Economic survey

Vanuatu's search for growth

Craig Sugden and Odo Tevi

Vanuatu has achieved macroeconomic stability, with a recent turnaround in growth accompanied by low inflation, low interest rates and a generous level of international reserves. The overall fiscal position is sound and the budget is being restructured to increase funding for key sectors. However it has not been possible to reverse the long-term stagnation in per capita income. While development continues despite this stagnation in incomes, the poor growth outcome appears to impose significant costs on the rural population. The key factors behind the stagnation in income are unclear but probably include the costs of political instability, the difficulty of mobilising land, the monopolisation of key sector and high fertility rates. 'Dutch-disease' type effects or the adoption of the wrong policy formulae may also be holding back growth. It appears that higher priority needs to be placed on directly meeting the needs of the rural population given the low returns so far from a 'fix the centre first' approach.

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The Vanuatu economy emerged from recession in 2003, recording growth of 1.6 per cent over 2003 after contracting by more than 2 per cent per annum in the previous two years. Projections are for continued growth over 2004 driven by expansion in tourism, land development around Port Vila and an increase in agricultural production in response to deregulation and favourable world prices. Macroeconomic stability has been achieved with growth accompanied by low inflation, low official interest rates and a generous level of international reserves. Despite the risk posed by political instability, the overall fiscal position is sound and the budget is being restructured to increase funding for key sectors.

But even with this turnaround in growth and achievement of macroeconomic stability, real income growth continues to elude Vanuatu. Real GDP per capita is on a downward trend that has being evident since 1997, and has now fallen below the levels seen immediately after independence. This trend in income persists despite recent progress in reforming the public service, the financial sector and the policy environment under the umbrella of a Comprehensive Reform Program (CRP). The economy has demonstrated a capacity to achieve stability and to take advantage of favourable external developments, such as increased world commodity prices or the interest of foreign investors in waterfront land. But it has been unable to generate its own internally driven growth.

This survey explores recent developments with a view to developing the understanding of long-run economic trends. It seeks to explain the constraints that may explain why growth has fallen below expectations and what has being achieved by other countries. The implications for policy of this analysis are also briefly explored.

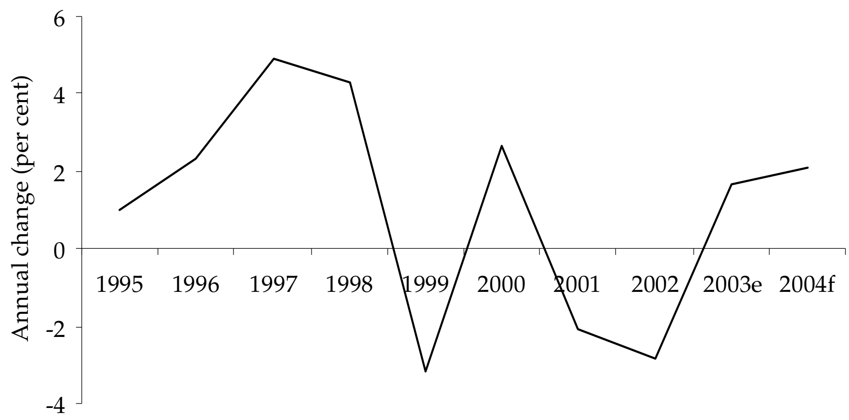
The next section reviews the state of the economy with an emphasis on the causes of the recent improvement in growth. Long-term stagnation in income and trends in key development indicators are examined and possible explanations for the stagnation of income are explored, before drawing out some of the implications for policy of both recent developments and long-run trends.

The state of the economy

After contracting by more than 2 per cent per annum in 2001 and 2002, the economy rebounded in 2003 and is estimated to have recorded growth of 1.6 per cent over the year.[1] The latest official estimate is for further growth of 2 per cent over 2004 (Figure 1).[2]

The turnaround in the economy has being led by gains in the agriculture sector (Figure 2). Gains over 2002 and 2003 in world prices for cocoa and to a lesser extent copra and coconut oil helped lay the foundation for a rebuilding of production of these core commodities, which normally account for somewhere in the order of 40 per cent of merchandise exports. Of potentially more importance has been the restructuring of commodity marketing. The Vanuatu

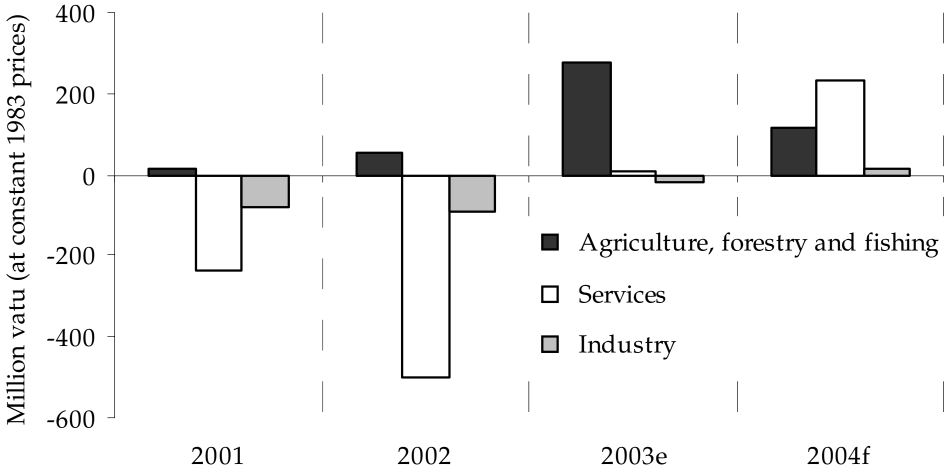
Figure 1 **Real GDP, 1995–2004** (per cent)



[f] Forecast

Source: Vanuatu, National Statistics Office, 2002. *National Accounts of Vanuatu, 1997–2002*, Government of the Republic of Vanuatu, Port Vila; Vanuatu, 2004. *Fiscal Strategy Report*, Budget 2004, Volume 1, Government of the Republic of Vanuatu, Port Vila.

Figure 2 **Contribution to the change in real GDP, 2001–04** (million vatu)



[f] Forecast
Source: Vanuatu, National Statistics Office, 2002. *National Accounts of Vanuatu, 1997–2002*, Government of the Republic of Vanuatu, Port Vila; Vanuatu, 2004. *Fiscal Strategy Report*, Budget 2004, Volume 1, Government of the Republic of Vanuatu, Port Vila.

