Economic surveys

Recent developments in Vanuatu

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After a year of lurching from crisis to crisis, in early 1997 the Government of Vanuatu announced a comprehensive reform program, to include strengthening of government capacity and legislation to regulate financial dealings. The benefits to Vanuatu of the reform program will be far-reaching, but the success of these reforms calls for much determination and leadership on the part of policymakers if it is to succeed.

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The broad background

There are more than 80 islands in Vanuatu, spread out over more than 1,000 kilometres, with a total land area of about 4,700 square miles. Air services which support a promising tourist industry and afford potential for airfreighting low-bulk, high-value agricultural and fisheries products, are well developed. The sea transport system within the Vanuatu islands and with its external markets is not as well developed and shipping services are irregular and expensive.

The population of Vanuatu was estimated at about 160,000 in 1994. With population growth projected at an average annual 2.4 per cent, the population is currently in the vicinity of 173,000. Some 32,000 people live in Port Vila, and a further 10,000 in Luganville, the only other urban centre, located on the largest island, Santo. These urban centres are growing at more than twice the national population growth rate, reflecting the accelerating pace of urbanisation in the country. Population growth had steadily declined from the 3.4 per cent average for the period 1967 to late-1970s as estimated in the 1979 census. The projected population structure will however remain predominantly young for the next ten to twenty years. The fiscal burden on government for providing social infrastructure and services in health, education and social welfare will stretch its domestic resource mobilisation capacity to the limit. The large influx of young people in search of jobs and other gainful economic pursuits will continue. The rate of absorption into an expanding economy of these young people will depend critically on the level of private sector investments, effective training programs for skills acquisition, enlightened domestic policies and an expanding pipeline of well thought out public sector investment programs which effectively support private initiatives and investments.

Pacific Economic Bulletin Volume 12 Number 1, 1997 © Asia Pacific Press

The country is well endowed with natural resources. It has good soils; some 40 per cent of the total land area has fertile soils. Its isolation has some offsetting advantages such as the relative absence of pests and a pollution-free environment. About 80 per cent of the country's total population live in the rural areas. These people depend entirely upon agriculture, fisheries and forestry for subsistence and cash income. As in the other larger island economies in the Pacific, the rural economy provides a dependable and effective economic shock absorber for the country. Traditional food crops provide ready substitutes in times of budgetary and balance of payments difficulties. Although supporting the livelihood of the bulk of the population, the contribution of the subsistence sector to the country's gross domestic product, GDP, is featured in the national accounts at only 9 per cent. This figure appears to be a gross underestimate, reflecting the weakness of national accounting capacity in the Statistics Office.

Substantial external aid receipts are available to Vanuatu each year, including external soft loans sourced from multilateral sources, which form a small proportion of the total. Aid receipts amounted to 3,174 million vatu in 1993, 3,600 million vatu in 1994 and 5,550 million vatu in 1995.[1] Since independence in 1980, aid has financed the bulk of government development expenditures and effectively underwritten the stability of Vanuatu's balance of payments and external reserve positions.

But the aid-giving climate appears to be changing. Larger developing countries which are strategically and economically more important to traditional donors have added to the collective demand on diminishing aid budget allocations. So, as in other island countries, aid in Vanuatu will steadily decline in importance as a source of first resort for development expenditures and balance-of-payments support.

Skills, at all levels, are scarce. For each 120 young people, at the age of six, only 100 are able to secure places in the first year of primary schooling. Of these, some 80 leave school before reaching the sixth form and only about 5 of the remaining 20 may ultimately get into tertiary institutions. Facilities for training and ensuring relevant skills acquisition in the vocational and technical areas for the 115 who have no formal schooling or drop out of school are grossly inadequate.

Gross domestic investment rates hover around 30 per cent in Vanuatu; a figure comparable to some of the dynamic economies of Asia. Reflecting the annual deficits in the current account of the balance of payments, domestic savings traditionally fall well below national domestic investments. Financing of investments from external sources including reinvestments of profits by overseas-owned entities and external public sector borrowings was, in recent years, regularly resorted to. But high domestic investment rates are associated with low average economic growth rates since independence. So the quality of investments, particularly of the public sector has been relatively low. The social and economic yields of such investments were low or average capital/output ratios very high.

