# 7

# COPING WITH VULNERABILITY BY BUILDING ECONOMIC RESILIENCE: THE CASE OF VANUATU

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**Abstract.** The objectives of this chapter are twofold, namely (i) to analyse the causes behind the economic vulnerability of Vanuatu and (ii) to evaluate the efforts of this small island state to build up economic resilience in order to achieve economic growth and higher living standards. It is well known that a number of inherently vulnerable small states have, through good governance and appropriate economic policies, succeeded in withstanding the impact of external shocks and registered acceptable rates of economic growth. There is no reason why Vanuatu cannot do the same. This chapter shows that in Vanuatu, man-made policies, including fiscal inflexibility and poor governance, have exacerbated the drawbacks associated with economic vulnerability. The chapter argues that Vanuatu will always remain inherently vulnerable, and it is therefore important that economic policy in this island state be geared towards strengthening economic resilience to cope with vulnerability. Good governance and sound macroeconomic policies are singled out for this purpose.

## 1. Introduction

The objectives of this chapter are twofold, namely (i) to analyse the causes behind the economic vulnerability of small islands in the South Pacific and (ii) to evaluate their efforts aimed at overcoming it and building up resilience for achieving economic growth and higher living standards.

The chapter takes Vanuatu as a case study. It is organised into five sections. The section that follows provides a brief background of the Vanuatu's economy. The third section deals with the inherent economic vulnerability conditions in Vanuatu as a result of proneness to various external shocks. The fourth section reviews some conditions for building economic resilience. It will be shown that certain developments in Vanuatu have served to exacerbate vulnerability rather than to build resilience. The last section concludes the chapter by emphasising the need for good governance and sound macroeconomic policies for resilience-building.

## 2. A Brief Background

The island nation of Vanuatu, one of the youngest independent countries, achieved political freedom in the 1980s from the joint Anglo-French condominium rule. It comprises an archipelago of about 80 islands located in the South Pacific, approximately 2,300 kilometres off the coast of Australia. The total land area measures 12,189 square kilometres with an exclusive marine economic zone of 710,000 square kilometres. The two largest islands of Espiritu Santo and Malekula measure 4,300 and 2,000 square kilometres respectively and together with the next six largest islands constitute 87 percent of total land area. Most islands are mountainous due to their volcanic origin, with a number of them however being very low-lying.

Vanuatu lies in the cyclone belt. Cyclones affecting the island nation in one part or another are almost an annual feature. It has been documented that on an average the country experiences 2.6 cyclones per year. There is a cyclone-free year once every seven to eight years. In addition, every year, Vanuatu experiences about 2000 earth tremors throughout its 80 islands. The earthquake of 2002, measuring 7.6 on the Richter scale, was one of the most severe inflicting damages to Port Vila's public and private properties.

Vanuatu's population was estimated at 190,000 in 2000, growing at a rate of 2.7 percent per annum. The GDP per capita has tended to decline at constant prices in recent years, partly attributable to the population growth (Table 1).

Vanuatu's apparently high per capita income of about US$ 1,200 hides the basic weaknesses of the country. Life expectancy is about 66 years and the adult literacy rate is 34 percent. Twenty percent of the population has no access to health services and 13 percent has no potable water supply. The Human Development Index (HDI) of Vanuatu was 0.425 in 1999. It was the third poorest country in a list of 14 island countries ranked by United Nations (UNDP, 1999).

Approximately 20 percent of the population live in the two urban centres of Port Vila and Luganville. The rural population is dispersed amongst the island group with limited communications among themselves and with the urban centres. Such dispersal of population

**Table 1**
**Selected Economic Indicators**

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| GDP per capita US$ (constant prices) | 1343 | 1262 | 1212 | 1177 | 1110 |
| GDP growth rate (% in constant prices) | 1.5 | 2.2 | -2.5 | 3.7 | -0.5 |
| Inflation (%) | 2.7 | 3.3 | 2.2 | 2.5 | 3.7 |
| Current account balance (% of GDP) | -1.0 | 2.7 | -5.3 | 1.0 | -2.1 |
| External debt ( % of GDP) | 20.1 | 27.5 | 28.6 | 30.4 | 31.3 |
| Exchange rate (vatu per US dollar) | 115.9 | 127.5 | 129.1 | 137.8 | 145.6 |

Source: Reserve Bank of Vanuatu, *Quarterly Economic Review*, Various issues United Nations Economic and Social Commission for Asia and Pacific, 2004.

and restricted availability of and access to basic infrastructure services, including power, and social services including health and education, have contributed to disparity in incomes, despite the prevalence of the much romanticised "subsistence affluence" among the isolated rural communities in remote islands (ADB, 1997).

