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Pacific Islands Development Program

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VANUATU: TOWARD ECONOMIC GROWTH

by

Mark Sturton

Andrew McGregor



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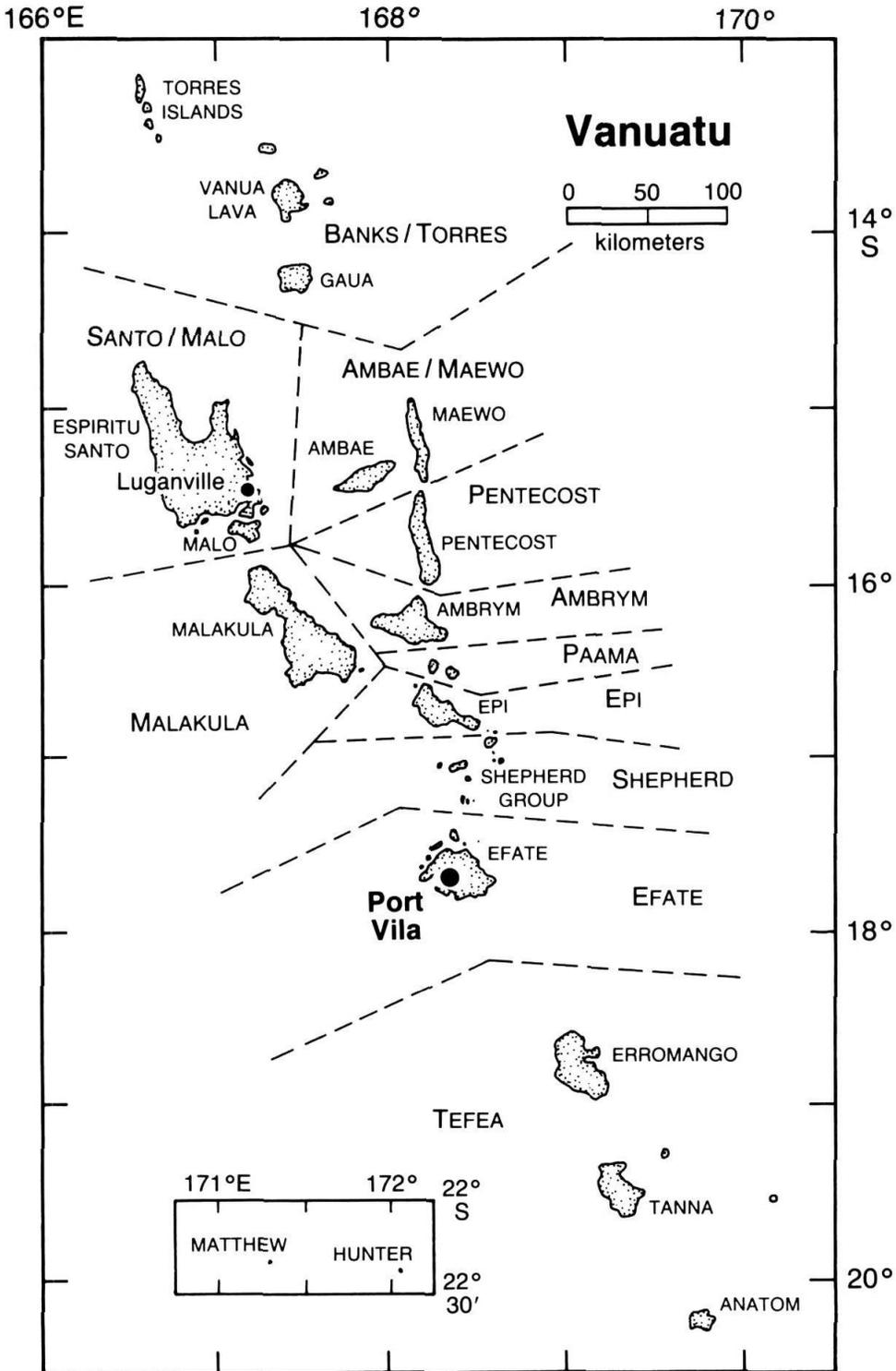
Foreword

This report is the second in a series of country reports relating to the Pacific island economies. The series is intended to fill the existing gap of available material about economic performance, policy, and prospects in the region. Because the economic survey reports issued by international agencies often have a restricted circulation and are not in the public domain, PIDP's new series is designed to improve the awareness of the economic problems and circumstances facing the Pacific island countries today.

The series follows a standard format with parallel discussions of economic performance for the island countries. Subjects include analysis of economic growth, sectoral performance, inflation, monetary developments, fiscal policy, and the external sector. Economic prospects for the future are also discussed. Concluding sections highlight important economic policy and development issues.

Sitiveni Halapua
Director
Pacific Islands Development Program

Map of Vanuatu



Executive Summary

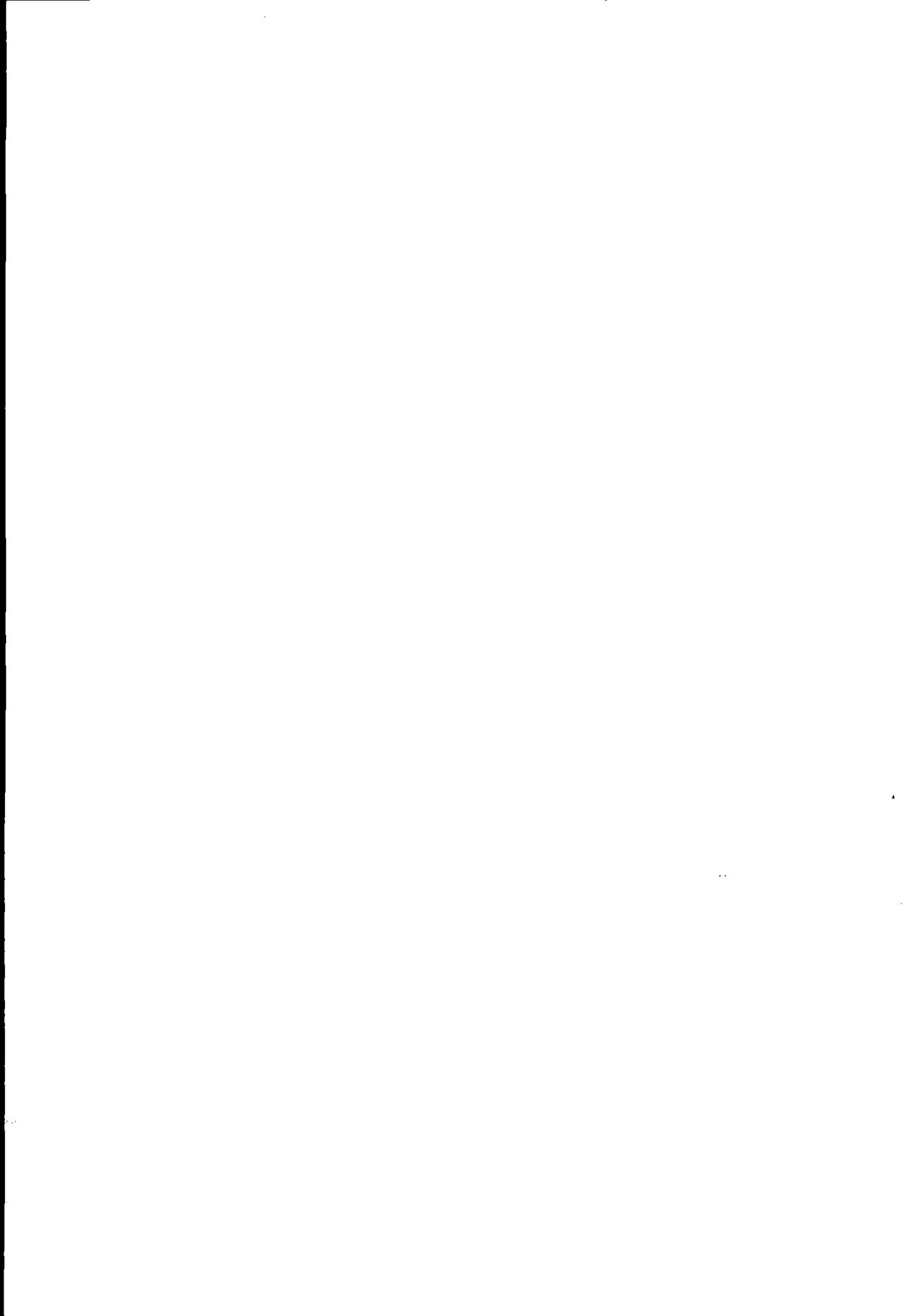
This report is intended to provide a thorough analysis of the economic developments in the Vanuatu economy since the mid-1980s. Vanuatu is a very small open economy dependent on a very limited range of exports of primary commodities and services. The economy is dualistic in nature with a large rural semi-subsistence sector producing agricultural commodities and a modern urban economy specializing in tourism and the provision of public services. The skill levels of the ni-Vanuatu, the indigenous population, are low, and the work force is supplemented by a sizable number of expatriates.

After the turbulent period of independence in the early 1980s, the economy stagnated, and GDP is reported to have grown by 1.8 percent per annum during the 1983-89 period. Population growth averaged 2.5 percent, which resulted in a decline in living standards. This outcome was the result of various forces: the reduction of budgetary support throughout the decade, a costly dualistic public administrative structure inherited from independence, a series of cyclones in the mid-1980s, poor commodity prices for the nation's primary commodity exports with declining terms of trade, and structural weaknesses in the nation's tourism industry.

However, although Vanuatu faces many disadvantages, there is considerable economic potential in both the agricultural and tourism sectors. Reflecting these conditions, the tourism sector experienced a substantial improvement toward the end of the 1980s, which revitalized the economy. Economic growth of approximately 5 percent per annum was recorded in both 1989 and 1990. Provided the external environment does not deteriorate, continued growth at a more moderate rate can be expected in the near future.

However, for sustained development into the 1990s the recently improved economic conditions need to be reinforced with economic policy restructuring. The establishment of Vanuatu's Financial Center conferred a tax free status on the nation and reliance on trade taxes as the main source of government revenue. This situation led to an inefficient tax system, encouraging uncompetitive import replacing industries and an inelastic tax base restricting the provision of public services. The fear of alienating the Financial Center has led to stagnation in new economic policy initiatives.

This report on Vanuatu discusses and analyzes all these developments in detail. In addition, discussion is devoted to economic growth, sectoral performance, savings and investment, inflation, monetary developments, fiscal policy, and the external sector. Each section analyzes recent developments, new policies, and prospects for the future. The report concludes with a discussion of development issues and economic policy.



Introduction

Vanuatu had an estimated per capita GDP of about US\$912 in 1989, which is slightly above average for the region. However, if the income of expatriates is excluded, the average per capita income of ni-Vanuatu, the indigenous population, falls to US\$451, which ranks Vanuatu as one of the least developed island economies of the Pacific.

The economy is dualistic in nature with the traditional subsistence sector comprising about 80 percent of the population. The modern sector includes plantation agriculture (particularly copra and cattle), tourism, the Finance Center, and government services. However, the dichotomy between the two sectors is becoming blurred with the increasing level of participation of village and other smallholders in the cash economy.

Smallholders now account for most of Vanuatu's copra and cocoa exports and for a significant proportion of commercial beef production. Services (government, tourism, and the Finance Center) account for nearly 70 percent of GDP, with agriculture accounting for 20 percent and industry the remaining 10 percent. The economically active population is estimated at about 60,000, of whom 13,000 are wage earners.