The land tenure system remains one of the many serious bottlenecks to private investment in Vanuatu. The Constitution declares that all lands in the Republic belong to the indigenous custom owners and their descendants. All existing freehold titles were therefore voided when the country became independent. But legislation has been enacted in an attempt to facilitate the leasing of lands in order to provide security to investors and to lenders.

The government is now effectively lessor of all urban lands and leases of such lands are readily bought and sold in the market place. But accessing custom lands outside of the plantations and the two urban areas of Port Vila and Luganville is fraught with difficulties. Permission from government is required for someone to negotiate a lease with custom owners. The boundaries of land claimed by custom groups are not determined. So lease negotiations and agreements with a land-owning group generally end up in the island court or proceed all the way to the Supreme Court to sort out competing claims from other custom groups. The land dispute resolution processes are inadequate.

The Offshore Financial Centre, OFC, is the best developed in the region. It was established in 1971 and is effectively supervised by the Vanuatu Financial Services Commission, VFSC, a regulatory body set up under statute. Licensed offshore banks, trust companies, insurance companies and shipping companies, operating in the OFC, like other entities in the country, are exempt from all direct taxes. These entities are also protected under domestic secrecy laws and are not required to file annual financial statements with the authorities.

The annual benefit to the country from the OFC is difficult to determine because of the paucity of information about the activities of entities within it. It employs skilled people and undertakes in-house training relevant for other sectors of the economy. It currently employs about 400 people and pays annual registration fees to government. The Reserve Bank estimates that the OFC contributes about 2.5 per cent of total GDP.

Recent political trends

The general elections in Vanuatu in December 1991 marked the beginning of a new phase in the politics of the country. Those elections brought to an end the unbroken post-independence rule of the Vanua'aka Party (VP) which had led the successful indigenous struggle for independence from the Condominium powers of France and Britain in 1980. Its success as a political party stemmed from an effective grassroots organisation extending throughout the islands, a coherent nationalist political agenda, and an unexpectedly high recognition and respect internationally deriving from its strong anti-colonial credentials and membership of the Non-Aligned Movement. Even more importantly for its dominance of domestic politics post-independence, it enjoyed internal unity behind a charismatic leader and a cohesion which arose from popular support for its nationalist platform among a majority of the predominantly anglophone, Protestant population who shared its anti-French character and ambitions.

The VP's loss of government at the elections in 1991 was attributable to its loss of internal party unity rather than any radical shift of voter preference away from traditional linguistic and denominational affiliations. A split in the once-dominant party and the division of its support base into two prevented either faction from gaining a majority in the elections.

The four years of francophone-led coalition governments which followed provided an object lesson in the dangers to political stability of unnatural alliances based on opportunistic self-interest and held together more by the desire and opportunity to destroy one's enemies than by any congruence of policy or political orientation. Although Maxime

Carlot-Korman was able to remain Prime Minister throughout the full four-year term 1991–95, it was at the head of a succession of unstable coalitions, assembled and re-assembled from internally fragmenting elements of the anglophone splinter group, the National United Party.

Principle and policy coherence were the first casualties in the process of coalition formation and hybrid government; the steady politicisation of the public service, and a concomitant erosion of its technical and administrative capacities, then ensured the insidious abandonment of the good governance of the country as a duty of office.

