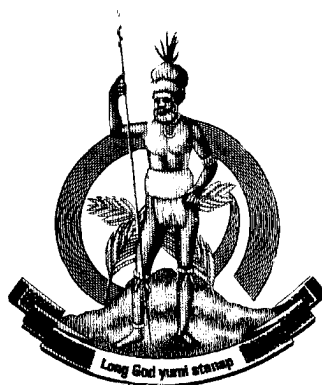


**GOVERNMENT
OF THE
REPUBLIC OF VANUATU**

BUDGET 2014

VOLUME 1 & 2



**Government
Of the
Republic of Vanuatu**

BUDGET 2014

VOLUME 1 / TOME 1

FISCAL STRATEGY REPORT

**INCORPORATING THE ECONOMIC AND FISCAL
UPDATE AND THE BUDGET POLICY STATEMENT**

Forward by the Minister



Budget 2014 is presented at a time when the global economy remains weak and the Vanuatu economy is only slowly beginning to recover. However, by committing to continue to undertake reforms, maintain sound fiscal management and create an environment conducive to economic activity; the Government will be able to support stronger economic growth and ensure that the benefits of stronger growth are felt by all of Vanuatu's communities through improved service delivery.

It is predicted that GDP growth will pick up from only 1.8 per cent in 2012 to 3.3 per cent in 2013, 5.1 per cent in 2014 and 5.9 per cent in 2015. Two key factors driving this forecast are the implementation of major donor-funded construction projects and continued strong increases in visitor arrivals. It is anticipated that these two factors will create positive, spillover benefits for a wide range of other sectors including retail and wholesale trade, real estate, finance and insurance and transport services. The Government will have a vital role to play in ensuring that these projects are implemented smoothly and tourists continue to visit Vanuatu. In turn this will create an environment that enables the production of high quality Ni-Vanuatu produced goods and services.

Budget 2014 has been designed to help the government achieve its national vision of "a Just, an Educated, Healthy and Wealthy Vanuatu". To these ends additional funding has been committed as obligations to predominantly donor funded construction projects, agricultural extension services and as support for the tourism sector in order to boost the economy. Furthermore, additional funding is being committed for health, education and justice to enable the provision of essential services to not just the urban centres but communities in the rural and remote areas. In addition, these funding commitments will be made through a balanced budget.

While demand for services and pressures on spending will continue to rise, it is essential that Ministries operate within their appropriated budget ceilings and manage their appropriated budgets in a way that ensures that their spending is made as efficiently and effectively as possible. In order to maintain overall fiscal and therefore macroeconomic stability, the Ministry of Finance and Economic Management (MFEM) will continue to take a hard line against supplementary appropriations and so it is critical that all agencies are prudent in ensuring that the Government meets the fiscal responsibility requirements as stipulated in the PFEM Act 1998.

As Minister responsible for Finance and Economic Management, I confirm that Budget 2014 is consistent with the 'Principles of Responsible Fiscal Management' as specified in the PFEM Act (1998). To Members of Parliament and citizens of Vanuatu, it is my honour to commend to you the Budget 2014.



Hon Maki Stanley Simelum (MP)
Minister of Finance and Economic Management

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1. Statement of Fiscal Responsibility

The following commentary and financial statements are presented in terms of Section 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 fiscal year.

This report presents updated fiscal and economic forecasts for the fiscal year 2013 and examines the economic updates and medium term prospects for the country up to 2016.

This Fiscal Strategy Report, required under Section 11 of the Act is consistent with the Budget Policy Statement that was released last year early this year as required by Section 10 of the Act. The policies contained within the Budget Policy Statement have been used to prepare Budget 2014. 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 early this year.



Hon. Maki Stanley Simelum (MP)
Minister of Finance and Economic Management
Ministry of Finance and Economic Management



Mr. George Maniuri
Director General
Ministry of Finance and Economic Management



2. Budget Overview

2.1. Budget Overview

The global economy has remained weak throughout this year leading to slow growth in the region. However, the Vanuatu economy is recovering but at the slower rate than originally anticipated. A recovery in tourist arrivals and the implementation of major donor projects are the key drivers of growth over the medium term.

The Budget 2014 is estimated to collect VT 15,252.7 million and spend VT 14,213.8 million. The major source of Government revenue is taxes and they will be diverted towards compensation of employees, use of goods and services, interests, subsidies, grants, social benefits, other expenses and acquisition of fixed capital assets.

The 2014 budget has allocated VT 731.1 million towards Government commitments; obligations and new policy proposals to strengthen and enhance service delivery within different sectors, including social sectors such as police, health and education. In addition, the productive sectors such as the Ministry of Commerce, Industry and Tourism as well as the Ministry of Agriculture, Livestock, Forestry, Fisheries and Bio-security are also provided with extra funding to strengthen and improve their service delivery, hence boost economic growth.

Furthermore, the 2014 budget has estimated to receive VT 1,827.8 million from donor partners. The main purpose of the project grants is to strengthened different sectors especially, social and productive sectors such as health, security, agriculture and trade.

The Government plans to draw down VT 506.4 million in loans in 2014 to assists in funding the Port Vila Lapetasi International Multi-Purpose Wharf Development Project, the Vanuatu Inter-Island Shipping Project and the Port Vila Urban Development Project. On top of that, these projects will receive VT 733.2 million in project grant funding from donors and VT 269.7 million in Government contributions in 2014. These projects are expected to be the main driver of strong future economic growth and further delays to their implementation will have adverse effects for the economy. However, once construction work begins these projects will have to be carefully sequenced and managed in order to maintain macro-economic stability.

The Budget 2014 is estimated to run a surplus budget which is in line with the principles of responsible fiscal management that are set out in section 22 of the PFEM Act (CAP 244). This means that the Government will continue to make sure that the public debt remains at a manageable level. In addition, the Government will continue to strengthen the administration, enforcement and compliance of the existing and future taxes to boost revenue collection. Whilst, the Government will continue to monitor and control the aggregate expenditure in line with the budget targets.

3. Economic Update and Medium Term Prospects

3.1. World Economic Outlook (WEO)

The global economy has been projected to be transforming toward a more stable growth path despite another soft landing is expected in 2013. The October WEO issued by the International Monetary Fund (IMF) estimated that global gross domestic product (GDP), which slowed in mid - 2012 is estimated to slow further in 2013, while a modest acceleration in quarterly GDP is still expected during the course of 2013. The strengthening of quarterly growth is expected to show up in the whole-year global GDP growth of 3.6 per cent for 2014 and 4.0 per cent in 2015 (Table 1). The projected weaker growth in 2013 is more pronounced in Emerging Asia and Developing Economies notably China and India. The transition in these two giant economies is expected to affect commodity exporters among the Emerging and Developing Economies. Furthermore, markets have become increasingly concerned about the challenges faced by high income countries to restore financial sector health, reform financial institutions and their weak commitment toward fiscal sustainability.

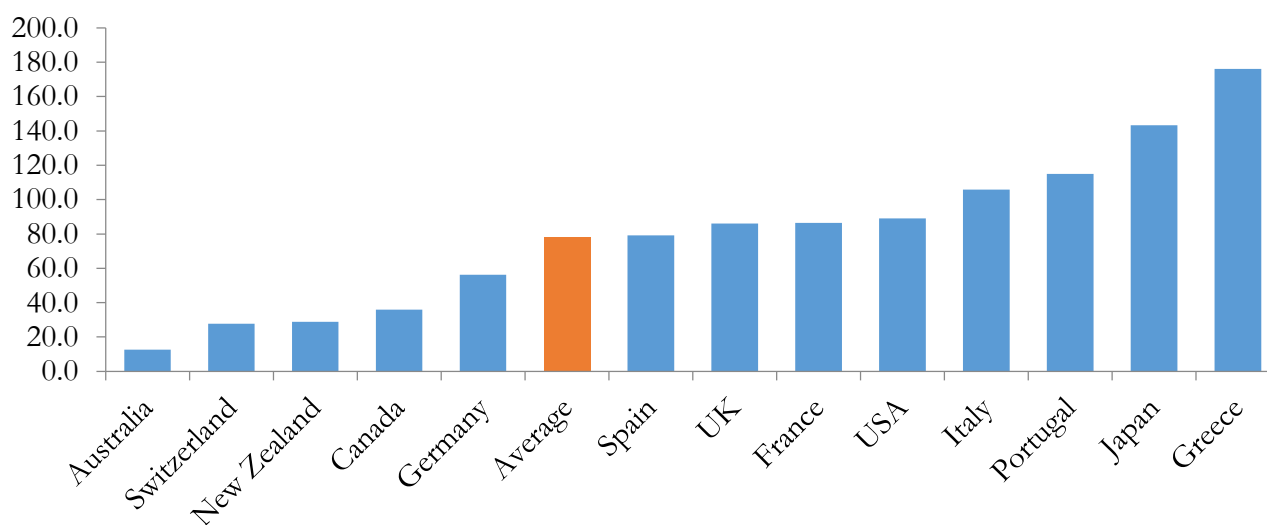
Table 1: World Economic Growth Trends (annual per cent change)

	Actual		Projections	
	2011	2012	2013	2014
World Output	3.9	3.2	2.9	3.6
Advanced Economies	1.7	1.5	1.2	2.0
United States of America	1.8	2.8	1.6	2.6
Euro Area	1.5	-0.6	-0.4	1.0
Japan	-0.6	2.0	2.0	1.2
Other Advanced Economies	3.2	1.9	2.3	3.1
Emerging Asia and Developing Economies	6.2	4.9	4.5	5.1
China	9.3	7.7	7.6	7.3
India	6.3	3.2	3.8	5.1

Source: IMF WEO, October 2013

Real-side economic activity remains sluggish, despite improvement in the management of old risks associated with a fragmented financial system in the Euro area combined with worrisomely high level of public debt in other advanced economies (Figure 1). In the United States, the recovery remains on track, despite being narrowly weakened by the recent 'US Shutdown'. Across to Japan, the recent easing of macroeconomic policy has sparked an uptick in economic activity with temporary impacts likely to be felt over the short run.

Figure 1: Advanced Economies: General Government Net Debt (in per cent of GDP)



Source: IMF Fiscal Monitor, October 2013

A somewhat firmer economic activity is expected in most Emerging and Developing Economies supported by less fluctuation in external demand, a resumption of capital flows, removal of capacity constraints in some middle income countries, and solid recovery in the high income countries are projected to generate gradual acceleration in Emerging and Developing Countries' growth from 4.5 per cent this year, to 5.1, and to 5.3 per cent in 2014 and 2015, respectively.

Overall, the acceleration is expected to be less strong than previously anticipated because most developing economies' growth rates have more or less reached their 2008 pre-crisis level or '*steady-state*'. Meanwhile many of these countries have little room for acceleration because their current and projected growth is already broadly in line with underlying growth potentials. Thus, GDP in the Developing Asia and the Pacific region is projected to expand by 6.3 per cent in 2013, followed by a broadly stable increase of 6.5 per cent in 2014 before reaching 6.6 per cent in 2015.

Even though debt related risks in high income countries are projected to be down, new risks are expected to emerge as these economies adjust. Nonetheless, current and projected risks are expected to be balanced supported by the possibility of stronger growth and a quicker turnaround in confidence than previously anticipated. For Pacific Island Countries (PICs) that have already recovered from the global economic crisis (GEC), or that are expected to in 2013, macroeconomic policy may need to be tightened to contain or prevent inflationary pressure, asset-price bubbles, and worsening current accounts. Such a tightening is expected to be varied from country to country. This would have the further advantage of restoring depleted policy buffers and reversing past negative trends. In countries where unemployment remains high and where there is spare capacity, a further loosening of policy would be warranted where policy space exists.

New risks have also emerged including a faster decline in commodity prices and the potential impacts of a withdrawal of quantitative easing (QE). Over the past years, commodity prices were high by historical standards (13.9 per cent) in response to disequilibrium over supply and demand. However, following recent developments in global industrial and agriculture production, the prices of energy and metals have been easing with metal prices contracting 1.5 per cent this year, (compared to its ten years average annual increase of 13.9 per cent) while energy prices are also down 1.5 per cent in 2013, (in relation to its ten years average annual growth of 17.7 per cent). If prices decline below their long term equilibrium more quickly than previously anticipated, GDP growth among metal exporter countries is likely to decline, with negative spillover effects to the current account and fiscal balances. Meanwhile, lower fuel prices would have similar impacts for fuel exporters but is likely to benefit fuel importing countries, including some PICs. Meanwhile some copra producing countries of PICs could suffer through lower prices of copra exports and declining coconut oil export prices.

The relaxation of global macroeconomic policy through QE was necessary and timely. These measures have benefited developing countries through stimulation of developed countries' per capita income, lowering borrowing costs and importantly mitigated an *almost* financial sector meltdown. On the one hand, the increased liquidity has generated little capital flows to developing countries, with World Bank (WB) estimating that net capital flows to developing countries recovered to 4.2 per cent of developing countries GDP, which is well below the 2007 level of 7.2 per cent of GDP. However, recent capital flows have been highly volatile. Based on past trends, the Japanese's recent QE is expected to generate large fluctuations in flows. This is expected not to be too disruptive for developing countries but in the short run it can be difficult to manage.

