

Vanuatu's economy: is the glass half empty or half full?

Timo Henckel

Vanuatu's economy paints a picture of contradictions: it has continued on the recent growth path with low inflation, government budget surpluses, and increased capital inflows. Yet successful management of the economy has not translated into a significant increase in per capita income levels. The country faces a host of structural problems that prevent growth rates from being even higher. These include high costs of doing business, political instability, high dependence on foreign aid, inadequate infrastructure investment, inefficient tariffs on international trade and, perhaps most importantly, insecure property and land rights. The reform process initiated by the current government promises to address some of these growth constraints but further bold reforms are necessary for living standards in Vanuatu to rise appreciably.

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The Vanuatu economy, after having displayed a lacklustre performance in the beginning of this decade, has regained some momentum, growing by 3.7 per cent in 2004 and 2.9 per cent in 2005. This may explain why a survey conducted by the UK-based New Economics Foundation declared in July that Vanuatu is the happiest place on earth, as measured by their 'Happy Planet Index'. The index is computed by combining life expectancy, the degree of contentment reported by a country's inhabitants, their use of resources and other statistics ranging from the quantifiable to the very subjective. Yet, however happy ni-Vanuatu may be, the country remains poor and underdeveloped. With an annual per capita GDP of about

US\$1,500, roughly the same as 25 years ago, it ranks 207th in a list of 233 countries.

Vanuatu's economy is strangely dichotomous. On the one hand the country enjoys a healthy macroeconomic environment—no mean achievement that even industrialised countries would be proud of. Budget deficits are small and rare, public debt contained, inflation low, and the domestic currency reasonably stable. On the other hand, this favorable environment has failed to generate income growth large enough to appreciably better the lives of ni-Vanuatu. Too many structural impediments to growth remain, some natural but most homemade. Past reforms to reduce the inefficiencies in the economy and to boost

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productivity, the key to prosperity, have been slow and timid. More recently, since 2004, the government has embarked on some important reforms such as the establishment of a regulatory body controlling the monopoly power of utilities and the revival of WTO accession talks. But outside observers remain skeptical, questioning whether the ambitious political rhetoric will be followed by committed actions.

This survey offers an update on the economy, focusing in particular on the period since 2004 when the last survey on Vanuatu was published in this journal. It paints a brief picture of the achievements, or lack thereof, in human development. Finally, it discusses some of the factors that have prevented Vanuatu from following a high growth path. While some small structural improvements are being made, the list of culprits is much the same as it was 5, 10 or 20 years ago. The author hopes that the analysis will galvanise policymakers to pursue bold reforms so that

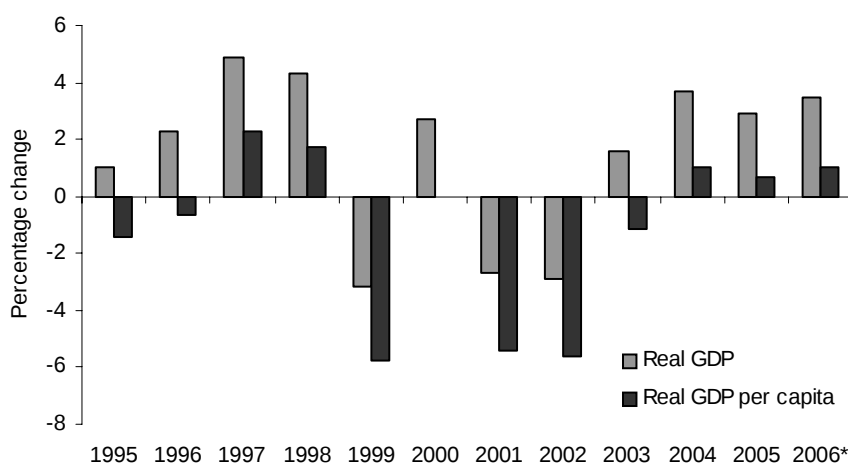
Vanuatu does not wake up every morning on 'Groundhog Day' when nothing has changed and yesterday's problems are still today's problems.

Recent macroeconomic performance

Production

After a recession at the beginning of this decade Vanuatu is once again showing signs of economic vigour. Real gross domestic product (GDP) grew for the third successive year in 2005, growing by an estimated 3.7 per cent in 2004 and 2.9 per cent in 2005 (Figure 1).¹ However, growth was highly concentrated with much of the value-added recorded in the service industry, where tourism-dependent wholesale and retail trade expanded particularly strongly, and in the industrial sector, which grew by 4.3 per cent mainly due to increased construction activity in Port Vila.

Figure 1 Growth in real GDP and real GDP per capita (per cent)

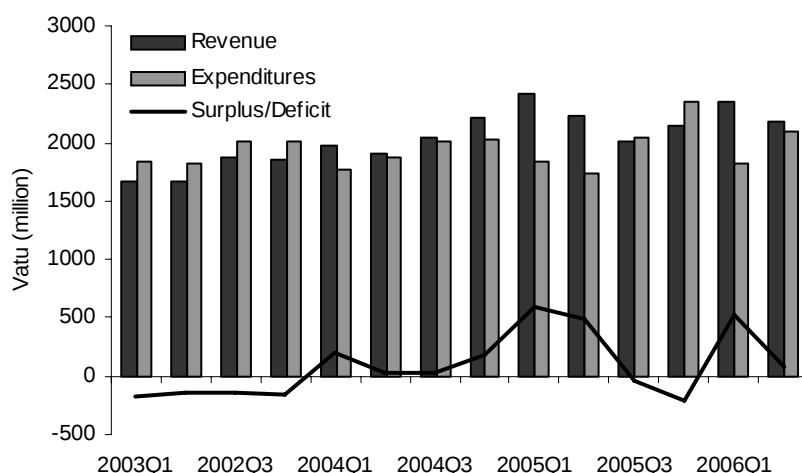


* Data for 2006 is estimated.

Source: Vanuatu National Statistics Office and author's calculations based on projected population growth.

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Figure 2 Government revenue and expenditures, 2003Q1–2006Q2 (million vatu)



Source: Reserve Bank of Vanuatu (various issues). *Quarterly Economic Review*, Reserve Bank of Vanuatu, Port Vila.

In contrast, the primary sector contracted significantly because of a reduction in copra, coconut oil, cocoa, and kava production, with current levels of output still below their 2004 values. At the end of 2005 copra production fell by 30.2 per cent year-on-year due to local changes in copra marketing and the decline in the world copra price. Coconut oil production declined precipitously in response to the indefinite closure of Vanuatu's main coconut oil mill, Coconut Oil Productions Limited, in February 2005 and cocoa production experienced a massive reduction of 81.9 per cent (177.7 tonnes). Kava exports fell by 65.2 per cent during the fourth quarter, after expanding during the first three quarters of 2005. The main culprit in this drastic reduction was the continuing import ban imposed by numerous countries, in particular the European Union, uncertainty governing the regulatory framework for kava exports, and a brief but

vicious trade war with Fiji in the latter half of that year. More recently, copra production increased by 1.1 per cent during the first quarter of 2006 and kava production was expected to have picked up. Cocoa production has contracted further by 9.8 tonnes in the same period although much of this drop is attributable to seasonal factors. Recent increases in the world price for cocoa suggest that cocoa production should rebound.