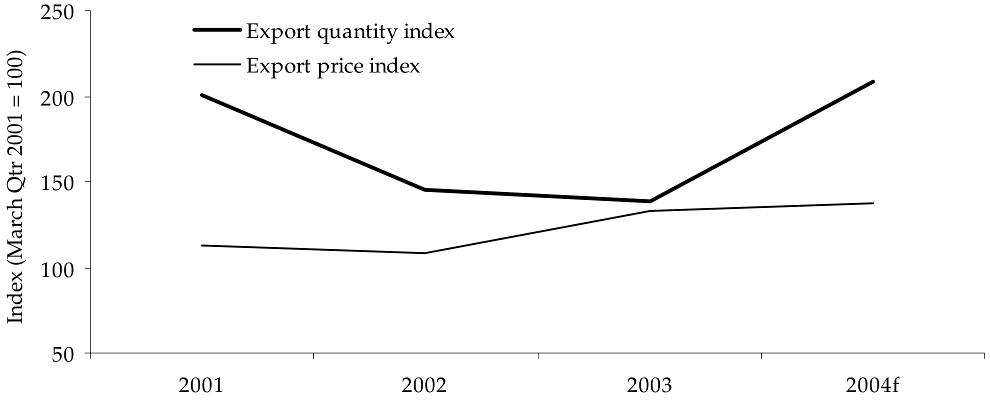
Commodity Marketing Board lost its monopoly rights to export marketing in 2003 as a costly price-support scheme pushed the Board to an unviable financial position. The Board has now stepped back from an active role in marketing, and a policy of allowing competition amongst licensed buyers has helped increase grower prices and raise the efficiency of exporting.

The contribution of agriculture, forestry and fishing to real GDP is estimated to have increased by 8.7 per cent in 2003, and the contribution is expected to have continued to expand over 2004. The latest official forecast is for an expansion in the sector of 3.3 per cent over 2004. In addition to an expansion in agriculture, forestry activity is also expected to grow over 2004.

Data to the end of June 2004 suggest that 3.3 per cent growth may be a conservative estimate of the contribution of agriculture, forestry and fishing over the year. The value of agricultural exports over the first half of 2004 was 66 per cent higher than for the same period of 2003. There has been a strong supply response this year, with the expansion in exports largely attributable to a substantial increase in export quantities (Figure 3). If copra and coconut oil exports in the second half of 2004 can match that seen the same time in 2003 and past quarterly patterns are repeated for other commodities, the purchasing power of the export income from the main agricultural exports is likely to be more than 40 per cent higher in 2004 than in 2003 (Figure 4). The value of timber exports over the first half of 2004 was 54 per cent higher than for the same period of last year.

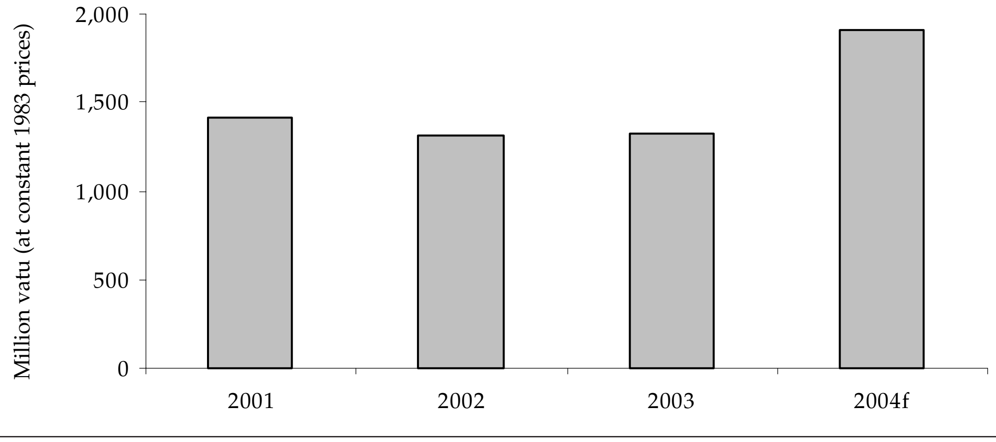
At a commodity level, the gains in agriculture in 2004 have been widespread. The value of exports of all major commodities, with the exception of cocoa, beef and veal,

Figure 3 **Export quantities and prices, 2001–04**



[f] Forecast
Note: Based on exports of copra, coconut oil, beef and veal, cocoa and kava, with weights equal to each commodity's share in the exports of these commodities in the previous year. Forecasts for 2004 are based on the assumption that copra and coconut oil exports for the second half match that seen in 2003 and that quarterly patterns of recent years are repeated for other commodities.
Source: Authors' estimates based on data presented in Reserve Bank of Vanuatu, 2004. *Quarterly Economic Review*, June, Reserve Bank of Vanuatu, Port Vila.

Figure 4 **The purchasing power of the main exports, 2001–04** (million vatu)



[f] Forecast
Note: Derived as the value of exports of copra, coconut oil, beef and veal, cocoa and kava deflated by the CPI. Forecasts for 2004 are based on the assumption that copra and coconut oil exports for the second half match that seen in 2003 and that quarterly patterns of recent years are repeated for other commodities.
Source: Authors estimates based on data presented in Reserve Bank of Vanuatu, 2004. *Quarterly Economic Review*, June, Reserve Bank of Vanuatu, Port Vila.

were at least 30 per cent higher over the first half of 2004 compared to the same period of 2003. The main cocoa production area of Malampa sustained damage from Cyclone Ivy in February and production early in the year was limited to one area (Sanma), and the unfavourable wet conditions have affected production adversely. Beef and veal exports slowed, with a contributing factor being the export of live animals, mainly to Australia, which has seen product diverted from local abattoirs. While Cyclone Ivy damaged the cocoa crop, it caused extra copra nuts to fall and this helped lift copra and coconut oil volumes by more than 25 per cent over the first half of 2004 (compared to the same period of 2003). Kava exports have suffered in recent years from the ban on kava exports to Europe, but a 61 per cent increase in export volumes were recorded over the first half of 2004 (compared to the same period of 2003). Exports of root crops have also continued to rise over the year.

Domestic demand had begun to show signs of improvement over 2003. The service sector had declined by 3.9 per cent over 2002, with most of the contraction accounted for by a contraction in retail and wholesale trade, hotels and restaurants, transport and communication. The contraction in the services sector in turn had accounted for most of the fall in real GDP in that year. The service sector stabilised over 2003, and is projected to grow by more than 2 per cent over 2004. Domestic demand is rising as the extra purchasing power from agricultural exports feeds through the economy and continuing interest in housing and property development centred on Port Vila help raise spending in the capital. By the end of June 2004 commercial bank lending for personal, housing and land purchases was 6 per cent above the level of December 2003, after having grown by 19 per cent in 2003 (Figure 5).

Tourism activity has played only a minor role in recent developments. In 2003 Vanuatu's share of total arrivals to the South Pacific Tourism Organisation (SPTO) countries had fallen to its lowest level in 10 years despite a small increase in tourism arrivals in Vanuatu (Vanuatu, National Statistics Office 2003). The sector appears to have expanded over the first six months of 2004, with visitor arrivals and the number of bed-nights occupied up approximately 10 per cent over the same period of 2003 (Figure 6). Day visitors have shown the most growth as the number of cruise ship visits has increased. The entry in the third quarter of Pacific Blue and the operation by Air Vanuatu of a second plane on the international service is expected to raise price competition and increase tourist catchment areas, thereby stimulating a further increase in tourism activity over the second half of 2004.

