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VANUATU

March 2023

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR VANUATU

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2023 Article IV consultation with Vanuatu, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis, following discussions that ended on January 25, 2023, with the officials of Vanuatu on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 1, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF
- A **Staff Supplement** updating information on recent developments.

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

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PRESS RELEASE

PR23/83

IMF Executive Board Concludes 2023 Article IV Consultation with Vanuatu

FOR IMMEDIATE RELEASE

Washington, DC – **March 20, 2023:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Vanuatu on March [20], 2023 and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

The reopening of borders and strong public infrastructure investment are paving the way for a faster recovery. GDP growth is expected to rise to 3.5 percent in 2023. Agricultural production, remittance inflows, and strong recovery in trading partners will support the economic activity. High energy and global commodity prices are pushing up headline inflation and widening the current account deficit, but core inflation remains subdued for now. Fiscal policy is expected to remain expansionary in the near term as the implementation of externally financed infrastructure projects accelerates. Monetary policy remains appropriately on hold amid weak private credit growth and negative output gap. The Economic Citizenship Program (ECP) is facing significant challenges, with important implications for revenue collection and governance. The financial and operational challenges of Air Vanuatu are worsening and affecting the economy in general, particularly the tourism sector. The banking sector weathered the pandemic well. However, elevated non-performing loans (NPLs), particularly for households, remain a concern.

Risks to the outlook are substantial and tilted to the downside. Labor and materials shortages and cost overruns could delay the implementation of externally financed infrastructure projects. A slowdown in main trading partners' economic activity could negatively weigh on tourism and remittances. Additional challenges to the ECP could impact revenue collection and derail medium-term fiscal sustainability. Finally, structural risks include high and increasing NPLs, weak governance and anti-corruption framework, and extreme vulnerability to climate change.

Executive Board Assessment

In concluding the 2023 Article IV consultation with Vanuatu, Executive Directors endorsed the staff's appraisal, as follows:

The new government faces daunting challenges that require bold reforms. The pandemic, increase in global commodity prices, and lower revenues from the ECP reduced macroeconomic policy buffers. Prospects for the return of tourism are at risk due to the operational and financial challenges faced by the national airline, and labor shortages.

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

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

Vulnerability to natural disasters increases uncertainty and reduces policy space. Bold reforms are needed to lift the country's growth potential.

Stronger GDP growth is expected in 2023 supported by public infrastructure spending and resumption in tourism. An expansionary fiscal policy geared toward more capital spending and a gradual recovery in tourism are expected to be the main drivers of growth in 2023. Growth will also be supported by higher agriculture production on the back of government support, ongoing recovery in trading partners, and resilient remittances.

Risks to the outlook are tilted to the downside. Short-term to near-term risks include: (i) the spread of COVID-19 variants following the reopening of borders delaying the implementation of major infrastructure projects; (ii) a slowdown in main trading partners' growth negatively weighing on tourism and remittances; and (iii) additional losses in ECP revenue that could derail medium-term fiscal sustainability. Structural risks include: (i) increasing NPLs and their effects on banks' financial performance and lending capacity; (ii) weak governance and anti-corruption framework; and (iii) extreme vulnerability to climate change.

A credible medium-term fiscal strategy that secures adequate consolidation is essential for preserving debt sustainability. Given the projected decline in ECP revenues, Vanuatu's ambitious infrastructure agenda must be accompanied by tax revenue mobilization and expenditure rationalization efforts to reduce the already high deficits and keep debt below 60 percent of GDP over the next decade. Increasing tax revenues—including through the introduction of corporate or personal income taxes and through base broadening—should be at the core of any fiscal strategy. Promptly launching fiscal consolidation efforts and securing at least two percent of GDP in savings would help meet the fiscal anchor while protecting capital spending. Fiscal buffers should be strengthened given Vanuatu's vulnerability to natural disasters which includes expanding the sizeable cash reserves built in recent years.

The restructuring of Air Vanuatu must be completed urgently to reduce fiscal risks. Despite financial support from the government in recent years, the national airline's operational and financial challenges are worsening, with implications for tourism and domestic connectivity. The rapid assessment by Australia's Department of Foreign Affairs and Trade (DFAT) is an important first step, but a careful analysis of restructuring options is needed to identify a sustainable solution that minimizes contingent liabilities and transfers from the government while preserving the airline's systemic economic role.

The current monetary policy stance is appropriate. Weak private credit growth, subdued core inflation, and negative output gap calls for keeping monetary policy on hold to support the fragile recovery. Monetary policy should remain data-driven, and the Reserve Bank of Vanuatu should stand ready to tighten if there are signs of second round effects such as rapid increases in core inflation.

Financial sector policies should focus on tackling elevated non-performing loans. The financial system appears to be sound overall, but the high level of NPLs are a concern. There is a need to strengthen the supervisory and resolution framework, increase the minimum capital requirements, and provisioning for some banks. Going forward, introducing a debt-service-to-income ratio can help contain the formation of unsustainable debt.

Bold structural reforms are needed to unlock growth potential. The authorities should continue to promote economic diversification particularly in the agricultural sector. Improving the public investment management process is essential for strengthening the capacity to implement large-scale projects. The authorities must also prioritize streamlining administrative processes for FDI and implementing policies that may help address labor shortages.

Strengthening Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) and improving governance remains essential. The authorities need to address significant deficiencies in Vanuatu's AML/CFT regime, including by better assessing and understanding ML/TF risks faced by the jurisdiction, strengthening the AML/CFT framework in line with international standards (including to regulate virtual asset service provider activities), and bolstering the capacity of competent authorities and law enforcement, and addressing governance risks surrounding the ECP. The upcoming APG review offers an opportunity to show tangible results. It is also necessary to strengthen governance in the public sector particularly with respect to the central bank and state-owned enterprises.

Vanuatu: Selected Economic Indicators, 2019–28

Population (2020): 301,695
IMF quota: SDR 23.8 million (0.01 percent of total)
Main products and exports: Kava, coconut oil, copra, cocoa, beef
Key export markets: New Caledonia, Australia, New Zealand

	2019	2020	2021	2022	2023
			Estimates	Projections	
Output and prices (annual percent change)					
Real GDP	3.2	-5.0	0.6	1.9	3.5
Consumer prices (period average)	2.7	5.3	2.3	4.6	3.5
Consumer prices (end period)	3.5	6.6	0.7	4.9	3.9
Government finance (in percent of GDP)					
Total revenue	42.6	41.4	45.7	38.1	40.0
Taxes	16.9	14.0	15.4	16.0	17.8
Other revenue	14.1	15.9	14.5	9.1	7.9
Grants	11.7	11.5	15.9	12.9	14.3
Expenditure	39.8	43.4	43.4	44.7	46.1
Expense	28.7	37.8	38.0	39.5	37.1
Net acquisition of non financial assets	11.1	5.6	5.4	5.2	9.0
Net lending (+)/borrowing (-)	2.8	-1.9	2.3	-6.6	-6.2
Public and publicly-guaranteed debt (end of period)	45.9	48.9	48.4	46.6	49.2
Domestic	6.0	8.6	8.6	10.1	8.8
External	39.9	40.4	39.8	36.5	40.5
Money and credit (annual percentage change)					
Broad money (M2)	9.2	5.3	14.2	9.1	7.4
Net foreign assets	24.2	16.9	8.4	8.7	9.0
Domestic credit	-6.4	-9.5	8.5	5.8	1.2
Of which: Credit to private sector	0.4	1.5	0.3	0.6	1.6
Interest rates (in percent, end of period) 1/					
Deposit rate (vatu deposits)	0.8	0.7	0.5	…	…
Lending rate (vatu loans)	9.9	9.5	9.4	…	…
Balance of payments (in percent of GDP)					
Current account	27.8	7.9	0.8	-2.2	-3.6
Trade balance	-24.0	-22.8	-24.9	-27.0	-32.2
Exports of goods	5.0	5.1	5.6	6.1	6.2
Imports of goods	-28.9	-27.8	-30.4	-33.1	-38.4
Travel receipts	28.8	6.2	0.2	5.1	15.9
Gross Remittances	15.5	11.9	16.3	17.0	16.6
Capital and financial account	3.9	11.6	14.6	6.3	8.2
Of which: Foreign direct investment	3.8	2.5	4.3	4.0	3.7
Overall balance	9.8	10.1	5.4	4.1	4.6
Gross international reserves (in millions of U.S. dollars)	511.6	613.6	664.8	706.0	754.5
Gross international reserves (in months of prospective G&S imports)	11.5	13.6	13.1	10.9	11.5
External debt service (in percent of GNFS exports)	6.9	16.6	39.5	27.3	4.5
Exchange rates 2/					
Vatu per U.S. dollar (period average)	115.6	104.1	112.9	113.5	…
Vatu per U.S. dollar (end of period)	114.3	107.7	112.2	114.8	…
Memorandum items:					
Nominal GDP (in millions of U.S. dollars)	930	1,008	942	1,001	1,064
GDP per capita (U.S. dollars)	3187.4	3341.0	3017.7	3103.0	3188.5

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

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

VANUATU

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

February 27, 2023

KEY ISSUES

Overview. Following a successful COVID-19 containment strategy, the border reopened in July 2022, and tourism is returning to Vanuatu. Economic activity is expected to be strong in the near term, with real GDP growing around 3.4 percent in 2023, as tourism and construction activities resume. High imported prices are likely to stoke inflation and push the current account into deficit, while fiscal policy will turn more expansionary. The Economic Citizenship Program (ECP) is facing significant challenges, with important implications for revenue and governance, while Air Vanuatu, the national airline, is facing serious operational and financial difficulties. Key structural vulnerabilities relating to climate change, limited infrastructure development capacity, and weak governance, persist.

Main Policy Recommendations. There is a need for strong policies to address the ongoing challenges, rebuild policy space, and boost Vanuatu's long-term potential.

- Capitalize on the recovery to adopt a credible medium-term fiscal strategy, consolidate, and enact meaningful reforms. The strategy should contain new revenue mobilization policies, including a well-designed income tax, and an expenditure rationalization agenda, while protecting productive and climate-critical infrastructure spending. Closer monitoring of fiscal risks stemming from SOEs, and promptly tackling risks materializing from financial stress at Air Vanuatu to contain spillovers, is also needed.
- Coordination towards careful calibration of an appropriate fiscal and monetary policy mix is needed to keep inflation under control while supporting growth. The exchange rate should continue to act as a shock absorber.
- Reducing elevated non-performing loans should be a priority. There is an urgent need to strengthen supervisory and resolution frameworks while increasing loan-loss provisioning and the minimum capital requirement.
- Structural reforms are needed to address governance and corruption weaknesses, including the governance of SOEs, the AML/CFT framework, the ECP, tax transparency, and central bank governance and autonomy.

Approved By
Era Dabla-Norris (APD) and Maria Gonzalez (SPR)

Discussions took place in Port Vila, Vanuatu during January 11–25, 2023. The staff team consisted of Evan Papageorgiou (head), Monica Petrescu, Mouhamadou Sy (all APD), and Seruwaia Cagilaba (Resident Representative Office, Fiji). Neil Saker (Resident Representative, Fiji) and Lodewijk Smets (WB) joined some of the meetings. Rob Nicholl and Philip Arubilake (both OED) attended the mission. Vatsal Nahata (APD) provided excellent research assistance and Connor Kinsella (APD) supported the mission. The mission met with Minister of Finance and Economic Management John Salong, Governor of the Reserve Bank of Vanuatu Simeon Malachi Athy, other senior officials from ministries, government agencies, the Reserve Bank of Vanuatu, and representatives from the private sector, development partners, and civil society.

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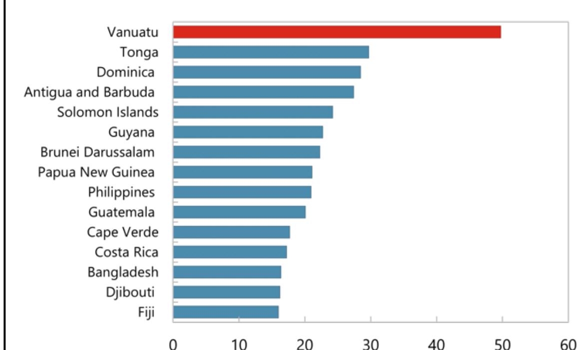
BACK TO GROWTH AMID A SERIES OF CHALLENGES

1. **Growth returned with the reopening of borders and the resumption of project implementation.** Vanuatu managed the pandemic well, despite the significant loss of economic activity from tourism during lockdowns, was aided by success in identifying alternative sources of revenue, remittances, and reprofiling of expenditures.

2. **The Economic Citizenship Program (ECP)—a citizenship-by-investment scheme—is facing significant challenges, with important implications for revenues and governance.** Since 2022 the European Union (EU) and Switzerland have identified weaknesses in the ECP, including deficiencies in the due diligence of applicants, and issued a temporary suspension of visa waiver agreements for recently issued Vanuatu passports. This triggered a decline in revenue collected under the scheme, adding to governance concerns. In February 2023, the EU agreed to delay converting the partial suspension to a full suspension (for all Vanuatu passport holders) until August 2024, giving the authorities more time to implement required reforms.

3. **Key structural vulnerabilities relate to climate change, limited infrastructure development capacity, and weak governance**. Vanuatu remains extremely vulnerable to climate change and other natural disasters, such as frequent tropical cyclones, earthquakes, and volcanic eruptions. Implementation of critical infrastructure projects is affected by limited domestic capacity and cost overruns. Weak governance and transparency in managing state-owned enterprises (SOEs) has led to the realization of fiscal risks.

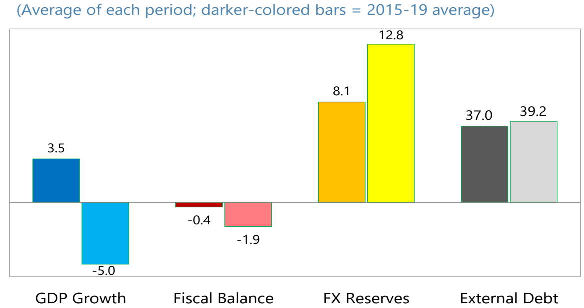
2021 World Risk Index



Source: World Risk Report 2021.
Note: The World Risk Index is based on countries' exposure, vulnerability, susceptibility, lack of coping capacities and lack of adaptive capacities (Bündnis Entwicklung Hilft and Ruhr University Bochum, Institute for International Law of Peace and Armed Conflict).

4. **The new government faces daunting challenges.** Early elections in October 2022 led to a new coalition government. The pandemic and surging commodity prices following Russia's war in Ukraine have reduced macroeconomic policy buffers and aggravated structural vulnerabilities. Bold reforms are needed to build climate resilient infrastructure, contain ballooning deficits, strengthen the banking system, resolve significant labor supply shortages, address governance and corruption vulnerabilities, and meet long-term development goals.

Economic Performance: 2015-19 vs. 2020
(Average of each period; darker-colored bars = 2015-19 average)



Sources: Vanuatu authorities; and IMF staff estimates.
Note: All variables expressed in percent (GDP Growth) or in percent of GDP (Fiscal balance, External Debt), except FX Reserves (in months of import cover).

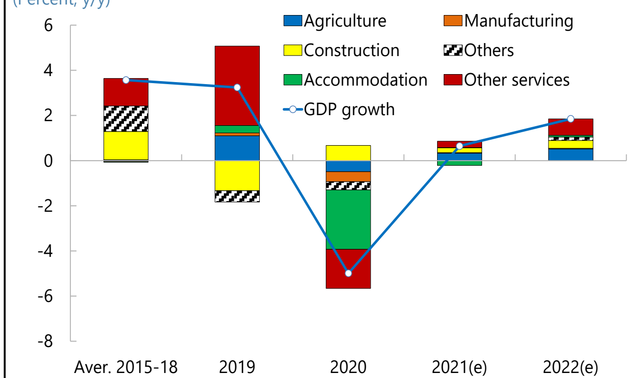
RECENT DEVELOPMENTS: A FRAGILE RECOVERY

5. Vanuatu re-opened its borders in 2022, after a challenging start to the year. After the first domestic transmission case in late March and a temporary lockdown, domestic restrictions were fully lifted in mid-June. Following strong progress toward vaccination targets, Vanuatu resumed international travel with no quarantine or testing requirements in July. Tourism has restarted, and several airlines and cruise lines have re-established connections with the country.

6. Economic activity gradually recovered in 2021 and 2022 following a sharp decline in 2020. Real GDP contracted by 5 percent y/y in 2020 following COVID-related border closures and lockdowns. As a tourism-dependent economy, the services sector—particularly accommodation—was hit hard. GDP growth is estimated to have increased by 0.6 percent in 2021 and have accelerated to 1.9 percent in 2022 on the back of continued recovery in tourism, strong agricultural production, resilient remittances,[1] and a return—albeit slower than initially anticipated—of large donor-funded investment projects which had slowed significantly during the pandemic. The direct impact of Russia's war in Ukraine on Vanuatu's economy is contained because of limited economic and financial ties, but Vanuatu is indirectly affected through higher commodity prices and potentially through a slowdown in its main trading partners.

GDP Growth and Decomposition

(Percent, y/y)



Sources: Vanuatu National Statistics Office; and IMF staff estimates.
Notes: Others includes Mining & Quarrying, and Electricity & Water Supply.

7. Inflation picked up in 2022H1 driven by external factors and is expected to accelerate in 2022H2 (Annex IV). Inflation increased to 3.7 percent (y/y) in June 2022 from 0.7 percent at the end of 2021. Through the first half of 2022, headline inflation remained slightly below the Reserve Bank of Vanuatu's (RBV) upper target of 4 percent. Food (5.2 percent), and housing and utilities (3.2 percent) represented the largest increases in the consumer price index (CPI) components. In November 2022 a ransomware cyber-attack severely disrupted the core IT infrastructure of many government agencies, affecting statistical data collection and dissemination. The delayed CPI data are likely to continue showing significant price increases.

8. The banking sector weathered the pandemic well, but asset quality remains a concern. The banking system remains profitable,[2] liquid, and adequately capitalized. As of 2022Q2, the capital

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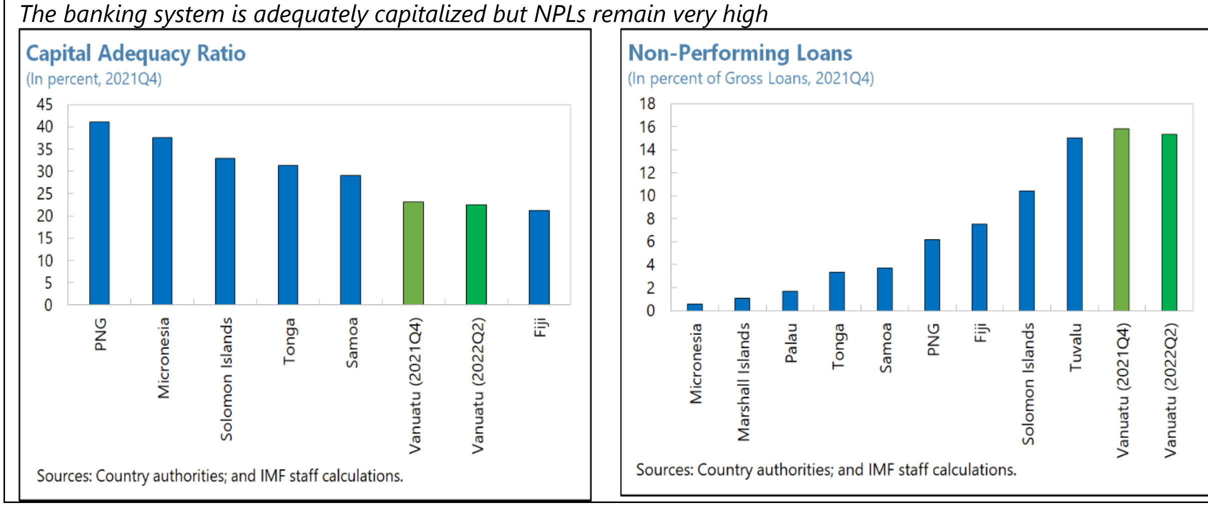
[1] Remittances in Vanuatu increased by 38 percent in 2021. In general, remittances remained resilient in many LIDCs during the pandemic, including in the Pacific Island Countries. See Kpodar et al. (2021).

[2] Interest margin to gross income declined to about 60 percent in 2022Q2 from an average of 68.8 percent in 2021 and 68 percent in 2020.

adequacy ratio (CAR) and the liquid asset ratio stood at 22.5 percent and 58.5 percent, respectively. Both are well above their minimum regulatory thresholds, at 10 percent and 5 percent, respectively. However, bank asset quality has deteriorated, and non-performing loans (NPLs) remain high compared to peers.

Vanuatu: Selected Financial Soundness Indicators Compared to Peers

The banking system is adequately capitalized but NPLs remain very high



9. **The decline of ECP revenues weighed heavily on 2022 fiscal outturns.** A fiscal deficit of 6.6 percent of GDP is projected for 2022, a very substantial deterioration from a surplus of 2.3 percent of GDP in 2021. Targeted programs under the second and third phases of the Economic Stimulus Package helped support demand, although take-up was limited by challenges in identifying recipients.[3] The third phase of the stimulus provided an additional VT 1.45 billion in relief, partially financed through donor grants, and reflected in the supplementary budget approved in May.[4] Provisional 2022 data show that revenue outturns have been weak, at only 80 percent of the supplementary

Second and Third Phases of the Economic Stimulus Package

Policy Measures	Budgeted second phase (Vatu mn)	Budgeted third phase (Vatu mn)	Total budgeted (Vatu mn)	Spending to date (Vatu mn)	Spending to date (% GDP)
Wage Subsidy Scheme	560	300	860	383	0.3
Small Business Grant	700	574	1,274	1,052	0.9
School Fee Subsidy	141	255	396	185	0.2
Commodity Subsidy	137	275	412	82	0.1
Shipping Subsidy	86	50	136	150	0.1
Cancellation of fees and charges; administrative support	100		100	829	0.7
Total	**1,724**	**1,454**	**3,178**	**2,681**	**2.4**

[3] The Small Business Grant scheme targets businesses with an annual turnover of less than VT 4 million. The Wage Subsidy Scheme is available for all VAT-registered businesses that pass a stress test defined by the Department of Finance and Treasury, based on the reduction in turnover as declared in VAT returns. Other facilities include the school fee subsidies, and subsidy schemes to support firms in the freight shipping and agricultural sectors.

[4] Budget support from development partners to fund the third phase of the Economic Stimulus Package and respond to COVID-19 community transmissions totaled VT 584.6 million.

budget target, due to reduced participation in the ECP and slower-than-expected deployment of grants from development partners, including budget support.[5]

10. The current account deficit widened, but the external sector position remains broadly in line with fundamentals and desirable policy settings (Annex II).[6] The current account balance is expected to move into a deficit of 2.2 percent of GDP in 2022 from a surplus of 0.8 percent of GDP in 2021, largely due to a widening of the trade deficit following rising import prices related to Russia's war in Ukraine. Gross international reserves remain adequate.[7]

OUTLOOK AND RISKS: MANY CHALLENGES AHEAD

11. GDP is projected to return to its pre-pandemic level in 2023 and inflation to decelerate over the medium-term. GDP growth is projected at 3.5 percent y/y in 2023 supported by a gradual recovery in tourism,[8] higher public infrastructure spending particularly for construction, and the ongoing recovery in trading partners.[9] Agricultural production is benefiting from government support and is responding to increasing demand, including by tourists. Ongoing execution of construction activities with the return of external experts and easing of supply chains disruptions will also boost economic activity. Growth is anticipated to peak in 2025 when tourism fully returns to pre-pandemic level before trending down to its long-term rate of about 3 percent. GDP level should return to its pre-pandemic level in 2023 along with many other Pacific Island countries. However, the output gap is expected to only close by 2025 with some scarring from the pandemic. Inflation is expected to remain high at 3.8 percent by end-2023,[10] below its 2022 level and the RBV's upper target, due to commodity base effects. Inflation is expected to converge to about 3 percent over the medium-term.

12. Fiscal policy is expected to remain very expansionary, and the current account deficit to narrow over the medium-term. Over the medium-term, widening fiscal deficits (Figure 3.1) will push public debt up from 46.6 to 64.3 percent of GDP between 2022 and 2028 (Figure 3.3), breaching the authorities' 60 percent of GDP ceiling. The current account deficit is expected to narrow over the same period, supported by a gradual recovery of tourism and strong remittances despite the decline in ECP revenues.

[5] ECP revenues were down 27 percent y/y in 2022.

[6] The ESA is preliminary and subject to uncertainty due to limited data availability for 2022.

[7] The 2021 SDR allocation is maintained with the Reserve Bank of Vanuatu to boost foreign reserves.

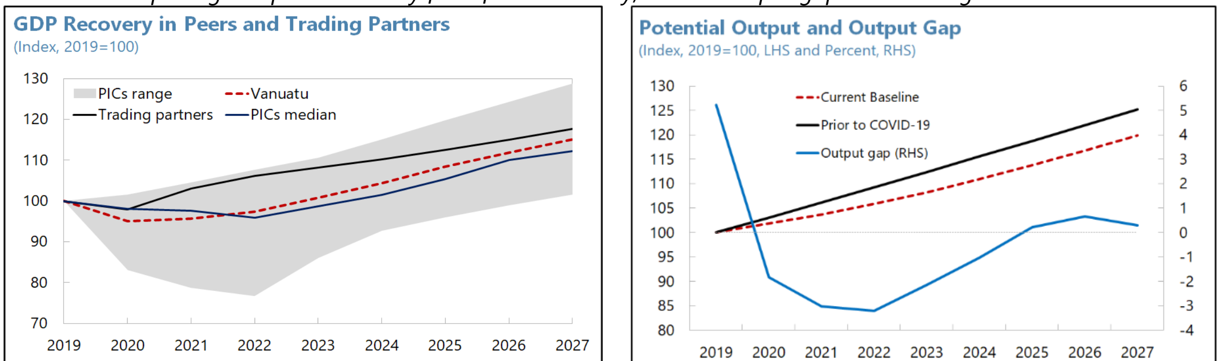
[8] Tourism is expected to recover to about 65 percent of its pre-pandemic level at the end of 2023. See Annex V for more details about the tourism sector in Vanuatu.

[9] GDP levels in Australia and New Zealand already returned to their pre-pandemic levels since 2021.

[10] The Parliament is expected to enact in 2023 the ''Price Monitoring and Consumer Affairs Act'' to enable the government to monitor price developments.

Vanuatu: Real GDP and Output Gap Developments

The recent reopening has paved the way for a faster recovery, but the output gap remains negative



Sources: Country authorities; and IMF staff calculations.
Notes: Australia, New Caledonia, and New Zealand are Vanuatu's main trading partners. PICs range include 12 Pacific Island Countries.

Sources: Vanuatu National Statistics Office; and IMF staff estimates.
Notes: Pre-pandemic estimates based on January 2020 data.

13. **Uncertainty around the outlook is high and the balance of risks is tilted to the downside** (Annex III). The list of conjunctural risks includes:

- **COVID-19.** The return of tourism, including cruise ships, could lead to the spread of other variants and new lockdowns. This could also affect the implementation of major projects by halting the return of foreign experts.

- **Slowdown in global outlook** particularly among main trading partners could negatively affect the economy through lower tourism and remittances.

- **Total loss of ECP revenues** could jeopardize medium-term fiscal and debt sustainability, as well as quickly erode reserve buffers (text Table 2 illustrates such a severe scenario).

Severe Downside Scenario, 2022-27

Percent of GDP, unless otherwise indicated

	Baseline			Downside Scenario		
	2022	2024	2027	2022	2024	2027
ECP revenues	7.5	4.6	4.2	7.5	0.0	0.0
Fiscal balance	-6.6	-7.3	-6.2	-6.6	-12.2	-11.7
Public debt	46.6	53.1	61.4	46.6	63.5	85.0
Current account	-2.2	-1.2	2.3	-2.2	-5.8	-1.9
Reserves coverage (months of prosepctive imports)	10.9	11.5	12.7	10.9	9.8	9.2

Source: IMF staff estimates.
Notes: The severe downside scenario assumes no ECP revenues from 2023, and no offsetting fiscal measures. The effects of such scenario are shown on the fiscal and external accounts under the assumption of no adjustments in public spending. The additional deficits are financed by new debt issuance: half by non-concessional external debt, and the other half by domestic debt.

At the same time, there are several structural risks:

- **Growing NPLs** could impact banks' profitability and capital position thus affecting their ability to lend and ultimately to consume and invest.

- **Weak governance, anti-corruption frameworks and financial integrity.** Air Vanuatu's financial distress and operational challenges pose risks to growth and debt sustainably. Lack of transparency and a supervisory framework for SOEs can lead to further materialization of fiscal risks. AML/CFT issues also remain a significant concern.

- **Higher frequency and severity of natural disasters** induced by climate change could cause severe economic damages.

Authorities' Views

14. The authorities concurred with the assessment on the economic recovery, uncertain outlook, and significant downside risks. They expect GDP to grow by 3.6 percent in 2023 driven by agriculture and construction, reflecting government support and infrastructure projects, but also retail trade and accommodation following the reopening of borders. Headline inflation is expected to remain above the RBV's upper target of 4 percent in early to mid-2023 but they expect it to converge toward the target by the end of 2023. The authorities agreed with the main risks to the outlook identified by staff and emphasized that the challenges that Air Vanuatu is facing will continue to affect the tourism sector and growth going forward.

POST-PANDEMIC POLICIES FOR GROWTH AND RESILIENCE

The authorities must capitalize on the recovery to enact much-needed fiscal and structural policy reforms (particularly on income taxation), rebuild buffers, improve financial supervision, and create space to finance climate adaptation. Coordination towards careful calibration of an appropriate fiscal and monetary policy mix is needed to keep inflation under control while supporting growth.

A. Fiscal Policy

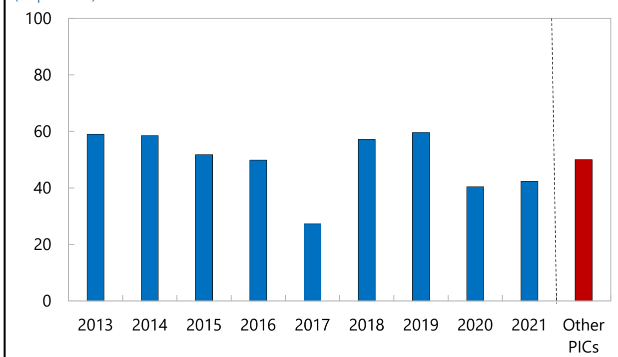
15. Fiscal policy will remain expansionary in the near term. The 2023 budget will lay out priorities for investment.[11] Staff estimate that the fiscal deficit will remain elevated, at 6.2 percent of GDP in 2023, and increase further in 2024 as the implementation of externally-financed infrastructure projects accelerates. The unwinding of pandemic-related support programs will help contain current spending, and the return of tourism will help boost VAT revenues, but reduced ECP receipts will offset revenue gains.

16. As the recovery unfolds, there is critical need for fiscal consolidation and rebuilding buffers. The implementation of donor-financed infrastructure projects delayed during the pandemic is expected to contribute to higher spending (Tables 2 and 3) and support growth. However, in the context of the large projected fiscal deficits, and the increase in current spending in recent years, scaling back non-priority domestic spending and improving tax collection during the recovery

[11] In the absence of a new budget, a continuing resolution has allowed the 2022 budget to remain in place for the first months of 2023, with no adjustment for inflation.

period is essential for protecting fiscal space and rebuilding cash buffers.[12] Priorities include: (i) addressing weaknesses in tax administration, especially in VAT collection, given the recent decline in C-efficiency;[13] and (ii) reviewing costly transfers to other government units. Targeted assistance to shield households from rising prices may be needed if inflation exceeds expectations, but costly and regressive untargeted subsidies and public wage increases should be avoided.[14]

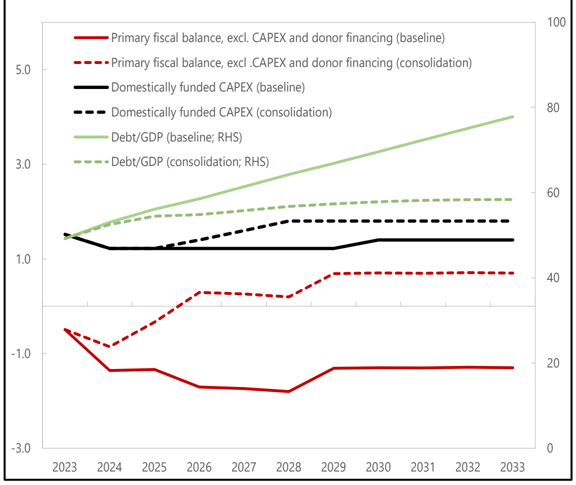
Vanuatu: VAT C-Efficiency
(In percent)



Sources: Vanuatu Ministry of Finance and Economic Management; Sy et al (2022); and IMF staff calculations.

17. A credible medium-term fiscal strategy, including significant revenue mobilization efforts, is needed. The 60 percent of GDP ceiling for public and publicly guaranteed (PPG) debt has served as a key fiscal anchor but would be breached by 2027 under current policies.[15] In this context, the authorities should formulate a credible medium-term fiscal strategy that secures adequate consolidation to keep debt below the ceiling while protecting growth-critical infrastructure spending and creating fiscal space for spending on adaptation needs. A strategy that generated at least an additional 2 percent of GDP in savings as early as possible would adequately meet these aims (text figure). The strategy should include:

Debt and Fiscal Balance Under Alternative Scenarios
(Percent of GDP)



- *Revenue mobilization policies, including updating and completing the proposed 2017 tax reforms, which envisioned the introduction of corporate and personal income taxes*. Revenue strategies should shift away from reliance on

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[12] In 2022, the authorities drew down cash reserves to cover financing needs, resulting in a decrease in cash reserves by an estimated 5.3 percent of GDP, from 7.3 percent of GDP at the start of the year.

[13] VAT C-efficiency conveys the percentage of potential VAT a country can collect. The decline in C-efficiency despite no change to the standard VAT rate suggests potential administrative gaps, linked to a large informal sector, and incentives for businesses to under-report earnings to fall below the VAT threshold. As outlined in the September 2022 PFTAC CD Report *Implementation of an Electronic Fiscal Device (EFD) System for VAT Compliance*, potential solutions to improve VAT collection in Vanuatu include the establishment of a robust, centralized, digitized business register; using incentives (e.g., invoice lotteries) to encourage consumers to request invoices; and implementation of EFDs in select industries and for select firms.

[14] While Vanuatu lacks a centralized mechanism for cash transfers, targeted assistance may include expanding social benefits and subsidizing school and health costs.

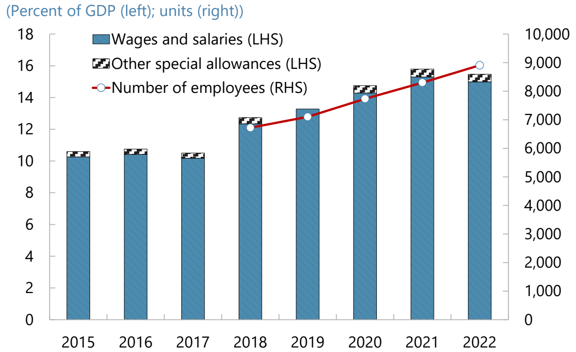
[15] Adjustments to fiscal deficits or financing plans would be required once the breach was imminent, which may lead to risks of cliff effects.

unstable revenue sources, notably the ECP. Staff analysis shows that a 2 percent of GDP increase in revenues can be achieved through combinations of new income taxes or increases in the VAT rate (currently 15 percent), entailing efficiency and distributional trade-offs (Annex VI). Given that the VAT rate has been recently increased,[16] and given the regressivity inherent to VAT taxation, introducing a progressive income tax—which, if well-designed, could decrease inequality (see Annex VI)—may be a more practical option. Some of the basic infrastructure for introducing income taxes has already been put in place through the Tax Administration Act. Broadening the tax base by reducing the significant level of informality is essential for the success of any revenue mobilization policy;[17] in addition to improving revenue collection from new measures, broadening the tax base would improve collection on existing taxes (notably VAT) and reduce the scale and efficiency losses from introducing new measures (Annex VI). Possible interventions to this end could include: offering incentives for businesses to register for VAT and for customers to request invoices; lowering the threshold for VAT registration;[18] and improving audit capacity. Higher associated administrative costs could be offset by increasing revenues in a non-regressive manner through higher VAT rates on select higher margin business sectors, such as tourism.

