Statement by the IMF Staff Representative
November 22, 2002

1. This statement contains information that has become available since the Staff Report for the 2002 Article IV consultation was circulated to the Executive Board on November 7, 2002. The information does not alter the thrust of the staff appraisal.

2. The government budget for 2003, currently being considered by Parliament and expected to receive final approval by early December, aims for a current budget balance. The overall budget deficit in 2003 is projected to be about 1 percentage point of GDP smaller than indicated in the staff report, mostly on account of lower capital expenditure.

3. Monetary developments through September 2002 are generally in line with staff projections. Broad money growth rose to 1 percent for the year ending September 2002, reflecting a reversal in the decline in foreign currency deposits observed in August. For the same period, credit to the private sector expanded by 4¾ percent. Net credit to government by the banking system increased by VT 464 million (1½ percent of GDP) from end-August, which staff understands has since been partially unwound. Inflation (period average) was at 2 percent for the year ending September 2002.

4. On November 11, Parliament approved the International Banking Act, which aims to strengthen oversight of offshore banks. Under the act, which takes effect from January 1, 2003, offshore banks will be supervised by the Reserve Bank of Vanuatu. They will face significantly tighter prudential regulations (in line with onshore banks), including in the areas of capital requirements, data provision, and audit procedures. Offshore banks can apply for a one-year interim license effective from January 1. To continue to operate beyond 2003, they must subsequently reapply for a regular license by end-August 2003, which will be granted only to those banks maintaining a physical presence in Vanuatu and meeting the minimum capital requirement, as well as all other provisions in the act.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/134
FOR IMMEDIATE RELEASE
December 11, 2002

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

IMF Concludes 2002 Article IV Consultation with Vanuatu

On November 22, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Vanuatu.[1]

Background

Since the mid-1990s, Vanuatu has experienced a trend slowdown in growth, owing to persistent fiscal and structural weaknesses, which have led to a loss in external competitiveness. Despite frequent shocks and an uncertain policy environment, macroeconomic stability has been maintained, but structural reforms have slowed. A national election in May 2002 has cautiously bolstered reform prospects.

Real GDP growth was 2½ percent in 2000 owing to an agriculture-led recovery. However, the economy contracted by 2 percent in 2001, due to the effects of several major cyclones and a global downturn in agriculture and tourism. Inflation remained subdued, increasing from 2½ percent in 2000 to 3¾ percent in 2001. The current account surplus declined from 2 percent of GDP in 2000 to ¾ percent in 2001, reflecting the impact of shocks to copra exports and tourism receipts. As a result, gross official reserves fell to US$38 million at end–2001 (three months of prospective imports).

[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. 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.

Performance so far in 2002 suggests that real GDP will further contract by ¼ percent, because of a slump in tourism and construction. This would still require a moderate rise in agricultural output, buoyed by a strong recovery in copra production. Inflation should stay below 3 percent with prudent monetary management, despite an increase in oil prices. A current account deficit of 2½ percent of GDP is projected, with a further softening in tourism receipts, but reserves should be unchanged at US$38 million by year end (three months of imports) on account of a slowing of capital outflows. External vulnerability appears to remain moderately low at this juncture, despite the weaknesses in economic performance in recent years, given a relatively small external debt and cautious monetary stance.

The fiscal situation improved in 2001, but most of the adjustment came from reduced capital spending. The overall budget deficit (excluding net lending) declined from 7¼ percent of GDP in 2000 to 3¾ percent of GDP in 2001. Despite this, problems persisted with tax compliance and expenditure prioritization. Revenue shortfalls stemmed from administrative problems and, in 2001, the economic slowdown. Expenditure priorities were skewed toward the wage bill, which remained in excess of one-half of the recurrent budget in each year. Education and health outlays grew slightly as a share of total spending, but stayed flat in terms of GDP, and service delivery to the outer islands and rural areas continued to lag due to resource shortfalls and capacity constraints.

