

Vanuatu—a case of mixed performance

Satish Chand

Vanuatu's real per capita GDP is estimated at US\$1,276 (1999 figure at 1983 prices), having peaked at US\$1,350 in 1995. A comprehensive reform program was embarked on in 1997 with multilateral and bilateral donor support to halt this fall and induce a revival. Areas targeted for reform and those with some success to date include the rescue of the national bank and the national provident fund. Areas of marginal achievement include containment of budget deficits and arrest of the rising national debt. Attempts to induce growth of private enterprises have yet to yield results. A revival of growth in per capita GDP is eagerly awaited.

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Vanuatu, located in the tropical southwest Pacific, is divided into six provinces comprising in excess of 80 islands with a total of 12,190 square kilometres of land and extending over 710,000 square kilometres of ocean. The population of approximately 200,000 have a per capita GDP of US\$1,276 (at 1983 prices), an average life expectancy of 66 years, an adult literacy rate of 70 per cent, and an infant mortality rate of 25 per 1,000 live births (Table 1). Donor generosity is reflected in Vanuatu's annual per capita aid receipts of approximately US\$222 (as of 1999).

The country annually hosts some 100,000 tourists; mostly Australians who make up some 64 per cent of the total, followed by New Zealanders who account for another 14 per cent. The number of tourists could be considerably larger except that Australia and New Zealand are the only

industrialised countries that have direct air links with Vanuatu. Most visitors to the country speak highly of its natural beauty and abundance of land (8.34 hectares per capita), fresh water and ocean resources.

The above is only half of the truth and the half with which most tourists are familiar due to the activity of the local tourism bureau. Growth in GDP over the two decades following independence in 1980 has barely kept pace with growth in population while nutrition-based measures of wellbeing suggest some deterioration in poverty (Table 1).¹ Beneath the picturesque scenery of the promotional brochures lie several simmering issues relating to the management of this resource-rich economy. In common with the experience in the rest of the developing world, large natural resource endowments are often not associated with spectacular economic

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Table1 Vanuatu: basic development indicators, 1980 and 1990

	1980	1999
Life expectancy (years)	63	66
Per capita GDP (US\$) ^a	1,270	1,276
Infant mortality (deaths per '000 births)	90	25
Literacy rate	..	74
Nutrition levels (per cent of children) ^b		
Underweight	23	12
Stunting	7	20
Wasting (acute or recent)	17	6

^a Figure for 1983, the first year when national statistics were compiled

^b Nutrition levels for 1980 are for children less than 5 years of age; the statistics in the 1999 column are for 1996 when the second nutrition survey was conducted.

Source: Asian Development Bank, 2002. *Vanuatu 2001 Economic Report: strengthening development policies*, Pacific Island Economic Report (PIER), Asian Development Bank, Manila:Table 1.1.

performance; this is not because a wealth of resources is bad for development, but because such endowments demand superior management to translate these resources into development. Some of the problems include growing budget deficits and rising public sector debt levels, rising unemployment and surges in petty crime in the urban centres, deteriorating levels of public service delivery to the rural sector, and a stagnant private sector. Allegations of abuse of office by politicians and senior civil servants and threats of mass protests and violence against the state constitute a significant risk to law and order and political stability.

Income disparity is already large and is growing. Across all households, the income of the highest quartile is 4.6 times that of the lowest; but income disparity is lower amongst rural households than among urban households. In Port Vila, for example, the highest quartile earns almost 52 times that of the lowest (Asian Development Bank 2001). Some 80 per cent of the population reside in rural districts and contribute 20 per cent of GDP; the implied rural–urban income gap from this broad measure is 1:16. Access to basic services, including public infrastructure

and social services, declines rapidly with distance from the two major urban centres; hence the pressure for rural to urban migration is significant. Difficulties in obtaining long-term access to land for residential purposes and lack of jobs in the urban centres have been countervailing forces to this migration.

The pleasant tropical climate that usually greets visitors is equally deceptive, given the havoc nature frequently inflicts on this island nation. Vanuatu experiences an average of 2.6 cyclones per year, and can only expect a cyclone-free year once every seven to eight years. Some 15 volcanoes remain active and are under constant watch, while some 2,000 earthquakes are recorded each year. An earthquake early in 2002 caused significant damage to buildings and infrastructure in Port Vila.

This survey of the economic performance of Vanuatu over the past decade draws on several sources, including a recent study conducted by a team of consultants led by the author for the Asian Development Bank and the Government of Vanuatu (Asian Development Bank 2002).² It is clear that the present situation of a stagnant economy, rising

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unemployment, and the deteriorating budgetary position of the public sector can be sustained only for the short to medium term. Such a position is neither sustainable over the longer term nor desirable from the perspective of the general population. The reforms instituted to revive investment and growth would have to be pursued with greater urgency if development is to be given a second chance; an issue which the incoming administration will soon have to confront.