As soon as markets becoming increasingly convinced that high income countries pursuit of accommodative monetary policy is reaching its turning point, long term average market interest rates are expected to rally. In anticipation, debt servicing costs are likely to rise adding additional pressure on the fiscal balance, which could increase the default rates on existing loans. High profile financial institutions in countries that have continue to enjoy strong growth and inflation driven by rising asset prices, coupled with high levels of private and public debts are particularly prone to risks of debt distress. This is particularly important because over the long run, banks will react by raising the costs of capital investment in developing countries thereby reducing the expected level of investment firms wish to make. In response, these firms are expected to make adjustments in their portfolios to reflect the anticipated higher capital costs, developing countries investment spending and growth will be affected and to some extent, decline.

3.2. Vanuatu Economic Outlook (VEO)

Real economic growth (domestic production) is expected to rise averaging 5.3 per cent over the medium term following several past years of disappointing growth. While production is forecasted to be highly industrially intense with forecasted growth averaging 18.2 per cent; the service sector is projected to expand 5.1 per cent over the period 2013-16. Development in the agriculture sector is assumed to be externally driven based on external market conditions and development in global commodity prices; with the latter showing declining trend and the former revealing weaker than initially anticipated. The much anticipated extension in growth over future years will be highly services oriented, followed by industry then agriculture. Apparently, the sectorial contribution to total output reveals that the service sector is expected to stand out and dominate growth with 3.4 percentage points contribution to GDP; while industry ranks second with industrial production contribution of 1.4 per cent to GDP growth and then, agriculture contributing 0.4 percentage points to GDP growth. Industrial production contribution to GDP growth is sourced from an expected burst in construction activity accounting for 1.2 percentage points to GDP growth on its own.

Consumption expenditure will bounce back in 2013 and over the medium term. Growth in total consumption is forecasted to rise 5.1 per cent in 2013 before normalising at 1.5 per cent over the medium term. Segregating the components suggests a stable private consumption path going forward while public consumption is forecasted to decline in real terms. In anticipation of the implementation of publicly funded projects, public investment is forecasted to expand 85.7 per cent; while a gradual annual growth of 9.5 per cent is expected from the private sector. As a result, growth in gross fixed investment is expected to retard, rising less quickly by negative 3.8 per cent in 2013 before accelerating to 12.0 per cent in 2016. Evidently, it is the growth contribution of 2.3 percentage points from private demand that will generate the upward trend in total demand while public demand is forecasted to contribute a mere 0.4 percentage points. Nonetheless, it is the high leakage in the net export growth contribution to GDP of 1.1 percentage points over the projection period that will continue to slowdown growth in aggregate demand.

Table 2: Constant Prices GDP by Consumption (annual per cent change)

	Actual			Projections			
	2010	2011	2012	2013	2014	2015	2016
Total domestic demand	0.1	-3.6	-4.3	1.5	7.4	10.8	2.8
Consumption	3.0	2.2	0.4	3.3	5.1	6.1	-1.1
Public	4.3	-0.8	-1.3	10.2	-11.1	-4.1	-6.7
Private	2.6	3.0	0.7	1.5	9.6	8.0	-0.6
Non Profit Institutions Serving Households	3.7	5.5	8.3	3.7	3.7	21.4	21.4
Gross fixed investment	-4.6	-15.3	-15.9	-3.8	14.6	24.7	12.0
Public	-16.6	-40.1	-40.5	-63.7	205.7	180.1	20.8
Private	-2.2	-11.2	-5.8	0.8	9.2	12.5	10.3
Changes in stocks	-11.6	-7.9	-4.3	0.8	5.2	12.5	18.0
Net Exports	-11.1	-50.1	-47.3	-60.6	188.3	161.5	-49.5
Exports of goods and services	0.4	10.4	9.7	7.5	6.1	5.5	4.4
Imports of goods and services	-2.2	-1.9	3.7	3.9	9.8	13.7	-2.1
Gross domestic product	1.6	1.2	1.8	3.3	5.1	5.9	6.8

Sources: National Statistics Office & Macroeconomic committee estimates and projections

3.3. Aggregate Supply

3.3.1. Agriculture, Forestry and Fishing

Production in the agriculture sector expanded 2.2 per cent in 2012 amid declines in global prices of exported copra, coconut oil and kava as a result of improved supply conditions and weak external demand. Following projected declines in the global prices of agricultural raw materials and commodities, agriculture production this year is estimated at 1.3 per cent before rising to 1.7 per cent in 2014 and to 2.5 per cent in 2015 respectively. The

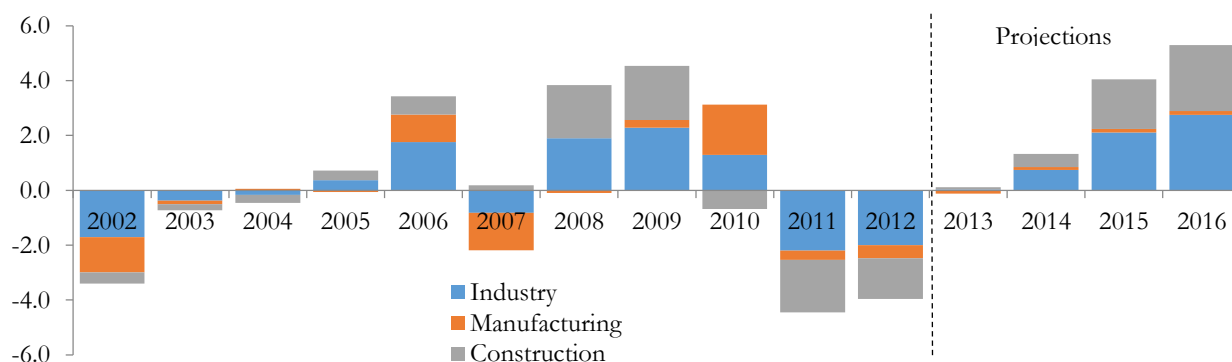
medium term projection is forecasted to be driven by domestic demand, particularly animal production and logging, in anticipation of an expected boom in public construction and the operation of the new Santo Meat Abattoir. As a result, animal production is estimated to contribute 0.2 percentage points to GDP growth; after which growth contribution will stabilise at 0.3 percentage points over the medium term. Meanwhile, the overall agriculture growth contribution to GDP for this year is now estimated at 0.3 percentage points following spillover effects of developments in global commodity prices. Production is expected to stabilise over the medium term accounting roughly 19.2 per cent of GDP as domestic demand strengthen; supported by growing population size.

3.3.2. Industry

Industrial output contracted 22.1 per cent annualised paced in 2012 with construction declining 44.3 per cent following continuous delay in the implementation of new publicly funded investment projects. Growth in other subsectors of industry is mixed in 2012 with mining and quarrying rising 46.2 per cent on the one hand, and manufacturing abating 13.8 per cent following weaker than previously anticipated crushing of coconut oil last year. Growth is estimated to bounce back this year at 4.0 per cent following developments in the construction sector. Likewise, industrial production is forecasted to be buoyant and impressive expanding at an annual average rate of 24.2 per cent over the medium term following implementation of publicly funded investments. Among the subsectors of industry, construction is estimated to contribute 0.1 percentage points to GDP in 2013 albeit three years of consecutive negative growth contribution. Partial data for import construction related materials suggests that the pace of contraction might be reversing over the first half of 2013 and a recovery is likely to be realised in 2014 and 2015.

Similarly, the growth contribution of construction output to GDP over the medium term – proxied by imported construction materials is forecasted to average 1.6 percentage points per year compared to last three years average growth contribution of -1.4 percentage points. The acceleration in industrial output is expected to result in spillover effects to other sectors of the economy with manufacturing and water and electricity; each is forecasted to contribute an average 0.1 percentage points growth to GDP over the medium term. This is expected because when construction commences, there are high possibilities that constructors will purchase domestically manufactured inputs; putting an upward pressure on the manufacturing sector. Similarly, once construction regains momentum and as happened in the period 2007-09, demand for fuel as an input in the production process will rise. The expected rise will be 3.1 per cent in annualised rate this year; while more expansion in excess of 6.0 per cent annualised rate is expected over the medium term. Noteworthy is the fact that despite expected stabilisation in 2013, anecdotal evidence suggests that general local business sentiments remain at low level implying that business confidence remains highly fragile. However, the possibility of stronger growth than the baseline suggests is another possibility following recent indicators of construction output.

Figure 2: Industrial Production Growth Contribution by Industry (in Percentage Points)



Sources: National Statistics Office & Macroeconomic committee estimates and projections

3.3.3. Services

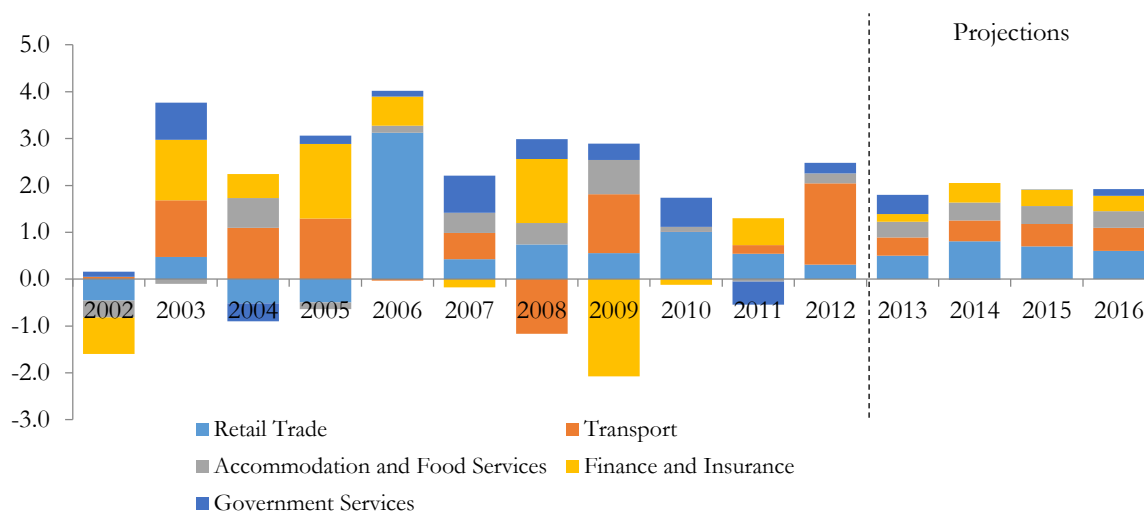
Production in the service sector expanded 2.8 per cent in 2012. This is supported by a big increase in tourist arrivals in 2012 over 2011 by 35.3 per cent; driven by increases in day arrivals growing by 48.2 per cent while air arrivals increased by 15.1 per cent. These increases are plausible with spillover effects seen over the domestic transport sector growing by 28.9 per cent in 2012. Similarly, the retail and other wholesale trade sectors responded positively to this increase in visitor arrivals with each growing by 28.0 per cent and 2.6 per cent over the year. Furthermore, accommodation and food services –a good proxy of tourism activity, particularly air arrivals captivated developments in the tourism sector with 4.4 per cent growth in 2012. Recovery in the property market is currently underway with 9.1 per cent annual growth recorded in the real estate sector in 2012; assisted by growing confidence in neighbouring Australia and New Zealand property markets.

Growth in both the finance and insurance sector and professional, scientific and technical and administrative services in the post period 2008-10 have been unimpressive domestically. After bouncing back following the immediate completion of the MCC road projects in 2011, production of finance and insurance related services combined with the demand for hiring domestic contractors with technical expertise, dipped again in 2012. The on-going global uncertainty in advanced economies financial system's and prolonged delays to implement much needed reforms in high income economies combined in some cases, with policy induced slowdowns in some of the larger developing countries and or capacity constraints in other developing countries have restrained the pace of activity in these sectors.

Among other industries in the service sector, growth in the value of government services also accelerated – reaching 2.0 per cent; up 6.0 percentage points annually in 2012, mostly on election related costs, hosting of the EU-ACP conference, pay out related to change in government administration and slight increase in payroll jobs have supported the acceleration in activity. Overall, growth in the services sector is projected to rise 4.1 per cent in 2013; which is 0.3 percentage points weaker than in 2011.

