

Forward by the Minister

Vanuatu continues to recover and adapt towards the ongoing global financial crises, the world financial turmoil's have made it extremely challenging for both developing and developed countries to buffer themselves appropriately. The effects of the crisis can quickly spread to the real economy, leading to sharp falls in economic output and rising unemployment. Yet with unprecedented levels of fiscal and monetary interventions, indications point to a very slow recovery in the global economy.

Although growth in the Vanuatu economy is estimated to have slowed down slightly in 2010 the economy has shown signs of picking up this year and it is forecast that GDP will grow by 4.3 per cent in 2011. This growth has been led by high commodity prices resulting in robust agricultural production expansion and a boost to rural incomes. Additionally a rebound in visitor arrivals has supported the service sector, whilst privately funded construction activity has slowly begun to improve. The main driver of growth over the medium term is major donor-funded construction projects and as these projects begin it is anticipated that the rate of growth will accelerate to 4.6 per cent in 2012 and 5.1 per cent in 2013. Maximising economic growth – the Government's overarching policy objective – is the only sustainable way of funding our country's social needs.

Budget 2012 is quite a challenging budget given that next year will see both National and Provincial elections and also the hosting of the Asia Pacific Caribbean (ACP) meeting. With these compulsory obligations to accommodate, the budget still continues to provide considerable investment aimed at broadening access to health and education. The i-Government's wider area network will become increasingly important in terms of assisting service delivery, allowing Government to communicate and extract information in real time, ensuring that decision makers are always well informed, and incurring telecommunication savings in the medium term. Hence, investing immediately in these sectors is the one way to develop a productive workforce which will be essential for long-run economic success.

It is essential that Ministries continue to operate within their appropriated budget ceilings, guard their resources accordingly, avoid off-budget spending, and look to their own budget to reallocate funds before requesting supplementary or additional appropriations. The Ministry of Finance and Economic Management will continue to take a hard line against supplementary appropriations given the tight fiscal positions, and so it is critical that all agencies must be prudent in ensuring that the Government meets the fiscal responsibility requirements as stipulated in the 1998 PFEM Act.

As Minister of Finance and Economic Management, I confirm that Budget 2012 is consistent with the 'Principles of Responsible Fiscal Management' as specified in the Public Finance and Economic Management Act (1998). To Members of Parliament and citizens of Vanuatu, it is my honour to commend to you the Budget 2012.



Honourable Moana Kalosil Carcasses (MP)
Minister of Finance & Economic Management

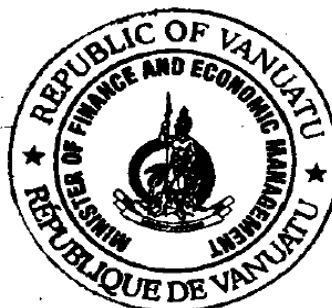


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1. Fiscal Responsibility Statement

The following commentary and financial statements are presented in terms of Sections 9, 10, 11, 13, 14, 17, 18, 23 and 24 of the Public Finance and Economic Management Act 1998 (the Act). These sections require the tabling of a fiscal strategy report, current year fiscal update and economic and fiscal update at the time of the introduction of the first Appropriation Bill for the forthcoming year.

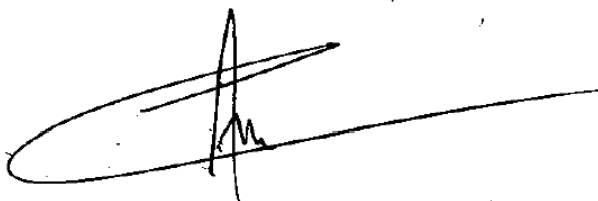
This report presents updated fiscal and economic forecasts for the fiscal year (2011) and examines the economic outlook and financial projections for the country up to 2014.

This Fiscal Strategy Report, required under Section 11 of the Act is consistent with the Budget Policy Statement that was released last year as required by Section 10 of the Act. The policies contained within the Budget Policy Statement have been used to prepare the 2010 Budget. The Act requires that the Budget Policy Statement be tabled in Parliament. Therefore, the Budget Policy Statement, as previously published, is presented in this report.

Statement of Responsibility

There have been no significant changes to the Government financial and economic policy or in the Government's strategic priorities since the Budget Policy Statement was published.

Pursuant to Sections 11, 13, 14, 17, 18, 23, and 24 the Government confirms that the fiscal policy objectives, priorities and intentions are consistent with the Principles of Responsible Fiscal Management specified in section 22 of the Act and that there is broad consistency with the Budget Policy Statement published earlier this year.



Honourable Moana Kalosil Carcasses (MP)
Minister of Finance &
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2. Budget Overview

2.1 Budget Overview

In its September World Economic Outlook (WEO) 2011, the IMF reported a moderation in the pace of global growth. The pace of economic expansion for major advanced economies, particularly the US, has picked up in the third quarter but they remain fragile and vulnerable to shocks. Output in Europe is a particular concern as the region deal with a sovereign debt crisis. In Asia economic activity has recovered after the devastating Japanese earthquake, and domestic demand in the region is generally sound, despite worries of slowing growth in China. Commodity prices, while remaining at high levels, have generally declined over recent months, in turn reducing pressure on global inflation.

Growth in the Vanuatu economy is estimated to have slowed down in 2010 which is consistent with world developments. However, the economy has shown signs of picking up in the second half of this year driven by all three sectors and it is forecast that GDP growth will pick up in 2011. Developments in visitor arrivals remain mixed reflecting the impact of natural disasters in Australia and New Zealand nevertheless privately funded construction activity has increased significantly.

The main driver of growth over the medium term will be donor-funded construction projects. It will therefore be essential to carefully sequence, plan and execute these projects in order to maintain macroeconomic stability.

Inflationary pressures have abated as the annual inflation rate dropped during the year. This was associated with low increases in overall domestic prices despite the inflationary pressures from surges in oil prices from oil exporting countries. However, the Reserve Bank maintains a cautionary stance in regard to interest rates due to the large amounts of excess liquidity and also the prospect of continued fiscal deficits from the Government.

Private sector credit slowed in 2011 following the Reserve Bank of Vanuatu's (RBV's) action to tighten monetary policy by raising its Statutory Reserve Deposit (SRD) requirement. Foreign reserves are currently at an adequate level but are projected to decline as a share of GDP over the medium term as the economy grows. However, net foreign assets as a proportion of GDP slowed in 2011, driven by declines in net foreign assets and increases in foreign liabilities held by commercial banks. Reflecting these pressures the vatu appreciated against the US dollar on average.

Government expenses this year have been in line with budget. However, political instability has exerted excessive pressure on Government's planned expenditures resulting in unfunded supplementary budgets. However, the Ministry of Finance continues to maintain aggregate fiscal control and has so far managed to ensure that the recurrent budget has remained within its original limits. Government revenues have also been on target and are higher than the previous year. This reflects better forecasting by the Treasury both in terms of revenue and expenditure.

In 2011 the Government drew down the final segment of the e-Gov loan. As a result the budget deficit in 2011 is slightly higher than projected. Total Government stock of debt has picked up this year in line with its budget deficit and new borrowings. The ratio of total stock of debt (including guarantees and indemnities) to GDP is a concern. As a result there is a need for some fiscal consolidation to curb the current growth in expenditures

which will be unsustainable in the future. Development partners' contribution has been maintained and is projected to hit target this year.

Budget 2012 will be slightly greater than past years. The increase is primarily to accommodate the national general election, several provincial elections and the EU – ACP annual meeting in Port Vila later during the year. Government receipts are forecast to be slightly below its expenditure in 2012 leading to a narrow forecasted budget deficit. However, donor grant is expected to continue their upward trend owing to bilateral and multilateral agreements. The medium term projections for donor support are solid but future support may severely affect the domestic economy if there is no careful coordination of project implementation dates.

3. Economic Update and Projections

3.1 World Economic Outlook

In its September 2011 World Economic Outlook (WEO) the IMF projected that world output would expand by 4.0 per cent in 2011; down from 5.1 per cent recorded in 2010. The deceleration is attributed to a slowdown in economic growth in advanced as well as emerging and developing economies. The former have experienced a sharp deceleration from 3.1 per cent in 2010 to an expected 1.6 per cent growth in 2011; while increases in the emerging and developing countries, including China and India, are forecasted to have slowed from 7.3 per cent last year to 6.4 per cent this year. Global growth is expected to be robust but bumpy, driven by uncertainties in financial markets volatility in major advanced economies, especially in the Euro area and the United States (US). This is expected to dampen confidence and increase financial distress in these regions.

Table 1: World Economic Growth Trends ^(a)

	Actual		IMF Projections ^(b)	
	2009	2010	2011	2012
World Economy	-0.7	5.1	4	4
Advanced economies	-3.7	3.1	1.6	1.9
United States	-3.5	3	1.5	1.8
Euro Area	-4.3	1.8	1.6	1.1
Japan	-6.3	4	-0.5	2.3
Other Advance economies	-1.1	5.8	3.6	3.7
Emerging and Developing Economies	2.8	7.3	6.4	6.1
China	9.2	10.3	9.5	9
India	6.8	10.1	7.8	7.5

(a) Percent change, year-on-year

(b)Source: IMF World Economic Outlook, September, 2011.

The supply side disruption from Japan's devastating earthquake and tsunamis coupled with the spreading unrest in the Middle East and North Africa (MENA) region and the related surge in the oil price were major setbacks to global growth in 2011. Similarly, the Euro zone debt crisis has proved very difficult for policy makers and has spread across the regions affecting investment and household's consumption. This has weakened public and private sector confidence disrupting the flow of credits from financial institutions to the society. This not only affect investment but fuelled unemployment in this region affecting consumption, productivity and hence, real GDP. Furthermore, another major impediment to global growth is the continued weakness of the US economy, driven by a deep political deadlock over fiscal consolidation, deterioration in consumer demand and a weak housing market. These expected downside developments have and will continue to drag down growth in both emerging and developing economies through their impact on commodity prices, international trade and movements in capital flows across international borders.

Despite the slower global growth, signs of overheating in emerging and developing economies still persist illustrated by increasing commodity prices and capital flows. The IMF estimates that the average oil price has stabilised at around \$105 a barrel in the early months of the second half of this year after peaking at \$120 a barrel in the early months of 2011.

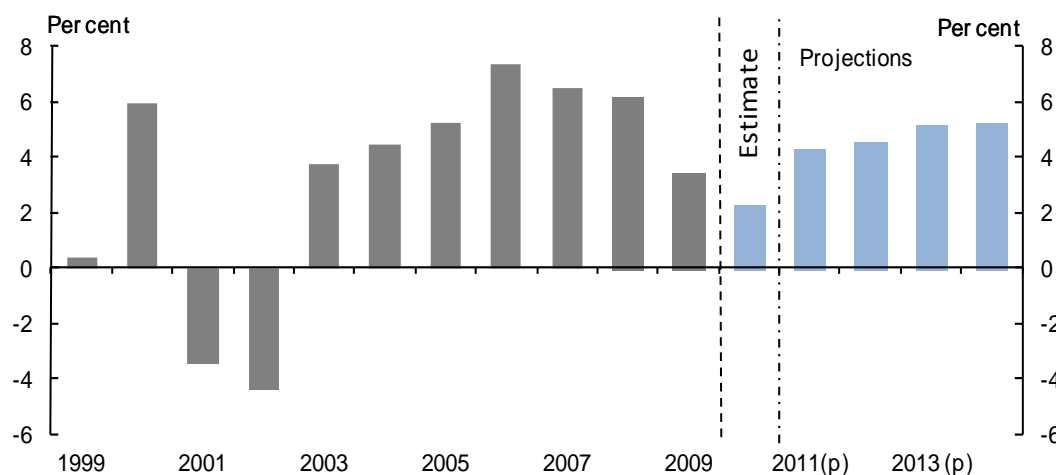
According to consumption indicators released by the IMF, consumption has been going strong for sometime in emerging market economies, fuelled by the effect of strong growth and perhaps paradoxically, tighter monetary conditions. Supported by strong financial conditions, bank credits in these regions have grown solidly and high interest rates have attracted capital flows, in turn creating new investment, employment and a boost to consumption.

Global growth is forecast to regain momentum during the second half of 2011 and real GDP in advanced economies is anticipating a decline to about 2 per cent. Similarly, growth is expected to remain very strong in emerging Asia, driven largely by growth in China and India, followed by Sub-Saharan Africa.

3.2 Vanuatu's Economic Outlook

Although growth in the Vanuatu economy is estimated to have slowed down to an estimated 2.2 per cent in 2010, the economy has shown signs of picking up this year and it is forecast that GDP will grow by 4.3 per cent in 2011. Consistently high commodity prices have driven robust agricultural production expansion and boosted rural incomes. A rebound in visitor arrivals has supported the service sector, whilst privately funded construction activity has also increased. The main driver of growth over the medium term is major donor-funded construction projects and as these projects begin it is anticipated that the rate of growth will accelerate to 4.6 per cent in 2012 and 5.1 per cent in 2013 (Figure 1).

