VANUATU

Economic growth slowed in 2023 as the impact of three cyclones damaged agriculture and infrastructure, and also pushed up inflation. Recovery in 2024 and 2025 is expected to depend mainly on tourism growth and construction, as the government tries to finance the huge reconstruction needs. With rising intensity and frequency of climate-induced disasters, the government must find alternative ways to finance disaster preparedness and response.

Economic Performance

Growth decelerated to 1.0% in 2023 as the country was pummeled by two cyclones in March and another in October (Table 2.36.1). Twin tropical cyclones (TC) Judy and Kevin affected 66% of the population. Total damage and loss was estimated at Vt51.3 billion, equivalent to 43.3% of GDP. For agriculture alone, the impact on crops and fisheries was around Vt15.1 billion. In October, category 5 TC Lola affected 37% of the population. Around 6,384 houses were destroyed and 12,768 damaged in March, while 5,750 were destroyed and 15,700 damaged in October.

Table 2.36.1 Selected Economic Indicators, %

Cyclone damage pulled down growth in 2023 and pushed up inflation.

	2022	2023	2024	2025
GDP growth	2.0	1.0	3.1	3.6
Inflation	6.7	13.5	4.8	2.9

GDP = gross domestic product.

Sources: Vanuatu National Statistics Office; Asian Development Bank estimates.

Widespread damage forced the government to prioritize infrastructure recovery. A TC Judy and Kevin post-disaster needs assessment cited total recovery needs of Vt91.6 billion (77.4% of GDP). The TC Lola recovery plan placed recovery needs at Vt43.3 billion (36.7% of GDP), with Vt40.8 billion for infrastructure. The government passed supplementary budgets to allot funding for relief and reconstruction needs, with capital spending raised by 33%. Relief allocations from subsidies, grants, and transfers were increased by 48%.

Despite the increased budget, government spending contracted. Government expenditure fell 8% in 2023 compared with the previous year. Although capital spending was up by 7%, current spending was down, largely because of delays in approving the budget due to political instability and cyclone-related delays to implementation of planned activities. The largest decline was in subsidies, grants, and transfers which fell by 25%. Conversely, tax revenue increased by 20% and nontax revenue by 15%. The fiscal balance therefore moved from a deficit equivalent to 5.8% of GDP in 2022 to a surplus of 1.5% in 2023 (Figure 2.36.1). This was in lieu of a deficit of 9.0% projected in the December supplementary budget.

Tourism and remittances provided relief to the economy. Tourism receipts jumped to $193 million (19.6% of GDP) in 2023. Although arrivals by air increased from 30,000 in 2022 to 82,000 in 2023, they slowed in the aftermath of the cyclones (Figure 2.36.2). Air arrivals for the year remained just 70% of the pre-pandemic average of 2018 and 2019. On the other

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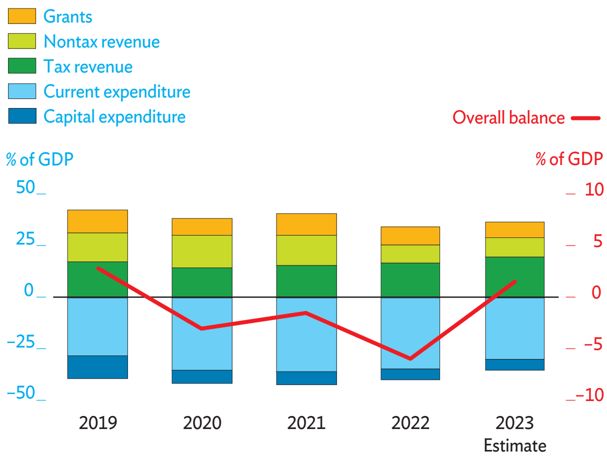
Figure 2.36.1 Fiscal Indicators

Disaster impact hampered program and project implementation leading to lower current spending and a fiscal surplus in 2023.