Production in the services sector is expected to remain strong over the medium term supported by strong inflows from international travellers. The direct impact of tourism arrivals is expected to hit the accommodation and food services sector, transport, retail trade and other whole sale trade; with each forecasted to expand 7.0, 6.1, 5.8 and 7.1 per cent, respectively over 2004-16. With the much anticipated implementation of publicly funded projects, the costs of private insurance is likely to rise for importers necessitating the likely 5.4 per cent rise in finance and insurance costs over the medium term. Similarly, the need to acquire professional and scientific contractors with technical expertise will rise 12.0 over the medium term in response to the expected scaling up of publicly funded projects. This is expected to contribute over 0.3 percentage points to total GDP growth over the years 2014-16 while the retail trade, transport and accommodation and food services are expected to contribute a minimum of 0.7, 0.5, 0.4 percentage points to GDP growth. Meanwhile, the finance and insurance sub-sector together with the information and communication services; the latter reflecting the launching of the submarine cable project in 2014 together are expected to contribute 0.8 percentage points to GDP growth over the medium term – making up roughly 12.0 per cent of total GDP. The biggest service sub-sector with the highest share of GDP is forecasted to be retail trade with an average share of 12.2 per cent; followed by government services having a forecasted share of 10.4 per cent, then real estate with a mean share of 8.1 per cent of GDP over the medium term.

Figure 3: Real Growth Contributions by Service sub-sectors (in Percentage Points)



Sources: National Statistics Office & Macroeconomic committee estimates and projections

Overall, total production rebounded 1.8 per cent in 2012 after growing low in 2011 at 1.2 per cent. Growth was driven by activity in the services sector contributing 2.8 percentage points to GDP, although partly offset through leakages in the industry sector of 2.0 percentage points while the agriculture sector contributed 0.5 percentage points to GDP growth. Over the course of 2013, it is estimated that services will contribute 2.7 percentage points to GDP growth and remain the main provider to economic growth over the medium term. On the other hand, the industry sector is expected to regain momentum over the period 2013-16 with growth contribution to GDP forecasted at 1.4 percentage points followed by growth in the agriculture sector with an average 0.4 percentage points. An increase in services production is expected to maintain its position as the largest component of real GDP by industry at 66.2 per cent; followed by agriculture covering up a 19.6 per cent share of GDP and then industry with an 8.3 per cent share of total GDP in the medium term.

Over the medium term, tourism is likely going to be one of the major determinants of growth because the IMF projection for real GDP growth in Australia point to sustained strong growth, with growth averaging 2.8 per cent over 2013-16, close to the strong growth performance during the boom period 2004-08. Empirical estimates of a tourist demand equation for Vanuatu point to a long-run elasticity of about 3, which would imply annual visitor arrival growth of approximately 9.0 per cent. However, this is expected to be partially offset by a loss in price competitiveness, which would peg the medium-term visitor arrival growth rate at around 6.0 per cent per annum.

Table 3: Total Real Production by Sectors (annual Per cent Change)

	Actual			Projections			
	2010	2011	2012	2013	2014	2015	2016
Agriculture, fishing & forestry	4.8	6.1	2.2	1.3	1.7	2.5	3.0
Animal production	11.3	7.0	14.4	8.0	8.8	9.0	9.2
Fishing	3.6	3.7	3.6	3.5	4.3	4.5	4.7
Industry	12.6	-19.4	-22.1	0.5	11.1	29.8	31.6
Manufacturing	86.5	-8.6	-13.8	-4.0	3.9	4.7	5.2
Construction	-11.2	-36.3	-44.3	4.0	25.9	82.1	63.7
Services	3.0	3.2	4.4	4.1	5.4	5.4	5.4
Retail trade	9.6	4.7	2.6	4.2	6.7	5.7	4.9
Transport	0.1	3.1	28.9	5.1	5.8	6.2	6.3
Accommodation and food services	1.8	-1.0	4.4	6.7	7.2	7.2	6.6
Finance and insurance	-1.9	9.1	-0.1	2.5	6.2	5.1	4.9
Government services	5.3	-4.1	2.0	3.5	-0.1	0.1	1.4
Gross domestic product (Constant prices)	1.6	1.2	1.8	3.3	5.1	5.9	6.8
Gross domestic product (Current prices)	4.3	4.4	2.0	5.0	7.7	8.7	10.4
Gross domestic product (Deflator)	2.6	3.1	0.2	1.7	2.4	2.6	3.5

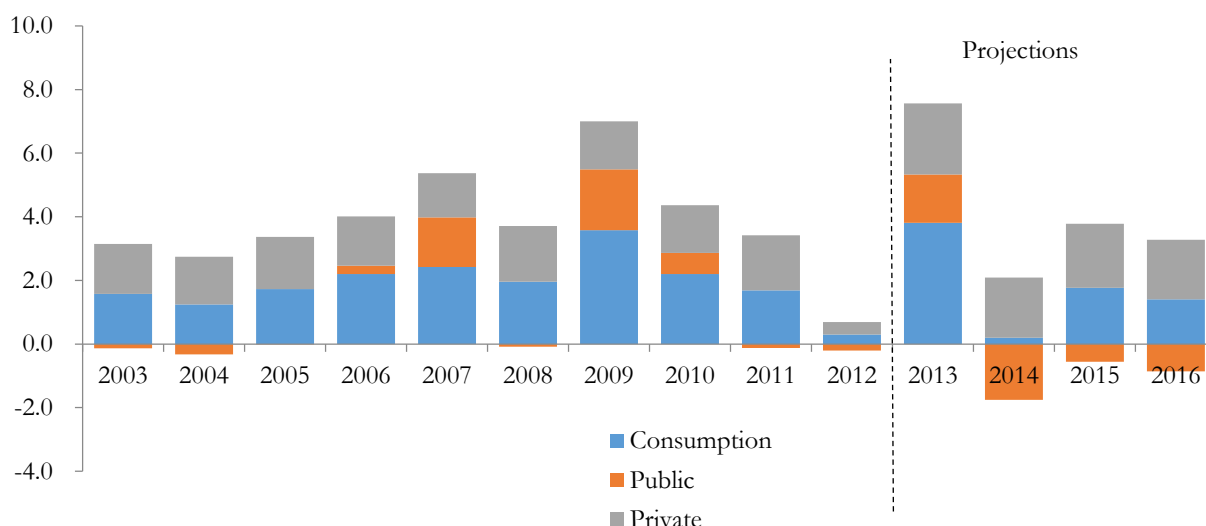
Sources: National Statistics Office & Macroeconomic committee estimates and projections

3.4. Aggregate Demand

3.4.1. Total Consumption

The value of real public consumption contracted 1.3 per cent in 2012 despite an increase in the costs of personal emoluments attributed to large pay-outs when the terms of the last government ended and the removing of a freeze on recruitment. The decline reflected the current fiscal policy stance and was the second consecutive decline in real public consumption. Meanwhile, it is now estimated that real public consumption rebounded 10.2 per cent in 2013 following the implementation of several public investments which have administrative components. The projected rise in public consumption will constitute 15.9 per cent of GDP in 2013 and is expected to boost overall GDP growth by 1.5 percentage points. Over the medium term, the contribution of public consumption growth to overall real GDP is forecasted to normalise. In contrast, growth in real private consumption expanded 0.5 percentage points higher in 2012 compared to 2011 and is estimated to grow 1.5 per cent in 2013 – which is proxy by strong growth seen in the retail trade, accommodation and food services, transport and other wholesale trade sectors. The sluggish growth in 2012 is not in isolation; because growth in real private sector credit slows over 2012 by 5.9 per cent; in line with the annual contraction in finance and insurance sector output. Growth in real private consumption over the medium term is forecasted to normalise at 5.5 per cent; constituting 59.1 per cent of GDP; boosting consumer demand and growth contribution to GDP by 3.2 percentage points.

Figure 4 Real Consumption Growth Contributions to GDP (in Percentage Points)



Sources: National Statistics Office & Macroeconomic committee estimates and projections

3.4.2. Total Investment

Public investment is estimated to be one of several key determinants of medium term growth. Accordingly, public investment is expected to regain momentum in line with the commencement of several public investment projects jointly financed by the Asian Development Bank (ADB) with AusAID and NZAID and other development agencies such as Japan International Corporation Agency (JICA) and China with other projects to be financed through grants. Growth in 2012 was disappointing, hitting the lowest record in history at minus 40.5 per cent owing to on-going delay in the implementation of expected new public projects. Public investment is projected to grow at a slow pace in 2013 before accelerating in 2014 and onwards. From the viewpoint of measuring the impact of these big projects on aggregate demand and growth, the change in public investment matters: public investment is expected to stabilise aggregate demand and growth in 2013, followed by a sizeable boost to aggregate demand and growth in 2014-16 when most public constructions are expected to commence.

However, focusing only on the change in public investment will overstate the expected growth contribution of these projects because a substantial part of spending will be leaked out of the economy in the form of imports. Hence, the large forecasted negative share of imports in 2013-16 of roughly 60.6 per cent of GDP is partly attributable to the expected commencement of these projects. In effect, the leakage in growth is best reflected with a negative growth contribution to GDP of 3.7 percentage points over this period. Overall, the total growth

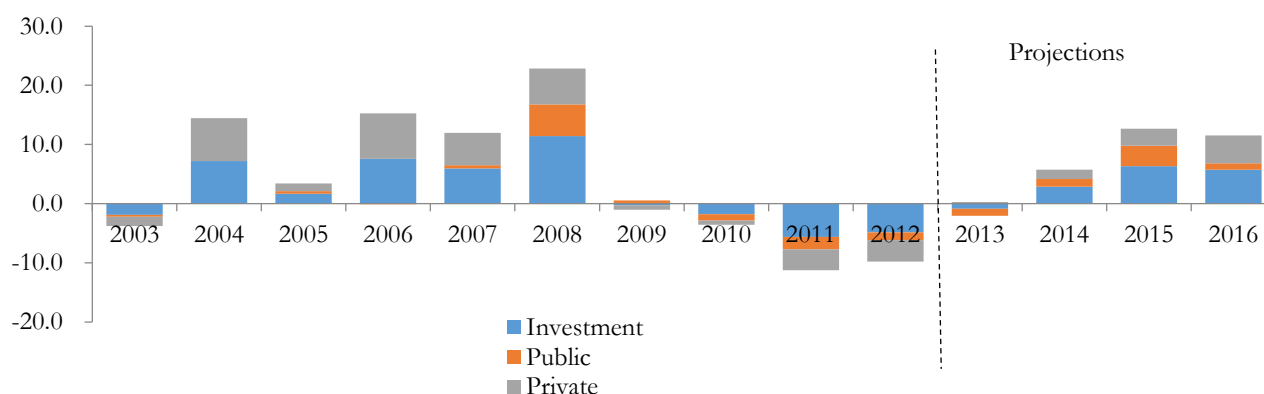
contribution of these publicly funded projects although huge, will be partially offset by large outflows through imports volume of construction related materials.

Private investment contracted by 5.8 per cent in 2012. 2012 marked the fourth consecutive years of contraction in real private sector investments manifested by the impact of current financial turmoil in high income countries, high level of uncertainty surrounding policy actions in the domestic economy and the tight credit conditions currently set in place by financial institutions have restricted the scope and pace of private sector activity. Nonetheless, in anticipation of rising activity in the industry and services sectors, private investment is estimated to resume activity in 2013 growing by 0.8 per cent. This is consistent with developments in the retail trade, tourist arrivals, transport and accommodation and food services and real estate; with all expecting maintenance of current growth trends. Specifically, such an anticipated recovery will be driven by strong domestic demand that in turn is attributed to strong growth in private investment.

On the supply side, the expected increase in investment will drive the expansion of the construction sector going forward. One of the expected key factors will be activity in the real estate, which is also visible in real GDP growth contributions of the finance and insurance sector that represents two types of services that are often required in the purchase of real estate. The likely contribution of finance and insurance is estimated at 0.2 per cent for 2013 and a further 0.4 per cent growth contribution is forecasted for the medium term. It is highly probable that the recovery in the real estate sector is expected from external inflows from neighbouring Australia, New Zealand, New Caledonia and also Asian investors. These investors are likely to invest part of their gains in Vanuatu following similar trends in the past and the expectation that Vanuatu will have favourable investment climate. That said, the expected boom in tourism, retail and wholesale trade, finance and insurance and growth in real estate investments probably have the same source, all are expected to be driven significantly by these investors' economic fortunes.

An internally generated forecast for Vanuatu's international investment position (IIP) supports this hypothesis because it forecast that foreigners are likely to built-up substantial holdings in Vanuatu in 2013 and over the medium term, which is recorded as liabilities in Vanuatu's IIP. Looking at the growth rates, it seems that expected external inflows would be a major driver for real private investment growth rising by an estimated 5.7 per cent this year and a further 7.2 per cent on average over the medium term. Of course, the expected build-up of holdings by foreigners in Vanuatu reflected not only real estate related inflows but also expected foreign direct investment (FDI) more generally. The above mentioned tourism activity was probably one major driver of FDI inflows. Another was the likely boom in information and telecommunication services, in the lead-up to the expected launching of the submarine cable operation in 2014. With this new investment expected launching, its impact is expected to be felt across the entire information and telecommunication sector; expecting a boost in communication related products accounting roughly 0.4 percentage points to real GDP growth. Going forward the FDI is forecasted to hold up relatively well, probably reflecting the expected strength of the tourism industry in Vanuatu, while other investment liabilities in the IIP are expected to remain soft. Meanwhile the expected net effect will be a stabilization of IIP liabilities measured in US dollars in 2012 with forecasted return to growth starting in 2013.