When, therefore, Vanuatu went to the polls, as scheduled in November 1995, for its fourth post-independence general election, more was seen to be at stake in the outcome than in any previous election. For twelve years after independence, the country's anglophone majority had held government and its constituents had enjoyed the benefits that being in office brings. For VP politicians and constituents alike, the four years spent in Opposition, 1991–95, were a painful lesson in the consequences of electoral defeat. By contrast, the francophone minority who, in their own view, had endured more than a decade of disadvantage and discrimination under anglophone rule, having finally won office in 1991 had only begun to redress those years of perceived injustice and inequality. By the end of 1995 there was, in both communities, a better appreciation of the real benefits of office. This sharpened the competition between not only rival parties but also between individual leaders and factions within parties. The general elections were held on 30 November, with a record number of 170 candidates, 12 political parties and 19 independents officially contesting the ballot in 15 constituencies. These numbers merely confirmed the growing fissiparousness in Vanuatu's erstwhile, seemingly stable, party-based politics—a characteristic common in other parts of Melanesia but clearly detrimental to policy coherence and good governance as party allegiances are soon subordinated to individual market leverage. Against such fractious and fragmenting party politics, the elections seemed doomed to result in a further period of uneasy coalition government.

When officially announced on 7 December, the results confirmed that no party had secured a simple majority in its own right and thus served only to entrench the trend towards coalition government. Indeed, the interval between the elections and the installation of a new government saw a farrago of improbable alliances and betrayals as leaders sought to forge a majority coalition. Aware of the high stakes they were playing for, many of Vanuatu's most senior and experienced politicians gambled with the country's fortunes in a winner-take-all power play. In doing so they unleashed, at least in the view of the sympathetic bystander, an *annus horribilis* in which the institutions of the state were continuously assaulted and their integrity dangerously threatened.

Table 1 **The General Elections November 1995: official results of political party seats**

Vanua'aku Pati	13	
Tan Union Unity Front	2	} 20
Melanesian Progressive Pati	5	
Union of Moderate Parties	17	
National United Pati	9	
Nagriamel	1	
Fren Melanesian Pati	1	
Independent	2	

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If the anglophones lost government in 1991 as a result of internal disunity and divisions, the francophones in 1995 hastened to follow their example. The francophone Union of Moderate Parties (UMP) had never been more than an umbrella which sheltered different political groups sharing little more than *francophonie* and opposition to the earlier unitary anglophone majority. The disintegration of that anglophone solidarity seemed to precipitate similar self-destructive tendencies among the francophones.

From early in 1995, the ruling UMP had begun increasingly to show signs of internal disunity with rival factions, conscious of the approaching elections, forming in support of the Party President Serge Vohor and his main opponent, the incumbent Prime Minister Maxime Carlot-Korman. The two men had a long history of rivalry which only became acute when UMP emerged from the 1991 general elections in a position to form government. At that time, Vohor, both as President of the party, and because within the party he commanded the strongest following, had expected to become Prime Minister. His disappointment at Carlot-Korman's appointment as Prime Minister and frustration at having to serve in his government were open secrets in Port Vila. Their personal rivalry, which was increasingly fought out during the year over the endorsement of party candidates for the elections, ultimately led to a break-away party of young disaffected party members, an increase in the number of candidates standing as independents and finally to litigation to decide the UMP's official candidate list; all of which served to divide the UMP's normal electoral vote.

These rifts in the UMP were thrown into sharp relief immediately after the elections on 4 December, when Vohor, claiming the support of a dozen MPs, signed a memorandum of understanding on coalition government with the Unity Front (UF, which with 20 seats controlled the largest bloc of seats in the Parliament), in which he would accept deputy-prime ministership. Two days later Carlot Korman's faction announced an agreement with NUP to re-establish the coalition entered into in the first UMP-led government in 1991. Over the ensuing days, changes were constantly rung on these combinations as Vohor brokered his numbers between UF, the rump of Korman's UMP and NUP. Finally the Parliament sat and on 21 December installed Vohor as the new leader of a UMP/NUP government, in which former long-serving Prime Minister Father Walter Lini agreed to become deputy-Prime Minister and Minister for Justice, Culture and Women's Affairs. Ironically, his sister, and Vanuatu's only women MP, Hilda Lini was denied a Cabinet post.

Not only were Vohor and Lini politically poles apart, but their hold on a majority was extremely frail. It took only until the end of January before the first formal challenge was issued by petition to the Speaker for an extraordinary session of Parliament to debate a motion of no-confidence in the government.