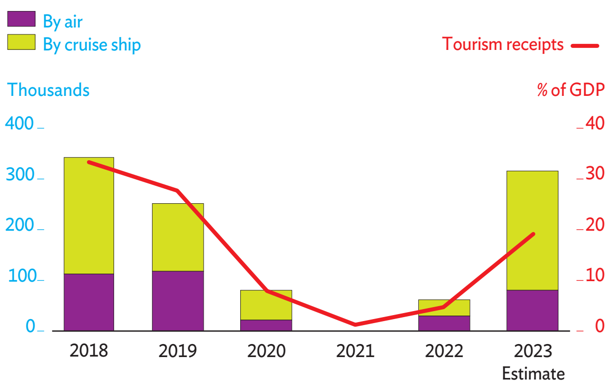


GDP = gross domestic product.

Sources: Vanuatu Department of Finance and Treasury; Asian Development Bank estimates.

Figure 2.36.2 Tourism Receipts and Visitor Arrivals, by Mode of Travel

While cruise ship arrivals exceeded pre-pandemic levels, the recovery of air arrivals slowed after the cyclones in 2023.



GDP = gross domestic product.

Sources: Vanuatu National Statistics Office; Reserve Bank of Vanuatu; Asian Development Bank estimates.

hand, cruise ship arrivals exceeded 240,000 in 2023. Remittances, mainly from seasonal workers in Australia and New Zealand, continued to grow—although at a slower pace—by 4% to $177 million in 2023 (equivalent to 17.9% of GDP).

Damage to supply networks and crops pushed inflation to its highest level in decades. From 6.7% in 2022, inflation increased to 13.5% in 2023, the highest since 1987, although based on a new price basket (Box). Aside from cyclone damage and the lingering impact of the Russian invasion of Ukraine on fuel prices, a 36.0% increase in the minimum wage in June increased inflationary pressures. With inflation significantly above the 0%–4% target range, the Reserve Bank of Vanuatu (RBV) tightened monetary policy in late 2023.

Box New Consumer Price Index Weights for Vanuatu

Incorporating the results of the 2019–2020 Household Income and Expenditure Survey, new weights for the basket of goods in the consumer price index were implemented in the first quarter of 2023. The weight for food and nonalcoholic beverages increased from 38.4% to 44.5%, transport rose from 6.8% to 14.2%, alcoholic beverages, tobacco, and narcotics rose from 7.1% to 11.2%. In contrast, the weight for housing and utilities declined from 20.9% to 11.6%. When an item has a greater weight in the basket of goods, price fluctuations of that item have a larger impact on overall reported inflation. Reported inflation for previous years was also adjusted (e.g., from 11.9% in the old series to 6.7% in the new series for 2022).

Source: Vanuatu National Statistics Office.

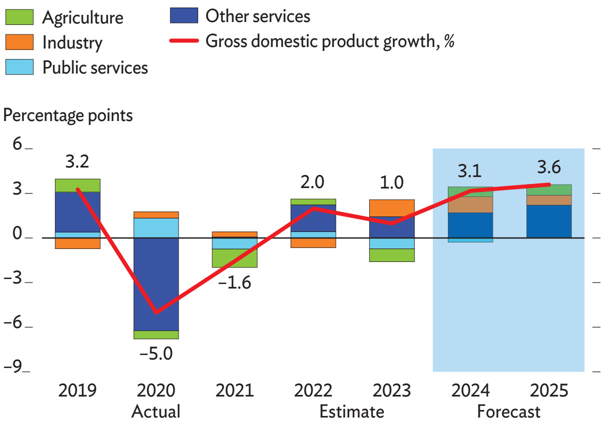
Economic Prospects

The economy is expected to recover with growth of 3.1% in 2024 and 3.6% in 2025, boosted by tourism and reconstruction. Spending by tourists and domestic households will likely boost services including retail trade, accommodation and restaurants, and transportation (Figure 2.36.3). Reconstruction is expected to be led by development partners, tourism-related businesses, and families of seasonal workers. Agriculture will also likely grow after contracting in 2023.