Figure 1: Real Annual GDP Growth



Source: Vanuatu National Statistics Office and Macroeconomic Committee

The international commodity prices for Vanuatu's major agricultural exports, including copra, beef and kava, have remained relatively high through 2011. In response, there have been solid increases in output across this sector and this is expected to continue over the medium term. The negative impact of natural disasters in Australia and New Zealand at the start of the year appear to have now abated with visitor arrivals in the second quarter of the year exceeding their level a year ago. Together with rises in the rural population's income (from high commodity prices and Universal Primary Education Program), the increase in visitor arrivals has supported the service sector growth. The services sector is expected to recover gradually over the next few years, in-line with an anticipated growth in the domestic economy and that of Vanuatu's main trading partners' (China, other MSG countries, Australia and New Zealand). The key determinant of the economy's performance over the

next few years is the industry sector, or more specifically the construction sector. The latest imported construction materials and building permit applications data suggest privately-funded activity will expand robustly through 2011 and 2012. However, more importantly the implementation of major donor-funded projects will have an extremely marked impact on the construction sector. This will have to be carefully managed in the medium term in order to maintain overall macroeconomic stability and avoid undue increases in inflation.

The Consumer Price Index (CPI) measure of inflation slowed to 0.6 per cent year-on-year in the first half of 2011 from 2.8 per cent over the same period in 2010. The main contributing factors to the decline in the inflation rate were health services and food supplies, most other components experienced increases.

Private sector credit slowed during the first half of 2011 following RBV's action to tighten monetary policy by raising its SRD requirement by 100 basis points to 6 per cent, withdrawing liquidity from the banking system. Foreign reserves are currently at an adequate level but are projected to decline as a share of GDP over the medium term as the economy grows. However, net foreign assets as a proportion of GDP declined to 28 per cent (from 43 per cent, a year ago) in 2011, primarily driven by the declines in net foreign assets and the increase in foreign liabilities held by commercial banks, pointing to pressures on foreign assets building up in the financial system. Reflecting these pressures the vatu appreciated against the US dollar on average by 9.6 per cent in the second quarter of 2011 and gross official reserves decline by 1.2 per cent year-on-year in March 2011.

On the downside, a sharper slowdown in the global economy fed through to lower commodity prices and tourist arrivals from some segments. This continued with domestic political instability adversely impacted on private sector investor confidence and the Government's fiscal position at the start of the year. Further delays to the start dates of donor projects could reduce growth prospects. On the upside, the global economy may perform more strongly than predicted, agricultural commodity prices remain high and it may be possible to kick start some of the larger donor projects earlier than expected.

Table 2: Major Economic Indicators (a)

	Actual	Estimate	Projections			
	2009	2010	2011	2012	2013	2014
Agriculture, fishing & forestry	1.7	4.3	2.9	2.1	2.1	2.1
Industry	9.2	-0.3	10.3	13.8	17.7	19.3
Services	6.8	1.4	3.6	3.7	3.8	3.6
Real GDP	3.5	2.2	4.3	4.6	5.1	5.3
Nominal GDP	4.8	5.0	8.7	7.7	8.6	9.7
GDP Deflator	1.3	2.8	4.2	3.0	3.3	4.2

^(a) Annual percentage change

^(b) Year-ended percentage change, 2009 figure is an actual outcome

Source: Vanuatu National Statistics Office and Macroeconomic Committee

3.3 Agriculture, Fishing and Forestry

The Agriculture sector supports the livelihood of around 75.6 per cent of the population living in the rural areas. For the last couple of years, this sector has maintained positive growth around 2 to 5 per cent per annum and it is expected to remain within this trend in the medium term provided commodity prices remain strong, although the sector remains vulnerable to shocks.

There has been a gradual increase in **copra** prices since late 2010 to a record level of VT 75,000 per ton in mid 2011 resulting in a surge in copra production. This price increase has motivated farmers to engage in re-planting; it created jobs and provided means of income to people in the rural areas which has had flow on effects to other sectors. Partial indicators show that copra production for both exports and processed oil in the first half of 2011 grew by 32.4 per cent compared to the same period a year ago. On the other hand, coconut oil production is expected to moderate due to an increase in the number of copra exporters competing for a limited stock of copra. The recent drop in the world market price of coconut oil has alerted buyers and farmers to the volatility of the copra price. However, the Government vision to maintain copra price at a competitive level is demonstrated by its effort to encourage competition into the industry. The outlook is for growth to remain strong this year and in the medium term, although the forecast is vulnerable to ageing coconut trees, volatility in world market prices and cyclones.

Cocoa production is expected to continue to grow at a steady rate this year. However, the forecast is subject to weather conditions and pests such as rats and black pod diseases. Activities in this sector continue to be supported by farmers engaging in the planting of new plantations and replanting through crafting techniques. We expect these developments to boost production in the medium term. The NSO inclusion of the data collected from large exporters will show a boost in production this year and over the medium term.

Partial indicators confirm the **beef** industry continues to grow compared to last year. Growth in this sector is supported by robust external demand in the major export markets namely PNG and the Solomon Islands. There are reports that the export market will expand to South East Asia by 2011. Despite challenges faced by small holder farmers, developments in this sector continues to remain healthy in terms of enhancing breeding programs, pasture improvement and farm maintenance¹ on big holders' farms. Supported by strong demand in both the domestic and international markets combined with the entry of a new abattoir in Santo, production is anticipated to remain strong with growth expected to remain high in the medium term.

Export of tuna is the main driver of growth this year as partial indicators show that **fish** exports in 2011 have recorded a very sharp growth compared to 2010. Exports recorded 925 tons in the first half of 2011 compared to 559 tons over the same period last year. This is mainly supported by the Government decision to reduce offload fees in Vanuatu; however, on the other hand this is a challenge in terms of reduced overall revenue collection. Live fish exports also continue to rise in growth terms. The outlook is for growth in this segment of the market is forecast to be slightly above the long run average subject to revisions in offload fees by the Government.

According to partial indicators, **kava** production and exports (in volume terms) increased by 46 per cent in the June quarter compared to the same quarter last year. Following a slight increase of production in 2010, kava production is expected to record solid growth in 2011 due to competitive market price and better coordination amongst buyers and farmers. The domestic market continues to dominate the kava industry and it is predicted that total production will remain strong in the medium term.

Production of **coffee**² in 2011 is projected to surpass production in 2010. The expected growth is due to both continued increase in the number of additional plantations and greater production from existing plantations as coffee farmers and associations become

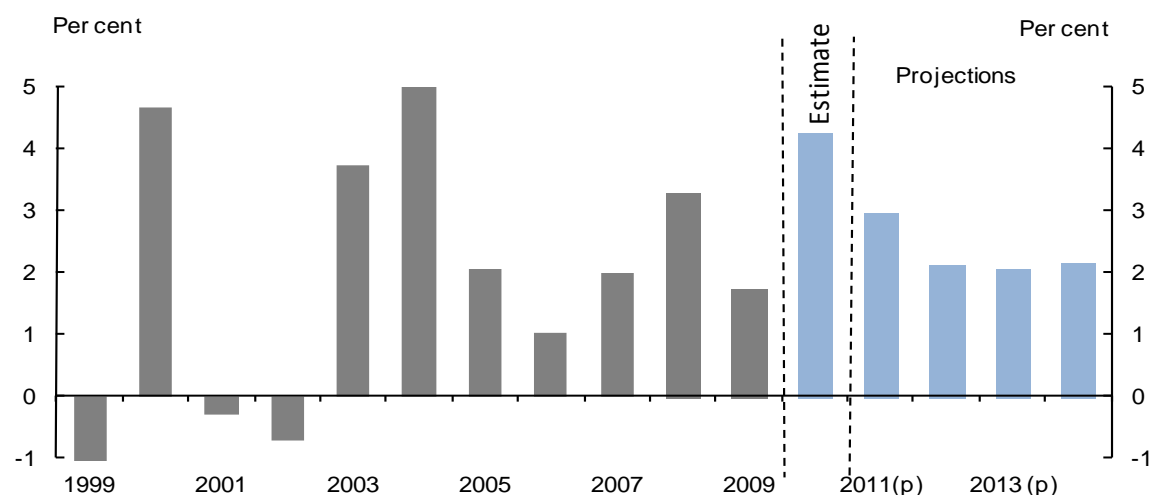
¹ Improvement of pastures in large holder farming remains a challenge

² Coffee produced in Tafea Province mainly in Tanna

financially viable through microfinance scheme and are better coordinated and managed by corporate. Subject to external factors such as weather condition, global price and external demand for organic coffee, production of coffee in the medium term is expected to remain healthy.

The Melcoffee saw mill in Santo resumed timber production early this year and is expected to remain in the market in the long run. It supplies domestic and export markets and aims to produce value added products for export as well. This will be a welcome addition to the currently limited domestic suppliers of locally produced **timber**. However, overall domestic production of timber³ is yet to meet the current demand given declining harvests of native trees due to diminishing stock. Efforts to replant a variety of timber trees, including sandalwood continue to increase in numbers as farmers begin to value its potential for future income. The growth potential of the industry may be undermined by a limited domestic supply of trees despite the strong likelihood of a boost in demand due to increased construction activity in the medium term.

Figure 2: Real Annual Agriculture, Fishing and Forestry Growth



Source: Vanuatu National Statistics Office and Macroeconomic Committee

3.4 Industrial Sector

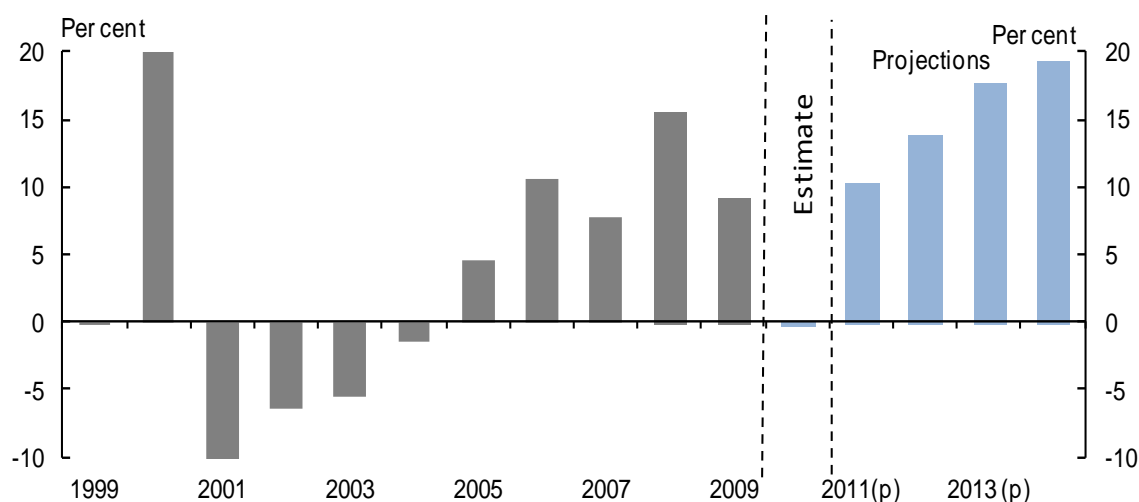
After contracting by an estimated 0.3 per cent in 2010, industrial sector activity is expected to increase by 10.3 per cent in 2011. The rate of growth is then expected to accelerate to 13.8 per cent in 2012 and 17.7 per cent in 2013.

The key driver of the industrial sector production forecast is **construction**. Following the completion of the Millennium Challenge Account (MCA) funded roads construction output is estimated to have fallen sharply in 2010. In 2011 there is evidence that privately funded residential and commercial building has rebounded (including several real estate projects such as the Akiriki project, a number of developments in Havannah Harbour and various Chinese owned wholesale and retail stores), whereas publicly/donor-funded activity has remained weak.

³ According to the Department of Forestry

A number of major donor-funded projects were initially scheduled to start in 2012; however, delays on the sides of both the Vanuatu Government and its donor partners have led to their postponement until 2013 at the earliest. Looking ahead, projects such as the development of an international multi model wharf in Port Vila, the Inter-Island Shipping Project and Phase 2 of the Vanuatu Transport Sector Support Program will have an extremely significant impact on the construction and industrial sector's activity levels.

Figure 3: Real Annual Industrial Sector Growth



Source: Vanuatu National Statistics Office and Macroeconomic Committee

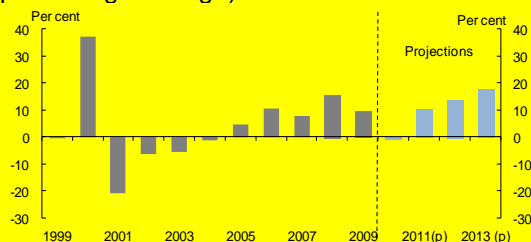
The **manufacturing** sector is anticipated to expand further in 2011 and in subsequent years. The Santo oil mill re-opened in late 2009 and despite disruptions to the domestic supply of copra to the industry this year, coconut oil production is likely to grow steadily over the forecast period. Manufacturing output was further boosted by the resumption of activities at the Melcoffee saw mill this year with both strong local and external demand (particularly from New Caledonia) which is anticipated to support future growth.