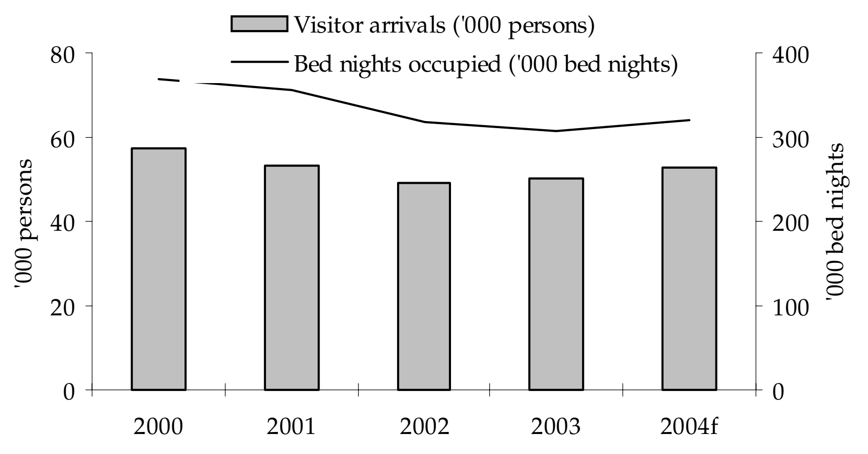
Key indicators of demand are pointing to strong growth in domestic demand in 2004. In particular, over the first six months of 2004 merchandise imports were up 18 per cent and total recurrent revenue was up 9 per cent where this included a 7 per cent increase in value-added tax (VAT) revenue (in nominal terms, relative to the first six months of 2003).[3] Total commercial bank lending increased by 4 per cent over the first six months after having increased by 11 per cent in 2003. But the very strong growth in agriculture seen in the first half of 2004 and the expansion in airline capacity suggest that the latest official projection of 2 per cent growth in real GDP may prove too conservative.

The growth in demand is being achieved in a low inflation environment. In the first quarter of 2004 annualised inflation, measured by the CPI, registered 1.9 per cent and the level of headline inflation decelerated to 1.4 per cent in June 2004. The small increase in the beginning of 2004 reflected increases in the categories for recreation, education and health as school tuition fees in certain schools were raised in the first quarter, increases in duty

Figure 5 **Contribution to the change in commercial bank lending, 2001–04** (million vatu)

[f] Forecasts for 2004 are based on the extrapolation of data for the first six months of the year using recent growth rates. Deflated by the CPI.
Source: Reserve Bank of Vanuatu, 2004. *Quarterly Economic Review*, June, Reserve Bank of Vanuatu, Port Vila.

Figure 6 **Tourism activity, 2000–04**



[f] Forecasts for 2004 are based on the extrapolation of data for the first six months of the year on the assumption that quarterly patterns of recent years are repeated.
Source: Vanuatu, National Statistics Office, 2004. *Quarterly Statistical Indicators*, April–June, Government of the Republic of Vanuatu, Port Vila; Reserve Bank of Vanuatu, 2004. *Quarterly Economic Review*, June, Reserve Bank of Vanuatu, Port Vila.

Figure 7 **Annual inflation rate, 1995–2004** (per cent per annum)

Source: Vanuatu, National Statistics Office, 2003. *Annual Statistical Indicators 2003*, Government of the Republic of Vanuatu, Port Vila; Reserve Bank of Vanuatu, 2004. *Monetary Policy Statement*, July, Reserve Bank of Vanuatu, Port Vila.

rates on alcohol beverages and the appreciation of the Australian dollar. Inflationary pressures are expected over the second half of 2004 as world inflation and world petroleum prices increase, but inflation is expected to remain below the comfort level set by the Reserve Bank of Vanuatu of an annual growth of headline inflation of below 4 per cent (Figure 7).

The exchange rate has been stable against most currencies since 2001 (the notable exception being the US dollar), with the nominal effective exchange rate relatively stable over this period. The real effective exchange rate (as calculated by the Reserve Bank of Vanuatu as the exchange rate corrected for changes in the price differential with its trading partners) had appreciated late in 2002 following the fall in Vanuatu's inflation rate. But it depreciated gradually in the period to mid 2004, indicating an improvement in Vanuatu's competitiveness.

The level of official international reserves rose to 5.2 months of import cover by mid October 2004, a marked improvement over 2003 when reserves declined to 4.4 months of import cover. The increase was attained principally from the additional inflow of donor funds, including cyclone rehabilitation and earth quake reconstruction funds, and continuing tight control by the Reserve Bank of its foreign exchange guidelines. The increase in copra and coconut oil exports have also helped lift reserves and as a result one of the commercial banks is selling its foreign exchange proceeds to the Reserve Bank, boosting the level of import cover. Over the remainder of 2004, the anticipated increase in tourism arrivals are expected to further ease the demand for foreign exchange, allowing the level of international reserves to continue to improve.

The trade deficit had declined over the second half of 2003 and the first quarter of

2004. But the rise in imports fuelled by rising domestic demand saw the deficit grow in the second quarter of 2004, despite a good export performance. Overall the balance of payments has been in surplus in the first half of 2004.

Following an overall negative annual growth of 0.8 per cent in 2003, the total money supply (M4) grew by 8.8 per cent to June 2004 compared to the beginning year period, a reflection of strengthening economic activity. The growth in M4 is associated with large liquidity inflows through the balance of payments and an expansion in domestic credit.

Domestic credit grew by 2.8 per cent from the beginning year period of 2004. Over the six months to June, private sector credit grew by 2.6 per cent and net claims on the government grew by 5.3 per cent. In general however, net claims on the government showed improvements from the level a year ago by 8.5 per cent. In particular, the net government position with the Reserve Bank of Vanuatu has improved from 2003, reflecting an improving level of revenue collection over last year and continuing expenditure control management measures.

There was a large lending drive by commercial banks and a drive to attract deposits. Weighted average lending rates from the commercial banks were at least 13.5 per cent over 2000 and 2001 and for much of 2002. But lending rates began to ease in late 2002 as the banks responded to the weakening economic conditions and by June 2004 the weighted average lending rate had fallen to 11.6 per cent. After a very slight rise over 2003, deposit interest rates were raised throughout the first half of 2004. While the interest rate spread of the commercial banks has eased from the 12.0 per cent of late 2002, it remains substantial at 9.1 per cent and presents an ongoing concern.

Tightening liquidity conditions prompted the Reserve Bank of Vanuatu to reduce its liquid asset ratio (LAR) from 15 per cent to 12 per cent in January 2004. The Reserve Bank also began to be more accommodating in its daily liquidity management through Open Market Operations. As a result, the liquidity of banks, measured by their level of excess reserves at the Reserve Bank and RBV Notes outstanding, began to show improvement in late June 2004.