With a population growth rate of 2.5 per cent in 2005, real per capita GDP increased by a paltry 0.4 per cent.

Fiscal policy

Vanuatu's fiscal position has been remarkably sound. Government revenues have exceeded expenditures for eight of the last ten quarters (Figure 2), giving rise to a record surplus of VT831.6 million for the year 2005. Surpluses for the first and second

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quarter in 2006 are tallied at VT525.7 million and VT83.7 million, respectively. This favorable fiscal position reflects both strong tax revenue collection as well as recurrent spending below budgeted levels.

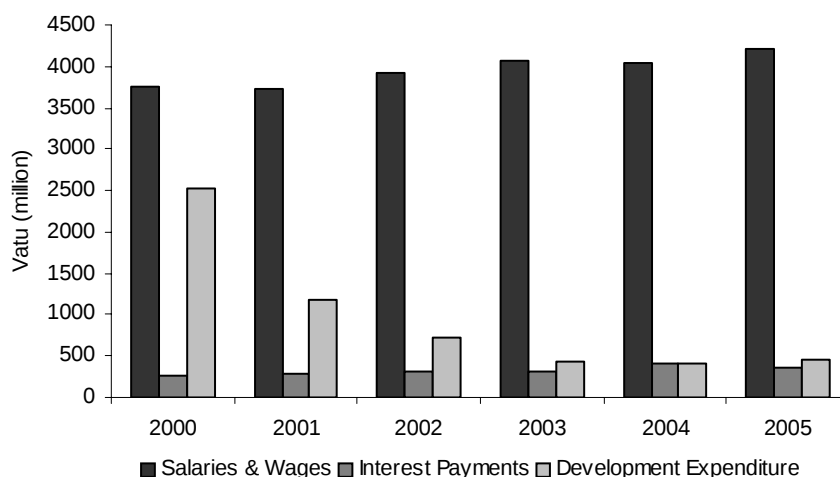
Total revenue (including grants from abroad) was VT4,528 million in the first half of 2006, a reduction of 2.6 per cent compared to the same period in the previous year. Of this, 96 per cent was recurrent revenue, with the difference being made up by grants from abroad; compared to 91.6 per cent and 93.4 per cent in 2004 and 2005, respectively. Tax revenue accounted for 91 per cent of total recurrent revenue collected in the first two quarters of 2006, slightly lower than in the same period last year. Of this, value-added tax (VAT) accounted for 36.9 per cent and tax on international trade (import and export duties) for 30.4 per cent. The difference was made up by other taxes. As noted by the Reserve Bank of Vanuatu (2006), the good performance in revenue collection during that year reflects an improvement in compliance

by government ministries. Total recurrent revenue has increased steadily from VT6,683.7 million in 2001 to VT8,213.5 million in 2005, except for a small decline in 2002. Grants from abroad peaked at VT720.3 million in 2002 and have been significantly lower since—VT381.4 million in 2003 and VT582.3 million in 2005.

Government expenditure has declined in the past few years in real terms, coming down from VT 8,612.6 million in 2001 to VT7,964.2 million in 2005. Salaries and wages continue to form the bulk of expenditures and now represent a much greater fraction, at around 56 per cent in 2005, compared to 43 per cent in 2001. This percentage increase has been largely due to the substantial increase in salaries and wages for public servants and to a lesser extent to a decline in other expenditures, in particular development expenditures. Interest payments in 2005 amounted to VT349 million, 78 per cent of which applied to domestic debt.

Subsidies and transfers have fallen somewhat between 2001 and 2005, from

Figure 3 Government expenditures by selected categories, 2000–2005



Source: Reserve Bank of Vanuatu (various issues). *Quarterly Economic Review*, Reserve Bank of Vanuatu, Port Vila.

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VT1,141 million to VT883.3 million. Data for the first half of this year suggests that the numbers will be comparable to the previous year's. The most striking feature of the expenditure accounts is the dramatic fall in total development expenditure. While VT1,189 million was spent in 2001 on development, only VT461.6 million was spent in 2005. And, more recently, only VT1 million was allocated to development in the first two quarters of this year (Figure 3). While spending on infrastructure and development tends to be lumpy, thus giving rise to volatile expenditure profiles, this drop in development expenditure over the last five years is massive. The reason for this precipitous decline is unclear, though it may be a direct consequence of the reduction in grants to the government from abroad.

The government has at its disposal two main instruments to finance any temporary revenue shortfalls: domestic bond issues and use of the overdraft facility at the Reserve Bank of Vanuatu (RBV). The government has repeatedly rolled over existing bonds, often into instruments of shorter maturity (one-year), but has had no need to resort to the RBV overdraft facility as it continues to maintain a positive operating balance.

At the end of March 2006, total outstanding debt was recorded at approximately VT12.9 billion, of which VT3.1 billion, or 24 per cent, was domestic debt. Hence, total debt amounted to 33.8 per cent of nominal GDP. Of the domestic bonds issued, 27.8 per cent was held by the RBV, 27 per cent by commercial banks, and 45.1 per cent by corporations. Compared to 2001, outstanding domestic debt, in nominal terms, is about 21 per cent higher, reflecting the high budget deficits in 2001 to 2003. The surpluses of the past two years have allowed the government to retire some of the previously accumulated debt. As Sugden and Tevi (2004) point out, Vanuatu's public debt levels are not high by international

standards. Yet the country's productive capacity is still very limited and the tax system primitive, making it difficult for the government to service the debt in the near future.² As such, the outstanding debt constitutes a significant drag on the government's ability to finance necessary infrastructure and development projects.