The **electricity and water** sector is forecasted to grow steadily, in-line with a greater number of electricity customers, higher electricity consumption and new construction activity. Plans are in place for the Port Vila electricity network to be improved and extended to areas such as Teouma, Manples, Blacksands and Havannah Harbour; as well as extending the Lenakel network to Whitegrass airport. With the introduction of new big customers such as Leader Price and NBV combined with expected major construction to kick start within the next few years, growth in consumption of electricity is expected to increase significantly in the medium term.

Box 1: A future construction boom?

Between 2005 and 2009, construction sector output grew by an average annual rate of 28 per cent. This buoyant growth was driven by both building of the Millennium Challenge Account (MCA) roads and privately-funded projects. Activity subsequently cooled and is likely to have contracted in 2010. However, leading indicators for private sector activity and potential donor funded projects suggest an even bigger boom is possible in the future.

Chart A: Construction output (annual percentage change)



Source: Vanuatu National Statistics Office, Macro-Economic Committee and Treasury

The value of construction materials imported during the first six months of 2011 was 41 per cent higher than for the same time period in 2010. Unless these imports are just being used to replenish stocks, this implies there will be strong construction production this year and next.

The estimated value of works pertaining to building permits applied for in the Port Vila Municipality area in 2010 totalled VT 4.7 billion. The awarding of a permit does not mean work will necessarily be carried out. However, assuming permits give some indication of future works and a lag of one year between being awarded a permit and starting construction, these numbers further suggest private construction will expand robustly in 2011 and 2012.

As outlined in the 2012 Budget Policy Statement a key policy priority is "providing reliable and accessible infrastructure"

To these ends several major donor-funded projects, including the development of an international multi model wharf in Port Vila, the Inter-Island Shipping Project and the Vanuatu Transport Sector Support Program are anticipated to start in 2013 and 2014.

The evidence suggests that there will be very strong growth in the construction sector over the next few years. However, projects implementation is going to have to be very carefully phased and managed to maintain macroeconomic stability.

There are significant concerns that Vanuatu lacks the physical capacity (for example, space at the wharf) to carry out a large number of projects simultaneously. It is likely that there will be a rise in demand for and consequently prices of construction materials. In addition, a large influx of donor funds and if private sector confidence rises, a boost in bank lending to support private construction, will significantly increase the level of liquidity in the economy. This will have to be carefully managed by the RBV otherwise there will be pressure on the general price level.

Table A: Major donor funded projects anticipated to start in the next 3 years

Project	Value (VT bn.)	Start
International wharf - Port Vila	5.5	2013
Inter-island Shipping	2.5	2013
Port Vila Urban Development	3.4	2013
Vanuatu Transport Sector Support Program Phase II	4.0	2013
Vila Central Hospital Upgrade	0.9	2013
Correctional Centre	0.5	2012
Education Buildings	0.2	2012
Convention Centre	0.3	2011
Submarine Cable	3.0	2013
Court House	1.5	2013

Source: Treasury

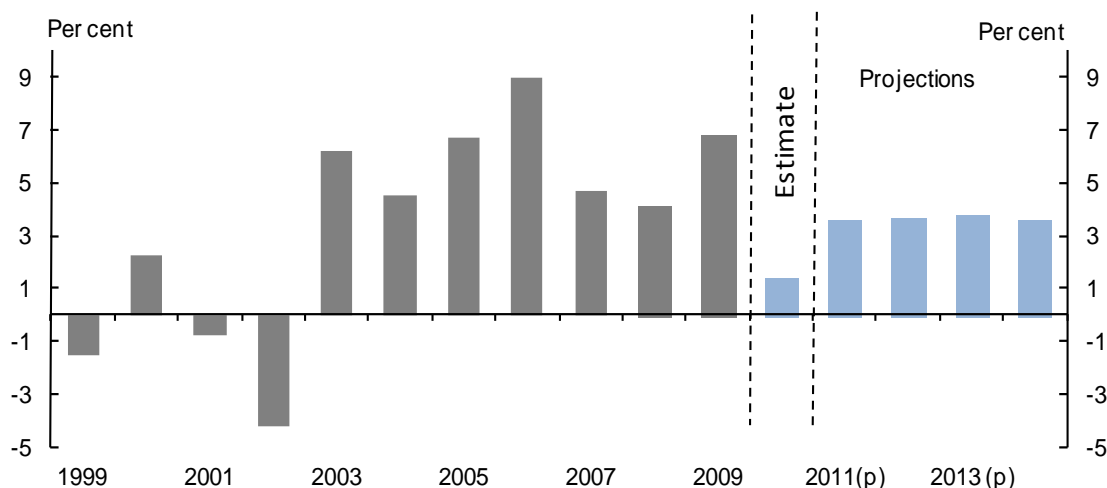
Long term, if carefully implemented, these projects will substantially raise productivity and the trend rate of economic growth.

3.5 Services sector

After growing at an average annual growth rate of 6 per cent for the past 7 years, growth in the service sector is expected to pick up from 1.4 per cent in 2010 to 3.6 per cent in 2011.

In addition, in line with a further recovery in the domestic economy and strong growth in our trading partners (China, Australia, and other MSG countries) the growth rate in this sector is projected to increase to 3.7 per cent in 2012 and a further 3.8 per cent in 2013 after slowing to 3.6 per cent in 2014 (Figure 4).

Figure 4: Real Annual Services Sector Growth



Source: Vanuatu National Statistics Office and Macroeconomic Committee

The projected increase in 2011 is expected to occur across almost all components that make up the services sector, with the wholesale & retail trade, transport, information and communication and hotels and restaurant sub-sectors all growing particularly stronger this year.

The continuous recovery in the domestic economy coupled with increasing global commodity prices, and improvements in the major trading partners' economies is expected to have boosted growth across most components of the service sector in 2011. In addition, the impact of the Universal Primary Education (UPE) program and the Regional Seasonal Employment Scheme (RSE) coupled with the Pacific Partnership Agreement (PPA) and the increasing copra price have boosted household spending and increased economic activities in the retail and transport sub-sectors in the outer islands.

Additionally, the on-going deregulation of the **telecommunication** industry should continue to strengthen growth over the projection period in this sector and is likely to lead to positive spill-over effects in other sectors. Anecdotal evidenced can be seen by the increase in the number of licensed internet service providers. The ongoing competition between Digicel and TVL has been very effective; creating new products and services for their clients and at the same time exploring new markets. With the entry of the Government's own telecommunication backbone (i-government), the industry is expected to see more competition in product and service innovation driving domestic prices further down. This is an important development in the economy; that is expected to increased coverage, faster and more reliable services at lower cost.

In addition, growth in tourism related sectors (such as **hotels** and **restaurants**) are expected to pick up during the second half of this year despite uncertainties surrounding the global economic recovery. This expectation is in line with strong monthly visitor arrivals from data published by the National Statistics Office for the second half of this year. Similarly, unfavourable socio-economic conditions abroad such as political turmoil, social unrest, and adverse weather conditions in other competitive tourism markets have contributed to this turn around in tourist arrivals into Vanuatu. The outlook for this sector is for growth to remain strong in 2012 following the recent launching of the tourism campaign by the Vanuatu Tourism Office (VTO), the ACP-EU conference and the

competitive air fares to and from certain destinations by Air Vanuatu. The biggest challenge in this sector is capacity constraint (number of beds) especially during peak sessions which would weigh down growth in visitor arrivals in 2012 and the subsequent years.

Recent reports gathered from Vanuatu's major property market indicate that for the past 2 to 3 months **real estate** activities have picked up following the appreciation of the Australian dollar and growing demand from French, Australian and New Zealand investors. According to latest development in this sector, more Chinese are transacting in this market. The medium term outlook is promising underpinned by high property prices in Australia and New Zealand and the shift of focus to Asian investors particularly the Chinese.

Box 2: Latest Trends in Visitors arrival

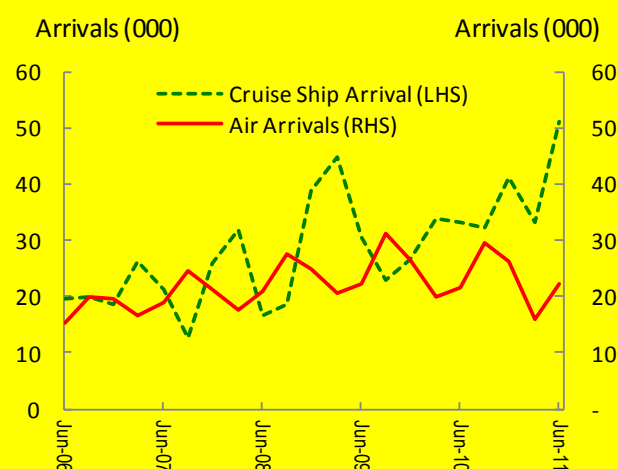
Between 2006 and mid 2010 visitors arrival numbers were strong for both air and cruise ships. However, air arrivals for 2011 fell throughout the first half of the year and were down by 7 per cent compared to the corresponding period in 2010. In contrast, cruise ship arrivals continue to experience an increase in port calls in the first 6 months of this year (Chart A). The weaker than anticipated air arrivals earlier this year is attributed to the natural disasters in Australia and New Zealand and the lower airfares and accommodation in other travel destinations that are in close competition with Vanuatu. Moreover, the recovery in the level of disposable income and appreciation of the Australian dollar saw a shift in destination by Australian travellers from less expensive short haul destinations such as Vanuatu to more expensive long haul destinations like the US and Europe.

Cruise ship arrivals have improved throughout the year, growing by 26 per cent on their level a year ago. When compared to 2009, cruise ship arrivals this year were up by 12 per cent owing to the increasing number of calls this year compared to other years (Chart A).

Given the relative length of stay of cruise ship (one day) relative to air arrival (eleven days) visitors, the per-visitor contribution to the Vanuatu economy is slightly higher for visitors arriving by air than cruise ships. However, this is offset by the far higher number of tourist arrivals by cruise ship.

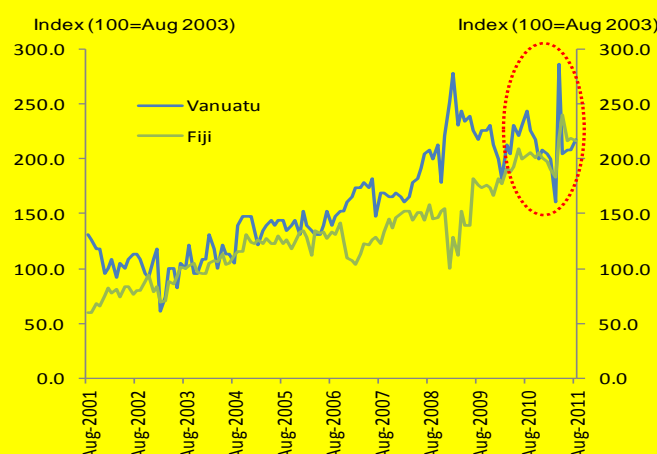
Australia maintains its share in Vanuatu's tourism market accounting for 60 per cent of all international arrivals in 2011. Recent tourism **air arrivals** in Vanuatu have been weak as a result of other destinations became very competitive. Fiji has always been our major competitor in the tourism

Chart A: Visitor arrivals (by air/cruise ship)



Source: Vanuatu National Statistics Office

Chart B: Visitor arrivals to Vanuatu by Countries



Source: Australian Treasury

industry for several years. Since the coup in late 2006, we have enjoyed their market share up until late 2009 when the devaluation of the Fiji dollar combined with a strong effort in promotions resulted in a turnaround in arrivals for Vanuatu – Chart B (dotted circle). Since 2010, Australian tourists have found Fiji more attractive compared to Vanuatu and though there are signs of a rebound in the second half of 2011, lower than expected arrivals in the first half of 2011 indicate that total arrivals in 2011 may not reach 2010 levels.

3.6 Monetary Developments

Total **money supply** (M2) saw a slight increase of 0.5 per cent and 2.7 per cent over the first eight months of 2011 and over the year to August respectively. The upward trend in money supply was largely driven by the movement in domestic credit, whilst net foreign asset (NFA) continued its downward trend. Similarly, reserve money has rebounded during the period after experiencing negative growth from its level one year previously. The increasing growth in reserve money this period is a direct result of the RBV's action to counter inflationary pressure by stepping up its Statutory Reserve Deposits (SRD) requirement to 6 per cent in August of 2010, keeping its money multiplier constant overtime.

Total **NFA** continued its downward trend from the previous year. The decline was largely attributed to decline in commercial banks' NFA, which outweighed the improvement in the Reserve Bank's NFA position. Commercial banks' holdings of foreign assets started declining in 2009; whilst at the same time their foreign liabilities have been progressively increasing since 2010, reflecting the ongoing accumulation of funds with domestic commercial banks by non-residents. Over the year to August 2011, the growth in commercial banks' NFA remained negative at 39.2 per cent. On the other hand, the Reserve Bank's NFA witnessed increases beginning from the first quarter of 2010 due to net inflows of foreign exchange, the bulk of which was via cash and projects grants on behalf of the Government. These inflows more than offset foreign exchange outflows, which were mainly for import financing by commercial banks. The NFA of the Reserve Bank during the first eight months remained sound compared to the same period in 2010.