Figure 5 Real Investment Growth Contributions to GDP (in Percentage Points)



Sources: National Statistics Office & Macroeconomic committee estimates and projections

3.4.3. Net Export

Performance in net export is less impressive contracting though, at a slower pace by 47.3 per cent pace in 2012. This is highly expected with Vanuatu been a small open economy and rely heavily on imported goods and services to offset rising demand; which undoubtedly unmatched by domestic production. The slight improvement reflected strong performance in the export of services which more than outweighs the rise in import of goods by 2.8 percentage points in 2012. The increase in visitor arrivals in the tourism industry has been the main source of foreign earnings. Meanwhile the recovery in the level of imports of goods in 2012, constituting 57.5 per cent of GDP compared to only 56.4 per cent in 2011; implies that a recovery in domestic demand is already underway – which makes more sense to think about that recovery in the construction and consumption activity have resumed.

Over the medium term the value of the balance in trade of goods and services is projected to improve due to the services surplus steadily increasing whereas the trade deficit in goods will remain relatively constant. With tourism activity expected to be the main driver of service exports, the trade balance of goods and services is forecasted to remain relatively constant growing by an average 22.9 per cent while net services growing by 9.2 per cent over the period 2013-16. Furthermore, this result can be traced to the steadily rising level of the export of tourism-related services during the projection period, which is broadly consistent with the historic trajectory. Considering the projected path of the services surplus in per cent of GDP, the fact that this ratio rises follows from the notion that tourism growth will be one of the key drivers of growth over the forecast period.

Following the expected increase in publicly funded projects, the import contains of construction materials is expected to add downward pressure on aggregate demand over the medium term. This is highly expected with forecasted growth of import values averaging 5.8 per cent over the medium term while that of service related outflows sits at 5.5 per cent. In effect, the composition of import of goods and services will grow steadily at an annual rate of 6.3 per cent between now and 2016. Reflecting this, the growth contribution to GDP, which is nothing more than *leakage* in aggregate demand, stand at 2.2 percentage points in 2013 with a further 4.2 percentage points expected over the above period. Generally, the forecast for services growth which would drive export of services assumes that the strong growth performance over the past ten years can be maintained, which—while potentially overly optimistic—follows from the assumption that tourist exports are likely to hold up relatively well compared to goods exports. Overall, the partial indicators suggests that the growth contribution of net export to GDP is estimated at 1.8 percentage points in 2013; with more outflows expected over the medium term averaging at 1.1 percentage points reducing total aggregate demand in the economy.

Figure 6 Real Net Export Components of Growth Contribution to GDP (in Percentage Points)



Sources: National Statistics Office & Macroeconomic committee estimates and projections

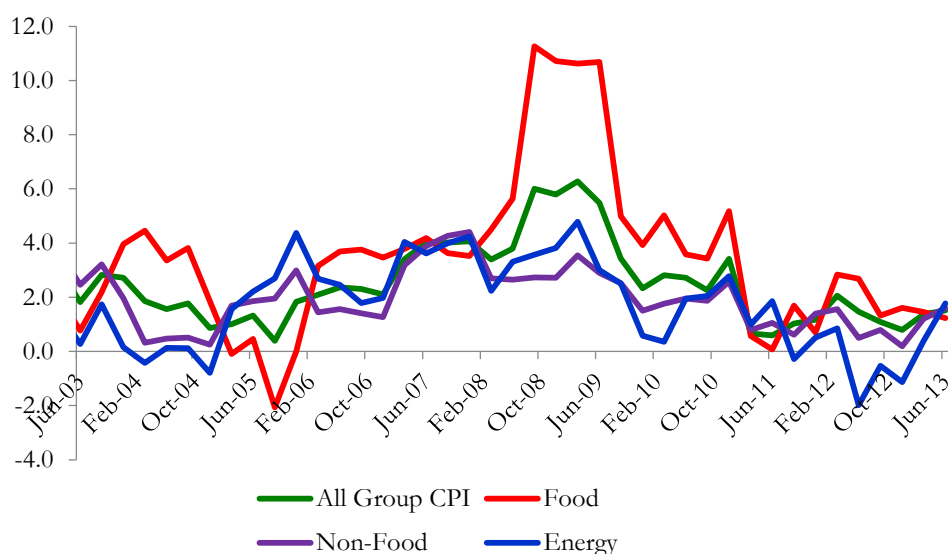
3.5. Inflation

Inflationary pressures have emerged over the year with inflation growing by 0.2 per cent in the June Quarter 2013. The increase was associated with increases in the overall price of clothing and footwear expanding 2.6 per cent while some gradual increases are also recorded elsewhere. Over the year to June 2013, the Consumer Price Index (CPI) rose by 1.5 per cent. The increase is driven by increased prices for housing and utilities (mainly high

rent prices), food, education, clothing and footwear, household supplies, recreation and communication. The rise in price of major food items specifically reflects rising domestic demand conditions.

Overall, growth in the CPI is expected to be driven by fuel and non-food inflation (Figure 7). This is in line with developments in the industry sector which is mostly construction activity. While growth in the construction sector is forecasted to rise over the medium term following expected implementation of public investments, there are possibilities that non-food inflation will be sourced from imported construction materials – *imported inflation*. Although growth in the fuel price is expected to moderate according to the IMF October WEO, there are indications that consumption of fuel could rise which may put upward pressure on the overall price domestically. Since the market for fuel supply is very thin coupled with fuel being a major input into the production process, any increase in demand can only be matched by an equal increase in price. Despite these expected developments, the projected inflation rate for the year-ended 2013 is projected to grow by roughly 2.0 per cent which is well within the RBV's annual inflation target range of 0-4 per cent.

Figure 7: Consumer Price Index (CPI) (annual per cent change)



Sources: National Statistics Office

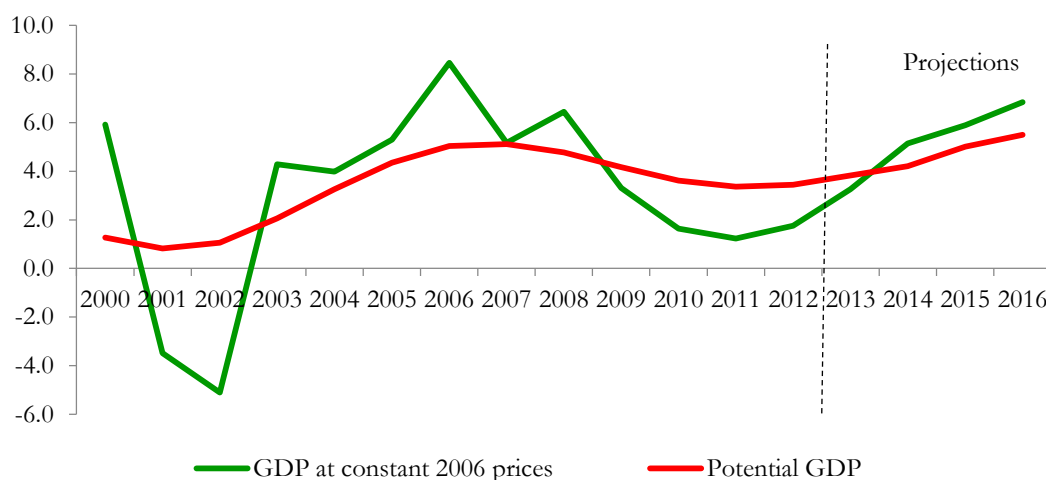
3.6. Real GDP and Potential Growth

Growth performance in the last four years was weak, with actual real GDP growth falling well short of potential growth rates. More specifically, the sharp drop in real GDP growth rates beginning in 2009 follows a strong and long boom during 2004-08. Booming growth in 2004-08 pushed output well above its potential level, in other words, demand conditions were very strong, with the output gap peaking at about 3.0 per cent of potential GDP in 2008. The sharp drop in growth in 2009-12 closed the output gap and by 2012 output has fallen below potential, indicating deficient demand, with the negative output gap amounting to approximately 1.7-3.3 per cent of potential GDP. The output gap is expected to close, i.e., demand conditions should normalize over 2013-14 at 3.3 per cent growth; which should provide another medium-term anchor for the forecasts. Over the medium term, growth is forecasted to expand rapidly growing by 5.1 per cent in 2014 before exploding 6.8 per cent in 2016.

The forecasted rapid pace of growth and already tight capacity constraint over the medium term, implying the risks of the economy being overheated is higher. These risks include high or rising inflation or both, growing current account deficits (as domestic supply is unable to meet rapidly rising demand); and higher asset prices. Against these backdrops, a tightening of either or both fiscal and monetary policy might be in order. Accordingly, this would suggest the underlying potential output growth will be slower than pre-2012 growth rates might have suggested. Indeed, an internally generated output gap estimate of potential output (Figure 8) indicates real output growth would translate to roughly 2.0 per cent in excess of potential growth. Over this period, the current output gaps will be positive, implying that any efforts to increase growth through monetary

and fiscal stimulus will risk being ineffective and might add to debt or inflationary pressures without any sustained progress in increasing output or reducing unemployment.

Figure 8: Actual and Potential Real GDP Growth (in Per cent)



Sources: Department of Finance and Treasury estimates and projections

3.7. Monetary Policy Update

Banking sector activities during the first six months of 2013 continued to slow relative to the same period of 2012, as mirrored in the downward trend in Money Supply (M2) growth over the same period. At the end of August 2013, money supply contracted by a slight 0.2 per cent from the level recorded in August 2012 due to the combined effects of a declining growth in net foreign assets (NFA) and a slowdown in domestic credit. Reserve Money (M0) in contrary continued to expand throughout the first six months of 2013 due to the accumulation of excess reserves of commercial banks. This trend implies that the Reserve Bank continues to maintain an accommodative monetary stance since March 2013 when it reduces its rediscount rate from 6.0 per cent to 5.5 per cent. In August 2013, M2 however contracted by 2.2 per cent from August 2012 however the excess liquidity continued to remain high above its minimum target

The continuous decline in net foreign assets (NFA) of commercial banks, since 2011, were due to issues surrounding the Australian Tax Office operations (ATO), the government's secrecy provisions and low interest rates in Australia. The trend in the NFA of the Reserve Bank depends on the offsetting effects of foreign exchange inflows and outflows vis-à-vis the bank. During the first half of this year the bank has witnessed net inflows of foreign exchange though the pace of growth was slower than in previous years.

Due to current slowdown in economic activities, growth in domestic credit slowed during the first six months of 2013. Over the year to August 2013, domestic credit expanded by 3.9 per cent as compared to 11.0 per cent recorded over the year to August 2012. The downtrend in domestic credit was particularly attributable to the current slowdown in private sector credit. Growth in private sector credit has witnessed a slower pace than normal since 2008. The slowdown in private sector credit during the first half of 2013 continues to reflect weak domestic demand. At the end of August 2013 year-on-year private sector credit growth slowed to 4.1 per cent, the lowest level of growth seen since May 2007. The Government's net credit position with the banking system depends largely on the movement in its budget position. Within the first six months of 2013 the government's net credit position deteriorated relative to last year's position implying that the Government has been drawing down its deposits within the banking system to finance the increasing demand for social services and other operational related expenses, however at the end of August 2013 the Government's net credit position with the banking system improved during the month and over the year respectively, due to the proceeds collected from the issuance of government bonds. Credit to non-financial public enterprises and municipalities over the first six months of 2013 have weakened relative to the previous year's level.

3.8. Balance of Payments

Vanuatu's economic activity continued to be supported by tourism services, and foreign direct investment in the first mid- 2013, even though lower than the level of the second mid-2012. A few public projects on the ground had also contributed significantly despite rescheduling to later periods. The Current account was further reduced reflected by a 6 per cent growth in Tourism earnings which supersede a 9 per cent expansion in Imports of goods. Even though Foreign Direct Investment slowed in 2012, the first half of 2013 had slightly signalled momentum, while official grants remained healthy with the continuous support of donor partners funding. Official reserves were kept at adequate levels, financing 6.7 months of imports at end June, 2013 from 7.4 months in December 2012, way above the Bank's threshold level of 4 months of import cover.

The medium term outlook is healthy. Vanuatu's economy is projected to grow by 3.3 per cent in 2013 in line with the improvement in services sector and the expected increase in construction activity. Accordingly, imports are forecast to increase due to the expected increased demand for construction materials. In spite of the increase, reserves are expected to remain sufficient to finance private import bills, forecasted to subsist at 6.7 months at end December 2013. Tourism earnings are forecast to remain healthy over the year with the expected increase in visitor arrivals. Official grants are forecast to increase reflecting the expected increase in donor funded projects. Consequently, capital financing are forecast to be able to finance increases in the current account payments (deficit) over the year.

