1. Overview of the Vanuatu Economy

This South Pacific island economy is based on the primary sectors agriculture, forestry and fishing, which provide a living for the majority of Vanuatu's population. Offshore financial services and tourism are other mainstays of the economy. The development of Vanuatu is constrained by its relatively narrow export base. Services, in particular tourism, account for 40% of the GDP and represent the most important source of income, together with real estate and wholesale and retail trade. Much of the growth in recent years has been driven by these sectors. Vanuatu heavily invests in social services, especially education. Mineral deposits are negligible. A small light industry sector caters to the local market. Tax revenues come mainly from import duties. Economic development is also hindered by the vulnerability to natural disasters, and long distances from main markets and between constituent islands. In response to foreign concerns, the government has promised to tighten regulation of its offshore financial center. In mid-2002, the government stepped up efforts to boost tourism through improved air connections, resort development, and cruise ship facilities. Australia and New Zealand are the main suppliers of tourists and foreign aid.

The trends of GDP and GDP per capita for the last 11 years are shown in Figure 1 and 2:

**Figure 1: Vanuatu GDP Trend 2000-2011**

Starting from 2002 Vanuatu GDP has been increasing reaching a 7.3 annual % growth in 2006, to stabilize in the last years at a 1% annual growth.
If the recent economic performance of Vanuatu hasn’t been impressive, forecasts predict a decisive increase in the GDP in 2013 and 2014; see figure 3 where the economic performance of Vanuatu is compared to the one of other Pacific Islands. The main reason for the forecasted economic expansion is the increase in tourist arrivals and foreign direct investments, as it will be point out in the next sections. Some of the growth has been speculative in nature, the growth in real estate and to a certain extent land speculation is a result of similar practices and also large price differentials with neighbouring countries such as Australia and New Zealand.

Vanuatu was admitted to the group of Least Developed Countries in 1985. Today it is still part of this group although its per-capita GDP exceeds the LDC thresholds. This situation is due to the adjustment based on the ‘vulnerability index’\(^1\), which takes into account the vulnerability of Vanuatu’s economy to natural disasters.

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\(^1\) The country strategy and National Indicative Programme: Vanuatu, 10\(^{th}\) EDF Programme of the European Commission (2008-2013)
2. Role of Services in Vanuatu Economy

The evolution of the weight of the Services Sector in terms of value added (% GDP) in Vanuatu economy, with respect to the primary and secondary sectors, is shown in Figure 3. The trends depicted in Figure 3 are not surprising because as already mentioned the economic growth of Vanuatu is mainly driven by the Services Sector. The Services Sector is dominant in terms of value-added (see Figure 4) but its growth has been very unstable (see Figure 5) and in terms of labour it involves only the 30% of the population; the 60% of Vanuatu population still works agriculture. It would be important to understand how the Services Sector can become more labour intensive so that its growth can have a bigger impact on local population and on poverty reduction.

![Figure 3: Vanuatu Services Sector evolution, 2000-2011](source: World Bank, Databank)

The Services Export Breakdown (Figure 6) can help understand which are the Services more relevant to Vanuatu economy and where the investments should be directed.

![Figure 4: Vanuatu Economy Breakdown, 2011](source: World Bank, Databank)

![Figure 5: Services Sector % Annual Growth](source: World Bank, Databank)

![Figure 6: Vanuatu Services Sector Breakdown, 2011](source: Trade Map, ITC)
Tourism counts for almost 80% of Vanuatu Services Export; as shown in Figure 7 Australia is the largest provider of visitors.

**Figure 7: Tourists’ origin countries**

As already highlighted, tourism is one of the most promising economic sectors for Vanuatu’s future development and it is mentioned as a priority sector in the “Priority and Action Agenda 2006-2015”. It offers great potential as a source of foreign exchange as well as creating employment and fostering development of the outer islands. Growth in the tourism sector is now underpinning growth in the economy as it accounts for around 40% of GDP.