Growth in **domestic credit** remained strong during the first eight months of 2011, but has been gradually easing from the levels recorded in 2010. The growth was largely due to increases in both private sector credit and the banking system's net claims on the Government. In August 2011, domestic credit stood at VT 45.4 billion, an increase of 2.3 per cent from July. Private sector credit⁴, which makes up the largest share of domestic credit, recorded an increase of 6.4 per cent in the first eight months of 2011. In year-ended terms, growth stood at 9.4 per cent over the year to August 2011. The growth in private sector credit during the first eight months was due to both loans to individuals and households and lending to businesses by 7.1 per cent and 4.3 per cent, respectively.

⁴ Includes data from commercial banks and RBV

3.7 Balance of Payments

Vanuatu's external **trade imbalance** is usually large reflecting an import dependent economy. Imports are about four times as large as merchandise exports, a level of deficit that has to be offset by services and transfers or financed by the capital and financial accounts. An overall balance of payment (BOP) deficit leads to a reduction of foreign reserves. To maintain external stability the RBV commit to maintain a minimum threshold level of official international reserves set at a minimum of 4 months of import cover. Hence, at the end of September 2011; total official reserves stood at VT 14,686 million which is equivalent to about 6 months of import cover.

In the medium term, **imports** are expected to grow, reflecting continuing expansion of the economy. In line with this, imports are expected to rise in the second half of 2011, supported by seasonal trends and continue strong domestic demand. In addition, the continued appreciation of the Australian dollar against the Vatu is expected to boost average spending in Vanuatu's tourism sector and improved Vanuatu's export volumes, particularly for beef, copra and other copra related products to Australia. The capital and financial accounts should continue to be in surplus into the medium term, financing the expected deficits in the current account. Barring adverse unforeseen circumstances, official international reserves are therefore expected to remain healthy equal to around 6.3 months of imported goods by the end of 2011 and a moderate fall to 5.5 months by the end of 2012. These changes will also be driven heavily by aid funds.

3.8 Exchange Rate Developments

The Vatu continued to appreciate on average, against the pound sterling and the US dollar during most part of 2011 amid growing investor concerns surrounding the Euro debt crisis and its likely spill over effect to other major advanced economies. It is worrisome that investors have significantly pushed up sovereign risks premium for most countries in the Euro area further reducing confidence in the economy. The strength of the Vatu relative to the USD and the pound have lessen the high cost for imports experienced by Vanuatu importers during the early months of 2011. On the other hand, the value of Vanuatu's imports has been increasing but at a much slower rate over the year relative to past years.

In contrast, the Vatu has recorded depreciated on average throughout most of 2011 against the Euro, the Australian dollar, the New Zealand dollar and the Japanese yen. The depreciation of the domestic currency against these major currencies was mirrored in the positive development in tourist arrivals from these countries as compare to the same period in 2010. Similarly, the weaker Vatu has boosted Vanuatu's export values destined for Europe, Australia, New Zealand and the Japanese markets relative to the same period one year previously.

3.9 Inflation

Inflationary pressures eased further as the annual inflation rate dropped from 3.4 per cent in December 2010, to 0.7 per cent in March 2011 and sliding further down to 0.6 per cent in June 2011. This was associated with low increases in overall domestic prices despite the inflationary pressures from surges in oil prices from abroad in the first half of the year.

In the June quarter 2011, the **Consumer Price Index** (CPI) rose by 0.7 per cent after recording a decline of 0.4 per cent in the March quarter. This was driven by higher prices for housing and utilities, transport, clothing and footwear prices. The prices of alcoholic drinks and food also rose. The price decline was shown for household supplies, recreation,

education and communication. The rate of change in the price of major food items remains modestly low, reflecting the change in the direction of trade towards MSG trade partner countries. Despite increases in price of fuel in the world market, the effect on domestic prices was moderately felt, with quarterly increase in categories with direct impact on fuel prices particularly transport and electricity costs remained low.

As expected, the inflationary pressures from higher fuel prices have started to seep through to transport and utility prices in the second and third quarter of the year. With the lag effect in prices, only moderate increases in price were seen in the first half of the year. As a result, the projected inflation for the year-ended 2011 has been revised downwards from a previous (March 2011) forecast of 3.2 per cent to 2.8 per cent (August 2011 forecast). It is expected that the annual inflation rate will remain within the RBV's target level of 0 - 4 per cent.

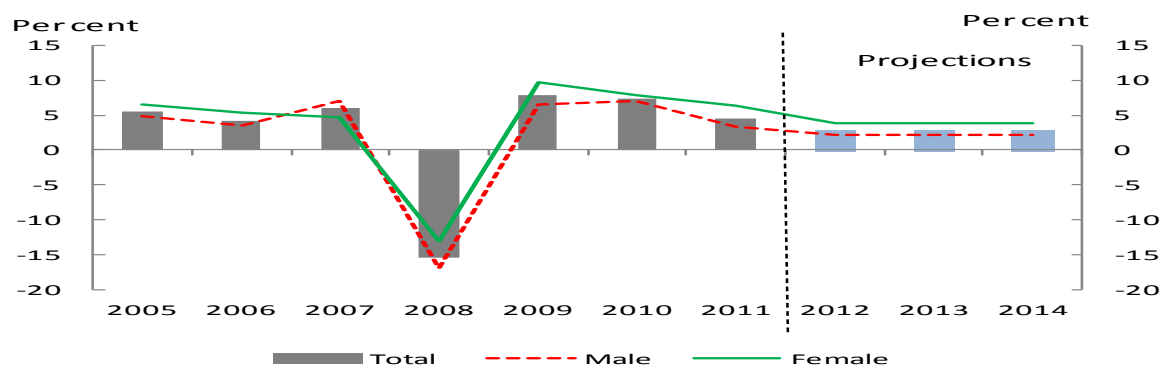
3.10 Employment

Vanuatu currently has very little, reliable labour market data, however with the formal and informal employment survey being carried out in late 2011 much more detailed analysis will be possible next year. One indicator of formal employment is the number of contributors to the Vanuatu National Provident Fund (VNPF). Over the past seven years total formal employment in Vanuatu has increased steadily, driven by the strong economic growth experienced by the country over this time period and an increasing number of investors creating new job opportunities. Total formal employment fell in 2008 compared to the previous year, in line with the effects of the global economic crisis. However, formal employment then picked up in 2009, 2010 and the beginning of this year by 8 per cent, 7 per cent and 5 per cent, respectively. The rebound in employment was supported by continued growth in the domestic economy. The outlook for the medium term is for employment growth to remain strong, new jobs will be created by the expectation of additional investment and a strong performance across most sectors of the economy.

In terms of employment by gender, the proportion of male employees (around 60 per cent) remains higher than females across the historical period. However, employment has increased at a similar rate for both males and females since 2004, with the two series appearing to move in parallel with evidence of moving towards gender equity where more females are joining the workforce each year. They are expected to move in similar direction over the medium term.

The New Zealand Recognized Seasonal Employment (RSE) scheme, since its inception in 2007, has contributed significantly in providing employment opportunities and income for unemployed Ni-Vanuatu. According to the Department of Labour, the scheme commenced with only 306 participants in 2007, numbers have subsequently risen significantly with 2,049 taking part in 2010 (growth of 570 per cent from the 2007 level). Remittances sent back by participants have improved standards of living and enabled some Ni-Vanuatu to establish micro and small businesses. In addition, participants in the scheme have benefitted from the acquisition of new skills and broadened their knowledge in various ways. It is expected that more people will be employed by such schemes in the future supported by increased access to other labour markets such as the Australian.

Figure 5: Changes in employment



Source: Vanuatu National Statistics Office

4. Fiscal Update and Projections

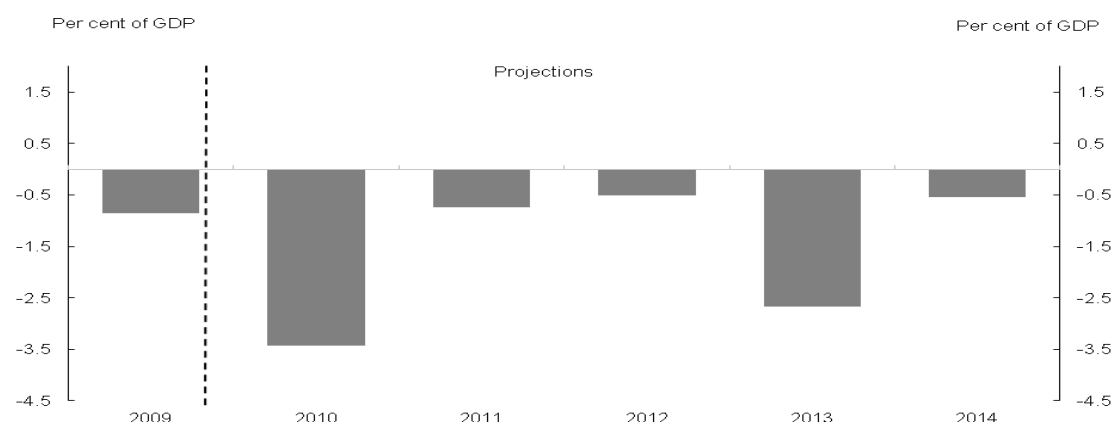
4.1 Budget Balance

The Public Finance and Economic Management Act obligates the Government to target a budget that maintains its ‘net worth’ at a level that provides a buffer against factors that may adversely impact its ‘net worth’ in the future. It also says that the Government should reduce and manage State debt. In other words, the Government aims to run recurrent surpluses over the medium term, in turn enabling it to reduce the stock of government debt and build reserves for times of difficulty and where it does borrow it does so only for investment purposes and not consumption. In line with this legislative requirement, the fiscal budget position published in Budget 2011 predicted a small deficit worth VT 395.1 million (equal to 0.5 per cent of GDP).

Expenditure during the first nine months of 2011 has been slightly above the Budget 2011 targets. Whilst the final drawdown and spending of the Chinese i-Government loan was not considered when Budget 2011 was prepared given delays and uncertainties surrounding the completion of earlier phases of the project (loan drawdown for this project were dependent on stages of work finishing). Revenue has performed considerably better than the previous two years and is expected to hit its Budget 2011 target driven by improved compliance, recovery in economic conditions and higher than expected Government spending. Given the impacts of the i-Government spending, it is now forecasted that a fiscal deficit worth VT 1,100.1 million (equal to 0.1 per cent of GDP) will be recorded at the end of 2011.

With respect to Budget 2012, the expected position will be another deficit; borrowing being undertaken to fund capital expenditure which will maintain or enhance the Government’s overall net worth. The Government is working on reviewing its revenue acts, improving compliance and expanding its coverage. Together with the removal of one-off recurrent expenditure on the elections and the ACP-EU Conference in 2013, these revenue measures should help the Government build up recurrent surpluses over the medium run. However, at the same time the Government along with its donor partners will be undertaking an adventurous investment program designed to stimulate growth; this will involve external concessional borrowing which will be used primarily for large infrastructure projects.

Figure 6: Overall Budget Balance

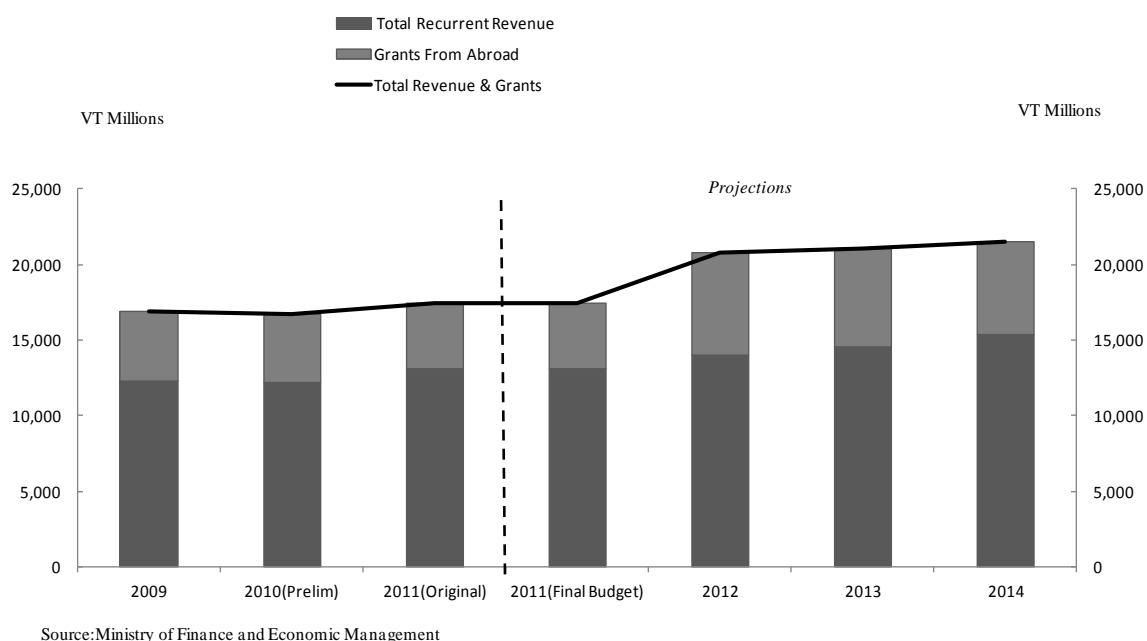


Source: Ministry of Finance and Economic Management

4.2. Revenue 2011

At Budget 2011, the recurrent revenue target was VT 13,131 million; this represented growth of 9.4 per cent from the VT 12,001.6 million collected in 2010. Over the year actual collections have increased considerably compared to 2010 and 2009 levels and with total recurrent revenue currently being on target, there has been no reason to revise the revenue forecast. Additionally, Government continues to prioritize enhancing revenue collections and the economy has shown signs of picking up this year which should support collections; it is forecast that GDP will grow by 4.3 per cent in 2011

Figure 7: Recurrent Revenue and Grants



Collections from Value Added Tax (VAT) and import duty, the major components of tax revenue, have been strong over the first nine months of 2011. This was a result of improved compliance and economic activity. Higher tax collections compared with the previous year also in part reflect the higher than expected Government expenditure so far this year, which has driven higher private consumption and filtered through to VAT, import duties and excise tax receipts. As a consequence, both the VAT and import duties targets remain unchanged at VT 4, 8661.1 million and VT 2,699.5 million, respectively. Of the main revenue handles to the end of September, VAT (the leading source of tax receipts) contributed VT 3,532.0 million to recurrent revenue (equal to 36.5 per cent of total recurrent revenue collected during the period). Notably, this is 10.9 per cent higher than that level received for the same period in 2010 (VT 3,185.1 million). Meanwhile import duty, the second leading revenue category, recorded VT 2,066.3 million (21.3 per cent of total recurrent revenue) – somewhat higher of the VT 1,877.2 million registered over the first nine months of 2010.