During the entire year, the country lurched from crisis to crisis: first, an attempt by the Vohor-Lini government to avoid defeat in the Parliament by a series of illegal acts which could be seen to have attempted a *coup d'etat* by administrative means; a succession of highly dubious investment schemes which ran the risk of bankrupting the country and brought the Ombudsman into courageous but risky conflict with the powers of the day; a parliamentary crisis which ended in a second successful vote of no-confidence and change in government after the Parliament was ordered by the Supreme Court to sit and the Speaker was cited for contempt; a crisis in the para-military wing of the security force which escalated from insubordination and a refusal to obey orders by a large segment of the force to their kidnap of the President, coercion of a civil aircraft and pilot, a grant of immunity from prosecution by the acting Prime Minister (which yielded them a virtual veto over government decisions they did not like), abduction of an expatriate official and final arrest and detention pending charges.

By the end of 1996, although the country appeared to have survived this succession of crises, the Supreme Court had three major cases awaiting its attention in the new year, all heavily freighted with political significance—the prosecution of Peter Swanson for his alleged involvement in the fraudulent US$100 million bank guarantee scheme, the prosecution of the mutinous members of the VMF, behind which lurks the shadow of a possible coup attempt involving other non-military figures, and the appeal by the former Chief Justice against wrongful dismissal.

On the positive side of the balance sheet, the government commanded a majority in parliament large enough to enable the implementation of policy and programs for the first time in twelve months; tentative moves, begun late in 1996, to reunite the two wings of the UMP seemed to have foundered, at least for the time being, by February this year, with Carlot-Korman again blaming Vohor for unwillingness to make concessions to his followers (one suspects his complaint reflects an unsurprising refusal to yield the Prime Ministership to him); and, in March, the three coalition parties finally managed to sign a formal Memorandum of Agreement to maintain their cooperation for the full-term until 1999. The memorandum, however, also contained some opaque language on proportional distribution of ministerial and other statutory offices which could have unsettling effects on their solidarity. With four ministerial portfolios each, the NUP (which brings only half as many MPs to the coalition as the UMP and VP), is obviously disproportionately endowed. The VP backbench is particularly restive and chafing at their exclusion from a more liberal enjoyment of the spoils of office and Carlot-Korman too has called for a more equitable redistribution as he seeks to keep alive simmering internal UMP discontents. There seems little prospect of real political stability in the government.

While the politicians thus toyed with the institutions of democracy and resorted to the Supreme Court as though to a gaming-house, apparently indifferent to the obligations of office, they seem not to have noticed a growing disenchantment among voters with their reckless politicking and the impact of an accompanying decline in services across the board. Voter turnout at the general elections in November 1995 overall had been comparable to previous years, but in the urban electorate of Port Vila, where observation of the political process is closest and most informed, voter turnout fell to a low of 51 per cent. Similar disenchantment most probably accounts for the fate which befell the most high-profile casualty of the elections, Deputy Prime Minister Sethy Regenvanu, who lost his seat in Malekula, after serving in every government since independence. His PDP, in fact, failed to retain a single seat, despite (or perhaps because of) its having been crucial to the longevity of Carlot-Korman's tenure in office.

This trend towards loss of public confidence in the politicians and for voting patterns to be less predictably along traditional party lines was further confirmed in March this year when voter turnout at the Port Vila Municipal Elections plummeted to an alarming 23 per cent. The results also tended to confirm other trends that are beginning to emerge with a further fall in support for the NUP (perhaps caused by the resignation from the party by Hilda Lini who is returned to the national parliament from the Port Vila electorate), and another success for the Liberal Party at the local government level; remarkable because the party was only founded in 1996 and by a woman, Maria Kalsakau, a non-indigenous ni-Vanuatu.