Developments during the 1980s

Vanuatu's economic growth averaged 1.6 percent in recent years, compared with a population growth of some 2.9 percent. However, since independence in 1980 considerable year-to-year fluctuations in GDP have occurred in response to world copra prices, tourist arrivals, and the incidence of tropical hurricanes. Recent trends in GDP growth are shown in Figure 1, and selected economic indicators for 1986-90 are shown in Table 1. The figure indicates that the economy largely stagnated during the 1980s and economic growth was minimal. More significantly, real living standards deteriorated.

The political disturbances and the large-scale departure of French plantation owners that accompanied Vanuatu's independence in 1980 led to significant economic contraction. A 10 percent negative growth rate is estimated for 1980, and the economy continued to stagnate in 1981 and '82 in face of low copra prices and little investment activity. By 1983 with the restoration of political stability, the economy began to show some recovery, recording an estimated growth rate of 3 percent, with the main contributors to growth being tourism and offshore banking, and showing an increase in smallholder copra production. In 1984 there was a sharp rise in world copra prices, and the growing

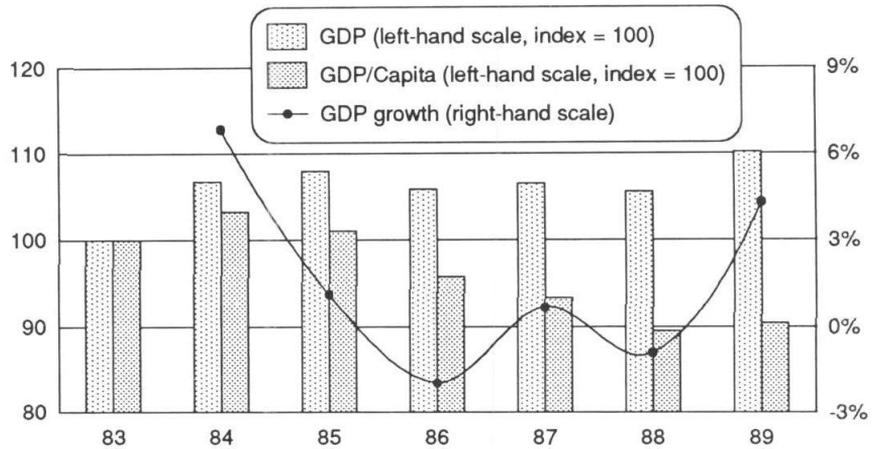


Figure 1. Movement in GDP, 1983-89

number of tourist arrivals was sustained. As a consequence, Vanuatu enjoyed a growth rate of almost 7 percent, placing the country in a sound balance of payments position and allowing for a substantial accumulation of foreign reserves.

The relatively good performance of the previous two years was reversed over the period 1985-87 with zero growth, and an overall balance of payments deficit was recorded in 1986. This poor showing was due to a combination of adverse shocks. Tourist arrivals halved as a result of disruptions to air services, perceived political instability, and the occurrence of a devastating tropical hurricane in the early part of 1987. Copra prices fell sharply from their high of 1984. In 1986 the value of copra exports was VT 460 million (VT 117 = US\$ 1) compared with VT 2,700 million in 1984. In 1987 the Finance Center experienced declining activity, apparently the result of investor confidence being undermined by Vanuatu's fishing agreement with the Soviet Union and unfounded rumors of political ties with Libya.

In 1988 GDP recorded a further decline of nearly 1 percent, but economic performance was mixed. Reflecting poor overall weather conditions, copra production fell significantly below the 1987 level but was counterbalanced by a significant rise in the international copra price. The value of exports rose by 32 percent. A hurricane hit a number of copra producing islands late in the year, which was reflected in the production and export figures for the following year. The performance of other primary industries was also poor with cocoa, beef, and timber production all significantly down on the 1987 levels.

Table 1. Selected economic indicators, 1986-90

		1986	1987	1988	1989	1990
Economic activity						
GDP at constant prices	% increase	-2.0	0.4	0.6	4.5	4.6
Copra production	'000 tonnes	41.8	36.3	29.6	24.9	45.1
Tourist arrivals	'000 visitors	17.5	14.6	17.5	23.9	35.0
Money and prices						
CPI	% increase	5.7	15.9	8.7	7.7	5.6
Money supply (M4)	% increase	15.2	-0.3	-6.5	35.6	11.0
Private sector credit	% increase	6.0	17.1	7.0	9.5	23.8
External sector						
Exchange rate	Vatu/US\$	106	110	104	116	117
Current account	VT million	-278	862	801	987	982
Overall balance	VT million	1,458	473	-279	3,528	1,780
Debt service	% exports	1.4	1.0	0.7	0.5	1.5
Fiscal						
Deficit	VT million	-722	643	-502	-1426	-411
Deficit	% GDP	-5.9	4.8	-3.3	-8.7	-2.3

Sources: National Accounts of Vanuatu 1985-89, and Statistical indicators, 4th quarter 1990, Statistics Office, N.P.S.O., Government of Vanuatu; Quarterly Economic Review, Reserve Bank of Vanuatu, December 1990; Unpublished budget documents, Ministry of Finance, Government of Vanuatu.

Tourism began a modest recovery, and arrivals increased from 14,600 in 1987 to 17,500 in 1988. Confidence began to return to the Finance Center, and foreign exchange earnings grew from VT 1,400 million to VT 1,700 million. After the re-construction efforts following the 1987 cyclone, real investment demand returned to trend and fell by 8 percent in 1988. The accumulated impact of these forces was a negative economic growth and an overall balance of payments deficit.

Structural change

Although economic growth has been poor, the economy experienced certain structural changes during the 1980s. In terms of export performance, Figure 2 indicates the relative changes in the contribution of the major primary products. With declining real product prices for copra, production shifted toward other more profitable activities. Cocoa, beef, and timber all increased their share of total exports. In terms of contribution to GDP, the share of agriculture has fallen since 1983, but industrial production has risen, and services remain largely unaltered. Figure 3 indicates these movements.

Various important facts can be derived about the Vanuatu economy from the two figures. Although the share of industrial production to GDP has grown, it has not been associated with any corresponding

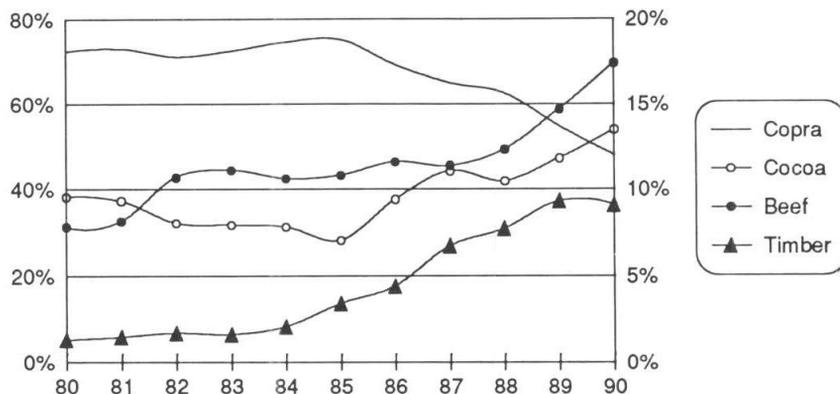


Figure 2. Share of major exports in total exports, (copra left-hand scale), 5-year moving averages, 1970-89

increase in exports of manufactures. The four commodities shown in Figure 2 comprise over 90 percent of Vanuatu's exports, and there has been no significant increase in exports of new commodities. The growth in industry reflects a growth both in manufacturing for the home market and in construction. Manufacturing development has largely occurred behind protective tariff barriers, while the growth in construction represents growth in aid financed investment.

Both developments are consistent with a sluggish economy. The weight of international evidence suggests that protective import substitution policies have not generated growing and dynamic economies. The potential for inward looking policies to be successful in a small open economy like Vanuatu is even more remote. While aid expenditures on infrastructure and training have an important role in development, they can also generate dependency and attract an un-

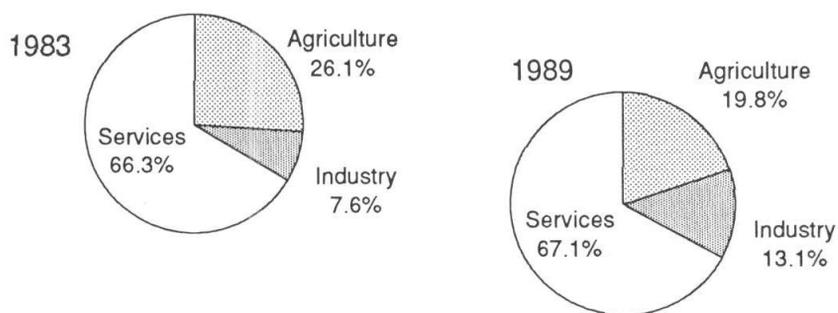


Figure 3. Contribution of major activities to GDP in 1983 and 1989

due proportion of economic resources. In summary, recent developments have not been in economically productive activities, nor have they generated potential for future growth.

Deterioration in income distribution

The lack of economic growth coupled with an increasing share of both aid and protected manufacturing had an adverse impact on the distribution of income. The majority of Vanuatu's population resides in the rural areas and depends on agricultural production as its main source of income. Not only has agriculture's share of total economic activity fallen, but also agricultural production itself declined by 10 percent between 1983 and 1989. Given the high rate of ni-Vanuatu population growth of 2.9 percent per annum, real living standards for this segment of the population would have fallen by 24 percent over the period.

Balance of payments structure

The balance of payments shows several important characteristics concerning the Vanuatu economy. The trade balance has been in continual deficit, representing about 40 percent of GDP during the 1983-89 period. Exports have averaged 15 percent while the share of imports has been 55 percent. Year-to-year fluctuations give rise to considerable variation in these figures, depending on the point of the product cycle. The current account balance is made up of tourism receipts (16 percent of GDP), development aid (24 percent of GDP), and large interest earnings on foreign assets of the banking sector (22 percent of GDP). While balance of payments equilibrium has been maintained, the poor trade balance reflects the underlying weakness of the economy and sluggish progress in export diversification.

The current account (including retained earnings of foreign companies) has shown persistent surpluses throughout the period, which represents an average of 13 percent of GDP. The establishment of the Finance Center was accompanied with free capital account movement and absence of exchange controls; residents are permitted to hold both Vatu and foreign currency bank accounts and investments. The continual balance of payments surpluses (apart from years of severe cyclone damage or tourism slumps) indicate that offshore investments are considered more attractive and domestic savings are invested overseas. Between 1983 and 1985 net foreign assets of the banking system rose from VT 5.8 to VT 14.9 billion and import coverage rose from 13 months to 23 months.

The limits of monetary policy

The Vatu was linked to the SDR from 1981 until February 1988, when adverse currency speculation led to the adoption of an undisclosed currency peg. The policy of pegging the Vatu to the SDR led to periodic devaluations required to bring the Vatu in line with its effective

exchange rate. The new peg based on trade weights established a more stabilizing and automatic adjustment process. However, the adoption of a fixed exchange rate with capital account mobility and absence of any exchange controls have meant that an active monetary policy has been largely impossible. The Reserve Bank specifies certain prudential liquidity requirements and interest rate guidelines to the commercial banks but otherwise adopts a non-interventionist policy toward the money supply and domestic credit growth.