One of the principal objectives of the Reserve Bank of Vanuatu is to maintain monetary stability. The Bank interprets monetary stability to mean, at the external level, the maintenance of an adequate level of official international reserves equivalent to 4 months of import cover, and at the domestic level, low inflation at a minimum comfort level of 4 per cent annual growth rate. These policy objectives were achieved over 2003 and in the first half of 2004.

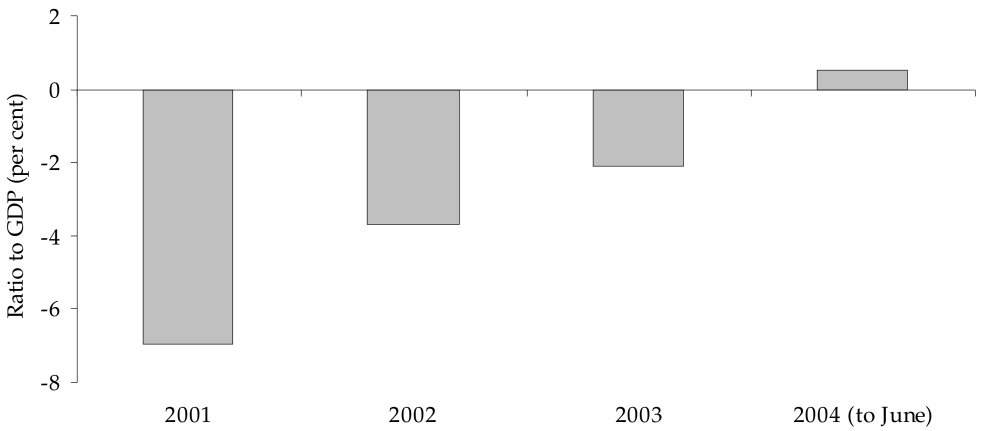
The Budget

Fiscal prudence has broadly been maintained in recent years, and the trend improvement in the budget balance has continued over 2004. The deficit reached 7 per cent of GDP in 2001 but had declined to 2 per cent by 2003, and a small surplus was recorded over the first six months of 2004 (Figure 8).

While the deficit for 2003 was much reduced from previous years, the government fell short of achieving its target surplus of 0.4 per cent of GDP. Expenditure was kept to the budgeted level, but revenue fell well short of expectations. Recurrent revenue had been budgeted to increase by 10 per cent over 2003, but instead only rose by 2 per cent (in nominal terms).

Revenue collections were above expectations over the first six months of 2004. But even with this good revenue outcome and the continuing application of tight expenditure control measures, notably on the wage and salary bill, it may be difficult to achieve the target budget surplus for the year of 0.4 per cent of GDP. This is because there are a number of unbudgeted expenditure items

Figure 8 **The budget balance, 2001–04**



Source: Reserve Bank of Vanuatu, 2004. *Quarterly Economic Review*, June, Reserve Bank of Vanuatu, Port Vila; Vanuatu, National Statistics Office, 2002. *National Accounts of Vanuatu, 1997–2002*, Government of the Republic of Vanuatu, Port Vila; Vanuatu, 2004. *Fiscal Strategy Report*, Budget 2004, Volume 1, Government of the Republic of Vanuatu, Port Vila.

that will require funding over the second half of 2004, including those related to elections, contributions to the Pekoa Airport terminal and cyclone-related expenditure.

Despite the improving fiscal position, the cash flow problems of the government have not abated. A monthly warrant system has been in place for some years to control cash flows, and the government has continued to rely on an overdraft facility at the Reserve Bank of Vanuatu. To date, the accommodating stance taken by the Reserve Bank to funding the deficit has not translated into excessive pressure on inflation or the exchange rate, but nonetheless it is an undesirable practice. However, a shallowness in the government debt market that hinders attempts to borrow debt domestically and rising external debt servicing costs in the face of ongoing deficits suggest a ready correction of the cash-flow problem is unlikely.

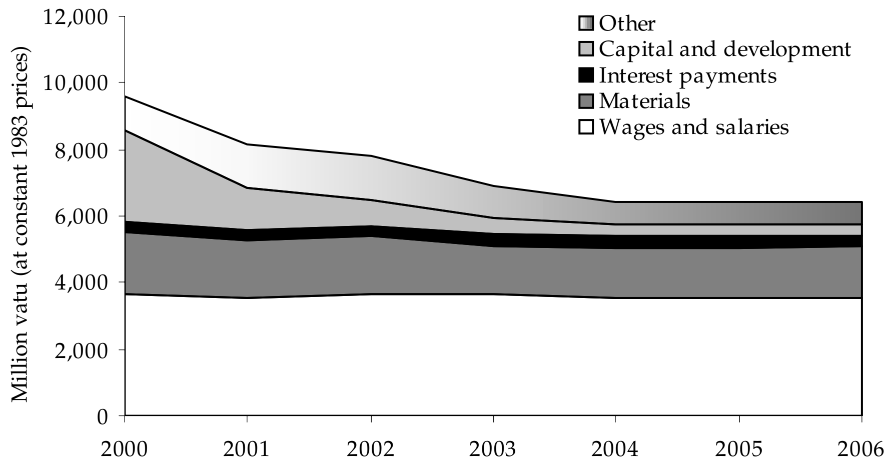
A number of imbalances in the budget have intensified in recent years. In particular, expenditure on wages and salaries has risen from 38 per cent of actual expenditure and net lending in 2000 to 55 per cent of budgeted expenditure and net lending for 2004. This is despite success in restraining the number of public servants to the rate of population growth.[4] In real terms the average wage and salary of a government employee rose slightly over 2002 and 2003 despite the contraction in the economy and a failure to meet key budget targets. At the same time as average wages and salaries have grown, the real value of government expenditure has declined substantially.[5]

Wages and salaries have been protected at the expense of expenditure on material inputs and capital expenditure. The grace periods on a large share of concessional external loans are close to expiry and the need to repay these loans from a tight fiscal position has prompted the government to only lend from the multilateral agencies if the loan generates an income flow to help service the debt. This policy has contributed to the overall decline in expenditure and in capital expenditure in particular. To date it has not been possible to compensate for this by cutting the wage and salary bill nor is such a reallocation in sight (Figure 9).

Rising external debt saw the book value of the government's debt rise from the 25 per cent of GDP in 1997 to a peak of 40 per cent of GDP in 2002. The book value of external debt peaked in the same year at 30 per cent of GDP, still below the government's preferred ceiling of 40 per cent. In net present value terms (a more meaningful way to express the level of debt) the ratio of future debt obligations to GDP was approximately 20 per cent in 2004, the ratio of domestic debt to GDP 11 per cent and the ratio of external debt to GDP 13 per cent.[6] If the budget balance is controlled and domestic debt is rolled over, interest and principal repayments are expected to rise by a further 20 per cent by 2009 at which point they will peak as external obligations begin to decline.