- *Expenditure rationalization policies, including:* (i) gradually reducing the size of the wage bill by improving digitalization and rationalizing staffing; and (ii) improvements in public infrastructure management, including adequate prioritization of projects with consideration for absorptive capacity and expected returns. Assigning to a central agency the responsibility of social protection and using newly-issued national IDs to create a database to inform social protection programs could significantly improve efficiency in spending to support vulnerable groups, and reduce reliance on more costly measures such as public sector wage increases or untargeted transfers.

Compensation of Employees

(Percent of GDP (left); units (right))



Sources: Vanuatu Ministry of Finance and Economic Management; and IMF staff calculations.

- *Contingent spending and revenue policies in case adverse shocks materialize,* particularly critical given contingent liabilities, climate change, and natural disaster risks.

[16] The standard VAT rate increased from 12.5 percent to 15 percent in 2018. The current VAT rate is well above the PICs average VAT rate (12 percent) and slightly below the world average VAT rate (16 percent).

[17] Informality in non-agriculture sectors in Vanuatu remains elevated (see Annex VI); interventions frequently employed to address informality in other countries include one-stop shops for business registration, information campaigns to clarify the potential benefits of business registration (through VAT refunds on inputs), and the use of financial incentives or penalties to incentivize formalization.

[18] Currently VAT registration is only required for businesses with over VUV 4 billion in total taxable supplies over a 12-month period.

18. The risk of debt distress remains moderate with limited space to absorb shocks (see Debt Sustainability Analysis). External debt indicators are below their thresholds, given the concessional nature of external borrowing. Vulnerabilities include rising risks from contingent liabilities associated with Air Vanuatu, as well as exposure to natural disasters. A severe downside scenario of a full loss of ECP revenues would lead to a significant deterioration in external debt sustainability, putting debt on a sharply increasing and unsustainable path. Beyond 2027, absent fiscal consolidation and given a limited pool of external donor support, Vanuatu will need to increasingly rely on domestic debt and monetary financing to meet financing needs, with important risks. A rapid expansion in domestic debt issuance may run against the absorption capacity of the domestic banking system, comes at the risk of crowding out private sector credit, and raises debt service costs. More importantly, the use of monetary financing risks damaging the RBV's credibility, and may trigger fiscal dominance effects, raise inflation, and erode international reserves. Strong reliance on domestic issuance would also put public debt and debt service on a steep upward trajectory, posing risks to sustainability.

19. The financial and operational challenges of Air Vanuatu are worsening and stress the need for an urgent solution. The national airline remains in severe financial distress and has been accruing arrears, while staff shortages have further compromised operations. The government has appointed new leadership and is assessing potential solutions, with help from a rapid assessment conducted by Australia's Department of Foreign Affairs and Trade (DFAT) and analysis by the IFC. Despite a capital injection of VT 334 million (0.3 percent of GDP) in 2022, further fiscal transfers,[19] government guarantees, or a transfer of some of the airline's debt (estimated at 6 percent of GDP) to the government may be needed as part of a deeper restructuring (see Debt Sustainability Analysis). Going forward, closer monitoring and timely policy action related to fiscal risks stemming from other SOEs is also needed.

Authorities' Views

20. The authorities expect fiscal policy to remain expansionary in the near and medium term, on the back of donor-financed infrastructure projects. They noted that the unexpected and sizeable drawdown of cash reserves in 2022 to finance spending under the supplementary budget was a result of weak support from development partners and could have been partly mitigated through additional bond issuance, given recent oversubscription. The cyber-attack also limited the authorities' abilities to manage financing challenges. The new government is in the early stages of developing and communicating its fiscal strategies. It does not envision the use of subsidies or transfers to mitigate the impact of higher prices on households. While seeking to implement the EU's recommendations regarding the ECP in order to reverse the visa waiver suspension, the authorities recognized that ECP proceeds are not a stable and sustainable source of revenues, and should not be relied upon to finance recurrent spending. However, they did not see scope for new revenue mobilization measures, particularly introduction of income taxes. Instead,

[19] Not currently considered in the baseline projections.

they noted that accelerating growth and improving tax compliance would help improve revenue collection. The authorities also underscored that existing cash reserves could provide some breathing space in the event of further significant declines in ECP revenues in the near term, while domestic debt issuance is expected to meet financing needs in the longer term. The authorities acknowledged there is significant scope for improvement in public investment management, particularly with regards to large-scale donor projects, and requested IMF support through a Public Investment Management Assessment (PIMA).

21. The authorities are actively looking into solutions for the grave fiscal and operational challenges facing Air Vanuatu. They expect challenges to persist through 2023, potentially resulting in additional fiscal costs, and plan to use the results of the Rapid Assessment and to request additional analyses from the IFC to develop further restructuring plans. The authorities also acknowledged the importance of better understanding fiscal risks stemming from both Air Vanuatu and other SOEs.

B. Monetary and Exchange Rate Policies

22. Monetary policy is appropriately on hold, but the RBV should stand ready to tighten if there are signs of second round effects. The RBV has kept unchanged the statutory reserve deposit (SRD) ratio to support the economy. Credit to the private sector is still weak but gradually improving (text figure) and the output gap remains negative. Despite accelerating headline inflation in 2022Q2, core inflation remains low.[20] However, the RBV should stand ready to tighten monetary policy, if growing import demand contributes to sustainably high inflation, or if signs of second-round effects, such as rapid increases in core inflation, emerge. Monetary policy tightening could be achieved by increasing the SRD ratio and reducing excess liquidity through open market operations, although greater coordination with fiscal policy is also needed given Vanuatu's relatively weak transmission of monetary policy into the real economy.[21]

23. The exchange rate should continue to act as a shock absorber. The nominal exchange rate of the vatu is pegged to an undisclosed basket of currencies corresponding to the bilateral exchange rates of the main trade and tourism partners[22] and serving as a key inflation anchor. At the same time, the basket-peg has allowed for flexibility, and the real and nominal effective exchange rates appreciated in 2022 (text figure), helping cushion the impact of rising import prices. This two-way flexibility should be maintained, and the RBV should monitor for emerging imbalances arising

[20] See Annex IV for more details about inflation developments in Vanuatu since the start of the pandemic. Reliance on renewable energy contributes to lower non-food inflation. Lack of more up-to-date data following the cyber-attack on government agencies, including the statistics office, complicates the assessment, but it is likely that core inflation is still lower than headline inflation which reflects a greater effect of higher commodity prices and imports.

[21] See IMF Country Report No. 19/162 (Annex VII) for more details on the link between excess liquidity and the effectiveness of monetary policy in Vanuatu.

[22] Among others Australia and New Zealand. The movements in the Vatu exchange rate mirror the bilateral movements of major currencies in the basket currencies.

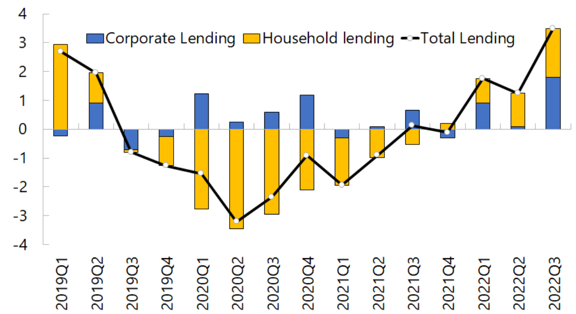
from any currency misalignment (Annex II). To that end, there is a need for more frequent reviews the currency basket to help the economy cope with shocks.

Vanuatu: Monetary Developments

Gradual credit growth is supporting the recovery amid rising price pressures and subdued core inflation…

Contribution to Bank Lending Growth

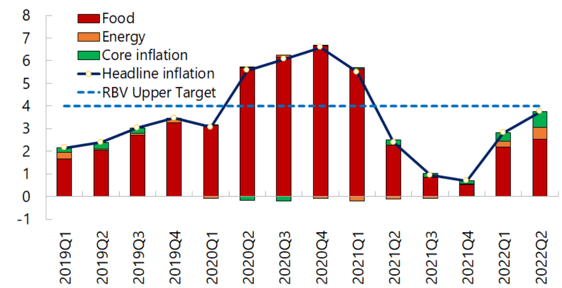
(In percent, year-on-year change)



Sources: Reserve Bank of Vanuatu; and IMF staff calculations.

Contribution to Headline Inflation 1/

(Year-on-year, percent change)

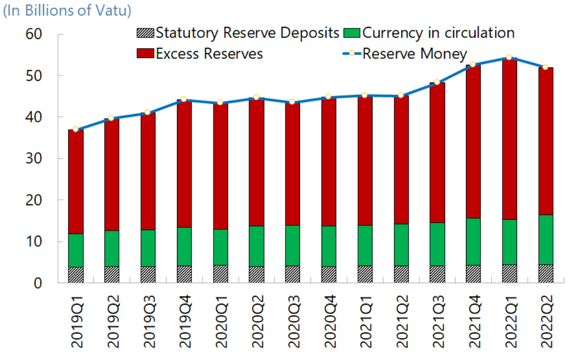


Sources: Vanuatu National Statistics Office; and IMF staff calculations.
1/ IMF staff estimate core inflation by excluding food and energy.

…but excess reserves could hinder monetary policy transmission while the exchange rate is acting as a shock absorber.

Components of Reserve Money

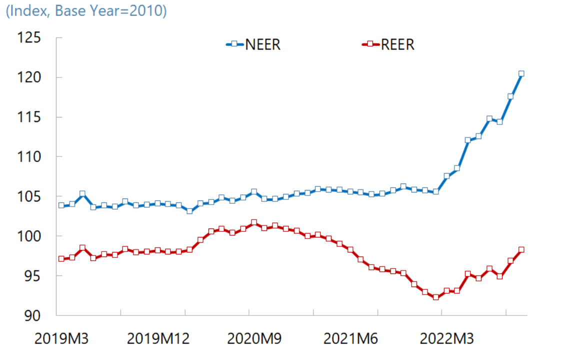
(In Billions of Vatu)



Sources: Reserve Bank of Vanuatu and IMF staff calculations.

Nominal and Real Effective Exchange Rate

(Index, Base Year=2010)



Sources: Reserve Bank of Vanuatu; and IMF staff calculations.

Authorities' Views

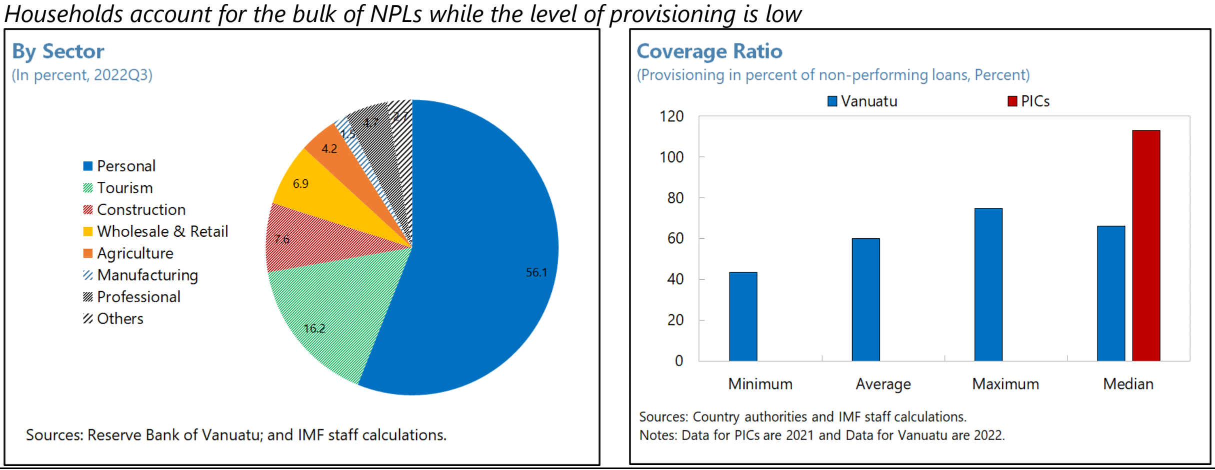
24. The RBV plans to keep policy on hold, given low underlying inflation and weak credit growth. The RBV has kept its policy rates unchanged through the pandemic, stressing that recent increases in headline inflation are mostly imported. In addition, given that credit to the private sector remains weak, the monetary policy will continue to be supportive. The RBV will conduct open market operations to mop up the excess liquidity from banks. The authorities consider that the exchange rate regime has served the country well, and are currently reviewing the weights of the vatu basket of currencies, including the possibility of adding more currencies. The central bank did not introduce any measures since the previous Article IV consultation that may give rise to exchange rate restrictions.

C. Financial Sector Policies

25. The gradual withdrawal of financial support measures and resumption of pre-pandemic financial supervisory practices are welcome. The banking system remains profitable and liquid. The authorities introduced policy measures to cushion the effect of the pandemic on the financial system. Moratoria on loan repayments and the easing of prudential requirement on asset quality expired in September 2022. On-site inspections to monitor banks are expected to resume in 2023. National Bank of Vanuatu (the largest bank with a majority stake by the state) re-established correspondent banking relationships (CBRs) with an international money transfer operator and a specialized foreign bank. This allows it to intermediate foreign currency transactions, particularly USD clearing, reducing somewhat a significant risk to its business strategy—albeit at a relatively high cost available to competitor banks (which are foreign-owned and maintain CBRs with their parent entities).

Vanuatu: Non-Performing Loans

Households account for the bulk of NPLs while the level of provisioning is low



26. The authorities need to strengthen the supervisory framework, increase loan-loss provisioning, and tackle elevated NPLs. High NPLs, particularly for households, and the National Bank of Vanuatu, remain a concern. High exposure of the banking system to the tourism sector has increased the risk of macro-financial risk feedback loop (Annex V). Impaired loans could further increase as forbearance measures expire, although a few banks have extended the relief measures to support some affected customers. The level of provisioning appears low in some banks, pointing to the need to accumulate more reserves in anticipation of potential loan losses and to preempt the decline in loan servicing capacity. The minimum capital requirement should be increased to encourage banks to accumulate additional buffers, such as via retained earnings. Efforts should also focus on strengthening the supervisory and resolution frameworks including through restructuring programs, introducing a DSTI[23] ratio, and reinforcing credit information by improving Vanuatu's credit bureau.

27. Enhancing digital finance could boost financial inclusion and improve financial sector efficiency. The remoteness and geographic dispersion of Vanuatu's 83 islands have resulted in one in three adults being unbanked. Establishing a retail CBDC could facilitate the digitalization of financial services for the rural and unbanked population (Annex VII). Appropriate legal, supervisory, and regulatory frameworks, and technological infrastructure should be in place before considering a CBDC or allowing for crypto assets to be used. The upcoming launch of the digital national payments system for real time and more efficient payments will contribute to strengthening the technological infrastructure.

Authorities' Views

28. The RBV assessed the banking system to be profitable and liquid but agreed that the high level of NPLs is a concern. The RBV is closely monitoring the banking system and is of the view that it remains sound, but high level of NPLs, cyber related risks and de-risking of CBRs are key challenges. The RBV is currently developing a new prudential guideline in line with Basel III that is expected to be issued in 2023. The new guideline will strengthen banks' capital and improve asset classifications and allocation of provisions consistent with best practices and IFRS 9 requirements. The new guideline is also expected to improve monitoring of NPLs, introduce a debt service to income ratio, and increase of loan-loss provisioning.

D. Structural Policies

29. Economic diversification and infrastructure development are essential for sustained and inclusive growth. The October 2022 ratification of the Pacific Agreement on Closer Economic Relations Plus will facilitate greater investment in the country. Efforts continue toward agricultural development, including through copra subsidies and a pilot program providing subsidies for investment in mechanization.[24] Agricultural subsidies should be designed to target well-identified market failures and subject to regular rigorous impact evaluations to ensure cost-effectiveness. Given limited fiscal resources, private investment remains critical to diversification efforts. In this regard, a reduction in administrative barriers—including through streamlining application and registration processes—could help attract additional foreign direct investment (FDI). The Foreign Investment Act should be reviewed to take into consideration the country's needs for greater partnerships with foreign investors, especially where shortages are most acute, balancing the

[23] Debt-service-to-income ratio to contain the formation of unsustainable household debt.

[24] The authorities are also making progress on plans for the production of medical cannabis and industrial hemp, including trough new regulations for importation, cultivation, processing, and exports. The regulations establish a due diligence process for granting licenses to investors; the latter are required to have extensive experience in the sector, in addition to access to land, financing, and a business plan. Efforts to ensure compliance with international standards to control narcotics production are critical.

authorities' preference for ni-Vanuatu representation in key sectors.[25] Infrastructure projects which help improve connectivity and allow the expansion of key sectors such as tourism (especially on electricity, internet, and waste management; see Annex V) remain essential for securing sustainable and inclusive growth.

Major Development-Partner-Financed Infrastructure Projects 2013-2022

Project	Started	Completed	Location	Development Partner(s)	Funding
Port Vila Urban Development Project	2013	2019	Port Vila	AUS, ADB	Grants, Loans (ADB)
Interisland Shipping Support Project	2013		Luganville, Ambae, Malekula, Tanna,	NZL, ADB	Grants, Loans (ADB)
Lapetasi Multi-Purpose International Wharf Development	2013	2018	Port Vila	JICA, others	Loans
Road Rehabilitation & Upgrade Program, Phase 1	2014	2018	Tanna, Malekula	China EXIM	Loans
Vanuatu Tourism Infrastructure Project	2015	2017	Port Vila	NZL, EIF	Grants
Luganville International Wharf	2015	2018	Luganville	China EXIM	Loans
Vanuatu Aviation Investment Project	2015	2019	Port Vila, Luganville,	WBG	Loans
Vanuatu Rural Electrification Project	2015	2020	All islands	WBG (IDA)	Grant
Vanuatu Cyclone Pam School Reconstruction Project	2016	2019	Tafea province	ADB, JPN	Grants
Vanuatu Infrastructure Reconstruction & Improvement Pro	2016	2023	All islands	WBG (IDA)	Grants, Loans
Vanuatu Rural Electrification Project Stage II	2017	2022	All islands	WBG (IDA)	Grants, Loans
Energy Access Project	2017		Malekula, Santo	ADB	Grants, Loans
Vanuatu Pam Road Reconstruction Project	2017	2020	Efate	ADB	Grants, Loans
Vanuatu Cyclone Pam School Reconstruction Project	2017	2019	All islands	ADB	Loans
Road Rehabilitation & Upgrade Program, Phase 2	2019	2022	Tanna, Malekula	China EXIM	Loans
Roads for Development, Phase 2	2019		All islands	AUS	Grants
Vanuatu Climate Resilient Transport Project	2020	2025	South Santo	WBG	Grants, Loans
Vanuatu Pentecost Road and Wharf Project Phase I	2021		Pentecost	China EXIM	Grants, Loans
Greater Port Vila Urban Resilience Project	2022		Port Villa	ADB	Grants
Vanuatu Affordable and Resilient Settlements Project	2022		Multiple islands	WBG	Loans

Sources: Vanuatu authorities, World Bank and ADB.
Notes: All loans are concessional; AUS is Australia, JPN is Japan, NZL is New Zealand, EIF is the Enhanced Integrated Framework
GREEN designates a post-cyclone-Pam reconstruction project
If no "completed" date is indicated, the project is ongoing as of November 2022.

30. Improving governance and financial integrity, reducing corruption, and bolstering Vanuatu's risk profile remains essential. Several priorities should be addressed to reduce immediate risks and enact long-term prosperity:

- **AML/CFT and financial integrity.** While there is demonstrable progress in recent years toward strengthening Vanuatu's AML/CFT regime, including via the establishment of an ultimate beneficial ownership database and boosting the independence of the Financial Intelligence Unit, there are ongoing deficiencies which are particularly critical in light of the risks associated with the ECP. AML/CFT weaknesses are considered one of the factors contributing to CBR pressures, although the latter also require regional solutions (Annex VIII). The Mutual Evaluation of Vanuatu by the Asia-Pacific Group on Money Laundering[26] represents a significant opportunity to demonstrate progress toward compliance with Financial Action Task Force standards. Although this review will not undertake an effectiveness analysis of AML/CFT system, it is critical that all relevant authorities (under the lead of the Financial Intelligence Unit) showcase tangible

[25] The Foreign Investment Act was adopted in 2019 to replace the Foreign Investment Promotion Act. FDI remains restricted to 15 business activities where only ni-Vanuatu can operate. See IMF Country Report No. 21/208 (Annex VII) for more details about FDI in Vanuatu.

[26] The next APG Review (4th mutual evaluation) is underway, and it will be completed by 2025.

improvement from the previous evaluation. In light of continuing CBR pressures, increasing concerns over the ECP, and forays into digital money, Vanuatu should continue to improve its AML/CFT framework and its effective implementation.

- **ECP program.** The new government is committed to addressing the governance issues around the ECP flagged by the EU, and has secured an 18-month extension (from February 2023 to August 2024) of the partial visa waiver suspension in order to enact reforms.[27] These reforms should ensure compliance with security and due diligence procedures, and allow comprehensive checks to be conducted by all suitable stakeholders on all applicants.[28] Strengthening the AML/CFT regime more broadly would also help mitigate risks to financial integrity posed by the ECP by strengthening the authorities' ability to detect and tackle illicit financial flows.
- **RBV Governance.** Progress towards implementing the recommendations of the 2016 Safeguards Assessment has been slow and greater momentum in their implementation is needed. While the authorities plan to repeal some of the 2022 amendments to the RBV Act that deteriorated the RBV's autonomy and governance arrangements, two remaining provisions (on the board seating allowance and the increase in the threshold of the government's borrowing) will continue to present serious challenges to RBV's independence. Legal reforms should continue and the remaining of the 2022 amendments should be repealed, in line with the Safeguards Assessment recommendations.
- **SOE governance.** Establishing supervisory frameworks for SOEs and enhancing transparency—including through timely publication of financial statements—is critical to reduce corruption vulnerabilities.
- **Public investment management**. Limited capacity to prioritize and manage infrastructure projects have led to delays and cost overruns. Centralizing all major project under a single unit (e.g., the Vanuatu Project Management Unit) from inception to completion could help reduce coordination failures. Moreover, a public investment management assessment (PIMA) could help the authorities identify gaps and expand expertise on best-practices.
- **Public financial management (PFM).** The authorities are finalizing a PFM Improvement Program for 2023–2026, a successor to the 2017–2021 PFM Reform Roadmap, with support from development partners.
- **Audits of COVID-related spending.** An external audit of the first phase of the Economic Stimulus Program has started. The authorities had planned audits the second and third phases of the stimulus, but these may be infeasible as most of the required data was lost in the November 2022 ransomware cyber-attack.

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[27] Prior to the extension, the EU had planned to implement a full suspension of the visa waiver agreement (for all Vanuatu passports) starting February 2023. Governance issues identified by the EU include concerns about due diligence, the low rejection rate and speed of approvals, granting citizenships to persons listed in Interpol databases, and lack of information exchange with applicants' country of origin.

[28] Planned reforms include administrative changes to the Citizenship Office and to application processing and management of approved agents, as well as legislative reforms to the Citizenship Act.

31. Enhancing climate resilience remains an urgent priority. Vanuatu's revised and enhanced Nationally Determined Contribution (NDC), issued in August 2022, details mitigation and adaptation needs over the next decade. The total cost is estimated at over 120 percent of 2022 GDP, and it is beyond the previously budgeted amounts. Financing plans for adaptation should be integrated into a medium-term fiscal strategy. Adequate prioritization of projects is key to maximize efficiency given capacity constraints and debt sustainability risks.

32. Policies that address skills shortages and improve labor market conditions need to be expedited. Following the reopening of borders, key economic sectors like tourism are facing a shortage of skilled labor as parts of the workforce have left to participate in international labor mobility programs (Annex V).[29] Increased participation in seasonal worker programs has created a labor drain in major economic sectors, and despite generating higher remittances, labor shortages are posing risks to growth; it will be important to evaluate the role and tradeoffs of these programs more broadly. The authorities need to improve labor market conditions and help develop local skills through apprenticeship and vocational training. There is also a need to increase the level of tourism and hospitality training and to improve female labor participation to meet tourism demand. With rising imported prices, the authorities are considering a significant hike to minimum wages (between 36 and 60 percent); this could lead to second-round effects for inflation and see more unskilled labor pushed into the informal sector. Revising the list of reserved occupations under the Employment Act could also help identify opportunities to defray the impact on the domestic labor market.

Authorities' Views

33. The authorities concurred on the importance of economic diversification, in particular in the agricultural sector. They highlighted the need for strategies to improve land productivity and reduce import dependance for food, most notably through adjustments in the types of livestock and crops produced. They also emphasized the importance of mechanization and evidence-based approaches to improve agricultural production. The authorities also acknowledged there is significant scope to streamline administrative processes for FDI and identified access to financing as a key challenge for domestic enterprises, including in the farming and fishing sectors.

34. Central bank governance and AML/CFT. The authorities will repeal some of the 2022 Amendments to the RBV Act to ensure the autonomy and independence of the central bank. They are making progress toward implementing the recommendations of the 2016 Safeguard Assessment. They have put in place a new internal auditor, a risk management unit, and approved a Board Charter. The authorities expect the upcoming APG review to be beneficial to Vanuatu even though there are many requirements that have to be met.

[29] Vanuatu has the largest participation of seasonal workers to Australia and New Zealand, even prior to the pandemic.

35. Labor market. Authorities agreed that there was a need to develop policies that will address the shortage of skilled labor and increase female participation in the local labor market. They acknowledged the potential risks of a significant increase in minimum wage as relates to increasing informality.

CAPACITY DEVELOPMENT INTEGRATION

36. The Fund is supporting Vanuatu authorities through various technical assistance. Ongoing technical assistance projects include capacity building on BOP data, financial supervision, and public financial management. While data provision is broadly adequate for surveillance purposes, statistical issues particularly on the real and external sectors will require more assistance going forward, particularly addressing issues related, but not limited, to potential measurement errors and methodological shortcomings in the consumer price index as it relates to the magnitude of price increases (see Informational Annex). The authorities requested capacity building on macro-forecasting, public investment management, national payment system, reserve management, and stress testing.

Authorities' Views

37. The authorities expressed their appreciation for the support received from the Fund and PFTAC and requested that this support be continued. The authorities reiterated their commitment to push ahead with reforms supported by capacity building, especially strengthening AML/CFT due diligence, financial sector supervision, and statistics.

STAFF APPRAISAL

38. The new government faces daunting challenges that require bold reforms. The pandemic, increase in global commodity prices, and lower revenues from the ECP reduced macroeconomic policy buffers. Prospects for the return of tourism are at risk due to the operational and financial challenges faced by the national airline, and labor shortages. Vulnerability to natural disasters increases uncertainty and reduces policy space. Bold reforms are needed to lift the country's growth potential.

39. Stronger GDP growth is expected in 2023 supported by public infrastructure spending and resumption in tourism. An expansionary fiscal policy geared toward more capital spending and a gradual recovery in tourism are expected to be the main drivers of growth in 2023. Growth will also be supported by higher agriculture production on the back of government support, ongoing recovery in trading partners, and resilient remittances.

40. Risks to the outlook are titled to the downside. Short-term to near-term risks include: (i) the spread of Covid-19 variants following the reopening of borders delaying the implementation of major infrastructure projects; (ii) a slowdown in main trading partners' growth negatively weighing on tourism and remittances; and (iii) additional losses in ECP revenue that could derail medium-term fiscal sustainability. Structural risks include: (i) increasing NPLs and their effects on banks' financial performance and lending capacity; (ii) weak governance and anti-corruption framework; and (iii) extreme vulnerability to climate change.

41. A credible medium-term fiscal strategy that secures adequate consolidation is essential for preserving debt sustainability. Given the projected decline in ECP revenues, Vanuatu's ambitious infrastructure agenda must be accompanied by tax revenue mobilization and expenditure rationalization efforts to reduce the already high deficits and keep debt below 60 percent of GDP over the next decade. Increasing tax revenues—including through the introduction of corporate or personal income taxes and through base broadening—should be at the core of any fiscal strategy. Promptly launching fiscal consolidation efforts and securing two percent of GDP in savings would help meet the fiscal anchor while protecting capital spending. Fiscal buffers should be strengthened given Vanuatu's vulnerability to natural disasters, including through expanding the sizeable cash reserves built in recent years.

42. The restructuring of Air Vanuatu must be completed urgently in order to reduce fiscal risks. Despite financial support from the government in recent years, the national airline's operational and financial challenges are worsening, with implications for tourism and domestic connectivity. The rapid assessment by Australia's DFAT is an important first step, but a careful analysis of restructuring options is needed to identify a sustainable solution that minimizes contingent liabilities and transfers from the government while preserving the airline's systemic economic role.

43. The current monetary policy stance is appropriate. Weak private credit growth, subdued core inflation, and negative output gap call for keeping monetary policy on hold to support the fragile recovery. Monetary policy should remain data-driven, and the RBV should stand ready to tighten if there are signs of second round effects such as rapid increases in core inflation.

44. Financial sector policies should focus on tackling elevated non-performing loans. The financial system appears sound overall, but high NPLs are a concern. There is a need to strengthen the supervisory and resolution framework, increase the minimum capital requirements, and provisioning for some banks. Going forward, introducing a debt-service-to-income ratio can help contain the formation of unsustainable debt.

45. Bold structural reforms are needed to unlock growth potential. The authorities should continue to promote economic diversification particularly in the agricultural sector. Improving the public investment management process is essential for strengthening the capacity to implement large-scale projects. The authorities must also prioritize streamlining administrative processes for FDI and implementing policies that may help address labor shortages.

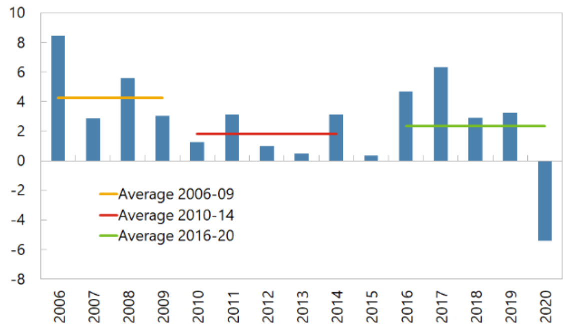
46. Strengthening AML/CFT and improving governance remain essential. The authorities need to address significant deficiencies in Vanuatu's AML/CFT regime, including by better assessing and understanding ML/TF risks faced by the jurisdiction, strengthening the AML/CFT framework to be in line with international standards (including to regulate virtual asset service provider activities), and bolstering the capacity of competent authorities and law enforcement. Reducing governance risks related to the ECP is also key. The upcoming APG review offers an opportunity to show tangible results. It is also necessary to strengthen governance in the public sector particularly with respect to the central bank and state-owned enterprises.

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

Figure 1. Vanuatu: Real Sector Developments

The pandemic caused the first GDP contraction in decades…

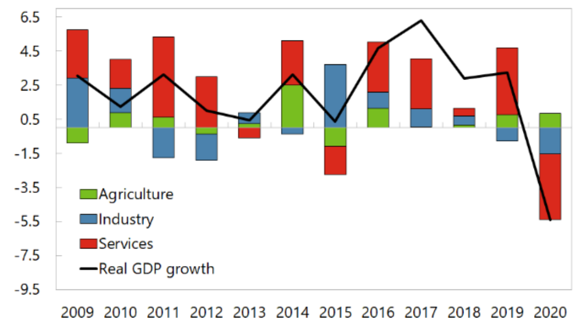
Real GDP Growth, 2006-20
(In percent, year-on-year)



Sources: Authorities; and IMF staff estimates.

… and services, via the loss of tourism, led the growth decline.

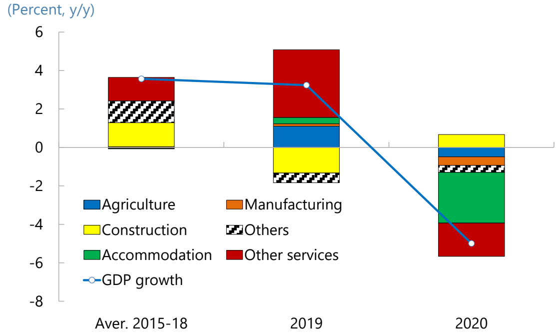
Contribution to Real GDP Growth by Sector 1/
(In percent)



Sources: Authorities; and IMF staff calculations.
1/ Sectors do not add to GDP; excludes effects of taxes and bank charges.

Apart from tourism, manufacturing also contracted.

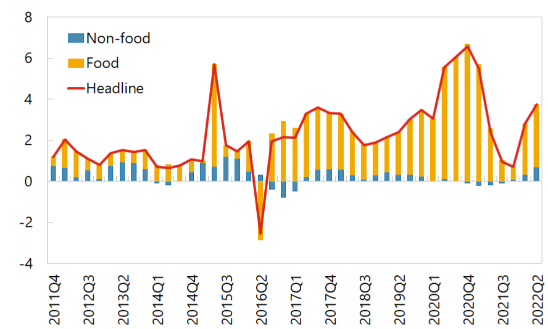
GDP Growth and Decomposition
(Percent, y/y)



Sources: Vanuatu National Statistics Office; and IMF staff estimates.
Notes: Others includes Mining & Quarrying, and Electricity & Water Supply.

Headline inflation is accelerating, led by food.

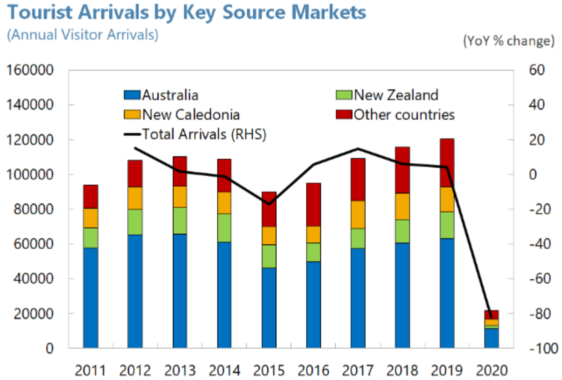
Contribution to Inflation
(In percent, year-on-year)



Sources: Vanuatu authorities; and IMF staff calculations.

The drop in tourists from the main source countries affected services.

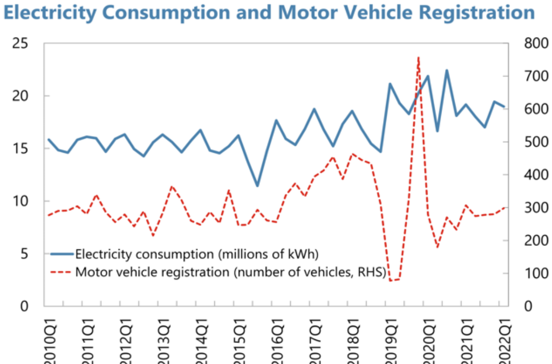
Tourist Arrivals by Key Source Markets
(Annual Visitor Arrivals)



Source: Vanuatu Authorities.

Economic indicators are now recovering.

Electricity Consumption and Motor Vehicle Registration

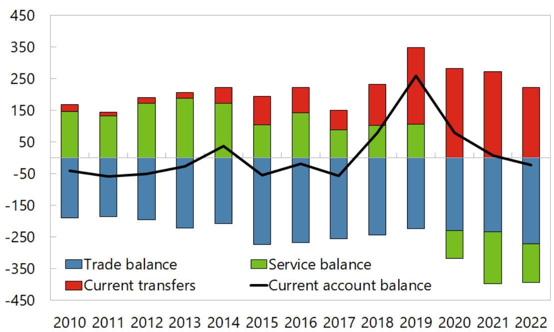


Source: Vanuatu authorities.

Figure 2. Vanuatu: External Sector Developments

The current account balance went into deficit in 2022 due to rising import prices.

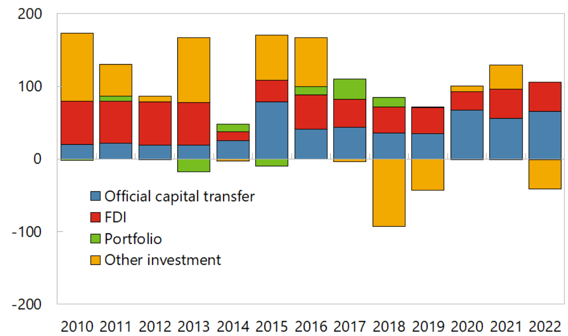
Current Account
(In millions of US dollars)



Sources: Vanuatu authorities; and IMF staff calculations.

Capital grants remained strong, and FDI is recovering.