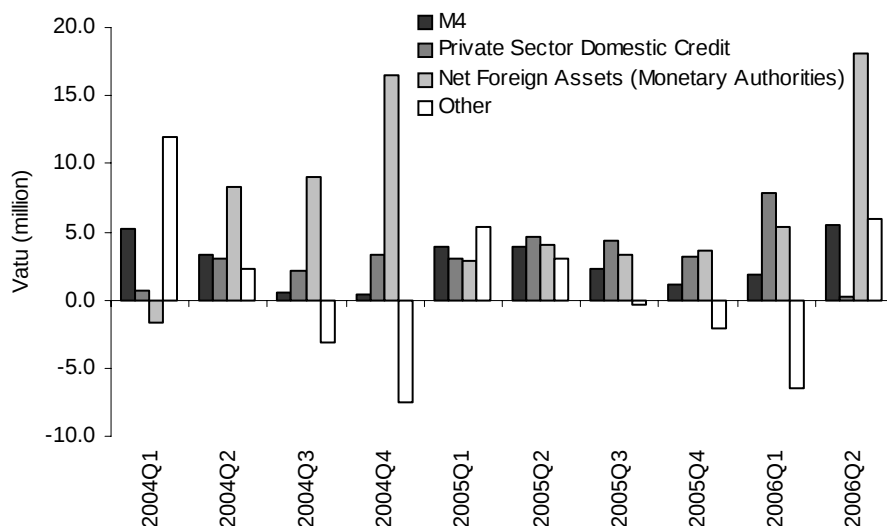
Money and prices

Inflation, measured in terms of the consumer price index (CPI), has remained well below the RBV's upper target of 4 per cent over the past few years, coming down from 2.9 per cent in 2003 to 1.8 per cent in 2005. More recently, it has crept up to 2.3 per cent (year-on-year) in the June quarter of 2006. Rent, water, and electricity (up 5.7 per cent), and recreation, education, and health (up 2.8 per cent) were the main contributing factors to the higher inflation. During the second half of 2006, prices of food items have risen by approximately 3.4 per cent (year-on-year) and rent, water, and electricity by 2.7 per cent. The transport and communications sector experienced a price rise of 2.3 per cent in the same period. Thus, the impact of higher world oil prices on domestic inflation is very muted and does not seem to pose a significant challenge for the Reserve Bank.

Even though inflation has been contained at low levels, broad money (M4) has posted very high growth rates during the last 2–3 years. In 2004 and 2005 broad money grew by approximately 10 per cent and 15 per cent, respectively, attributable mainly to rapid expansion in domestic private sector credit of around 15 per cent and to an increase in net foreign assets (Figure 4). The substantial increase in private sector credit is indicative of positive consumer and investor sentiment. The greatest share of loans went to housing and land purchases (23 per cent), followed by other personal sectors (19 per cent), the construction industry (15 per cent), and the

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Figure 4 Broad money (M4) growth and components, 2004Q1–2006Q2 (million vatu)



Source: Reserve Bank of Vanuatu (various issues). *Quarterly Economic Review*, Reserve Bank of Vanuatu, Port Vila.

tourism industry (11 per cent). The growing importance of tourism is reflected in a near doubling of commercial bank credit to the entertainment and catering industry during the past year, while credit to the agricultural sector grew by 83 per cent, followed by the transport sector with 43 per cent.

Net foreign assets have increased considerably since 2003 when they stood at VT24.68 billion. At the end of 2005 they reached VT29.49 billion and in June of this year VT32.79 billion. The bulk of this increase falls on net reserves held by the monetary authority, which increased by approximately 95 per cent between 2003 and June 2006, compared with an increase in commercial bank net foreign assets of around 18 per cent. The RBV ascribes the increase in foreign exchange inflows mainly to inflows from the government, foreign exchange activity by foreign embassies, and interest received by the RBV on foreign assets. By the end of 2005,

import cover of official reserves stood at 5.8 months, 1.8 months more than the official target.

The large increase in liquidity begs the question of where all the money has gone, since it has not led to significant inflation growth. With the economy growing at around 3 per cent in 2005 and inflation below 2 per cent, 10 per cent has dissipated into the system. There are three possible explanations for what has happened.

- The velocity, viz. the speed with which money circulates in the economy, has decreased. While certainly a possibility, especially if inflationary expectations have fallen, this is unlikely to account for the full gap.
- The extra liquidity has fuelled asset price inflation, in particular real estate prices in the urban centres. Although there is no reliable data available, anecdotal

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evidence suggests that this has indeed happened, most prominently in Port Vila.

- The additional money has found its way into the unrecorded economy, both in urban centres and in the more traditional rural areas. If this is indeed the case, then actual GDP is higher than what the official statistics report. Only improved data will be able to provide a conclusive explanation.

Financial and banking sector

Commercial deposit interest rates have fallen slightly in the last few years. They are now between 2.75 per cent and 6.5 per cent for maturities above 6 months and 0.5–2 per cent for liquid savings accounts. The overall weighted average interest rate for bank deposits increased marginally to 2.38 per cent in the second quarter of 2006, compared to 2.25 per cent in 2005 and 2.4 per cent in 2004. This recent increase in deposit rates coincided with a reduction of the official discount rate, which was lowered 25 basis points to 6 per cent in March 2006, and an unchanged inter-bank rate of 5.5 per cent. In contrast, commercial bank lending rates have risen over the same period, with the weighted average being 11.65 per cent, compared to 11.37 per cent in 2005 and 11.59 per cent in 2004. As a result, the interest rate spread has fluctuated around 9 per cent, a noticeable improvement over spreads around 12 per cent four years ago, but still undesirably large. The high interest rate spread remains a concern to policymakers for it points to inefficiencies and lack of competitiveness in the banking sector, thereby depressing saving and investment and increasing the reliance on foreign capital which is often available at better conditions.³

Banks' balance sheets have continuously lengthened throughout the past two years, with bank assets, reserves held at the RBV, and foreign assets all increasing. In the

second quarter of 2006, total assets grew by 6.3 per cent. On the liability side, the industry's domestic and foreign liabilities also rose slightly, the former largely being the result of growth in vatu deposits. Overall bank profits rose throughout 2005 from approx. VT500 million in the first quarter to VT600 million in the fourth quarter.

Vanuatu's offshore financial sector has lost much of its significance but still accounts for 8–10 per cent of GDP, according to recent estimates (see Asian Development Bank 2006). Greater competition from other jurisdictions offering similar services and new legal requirements by the International Monetary Fund have eroded Vanuatu's competitive advantage. Following revisions to the International Bank Act in 2002, banking supervision was transferred to the RBV. Offshore banks are now required to be physically located in Vanuatu so that they may be properly supervised and regulated.

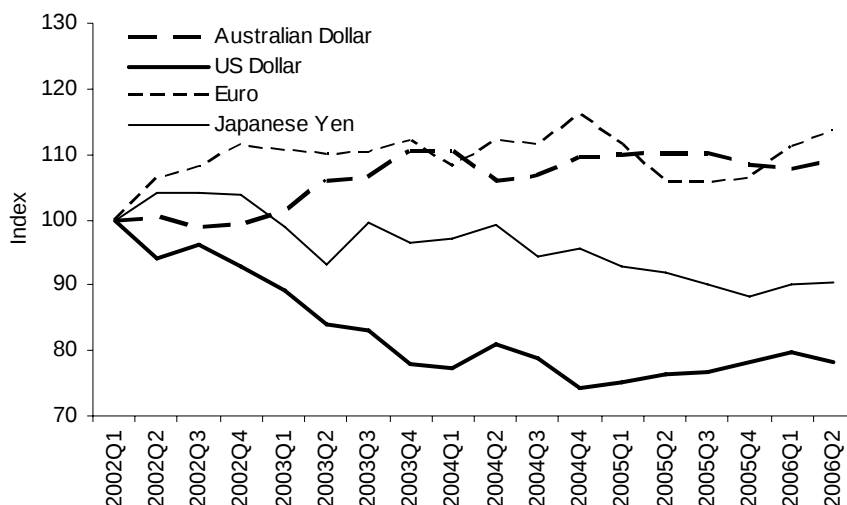
Exchange rate and balance of payments

The vatu, which is fixed against a basket of currencies, has experienced modest fluctuations against the individual component currencies (Figure 5). In September of this year, the vatu/US\$ exchange rate posted a high of 110.75 and a low of 109.05 while the vatu/A\$ exchange rate marked a high of 84.22 and a low of 82.70. Since 2003 the vatu has appreciated *vis-à-vis* the NZ dollar by approx. 15 per cent and *vis-à-vis* the Australian dollar by around 5 per cent. The currency has fallen against the US dollar by approximately 10 per cent and appreciated slightly against the euro. Low rates of inflation mean that the real exchange rate has been relatively stable and no reduction in competitiveness has taken place.