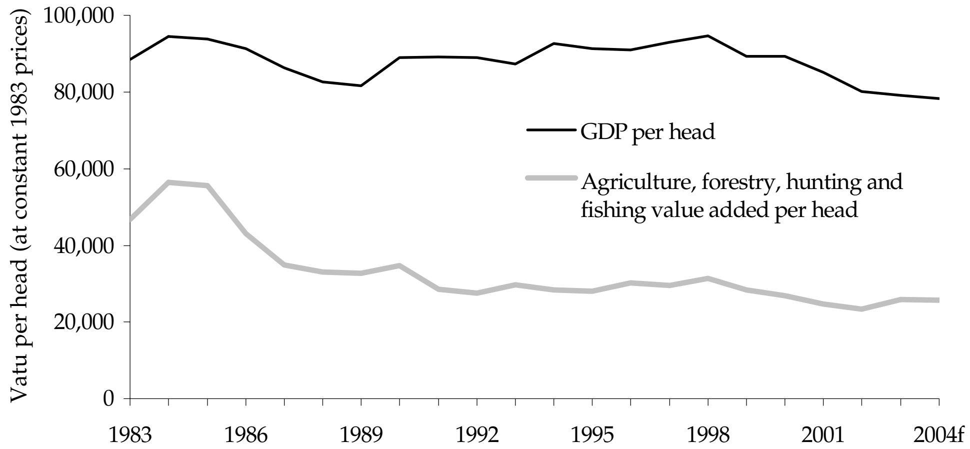
While Vanuatu's public debt levels are not high by international standards, it needs to be seen in the context of the failure to achieve a shift in government funds away from labour costs and the absence of an income tax. The absence of an income tax results in a relatively low ratio of government internal revenue to GDP. This means the government has less ability than would be expected to service any given debt level. Much of the external debt was used to fund the refinancing of the National Provident Fund and the National Bank of Vanuatu, and consultant input to the development and implementation of the CRP (roughly on a 50:50 basis). The refinancing was essentially

Figure 9 **Composition of expenditure and net lending, 2000–06** (million vatu)



Note: 2004 and future years are as projected in the 2004 Budget. Expenditure is deflated by the CPI at a future rate of 2.5 per cent per annum.
Source: Author's estimates derived from Reserve Bank of Vanuatu, 2004, *Quarterly Economic Review*, June, Reserve Bank of Vanuatu, Port Vila; Vanuatu, 2004. *Fiscal Strategy Report*, Budget 2004, Volume 1, Government of the Republic of Vanuatu, Port Vila.

Figure 10 **Real GDP and primary sector income per head, 1983–2004** (vatu at constant 1983 prices)



[f] Forecast
Note: Value added of agriculture, forestry, hunting and fishing deflated by CPI.
Source: Author's estimates derived from Vanuatu, National Statistics Office, 2002. *National Accounts of Vanuatu, 1997–2002*, Government of the Republic of Vanuatu, Port Vila; Vanuatu, National Statistics Office, 2002. *National Accounts of Vanuatu, 1983–98*, Government of the Republic of Vanuatu, Port Vila; Vanuatu, 2004. *Fiscal Strategy Report*, Budget 2004, Volume 1, Government of the Republic of Vanuatu, Port Vila.

a consumption expenditure, as it was to compensate for the past dissipation of asset values arising from poor management, and the CRP is yet to realise the hoped-for growth dividend.[7] So debt has been accumulated without generating increased capacity to service the debt, inevitably putting pressure on the budget.

At a sectoral level, expenditure cuts have fallen heaviest on economic affairs, transport and mining, manufacturing and construction. On the positive side, the share of the budget allocated to education has increased from 22 per cent in 1998 to 29 per cent in 2003. While the share of the budget allocated to health has increased lightly to 13 per cent of expenditure and net lending, health expenditure has declined slightly in real terms.[8]

Stagnation in income and its consequences

An issue attracting increasing attention in Vanuatu is the failure to secure rising incomes. Real GDP per head has being in decline since 1998, a poor performance that followed after an extended period of very little growth (Figure 10). In real terms GDP per head has now fallen below the level of 20 years ago, an outcome that paints a picture of economic stagnation since independence.

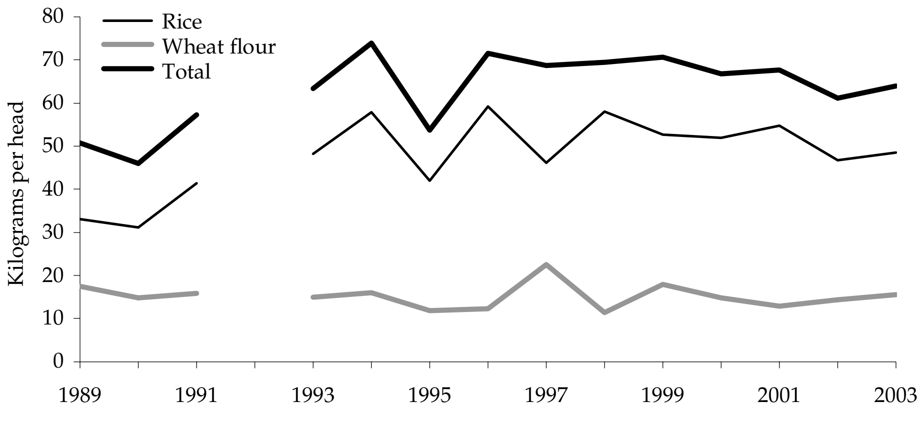
In public policy terms what matters most is the income levels of those living in rural areas away from the main opportunities of government employment and the enclave-type activities (such as tourism, property development and the finance sector). A sense of the level of rural incomes is provided by the real value-added in agriculture, forestry, hunting and fishing. When deflated by the CPI this also shows a long-term stagnation in income and a relatively poor outcome in recent years (Figure 10).

A limitation of the data on value-added in agriculture, forestry, hunting and fishing is that the subsistence component is based on the extrapolation by population growth of estimates from an old agricultural survey. This survey was conducted in the early 1980s and is the latest survey of its type. So the national accounts data would fail to capture any subsequent growth or contraction in production of food and timber for local consumption. There are also some concerns regarding the quality of export data, notably for kava.

In light of these limitations, Figure 11 presents estimates of the imports of rice and flour per head. The data are consistent with a weakening in incomes per head in recent years, as reflected in the slight downward trend in the total imports of these items after demand appeared to reach a plateau in the 1990s.[9]

Stagnation in income has an obvious adverse effect on the rural population's ability to lift their material consumption levels. It is also reasonable to expect this could affect broader dimensions of well being, notably by limiting the resources available to lift health and education standards. Perhaps somewhat surprisingly the available data point to substantial improvements over time in life expectancy and infant and child mortality rates (see Appendix Table 1). While the data need to be interpreted with care, they suggest that Vanuatu has been able to achieve substantial development, in some key aspects, without income growth. The rate of improvement in life expectancy and infant mortality substantially exceeds that of the

Figure 11 **Imports of staples per head, 1989–2003** (kilograms per head)



Note: Data are unavailable for 1992.
Source: Vanuatu, National Statistics Office, 2004. *Quarterly Statistical Indicators*, June, Government of the Republic of Vanuatu, Port Vila; Vanuatu, National Statistics Office, 2003. *Annual Statistical Indicators*, Government of the Republic of Vanuatu, Port Vila; and personal communication.

low income, the low middle income and the least developed group of economies.[10]

However there are very important weaknesses in education attainment, with the limited data that are available pointing to a slow rate of improvement in primary school enrolments, falling secondary enrolments and potentially a fall in literacy rates. While the reasons for this have not being identified, it appears reasonable to posit that the absence of income growth has limited the ability to fund education. While the international donor community could have corrected for this problem by targeting their funds on the highest development priorities, this appears not to have been the case.[11]

In addition, there has recently been a substantial increase in the number of reported crimes, notably of petty theft in the urban areas by the unemployed and poorly skilled (Criminal Records Unit, Vanuatu Police Force, personal communication). This may be an early warning of a long-term adverse impact on law and order of income stagnation.