Public finances have further improved in 2002, but the spending mix is still skewed towards unproductive outlays. An overall budget deficit of 1¾ percent of GDP was initially targeted in 2002, but it is now projected to be 1 percent of GDP, although this decline is largely attributable to delays in implementing externally-financed capital projects. Revenue shortfalls are expected to moderate, despite the continued economic slump, given some steps to broaden the tax base and improve VAT and customs administration. Problems continue to arise from unbudgeted appropriations, which given a tight cash situation act to squeeze spending on operations and maintenance and for key social and infrastructure needs. Starting in mid-2001, the government instructed the Vanuatu Commodity Marketing Board (VCMB) to pay subsidies to copra farmers, which have been financed through direct advances from the Reserve Bank of Vanuatu (RBV). These payments have continued in 2002, which given the poor financial state of the VCMB have potential budget implications.

Monetary policy has been generally restrained. Broad money grew by 6 percent in both 2000 and 2001, fueled by foreign currency deposits (FCDs) arising from a relatively strong current account. Exchange rate policy has also been generally appropriate, but declining exports and reserves continue to warrant a flexible exchange rate management. Domestic liquidity conditions were allowed to ease through the first half of 2002, although private sector credit growth slowed from 6½ percent at end-2001 to 4 percent at end-June 2002 reflecting weak overall growth. However, even with a seasonal pickup in domestic demand, broad money growth in 2002 is projected to be very modest, with private sector credit growth expected to stay at 4 percent.

In the financial sector, a number of steps have been taken since the last Article IV consultation to strengthen the RBV's oversight of domestic banks, in line with the Basel Core Principles (BCPs) for bank supervision. Most recently, "know-your-customer" guidelines were adopted in mid 2002, in part to improve anti-money laundering (AML) controls. Financial and operational restructurings of the state-owned National Bank of Vanuatu (NBV) and Vanuatu National Provident Fund (VNPF) have also been completed, but the Asset Management Unit set up to handle nonperforming loans transferred from the NBV and VNPF has underperformed.

The global focus on combating money laundering and terrorism financing has given further impetus to also strengthening oversight of Vanuatu's offshore financial sector. Initial steps were taken in this regard in late 2000, particularly in relation to the reporting of suspicious transactions, but enforcement continued to be constrained for legal, operational, and budgetary reasons. A new international banking act approved by Parliament in mid-November 2002 puts offshore banks under the direct supervision of the RBV starting in 2003. With proper enforcement, this act is expected to bring the supervisory regime for offshore banks into line with international standards, both in terms of the BCPs and AML requirements. The authorities also are currently developing proposals for a more effective supervisory response in the non-bank area.

Progress in other structural areas has been slow since the last consultation, which limits long-term growth potential. On state-owned enterprise (SOE) reform, the process of privatizing and commercializing SOEs is lagging due to a lack of political consensus. The government has sold or liquidated ten small and medium-sized SOEs since the beginning of 2001, but actions still need to be taken on another 20 enterprises, including Air Vanuatu. On trade reform, WTO accession stalled just prior to completion in late 2001. In the areas of private sector development and FDI, prospects still depend on swift and effective actions to reduce administrative constraints, including streamlining land procurement and business licensing procedures.

Statistical methods and reporting have improved in the past few years, which should assist in policy formulation and monitoring. In two of the weaker statistical areas—national income accounts and the balance of payments—work is ongoing to improve accuracy and coverage with donor technical assistance.

Executive Board Assessment

Directors commended Vanuatu for maintaining macroeconomic stability and making progress on structural reforms under difficult economic and political conditions. Inflation has remained subdued, the external debt is manageable, and the fiscal situation has improved. However, Directors observed that Vanuatu's recent economic growth performance has been lackluster—especially in view of the rapid population growth. They acknowledged that Vanuatu's susceptibility to external shocks and natural disasters, its fragmented geography and small size, and recent political developments have affected this performance. Nevertheless, they noted that persistent fiscal and structural weaknesses have led to a relatively high-cost production structure and inadequate basic infrastructure, which have eroded Vanuatu's competitiveness vis-à-vis neighboring countries. They recommended that prompt action be taken to remove these weaknesses, including through continued implementation of the Comprehensive Reform Program. Noting that international donors play an active and important role in Vanuatu, Directors stressed the importance of better aid coordination and consistency of policy advice by the international community.