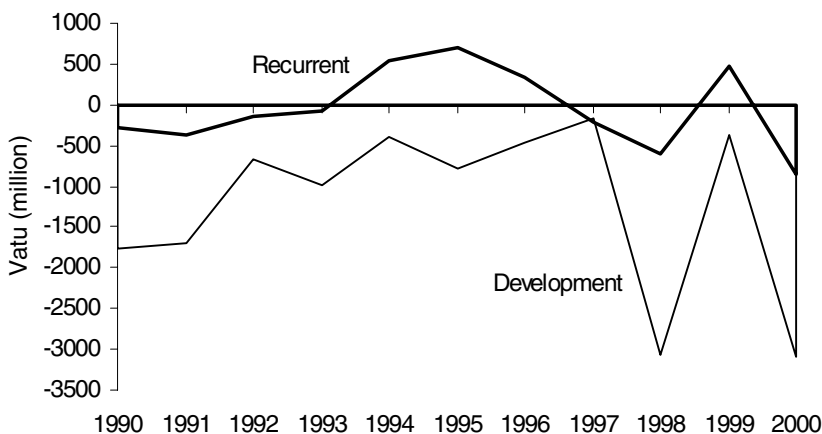
The macroeconomic aggregates

Historically, Vanuatu has been prudent in macroeconomic management. For much of the 1990s, the Department of Finance and the Reserve Bank of Vanuatu were successful in maintaining price stability, a healthy reserve position (sufficient for 6 to 7 months of import cover), and low debt levels both as a ratio of GDP and in terms of debt-service as a proportion of export income. The recurrent budget experienced small deficits until 1993 that were more than offset by the surpluses of the following three years (Figure 1). However,

the overall deficit increased to an all time high of 8.1 per cent of GDP in 1998, reached a similar magnitude in 2000, and is likely to reach 4 per cent of GDP in 2001. Such high and persistent deficits, often funded by external loans, have seen debt levels rise from 27 per cent of GDP as of 1997 to approximately 40 per cent by 2001 (Asian Development Bank 2002). Debt service commitments, however, are likely to remain modest given the concessional nature of many of the loans.

The aggregates considered in further detail include GDP, employment, and movements in the consumer price index. A qualification on the use of published statistics on Vanuatu is in order here. The economy is highly dualistic with the quality and availability of public services falling dramatically outside the major towns of Port Vila and Luganville. Some 80 per cent of the population reside in rural areas and outer islands and live off the land. Data on output produced by the National Statistics Office adjust for subsistence production, but these must be interpreted with care. Employment data is for the wage sector and therefore misses

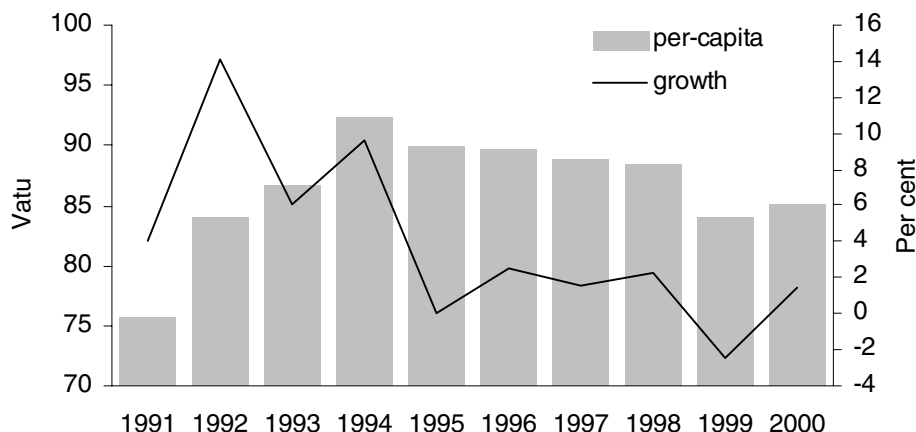
Figure 1 Vanuatu: budget deficits, 1990–2000 (vatu million)



Source: Asian Development Bank, 2002. *Vanuatu 2001 Economic Report: strengthening development policies*, Pacific Island Economic Report (PIER), Asian Development Bank, Manila.

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Figure 2 Vanuatu: per capita GDP, levels and growth rates, 1991–99



Source: Author's calculations based on National Statistics Office data.

the bulk of the working-age population. Similarly, inflation statistics are for the urban economy. Therefore, the time trends in the above aggregates are only broadly indicative of the performance of the economy.

Annual growth in real GDP for the decade to 2000 averaged 4 per cent, some 1.4 percentage points above the growth rate of the population. As a consequence, per capita GDP in the 1990s has increased only marginally (Figure 2). The period of the implementation of the comprehensive reform program (CRP) has not seen a shift in the trend of GDP; this could be due to several factors and does not necessarily imply a failure of the reforms to accelerate productive activity. A restructuring process inevitably imposes adjustment costs that could lower growth of output in the short term. These costs are incurred in anticipation of future prosperity; a promise that needs to materialise soon.