Looking ahead, there are some encouraging signs that the institutions of the state are holding despite constant battery and some internal subversion. The Supreme Court, while itself the object of politically motivated interference, continues to be seen as arbiter of the constitutionality of the political stratagems and ruses being used in the struggle for power. It retained, for all contestants, its ultimate authority and its decisions were sought in order to validate political triumph and defeat. The acting Chief Justice, in opening the legal year in March, and no doubt conscious of the profile of the court in recent years, set out the need for the integrity of the Judiciary to be protected from political interference; a reference the more valuable because made by a francophone ni-Vanuatu. Fr Lini having been enjoined on becoming Minister for Justice in November to resolve the crisis within the Mobile Force, acted with a daring and boldness which might justly have earned him the honorific of 'saviour of the nation' to add to his existing 'father of independence', and demonstrated that at least he was not paralysed by the need for decisiveness in the face of a difficult problem. In the aftermath of the successful arrest of the mutinous VMF stand-down group, the government established a Committee to conduct a Strategic Review of the security of the nation under the chairmanship of Peter Taurokoto, political first secretary to Fr Lini. The Review, although planned earlier, and more for reasons of fiscal restraint than to question, much less pre-judge, the real need to retain the two elements of the security force, was to consider Vanuatu's security environment and the roles and tasks of the security forces. The Review very quickly came to be seen as a device through which to recommend to Parliament the disestablishment of the Mobile Force, a course of action the Minister and a significant number of other senior leaders were thought to favour. The Committee included in its membership representatives of women, chiefs and churches and held public hearings around the country to ensure widespread consultation and a comprehensive range of views. It presented its report to the Minister in late March and its recommendations may be considered when Parliament sits in ordinary session in May 1997. While the Committee's final recommendations are not known, an interim report revealed that there was wide public support for the retention of the para-military wing separate from the police force. Those public views are, however, more likely to reflect local area concern with employment and appreciation of the construction work of the VMF Engineers, ceremonial displays and the deployment of the Band for public enjoyment than any assessment of Vanuatu's security outlook, the VMF's defence capability or the government's inability to finance a separate service to combat a non-existent threat.

At the end of March, the three major court cases that awaited trial at the end of 1996 remained unconcluded with their explosive potential undefused. The trial of Peter Swanson in the bank guarantee case had been heard but a decision had not been handed down. The government's defence of its dismissal of Chief Justice D'Imecourt (which is costing it a lot of money through continued payment of his salary pending resolution of his claim) became even more difficult when the Attorney-General revoked the appointment of the government's counsel, Roger de Robillard, who was cited by the acting Chief Justice for contempt of court. De Robillard added to the gravamen of his alleged contempt by appearing on television to repudiate the charge and failing to return the case files on the grounds that he had not been paid. The Attorney-General consequently issued a warrant for his arrest. Prime Minister Vohor then suspended the Attorney-General saying he had been disloyal and incompetent and that he no longer had confidence in him. At the end of the month, on returning to Vanuatu from Australia, De Robillard was arrested and gaoled for two months. At a critical time, the Judiciary and the principal law officer of the state were once again entangled in the snares of political cronyism and their roles vulnerable to potentially serious harm. The trial of the 76 members of the VMF was set down for hearing in late April, and all the detainees had been released on bail, some under very exacting conditions which effectively confined them to their houses except for attendance at Church on Sundays. Their sense of grievance at their long detention and the further delay before their scheduled court appearance is likely to accentuate their resentment and pugnacity. Against the background of the recent crisis in Papua New Guinea, in particular the confrontation between the military commander and the Prime Minister, they may even begin to regret not having pressed their abortive coup plans further.

Recent economic developments

Vanuatu is regularly subjected to external and domestic economic shocks over which it has no control. In recent years, the country has also been subjected to domestic economic shocks stemming from political developments of its own making. Economic shocks are generated by natural disasters such as hurricanes which destroy crops and infrastructure, adverse movements in export and import prices or adverse movements in exchange rates and interest rates. Such shocks invariably result in falling current account receipts, government revenue and national income, increased government expenditures and national import bills and accompanying deterioration in balance of payments, fiscal position of government, external reserves and liquidity in the banking system. Managing national economic shocks is normally a delicate exercise requiring depth of experience and expertise and luck. But in Vanuatu this problem has, to date, been effectively addressed with generous aid and other windows of assistance such as STABEX under the Lomé Convention.

The economy is narrowly based; it depends upon a very limited number of agricultural exported items. These are copra, beef, cocoa, coffee, kava and more recently squash. The total export receipts from the sale of these items rose from 1,600 million vatu in 1991 to about 2,550 million vatu in 1995.

