

## Budget Policy Statement 2015

### 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 2014 budget policy.



Hon. Moana CARCASSES Katokai Kalosil (MP)  
Prime Minister – Premier Ministre  
A/Minister of Finance & Economic Management



Letlet August  
A/Director General  
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## 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 2015 is to boost Vanuatu's economic growth and improve 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. 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.

## 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 2015;
2. Economic and Fiscal Targets for 2015; and
3. Long Term Fiscal Objectives

### ***a) Budget Priorities for 2015***

Budget priorities has been develop following the national broad policy framework in the national planning documents (PAA and PLAS) and also acknowledged the 100 Days Priority List in 2013 issued by the Honourable Prime Minister. In 2015, the Government will put more emphasis in enhancing the productive sectors in order to grow the economy.

The core strategic policy priorities for 2015 are set out as follows:

- Increase allocation to fisheries, agriculture and forestry, livestock and quarantine in order to grow exports and boost revenue;
- Increase allocation to Industry sector, Cooperative & Ni Vanuatu Business, Department of Tourism and also TBT & SPS in order to boost relationship between Trade, Tourism, Investments and private sector participation that will in turn increase employment, and grow exports;
- Strengthen support to foreign policy to continue enhance dialogue abroad and attract more aid in to the Country;
- To continue allocate resources to government contributions on public projects, and establishment and empowerment of an Independent Vanuatu Maritime Sector Regulator including strengthening Ports and Harbour and increase support to civil aviation sector, for equitable, social and economic development;
- Increase allocation of resources by having lands properly registered in compliance and enforcement of land laws (fair land dealing processes) throughout Vanuatu;
- Increase allocation and access to quality youth services and programmes at all levels throughout Vanuatu with more focus to the 2017 Pacific Mini Games;
- Increase allocation of resources to improve national health services as well as to implement Vanuatu National Population Policy;
- Increase allocation to strengthen policy directive from the head of executive and ensure that appropriate measures are in place to maintain law and order (security);
- Maintain support to the development of the national human resource focused on maximising Vanuatu's economic growth. Improving quality of educational outcomes, more equitable access to education and skills development in all sectors

#### ***(b) Fiscal Policies***

The Government will continue to effectively manage its budget in 2015 in a way that is in line with the Public Finance and Economic Management Act. In addition, the Government will continue to implement sound policies that encourage private sector led growth throughout the communities of Vanuatu. These policies will also ensure that the State-Owned Enterprises remain productive over the long term.

#### ***(c) Economic Update in 2014***

##### **World Economic Outlook (WEO)**

Following several years of disappointing growth, recent estimates released by the International Monetary Fund (IMF) in April suggests that the global economy is slowly recovering. The recovery is heavily driven by major Advanced Economies (AEs) (G7); supported by the Emerging and Developing Economies (EDEs). Growth in major AEs is now projected to rise by 2.3 per cent in 2014 and 3.0 per cent in 2015 – with US and Germany being ahead of others. Meanwhile; growth in Emerging Market Economies (EMEs) is forecasted to grow by 5.0 per cent in 2014 and 5.4 per cent in 2015. The current growth trend experienced by AEs has been the result of timely intervention after the aftermath of the 2007/2008 Global Economic Crisis (GEC). Supported by timely repair of bank balance sheets and right policy mixed have assisted to restoring confidence in the banking system. This has boosted real external demand which is now forecasted to grow by 1 percentage point higher this year at 2.0 per cent compared to 1.0 per cent in 2013. As a result, there has been increased in volumes of trade across international

borders. International investments have registered strong growth in 2013 and expected to continue into 2014; led by growth in Emerging and Developing Asia (EDA) by 42.7 per cent; followed by Latin America (LA) with an estimated 21.1 per cent, assisted by growth in AEs by an average 20 per cent.

Indicators of financial markets have revealed that economic recovery is already underway with most country's output gap (measured in per cent of potential output) expected to close over the forecast period. Furthermore, the narrowing of the output gap is anticipated to generate inflationary pressures over the medium term with inflation rate forecasted to rise by 8.0 per cent in India, 3.0 per cent in China, 2.3 per cent in Australia and 2.2 per cent in the U.K. Meanwhile the average inflation rate for AEs is forecasted to grow by just over 2.0 per cent over the medium term. In anticipation, monetary policy will start to contract gradually to offset evolving inflation expectations. This development falls in line with the Federal Reserve Bank move to cut back on its planned quantitative easing (tapering). Furthermore, most central banks will revisit their main policy rates and hence, the value of their national currencies. This move could destabilise capital flows in search for higher yields especially in EMs.

