

FINANCIAL ANALYSIS

A. Introduction

1. The main damage to the transport sector caused by severe Tropical Cyclone Pam (TCP) was to the Efate ring road. The 120 kilometer (km) sealed two-way road provides transport services for the rural population around Efate Island and connects them to the capital, Port Vila. TCP caused Vanuatu's gross domestic product (GDP) growth to contract to 0.9% in 2015, down from 2.3% in 2014. It had a notable effect on tourism, with immediate and future bookings affected for up to 12 months.

2. The Cyclone Pam Road Reconstruction Project was approved as an emergency project to accelerate economic and social recovery in Vanuatu's cyclone-affected provinces.¹ The intended outcome is to restore socioeconomic activities to at least pre-cyclone levels. Financing for the original scope of the project was composed of two Asian Development Bank (ADB) loans, three ADB-administered grants, and government in-kind support:

- (i) Asian Development Fund (ADF) loan: SDR708,000 (\$1,000,000)²
- (ii) Disaster Response Facility loan: SDR1,986,000 (\$2,805,000)
- (iii) Asian Development Fund (ADF) grant: \$7,000,000
- (iv) Disaster Response Facility grant: \$2,805,000
- (v) Global Environment Facility grant: \$2,680,000
- (vi) Government (in kind): \$2,210,000

3. The original scope of the project included outputs to reconstruct and make seven bridges, 10 culverts, and 14 km of roads climate-resilient; and to stabilize a landslide at Klems Hill. The additional financing of the project being proposed is as follows:

- (i) ADF loan additional financing: \$4,100,000
- (ii) ADF grant additional financing: \$4,100,000
- (iii) Government (in kind): \$1,200,000

4. The scope of the additional financing includes an expanded scope of work on the Efate ring road at two of the sites that were in the original project, three new bridge structures, and a major urban road upgrade and drainage improvements.

B. Economic Background

5. Vanuatu is an archipelago of 83 volcanic and calciferous islands (65 of them inhabited) covering about 12,200 km, of which about a third is land. Vanuatu is one of the 20 most vulnerable countries in the world to disasters caused by natural hazards, including cyclones, floods, landslides, storm surges, earthquakes, tsunamis, and droughts. Climate change will affect disaster risk through changes in the intensity and frequency of weather hazards. Projections for Vanuatu indicate that the frequency and intensity of extreme rainfall events are projected to increase, as is the intensity of cyclones. Transport infrastructure is highly vulnerable to these hazards.

¹ ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loans, Grants, and Administration of Grant to the Republic of Vanuatu for the Cyclone Pam Road Reconstruction Project*. Manila.

² Exchange rate: SDR1 = US\$1.41243.

6. Vanuatu's population of about 253,000 people is almost evenly distributed among the six administrative provinces: Malampa, Penama, Sanma, Shefa, Tafea, and Torba. It is estimated that about three-quarters of households engage in primarily subsistence livelihoods in rural areas.

7. Three key economic sectors dominate Vanuatu's economy are: agriculture, tourism, and commerce and industry. Vanuatu's exposure to agriculture and tourism contributes to its vulnerability, with natural disasters adversely affecting both sectors. The proportion of GDP of these key sectors are (i) agriculture (about 25% of GDP in 2013); (ii) tourism (about 33% of GDP in 2010); and (iii) commerce and industry (about 36% of GDP in 2013).

8. Several major development partners-funded projects are under way and planned for Vanuatu, predominantly in Port Vila. This is a boost to the economy during the construction phase, and should provide durable economic infrastructure. However, this contributes to the vulnerability of Vanuatu since (i) aid funding is subject to financial and political shocks; and (ii) these projects provide assets that require maintenance and often loan repayments—government expenditures that need to be planned over several decades. The list of infrastructure projects in Vanuatu is in Table 1.

Table 1: Ongoing and Future Infrastructure Projects in Vanuatu

Source of Financing	Project	Overall Project Value (\$ million)	Status
A. Projects under Construction			
JICA	Lapetasi Wharf	94.6	Under construction
ADB and Government of New Zealand	Vanuatu Interisland Shipping Project	48.1	Under construction
ADB and Government of Australia	Port Vila Urban Development Project	31.9	Under construction
Government of New Zealand	Vanuatu Tourism Infrastructure Project	16.5	Under construction
World Bank	Vanuatu Airports Infrastructure Project	58.9	Design and construction
PRC	South Tanna and Malekula Roads	52.3	Under construction
	Luganville Wharf	81.0	Under construction
ADB and SPREP	Vanuatu Energy Access Project	15.1	Design and construction
	Subtotal (A)	398.4	
B. Projects in the Design			
World Bank	Vanuatu Infrastructure Reconstruction and Improvement Program	50.0	Under design
ADB	Cyclone Pam Road Reconstruction Project	18.5	Under design
	Subtotal (B)	68.5	
TOTAL		466.9	

ADB = Asian Development Bank, PRC = People's Republic of China, JICA = Japan International Cooperation Agency, SPREP = Secretariat of the Pacific Regional Environment Programme.
Source: Vanuatu Project Management Unit.

9. Port Vila is a growing capital city with about 44,000 residents, while greater Port Vila has a population of 58,000 that is forecast to increase to more than 109,000 by 2025. Urban services must be expanded to cater to the needs of the growing population of Port Vila and its peri-urban

settlements.³ The project focus was on connecting rural areas with Port Vila. The proposed additional financing of the project enhances this and includes improved infrastructure to urban areas.