Fiscal position

The fiscal position of the government has remained tight since the blow-out in the deficit in 1998. The Department of Finance

has since maintained tight controls on non-salary outlays via the issue of expenditure warrants for the purchase of goods and services to line ministries and departments. Consequently, public expenditure for the first nine months of 2001 was VT90.4 million lower than for 2000.³ The budget deficit, however, increased to VT765 million for the nine months to September 2001, a sharp rise over VT241.8 million and VT377 million for the corresponding periods for 1999 and 2000, respectively (Reserve Bank of Vanuatu 2002). The sharp increase in the deficit was due to revenue shortfalls, in particular shortfalls in value-added tax collections and import duties. Overly optimistic revenue projections, including those from internet gaming and asset sales, made cashflow management all the more difficult.⁴

The government established a Revenue Review Committee in 2001 with the task of reviewing the existing structure of taxes with a view to broadening the revenue base. A wide range of measures have been proposed, including the introduction of excise tax,

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adjustments of import duties to keep pace with inflation, and the introduction of some form of direct taxation. As of April 2002, legislation to give effect to the proposals was yet to go through parliament.

Monetary developments

The Reserve Bank of Vanuatu (RBV) is entrusted with conduct of monetary policy with the objectives of maintaining price stability and a healthy balance of payments position. The policy instruments used to achieve these dual objectives include use of open market operations, setting and enforcement of reserve requirements for financial institutions, operation of the discount window by the central bank, and setting of interest rates. Given the open capital account and the fixed exchange rate regime, the RBV has limited scope for influencing either the domestic money supply or interest rates. The presence of a large offshore financial centre (OFC) as well as access to foreign currency deposits within domestic banks further reduces the RBV's ability to use monetary policy for demand management.

Notwithstanding the limited coverage of the CPI-basket, inflation has remained low, albeit rising since 1997. The RBV has had limited success in maintaining low interest rates. The foreign exchange position deteriorated significantly following the Vanuatu National Provident Fund (VNPF) crisis of 1998. The central bank has since been using a combination of capital controls and moral suasion to maintain reserves.

Prices and wages

Vanuatu has maintained price stability for much of the 1990s; annual CPI inflation rates have remained within the 2 to 3 per cent range, the real exchange rate has been stable, and wages have remained steady. It is important to note that the CPI basket is based on import weights of urban residents, and hence may not provide a true reflection of movement in consumer prices throughout

the economy, particularly when some 80 per cent of the population reside in rural areas. Notwithstanding the above, the slight rise in (urban) inflation in 1998 was the result of increased liquidity from government-directed payments from the Vanuatu National Provident Fund, a *de facto* depreciation of the vatu against the US dollar as a result of adjustments in the weights of the currency basket, and the replacement of the manufacturing turnover tax with a 12.5 per cent value-added tax. Tariffs on imports were reduced by 22 per cent in 1998; this would have had an offsetting effect to the aforementioned inflationary pressures. Annual inflation for 2000 was moderated to 1.9 per cent after having reached 4.2 per cent in 1999. Inflation figures for 2001 were unavailable at the time of writing of this survey, but the figure is estimated be similar to that for 2000.

Financial sector and high interest rates

At the commencement of the CRP the financial sector was in a very poor state with the three state-owned institutions: the Development Bank of Vanuatu, the National Bank of Vanuatu and the National Provident Fund experiencing serious financial problems. The reform of the sector has had some success in restoring confidence in both the National Bank of Vanuatu and the National Provident Fund while the Development Bank of Vanuatu has since been closed.⁵ There is little doubt that had the reforms not been undertaken, financial intermediation and consequently investment and growth in the economy would have been seriously damaged. The closure of the development bank has left a void in the provision of credit to the rural and smallholder sector. Some new schemes, for example, the Vanuatu Women's Development Scheme (VANWODS), have emerged but these as yet have not made a noticeable difference in enabling access to competitively priced credit to the informal and smallholder sectors. Calls for a revival of the development bank has been made from some quarters

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including the Chamber of Commerce, but this needs to be carefully considered in light of the failure of the Development Bank of Vanuatu and similar institutions in many other developing countries.