As external demand strengthen in AEs coupled with improved supply conditions, prices of major commodities will start to decline allowing output to expand – putting pressures on both energy and natural gas prices to contract even further. Since fuel is an input into the production process, this means the final output prices will fall leaving households better off, thus allowing firm to start accumulating profit again, generating more employment. Nonetheless, development in the industry sector will remain subdued supported by mixed prices for most metals. This trend is expected to remain unaltered over the next few years signalling weak construction activity ahead.

### **Vanuatu Economic Outlook (VEO)**

The expected decline in global commodity prices will affect domestic agriculture production especially its commercial sector while domestic demand is expected to drive subsistence production. Local farmers will be forced to scale back production affecting total exports (of goods) and hence foreign exchange earnings. As a result, total agriculture production is expected to grow marginally slower in 2014 by 2.3 per cent, 2.5 per cent in 2015 before expanding by 3.8 per cent in 2017. The expected decline in production will be offset through a forecasted 6.3 per cent growth increased in the value of imports in 2014 thereby injecting pressure on the level of gross official reserves.

Supported by on-going structural reforms led by the Government, fiscal policy is expected to drive economic growth over the next few years. In anticipation, the Government is expected to acquire more fixed assets through concessional loans with an estimated value of VT950 million this year before reaching over VT4.0 billion by 2016; boosting VAT collection even higher. The expected implementation of government sponsored projects will inject more activity into the economy, particular benefits is expected felt in industrial production. Accordingly, construction activity is expected to increase allowing for employment opportunities for households and indeed boosted consumption.

Similarly, the upbeat in the services sector will continue over the medium term reinforced by the increased volumes of travellers and transport. Indeed, movement in international travellers depend entirely on demand conditions in neighbouring Australia and New Zealand; with the former accounting for most visitors coming to Vanuatu. Meanwhile, external demand conditions have direct impact on the relative prices of both domestic and foreign currencies, which induces predicted movement in visitors' arrivals.

Monetary policy, which has been very accommodative, will remain so in line with current economic fundamentals. Persistence liquidity in the banking system will continue to support economic activity domestically. However, as spending pressure begins to mount, there is anticipation that current accommodative monetary policies will begin to reverse to prevent inflationary pressures. In anticipation, the Reserve Bank of Vanuatu (RBV) could adjust its statutory reserve deposit (SRD) rate accordingly while continue with the conduct of its open market operations to ensure sufficient level of liquidity is maintain and so inflation expectations are effectively managed. Fundamentally, pressures on the RBV policy rate will start to emerge as central banks in major AEs adjust their main policy rate in line with development in real external demand. This is likely to lead to capital flow; affecting the stock of direct investment as investors search for the highest return paid on investments.

The implementations of several public projects will boost broad money, driven by foreign currency deposits. The rise in broad money is expected to support private sector credit raising deposits money banks' (DMB) net worth. On the other hand, growth in domestic assets will start to rise gradually coupled with expected favourable external financial conditions will raise commercial banks net foreign assets (NFA). Nonetheless, the expected contraction in commercial agriculture production will affect goods export; affecting the inflow of foreign exchange earnings. Indeed, the expected mass value of import of goods to offset the low capacity of production; coincide with the importation of construction related materials will strain the level of gross official reserves going forward.

In anticipation, the RBV will intervene appropriately in aligning the vatu currency vis-à-vis the currencies of trading partners. This process is expected to stabilise the Vatu/USD exchange rate so as the keep the nominal effective exchange rate (NEER) stable overtime. The intervention process will be expected so as to maintain an adequate level of reserves. Meanwhile the bilateral real exchange rates of the vatu against its major currencies of trading partners are forecasted to normalise overtime, with the exception of the USD appreciating slightly driven by economic conditions in the US economy.

Together, all economic policies will accelerate economic growth domestically by a projected 3.6 per cent this year; after an estimated growth paced of 2.2 per cent in 2013. Furthermore, economic growth is forecasted to expand by an average 5.3 per cent over the next two years before normalising at 3.6 per cent in 2017. The rapid growth over the next two years is forecasted to grow beyond its potential rate, thereby adding pressures on wages as firms compete for scarce resources. This in turn, expected to destabilise movement in general price level in the economy. However, since wage rate is sticky in Vanuatu, it would appear unlikely that expected inflationary pressures will stem from domestic demand conditions; rather sourced externally especially from the expected import of construction related materials.