Economic growth over the last ten years averaged about 3 per cent per annum. Annual growth rates also fluctuated widely, mainly as a result of natural disasters affecting agricultural and services outputs and uncertainties in policymaking. As real growth rates barely kept up with the population growth rates, the standard of living in the country has not improved during the period.

The services sector, including tourism, government and the finance sector, contributed some 64 per cent to GDP in 1995. The contribution to GDP of the Agriculture, Forestry and Fisheries sector has fluctuated over the last ten years, mainly due to varying commodity prices and disruptions to production in the wake of inclement weather, it was 28.7 per cent in 1985, 18.5 per cent in 1989, 22 per cent in 1993 and 22.7 per cent in 1995. The manufacturing sector is small but has gradually increased its share of GDP from 3.9 per cent in 1985 to 5.2 per cent in 1995. The GDP growth rate was estimated at 3.2 per cent in 1995 and 3.0 per cent in 1996. It is expected to decelerate further during the current year.

Domestic inflation is heavily influenced by price movements in Australia, New Zealand, Japan, Fiji, New Caledonia and France, countries from where the bulk of Vanuatu's imports are sourced. There is no price control legislation and prices are determined by supply and demand in the market place. But a number of distortions in the market place, such as import licensing on a range of important essential goods, bear heavily upon the level of prices in the country. Inflation, measured in movements in the consumer price index, has declined steadily from about 4 per cent in 1992 to near zero per cent in 1996. This trend reflects falling overseas inflation rates, declining levels of economic activity in Vanuatu and absence of hurricanes during the period.

There are no direct taxes in Vanuatu; corporate or personal income tax are not levied. Reliance upon indirect trade taxes is therefore heavy. Import taxes accounted for 75 per cent of total tax revenue and 55 per cent of total revenue in 1990. The corresponding actual figures for 1995 and budgeted for 1997 are 62 per cent and 46 per cent, and 66 per cent and 52 per cent, respectively. Trade taxes distort the allocation of domestic resources. They impose high protection on inefficient domestic production and add to the costs of exporters, thereby eroding their competitiveness.

The government accepts an open and outward-looking trading relationship as part of its development strategy. It has made formal application for membership of the WTO and has expressed its determination to honour the obligations that will be imposed under the WTO rules. So import licensing will have to be totally removed and over time the level and dispersion of tariffs will need to be brought down. Sequencing this trade deregulation program must be handled with care. New tax bases will need to be brought into the tax net to ensure that the level of revenue is protected and the elasticity of the tax system with respect to GDP enhanced. At the same time, adjustment to the exchange rate will be necessary to add additional support to the traded goods and services sector while allowing the import substituting businesses breathing space within which to make the necessary adjustments.

A report on the taxation system reforms for Vanuatu prepared by Warren and Whyte in 1994 made enlightened tax proposals for Vanuatu. The main recommendations were

- revenue losses through progressive reduction in tariff rates should be offset by a comprehensive consumer tax which could ultimately take the form of a value-added tax and introduction of business and personal taxes set at relatively low levels. Progressive personal income tax could be grafted on to the schedule at a later stage. A levy of 1 per cent on the wage and salary bills of all employers including government, to fund training, should be introduced

- a 3 per cent wage and salaries tax should be imposed and the proceeds of it earmarked for education, health and infrastructure programs
- a 4 per cent business sales tax should replace the business license fees
- tax concessions under the customs legislations which were readily given without strict guidelines and which were substantially eroding the country's tax base should be severely restricted.

Warren and Whyte's proposals, made after extensive discussions with the government, the private sector and other sections of society were widely debated. Vigorous objections from the corporate sector, particularly the offshore banking sector, put paid to all proposals save for the last recommendation which was accepted only after much difficulty. But the need for tax reform cannot be put off for long. The share of government revenue to GDP will continue to decline with progressive reduction in tariff rates while the pressures upon the government budget will most certainly continue to escalate.