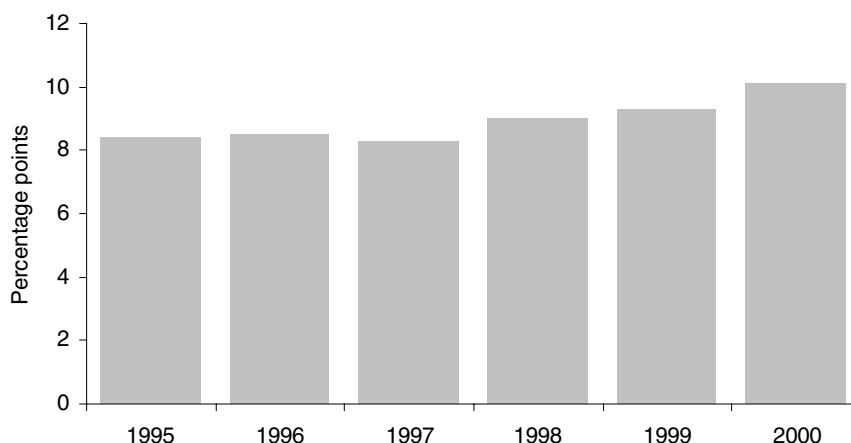
Interest rates for lending have been high and increasing while deposit rates have been consistently low, implying a high and rising interest rate spread. The interest rate spread between the average lending and deposit rates widened from an average of 8.3 percentage points in 1996 to 11.5 percentage points by the third quarter of 2001 (Figure 3). In addition to the high-interest cost of funds, conditions have been placed on loans such that the effective cost of borrowing has risen to between 32 and 60 per cent (Asian Development Bank 2002). The high interest rates have inhibited investment and therefore growth of the economy. Several micro-credit schemes are being experimented with the hope of facilitating access to competitively priced credit, but the problem may be a lot more serious than a simple deficiency in supply. Interest rates have remained high in

the presence of excess liquidity in the banking system. For example, commercial banks continue to hold large non-interest bearing deposits with the RBV.

The offshore financial centre

Having established its offshore financial centre (OFC) in 1971, Vanuatu has the longest-operating OFC in the South Pacific region. An absence of income taxes, exemption of international companies not engaged in the domestic economy from the statutory requirements of lodging audited annual financial returns, and confidentiality protection by statute have all contributed to the growth of the OFC. But these very same provisions are considered by the OECD as 'harmful tax competition', thereby threatening the continued viability of the OFC. As of 18 April 2002, Vanuatu, together with regional partners Marshall Islands and Nauru, remained on OECD's list of 'uncooperative tax havens'.⁶ Samoa and Niue were removed from the earlier list (compiled in 2000) after their governments agreed to 'effective

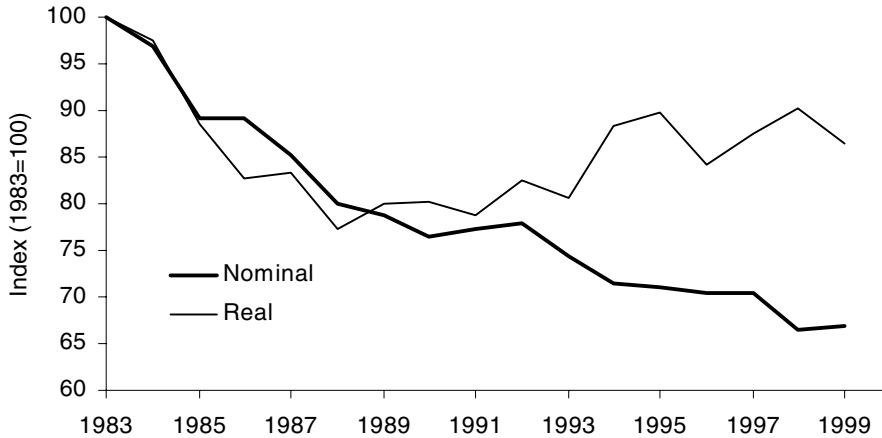
Figure 3 Vanuatu: interest rate spread, 1995–2000 (percentage points)



Source: Asian Development Bank, 2002. *Vanuatu 2001 Economic Report: strengthening development policies*, Pacific Island Economic Report (PIER), Asian Development Bank, Manila.

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Figure 4 Vanuatu: nominal and real exchange rate, 1983–99 (1983=100)



Source: Asian Development Bank, 2002. *Vanuatu 2001 Economic Report: strengthening development policies*, Pacific Island Economic Report (PIER), Asian Development Bank, Manila.

exchange of information', thereby qualifying as cooperative jurisdictions by the OECD's Committee on Fiscal Affairs. Vanuatu has been working towards introducing new OFC legislation, being prepared with Asian Development Bank assistance, to remove itself from the list of uncooperative tax havens. The recent US clampdown on terrorist activities, including money laundering, muddies the distinction between legitimate tax competition and criminal financial activity. Any actions by Vanuatu or by other countries that make it a less attractive destination for capital movements could adversely affect growth of the OFC that as of second quarter of 2001 contributed some VT11 million to the budget in the form of taxes and levies and provided some 300 jobs.⁷

Exchange rate and balance of payments

The vatu has been pegged since 1988 to an undisclosed transaction (trade and tourism receipts) weighted basket of currencies of Vanuatu's major trading partners. The RBV has limited discretion in shifting the

composition of and weights within the basket, with changes in the latter being used only twice, once in 1998 and the other in 2001, to induce a depreciation of the currency against the US dollar. Since 1998, the vatu has remained relatively steady against the US dollar, depreciated against the yen, and appreciated against the Australian and New Zealand dollars. The RBV's exchange rate policy is aimed at maintaining price stability, given the large share of imports⁸ in the CPI, exchange rate stability is central to maintaining price stability. The real exchange rate has been appreciating since 1989 (Figure 4). Given the poor performance of the economy, this is likely not to be due to an increase in productivity. The appreciation of the US dollar against other currencies may have had some impact. The high interest rates, partly due to domestic financing of growing budget deficits, and large capital inflows from the CRP may have contributed to the real appreciation.

