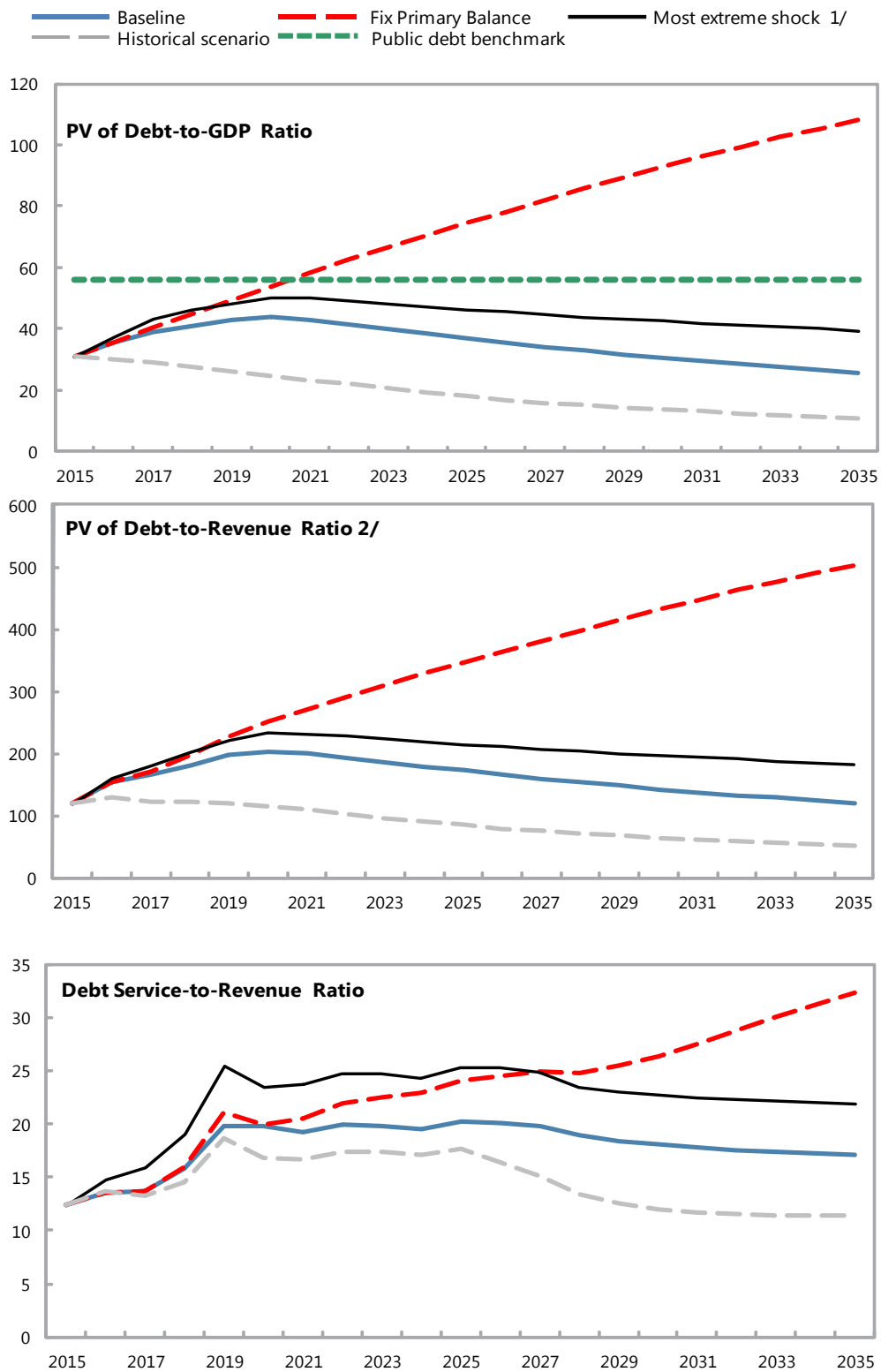
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

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

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

Figure 2. Vanuatu: Indicators of Public Debt Under Alternative Scenarios, 2015-2035 ^{1/}



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025.

2/ Revenues are defined inclusive of grants.