These considerations suggest that, although Vanuatu is continuing to develop, the failure to achieve income growth imposes an important cost on living standards for much of the population.

Such an outcome is similar to the Papua New Guinea experience. Papua New Guinea has also achieved important progress since independence in key aspects of development without income growth per head (see for example AusAID 2002 and the updated development indicators presented in Sugden 2004). The performance of both countries is at odds with the usual expectation that income growth is required for development. The reasons for this atypical outcome have potentially important policy implications but are poorly understood. For example, is it due to inevitable trickle-down effects of world development, such as improved and cheaper medicine or a broader understanding of the benefits of clean water, education, and so on. Or are governments or the international donor community playing a critical role as facilitators of development and successfully relieving the key constraints to development?

The performance of these Melanesian neighbours calls into question whether the priority for government and the donor community should be achieving a pro-growth environment or meeting the more basic needs of communities. This is because income growth has not be required to achieve development, in some key respects.

Possible explanations for the stagnation in income

Political instability

Until the early 1990s Vanuatu had been characterised by stability in government. But since then Vanuatu has faced a series of short-lived governments as coalitions have dissolved and re-formed, typically along Anglophone/Francophone lines (Ambrose 1997, Ambrose and Siwatibau 1997). The political jockeying is credited with the politicisation of the public service and associated erosion of professional standards and the independence of advice. More recently, in early 2002 the Vanuatu Police Force took the unprecedented step of arresting the Head of State and Minister of Finance over unpaid allowances, raising questions as to national security and perceptions of sovereign risk (Vanuatu 2002:23). Such instability can erode the quality of output of the public service and also deter potential investors concerned at the prospect of volatility in the exchange rate and changes in government policy. An ability for Members of Parliament to be voted in on only a small share of the vote in their electorates has generally undermined the accountability of politicians as they need only develop the support for key groups within their electorates. These problems with the political environment persist despite some recent progress through the adoption of a Leadership Code and the reform of the public service.

The economic cost of Vanuatu's political instability is difficult to appreciate fully. The erosion of standards led by the political system can be partially credited with the less than desirable performance of the public sector, culminating in the need for the government to refinance the Vanuatu National Provident Fund in 1998 and then again in 2001 and episodes of civil unrest in Port Vila, notably in 1998. And the cost to living standards in rural areas of public funds being consumed by the public service wage bill and relatively poor service standards outside Port Vila is probably substantial. Between 1980 and 1991, a period of 11 years of political stability, the government's budgetary reserves at the Reserve Bank of Vanuatu were 800 million vatu and between 1991 and 1997 these declined by 600 million vatu. As a result the government continues to face cashflow problems and this was exacerbated by the problems in the Vanuatu National Provident Fund.

Despite these concerns, there have been some reassuring developments in recent years. There has been a surge of investor interest in land and small hotel developments in Port Vila and its surrounds despite the political environment. Fiscal discipline is demonstrated by the control of the budget deficit and the increasing priority accorded to expenditure on education. It is important to appreciate that this fiscal discipline is against a background of the very high actual and/or planned deficits seen at the time of adoption of the costly CRP.[12] The adoption of the CRP was accompanied by unrealistic expectations of an ability to immediately increase expenditure funded from an early growth dividend, a dividend that is yet to eventuate. Recent budget developments underpin the macroeconomic stability that has been achieved and help lay the foundation for correcting the nation's poor education record. Such fiscal discipline is particularly encouraging as its absence is often a key manifestation of a damaging political system. Maintaining fiscal discipline will be a key challenge for the government.

Land mobilisation

The potential hurdles to growth of the rural areas imposed by customary title have been widely documented.[13] Obvious problems, including the difficulties in coordination, of encouraging investment by an individual and in using customary land as security for loans, are well understood. Recent action to address these issues include the passage in November 2003 of laws to improve administration in the Ministry of Lands, to improve the transparency and fairness of land fees and charges and to allow for an increase in the term of land leases. These changes are intended to encourage private investment, increase government revenues and at the same time promote the rights and interests of landowners.

While it is too early to assess the contribution of this package of reforms, a further issue is already apparent within the leasehold systems in use in developed areas. Land values in readily accessible seaside areas have increased substantially in recent years with a key factor being the rising cost of such land in Australia, in turn encouraging foreign investment in Vanuatu. Most landowners lack a mechanism to share in the increase seen in land values, and furthermore can be disadvantaged when negotiating leases with more experienced parties. Exploitation of landowners that will see them lose access to land for up to 75 years without an equitable return is a growing concern. The opening of prime development land under such conditions offers limited development benefits. While recent legislative changes have seen lessors of government land pay annual land rent based on regularly updated land values, such innovations are yet to be shared with the broader community.

The cost of monopolies

The high cost structure of the Vanuatu economy has been widely documented, as has the potential cost to economic growth of the monopolies that are one of the key causes of these high costs (see for example Asian Development Bank 2002a and 1997). The transport, communication and electricity services alone account for a quarter of intermediate input costs, where in some industries the figure is as high as 50 per cent (Vanuatu, National Statistics Office 2003). These services have been characterised by a lack of competition, and in the case of communication and electricity, of monopoly. There are also concerns in the lack of effective competition in the banking sector where interest rate spreads are very high.

The small size of the market means that the possession of market power is inevitable in some key parts of the economy. For example, it may be possible to provide for effective competition in the provision of internet and possibly some mobile services, but competition in the provision of land lines is impractical. Where effective competition is not possible, prices and service quality need to be appropriately regulated. It is not just the high charges and poor quality of monopolies and/or oligopolies that damage an economy. Damage also arises from the risk that a supplier with market power will act to capture profits that do ultimately emerge in the economy and/or will act to prevent the beneficial effect of competition.

A good example was the withdrawal in 2000 of the ability for reverse charge calls to be made from Vanuatu. Reverse charge calls were a competitive pressure on the monopoly supplier, Telecom Vanuatu Limited. In a competitive market it is not possible for one competitor to prevent the operation of a competitor, and Telecom Vanuatu's action is a clear case of the abuse of market power. A sound regulatory system would have prevented such anti-competitive behaviour, but there is no such system in Vanuatu.

