

# Vanuatu: The Pacific's success story

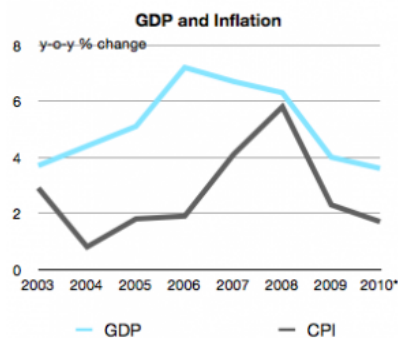
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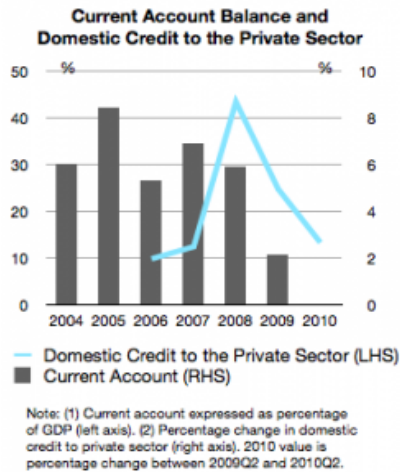
Over the last decade Vanuatu has leaped ahead of its neighbours on economic reform. Should it be a model for other island countries? This question may be answered by looking at Vanuatu's performance, what stands behind it, and at the conditions that must be met for these achievements to be sustained.

Since 1993, Vanuatu has outperformed most other Pacific island countries in terms of growth, macroeconomic equilibrium, and microeconomic reform. In the period 2003 through 2008, real GDP grew by about 6% on average. It has since moderated but remained well above the growth rate of the population despite the global financial crisis.



- Tourism and construction, including house building, were the main contributors to growth, while agriculture, which occupies the majority of the population, expanded much more slowly.
- The year-on-year inflation rate, which had been pushed up by food and oil prices, peaked at 6.4% in the June 2009 quarter, then dropped to 2.3% in the December quarter, and has remained below 3% so far in 2010.
- The current account of the balance of payments recorded a deficit averaging 5.8 % of GDP over 2004-09. It was easily financed by official and private capital inflows, and official reserves rose by mid-2010 to peak levels that exceeded the equivalent

of 6 months of imports.



- Fiscal operations of the central government have been characterized for a number of years by a growth rate of current expenditure in line with that of GDP (in current prices), tax and non-tax revenue that was sufficient to cover current expenditure, and “development expenditure” that was financed by foreign grants, leaving an overall surplus.
- Monetary developments have been volatile over the recent years, with bank credit to the private sector more than doubling from end-2006 to end 2009, but the banking sector has weathered well a potentially hazardous period. Substandard and doubtful loans, which reached a peak equivalent to 19% of total lending in the 4<sup>th</sup> quarter of 2006, have diminished gradually.

## Sources of Vanuatu’s success

Since the early 2000s, Vanuatu has had a stable government, committed to fiscal discipline and macroeconomic equilibrium, and supportive of private sector development. Donors have been behind an agenda of enhanced governance and economic reform. The latter has featured *inter alia* a successful increase in competition for communications and air transport.

The result has been a virtuous circle, with improvements in governance stimulating foreign aid, which in turn contributed to the reform process. An example of this has been the selection of Vanuatu, the only country in the Pacific area, by the US Millennium Challenge Corporation, for a large program of road construction.

A similar virtuous circle characterizes developments in the foreign investment sector. Vanuatu’s ability to attract private foreign investment is both a measure of its success and a cause of it. In tourism, house building, telecommunications, air transport, and cattle breeding, foreign private investment has played a major role.

An important factor in fostering economic growth has been the development of an active property market with long term leases used as substitutes for freeholds. This reconciles the indigenous custodianship principle for land with the possibility of

acquiring its use. It can be said that it is now uncommon for land ownership issues to be an obstacle to the establishment of a new business.

Finally, Vanuatu has been lucky in that it has been sheltered from most of the brunt of the global financial crisis thanks to its close links to Australia's economy, and to a lesser extent, Asia.

### **The challenges ahead**

Given its relatively high rate of population growth and an already worrisome level of youth unemployment, Vanuatu must continue to aim at a strong expansion of its economy while taking advantage of opportunities for migration. However, economic activity has turned more subdued: the official forecast for real GDP in 2010 has been revised downward to 3.6 %, recovering to 4% in 2011. This is due in part to a slight decline in tourist arrivals through October 2010, associated with a stronger competition from Fiji and a pick up of demand in Australia for longer distance travel, the winding down of the MCC road construction program, and a more moderate pace of bank credit. On the other hand, exports, notably copra, are growing more rapidly and the government has stepped up its capital expenditure.

Tourism is clearly the area where there is a potential for further development. The improvement in road and air transport should contribute to this. The financial sector could also expand, following the example of Mauritius, helped by the low tax environment. However, it is in agriculture where progress would have the greatest impact on the overall economy and on poverty. Already some sub-sectors, viz. cattle breeding, cocoa, and vanilla are doing well. Better transportation facilities and communications will help, and so would, as in Fiji, the organization of farmer cooperatives. Renewable energy, including biofuel (from copra), has also scope for development.

Vanuatu remains vulnerable, not just from natural disasters or economic shocks from abroad, but also to a reversal of progress toward political stability and governance, and to populist policies, such as the large increase in minimum wages granted in 2008. The preconditions for the extension of its good performance are the maintenance of sound macroeconomic policies and the continuation of microeconomic reform.

On the macroeconomic side, the tightening of monetary policy in June 2010 was appropriate given the steep decline in the commercial banks' net foreign assets (mainly claims on foreign banks), and the high rate of lending to individuals and households. The 2010 government budget is under strain as a result of lower revenue and a sharp increase in expenditure. Recurrent expenditure is higher due

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in part to the decision to make primary education free and to raise appropriations for health. Ongoing infrastructure projects have also raised development expenditure. Although there is scope for the state to borrow and infrastructure work is essential for further development, the current rate of spending is unlikely to be sustainable.

On the reform side, there is still a large agenda, ranging from public sector efficiency to increased competition in the energy and stevedoring sectors, modernization of commercial law, and reform of the land leasing system. This last item is important if a backlash against the current system, fuelled by instances of speculative gains by foreign leaseholders, were to lead to restrictions on the availability of land for business related activities.

At present there is a consensus on the reform agenda among donors, and with the government, that augurs well for Vanuatu's prospects.

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