

Reserve Bank of Vanuatu



Half-Yearly Monetary Policy Statement.

March 2009

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1. Governor's Statement

The world economy has weakened significantly in the past six months and is expected to remain weak for some time. Liquidity remains tight in major credit markets and this has had an adverse effect on the real economies in the developed world. Trade flows, investment activity and industrial production have weakened significantly towards the latter part of 2008, which resulted in world economic activity slowing sharply in the December quarter. In response, Central Banks and Governments in many of the largest economies have attempted to stimulate economic activity through coordinated policy actions. To date, these policy initiatives have had only a modest effect on the global economy, though in time they should improve the prospects for an eventual recovery.

In contrast, Vanuatu has, so far, been resilient to the developments in the global marketplace. Preliminary figures for 2008 show the economy to have grown by 6.6 per cent. Much of this growth owes to the strong performances of both the tourism and construction sectors. In 2009, the economy is forecast to expand by a further 3½ per cent with domestic economic activity underpinned by existing construction activity and the recent growth in private sector credit. However, the outlook is not without risk. Vanuatu, as a net importer is highly dependent on developments in the international arena. Much of Vanuatu's income and foreign exchange receipts come from the tourism industry, while foreign direct investment as a share of output is high relative to other countries in the region. Vanuatu's major trading partners – Australia and New Zealand – have slowed significantly in recent months, and there are risks that demand for tourism and investment will slow sharply. If this occurs, then it is possible that the Vanuatu economy will grow at a slower pace than currently forecast. While there are likely to be some offsetting factors to this, such as proximity to major tourism markets and recently added capacity and discounting in the airline industry, it is likely that these factors will simply limit the extent of the weakness, rather than offset it entirely.

In this uncertain economic environment, prudent and coordinated fiscal and monetary policies must be used to combat any problems that arise from the global economic downturn. The RBV remains committed to maintaining financial stability, having proven in late 2008 that it can respond quickly when required to free up liquidity. At the same time, the Government's fiscal position remains sound, with a string of recent surpluses available in the event that expansionary fiscal policy is required.



Odo Tevi
Governor, Reserve Bank of Vanuatu

2. Objective

The Reserve Bank of Vanuatu (RBV) is responsible for the formulation and implementation of monetary policy in Vanuatu. The RBV aims to promote monetary stability as well as economic growth by maintaining a stable value of the Vatu. The RBV concentrates on maintaining a low and stable inflation rate and maintaining sufficient international reserves to meet the country's external obligations. The Bank aims to keep year-ended growth in inflation contained between 0 and 4 percent, and aims to hold sufficient international reserves to cover at least 4 months worth of goods imports.

3. Recent Developments

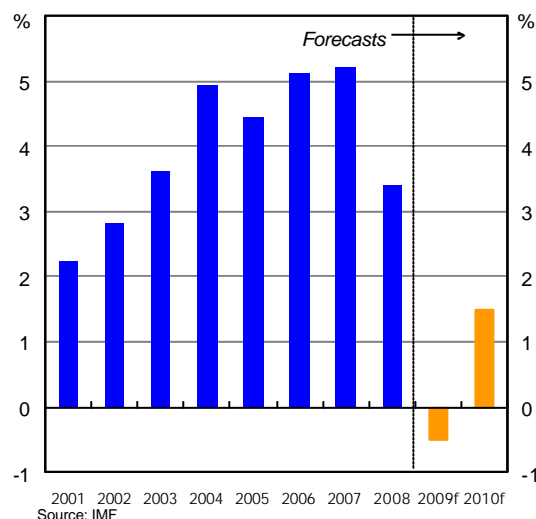
The International Economy

During the past six months conditions in the global economy have deteriorated as a crisis in the financial markets of the developed countries emerged. The bankruptcy of some large banks in the United States and Europe undermined the confidence in lending markets around the world. This led to a sharp decline in the availability of credit in most major economies and gave rise to large fluctuations in currency markets as investors sought the safest places to invest.

The slowdown in the availability of credit has since broadened and intensified to become a highly synchronised global recession. Asset values have fallen sharply across both advanced and emerging economies, while credit markets have remained dislocated. This has led to a substantial reduction in the amount of wealth around the world and caused consumption, investment and trade to weaken. The seven largest economies in the world contracted by 1.8 percent in the December quarter, as global trade and industrial production contracted sharply, its largest fall since records began in the early 1960s.

In response, many Governments and Central Banks have attempted to stimulate their respective economies with coordinated easing of fiscal and monetary policy, in addition to direct capital injections into major lending institutions, purchases of troubled assets and the provision of various forms of guarantees. To date these actions appear to have reduced some of the excess volatility in credit and currency markets and should ultimately improve the prospects for a global recovery.

Figure 1: World Economic Growth
(IMF World Economic Outlook; Annual Growth)



In March, the IMF revised down its forecast for the world economy in 2009 and 2010. Global activity is now projected to fall by between ½ and 1 percent in 2009 – the first fall in 60 years (Figure 1). This weakness is expected to be concentrated in the developed economies, which are forecast to contract

between 3 and 3½ percent in 2009. However, economies that rely on exports are expected to be particularly affected by the downturn in global demand. In 2010, the world economy is forecast to recover gradually with growth between 1½ and 2½ percent. However this outlook is highly uncertain and the timing and pace of the recovery depend critically on strong policy actions restoring confidence in the markets.