Across the remaining tax revenue categories, performance in revenue collection has been mixed. Property taxes, which were targetted to raise VT 502.8 million in 2011, had by the end of September raised only VT 313.7 million (equal to 3.2 per cent of total recurrent revenue collected). Additionally, Business Licence revenues have decreased, the reason being the removal the businesses licences being required by companies with a turnover of

less than VT 4 million. By the end of September, receipts collected were only VT 199.5 million (equal to 2.1 per cent of total recurrent revenue collected) . On the other hand, turnover tax has exceeded target with VT 311.4 million (109.7 per cent of forecast) collected at the end of September.

Alongside receipts from taxes, non-tax revenues were forecast to contribute VT 5,610.8 million to fiscal receipts in 2010. Yet, at the end of September total receipts from non-tax sources reached VT 2,921.8 million (52.1 per cent of forecast). Of non-tax revenue, the largest category of administrative fees and charges had contributed VT 651.6 million receipts by the end of September (78.4 per cent of forecast). Within administrative fees and charges, the leading components of revenue collection have been work permits (VT 124.6 million receipted), residency permits (VT 108.1 million) and merchant charges (VT 17.2 million).

Income earned from entrepreneurial and property related activities forms the other sub-category of non-tax revenue. To the end of September, the total collected for entrepreneurial and property related income stood at VT 202.8 million – equal to 46.8 per cent of the Budget 2011 target of VT 433.4 million.

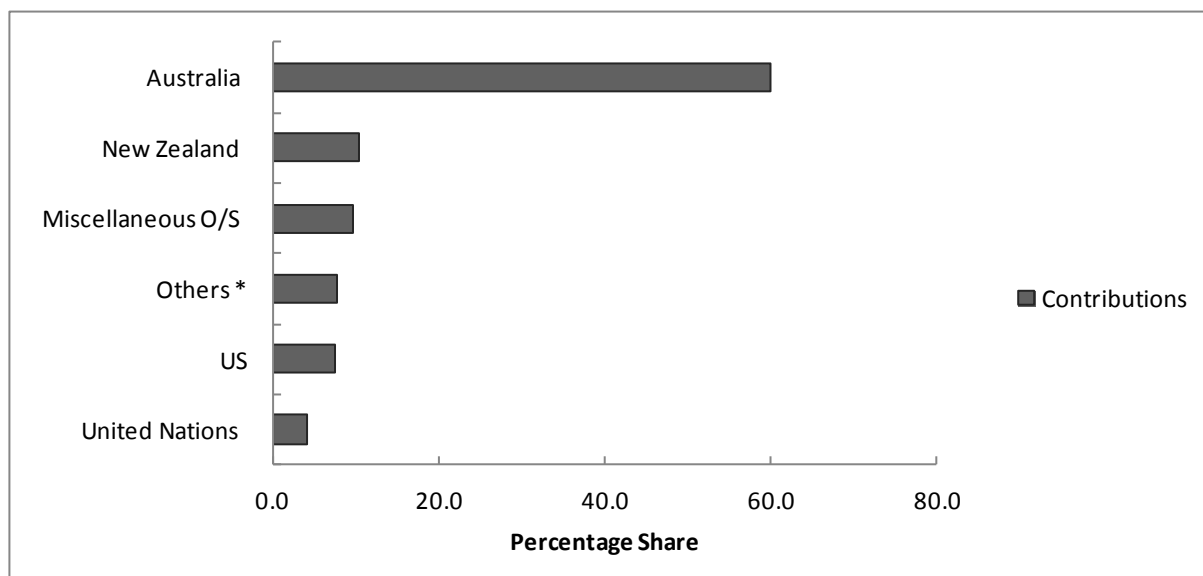
Dividends (part of income earned from entrepreneurial and property related activities) as at end of September 2011 recorded VT 50 million (26.3 per cent of budget) and this consists of only one contributor, the Reserve Bank of Vanuatu. The Post Office has announced a dividend of VT 70 million but it had not been receipted at the time of writing. Other State Owned Enterprises (SOE's) such as the NBV, NISCOL and Ifira Stevedoring that annually pay dividends have not indicated that they will contribute this year.

Land rent has also contributed VT 132.5 million to the sub-category total and it is likely that it will not meet the Budget 2011 target of VT 213.2 million due to the ending of contracts for enforcement officers at the Department of Lands mid way through the year.

External of recurrent revenue, donor partner funds also contribute significantly to the basket of Government resources. With the importance on donor partners providing an incentive to mitigate any adverse impacts of the continued weaknesses in the global economy, grants from abroad registered a robust level of VT 2,042.7 million over the year to the end of September. With three months yet to be accounted for, the expectation is that donor support will reach VT 2,437.3 million. Such an amount would be smaller than the VT 4,529.1 million registered in 2010. The main reason being delays in some project implementations schedules and also the fact that some of the projects undertaken in 2011 have been through aid-in-kind and are not captured in the Vanuatu Budget Management System (VBMS). Of the VT 2,042.7 million received, the leading contribution came from Australia with VT 1,165.4 million. This was followed by New Zealand with VT 253.6 million worth of contributions and MCA at VT 155.2 million (Figure 8).

The Government benefits from direct budget support from the European Union, which was supposed to be worth VT 266.0 million for 2011. However the disbursement of EU support has been postponed and will take place early 2012.

Figure 8: Support provided by major aid partners to the Government of Vanuatu (2011)



Source: Ministry of Finance and Economic Management.

*Includes South Pacific Commission, World Health Organisation, ISP, Vanuatu Government, France, and China.

4.3 Revenue Estimates in Integrated National Budget 2012

The Integrated National Budget initiative will be ongoing in 2012. Through this initiative the Government aims to bring together Government and donors partners in aligning the objectives of aid programs with Government policy and that will help in better management of the recurrent cost implications and hence the financial sustainability of capital investment in essential public services.

Total recurrent revenue is forecast to be VT 13,970 million in 2012. This is 6.4 per cent higher than the initial Budget in 2011 estimate of VT 13,131 million. This forecast represents the limit of the level that is consistent with fiscal prudence.

Of the main revenue handles, VAT should continue to dominate the stream of tax revenues in 2012, being forecast to contribute VT 5,167 million of recurrent revenue (equal to 387.0 per cent of the total recurrent revenue). This represents an increase in growth of 6.2 per cent from the 2011 projection. The next leading category is import duty, which is projected to register VT 2,977 million in 2012 – a slight increase of 10.3 per cent from the 2011 budget. This increase is mainly driven by forecast increases in prices and has factored in WTO commitments on Vanuatu's agreed goods schedule. Furthermore, with a positive outlook for business activity in 2012, contributions from business licenses and turnover tax are anticipated to register VT 223 million and VT 330 million respectively.

Administrative fees and charges are forecast to decrease from the foprecast in 2011 of VT 831 million to VT 703 million in 2012 this reflects more realistic forecasting in terms of actual cash collections from line Ministries as well as reductions in some fees and charges such as those levied on fishing vessels. 2010 was a very quiet year in terms of econmic growth with latest estimates suggesting the economy grew at 2.2 per cent. As a result, many companies were affected by this and also the change in the Employment Act in regard to severance payments. As a result dividends paid by State Owned Enterprises to

Government in 2011 was very low. However the latest, preliminary economic data suggest that 2011 has been better year and as a result Government can expect more dividends in 2012.

The Government recognises that rigorous efforts must continue in order to improve the potential scope and enforcement of revenue handles. Greater collections levels are essential for the enhanced provision of Government services to the people of Vanuatu – an aim which forms a key pledge of Budget 2012.

Given the usual bilateral agreements with donor partners will remain in place, it is expected that significant donor support will continue throughout 2012. One significant example is the ongoing Government policy of Universal Primary Education which is jointly funded by the Governments of Vanuatu VT 164.3 million, Australia VT 134.6 million and New Zealand VT 164.3 million. Notwithstanding other commitments by donor partners that are forecast to grow to a record VT 6556 million in 2012. This is a substantial level of commitment and is forecast to continue at similar levels into the medium term. This represents a recognition of Vanuatu's sound performance in financial management and good governance.

4.4 Expenditure 2011

Expenditure remains broadly in line with the budget targets for most line agencies. However there has been some unforeseen increase in expenditure associated with loss of legal control by higher executives particularly the large number of deeds of releases being signed by the Government at the start of the year and also the impact of the supplementary budget during the middle of the year. Therefore the Ministry of Finance and Economic Management has taken proper measures in place to control expenditure through out line agencies where possible. This includes new legal provisions for managing such deeds. However, most aspects of expenditure showed increases when compared to the same period last year but importantly remain within the original budget forecasts.

Total recurrent expenditure at end September accounted for VT 10,984 million, equal to 78.8 per cent of the Budget 2011 provision for recurrent expenditure (VT 13,936 million). Consistent with the pattern of higher expenditure towards year end that has been a characteristic of recent years, it is expected that the full Budget 2011 provision will be drawn upon. Furthermore, eleven supplementary appropriations and three emergency appropriations with a combined value of VT 548.9 million raise the expenditure forecast for 2011 to VT 14,484 million.

The two emergency appropriations were in response to tropical cyclone Vanua effects on Tafea province (which accounted for VT 35.5 million of expenditure) and the exemption of school fees on Tafea province due to cyclone Vanua impacts on commercial farm crops (VT 63.6 million). The supplementary appropriation was passed by Parliament in August and constituted of VT 548.9 million. (Table 3).

Table 3: Total supplementary budget 2011

Supplementary Item	Amount (VT)
Tourism Branding	13,000,000
SPG Games	19,000,000
MP Allocation	52,000,000
Nurses New Graduates 2011	23,000,000
Doctors New Graduates 2010 and 2011	18,000,000
Recruitment of Solomon Island nurses	20,000,000
Shortfall of current staffing salary	28,000,000
ACP Deposit, related costs and others	41,600,000
WTO	25,000,000
Scholarships	96,800,126
Torba Games	39,481,700
Tafea School Fee Exemption due to cyclone Vania	63,661,120
Tropical Cyclone Vania	35,500,000
RVS Tukoro Slipway expenses	30,000,000
Parliament	13,887,219
MOH	30,000,000
Total	548,930,165

The leading category of recurrent expenditure is personal emoluments (that is, payroll costs and superannuation), which accounted for VT 5.6 million of expenditure to end September which is a 5.6 per cent increase compare to 2010.

The next leading category of recurrent expenditure is goods and services (that is, operational expenditure). Spending on other goods and services to end September stood at VT 2,086.3 million, equal to 74.3 per cent of the expense target of VT 2,809.7 million. Unlike personal emoluments, which constitute a legal obligation, government agencies' operational expenditure cannot exceed the budgeted amounts – meaning that the fiscal risk associated with overspending does not extend to goods and services expenditure.

The final major expenditure category of subsidies and other transfers accounted for VT 1,639 million to end September which is 82.8 per cent of target (VT 1,978.6 million). As with expenditure on goods and services, spending on transfers is limited to the budgeted provision.