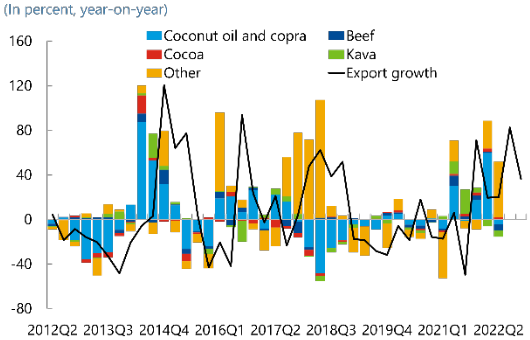
Capital and Financial Accounts
(In millions of US dollars)



Sources: Vanuatu authorities; and IMF staff calculations.

Exports, mainly agricultural products, are slowly recovering.

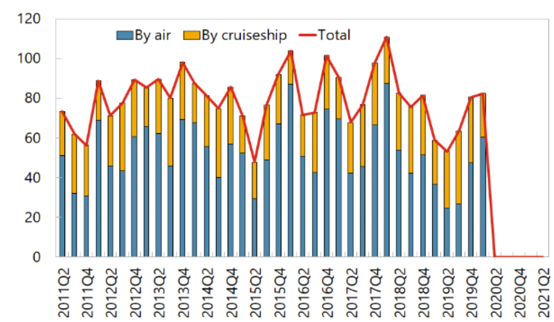
Export Growth
(In percent, year-on-year)



Source: Vanuatu authorities.

Tourism was particularly affected by the pandemic

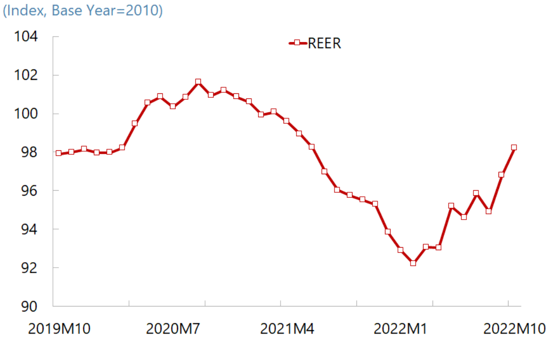
Tourist Arrivals
(In thousands of persons)



Source: Vanuatu authorities.

The real effective exchange rate appreciated in 2022 due to nominal exchange rate appreciation.

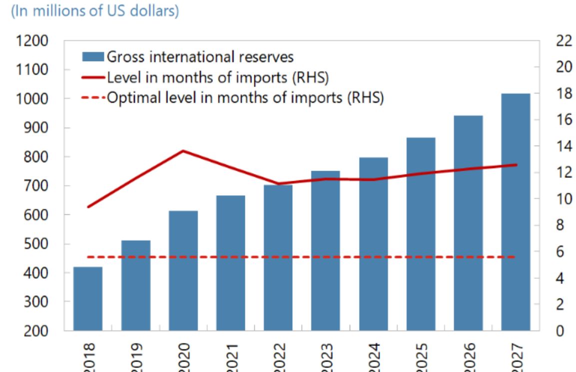
Real Effective Exchange Rate
(Index, Base Year=2010)



Sources: Reserve Bank of Vanuatu; and IMF staff calculations.

Reserves, supported by remittances and donors' funds, remain adequate.

Official Foreign Exchange Reserves
(In millions of US dollars)



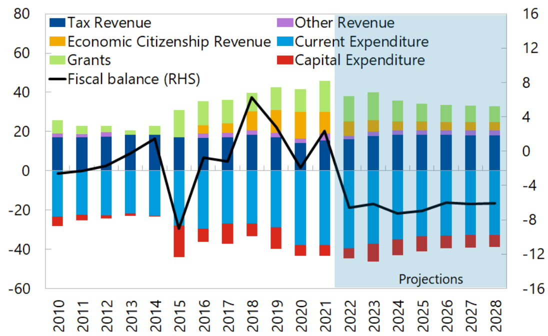
Sources: Vanuatu authorities; and IMF staff estimates.

Figure 3. Vanuatu: Fiscal and Monetary Sector Developments

Fiscal deficits will remain elevated as infrastructure projects accelerate and ECP revenues decline further.

Fiscal Revenue and Expenditure

(In percent of GDP)

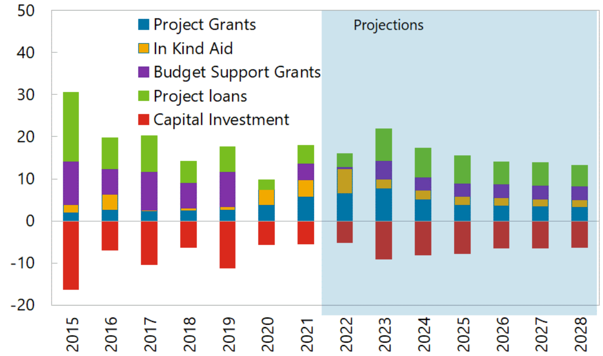


Sources: Vanuatu authorities; and IMF staff calculations.

In the medium-term, external infrastructure financing will moderate once excess from pandemic delays is absorbed.

Capital Spending and External Financing

(In percent of GDP)

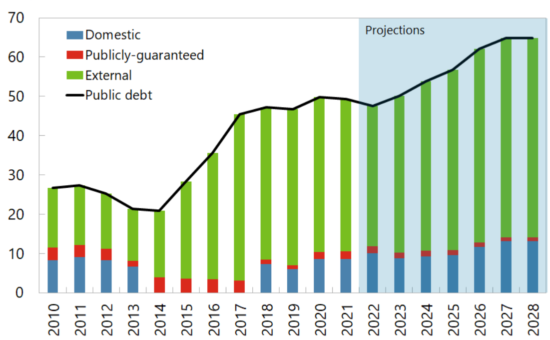


Sources: Vanuatu authorities; and IMF staff estimates.

Public debt will increase rapidly absent fiscal consolidation, reaching 60 percent of GDP by 2027.

Public and Publicly-guaranteed Debt

(In percent of GDP)

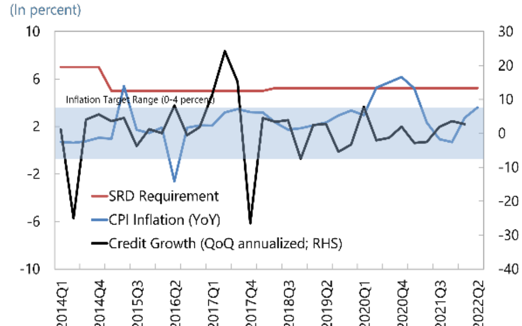


Sources: Vanuatu authorities; and IMF staff estimates.

The RBV maintained the SRD at 5 percent to support the recovery.

SRD Requirement, Inflation and Credit Growth

(In percent)

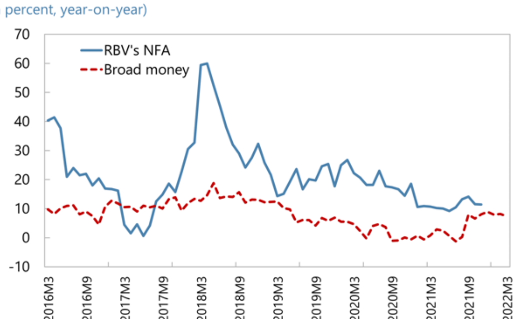


Note: SRD refers to statutory reserve deposit.
Source: Vanuatu authorities.

Money supply has increased, driven by foreign inflows.

RBV's NFA and Money Supply Growth

(In percent, year-on-year)

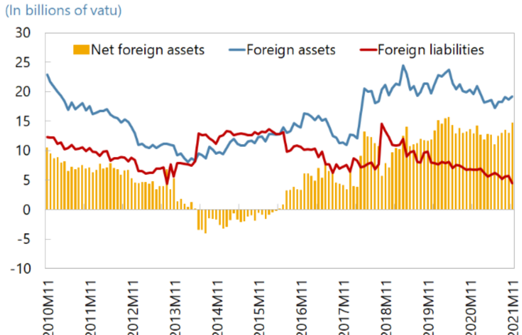


Source: Vanuatu authorities.

Net foreign assets of commercial banks are stable, through increasing asset positions.

Banks' Foreign Assets and Liabilities

(In billions of vatu)



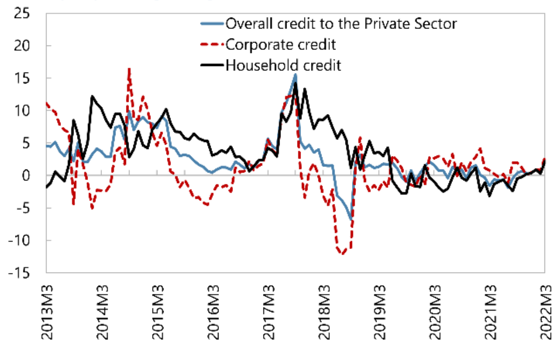
Source: Vanuatu authorities.

Figure 4. Vanuatu: Financial Sector Developments

Private credit growth is recovering…

Private Credit Growth

(Year-on-year percentage change)

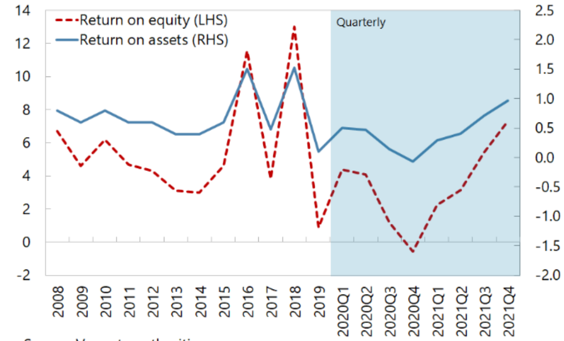


Source: Vanuatu authorities.

… boosting bank profitability…

Bank Profitability

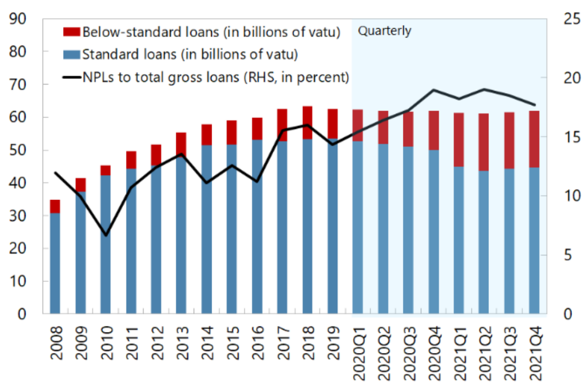
(In percent)



Source: Vanuatu authorities.

… but bank asset quality has deteriorated.

Non-Performing Loans

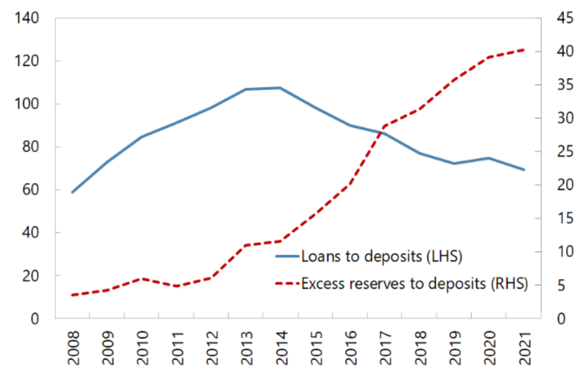


Source: Vanuatu authorities.

The banking system is liquid.

Loan-to-Deposit and Excess Reserve Ratio

(In percent)

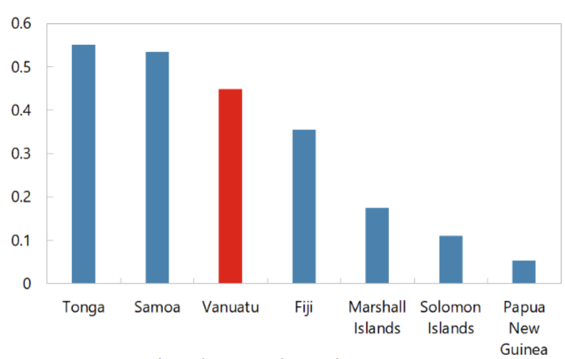


Source: Vanuatu authorities.

Financial access of households is moderately high compared to its Pacific peers…

Financial Institutions Access Index, 2020

(Bank branches and ATMs per 100,000 adults)

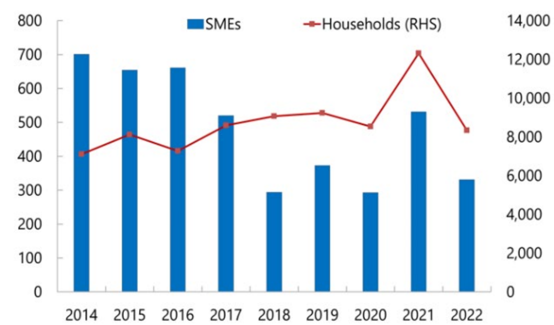


Source: IMF Financial Development Index Database.

… and access to bank loans for households and SMEs are stable.

Commercial Bank Borrowers

(Number of borrowers)



Sources: IMF Financial Access Survey; Vanuatu Authorities.

Table 1. Vanuatu: Selected Economic Indicators, 2019–28

Population (2020): 301,695
Per Capita GDP (2020): US$ 3,341
IMF quota: SDR 23.8 million (0.01 percent of total)
Literacy rate (2018): 87.5 percent
Main products and exports: Kava, coconut oil, copra, cocoa, beef
Key export markets: New Caledonia, Australia, New Zealand

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Estimates		Projections					
Output and prices (annual percent change)											
Real GDP	2.9	3.2	-5.0	0.6	1.9	3.5	3.6	3.9	3.1	3.0	2.5
Consumer prices (period average)	2.4	2.7	5.3	2.3	4.6	3.5	3.0	3.1	3.1	3.1	3.1
Consumer prices (end period)	1.9	3.5	6.6	0.7	4.9	3.9	3.1	3.1	3.1	3.1	3.1
Government finance (in percent of GDP)											
Total revenue	39.5	42.6	41.4	45.7	38.1	40.0	35.7	34.0	33.5	33.2	32.9
Taxes	18.4	16.9	14.0	15.4	16.0	17.8	18.3	18.3	18.2	18.2	18.1
Other revenue	12.0	14.1	15.9	14.5	9.1	7.9	7.0	6.8	6.5	6.5	6.5
Grants	9.2	11.7	11.5	15.9	12.9	14.3	10.5	9.0	8.7	8.5	8.2
Expenditure	33.3	39.8	43.4	43.4	44.7	46.1	42.9	41.0	39.5	39.3	39.0
Expense	26.9	28.7	37.8	38.0	39.5	37.1	34.9	33.3	33.0	32.8	32.8
Net acquisition of non financial assets	6.4	11.1	5.6	5.4	5.2	9.0	8.0	7.7	6.5	6.5	6.2
Net lending (+)/borrowing (-)	6.3	2.8	-1.9	2.3	-6.6	-6.2	-7.3	-6.9	-6.0	-6.2	-6.1
Public and publicly-guaranteed debt (end of period)	46.3	45.9	48.9	48.4	46.6	49.2	53.1	56.1	58.5	61.4	64.3
Domestic	7.3	6.0	8.6	8.6	10.1	8.8	9.3	9.6	10.3	11.7	13.1
External	39.0	39.9	40.4	39.8	36.5	40.5	43.7	46.5	48.3	49.7	51.1
Money and credit (annual percentage change)											
Broad money (M2)	-0.5	9.2	5.3	14.2	9.1	7.4	13.7	7.1	7.7	8.0	8.4
Net foreign assets	39.0	24.2	16.9	8.4	8.7	9.0	15.2	6.9	7.4	6.9	7.5
Domestic credit	-4.4	-6.4	-9.5	8.5	5.8	1.2	5.0	4.8	5.7	7.6	7.8
Of which: Credit to private sector	1.2	0.4	1.5	0.3	0.6	1.6	1.6	1.6	1.6	1.6	1.6
Interest rates (in percent, end of period) 1/											
Deposit rate (vatu deposits)	1.2	0.8	0.7	0.5	…	…	…	…	…	…	…
Lending rate (vatu loans)	10.0	9.9	9.5	9.4	…	…	…	…	…	…	…
Balance of payments (in percent of GDP)											
Current account	8.7	27.8	7.9	0.8	-2.2	-3.6	-1.2	2.2	2.6	2.3	2.3
Trade balance	-26.2	-24.0	-22.8	-24.9	-27.0	-32.2	-30.0	-29.0	-27.9	-27.6	-27.6
Exports of goods	6.9	5.0	5.1	5.6	6.1	6.2	5.9	5.9	5.9	5.9	5.9
Imports of goods	-33.1	-28.9	-27.8	-30.4	-33.1	-38.4	-35.9	-34.9	-33.8	-33.6	-33.5
Travel receipts	26.6	28.8	6.2	0.2	5.1	15.9	18.9	22.9	22.6	22.4	22.2
Gross Remittances	11.9	15.5	11.9	16.3	17.0	16.6	15.9	15.7	15.7	15.7	15.7
Capital and financial account	0.0	3.9	11.6	14.6	6.3	8.2	5.3	3.5	3.6	3.5	4.1
Of which: Foreign direct investment	3.9	3.8	2.5	4.3	4.0	3.7	3.7	3.8	3.9	3.8	3.7
Overall balance	2.7	9.8	10.1	5.4	4.1	4.6	4.1	5.7	6.1	5.8	6.4
Gross international reserves (in millions of U.S. dollars)	420.6	511.6	613.6	664.8	706.0	754.5	801.4	871.1	950.5	1,030.2	1,122.7
Gross international reserves (in months of prospective G&S imports)	9.4	11.5	13.6	13.1	10.9	11.5	11.5	12.0	12.4	12.7	13.0
External debt service (in percent of GNFS exports)	4.3	6.9	16.6	39.5	27.3	4.5	4.1	3.7	3.8	4.9	4.8
Exchange rates 2/											
Vatu per U.S. dollar (period average)	108.5	115.6	104.1	112.9	113.5	…	…	…	…	…	…
Vatu per U.S. dollar (end of period)	112.3	114.3	107.7	112.2	114.8	…	…	…	…	…	…
Memorandum items:											
Nominal GDP (in millions of U.S. dollars)	929	930	1,008	942	1,001	1,064	1,137	1,217	1,293	1,372	1,449
GDP per capita (U.S. dollars)	3256.4	3187.4	3341.0	3017.7	3103.0	3188.5	3292.4	3408.6	3501.9	3592.6	3668.2

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

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

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

Table 2. Vanuatu: Central Government Budgetary Operations, 2019–28

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Estimates		Projections				
					(In millions of vatu)					
Total revenue	45,807	43,471	48,652	43,260	48,829	46,563	47,569	49,683	52,232	54,785
Domestic revenue	33,254	31,399	31,718	28,561	31,360	32,918	35,054	36,733	38,919	41,063
Taxes	18,154	14,732	16,336	18,201	21,737	23,834	25,606	27,020	28,612	30,179
Taxes on property	606	496	468	443	521	556	595	633	671	709
Taxes on goods and services	13,864	11,097	11,906	13,862	16,447	18,536	20,100	21,359	22,663	23,933
Taxes on international trade	3,684	3,140	3,962	3,896	4,769	4,743	4,911	5,029	5,278	5,537
Other revenue	15,101	16,667	15,382	10,361	9,623	9,084	9,448	9,713	10,306	10,884
Of which: Economic citizenship programs	12,558	14,352	11,647	8,482	7,133	6,053	6,202	6,263	6,646	7,018
Grants from development partners 2/	12,552	12,072	16,934	14,699	17,469	13,645	12,514	12,950	13,313	13,722
Expenditure	42,786	45,514	46,175	50,763	56,358	56,032	57,250	58,623	61,968	64,870
Current Expenditure 3/	30,817	39,645	40,411	44,903	45,317	45,559	46,465	48,998	51,662	54,491
Compensation of employees	14,270	15,471	16,796	17,583	19,129	20,088	21,327	22,644	24,015	25,327
Use of goods and services	9,598	9,810	10,574	11,579	13,489	12,248	11,536	12,187	12,881	13,468
Interest payment	942	863	1,005	1,033	1,211	1,311	1,475	1,651	1,857	2,164
Subsidies	201	1,510	422	330	355	379	406	431	457	483
Grants by central government	2,514	4,646	4,574	4,147	4,458	4,667	4,572	4,805	5,061	5,243
Social benefits	616	1,315	500	1,296	1,149	1,227	1,313	1,396	1,481	1,564
Other expense 2/	2,676	6,030	6,540	8,936	5,528	5,641	5,836	5,884	5,911	6,242
Acquisition of nonfinancial assets 3/	11,969	5,869	5,764	5,860	11,041	10,473	10,785	9,625	10,305	10,379
Gross operating balance 4/	14,990	3,826	8,240	-1,643	3,511	1,004	1,104	685	570	294
Domestic fiscal balance 5/	6,674	2,017	-177	-6,321	-3,669	-4,672	-5,043	-5,995	-6,519	-7,192
Net lending (+)/borrowing (-))	3,021	-2,043	2,476	-7,503	-7,530	-9,469	-9,681	-8,940	-9,736	-10,085
Net acquisition of financial assets	6,240	589	3,640	-5,994	-129	-129	-429	-429	71	71
Net incurrence of liabilities	3,219	2,646	1,265	1,510	7,400	9,339	9,252	8,510	9,806	10,156
Domestic	-673	2,448	137	2,332	-807	1,445	1,451	2,017	3,319	3,712
Foreign	3,892	198	1,128	-822	8,207	7,894	7,800	6,494	6,487	6,444
Memorandum items:										
Public and publicly-guaranteed debt	49,354	51,326	51,473	53,009	60,147	69,224	78,599	87,309	97,315	107,671
Domestic	6,492	8,974	9,160	11,518	10,711	12,156	13,608	15,624	18,943	22,655
Publicly guaranteed	898	935	984	1,010	1,010	1,010	1,010	1,010	1,010	1,010
External	42,862	42,352	42,313	41,491	49,436	57,067	64,991	71,685	78,372	85,016
Debt service	4,076	4,529	5,269	6,406	3,303	3,344	2,555	3,802	3,576	3,870
External debt service	2,950	2,734	3,853	4,734	1,453	1,550	1,721	1,839	2,497	2,592
Primary balance	3,963	-1,180	3,481	-6,470	-6,319	-8,158	-8,207	-7,288	-7,879	-7,921
					(In percent of GDP)					
Total revenue	42.6	41.4	45.7	38.1	40.0	35.7	34.0	33.5	33.2	32.9
Domestic revenue	30.9	29.9	29.8	25.1	25.7	25.2	25.1	24.7	24.7	24.7
Taxes	16.9	14.0	15.4	16.0	17.8	18.3	18.3	18.2	18.2	18.1
Taxes on property	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Taxes on goods and services	12.9	10.6	11.2	12.2	13.5	14.2	14.4	14.4	14.4	14.4
Taxes on international trade	3.4	3.0	3.7	3.4	3.9	3.6	3.5	3.4	3.4	3.3
Other revenue	14.1	15.9	14.5	9.1	7.9	7.0	6.8	6.5	6.5	6.5
Of which: Economic citizenship programs	11.7	13.7	11.0	7.5	5.8	4.6	4.4	4.2	4.2	4.2
Grants from development partners	11.7	11.5	15.9	12.9	14.3	10.5	9.0	8.7	8.5	8.2
Infrastructure projects grants	2.6	3.7	5.6	6.6	7.6	5.0	3.6	3.5	3.4	3.2
Budget support and social program	9.1	7.8	10.3	0.5	4.4	3.1	3.2	3.3	3.3	3.3
In kind aid	0.0	0.0	0.0	5.9	2.4	2.4	2.1	1.9	1.7	1.7
Expenditure	39.8	43.4	43.4	44.7	46.1	42.9	41.0	39.5	39.3	39.0
Current Expenditure 3/	28.7	37.8	38.0	39.5	37.1	34.9	33.3	33.0	32.8	32.8
Compensation of employees	13.3	14.7	15.8	15.5	15.7	15.4	15.3	15.3	15.2	15.2
Use of goods and services	8.9	9.3	9.9	10.2	11.0	9.4	8.3	8.2	8.2	8.1
Interest payment	0.9	0.8	0.9	0.9	1.0	1.0	1.1	1.1	1.2	1.3
Subsidies	0.2	1.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Grants by central government	2.3	4.4	4.3	3.6	3.6	3.6	3.3	3.2	3.2	3.2
Social benefits	0.6	1.3	0.5	1.1	0.9	0.9	0.9	0.9	0.9	0.9
Other expense 2/	2.5	5.7	6.1	7.9	4.5	4.3	4.2	4.0	3.8	3.8
Acquisition of nonfinancial assets 3/	11.1	5.6	5.4	5.2	9.0	8.0	7.7	6.5	6.5	6.2
Gross operating balance 4/	14.0	3.6	7.7	-1.4	2.9	0.8	0.8	0.5	0.4	0.2
Domestic fiscal balance 5/	6.2	1.9	-0.2	-5.6	-3.0	-3.6	-3.6	-4.0	-4.1	-4.3
Net lending (+)/borrowing (-)	2.8	-1.9	2.3	-6.6	-6.2	-7.3	-6.9	-6.0	-6.2	-6.1
Net acquisition of financial assets	5.8	0.6	3.4	-5.3	-0.1	-0.1	-0.3	-0.3	0.0	0.0
Net incurrence of liabilities	3.0	2.5	1.2	1.3	6.1	7.2	6.6	5.7	6.2	6.1
Memorandum items:										
Public and publicly-guaranteed debt	45.9	48.9	48.4	46.6	49.2	53.1	56.1	58.5	61.4	64.3
Domestic	6.0	8.6	8.6	10.1	8.8	9.3	9.6	10.3	11.7	13.1
External	39.9	40.4	39.8	36.5	40.5	43.7	46.5	48.3	49.7	51.1
Of which: RCF/RFI	1.6	1.0	0.9	0.6	0.3	0.1	0.0	0.0	0.0	0.0
Debt service	3.8	4.3	5.0	5.6	2.7	2.6	1.8	2.6	2.3	2.3
Of which: External debt service	2.7	2.6	3.6	4.2	1.2	1.2	1.2	1.2	1.6	1.6
Primary balance	3.7	-1.1	3.3	-5.7	-5.2	-6.3	-5.9	-4.9	-5.0	-4.8
Nominal GDP (millions of vatu)	107,450	104,929	106,348	113,653	122,174	130,480	139,717	148,464	157,533	166,360

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

1/ Fiscal year corresponds to the calendar year.

2/ Includes aid in kind; the large decline between 2022 and 2023 reflects the reduction in COVID-related aid in kind.

3/ Does not include consumption of fixed capital (depreciation).

4/ Gross operating balance is used instead of net, as there is no data on consumption of fixed capital (depreciation).

5/ Defined as domestic revenue minus government-funded expense and acquisition of nonfinancial assets.

Table 3. Vanuatu: Reconciling the Domestic Budget with the IMF Presentation, 2019–28

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
			Estimates			Projections				
Domestic budget (excluding development partners)										
				(In millions of vatu)						
Revenue (excluding development partner grants)	33,254	34,030	33,664	29,116	31,360	32,918	35,054	36,733	38,919	41,063
- Expense (excluding development partners)	25,580	30,575	32,554	33,029	33,173	35,999	38,394	40,918	43,516	46,225
= Gross operating balance (excluding development partners)	**7,674**	**3,456**	**1,109**	**-3,912**	**-1,813**	**-3,081**	**-3,339**	**-4,185**	**-4,598**	**-5,163**
- Acquisition of non-financial assets (excluding development partners)	1,001	1,439	1,286	2,409	1,857	1,591	1,704	1,811	1,921	2,029
= Net lending/borrowing (excluding development partners)	**6,674**	**2,017**	**-177**	**-6,321**	**-3,669**	**-4,672**	**-5,043**	**-5,995**	**-6,519**	**-7,192**
				(In percent of GDP)						
Revenue (excluding development partner grants)	30.9	32.4	31.7	25.6	25.7	25.2	25.09	24.74	24.71	24.68
- Expenses (excluding development partners)	23.8	29.1	30.6	29.1	27.2	27.6	27.5	27.6	27.6	27.8
= Gross operating balance (excluding development partners)	**7.1**	**3.3**	**1.0**	**-3.4**	**-1.5**	**-2.4**	**-2.4**	**-2.8**	**-2.9**	**-3.1**
- Fixed assets (excluding development partners)	0.9	1.4	1.2	2.1	1.5	1.2	1.2	1.2	1.2	1.2
= Net lending/borrowing (excluding development partners)	**6.2**	**1.9**	**-0.2**	**-5.6**	**-3.0**	**-3.6**	**-3.6**	**-4.0**	**-4.1**	**-4.3**
Consolidated budget (including development partners)										
				(In millions of vatu)						
Gross operating balance (excluding development partners)	**7,674**	**3,456**	**1,109**	**-3,912**	**-1,813**	**-3,081**	**-3,339**	**-4,185**	**-4,598**	**-5,163**
+ Additional revenues (development partners grants)	12,552	9,440	14,988	14,144	17,469	13,645	12,514	12,950	13,313	13,722
- Additional expenses (using development partner grants and/or loans)	5,237	9,070	7,857	11,875	12,145	9,560	8,071	8,080	8,146	8,265
= Gross operating balance (overall)	**14,990**	**3,826**	**8,240**	**-1,643**	**3,511**	**1,004**	**1,104**	**685**	**570**	**294**
- Fixed assets (excluding development partners)	1,001	1,439	1,286	2,409	1,857	1,591	1,704	1,811	1,921	2,029
- Fixed assets (using development partner loans)	10,969	4,430	4,478	3,451	9,184	8,881	9,081	7,814	8,384	8,350
= Net lending/borrowing (overall)	**3,021**	**-2,043**	**2,476**	**-7,503**	**-7,530**	**-9,469**	**-9,681**	**-8,940**	**-9,736**	**-10,085**
				(In percent of GDP)						
Gross operating balance (excluding development partners)	**7.1**	**3.3**	**1.0**	**-3.4**	**-1.5**	**-2.4**	**-2.4**	**-2.8**	**-2.9**	**-3.1**
+ Additional revenues (development partners grants)	11.7	9.0	14.1	12.4	14.3	10.5	9.0	8.7	8.5	8.2
- Additional expenses (using development partner grants and/or loans)	4.9	8.6	7.4	10.4	9.9	7.3	5.8	5.4	5.2	5.0
= Gross operating balance (overall)	**14.0**	**3.6**	**7.7**	**-1.4**	**2.9**	**0.8**	**0.8**	**0.5**	**0.4**	**0.2**
- Acquisition of non-financial assets (excluding development partners)	0.9	1.4	1.2	2.1	1.5	1.2	1.2	1.2	1.2	1.2
- Acquisition of non-financial assets (using development partners' loans)	10.2	4.2	4.2	3.0	7.5	6.8	6.5	5.3	5.3	5.0
= Net lending/borrowing (overall)	**2.8**	**-1.9**	**2.3**	**-6.6**	**-6.2**	**-7.3**	**-6.9**	**-6.0**	**-6.2**	**-6.1**
Memorandum items:										
Nominal GDP (millions of vatu)	107,450	104,929	106,348	113,653	122,174	130,480	139,717	148,464	157,533	166,360

Sources: Vanuatu authorities; and IMF staff estimates and projections.
1/ Fiscal year corresponds to the calendar year.

Table 4. Vanuatu: Monetary Survey, 2019–24

	2019	2020	2021	2022	2023	2024
			Estimates	Projections		
	(In millions of vatu; end of period)					
Net foreign assets	67,017	78,328	84,941	92,321	100,671	115,953
Monetary authorities	55,212	65,469	70,609	75,339	80,914	86,297
Commercial banks	11,805	12,859	14,332	16,982	19,756	29,656
Net domestic assets	25,265	18,826	26,006	28,697	29,282	31,785
Domestic credit	47,349	42,842	46,499	49,190	49,775	52,278
Claims on government (net)	-15,803	-21,116	-17,833	-15,502	-16,309	-14,863
Claims on municipalities	67	37	31	31	31	31
Claims on other sectors	63,085	63,921	64,301	64,661	66,052	67,110
Claims on nonfinancial public enterprises	1,067	949	1,141	1,098	1,448	1,448
Claims on private sector	62,017	62,972	63,160	63,563	64,604	65,663
Other items (net)	-22,084	-24,016	-20,493	-20,493	-20,493	-20,493
Total broad money (M2)	92,282	97,154	110,947	121,018	129,952	147,738
Narrow money	62,949	67,668	76,326	89,282	101,047	126,970
Currency outside banks	9,345	10,384	11,333	14,999	16,147	29,934
Demand deposits	53,603	57,284	64,993	74,283	84,901	97,037
Quasi-money	29,334	29,486	34,621	31,737	28,905	20,768
	ınual percentage change, unless otherwise indicat					
Net foreign assets	24.2	16.9	8.4	8.7	9.0	15.2
Net domestic assets	-17.2	-25.5	38.1	10.3	2.0	8.6
Domestic credit	-6.4	-9.5	8.5	5.8	1.2	5.0
Credit to the economy	0.4	1.3	0.6	0.6	2.2	1.6
Private sector credit	0.4	1.5	0.3	0.6	1.6	1.6
Total broad money	9.2	5.3	14.2	9.1	7.4	13.7
Vatu broad money	9.4	5.2	9.0	12.0	9.6	18.4
Memorandum items:						
Vatu broad money multiplier	1.3	1.3	1.2	1.2	1.2	1.1
Total broad money multiplier	1.5	1.4	1.5	1.4	1.3	1.2
Velocity						
Narrow money	1.8	1.6	1.6	1.4	1.3	1.1
Vatu broad money	1.4	1.2	1.2	1.1	1.1	1.0
Total broad money	1.2	1.1	1.0	1.0	1.0	1.0
Reserve money (in millions of vatu)	58,718	68,427	73,311	78,714	84,436	90,444
Reserve money (annual percentage change)	15.2	16.5	7.1	7.4	7.3	7.1
Credit to private sector (in percent of GDP)	57.7	60.0	59.4	55.9	52.9	50.3
Foreign currency deposits (annual percentage change)	4.7	0.3	24.7	-8.3	-8.9	-28.1
Foreign currency deposits/total deposits (percent)	11.1	11.3	15.8	13.6	11.5	8.0
Foreign currency credit/total credit (percent)	29.8	28.4	27.5	27.5	27.5	27.5
Net foreign assets of banks (in millions of U.S. dollars)	103.3	119.4	127.7	147.9	172.1	258.4
Net foreign assets (in percent of GDP)	62.4	74.6	79.9	81.2	82.4	88.9
Nominal GDP (in millions of vatu)	107,450	104,929	106,348	113,653	122,174	130,480