The government has adopted a policy of maintaining balance in the recurrent budget for some time. Small annual surpluses in the recurrent budgets were in fact achieved for most of the years 1987–95, enabling annual transfers for the financing of development expenditures to be made.

But concerns about fiscal developments in Vanuatu have arisen from a different direction. Since independence, development expenditures were determined by Cabinet outside of Parliament. Pipelines of projects were assessed by the National Development Commission and Cabinet through the National Planning Office. Approved expenditure programs were determined according to available finance from donors and the soft windows of the Multilateral Financial Institutions. However, in 1992, the government began to push through additional development projects, most of which were not effectively quality tested, and were well in excess of available financial resources from traditional funding sources. Additional development expenditures had therefore to be financed through running down government deposits with the banking system and domestic and external borrowings. The net positive balances of government with the Reserve Bank and the commercial banks which was about 1,000 million vatu in 1991 is now near zero.

External debts, which have been very low because of the prudent approach to development financing in the past, have increased at an annual rate of 12 per cent since 1990. While the current level of debt service burden at about 1 per cent is low by international standards, its rapid rate of increase is of concern. Fiscal prudence is an important pre-condition for stable future development as widening fiscal deficits, expanding external debt and apparent lack of capacity for sound and determined policymaking by the authorities conjures up in the minds of investors and consumers the real likelihood of rapid inflation, widening budget and balance of payments deficits, evaporating external reserves, capital flight, slow economic growth, falling demand, corporate losses followed by

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tight fiscal and monetary policies and exchange rate adjustments to re-establish national financial stability. Faced with such prospects a potential investor may well decide to sit and wait or find alternative countries within which to invest.

Wide trade deficits are recorded for Vanuatu each year. But services, particularly tourism, the domestic finance sector and the Offshore Finance Centre which register surpluses annually and official transfers or aid, help to offset the trade deficits each year. However, deficits in the current account of the balance of payments have persisted since 1991 and were financed with relative ease through inflows in the capital account and there were positive changes in net foreign assets of the banking system in three out of the five years from 1991 to 1995.

The country's external reserves held by the Reserve Bank and commercial banks increased from 16.702 million vatu in 1990 to 23,808 million vatu at the end of 1996. External reserves held by the Reserve Bank were equivalent to about 6.2 months of imports in 1996. This is only about 23 per cent of the country's total external reserves. The other 77 per cent is held and invested in short-term investments overseas by the commercial banking system. Among the Pacific island countries, Vanuatu has the highest level of external reserves—some 27 months of imports—available for funding international transactions at present.

Unlike the other island countries, the Vanuatu government has up to now been a net lender to the banking system including the Reserve Bank. Liquidity in the banking system, reflecting the high external reserves and sluggish economic growth, is high. And so far, the private sector has not had to compete with the public sector for credit from the banks. But the widening overall budget deficit, if it continues, could well result in escalation in borrowings from the banking system for working capital requirements and progressively 'crowd out' the private sector from the domestic credit market.

Adjustment and reform for future development

Because of prudent fiscal management in the past and generous aid receipts, the authorities have been able to maintain domestic and external financial stability or stable domestic prices and balance of payments positions since independence. But private investment and growth have not kept up with the needs and aspirations of the expanding population. Standards of living have not improved and the quality of social services, particularly in education and health, appear to be steadily deteriorating. The future of aid, which has underpinned development spending and the external sector, has to be re-assessed. Expectations are that aid will most likely decrease in real terms. This implies that future aid must be used more efficiently and increased domestic resource mobilisation given the highest priority.

Encouraged by the Asian Development Bank, the government announced early this year that it will embark upon a comprehensive reform program for Vanuatu. A number of experts provided by the Asian Development Bank and bilateral donors, working with officials of the Reserve Bank, Department of Finance and the National Planning Office, are to prepare draft briefing and policy papers for submission to two separate task teams—one on public sector reforms and the other on economic reforms. The task

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teams are to be chaired by senior Ministers and to include representatives from the private sector, non-government organisations, government, the churches, trade unions and the opposition. Variations to policy proposals may be made by the Task Teams before they are presented to the Council of Ministers for decision.