Current official international reserves are sufficient to cover nearly 6 months of imports, having gradually increased during the past couple of years. The high level of reserves is

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Figure 5 Nominal exchange rate: vatu against key currencies, 2002Q1–2006Q2



Source: Reserve Bank of Vanuatu (various issues). *Quarterly Economic Review*, Reserve Bank of Vanuatu, Port Vila.

indicative of the sound macroeconomic environment and the trust international investors place in Vanuatu's economy.

The current account deficit continues to be driven by the trade balance, which was in deficit by VT10.09 billion in 2005, an increase of 21.7 per cent from the previous year (Figure 6). Imports of machinery and transport equipment and petrol constitute the bulk of imports, having increased even further in 2006 even though other imports have fallen. The services account continues to display a surplus, reflecting the strength and importance of tourism as the primary source of foreign exchange earnings. The income account remains in deficit and fell significantly in the first two quarters of 2006, capturing increased investment income through foreign direct investments (FDI). Net transfers remain positive, having risen from VT891 million in 2003 to VT2,091 million in 2005 and VT1,456 million in the first two

quarters of 2006 alone. Both official grant flows and private sector inflows were the main contributors to this increase.

Human development

Sadly, fiscal and monetary prudence did not appreciably raise the living standards of the ni-Vanuatu. In 2005 Vanuatu ranked 118th of 177 countries on the United Nations Human Development Index (HDI), placing it in the medium human development category. On the HDI's education index it scores a 0.69, below the average of 0.75 for that category. This is a reflection of low enrollment rates, particularly at the secondary level. Vanuatu performs better on the 2005 Human Poverty Index (HPI), taking 52nd place. More specifically, around 40 per cent of the population does not have continuous access to clean water, 20 per cent of children

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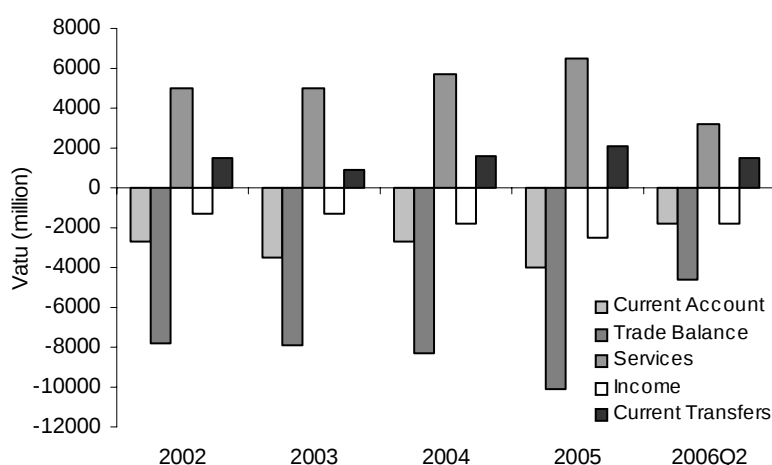
are underweight, and the same percentage are underheight for their age. Infant mortality remains high at around 31 per 1,000 births and immunisation coverage of one-year olds is only 63 per cent and 48 per cent for tuberculosis and measles, respectively.

There are no reliable estimates of incomes for the poorest part of the population. The ADB (2006) reports that in 1998 some 40 per cent of the population and 51 per cent of the rural population lived below the \$1 per day poverty line. These numbers overstate the degree of poverty as they do not adequately take into account income derived from the subsistence economy. However, the situation is not likely to be much different. Poverty is largely a consequence of low agricultural productivity and poor infrastructure in the remote areas. Only increases in agricultural productivity will be able to sustainably raise living standards of rural ni-Vanuatu.

Pacific islanders have experienced some of the worst education outcomes in the world, and ni-Vanuatu are no exception (see Hughes and Sodhi (2006) for an overview). There is still no blanket coverage of primary school education, although recently aid has been earmarked to redress this problem. Official statistics put primary school attendance at 96 per cent but there is good reason to believe the numbers are inflated. Adult literacy levels are estimated at around 75 per cent, assuming reasonable proficiency in at least one of the three official languages, Bislama, English and French. Secondary education is exceptionally poor with an official annual enrollment of less than 5,000. Hughes and Sodhi note that the underlying problem of secondary education is the absence of sufficient educational standards upon completion of primary school.

The labour market is such that there exists a significant skill shortage in Port Vila

Figure 6 Current account with selected components, 2002–2006Q2 (million vatu)



Source: Reserve Bank of Vanuatu (various issues). *Quarterly Economic Review*, Reserve Bank of Vanuatu, Port Vila.

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and to a lesser extent in Luganville, while the rural areas and the unskilled experience rising underemployment and unemployment. Sustainable long-term growth in Vanuatu will not be possible without a dramatic improvement in the education of its people. Once jobs rewarding skills become more plentiful, communities and parents will begin to value education more, setting in motion a virtuous cycle. It can only be hoped that the recent plans to provide universal primary education will kickstart this process.

Population growth remains high, the most recent estimate putting it at 2.5 per cent in 2005. Around 45 per cent of the population is less than 15 years of age and an increasing proportion locate in the two major urban centres. Many analysts worry about the high population growth rate, believing that it compromises the ability to educate the population, thus leading to impoverishment. Indeed, high population growth may prevent an increase in living standards but this need not be so. History has shown that vigorous economies that grow rapidly can absorb a big influx of labor. There is actually little agreement about what the optimal population growth rate for the purpose of developing a country is. But we do know that fertility rates decline as income levels rise. Thus, while family planning measures to contain population growth are useful, the primary focus for policymakers should be on generating high economic growth in order to raise living standards.

Outlook

The medium-term outlook is for a slight acceleration in economic growth within a stable macroeconomic environment (Asian Development Bank 2006).⁴ Real GDP growth is expected to increase from 3.5 per cent in 2006 to 3.7 per cent in 2008. The industry and

services sector are expected to grow by 3.4 per cent and 3.7 per cent, respectively. Tourism is likely to expand with the introduction of two new international air carriers and the completion of a new air terminal on the island of Espiritu Santo. The investment projects funded by the Millennium Challenge Corporation will also help to boost aggregate growth. The agricultural sector is assumed to rebound and grow at around three times the trend growth rate.