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

Table 5. Vanuatu: Balance of Payments, 2019–28

(in percent of GDP, unless otherwise stated)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
				Estimates		Projections				
Current account balance	**27.8**	**7.9**	**0.8**	**-2.2**	**-3.6**	**-1.2**	**2.2**	**2.6**	**2.3**	**2.3**
Trade balance	**-24.0**	**-22.8**	**-24.9**	**-27.0**	**-32.2**	**-30.0**	**-29.0**	**-27.9**	**-27.6**	**-27.6**
Exports of goods (f.o.b.)	5.0	5.1	5.6	6.1	6.2	5.9	5.9	5.9	5.9	5.9
Domestic exports	4.8	4.4	5.3	5.4	5.5	5.5	5.5	5.5	5.5	5.5
Re-exports	0.2	0.6	0.2	0.7	0.7	0.4	0.5	0.4	0.4	0.4
Imports of goods (f.o.b.)	-28.9	-27.8	-30.4	-33.1	-38.4	-35.9	-34.9	-33.8	-33.6	-33.5
Services balance	**11.5**	**-8.8**	**-17.3**	**-12.2**	**-7.0**	**-3.0**	**0.0**	**-0.3**	**-0.5**	**-0.7**
Receipts	34.9	10.6	3.6	9.1	20.0	23.0	27.0	26.7	26.5	26.3
Of which: travel	28.8	6.2	0.2	5.1	15.9	18.9	22.9	22.6	22.4	22.2
Payments	-23.3	-19.4	-20.9	-21.3	-27.0	-26.0	-27.0	-27.0	-27.0	-27.0
Primary income	**14.3**	**11.4**	**14.1**	**14.9**	**14.5**	**13.6**	**13.5**	**13.4**	**13.4**	**13.5**
Receipts	17.6	13.6	17.8	18.6	18.2	17.3	17.2	17.1	17.1	17.2
Gross Remittances	15.5	11.9	16.3	17.0	16.6	15.9	15.7	15.7	15.7	15.7
Payments	-3.3	-2.2	-3.6	-3.6	-3.7	-3.7	-3.7	-3.7	-3.7	-3.7
Secondary income	**25.9**	**28.1**	**28.8**	**22.1**	**21.1**	**18.1**	**17.7**	**17.3**	**17.0**	**17.0**
Official	15.7	21.3	24.0	16.4	15.4	12.4	12.0	11.6	11.3	11.3
Economic Citizenship Program Revenues	10.5	11.7	11.0	7.5	5.8	4.6	4.4	4.2	4.2	4.2
Private	5.4	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7
Capital and financial accounts	**3.9**	**11.6**	**14.6**	**6.3**	**8.2**	**5.3**	**3.5**	**3.6**	**3.5**	**4.1**
Capital account	**4.6**	**8.4**	**6.9**	**6.4**	**6.7**	**4.1**	**2.9**	**2.8**	**2.8**	**2.6**
Of which: Official capital transfers (net)	3.8	6.7	5.9	6.6	7.6	5.0	3.6	3.5	3.4	3.2
Financial account	**-0.7**	**3.2**	**7.8**	**-0.1**	**1.5**	**1.2**	**0.6**	**0.7**	**0.7**	**1.5**
Foreign direct investment	3.8	2.5	4.3	4.0	3.7	3.7	3.8	3.9	3.8	3.7
Portfolio investment	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other investment	-4.6	0.8	3.5	-4.1	-2.1	-2.5	-3.1	-3.0	-3.0	-2.1
Net errors and omissions	**-22.0**	**-9.3**	**-10.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Overall balance	**9.8**	**10.1**	**5.4**	**4.1**	**4.6**	**4.1**	**5.7**	**6.1**	**5.8**	**6.4**
Financing:	**-10.4**	**-10.5**	**-5.7**	**-4.3**	**-4.8**	**-4.3**	**-5.8**	**-6.1**	**-5.8**	**-6.4**
Change in international reserves (- = increase)	-9.8	-10.1	-5.4	-4.1	-4.6	-4.1	-5.7	-6.1	-5.8	-6.4
IMF's RCF/RFI	-0.6	-0.4	-0.3	-0.2	-0.2	-0.2	-0.1	0.0	0.0	0.0
Memorandum items:										
Gross international reserves	55.0	60.9	70.6	70.5	70.9	70.5	71.6	73.5	75.1	77.5
In months of prospective imports	11.5	13.6	13.1	10.9	11.5	11.5	12.0	12.4	12.7	13.0
Exports of goods (annual percentage change)	-27.7	10.3	2.7	16.5	8.1	2.1	6.9	5.8	6.9	5.8
Imports of goods (annual percentage change)	-12.5	4.4	2.1	15.7	23.0	-0.1	4.1	2.9	5.4	5.4
Exchange rate (vatu per U.S. dollar, period average)	115.6	104.1	112.9	...	...	...	...	...	...	...
Exchange rate (vatu per U.S. dollar, end of period)	114.3	107.7	112.2	...	...	...	...	...	...	...
Public external debt	39.9	40.4	39.8	36.5	40.5	43.7	46.5	49.7	51.1	51.1
Public external debt service (in percent of G&S exports)	6.9	16.6	39.5	27.3	4.5	4.1	3.7	3.8	4.9	4.8
Nominal GDP	930	1,008	942	1,001	1,064	1,137	1,217	1,293	1,372	1,449

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

Table 6. Vanuatu: Medium-Term Baseline Scenario, 2019–2028

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
		Estimates		Projections						
Output and prices (annual percentage change)										
Real GDP	3.2	-5.0	0.6	1.9	3.5	3.6	3.9	3.1	3.0	2.5
Consumer prices (period average)	2.7	5.3	2.3	4.6	3.5	3.0	3.1	3.1	3.1	3.1
Consumer prices (end period)	3.5	6.6	0.7	4.9	3.9	3.1	3.1	3.1	3.1	3.1
Government finances (in percent of GDP)										
Total revenue	42.6	41.4	45.7	38.1	40.0	35.7	34.0	33.5	33.2	32.9
Taxes	16.9	14.0	15.4	16.0	17.8	18.3	18.3	18.2	18.2	18.1
Other revenue	14.1	15.9	14.5	9.1	7.9	7.0	6.8	6.5	6.5	6.5
Grants	11.7	11.5	15.9	12.9	14.3	10.5	9.0	8.7	8.5	8.2
Expenditure	39.8	43.4	43.4	44.7	46.1	42.9	41.0	39.5	39.3	39.0
Expense 1/	28.7	37.8	38.0	39.5	37.1	34.9	33.3	33.0	32.8	32.8
Acquisition of nonfinancial assets 1/	11.1	5.6	5.4	5.2	9.0	8.0	7.7	6.5	6.5	6.2
Net lending (+)/borrowing (-)	2.8	-1.9	2.3	-6.6	-6.2	-7.3	-6.9	-6.0	-6.2	-6.1
Public and publicly-guaranteed debt (end of period)	45.9	48.9	48.4	46.6	49.2	53.1	56.1	58.5	61.4	64.3
Domestic	6.0	8.6	8.6	10.1	8.8	9.3	9.6	10.3	11.7	13.1
External	39.9	40.4	39.8	36.5	40.5	43.7	46.5	48.3	49.7	51.1
Of which: RCF/RFI	1.6	1.0	0.9	0.6	0.3	0.1	0.0	0.0	0.0	0.0
Balance of payments (in percent of GDP)										
Current account	27.8	7.9	0.8	-2.2	-3.6	-1.2	2.2	2.6	2.3	2.3
Trade balance	-24.0	-22.8	-24.9	-27.0	-32.2	-30.0	-29.0	-27.9	-27.6	-27.6
Exports of goods	5.0	5.1	5.6	6.1	6.2	5.9	5.9	5.9	5.9	5.9
Imports of goods	-28.9	-27.8	-30.4	-33.1	-38.4	-35.9	-34.9	-33.8	-33.6	-33.5
Travel receipts	28.8	6.2	0.2	5.1	15.9	18.9	22.9	22.6	22.4	22.2
Capital and financial account	3.9	11.6	14.6	6.3	8.2	5.3	3.5	3.6	3.5	4.1
Of which: Foreign direct investment	3.8	2.5	4.3	4.0	3.7	3.7	3.8	3.9	3.8	3.7
Overall balance	9.8	10.1	5.4	4.1	4.6	4.1	5.7	6.1	5.8	6.4
Gross international reserves (in millions of U.S. dollars)	512	614	665	706	755	801	871	950	1030	1123
(in months of prospective G&S imports)	11.5	13.6	13.1	10.9	11.5	11.5	12.0	12.4	12.7	13.0
External debt service (in percent of GNFS exports)	6.9	16.6	39.5	27.3	4.5	4.1	3.7	3.8	4.9	4.8
Memorandum items:										
Nominal GDP (in billions of vatu)	107.5	104.9	106.3	113.7	122.2	130.5	139.7	148.5	157.5	166.4
Nominal GDP (in millions of U.S. dollars)	930	1,008	942	1,001	1,064	1,137	1,217	1,293	1,372	1,449

Sources: Vanuatu authorities and IMF staff estimates and projections.

1/ Does not include consumption of fixed capital (depreciation).

Table 7. Vanuatu: Banks' Financial Soundness Indicators, 2017–22

	2017	2018	2019	2020	2021	2022Q1
Capital adequacy						
Regulatory capital to risk-weighted assets	18.0	20.1	19.2	20.0	24.1	23.3
Regulatory Tier 1 capital to risk-weighted assets	15.6	16.3	17.9	18.9	21.5	22.7
Asset quality						
Nonperforming loans net of provisions to capital	57.1	52.2	42.5	57.5	48.9	46.7
Nonperforming loans to total gross loans	15.6	16.0	14.4	19.0	17.7	16.3
Earnings and profitability						
Return on assets	0.5	1.5	0.1	-0.1	1.0	0.9
Return on equity	3.8	13.0	0.9	-0.6	7.3	6.5
Interest margin to gross income	63.6	65.3	65.1	68.0	69.0	65.4
Noninterest expenses to gross income	63.2	63.3	70.4	78.1	71.8	77.4
Liquidity						
Liquid assets to total assets (liquid asset ratio)	35.5	45.2	43.6	44.0	46.0	47.6

Source: Reserve Bank of Vanuatu.

[1/] There are seasonal effects explaining the quarterly trend in the return on assets and return on equity as banks pay some non-interest expenses and overhead costs towards year end. Provisioning expenses also tend to be higher by year end.

Table 8. Vanuatu: Integration Matrix of Surveillance Issues and Capacity Building

Surveillance Issues	IMF			Asian Development		World Bank	
	Past	2022 1/	Planned/ Ongoing	Past	Planned/ Ongoing	Past	Planned/ Ongoing
Fiscal Sector:							
Public financial manegement	✓	✓	✓			✓	✓
Expenditure framework			✓				
Revenue framework	✓	✓	✓				
Macro-financial Issues:							
Financial Supervision and Regulation	✓	✓	✓	✓	✓		
Financial Market Development				✓	✓		
Correspondent Banking Partnerships			✓		✓		
Macro-structural Issues:							
Infrastructure				✓	✓	✓	✓
Private sector development				✓	✓		
Governance issues				✓	✓		
Poverty/gender/inequality							
Climate change							
Natural disaster management						✓	✓
Financial inclusion				✓	✓		
Statistics:							
Data enhancement	✓	✓	✓				
1/ IMF Fiscal year.							

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Annex I. Authorities' Actions to Previous Fund Policy Advice

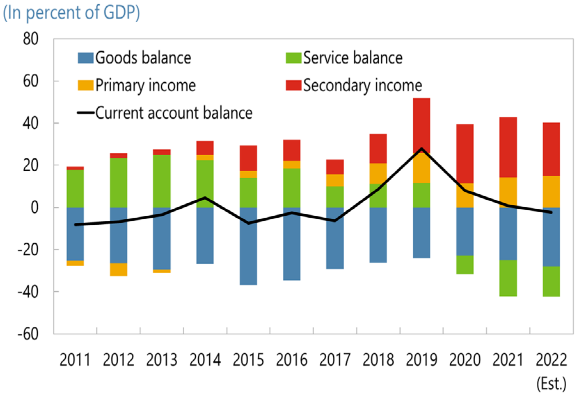
Fund Recommendation	Policy Actions
Fiscal Policy	
Formulate a medium-term fiscal strategy; complete the proposed 2017 tax reforms that include the introduction of a personal and corporate income taxes; and stabilize expenditures as a share of GDP.	• The authorities did not formulate a medium-term fiscal strategy, and did not adopt the 2017 tax reforms and have not introduced an income tax • The authorities established a national revenue governance committee to oversee the government's efforts in expanding its revenue base, but it has not yet been staffed.
Properly manage fiscal risks by minimizing the contingent the contingent liabilities of Air Vanuatu; establish effective supervision and transparency of SOEs and limit and prioritize their external borrowing.	• There has been no progress on SOEs governance reform since the last Article IV consultation; the unit overseeing SOEs at the MFEM (GBE Unit) has been reactivated and is working on collecting data on SOE debt and finances. • Air Vanuatu continues to be a drag on the budget and its restructuring has been delayed.
Monetary Policy	
The RBV should maintain an accommodative macroeconomic and financial policies in the near term to support the recovery.	• The RBV has kept unchanged the policy and statutory reserve deposit (SRD) rates to support the economy. • The authorities are also gradually withdrawing the financial support measures given the ongoing recovery.
Financial Sector Policy	
Closely monitor the banking sector and establish crisis management frameworks.	• The authorities stated that they are closely monitoring the banking system to safeguard financial stability. They are eager to establish crisis management framework and resolution frameworks in the future.
Strengthen legal frameworks and institutional capacities on AML/CFT.	• Legislative frameworks have been developed and amended, including to the AML/CFT Act with regard to its governance and structure resulting in re-establishing the Financial Intelligence Unit as an independent institution.
Strengthen the RBV's autonomy and governance to help ensure the continuation of effective monetary and financial policies	• 2016 Safeguards Assessment recommendations are still incomplete.
Structural Policy	
Diversify the economy to foster stable growth and resilience.	• The authorities have ratified the Pacific Agreement on Closer Economic Relations (PACER) Plus in October 2022. • Economic Development Zone (EDZ) legislation is in progress and the Vanuatu Electronic Single Window (WESW) project, aiming to reduce the cost and time of trading, was completed.
Natural Disasters and Climate Change	
Integrate financing plans, consistent with a medium-term fiscal strategy, for the adaptation plan and disaster response in a more efficient and effective manner.	• The authorities published a revised NDC, including estimated costs of needed adaptation and mitigation efforts. • The authorities have not integrated climate investment needs or disaster response into medium term fiscal planning

Annex II. External Sector Assessment

The external sector position for 2022 is broadly in line with the level implied by fundamentals and desirable policy settings.[1] The current account balance is expected to have shifted to a deficit in 2022 due to further worsening of the trade balance and decline in revenue from the Economic Citizenship Program (ECP). The external sector assessment suggests that the real effective exchange rate is not misaligned, but this assessment is subject to uncertainty. International reserves have increased, largely reflecting the increased donor support, and remittances, and resumption of travel receipts, but are expected to gradually decrease over the medium term. Efforts are required to maintain medium-term external balance by strengthening the public finances, promoting private sector development, and diversifying the export base.

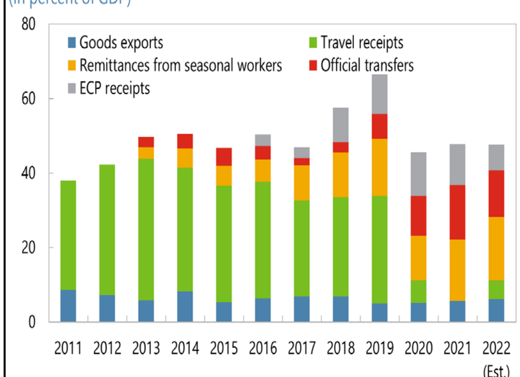
1. Current account balance. Vanuatu's current account (CA) is estimated to have declined to a deficit of 2.2 percent of GDP in 2022 from a surplus of 0.8 percent of GDP in 2021. This largely reflects import payments which have risen to 34.1 percent of GDP in 2022 (from about 31.2 percent of GDP on average over 2017–21) due to rising import prices, particularly for commodities. Larger-than-expected remittances from seasonal workers and increased donor support in response to the pandemic prevented a worse CA position in 2021. The CA balance is expected to decline in 2022, mainly due to higher import bills as a result of higher commodity prices, declining receipts from the ECP, and delayed grants. The gradual recovery of tourism in 2022 is expected to have been too small to counteract the effect of the other factors.

Current Account
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff estimates.

Select Credit Items of the Current Account
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff estimates.

2. The EBA-lite CA model results indicate a gap of 0.6 percent of GDP in 2022, consistent with an estimated cyclically adjusted CA balance of -3.2 percent of GDP and a model-based CA norm of -3.8 percent of GDP. The CA in 2022 is assessed to be broadly in line with the level implied by fundamentals and desirable policy settings. The cyclical adjustments incorporate the temporary impact of the pandemic on the tourism, grants, and remittances from seasonal workers;

[1] The ESA is preliminary and subject to uncertainty due to limited data availability for year 2022.

and additional adjustment on the excess revenue windfall from the ECP. The main contributors of the positive policy gap are the partners' policy gap, lower than desirable public health spending, and reserve accumulation.

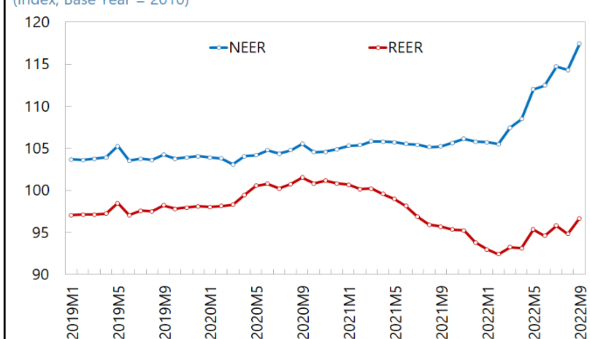
3. Exchange rate assessment and competitiveness. The exchange rate of the vatu is linked to a transaction-weighted (trade and tourism receipts) basket of currencies with weights adjusted periodically. The real effective exchange rate (REER) appreciated in 2022, mainly due to the appreciating nominal exchange rate. The CA gap model implies a small REER undervaluation of 2.2 percent (applying an estimated elasticity of the trade balance with respect to changes in the REER of 0.3), which effectively suggests that the currency is not misaligned. The real effective exchange rate is also relatively stable over the last 3 years, but a valuation assessment is subject to uncertainty, not least due to measurement issues as reflected in the sizable periodic revisions of the current account. While the lack of CA and REER gaps imply no immediate need for nominal exchange rate adjustment, other policy gaps may contribute or give rise to latent and evolving misalignments. Medium-term fiscal consolidation and greater efforts to boost productivity and address competitiveness would help the currency to stay in line with fundamentals.

EBA-lite Model Results, 2022

	CA model 1/ (in percent of GDP)
CA-Actual	**-2.2**
Cyclical contributions (from model) (-)	0.5
COVID-19 adjustors (-) 2/	2.0
Additional temporary/statistical factors (-) 3/	-1.0
Natural disasters and conflicts (-)	-0.5
Adjusted CA	**-3.2**
CA Norm (from model) 4/	**-3.8**
Adjustments to the norm (-)	0.0
Adjusted CA Norm	**-3.8**
CA Gap	**0.6**
o/w Relative policy gap	2.6
Elasticity	-0.3
REER Gap (in percent)	**-2.2**

1/ Based on the EBA-lite 3.0 methodology
2/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism (4.6 percent of GDP), grants (-2.25 percent of GDP), and remittances from seasonal workers (-0.33 percent of GDP).
3/Adjustment to the revenue windfall from the ECP (-1.0 percent of GDP).
4/ Cyclically adjusted, including multilateral consistency adjustments.

Nominal and Real Effective Exchange Rate
(Index, Base Year = 2010)

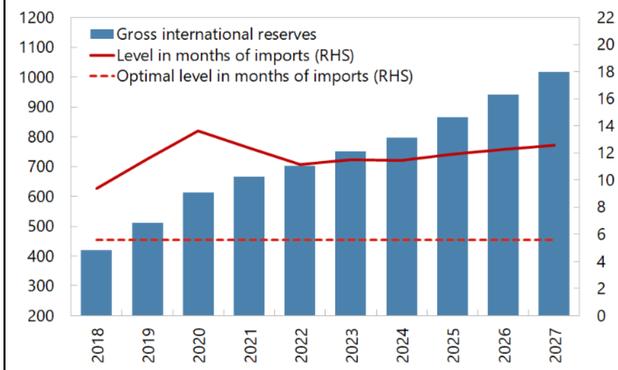


Sources: Country authorities; and IMF staff calculations.

4. Capital and financial accounts. Vanuatu's capital and financial account flows are mainly driven by donor project-related capital grants, and FDI in 2022. Net errors and omissions remained large at -10.1 percent of GDP in 2021.

5. International reserves and adequacy. Vanuatu's gross official reserves increased somewhat since 2021 and are adequate at USD 706 million (10.9 months of imports) in 2022, largely reflecting increased donor support, remittances and resumption of travel. A reserve adequacy methodology for credit-constrained economies is used to estimate an optimal level of reserves by comparing the costs and benefits of holding reserves. When measured against Vanuatu's vulnerability to external shocks, the adequate level of reserves is estimated to lie in the range of 4.4 to 5.6 months of imports, based on the sample average of countries (50 percent) and Vanuatu's high vulnerability to natural disasters (75 percent). Staff's estimate for reserve adequacy is somewhat higher than the RBV's objective to maintain enough official reserves to cover at least four months of imports. Over time, reserve coverage is expected to remain adequate to finance imports and loan repayments, despite moderating ECP revenues. Vanuatu needs buffers to cover its imports needs for reconstruction and losses in domestic production in the event of natural disasters. For example, Cyclone Pam in 2015 destroyed between 70 and 80 percent of GDP and led to large reconstruction and imports needs.

Official Foreign Exchange Reserves
(In millions of US dollars)



Sources: Vanuatu authorities; and IMF staff estimates.

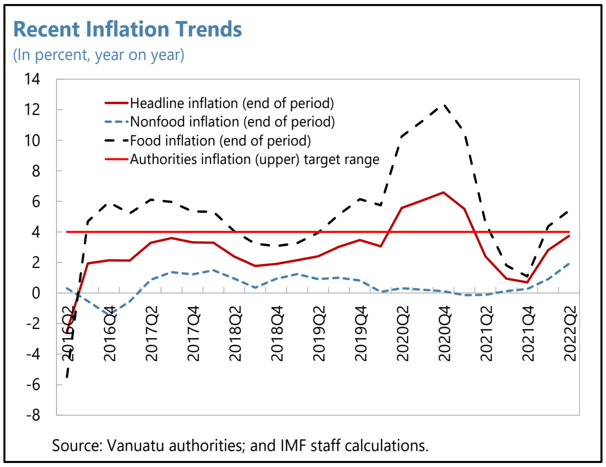
Annex III. Risk Assessment Matrix[1]

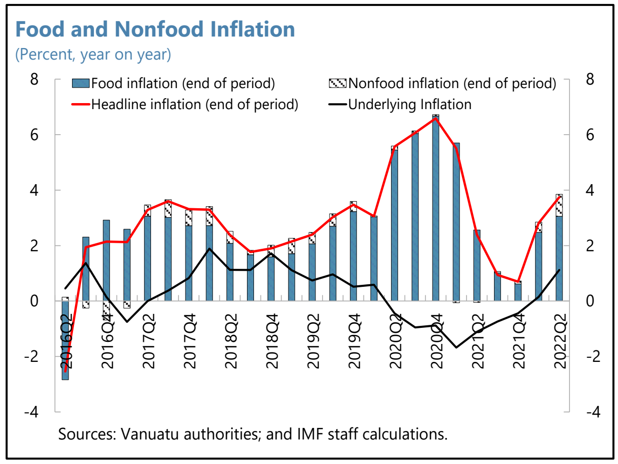
Likelihood	Risks	Expected Impact	Main Policy Recommendation
Medium	**Local COVID-19 outbreaks.** Outbreaks in slow-to-vaccinate countries or emergence of more contagious vaccine-resistant variants force new lockdowns or inhibit commerce. This results in extended supply chain disruptions, slower growth, capital outflows, and debt distress in some EMDEs.	Medium. Spread of new variants could lead to a total new lockdown. This will induce a drop in tax revenue collections and hinder the recovery.	Continue to observe global health guidelines.
Medium	**Delays in major infrastructure projects.** Foreign experts could slowly return to Vanuatu given different pace in international borders reopening. This could affect the execution of major infrastructure projects given weak domestic capacity.	Medium. Delays in the execution of major infrastructure projects could negatively affect GDP growth and jeopardize the fragile recovery.	Continue building internal capacity. Plan with technical and financial partners about the modalities for the execution of major infrastructure project. The authorities could consider diversifying the tourism sector's activities into related businesses, such as local catering services.
Medium	**Abrupt global slowdown or recession.** Global and idiosyncratic risk factors combine to cause a synchronized sharp growth slowdown, with outright recessions in some countries, spillovers through trade and financial channels, and downward pressures on some commodity prices.	Medium. Global economic slowdown particularly in main trading partners Australia and New Zealand could negatively affect the GDP prospects of Vanuatu particularly via the tourism and remittance channels.	New stimulus package would also be needed to support the economy.
High	**Potential further drop in ECP revenues**. ECP revenues could further fall sharply amid growing concerns regarding risks to financial integrity, amplified by the loss of key correspondent banking relationships. AML/CFT deficiencies could lead to lessening Vanuatu's passport attractiveness. The EU has postponed a full suspension of the visa waiver agreement with Vanuatu to August 2024, but may proceed with the suspension if no meaningful progress occurs. Other countries could follow leading to further revenue drop.	High. ECP revenue accounted for 33 percent of total revenue (including grants) in 2020 Further ECP revenue drop might jeopardize medium-term fiscal sustainability. The cash reserve buffer can mitigate the shock if the decline is temporary.	Formulate a medium-term fiscal consolidation plan. Strengthen AML/CFT controls and strengthen ECP due diligence. Improve tax revenue mobilization by introducing income tax and strengthening the tax administration to improve VAT collection. Rationalize some spending such as wages and salaries.
High	**Rising non-performing loans (NPLs).** Financial institutions' assets quality could further deteriorate with a spike in ratios given the end of forbearance measures or if the recovery is jeopardized.	Medium. Banks could deleverage to rebuild capital buffers and subsequently tighten credit conditions. Structurally high NPL ratio in for household could hinder the promotion of financial inclusion.	Guide banks to accumulate further general provisioning early. Establish crisis management and resolution frameworks.
High	**Weak governance** Lack of transparency and supervising framework for state-owned enterprises (SOEs) could deteriorate their financial performance and induce large fiscal costs.	High. Promoting FDI is key for Vanuatu's economic growth. Weak FDI could lead to slow economic growth and deterioration of external fiscal sustainability.	Establish the governance structure of the SOEs.
High	**Weak financial integrity and financial sector oversight.** Weaknesses in the AML/CFT framework and its implementation and EU blacklisting related to tax transparency could undermine business appetite of foreign companies in a de-risking context, leading to renewed loss of CBRs and hindering promotion of foreign direct investment (FDI). Lack of autonomy of the Reserve Bank of Vanuatu could also affect their ability to act and the appropriate conduct of monetary policy.	**High.** Promoting FDI is key for Vanuatu's economic growth. Weak FDI could lead to slow economic growth and deterioration of external fiscal sustainability.	Strengthen the AML/CFT regime. Make the tax bill consistent with the international standard of tax transparency. Implement the 2016 recommendations of the Safeguards Assessment.
Medium	**Natural disasters related to climate change.** More frequent natural disasters deal severe damage to infrastructure (especially in smaller vulnerable economies) and amplify supply chain disruptions and inflationary pressures, causing water and food shortages and reducing medium-term growth.	High. Vanuatu faces high natural disaster risk, including tropical cyclone, earthquakes, floods, and volcanic activity. Climate change is likely to alter weather and precipitation patterns, raise sea levels and increase the intensity and frequency of some types of natural disasters.	Build climate-resilient infrastructure. Integrate financing plans that are consistent with the medium-term fiscal strategy, for the adaptation plan and disaster response to support resilient building.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff' s subjective assessment of the risks surrounding the baseline (" L" (low) is meant to indicate a probability below 10 percent, " M" (medium) a probability between 10 percent and 30 percent, and " H" (high) a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

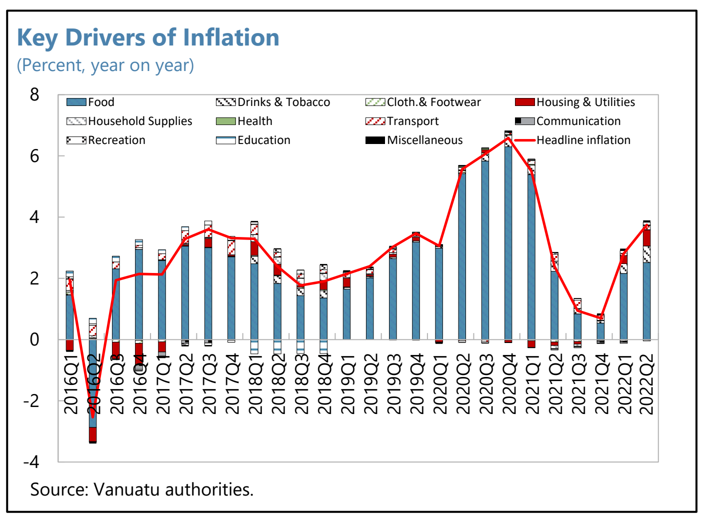
Annex IV. Post-COVID-19 Inflation Dynamics in Vanuatu[1]

1. **Headline inflation in Vanuatu was elevated for most of 2020 and 2021 primarily due to escalating food prices.** Since the onset of the pandemic, headline inflation rose to unprecedented highs on the back of high food inflation, while nonfood, and underlying inflation,[2] remained low. Inflation is partly import-driven because of its high dependence on food related and fuel imports, which accounted for 40 percent of the annual import bill in 2021. More recently, domestic factors explain a larger share of the recent inflationary outcomes.





2. **Recent inflationary trends reflect cost push rather than demand pull inflation.** Inflation dynamics since the onset of the pandemic reflect growing supply side constraints rather than rising domestic demand. Domestic demand in Vanuatu has been weak as the economy is still recovering from the negative impacts of Tropical Cyclone (TC) Harold and the pandemic.[3] Although fiscal spending increased during the pandemic, it has not created inflationary pressures partly because of slow implementation of major public infrastructure projects. Price pressures have risen due to supply side constraints created by the TC Harold shock (which lasted until 2021Q1 and had a devastating impact on the domestic agriculture food supply), and global supply-chain disruptions. For the more



[1] Prepared by Seruwaia Cagilaba.

[2] Underlying inflation according to authorities' definitions excludes volatile food and fuel items.

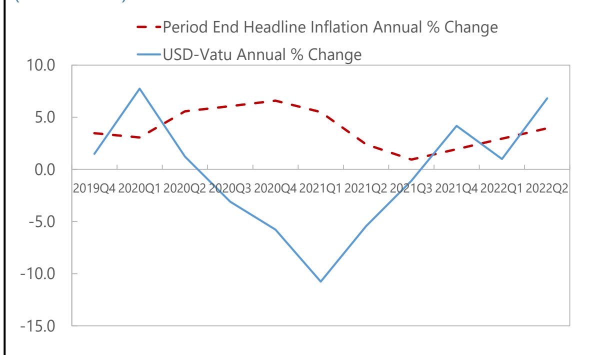
[3] TC Harold made landfall in Vanuatu in April 2020.

recent period, the assessment remains incomplete for two reasons. First, in November 2022 a ransomware cyber-attack severely disrupted the core IT infrastructure of many government agencies and affected the administration of many critical services, including statistical data collection and dissemination. Nevertheless, the delayed CPI data are likely to continue showing significant price increases. Second, there may be measurement errors and methodological shortcomings in the consumer price index as it relates to describing the magnitude of prices increases.

3. **Shocks stemming from global supply-chain disruptions could be persistent**. Carrière-Swallow et al. (2022) found that global shipping costs rose seven-fold during the pandemic with the inflationary impact being most persistent in remote and small island states. The pass-through of higher global commodity prices and shipping costs to domestic consumer prices was mostly in food, drinks and tobacco, and transport. Food prices accelerated to an average yearly growth of 7.7 percent from 3.1 percent pre pandemic. Drinks and tobacco prices, which are mainly imported, rose rapidly from 0.9 percent over the 2016–2019 period to 2.6 percent. Transport prices, which account for more than 6 percent of headline inflation have also worsened since end 2020. Notably, domestic prices for transport and drinks and tobacco began rising steeply about a year into the pandemic, which suggests a gradual passthrough of increased shipping costs to consumer prices.

4. **Certain country specific factors have helped contain the inflationary impact of rising global commodity prices in Vanuatu.** The country's fixed exchange rate system has helped cushion the impact of higher import prices on domestic prices. Bai et.al (2016)[4] found that for Pacific Island countries like Vanuatu, depreciation of the domestic currency against the Australian dollar puts pressure on headline inflation, while appreciation in the nominal effective exchange rate is associated with an equal decline in inflation. From 2019 to 2021, the nominal effective exchange rate has broadly appreciated, as the vatu largely strengthened against the Australian and US dollars. The stronger domestic currency is expected to have helped contain domestic inflationary pressures over 2020–21 because Australian imports account for a large share of total imports and other countries' imports are likely to be invoiced in US dollars.[5] According to the authorities, since 2019 around 57 percent of imports were denominated in US dollars whereas 16 percent were in Australian dollars. Exchange rate hedges (such as forwards) may have helped contain domestic inflationary pressures by delaying the transmission of higher import

USD Nominal Exchange Rate Trend
(Period End)

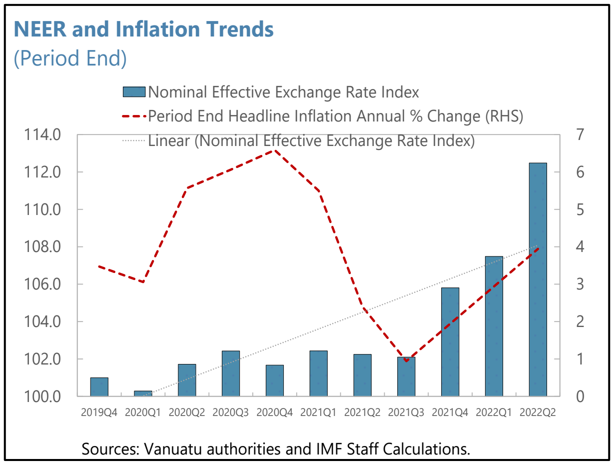


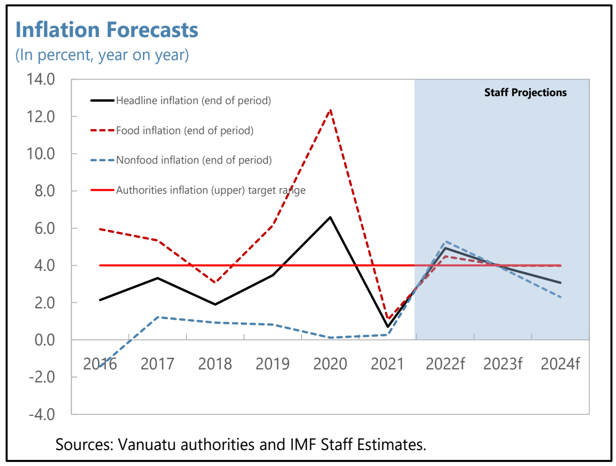
Source: Vanuatu authorities and IMF International Finance Statistics.

[4] The authors performed an empirical estimation of the inflation passthrough of international commodity prices (food and fuel) and exchange rates in six Pacific Island countries including Vanuatu.

[5] In 2021, imports from Australia accounted for 22 percent of total imports in Vanuatu. Other major countries of imports for Vanuatu include New Zealand, Fiji, Japan, France, New Caledonia, Hong Kong SAR, and Singapore.

prices to domestic prices. Moreover, renewable energy production[6] in some parts of the country, has helped contain the passthrough of rising global fuel prices to domestic energy prices.





5. Near-term inflation is expected to remain elevated. While Vanuatu has limited direct trade connections with Ukraine and Russia, the impact of the war is still being felt mainly through higher imported prices for food and fuel, as also noted by the authorities in their April 2022 report (RBV, 2022). There are also indications that the agricultural supply side constraints have led to shortages of key commodities like flour. Furthermore, ongoing pandemic-related supply chain disruptions and the Russia's war in Ukraine are likely to raise shipping costs even further. Headline inflation is expected to surge to 4.9 percent in 2022 with both food and nonfood inflation expected to rise above 4 percent. Inflation is expected to decline over the medium term within the RBV's target range of 0–4 percent, as supply side disruptions from the pandemic and the war in Ukraine are expected to subside. Risks to the inflation outlook remain on the upside.

6. The timing and appropriateness of policy responses will help shape the post pandemic economic recovery. Even though the transmission mechanism is weak (Yang et.al, 2011), the RBV's on hold monetary policy stance remains appropriate given the subdued economic conditions and weak private sector credit growth. However, once aggregate demand strengthens, the central bank will need to review the stance of monetary policy to avoid unnecessary pressure on inflation. Appropriate tightening of monetary policy may be warranted if growing import demand contributes to headline inflation rising beyond the RBV's target. Policymakers should balance the need to contain inflationary pressures with supporting the ongoing post-pandemic economic recovery and calibrate their monetary policy with exchange rate and fiscal policies. The fiscal-monetary-FX policy mix needs to be coherent and appropriately tailored to contain macro stability risks and secure policy buffers. Authorities should avoid a premature tightening of financial conditions and may need to tackle pockets of vulnerabilities that pose inflationary risks by appropriately tightening macroprudential tools where possible. To the extent possible and where relevant, targeted fiscal

[6] Housing & utilities within the CPI basket is based on Port Villa and Luganville. Energy production in Luganville is largely hydro based.

support for vulnerable groups may be considered to reduce potential inequalities that arise from the higher food and fuel prices.

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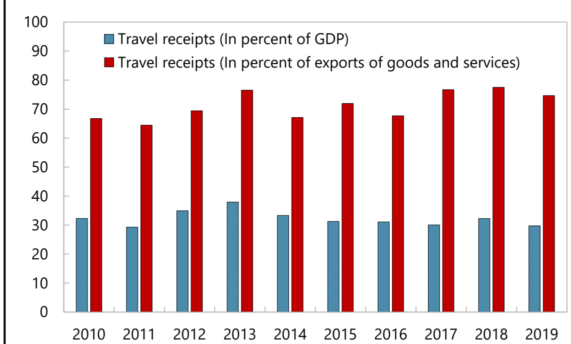
Annex V. Tourism Sector in Vanuatu[1]

Vanuatu's tourism industry has been hit hard by the COVID-19 pandemic. This annex provides an overview of Vanuatu's tourism sector before the pandemic, especially on its importance to the economy, examines the impact of the pandemic, and outlines policy recommendations to support this sector's post-pandemic recovery and expansion.

