Economic surveys

An educated, healthy and wealthy Vanuatu

Patrick de Fontenay

After a decade of stagnation, Vanuatu has recorded six years of rapid growth since 2003, due mainly to growth in the tourism and construction sectors fostered by successful reforms, political and macroeconomic stability and donors' assistance. With a population growing by 2.8 per cent annually and emigration possibilities still very limited, Vanuatu has no choice but to aim for continued fast growth. Tourism is the clearest choice for such growth, but more rapid growth in agriculture would have the greatest impact on poverty reduction and employment. Faster growth in agriculture and elsewhere will require further infrastructure building, a political and business climate favourable to foreign investment and reforms in some key areas on which private sector development depends.

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The title of this survey is the subtitle of the Vanuatu government's *Priorities and Action Agenda: 2006–15* (Government of Vanuatu 2006). If the penultimate word is changed slightly to 'wealthier', progress has so far been steady in that direction. In spite of major obstacles—mainly the small size of its market, the large distance from industrialised economies, the dispersion of the population across some 60 islands and the global financial crisis—from 2003 to 2008, real GDP has grown on average by about 6 per cent, or more than twice the rate of population growth. This performance, which outshines that of most other island nations in the South Pacific (Figure 1), has nevertheless raised questions about its durability (see Henckel 2006; Duncan 2009); scepticism has been further fuelled by the slowdown in economic activity estimated for 2009 and forecast for 2010–11.[1] Such questions should be answered by looking at what stands behind Vanuatu's achievements and at the conditions that must be met for these achievements to be sustained.

This survey updates the comprehensive *Vanuatu Economic Report* for 2009 from the Asian Development Bank (ADB 2009a) by looking at recent economic developments, prospects and policies, and at the factors that account for Vanuatu's good recent performance. It then discusses the potential for further economic growth in excess of population growth and under what conditions it can be achieved.

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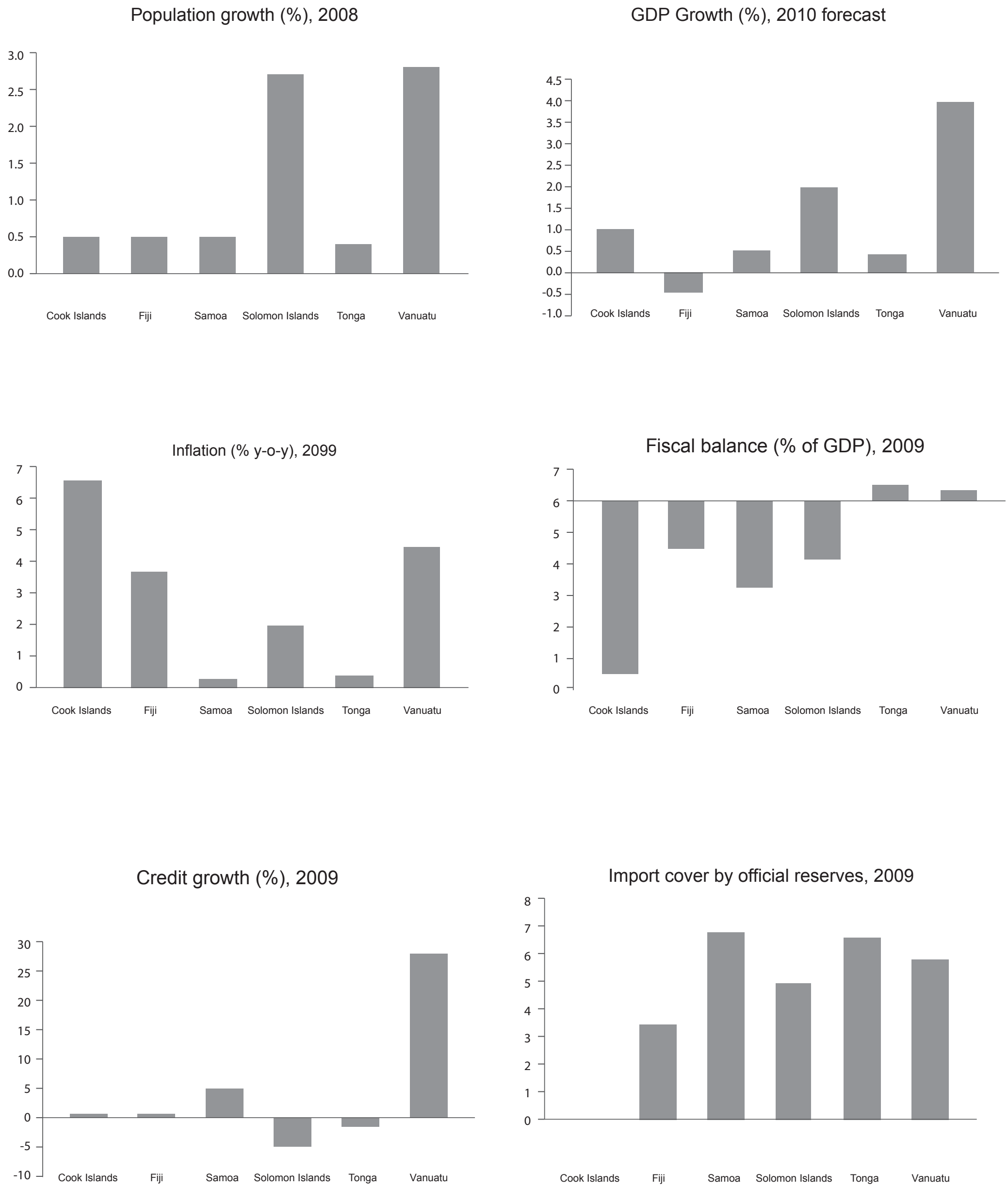
Figure 1 **Comparative economic indicators**



Source: *Pacific Economic Monitor*, March 2010, Asian Development Bank.