A survey on poverty (ADB, 2002) reveals a rural-urban income gap at 1:16. This result stems forth from the finding that in Port Vila, the country's capital located on the island of Efate, the highest quartile income is almost 52 times that of the lowest. However, among the rural households (i.e., other than the two urban centres), the income disparity is much lower. The rural-urban drift is on the increase and the adverse effects of squatter settlements with unemployed youth are quite obvious (Chand, 2002).

Land ownership is closely related to indigenous culture, generally known in Vanuatu as *kastom*. It is a unique feature of the South Pacific region under which ownership of land is vested in the community. While availability of land in the relatively densely populated areas is a problem, land for lease for agriculture and forestry in the less populated areas is now increasingly possible.

Subsistence agriculture dominates land-related economic activities. It amounts to about 55 percent of the primary sector's output, which is mostly consumed by rural households. This alone ensures the drift to urban towns to be kept to a reasonable level.

Subsistence agriculture also determines the reservation wage of an aspiring migrant to urban centres in search of jobs. Under the current minimum-wage law, the urban wage which takes into account the transfer cost to urban areas has been fixed at vatu 19,000 per month for unskilled workers. At the exchange rate of US$1 = vatu 112, as of December 31, 2003, this amounts to US$170 per month. Skilled labour in urban areas is remunerated at a much higher rate—one of the highest in the region.

Four major agriculture products, copra, cattle (beef), cocoa and *kava*[1], which are also known as the four Cs, support the rural population and are the mainstay of cash incomes for the rural residents to pay for the children's education and medicines, kerosene and other non-farm essentials. Copra is marketed by the state owned Vanuatu Commodity Marketing Board (VCMB) and beef by the commercial ranches. Cocoa and kava exports are handled by middlemen. These four products along with vegetables and fruits contribute 15 percent of the gross domestic product of the nation. While vegetables and fruits are mostly for local consumption, the four Cs have also been the chief commodity exports. In the 1980s, copra accounted for 35.3 percent of total exports, while the shares of beef and cocoa were 5.9 percent and 4.3 percent. Adverse weather conditions, especially cyclones, severely affect steady growth in their contributions to GDP. Considerable annual variability in growth rates in agricultural production has serious implications on rural incomes and the country's export earnings.

Vanuatu has no direct taxation of any kind. Thus, government revenues are dependent only on import taxes and other indirect taxes including value added taxes. In addition, freedom for its citizens and residents alike to hold deposits in any currency in commercial banks and absence of exchange controls on both the current and capital accounts of the balance of payments, have rendered the country a pure tax haven.

However, offshore financial centre (OFC) activities have had a limited impact on the economic progress of the nation (Jayaraman, 1998a). It has mainly served to accentuate the dual nature of the economy. Modern and urban activities revolving around finance and tourism activities, which are confined to the capital Port Vila on the island of Efate, and primitive agricultural activities are prevalent in the rest of the country.

[1] A popular root beverage crop.

Tourism activities, which would have spread the modernisation process to other islands, are very constrained by poor air connections and communications, as well as lacunae in other physical infrastructure services. For example, the island of Tanna has the live volcano displaying a 24-hour non-stop pyrotechnic show. Because of lack of hotels, tourists have to return to Port Vila the same day, depriving Tanna of the likely earnings of an extended stay of tourists.

Yet, tourism has been the mainstay of foreign exchange earnings of the country. Nearly 60 percent of total foreign exchange receipts are contributed by tourism, which also dominates the services sector. The OFC's contribution is around 16 percent of total foreign exchange earnings. The rest of the earnings come mostly from the rural sector.