A. Inbound tourism in Vanuatu prior to the pandemic

1. **The tourism sector is a mainstay of Vanuatu's economy.** Tourism receipts accounted for 30 percent of GDP and 72 percent of total exports of goods and services in 2019. In addition to activities directly involved in tourism (mainly accommodation and tours), the sector also has large spillover effects to activities such as food services, retail and wholesale, traditional handicraft, transports, and other services. The World Travel and Tourism Council estimated that tourism sector in Vanuatu contributed about 32.7 percent of GDP and provided about 32.5 percent of total employment in 2019.[2] The accommodation and food service activities were the most attractive areas for foreign investors, accounting for 36 percent of the total proposed investment value and 26 percent of the total proposed number of local employment over 2010–19 (IMF, 2021).

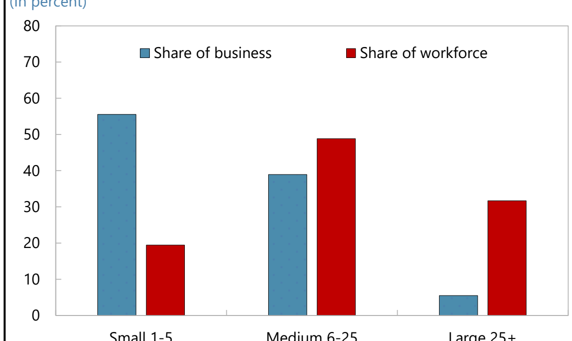
Travel Receipts



Sources: Vanuatu authorities; and IMF calculations.

2. **Most tourism businesses are small and medium sized.** Prior to the pandemic, about 56 percent of businesses were small-sized enterprises, having fewer than five employees and typically being transport operators, community-based bungalow managers, and tour operators in the outer islands. The bulk of the workforce was employed by the medium-sized companies. Large businesses hiring more than 25 employees were mainly resorts and hotels, which hired 32 percent of the total employees despite accounting for only 5 percent of all businesses (Vanuatu Department of Tourism, 2020).

Distribution of Tourism Businesses and Employees
(In percent)



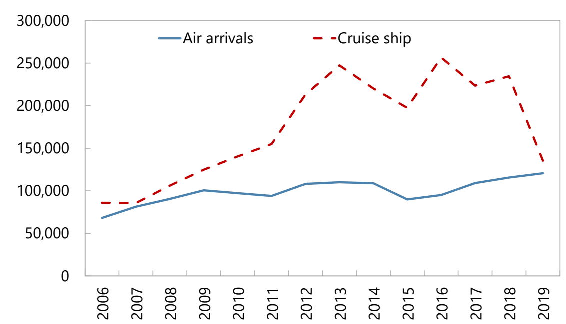
Sources: Vanuatu authorities; and IMF staff calculations.

[1] Prepared by Yinqiu Lu.

[2] [Travel & Tourism Economic Impact | World Travel & Tourism Council (WTTC).]

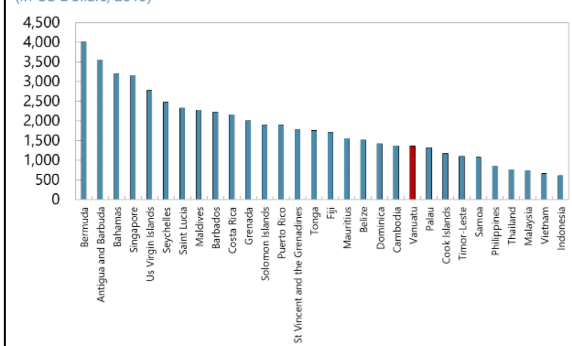
3. Air arrivals and day visitors who arrive by cruise ships comprise main tourists to Vanuatu. The number of air arrivals had remained stable in the past ten years prior to the pandemic while the number of cruise ship arrivals was more volatile. There were 120,513 international visitors arrived at Vanuatu via 1,785 international flights in 2019. About 80 percent of these arrivals were on holiday travel. Most of them only travelled to the main island of Efate, although visitors were increasingly travelling to outer islands, especially those with international connections such as Tanna and Espiritu Santo. The majority of cruise ship calls were to Port Vila and Mystery Islands, with the market dominated by Carnival Australia and Royal Caribbean Cruise Lines. Despite the larger number of arrivals by cruise ships compared with air arrivals, their contribution to the tourism sector is smaller, as the those arrived by air stayed on average 11.9 nights in Vanuatu in 2019.

Number of Arrivals by Vehicle



Source: Vanuatu authorities.
Note: There was a decline in port calls in 2019.

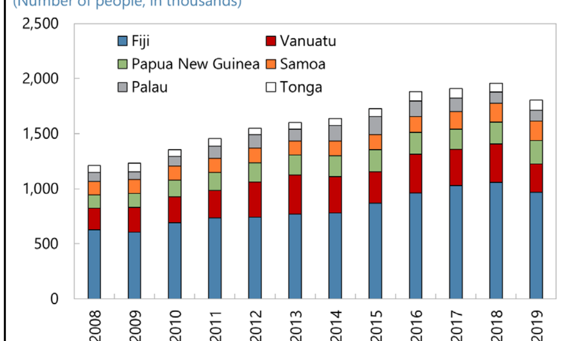
Average Cost of a 7-day-trip in A Beach Destination
(In US Dollars, 2019)



Sources: IMF "Week at the Beach Index"; and IMF staff calculations.

4. The short haul markets of Australia, New Zealand, and New Caledonia dominated the tourism sector in Vanuatu. These three markets accounted for about ¾ of the total arrivals by air in 2019, and Australia alone accounted for about half of those, followed by New Zealand (13 percent) and New Caledonia (12 percent). This level of concentration is typical among the Pacific Island countries (PICs) due to their geographical proximity to Australia and New Zealand. For example, visitors from Australia and New Zealand accounted for 41 percent and 23 percent of total arrivals in Fiji in 2019. The China market had been growing fast in Vanuatu before the pandemic, though it only accounted for about 4 percent of total arrivals by air in 2019.

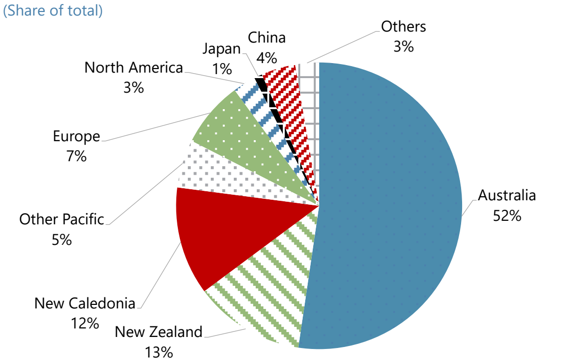
International Visitor Arrivals in Select PICs
(Number of people, in thousands)



Sources: World Development Indicators; and IMF staff calculations.

5. Among the 12 PICs, Vanuatu was the second largest tourism destination after Fiji. Vanuatu remains a popular destination among PICs, but its share in the region's tourism market has fluctuated between 14 and 21 percent over 2010–19, affected by natural disasters and the volatile calls of cruise ships. For example, in 2015 Tropical Cyclone Pam was the main reason for the 13 percent drop of arrivals; in 2019 the 27 percent drop of arrivals was due to a 42 percent drop in visitors via cruise ships (a result from the reduction in port calls of cruise ships) despite a 4 percent increase in air arrivals. The impact of the pandemic on the tourism sector

Air Arrivals by Country of Residence, 2019
(Share of total)



Sources: Vanuatu Authorities; and IMF staff calculations.

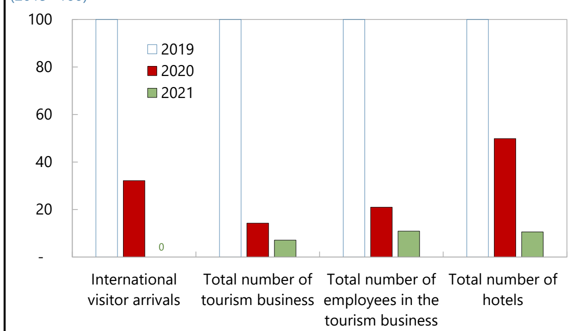
6. The pandemic had disrupted virtually all aspects of tourism in the PICs, and Vanuatu was no exception. Foreign arrivals to the PICs went through an unprecedented sudden stop in March 2020. Border closures in the main markets such as Australia and New Zealand led to an evaporation of tourist demand, while the PICs also closed the borders to prevent local outbreaks of COVID-19. Consequently, arrivals to the PICs declined by 84 percent in 2020. Vanuatu closed its borders effectively on March 26, 2020, under a state of emergency. Arrivals to Vanuatu declined by 68 percent and travel receipts by 76 percent in 2020. It is estimated that the activities in accommodation and food services declined by 40 percent, and overall services activities by 6 percent.

7. The authorities introduced two rounds of economic stimulus packages and a supplementary budget for 2022 to mitigate the economic and social hardship. In the two packages, introduced in April 2020 and May 2021, the authorities budgeted 4.2 percent of GDP for an employment stabilization program, small business grants, and a wage subsidy scheme. However, only 1.8 percent of GDP of support was actually distributed as of March 2022, partly due to limited implementation capacity. In March 2021, the tourism business support program with an initial funding of 0.03 percent of GDP was launched to directly support the tourism. In May 2022, Parliament approved a supplementary budget with the largest portion to be spent on the Vanuatu Tourism Assistance Program.

8. In addition to financial support, the authorities put in place action plans to guide the crisis response. The Vanuatu Department of Tourism (DoT) established the Tourism Crisis Response and Recovery Advisory Committee in March 2020. The committee comprised government agencies and private sector representatives and met fortnightly through 2020. Two planning documents with action plans were produced: (i) *Immediate Safety, Response and Economic Recovery Plan, May to December 2020*, with programs delivered under the five pillars of health, access, product, marketing and communications; and (ii) *Tourism Crisis Response and Recovery Plan, 2020 to 2023*, which the DoT has been implementing through the revised *Vanuatu Sustainable Tourism Strategy 2021 to 2025* (VSTS) to enable a transition of the tourism sector and become more resilient.

9. Despite the government support, the tourism sector and the labor market took a sharp hit. As the sector is disproportionally dependent on international travel, with domestic travel only accounting for an estimated 6 percent of total visitors prior to the pandemic, businesses either shut down or reduced services, and accordingly laid off staff members or cut their hours. The number of tourism business was estimated to have collapsed by 93 percent, and the numbers of hotels and employees each dropped by 89 percent in 2021 compared with 2019. Many of those that had lost jobs in the tourism sector moved to the agricultural sector or took advantage of the labor mobility schemes in Australia and New Zealand.

The Collapse of the Tourism Sector
(2019=100)



Sources: Vanuatu authorities; and IMF staff calculations.

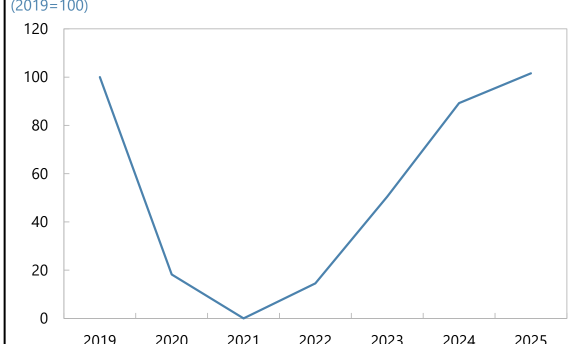
10. High exposure of the Vanuatu's banking system to the tourism sector has increased the risk of a macro-financial feedback loop. Loans to hotels and accommodations—the largest segment of banks' corporate lending—accounted for 27.2 percent of total corporate lending and 27.7 percent of corporate NPLs at end-2021; while the recognition of NPLs has been delayed by the introduction of the moratorium on loan repayments and loan classification requirements in response to the pandemic. The take-up rate of these measures in loans to hotels and accommodation at end-2021, at 38 percent, was higher than the average take-up rate of 11 percent.

B. Outlook for tourism

11. The border reopened on July 1, 2022. Achieving 70 percent fully vaccinated rate among adult population has been a major criterion for border reopening. The planned border reopening in March 2022 was postponed due to the low take-up of vaccination. The outbreak of domestic transmission in March 2022 increased the take-up of vaccination. In April, the authorities announced the plan to reopen the border on July 1, based on the positive trend in the vaccination rate. On July 1, 2022, the border reopened to international travelers, quarantine free.

12. The recovery is underway since the border reopening but a full recovery to the pre-pandemic levels is expected only over the medium-term. The recovery was led by Australia, New Caledonia, and New Zealand markets, driven by the pent-up demand, a phenomenon observed in Fiji as well, where the border opened in December 2021. Air Vanuatu—the state-owned air carrier—and other regional airlines, including Fiji Airways and Aircalin (New Caledonia), have restarted operations connecting Vanuatu's islands

Tourist Revenues
(2019=100)



Sources: Vanuatu authorities; and IMF staff estimates.

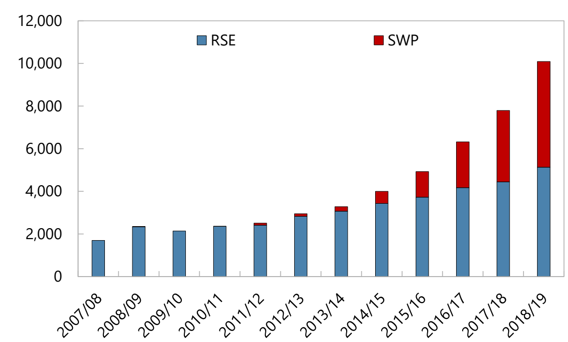
to major cities in the region. The pace of recovery is expected to strengthen in 2023, as Virgin Australia announced that it would start direct flights from Brisbane to Port Vila—the capital city—from March 2023. A full recovery to the pre-pandemic levels is expected only in 2025. The pace for recovery is subject to local capacity, the economic developments in Australia and New Zealand, and China's re-opening path.

C. Challenges and policy recommendations

13. The Vanuatu authorities' ambition to expand the tourism sector has been sidetracked by the pandemic. In 2019, the authorities introduced Shared Vision 2030, aiming at setting in place policies and facilities that will enable Vanuatu to secure the achievement of 300,000 visitors by 2030. The VSTS (2021-2025) launched in 2021 has a focus on the short- to long-term recovery of the tourism sector. It is framed around four themes: wellbeing through high value, low impact tourism; resilience through niche tourism product development; diversification through agritourism, and sustainability through sustainable tourism certification, investment and Ni Vanuatu entrepreneurship. Its primary focus is to "support in the transition to a more resilient and less dependent tourism industry and ensure that the undesirable aspects of the tourism industry do not return." Given the strategic importance of the tourism sector in Vanuatu, efforts are still needed to fix the scars left by the pandemic and further develop a sustainable tourism sector.

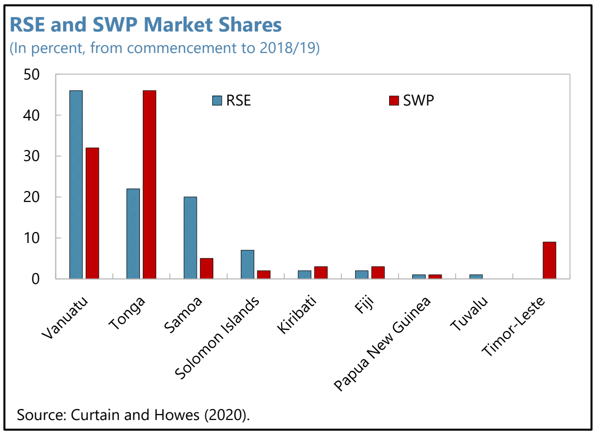
14. One major challenge the tourism businesses face is a shortage of trained workers. During the pandemic, the loss of jobs in the tourism sector resulted in some tourism and hospitality employees taking advantage of the labor mobility schemes in Australia and New Zealand. Prior to the pandemic, Vanuatu was already the largest supplier of seasonal workers to Australia and New Zealand, accounting for 41 percent of the combined Australia's seasonal worker program (SWP) and New Zealand's recognized seasonal employer (RSE) market share from the commencement of the programs to 2018/19. The number of seasonal workers had been steadily increasing since the commencement. These workers accounted for about 8 percent of the total adult male workforce aged 20 to 45 in Vanuatu (Curtain and Howes, 2020).[3]

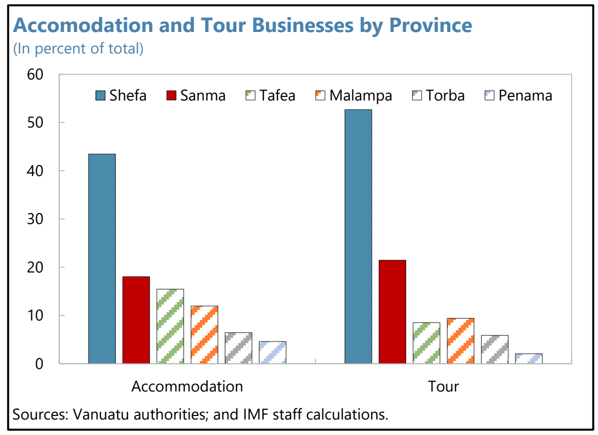
Number of Vanuatu Workers in RSE and SWP



Sources: Curtain and Howes (2020).

[3] The male workforce number is used, as 83 percent of seasonal workers from Vanuatu were men.





15. The shortage could be exacerbated by a large overlap between the main locations of the tourism business and the labor pools of the seasonal workers. It is estimated that 73 percent of those employed under the SWP scheme are recruited from Efate/Port Vila (Shefa province) and 55 percent of those under the RSE scheme are recruited from Efate/Port Vila and Santo (Sanma province). This high concentration of labor pools in the provinces of Shefa and Sanma provinces could create recruitment pressure for the tourism businesses even in normal times, given that 62 percent of accommodation businesses and 74 percent of tour businesses were located in these two provinces (Vanuatu Department of Tourism, 2020). Some of the loss is likely to be permanent and therefore create staffing shortage when tourists return.

16. Accordingly, there is a need to increase the level of tourism and hospitality training and aim for greater participation by women to meet the demand from the sector. A survey conducted by the DoT indicated that 72 percent of tourism businesses found it either hard or very hard to recruit Ni-Vanuatu workers with the required skills (Vanuatu Department of Tourism, 2020). As the Australian seasonal worker program has expanded the job categories into tourism and hospitality industry, and has also increased in duration, the under-supply of workers with the required skills has become more severe and may become more protracted than before.[4] In addition, as a majority of seasonal workers from Vanuatu are male, to limit the impact of the brain drain on the available labor pool, absorbing more women into the tourism sector could help to alleviate the labor shortage in the sector.

17. The gaps in key infrastructure could also impede the recovery and expansion of the tourism sector.

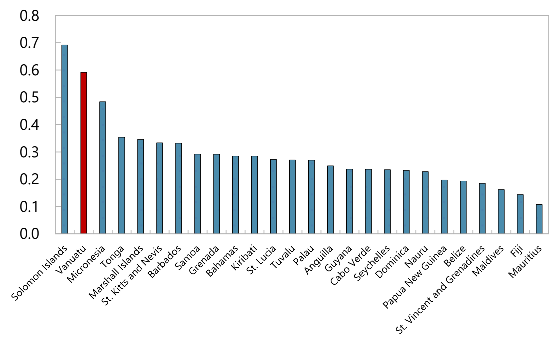
- **Electricity.** Electricity is a key input to the cost of running a business such as accommodations. Electricity in Vanuatu is largely solar driven, as grid electricity is only accessible in the main urban centers such as Port Villa and Luganville. Energy costs in Vanuatu are higher than most PICs and other tourism-based small states. In addition, only 61.9 percent of the population had access to

[4] Australia's new Labor government announced in September 2022 greater efforts to encourage more migration from Pacific islands, including by reforming the Pacific Australia Labor Mobility Scheme and creating a new Pacific engagement visa.

electricity in 2018, with urban areas having higher access (93.7 percent) compared with rural areas (51.1 percent) (IMF, 2021).

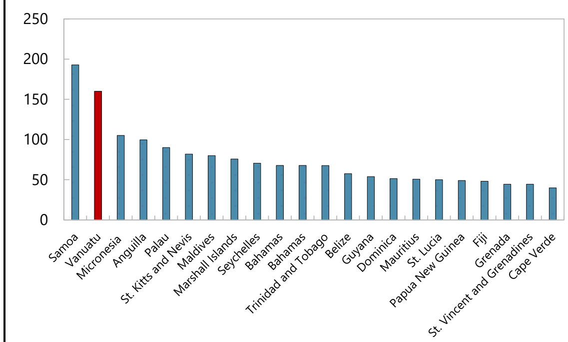
- **Internet.** Internet provides important support functions for the tourism sector, facilitating booking and communications. In Vanuatu, internet is only accessible by a quarter of the population (26 percent) compared with 82 percent in New Caledonia, and 50 percent in Fiji (IMF, 2021). The monthly cost of broadband is about USD 160, significantly higher than many PICs and tourism-based small states. Cyber resilience is also needed, as highlighted by the 2022 ransomware attack against government digital infrastructure.

Average Price of 1KW/h
(US Dollar, 2021)



Source: Cable.co.uk.

Average Cost of Broadband
(Per month in US dollar, 2020-21)



Source: Cable.co.uk.

- **Waste management and sewage system.** To accommodate increased tourism levels, there is a need to further improve waste management and sewage systems, particularly in the downtown, harbor areas, and upscale resort and vacation home developments within and outside of Port Vila. The authorities imposed a ban on swimming in Port Vila harbor in 2018 because of the unsafe level of bacteria in the harbor. The ban was partially lifted in April 2021, but continued monitoring and managing is still required, and the arrival of tourism will add pressure to the sewage system.

18. In the post-COVID world, the quality and capacity of medical care and overall level of health preparedness could influence tourists' choice for a vacation destination. Balasundharam and Koepke (2021) concluded that health considerations will likely be a key differentiating factor for prospective travelers. According to the World Vision,[5] Vanuatu's health system suffers from a lack of facilities and qualified staff, especially midwives, doctors, and specialists. Similar to most PICs, patients with serious conditions are flown to Australia, New Zealand, or New Caledonia for treatment. Developing and improving medical facilities could help attract more tourists, but also create the conditions to develop a hospitality sector able to serve the needs of the elderly, especially given that the number of pensioners from Australia and New Zealand are projected to increase.

19. Improvement in the business environment and governance could encourage private sector investment in the tourism industry. The costs involved in starting a business are high and

[5] Country-profile-vanuatu.pdf (worldvision.com.au).

the bottlenecks on registering property and land titling remain. The judicial effectiveness is relatively low in Vanuatu, leading to weak enforcement of contracts (IMF, 2021). Improvement in these areas will reduce the cost of running a tourism business in Vanuatu and further attract private and foreign investment to the tourism industry.

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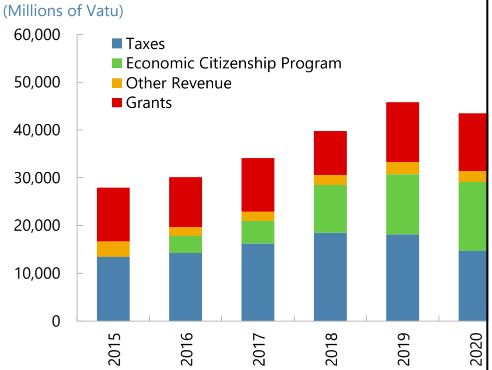
Annex VI. Toward a New Revenue Strategy for Vanuatu: The Role of Income Taxes[1]

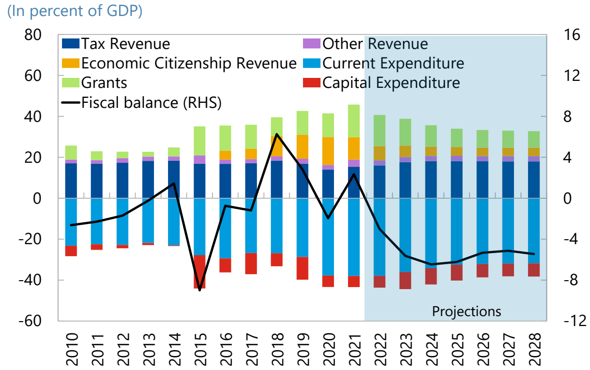
1. **Stagnant tax revenues, increasing reliance on non-tax revenues, and growing development needs highlight the need for designing a new medium-term revenue strategy.** Vanuatu's tax revenues have remained stagnant since at least 2016, with increasing reliance on non-tax revenue from the Economic Citizenship Program (ECP) (Figures 1 and 2). Vanuatu's tax revenues are at or below the median when compared to peers in the region, with the highest reliance on indirect taxes (Figure 3). With large development needs to achieve the Sustainable Development Goals, increasing pressures on spending related to climate change, and the ECP revenues at risk due to international risk perceptions and visa-free travel ban by the EU, Vanuatu needs to design a credible

Figure 1. Vanuatu: Government revenue
(Millions of Vatu)



Sources: Vanuatu authorities; and IMF staff calculations.

Figure 2. Vanuatu: Fiscal revenue and expenditure
(In percent of GDP)



Sources: Vanuatu authorities; and IMF staff calculations.

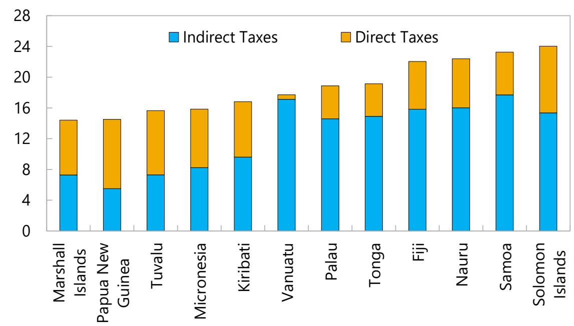
and ambitious medium-term revenue strategy to cover impending needs.

2. **This note analyzes the role for income taxes in this new revenue strategy, taking into account its aggregate and distributional effects.** An outstanding issue has been the proposal from the 2017 Vanuatu Revenue Review of introducing a personal income tax. This annex considers the distributional effects of alternative revenue-mobilization strategies for Vanuatu through three exercises: (i) the introduction of a personal income tax without changing value-added tax rates; (ii) alternative combinations of value-added and income taxes that can increase the tax-to-GDP ratio by 2 percentage points; and finally; (iii) introduction of income taxes in an economy with a smaller informal sector. These exercises are performed using a heterogeneous agents general equilibrium model for low-income countries (developed by Peralta-Alva, Tam, Tang, and Tavares; 2019, 2022). The model was designed to analyze the trade-offs between efficiency and equity of different taxes and to study the trade-offs between different tax structures. The

[1] Prepared by Gabriela Cugat (RES).

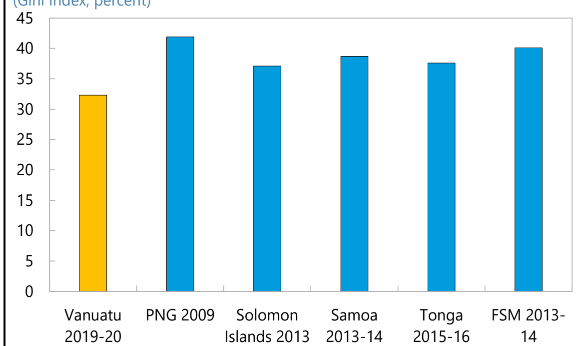
model is rich, but to be made tractable it abstracts from external sector dynamics, and debt and investment decisions.

Figure 3. Vanuatu: Indirect vs. direct taxes, Vanuatu and Pacific Island countries, 2010-2021
(Percent of GDP)



Source: Sy and others (2022)

Figure 4. Vanuatu: Consumption inequality, Vanuatu and other PICs
(Gini index, percent)



Source: VNSO (2021b).

3. **Most of Vanuatu's population is concentrated across rural areas, while inequality is lower than for other PICs, there is significant inequality between rural and urban areas.** According to the 2020 Population and Housing census, 78 percent of Vanuatu's population lives in rural areas, while only 22 percent lives in urban ones. Consumption inequality in Vanuatu is low when compared to other Pacific Islands Countries (PICs) (Figure 4), with a Gini coefficient of 0.319 in rural areas and 0.269 in urban areas, while when considering the whole economy, the Gini coefficient is 0.323. A lower Gini coefficient indicates lower inequality, so urban areas are less unequal than rural ones, but overall inequality increases when considering the inequality across regions. Average monthly income in urban areas is 1.8 times larger than in rural areas. The income shocks in the model are calibrated to match consumption inequality in the urban and rural areas (Table 1).

4. **Vanuatu's export base is narrow, with economic activity largely concentrated on tourism and agriculture.** More than 90 percent of households in rural areas engage in subsistence agriculture, while commercial agriculture is relatively underdeveloped with exports concentrated in unprocessed crops.[2] Analyses by the Vanuatu National Statistical Office (VNSO 2012b, 2021c, 2021d) point to a large share of workers receiving income informally: on average between 30 to 40 percent of households report wages/salary from the formal sector as their main source of income (Figure 4).

5. **The general equilibrium, heterogeneous agents model for low-income countries developed by Peralta-Alva, Tam, Tang, and Tavares (2019, 2022) is calibrated to Vanuatu.** The model has three sectors divided between rural and urban areas. In the rural area, there is food production for domestic consumption and cash crops for exporting, while in the urban area there is production of formal and informal non-

[2] See UNCTAD (2019) and VNSO (2021).

agricultural goods. Given Vanuatu's population distribution between rural and urban areas, the rural-urban structure of the model is kept. Crop production is mapped into the rural cash crop sector, and animal production, forestry, and fishing into the rural food production sector. While tourism is a main source of exports for Vanuatu, the model only considers exports from the rural area. This difference is bridged between model and data by only considering goods exports for the calibration (and not services). This simplifying assumption does not distort the analysis on the fiscal front since there are no special taxes on exported services activities (such as tourism). The remaining sectors are mapped into urban production. Some sectors that are traditionally more formal or easy to observe are mapped directly into the formal sector, while the remaining ones are mapped according to the share of the informal economy estimated by the VNSO (2012b): 30 percent of activity is allocated to the formal sector and 70 percent into the informal one, see Table 1 for details.

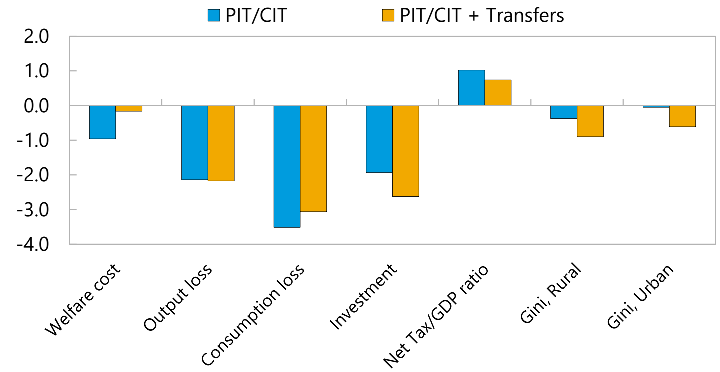
6. **The model centers the activity of the government around the domestic tax structure.** The model assumes that the government has access to three taxes: a Value Added Tax (VAT) on agricultural goods and the urban formal sector; a personal income tax (PIT) on household income from formal labor markets; and a corporate income tax (CIT) on urban formal firms and rural exporters. The government is assumed to run a balanced budget and spend only on formal non-agriculture goods. As an additional tool, the government can make direct transfers to the rural and/or urban areas. The fiscal instruments are calibrated to reflect that Vanuatu has no income taxes, and the VAT rate is set to match the average 2015–2019 revenue-to-GDP ratio from tax revenue from goods and services, which includes VAT collections, excise tax, as well as other taxes on goods and services, but it excludes taxes on international trade and non-tax revenue such as grants and ECP revenues.

First Exercise: Effects of the Income Tax

7. **The introduction of income taxes at the corporate and personal levels is incorporated.** The model is designed to exempt investment from the corporate income tax. The taxes are such that they raise 1 percent of GDP in additional revenue and account for about 10 percent of tax revenue. Given the structure of the model, there are no minimum tax exemptions, the rate is the same for all workers (rural and urban) and for all formal firms (rural formal and rural exporters and urban formal). To alleviate the distributional effects of the income tax (and as proxy for minimum income exemption), the exercise considers a flat redistribution of about 25 percent of the additional revenues in transfers to both the urban and rural areas.

8. Modeled outcomes provide useful insights from the introduction of income taxes, in terms of tradeoffs between output and welfare costs. The model shows that the introduction of income taxes leads to a reduction in welfare if not compensated by transfers (or the appropriate exemption). The welfare cost indicates that households would prefer to permanently reduce their baseline consumption by 1 percent rather than face the income tax (see Figure 5). Regardless of whether the income tax is implemented with exemptions, there is an expected output loss of 2 percent of GDP, driven by a reduction of consumption and investment by all sectors. The output loss arises from the labor supply distortion of income taxes (i.e., disincentivizing workers). The spillover effect from lower demand leads to contractions is both the informal sector and rural production. While the introduction of transfers reduces the welfare loss from income taxes, the output loss remains similar since the individuals most affected are those with higher productivity for whom the transfer does not compensate their increased tax burden.

Figure 5. Vanuatu: Introduction of a corporate and personal income tax
(In percent)



Source: IMF staff estimates.

9. In terms of distributional costs, the introduction of income taxes without transfers (exemptions) decreases inequality in the rural area, while it marginally improves inequality in the urban areas. Improvement in inequality in the rural area arises from taxing the exporting firms. The welfare loss of income taxes is mostly driven by their effect on aggregate outcomes (Table 3), both in urban and rural areas. However, income taxes are welfare-improving through their distributional effects, by taxing cash crop exporters and high productivity/income individuals while redistributing spending

Table 3. Vanuatu: Welfare cost decomposition, income taxes

PIT/CIT			
Welfare	Rural	Urban	Whole
Total	-1.0	-1.2	-1.0
Aggregate	-1.0	-1.4	-1.3
Distributional	0.0	0.2	0.3
PIT/CIT + Transfers			
Welfare	Rural	Urban	Whole
Total	0.1	-1.1	-0.2
Aggregate	-0.1	-1.3	-1.0
Distributional	0.2	0.2	0.8

Source: IMF staff calculations.

Source: IMF staff calculations.

into the formal sector. When introduced with transfers, the income tax can have an almost negligible welfare effect, as transfers amplify the distributional effects of the taxes.

10. The takeaway from the first exercise is that a well-designed, progressive income tax can raise the revenue-to-GDP ratio and decrease inequality by taxing high-earners more heavily and exempting lower-income earners. However, it comes at the cost of distorting labor market allocations and reducing GDP, and potentially disincentivizing work in the formal sector.[3]

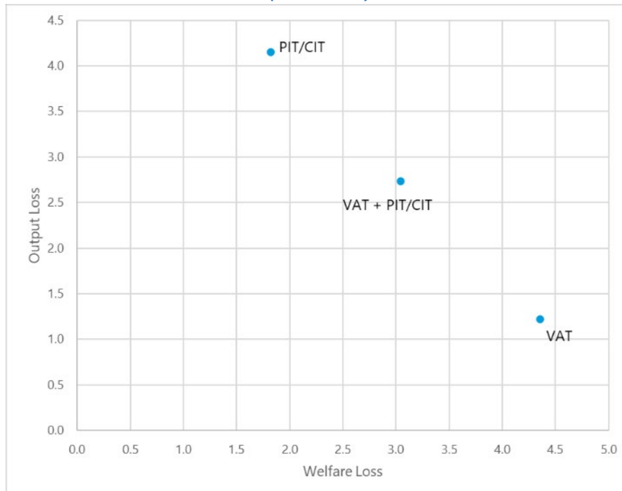
[3] In the model the size of the formal and informal sector is ultimately driven by preferences, which do not respond to incentives, so the size of the informal sector is independent of taxation.

Second Exercise: Exploring the Configuration of Tax Revenues

11. The second exercise consists of comparing three alternative ways of increasing the tax-to-GDP ratio by 2 percentage points. The exercise considers using VAT only; PIT/CIT only; and a combination of VAT and PIT/CIT. Transfers are not considered as they affect the distributional outcomes, but not the aggregate ones. Figure 6 shows a revenue possibility frontier between the alternatives in terms of output loss and welfare cost, while Table 4 decomposes the welfare cost in aggregate and distributional components.