Fiscal discipline is likely to be maintained, with a small budget deficit of 0.1 per cent of GDP projected, to be followed by surpluses of less than 1 per cent of GDP in the two subsequent years. The projections assume that the economy will grow in real terms by just over 3 per cent and inflation will increase by 2.5 per cent as a depreciated vatu puts upward pressure on prices. Total expenditure in 2006 is planned to rise by 4.6 per cent, mainly because of a significant increase in public sector wages. Uncertainty surrounds public finances, however, as it is not clear whether the decision of the Government Remuneration Tribunal to raise salaries will be implemented and whether the Government will have to pay damages awarded to an island resort in a 2006 Supreme Court decision.

For the period 2006–08, merchandise exports and tourism receipts are expected to rise significantly, coinciding with a reduction in net outflows on the investment account. Thus, the balance of payments is forecast to fall from around 7 per cent of GDP to under 4 per cent of GDP. Import cover of foreign reserves is likely to stay between 5 and 6 months, and external debt should fall by 15–20 per cent of GDP by the end of 2008 as outstanding debt is retired. Further increases in the world price of crude oil and a severe deterioration of the terms of trade would yield a less optimistic outlook.

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Challenges to sustainable growth

Sound macroeconomic management sets the stage for a high level of stable and predictable aggregate demand. However, economic growth is the consequence of an increase in aggregate supply and this can only be sustained when the country's productive capacity expands continuously as a result of improvements in productivity. Vanuatu continues to disappoint on this front with growth of output barely keeping pace with population growth. Therefore, real living standards remain roughly at the same level as 1980.

The reasons for sluggish output growth now are much the same as they were ten years ago. They include physical and geographical constraints such as low population density, distance to markets, and the prevalence of natural disasters. But other constraints such as the high cost of doing business, inefficient credit markets, political instability, insecure property rights, etc., are artificial and, in principle, remediable. Therefore, some blame for failing to speed up reforms may be apportioned to governments, past and present.

Improvements seem to be underway. The Government Priorities and Action Agenda 2006–2015 acknowledges that economic growth has, on average, not been able to match population growth. Insufficient private sector investment is responsible for rising unemployment and low economic and human development indicators. Its objectives are to lower costs of doing business, improve access to land, provide better support services to business and ensure a conducive environment for increased commodity exports. Some reforms have been initiated but it remains to be seen whether the momentum to instigate change can be maintained.

The cost of doing business

One of the most revealing signs of the impediments to growth in Vanuatu is the cost of doing business. The World Bank (2006) provides comprehensive cross-country comparisons of key indicators relating to the ease of doing business. Vanuatu does not fare well in the majority of the categories and does not even compare favorably to other countries within the region (East Asia and Pacific). The direct costs of starting a business in 2006, for example, constitute 61.3 per cent of gross per capita national income (GNI), compared to 42.8 per cent in the region and a lowly 5.3 per cent for the OECD. Complying with licensing and permit requirements for ongoing operations in Vanuatu takes seven steps and 82 days to complete, at a cost of 398.8 per cent of income per capita, nearly double that for the region and more than five times that for the OECD.

The rigidity of employment index, averaging the difficulty of hiring, the rigidity of hours, and the difficulty of firing by assigning a value between 0 and 100, with higher values representing more rigidity, equals 33, the same as OECD countries but 10 points more than the region.

The ease with which businesses can secure rights to property is an important indicator of a country's attractiveness to local and foreign investors. While the procedure of registering property is relatively simple, the process takes 188 days and generates a cost of 7 per cent of the property value, compared with 85 days (4 per cent) across the region and 32 days (4.3 per cent) in the OECD.

Effective tax rates for medium sized companies are low in Vanuatu, making up 14.4 per cent of profits, compared to 47.8 per cent in the OECD. As expected, the costs involved in importing and exporting a standardised shipment of goods in Vanuatu are very high. It costs US\$1,565 per container

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to export and US\$1,975 to import while it costs approximately half that in the region and the OECD. Part of these costs are incurred in the process of collecting import duties, the most important revenue source for the government, apart from the value-added tax. But these costs are nevertheless excessive and point to large inefficiencies in the bureaucracy.

A summary of Vanuatu's rank in each of the World Bank's categories is given in Table 1. Vanuatu does not perform universally badly, but ranks low in particularly important areas such as the ease of obtaining credit, trading across borders, and registering property.

From an economic point of view, there is no justification for this kind of red tape as it only serves to deter potential investors and reduce profits of incumbent firms. This, in turn, ossifies the oligopolistic market structures characterising Vanuatu's economy, as only large firms benefiting from increasing returns to scale are capable of absorbing these costs. The authorities such as the land registry and the courts are often unaware of just how tedious and costly bureaucratic processes can be for businesses.

Moreover, there are usually few incentives for the staff in the ministries to work more efficiently. Hence, reforms to reduce red tape must come from the top, with clear directives to cut down on the bureaucracy and a well-entrenched system of quality control and compliance. Unlike certain geographical or demographic constraints, the presence of red tape is homemade and can be easily redressed. In fact, the reduction of red tape is probably the most cost-effective way of raising competitiveness (Baily and Farrell 2006). The World Bank report indicates that Vanuatu has not introduced any reforms during the last two years to address this problem. The reduction of red tape should be high on the government's reform agenda so as to promote private sector investment and growth.

Property and land rights

The economist Hernando de Soto (2003) persuasively argues that the key to economic growth lies in the existence of transparent, fair, and enforced property rights. Going back in history and looking at a wide cross-section of countries across the globe, he documents that low-income countries almost universally

Table 1 How Vanuatu ranks in the costs of doing business

Ease of...	2006 rank	2005 rank	Change in rank
Doing business	58	54	-4
Starting a business	65	61	-4
Dealing with licences	33	31	-2
Employing workers	96	90	-6
Registering property	91	88	-3
Getting credit	117	117	0
Protecting investors	60	58	-2
Paying taxes	19	18	-1
Trading across borders	120	120	0
Enforcing contracts	88	84	-4
Closing a business	45	42	-3

Source: World Bank, 2006. *Doing Business*, World Bank, Washington, DC.

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suffer from weak property rights: houses are built on land with disputed ownership rights, unincorporated businesses exist with undefined liability, industries locate where financiers and investors cannot see them. With the rights to possessions not adequately documented, these private assets cannot be readily transformed into capital, cannot be traded in anonymous markets, cannot serve as collateral for credit, and cannot be used as a share against investment. As a consequence, 'Third World and former communist nations...are undercapitalised, in the same way that a firm is undercapitalised when it issues fewer securities than its income and assets would justify... Without representations, their assets are dead capital' (de Soto 2003:6).