Table 4: Balance of Payments (Millions of Vatu)

	Forecast			
	Dec-11	Dec-12	Dec-13	Dec-14
Stock of FX (less IMF Positions)	15,767	16,149	15,964	16,200
Import Covers	7.9	6.7	6.7	6.5
Import Covers (Goods and Services)	4.6	3.3	6.5	3.1
Current Account Deficit (% of GDP)	1.7	5.5	5.8	7.0
Imports of goods (% of GDP)	40.3	39.8	42.8	43.8
Tourism Earnings (% of GDP)	44.2	50.6	52.6	54.8

Source: Reserve Bank of Vanuatu

3.9. Exchange Rate Developments

Over the first half of 2013, the Vatu appreciated against the US Dollar (USD) and the Euro (EUR) but depreciated against the Australian (AUS) and New Zealand (NZ) dollars.

In October, recent developments such as the relatively rapid policy interest rate cuts by the Reserve Bank of Australia do not appear to have fed into a weakening of the Australia Dollar. Compared to the USD, the political tension in Washington has caused the Federal Reserve to pump more dollar into the US financial system hence the value of the US dollar becomes weaker.

The Vatu has moved against the Euro and NZD since March 2009. Over the first half of 2013 the Vatu appreciated significantly against the Euro. Lately, the NZD has jumped to its highest after weaker than expected job growth in the US which reinforced the likelihood that the Fed will keep monetary stimulus for longer, devaluing the greenback. The Euro has somewhat strengthen in recent weeks, partly reflecting a stabilisation in the region's economic outlook.

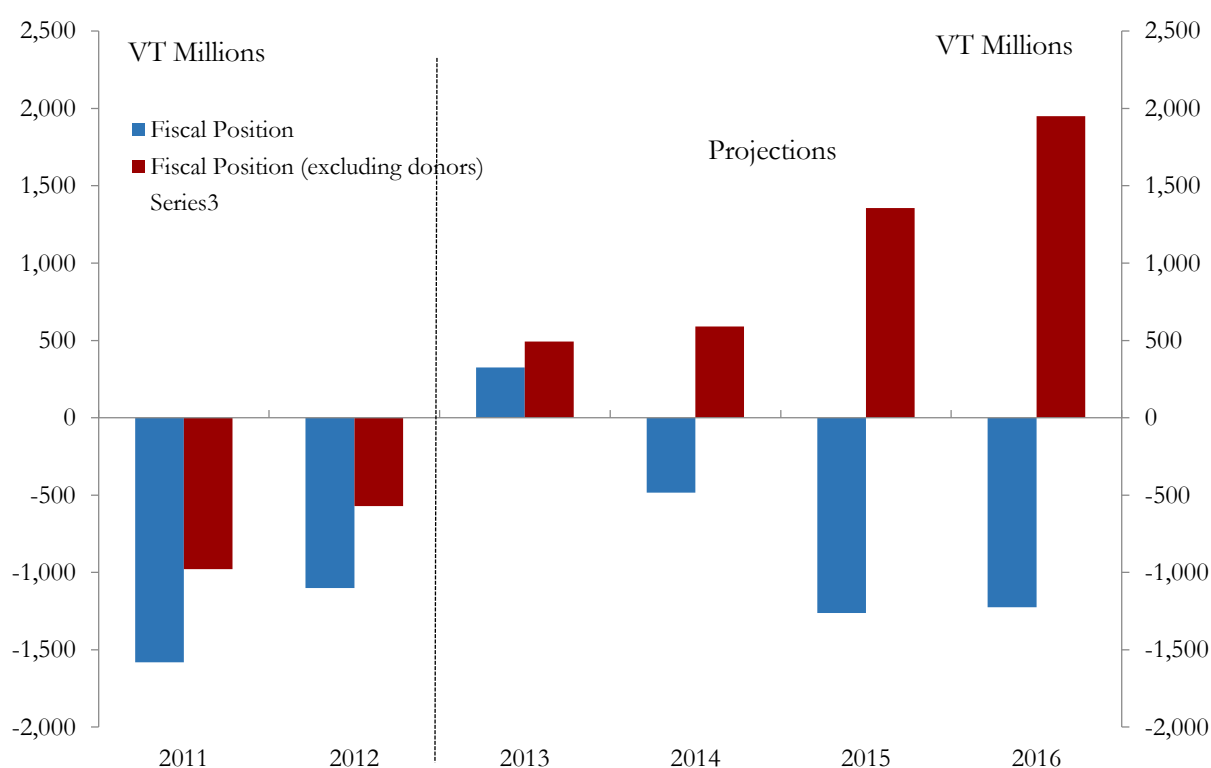
4. Fiscal Update and Projections

4.1. Budget Balance

The Public Finance and Economic Management Act obligates the Government to reduce and manage State debt at prudent levels; as well as 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. In other words, the Government aims to run surpluses over the medium term, in turn enabling it to reduce the stock of Government debt and build reserves for times of difficulty. In line with the legislative requirement, the fiscal budget position excluding grants, published in the Budget 2013 predicted a surplus worth VT 493.5 million (equal to 0.6 per cent of GDP).

Excluding donor finance the Government expenditure during the first nine months of 2013 is in line with the 2013 budget target. However, it is expected that all funds appropriated under budget 2013 will be expended by year end. To date, the Government issued VT400 millions of new domestic bonds, whilst no new external loans were drawdown.

Figure 9: Overall Budget Balance



Source: Ministry of Finance and Economic Management

Recurrent revenue has performed significantly better as result of improved compliance in VAT and inflows from the PRG Hong Kong based residency programme. Though, with just three months left to the end of the year, it is expected that with additional spending pressures the Ministry of Finance and Economic Management will have to enforce strict control on expenditures. Meanwhile to date the Government recorded a fiscal deficit worth VT 319.7 million (equivalent to 0.4 per cent of GDP) due to spending of Donor funds received in earlier years. However, excluding donor financed spending; the Government has recorded a fiscal surplus worth VT 66.9 million.

Excluding donor financed spending; the Government's Budget for 2014 expects to record a surplus worth VT 591 million (or 0.7 per cent of GDP). The surplus funds will be used to meet external debt repayments. Following historical problems with delays in the timing of its receipt, no budget support is factored into the 2014 Budget. The Government will be working harder in 2014 to review its revenue acts, develop new revenue

initiatives and improve compliances. Whilst at the same time the Ministry of Finance and Economic Management is continuing to work on maintaining its control of aggregate expenditure.

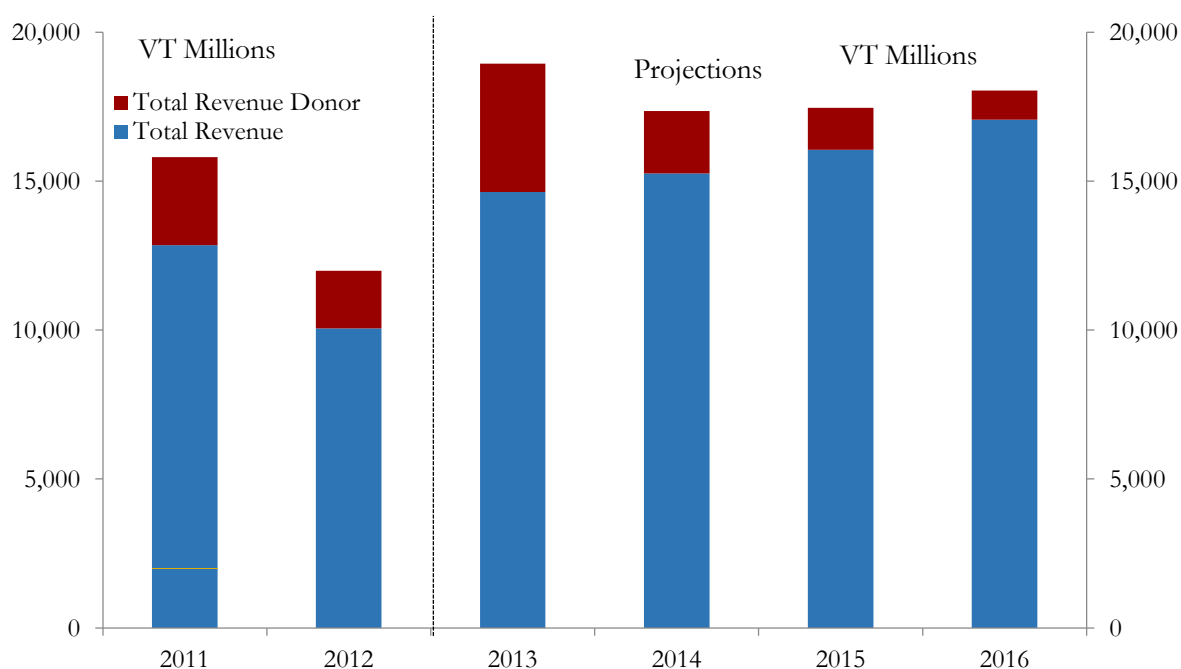
However, the Government along with its donor partners will also be undertaking a huge investment program designed to stimulate growth; this will involve external concessional borrowing which will be used primarily for large infrastructure projects.

Including donor finance spending the 2014 Budget expects to record a fiscal surplus worth VT 84.6 million (or 0.1 per cent of GDP). The Government plans to draw down VT 506.4 million in loans from the Japanese International Cooperation Agency (JICA) and the Asian Development Bank (ADB) in 2014 to help begin funding the Port Vila Lapetasi International Multi-Purpose Wharf Development Project, the Vanuatu Inter-Island Shipping Project and the Port Vila Urban Development Project.

4.2. Revenue 2013

The budget 2013 Government revenue target is VT 14,629.5 million. This represents growth of 10.0 per cent from the VT 13,302.9 million collected in 2012. Actual collections to date have shown a positive response compared to 2011 and 2012 levels and with total Government revenue currently being on target. Furthermore, the Government especially the Department of Customs and Inland Revenue (DCIR) continues to prioritize and work on enhancing revenue collections.

Figure 10: Government Revenue and Donor Cash Grants



Source: Department of Finance and Treasury

The leading item of tax revenue continues to be VAT which had contributed VT 4,017.9 million at the end of September representing 75 per cent of the budget 2013 target (VT 5,353.3 million) and 13.1 per cent higher than what was collected (VT 3,551.6 million) during the same period in 2012. The main reasons are that both economic conditions and compliance have improved during the year.

The second leading revenue category is import duty, collected only VT 1,876.5 million representing 67 per cent of the budget target (VT 2,803.7 million) and 2.5 per cent higher than the level collected (VT 1,829.9 million) during the same period last year. The main factor was due to introduction of the exemption committee which have imposed tougher control measures. Whilst import duty, still are under performing due to increase in trade with countries which Vanuatu has trade agreements with.

Across the remaining tax revenue categories, tax on property collected VT 295.3 million (53.7 per cent) against a budget target of VT 550.3 million. Moreover, the main component of the total came from land registration at VT 277.6 million (50.5 per cent) against a budget target of VT 549.8 million. The last two contributing items are land premiums and land lease which recorded VT 17.3 million and VT 403 thousand, respectively. Whilst, residency permit registered a significant increase through the Hong Kong Scheme at VT 593.9 million of the budget target of VT 425 million and 69.7 per cent higher than the amount collected (VT 255.7 million) during the same period in 2012.

In conjunction with receipts from taxes, other revenues were forecast to contribute VT 1,148.5 million to fiscal receipts in 2013. Of other revenues, port dues collected VT 133.3 million (65 per cent) of the Budget target of VT 205 million, Land rent at VT 149.7 million (78 per cent) against a budget target of VT 191.6 million, and road tax received VT 160.2 million (84 per cent) against a budget target of VT 190.4 million. In addition, State Own Enterprise's (SOE's) such as Reserve Bank of Vanuatu, NBV, and NISCOL have not paid their dividends to date.