The rural sector thus continues to be critical for economic and social development from many points of view including the generation of employment and incomes, the avoidance of urban overcrowding and above all the maintenance of social and political stability of the nation.

## 3. Vanuatu's Vulnerability

The term vulnerability denotes the potential of a given economy to suffer from external shocks (Briguglio, 1995). In the case of Vanuatu, most shocks stem from the openness of the economy, defined in terms of high percentage of total exports and imports of goods and services to GDP. Total exports and imports of Vanuatu have been in the range of 85 percent to 100 percent of GDP during the last 10 years. The risks emanating from this high dependency are further compounded by a high degree of export concentration, since the island economy's exports are confined to a few commodities.

An IMF study (2002) has shown that the export concentration ratio of three major exports of Vanuatu (copra, beef and timber) had declined from 46 percent in the early nineties to 40 percent in 2001 (Table 2).

**Table 2**
**Vanuatu: Export Concentration**

| Year | Export Concentration Ratio | Share of largest Commodity Export (% of total exports) |
|---|---|---|
| 1992-1996 | 0.46 | 40.4 |
| 1997-2001 | 0.43 | 41.6 |

Source: IMF (2002).

During the 1990s, timber emerged as one of three major exports, edging out cocoa, as world cocoa prices tumbled and farmers were forced to move out of this commodity. Because of logging interests by Malaysians and Koreans, timber exports became important. Timber (11.3 percent of total exports), copra (31.2 percent) and beef (9.3 percent) now account for 51.8 percent of total exports of Vanuatu (Yari, 2003).

Most of the exports are therefore primary agricultural goods, competing with those of other island economies. As they form a minute proportion of world trade, Vanuatu is a price taker. Consequently, export earnings are subject to a high degree of variation in international prices. The unit values of exports of Vanuatu displayed a high degree of variability since 1997. In particular, prices of copra and cocoa have fallen considerably. On the other hand, prices of most of the imports, including essential items such as petroleum fuel and manufactured goods, have been on the rise. The resultant effects of high variability in the terms of trade, which happen to be adverse, are reflected in high volatility in export earnings of Vanuatu.

A study on the instability of export earnings (Yari, 2003) shows that Vanuatu suffered considerably in recent years. The instability measure (average percentage deviation of export earnings from the exponential trend level for 1998-2000) for Vanuatu was 21.5 percent, which was higher than those of Nauru (20 percent), Papua New Guinea (17.9 percent), Solomon Islands (17.4 percent), and Fiji (14.1 percent). Aside from the negative effects of the terms of trade, production levels of the commodity exports themselves also fluctuated.

Frequent cyclones resulting in uprooting of crops have been the main reason for these variations in output. Damages to roads from hinterland to ports and jetties for transporting agricultural commodities also had an effect in this regard. Delays in restoration of the links, which sometimes took years, affected export levels as well as rural incomes.

The earnings of the services sector, mainly from tourism, are also subject to external economic conditions. Recession in the rest of the world and other adverse conditions, including the new and emerging one from terrorism, adversely affect holiday travel to regular tourist destinations. These factors are beyond the control of the island economies and Vanuatu is no exception. A hefty rise in tourist arrivals in 2000 was reversed in the following year soon after the September 11 terror attack. Added to these woes, frequent occurrences of cyclones and earthquakes have had their own toll on tourism. Physical infrastructures for tourism such as hotels and resorts get damaged or become inaccessible due to destruction of roads and communications. The shocks, both external and internal, have had their impact on growth rates of Vanuatu and led to a high degree of volatility. Table 3 presents the annual growth rates of both real GDP and per capita GDP.