The state of land tenure rights in Vanuatu is confusing. Nari (2000) provides an overview of the pressing issues, which can be summarised as a conflict between a Western-style absolute ownership principle and the traditional indigenous custodianship principle. In 2000 about 97 per cent of the land and sea and their resources were under customary tenure. The constitution of Vanuatu states that, 'all land in the Republic of Vanuatu belongs to the indigenous custom owners and their descendants. The rules of custom shall form the basis of ownership and use of land in the Republic of Vanuatu' (Nari 2000:3). The critical issue here is not who owns title at any one point in time and how land and resources are distributed but rather the means and processes by which ownership is transferred. According to customary ownership principles tenure rights are vested in groups, based on common descent, and acquisition of land rights is a function of a host of variables in various unwritten codes and custom of the people. These principles are anathema to Western-style, capitalist ownership patterns and create an incentive structure that is not conducive to the modernisation of the economy.

While some improvements have been made in late 2003 to improve the transparency and fairness of land fees and charges and to increase the length of land leases, most of the problems associated with insecure property rights remain. Disputes are still common and take up a significant amount of judges' time. In September 2006 the first ever National Land Summit was held in Port Vila, the theme of the conference being, 'sustainable land management and fair dealings to ensure progress with equity and stability'. While it is much too early to say whether any legislation will come out of this summit, it is questionable whether any action would serve to reduce the uncertainty surrounding land rights, for there has been considerable pressure to change existing land laws in favour of more customary ownership rules (in particular, restricting individual titles).⁵ The Land Summit was initiated by the Vanuatu government following concerns over the controversial liberalisation policies implemented in response to an Asian Development Bank program. The new policies dramatically increased the share of customary land leased out to foreigners.⁶

Land rights are a culturally sensitive issue, not only in Vanuatu but all over the world. A culture of investment can typically only flower when there is no doubt about who reaps the rewards. This notion of ownership clashes with traditional cultures in which land is not seen as an exploitable resource. The tension between these diametrically opposed paradigms is unlikely to be resolved any time soon. However, the government ought to publicly acknowledge and base policy on the notion that there is a likely trade-off between the preservation of traditional land rights and economic development and modernisation. Policymakers should not pretend to be able to square the circle when all the empirical evidence suggests it is not possible. Recent research

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on economic growth reveals that people respond powerfully to incentives (see, for example, Easterly 2001). Even small amounts of uncertainty surrounding property rights can be big deterrents to investment and hold back growth.

Political stability

The recent improvement in macroeconomic conditions has coincided with a brief period of relative political stability, for which Prime Minister Ham Lini deserves considerable credit.⁷ However, the political situation remains inherently unstable, with 11 of the 12 parties currently participating in government. The ADB (2006) finds that this situation has heightened uncertainty for foreign investors and development partners, stifled several economic reforms, and placed government finances under stress through generous severance pay to outgoing ministers and their advisers. The political landscape, not only in Parliament but also within the government and the ministries, is so fractured that coordination of policies and constructive compromise is often elusive. As a result, important government decisions are tabled, the reform process collapses under the weight of conflicting interests, and constituents, particularly in the rural areas, lose faith in the system.⁸ The key reason for this instability was identified by Sugden and Tevi (2004:13) as, 'an ability for Members of Parliament to be voted in on only a small share of the vote in their electorates', thus undermining the accountability of politicians.

In the past, political instability translated to political incompetence, with government policies largely responsible for the failure of the National Provident Fund in 1998 and 2001 and the highly inefficient provision of basic services to rural areas. Today, government policy is strongly committed to and capable of fiscal prudence, which is being rewarded by increased levels of foreign

direct investment and a growing tourism industry. Given the fractious nature of party politics in Vanuatu, this is a remarkable achievement and unique among the South Pacific and the least developed countries more generally. Nevertheless, pork barrelling does still take place and stymies much needed investment.

The risks of the current situation are two-fold. First, in spite of the sound macroeconomic management, structural reforms have been timid. The Comprehensive Reform Program (CRP), approved by the government in June 1997 to address numerous structural problems in the Vanuatu economy, cannot be labeled a success. The ambitious rhetoric, which included goals such as the broadening of governance reforms, promotion of economic growth, enhancement of the social reforms, was not followed by equally ambitious actions. Vanuatu cannot afford to put the breaks on the reform process. The splintered makeup of Parliament may, however, do just that. Second, while the Prime Minister has successfully reigned in excessive fractiousness, this may change at short notice. Moreover, once the cards are reshuffled at the next election in 2008, new and existing members will start jockeying for influence again, jettisoning any previously held loyalties.

Delivering policy advice in this context is quickly greeted with suspicion. However, constitutional reform to limit the power of minorities in Parliament and to strengthen the executive's capacity to act, while ensuring sufficient checks and balances would go a long way towards reducing partisan politics and enabling greater transparency of the policy process.⁹

Dependence on foreign aid

Since independence in 1980 Vanuatu has received large amounts of foreign aid. According to the World Bank, Vanuatu was the fourth largest aid recipient in per capita

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terms for the period 2000–03, receiving approximately US\$170 in 2002 prices. Only East Timor, São Tomé and Príncipe, and Kiribati received more aid in per capita terms. In 2005–06 total aid flows are estimated at \$34 million, with \$24 million coming from Australia. Aid flows make up around one-third of the government's revenues.

In 2004 Vanuatu was the only Pacific country to be awarded a grant from the Millennium Challenge Corporation, a new US agency independent of the US Aid Development Agency. The US\$65.69 million grant is to be paid out in several tranches over a period of five years, front-loaded, and is earmarked for infrastructure projects on eight islands, including roads, wharfs, an airstrip, and warehouses, and institutional strengthening and policy reform initiatives. The project is supposed to increase average income per capita by 15 per cent within five years which, given the previous poor performance of aid programs, seems unrealistic. In addition to the MCC funds, AusAID has significantly stepped up its financial commitment in Vanuatu, implying that aid flows will reach record highs.

In the past, little of the foreign aid has been spent on visible projects such as improvements to the country's infrastructure. Instead, the funds have ultimately served to finance recurrent expenditures of the government. The benefits of foreign aid have been debated in the academic literature for decades but, more recently, the criticism is mounting. Critics such as Easterly (2001) and Hughes and Sodhi (2006) argue that foreign aid creates a host of problems. First, it generates a huge moral hazard problem, preventing countries from becoming self-sufficient and making them dependent on foreign transfers. Second, large sums of foreign exchange slushing around in government coffers perpetuate corruption and lead to systemic inefficiencies. Resources are drawn from the private to the

public sector, allowing public sector wage increases that would not have been possible otherwise. Third, large inflows of foreign capital put upward pressure on the domestic currency, making exports and import substitutes less competitive. Hughes and Sodhi are cynical in their assessment of the MCC, stating that the projects being funded are ones that should have been completed with help from previous funds. They point to the high level of corruption still endemic in Vanuatu, which will guarantee that funds are channeled into the wrong hands. While Hughes and Sodhi embrace an extreme viewpoint, there is no denying that Vanuatu has come to rely on external funds to an extent that is not healthy. The MCC funds provide the opportunity to make up on some lost ground in infrastructure development but long-term policy must clearly signal to the outside world that Vanuatu is committed to weaning itself off the financial drip proffered by foreign aid agencies. At present this does not seem to be the case.