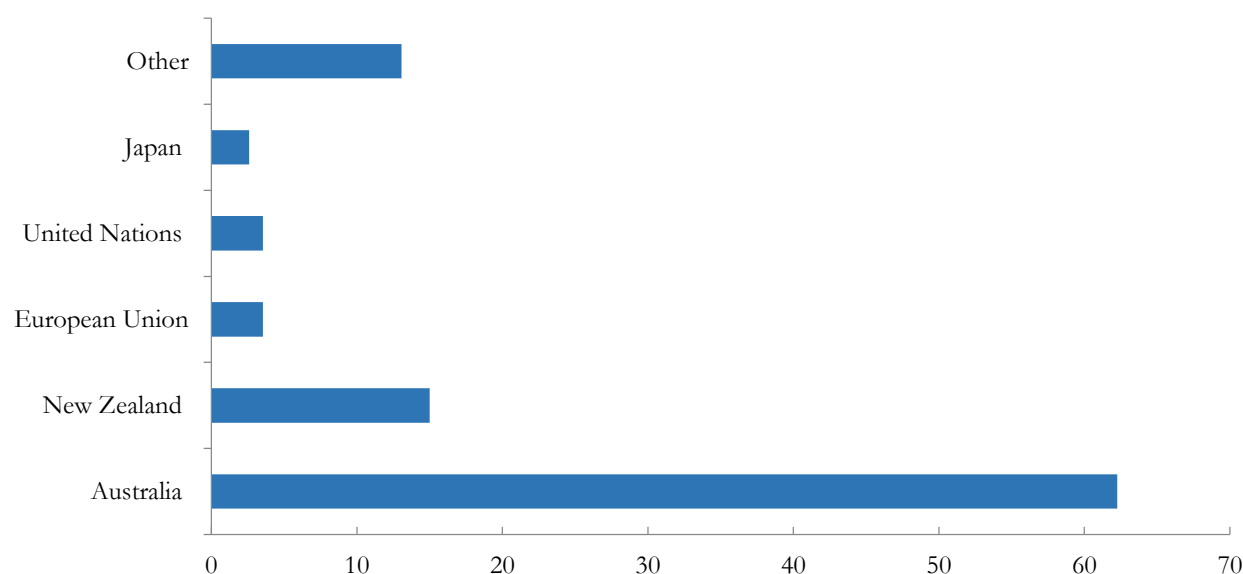
Aside from recurrent revenue, donor partners have made a significant contribution to the overall Government resources. With a projection of VT 4,310.9 million, total grants recorded only VT 1,369.7 million. The continuous delaying of implementing the major projects has caused the shortfall from the 2013 forecast. Additionally, another reason was that a few projects carried out in 2012 have been through aid-in-kind and are not captured in the Vanuatu Budget Management System (VBMS). The leading contributing donor is Australia with VT 683.9 million followed by New Zealand and other Donors as show in Figure 5.

4.3. Revenue Estimates in Integrated National Budget 2014

Total Government revenue is forecast to be VT 15,252.7 million in 2014. This is 4.3 per cent higher than the preliminary budget for 2013 of VT 14,629.5 million. This forecast represents the limit of the level that is consistent with fiscal prudence.

The Integrated National Budget initiative will be ongoing in 2014. Through this initiative the Government aims to bring together Government and donor partners in aligning the objectives of aid programs with Government policy which will help in better management of the recurrent cost implications and hence the financial sustainability of capital investment in essential public services.

Figure 11: Support Provided by Major aid Partners to the Government of Vanuatu in 2013 (in Per cent)



Source: Ministry of Finance and Economic Management.*Includes South Pacific Commission, World Health Organisation, ISP, Vanuatu Government, France and China

Of the major revenue categories, VAT should continue to dominate the stream of tax revenues in 2014, being forecasted to contribute VT 5,698 million of recurrent revenue (equal to 37 per cent of the total recurrent revenue). This represents growth of 6.4 per cent from the 2013 projection. The next leading category is import duty, which is projected to register VT 2,561.9 million in 2014, a slight decrease of 8.6 per cent from the 2013 budget. This decrease is mainly due to recent legislation amendments and changes to tariff rates that have affected revenue collections in recent years.

Other revenues are forecasted to increase from the 2013 budget target of VT1, 463.6 million to VT 1,638.1 million in 2014. This reflects more realistic forecasting in terms of actual cash collections from line Ministries as well as strengthening of revenue generating agencies in terms of legislative amendments and improving compliance. For example, an amendment of the Excise Act and introduction of the new Quarry Act. Furthermore, all Ministries have been instructed to continue to implement new revenue initiatives which are outlined in the Revenue Outcome Matrix. Moreover, continuous inefficient collections in dividends paid by SOE's to the Government in 2013 and escalated pressure on Government to increase revenue, meaning that Government can expect more dividends in 2014.

It is expected that bilateral agreements with donor partners will remain in place and donor support will continue throughout 2014. Significant support from our donor partners are forecasted at VT 1,827.8 million in terms of cash grants and VT 5,258.6 million aid-in-kind. This is a substantial level of commitment, and is forecasted to continue at similar levels into the medium term. This represents recognition of Vanuatu's sound performance in financial management and good governance.

4.4. Expenditure 2013

Government continues to manage and control its expenditures in line with the 2013 budget target. However, there has been increase in some aspects of expenditure compared to same period last year due to unforeseen and under budgeted expenditures.

In 2013, the national Parliament appropriated VT 400.0 million for supplementary to meet some of these unbudgeted expenses.

The total cost of supplementary and declared state of financial emergency were funded by VT 400 million worth of new bonds issued in August this year.

To date, the Government expended VT 10,582.3 million against an annual budget of VT 13,884.1 million at the end of September 2013. This is broadly in line with the budget target at 76.2 per cent but 2.5 per below VT 10,853.4 million expended during the same period last year. Similarly, the slightly lower figure this time around last year is attributed to tight expenditure control measures approved by Council of Ministers in the last financial year.

The largest portion of government expenses was consumed by compensation of employees at VT 5,989.6 million. This represents 56.6 per cent of the Government's expenses and 74.6 per cent of the 2013 budget target (VT 8,029.0 million). However, it represents a 2.3 per cent decrease from the VT 6,124.6 million recorded over the same period last year. This is mainly due to removal of one off Member of Parliament's (MP) gratuity payment last year. In addition, there has been improvement in management of allowances in some government ministries.

The next leading category of government expenses is used of goods and services which accounted for 20.5 per cent of the Government expenses at VT 2,169.1 million. This represent 66.6 per cent against budget target of VT 3,258.6 million but 9.7 per cent below VT 2,401.4 million expended during the same period in 2012. The decrease is mainly due to removal of one off expenditure activities, such as the national and provincial election as well as the cost of hosting the ACP-EU meeting.

Table 5: Total Supplementary Budget for 2013

Ministry	Supplementary Description	Amount (VT)
Ministry of Education	Government Scholarship Fund	298,000,000
Ministry of Youth and Sport	2017 Games preparation	2,000,000
Ministry of Youth and Sport	Department Operation	1,000,000
Ministry of Youth and Sport	Cabinet operational budget	1,000,000
Ministry of Climate Change Adaptation, Geo-hazards, Meteorology and Energy	Operational budget	1,000,000
Ministry of Agriculture, Livestock, Forestry, Fisheries and Bio-security	Department of Bio-security operational budget	3,300,000
Ministry of Foreign Affairs and External Trade	MSG contribution	22,000,000
Ministry of Foreign Affairs and External Trade	Severance payment for DG	5,000,000
Ministry of Prime Minister	Parliamentary Secretary	5,000,000
Ministry of Prime Minister	Police operational Budget	4,000,000
Ministry of Internal Affairs	Department of Labour and Immigration operational cost	10,000,000
Ministry of Finance and Economic Management	Grant to Vanuatu Tourism Office	20,000,000
Ministry of Finance and Economic Management	Central payments	27,700,000
Total	ALL	400,000,000

In addition to the supplementary list above, the Parliament also appropriated VT 53,118,826 under section 34(C) of the PFEM ACT. This relates to the Standing Appropriation of a Financial Emergency due to the creation of two new ministries (Ministry of Youth Development, Training and Sports and Ministry of Climate Change Adaptation, Geo-hazards, Meteorology and Energy) in March this year.

Table 6: Total Standing Appropriation for 2013

Ministry	Financial Emergency Description	Amount (VT)
Ministry of Youth and Sport	Cabinet payroll budget	27,011,669
Ministry of Youth and Sport	Cabinet operational budget	2,292,955
Ministry of Climate Change Adaptation, Geo-hazards, Meteorology and Energy	Cabinet payroll budget	17,205,700
Ministry of Climate Change Adaptation, Geo-hazards, Meteorology and Energy	Cabinet operational budget	6,608,502
Total	ALL	53,118,826

The other major category of Government expenses is grants accounting for VT 1,227.6 million which is equivalent to 11.6 per cent of the Government expenses. Expenses on grants have reached 96.9 per cent of the budget target and 10.3 per cent above VT 1,113.3 million expended during the same period last year. The increase is driven mainly by the expenses of the new grant body, Utility Regularity Authority (URA) as well as advancing of grants stored in later months.

The other categories of expenses are interest, social benefits and other expenses. Interest expended VT 491.1 million, equivalent to 81.4 per cent of the budget target of VT 603.1 million. This represents 4.6 per cent of the Government expenses and is 17.0 per cent above VT 419.7 million expended during same time a year ago. The increase was recorded as the result of issuing of bonds in 2012 because Government has to pay the cost of their interest in 2013 onwards depending on the term of their maturity. Social benefits consumed VT 189.9 million, equivalent to 143.2 per cent of the budget target of VT 132.6 million and 1.5 per cent lower than VT 192.7 million expended during the same period last year. Other expenses on the other hand, has recorded VT 515.1 million against budget target of VT 485.3 million, representing 106.1 per cent of the budget target and 6.5 per cent above VT 483.7 million expended during the same period in 2012 due to increase expenses on scholarship fees and allowances.

The final category of Government expenses is subsidy, spending VT 106.9 million against a budget of VT 108.0 million. This is equivalent to 98.9 per cent of the budget target and 9.5 per cent below VT 118.1 million expended during the same period last year.

To date, the Government spent VT 148.8 million acquiring fixed assets against budget of VT 253.4 million. This expenditure is equivalent to 58.7 per cent of the budget target and 39.0 per cent below VT 243.9 million expended during the same period last year.

In contrast, the Development fund spent VT 1,362.4 million against budget target of VT 4,310.9 million. This represents 31.6 per cent of the budget target and 6.5 per cent above VT 1,278.7 million expended during the same period in 2012.

The total estimated expense (Government and Donor Funding) is VT 11,942.8 million, representing 65.6 per cent of the budget target (VT 18,195.0 million) and 1.6 per cent below VT 12,132.1 million expended during the same period a year ago.

4.5. Expenditure Estimates in Integrated National Budget 2014

Total estimated recurrent expenditure for the Government in 2014 is VT 14,213.8 million. This is equivalent to a 2.4 per cent increase from the total budgeted expense of VT 13,884.1 million in 2013. The increase was driven mainly by the increase costs related to Government commitments, legal obligations and new policy proposals (NPPs).

The largest portion of the total estimated expense is allocated to compensation of employees at VT 8,302.9 million. This represents 56.8 per cent of the total estimated expense and 8.4 per cent above VT 8,029.0 million budgeted in 2013 due to the provision for additional recruitments.

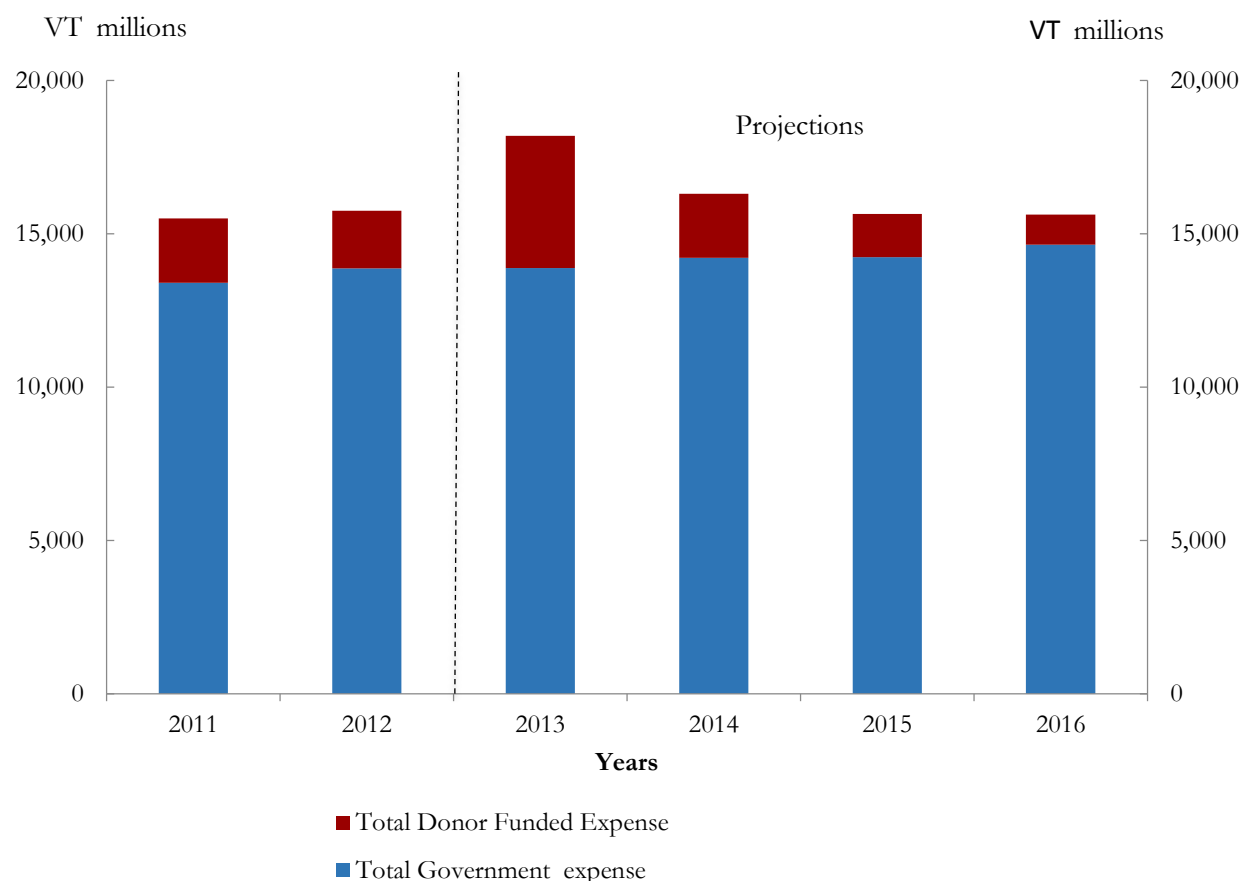
The next category of recurrent expenses is used of goods and services estimated at VT 2,989.6 million. This represents a 8.3 per cent decrease from VT 3,258.6 million budgeted in 2013 due to MBC agreed cuts and removal of one of NPPs, especially cost relating to elections such as the gratuity for Malvatumauri members, Malvatumauri island council elections, Tanna bi-election, Torba provincial council election and Port Vila municipal council election.