Although remittances are expected to slow, they will remain significant. Various proposals are being considered to balance the benefits of outmigration for seasonal work programs with the needs of domestic industries, especially tourism and public services. Several issues need to be addressed. These include ensuring that workers outside the main urban areas also gain access to seasonal worker opportunities,

Figure 2.36.3 Supply-Side Contributions to Growth

Growth in tourism and reconstruction drives economic recovery as services and industry expand.



Sources: Vanuatu National Statistics Office; Asian Development Bank estimates.

protecting the welfare of seasonal workers at their workplace, minimizing absconding, and improving reintegration after workers return.

Despite problems hounding Air Vanuatu, the tourism outlook remains bright. The state-owned carrier continued to experience maintenance woes leading to flight cancellations and delays. The slack was picked up by other regional carriers. Opening more routes to these carriers could support the tourism revival. For instance, arrivals from New Zealand have exceeded the pre-pandemic average since the reopening of Honiara-Port Vila-Auckland flights by Solomon Airlines in July 2023.

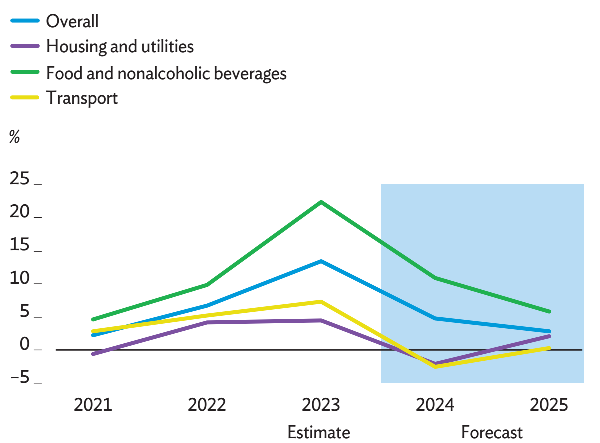
Cruise ship visitors will continue leading the tourism revival in 2024 and 2025. A significant dip in arrivals by air was seen after the cyclones in March 2023, but cruise ship arrivals remained resilient and are expected to continue growing in the forecast period. With frequent disasters, developing more areas for cruise ship tourism and climate-proofing tourism infrastructure will consolidate the sector's growth potential. Demand from cruise ship visitors can provide immediate support to communities in cyclone-hit areas. Although the average expenditure per visitor arriving by plane is around five times that of a cruise ship visitor, the infrastructure needed for cruise ships is also relatively lower.

Although overall revenues are expected to increase, they will not cover extensive reconstruction needs. The delay in the passage of the 2024 budget means that spending in the first quarter was likely restrained once again. This means that government-led reconstruction and other major recovery support measures will likely be delayed. While tax revenue is expected to increase significantly with increased tourism activity, nontax revenues—mainly from Honorary Citizenship Programs (HCPs)—are expected to continue to decline. HCP revenues fell from Vt14.4 billion in 2020 to Vt8.1 billion in 2023. With lingering issues on visa-free access to the European Union and United Kingdom, HCP revenues are projected to decline to around Vt6.0 billion in 2024 (equivalent to 4.8% of GDP).

Inflation is expected to ease as supply chains are restored and agriculture recovers. Along with lower global commodity prices, the normalization of supply chains, especially for food, should lead to lower inflation at 4.8% in 2024 and 2.9% in 2025 (Figure 2.36.4). The impact of monetary policy tightening in late 2023 is expected to be felt fully in 2024. Although the key policy rate was kept at 2.25%, the RBV doubled the volume of RBV notes to Vt200 million per month effective October 2023. In January 2024, the commercial bank statutory reserves deposit ratio was raised to 5.50% from 5.25%.

Figure 2.36.4 Inflation

Massive damage to agriculture and infrastructure pushed up food prices in 2023.