There have been some structural reforms that have increased competition in transport, notably the decision to allow international shippers to supply some inter-island services and the open-sky policy that has allowed Pacific Blue to supply international services in competition to Air Vanuatu. But an appropriate regulatory environment is still missing for areas of the economy where competition lacks sufficient vigour, and the option provided in at least one long-term supply contract to review the terms of supply are not acted on. This is despite the commitment of the CRP to reform the public utilities, including for the conduct with external support of an early review of the utilities (Vanuatu, Office of the Prime Minister 1997:29).

The World Bank is scheduled to release the long planned report on the utilities in 2004—a report that is intended to help set out a plan of action to address the abuse of market power in the economy. One of the key issues to be faced in addressing market power is the presence of cross-subsidies and community service obligations. Industry argues that high cost services are required in urban areas to subsidise the provision of services to rural areas, and that those on higher incomes need to cross-subsidise those on lower incomes, even within urban areas. It will be important that such issues are formalised and that community service obligations are costed in an open and transparent manner so that their provision is in accord with development and social needs.

In an efficient government system with strong capacity it would probably take in the order of 5 to 10 years for an appropriate regulatory regime to be put in place and effectively implemented. This is the time taken to develop the political, bureaucratic and community support, to undertake the required technical assessment, to draft and implement legislation and regulatory agreements and to allow for a period of adjustment to the new regime.[14] Vanuatu's record of a very slow rate of competition reform, the presence of long-term concessions in key industries and the lack of experience with the regulation of utilities suggest that it could take much longer than in other jurisdictions, perhaps two to three decades, to achieve substantive reform.

Population growth

Vanuatu has a high population growth rate. While the additional labour provides a resource that can be called upon to exploit the country's agricultural potential, too high a fertility rate can be imposing a high cost on the ability to raise the quality of the labour input. With much of the resources available for the rural areas drawn from Port Vila and donor input, a high population growth rate puts additional strain on what is effectively a fixed pool of resources.

Dutch-disease effects?

Internationally the 'Dutch-disease' problem is normally faced when large export revenue from enclave-type resource projects raise the demand for local currency and leads to a higher exchange rate than would otherwise be the case (this can see the real exchange rate appreciate relative to what it would otherwise be). This reduces the international competitiveness of other sectors, normally export-focused agricultural activities and import-competing activities such as local food production. The result is that enclave-type resource projects can indirectly take place at the expense of other forms of activity.

In the Vanuatu context, such effects may arise from the tourism and financial sector activities centred in Port Vila and potentially from the provision of foreign aid. The adverse exchange-rate effects on production decisions may be more than offset by the services funded by these activities and foreign aid (through for example a beneficial effect on the cost of key inputs such as transport or by raising the productivity and availability of labour). But it is difficult to assess if this is, or is not, the case in Vanuatu.

The usual rule is that the exchange rate is managed to maintain a reasonable level of foreign reserves. However it may be that the exchange rate should be set at a lower nominal level than this would yield and that foreign reserves should be expected to rise steadily over time. This approach may shift relative prices sufficiently to stimulate increased incomes per head for the rural population. However this argument rests on the likelihood of a sustained supply response from agriculture. A supply response has been evident in Vanuatu following the recent improvement in prices and deregulation of export marketing, but the typical pattern has been that supply increases in agriculture are temporary and not cumulative. Alternative crops such as kava and vanilla could break this pattern owing to the higher potential returns resulting from a relatively low labour input, but this remains to be seen. Furthermore, to support the supply response it is important that structural reforms be undertaken such as in the areas of infrastructure and land as discussed above. Thus to address any exchange rate reform that is needed, sound structural policies need to be in place first.

The policy formula?

The features of the CRP were the renewal of the institutions of governance, a redefined role for the public sector, improvements to public sector efficiency, private sector-led growth—including from small business and the rural sector—and improved equity between sections of the population (Vanuatu, Office of the Prime Minister 1997:4). The policy 'formula' underlying the ongoing

CRP has evolved somewhat over time, but continues to emphasise the support of growth through the formal sector centred on the main urban areas. The Asian Development Bank's 1999 review highlighted the over-optimism of the original program, an interpretation that has been borne out by the subsequent growth record (Asian Development Bank 1999:150). Much of the initial cost of the CRP was incurred in refinancing the Vanuatu National Provident Fund and in funding consultant input. Funding the delivery of basic services was given a lower priority, seemingly in the expectation that this would be addressed once a stronger economy had generated additional revenue.

The CRP can be characterised as a program that sought to fix the 'centre' in the expectation the benefits would ultimately be dispersed through increased income opportunities and better services in rural areas. This is an increasingly common approach of donor-funded support under the banner of governance. It stands in contrast to the previous emphasis on the direct provision of support to rural communities through infrastructure, agricultural development etc. The shift away from infrastructure etc reflects a recognition that aid works best in an environment of good governance. While this recognition is sound, it remains to be seen whether the donor community has found the balance or appropriate mode of support for governance.

The approach underlying the CRP, in both its original and evolved form, has yet to provide the hoped-for gains. The reasons for this are somewhat unclear. They may arise from the failure to find the right policy formulae, at least under initial reform efforts. It may be for example that the gains made in the formal economy will inevitably be captured by the public service through increased wages and employment opportunities, rather than being converted to better quality and more extensive services for the rural population. There are some signs of such a problem in the recent budget trends, although the budget has being reoriented to provide more support for education, a sector that is probably one of the highest priorities for the rural poor given the disappointing education outcomes since independence. Or it may be that the reform program did not focus on the critical bottlenecks in the country. For example, as noted above, there has been very little progress in addressing the market power held in key sectors of the economy. Or it may be that the absence of an income tax means that even if the formal sector does expand, the normal mechanism of transferring benefits to other sectors of the economy via increased government services is too weak. Gay (this issue) also raises concerns on the policy mix of the CRP.

Or perhaps there were problems in implementation. The CRP envisaged quick action in a wide range of areas, and this ambitious approach may have spread resources so thinly that substantive reform, other than control of the fiscal position and stabilisation of the finance sector, was not achievable. In this respect, it is important to note that changes in the formal rules are only one component of a system, the supporting environment must also be suited to effective implementation of new rules. The 2002 UNESCAP review of the CRP highlighted the problems in implementation, arising from the speed and breadth of the reform and the heavy reliance on consultant input (UNESCAP 2002:17).

Conclusions

Substantial progress has been made recently to correct the overall budget position and also in redirecting expenditure to key sectors. However the failure to compress the wage and salary bill in the face of declining real expenditure and rising debt servicing costs is tending to shift expenditure away from essential goods and services and capital, a trend that needs to be reversed over the medium term.

While macroeconomic stability has been achieved and key elements have been in place for some time, growth in incomes per head remains elusive. Although Vanuatu is continuing to develop, the failure to achieve income growth appears to be imposing an important cost on living standards, notably for those living in rural areas but increasingly for urban areas as well. The economy now appears well equipped to respond to improved external conditions, with the agricultural-led growth of 2003 and 2004 a good illustration of this potential. If external conditions remain favourable, and if the sound monetary and fiscal regime of recent years is continued, growth can be expected over the medium term. However the internally driven growth that is probably required to ensure a sustainable reversal of the trend decline in incomes per head has not materialised.