**Table 3**
**Vanuatu: Annual Real GDP Growth Rates (%)**

| Year | Real GDP | Per Capita GDP |
|---|---|---|
| 1985 | 1.0 | -0.7 |
| 1986 | -0.1 | -2.7 |
| 1987 | -2.9 | -5.4 |
| 1988 | -1.7 | -4.2 |
| 1989 | 1.5 | -1.3 |
| 1990 | 11.7 | 8.8 |
| 1991 | 3.1 | 0.3 |
| 1992 | 2.6 | -0.1 |
| 1993 | 0.7 | -1.9 |
| 1994 | 9.1 | 6.2 |
| 1995 | 1.0 | -1.5 |
| 1996 | 2.3 | -0.3 |
| 1997 | 4.9 | 2.2 |
| 1998 | 4.3 | 1.7 |
| 1999 | -3.2 | -5.6 |
| 2000 | 2.7 | 0 |
| 2001 | -2.1 | -4.6 |
| 2002 | -2.8 | -5.4 |
| 2003 (est) | 0.8 | -1.9 |

Source: Reserve Bank of Vanuatu, *Quarterly Economic Review* (Various Issues).

Although in the 1980s and early nineties, there were some periods of positive growth rates, in late 1990s and early 2000s, the growth rates were mostly negative. Growth in real per capita GDP has also been negative in a large number of years. Such GDP volatility is a common characteristic among small states (see Kose and Prasad, 2003).

## 4. Building Resilience

Economic resilience refers to the capacity to withstand adverse impacts of shocks and forging ahead economically as well (Briguglio, 2004). Building resilience would also imply learning from past experiences, as the shocks discussed above are not new in any way. This underscores the need for correcting mistakes, putting in place appropriate policies and establishing appropriate institutional structures towards upgrading capacity at all levels, both in the public and private sectors (Commonwealth Secretariat, 2000).

*Diversification*

The standard remedy, which is invariably suggested for a small, open island economy is diversification of its commodity trade and branching out into new profitable areas. Although the suggestion would point to the directions in which small islands would ultimately like to move, one should realise that diversification takes a long time to achieve. Fiji, an island country in the South Pacific which is better endowed than Vanuatu in terms of human resources, did achieve a degree of diversification over a period of time when it began experimenting with garments and other new forms of production. The circumstances were however, changed when an armed conflict resulted in the overthrow of a government. Firm policies by an interim government, including devaluation of the currency, a wage freeze in the civil service and control over trade unions paved the way for reforms.

Vanuatu cannot avail itself of the skills required for the garment industry or any skill-based industry at this present point in time. One should recognise that Vanuatu's manufacturing base, based on local or imported raw materials, is weak. The areas which it can attempt to experiment with are limited and mostly lie in agriculture. In fact, Vanuatu's efforts to compete for a niche market in Japan for pumpkin squash, along with Tonga, which was the earliest entrant in the nineties, were successful. However, the success was short-lived. Entry of other island nations as competitors, including Samoa, for the same Japanese market only resulted in oversupply of squash, leading to a crash of squash prices, forcing the exit of Vanuatu from the market.

The latest effort by Vanuatu in the area of primary processing is coconut oil production for export. A mini oil mill set up in 2000 by a private entrepreneur has resulted in additional export earnings of US$2.2 million, almost equal to that of timber in 2001. Such an effort in primary processing and value added activity was not new. A similar undertaking for manufacturing coconut oil and coconut oil-based detergents and soap in the early nineties folded up after a while. The sustainability of efforts towards any value-added production in agriculture depends on the entrepreneurial and marketing skills of the domestic private sector. The present venture is a result of foreign direct investment from a Fijian entrepreneur, who is expected to bring in expertise in this area.

In the short run, efforts should be concentrated on traditional export commodities. Raising production levels for improving export earnings in the face of a fall in world prices is critical. This is necessary in regard to copra exporting operations of the Vanuatu Commodity Marketing Board (VCMB); the only state-owned procurement agency functioning in the region. The VCMB's operations have been well defended on social welfare grounds, as it offers guaranteed prices for copra, at a level higher than world prices. It is the major source of cash incomes to rural residents, since tourism is confined to the two major towns of Port Vila and Santo. It is imperative that VCMB brings down its operating costs and raises its revenues. The VCMB's operations can be facilitated only if the rural infrastructure in terms of roads and improvements to jetties and ports is strengthened. Substantial investments are needed in this sphere so that movement of produce is improved. Past investments have not been adequate in this area.

*Upgrading the Public Infrastructure*

This brings us to a discussion of government's investment programme, which is funded fully by official development assistance (ODA), consisting of grants and loans on concessional terms. The ODA flows, which were about 32 percent of GDP in 1990 have declined to 18 percent of GDP in 2000. Although nearly one third of capital expenditure is spent on transport and communications, only a small proportion is devoted to the creation of rural assets in terms of market roads and improvements to transportation of produce.