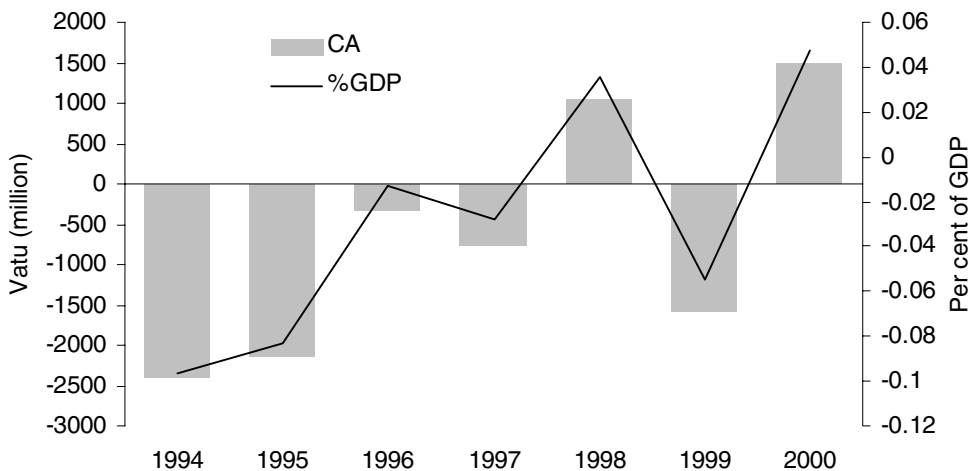
The currency has come under intermittent pressure since the financial crisis of 1998. The problems for the RBV in

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maintaining exchange rate (and price) stability were exacerbated when the decision of 27 March 1998 to devalue the currency by 20 per cent was revoked three days later. A sharp loss of reserves followed. In response, on 13 May 1998 the RBV introduced foreign exchange guidelines, including placing restrictions on the sale of foreign exchange for current account transactions only and raised its base lending rate by five percentage points to 11 per cent. These measures were successful in restoring foreign reserves that subsequently reached a level sufficient to cover six months of imports. The foreign exchange controls were removed on 13 October 1999, but then reimposed in February 2000 as the foreign reserves position worsened once more. As of December 2001, commercial banks were requested to sell foreign exchange to the RBV more frequently and warned that the central bank would consider introducing a surrender system for foreign currency should reserves fall below four months of import cover.

The balance of payments has been characterised by extended periods of merchandise trade deficits financed by large surpluses on the services account and inflows of foreign aid and foreign direct investment (Figure 5). Since 1998, release of funds from multilateral agencies and bilateral donors under the CRP have been a significant source of foreign exchange. Principal merchandise exports from Vanuatu include copra, cocoa, beef, timber and kava with the major export destinations for these exports being the European Community, Japan, Australia, South Korea, New Zealand, and New Caledonia. The current account for 2001 is likely to record a deficit due to large falls in the world price of copra, coconut oil, and coffee, combined with an increase in import payments. Prices of beef and commercial logs have risen recently and this will ameliorate some of the fall in export income. Gross official reserves as of September 2001 stood at VT5.3 billion, equivalent to 5.3 months of import cover (Reserve Bank of Vanuatu 2002:Table 35).

Figure 5 Vanuatu: current account balance, 1994–2000 (million vatu)



Source: Author's calculations based on National Statistics Office data.

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Table 2 Distribution of work-age population by sector, 2000

	Persons	Per cent
Subsistence agriculture	77,000	49
Non-subsistence agriculture	57,000	37
Not working	22,000	14
Total	156,000	100

Source: National Statistics Office, 2001a. *Informal Sector Survey 2000*, Government of Vanuatu, Port Vila:Table 3.1.

Population and employment

According to the national population census of 1999, the population was 187,000 as compared to 142,400 at the earlier census of 1989; the implied annual rate of growth from these figures is 2.7 per cent. Some 80 per cent of the population resides in rural districts with the rural population estimated to be growing at an annual rate of 2.6 per cent. The population of Port Vila and Luganville, the two major urban centres, at the 1999 census was 29,400 and 10,700, respectively, and growing annually at 4.2 per cent. The large growth differential between the urban and rural population is partly explained by the large urban drift. Some 43 per cent of the population is less than 15 years of age, implying that the growth momentum for the population is likely to remain for at least a generation and suggesting that demand for education and health care will continue to rise for the foreseeable future.