Figure 6. Vanuatu: Revenue possibility frontier

(Percent)



Source: IMF Staff estimates.

Note: The scatter plot displays the costs in terms of welfare and output for different combinations of VAT and PIT/CIT taxes that achieve a 2 percent increase in the revenue-to-GDP ratio.

12. The different alternatives to increase the revenue-to-GDP ratio by 2 percent of GDP present different trade-offs in terms of efficiency (output loss) and well-being (welfare loss). While using the VAT tax exclusively has the lowest cost in terms of output loss, it has the highest cost in terms of welfare, since it decreases aggregate demand the most and redistributes spending towards formal sector goods increasing the gap between urban and rural areas. In the other extreme, using only income taxes to increase the revenue-to-GDP ratio has the highest cost in terms of output due to the labor market distortions it introduces, but it has the lowest welfare cost since there are no major redistribution across urban and rural areas in terms of aggregate demand and it has the largest distributional component in terms of welfare. Combining both instruments as in the VAT+PIT/CIT case allows for an intermediate solution.

13. The takeaway from the second exercise is that the same increase in the revenue-to-GDP ratio can be achieved combining different instruments, according to the priorities set by the government in terms of efficiency and distributional concerns. While VAT has lower output costs, it has higher welfare costs, while income taxes operate in the opposite direction. The right combination depends on the weights placed on output versus welfare costs.

Table 4. Vanuatu: Welfare cost decomposition, revenue possibility frontier

VAT + PIT/CIT

Welfare	Rural	Urban	Whole
Total	-3.7	-2.0	-3.0
Aggregate	-3.9	-2.1	-2.5
Distributional	0.1	0.1	-0.5

VAT

Welfare	Rural	Urban	Whole
Total	-5.7	-1.5	-4.4
Aggregate	-6.0	-1.4	-2.7
Distributional	0.3	0.0	-1.7

PIT/CIT

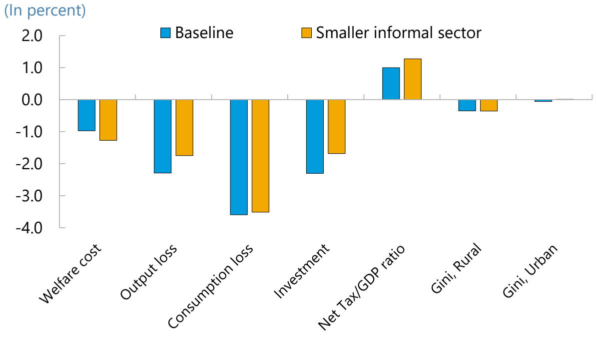
Welfare	Rural	Urban	Whole
Total	-1.9	-2.4	-1.8
Aggregate	-1.9	-2.7	-2.5
Distributional	0.0	0.4	0.7

Source: IMF staff calculations.

Third Exercise: Offsetting the Effect of Income Taxes via More Efficient VAT Collection

14. Finally, the introduction of PIT/CIT is considered in an alternative economy with a smaller informal sector. First, and related to the previous exercises, VAT collections are automatically higher in an economy with a lower informal sector than in the baseline calibration. To make the distortions similar in the economy with a smaller informal sector and the baseline, this modeling exercise also lowers the VAT rate to ensure the initial steady state has the same tax-to-GDP ratio as our initial baseline. Figure 7 presents the results of introducing income taxes of the same magnitude as in the first exercise in this economy, compared to the initial PIT/CIT introduction. While the welfare cost of PIT/CIT introduction remains in a similar range as in the baseline economy, the output loss is reduced by 30 percent, for a similar increase in revenue. In terms of distributional outcomes, in the economy with a smaller informal sector, income taxes improve the consumptions distribution by more, particularly in the urban area. The costs of introducing a similar PIT/CIT tax are lower than in the baseline calibration due to a more efficient VAT collection with a broader base, while the distributional costs remain similar than under the baseline (Table 5).

Figure 7. Vanuatu: Introduction of a corporate and personal income tax, baseline versus small informal sector
(In percent)



Sources: IMF staff estimates.

Table 5. Vanuatu: Welfare cost decomposition, income taxes with smaller informal sector

PIT/CIT, smaller informal sector			
Welfare	Rural	Urban	Whole
Total	-1.5	-1.1	-1.3
Aggregate	-1.5	-1.8	-1.7
Distributional	0.0	0.7	0.4

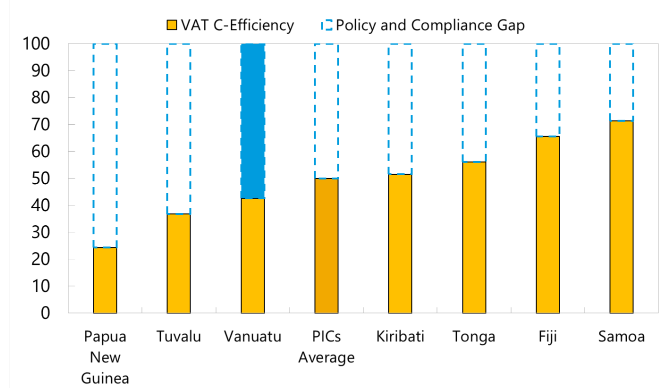
Source: IMF staff calculations.

15. The takeaway from this exercise is that the costs of introducing income taxes can be vastly reduced by first improving the coverage of the formal sector and second by boosting the efficiency of VAT collection. By reducing the prominence of the informal sector, the same revenue-to-GDP collection can be achieved more efficiently, VAT and income taxes have a broader base and create smaller distortions.

16. The main lessons of the model are related to the importance of reducing the informal sector, the scope for direct taxation, and the need to balance efficiency and distributional concerns. While the model applied attempts to be calibrated to Vanuatu and more refinements could be made, the exercises performed are informative for the discussion of Vanuatu's revenue strategy. First, increasing the coverage of the formal sector has the potential of increasing tax revenues without introducing additional distortions and without worsening distributional outcomes, for a related discussion on the potential of improving VAT C-efficiency for Vanuatu (Figure 8), see Sy and others (2022). Second, there is scope for introducing a personal income tax. This would not increase inequality if the minimum exemption were appropriately set, however it has a cost in terms of growth by introducing an additional distortion. Third, the tax-to-GDP ratio could be increased by up to 2 percentage points of GDP with different combinations of direct and indirect taxes, using a combination of both types of instruments achieves a balance between efficiency and well-being costs.

Figure 8. Vanuatu: VAT C-efficiency ratios, Vanuatu and PICs

(Percent)



Note: VAT C-efficiency conveys the additional percentage of potential VAT a country can collect. Data pertains to 2020.
Source: Sy and others (2022).

Table 1. Vanuatu: Model calibration and fit

Exogenously calibrated parameters

Parameter	*Value*
Depreciation rate	0.06
Labor share in food production	0.46
Labor share in informal sector production	0.67
Capital share in formal sector production	0.33
Persistence of urban income shocks	0.95
Persistence of rural income shocks	0.95
Urban population share	0.22
Rural population share	0.70
Rural population, exporter	0.08

Endogenously calibrated parameters

Parameter	*Value*	*Target*	*Data*	*Model*
Informal goods preference	1.2812	Informal goods share in consumption	42.5%	42.2%
Formal goods preference	1.2764	Formal goods share in consumption	32.3%	32.4%
Rural income shock variance	0.3525	Rural consumption Gini index	0.3190	0.3187
Urban income shock variance	0.3425	Urban consumption Gini index	0.2690	0.2695
Value added tax	0.30	Tax revenue as share of GDP	13.0%	13.0%
Profit tax	0	Corporate tax share in tax revenue	0%	0%
Income tax	0	Income tax share in tax revenue	0%	0%
Agricultural productivity	0.5469	Agricultural share in GDP	19.8%	19.1%
Manufacturing productivity	39.2390	Formal sector share in GDP	46.9%	43.2%
Exporting productivity	1.25	Exporting agricultural share in GDP	6.0%	6.0%

Table 2. Vanuatu: Correspondence of sectors in the model and industries in the economy.

Industry	Percent in GDP
Agriculture	***19.8%***
Crop production, animal production, forestry and fishing	19.8%
Formal non-agriculture	***46.9%***
Manufacturing	2.7%
Electricity and water supply	2.3%
Construction	30% x 5.8% = 1.7%
Wholesale trade	30% x 5.1% = 1.5%
Retail trade	30% x 13.8% = 4.1%
Transport	30% x 4.4% = 1.3%
Accommodation and food services	30% x 4.8% = 1.4%
Information and communication	7.4%
Finance and insurance	7.8%
Real estate	30% x 8.7% = 2.6%
Professional, scientific, technical, and administrative services	30% x 3.1% = 0.9%
Government services	12.5%
Education, Health, Recreation, and other services	30% x 1.8% = 0.5%
Informal non-agriculture	***33.3%***
Construction	70% x 5.8% = 4.1%
Wholesale trade	70% x 5.1% = 3.6%
Retail trade	70% x 13.8% = 9.7%
Transport	70% x 4.4% = 3.1%
Accommodation and food services	70% x 4.8% = 3.4%
Real estate	70% x 8.7% = 6.1%
Professional, scientific, technical, and administrative services	70% x 3.1% = 2.2%
Education, Health, Recreation, and other services	70% x 1.8% = 1.3%

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Annex VII. The Digital Money Landscape in Small Island Developing States: The Case of Vanuatu[1]

1. **The growing global demand for contactless digital payment solutions is driven by several factors.** For countries at more advanced stages of the digital money landscape, widespread adoption of crypto currencies was one of the main drivers for policymakers to explore central bank digital currencies (CBDCs). By end 2021, several countries have CBDCs pilots underway (see Jahan et. al., 2022), and many others have imposed restrictions on the use and trade of crypto currencies due to their heightened money laundering and terrorism financing risks. Within the context of a small island developing state like Vanuatu, the shift to digital payment solutions is underpinned by existing payment system challenges. Financial inclusion is one of the main challenges, where 32 percent of adults remain unbanked and excluded from the formal financial sector[2] because of Vanuatu's remote and geographically dispersed islands. Another main policy concern for authorities is corresponding banking relationships (CBR) issues which are a result of de-risking by international correspondent banks attributable in part to financial integrity concerns regarding its offshore financial center dealings and Vanuatu's sale of passport scheme called the Economic Citizenship Program (ECP). In 2021, some domestic banks including the main ECP recipient bank, lost their US dollar CBR when National Australia Bank pulled out of Vanuatu. The high cost and slow processing time of transactions is also a key driving factor behind the need for better digital payments solutions.

2. **Recent advances in digital payments may help address key challenges faced by small island developing states, but with a careful evaluation of the costs.** The shift towards more contactless payments solutions during the pandemic period has raised global interest in CBDCs, including among small island developing states. The Bahamas is the only small island developing state that has launched its own CBDC, although several others have recently expressed interest in this area. To better understand the potential benefits and application of CBDCs to Vanuatu one needs to distinguish between the different types. There are two types of CBDCs, wholesale CBDCs which can facilitate inter-bank settlements, and retail CBDCs which are for domestic use. At present, there are many wholesale CBDCs projects being undertaken globally (e.g., project Jura, project mBridge, project Atom), as well as several pilots of retail CBDCs are currently underway (e.g., China, Thailand). Retail CBDCs could benefit Vanuatu because they could reduce financial inclusion issues by facilitating the digitization of financial services for the rural and unbanked population, but they also need to be evaluated against the risks, resource burden, and costs raised by implementation. Financial inclusion was one of the main reasons Nigeria and the Bahamas issued CBDCs. CBDCs also have several features that

[1] Prepared by Seruwaia Cagilaba.

[2] https://www.dailypost.vu/news/32-ni-vanuatu-adults-unbanked/article_607561b4-1443-53c6-9498-e7f5afdceb27.html

make it more attractive for policymakers compared to other forms of digital money. CBDCs is fiat money that is issued and controlled by the central bank, which in principle should make it easier to supervise. Theoretically, CBDCs should be a more reliable store of value as it is backed by central bank reserves, compared to crypto assets which fluctuate in value and are usually not tied to an asset or legal tender. Offline functionality is another important consideration for Vanuatu, which like other small island developing states are prone to natural disasters and connectivity issues. Recent examples of CBDCs like China's e-CNY prove that retail CBDCs can also provide offline functionality.

3. **Digital money solutions, including CBDCs, need to be appropriate for the local context.** The underdeveloped financial and physical infrastructure, and extensive geographic span of Vanuatu poses several challenges for having an efficient, accessible, and stable form of payment system. The country is still at its early stages of digital payments development, and with respect to CBDCs, it currently lacks the technical capacity and infrastructure to test and adopt one. Although there are no immediate plans to adopt a CBDC in Vanuatu, there are indications of a gradual shift towards digital payment solutions. Digital payment transactions in Vanuatu are taking hold more recently with the pandemic that saw an increase in mobile money transfer operators and some uptake in digital payments by the public. Other applications of digital money include the use of blockchain technology to deliver digital aid by Oxfam's Unblocked program following the Tropical Cyclone Harold in 2020.

4. **The merits of digital assets have been considered and more regulatory work is underway.** Authorities have recently taken steps to better regulate digital money activities in Vanuatu through the enactment of the National Payment System Act in 2021. Progress is also being made on a digital national payments system that will allow real time and fully automated digital payments in Vanuatu which is expected to go live in 2023 (a go-live decision is planned for June). Investment in certain types of crypto assets has also been made possible with the amendment of the Financial Dealers Licensing (FDL) Act in 2021. However, no companies have been licensed under this FDL Act amendment and therefore there is no data to show regulated crypto asset activity in Vanuatu. Furthermore, authorities assert that crypto assets are not regarded as legal tender in Vanuatu. Currently, domestic commercial banks are not allowed to exchange crypto currencies for legal tender, and authorities progress on the Virtual Asset Providers Bill has been slow. This upcoming legislation is expected to cover the domestic use of crypto assets.

5. **Policymakers need to weigh the macroeconomic implications and policy considerations of adopting CBDCs.** Should the authorities seriously consider issuing a CBDC, they will need to ensure that they have the appropriate legal authority and capacity to supervise CBDC activities. Authorities need to develop a better understanding of the local application of CBDCs by drawing on the experiences of other developing economies. Through the use of technical assistance, Vanuatu can develop its own capacity to implement a CBDC arrangement. However, implementing CBDCs in small island

developing states has challenges. Vanuatu is prone to natural disasters and connectivity issues, so investment in better telecommunications and energy infrastructure is foremost for digital payments to be effective. Since Vanuatu is a highly open economy with a fixed exchange rate regime, the use of CBDCs may put pressure on foreign reserves and override its potential to improve monetary policy effectiveness as maintaining the exchange rate peg will take precedence (Cover-Kus, H. 2021). There are also concerns on central bank credibility and authorities will need to invest in better cybersecurity before it can adopt more advanced forms of digital money. The regulatory frameworks governing privacy and consumer protection will also need to be strengthened to allay any concerns that households and businesses have with using CBDCs. More broadly, there are concerns that increased use of CBDCs could reduce demand for bank deposits and create bank disintermediation. Finally, CBDCs could potentially raise additional risks to financial integrity in a setting where existing risks are not effectively mitigated.

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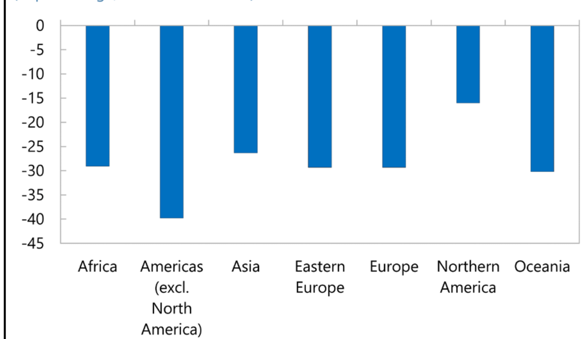
Annex VIII. De-Risking Leading to De-Banking: Key Issues and Considerations for Vanuatu[1]

Current Situation

1. **The Pacific Island Countries continue to face a loss in banking services from international banks and Vanuatu is no exception**. This trend has manifested, over the past two decades, in a loss of correspondent banking relations (CBRs) by international banks with local banks and regional money transfer operations (MTOs) providers amidst a more general withdrawal of international (mainly Australian and US) banks from the region. While this trend has been known as *de-risking*, it has in some countries led to more significant *de-banking* raising concerns of exclusion of these countries from international networks and worsening inclusion and access issues domestically. In some countries the loss of CBRs has been quite severe as in Tuvalu, where there is only one CBR, left and in Samoa. In any case, transaction costs are high, as seen in the high spreads in the region, and large fees that diminish societal welfare.[2]

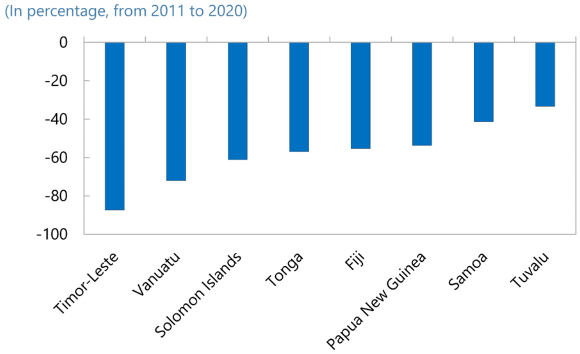
Decline in CBRs by Value across Regions
(In percentage, from 2011 to 2022)



Sources: BIS based on SWIFT data.

2. **In Vanuatu the situation is currently not as problematic as in some PICs but nevertheless risky.** Vanuatu shows one of the highest losses of CBR transactions in the region although the high predominance of foreign owned banks in Vanuatu provides much needed resilience to the system. This cannot be taken for granted given these trends, raising the risks of de-banking.[3] In 2021, the largest commercial (and public sector owned) bank, the National Bank of Vanuatu (NBV) lost its US dollar CBR with National Australia Bank. While the

Decline in CBR Relations
(In percentage, from 2011 to 2020)



Sources: BIS using SWIFT data.
Note: Changes in the ratio of the number of banks abroad receiving payment messages from the stated country, and the number of banks receiving payment messages in the stated country, 2011-2020

[1] Prepared by Neil Saker.

[2] IMF 2015

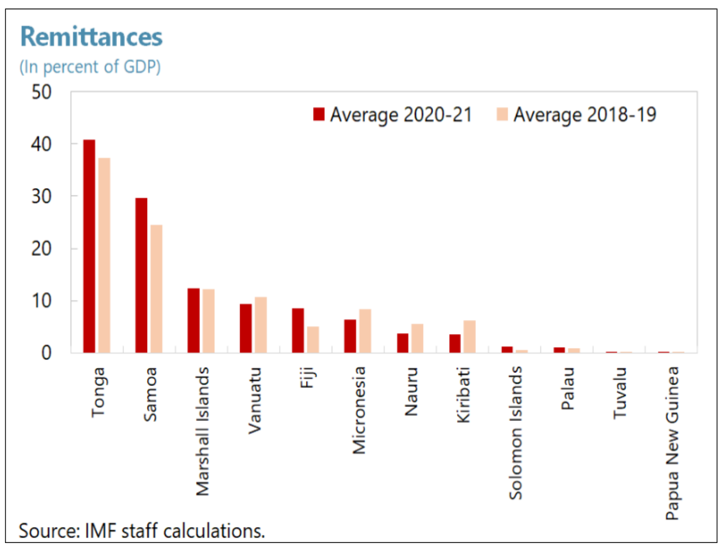
[3] The Vanuatu banking system comprises: (i) two domestic banks and three foreign banks in the onshore market; and (ii) nine foreign banks in the Offshore Financial Center, OFC (RBV 2022). It is unclear how the OFC is affected by the CBR problems.

latter cut links across the region, it is likely that this decision was influenced by the fact that NBV is the main conduit for investments under Vanuatu's economic citizenship programs (ECP). This scheme has raised concerns, especially by the EU, for its weak governance and vulnerability for being misused by criminals. In addition, Vanuatu is on the EU list of non-cooperative tax jurisdictions which raises reputational risks and may accentuate negative perceptions by international bankers.[4] The foreign owned commercial banks in Vanuatu may be better able to continue cross border business as they can transact through their parent banks but there is always the risk that the parent banks may discontinue their operations in the PICs in general and Vanuatu in particular.

Main Factors

3. The causes of de-banking are multifaceted but overall they reflect the calculation that risks in the PICs outweigh the opportunities to maintain or grow the business. As international banks continuously refine their methodologies for allocating capital to the most profitable business lines, the effect is that their banking activities in the region come under strong divestment pressure. The disincentives relate to two main areas: business opportunities and costs of performing banking operations in the Pacific Islands region.

4. Business opportunities in the PICs are generally not as attractive as in other regions. In general, GDP per capita growth in the region has been low and in fact below the growth in the home markets of the international banks. This indicates that the PICs are not converging with the richer countries in the region as would be suggested in the growth literature but are either stagnating or falling behind in relative terms. Allied to this is that the sectors that could typically benefit from foreign bank funded FDI such as tourism, retail, and manufacturing, have idiosyncratic problems such as land tenure issues, lack of rule of law and political certainty and so are not as attractive as elsewhere. Thus, the economic case for enhancing banking links is seen as weak by international banks' management.



[4] The EU cites Vanuatu as being in non-compliance because it: (i) *facilitates offshore structures and arrangements aimed at attracting profits without real economic substance and has not resolved this issue yet; and (ii) is waiting for a supplementary review by the Global Forum in relation to Exchange of Information on Request*. Council of the European Union 13092/22 2022.

5. Secondly, the costs of doing banking business with the PICs are high. This mainly relates to the high compliance costs of operating in the PICs and dealing with individuals and relatively small MTOs. These compliance costs include: (i) cost related to AML/CFT compliance, including the due diligence costs of the correspond bank; (ii) tax reporting and information sharing as required by the OECD, US, and EU standards often relating to OFCs such as in Samoa and Vanuatu. The trend in recent years has been for these requirements to become more detailed and onerous for the banks. International banks based in Australia and New Zealand also face pressure from their own correspondent banks, typically US based ones, to limit their exposure to perceived risky local banks and MTOs.

6. The costs of compliance violations or breaches can be high. This can be in terms of both financial penalties hitting the balance sheet and associated reputational costs. In addition, the operational costs of banking in the PICs are relatively high especially in terms of salaries and staff training amidst low capacity and high staff turnover.

Consequences

7. These trends effectively act as a brake on economic growth and so impose significant costs on society. Foreign banks have played important roles in developing the banking systems in PIC countries, bring in technology infrastructure such as ATMs, staffing, and capital. In addition to their role in domestic banking transactions, they facilitate cross-border payments and currency exchange that are vital for trade flows, foreign direct investment, and inward remittances by PIC migrant and seasonal workers. In turn these factors drive growth and support foreign exchange reserve accumulation. While Vanuatu is not as reliant on remittances as in other PICs (as these amount to about 15 percent of GDP compared to 27 and 21 percent of GDP for Tonga and Samoa), they might increase as Australia and New Zealand expand their overseas worker and permanent residency programs from the region.

8. The risk is that the de-banking trends will hinder or severely limit such flows. Reducing access to international flows would further marginalize the PIC economies accentuating their economic vulnerability. For the financial system, it would: (i) further increase the costs of banking services, which are already high by international standards with very high spreads, reducing remittance flows and raising trade costs; (ii) lead to an undue concentration on a few players that adds to market and systemic risks; and (iii) perhaps force PIC banks and customer toward more risky channels including more marginal institutions and/or informal and unregulated payment networks that could have unintended consequences especially they could facilitate money laundering with a reversion to cash flows. Impediments on trade could also restrict efforts to build climate proofed infrastructure as these tend to be import intensive and relying on foreign donor flows.

Mitigation Strategies

9. Mitigating these problems is a clear priority for the region including for Vanuatu. Below are a number of broad mitigation strategies. In general, a multi-pronged approach is necessary with measures working best in combination; but it should be stressed that there is unlikely to be any magic bullet that will immediately remedy the problem - rather sustained action is needed at every level. Ideally, these should be implemented at the regional level and the recently announced *2050 Strategy for the Blue Pacific Continent* that was endorsed by the region's leaders ministers in mid-2022 would be an ideal vehicle for taking these reforms forward in a consistent and comprehensive manner.[5, 6]

Market Solutions

10. A clear priority is improving the incentive structure for international banks to be involved in the region. This involves creating the business opportunities for the banks to intermediate transactions and increase their profitability. This in turn requires improvements in the business climate, an acceleration of on-going structural reforms and other supportive policies.[7] Of course, these will take time to implement and affect banks' behavior but without a healthy and growing economy, other remedies to this problem are unlikely to be durable.

11. In addition, new relationships are being developed to compensate. In Vanuatu, USD CBR business is now being channeled through a new intermediary, Choice Mauritius that has expertise in dealing with similar issues in Africa.[8] The other USD CBR is Western Union whose main agent is Vanuatu Post. However, as noted above increasing CBR providers would lead to greater competition and lower costs.

Non-market solutions

12. Given the public good nature of banking in general, and the negative externalities that follow the ending of these banking relationships, there are strong

[5] Pacific Islands Forum Secretariat, 2050 Strategy for the Blue Pacific Continent.

[6] At the 2022 Forum Economic Ministers Meeting (FEMM) held in Vanuatu in August 2022, the region's "*Finance Ministers: (i) welcomed the urgent support from Australia and New Zealand to assist PICs in re-establishing CBRs; (ii) acknowledged the detrimental impact that the listing of PICs on the EU's Non-Cooperative Tax Jurisdiction Blacklist was having in facilitating international financial transactions; and (iii) acknowledged the complex mix of factors that contribute to de-risking in the Pacific and agreed to continue to engage in Asia Pacific Group on Money Laundering (APG) and Financial Action Task Force (FATF) policy development processes and reiterated the importance of APG and FATF mechanisms accounting for the unique risk and context of PICs",* Pacific Islands Forum Secretariat 2022 Forum Economic Ministers Meeting Hybrid Meeting 11–12 August 2022 Outcomes.

[7] World Bank. 2017. Pacific Possible: Long-term Economic Opportunities and Challenges for Pacific Island Countries.

[8] https://www.choicemauritius.com.

theoretical arguments for public sector intervention. These could include action at different levels and by individual governments and international organizations:

- On the basis that CBRs are necessary financial infrastructure needed for economic growth and their absence leads to negative externalities, welfare economics suggests a case for subsidies. Like public utilities such as transport, there are theoretical and real-life evidence that the private sector under-provides such services and at a higher cost than is socially optimal. On this basis, governments could provide subsidies to allow CBR and other cross border transactions to be conducted. Of course, such subsidies would have to be carefully designed in order to avoid moral hazard and governance issues and could be made in the form of direct cash payouts, capital endowments, or tax rebates. In particular, there would need to be strong coordination between the relevant banks and the source country authorities, the PICs, and IFIs on the amounts and design of such subsidies. There could be a need for burden sharing between the various parties involved.

- The host country central banks could act as a conduit for CBRs and other cross border transactions. It could facilitate these transactions by maintaining a single account with the overseas banks while intermediating the CBRs. Undoubtedly this would place considerable risks on the central banks as they would need to undertake the due diligence themselves and would be exposed to financial and reputational risks if not done properly. Also most of the regional CBs may not have the capacity to undertake this role. Anecdotal reports suggest that a number of central banks in the region have indeed attempted such an approach but have faced problems in establishing accounts with the overseas banks especially at the branch level. Thus, it would probably require a commitment by the overseas banks at the HQ level perhaps with support by the relevant source central banks.

- Additionally, the source country central banks could help facilitate payment corridors with the PICs either through local banks or through the central bank itself. Especially when the transactions are considered low risk such as is the case by documented overseas workers, there is scope for the regional authorities to work on facilitating flows, for instance by pre validating and approving the remitters and recipients. As an example, in Tonga a cashless remittance service has been developed by the IFC and the Tonga Development Bank in collaboration with Reserve Bank of Australia (RBA) and Reserve Bank of New Zealand (RBNZ).[9] This could provide a template for the region including Vanuatu.

- The initiative in 2019 by the RBNZ to establish the Pacific Remittance Project with the aim of enhancing remittance flows in the region could be further developed.[10] The

[9] International Finance Cooperation (2020).

[10] RBNZ (2022).

project is currently exploring a range of initiatives including ongoing information gathering exercises, policy/legislative changes and operational improvements.

Operational and Technical Improvements

13. Improvements in the regular way of business conduct are needed. It is widely accepted that a vital reform would be the proper implementation of the required improvements to AML/CFT and tax frameworks, weaknesses in which have, inter alia, presented risks.

- **AML/CFT.** Reforms especially require action on implementing international standards including improving the application of AML/CFT preventive measures by reporting entities, establishment of an FIU, and increased supervisory capacities. This applies to the regional respondent banks and also to the MTs especially given the perception that these are high risk. Development partners continue to provide TA) in these areas. Additionally, the RBNZ, the Australian Transaction Reports and Analysis Centre (AUSTRAC) has made it clear that correspondent banks should not apply blanket de-risking and be selective in their actions, especially as the risks involved in remittances transfers are considered low.[11] Encouragingly, Vanuatu was officially removed from the FATF "Grey List" in June 2018 after significant progress was made in address the key technical deficiencies identified in the 2015 Mutual Evaluation Report, although effectiveness was not examined (at that stage but further reviews will take place in 2023).[12]
- **International financial center tax and transparency issues**. Several PICs including Samoa and Vanuatu have international financial centers (IFCs) with very liberal disclosure and reporting requirements. Concerns over the opaque nature of these IFCs has led to the EU placing both PICs on its list of non-cooperative tax jurisdictions. Sufficiently strengthening the national framework and moving off the list of non-cooperative jurisdictions would be a strong signal and address such concerns. Vanuatu should continue to negotiate with the EU on next steps including a review by the Global Forum on Tax Transparency and greater information sharing. In addition, Vanuatu still undertakes the ECP that is now paid in a variety of currencies. Such activities affect the country risk-reward calculus, and more transparency would help.

Technological Changes

14. Digital innovations in the banking sector, if appropriately designed and managed, could provide a durable and safe resolution to a number of financial sector challenges. These include inclusion and access issues as a result of de-banking by international banks and cross border issues including the CBR problem and also overcome

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[11] See Australian Transaction Reports and Analysis Centre, AUSTRAC, (2017).

[12] APG (2018).

economies of scale problems. The relevant innovations include the rise of e-money that is a means of payment and a store of value that is fully backed by fiat currency. This approach could be manifested broadly through versions of central bank digital currencies and/or private sector stablecoins that use blockchain technology. There is considerable interest in such innovations across the region including in Vanuatu where some legal reforms have been made recently regarding cyptoassets and digital trading in the OFC.[13]

15. Such an approach could provide solutions to the problems noted above.[14] For instance, e-money can provide benefits in terms of greater convenience, lower transaction costs, and benefitting from network effects. The use of e-money could reduce the reliance on bank branches as all that is needed are appropriate mobile phones, adequate internet, and agents who can easily convert digital to fiat currency and vice versa. These benefits could mean that a loss of international banks in the PICs could be mitigated by greater access and inclusion by the population. For cross border flows such as money transfers by overseas workers or trade financing, such technology using token versions of e-money on the blockchain could simplify the transactions by making them faster, more transparent and cheap - clear improvements from the current situation.

16. However, much needs to be done before such innovations materialize and this will take time requiring considerable consultation. Despite the promise of such technology, there are several key reforms that have to proceed in any case. Importantly, this includes work on enhancing the AML/CFT regime as innovations may introduce new risks or exacerbate existing one.[15] There also need to be appropriate legal and regulatory changes to allow such instruments including changes to the central bank and banking laws; and the payments infrastructure will need to be upgraded. Especially regarding remittances, the PIC central banks will need to coordinate very closely with their counterparts in source countries, notably Australia, New Zealand and US, notably on establishing common platforms. The IFIs and other development partners can also help guide and advise in this process with a capacity development program on e-KYC already supported by the ADB. These will all take time but it is important to get these necessary infrastructural and regulatory aspects right given the dangers of path dependency inherent in undertaking the wrong approach.

17. Also associated wider risks need to be addressed. Some inherent disadvantages will also need to be carefully looked at before implementation. An important one is that dollarization could be encouraged by this approach and this carries risks to monetary policy and financial stability. As overseas workers send money back in the form of foreign currency denominated coins, digital money could lower the barriers to

[13] See IMF 2022 for a survey of regional developments.

[14] See IMF 2019.

[15] In some ways, the digital approach improves transparency (e.g., recording transactions on the ledger); however, in other ways, technological developments can also obfuscate user and geolocation data and the transaction trail.

the greater use of foreign currency in the PICs and so encourage dollarization. If the advanced countries introduce such digital currencies ahead of the PICs then first mover advantages could lead to a permanent increase in such trends that would become very difficult to reverse. Consumer protection, literacy and other safeguards also need to be developed.

18. This highlights the need for regional cooperation especially between the PICs and the advanced economies in the region. Such innovations also place a premium on sound macroeconomic framework and policy making to limit such dollarization. Otherwise, overseas workers could maintain their balances "in the cloud' and this would limit the substantial impact on remittances on reserves and foreign exchange market liquidity.

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INTERNATIONAL MONETARY FUND

VANUATU

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 27, 2023

Prepared By

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

CONTENTS

FUND RELATIONS

(As of December 31, 2022)
Membership Status: joined September 28, 1981; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	23.80	100.00
Fund holdings of currency	19.61	82.38
Reserves tranche position	4.20	17.63

SDR Department:

	SDR Million	Percent Quota
Net cumulative allocations	39.08	100.00
Holdings	22.10	56.55

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	4.25	17.86
Emergency Assistance 1/	0.0	0.0

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

Latest Financial Arrangements: None

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

	Forthcoming 2023	2024	2025	2026	2027
Principal	1.70	1.70	0.85		
Charges/Interest	0.49	0.50	0.50	0.50	0.50
Total	2.19	2.20	1.35	0.50	0.50

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

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative: Not applicable

Implementation of Catastrophe Containment and Relief: Not applicable

Exchange Arrangements

Since 1988, Vanuatu has officially maintained an adjustable peg exchange rate arrangement. Currently, the exchange rate of the vatu is linked to a transactions-weighted (trade and tourism receipts) basket of currencies. The weights and composition of the basket, which are not publicly disclosed, are adjusted periodically. The Reserve Bank of Vanuatu (RBV) quotes daily buying and selling rates for the vatu against the U.S., Australian, and New Zealand dollars; the euro; the U.K. pound; and the Japanese yen. The rate in terms of the U.S. dollar as of January 30, 2023 was VT 114.44 per U.S. dollar. The de facto classification is "other managed," as the composite weights are not disclosed and cannot be confirmed. Vanuatu has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on making of payments and transfers for current international transactions and multiple currency practices.

Article IV Consultation

Vanuatu is on a 12–month consultation cycle. The previous Article IV consultation mission took place over June 28 – July 22, 2021, and the consultation was concluded on August 31, 2021 (Country Report No. 21/208).

OFC Assessments

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

Safeguards Assessment

The first safeguards assessment of the RBV was completed in October 2016 in connection with emergency financing received in 2015. The assessment found that the RBV has a recognized accounting framework and publishes annual financial statements, albeit with some delay. It also identified several weaknesses in its governance arrangements, autonomy, transparency, and audit mechanisms. Recommendations included: (i) drafting amendments to the Reserve Bank of Vanuatu Act to align it with leading practices for central banks; (ii) establishing an Audit Committee; (iii) outsourcing internal audit services to an independent international audit firm; and (iv) formulating a recapitalization plan. The RBV received technical assistance on the recapitalization framework and appointed a Chief Risk Officer. That said, the absence of an audit committee and an internal audit function continue to present risks to the RBV's control environment. Furthermore, the RBV's plans to draft relevant amendments to the RBV Act in line with the 2016 safeguards recommendations have not materialized. Instead, the Parliament enacted, in June 2022, amendments to the RBV Act that further deteriorate the RBV's autonomy and governance arrangements. The authorities committed to repeal the 2022 amendments to the RBV Act in 2023.

Technical Assistance

Technical assistance on revenue administration, public financial management, debt management, banking regulation and financial sector supervision, and statistics (GDP, external sector statistics, government finance statistics) has been provided mainly through PFTAC.