Persistent fiscal imbalances

The maintenance of fiscal balance has been a persistent problem since independence when Vanuatu inherited an adverse set of fiscal characteristics. Recurrent budgetary aid, which represented about 50 percent of recurrent expenditures in 1981, was phased out by 1989. The colonial government structure required dual British and French administration and imposed heavy administrative costs. The development of the Finance Center was promoted through the absence of income, cooperate, capital gains, and other related taxes. The sluggish growth in the economy during the 1980s, a reduction of budgetary aid, and an inelastic tax system with a limited range of potential new revenue measures, all made difficult attainment of the fiscal balance.

The central government's fiscal operations are composed of a recurrent and development budget. Recurrent balance was achieved in the majority of the 1980s through substantial additional indirect tax measures in 1983 and 1987 and continual expenditure constraint. Fiscal policy was designed to maintain balance on the recurrent budget and generate some small savings for transfer to the development budget.

Major difficulties occurred with maintaining control over development expenditures. Since 1985 the development budget has been in substantial deficit in every year with the exception of 1987. This difficult situation was fortuitously eased by substantial Stabex receipts in 1987 and 1988, although large outlays to Air Vanuatu for the purchase of a jet aircraft in 1989 meant that the overall budget deficit rose to 9 percent of GDP. Use of foreign credit to fund the deficit has been moderate and restricted to aid sources with low finance charges. Substantial recourse to domestic bank finance has become necessary, particularly in 1989, given the undeveloped nature and limited funding ability of domestic financial institutions.

Recent Economic Growth and Sectoral Performance

Overview

The economy entered a phase of tourist driven recovery during 1989, and GDP is estimated to have grown 4.5 percent. Growth of a similar if not greater magnitude is projected for 1990. Tourism activity rebounded from the low levels of 1987, and visitor arrivals reached levels above those recorded in the early 1980s. Copra production was low in 1989 due to cyclonic damage, but better yields are expected for 1990, even though international prices were significantly down. Beef production rose in 1989 but is anticipated to fall slightly in 1990. Timber production improved in 1989, and the Finance Center recovered strongly from its recent poor performance during the 1986-88 period. Table 2 indicates constant price GDP growth by economic sector since 1986 and also projections for 1990.

Present indications suggest that continued economic growth around the 4 percent level should continue into 1991. An increase in visitor

Table 2. Constant price GDP, 1986-91 (percent change)

	1986	1987	1988	1989	1990*
Agriculture, fishery, & forestry	-8.4	-6.2	-9.8	9.3	-2.7
Subsistence agriculture	2.3	2.6	-4.5	5.5	-4.4
Copra	5.0	-13.2	-18.2	-8.0	37.5
Cattle	2.9	11.3	3.6	4.2	4.2
Cocoa	32.1	-8.7	-35.1	101.6	27.7
Other agriculture	-51.8	-64.2	29.5	-0.8	4.7
Forestry and logging	-33.9	88.5	-45.6	140.0	2.7
Manufacturing	0.2	25.9	50.3	-12.4	9.9
Electricity	-1.0	-5.3	6.1	12.0	8.5
Construction	29.8	40.4	16.3	6.7	-7.5
Wholesale & retail trade	-7.8	2.5	-1.9	-0.7	1.1
Hotels & restaurants	-24.8	-0.5	18.2	10.0	26.2
Transport, storage, & communication	-3.8	-0.8	5.6	9.1	12.9
Finance & insurance	32.9	-41.1	40.6	-0.2	2.8
Government services	5.6	-6.2	-3.1	-11.1	0.0
Other services	3.4	2.7	-3.0	11.2	10.2
GDP at factor cost (includes imputed bank service charges)	-2.0	0.4	0.6	4.5	4.6

Source: National Accounts of Vanuatu 1985-89, and Statistical indicators, 4th quarter 1990, Statistics Office, N.P.S.O., Government of Vanuatu.

Note: * Projections based on PIDP's economic model (see Sturton, Mark. Policy Modeling in the Small Island Economies of the South Pacific: The Case of Vanuatu, Research Report Series No. 11. PIDP, East-West Center, 1989).

arrivals is anticipated, although the deepening Australian recession is a cause for concern, and some improvement in copra production is expected. Provided the continuing recession in the developed nations does not adversely affect demand conditions for Vanuatu's other major exports, and investor confidence remains buoyant, Vanuatu's prospects look reasonably encouraging.

Tourism

Visitor arrivals in 1989 were 23,865, their highest level since 1985. This was despite the temporary disruption of arrivals following adverse publicity in Australia of domestic political disturbances that occurred in late 1988. Hotel occupancy rates turned around from 28 percent in the first quarter of 1989 to 55 percent during the peak tourist season at the end of the year. For 1990 tourist arrivals reached a record of 35,043 exceeding the National Tourism Office's 1991 projection. The major factor contributing to this dramatic turnaround was because the government-owned Air Vanuatu provided three direct flights weekly from Australia to Vanuatu, which was supported by an active promotional campaign in Australia. Australian aid was used to finance the purchase of a Boeing 727 jet aircraft and to fund the promotional campaign. The subsiding of political disturbance in Vanuatu and a prolonged domestic airline dispute in Australia increased the popularity of Vanuatu as a tourist destination.

Currently, Air Vanuatu flies its aircraft on weekends, leasing it to Australian Airlines for domestic Australian use on week days. To accommodate expansion in tourist arrivals much beyond 35,000 will require adjustment in these leasing arrangements. At present there are no firm plans for any substantial additions to the installed tourist plant, and capacity constraints will start to emerge once the volume in tourist arrivals exceeds 40,000.

The optimism toward continued strong growth in tourist arrivals needs, however, to be tempered by consideration of the erratic growth history of this sector. While the natural beauty of Vanuatu offers outstanding tourism potential, tourist arrivals have been very sensitive to the perception of domestic political developments, flight availability, and the state of the Australian economy. The start-up of a regular Air Vanuatu service from Australia, and more recently New Zealand, supported by a strong promotional effort, should help to stabilize tourism growth. National elections will be held in 1991, and it will be important that these occur without adverse publicity in Australia. A more peaceful outlook for New Caledonia augers well for Vanuatu tourism because the two countries are often associated together in the tourist market.

The short-run economic outlook for Australia is not particularly bright. However, provided Vanuatu can remain competitive with destinations such as Fiji and Bali, it can expect to obtain a reasonable share of Australian tourists. It is significant that in the first quarter of 1991 Fiji experienced a substantial downturn in tourist arrivals attributed to the Australian recession. Preliminary indications are that this was not the case for Vanuatu. In maintaining a market share against these destinations, Vanuatu has the advantage of still being sufficiently small to be considered "exotic" in the Australian market. However, for the medium to longer term there is a need to diversify the tourist markets to Japan and North America.

Copra

The performance of the agricultural sector has been mixed over the last two years. Copra export earnings fell from VT 953 million in 1988 to VT 750 million in 1989. Production in 1989 was 24,907 tonnes, a 16 percent decline from 1988 and the lowest level since 1972. The decline was greatest in the plantation sector, where senile trees had been severely affected by a succession of hurricanes. The year also saw a modest decline in prices from their reasonably high 1988 level.

By 1990 coconut stands were beginning to recover from hurricane damage with 45,071 tonnes produced, about a 80 percent increase. However, world copra prices declined sharply throughout the year to US\$196/tonne (CIF Rotterdam) in September compared with an average price of \$349/tonne for the previous year. Prices were their lowest level since the third quarter of 1986. Vanuatu can expect a further price discount of 20 percent due to the poor quality of its copra. Problems of low price and poor quality were compounded by storage and stevedoring problems at the port serving the main producing area. Thus despite the marked increase in production in copra, earnings in 1990 fell by around 20 percent.

A further modest increase in copra production of around 20 percent can be expected in 1991, provided the coconut areas are not hit by a major hurricane. However, the World Bank is forecasting an even further decline in copra prices. The industry also faces serious marketing problems in terms of storage, stevedoring facilities, and their operation that need to be resolved as a matter of priority, given the high value added and linkages of the industry.

Beef

Vanuatu is the only Pacific island country to export beef, which has become the most important agricultural diversification commodity. Recent years have seen significant investment being made in pasture improvement and abattoir development. In 1989 beef exports were valued at a record VT 262 million, which represents 16 percent of do-

mestic exports. The principal export markets are Japan and New Caledonia. The value of exports in 1990 increased to VT 368 million. The steady improvement in the quality of the national cattle herd has been such that there is now a shortage of stock suitable for manufacturing beef for export to the Japanese market.

Some growth in beef exports can be expected in 1991, provided orderly marketing problems can be resolved. The growth in tourism will increase the domestic demand for beef. The passing of the Meat Industry Act in April is a significant development in terms of facilitating orderly marketing. A major constraint to future development is the lack of access to overseas markets because of the absence of an accredited disease free status and abattoir standards.

Cocoa

Cocoa, the second major export crop, has enjoyed strong growth over the last two years, despite low world prices and some hurricane damage. The 1,538 tonnes of dry beans produced in 1989 was a record and double the production of the previous year. In 1990, 2,173 tonnes were produced, which generated export earnings around those of beef. Most cocoa is grown under coconuts by smallholders who find it an attractive crop even at current prices. Vanuatu cocoa, unlike copra, has a reputation for superior quality that commands a premium price. The quality is such that a cocoa processing project (butter and powder) is planned, which will be targeted at the "organic" (no fertilizer and chemicals) chocolate market.

Cocoa is likely to continue to grow strongly despite pessimistic price forecasts and to surpass beef as the second major export earner.

Coffee

Further diversification of agricultural exports can be expected over the next few years. A number of areas could prove to be important sources of growth. Effort in recent years has been made to increase coffee exports, which at the time of independence exceeded 100 tonnes. However, the expected results have not to date been achieved. Particularly disappointing has been a joint venture between the government and Commonwealth Development Corporation involving a nucleus estate to grow arabica coffee. Total coffee (green bean) production in 1989 was 25 tonnes, while no coffee was exported in that year. In 1990, 15 tonnes were reported.

A coffee processing project is being proposed that is directed at speciality niche market exports and high value retail packs for the tourist market. Based on the Hawaiian coffee as the model, the expectation is that high value processing will offer longer-term viability to this industry. However, this will require vertically integrated private investment, with strong emphasis on marketing.

Kava

A major growth area in the agricultural sector has been in the production of kava. To date this traditional beverage has been mainly for the domestic market, which has grown rapidly with the proliferation of kava saloons in urban areas. However, the sizable pharmaceutical and herbal export market is now starting to be exploited. In 1990, 43 tonnes were exported for an estimated value VT 15 million, with these figures expected to double in 1991.

Kava exports could be on the brink of a major expansion. Vanuatu has a wider range of commercial kava varieties than any other Pacific island country. Recently, a technology has been developed to produce soluble kava for a "ginseng" type product. If herbal and pharmaceutical markets can be realized, potential exists for establishing a multi-million dollar industry. However, a high level of marketing skill will be required to develop significant herbal beverage market. Furthermore, the kava supply will need to be carefully managed due to the cultural sensitivity of this traditional crop.

Other exports

Spices such as vanilla and black pepper, which are being developed on a smallholder basis, offer good prospects, particularly if linkages to tourism can be established. The establishment of Air Vanuatu flights to Australia and New Zealand now offers backloading opportunities to export fresh produce to those markets. The export of high quality root crops is an immediate prospect in this respect.