C. Existing Assets and Condition

10. Some 92 km of the Efate ring road were upgraded in 2008–2010 under the Millennium Challenge Account of the United States, providing the essential durable asset of stable road formation. However, several of the structures were not upgraded at that time and the condition of existing transport infrastructure on the ring road contributed to the damage incurred during TCP. These remain vulnerable to future disasters.

11. Asset performance measures and defined targets have not been available until recently—2017 will be the first year this type of performance is measured objectively. Anecdotally, performance is considered satisfactory. Response times to minor defects, which soon become major defects, are the most frequently observed shortcoming.

D. Fiscal Position

12. Vanuatu has demonstrated a steady fiscal stance over the past 4 years (2013–2016). Except for a spike in revenue and subsequent operating balance following TCP in the first quarter of 2015, the fiscal balance has generally oscillated between a surplus or deficit of up to Vt500 million per quarter. Quarterly expenditure has been steady at just over Vt4,000 million during this period (average 2013–2016: Vt4,250 million).⁴ A surplus was achieved in fiscal year (FY) 2009, with deficits in the following years.

13. The government has not achieved its goal of balanced budgets in most recent years, with budget deficits varying, indicating some unpredictability of aggregate fiscal discipline (Table 2).

Table 2: Summary of Government's Financial Performance, 2009–2013

Items	FY2009 (Vt million)	FY2010 (Vt million)	FY2011 (Vt million)	FY2012 (Vt million)	FY2013 (Vt million)
A. Consolidated Financial Performance					
1. Revenue	18,125	17,083	15,842	16,807	17,088
2. Expenditure	14,541	15,918	17,245	17,697	17,738
B. Revenue less Expenses	3,684	1165	(1,403)	(890)	(650)
1. Net surplus/(deficit) of GBEs	(761)	(1,657)	262	392	(650)
C. Operating Balance	2,823	(492)	(1,141)	(498)	(1,158)

() = negative, FY = fiscal year, GBE = government business enterprise.

Source: Department of Finance and Treasury Administration.

14. However, Vanuatu faces several risks to the maintenance of a sound fiscal position. These risks are typical of those identified for small island developing states, such as being a small, open economy; global commodity price fluctuations affecting exports such as copra and imports such

³ ADB. 2011. *Report and Recommendation of the President: Proposed Loan and Administration of Grants to the Republic of Vanuatu for the Port Vila Urban Development Project*. Manila (Economic and Financial Analysis [available from the list of linked documents in Appendix 2]).

⁴ Reserve Bank of Vanuatu, Research and Statistics Department. 2016. *Quarterly Economic Review: March 2016*. Port Vila.

as oil; market isolation; the potential emigration of skilled workers; susceptibility to natural disasters;⁵ and reliance on bilateral aid for budget support.⁶

15. The features that support continued healthy fiscal outcomes are political stability, relatively stable economic performance, and ongoing economic and institutional reforms. Public financial management continues to improve, and tax compliance has been strengthened. Since the snap election in January 2016, a period of relative political stability has ensued. However, the governing coalitions remain susceptible and fragile, and two no-confidence motions in the government were tabled in December 2016.

16. The central bank is effectively independent, the budget is comprehensive and generally credible, public accounts are timely and comprehensive, and noncash items are reported quite extensively.

17. A commitment to responsible fiscal management and inflation stability (monetary policy) was included in the key goals and policy objectives of the National Sustainable Development Plan, 2016–2030.⁷

E. Financial Analysis

18. Financial analysis was undertaken to assess the size of the budgetary allocation required to ensure the sustainability of the investment. Incremental and intermittent finance planning is required to accommodate routine operation and maintenance, and periodic repairs of the rehabilitated and upgraded assets. Recent projects have adopted a top-down approach to estimating the amount of finance necessary. This analysis integrated the bottom-up costing undertaken for asset management planning of routine and periodic maintenance, taken over a 20-year horizon, and aligning with the economic analysis.

19. The estimated routine maintenance costs for the subprojects, including bridge inspections and minor rectification works, is \$43,100 per annum. This excludes corridor maintenance beyond the subproject area, which maintenance contracts already cover. The estimated average annual periodic maintenance cost is \$167,000, excluding asset replacement costs in year 10 (\$743,000) and year 20 (\$1,618,000). This average annual total maintenance cost of \$210,100 is within planned funding envelopes for the combination of maintenance and replacement capital expenditure, understood to be about Vt500 million. The works will need to be captured and integrated into the Public Works Department's annual work plans. No plan is in place to increase revenue to fund this expenditure.

20. For further information on public financial management and accounting controls, refer to the financial management assessment, issued as a draft in September 2016 and finalized in December 2016.⁸

⁵ W. Easterley and A. Kraay. 2000. Small States, Small Problems? Income, Growth, and Volatility in Small States, *World Development*. 28 (11). pp. 2013–2027. Easterly and Kraay find that small states need not be singled out for policy attention, as they typically outperform larger states on per capita income (this is supported by data from World Bank. World Development Indicators. <http://data.worldbank.org/data-catalog/world-development-indicators>). Therefore, lessons regarding economic growth in large countries can be applied to small states such as Vanuatu.

⁶ H. Hughes. 2003. Trade or Aid? Which Benefits Developing Countries More? *Economic Papers*. 22(3). pp. 1–19.

⁷ Vanuatu Department of Strategic Policy, Planning and Aid Coordination. 2016. *National Sustainable Development Plan, 2016–2030*. Port Vila.

⁸ Financial Management Assessment (accessible from the list of linked documents in Appendix 2).