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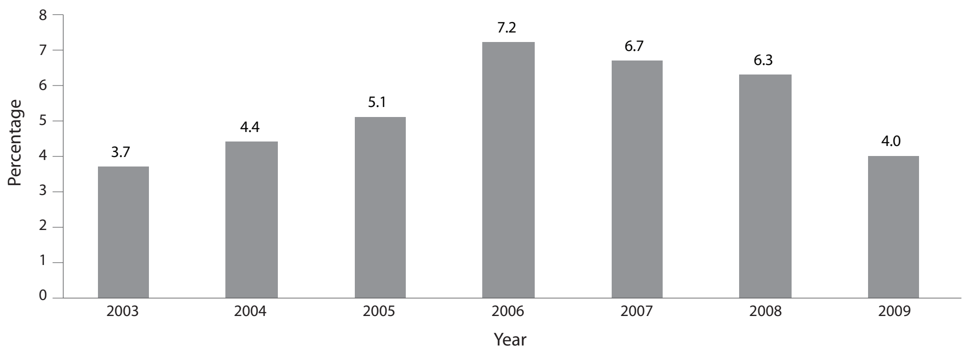
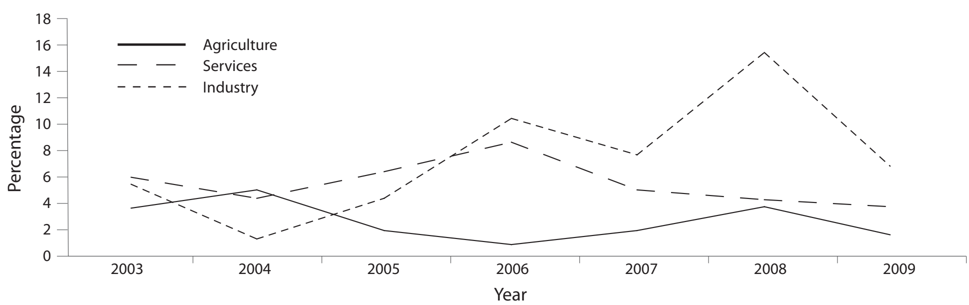
Recent economic developments and prospects

After two years of growth in excess of 6 per cent, in 2009, real GDP is estimated to have increased by 4 per cent as business and consumer confidence was adversely affected by the global financial crisis and a tightening of lending terms by banks aimed at reining in an unsustainable rate of growth of credit, and by restrained domestic spending. As in the previous six years, in 2009, the services sector was the largest contributor to the growth of GDP (Figure 2). Tourism-related sectors alone made up about half of the total contribution to GDP growth. After an exceptionally strong year in 2008, in 2009, the growth of the industrial sector slowed to an estimated 7 per cent, with construction (including house building) making the largest contribution to the overall performance. The agriculture, fishing and forestry sector was hurt by the fall in commodity prices up to mid 2009, with copra production declining to its lowest level in years. The sector is estimated to have expanded by less than 2 per cent in 2009, compared with 3.8 per cent in 2008. All in all, Vanuatu weathered the 2008–09 world economic recession reasonably well.

Figure 2 **Annual growth rate: real GDP**





* Based on unrevised official projections in *Budget 2010* (Government of Vanuatu 2009).
Source: Vanuatu National Statistics Office.

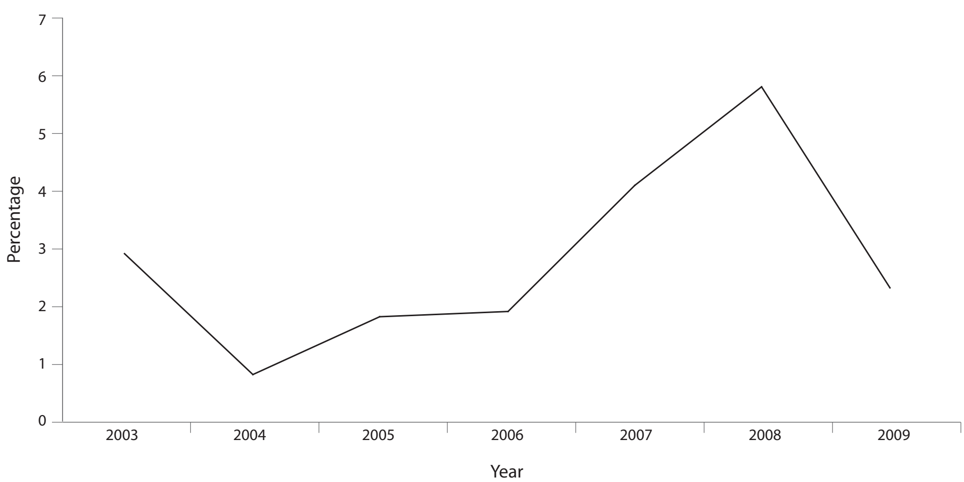
The year-on-year inflation rate—which had been pushed up by food and oil prices—peaked at 6.4 per cent in the June 2009 quarter, then fell to 2.3 per cent in the December quarter, compared with 5.8 per cent in the last quarter of 2008 (Figure 3). Data on wages and employment are unavailable, but a tightening of the labour market for skilled workers in the construction and telecommunications sectors has been reported. The October 2008 decision to raise the minimum wage by 30 per cent must have had flow-on effects on labour costs, especially in the retail trade and hospitality sectors.