Infrastructure

The state of Vanuatu's infrastructure remains poor and prices for transport, communication and electricity services extremely high. Vanuatu is a sparsely populated country of only 210,000 people spread over some 50 islands;¹⁰ hence, the country is not able to benefit from any meaningful agglomeration externalities or economies of scale, giving rise to natural monopolies. Where the market is small but technologies are characterised by decreasing marginal cost, it needs to be regulated. Proper and thorough supervision and regulation of these industries limits the economic rents monopolists and oligopolists can reap, passing on the savings to consumers and increasing economic efficiency. The need for effective regulation has been noted many times before (see, for example, Sugden and Tevi 2004), but only since a World Bank study in 2004 has some

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progress been made. Bank officials visited Vanuatu in 2004 to study the water, electricity and telecommunications sectors. Based on these consultations, the World Bank designed a technical assistance project, funded by the Public Private Infrastructure Advisory Facility (PPIAF). The project is structured in three phases. The first phase, completed last year, consisted of a comprehensive assessment of the extant regulatory framework and service providers. The second phase, which is nearing completion, focused on the design of a universal regulatory institution, taking into account Vanuatu's economic characteristics and needs. The third phase, to begin next year, will engage in capacity building and provide start-up assistance. Preliminary results were discussed at a government and World Bank sponsored workshop in October 2006, with the main focus on the proposal to form a Utilities Regulation Authority (URA). The move enjoys the support of the Ministry of Finance, which said in a statement, 'recognising the importance of this new initiative to Vanuatu, the Government of Australia has also offered A\$1.5 million to support the URA's implementation, and capacity building of its staff'. Assuming that the URA's implementation is successful and enjoys political support, utility prices should come down significantly, making businesses more competitive and freeing up household resources.

However, while prices may fall significantly in the urban centres, where the utilities face increasing returns to scale, it is not clear what will happen to prices in rural areas. In the past, utility providers have defended high prices on the grounds that, in order to provide remote areas with (expensive) services, cross-subsidisation was necessary. It remains to be seen how the government and World Bank address this issue, as there is considerable pressure, both locally but also from overseas development

agencies, to provide adequate utility services to the outer islands.

The physical infrastructure, for example, roads, ports, airports, bridges and so on, has suffered from serious underinvestment over the past few years. The government's total development expenditure fell dramatically from VT1,189 million in 2001 to only VT461.6 million in 2005. In the first half of 2006 a paltry VT1 million was spent. Clearly, such low levels of spending are not sustainable without leading to significant deterioration of the physical infrastructure. The massive drop in development expenditures this year may be in anticipation of imminent infrastructure investments financed by the US Millennium Challenge Corporation (MCC). Whether these projects are the most deserving and whether they will deliver positive returns in terms of higher growth rates is very difficult to ascertain. Critics of the MCC grant argue that the projects funded by the MCC were chosen on political grounds and were not based on sound economic cost-benefit analysis.¹¹

Sparsely populated countries like Vanuatu are shackled by political pressures, both internal and external, to provide services to remote, rural areas. The reasons are self-evident—the government is accountable to and responsible for all citizens, no matter how far removed they are from commercial and political centres. However, it is very economically inefficient to build a road in a village of 300 people when the same funds could have been spent on a project in Luganville or Port Vila that may yield benefits to several thousand people. In economic parlance, the opportunity costs of developing remote, sparsely populated regions are extremely high. Infrastructure provision, in particular that which satisfies basic needs such as clean water and shelter, should not be predicated on economic principles alone. However, the need to spread investment thinly across the country implies that

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Vanuatu is forgoing vital economies of scale and agglomeration benefits. As argued above on the issue of property rights, the policy debate should publicly acknowledge the trade-off between funding projects in the centre and the periphery. Only when opportunity costs are properly accounted for and development objectives honestly framed, will infrastructure policy be able to become more effective.

Credit

Interest rate spreads in Vanuatu remain inefficiently high, currently standing at around 9 per cent, and point to a lack of competitiveness in the banking sector. Some three years ago when there was considerable liquidity idle in the banking system, interest rate spreads were not bid down, suggesting that commercial banks enjoyed significant monopoly power. This might be expected in a country of limited size but international evidence suggests that this need not be so. In a recent study comparing interest rate spreads across numerous Caribbean island nations, Samuel and Valderrama (2006) find that interest rate spreads are only marginally affected by bank size and market concentration while monetary policy variables, in particular reserve requirements and capital controls, appear to be important determinants of *ex ante* spreads. These findings should provide a useful starting point for an expansive analysis of interest rate spreads in Vanuatu. At any rate, they do not obviate the need for prudent regulation of banks to limit their monopoly power.

The last couple of years have seen a significant increase in micro-credit extended to rural areas where standard commercial banking is grossly underdeveloped and potential borrowers lack collateral. The National Bank of Vanuatu approved more than VT200 million worth of microfinance loans after just two years of introducing the scheme. The micro business and small rural

development loans have so far been used for agriculture and livestock purchases (20 per cent), the fishing sector (25 per cent), and other trades and services ('NBV's microfinance product stimulates business in rural areas', *Vanuatu Daily Post*, 8 October 2006). It is anticipated that a further VT100 million will be approved in new loans by the end of this year. Mobile microfinance officers operate from seven rural branches throughout Vanuatu with further branches on the islands of Pentecost, Ambrym and Malekula planned for the immediate future. They deliver credit and provide financial advice to local communities, travelling on motor bikes and on boats when necessary. NBV's microfinance branch prides itself on its community involvement. Micro-credit is sold to rural and island village communities and semi-urban areas through village and community Chiefs. The whole operation, from credit appraisals to loan disbursements to monitoring, relies on the traditional community custom value system.

The Asian Development Bank provided technical assistance for rural and microfinance outreach, helping to expand rural financial services provided by the National Bank of Vanuatu by designing a rural and microfinance facility, refining lending modalities and contractual specifications, training rural loan officers, and helping evaluate performance and costs of credit packages (Asian Development Bank 2006). The assistance also included the establishment of a microfinance task force that is supposed to assist in drafting a legal and regulatory rural and microfinance framework, performance indicators, and a monitoring and evaluating system.

The microfinance schemes in Vanuatu are universally considered a success. The bank has enjoyed lower than industry standard default rates, thanks to the peer monitoring aspect of micro-credit. While microfinance is not a panacea in every

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circumstance, the potential benefits have been widely documented and enjoyed the world over (see, for example, Armendàriz de Aghion and Morduch 2005). For a country like Vanuatu where 80 per cent of the population lives in rural areas, access to modern banking facilities are non-existent, traditional trading practices are still pervasive, and land rights prevent property from being used as collateral, microfinance can make a substantial difference to the poor. It also empowers women who would otherwise not have access to finance, giving them a stake in their family's and group's commercial operations. The recent success of the nascent microfinance industry in Vanuatu suggests that it will continue to expand. This expansion should be encouraged.