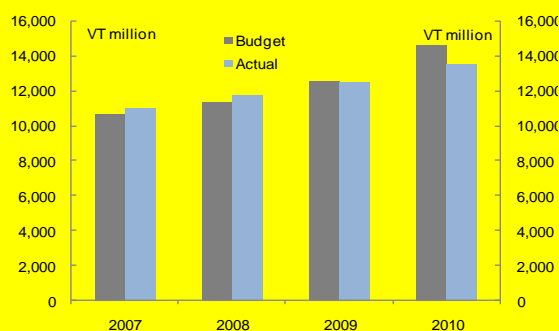
Of the transfers, transfers to government bodies constitutes the major component with VT 882.3 million utilised to end September. Transfers to households follow with VT 509.3 million of expenditure. Meanwhile, transfers to the provinces and municipalities accounted for VT 174 million, with the remaining sub-category of transfers abroad responsible for VT 73.4 million. Transfers abroad reflect Vanuatu's membership obligations to international organisations as well as student allowances and tuition fees payable to overseas institutions.

Box 4: Financial Management Report 2010

In 2011 the Treasury Division of the Ministry of Finance and Economic Management (MFEM) produced its first ever Financial Management Report. The report was produced with the aim of assessing how public resources have been used by the individual agencies of the Government between January 1st 2007 and December 31st 2010. Each individual Ministry and Constitutional Body differs in the way that it uses public funds however this report highlighted some key expenditure issues that are present across Government.

At an aggregate level and as illustrated by Chart A, actual recurrent expenditure of the Government was marginally above its budgeted amounts in 2007 and 2008, reflecting additional capital spending required for the Millennium Challenge Account roads not known at the time of budget preparation. Whilst in 2009 and 2010, actual spending was within its budgeted amounts as appropriated by Parliament. This emphasised the success of the Financial Management Information System and internal controls in place at MFEM in maintaining aggregate control.

Chart A: Actual versus budgeted recurrent expenditure



Source: Ministry of Finance and Economic Management

As a measure of the quality of individual line agencies budget preparation, the value of virements across programs and transfers across cost centres have shrunk from VT 1,217 million and VT 531 million in 2007 to only VT 159 million and VT 145 million in 2007. This means that agencies are using their fund as they intended to use them at the time budgets are prepared and appropriated. Although the 2010 reduction partially reflected a policy of not allowing virements from savings in payroll to operational budgets to reduce spending..

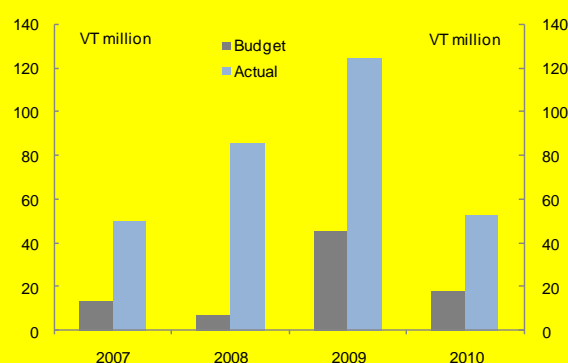
In 2008, a policy decision was made to increase the domestic subsistence allowance for travel to VT 10,000 per day for the first ten days of travel before then being reduced to VT 5,000 for any additional days. However, evidence suggests that some agencies are not strictly applying these rules and as a consequence spending has grown from VT 65 million in 2007 to VT 244 million in 2010. In addition, expenditure on domestic subsistence allowance has exceeded its budgeted amounts for the past 3 years (for example in 2010 VT 244 million actual versus VT 172 million budget). This means spending on subsistence allowances are diverting money intended for other uses.

There has also been a significant increase in spending on termination payments due to retirement. This is partly due to a change in Public Service Commission rules allowing some civil servants to be paid two months severance for every year served (under the Employment Act you are entitled to only one months severance for every year served). As well as partly due to the fact that many of the civil servants recruited at Independence are now retiring. Spending has risen from VT 121 million in 2007 to VT 392 million in 2010.

Court costs (excluding lawyer fees) paid out by the Government have also tended to exceed budgets over the past few years. For example in 2010, VT 10 million was budgeted for court cost but VT 113 million was spent. In part, this reflects Ministers having discretion to sign off deeds of releases.

An additional area of particular concern where there has been a rapid increase in the spending and actuals have exceeded budgeted amounts, without an obvious change in Government policy, is spending on new vehicles (Chart B).

Chart B: Actual versus budgeted spending on new vehicles



Source: Ministry of Finance and Economic Management

The Government has some major one-off commitments such as the ACP-EU meeting and elections so is under severe pressure to run a balanced budget and maintain a positive cash flow position in 2012. This Financial Management report has helped to identify some "efficiency gains" across the Government so that savings can be realised without a draconian fixed percentage cut across the board being required.

Spending measures being introduced in 2012 as a result of this report's findings include:

- Reducing the domestic subsistence allowance to VT 3,500.
- Making the PSC Act in line with Employment Act in terms of severance.
- Ensuring all deeds of releases with a value more than VT 10 million must pass through the Council of Ministers.

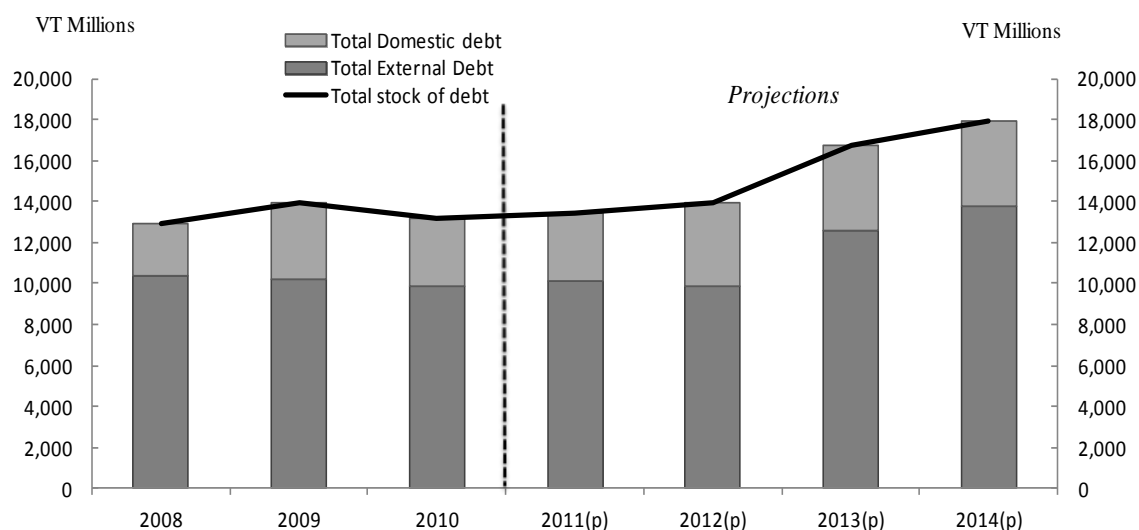
Debt Sustainability analysis (DSA)

The Treasury undertook a detailed Debt Sustainability Analysis at the start of the year jointly with some of our donor partners. That analysis found that the current stock of debt was manageable as was the forecast increase in borrowing due to major infrastructure works. There may be challenges in terms of the flow of debt payments in the future but currently these are forecast to be well within internationally recognised prudential limits. The analysis also showed that when we include the stock of quantifiable contingent liabilities the Government has reached its stated prudential limit of debt to GDP of 40 per cent.

The stock of debt is forecast to rapidly increase by 33.7 per cent over the medium term reaching VT 17,913 million by 2014. This increase is driven mainly by external concessionary borrowing associated with large infrastructure projects. It is also driven in part by the increased in domestic borrowing associated with the financial shortfalls experienced in 2010 and 2011 which were financed by domestic borrowing. This may be the case in 2012 if budget support funds fail to materialise.

However, the main risks to sustainability may arise from liquidity problems where the Government may not have sufficient liquidity to cover maturing obligations within the medium term. Whilst bonds and concessional payments are likely to be unaffected the major challenge will be in the event of a large increase in payments due to the actualisation of contingent liabilities. Whilst these are difficult to quantify, partly due to the poor accounting standards in some State Owned Enterprises the Ministry of Finance estimates that these will have reached approximately VT 22.7 million by end 2010 making the total stock of debt 55 per cent of GDP which is a concern.

Figure 9: Stock of debt not including contingent liabilities



Source: Department of Finance and Economic Management

4.5 Expenditure Estimates in Integrated National Budget 2012

Total estimated recurrent expenditure for the Government in 2012 is VT 14,766.8 million. This represents a 5.9 per cent increase compared to 2011's estimated recurrent expenditure of VT 13,935.6 million. The increase is largely driven by an increase in spending associated with the national and provisional elections as well as the cost of hosting the ACP meeting. As a result, spending on goods and services is estimated to increase by 7.4 per cent from VT 11,188.6 million in 2011 to VT 12,021.3 million in 2012. The increase is associated with higher spending on salary and wages as well as other goods and services (operations) exceeding lower estimates for other contributions.

Subsidies and other transfers is also estimated to increase by 0.4 per cent from VT 1,978.6 million in 2011 to VT 1,985.9 million in 2012. The increase spending on subsidies and other transfers reflects increase spending on subsidies that are associated with the new initiative of a kava subsidy worth VT 50 million, and additional increase of VT 42 million in the copra subsidy budgets.

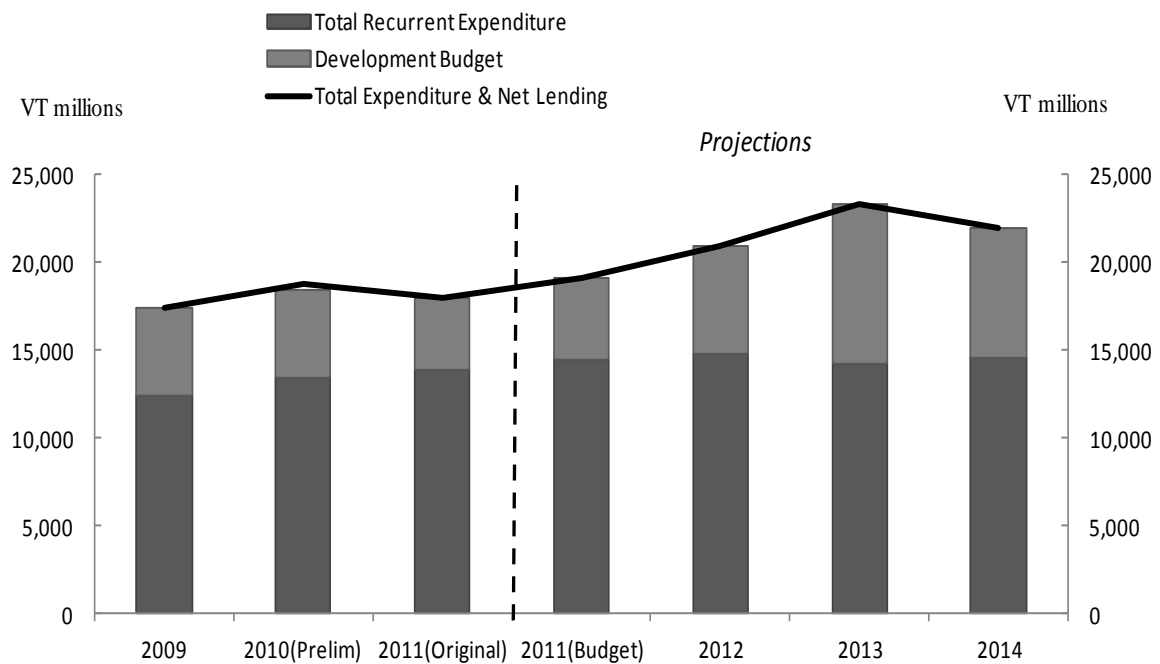
The estimated recurrent expenditure in the 2012 budget includes all New Policy Proposals (NPPs), which amount to VT 618 million. It is a significant increase in NPP allocations by 115 per cent from VT 287 million agreed in 2011. This upward trend in NPP allocations reflects the increasing needs of the people of Vanuatu and involves strengthening of social and productive sectors. The concern remains though that these NPP's will have to be funded from cash reserves rather than recurrent revenue flows.

Within the social sectors, Government is planning to allocate an additional VT 137 million to the Ministry of Education to meet current teachers' salaries and allowances. National security will also be enhanced with VT 47 million that is allocated to the Vanuatu Police Force, for improved community policing in remote areas of Vanuatu. While in furthering the pursuit of social outcomes, the Ministry of Health will receive an additional VT 38 million for new nurses' graduating in 2011 to strengthen and offer quality health care for all people.

The Government will continue to strengthen and enhance the productive sectors in 2012 to promote economic growth and this is reflected through additional budget of VT 60 million being allocated to the Vanuatu Tourism Office (VTO) for strengthening and better marketing of Vanuatu as a tourist destination.

The 2012 recurrent expenditure estimate is the utmost limit of what the Government can spend towards its policy priorities that were outlined in the 2012 Budget Policy Statement.

Figure 10: Total Expenditure and Net Lending



Source: Department of Finance and Economic Management

In addition to the recurrent expenditure, donor funds worth VT 6,156 million are scheduled for disbursement in 2012. This brings the total expenditure and net lending to VT 20,923 million.