The trade deficit for 2009 was slightly lower than for the previous year (Table 1). Imports for domestic consumption fell by 6.4 per cent—due mainly to lower imports of fuels and machinery/transport equipment—offsetting a 17 per cent decline in exports (excluding re-exports). The value of the main export, copra, fell by half to an amount below that of kava exports, as prices for the two commodities moved in opposite directions. Surpluses on the services account and on current transfers helped reduce the current account deficit from 5.9 per cent of GDP in 2008 to 2.1 per cent in 2009. As the capital and financial account continued to show a large surplus—due in part to foreign direct investment—the official reserves of the central bank rose to a record level, equivalent to nearly six months of imports.

Economic outlook

Provisional data for the first two months of 2010 suggest that economic activity was slowing. Value-added tax (VAT) receipts and imports for January/February 2010 were lower than for the same period in 2009. Visitor arrivals—estimated from Australian data only—also show a softening in the tourism sector (Figure 4). Prices for Vanuatu's main commodity exports have not strengthened markedly—and bank credit to the private sector is moderating from the torrid pace it recorded in 2008–09.

Figure 3 **Rate of change: consumer price index (year-end)**



Source: Vanuatu National Statistics Office.

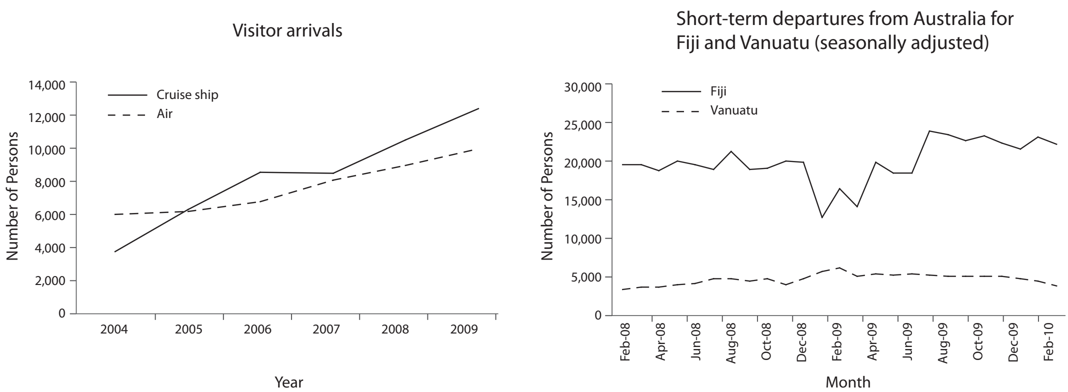
Table 1 **Central government finance (millions of vatu)**

	2004	2005	2006	2007	2008	2009 Budget	2009 Outcome	2010 Budget
Current revenue	7,390	7,879	9,162	11,052	12,635	12,999	12,290	14,657
Tax	6,622	6,854	8,121	9,847	11,444	11,996	10,858	13,180
Non-tax	768	1,025	1,041	1,205	1,191	1,003	1,438	1,411
Grants	852	1,235	853	980	3,975	1,890	4,529	4,899
Total	8,242	9,114	10,015	12,032	16,610	14,900	16,825	19,490
Percentage of GDP	19.6	20.5	20.1	21.6	26.5	21.8	24.6	26.6
Expenditure plus net lending								
Recurrent expenditure	7,331	7,576	8,659	11,051	11,840	12,552	12,397	15,775
Development expenditure	584	368	814	912	3,389	1,771	4,392	4,898
Total	7,915	7,943	9,809	11,963	15,229	14,324	16,789	20,674
Percentage of GDP	18.8	17.9	19.7	21.4	24.3	20.9	24.5	28.2
Budget balance	326	1,170	206	70	1,318	577	36.1	0.1
Percentage of GDP	0.01	0.03	--	--	2.1	0.8	0.05	--

-- zero

Source: Government of Vanuatu, 2009. *Budget 2010*, Ministry of Finance and Economic Management, Port Vila; Reserve Bank of Vanuatu (RBV), 2009. *Quarterly Economic Review*, December, Reserve Bank of Vanuatu, Port Vila.

Figure 4 **Tourism indicators**



Visitor arrivals source: Reserve Bank of Vanuatu (RBV), 2009. *Quarterly Economic Review*, December, Reserve Bank of Vanuatu, Port Vila.

Departures Source: Australian Bureau of Statistics.

Nevertheless, there are positive factors that should sustain growth for the balance of the year. Tourism picked up in March/April. Tourist arrivals by air in April were 21 per cent higher than 12 months earlier and the number of tourists arriving on cruise ships was double the figure for April 2009. Banks reported that the demand for credit picked up in the last weeks of April. As discussed in the next section, macroeconomic policies are accommodating, and the relatively strong balance-sheet position of the banking sector makes a credit crunch unlikely. Donors are expected to continue their support to the government.