Sources: Vanuatu National Statistics Office; Reserve Bank of Vanuatu; Asian Development Bank estimates.

Political instability is a risk to growth. Political instability contributed to the slow disbursement of government funds in 2023 and delayed the resolution of key policy issues. The ruling coalition was replaced in September 2023 but returned to power in October under a different prime minister. To address political instability, several laws, including one requiring political party registration, will be subject to a referendum in May 2024.

Policy Challenge—Financing Immediate Disaster Response

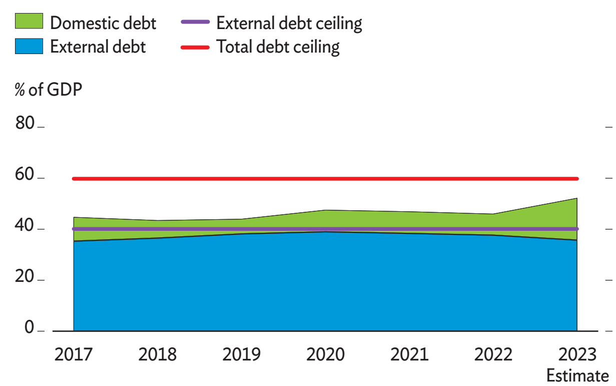
The disasters that struck in 2023 highlight the need to scale-up disaster response financing and implementation support. The government can use up to 1.5% of approved appropriations during a state of emergency after a disaster or financial crisis. After the cyclones in March, the Vt813 million in emergency funds was clearly insufficient. This necessitated supplementary budgets of Vt1.4 billion in May 2023 and Vt3.2 billion in December. There are also constraints in implementing projects using available resources.

In past disasters, Vanuatu benefitted from contingent disaster financing, but it remains insufficient to meet recovery needs. Contingent disaster financing gives economies rapid access to disaster response finance. After TC Pam in 2015, Vanuatu received $1.9 million from the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI)—a regional market-based parametric disaster insurance pool. However, after a cyclone in 2018 and volcanic eruptions in 2017–2018, Vanuatu was not deemed eligible for payouts. With perceived low returns amid high costs, Vanuatu opted out of the insurance in 2018. Nevertheless, Vanuatu has access to contingency financing from development partners. For example, under the World Bank's contingency financing program, Vanuatu received a $10 million grant in 2020 for TC Harold and COVID-19, and a $9.5 million grant in March 2023.

Options for borrowing to finance recovery and reconstruction remain limited. Reconstruction after TC Pam in 2015 led to a sharp increase in external debt from 14% of GDP in 2014 to 39% in 2020. Despite a decline to 36% in 2023, external debt remains close to the 40% external debt ceiling with limited scope for further domestic borrowing (Figure 2.36.5). Yet, additional financing will likely be needed to complete some existing loan-funded projects due to higher input costs.

Figure 2.36.5 Public Debt

Massive reconstruction needs after Tropical Cyclone Pam in 2015 pushed external debt near the 40% debt-to-GDP ceiling.



GDP = gross domestic product.

Sources: Vanuatu Department of Finance and Treasury; Asian Development Bank estimates.

More options for disaster response financing and climate resilience are needed. Analysis is ongoing on disaster-responsive budgeting and financial instruments. The TC Lola Recovery Plan calls for establishing trust funds for disaster relief and response to reduce post-disaster food insecurity. It also stresses the key role development partners have to play. More broadly, the importance of accessing international climate funds cannot be overstated, as they can be used to enhance climate resilience and reduce vulnerability of communities and infrastructure to disasters triggered by natural hazards. Reduced vulnerability will have a direct flow-on effect to future requirements for disaster response financing. Vanuatu has long advocated compensation for countries most affected by climate change. It is now leading on the international stage for climate change accountability through the International Court of Justice. A loss and damage fund was agreed upon at COP28 in December 2023—a fund first proposed by Vanuatu in 1991. As the frequency and intensity of disasters rise, both disaster response and climate resilience financing must increase complemented by increased implementation support.