Resident Representative

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

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS (IFIs)

Relations with other IFIs:

- World Bank Group:
http://projects.worldbank.org/search?lang=en&searchTerm=&countrycode_exact=VU
- Asian Development Bank:
https://www.adb.org/countries/vanuatu/main
- Pacific Financial Technical Assistance Center:
https://www.pftac.org/content/dam/PFTAC/Documents/Workplans/fy23/Vanuatu.pdf

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
General: Data provision has shortcomings but is broadly adequate for surveillance. The frequency and quality of national accounts could be further improved, while the coverage of government finance statistics (GFS) and external sector statistics could be expanded, and data provision lags could be shortened.
National accounts: While there have been improvements in the methodology and the development of additional data sources, the accuracy of expenditure-based GDP estimates could be further improved. Data are compiled only on an annual basis. Plans to rebase GDP and develop a new quarterly measure to at least 2022 have been delayed. PFTAC is providing technical assistance in national accounts compilation and has refocused on core capacity development to provide a solid basis for reviving development work in FY2024. **Price statistics:** A quarterly CPI covering the two urban centers of Port Vila and Luganville is produced. Dissemination is irregular, with the 2nd quarter of 2022 currently the most recent release. The CPI weights are based on 2010 household surveys. Rebasing the CPI to a more recent base year has been reprioritized due to delays in the Household Income and Expenditure Survey.
Government finance statistics: The budget classification is broadly consistent with the budgetary central government under GFSM 2014. The classification of some budget items are still to be reviewed in line with GFSM 2014 and technical support has been provided by the Fund to help address these. The lack of a dedicated compiler of government finance statistics (GFS) has slowed-down overall progress on data compilation and dissemination. Central government debt and government guarantees are compiled on a quarterly basis; starting to report data to the joint IMF and World Bank QPSDS database could help support surveillance. Expanding the coverage of GFS to the consolidated general government and debt to the wider public sector are essential for surveillance purposes, but capacity constraints and source data gaps delay progress in this area. Discrepancies in fiscal data published across the Department of Finance and Treasury (DoFT), the Vanuatu National Statistics Office (VNSO), and the Reserve Bank of Vanuatu (RBV) need to be reconciled.
Monetary statistics: Monetary statistics are compiled broadly in line with the Monetary and Financial Statistics Manual. The RBV reports monthly monetary data, using Standardized Report Forms (SRFs) for the central bank and other depository corporations, which are published in the International Financial Statistics. However, the SRFs have not been updated since March 2022. The RBV reports data for some indicators to the Financial Access Survey (FAS) including mobile and internet banking, gender-disaggregated data, and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs). **Financial sector surveillance:** The RBV also reports Financial Soundness Indicators (FSIs) on a quarterly basis, including all 13 core and 6 encouraged indicators for deposit takers. The FSI data along with accompanying meta data are published in the IMF's FSI data portal. However, data has not been updated since 2018Q1.

External sector statistics: The RBV releases quarterly BOP and IIP data in its Quarterly Economic Review and are in the process of disseminating the data in line with the Balance of Payments and International Investment Position Manual (BPM6) format. The dissemination lag of quarterly external sector data could be further shortened to support surveillance, and frequent large-scale revisions to the external sector statistics could be reduced to support surveillance. The coverage of external sector statistics could be further improved, for example, by addressing any incomplete coverage of positions of other financial corporations.	
II. Data Standards and Quality	
Since April 2019, Vanuatu has implemented the recommendations of the IMF's Enhanced General Data Dissemination System (e-GDDS) by publishing essential data through a National Summary Data Page (NSDP), an important achievement in data transparency.	No data ROSC is available.

Vanuatu: Table of Common Indicators Required for Surveillance (As of February 2023)					
	Date of Latest Observation	**Date Received**	**Frequency of Data[1]**	**Frequency of Reporting**	**Frequency of Publication**
Exchange Rates	04/2022	06/2022	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	03/2022	06/2022	M	M	M
Reserve/Base Money	03/2022	06/2022	M	M	M
Broad Money	03/2022	06/2022	M	M	M
Central Bank Balance Sheet	03/2022	06/2022	M	M	M
Consolidated Balance Sheet of the Banking System	03/2022	06/2022	M	M	M
Interest Rates[3]	09/2021	11/2021	M	M	M
Consumer Price Index	06/2022	06/2022	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[4] —General	N/A	N/A	N/A	N/A	N/A
Revenue, Expenditure, Balance and Composition of Financing[4,5]—Central Government	12/2022	02/2023	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[6]	2022	01/2023	M	M	M
External Current Account Balance	9/2022	9/2022	Q	Q	Q
Exports and Imports of Goods and Services	9/2022	9/2022	Q	Q	Q
GDP/GNP	2020	9/2022	A	A	A
Gross External Debt	12/2022	01/2023	Q	Q	Q
International Investment Position	03/2022	10/2022	Q	Q	Q

[1] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I), and Not Available (N/A).
[2] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[3] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[4] Foreign and domestic financing.
[5] The central government is only the budgetary central government. The data not monthly to STA or IFS. The last available information in IFS available is December 2018. On April 30, 2019 the Government started to release the data through its eGDDS National Summary Data Page
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

VANUATU

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

February 27, 2023

Approved By
Era Dabla-Norris and Maria Gonzalez (IMF) and Manuela Francisco and Hassan Zaman (IDA)

Prepared by the staff of the International Monetary Fund and the International Development Association

Vanuatu: Joint Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress:	Moderate
Overall risk of debt distress:	Moderate
Granularity in the risk rating:	Limited space to absorb shocks
Application of judgement:	No

The 2023 Debt Sustainability Analysis (DSA) indicates that the risk of debt distress for Vanuatu remains moderate for both external and overall public debt, with limited space to absorb shocks; the rating is unchanged from the 2021 DSA.[1] External debt stock and liquidity indicators remain below their benchmark levels in the baseline scenario, given the concessional nature of Vanuatu's external borrowing, but stock indicators are vulnerable to natural disasters and macroeconomic shocks. A severe downside scenario with a full loss of Economic Citizenship Program (ECP) revenues would likely cause three external debt indicators to breach their benchmarks. The public debt stock and public debt service costs are forecast to grow over the long term, with increasing reliance on domestic borrowing necessitating the development of domestic debt markets. In light of these results, it is essential for Vanuatu to rebuild fiscal space and enhance resilience against shocks. Formulating a medium-term fiscal strategy with robust revenue mobilization and expenditure rationalization measures is essential to preserve sustainability and create space for growth-critical infrastructure. When financing new infrastructure, the authorities are encouraged to continue seeking grants and concessional loans.

[1] The composite indicator for Vanuatu is estimated at 2.99, based on October 2022 WEO and 2021 World Bank CPIA, indicating a medium debt carrying capacity.

PUBLIC DEBT COVERAGE

1. **The coverage of public sector debt for this DSA is central government debt, central government guaranteed debt, and central bank debt borrowed on behalf of the government.** The debt of Air Vanuatu is not included due to lack of data. Staff plans to work with the authorities based on information from ongoing and planned assessments by Australia's DFAT and the IFC (see Staff Report), and Air Vanuatu's updated financial statements, to address missing information on debt stock and flows in order to incorporate the debt of Air Vanuatu into the stock of government debt in the next DSA, if the SOE continues to pose significant fiscal risks (see paragraph 2). Because of data limitations, other elements in the general government, other non-guaranteed state-owned enterprise (SOE) debt, and private external debt are also not included in the analysis.[2] Given the limited capacity of Vanuatu's state and local governments, SOEs, and the private sector to borrow either externally or domestically, data deficiencies are not expected to affect the overall assessment. PFTAC continues to provide technical assistance to help the authorities expand the coverage of government financial statistics (GFS) from budgetary central government to general government and SOEs. The DSA uses a residency-based definition of external debt.

Coverage of Public Sector Debt

	Subsectors of the public sector	Check box
1	Central government	X
2	State and local government	
3	Other elements in the general government	
4	o/w: Social security fund	
5	o/w: Extra budgetary funds (EBFs)	
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	X
8	Non-guaranteed SOE debt	

2. **The DSA includes a combined contingent liabilities stress test.** Contingent liability risks mostly stem from the financially distressed national air carrier, Air Vanuatu, as well as from other SOEs. Large cost overruns and an overambitious investment plan involving the order of six Airbus aircraft resulted in losses and brought the viability of the airline into question. In March 2021, the government took temporary control of Air Vanuatu in order to restructure the enterprise; the restructuring process is ongoing. While the contract with Airbus has been revised to reduce the number of aircraft and the associated liabilities, the airline remains in severe financial distress, which is affecting operations. The ongoing restructuring entails several significant fiscal risks: i) forgiveness of the VUV 2.1 billion (1.8 percent of GDP) in loans owed to the government by Air Vanuatu; and ii) transfer of the remainder of the airline's VUV 5.8 billion (5.1 percent of GDP) in debt, including costs associated with the Airbus contract, to the government as part of the restructuring process. The total debt of other non-financial SOEs was estimated at VUV 2.1 billion (1.8 percent of GDP) based on the most recent data available for each enterprise. In order to capture these risks, the magnitude of the shock of SOE debt has been adjusted from the default value of 2 percent to 8.7 percent of GDP.

[2] While the financial statements of most State-Owned Enterprises (SOEs) are published online, these are only available with a significant lag. The GBE unit is working on collecting consolidated debt data.

Contingent liabilities from financial markets are set at the default value of 5 percent of GDP, which represents the average cost to the government of a financial crisis in a low-income country.

Combined Contingent Liability Shock

		Default	Used for the analysis	Reasons for deviations from the default settings
1	The country's coverage of public debt	The central government, central bank, government-guaranteed debt		
2	Other elements of the general government not captured in 1.	0 percent of GDP	0	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2 percent of GDP	8.7	Air Vanuatu (7.9 percent of GDP); other SOEs (1.8 percent of GDP)
4	PPP	35 percent of PPP stock	0	
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5 percent of GDP	5	
	Total (2+3+4+5) (in percent of GDP)		13.7	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

BACKGROUND ON DEBT

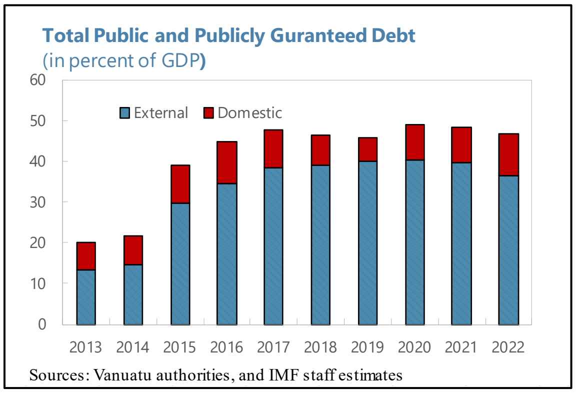
3. **Public and publicly guaranteed (PPG) debt was estimated at 46.6 percent of GDP at end-2022, having stabilized in recent years.** PPG debt more than doubled between 2014 and 2016 (from 21.6 to 45 percent of GDP), mainly due to new disbursements in support of reconstruction after Tropical Cyclone (TC) Pam, as well as infrastructure development support. Key bilateral and multilateral lenders over this period included the Export-Import Bank of China (China Eximbank), the Japan International Cooperation Agency (JICA), the ADB, IDA, and the IMF. After 2016, PPG debt stabilized around 45-48 percent of GDP, as the initial policy responses to the COVID-19 pandemic and natural disasters in 2020 and 2021 were primarily financed by revenues from the Economic Citizenship Program (ECP)[3] and grants from donors. ECP revenues also enabled Vanuatu to not opt into the Debt Service Suspension Initiative. Vanuatu's debt obligations are largely external, with external debt accounting for 78 percent of total PPG debt as of end-2022. China Eximbank is the largest creditor, accounting for 30 percent of total PPG debt.

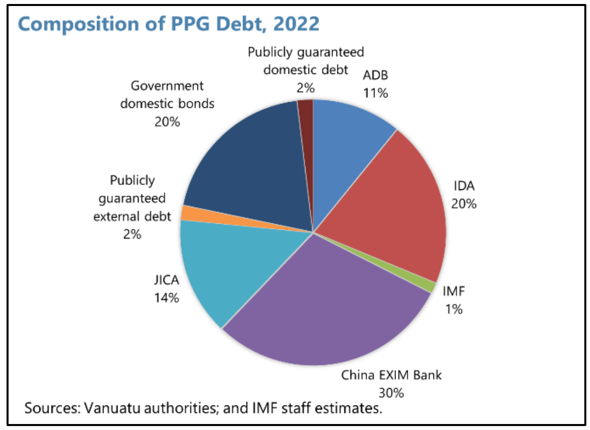
Stock of Public and Publicly Guaranteed Debt at End-2022

	Vatu mn	USD mn	% of total debt
Total public debt	53,009	462	100
External	41,490	361	78
Multilateral	17,212	150	32
ADB	5,748	50	11
IDA	10,815	94	20
IMF	649	6	1
Bilateral	23,360	204	44
China EXIM Bank	15,724	137	30
JICA	7,636	67	14
Others	0	0	0
Publicly guaranteed debt	918	8	2
Domestic	11,518	100	22
Government bonds	10,508	92	20
RBV	3,319	29	6
VNPF	4,600	40	9
Commercial banks & other	2,590	23	5
Publicly guaranteed debt	1,010	9	2

Source: Vanuatu authorities and IMF staff estimates.

[3] Since 2017, the ECP offers passports in return for investment. The ECP consists of the Vanuatu Development Support Program (VDSP) and the Vanuatu Contribution Program (VCP). These schemes offer "honorary citizenship" that includes most ni-Vanuatu rights except voting and political involvement, in exchange for a one-time contribution. Application costs range from USD 135,000 for a single applicant (of which the government's share is USD 80,000), to USD 185,000 for a family of four (of which the government's share is USD 130,000). See also Appendix II of the Staff Report for the 2021 Article IV Consultation.





4. The authorities have been making early repayments on external loans since 2018. Supported by stronger-than-expected revenues from the ECP, the authorities prepaid VUV 2 billion (1.6 percent of GDP) in 2021, primarily on less concessional loans from China Eximbank. Despite a significant weakening of fiscal prospects, early repayments continued in 2022, when VUV 687 million (0.5 percent of GDP) were paid in advance on a concessional JICA loan.

5. Currently, Vanuatu's domestic debt market is shallow and underdeveloped, with excessive dependence on a few investors. Public domestic debt, in the form of central government bonds, is largely held by the Vanuatu National Provident Fund (VNPF), the Reserve Bank of Vanuatu (RBV), and commercial banks (including publicly owned NBV). Government-guaranteed SOE debt accounts for just 1.9 percent of total PPG debt.[4] In the absence of significant revenue mobilization efforts, elevated fiscal deficits will require Vanuatu to increasingly rely on domestic issuance over the long term (especially after 2027), putting pressure on these markets. Domestic debt is projected to rise gradually from 10 percent of GDP in 2022 to 15 percent of GDP by 2030, and then to surge to 40 percent of GDP by 2043. While recent bond issuances have been over-subscribed, signaling some scope to expand domestic issuance going forward, expanding domestic debt at this rapid pace would likely imply large-scale monetary financing, with significant repercussion (see accompanying Staff Report).

6. A new Debt Management Strategy (DMS) which preserves the prudent approach of previous strategies is needed. The previous DMS expired at end-2022; the authorities have been preparing a new DMS, and have received Fund TA support in this regard, but have not yet finalized the strategy. The new DMS should continue to require all new external borrowing be concessional (with a 35 percent grant element), and should also continue to encourage the development of domestic debt markets. Given the deterioration in medium-term fiscal prospects and Vanuatu's high exposure to risks, the new DMS should limit prepayments of external debt and instead focus on strengthening cash buffers if revenues exceed expectations. The new DMS should be aligned with a new medium-term fiscal strategy, and should be based on realistic fiscal assumptions. As part of the Sustainable Development Finance Policy (SDFP), Vanuatu satisfactorily implemented the FY21 and FY22 Performance and Policy Actions (PPAs) to improve fiscal sustainability and reduce debt

[4] This reflects the current outstanding amount reported by the authorities.

vulnerabilities. As an FY23 PPA, the country committed to adhere to a zero non-concessional borrowing ceiling, in line with domestic legal requirements.

BACKGROUND ON MACROECONOMIC FORECASTS

7. Growth is back with the reopening of borders and expansionary fiscal policies. In 2022, targeted assistance via the second and third phases of the Economic Stimulus Package supported demand prior to the reopening of borders. Domestically financed capital expenditure also increased substantially. Domestic restrictions were lifted in June, and international borders reopened in July, with tourism returning gradually (though tax revenues remained below target). Revenues from the ECP declined significantly after the EU and Switzerland suspended in 2022 visa waiver agreements for Vanuatu passports issued after May 2015. Consequently, for 2022, growth is projected at 1.9 percent, and a fiscal deficit of 6.6 percent of GDP is estimated based on preliminary data, a massive deterioration from a surplus of 2.3 percent of GDP in 2021. The current account is estimated to have turned to a deficit of 2.2 percent of GDP, from a surplus of 0.8 percent of GDP in 2021, on the back of higher import costs.

8. The assumptions in the baseline scenario are consistent with the macroeconomic framework. The main assumptions are:

- ***Real GDP growth*** over 2023–33 is projected to average 2.9 percent.[5] Donor-funded infrastructure projects will pick up speed in 2023 and 2024 after the return of international experts and the easing of supply chain bottlenecks, with construction boosting growth in the near term. The gradual return of tourism—which will only reach pre-pandemic levels in 2025—will also support growth; average growth during the recovery period (2023–25) is projected at 3.7 percent.

- ***Inflation*** (measured by the GDP deflator) is projected to average 3.0 percent (in U.S. dollar terms, the relevant measure for external debt), and 3.1 percent (in domestic currency terms, the relevant measure for public debt) over 2023–33. This is consistent with CPI inflation, which peaked in 2022 due to the global conjuncture, and is projected to decline gradually in 2023 and 2024 and stabilize over the medium-term within the RBV's target range of 0 to 4 percent.

- The ***non-interest current account*** is projected to deteriorate slightly to a surplus of 1.5 percent of GDP on average over 2023–33 relative to the historical average surplus of 3.2 percent. The non-interest current account was in slight deficit in 2022 (1.8 percent of GDP) due to high import costs, high import content for infrastructure projects, and depressed travel receipts. However, over the medium term, travel receipts are expected to gradually recover, remittances are expected to strengthen, and commodity prices are likely to moderate, reducing the deficit.

[5] Growth between 2013–2022 was 1.9 percent, including the severe economic downturn in 2020.

- ***Foreign direct investment inflows*** are expected to average 3.7 percent of GDP over 2023–33, below the historical average of 4.2 percent (the latter reflecting the post TC Pam investment boom). FDI remains key for Vanuatu's growth and economic diversification.

- The ***primary deficit*** is expected to average 4.9 percent of GDP over 2023–33, a substantial deterioration from the historical average surplus of 0.1 percent of GDP. The projection reflects a rapid decline and lasting weakness in ECP revenues, a medium-term slowdown in grants (see below), the persistence of the increase in current expenditures in recent years (particularly the wage bill), and elevated infrastructure spending needs going forward, given Vanuatu's vulnerability to climate change and natural disasters.

- ***External borrowing and grants*** will continue at elevated levels in the medium term, reflecting commitments from multilateral and bilateral partners. External borrowing for infrastructure projects will accelerate significantly in 2023 and 2024, as the return of external experts and easing of supply chains blockages facilitates the restart of delayed projects. All new external borrowing is assumed to be at concessional terms, consistent with Vanuatu's debt management strategy (including new loans from China and other bilateral partners, which are all expected to contain a grant element of 35 percent). Grants are expected to average 9.0 percent of GDP over 2023–33, down slightly down from 10.6 percent of GDP over the last decade. Grant financing peaked in 2021, on the back of elevated pandemic-related in-kind aid. It is expected to increase in 2023 (reflecting the receipt of delayed grants from 2022), but decline gradually over the medium term, as in-kind aid is scaled back and the 'glut' of available grant financing linked to delayed projects is eventually absorbed. Grant support from multilateral partners (IDA and the ADB) is nonetheless expected to remain robust over the medium-term. Over the long-term, grant financing for infrastructure projects will gradually decline as the economy grows, and the composition of external financing will shift towards concessional lending. Domestic financing is expected to increase significantly over the long term, given persistent fiscal deficits and the limited pool of external resources.

- ***Government-guaranteed debt*** is forecast to remain stable at 2022 levels for the entire projection period. In the baseline, staff assumes that the government will not provide any guarantees for any new borrowing by SOEs, including Air Vanuatu. However, significant fiscal risks related to Air Vanuatu are assessed as part of the contingent liabilities shock.

- The **effects of natural disasters and climate change** over the longer term are incorporated into the baseline scenario. The years 2023–27 are assumed to be free from major costly disasters to simplify the policy discussion of the near-term outlook—a standard practice in DSAs for other small states with a similar risk profile. However, from 2027 onwards, the baseline macroframework incorporates the average long-term effects of natural disasters and climate change. Based on empirical evidence on the impact of natural disasters, real GDP growth is lowered by 0.5 percentage points annually, the current account deficit is raised by 1.3 percentage points of GDP and the fiscal deficit is increased by 0.35 percentage points of GDP relative to disaster-free projections.

9. Major differences in assumptions between the previous DSA and the current DSA reflect higher inflation and a worsening of the fiscal balance. Relative to the 2021 DSA, the current DSA assumes: (i) higher inflation in the near term, reflecting a gradual pass-through of elevated global commodity prices; (ii) higher revenues and grants, reflecting additional donor commitments and a stronger projected recovery in VAT revenues;[6] (iii) higher primary expenditures, reflecting the persistent increase in the wage bill, a lack of significant expenditure rationalization plans, and additional commitments by donors for infrastructure project lending; and (iv) higher import costs, reflecting elevated global commodity prices and higher infrastructure spending.

DSA Key Macroeconomic and Fiscal Assumptions

	Previous DSA		Current DSA		(current vs previous)	
	2023-28	2023-33	2023-28	2023-33	2023-28	2023-33
Real GDP growth, percent	3.0	2.8	3.2	2.9	0.2	0.1
Inflation (GDP deflator), percent	2.2	2.2	3.2	3.1	1.0	1.0
Nominal GDP (Millions of $US Doll	1284.6	1455.2	1255.5	1462.9	-29.1	7.7
Revenue and grants	30.9	30.2	34.9	33.9	3.9	3.6
Primary expenditure	33.9	33.1	40.2	38.8	6.3	5.6
Primary balance	-3.0	-2.9	-5.3	-4.9	-2.4	-2.0
Exports of goods and services	30.3	31.5	30.9	31.4	0.6	-0.1
Imports of goods and services	53.7	55.4	61.8	61.7	8.1	6.3
Current account balance	-4.3	-4.2	0.8	1.0	5.1	5.2

10. Realism tools do not flag substantial risks around the forecast (Figure 4)**.** The projected three-year fiscal adjustment (between 2022 and 2025) reflects a sharp increase in the deficit on the back of the loss of ECP revenues and a resumption of large-scale infrastructure projects. Real growth forecasts for 2023 and 2024 are higher than projected growth paths under different fiscal multipliers; growth forecasts reflect: (i) higher expenditures in 2023 relative to 2022 (financed by higher external grants, and thus not affecting the deficit); and (ii) a large growth contribution of externally financed capital spending, which accelerate significantly over these years.[7] The realism of projections for public and private investment rates and their contribution to real GDP could not be assessed due to data availability constraints.

11. No significant change in external debt drivers is projected. The current account is not projected to be nearly as strong a mitigator for external debt growth as in the previous five years, due to the higher import bill in the near term. Growth is expected to play a slightly larger role in containing external debt increases than in the previous five years, when growth was suppressed by the pandemic. While a primary fiscal surplus over the past five years—driven by high ECP revenues—helped mitigate public debt growth, the widening primary deficit is expected to be a significant driver of public debt growth over the next five years.[8] Over 2018–2021, the use of part of the primary

[6] VAT revenues are now projected to gradually recover to pre-pandemic levels on the back of the return of tourism, while previous assumptions were more conservative.

[7] Externally financed capital spending is related to large-scale infrastructure projects, the implementation of which is expected to have a significant impact on the construction sector.

[8] The large contribution of the residual in historic debt accumulation is mostly associated with the government increasing its holdings of domestic financial assets (cash), taking advantage of elevated revenues from the ECP. Given large fiscal deficits forecast in the medium-term, and the decline in the ECP, it is not expected that the government continue this rapid pace of expansion of cash holdings, and as such the contribution of the residual shrinks in the projection period.

surplus to accumulate cash buffers instead of paying down debt can be seen as a 'residual' driver of debt; this practice is not expected to continue, given the worsening of the fiscal outlook.

COUNTRY CLASSIFICATION

12. **Vanuatu's debt carrying capacity is assessed as medium.** The debt carrying capacity determines the applicable thresholds for the PPG external and total public debt sustainability indicators used in the assessment. The composite index (CI) of 2.99 is based on the October 2022 World Economic Outlook (WEO) data. The methodology relies on a composite indicator (CI) based on: (i) information from the 2021 World Bank Country Policy and Institutional Assessment (CPIA) score; (ii) external conditions as captured by world economic growth; and (iii) country-specific factors including import coverage of reserves. Vanuatu's CI score of 2.99 indicates a medium debt carrying capacity, reflecting moderate growth and rising remittances. The CI score is similar to that in the 2021 DSA, which was based on April 2021 WEO data.

Debt Carrying Capacity	Medium		
Final	Classification based on current vintage	Classification based on the previous vintage	Classification based on the two previous vintage
Medium	Medium 2.99	Medium 2.98	Medium 2.95

Applicable thresholds

APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	180
GDP	40
Debt service in % of	
Exports	15
Revenue	18

APPLICABLE	
TOTAL public debt benchmark	
PV of total public debt in percent of GDP	55

SCENARIO STRESS TESTS

13. **In addition to the six standardized stress tests, the analysis includes two tailored stress tests.** The combined contingent liability stress test is described in paragraph 2 above. Given Vanuatu's vulnerability to natural disasters, a tailored stress test for a natural disaster shock is also conducted. As a small developing natural disaster-prone state, Vanuatu is automatically subject to a natural disaster shock in the DSA. As in the previous DSA, the stress scenario is tailored to reflect small states' experiences with natural disasters, and entails a one-off shock of 10 percentage points

to the debt-to-GDP ratio in 2023; real GDP growth and exports are also lowered by 4 and 10 percentage points respectively in the year of the shock.[9]

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

14. Under the baseline scenario, there are no breaches in any debt stock or liquidity indicators vis-à-vis indicative thresholds (Figure 1 and Table 1). The PV of PPG external debt-to-GDP ratio is expected to increase gradually from 22.6 percent in 2023 to 32.5 percent in 2033, due to new loan disbursements for key infrastructure projects. As exports continue increasing during the recovery, the PV of debt-to-exports and the debt service-to-exports ratios drop slightly in the near term, before increasing and stabilizing respectively in the medium-term. The two liquidity indicators remain well below their thresholds over the medium and long term, reflecting the concessional nature of external debt.

15. The stress tests suggest external debt dynamics are somewhat robust to contingent liabilities, natural disasters, and macroeconomic shocks. The combined macroeconomic and export shocks have the largest impact on external debt dynamics, resulting in the PV of debt-to-GDP and the PV of debt-to-exports respectively breaching thresholds from 2025 onwards, indicating a need for the authorities to strengthen fiscal buffers. The tailored natural disaster shock would elevate the PV of debt-to-GDP ratio above its threshold starting in 2032. No shocks would cause a breach of liquidity indicators, suggesting Vanuatu's external debt service capacity is strong, consistent with the concessional nature of donor financing.

16. A severe downside scenario reflecting a complete loss of ECP revenues is applied to both external and public debt sustainability analyses. ECP revenues accounted for one third of total revenues in 2021, but have come under stress after the suspension of the EU visa waiver agreement. While a sharp deterioration in ECP revenues is already included in the baseline macroframework forecast, the shock scenario assumes a complete loss of ECP revenues from 2024 onward to capture the tail risk of a sudden stop in demand. Three quarters of lost ECP revenues are projected to be replaced by non-concessional external financing, with the remaining quarter by local debt issuance; this assumption is more conservative than in the 2021 DSA, where new external debt issued under this scenario was assumed to be at concessional terms.

17. The severe downside scenario of a full loss of ECP revenues would lead to a significant deterioration in external debt sustainability (Figure 1 and Table 3). In this scenario, three indicators would breach their thresholds over the projection horizon: the PV of debt-to-GDP in 2027, the PV of debt-to-exports in 2032, and the debt service-to-revenue ratio in 2033. The vulnerability of

[9] See "Small States' Resilience to Natural Disasters and Climate Change: Role for the IMF," *IMF Policy Paper December 2016.*

Vanuatu's debt sustainability to a complete loss of ECP revenues underscores the need for formulating a robust medium-term fiscal strategy to reduce the reliance on the ECP and identify alternative and more sustainable revenue sources.

B. Public Sector Debt Sustainability Analysis

18. The projected evolution of the public debt burden under the baseline and stress scenarios suggests heightened vulnerabilities. Given large primary deficits, the PPG debt-to-GDP ratio is expected to rise from 46.6 percent in 2022 to 75.1 percent of GDP in 2032, breaching the authorities' fiscal anchor (to keep PPG debt-to-GDP below 60 percent) in 2027 (Table 2 and Figure 3). The PV of PPG debt-to-GDP ratio does not breach the 55 percent benchmark under the baseline scenario but is projected to follow an upward trajectory and reach 52.9 by 2033 (Figure 2 and Table 2). The PV of debt-to-revenue ratio is also projected to rise under the baseline scenario; the debt service-to-revenue ratio is projected to rise steeply on the back of rising interest costs from domestic debt and declining ECP revenues.

19. Stress tests indicate that a shock to growth has the largest impact on public debt dynamics. This shock causes a breach of the PV of PPG debt-to-GDP benchmark from 2028 onward; it assumes a negative growth rate in 2024 and 2025, contrary to the economic rebound currently projected, highlighting the importance of entrenching the recovery. Public debt is also highly vulnerable to a severe downside scenario with a full loss of ECP revenue (Figure 2 and Table 4). In this scenario, PV of PPG debt-to-GDP ratio would also breach the threshold of 55 percent in 2028.

RISK RATING AND VULNERABILITIES

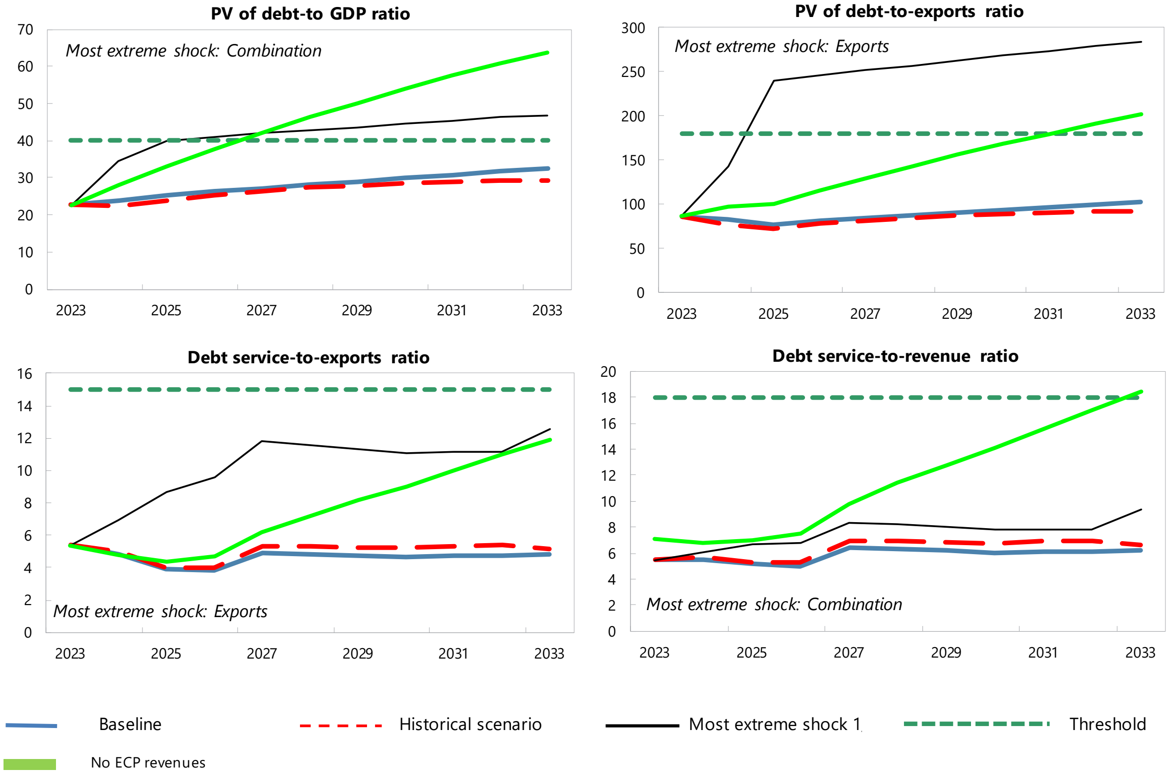
20. Vanuatu's risk of external debt distress remains moderate. Under the baseline, both debt stock and liquidity indicators remain below their benchmark levels for countries with medium debt carrying capacity. Stress tests indicate that broad-based macroeconomic shocks could increase debt substantially, signaling a need to build additional buffers and create fiscal space. However, under most stress scenarios, the external debt service burden would remain contained, indicating that Vanuatu is not expected to face challenges repaying external liabilities. Under the extreme downside scenario of a total loss of ECP revenues, stock and liquidity indicators would both rise rapidly, and most indicators would breach their thresholds. Going forward, Vanuatu's debt strategy should aim for a close-to-even external financing mix between grants and loans, and should also continue to restrict external borrowing to loans at concessional terms (greater than 35 percent grant element), in order to preserve a low debt service burden. Vulnerability to various shocks also underscores the importance of proper supervision and oversight of SOEs, and of enhancing resilience against natural disasters.

21. The overall risk of debt distress is moderate. Even though the 55 percent benchmark for the PV of PPG debt-to-GDP would not be breached under the baseline scenario, public debt and debt service costs are on a steep upward path. Under the severe downside scenario of a total loss of ECP revenues, as well as under a shock to growth, the PV of PPG debt-to-GDP ratio would breach its benchmark. The granularity assessment from the moderate risk tool indicates that Vanuatu has limited space to absorb shocks (Figure 5).

22. Under current policies, authorities' fiscal anchor, aimed at keeping PPG debt under 60 percent of GDP, will be breached in 2027, and increased reliance on domestic issuance will raise interest costs over the long term. Accelerated development of domestic debt markets and a credible medium-term fiscal strategy securing adequate consolidation via revenue mobilization and expenditure rationalization measures are critical to preserve public debt sustainability, respect fiscal anchors, and protect growth-critical infrastructure spending. Diversifying external financing sources by seeking out concessional financing from new development partners could also help Vanuatu avoid reliance on more costly domestic issuance and thus contain total debt service costs.[10]

[10] The Debt Management Office has been working on establishing contacts with various development and agricultural funds in order to attract new sources of financing.