Timber

Timber is the third most important export earner after beef; however, the industry has shown little growth in recent years. During the period 1984 to 1989 an average of 13,900 tonnes of sawn timber were exported annually. In 1989, 12,600 tonnes were exported for a value of VT 204 million. While 75 percent of Vanuatu's land area (some 900,000 ha) is under natural vegetation, it does not have the same commercial indigenous forest resources as the other large Pacific island countries (Papua New Guinea, Solomon Islands, and Fiji). Pending the completion of a national forestry inventory, a ban has been placed on log exports. Hence timber exports in 1990 fell to 1,800 tonnes valued at VT 91 million. Government policy has emphasized small-scale timber processing facilities with maximum landowner participation. The government has also embarked on a hardwood plantation program that has yet to reach maturity.

The export timber industry is expected to show little growth over the next two years.

Fishing

Fishing is a major subsistence activity. Yet, considering the size of Vanuatu's potentially rich Exclusive Economic Zone (EEZ), there has

been limited commercial fisheries activity since the closure of the Japanese owned South Pacific Company's operations in 1986. The company that re-exported frozen albacore tuna to Hawaii and Japan has relocated its operations to American Samoa. At the peak of its operations in 1980 the value of these re-exports was US\$15.6 million. Efforts by the Vanuatu government to re-activate the tuna exporting base have proved unsuccessful, principally because the longline albacore fishery has been in decline throughout the South Pacific. The manufacture of trochus shells for domestic buttons is the only marine based commercial activity that has grown strongly in recent years. The value of exports in 1990 was VT 109 million, compared with VT 59 million in 1989 and VT 35 million in 1988.

The export fishing sector is expected to show little growth over the next two years. A recent analysis concluded that it would be unwise for Vanuatu to reenter the longline tuna fishery and that activity should be restricted to licensing and servicing foreign fleets.

Mining

Since the closure of a small manganese mine in 1977, Vanuatu has had no mineral exports. However, Vanuatu is part of the Pacific "rim of fire." The discovery of the Lihir gold and copper deposit in Papua New Guinea has promoted considerable exploration activity in Vanuatu. In 1984 there was only one active prospecting license, but by the end of 1987, 130 licenses had been issued. Exploration expenditure in 1988 was approximately US\$1 million, which led to epithermal gold and silver discoveries at several locations. However, the cash flow problems of the company holding most of the prospecting licenses has meant that the momentum of exploration has not flowed over in 1989 and 1990 and is not expected to pick up until these licenses are transferred to active exploration companies.

It is hoped that the passing on of prospecting licenses to companies financially better placed to carry on active exploration can yield more fruitful results.

Manufacturing

Vanuatu has a small but growing manufacturing sector focused toward import substitution, food, and beverage production. In 1987 food and beverages accounted for 45 percent of total manufacturing value added. The manufacturing sector relies on the substantial participation of skilled expatriate labor, which places a high cost burden on manufacturing costs. However, there have been some encouraging developments in ni-Vanuatu participation in furniture manufacture. To provide small businesses with access to reasonably priced and serviced factory space, a small industry estate, based on the successful Tongan model, is proposed for the island of Espiritu Santo. A few

enterprises have already commenced operations on the site of this estate.

It is anticipated that the Santo small industry estate will be commissioned during 1991 and that it will provide the impetus to export manufacturing development.

The Finance Center

The Finance Center includes a range of companies, banks, trust companies, and other financial institutions registered in Vanuatu but with a distinction made between institutions providing services in Vanuatu and "exempt" companies. The former group comprises institutions entitled to carry on both onshore and offshore business, and their financial statements are available to the public. The exempt companies are registered in Vanuatu and guaranteed secrecy about their business activities provided they conduct no business with nonbank residents. The Finance Center also includes a shipping registry operated on behalf of the Vanuatu government.

The perception of a more stable political environment and an upturn in tourist arrivals has been accompanied by a returning confidence in Vanuatu's Finance Center. The foreign exchange earnings of the Financial Center reached VT 2,574 million in 1989 compared with VT 1,696 million in 1988. In 1990 the export earnings of the center continued to expand and reached VT 3,077; a 20 percent increase compared with 1989.

Savings and Investment

Table 3 indicates recent movements in investment, savings, and the external resource gap. The figures show that Vanuatu has maintained a high ratio of gross capital formation to GDP and that investment expenditures have been growing faster than GDP over the period. However, while investment has been buoyant and grew on average by 6 percent, economic growth has been sluggish and recorded an average of only 1.6 percent. This implies not only a poor but also a declining rate of capital productivity and a very high incremental capital output ratio (ICOR). Investment in the economy, as the data for transfers indicate, has been largely driven through aid. While aid related investment can perform a useful function, it is not necessarily related to greater economic output. The poor relationship between investment and growth in Vanuatu would appear to underline this point.

Domestic savings rates are not large and quite erratic with variation reflecting the point in the product cycle. If Vanuatu is to become more self-reliant, greater efforts at domestic resource mobilization will be needed. The excess of investment over domestic savings (the foreign resource gap) is made up of a variety of important elements. Net factor incomes include sizable earnings on net foreign assets and large imputations for re-invested profits, which are recorded as an outflow on the current account with a counterbalancing item on the capital account. If re-investment of profits are ignored, capital flows are small. In recent years direct foreign investment has been negligible, and official foreign borrowing has been small.

Table 3. Investment, savings, and resource gaps, percent of GDP, 1983-89

	1983	1984	1985	1986	1987	1988	1989
Gross capital formation	25.1	23.3	28.4	33.9	35.0	29.9	35.9
Domestic savings	12.1	18.0	7.0	2.9	5.9	5.9	8.8
Resource gap	13.1	5.3	21.4	31.0	29.1	24.0	27.1
Net factor incomes	-12.5	-22.1	-9.1	1.9	-6.4	2.8	2.3
Transfers	31.5	31.5	27.3	25.6	42.3	32.1	25.7
Capital account	3.1	6.5	2.7	2.2	11.2	9.2	7.1
Residual movements	-9.0	-10.6	0.5	1.3	-18.1	-20.0	-8.1

Source: National Accounts of Vanuatu 1985-89, Statistical indicators 4th quarter 1990, Government of Vanuatu, Statistical Office, N.P.S.O.

Quarterly Economic Review, Reserve Bank of Vanuatu, December 1990.

Finance of the external resource gap is dominated by development aid assistance. However, an important ingredient of the finance of the resource gap is "residual movements," which include both movements in net foreign assets and the statistical discrepancy in the balance of payments, which is not negligible. However, net foreign assets have grown dramatically in recent years, which is recorded as a negative movement in Table 3. The implication of these changes is that aid expenditures have largely financed investment needs, leaving an excess of domestic savings. These savings have been invested in an accumulation of foreign assets. Given the absence of capital account restrictions in Vanuatu, it would appear that private sector entrepreneurs feel a greater return may be derived through offshore investment than in Vanuatu. In most other Pacific island economies, exchange controls camouflage the private accumulation of external assets. In Vanuatu, there is no incentive to hide offshore investment of funds, and the outcome is readily visible.

At the sectoral level the main investment in 1989 and 1990 has been aid funded public investment to support the tourist sector. The extension and upgrading of the Port Vila runway were completed in 1990 under Australian aid, and all but the largest aircraft can now be accommodated. The construction of the new terminal facilities was completed in early 1991. Australian aid totaling VT 500 million and domestic resources of VT 1,000 million were transferred to Air Vanuatu to purchase a Boeing 727. However, the only significant private investment in the tourism sector has been a refurbishing and casino development at one of the major resort hotels.

In agriculture the main investment has been in pasture improvement in the cattle industry. New planting in the cocoa industry continued, with an estimated 500,000 seedlings planted in 1989.

Inflation

Figure 4 indicates recent movements in the consumer price index (CPI) and imported inflation (estimated from inflation rates in Vanuatu's import suppliers). The import weight in the CPI is 65 percent, and a close correspondence exists between movements in import prices and the overall CPI. In 1985 the Vatu was devalued by 9 percent and a further 29 percent in 1986. The high rate of inflation experienced in 1987 of 16 percent reflects these changes, together with the impact of supply shortages on domestic food stuffs caused by a tropical cyclone at the beginning of the year. Various increases in import duties also occurred in 1987. In 1988 and 1989 inflation subsided to 9 and 8 percent, respectively, without the influence of exchange rate devaluations or adverse climatic conditions. In 1990 the trend continued its downward movement, and inflation fell to a respectable 6 percent.

Little data exist on movements in wages. A minimum wage exists, which was raised from VT 7,000 in the urban areas to VT 8,500 in 1987, but since that time there has been no change. There is no formal process of wage determination or indexation, and wages are largely determined through market forces. In the public sector with the stringencies on the fiscal budget there was no expansion in wages between 1985 and 1989, with the exception of a 3 percent adjustment in 1985. In 1990 a 10 percent cost of living adjustment was granted.

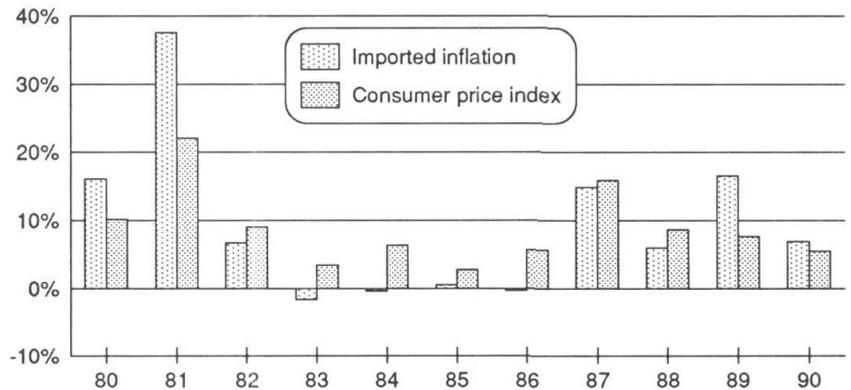


Figure 4. Comparison of CPI and estimated imported inflation, 1980-90

Current indications of inflation in Vanuatu's trading partners, together with a reduction in fuel prices following the gulf crisis, suggest moderation in the rate of imported inflation. Current domestic demand conditions have improved with the economic recovery and pay award for civil servants in 1990. A combination of these factors suggests a continuing decline in inflation, and a rate of 5 percent is forecast for 1991.

Fiscal Developments

Recurrent budgetary developments

Vanuatu inherited a problematic fiscal situation at independence. Sizeable grants for budgetary support, representing 50 percent of recurrent expenditures in 1980, were gradually eliminated by 1988. A dual French and British administration made the provision of services, particularly in education, a costly overhead. A narrow tax base reliant on import duties for 70 percent of revenues produced an inelastic foundation for expenditure growth. Attempts to widen the base to include a range of income related taxes were frustrated by the fear of alienating Vanuatu's Finance Center, which enjoyed a tax haven status. Recent trends in the government's budget are shown in Tables 4 through 7.

Figure 5 indicates the experience of the recurrent budget through the 1980s, and Table 6 indicates the level of both the recurrent deficit (government savings) and the overall budget deficit. Recurrent deficits were successfully avoided throughout most of the period, despite the gradual withdrawal of budgetary aid, through periodic increases in import duties and other indirect taxes plus tight control

Table 4. Government expenditure (VT million)

	1985	1986	1987	1988	1989	1990*
Current expenditure	4,553	4,591	4,708	5,054	4,804	5,344
Wages & salaries	1,735	2,052	2,159	2,342	2,264	2,373
Goods & services	1,013	782	749	901	808	1,027
Transfers & subsidies	410	350	388	361	249	294
Technical assistance	1,362	1,362	1,377	1,370	1,400	1,450
Interest payments	33	27	33	80	83	200
Other	0	18	2	0	0	0
Development expenditure	1,269	1,252	2,940	3,084	4,649	2,830
Cash	0	817	1,914	2,371	3,899	1,830
Air Vanuatu	0	0	0	200	1,503	200
In kind	0	435	1,026	713	750	1,000
Total expenditure	5,822	5,843	7,648	8,138	9,453	8,174
Current expenditure/GDP	36.3%	37.7%	35.1%	33.7%	29.4%	29.4%
Development expenditure/GDP	10.1%	10.3%	21.9%	20.6%	28.4%	15.6%
Total expenditure/GDP	46.4%	48.0%	57.1%	54.2%	57.8%	45.0%

Source: Unpublished budget documents, Ministry of Finance, Government of Vanuatu.

