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Economic lessons from Vanuatu's performance

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Last week, we discussed Samoa's exchange controls. Fears of falling foreign exchange reserves and rising external debt prompted these stringent steps.

This week, our focus is on Vanuatu.

The picture is in sharp contrast to what we saw last week.

Praise from IMF

At the end of a weeklong mission to the country, International Monetary Fund (IMF) in a public announcement on March 4 commended Vanuatu's efforts towards stable economic growth. Specifically, IMF referred to the country's record of a low public debt and substantial international reserves.

The IMF undertakes in the case of its member countries in the region, except Fiji and Papua New Guinea, biennial consultative missions to review in a very comprehensive manner their economic health under Article IV of its Charter. In the case of Fiji and PNG, which are major PICs, the Article IV consultation missions are normally annual.

The last Article IV mission to Vanuatu was in June 2013.

The latest 24 February 24- 3 March 2014 mission is part of follow up missions. Its purpose was to discuss the economic outlook and policies with the government, private sector and development partners.

The Progress

The IMF notes impressive pickup in economic activities in Vanuatu. The economy has recorded a notable growth rate of 3 percent in 2013, with several donor-funded infrastructure projects under construction.

Inflation for 2014 is expected to be within the target range of 1 percent to 4 percent.

Further, Vanuatu’s foreign exchange reserves are at a comfortable level of around 7 months import equivalent, much higher than those of Fiji and Samoa. Further, the debt level at the end of 2013 is low: 22 percent of gross domestic product (GDP), domestic debt being 9 percent and external debt 13 percent.

These favourable developments are tempting the country to launch an ambitious phase of economic programmes. This includes loan funded infrastructure projects.

The concerns

The IMF has concerns with ambitious projects which are likely to be funded with borrowed funds. Although Vanuatu, being a low middle income country and hence eligible for concessional borrowing from international funding agencies such as Asian Development Bank, servicing them does involve foreign exchange.

The IMF advised the government to undertake careful project analysis and sound evaluation of returns before deciding upon committing their limited capacity to project implementation.

Implementation capacity determines returns on each project. They have impact on future debt. Even concessional loans would result in a heavy debt service burden, if returns are disappointing.

Any rash decision in the light of the current favorable conditions would land the economy in difficulties. The IMF mission highlighted the need for taking into account the implementation capacity before deciding the scale and sequencing of the public investment programmes.

Vanuatu has been following prudent budgetary policies. Thanks to strict public expenditure control measures in place, the country is on track to deliver a budget surplus for 2013.

With damages inflicted on the economy by Cyclone Lusi on Vanuatu, the authorities are well aware of the need for retaining the policy space to maintain confidence and as a cushion against recurring shocks.

Lessons for island nations

Vanuatu has been a consistent, top performer in the region.

By pursuing sound budgetary policies since the early 2000s, it accumulated enough fiscal space. That stood in good stead to mitigate the adverse consequences during bad times, which followed the world economic downturn since 2009.

By running budget surpluses in good years, it also avoided domestic borrowing in bad years. Its debt has been only from international lending agencies. The loans were on concessional terms.

Supported by tourism earnings all along because of its high reputation as an open economy with no exchange controls and no personal income taxes, and along with remittance inflows ever since the Australian Seasonal Work Program began three years ago, Vanuatu was able to build sizable foreign exchange.

With limited commodity export earnings unlike the more fortunate Papua New Guinea and Solomon Islands, Vanuatu emerged unscathed in recent years, despite unpredictable natural disasters.

Its low public debt record (22 percent of GDP), against Samoa's 65 percent of GDP, and Fiji's and Tonga's 50 percent, is the envy of all.

The IMF advice to Vanuatu, in the context of its ambitious borrowing plans to fund new infrastructure projects, holds good for all: Screen the planned projects with an eye on their returns and remember the implementation capacity restraints, as every external loan, concessional or otherwise, has to be serviced.

"The challenge before authorities is to support growth while protecting its policy buffers."

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