Figure 1. Vanuatu: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2022–2033



Customization of Default Settings		
	Size	Interactions
Standardized Tests	Yes	
Tailored Stress		
Combined CL	Yes	
Natural disaster	No	Yes
Commodity price	n.a.	n.a.
Market financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing assumptions on additional financing needs resulting from the stress tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.2%	1.2%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	35	35
Avg. grace period	8	8

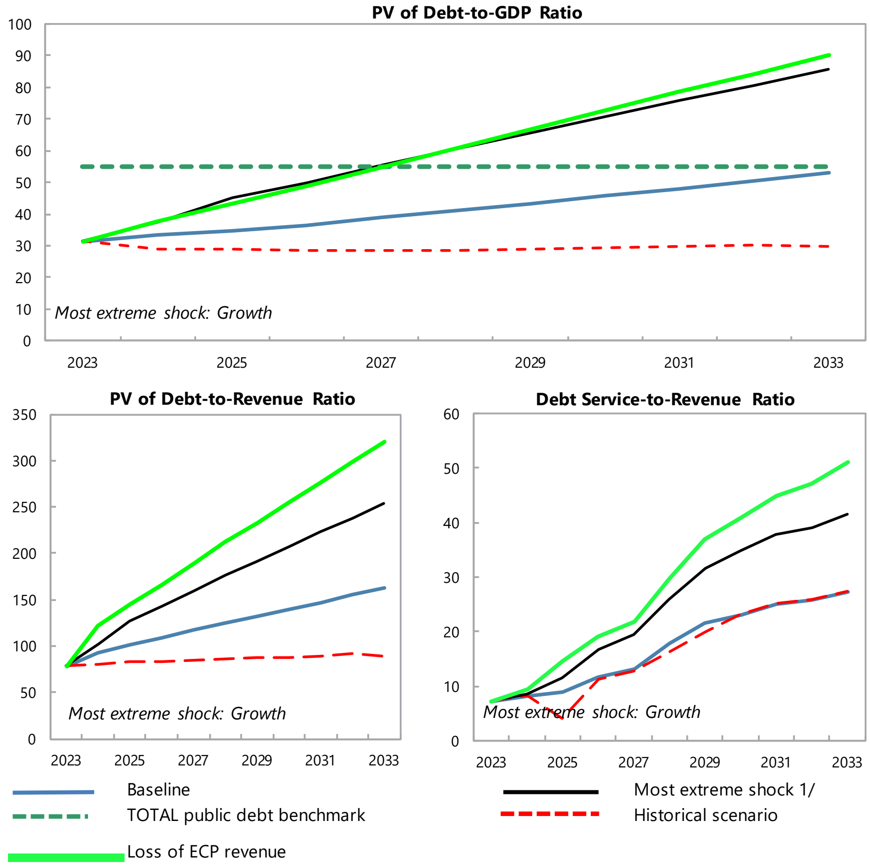
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2033. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Vanuatu: Indicators of Public Debt under Alternative Scenarios, 2022–2033



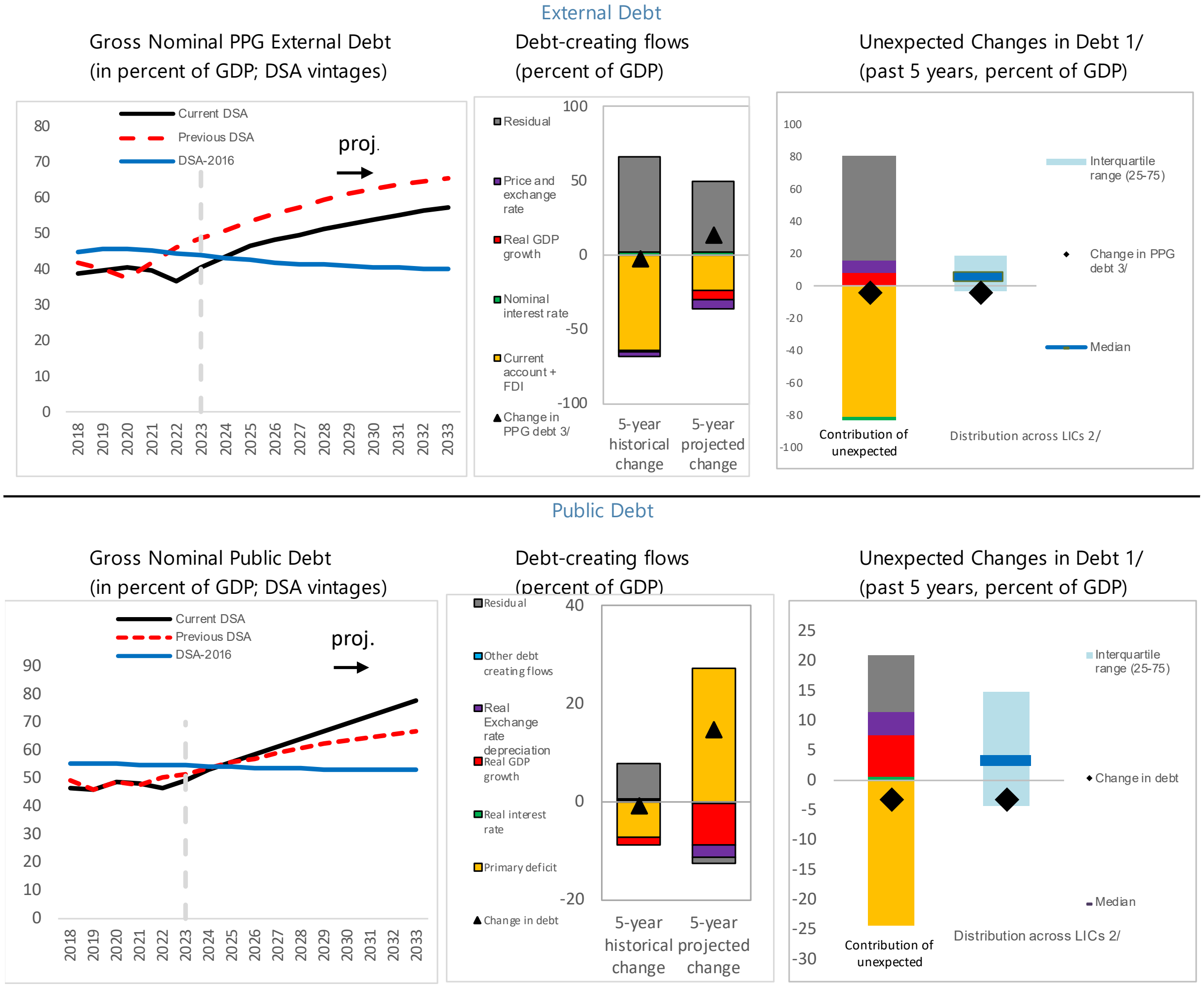
Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	56%	56%
Domestic medium and long-term	19%	19%
Domestic short-term	25%	25%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.2%	1.2%
Avg. maturity (incl. grace period)	35	35
Avg. grace period	8	8
Domestic MLT debt		
Avg. real interest rate on new borrowing	5.4%	5.4%
Avg. maturity (incl. grace period)	5	5
Avg. grace period	3	3
Domestic short-term debt		
Avg. real interest rate	1.1%	1.1%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2033. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

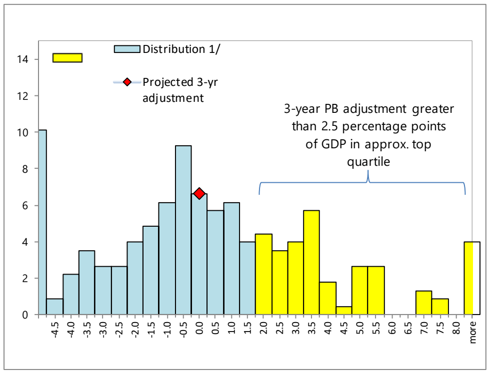
Figure 3. Vanuatu: Drivers of Debt Dynamics – Baseline Scenario



1/ Difference between anticipated and actual contributions on debt ratios.
2/ Distribution across LICs for which LIC DSAs were produced.
3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

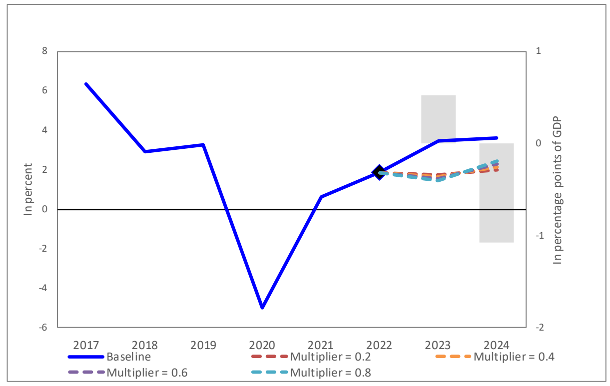
Figure 4. Vanuatu: Realism Tools

3-Year Adjustment in Primary Balance
(Percentage points of GDP)



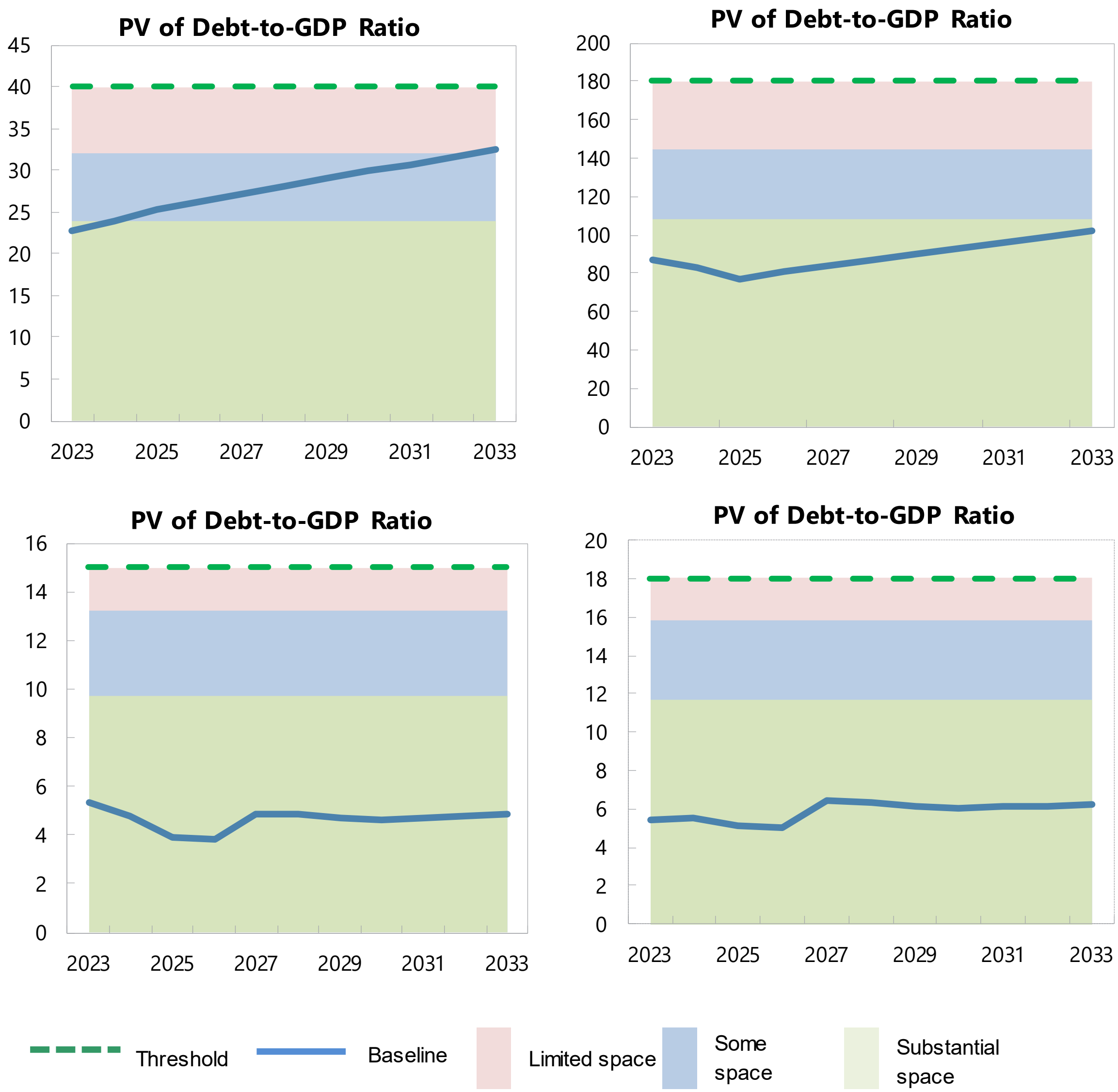
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Figure 5. Vanuatu: Classification of the Moderate Category, 2022–2033[1/]



Sources: Country authorities; and staff estimates and projections.

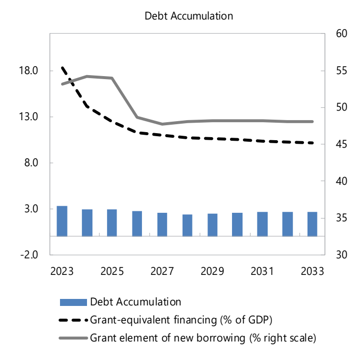
1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percent and y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

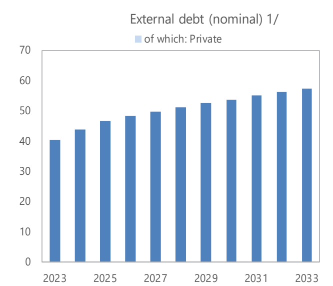
Table 1. Vanuatu: External Debt Sustainability Framework, Baseline Scenario, 2019–2043

(in percent of GDP, unless otherwise indicated)

	Actual			Projections												Average 8/	
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2043	Historical	Projections
External debt (nominal) 1/	40.4	39.8	36.5	40.5	43.7	46.5	48.3	49.7	51.1	52.4	53.8	55.0	56.3	57.4	62.5	32.6	50.4
of which: public and publicly guaranteed (PPG)	40.4	39.8	36.5	40.5	43.7	46.5	48.3	49.7	51.1	52.4	53.8	55.0	56.3	57.4	62.5	32.6	50.4
Change in external debt	0.5	-0.6	-3.3	4.0	3.3	2.8	1.8	1.5	1.4	1.3	1.3	1.3	1.2	1.1	-0.4		
Identified net debt-creating flows	-13.5	-2.3	-4.2	-1.3	-3.9	-7.6	-7.8	-7.4	-7.1	-6.7	-6.4	-5.9	-5.8	-5.7	-4.7	-8.0	-6.0
Non-interest current account deficit	-8.4	-1.3	1.8	3.2	0.8	-2.7	-3.1	-2.8	-2.8	-2.5	-2.1	-1.7	-1.6	-1.5	-0.7	-3.2	-1.5
Deficit in balance of goods and services	31.6	42.1	39.2	39.2	33.0	28.9	28.1	28.1	28.2	28.7	29.1	29.5	29.9	30.4	35.2	20.7	30.3
Exports	15.7	9.2	15.2	26.2	28.9	32.9	32.6	32.4	32.3	32.1	32.0	31.9	31.8	31.7	24.7		
Imports	47.3	51.3	54.4	65.4	61.9	61.9	60.8	60.6	60.5	60.8	61.1	61.4	61.8	62.1	59.9		
Net current transfers (negative = inflow)	-28.1	-28.8	-22.1	-21.1	-18.1	-17.7	-17.3	-17.0	-17.0	-17.0	-17.0	-17.0	-16.9	-16.8	0.0	-15.7	-17.5
of which: official	-21.3	-24.0	-16.4	-15.4	-12.4	-12.0	-11.6	-11.3	-11.3	-11.3	-11.3	-11.2	-11.2	-11.1	0.0		
Other current account flows (negative = net inflow)	-11.9	-14.6	-15.3	-14.9	-14.1	-13.9	-13.9	-13.9	-14.0	-14.1	-14.2	-14.3	-14.7	-15.1	-35.9	-8.2	-14.3
Net FDI (negative = inflow)	-2.5	-4.3	-4.0	-3.7	-3.7	-3.8	-3.9	-3.8	-3.7	-3.6	-3.6	-3.6	-3.5	-3.4	-2.7	-4.2	-3.7
Endogenous debt dynamics 2/	-2.6	3.3	-2.0	-0.8	-0.9	-1.1	-0.9	-0.8	-0.6	-0.6	-0.7	-0.7	-0.7	-0.7	-1.3		
Contribution from nominal interest rate	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.7		
Contribution from real GDP growth	1.8	-0.3	-0.7	-1.2	-1.4	-1.6	-1.4	-1.3	-1.2	-1.2	-1.2	-1.3	-1.3	-1.3	-2.0		
Contribution from price and exchange rate changes	-4.9	3.1	-1.7	...	...	...	...	...	...	...	...	...	...	...	...		
Residual 3/	14.0	1.7	0.9	5.2	7.2	10.4	9.6	8.9	8.5	8.1	7.7	7.2	7.0	6.8	4.3	10.3	7.9
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators																	
PV of PPG external debt-to-GDP ratio	...	...	20.8	22.6	24.0	25.2	26.3	27.2	28.0	28.9	29.8	30.7	31.6	32.5	36.5		
PV of PPG external debt-to-exports ratio	...	...	136.3	86.5	83.0	76.4	80.6	83.8	86.8	89.9	93.0	96.1	99.3	102.3	148.0		
PPG debt service-to-exports ratio	19.2	42.2	13.9	5.4	4.8	3.9	3.8	4.9	4.8	4.7	4.6	4.7	4.8	4.8	7.7		
PPG debt service-to-revenue ratio	10.1	13.0	8.4	5.5	5.5	5.1	5.0	6.4	6.3	6.2	6.0	6.1	6.1	6.2	7.8		
Gross external financing need (Million of U.S. dollars)	-79.5	-16.7	-1.2	9.9	-17.8	-63.4	-73.5	-68.4	-71.3	-69.9	-68.7	-64.3	-65.2	-65.2	-51.2		
Key macroeconomic assumptions																	
Real GDP growth (in percent)	-5.0	0.6	1.9	3.5	3.6	3.9	3.1	3.0	2.5	2.5	2.5	2.5	2.5	2.5	3.4	1.9	2.9
GDP deflator in US dollar terms (change in percent)	14.1	-7.2	4.4	2.7	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.6	1.4	3.0
Effective interest rate (percent) 4/	1.4	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2	1.3	1.1
Growth of exports of G&S (US dollar terms, in percent)	-57.3	-45.5	76.9	82.5	17.9	22.0	5.3	5.4	5.2	5.2	5.3	5.3	5.3	5.3	-14.9	-2.3	15.0
Growth of imports of G&S (US dollar terms, in percent)	-1.9	1.4	12.8	27.6	1.1	7.1	4.4	5.7	5.5	6.2	6.1	6.1	6.1	6.2	-2.1	3.6	7.5
Grant element of new public sector borrowing (in percent)	...	...	...	53.1	54.2	54.0	48.7	47.8	48.1	48.1	48.2	48.1	48.1	48.1	48.1	...	49.7
Government revenues (excluding grants, in percent of GDP)	29.9	29.8	25.1	25.7	25.2	25.1	24.7	24.7	24.7	24.7	24.7	24.7	24.7	24.7	24.4	25.5	24.9
Aid flows (in Million of US dollars) 5/	116.0	149.9	129.5	213.7	187.5	178.9	166.0	169.1	173.8	182.4	191.0	199.6	208.7	218.8	265.6		
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	18.3	14.1	12.5	11.3	11.0	10.7	10.6	10.5	10.4	10.3	10.2	6.8	...	11.8
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	83.9	82.0	80.6	80.7	79.8	80.4	80.3	80.1	79.9	79.7	79.5	73.6	...	80.6
Nominal GDP (Million of US dollars)	1,008	942	1,001	1,064	1,137	1,217	1,293	1,372	1,449	1,530	1,616	1,707	1,802	1,903	3,331		
Nominal dollar GDP growth	8.4	-6.6	6.4	6.3	6.8	7.1	6.3	6.1	5.6	5.6	5.6	5.6	5.6	5.6	7.1	3.3	6.0
Memorandum items:																	
PV of external debt 7/	...	...	20.8	22.6	24.0	25.2	26.3	27.2	28.0	28.9	29.8	30.7	31.6	32.5	36.5		
In percent of exports	...	...	136.3	86.5	83.0	76.4	80.6	83.8	86.8	89.9	93.0	96.1	99.3	102.3	148.0		
Total external debt service-to-exports ratio	19.2	42.2	13.9	5.4	4.8	3.9	3.8	4.9	4.8	4.7	4.6	4.7	4.8	4.8	7.7		
PV of PPG external debt (in Million of US dollars)			208.0	240.9	272.6	306.4	340.0	372.7	406.0	442.2	481.8	524.1	569.6	617.9	1217.4		
(PVt-PVt-1)/GDPt-1 (in percent)				3.3	3.0	3.0	2.8	2.5	2.4	2.5	2.6	2.6	2.7	2.7	2.4		
Non-interest current account deficit that stabilizes debt ratio	-8.9	-0.7	5.1	-0.7	-2.5	-5.5	-4.8	-4.3	-4.2	-3.8	-3.5	-3.0	-2.9	-2.7	-0.3		

Definition of external/domestic debt	Residency-based
Is there a material difference between the two criteria?	No





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g) + Ɛα (1+r)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, ρ = growth rate of GDP deflator in U.S. dollar terms, Ɛ=nominal appreciation of the local currency, and α= share of local currency-denominated external debt in total external debt.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

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

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

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

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

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

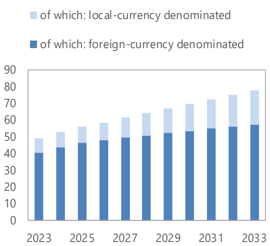
Table 2. Vanuatu: Public Sector Debt Sustainability Framework, Baseline Scenario, 2019–2042

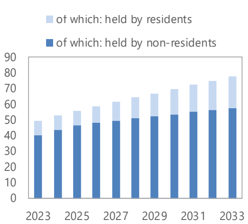
(in percent of GDP, unless otherwise indicated)

	Actual			Projections												Average 6/	
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2043	Historical	Projections
Public sector debt 1/	**48.9**	**48.4**	**46.6**	**49.2**	**53.1**	**56.1**	**58.5**	**61.4**	**64.3**	**66.9**	**69.6**	**72.4**	**75.1**	**77.8**	**98.8**	**40.9**	**64.0**
of which: external debt	**40.4**	**39.8**	**36.5**	**40.5**	**43.7**	**46.5**	**48.3**	**49.7**	**51.1**	**52.4**	**53.8**	**55.0**	**56.3**	**57.4**	**57.8**	**32.6**	**50.4**
			10.13												41.01		
Change in public sector debt	3.0	-0.5	-1.8	2.6	3.8	3.1	2.4	2.9	2.8	2.6	2.8	2.8	2.7	2.7	-3.2		
Identified debt-creating flows	**0.8**	**-1.3**	**4.4**	**3.5**	**4.5**	**3.9**	**3.2**	**3.3**	**3.3**	**2.8**	**2.9**	**3.0**	**3.0**	**3.0**	**-2.5**	**-0.7**	**3.3**
Primary deficit	**1.1**	**-3.3**	**5.7**	**5.2**	**6.3**	**5.9**	**4.9**	**5.0**	**4.8**	**4.3**	**4.4**	**4.5**	**4.5**	**4.5**	**-0.2**	**-0.1**	**4.9**
Revenue and grants	41.4	45.7	38.1	40.0	35.7	34.0	33.5	33.2	32.9	32.9	32.8	32.7	32.6	32.5	28.9	**36.1**	**33.9**
of which: grants	11.5	15.9	12.9	14.3	10.5	9.0	8.7	8.5	8.2	8.2	8.1	7.9	7.8	7.8	4.5		
Primary (noninterest) expenditure	42.6	42.5	43.8	45.1	41.9	39.9	38.4	38.2	37.7	37.1	37.2	37.1	37.0	36.9	28.6	**36.0**	**38.8**
Automatic debt dynamics	**-0.4**	**2.0**	**-1.3**	**-1.6**	**-1.7**	**-2.0**	**-1.8**	**-1.7**	**-1.5**	**-1.5**	**-1.5**	**-1.5**	**-1.5**	**-1.5**	**-2.3**		
Contribution from interest rate/growth differential	2.6	-0.1	-1.1	-1.6	-1.7	-2.0	-1.8	-1.7	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5	-2.3		
of which: contribution from average real interest rate	0.2	0.2	-0.2	-0.1	0.0	0.0	-0.1	-0.1	0.0	0.0	0.1	0.2	0.3	0.3	1.1		
of which: contribution from real GDP growth	2.4	-0.3	-0.9	-1.6	-1.7	-2.0	-1.7	-1.7	-1.5	-1.5	-1.6	-1.7	-1.7	-1.8	-3.3		
Contribution from real exchange rate depreciation	-3.0	2.1	-0.3	...	...	...	...	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	**2.2**	**0.8**	**-6.1**	**-0.9**	**-0.7**	**-0.8**	**-0.7**	**-0.4**	**-0.4**	**-0.2**	**-0.2**	**-0.2**	**-0.3**	**-0.3**	**-0.6**	**3.5**	**-0.5**
Sustainability indicators																	
PV of public debt-to-GDP ratio 2/	**...**	**...**	**31.1**	**31.4**	**33.3**	**34.8**	**36.5**	**38.8**	**41.2**	**43.3**	**45.6**	**48.0**	**50.4**	**52.9**	**75.3**		
PV of public debt-to-revenue and grants ratio	**...**	**...**	**81.8**	**78.6**	**93.3**	**102.1**	**109.2**	**117.1**	**125.0**	**131.8**	**139.3**	**147.1**	**154.9**	**162.9**	**260.8**		
Debt service-to-revenue and grants ratio 3/	**11.5**	**11.5**	**9.4**	**7.3**	**8.1**	**9.0**	**11.6**	**13.2**	**18.0**	**21.6**	**23.2**	**25.1**	**25.7**	**27.4**	**51.8**		
Gross financing need 4/	5.9	2.0	9.3	8.1	9.2	8.9	8.8	9.4	10.7	11.4	12.0	12.7	12.8	13.4	14.7		
Key macroeconomic and fiscal assumptions																	
Real GDP growth (in percent)	-5.0	0.6	1.9	3.5	3.6	3.9	3.1	3.0	2.5	2.5	2.5	2.5	2.5	2.5	3.4	**1.9**	**2.9**
Average nominal interest rate on external debt (in percent)	1.3	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2	**1.4**	**1.1**
Average real interest rate on domestic debt (in percent)	3.2	5.5	1.3	2.4	3.8	3.7	3.8	3.7	3.8	3.7	4.0	4.1	4.3	4.4	4.1	**3.3**	**3.8**
Real exchange rate depreciation (in percent, + indicates depreciation)	-7.1	5.4	-0.7	...	...	...	...	...	...	...	...	...	...	...	...	**0.5**	**...**
Inflation rate (GDP deflator, in percent)	2.8	0.7	4.9	3.9	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	4.1	**3.2**	**3.1**
Growth of real primary spending (deflated by GDP deflator, in percent)	3.8	0.5	4.9	6.7	-3.7	-1.1	-0.9	2.4	1.2	1.0	2.7	2.2	2.2	2.2	-18.5	**11.1**	**1.3**
Primary deficit that stabilizes the debt-to-GDP ratio 5/	-1.9	-2.8	7.5	2.6	2.4	2.8	2.5	2.1	1.9	1.7	1.7	1.7	1.7	1.7	2.9	**0.9**	**2.1**
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**No**

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.
1/ Coverage of debt: The central government, central bank, government-guaranteed debt . Definition of external debt is Residency-based.
2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.
3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.
4/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.
5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.
6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Table 3. Vanuatu: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2022-2033

(in percent)

	Projections 1/										
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
PV of debt-to GDP ratio											
Baseline	23	24	25	26	27	28	29	30	31	32	32
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	23	22	24	25	26	27	28	29	29	29	29
A2. Alternative Scenario: [Loss of ECP revenues]	23	28	33	38	**42**	**46**	**50**	**54**	**57**	**61**	**64**
B. Bound Tests											
B1. Real GDP growth	23	26	29	31	32	33	34	35	36	37	38
B2. Primary balance	23	25	28	30	31	32	33	34	35	36	36
B3. Exports	23	30	**41**	**42**	**42**	**43**	**44**	**45**	**45**	**46**	**47**
B4. Other flows 3/	23	31	39	**40**	**41**	**41**	**42**	**43**	**43**	**44**	**44**
B5. Depreciation	23	30	26	28	29	30	31	33	34	35	36
B6. Combination of B1-B5	23	34	**40**	**41**	**42**	**43**	**44**	**45**	**45**	**46**	**47**
C. Tailored Tests											
C1. Combined contingent liabilities	23	28	30	31	32	33	35	36	37	38	39
C2. Natural disaster	23	28	30	32	33	35	37	38	39	**41**	**42**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	40	40	40	40	40	40	40	40	40	40	40
PV of debt-to-exports ratio											
Baseline	86	83	76	81	84	87	90	93	96	99	102
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	86	77	72	78	81	84	87	89	90	91	92
A2. Alternative Scenario: [Loss of ECP revenues]	86	97	100	115	130	143	156	168	180	**191**	**201**
B. Bound Tests											
B1. Real GDP growth	86	83	76	81	84	87	90	93	96	99	102
B2. Primary balance	86	87	85	91	94	98	102	105	109	112	115
B3. Exports	86	143	**239**	**247**	**252**	**257**	**263**	**268**	**274**	**279**	**283**
B4. Other flows 3/	86	108	119	123	125	128	130	133	136	138	140
B5. Depreciation	86	83	64	68	71	74	78	81	84	87	91
B6. Combination of B1-B5	86	128	104	150	154	157	161	165	169	173	175
C. Tailored Tests											
C1. Combined contingent liabilities	86	97	91	96	100	104	108	112	115	118	121
C2. Natural disaster	86	102	97	103	108	114	120	125	130	135	140
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	180	180	180	180	180	180	180	180	180	180	180
Debt service-to-exports ratio											
Baseline	5	5	4	4	5	5	5	5	5	5	5
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	5	5	4	4	5	5	5	5	5	5	5
A2. Alternative Scenario: [Loss of ECP revenues]	5	5	4	5	6	7	8	9	10	11	12
B. Bound Tests											
B1. Real GDP growth	5	5	4	4	5	5	5	5	5	5	5
B2. Primary balance	5	5	4	4	5	5	5	5	5	5	5
B3. Exports	5	7	9	10	12	12	11	11	11	11	13
B4. Other flows 3/	5	5	4	5	6	6	6	5	5	5	7
B5. Depreciation	5	5	4	4	5	5	4	4	4	5	5
B6. Combination of B1-B5	5	6	6	6	8	7	7	7	7	7	9
C. Tailored Tests											
C1. Combined contingent liabilities	5	5	4	4	5	5	5	5	5	5	5
C2. Natural disaster	5	5	4	4	6	6	6	6	6	6	6
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	15	15	15	15	15	15	15	15	15	15	15
Debt service-to-revenue ratio											
Baseline	5	6	5	5	6	6	6	6	6	6	6
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	5	6	5	5	7	7	7	7	7	7	7
A2. Alternative Scenario: [Loss of ECP revenues]	7	7	7	7	10	11	13	14	16	17	**18**
B. Bound Tests	7	7	7	7	10	11	13	14	16	17	**18**
B1. Real GDP growth	5	6	6	6	8	7	7	7	7	7	7
B2. Primary balance	5	6	5	5	7	7	6	6	6	6	7
B3. Exports	5	6	6	7	8	8	8	7	7	7	8
B4. Other flows 3/	5	6	6	6	8	7	7	7	7	7	8
B5. Depreciation	5	7	6	6	8	7	7	7	7	7	7
B6. Combination of B1-B5	5	6	7	7	8	8	8	8	8	8	9
C. Tailored Tests											
C1. Combined contingent liabilities	5	6	5	5	7	7	7	7	7	7	7
C2. Natural disaster	5	6	5	5	7	7	7	7	7	7	7
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	18	18	18	18	18	18	18	18	18	18	18

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private transfers and FDI.

Table 4. Vanuatu: Sensitivity Analysis for Key Indicators of Public Debt, 2022–2033

	Projections 1/										
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
PV of Debt-to-GDP Ratio											
Baseline	31	33	35	37	39	41	43	46	48	50	53
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	31	29	29	28	28	29	29	29	30	30	30
A2. Alternative Scenario: [Loss of ECP revenue]	31	38	43	49	55	**61**	**67**	**73**	**78**	**84**	**90**
B. Bound Tests											
B1. Real GDP growth	31	37	45	50	**55**	**61**	**66**	**71**	**76**	**81**	**86**
B2. Primary balance	31	37	41	42	44	47	49	51	53	**55**	**57**
B3. Exports	31	38	48	50	52	54	**56**	**58**	**60**	**62**	**64**
B4. Other flows 3/	31	41	49	50	52	54	**56**	**58**	**61**	**63**	**65**
B5. Depreciation	31	37	36	36	36	37	37	38	38	39	40
B6. Combination of B1-B5	31	35	38	38	41	43	46	48	51	53	**56**
C. Tailored Tests											
C1. Combined contingent liabilities	31	43	44	45	47	49	51	53	**55**	**57**	**60**
C2. Natural disaster	31	43	44	46	49	52	54	**57**	**60**	**63**	**66**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	55	55	55	55	55	55	55	55	55	55	55
PV of Debt-to-Revenue Ratio											
Baseline	79	93	102	109	117	125	132	139	147	155	163
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	79	81	84	84	84	86	87	88	90	91	90
A2. Alternative Scenario: [Loss of ECP revenue]	7	9	15	19	22	30	37	41	45	47	51
B. Bound Tests											
B1. Real GDP growth	79	102	127	143	160	177	192	207	223	238	254
B2. Primary balance	79	103	120	127	134	142	148	154	162	169	177
B3. Exports	79	106	141	148	155	163	169	176	184	191	198
B4. Other flows 3/	79	114	143	150	158	165	171	178	186	193	200
B5. Depreciation	79	107	107	109	111	113	115	117	120	123	126
B6. Combination of B1-B5	79	99	110	113	122	131	138	146	154	163	171
C. Tailored Tests											
C1. Combined contingent liabilities	79	121	128	135	143	150	155	162	169	176	184
C2. Natural disaster	79	118	128	137	147	156	164	173	182	192	201
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio											
Baseline	7	8	9	12	13	18	22	23	25	26	27
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2023-2033 2/	7	8	4	11	13	16	20	23	25	26	27
A2. Alternative Scenario: [Loss of ECP revenue]	7	9	15	19	22	30	37	41	45	47	51
B. Bound Tests											
B1. Real GDP growth	7	9	12	17	20	26	32	35	38	39	42
B2. Primary balance	7	8	13	17	15	20	25	26	27	27	29
B3. Exports	7	8	9	12	14	19	22	24	26	26	29
B4. Other flows 3/	7	8	9	13	14	19	22	24	26	26	29
B5. Depreciation	7	8	10	11	14	18	21	23	25	25	27
B6. Combination of B1-B5	7	8	9	12	14	19	23	25	27	27	29
C. Tailored Tests											
C1. Combined contingent liabilities	7	8	20	15	15	23	27	26	27	27	29
C2. Natural disaster	7	8	18	16	16	24	28	28	30	30	32
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the benchmark.

2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

3/ Includes official and private transfers and FDI.

INTERNATIONAL MONETARY FUND

VANUATU

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

March 8, 2023

Prepared By | Asia and Pacific Department

This supplement reports on a natural disaster that impacted Vanuatu since the staff report was issued to the Executive Board on March 1, 2023. The assessment of damages and their economic impact is ongoing. This update does not alter the thrust of the staff appraisal.

1. **Vanuatu was struck by successive natural disasters in early March and is under a state of emergency.** Two category 4 tropical cyclones (TC Judy on March 1 and TC Kevin on March 3) made landfall on several major islands, and a 6.5 magnitude earthquake was recorded on March 3 near the largest island, Santo. While so far, no casualties have been reported, thousands of people on several major islands are affected. Many thousands were evacuated to shelters, and widespread damage to property and infrastructure including roads, public buildings, schools, and hospitals, have been reported. Power outages, water supply disruptions, fuel shortages and communication network failures continue. Tanna and Erromango islands appear particularly affected by both tropical cyclones, but the full assessment of the damage is expected to take considerable time. The government has declared a six-month state of emergency and has sought international aid.

2. **While an assessment of the economic impact is not yet available, the natural disasters are likely to add significant pressure to government spending, inflation, and external balances.** In addition to the immediate expenditure required to address the aftermath of the disaster, additional spending will likely be needed for recovery and reconstruction of the affected areas in the coming months. Tourism may be temporarily disrupted, with negative implications for growth and fiscal revenues. Additional spending, temporary supply shortages resulting from damage to existing stocks, and slow resupply (given the remoteness of several islands) are likely to add to inflation. Moreover, higher imports, the disruption in tourism, and lower agricultural exports are expected to weaken external balances relative to staff's baseline projection. Given the already limited capacity in executing infrastructure plans (which resulted in a lagged reconstruction response in the aftermath of Tropical Cyclone Pam in 2015 and Tropical Cyclone Harold in 2020), reconstruction efforts may lead to delays in other

planned large-scale projects, adding to the already extensive pipeline and setting back growth prospects further. Staff do not yet have adequate information to revise their forecast, but lower growth could potentially weaken the overall assessment of debt vulnerabilities over the long term (although there is space to absorb spending in the immediate term). The authorities have comfortable buffers (with reserves exceeding the ARA metric at 6 months of imports); however, these are exposed to pressures as discussed in paragraph 5 of the External Sector Assessment Annex II of the accompanying staff report. A deep and protracted impact on growth from the two tropical cyclones could add to such external sector pressures.

3. **The international community is responding swiftly, and staff is in contact with the authorities to offer assistance.** The United Nations, Australia, New Zealand, France, and others are providing essential humanitarian relief supplies. Australia and New Zealand are also providing logistical support on the ground with rapid assessment of the damage. Development partners have also extended immediate aid. The World Bank is expected to provide emergency assistance, including through the Catastrophe Deferred Drawdown Option (Cat DDO). Staff is in contact with the Vanuatu authorities, and has offered to discuss potential avenues of support, including the drawdown of the SDR allocation and possible access to the Fund's emergency financing facilities.