Note: * Budget estimates

Table 5. Government revenue (VT million)

	1985	1986	1987	1988	1989	1990*
Revenue & grants	5,710	5,121	8,291	7,636	8,027	7,763
Revenue	2,970	2,778	3,503	3,747	4,079	4,235
Taxes	2,298	2,248	3,013	3,151	3,380	3,383
Trade	1,724	1,585	2,041	2,390	2,436	2,470
Other	574	663	972	761	944	913
Non-tax revenue	672	530	490	596	699	852
Grants	2,740	2,343	4,788	3,889	3,948	3,528
Budgetary aid	279	133	75	20	0	0
Technical assistance	1,362	1,362	1,377	1,370	1,400	1,450
Development	1,099	848	1,849	1,888	2,548	1,808
In cash	n.a.	413	583	1,042	1,777	808
Cyclone reconstruction	n.a.	0	240	133	21	0
In kind	n.a.	435	1,026	713	750	1,000
Stabex	n.a.	0	1,487	611	0	270
Revenue & grants/GDP	45.6%	42.0%	61.9%	50.9%	49.0%	42.8%
Tax revenue/GDP	18.3%	18.5%	22.5%	21.0%	20.7%	18.6%

Source: Unpublished budget documents, Ministry of Finance, Government of Vanuatu.

Note: * Budget estimates

over expenditures. Recurrent balance was maintained without serious problems during the 1980-84 period, although sizable increases in import taxes were introduced in 1983. In 1985 the economy entered a significant recession from reduced tourism arrivals and falling copra prices, and in 1986 in the trough of the cycle a large recurrent imbalance occurred. In 1987 a series of further revenue measures were introduced, and a continued freeze on wages was maintained, together with expenditure reductions and a halt on new recruitment. These policies corrected the earlier difficulties, and recurrent balance was restored.

In 1989, although no new taxes were introduced, a recurrent surplus was planned through compression of expenditures particularly in the health and education sectors. As a result, real recurrent outlays fell by 5 percent. In 1990, with a year of successful growth behind and continued expansion anticipated for 1990, the budget allowed for a 10 percent rise in civil servant remunerations. During the period 1985 through 1989 no increase in civil servant pay had been allowed except for a small cost of living allowance of 3 percent in 1985. No major new revenue measures were introduced during 1990 despite earlier intentions to introduce a turnover tax although business license fee collections were to be increasingly based on turnover. Economic expansion

Table 6. Financing of government deficit (VT million)

	1985	1986	1987	1988	1989	1990*
Recurrent savings	58	-318	247	83	675	341
Overall budget deficit	112	722	-643	502	1,426	411
Foreign (net)	88	92	289	269	559	211
Borrowing		139	341	311	591	261
Repayments		47	52	42	32	50
Domestic (net)	24	630	-932	233	867	200
Commercial bank deposits	-78	1,267	-83	37	-72	n.a.
Commercial bank credit	-8	23	175	168	41	n.a.
Reserve Bank of Vanuatu credit (net)	-4	-570	-1,388	-98	796	n.a.
Non-bank (net)		4	144	144	356	n.a.
Discrepancy	114	-94	220	-18	-254	n.a.
Recurrent savings/GDP	0.5%	-2.6%	1.8%	0.6%	4.1%	1.9%
Overall deficit/GDP	0.9%	5.9%	-4.8%	3.3%	8.7%	2.3%

Source: Unpublished budget documents, Ministry of Finance, Government of Vanuatu.

Note: * Budget estimates

was anticipated to generate a growth in receipts of 4 percent, and a continued recurrent surplus was anticipated although at a reduced level compared with that in 1989.

The budget presented for 1991 incorporated no significant changes in policy or new revenue measures. Revenues are projected to grow by nearly 8 percent with allowances for growth in expenditures of nearly 7 percent. As a result, the recurrent budget is projected to remain in approximate balance. The continuing economic recovery should improve revenue collections in 1991, present a less critical position for the recurrent budget, and afford the opportunity for the government to expand some important expenditures that have been restricted in recent years.

Table 7. Government debt (VT million)

	1984	1985	1986	1987	1988	1989
Debt outstanding	401	490	691	1,603	2,003	3,560
Domestic	157	161	222	702	885	1,845
Overseas	244	329	469	900	1,118	1,715
Debt/GDP	3.2%	4.0%	5.2%	10.7%	12.2%	19.6%

Source: Accounts and Financial Statements 1984-89, Ministry of Finance, Government of Vanuatu.

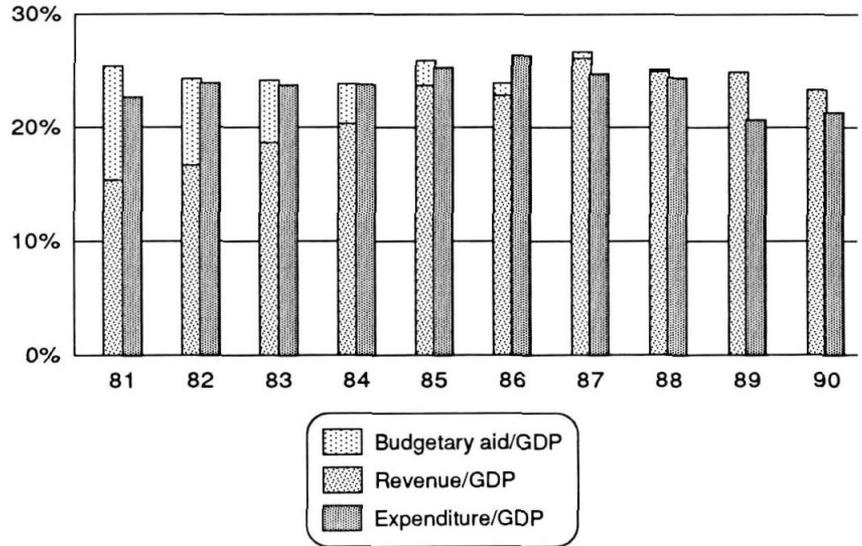


Figure 5. Recurrent revenue, budgetary aid, and expenditures (less technical assistance) as percent of GDP

The development budget

While maintaining recurrent balance had by and large been achieved successfully, albeit with the periodic pain of adjustment, the operation of the development budget was not nearly as satisfactory. The outcome of the overall budget is shown in Figure 6 and Table 6. Sizable overall deficits were recorded in 1982 and throughout the latter part of the 1980s. Development grant aid both in cash and in kind funds a substantial proportion of development outlays, but growing pressures for new projects, particularly in the latter 1980s, resulted in a series of deficits. Two distorting influences affecting the outcome need to be included in the discussion. The first is the receipt of Stabex funds for stabilization purposes received from the EEC, which are periodic in nature and mask the underlying budgetary position. The second is the substantial funds transferred to Air Vanuatu for the purchase of a 727 Boeing jet airliner in 1989.

Development budgetary problems started to emerge in 1986, but the receipt of substantial Stabex money in 1987 gave the appearance of a sizable surplus, whereas the underlying deficit (without Stabex) had fallen to more than 6 percent of GDP. In 1988 sizable Stabex flows were again recorded, and the first transfer of VT 200 million to Air Vanuatu was incurred. Tourism arrivals had halved since 1984, and the government felt that only through the provision of better air services and the operation of Air Vanuatu would the situation be im-

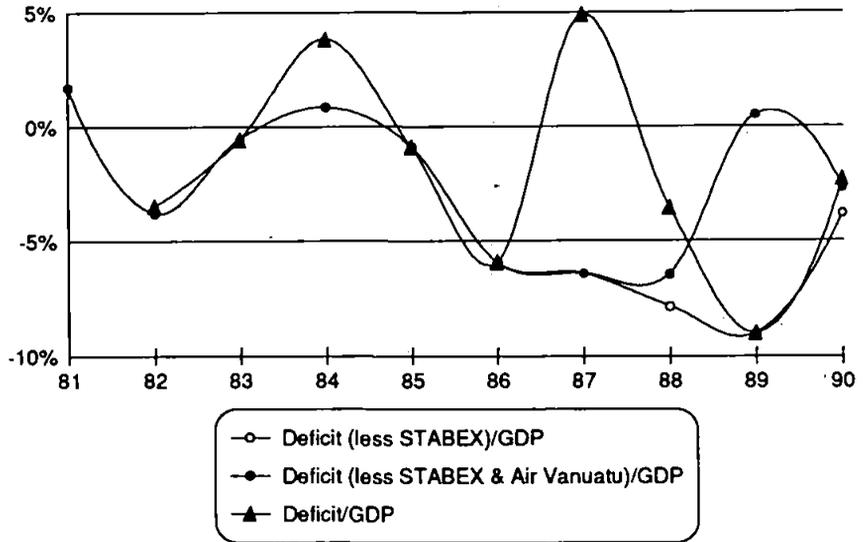


Figure 6. Overall deficit with and without Stabex and Air Vanuatu as a percent of GDP, 1981-90

proved. Events since that time have proved this to have been a correct assumption, although doubts over the profitability of Air Vanuatu continue to linger.

In 1989 with no Stabex receipts but with a sizable transfer of VT 1,500 million to Air Vanuatu, the overall deficit rose to 9 percent of GDP despite a recurrent surplus of 4 percent. However, earlier measures to rationalize development expenditures were paying off, and the underlying deficit (without Stabex and Air Vanuatu) was largely in balance. In 1990 the three measures of the deficit as shown in Figure 6 had fallen into line, and a much improved deficit of 3 percent is anticipated when the final figures emerge.

Financing and public debt

The volatile movement in Stabex receipts and Air Vanuatu payments led to an erratic pattern of financing. Until 1986 both foreign and domestic borrowing had been moderate; the large Stabex monies received in the early '80s had accumulated in bank deposits, which were later drawn in times of deficit. In 1986, the first year to record a substantial deficit, commercial bank deposits were drawn down significantly, although this was accompanied by an accumulation of Reserve Bank deposits. In 1987 with the massive VT 1,500 million receipt of Stabex money, an increase in foreign borrowing of VT 300 million, and floatation of development bonds of VT 500 million, Reserve Bank

deposits again rose by VT 1,400. In 1988 there was a further issue of VT 200 development bonds, which together with foreign borrowing of VT 270, funded the deficit.

In 1989 the deficit rose to VT 1,500 million, which matched the amount transferred to Air Vanuatu. Foreign borrowing of VT 600 million and issue of VT 1,000 million of bonds provided the main source of finance to fund the deficit. The domestic capacity to absorb this large additional increase in bonds was limited. The commercial banks were already holding sufficient bonds for their needs, and the Reserve Bank became the lender of last resort, although VT 300 million was taken by the non-banking sector. In 1990 with a much reduced deficit and funding need, plus foreign net borrowing of VT 200 million, the domestic market was able to absorb the additional VT 200 million to fund the deficit without resort to inflationary finance.