Expenditures for finance, commerce and industry and general administration have been on the rise and are mostly for vehicles and equipment. Political interests often govern investment programmes in transport and communications. They are either for airport development or for urban infrastructure, which is generally confined to Port Vila or the second largest town Santo. A recently approved investment project focusing on outer island development, which is funded by ADB, is expected to fulfil a long felt need.

The Government's recurrent budget, which is dominated by wages and salaries and other housekeeping expenditures, has been in deficit in recent years. Government efforts to contain the deficit usually end up in keeping the maintenance expenditures on existing assets to a low level. The operating and maintenance expenditures on roads, bridges and jetties and harbours have remained a small proportion of the total recurrent budget, with the result that damaged public properties in the islands received least priority for maintenance, while the urban ones got urgent attention. Since the international funding agencies do not lend for operational and maintenance expenditures, the focus of attention on maintenance of existing assets may not be considered a priority by the government.

It is noteworthy that fiscal deficits of governments, both present and past, have not given rise to serious inflation. In recent years, except for 2001, inflation has been below three percent. This may be, in part, attributable to recessionary conditions worldwide. Most of the imports are sourced from Australia and New Zealand, which have been successful in their efforts in targeting inflation at home. In addition, an overvalued exchange rate of Vanuatu has contributed to keep domestic price levels low.

*Attracting FDI*

Because of its openness, absence of exchange controls and of direct taxation, Vanuatu has traditionally attracted higher FDI inflows than Fiji, even though the latter has better physical and human resource endowments and a bigger domestic market. These FDI inflows have been in the tourism and beef industries. Obviously, the government is aware that with greater facilitation and official support to obtain land leases, a more liberal atmosphere can be created and maintained to attract FDI inflows consistently in order to bridge the resource gap and upgrade domestic skills in many ways. The tourism and beef industries are major foreign exchange earners for Vanuatu, and FDI in these industries would contribute towards building the country's resilience to withstand external shocks.

However, FDI flows cannot be taken for granted. First of all competitiveness in Vanuatu needs to be improved (Jayaraman, 2004). In addition domestic issues such as poor governance, ending in scams and failure to take action on the Ombudsman reports on corruption in high places, have contributed to a rapidly deteriorating environment for FDI.

*Governance*

Good governance is considered of paramount importance for resilience-building. In Vanuatu, governance leaves much to be desired. (Jayaraman, 1998b). In recent years, emerging political instability, leading to law and order problems, have had additional negative effects on the economy of Vanuatu. Security concerns have also had an adverse impact on tourism. Vanuatu's problems, which surfaced in early 1998, were not of the armed conflict kind, which Fiji and Solomon Islands had to face in recent years, but were more related to governance issues. These involved abuses of powers by government ministers through misuse of resources of the Vanuatu National Provident Fund, (VNPF), which had been built by monthly contributions by employees and their employers in the formal sector. Government inaction and subsequent rejection of the Ombudsman reports on corrupt practices of the higher-ups in the government led to a loss of trust in VNPF. This resulted in a run on the funds and damage to its properties by agitators (Jayaraman, 2003).

The Reserve Bank of Vanuatu devalued the currency, as a measure to discourage the efforts of citizens to move funds overseas. The devaluation decision was however reversed and the Governor of Reserve Bank who took the devaluation decision was also removed (Jayaraman, 2002). After some quick fire fighting solutions, including the imposition of exchange controls for the first time in an otherwise pure tax haven, normality was restored. It took nearly two years for the country to recover from the ill effects of the 1998 events.

*The Fiscal Regime*

Another source of resilience can take the form of an appropriate fiscal policy. Here again, there are shortcomings in Vanuatu, due to the inflexibility of the fiscal regime, which in Vanuatu is unique due to its historical inheritance of a pure tax haven status from its colonial past. All political parties involved are aware of the need for finding alternative sources of tax revenue when import duties have to be lowered consequent to accession to WTO and when a free trade area in the region becomes a reality by 2010, under Pacific Island Countries Trade Agreement (PICTA). A more flexible fiscal framework would help Vanuatu, which is highly dependent on uncertain ODA flows for investment expenditures, to cope with high volatility in revenues.