The wage sector accounts for 18 per cent (amounting to 14,272 employees) of the total working-age population, defined as those in the 15–64 year age cohort. The public sector is the largest employer, accounting for approximately one-third of formal sector employment. The subsistence sector absorbs around half of the workforce, with another 10 per cent being absorbed in the informal sector, including those counted as self-employed. Another 14 per cent of the workforce, constituting some 22,000 individuals, are categorised as 'not working' (Table 2).

Given the gap between demand and supply of jobs, the prognosis for employment and social stability is not good. Some 3,500 school leavers enter the workforce each year while less than 1,000 jobs are created annually. The pressure on land within the urban fringes has been increasing, while a significant proportion of urban youth who have been detached from the land for a long period are unable to return to subsistence agriculture. It is now common to see groups of youths on the streets of Port Vila and Luganville late at night; this is not a healthy sign for future social stability and security. While Vanuatu remains a relatively safe and secure place to live and visit, this state cannot be taken for granted given the worsening trends in urban unemployment.

The dualistic nature of production is most apparent in the labour market where a clear demarcation exists between formal sector employees and the rest of the population. Being the major employer, the public sector acts as the wage leader. Minimum wages of VT19,000 per month (as of 2001) are considerably higher than in the informal sector and approximately equal to the VT20,000 median monthly salary of skilled agriculture and fishery workers (National Statistics Office 2001b:Table 6.5). Wage rigidities would have to be removed for employment to increase while the investor climate has to be improved to see growth of employment opportunities.

Comprehensive Reform Program

In June 1997 the government approved an overarching program of comprehensive reforms to address several structural problems within the economy. The Comprehensive Reform Program (CRP) entered its third phase for 2000–2002. The National Summit, held in Port Vila on 20 July 2000, espoused the following vision for the future of Vanuatu.

A unified, peaceful, self-reliant and democratic nation, upholding the rule of law, Melanesian values and Christian principles, with effective institutions of governance, a dynamic private sector, a stronger commitment to social equity and a rate of economic growth that provides an improved standard of living for the benefit of all people of Vanuatu (Vanuatu 2000).

Reform targets endorsed by the National Summit under Phase III of the CRP included

- further entrenchment and broadening of governance reforms
- extension of public sector reform to encompass the parliament, judiciary, and the legal sector
- promotion of economic growth
- enhancement of the social reforms such that the benefits of the CRP are shared throughout the population
- improvements in the economic and social wellbeing of the village and rural sectors.

The vision espoused and actions taken to realise it are laudable but whether action will follow the rhetoric and if this will be sufficient to achieve the espoused ideals will only be revealed over time. Given the target date for expiry of the third phase of the CRP is approaching rapidly, some fine tuning in policy may have to be made to ensure that at least some of the targets are achieved. Vanuatu has had limited success in implementing many of the planned reforms, in common with the experience of other countries.

As part of the public sector reforms, the Government Business Enterprise Unit (GBEU) was established in 1998 within the Ministry of Finance and Economic Management (MFEM). The GBEU was tasked to evaluate the financial position and health of the government's commercial investments. The GBEU was also mandated to provide advice on the corporatisation and privatisation of government entities. With the assistance of the GBEU, postal services and the airports were corporatised in 1998. As of August 2001, the state wholly-owned 17 enterprises and had some equity in another ten. It is evident that the divestiture process still has a long way to go.

As part of the broadening of the revenue base of the public sector under the CRP, a new value-added tax of 12.5 per cent was introduced in 1998. This was accompanied by the lowering of tariffs,⁹ rationalisation of business licences, and abolishment of the turnover tax. This major revenue initiative was undertaken in concert with the right-sizing of the Department of Customs that saw its staff establishment reduced from 78 to 48. This shift in sourcing of revenues for government from border taxes to indirect taxes on domestic production has resulted in a sharp deterioration in total revenues accruing to government.¹⁰

Vanuatu has made several policy changes as part of the CRP in order to promote international trade. As of July 1998 import duties were reduced to a band within zero to 30 per cent and simplified to a total of eight categories. The customs service charge of 5 per cent for imports was abolished, as well as export taxes and duties on most goods from 1998. Restrictions limiting kava exports to licensed dealers were lifted in April 1999. These initiatives, managed jointly by the MFEM and the Ministry of Trade, are part of the process leading to Vanuatu joining the World Trade Organization.

As of December 2001, negotiations on several trade agreements were ongoing. Free

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trade under the auspices of the recently signed Melanesian Free Trade Agreement between the Melanesian countries is to take effect for Vanuatu and Solomon Islands from 2003. A proposal for free trade amongst the Forum island countries via a Pacific Island Countries Trade Agreement (PICTA) has been agreed while the Pacific Area Commercial and Economic Relations (PACER) arrangement was accepted in the September 2001 meeting of the Pacific Island Forum. Ratification of these agreements will lower tariffs whilst necessitating new taxation measures to compensate for the loss in revenues from customs collections. Discussions on a new bilateral trade agreement with New Caledonia are in progress. A new bill giving greater powers to the Foreign Investment Authority to promote Vanuatu abroad as a favourable investment destination was passed by Parliament in June 2001.