Table 7 reveals the rapid expansion of public debt in recent years, with the level of foreign debt matching that of the domestic debt. Total outstanding debt rose from a level of 3 percent of GDP in 1985 to nearly 20 percent by 1990. The rapid expansion matches the growth in development expenditures and the need to fund the large deficits. However, better control over development expenditures is now in place, and with the lumpy outlays on Air Vanuatu in the past, the situation should be less explosive in the 1990s. Given the concessionary nature of much of the foreign debt and the overall low ratio of public debt to GDP, debt service should not present any significant financing problems in the foreseeable future.

Conclusion

The fiscal outturn for the 1980s produced a varied set of results, which, given the poor performance of the economy and circumstances inherited at independence, must be regarded as a success. The recurrent budget has been held in balance by a series of painful adjustments, although insufficient control over development expenditures resulted in large deficits in the latter part of the period. Improved development planning, monitoring, control, project identification, and evaluation would all contribute toward greater success in the 1990s.

Monetary Developments

Monetary policy

The financial sector in Vanuatu is composed of three foreign commercial banks, the Development Bank of Vanuatu, the Vanuatu Cooperative Savings Bank, and the Reserve Bank of Vanuatu. In addition, there is the Finance Center, which was attracted by Vanuatu's tax haven status. There are no restrictions on capital account or exchange controls, and residents are permitted to hold both Vatu and foreign currency denominated deposits. As a result, Vatu deposits represented less than 30 percent of total deposits in 1990. With the choice of a fixed exchange rate, the potential for independent monetary and interest rate policies is extremely restricted. Both money supply and interest rates are essentially market determined. Under these circumstances monetary policy has been limited to the issuance of a set of guidelines to the commercial banks from the Reserve Bank.

Present guidelines to the commercial banks include a maximum weighted average interest rate of 14 percent, with interest rates on loans to "productive" sectors, as defined by the Reserve Bank, not to exceed 14 percent. Credit to ni-Vanuatu is to be favored, but personal loans for consumer imports are to be restrained. In recent years these guidelines have been largely ignored. In 1987 the average interest rate on Vatu loans was 13 percent, which rose to 13.4, 14.3, and 14.3 percent, respectively, in 1988, 1989, and 1990. Loans to productive sectors fell from 34 percent in 1987 to 32, 31, and 29 percent in 1988, 1989, and 1990, while the proportion of productive sector loans with interest rates above 14 percent rose.

In 1988 after a period of excessive speculation against the Vatu, the Reserve Bank delinked the Vatu from the SDR in February and imposed a 10 percent reserve requirement in June. Commercial banks were required to maintain 10 percent of Vatu denominated deposits as non-interest bearing cash reserves with the Reserve Bank. At a later point the commercial banks were allowed to hold 50 percent of these requirements in government bonds.

Developments in liquidity

Under the set of monetary conditions existing in Vanuatu, money supply growth is largely determined through the demand for liquidity and financial assets. Table 8 indicates movements in the monetary aggregates in recent years. M4, the broad measure of money supply used in Vanuatu, including both foreign and Vatu deposits, grew very rapidly in the early 1980s from VT 3,760 million to VT 10,559 in 1984, with the share of Vatu denominated deposits falling from 44 to 35

Table 8. Monetary survey (VT million)

	1984	1985	1986	1987	1988	1989	1990
Money supply (M4)	10,559	11,131	12,827	12,788	11,954	16,214	17,996
Currency	922	964	906	1,000	955	1,037	934
Demand deposits	2,104	1,678	1,903	3,102	2,441	3,270	2,918
Vatu	1,212	1,242	1,271	1,770	1,578	2,061	1,761
Foreign	892	436	632	1,332	863	1,209	1,157
Time & savings	7,533	8,489	10,018	8,686	8,558	11,907	14,144
Vatu	2,156	1,781	2,264	1,958	2,269	2,284	3,021
Foreign	5,377	6,708	7,754	6,728	6,289	9,623	11,123
Net foreign assets	9,356	9,904	11,196	11,669	11,393	14,921	16,699
Reserve Bank	817	1,038	2,460	4,033	4,244	3,986	4,078
Commercial banks	8,539	8,865	8,735	7,635	7,148	10,935	12,621
Domestic credit	2,267	1,955	2,710	1,990	2,333	3,289	4,621
Claims on govt.	-1,263	-1,380	-865	-2,173	-2,054	-1,522	-1,445
Monetary authorities	-633	-785	-825	-2,254	-2,373	-1,844	-1,765
Commercial banks							
(net)	-630	-595	-40	81	319	322	320
Claims on private sector	3,497	3,287	3,485	4,080	4,364	4,777	6,048
Vatu	2,662	2,903	3,065	3,375	3,650	4,007	5,349
Foreign	835	384	420	705	714	770	699
Other items net	-1,063	-726	-1,079	-866	-1,854	-2,102	-3,343

Source: Quarterly Economic Review, Reserve Bank of Vanuatu, December 1990.

percent. Total liquidity oscillated somewhat between 1984 and 1988 when M4 had risen 13 percent to VT 11,954 million. In real terms liquidity had fallen 14 percent, which reflects the severe recession the economy was experiencing during that period. In 1989 liquidity growth picked up substantially with the rekindling of economic growth and rose 36 percent with the majority of the additional deposits accumulating in foreign currencies. The proportion of Vatu deposits fell from 35 percent to 29 percent. With continued economic buoyancy in 1990 M4 liquidity continued to expand and rose by 11 percent, which represented a real growth of 5 percent.

Movements in domestic credit

During the 1981-90 period domestic credit rose overall from VT 1,883 million to VT 4,078 million or 117 percent and considerably less than the explosive growth in M4. In real terms domestic credit growth was only 2 percent on an annualized basis, which would indicate why the large growth in money supply was not reflected in a similar growth in prices or inflation. The overall movement in domestic credit, however, masks erratic year-to-year changes, which reflect large oscillations in government deposits. The sizable Stabex receipts and more

recent transfers to Air Vanuatu, in conjunction with the changes in the government's overall fiscal position, have generated an erratic outcome. For example, domestic credit fell 14 percent in 1985, rose 39 percent in 1986, fell 27 percent in 1987, and rose 17 and 41 percent in 1988 and 1989, respectively. In 1990 domestic credit again grew by a substantial 40 percent

With the increases in overall fiscal deficit in 1988 and 1989, the government needed to float an increasing volume of domestic debt instruments. In 1987 VT 500 million of development bonds were floated, followed by an additional VT 200 million in 1988, and a net increase of VT 1,000 million in 1989. No additional borrowing was incurred in 1990. The banking sector was able to absorb the increases of 1987 and 1988, but the sizable demand for credit in 1989 meant the Reserve Bank had to purchase VT 765 million. This was considered a short-term measure, and the bonds will be sold once the market is in a position to absorb them. Some have already been sold to the Vanuatu Commodities Marketing Board (VCMB), which financed them from Stabex grants.

*Sluggish demand
for private sector
credit*

Credit to the private sector has been far less erratic although overall performance has been poor. Private sector demand for credit was particularly weak in the early 1980s rising only 5 percent between 1981 and 1985 and representing a real decline of 10 percent. Since 1985 private sector credit growth picked up in nominal terms and rose 45 percent in the 1985-89 period. This, however, represents only a 3 percent real growth over the period, not a particularly inspiring outcome and one that suggests sluggish business expectations. With the growth in credit to the private sector in each of these four years barely exceeding the rate of inflation, credit needs have been to support current levels of economic activity, and there was little interest in new investment.

In 1990, however, with the revitalization of the economy demand for private sector credit rose 27 percent reflecting the rapidly expanding tourist sector. This trend is expected to prevail in 1991 with continuing strong tourist demand and economic growth.

**Large interest
rate spreads**

An important feature of the Vanuatu banking system has been the very large interest rate spread between the deposit and lending rates. With average Vatu lending rates in the proximity of 14 percent and average rates on deposit of only 4 percent, the interest rate spread has been in excess of 10 percent. In the early 1980s the Reserve Bank attempted to reduce the spread to 4.5 percent but had little success and abandoned further attempts. The continued demand for low interest

yielding Vatu deposits is irrational given the high yielding foreign currency alternatives available to depositors, even acknowledging the exchange rate risk. The lack of information provided to small unsophisticated depositors may well have encouraged this situation, which the commercial banks have used to increase their profitability.

Normal commercial bank practice has been in most cases to back Vatu and foreign currency liabilities with matching assets, except in times of anticipated currency depreciation such as in 1988. In the earlier part of the 1980s, however, Vatu deposit growth outstripped (even at negative real interest rates) the demand for Vatu credit and the bank's accumulated excess Vatu liabilities. In a competitive market, forces would have acted to reduce lending rates given irrational deposit behavior. However, it has been suggested that high risks and administrative costs of Vatu lending, limited proportion of business in Vatu claims, and lack of competition have preserved the situation. In the latter 1980s the situation has changed to some extent with Vatu lending exceeding Vatu deposit growth, and domestic interest rates have firmed. However, there has been no reduction in the interest rate spread.

Expectations for 1991

The favorable economic circumstances predicted for 1991 should result in improved business profitability and growth in foreign deposits and external reserves. Following recent trends, growth in Vatu liquidity would be expected to be less buoyant, and domestic credit expansion should be moderate.

The External Sector

Balance of payments structure

The external sector has displayed a persistent trade imbalance throughout the 1980s with domestic exports covering approximately one-quarter of imports destined for home consumption. However, this situation has deteriorated. In the first part of the 1980s, exports covered 35 percent of the value of imports but fell to 24 percent in the late 1980s and had fallen to 17 percent in 1990. The trade deficit is normally counterbalanced by a surplus on the service account and large transfer receipts of foreign aid. With the exception of 1986, the current account was in surplus throughout the 1980s. The capital account was also in surplus throughout the period, recording small levels of direct investment and official borrowing, as well as sizable volumes of reinvested profits.

Tendency toward external surplus

The balance of payments has a tendency to produce an overall surplus. With business preferences to reinvest savings offshore rather than in Vanuatu, the balance of payments has recorded an overall surplus in times of normal profitability. In the early part of the 1980s, the balance of payments recorded large surpluses, which resulted in a very sizable accumulation of foreign reserves. In the 1986-88 period with the exceptionally poor set of economic circumstances and low business profitability, the balance of payments outcome deteriorated and a deficit was recorded in 1988. In 1987 the large Stabex receipts counterbalanced the prevailing trend and produced an overall surplus. In 1989 the economy returned to more favorable conditions, and the balance of payments produced a large surplus with the corresponding accumulation of foreign reserves. In 1990 with continued economic growth a sizeable surplus was again experienced.

Trends in exports and imports

Recent trends on the trade account are shown in Figure 7 and Table 9. Copra exports have dominated the movement in total exports, but the figure reflects significant variation. Relatively large exports and copra earnings were recorded in 1984 with the boom in copra prices, but since that time prices have been depressed although improving slightly in 1988 and 1989. In 1990 the overall volume of domestic exports increased significantly, but due to the sharp decrease in copra prices, the total value of exports remained unchanged and recorded a value of VT 1,606 million similar to that in 1989.