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

	Actual			Average ^{5/}	Standard Deviation ^{5/}	Estimate						Projections		
	2012	2013	2014			2015	2016	2017	2018	2019	2020	2015-20 Average	2025	2035	2021-35 Average
Public sector debt 1/	24.6	23.3	24.0			38.9	47.8	54.1	57.9	61.8	63.8		53.7	37.6
<i>of which: foreign-currency denominated</i>	14.0	12.7	11.7			26.4	35.6	42.2	46.2	50.3	52.5		43.2	28.2
Change in public sector debt	1.0	-1.3	0.7			14.9	8.9	6.3	3.8	3.9	2.0		-2.1	-1.3
Identified debt-creating flows	0.8	-0.1	-1.5			11.8	8.9	6.3	3.8	4.1	1.9		-2.1	-1.3
Primary deficit	1.0	-0.5	-1.7	-0.3	15	10.7	10.6	8.6	6.0	5.7	3.8	7.5	-0.1	0.0
Revenue and grants	21.8	21.3	23.3			26.0	23.3	23.7	22.7	21.7	21.5		21.5	21.5
<i>of which: grants</i>	3.0	2.2	4.1			5.1	2.7	2.7	2.3	1.5	1.5		1.5	1.5
Primary (noninterest) expenditure	22.8	20.8	21.6			36.6	33.9	32.3	28.6	27.4	25.3		21.4	21.5
Automatic debt dynamics	-0.1	0.4	0.2			1.1	-1.7	-2.3	-2.2	-1.6	-1.9		-2.0	-1.3
Contribution from interest rate/growth differential	-0.1	-0.3	-0.3			1.1	-1.5	-1.8	-1.8	-1.2	-1.5		-1.6	-1.0
<i>of which: contribution from average real interest rate</i>	0.3	0.2	0.2			0.6	0.4	0.3	0.0	0.2	0.0		0.0	0.1
<i>of which: contribution from real GDP growth</i>	-0.4	-0.5	-0.5			0.5	-1.9	-2.1	-1.8	-1.4	-1.5		-1.6	-1.1
Contribution from real exchange rate depreciation	0.0	0.7	0.5			0.1	-0.2	-0.5	-0.3	-0.3	-0.4		...	...
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Residual, including asset changes	0.1	-1.2	2.2			3.1	0.0	0.0	0.0	-0.2	0.2		0.0	0.0
Other Sustainability Indicators														
PV of public sector debt	...	10.6	21.5			30.9	35.6	39.1	41.1	42.7	43.7		37.0	25.6
<i>of which: foreign-currency denominated</i>	...	0.0	9.2			18.3	23.4	27.2	29.4	31.2	32.4		26.5	16.3
<i>of which: external</i>	...	...	9.2			18.3	23.4	27.2	29.4	31.2	32.4		26.5	16.3
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	2.9	2.1	0.9			13.9	13.8	11.8	9.6	10.0	8.0		4.2	3.7
PV of public sector debt-to-revenue and grants ratio (in percent)	...	49.6	92.5			118.8	153.3	164.9	181.3	196.7	203.4		172.1	119.3
PV of public sector debt-to-revenue ratio (in percent)	...	55.2	112.3			147.7	173.5	186.3	202.2	211.1	218.4		184.8	128.1
<i>of which: external 3/</i>	...	...	48.0			87.7	113.9	129.4	144.7	154.3	161.9		132.4	81.2
Debt service-to-revenue and grants ratio (in percent) 4/	8.8	12.4	11.1			12.4	13.6	13.6	15.9	19.8	19.8		20.3	17.1
Debt service-to-revenue ratio (in percent) 4/	10.2	13.8	13.5			15.5	15.4	15.4	17.7	21.2	21.3		21.8	18.3
Primary deficit that stabilizes the debt-to-GDP ratio	0.0	0.8	-2.4			-4.2	1.7	2.3	2.2	1.8	1.7		2.0	1.3
Key macroeconomic and fiscal assumptions														
Real GDP growth (in percent)	1.8	2.0	2.3	3.8	25	-2.0	5.0	4.5	3.5	2.5	2.5	2.7	3.0	3.0
Average nominal interest rate on forex debt (in percent)	1.3	1.7	1.7	1.4	0.3	3.7	2.3	2.0	1.9	2.1	1.7	2.3	1.6	1.5
Average real interest rate on domestic debt (in percent)	4.7	2.2	2.2	3.2	2.0	2.5	1.8	1.3	1.5	1.7	1.9	1.8	2.3	2.9
Real exchange rate depreciation (in percent, + indicates depreciation)	-0.3	5.2	4.1	-1.1	7.3	0.5	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	0.4	2.7	2.9	3.1	2.1	2.0	2.5	3.2	3.1	3.0	2.9	2.8	2.9	2.9
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.0	-6.8	6.2	-0.3	3.2	66.4	-2.9	-0.4	-8.2	-2.0	-5.4	7.9	3.1	3.1
Grant element of new external borrowing (in percent)	...	...	...	...	...	38.6	43.0	42.9	44.8	46.7	45.4	43.6	44.1	44.1

Sources: Country authorities; and staff estimates and projections.

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

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

3/ Revenues excluding grants.

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

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

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

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

Sources: Country authorities; and staff estimates and projections.

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

2/ Revenues are defined inclusive of grants.

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

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

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

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

Damage Assessment and Economic Outlook

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

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

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

Request for Assistance

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

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

Fiscal policy

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

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

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

Monetary Policy and the Financial Sector

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

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

Structural Reforms

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

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

International Response

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

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

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