The main determinants of receipts from tourism—such as security and the availability of accommodation and transport being equal—are disposable income in the countries from which most of the visitors originate and relative costs compared with other destinations. This suggests that the strength of the Australian economy and currency should have a positive impact on Vanuatu's tourist sector. There are, however, two considerations that could have the opposite effect. One is the preference shown by tourists from Australia and New Zealand in 2008–09 for short-distance destinations in an economic environment marked by uncertainty and apprehension, favouring Vanuatu. If this situation were to be reversed, it could adversely affect Vanuatu. The other is the risk that Fiji could succeed—after a couple of bad years—in restoring its share of the tourist market, with the help of the devaluation of its currency.

The construction sector—including house building—will remain a strong driver of the Vanuatu economy. Some large projects are continuing, including the Éfate ring road and the new road in the East of Espiritu Santo, financed by the US Millennium Challenge Corporation (MCC). There are other projects in the pipeline—some linked to the surge in government capital spending in the last quarter of 2009. The strength of the Australian property market is also likely to encourage house buying and building in Vanuatu.

All in all, the current official forecast of a 4.1 per cent increase in real GDP appears realistic. The slight slowdown in growth foreseen for 2011 is also reasonable, given the expected completion of the MCC projects at the end of 2010, unless they are replaced by new ones.[2] The outcome for inflation is dependent largely on what happens to import prices—notably fuel and foodstuffs—but there is a lag of about six months between a rise in the price of crude oil and the import price of petroleum products. The exchange rates of the vatu against the currencies of Australia and New Zealand can also have a strong impact on import prices. Upward pressure on wages is expected to moderate as the demand for labour eases. On the external side, the level of official reserves held by the Reserve Bank of Vanuatu (RBV) and the expected inflow of capital should continue to finance the current account deficit of the balance of payments and keep Vanuatu's external debt position at its present low level.

Macroeconomic policies

The fiscal operations of the central government have been characterised for a number of years by a growth rate of current expenditure in line with that of GDP (in current prices), tax and non-tax revenue sufficient to cover current expenditure and 'development expenditure' that was easily covered by foreign grants, leaving an overall surplus (Table 2)[3]. The provisional outcome for 2009 does not differ markedly from this pattern, although current revenue was slightly lower than the budget figure[4] and current expenditure was slightly higher—and there was a surge in development expenditure in the last quarter of the year.

Table 2 **Balance of payments (millions of vatu)**

	2004	2005	2006	2007	2008	2009
Exports of goods and services	17,984	19,348	20,282	21,999	26,842	29,620
Imports of goods and services	19,949	22,404	23,464	25,700	34,316	32,977
Current account	–2,509	–3,727	–2,627	–3,866	–3,728	–1,458
As a percentage of GDP	6.0	8.4	5.3	6.9	5.9	2.1
Capital and financial accounts	5,227	5,561	3,778	2,149	4,416	2,230
of which: direct investment	2,219	1,455	4,821	3,486	3,338	2,901
Gross official reserves (end of period)	22,522	28,846	38,809	45,159	48,851	54,874
In months of next year's imports	5.5	5.8	6.8	7	5.8	5.9

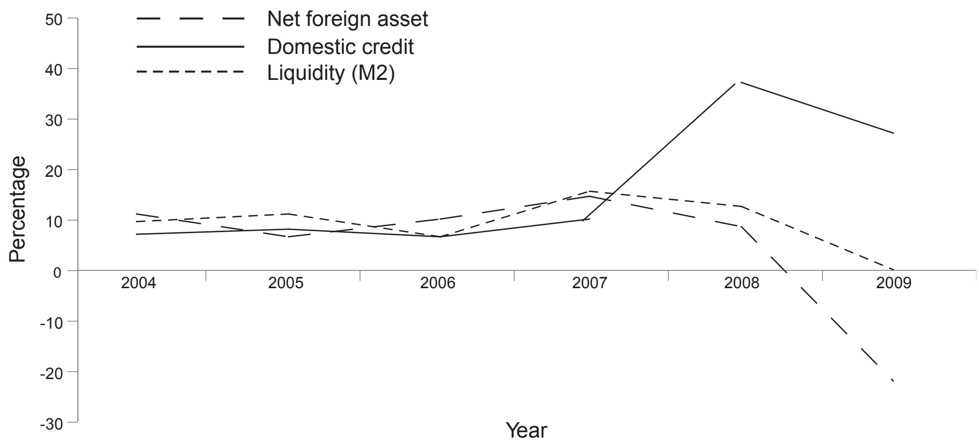
Source: Reserve Bank of Vanuatu (RBV), 2009. *Quarterly Economic Review*, December, Reserve Bank of Vanuatu, Port Vila.

The budget for 2010 features a 12.2 per cent increase in current revenue—an ambitious projection given the weakening of tax collections, especially the VAT, in 2009 and the first two months of 2010. The government expects import duties to be 21.3 per cent higher than in 2009 due to reclassification of import categories and a reduction in exemptions. On the spending side, current expenditure is projected to rise by 27 per cent from the 2009 expected outcome as a result in part of the move to free universal education, higher allocations to health and training and the delay in the final approval of the 2009 budget, which slowed spending in the first part of that year. The budget acknowledges that the recurrent total signals the upper band of a fiscally responsible budget. Development expenditure is to rise slightly from the high level of 2009, but the overall budget is expected to be balanced, with public debt remaining below 20 per cent of GDP. The Budget Policy Statement 2011 (Government of Vanuatu 2010) tabled at the end of April sets as targets for 2011 a balanced budget, with revenue at 19 per cent of GDP at least and expenditure also at 19 per cent of GDP.