It is unclear why incomes have stagnated. There are some institutional features of the economy that inevitably constrain growth, notably the seemingly inherent tendency to political instability and difficulties in mobilising land. The constraint imposed on growth by the monopolisation of key sectors is probably severe. There has been very little progress in addressing this constraint and a solution is probably some decades away. This constraint alone could be so severe as to constrain Vanuatu to a low growth path. It is important that structural impediments to growth be addressed.

While more research is required to clarify the relative importance of these and other constraints, it appears that a higher priority should be placed on directly meeting the needs of the rural population given the low returns so far from a 'fix the centre' based approach. The opportunity cost of investing so heavily in the centre at the expense of more basic initiates may be too high to warrant continuing. However, it will be difficult to achieve such a reprioritisation given the imbalances in the composition of expenditure. Achieving higher growth may also require forgoing some of the initiatives of the broad policy agenda now in place so that the political system and civil service can ration their efforts to those initiatives likely to provide the best development return.

Notes

1 Note that there is some uncertainty in the growth outcome for 2002.

2 See Asian Development Bank (2002a and 1997) and Chand (2002) for an overview of developments prior to 2003.

3 There have been ongoing problems with compliance with the VAT since its introduction and improved enforcement may also have contributed to the increase in VAT revenue.

4 The National Statistics Office reports approximately 22 government employees per 1,000 residents from 1998 to 2003 (personal communication).

5 By 4 per cent in 2002 and 11 per cent in 2003, when deflated by the CPI.

6 Because external debt is normally concessional, the net present value of interest and principle repayments is normally substantially less than the book value. This is not the case with domestic debt placed with the private sector.

7 It may be argued that the CRP prevented a fall in GDP. The difficulty with this argument is that the economy was growing well at the time the CRP was adopted, and growth only faltered thereafter.

8 Note that data on the allocation over time to the development priorities of basic education, basic health care and infrastructure maintenance are not readily available and the broad trends may hide the important trends in the funding of the development priorities.

9 It is possible that a change in relative prices between imported and locally produced staples following the introduction of the VAT

and/or changes in the exchange rate could also help explain this apparent downward trend in demand.

[10] Data for other countries are from World Bank (2003).

[11] Based on DAC data and data supplied by AusAID on expenditure by type of activity.

[12] See for example the discussion of the program cost and the budget planning of the late 1990s presented in Asian Development Bank (1999:145–47, 153).

[13] See for example Asian Development Bank (1997, 2002a and 2002b) for a discussion of the situation in Vanuatu.

[14] Within the region attempts have been made to shortcut this process by simply relocating overseas legislation, notably variants of the Australian Trade Practices Act. This is an approach to reform fraught with difficulty as it does not allow for the alignment of regulatory frameworks with local needs and capacity.

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Economic survey

Appendix Table 1 **Development indicators, 1970–2000**

	Levels, circa						
	1970	1975	1980	1985	1990	1995	2000
Census data[a]							
Infant mortality rate (deaths per '000)	..	..	..	..	45	..	27
Under-five mortality rate (deaths per '000)	..	..	..	..	79	..	33
Ministry of Education data[a]							
Net enrolment ratio in primary education (per cent)	..	..	..	..	75	..	78
Ratio of girls to boys in primary school (per cent)	..	..	..	..	88	..	91
Ratio of girls to boys in secondary school (per cent)	..	..	..	..	..	84	93
Ratio of girls to boys in tertiary education (per cent)	..	..	..	..	..	..	50
Gross enrolment rates (per cent)[b]							
Female primary school enrolment	..	..	66	..	..	70	..
Male primary school enrolment	..	..	72	..	..	73	..
Ratio of female to male primary school enrolment	..	..	91	..	..	96	..
Female secondary school enrolment	..	..	24	..	..	18	..
Male secondary school enrolment	..	..	57	..	..	26	..
Ratio or female to male secondary school enrolment	..	..	46	..	..	69	..
Other data[c]							
Life expectancy at birth (years)	51	55	55	61	63	65	67
Infant mortality rate (deaths per '000)	111	95	85	67	62	42	37
Adult literacy rate (per cent)	..	..	53	..	64	34	34

Sources: [a] Vanuatu, National Statistics Office, MDG indicators, PRISM web site.
[b] South Pacific Commission, 1985. *Population 1983, Statistical Bulletin of the South Pacific No. 26*, August, Noumea; United National Development Programme (UNDP), 1999, *Pacific Human Development Report*, UNDP, New York.
[c] Simple average of data presented in Ahlburg, D., 1986. 'Population and economic development in the island nations of the South Pacific', in R.V. Cole and T.G. Parry (eds), *Selected Issues in Pacific Island Development: papers from the islands/Australia project*, Pacific Policy Papers No. 2, National Centre for Development Studies, The Australian National University, Canberra; Caldwell, J.C., Harrison, G.E. and Quiggin, P., 1980. 'The demography of micro states', in R.T. Shand (ed.), *The Island States of the Pacific and Indian Oceans,* Monograph No. 23, National Centre for Development Studies, The Australian National University, Canberra (per capita income except for Kiribati which is per capita GDP at factor cost); Castles I., 2003. 'Social indicators for Papua New Guinea and the Pacific with comparisons for the Caribbean region and Sub-Saharan Africa (Table 5)', *World Population Prospects: the 2000 revision*, United Nations, New York; United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP), 1993. *Compendium of Social Development Indicators in the ESCAP region* (Table D4), UNESCAP, Bangkok; UNESCAP, 2001. *Economic and Social Survey of Asia and the Pacific 2001*, UNESCAP, Bangkok; UNESCAP, 2002. *Economic and Social Survey of Asia and the Pacific 2002*, UNESCAP, Bangkok; International Monetary Fund, Consultation papers Article IV; Key Statistics downloaded from the SPC's PRISM web site and links to regional Statistics Offices; Rotem, A. and Dewdney, J., 1991. *The Health Workforce: South Pacific island nations*, World Health Organisation, Western Regional Office, Manila; UNDP, 1994. *Pacific Human Development Report—putting people first*, UNDP, Suva; UNDP, 1999. *Pacific Human Development Report,* UNDP, Suva; World Bank, 1991. *Toward Higher Growth in Pacific Island Economies: lessons from the 1980s, Volume II: country surveys*, Country Operations Division, World Bank, Washington, DC; World Bank, 1994. *Health Priorities and Options in the World Bank's Pacific Member Countries*, Population and Human Resources Division, Country Department III, East Asia and Pacific Region, October, Table 1.1:3; World Bank, 2003. *World Development Indicators*, World Bank, Washington, DC; World Health Organisation, 2002. *World Health Report*, World Health Organisation, Geneva, Annex Table 1; Volume 1: Comprehensive Tables.