#### ***(d) Budget Management***

The 2015 budget will be managed in a way that is consistent with the Public Finance and Economic Management Act. The Government will ensure that there is effective administration, compliance and enforcement of the existing tax to provide enough funding to meet Government expenditure programs and activities. In addition, the Government will continue to commit itself in managing state debt and implement revenue and expenditure measures to achieve a balanced budget in 2015.

#### ***(e) Government Debt and Borrowing***

The Government will continue to manage state debt at a prudent and sustainable level in 2015 and years thereafter. From 2015 onwards, new borrowing will be prioritise towards productive purpose such as capital investment projects that will enhance economic growth and generate future capacity to repay the

loans bestowed upon future generations. In addition, repayment of state debt will depend on the revenue raised and implementation of expenditure programmes.

#### ***(f) Revenue and Taxes***

The implementation of Government expenditure programmes and activities will depend on Government revenue collection and borrowing. Therefore, in 2015 the Government will continue to enhance revenue collection by strengthening the administration of compliance and enforcement of the existing taxes to boost revenue collection. In addition, the Government will look into implementing the outcomes of the revenue matrix initiatives identified during the 2013 Government retreat.

#### ***(g) Expenditure Programme Policies***

The Government will continue to make sure that there is available funding to meet its expenditure plans and activities. In 2015, the Government expenditure programmes will be managed in line with the PFEM Act. The requesting and accessing of funds will be linked to the 2015 strategic policies priorities that will improve the welfare of the people and at the same time improve economic growth.

In 2014, the Government has allocated some funding to meet the cost of severance payment. However, there are remained huge outstanding legal severance obligations within government agencies. The Government has developed a strategy on how to start addressing the issue of severance.

In addition, in 2015 the access and usage of funds will be managed in line with the budget targets. Fundamentally, the Government will continue to enforce strict fiscal discipline and effectively implement past COM decisions where necessary to control expenditure programmes in line with budget targets.

### ***4. New Policy Proposals***

The Government will continue to allocate recurrent funding for New Policy Proposals (NPP) that are consistent with the Government's strategic priorities identified in 3 (a).

The NPPs will be strictly considered for funding in 2015 if they are:

- able to be accommodated within the overall aggregate fiscal envelope;
- well researched and 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 2015 budget will include donor funded NPPs. Therefore, the Government will continue to emphasize the importance of using the Government Financial Systems to fund expenditure programmes that are in line with Government priorities.

### ***5. Economic and Fiscal Targets for 2015***

In line with the Public Finance and Economic Management Act, the Government will continue to pursue policies towards achieving a balanced budget in 2015. The economic growth rate for 2015 is forecasted to be 4.9 per cent in real terms, while the inflation rate is projected to be around 1.5 per cent.

<b>Budget Targets for 2015</b>	<b>Long term fiscal objectives</b>
<b>Budget balance</b> Balanced Budget	Recurrent balance is positive over the medium-term
<b>Revenue</b> Recurrent revenue is forecast to be at least 18.0 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 per cent of GDP.
<b>Expenditure</b> Recurrent expenditure is forecast to be 17.0 per cent of GDP	Expenditures are consistent with the budget balance objective
<b>Debt</b> Public debt remains at manageable level	Debt maintained at prudent levels so its share of GDP remains below 40.0 per cent
<b>Economic Growth</b> Growth forecast at 4.9 per cent	Annual economic growth rate averages at least more than population growth rate (2.3 per cent)
<b>Inflation</b> Inflation forecast at between 2.0 and 3.0per cent	Annual inflation rate remains between 0 and 4.0 per cent

## **6. Conclusion**

The “Principles of Responsible Fiscal Management” will guide the preparation of the 2015 National Budget and it will have more emphasis on allocating funding to the existing Government policies and priorities.

The PFEM Act (CAP 244) will guide the implementation of Budget 2015 and the Government will remain cautious in every decision making, to ensure that both revenue and expenditure target are met to achieve a surplus budget in 2015. Hence, the Government will continue to remain fiscally prudent and at the same time promote economic growth and raise its people’s per capita income.