The decision in late 2003 to adopt an “open sky policy” encouraged the introduction of Pacific Blue Company into the Vanuatu market in late 2004. This has boosted visitor numbers and provided healthy competition to Air Vanuatu.

Tourism still faces some serious constraints. These include:

- The inadequacy of existing accommodation in terms of quality, size of units and limited distribution around the country including a lack of boutique resorts to attract high income tourists;
- Lack of adequate infrastructure for international air passengers and cruise ship passengers as well as poor roads on the main resort islands and air services between the islands;
- International and domestic air services are underdeveloped and unnecessarily expensive;
- The land on beachfronts for building tourist facilities is insecure;
- Lack of effective and targeted marketing and promotion of Vanuatu and its unique tourist attractions particularly in niche markets such as adventure, diving, game fishing, nature tourism and other special activities;
- Lack of community awareness of tourism developments and the benefits that can accrue to the local community;
- Absence of a systematic training program for tourism personnel at all levels².

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² Priorities and Action Agenda 2006-2015: An educated, healthy and wealthy Vanuatu
3. The role of Foreign Direct Investment

Figure 7: PNG FDI Trend, 2000-2011

FDI have been increasing in the last years reaching the 7.6% of GDP in 2001.

Source: World Bank, Databank

The increasing trend of FDI can be explained with a variety of institutional factors such as Vanuatu’s past macroeconomic stability and also some of the policies implemented in the last few years (open skies policy, more open trade environment). Recent development and reviews of the land tenure policies also helped attracting foreign investors. Other important policy initiatives attracting investment include the recent adoption of a legislation covering all the main OECD Financial Action Task Force recommendations including the setting up of a Financial Intelligence Unit.

Still, according to the Index of Economic Freedom (see Figure 8) Vanuatu is considered as a mostly un-free economy, but performing better than neighbouring economy such as Papua New Guinea and Solomon Islands. Public sector is characterized by low productivity, investment approval process is non-transparent, administrative delays and uncertainties remain.

Figure 8: Degree of Vanuatu Economic Freedom

Source: 2013 Index of Economic Freedom
4. Trade in Services and Trading Partners

The share of Trade in Services for Vanuatu is far above the average for the LDCs (around 30%), in 2011: 56.7%.
The value of Vanuatu Exports in Commercial Services with the world is 0% of the total world Exports as Figure 10 shows. Even if negligible in value, Figure 9 shows how the Exports of Commercial Services exceed the Imports for all the three years considered. As already mentioned, tourism is counting for 80% of Services Export.

Figure 9: Vanuatu Trade in Commercial Services with the world 1

![Graph showing Vanuatu Trade in Commercial Services](image1)

Figure 10: Vanuatu Trade in Commercial Services with the world 2

<table>
<thead>
<tr>
<th>Year</th>
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<th>Exports</th>
<th>Balance</th>
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<tr>
<td>2010</td>
<td>0.3</td>
<td>0.1</td>
<td>0.2</td>
</tr>
</tbody>
</table>

Source: EU Statistics

Main trade partners for Vanuatu are the following:

Exports: Thailand 57.3%, Japan 21.8% (CIA World Factbook 2011)

Imports: China 26.7%, Singapore 21.2%, Australia 13.6%, NZ 7.2%, Fiji 6.7%, Japan 5.4% (CIA World Factbook 2011)

5. Regional Integration

Vanuatu ratified the Pacific Island Countries Trade Agreement (PICTA) in July 2005. Vanuatu is also a member of the Melanesian Spearhead Group (MSG) whose Free Trade Agreement entered a second phase, involving tariff cuts for key traded products. Work has begun to extend both the MSG and PICTA to cover services, which has the potential to increase competition and investment in important sectors.

Two other major trade agreements are the Economic Partnership Agreements (EPA) with the EU and the Pacific Agreement on Closer Economic Relations (PACER), an umbrella agreement between members of the Pacific Islands Forum with Australia and New Zealand which provides a framework for the future development of trade cooperation.