Directors welcomed the overall improvement in the fiscal situation, but emphasized that more needs to be done to boost revenue and redirect spending toward infrastructure and the provision of social services, with the objective of achieving a lasting fiscal consolidation. They therefore supported the authorities' cautious approach to formulating the 2003 budget, which aims for a current budget balance. On revenue, Directors encouraged a broadening of the tax base and strengthening of VAT and customs administration. They supported current plans to adopt new excises on alcohol and tobacco in the 2003 budget, which they viewed as essential to improving revenue performance. On expenditure, Directors suggested stepped-up efforts to improve expenditure control and debt management, including strict limits on supplemental appropriations. They emphasized the need to control the wage bill and to further shift spending to the social sectors and infrastructure development, but also to increase the effectiveness of spending on education. They supported higher capital spending within the framework of a well-designed public investment program with coordinated donor support.

Directors welcomed the progress that has been made in strengthening budget procedures under the government's Comprehensive Reform Program. However, Directors stressed that government subsidies, including those to copra farmers, need to be scaled back and better-targeted given more critical spending priorities and prevailing market conditions.

Directors considered that monetary policy has been generally restrained, and that it should continue to be so in order to keep inflation low and support the external position. They urged limits on the use of central bank advances to finance the public sector, in order to avoid undermining fiscal discipline, and called on the authorities to develop the capacity to use treasury bill auctions instead.

Directors viewed the adjustable peg exchange rate arrangement as broadly appropriate, but stressed that it needs to be backed up by sound macroeconomic and structural policies to enhance external competitiveness. Most Directors were of the view that any significant weakening in external performance would call for a more flexible exchange rate management, and, in this respect, were pleased to note that the authorities are willing to consider a widening of the trading band. Some Directors also recommended greater transparency regarding the composition of the currency basket. Others, however, expressed concern that this could lead to destabilizing speculation on the exchange rate. Directors supported the authorities' request for technical assistance in the area of foreign reserve management.

Directors welcomed the progress made in strengthening the regulation and supervision of onshore banks, as well as the recent passage of the International Banking Act to improve the oversight of offshore banks. They advised the authorities to strictly enforce the new legislation.

Directors stressed the need to effectively regulate non-bank activity as well in the offshore sector, to ensure effective controls against money laundering and terrorism financing in line with internationally agreed standards. Some Directors suggested that the authorities undertake a comprehensive study of the costs and benefits of the offshore financial center.

Directors commended the completion of restructuring of the National Bank of Vanuatu and the National Provident Fund, and cautioned that close supervision is needed to ensure that these two institutions remain financially sound. They called for a more aggressive approach by the Asset Management Unit on non-performing loan recoveries, given delays so far and limited budget resources.

Directors stressed that additional structural reforms are needed to bolster medium-term growth prospects and address the high-cost production structure. They encouraged the development of a strategy to commercialize and privatize remaining state-owned enterprises, as envisaged in the original Comprehensive Reform Program. Directors also urged timely implementation of trade commitments and a reinvigorated effort at WTO accession, to improve market access, reduce costly barriers, and attract foreign direct investment. In this regard, they expressed concern about the high share of trade taxes in government revenue, and suggested that the Fund might consider providing technical assistance to address these imbalances. Directors noted that private investment would also benefit from a more transparent legal and regulatory framework and fewer administrative barriers, and that tax exemptions to investors should be limited in scope and applied uniformly.

Directors welcomed the recent steps taken to improve the accuracy and coverage of the national income accounts and balance of payments statistics. They looked forward to a further strengthening in these areas, including through continued support from the Pacific Financial Technical Assistance Center. Directors also encouraged Vanuatu's timely participation in the Fund's General Data Dissemination System.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Vanuatu is also available.