Grant is another category of expenses and is estimated to increase by 12.3 per cent from VT 1,267.5 million in 2013 to VT 1,423.1 million in 2014. This increase is mainly driven by the establishment of new grant bodies such as the Utility Regulatory Authority (URA) and Vanuatu National Archives (VNA) and new policy proposals for budget 2014.

The other categories of expenses are interests, social benefits and other expenses. Interest payment is forecasted to decline by 1.1 per cent from VT 603.1 million in budget 2013 to VT 596.5 million in 2014. In contrast, social benefits are estimated at VT 210.5 million, representing a 58.7 per cent increased from VT 132.6 million budgeted in 2013. The increase is mainly driven by the rising cost of legal obligations related to termination payments. Other expenses is estimated at VT 631.2 million in 2014, representing a 30.1 per cent increased from VT 485.3 million budgeted in 2013 due to additional scholarships being issued (more than the budgeted value) in 2013.

The final category of expense is subsidy, estimated at VT 60 million in 2014. This represents a 44.4 per cent decrease from VT 108 million estimated in 2013 due to MBC decision to cut copra subsidy by VT 48 million.

Figure 12: Total Estimated Expense



Source: Department of Finance and Treasury

The estimated expense in the 2014 budget includes Government commitments, legal obligations and NPPs, which amount to VT 731.1 million. This represents 48.1 per cent increase compared to VT 493.6 million in Budget 2013. The upward trend reflects the increasing need of the people of Vanuatu and with more funding allocated toward the social and productive sectors.

Within the social sectors, the Government will allocate an additional VT 150 million to the Ministry of Education to meet the cost of scholarships. In addition, VT 19.5 million will be allocated to the Prime Minister's Ministry for additional police recruitments. The additional recruitment is necessary given the rising demand for public security to ensure that law and order is maintained at all times. This is in addition to maintaining a peaceful and investor friendly environment.

The Government also plans to improve the productive sector to raise its contribution to economic growth in 2014. This is reflected through the additional allocation of funds within the Ministry of Commerce, Industry and Tourism and Ministry of Agriculture, Live Stock, Forestry, Fisheries and Bio-security at VT 6 million and

VT37.7 million respectively. The additional funding will see more recruitment and service delivery in this sector which in the end expected to boost production.

In addition, the Government has also committed itself to major infrastructure projects thus allocating VT 269.7 million towards the Port Vila Laitasi Multi-Purpose Wharf Development and the Vanuatu Inter-Island Shipping project. These projects are expected to be the main driver for strong future economic growth.

Donor funding is estimated at VT 1,827.8 million, representing 56.6 per cent decrease from VT 4,310.9 million budgeted for in 2013. The portion of the 2014 estimate will be allocated to strengthen the social sector such as Ministry of Health (VT 359.5 million) and Police (VT 9.5 million). On the same note, the productive sectors will also be enhanced through the allocation of funding towards the Ministry of Commerce, Industry and Tourism (VT 12.8 million) and Ministry of Agriculture, Quarantine, Forestry and Fisheries (VT 19.6 million).

The total estimated expense (Government and Donor funding) in 2014 is VT 16,084.1 million. This represents a 4.2 per cent increase from VT 18,195.0 million projected in 2013.

4.6. Public Debt

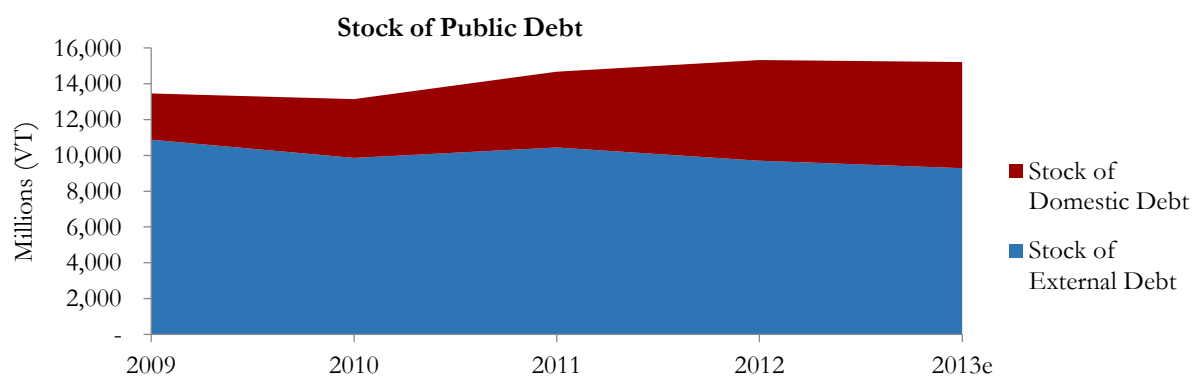
Following relatively strong revenue receipts, the Government's financing needs have declined in 2013 compared to 2012, which has led to the slowdown in borrowing. Furthermore, it is estimated that the stock of public debt at the end of 2013 will decline by 0.4 per cent over the year to reach VT 15,262 million (20 per cent of GDP). The estimated decline is possible as there were no new external loan drawdown transacted or expected to occur in 2013 whilst with the exception of the new domestic borrowing in mid-2013 to finance the supplementary budget.

The estimated decline in stock of debt can be attributed to delays to the drawdown of several major, new donor funded projects loans expected to kick start in 2013 as well as old external loans continued to be repaid. Furthermore the domestic financing gap has been reduced in 2013 due to strict expenditure control measures imposed by MFEM and strong domestic revenue collections.

Domestic borrowings has risen by an estimated 5.5 per cent in 2012 adding to the stock of debt while the stock of external debt declined owing to amortisation totalling at VT 458 million with repayment of the e-government loan constituting the highest share at VT 98 million in 2013. Meanwhile, the stock of public debt as per cent of GDP is estimated to remain well within the IMF's recommended threshold of 40 per cent at the end of 2013.

However, this ratio will rise closer to the comfortable threshold over the medium term, following the Government's new borrowing plans for several major public funded infrastructure projects.

Figure 13: Central Government Stock of Gross Debt



Source: Department of Finance and Treasury

4.7. Annex

Table 7: Statement of Government Operation, excluding donors using GFS01 Classification

GFS Code	GFS Description*	Actual 2011	Preliminary 2012	Budget 2013	Jan-Sept 2013	Budget 2014	Forecast 2015	Forecast 2016
TRANSACTIONS AFFECTING NET WORTH:								
A1	Revenue	12,850.5	13,590.1	14,629.5	10,796.1	15,252.7	16,049.8	17,065.2
A11	Taxes	11,630.3	11,982.4	13,165.9	9,647.6	13,614.6	14,320.1	15,217.5
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	430.6	548.3	550.3	295.3	353.5	373.3	398.8
A114	Taxes on goods & services	8,328.2	8,853.9	9,811.6	7,475.8	10,544.3	11,078.2	11,754.3
A115	Taxes on international trade & transactions	2,871.4	2,580.2	2,803.9	1,876.5	2,716.8	2,868.6	3,064.4
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	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A14	Other revenue	1,220.2	1,607.7	1,463.6	1,148.5	1,638.1	1,729.6	1,847.7
A2	Expense	13,404.0	13,894.8	13,884.1	10,582.3	14,213.8	14,236.5	14,643.9
A21	Compensation of employees	7,642.8	8,164.7	8,029.0	5,989.6	8,302.9	8,552.0	8,808.5
A22	Use of goods and services	3,102.2	2,940.7	3,258.6	2,169.1	2,989.6	2,783.5	2,867.0
A23	Consumption of fixed capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A24	Interest	397.8	463.1	603.1	491.1	596.5	596.5	596.5
A25	Subsidies	0.0	176.5	108.0	0.0	60.0	60.0	60.0
A26	Grants	1,362.8	1,286.3	1,267.5	1,227.6	1,423.1	1,465.8	1,509.8
A27	Social benefits	239.7	309.8	132.6	189.9	210.5	128.6	132.5
A28	Other expense	658.8	553.7	485.3	515.1	631.2	650.1	669.6
GOB	Gross operating balance (1-2+23+NOBz)	-553.5	-304.7	745.3	213.8	1,038.9	1,813.2	2,421.3
NOB	Net operating balance (1-2+NOBz) ^{c/}	-553.5	-304.7	745.3	213.8	1,038.9	1,813.2	2,421.3
TRANSACTIONS IN NONFINANCIAL ASSETS:								
A31	Net Acquisition of Nonfinancial Assets	426.0	313.0	251.8	146.9	447.9	454.9	468.6
A311	Fixed assets	426.0	313.0	251.8	146.9	447.9	454.9	468.6
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)	(979.6)	(617.7)	493.5	66.9	591.0	1,358.3	1,952.7
TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):								
A32	Net acquisition of financial assets	(336.6)	435.8	0.0	(43.9)	0.0	821.8	1,416.2
A321	Domestic	(336.6)	435.8	0.0	(43.9)	0.0	821.8	1,416.2
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	643.0	1,053.5	(493.5)	(110.7)	(591.0)	(536.5)	(536.5)
A331	Domestic	950.2	1,388.6	0.0	306.4	0.0	0.0	0.0
A332	Foreign	(307.2)	(335.1)	(493.5)	(417.1)	(591.0)	(536.5)	(536.5)

Table 8: Statement of Donor Operations using GFS01 Classification

GFS Code	GFS Description*	Actual Preliminary		Budget	Jan-Sept	Budget	Forecast	Forecast
		2011	2012	2013	2013	2014	2015	2016
TRANSACTIONS AFFECTING NET WORTH:								
A1	Revenue	2,953.8	2,174.1	4,310.9	1,369.7	1,827.8	1,411.4	978.1
A11	Taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
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	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A114	Taxes on goods & services	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A115	Taxes on international trade & transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
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	2,953.8	2,174.1	4,310.9	1,369.7	1,827.8	1,411.4	978.1
A14	Other revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A2	Expense	2,101.2	1,908.5	4,310.9	1,362.4	1,827.8	1,411.4	978.1
A21	Compensation of employees	218.8	247.1	530.4	197.5	224.9	173.7	120.3
A22	Use of goods and services	1,582.6	1,215.4	3,083.0	823.9	1,307.1	1,009.4	699.5
A23	Consumption of fixed capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A24	Interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A25	Subsidies	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A26	Grants	289.1	430.0	669.3	217.9	283.8	219.1	151.9
A27	Social benefits	0.3	1.8	5.1	96.1	2.2	1.7	1.2
A28	Other expense	10.4	14.3	23.2	27.1	9.8	7.6	5.3
GOB	Gross operating balance (1-2+23+NOBz)	852.6	265.6	0.0	7.2	0.0	0.0	0.0
NOB	Net operating balance (1-2+NOBz) ^{c/}	852.6	265.6	0.0	7.2	0.0	0.0	0.0
TRANSACTIONS IN NONFINANCIAL ASSETS:								
A31	Net Acquisition of Nonfinancial Assets	1,454.5	825.5	168.7	393.8	506.4	2,618.8	3,174.6
A311	Fixed assets	1,454.5	825.5	168.7	393.8	506.4	2,618.8	3,174.6
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)	(601.9)	(559.9)	(168.7)	(386.5)	(506.4)	(2,618.8)	(3,174.6)
TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):								
A32	Net acquisition of financial assets	(12.3)	(559.9)	0.0	(386.5)	0.0	-140.4	-190.0
A321	Domestic	(12.3)	(559.9)	0.0	(386.5)	0.0	-140.4	-190.0
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	589.6	0.0	168.7	0.0	506.4	2,478.4	2,984.6
A331	Domestic	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A332	Foreign	589.6	0.0	168.7	0.0	506.4	2,478.4	2,984.6