Refocusing the future role of government in national development is central to the exercise. The focus is expected to be upon the maintenance of law and order, good governance; sound policies for macroeconomic stability, supportive legal framework for dynamism in the economy, sound microeconomic policies for encouraging private investments, productivity and competitiveness in the economy, economic and social policies which ensure wide participation in the development process by all sections of the population and better access to social services, particularly education and health, for the economically weak, and the formulation and implementation of well appraised public sector investment programs which yield high social and economic returns and complement private sector investments.

The strengthening of government machinery for improved decision-making and coordination will also need to be addressed. Such a machinery, with the Planning Office providing secretariat support, should ensure that

- decision-makers are regularly briefed
- policy decisions are made quickly as circumstances change
- collective decisions are based upon detailed analysis with arguments for and against the various decision options carefully presented
- the recommended allocation of resources, both aid and budgetary, reflect the assessed and balanced needs of all sectors of the economy.

Public sector reform is generating much interest within the relevant task force and members of the public. It is increasingly appreciated that inefficiency in the public sector imposes additional costs and burden on the private sector. An inefficient and bloated public service also raises the possibility of increased taxes, deteriorating fiscal and debt positions, and erosion of investor confidence. Measures for improvement in efficiency and productivity in the public service are likely to include

- training in technical and administrative areas
- insistence on merit as the only determinant for recruitment and promotion
- strict observation of legal provisions which vest in the Public Service Commission the power to hire and fire
- introduction of an appraisal system which sets out targets for assessing staff
- better understanding of the boundaries of responsibilities between the Ministers and their political secretaries on the one hand and departmental directors on the other. Ministers, as part of this exercise, will need to understand the relevant provisions of the Constitution and the various statutes administered by them.

Other important objectives which the reform program is targeting in the pursuit of good governance, an important precondition for stable long-term development, include

- strengthening current legislative provisions such that parliamentary authorisation should be required for all government loans which must be confined to approved development expenditures

- future development expenditures should be presented in a capital budget which must require the approval of parliament
- loan or project negotiations, particularly with outside third parties, should be undertaken by a selected group of officials with relevant experience and negotiating within guidelines previously approved by government
- strengthening legislation on financial and audit procedures and provision and use of sanctions in cases where rules are not followed
- strengthening of accounting and audit capacity in government
- progressive deregulation and gradual removal of discretions on the granting of business licenses, customs concessions and other forms of assistance to businesses
- strengthening the police, the judiciary and the offices of the Ombudsman and Director of Public Prosecution
- encouragement to civil societies to strengthen themselves and participate more actively in policy and other national debates
- freedom for the media.

The adjustment and reform exercise is currently going through the educational and policy formulation stage. The details of the policies and measures which government will need to adopt will slowly emerge. Ideally, these must carry the collective support of the various interest groups if they are to have easy passage to implementation.

Different groups are likely to be affected differently. Some will be losers and some will benefit in the short term as adjustment and reform involves redistribution of opportunities, income and ultimately wealth and economic power among sections of the community.

Normally, adjustment and reform are adopted by governments following gross financial management or economic shocks over which they have no control. In such cases, a country will have gone through a period of unsustainable balance of payments positions and fiscal difficulties, exhausted external reserves, mounting external debt and tight liquidity in the banking system. No external funding would be on tap except with a comprehensive adjustment and reform program designed by the Bretton Woods Institutions. In such circumstances, political will during the period of assistance, would certainly be present on the part of the government as there would in fact be no option to implementing such a program.

The case of Vanuatu is, however, somewhat different. They are launching a reform program when external reserves are high and liquidity in the banking system is abundant. They in fact do not need the inputs of the Bretton Woods Institutions. It is of course a very commendable approach for a country to adopt, particularly at a time when worrying signs of fiscal mismanagement are emerging. It is for Vanuatu a voluntary exercise which calls for much determination, leadership and political will from leaders and the Government of Vanuatu if it is to succeed.

Note

[1] The mid-rate of the vatu was 114.92 vatu to the US dollar on 30 June 1997.

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