Table 4: Revenue

	Actual 2009	Prelim 2010(Prelim)	Original Budget 2011(Original)	Final Budget 2011(Final Budget)	Budget 2012	Forecast 2013	Forecast 2014
Tax Revenue	10,825.0	10,926.5	11,836.3	11,836.3	12,743.4	13,293.5	14,050.9
Taxes on income and profits	0	0	0	0	0	0	0
Taxes on property	463.3	485.4	502.8	502.8	550.3	581.1	617.7
Taxes on the use of goods	6,445.6	7,776.0	8,628.8	8,628.8	9,213.7	9,581.1	10,123.2
VAT	4,304.9	4,301.1	4,866.1	4,866.1	5,166.9	5,455.8	5,799.7
Business Licenses	280.9	255.3	222.3	222.3	223.3	235.8	250.7
Turnover Tax	262.3	267.8	284.0	284.0	330.0	348.4	370.4
Internet Casino	29.1	5.6	35.1	35.1	25.3	26.7	28.4
Debits Tax	0	-	0	0	0	0	0
Service Taxes	74.5	69.8	81.9	81.9	85.0	89.8	95.4
Excise	606.9	1,792.5	2,022.8	2,022.8	2,096.1	2,165.6	2,240.2
Other	887.0	1,083.9	1,116.6	1,116.6	1,287.0	1,259.0	1,338.4
Taxes on international trade	3,916.1	2,665.1	2,704.7	2,704.7	2,979.3	3,131.4	3,309.9
Export duty	8.0	1.4	5.2	5.2	2.3	2.4	2.6
Import duty	3,908.0	2,663.6	2,699.5	2,699.5	2,977.0	3,128.9	3,307.3
Import duty breakdown							
beer & wine	260.8	183.0	176.5	176.5	189.3	199.8	212.4
tobacco	546.9	165.1	143.3	143.3	170.0	175.6	181.7
vehicles	258.6	196.5	209.5	209.5	225.0	237.6	252.6
motor spirits	758.1	244.9	293.6	293.6	469.0	484.6	501.3
other	2,083.7	1,874.1	1,876.6	1,876.6	1,923.8	2,031.3	2,159.4
Non-Tax Revenue (incl grants)	6,081.2	5,788.7	5,619.0	5,619.0	8,084.4	7,778.6	7,446.9
Entrepr & Property Income	639.5	229.2	433.4	433.4	512.2	523.5	537.0
Dividends	440.7	55.0	190.2	190.2	310.0	310.0	310.0
Property Income	140.2	145.5	213.2	213.2	192.2	202.9	215.7
Other	58.6	28.7	30.0	30.0	10.0	10.6	11.2
Administrative fees and charges	793.0	998.5	831.5	831.5	703.1	742.4	789.3
Households	313.8	343.6	392.1	392.1	325.5	343.7	365.3
Other	479.2	654.9	439.4	439.4	377.7	398.8	423.9
Other non-tax revenue	32.4	32.1	29.7	29.7	11.4	12.0	12.8
Total Recurrent Revenue	12,289.9	12,186.3	13,131.0	13,131.0	13,970.1	14,571.5	15,389.8
as % of GDP	19.5%	18.4%	18.2%	18.2%	18.0%	17.3%	16.7%
Sales of fixed capital assets	6.3	4.8	8.2	8.2	1.6	1.7	1.8
Grants From Abroad	4,610.0	4,528.8	4,316.2	4,316.2	6,856.1	6,499.0	6,106.1
Project Grants	4,610.0	4,431.1	4,050.2	4,050.2	6,156.1	6,099.0	5,606.1
Budget Support	0	97.7	266.0	266.0	700.0	400.0	500.0
Total Revenue & Grants	16,906.2	16,720.0	17,455.3	17,455.3	20,827.8	21,072.1	21,497.8
as % of GDP	26.8%	25.3%	24.3%	24.3%	26.9%	25.0%	23.3%
Gross borrowing	1,729.4	1,761.2	1,471.4	2,041.1	1,323.1	4,343.7	4,107.6
Domestic	590.0	1,199.5	1,471.4	1,471.4	1,323.1	1,301.9	2,301.8
External	1,139.4	561.8	0.0	569.7	0	3,041.8	1,805.8
Sale of financial assets	0	0	0	0	0	0	0
Principal receipts from lending	0	0	0	0	0	0	0
TOTAL RECEIPTS	18,635.7	18,481.2	18,926.7	19,496.5	22,150.8	25,415.8	25,605.4
as % of GDP	29.6%	27.9%	26.3%	26.3%	28.6%	30.2%	27.7%

Table 5: Expenditure

	Actual 2009	Prelim 2010(Prelim)	Original Budget 2011(Original)	Final Budget 2011(Budget)	Budget 2012	Forecast 2013	Forecast 2014
Goods and Services	10,006.8	11,236.9	11,188.6	11,486.6	12,021.3	11,631.9	11,980.9
Salary & Wages	7,186.6	7,668.0	7,793.4	7,896.3	8,383.1	8,346.6	8,597.0
Other Contributions	435.7	650.5	585.4	585.4	418.6	431.1	444.1
Other Goods and Services	2,384.5	2,918.4	2,809.7	3,004.8	3,219.6	2,854.2	2,939.8
Interest Payments	317.8	333.5	467.5	467.5	509.6	459.5	468.5
Domestic	189.0	194.4	363.5	363.5	355.4	328.5	328.5
External	128.8	139.1	104.0	104.0	154.2	131.0	140.0
Subsidies and other transfers	1,430.6	1,468.6	1,978.6	2,199.5	1,985.9	1,839.5	1,894.7
Subsidies	108.0	0	108.0	108.0	200.0	0	0
Transfers to Government Bodies	835.4	894.3	1,043.1	1,043.1	1,001.3	1,031.4	1,062.3
Transfers to Provinces & Municipalities	209.6	216.7	248.1	248.1	255.8	263.5	271.4
Transfers to Households	202.4	324.0	496.4	692.4	432.6	445.5	458.9
Transfers Abroad	75.4	33.7	82.9	107.9	96.2	99.1	102.1
Acquisition of fixed capital assets	676.2	447.9	300.9	330.9	250.0	250.0	250.0
Total Recurrent Expenditure	12,431.4	13,486.9	13,935.6	14,484.5	14,766.8	14,180.9	14,594.0
as % of GDP	19.7%	20.4%	19.4%	20.1%	19.1%	16.9%	15.8%
Lending minus repayments	0	0	0	0	0	0	0
Non-Recurrent Transfers to Govt Bodies	0	400.0	0	0	0	0	0
Development Budget	5,009.9	4,933.6	4,050.2	4,619.9	6,156.1	9,140.8	7,411.9
Salary & Wages	277.8	428.1	287.5	287.5	437.0	648.9	526.2
Other Goods and Services	1,030.8	1,236.4	923.5	923.5	1,403.6	2,084.2	1,690.0
Acquisition of Fixed Capital Assets	3,492.9	2,863.7	2,589.2	3,158.9	3,935.4	5,843.4	4,738.2
Other Expenditures	208.4	405.4	250.0	250.0	380.0	564.2	457.5
Total Expenditure & Net Lending	17,441.3	18,820.6	17,985.8	19,104.4	20,922.9	23,321.7	22,005.9
as % of GDP	27.7%	28.4%	25.0%	26.5%	27.0%	27.7%	23.8%
Amortisation	1,065.5	697.4	941.0	941.0	1,228.0	1,599.9	2,599.8
Domestic	688.3	399.5	600.0	600.0	901.8	1,301.9	2,301.8
External	377.2	298.0	341.0	341.0	326.2	298.0	298.0
Change In Balances	128.8	(1,036.8)	(0.0)	(549.0)	-	494.3	999.6
Currency	0	0	0	0	0	0	0
Operational	(610.8)	(1,096.0)	(0.0)	(549.0)	-	494.3	999.6
Development	739.6	59.3	0	0	0	0	0
TOTAL PAYMENTS	18,635.7	18,481.2	18,926.7	19,496.5	22,150.8	25,415.8	25,605.4
as % of GDP	29.6%	27.9%	26.3%	27.1%	28.6%	30.2%	27.7%

Table 6: Financing

	Actual 2009	Prelim 2010	Original Budget 2011	Final Budget 2011	Budget 2012	Forecast 2013	Forecast 2014
A. Total Revenue and Grants	16,906.2	16,720.0	17,455.3	17,455.3	20,827.8	21,072.1	21,497.8
B. Total Expenditure and Net Lending	17,441.3	18,820.6	17,985.8	19,104.4	20,922.9	23,321.7	22,005.9
Balance Budget	(535.1)	(2,100.5)	(530.4)	(1,649.1)	(95.1)	(2,249.5)	(508.2)
Per cent of GDP	(0.8)	(3.2)	(0.7)	(2.3)	(0.1)	(2.7)	(0.6)
D. External Financing	762.2	263.8	(341.0)	228.7	(326.2)	2,743.8	1,507.8
D1. Concessional Financing	762.2	263.8	(341.0)	228.7	(326.2)	2,743.8	1,507.8
New Borrowing	1,139.4	561.8	0	569.7	0	3,041.8	1,805.8
(Less Amortisation)	377.2	298.0	341.0	341.0	326.2	298.0	298.0
D2. Commercial Financing	0	0	0	0	0	0	0
New Borrowing	0	0	0	0	0	0	0
(Less Amortisation)	0	0	0	0	0	0	0
E. Domestic Financing	(227.1)	1,836.8	871.4	1,420.4	421.3	(494.3)	(999.6)
E1. Domestic Market Borrowing (NET)	(98.3)	800.0	871.4	871.4	421.3	0	0
New Domestic Market Borrowing	590.0	1,199.5	1,471.4	1,471.4	1,323.1	1,301.9	2,301.8
(Less Amortisation)	688.3	399.5	600.0	600.0	901.8	1,301.9	2,301.8
E2. Other Domestic Borrowing	(128.8)	1,036.8	0.0	549.0	0	(494.3)	(999.6)
New Domestic Borrowing	0	0	0	0	0	0	0
(Less Amortisation)	0	0	0	0	0	0	0
(Change In Balances)	128.8	(1,036.8)	0	(549.0)	0	494.3	999.6
TOTAL FINANCING	535.1	2,100.5	530.4	1,649.1	95.1	2,249.5	508.2
Gross Borrowing	1,729.4	1,761.2	1,471.4	2,041.1	1,323.1	4,343.7	4,107.6
Concessional	1,139.4	561.8	0	569.7	0	3,041.8	1,805.8
Commercial	0	0	0	0	0	0	0
Domestic	590.0	1,199.5	1,471.4	1,471.4	1,323.1	1,301.9	2,301.8

Table 7: Government Fiscal Operations

This table is produced in accordance with the latest IMF GFS 01 guidelines

GFS Code	GFS Description*	Actual 2009	Prelim 2010	Original Budget 2011	Final Budget 2011	Budget 2012	Forecast 2013	Forecast 2014
	TRANSACTIONS AFFECTING NET WORTH:							
A1	Revenue	16,900.0	16,715.2	17,447.2	17,447.2	20,826.2	21,070.4	21,496.0
A11	Taxes	10,435.0	10,525.8	11,329.6	11,329.6	12,065.3	12,560.1	13,251.7
A111	Taxes on income, profits, and capital gains	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A112	Taxes on payroll & workforce	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A113	Taxes on property	25.9	12.3	0.0	0.0	0.0	0.0	0.0
A114	Taxes on goods & services	6,512.5	7,867.6	8,696.2	8,696.2	9,230.9	9,567.3	10,070.2
A115	Taxes on international trade & transactions	3,896.6	2,645.9	2,633.4	2,633.4	2,834.4	2,992.9	3,181.5
A116	Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A12	Social contributions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A13	Grants	4,610.0	4,528.8	4,316.2	4,316.2	6,856.1	6,499.0	6,106.1
A14	Other revenue	1,855.0	1,660.5	1,801.3	1,801.3	1,904.8	2,011.3	2,138.1
A2	Expense	13,272.2	15,108.9	15,095.7	15,614.7	16,737.5	17,228.2	17,017.8
A21	Compensation of employees	7,235.6	7,830.8	7,985.2	8,088.1	8,653.2	8,963.0	9,089.8
A22	Use of goods and services	3,920.1	4,693.3	4,113.8	4,308.9	5,138.7	5,502.6	5,087.3
A23	Consumption of fixed capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A24	Interest	317.8	333.5	467.5	467.5	509.6	459.5	468.5
A25	Subsidies	108.0	0.0	108.0	108.0	200.0	0.0	0.0
A26	Grants	1,278.0	1,510.4	1,586.2	1,807.1	1,638.5	1,687.6	1,738.3
A27	Social benefits	201.8	410.0	329.3	329.3	180.0	185.4	190.9
A28	Other expense	210.7	330.9	505.8	505.8	417.5	430.1	443.0
GOB	Gross operating balance (1-2+23+NOBz)	3,627.8	1,606.2	2,351.4	1,832.5	4,088.6	3,842.2	4,478.2
NOB	Net operating balance (1-2+NOBz) ^{c/}	3,627.8	1,606.2	2,351.4	1,832.5	4,088.6	3,842.2	4,478.2
NOB	Net operating balance (1-2+NOBz-A13) excluding donor grants ^{c/}	(982.3)	(2,922.6)	(1,964.8)	(2,483.7)	(2,767.4)	(2,656.8)	(1,628.0)
	TRANSACTIONS IN NONFINANCIAL ASSETS:							
A31	Net Acquisition of Nonfinancial Assets	4,162.9	3,306.8	2,881.9	3,481.6	4,183.8	6,091.7	4,986.4
A311	Fixed assets	4,162.9	3,306.8	2,881.9	3,481.6	4,183.8	6,091.7	4,986.4
A312	Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A313	Valuables	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A314	Nonproduced assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NLB	Net lending / borrowing (1-2+NOBz-31)	(535.1)	(1,700.5)	(530.4)	(1,649.1)	(95.1)	(2,249.5)	(508.2)
	TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):							
A32	Net acquisition of financial assets	128.8	(636.8)	0.0	(549.0)	0.0	494.3	999.6
A321	Domestic	128.8	(636.8)	0.0	(549.0)	0.0	494.3	999.6
A322	Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A323	Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A33	Net incurrence of liabilities	663.9	1,063.8	530.4	1,100.2	95.1	2,743.8	1,507.8
A331	Domestic	(98.3)	800.0	871.4	871.4	421.3	0.0	0.0
A332	Foreign	762.2	263.8	(341.0)	228.7	(326.2)	2,743.8	1,507.8
	Vertical check: Difference between net lending/borrowing and financing (1-2-31=32-33-NLBz=0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Table 8: Statement of Government Borrowing