In the early 1980s and after independence imports grew strongly in real terms, reflecting an expanding economy, and recorded an average 12 percent growth in the 1982-85 period. With the economic

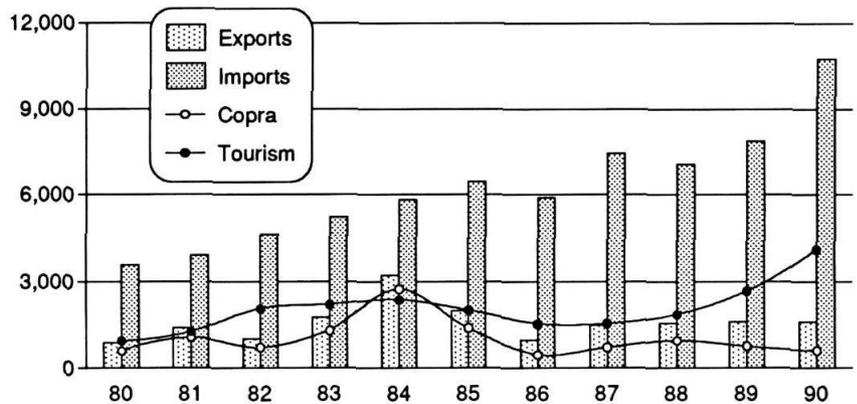


Figure 7. Exports, imports, copra, and tourism receipts (VT million), 1980-89

downturn between 1985 and 1989 the trend in real imports has been downward although the level of nominal imports has oscillated. In 1987 with the aftereffects of Cyclone Uma and the reconstruction effort, real imports grew by 10 percent but, following the rebuilding stage, fell back in both nominal and real terms in 1988. In 1989 nominal imports rose with the improving economic climate but indicated stagnant demand in real terms. With the strong economic recovery in 1990 import demand rose rapidly, reflecting the growth in tourist demand. With rising imports and stagnant exports the trade balance deteriorated substantially.

Terms of trade

Figures 8 and 9 indicate the extremely interesting changes in Vanuatu's terms of trade. Figure 8 shows movements in the commodity terms of trade with and without tourism over the 1980-89 period. Export prices use five-year moving averages to iron out commodity price fluctuations. Figure 9 indicates movements in the terms of trade and the ratio of copra to import prices over the longer term of 1970-89 with all data based on five-year moving averages. Data on estimated tourism earnings were available only from 1980 so it was not possible to combine the two graphs. Figure 8 indicates the oscillations in Vanuatu's terms of trade. The direction has been downward, but it has been ameliorated by the substantial commodity price boom for copra in 1984 and 1985. If tourism is included in the terms of trade the cyclical effect is not ironed out, but the overall deterioration is reduced.

Figure 9 indicates the long-term secular deterioration in the commodity terms of trade. The graph also indicates the ratio of copra

Table 9. Exports by commodity (VT million)

	1985	1986	1987	1988	1989	1990
Copra						
Value	1,392	461	719	953	750	598
Volume (tonnes)	34,930	42,293	31,846	31,681	23,620	37,246
Unit price (VT000/tonne)	39.9	10.9	22.6	30.1	31.8	16.1
Cocoa						
Value	133	196	207	117	174	248
Volume (tonnes)	814	1197	1243	813	1573	1961
Unit price (VT000/tonne)	163.4	163.7	166.5	143.9	110.6	126.5
Beef						
Value	186	149	252	243	262	368
Volume (tonnes)	1,134	502	1,047	1,005	991	1,217
Unit price (VT000/tonne)	164.0	296.8	240.7	241.8	264.4	302.4
Timber						
Value	136	63	208	106	204	91
Volume (tonnes)	17,423	7,839	19,283	6,999	12,626	1,844
Unit price (VT000/tonne)	7.8	8.0	10.8	15.1	16.2	49.3
Other						
	123	101	117	139	222	301
Total	1,970	970	1,503	1,558	1,612	1,606

Source: Statistical indicators, 4th quarter 1990, Statistics Office, N.P.S.O., Government of Vanuatu.

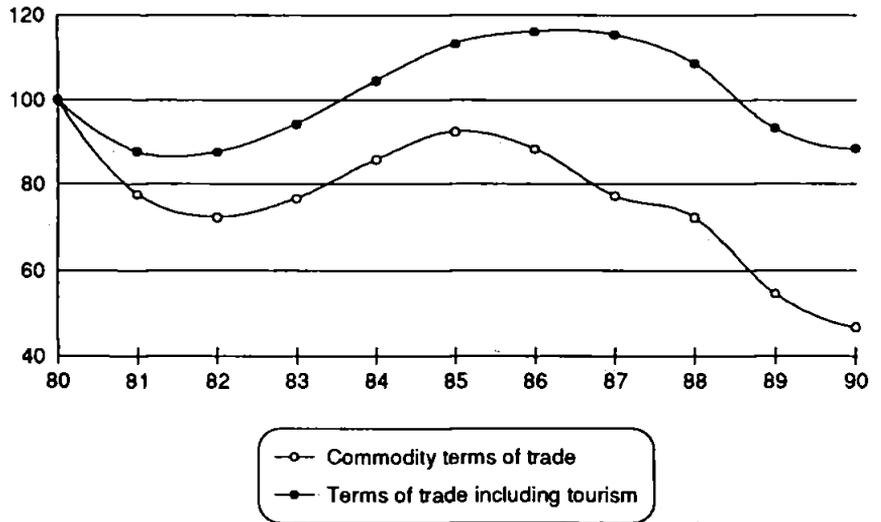


Figure 8. Terms of trade with and without tourism, export prices, 5-year moving average, 1980-89

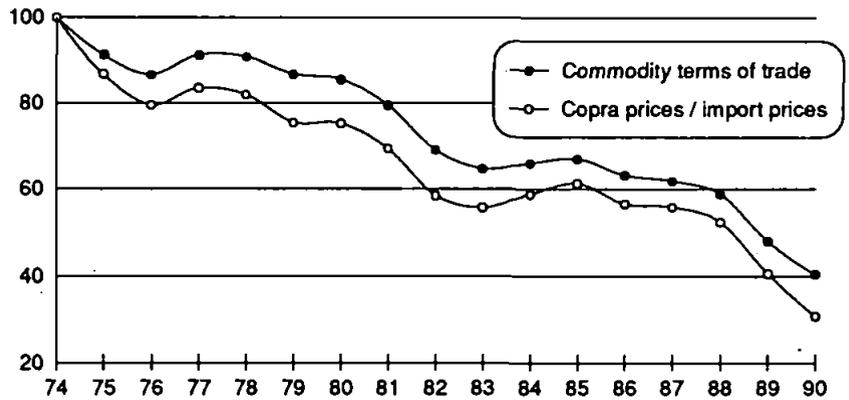


Figure 9. Terms of trade and copra/import price ratio, 5-year moving averages, 1970-89

prices to import prices. Clearly, copra prices have exerted a strong downward pressure on the overall terms of trade representing approximately 70 percent of commodity exports. Vanuatu's rural communities are particularly dependent on copra production, and few potential alternative export commodities have been developed. In other Pacific island countries the deterioration in the terms of trade has seen the virtual disappearance of copra as an export commodity. In the absence of profitable alternative substitutes, production of copra in Vanuatu is still substantial. However, the falling real copra price would account for an important element of the deteriorating position of the trade account.

The service account

The service account has maintained a surplus position throughout most of the 1980s and is dominated by a number of significant elements. Table 10 indicates recent movements in the balance of payments current account. Tourism, representing the most important generator of foreign exchange earnings on the service account, contributed a quarter of the total current account receipts in 1990. With the decline in tourist arrivals in the mid-1980s, tourist foreign exchange earnings fell in step but rose by a substantial 43 percent in 1989 with the revitalization of the industry. With tourist arrivals growing by nearly 50 percent in 1990, foreign exchange receipts recorded a 69 percent increase. The sizable holding of net foreign assets of the commercial banks has generated a substantial volume of interest receipts representing about 25 percent of total service earnings in 1990. Net receipts generated from this source have remained relatively stable during the 1980s. The contribution of the Finance Center, however, is not that substantial, with foreign exchange earnings representing only 4 percent of total service receipts in 1990.

Table 10. Balance of payments, current account (VT million)

	1985	1986	1987	1988	1989	1990
Trade balance	-3,571	-3,995	-4,768	-4,487*	-5,139	-7,669
Exports	1,970	970	1,502	1,558	1,612	1,606
Imports	5,541	4,965	6,270	6,045	6,751	9,275
Services balance	884	597	-44	478	1,924	4,400
Service credits	6,849	7,697	7,189	6,603	7,527	10,746
(Tourism)	2,000	1,520	1,544	1,853	2,659	4,499
(Factor incomes)	2,829	4,328	3,426	2,432	2,548	3,710
Service debits	5,965	7,100	7,233	6,125	5,603	6,346
(Expatriate services)	1,362	1,362	1,377	1,370	1,400	1,450
(Factor incomes)	2,445	3,845	4,332	2,932	2,078	2,512
Goods & services	-2,687	-3,398	-4,812	-4,009	-3,215	-3,269
Transfers (net)	3,428	3,120	5,674	4,810	4,202	4,251
Current account balance	741	-278	862	801*	987	982

Source: Quarterly Economic Review, Reserve Bank of Vanuatu, December 1990.

Note: *Differences between figures and official RBV data due to inconsistencies in QER tables.

On the payment side the main items are the value of expatriate services and the outflows of re-invested profits. Both of these are imputed values and represented by contra items elsewhere in the balance of payments. The import of expatriate services is matched by an identical amount of aid flows in the transfers account, and profit remittances are matched by an equivalent volume of direct capital investment in the capital account. If these two items are ignored, the service account would be in substantial surplus. In the mid-1980s with poor economic conditions and weak tourist demand, the service account recorded a deficit for the first time in 1987. However, matters improved in 1988 and a sizable surplus was generated in 1989 representing 25 percent of total service receipts. With the continued growth in tourist arrivals, the service account produced a record surplus in 1990.

Foreign aid

Foreign aid makes a very important contribution to the balance of payments but fluctuates significantly from period to period. In the early 1980s the situation was depressed by the steady withdrawal of budgetary support, but even so the underlying volume fell from an average of VT 2,600 million in the 1980-82 period to about VT 2,200 million in the 1983-86 period (ignoring recurrent budgetary aid and Stabex receipts.) In 1987 and 1988 sizable Stabex transfers pushed this level up to VT 4,817 million and VT 3,712 million, respectively, but even without these large transfers the trend was up. In the 1987-90

period the underlying volume of foreign aid receipts reached a new plateau of about VT 3,300 million (ignoring Stabex receipts.)

Capital flows and external debt

The capital account described in Table 11 has been in substantial surplus in recent years, but this largely reflects re-investment of profits earned by foreign companies, which in Vanuatu represent a very large proportion of total private sector earnings. Direct foreign investment has been negligible, and both private and official borrowing has been moderate.

External debt is also not large and represented 10 percent of GDP in 1989. However, growth has been substantial in recent years, albeit from a low base, and external debt has risen from VT 244 million in 1984, to VT 900 million in 1987, to VT 1,118 million in 1988, and VT 1,715 million in 1989. External borrowing has been on concessionary terms from donor agencies with interest rates ranging from 0.75 to a maximum of 5 percent. As a consequence, external debt service is very moderate and represents about 1 percent of exports of goods and services.