Monetary developments have been volatile in recent years, with credit to the private sector more than doubling from the end of 2006 to the end of 2009, but the banking sector has weathered well a potentially hazardous period. During 2008, loans for housing and land purchases accounted for a large part of the 45 per cent growth in credit to the private sector (Figure 5). Attempts by established banks to counter the inroads made by a new bank into their market shares contributed to this development.[5]

The rapid expansion of credit impacted on the banks' liquidity position, which, together with concern about the possible impact of the global financial crisis, led the RBV in December to lower its discount rate—the liquid asset requirement—and the statutory reserve deposit requirement. At the same time, commercial banks began to tighten lending terms for fear of fuelling a property price bubble and mounting insolvencies. These actions succeeded in slowing the expansion of loans to individuals and households to 3.5 per cent in the year to January 2010 (RBV 2010). Credit to business remained buoyant, however, expanding

Figure 5 **Money and credit: percentage change, end of year**



Source: Reserve Bank of Vanuatu (RBV), 2009. *Quarterly Economic Review*, December, Reserve Bank of Vanuatu, Port Vila, various issue.

by 38 per cent over the same period and keeping the rate of growth of private sector credit at a strong 21 per cent.[6]

Monetary authorities are monitoring economic developments—notably, inflation, official international reserves, credit expansion and the high level of commercial banks' excess reserves—before deciding whether to rescind the December 2008 loosening of their policy stance. The objective of continued stability of the effective exchange rate remains unquestioned. Among the reasons for this is the 50 per cent share of the money supply that is denominated in foreign currencies.

The banking sector's net profits declined in 2009 as greater competition within the sector narrowed the interest rate spread between average lending and deposit rates, but their balance sheet position remained strong. Substandard and doubtful loans represented 10 per cent of total loans in December 2009—down from about 19 per cent in December 2006.

The offshore sector

Since the passage of the *International Banking Act* and the *Financial Transactions Reporting Act* in 2003, Vanuatu has remained a low-tax centre but can no longer be branded as a tax haven, which would imply that it facilitates tax evasion. The change has been consolidated by the signature with Australia of a 'Tax Information Agreement' on the exchange of information between the respective tax authorities, to be followed by similar agreements with other countries. The Vanuatu International Finance Centre now includes seven banks, 15 trusts and 28 insurance companies that do no business in Vanuatu. International banks are now supervised by the RBV and the Vanuatu Financial Services Commission (VFSC) supervises insurance companies. Tighter oversight has contributed to a reduction of their number, but their local expenditures in 2009 were still equivalent to about 3.8 per cent of GDP. The number of other non-financial international and exempt companies has also fallen from a peak at the end of 2006.[7] In contrast, shipping registrations—which accounted for VT181 million in fees in 2009—increased by 3.6 per cent over the same period. Overall, the offshore sector has not developed as much as some might have hoped, but it is 'respectable' and this could ensure its viability.

Sources of Vanuatu's success[8]

Reform

In the late 1990s, the ADB's Comprehensive Reform Program for Vanuatu had already emphasised improvement in governance and public sector reform as preconditions for economic and social progress. It achieved a strengthening of the financial sector, with the rescue of the National Bank of Vanuatu and of the Vanuatu Provident Fund. It was not until the early 2000s, however—with the installation of a new, more committed coalition government—that the reform process took off, supported by the ADB's new Country Partnership Strategy. The government endorsed the goal of financial discipline—as set up by the *Public Finance and Economic Management Act* of 1998—and the principle of a balanced budget. The government also encouraged private sector development and the independence of the civil service, and established reform impact-monitoring systems. In 2007, the Australian Agency for International Development (AusAID) 'Governance for Growth' program gave a new impetus to reform. The introduction of competition in the air transport and telecommunication sectors was an important step that reduced costs and provided greater availability of services. It made a major contribution to the strong expansion of tourism.

An active land market

The Vanuatu government has allowed the development of an active property market with long-term leases of customary land as a substitute for freehold title. This reconciles the indigenous custodianship principle for land with the possibility of acquiring its use. The Ministry of Land and Natural Resources has developed systems for registry (now moving to a computerised 'e-registry'), transfer and settlement of disputes. The minister may intervene in land disputes and the government may substitute itself for the traditional owners in some cases. The large number of property agents now operating in Vanuatu testifies to the activity of the land market. It is now uncommon for security of land title to be an obstacle to the establishment of a new business.

Political and macroeconomic stability

Since 2004, political stability has provided continuity to the reform process and to economic management. Fiscal and monetary policies have ensured that balanced budgets, low inflation and a stable exchange rate offer a favourable environment for private sector investment. Supervision of the banking sector by the RBV has been effective in maintaining the financial soundness of the commercial banks.

Role of donors

The main donors—notably, Australia, New Zealand and the ADB—have made major contributions through financial and technical assistance to economic development and poverty reduction in Vanuatu. Aid flows almost doubled between 2006 and 2007 to VT7.6 billion and increased further in 2008–09.[9] Coordination between donors and between donors and the government has remained close. Vanuatu appears to have entered a 'virtuous circle', with improvements in governance and reform encouraging donors to scale up their assistance, which in turn reinforces the government's commitment to reform. A case in point has been the selection of Vanuatu by the MCC as the only country in the South Pacific to gain access to its resources.

Role of foreign investment

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

Luck

Vanuatu has been largely sheltered from the global financial crisis by the relative economic strength of its industrialised neighbours, especially Australia. The three-quarters of the population that still makes up the subsistence economy would, however, have been largely unaffected in any case.