	2009 Actual	2010 Actual	2011(p) Projection	2012(p) Budget	2013(f) Forecast	2014(f) Forecast
External Debt						
Bilateral						
CFD	425.9	297.1	259.9	227.9	193.3	158.7
China	2,796.3	3,103.0	3,672.7	3,672.7	3,672.7	3672.7
Japan					2,209.0	3313.5
Total Bilateral Debt	3,222	3,400	3,933	3,901	6,075	7,145
Multilateral						
ADB	5,911.5	5,149.8	4,991.6	4,840.7	4,861.5	5101.4
EIB	362.0	222.76	164.86	112.73	57.72	2.7
IDA	1,382.2	1,086.89	1,026.59	979.27	1,582.91	1529.1
Total Multilateral Debt	7,655.7	6,459.5	6,183.1	5,932.7	6,502.1	6,633.2
Total External Debt	10,877.9	9,859.6	10,115.7	9,833.4	12,577.2	13,778.2
Total Domestic debt	2,484.7	3,284.7	3,284.7	4,656.2	4,656.2	4,656.2
Total stock of debt	13,362.6	13,144.3	13,400.4	14,489.6	17,233.4	18,434.4
<i>(In percent of GDP)</i>	21%	20%	19%	19%	20%	20%
Contingent liabilities	18,086	22,975				
Total as % of GDP	50%	55%				

5. Budget Policy Statement 2012

5.1 Statement of Responsibility

The following Budget Policy Statement is made with reference to and in accordance with sections 9 and 10 of the Public Finance and Economic Management (PFEM) Act number 6 of 1998.

Section 9 requires the Government to:

- specify its economic and financial policies, including those relating to key economic and fiscal variables; and
- State the discipline it will adhere to in its economic and financial dealings.

Section 10 requires the Government to:

- state its **long term objectives** for fiscal policy in terms of major economic and fiscal variables;
- specify the main **strategic priorities** guiding the preparation of the budget;
- indicate the Government's **targets** for fiscal and economic variables; and
- provide an assurance that the long term objectives outlined in the statement are:
 - a. consistent with the Principles of Responsible Fiscal Management laid down in section 22 of the PFEM Act; and
 - b. consistent with the previous year's Budget Policy Statement – that is, policies have remained consistent over time or, otherwise, justifications have been made for their departure.

Pursuant to section 10, the Government confirms that the fiscal policy objectives, strategic priorities and intentions are consistent with the Principles of Responsible Fiscal Management specified in section 22 of the PFEM Act of 1998 and that there is broad consistency with the

5.2 Economic and Financial Policies

The PFEM Act of 1998 specifies the principles of responsible fiscal management. These require that the Government pursues budget policies that:

- Ensure that the Government's borrowing is kept at manageable levels;
- Maintain public assets in good condition;
- Manage fiscal risks prudently;
- Maintain stable and predictable tax rates.

The Government's highest priority for Budget 2012 is to maintain Vanuatu's economic growth and the well-being of all Ni-Vanuatu, in a way that is financially sustainable and does not jeopardize future economic growth.

The Government will achieve this by sound management of public finances and by following fiscally responsible policies. Section 22 of the PFEM Act requires that the Government adheres to a set of defined principles of responsible fiscal management. These are set out in the box opposite.

Principles of Responsible Fiscal Management

1. Reducing and then managing, total State debt at prudent levels so as to provide a buffer against factors that may impact adversely on the level of total State debt in the future, by ensuring that, unless such levels have been achieved, the total overall expenditures of the State in each financial year are less than its total overall receipts in the same financial year;
2. Achieving and maintaining levels of State net worth that provide a buffer against factors that may impact adversely on the State's net worth in the future;
3. Managing prudently the fiscal risks facing the State; and
4. Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

5.3 Budget Policies

Government's Budget Policies come from the application of the "Principles of Responsible Fiscal Management" section 22 of the PFEM Act of 1998. The Budget Policies consist of:

1. Budget Priorities for 2012;
2. Economic and Fiscal Targets for 2012; and
3. Long Term Fiscal Objectives

(a) Budget Priorities for 2012

As a matter of careful consideration, the Government has selected for the four year duration, priority areas set forth in the Planning Long and Acting Short (PLAS) matrix. In 2012, the

Government will remain prudent in achieving its existing policies, which are set out as follows:

- better access to primary education and development of youth programmes and employment opportunities;
- enhance good governance via strengthening accountability, strengthening rule of law, reduce corruption and maintain transparency in public offices and institutions;
- ensuring equitable and sustainable development of land and natural resources;
- providing reliable and accessible infrastructure services;
- enhance an enabling environment to supporting the productive sectors;
- enabling a conducive business environment;
- offering quality health care;
- decentralisation and institutional strengthening;
- enhance democratic processes towards political stability; and
- Strengthening security and the rule of law

The Government will continue to implement policies that will improve the economy, with particular emphasis on issues constraining growth prospects. As part of this program, the Government will resort to continue to monitor and conduct reforms of State-Owned Enterprises and utilities where necessary. It is also paramount that the Government facilitates the smooth operation of the general election in 2012.

(b) Fiscal Policies

The Government's high priority for 2012 is to effectively manage its budget in a way that promotes economic growth and the distribution of that growth to all the communities of Vanuatu. The Government will continue to implement policies that encourage private sector led growth and will ensure that long-term growth for the State-Owned Enterprises remain productive.

(c) Economic Update in 2012

In its January 2011 World Economic Outlook (WEO), the IMF has revised its global economic growth forecast upward by a ¼ percentage point from its prediction made last October to 4½ per cent for 2011. It is expected that world growth are to be more pronounced in the emerging markets. Looking ahead, it is expected that world output growth is projected to grow by another 4½ per cent in 2012.

However, there are concerns surrounding global growth over the dramatic increase in the size and volatility of capital flows to emerging economies. Similarly, global inflation risks remain to the upside in 2011. This is due to robust demand and a sluggish supply response to tightening market conditions. On the other hand unemployment in advanced economies still remains high. The non-oil commodity prices are expected to increase in 2011 due to weather related conditions. This will in turn strain the budgets of low-income households and beginning to feed into overall price inflation of economies.

Real economic growth in the domestic economy is expected to pick up moderately to 3.0 per cent and 4.0 per cent in 2011 and 2012 respectively, driven by the services, industry and the agriculture sectors. However, given imbalances in global growth there are downside risks to the GDP forecast. With unemployment remaining high in advanced economies; combining with political turmoil in oil exporting countries, the misalignment of exchanges rates in developing countries and the economy been subject to natural disasters, poses further uncertainties about the recovery of the domestic economy.

The domestic Consumer Price Index (CPI) rose in 2010 by 2.8 per cent on average, to level at 135.8 with annual inflation rate reaching 3.4 per cent relative to 2009. The rise in price level was in response to external forces and improved economic conditions abroad driving Vanuatu's import prices higher. Accordingly, it is also a reflection of the monetization of the budget deficit in 2010. It is expected that the annual inflation growth may exceed the RBV's annual target of around 3.0-4.0 per cent in 2011 with pressures escalating from both the fiscal sector and abroad.

(d) Budget Management

The Government will commit to achieving a balanced budget in 2012, in line with the 2012 Budget policies and priorities. The principles of responsible fiscal management that are set out in section 22 of the PFEM Act will help and guide the Government to manage its revenue and expenditure at prudent levels to achieve a balanced budget in 2012.

(e) Government Debt and Borrowing

The Government will continue to make sure that public debt remains at a sustainable level in 2012 and beyond. This will provide a buffer to help absorb any future adverse shocks to the Government's fiscal position. The Government will ensure that all new external and domestic borrowing is limited to the financing of capital investment projects which will generate additional capacity and high financial returns to repay the debts bequeathed upon future generations.

(f) Revenue and Taxes

The Government's priority for revenue is to maximise collections through increasing coverage to the islands and strengthening the compliance and administration of existing taxes. This will be supported by improved compliance in regard to Import Duties, Excise, VAT and Business Licences legislation. The Government will continue to minimise

exemptions and continue to put great emphasis on the collection of taxation debts, using disciplinary measures against non-payers if necessary. The Government will continue to focus on improving efficiency and effectiveness of revenue collection through out the year.

(g) Expenditure Programme Policies

The Government's priorities for expenditure programmes are to continue to give sufficient funding for the provision of essential services and ensure that expenditure levels remain within the budgeted amounts. The Government will also be looking to make substantial savings where necessary, across all Ministries, Departments and Constitutional Bodies in 2012 relative to the previous budget year. Productivity maximization remains the core target of approved programs and activities, adding value to the use of already limited public funds. The findings of regulation 2.2 report have critically identified areas that require re-allocation, reduction, and realistic budgeting. Hence, the Government will be focusing on improving efficiency, eliminating unproductive expenditures and enforcing strict fiscal discipline as well as imposing punitive measures if necessary. These efforts should ensure that the public finances remain sustainable and are all part of the Government's aims to achieve a higher quality, greater efficiency and improved accountability of service.

5.4 New Policy Proposals

Each year the Government sets aside funds for New Policy Proposals that are consistent with the Government's policy priorities.

New Policy Proposals that fall within the policy areas identified at 3 (a) will only be considered for funding in 2012 if they are:

- able to be accommodated within the overall aggregate fiscal envelope;
- well researched and proper detailed proposals to reinforce the Government's key policies and programs;
- within the capacity of the Ministry to implement over the suggested time frame;
- able to expand and develop the economic capacity and growth rate of the country; and
- must be financially sustainable if it is to become a recurrent activity.

The 2012 budget will include donor funded New Policy Proposals that have been developed to implement government policy priorities such as access to primary education. This will ensure that donor funding is channelled through the Vanuatu Budget Management System (VBMS) and is in line with Government priority. Merging the two funding streams will result in efficiency gain. The integration of donor resources with Government recurrent resources will enable the Government to better manage the recurrent cost implications and hence improve the financial sustainability of capital investment in essential public services.

5.5 Economic and Fiscal Targets for 2012

In preparation for unforeseen shocks to the domestic economy, the Government will continue to pursue policies towards achieving a balanced budget in 2012. The economic growth rate for 2012 is forecasted to be 4.0 per cent in real terms, while the inflation rate is projected to be within the range of 3.0 to 4.0 per cent.

Budget Targets for 2012	Long term fiscal objectives
Budget balance Balanced Budget	Recurrent balance is positive over the medium-term
Revenue Recurrent revenue is forecast to be at least 19.0 per cent of GDP	There is a broad revenue base with sufficient revenue to meet the budget balance objective. Recurrent revenue to reach at least 22% of GDP.
Expenditure Recurrent expenditure is forecast to be 19.0 per cent of GDP	Expenditures are consistent with the budget balance objective
Debt Public debt remains at manageable level	Debt maintained at prudent levels so its share in GDP remains below 40.0 per cent
Economic Growth Growth forecast at 4.0 per cent	Annual economic growth rate averages at least more than population growth rate (2.3 per cent)
Inflation Inflation forecast at 3.0 – 4.0 per cent	Annual inflation rate remains below 4.0 per cent

5.6 Conclusion

Preparation for the Budget 2012 will be based on existing government policies and priorities. The budget will be prepared in line with the “Principles of Responsible Fiscal Management” and the long term fiscal objectives of the Government.

The Government will remain cautious in every decision making, regardless of 2012 being the year of election; it will focus on being critically accountable and fiscally responsible towards achieving a sound, manageable and balanced budget 2012.