The government has taken a decision to join a free trade area with thirteen other island countries under PICTA by 2010 (Scollay, 1998). Eventually, this would be followed by a larger Free Trade Area with Australia and New Zealand by 2018 under the Pacific Agreement on Closer Economic Relations (PACER). These two agreements, which are yet to be ratified by the legislature (Kelsey, 2004), would mean the lowering of import duties to a near zero level. The loss of sizeable import tax revenues will have to be compensated by the imposition of new kinds of taxation. Government may have no alternative left but to introduce income and company taxes. Further, the need for new revenue sources becomes urgent in the context of a declining trend in ODA flows. Although foreign aid during disaster years for rehabilitation has been significant, there is a high degree of volatility in ODA flows.

All along, the country's efforts to retain a pure tax haven status have resulted in strong resistance to any suggestion of introduction of any direct taxation. However, OFCs in general have come under heavy fire from the Organisation for Economic Cooperation and Development (OECD) which accused OFCs of unfair tax competition and of money laundering. For a while in 2002-2003, Vanuatu figured in the OECD's list of uncooperative tax havens. Although temporary palliatives, such as bringing the OFCs under the control of Reserve Bank of Vanuatu for better supervision, have resulted in the removal of Vanuatu from the OECD's black list, the time has probably arrived for Vanuatu to reconsider its OFC policies.

Pressures on tax policies in future are likely to result in larger fiscal deficits, as a regional free trade area envisaged under PICTA by 2010 and PACER by 2018 takes shape with mandated reduction in import duties. Presently, overall fiscal deficits are below four percent of GDP (Government of Republic of Vanuatu 2004). The domestic debt of the country in 2001 was about 11 percent of GDP and external debt was 32 percent of GDP (Table 1). Nearly 75 percent of external debt is on concessional terms since Vanuatu, because of its LDC status, is eligible for soft loans from both the Asian Development Bank and the World Bank. Consequently, the external debt servicing ratio to total receipts from exports of goods and services has been around one percent.

It will be appropriate to ensure that OFCs make some tax contribution to Vanuatu's economy. In the past, successful OFCs in other countries such as Hong Kong and Singapore as well as those in the Caribbean were subject to direct taxation.

*Regional Integration*

Recent economic integration initiatives in the Caribbean have been hailed as an example for island countries towards overcoming geographical hurdles with regard to size and trade. However, one should recognise that island countries in the South Pacific region are all exposed to similar external shocks and their exports are more competitive than complementary. Thus, in the short run, such regional alliances are unlikely to be helpful. However, they would provide opportunities for pooling resources to reduce the cost of public goods and services. These are mostly in the area of shipping and transport and communications and education. Further, regional alliances may increase their bargaining power in their negotiations in matters related to trade and investment.

## 5. Summary and Conclusions

One of the conclusions of a recent study on 43 small island states, which are the members of IMF (Kose and Prasad, 2003), is that size matters. Vanuatu is no exception. The disadvantages relating to geography (remoteness from major markets and natural disasters), vulnerability (trade openness, heavy reliance on export earnings and high export concentration) and limited ability to exploit economies in production are indeed real. High volatility in GDP growth of Vanuatu has been observed to be due to the less diversified nature of its economy leading to high volatility in its export prices and consequently in terms of trade. There were also high degrees of fluctuations in aid and FDI inflows.

It is well known that a number of vulnerable small states, have, through good governance and appropriate economic policies, succeeded in withstanding the impact of external shocks and registered acceptable rates of economic growth. There is no reason why Vanuatu cannot do the same. This chapter however has shown that in Vanuatu, man-made policies, including fiscal inflexibility and poor governance, have exacerbated the drawbacks associated with vulnerability of the island nation. Vanuatu will always remain inherently vulnerable, and it is therefore important that economic policy in this island state be geared towards strengthening economic resilience to cope with vulnerability. Good governance and sound macroeconomic policies should be placed at the top of the agenda towards this end.

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