Looking ahead

The agenda

As noted above, the Vanuatu government has set out its agenda in *Priorities and Action Agenda 2006–2015*. The agenda identifies the following key priority areas

- private sector development and employment creation
- macroeconomic stability and equitable growth
- good governance and public sector reform
- primary sector development
- provision of better basic services, especially in rural areas
- education and human resource development
- economic infrastructure and support services.

Implementation of the agenda is the responsibility of the various ministries. For each of the priority areas, the agenda lists the key issues and challenges, policy objectives, priorities and strategies and performance indicators. The government has also endorsed the Millennium Development Goals (MDGs). Vanuatu is on track to reach the goals for poverty reduction, universal primary education and environmental sustainability; it lags on gender equality and some health targets.

The main donors' programs broadly support the government's agenda. The Vanuatu–Australia Partnership for Development of 2009 (AusAID 2009) lists as priority outcomes to

- support increased access to and quality of education
- strengthen health services and accelerate progress towards the health MDGs
- progress reform on economic governance
- address the equality of opportunity for all men and women.

New Zealand's five-year strategy rests on three pillars: education, governance and economic development. The ADB's Country Partnership Strategy (ADB 2009b) has three priority sectors: transport, urban development and energy.

Vanuatu's potential

It is clear that Vanuatu has a comparative advantage in tourism and can develop this sector further if it maintains its competitiveness, protects its environment, ensures security and facilitates access to the most attractive parts of the country. The number of tourists arriving by air in 2008 was still less than for Fiji and less than one-tenth of the 931,000 arrivals recorded by Mauritius in 2008 (Box 1). The new roads being built on the islands of Éfate and Espiritu Santo have already sparked interest in the development of new tourist facilities in locations that were previously difficult to reach. Further expansion of the tourist sector will require private foreign investment, improved infrastructure—especially for inter-island transport—and promotion by the government. The Asian market is yet to be tapped.

Given that agriculture employs more than two-thirds of the active population, productivity gains in that sector would have a large impact on the economy and on poverty reduction. Until now, agriculture proper, as distinct from forestry and fishing, has grown very slowly, except for cattle production in recent years and some niche markets. The government has announced a Coconut Sector Investment Program,

> which aims at revitalising the sector. This program will focus on replanting, improving information that is available to farmers, strengthening access to credit, and providing investment incentives for upgrading machinery and equipment…The coconut industry remains the largest contributor to rural income (Government of Vanuatu 2009).

Although there is strong competition in the region for coconut production, there are good prospects for the use of copra for biodiesel. Food imports represent about 15 per cent of total imports. Some of those imports could be replaced by local production if its cost and quality can become competitive.

Recent studies have shown that high transportation costs delay gains in agricultural productivity and the growth of commercial agriculture (for a case study on Uganda, see Gollin and Rogerson forthcoming). Current road building in Vanuatu should therefore contribute to the transformation of subsistence agriculture, although it will need to be supplemented by better and cheaper inter-island transport. The rapid expansion of mobile phone coverage will also alleviate 'coordination failure' and reinforce the impact of new roads—as

Box 1 **Lessons from Mauritius**

Mauritius has long been held up as an example for other island countries, although its success has benefited a great deal from free access to the EU market for its main agricultural production—sugar—and its manufactured products. This in turn has stimulated direct foreign investment, which represented 4 per cent of GDP in 2008.

The long distance from industrialised markets has not prevented Mauritius from building a large tourism sector, which contributed US$1 billion to its balance of payments in 2008. The volatility of tourism was, however, brought home in 2009 when receipts from tourism fell by almost 25 per cent. Fortunately, the economy is now diversified and, while it was adversely affected by the global financial crisis, its growth remained positive. Manufacturing represented 20 per cent of GDP in 2008, partly for the reasons given above but also due to the high quality of the labour force and the flexibility of the labour market, which maintained competitiveness. The finance sector has expanded to 12 per cent of GDP by attracting so-called 'global business companies', in addition to banks, insurance companies and investment trusts.

In recent years, Mauritius has implemented a program of reforms aimed at improving public sector efficiency, enhancing competitiveness (through liberalisation of air access, *inter alia*) and improving the business climate (IMF 2009). Acquisition of land by non-residents has been restricted. New labour market legislation has improved the flexibility of the labour market. Recent measures facilitate the re-employment of laid-off workers by paying them an amount linked to the basic wage if they choose one of three programs offered by the government: job placement, training or assistance in starting a new business.

would extension services and the formation of farmers' groups. Better access to credit, besides microfinance, would also be beneficial. The newly created Agricultural Development Bank could play a useful role.

The forestry sector has recorded a strong rate of growth over the current decade, but its expansion can be sustainable only if reforestation takes place. Fishing, in which Vanuatu also has a comparative advantage, has experienced slow growth, except in the niche market for aquarium fish exports. Expansion would require major investments for processing, freezing and shipping, which might not be cost effective given the relatively small size of the catch.

The finance sector (including insurance) represented only 7.6 per cent of GDP in 2008, but it has the potential for further growth. Vanuatu's low-tax environment makes it attractive for international companies. The banking and communication facilities are at world standard, but for this activity to expand major reforms of the commercial legal system must take place (see ADB 2009c).