Tariffs and trade

Vanuatu's export performance remains poor. Its total merchandise and service exports per capita are among the lowest in the region, which are already low by global standards. Copra and coconut oil make up the bulk of merchandise exports, followed by beef, timber and kava. Agricultural exports come from relatively large plantations; small-scale farmers do not typically produce for the export market. The main service export is tourism, which makes up around 16 per cent of GDP and generates some 75 per cent of total foreign earnings. Tourism has grown considerably in the last five years with 20 per cent growth in 2004 alone but, compared to other South Pacific nations, the tourism industry started from a relatively low base.

The crucial role of exports in economic development is by now well documented (see, for example, Easterly 2001). Not only do exports directly contribute to domestic income and provide much needed jobs in countries where labour is plentiful, but they force firms to become more efficient as they compete on the world market. These

productivity improvements in the export sector spill over into domestic production, thus raising living standards. Hughes and Sodhi (2006) suggest that for Vanuatu to grow at a good clip, as other countries such as Botswana and Mauritius have done, per capita exports would have to rise ten-fold. While only a crude estimate, this number indicates that Vanuatu is distinctly under-represented in world markets and not fully exploiting potential gains from trade.

Import tariffs are the government's primary source of revenue and have remained very high. In 2002 they stood between 0 and 55 per cent, compared to 0–27 per cent in Fiji, 0–20 per cent in Samoa, and 0–25 per cent in Tonga (Hughes and Sodhi 2006). Tariffs of this magnitude inefficiently distort prices and give rise to damaging rent-seeking activities by large producers and custom officials. Export prices have been distorted by the Vanuatu Commodities Marketing Board, which has been consistently accused of blatant corruption, and by the imposition of silly export taxes. For example, in early 2006 a 30 per cent export tax was imposed on live animal exports.

While the primitive tax system prevents the government from eliminating tariffs altogether, at least in the short term, there is a pressing need for import and export duties to fall to enhance economic efficiency. Vanuatu formally applied for accession to the World Trade Organization (WTO) in 1995 but the government abandoned negotiations in 2001 over disagreements relating to the retail, services and telecommunications sectors. Late last year the government reaffirmed its commitment to the WTO and talks have resumed but it will be a long time before any agreement is reached. The government should put the accession bid high on its agenda in order to facilitate the flow of goods and services across its borders.

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Conclusion

Vanuatu's economy paints a picture of contradictions—solid macroeconomic policy that has delivered balanced budgets, low inflation, and a reasonably stable currency is spoilt by poor structural performance that has left ni-Vanuatu barely better off than a decade ago. The focus on macro-economic policy is perhaps an unconscious consequence of the Washington Consensus agenda, which argues vehemently that long-term growth is not achievable without macro-economic stability. Despite a weak political system, the government in the last three years—helped by favorable global economic conditions and munificent overseas transfers—has managed to restore fiscal order.

However, while sound macroeconomic policy may well be a necessary condition for high growth rates, it is not a sufficient condition. Per capita income has barely improved and access to basic facilities such as clean water, health care, and education remain embarrassingly poor, especially in remote rural areas. Credit is still expensive, import and export tariffs are highly distorting, the costs of doing business prohibitively high, the infrastructure in need of repair, and land rights uncertain. While all of these constraints work in tandem and it is unlikely that only one factor is ultimately responsible for holding back growth, the issue of land and property rights does stand out as perhaps the most pressing. International evidence, both historical and cross-sectional, strongly suggests that without a fair, transparent, and reliable system of land rights, economic growth will not be possible. Unfortunately, the recent National Land Summit does not make a favourable resolution look likely.

The outlook for the future is unclear. Optimists will consider the glass half full, pessimists half empty. Some of the criticisms raised by Sugden and Tevi in their 2004

survey have been addressed. The reform process seems to have gained a little momentum, although it is much too early to say how successful it will be. Vanuatu is starting from a low base, and some 20 years have been wasted in missed opportunities to improve the structure of the economy. Comparisons with other small island nations may be helpful and should give support to the reform process. For example, the Caribbean countries of Barbados, the Bahamas, and Bermuda have faced similar physical constraints to Vanuatu but clear property rights and economic freedom have raised their income levels to more than ten times that of Vanuatu. If the political will is present, similar achievements are also possible in Vanuatu and the inhabitants of this beautiful island nation will not only be the happiest but also enjoy health, wealth, and economic prosperity.

Notes

- ¹ GDP estimates are taken from the National Statistics Office; fiscal data are from the Department of Finance; and inflation, monetary, and balance of payments data are from the Reserve Bank of Vanuatu. See also Asian Development Bank (2006) for a summary.
As Chand (2002) points out, official statistics must be interpreted with care. With some 80 per cent of the population living in rural areas and engaging in subsistence production, a significant amount of economic activity is simply not recorded. Data provided by the National Statistics Office is adjusted to reflect this activity but estimates of wages, production, and inflation in rural areas are necessarily crude.
- ² A large portion of the external debt was used to bail out the National Provident Fund and the National Bank of Vanuatu, which had experienced serious financial problems. Thus, the debt did not lead to any useful investment but only corrected past economic vices.
- ³ For example, Australian dollar one-month deposit rates currently lie between 3.5 and 4.5 per cent.

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- ⁴ The ADB projections are based on forecasts prepared by the Department of Economic and Sector Planning.
 - ⁵ On Radio Australia, Selwyn Garu, General Secretary of the Malvatuma Council of Chiefs of Vanuatu, said about the Summit, 'during the last few days of presentations and discussions, it was quite obvious that people, the participants all wanted change in land policies, or an improvement in strengthening land policies in the country. The way things stand now for them is not satisfactory. There need to be changes that would reflect not only the government's view, but also the chiefs' and custom ways of the land dealing in the country'.
 - ⁶ In Port Vila approximately 85 per cent of customary land is now leased out to foreigners.
 - ⁷ This compares to the latter half of the 1990s when extreme parliamentary instability brought policymaking and oversight to a near halt (see Morgan 2005).
 - ⁸ This point is emphasised by Morgan (2005:4) who argues, for example, that in northern Vanuatu 'parliamentary democracy is seen to contribute to the erosion of community cohesion and benefit no one but a political élite'.
 - ⁹ Morgan (2005) argues that special interest politics has meant that policymaking and lawmaking increasingly takes place behind closed doors, thus escaping public scrutiny.
 - ¹⁰ 210,000 is roughly a mean value of estimates of Vanuatu's population which range from 190,000 to 230,000.
 - ¹¹ See, for example, the comment by John Salong in the Port Vila Presse on 1 January, 2006.
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