Exchange rate movements

The domestic currency was pegged at 106.2 Vatu to the SDR shortly after independence. In March 1984 the Vatu was revalued to 100.6 to the SDR, devalued to 110 in April 1985, and devalued twice in February and October of 1986 to 122 and 142, respectively. In

Table 11. Balance of payments, capital account (VT million)

	1985	1986	1987	1988	1989	1990
Direct foreign investment	100	342	1,386	1,127	1,005	1,452
Equity	16	2	10			8
Reinvested earnings	84	340	1,376	1,127	1,005	1,444
Public debt	85	79	421	258	175	385
New drawings	131	139	473	300	208	429
Repayments	-46	-60	-52	-42	-33	-44
Other long term	148	-219	21	37	21	42
Short term (identified)	0	65	0	0	0	0
Capital account balance	333	267	1,828*	1,422	1,201	1,879
Errors & omissions	-612	1,469	-2,217*	-2,502	1,340	-1,081
Overall balance	462	1,458	473	-279	3,528	1,780
Memorandum items						
Valuation adjustments	-248	-2,093	492	-1,017	-130	-1,023
Net change in reserves	214	-635	965	-1,269	3,398	757

Source: Quarterly Economic Review, Reserve Bank of Vanuatu, December 1990.

Note: *Differences between figures and official RBV data due to inconsistencies in Quarterly Economic Review tables.

February of 1988 after a period of speculation about an impending currency depreciation the Vatu was pegged to a basket of undisclosed currencies.

Figure 10 indicates movements in Vanuatu's nominal and real effective exchange rates. The nominal effective exchange rate compares the movement of the Vatu to a weighted index of currencies, where the weights in the index include the currency composition of exports, imports, and tourism. The figure indicates a rise of the nominal effective exchange rate until 1984, reflecting the relative appreciation of the SDR to the currencies of Vanuatu's major trading partners: the Australian (49 percent) and US dollars (24 percent). In 1984 the Vatu was revalued and depreciated in 1985 and 1986, which is reflected by the peak and decline in those years. In 1988 the Vatu was delinked from the SDR, and the nominal effective exchange rate continued to depreciate in 1989 and 1990, which reflects the fact that the currencies in Vanuatu's secret currency basket depreciated relative to those used in the present calculations.

The real exchange rate compares the relative movement of domestic prices in Vanuatu to its trading partners, adjusting for exchange rate variations. It measures the relatively competitiveness of Vanuatu to its trading partners. The weights in the index are the same as for the nominal effective exchange rate but uses CPIs for the price indicators. It should be noted that the CPI is not a good indicator of domestic prices in Vanuatu due to the high component of imports in the CPI basket, which approximate 60 percent. The estimated real exchange rate indicates that Vanuatu became less competitive in the mid-1980s but since that time has improved its competitive edge. The devalua-

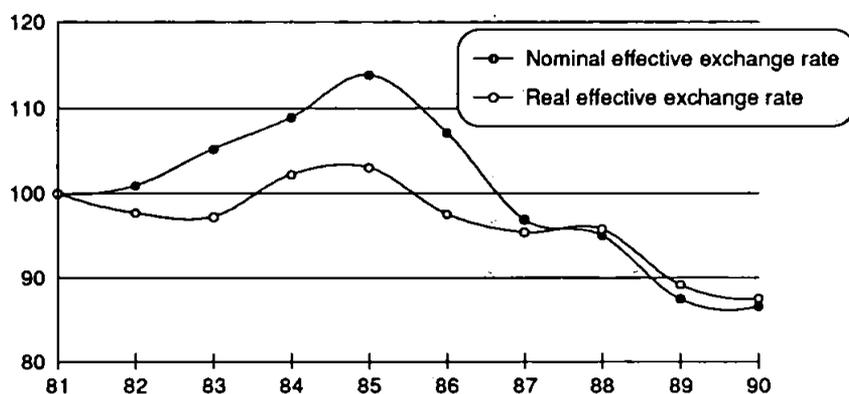


Figure 10. Nominal and real effective exchange rates, 1981-90

tions in 1985 and 1986 were successful, and the delinking of the Vatu from the SDR since 1988 has avoided the need for further explicit depreciation. In 1989 and 1990 the SDR rose relative to the Vatu, and the new basket automatically depreciated the currency.

**The external
outlook for
1991**

With continuing depressed prices for copra in 1991 the value of total exports is unlikely to show growth, and the trade balance will deteriorate if import demand remains strong reflecting growth in tourism. The resolution of the gulf-crisis and the ensuing stability in fuel prices will, however, alleviate one source of balance of payments anxiety. If tourism demand remains strong the services account will continue to improve and a substantial surplus on the current account balance is again likely to emerge. In turn the current account surplus will be translated into an overall surplus and rising external assets, validating the monetary developments.

Development Issues and Economic Policy

Agricultural development

Vanuatu has some of the best agricultural land in the Pacific islands. Low population densities on the larger islands such as Espiritu Santo mean that much of this land is unused or underutilized. Thus the potential for agricultural development is considerable. All land, under the Vanuatu constitution, is held by its customary owners. However, disputes between rival claimants have resulted in prime agricultural land not becoming available for long-term activities. In recent years a few foreign companies, particularly those in joint ventures with government, have been able to secure long-term access to land for agricultural purposes. Land registration and leasing procedures need to be developed to make long-term access to agricultural more generally available.

The VCMB had the reputation of being a professionally managed institution that has contributed significantly to agricultural development. However, the VCMB has contributed to the ongoing copra marketing crisis. There is now a need to take stock of the role and performance of the VCMB, which should include giving serious consideration to privatizing all or some of the VCMB's functions.

High cost expatriate labor

A major constraint to both private sector and commercial agricultural development is the dearth of ni-Vanuatu skilled labor and managerial capability. The reliance on expatriates for both skilled labor and entrepreneurship is a major factor contributing to the high cost of most economic activities dependent on modern technology. With expatriate salaries 5 to 10 times the ni-Vanuatu equivalent, the use of foreign labor places any new enterprise at an immediate cost disadvantage. The correction of this situation will not be achieved overnight and will need appropriate long-term education and training policies. However, development of competitive new industries will be frustrated until costs can be reduced, which must imply a reduction in the expatriate wage component of total cost.

Erosion of investor confidence

The recent efforts to deport several expatriate residents who were leading figures in the private sector and commercial agriculture are likely to have undermined investor confidence. Hopefully, the resolution of these cases will establish appropriate administrative procedures for these circumstances. However, with Vanuatu's economy now returning to more favorable conditions, the arbitrary expulsion of entrepreneurs will discourage further foreign investment, which Vanuatu so critically needs if the economy is going to develop in the 1990s.

Need for new fiscal initiatives

Regarding fiscal policy, the fear of alienating the Finance Center has been used as a reason to avoid implementation of new tax measures, which has resulted in several disadvantages. Revenue growth has been stagnant with an inelastic tax system based on import duties. Concentration has focused on raising duties in a system already overextended rather than on altering the system itself. Domestic costs are already high, and further increases in trade taxes will not enhance Vanuatu's competitiveness. The wide scale use of import duties encourages inefficient production of import substitutes even before specific measures are targeted to protect local industries. The need for new projects to get off the ground encourages concessionary importation of materials and equipment. The growing size of concessionary imports, now greater than 30 percent of the total, generates fruitless attempts by the authorities to cutback on concessions, which has not been achieved.

Vanuatu's control on its recurrent and development expenditures is better placed for the coming decade than in the latter part of the 1980s. However, the taxation policy is in need of substantial overhaul. The existence of the Finance Center is not an adequate reason to restrict the implementation of a more efficient tax system. Companies registered under the Finance Center can continue to attract the usual incentives, and domestic companies can be subject to a normal tax burden. There is no reason why these policies should reduce the profitability of the Finance Center or threaten its existence. Import duties need to be substantially reduced to correct the bias against exports and reduce Vanuatu's high cost structure. The loss of revenue can be made up through a sales or value added tax, plus a moderately rated income tax applicable to both individuals and companies.

Inefficiencies in financial intermediation

The combination of Vanuatu's monetary system, banking practices, and the Finance Center have resulted in an economically inefficient financial system, which, while benefiting offshore financial interests, has hindered domestic economic development. In a more competitive environment lending rates would fall, encouraging greater domestic investment and economic activity. Depending on the level at which reduced lending rates cleared the market, market forces would tend to push up deposit rates and encourage financial deepening. A more economically efficient system would generate an equilibrium interest rate that would benefit both depositors and investors, as well as Vanuatu development. However, it must be recognized that the lack of local entrepreneurial ability, unsophisticated depositors, and generally weak investment demand have reinforced the structural weaknesses generated by the financial system.

A major development problem facing Vanuatu will be how to channel the high level of largely expatriate savings presently invested in external deposits into productive investment. Clearly, with the high rates of interest paid on these deposits, which currently prevail in Australia, it is not a simple matter for the private entrepreneur to identify projects that will yield a higher rate of profit. The most appropriate response is to provide a policy environment that encourages productive investment. In this assessment, policies that are directed toward reducing Vanuatu's high cost structure, that is, reducing the high level of import duties and the expatriate wage component, will be most important. Improvements in the present system of financial intermediation will help reduce interest rate spreads and lending rates and encourage domestic investment. Creating a secure environment for investment is also critical.

Conclusion

With the revival of the tourism industry over the last two years and tourist arrivals now at their highest levels ever, the Vanuatu economy is beginning to perform at a rate commensurate with its potential. This development, however, needs to be reinforced by economic diversification. The copra industry, which has served as the basis of the rural economy, does not provide the springboard for future growth. The poor copra price performance over most of the last two decades indicates the need to establish new agricultural activities that exploit Vanuatu's comparative advantage through the development of new export products with greater potential.

On the policy front the fear of alienating the Financial Center, whose benefits to the Vanuatu economy are yet to be established, has reduced the incentive to implement new policy initiatives. The avoidance of restructuring fiscal policy has led to continuing reliance on import taxes and a high cost economy encouraging inefficient import substitutes. A broader based tax system would streamline incentives, reduce domestic costs, and yield a more elastic revenue base for maintaining public services. At the current stage of Vanuatu's development, new policy initiatives are needed to reinforce the expanding economy if the present momentum is to be sustained.

However, the natural disadvantages of the Vanuatu economy, the lack of skilled manpower, and the reliance on high cost expatriate labor mean that a more dynamic and competitive economy will take time to develop. The duality of the economy and the relationship between expatriate interests and the ni-Vanuatu are fragile. The relationship between the two economies needs to be carefully nurtured so that expatriate development is not frustrated by unsound administrative decisions, and at the same time the ni-Vanuatu need to acquire the skills and experience needed to maintain a self-sustaining economy.

Pacific Islands Development Program

The purpose of the Pacific Islands Development Program (PIDP) of the East-West Center is to help meet the special development needs of the Pacific islands region through cooperative research and training. PIDP conducts specific research and training activities based on the issues and problems prioritized by the Pacific Islands Conference of Leaders, which meets every three years. The Standing Committee, composed of eleven island leaders, reviews PIDP's research projects annually to ensure that they respond to the issues and challenges raised at each Pacific Islands Conference. This unique process enhances the East-West Center's capability in serving the Pacific.

East-West Center

The East-West Center is a public, nonprofit educational institution established in Hawaii in 1960 by the United States Congress. The Center's mandate is "to promote better relations and understanding among the nations of Asia, the Pacific, and the United States through cooperative study, training, and research."

Some 2,000 research fellows, graduate students, and professionals in business and government each year work with the Center's international staff on major Asia-Pacific issues relating to population, resources and development, the environment, culture, and communication. Since 1960, more than 25,000 men and women from the region have participated in the Center's cooperative programs.

Principal funding for the Center comes from the U.S. Congress. Support also comes from more than 20 Asian and Pacific governments, as well as private agencies and corporations. The Center has an international board of governors.