Finally, Vanuatu is well placed to develop renewable energy—from solar, biomass and geothermal sources.[10]

The challenges

The goal of an educated, healthy and wealth(ier) Vanuatu is attainable but achievement means that a number of obstacles have to be overcome. Moreover, Vanuatu's success so far remains fragile. It can be seriously compromised by natural disasters, a return to political instability, the temptation of populist policies, a reversal of progress towards better governance, a change in tourists' tastes, adverse commodity price movements, an economic downturn in Australia and New Zealand or the impact of tighter budgets on donors' ability to offer financial assistance. The fact that more than three-quarters of the deposits in commercial banks are denominated in foreign currencies suggests that confidence in the government's management of the economy is still shaky (although taxation considerations could be another factor).

Demographic pressure

Demographic pressure puts a heavy constraint on the possibility of improving living standards more rapidly in the near term. Like other Melanesian countries, Vanuatu has a high rate of population growth, which has been revised upwards to 2.8 per cent as a result of the 2009 census. The urban population has experienced growth of 4.1 per cent due to the rapid rate of internal migration. In comparison, the population of Mauritius grows at a rate of only 0.5 per cent. The average age of the population is low and the rate of unemployment for young people is high. The ADB estimates that private sector employment would have to grow by about 30 per cent annually to absorb new entrants into the labour force. In addition, it would have to absorb the continued migration out of subsistence agriculture. As education and incomes improve, the population can be expected to grow more slowly. In the meantime, greater availability of family planning facilities would help, and the country should take full advantage of the seasonal employment programs offered by Australia and New Zealand,[11] as well as explore other avenues for migration. Besides the reduction in unemployment that it would achieve, migration would increase transfers from abroad and stimulate tourism. (On this, see Opeskin and MacDermott 2010). Otherwise, there is a risk that young people unable to find work could be attracted by illegal activities.

Public sector inefficiency

Public sector inefficiency is often mentioned as a bottleneck facing private business investment and as a cause of the limited absorptive capacity of the country. It must be recognised that for a small country such as Vanuatu, the State's apparatus can be overwhelmed by tasks that can be shared over a greater number of civil servants in larger countries or made easier and less costly by economies of scale. For example, the Vanuatu government has recently decided to provide universal free bilingual education at the primary level. This is bound to put great pressure on the Ministry of Education and to require a major effort to train new teachers and supervisors. While there is scope for reducing the weight of the government in the economy—in particular, through the elimination of regulations that impede the creation of new businesses and their operations and by privatising or corporatising inefficient public enterprises—there is a role for the government in providing a framework for the private sector in areas such as commercial law, urban planning, land leasing arrangements and environmental protection.

Thus, if Vanuatu is to remain attractive—for visitors and residents—the authorities must prevent construction that will damage the landscape and pollute or destroy the habitat of protected species. This could be done through zoning regulations and by setting aside parts of the country as reserves or national parks, although demographic pressure pushes in the opposite direction. In the two main cities, urban planning could achieve the same goals. At present, new tourist developments on the coast must go through an environmental assessment, but it would be preferable for such assessments to be guided by nationwide guidelines.

Human capital

The emphasis placed by the government and donors on improving human capital through education and health measures is commendable, and such measures will benefit the whole economy over time. The provision of universal free primary education was a major step, but Vanuatu is still lagging in two MDGs—on child health and maternal mortality.

Labour market

Labour market regulations are intended to protect workers where it is necessary—for example, for safety—but they should also protect jobs, which has not always been the case in Vanuatu. The 30 per cent increase in the minimum wage granted in October 2008 and last year's amendments to the *Employment Act* of 1998 have increased labour costs, impaired the competitiveness of goods and services sold by Vanuatu, endangered the viability of some small businesses and reduced the employment prospects for unskilled, inexperienced or disabled work seekers, given that the minimum wage in Vanuatu is clearly above the equilibrium level (ADB 2009a). It would have been preferable when deciding to help the 'working poor' to use measures such as bonuses or co-contributions to the Vanuatu Provident Fund from the government budget that did not raise labour costs (Box 2). The most pressing case for help is for those who migrated to Port Vila or Luganville and cannot find work. Many of them come from other islands and no longer have the traditional support from kith and kin. They live in squalid conditions. Training and/or public works are needed.

Box 2 **The effect of increases in the minimum wage**

This issue has been hotly debated in the economics profession for some time. The traditional view has been that raising the minimum wage above its equilibrium level reduces the demand for labour and affects the employment opportunities mainly for unskilled and inexperienced workers, who are often young people (Mankiw 2007). This view assumes that the labour market is not characterised by monopolistic competition or that the product market is price inelastic, which is rarely the case. A review for the US National Bureau for Economic Research of the evidence on the effect of increases in the minimum wage on employment concluded that most of the evidence pointed to a negative effect (Neumark and Wascher 2006). A number of studies that found no effect were flawed by the neglect of long-term effects. Another result of rises in the minimum wage is to increase the income gap between those who have work and those who do not. Many economists prefer measures that are targeted at the poorest—such as better social services or food stamps—or measures targeted at the working poor that do not affect the demand for labour, such as tax credits (not relevant for Vanuatu), bonuses paid by the government or credits for pensions.

Infrastructure

Infrastructure remains insufficient to support the development of private business, especially in the areas of transport (by road, sea and air), communications, water and electricity distribution, waste management and renewable energy production. Financing is not the problem, as the government has room to borrow. It is the ability to design and implement new projects—that is, the absorptive capacity—which is the main constraint. The MCC road construction program offers a good example of what can be achieved with competent foreign assistance.