These numbers just reflect cash grants and cash loans through the Central Treasury Account, aid-in-kind contributions are not included in the Budget and forecasts given for example difficulties measuring the value of half complete, in-kind infrastructure projects. These are only recorded in the accounts once a project is completed and the value of a new asset is realized

Table 9: Statement of Consolidated Operations using GFS01 Classification

GFS Code	GFS Description*	Actual 2011	Preliminary 2012	Budget 2013	Jan-Sept 2013	Budget 2014	Forecast 2015	Forecast 2016
TRANSACTIONS AFFECTING NET WORTH:								
A1	Revenue	15,804.3	15,764.2	18,940.4	12,165.8	17,080.4	17,461.1	18,043.4
A11	Taxes	11,630.3	11,982.4	13,165.9	9,647.6	13,614.6	14,320.1	15,217.5
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	430.6	548.3	550.3	295.3	353.5	373.3	398.8
A114	Taxes on goods & services	8,328.2	8,853.9	9,811.6	7,475.8	10,544.3	11,078.2	11,754.3
A115	Taxes on international trade & transactions	2,871.4	2,580.2	2,803.9	1,876.5	2,716.8	2,868.6	3,064.4
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	2,953.8	2,174.1	4,310.9	1,369.7	1,827.8	1,411.4	978.1
A14	Other revenue	1,220.2	1,607.7	1,463.6	1,148.5	1,638.1	1,729.6	1,847.7
A2	Expense	15,505.3	15,803.3	18,195.0	11,944.7	16,041.5	15,647.9	15,622.1
A21	Compensation of employees	7,861.6	8,411.7	8,559.4	6,187.1	8,527.8	8,725.6	8,928.9
A22	Use of goods and services	4,684.8	4,156.1	6,341.6	2,992.9	4,296.7	3,792.8	3,566.5
A23	Consumption of fixed capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
A24	Interest	397.8	463.1	603.1	491.1	596.5	596.5	596.5
A25	Subsidies	0.0	176.5	108.0	0.0	60.0	60.0	60.0
A26	Grants	1,651.9	1,716.3	1,936.8	1,445.5	1,706.9	1,684.9	1,661.6
A27	Social benefits	240.0	311.6	137.7	285.9	212.7	130.3	133.6
A28	Other expense	669.2	568.0	508.5	542.2	641.0	657.7	674.9
GOB	Gross operating balance (1-2+23+NOBz)	299.1	-39.1	745.3	221.0	1,038.9	1,813.2	2,421.3
NOB	Net operating balance (1-2+NOBz) ^{c/}	299.1	-39.1	745.3	221.0	1,038.9	1,813.2	2,421.3
TRANSACTIONS IN NONFINANCIAL ASSETS:								
A31	Net Acquisition of Nonfinancial Assets	1,880.6	1,138.5	420.6	540.7	954.3	3,073.7	3,643.2
A311	Fixed assets	1,880.6	1,138.5	420.6	540.7	954.3	3,073.7	3,643.2
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)	(1,581.5)	(1,177.6)	324.8	(319.7)	84.6	(1,260.5)	(1,221.9)
TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):								
A32	Net acquisition of financial assets	(348.9)	(124.1)	0.0	(430.4)	0.0	681.4	1,226.2
A321	Domestic	(348.9)	(124.1)	0.0	(430.4)	0.0	681.4	1,226.2
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	1,232.6	1,053.5	(324.8)	(110.7)	(84.6)	1,941.9	2,448.1
A331	Domestic	950.2	1,388.6	0.0	306.4	0.0	0.0	0.0
A332	Foreign	282.4	(335.1)	(324.8)	(417.1)	(84.6)	1,941.9	2,448.1

Table 10: Statement of Central Government Borrowing

	2011 Actual	2012 Actual	2013 Preliminary	2014 Budget	2015 Forecast	2016 Forecast
External Debt						
Bilateral						
CFDD	258.9	226.6	190.6	154.6	118.6	82.6
China	3,846.6	3,789.3	3,631.1	3,371.1	3,111.1	2,851.1
Japan	0.0	0.0	122.0	250.5	2,144.0	4,847.3
Total Bilateral Debt	4,105.5	4,015.9	3,943.7	3,776.2	5,373.6	7,780.9
Multilateral						
ADB	5,133.6	4,616.9	4,438.4	4,636.8	5,042.3	5,144.1
EIB	165.3	111.3	53.3	0.0	0.0	0.0
IDA	1,036.7	958.1	897.1	836.1	775.1	714.1
Total Multilateral Debt	6,335.6	5,686.4	5,388.8	5,472.9	5,817.4	5,858.2
Total External Debt	10,441.1	9,702.2	9,332.4	9,249.1	11,191.0	13,639.1
Total Domestic Debt	4,234.9	5,623.5	5,929.8	5,929.8	5,929.8	5,929.8
Total stock of debt	14,676.0	15,325.7	15,262.3	15,179.0	17,120.8	19,569.0
<i>(In per cent of GDP)</i>	<i>21%</i>	<i>21%</i>	<i>20%</i>	<i>19%</i>	<i>19%</i>	<i>20%</i>

These figures represent end of year estimates and will vary due to exchange rate fluctuations

Source: Department of Finance and Treasury

5. Budget Policy Statement 2014

4.1. 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 2013 budget policy.



Hon. Maki Stanley Simelum (MP)
Minister of Finance and Economic Management
Ministry of Finance and Economic Management



Mr. George Maniuri
Director General
Ministry of Finance and Economic Management



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 2014 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 2014;
2. Economic and Fiscal Targets for 2014; and
3. Long Term Fiscal Objectives

a) Budget Priorities for 2014

The development of 2014 policy priorities captured the essence of 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 Prime Minister.

The strategic policy priorities are set out as follows:

- Broaden economic capacity to grow revenue base (reassess the current tax base and other measures to strengthen revenue collection), maintain quality expenditure, (revenue greater than expenses) boost government savings and trigger public investment;
- Strengthen relationship between Trade and Investments in order to build confidence for private sector participation, increase employment, and grow exports;
- Enabling continuous political reform, decentralization, human and institutional strengthening to improve service delivery;

- Enhance protection and conservation of Vanuatu's natural resources and biodiversity, taking climate change issues into consideration;
- Improve quality of educational outcomes, more equitable access to education and skills development at all levels with continued emphasis on overall strengthening of sectoral management;
- Improve management and access to quality youth services and programs at all levels throughout Vanuatu with more focus to the 2017 Pacific Mini Games;
- Continue allocate resources to improve health services as well as to implement Vanuatu National Population Policy;
- To provide sustainable, resilient, appropriate infrastructure and services for equitable, social and economic development; and,
- Ensure that appropriate measures are in place to address tension between informal and formal system, backlog of cases, support to victim of the crime and gender mainstreaming initiative.

b) Fiscal Policies

The Government's top priority for 2014 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 sound policies that encourage private sector led growth and ensure that the State-Owned Enterprises remain productive over the long term. The Government aims to provide audited financial statements in a timely manner, and will continue to maintain stringent financial discipline.

c) Economic Update in 2013

World Economic Outlook (WEO)

Global growth has been revised upwards by the International Monetary Fund (IMF) in its January WEO from 3.5 per cent in October 2012 to 3.8 per cent for 2013. The revision was necessary following improved management of the global uncertainties stemming from the Euro debt crisis in the euro area, an unexpected pickup in economic activity in the US whilst the possibility of Japan sliding into recession was prevented thanks to timely policy intervention through stimulus to boost growth. Despite mixed growth experiences in the advanced economies, growth in the emerging economies held up comparatively well with 5.5 per cent expected in 2013 and a further 5.9 per cent forecasted for 2014.

Vanuatu Economic Outlook (VEO)

Following unfolding uncertainties in the global economic environment, economic activity in Vanuatu is expected to be driven by the expected scaling up of public investment and buoyant activity of the services sector particularly tourism while developments in the agriculture remain broadly modest. The spillover effects of increasing tourism arrivals together with construction is expected to benefit retail trade, transport, manufacturing, professional, scientific, research and administrative services, accommodation and food services. While developments in the agriculture sector is dependent on external demand and supply conditions of closely traded commodities such as copra, beef, fish and coconut oil. Against these backdrops, the macroeconomic committee believes the economy will grow by 4.5 per cent and 4.6 per cent in 2013 and 2014 while more expansion is expected in 2015 before normalization kicks-in from 2016.

Inflation, which is closely related to economic activity, is expected to gather momentum as use of resources become scarce while at the same time pressure from domestic demand starts to accumulate. The average inflation, measured by the consumer price index, is expected to grow by 1.5 per cent in 2014 on the back of an expected increase in construction activity combined with rising demand emanating from consumption and investment activities from the services sector.

Monetary conditions remain comparatively weak to date although monetary policy has been very accommodative. Private sector credit remains sluggish growing by 5.9 per cent in 2012 after reaching its growth peak in 2008 at 36.6 per cent. The sluggish growth in private sector credit reflected the high level of

uncertainties in the economy together with ongoing supply constraints affecting private sector incentives for investment despite the high level of liquidity in the banking system. With the banking sector's net foreign assets contracting for the third straight consecutive year in 2012 by 6.2 per cent, Vanuatu's competitiveness (measured through pricing of its currency – exchange rate) needs further consideration so does its effect on the value of export and service earnings.

Expectations about increased public investments and tourism activities over the medium term will impact on the country's balance of payments with the current account expected to remain strong supported by developments in the services sector. While the capital account is anticipated to rise following anticipated inflows from donor funded projects however, developments in the financial accounts are forecasted to remain subdued. The overall balance of payments is forecast to remain sufficient with stock of foreign reserves anticipated to rise over the medium term, pushing the projected months of import cover comfortably higher than its threshold level of 4 months.

d) Budget Management

Budget 2014 will be consistent with the principles of fiscal responsibility as defined by Section 22 of the PFEM Act. The Government will continue to commit itself towards achieving a balanced budget in 2014.

e) Government Debt and Borrowing

The Government will continue to make sure that public debt remains at a sustainable level in 2014 and years thereafter. From 2014, the Government will restrict new borrowing unless for productive purposes to reflect current policy implementations. Definitely, the Government will make sure that new external and domestic borrowings are limited to the financing of capital investment projects which will generate future capacity to repay the loans bestowed upon future generations.

f) Revenue and Taxes

The Government's priority for revenue is to improve and strengthen the administration of compliance with existing taxes, including in the remote areas of the country. There will also be emphasis on the effective implementation of an amendment to the Import Duties Act on exemptions and Gaming Licences Act and likewise, there will also be the execution of new revenue initiatives such as fees and charges by revenue generating Departments across the Government following the 2013 Revenue Initiative Forum. In addition, the Government has tightened the compliance unit under the Department of Customs and Inland Revenue to reinforce the administration of swift and timely collection of taxation debts. It will focus on the level of compliance and the continuity of revenue collections throughout the year.

g) Expenditure Programme Policies

The Government will continue to ensure that procedures of requesting and accessing funds for expenditure programmes are in line with the Public Finance and Economic Management Act. In 2014, the Government's priority is to provide adequate and sufficient funding for expenditure programmes that are linked to 2014 strategic policies priorities. This includes expenditure programmes and policies that will cover a wide range of different activities and services that will enhance service delivery and at the same time promote efficient and effective use of resources to improve economic growth.

On this note, the Government will ensure that expenditure programmes remain broadly in line with budget target and there is efficient and effective use of funding provided by the Government and the Donors to achieve higher quality and improved accountability of services. Hence, the Government will continue to enforce strict fiscal discipline as well as imposing prudent and punitive measures if necessary to control expenditure programmes in line with Budget targets and the Principles of Responsible Fiscal Management.

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 in 3 (a) will be strictly considered for funding in 2014 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 2014 budget will include donor funded New Policy Proposals, new and on-going, that have been developed to implement government policy priorities. This will ensure that donor funding is channelled through the Vanuatu Budget Management System (VBMS) and is in line with Government's priorities. Merging the two funding streams will result in efficiency gains. 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 2014

In preparation for unforeseen shocks to the domestic economy, the Government will continue to pursue policies towards achieving a balanced budget in 2014. The economic growth rate for 2014 is forecasted to be 4.6 per cent in real terms, while the inflation rate is projected to be around 1.5 per cent.

Budget Targets for 2014	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 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.
Expenditure Recurrent expenditure is forecast to be 17.0 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 of GDP remains below 40.0 per cent
Economic Growth Growth forecast at 4.6 per cent	Annual economic growth rate averages at least more than population growth rate (2.3 per cent)
Inflation Inflation forecast at 1.5 per cent	Annual inflation rate remains between 0 and 4.0 per cent

5.6. Conclusion

Preparation for the Budget 2014 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, and it will mainly focus on being critically accountable and fiscally responsible towards achieving a sound, manageable and balanced budget 2014.