Sectoral outlook

The tourism sector remains buoyant with the hotel occupancy rate at 61.1 per cent in the September quarter of 2001 compared to 54.1 per cent in the preceding quarter. This is indeed good news for Vanuatu given the global slowdown in tourism activity following the terrorist attacks in the United States. Of the total growth of 2.4 per cent in private sector lending for the September 2001 quarter, some 55.6 per cent went to tourism-related activities (Reserve Bank of Vanuatu 2002). This suggests that tourism is likely to remain healthy for the foreseeable future. Of concern to the industry is the potential adverse effect on tourist arrivals of a 2002 decision by Air Vanuatu to reduce the frequency of its international flights.

The agricultural sector, that provides livelihoods to nearly 80 per cent of the population, has been stagnant and needs to grow to improve the wellbeing of the majority of the population. Copra (and coconut oil) production rose in 2001 following a price

increase of VT10,000 to VT25,000 per ton made possible via a government subsidy. This could be a short-term (and expensive) respite, given the inability of the state to retain the subsidy for long.¹¹ Kava production recovered in 2001 and is poised for further growth, but this may also be short-lived given the global slump in demand resulting from claims that kava causes fatal liver disease. France, Germany and Switzerland have banned the sale of kava-based medicinal products while the United States and Britain have asked for a voluntary withdrawal of kava products by their suppliers.¹² Even though Fiji and New Caledonia account for 65 per cent of total kava exports from Vanuatu, a fall in international demand for kava will adversely impact on prices and therefore on the growth of the domestic industry. Cocoa production has declined, principally due to the suspension of activity on Metenesel Estate on Malekula that traditionally accounted for some 40 per cent of total output. Vanuatu beef showed considerable prospect as an organic product for niche marketing. Success on this front has been mixed, however, due to the lack of the organic certification necessary to earn the price premium and lack of scale economies in packaging and transportation.

Constraints to growth

Vanuatu has good growth prospects based on its abundant natural resources, but this potential is yet to be realised. Four of the potentially several reasons for this failure are enumerated below. First, weak economic management and poor governance has prevented the best use of available resources for growth. Second, weak social service delivery has constrained access to basic services including primary education and health care to a significant proportion of the population. Third, a rapidly growing population in an environment of sluggish economic activity has put increasing strain on existing services provided by the public

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sector. Fourth, regulatory barriers, limited access to credit, and the high cost of inputs have constrained growth of the private sector and prevented it from filling the void left by the public sector in the provision of basic services.

The Chamber of Commerce, through a survey conducted in mid 2001, reports on the following problems that hinder private sector investment in Vanuatu (see Asian Development Bank 2002). Policy instability and corruption are cited as amongst the biggest problems followed by lack of confidence in the legal and judicial institutions in their ability to protect investment, particularly in land-based investment. Lack of access to credit, the high cost of business inputs including utilities and transportation, and high taxes are listed last as factors impeding private sector growth. These problems are well known, with recent reforms targeted at addressing several of them. Given the continued lack of growth of output and private sector investment, the policies put in place are either ineffective or taking longer than originally anticipated to be successful.

Vanuatu is amongst the most expensive countries in which to run a business. While some 40 per cent of total land area is cultivable, only half of this is under cultivation. Absence of competitively priced infrastructure and difficulties in obtaining secure long-term access to land are reported to be the major impediments to expansion of agriculture (Asian Development Bank 2002). Lack of access to land for development is a familiar problem in much of the South Pacific. Recognising the problems of long-term secure access to land for investment, the government is in the process of setting up a Land Tribunal with the sole responsibility of resolving land disputes and facilitating long-term access to this resource to induce increased private sector investment. This proposal would make the state an intermediary between landowners and investors (and is a form of land warehousing).

Lack of skilled labour has been another constraint to growth of private enterprise. For example, the 2000 Labour Market Survey covering the entire population of 1,004 formal sector businesses, reports that 59 per cent of the businesses had difficulties in recruiting appropriately qualified and skilled personnel (National Statistics Office 2001b). For this reason, together with the high cost of credit and utilities, Vanuatu has gained the reputation of being an expensive place to do business. Hence, only investments providing superior returns survive on purely commercial considerations in the prevailing climate. Consequently, investments have been drawn into high-return activities such as fishing that is supported by large valuable fish stocks, agriculture and agro-processing in high-value products such as kava and organic beef, and tourism that is supported by the natural beauty of the country. The small manufacturing sector is sustained by protection from external competitors and on the basis of preferential access to larger markets for certain manufactures.