Reform

It is crucial for the reform process to continue in order to reduce the often-mentioned difficulties and high costs of doing business in Vanuatu and to stimulate investment and employment by the private sector. A good discussion of this issue is in the 'Supplementary appendix' to *Sustaining Growth: a private sector assessment for Vanuatu* (ADB 2009c), which focuses on the reform of state-owned enterprises, promotion of competition, modernising the commercial legal framework, expanding access to finance and reforming the land leasing system. This survey will add only a few points to the ADB's assessment.

The AusAID Governance for Growth program—in cooperation with the ADB and the World Bank—is engaged in extending previous reforms in information and communication technology by improving broadband access with a view to, *inter alia*, facilitating access to e-government.[12] It is also tackling the monopolies in electricity production and distribution, and stevedoring. The long-term concessions the two companies operating in these areas have received appear to leave room for a review of tariffs and an agreement on efficiency improvements. The establishment of a utility regulatory agency is also envisaged.

In August 2009, the Council of Ministers approved a Land Sector Framework 2009–18 (LSF) to follow up on the recommendations of the 2006 Land Summit and to act 'as a road map for Government, the private sector and civil society for the use and management of Vanuatu's land resources' (Government of Vanuatu 2009b). Some of the key principles that have informed LSF developments to date include

- the prevalence of customary land tenure
- uncertainty over customary authority and leadership
- the Weakness of women's land rights
- looming effects of urbanisation and informal settlements
- land tenure security for customary landholders and vulnerable groups.

There is no denying that the present system of landholding and leasing has a number of flaws—as was inevitable given that it is a compromise; but at least it has produced an active property market and there seem to have been very few cases in which it has stood against the establishment of new businesses. There is, however, a risk that the review will raise new obstacles to land use. This risk is linked to the resentment expressed by some ni-Vanuatu at what they view as the takeover of their land by foreigners, who can in some cases make large short-term profits—for example, by transferring their lease at a higher price.[13] If the influx of foreign buyers of leases for land on which they build houses—often retirees, mainly from Australia,[14] attracted by the lower cost of seaside properties and the tax-free environment—continues, such resentment could grow. The issue of the respective rights of leasers and lessees is one that has attracted much attention recently. Introduction of a capital gains tax could discourage speculation.[15]

Another area for reform that is often discussed without much result so far is the poor integration of the various islands, the difficulty of providing services equally to all and the differences in incomes and quality of life between the islands. Better information and communication technology will help integration, but decentralisation is also seen as a possible way of dealing with the problem.

Conclusion

After a decade of economic stagnation, Vanuatu has recorded an impressive stretch of six years of rapid growth. Now, unless it can find new opportunities for migration, because of its high rate of population growth, Vanuatu has no choice but to aim for continued rapid economic growth in order to absorb the new entrants into the labour force and those moving from subsistence agriculture to urban areas in search of work. Tourism is the best choice for rapid growth—as long as its competitiveness is not impaired by misguided labour market measures—as it can be developed relatively rapidly. Infrastructure building is both a condition for tourism and agricultural expansion and an important source of employment. Because agriculture employs the majority of the population, raising its present feeble growth rate would reduce poverty and help to retain those who are tempted to leave the sector. The financial sector could also be a source of employment when commercial legislation has been modernised. As preconditions for all this, the political and business climates have to remain favourable to attract foreign investment, the land market must continue to operate satisfactorily and the successes achieved in several reform areas in the past decade must be repeated where it has been shown new reforms are most needed.

Notes

1 The official forecasts for real GDP growth in 2010 and 2011 were revised downwards from 4.6 per cent and 4 per cent, respectively, in the

2010 Budget papers to 4.1 per cent and 3.7 per cent in the *Budget Policy Statement 2011* issued at the end of April 2010. For 2009, the estimate has been revised upwards to 4 per cent.

2 Cape Verde is so far the only country declared eligible for a second MCC grant. The likely graduation of Vanuatu to middle-income status could also make a new grant more difficult to obtain.

3 The growth of expenditure has been affected by the degree of integration of donor-financed expenditure in the budget. Thus, the MCC construction work has been integrated into the budget since 2006.

4 The 'budget' for 2009 consisted of the initial budget, two 'extraordinary budgets' (linked to natural disasters) and two 'supplementary budgets'.

5 The 'established banks' are ANZ, the National Bank of Vanuatu and Westpac. The new bank is BRED, which is part of the French Banque Populaire group.

6 Credit to the business sector in 2009 was also inflated by loans to enterprises that carried out their main activities in other countries.

7 International companies are foreign compaies incorporated in Vanuatu; exempt companies are simply registered with the VFSC. Both are prevented from doing business in Vanuatu.

8 On this, see also Howes and Soni (2009a, 2009b).

9 See *Vanuatu Country Partnership Strategy 2010–14* (ADB 2009b) for a description of individual donors' contributions.

10 Wind is another possible source of energy, but it is distressing to visualise wind farms covering Vanuatu's beautiful landscapes!

11 New Zealand is taking 2,500 ni-Vanuatu seasonal workers annually. The Australian program began later and more slowly, but aims to reach 800 workers from Vanuatu by 2012.

12 In 2009, Vanuatu received a concessional loan from China to develop e-government.

13 The Minister of Infrastructure and Public Utilities has been reported as saying that 'we have some laws that pave ways to sell away what we have, including lands and [they] need to be reviewed' (*The Independent*, 23 April 2010).

14 In some circles, Vanuatu is seen as an alternative to Norfolk Island.

15 Otherwise, tax reform does not seem an urgent matter. Reliance on the value-added tax, customs duties and excise has the advantage of simplicity and of limiting tax evasion.

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