Three policy lessons

This analysis poses three immediate challenges to policymakers. First, the cost of investment in the economy has to be brought down. This includes lowering interest rates, which can only be achieved after gaining a good understanding of the mechanisms sustaining high interest rates in the face of the excess liquidity in the banking system. The high interest rates prevailing in the market could reflect a combination of three factors: lack of competition; financing of the budget deficits by borrowing from domestic banks and VNPF; and increased risks of lending due to the risks of devaluation of the vatu and/or inability to enforce debt contracts. Interest rates can be brought down by inducing greater competition amongst the financial intermediaries through relaxation of regulatory barriers to entry and allowing

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for better enforcement of debt contracts by a strengthened courts and legal system. The government can reduce the country risk premium by ensuring that the macro-economic fundamentals remain healthy such that perceptions of the risks of devaluations are kept to a minimum. Ensuring that the budget balances over the business cycle would be a significant step in the right direction.

Second, the budget deficit has to be contained to create an investor-friendly climate. Expenditure cuts have been pursued since 1998 with some success but options for raising revenues have to be considered as well. Raising revenues is made all the more difficult in a climate of falling GDP since higher taxes have the potential to dampen investments even further. Policymakers need to be cognisant of the above in broadening the revenue base of the public sector.

Third, a start on long-term investments in public infrastructure and skills upgrading in the workforce has to be made soon. Given the prevailing budgetary constraints of the public sector, immediate consideration should be given to judicious use of the 'user-pays' principle in provision of public services and to use donor support in building critical infrastructure. It is clear that building physical and social infrastructure takes considerable resources and time, but some boost to current levels of activity on this front is long overdue. Otherwise, the level of access to basic services in the rural districts will diminish over time.

Conclusions

To the occasional visitor, Vanuatu leaves an impression of paradise. The friendly people, pleasant climate and picturesque scenery that greet the tourist are as real as the stagnant economy, rising crime, deteriorating fiscal position of the state and worsening income distribution. Per capita income has hardly changed from independence in 1980 to 2000,

while nutrition-based measures of wellbeing suggest a deterioration amongst the poorest of the population during this period. Vanuatu embarked on an ambitious reform program in 1997 with the aim of raising growth of output. The private sector was to have led the investment boom under a policy regime conducive to such activity. On this count and with the benefit of hindsight, the reforms are yet to deliver. It would be premature to suggest a failure of reforms, given some of the successes. For example, the reforms and particularly external support from multi-lateral agencies and bilateral donors averted an impending liquidity crisis. Many of the reforms are yet to be completed, with fine-tuning to policy warranted on the way to maximise the chances of improving growth. Given the constraints, achieving such a target will not be easy.

Growth of output in Vanuatu is impeded by the small local market and the high cost of inputs including land, labour, capital, and utilities. Infrastructure costs are amongst the highest in the region, the cost of bank lending is also high despite the presence of significant liquidity in the banking system, and regulatory barriers to entry into commerce are both high and non-transparent. Insecure property rights, extensive involvement of government and public enterprises in the economy, and uncertainty of policy remain the major constraints to expansion of business. These structural problems are aggravated by the geographic dispersion of the islands making up the Vanuatu archipelago, shortages of skilled labour, and large variability in income distribution and access to services between the urban regions on the one hand and rural and outer regions on the other.

The people of Vanuatu go to the polls in May 2002 to elect a new government. If past outcomes of elections in Melanesia are any guide, political allegiances will remain fluid and often based on family, regional and ethnic ties. Political instability in such a climate is inevitable but it is policy instability

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that is most damaging to growth of private enterprise. Hence, the perennial challenge to policymakers of creating a buffer between political and policy instability will remain. Separation of the policymaking arms of government from those responsible for implementation provides one mechanism to decouple policy from political instability. The incoming administration will be judged on the performance of the economy and the very same outcomes targeted under the reform program.

Notes

- ¹ While the proportion of underweight children less than 5 years of age fell between the two nutrition surveys, the increase in stunting suggests a long-term rise in poverty within the bottom income strata.
- ² Views expressed here are of the author alone and should not be attributed to either the Asian Development Bank or the Government of Vanuatu. The coverage here is selective, based as it is on the requirements of an economic survey, recent developments and the personal interests of the author.
- ³ The exchange rate as of September 2001 being VT148.77 to US\$1.
- ⁴ Internet Gaming and asset sales were projected to raise VT240 million and VT150 million, respectively.
- ⁵ The problems may not have been fully overcome since the VNPF required an injection of VT325 million from the 2001 Budget.
- ⁶ Other countries on this list include Andorra, Liberia, Liechtenstein and Monaco (<http://www.oecd.org>).
- ⁷ Data drawn from Reserve Bank of Vanuatu (2002:Table 23).
- ⁸ Commodity imports amount to approximately 35 per cent of GDP while commodity imports and exports, together, amount to more than half of GDP.
- ⁹ As of 1 July, 1998 tariffs were reduced by an average of 24 per cent as part of the reforms under the CRP.

- ¹⁰ The reforms were intended to be revenue-neutral.
- ¹¹ The subsidy will cost the 2002 Budget approximately VT200 million.
- ¹² See *Pacific Islands Monthly*, February 2002. Forum Economic Ministers have voiced strong concerns in several international forums on the adverse effects of this decision on their economies.

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Acknowledgments

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