Inflation pressures across the world have started to ease as commodity prices begin to fall. Oil prices have more than halved while the price of raw materials and food have fallen substantially in recent months. This has led policy makers in the largest economies to be more concerned with the prospect of deflation rather than inflation at the moment. In contrast, inflation is expected to persist in the emerging and developing economies though it is likely to subside to around 5¾ percent in 2009, down from 9½ percent in 2008.

Closer to home, the Australian economy, the largest in the region and most important for Vanuatu's economic growth prospects, has in recent months fared better than most similar developed nations. This has been the result of sound banking regulation as well as the strength in commodity prices underpinning Australian incomes. However, in line with the slowdown in Australia's major trading partners, and falling commodity prices, it appears that the Australian economy is starting to slow. In the December quarter, the Australian economy shrank by 0.5 percent, to be only 0.3 percent higher over the year – the weakest growth since the recession of the early 1990s. In line with the weakening economy, Australian unemployment increased sharply in February, which is likely to hurt consumer confidence and demand, which, in turn, may impact on demand for tourism. Conditions in the New Zealand economy, Vanuatu's second largest trading partner, are somewhat worse than in Australia, with the economy already in recession, having shrunk by 1.9 percent over the year to the December quarter 2008. Recent labour data indicate that unemployment in New Zealand has started to increase sharply in recent quarters, which is also likely to have a negative effect on consumer demand.

The Domestic Economy

In contrast to the world economy, Vanuatu has continued to expand. It is estimated that the economy grew by 6.6 percent in 2008, driven mainly by the construction and services sectors. The increase in economic activity in 2008 gave rise to a government surplus, of around VT 1.3 billion. Growth in private sector credit has remained strong, while indicators of household consumption, such as VAT collections and motor vehicle registrations, remain at high levels. The commencement of the Millennium Challenge Account (MCA) program has provided a significant boost to the construction sector. Recent tourism arrival data indicate that visitor arrivals have, to date, remained resilient in the face of the worsening global economic conditions. The number of non-visitor arrivals increased over the year to February 2009, with solid growth in both air and cruise ship arrivals. The strong increase in tourism is particularly noteworthy given the sharp appreciation of the Vatu against both the Australian dollar and the New Zealand dollar in the second half of 2008.

The Consumer Price Index increased by 5.8 percent over the year to the December quarter, which was down slightly from the 6.0 percent growth over the year to the September quarter of 2008. Much of this growth reflected rising world food and fuel prices. However, with commodity prices falling sharply in the second half of 2008, the year-ended inflation rate is expected to moderate further as these price falls are passed through to the domestic economy.

Despite strong import growth through much of 2008, the amount of foreign exchange reserves at the RBV remained sufficient to finance around 54 months of goods imports as at February 2009. This remains above the RBV minimum level of import cover of 4 months of import cover.

In terms of monetary policy, the main issue through much of 2008 was the inflation rate, which exceeded the Bank's target range of 0-4 percent. This growth in inflation reflected increasing international fuel and food prices, though to a lesser extent, domestic pressures also made a contribution. Private sector lending grew strongly during 2008, which led to solid growth in the money supply. Part of this increase was attributable to increased competition in the banking sector following the introduction of a new private bank.

In an attempt to curtail domestic inflationary pressures, the RBV increased its rediscount rate by 25 basis points in September 2008 to 6.25 percent. However, with bank excess reserves falling to very low levels, subsequent concerns emerged over the liquidity situation in the banking sector. In response, the RBV reduced its rediscount rate to 6.00 percent in December 2008 and took additional steps to alleviate the tight liquidity conditions. These included introducing a secured advance facility in October 2008; reducing the Liquid Asset Requirement from 8.0 percent to 7.0 percent; reducing the Statutory Reserve Deposit ratio to 8.0 percent in November and then further reducing it to 5.0 percent in January. To date these measures have been successful in restoring liquidity.

4. International and Domestic Economic Outlook

Outlook for the International Economy

Conditions in the global economy are likely to remain depressed for some time to come. With confidence low and liquidity tight, the real economy has been affected through reduced financing for investment and trade, which has led to falling asset prices, lower household wealth and falling consumer demand in the wealthiest nations. This has undermined confidence and placed further pressure on liquidity. This mutually-reinforcing negative feedback loop, between the stalling real economy and troubled financial markets will require strong and coordinated fiscal and monetary policy actions in the largest economies to break. The IMF has encouraged governments to continue to engage in stimulus packages, worth around 2 percent of global GDP. However, to date the stimulus packages announced fall short of this mark.

While much of the fall in global economic activity is expected to be concentrated in the developed world, the effects of the downturn are likely to spill over to the developing world. Weak demand in the largest consumer countries is causing global trade in goods and services (including tourism) to contract. The World Bank expects international trade to experience its largest fall for 80 years in 2009. Commodity prices have also fallen significantly from their mid-2008 peaks, particularly for food, fuel and other raw materials, which is likely to negatively affect the terms of trade for that rely on those commodities for export income. Despite this, the IMF expects growth in emerging markets to remain at or above rates seen in previous global downturns.

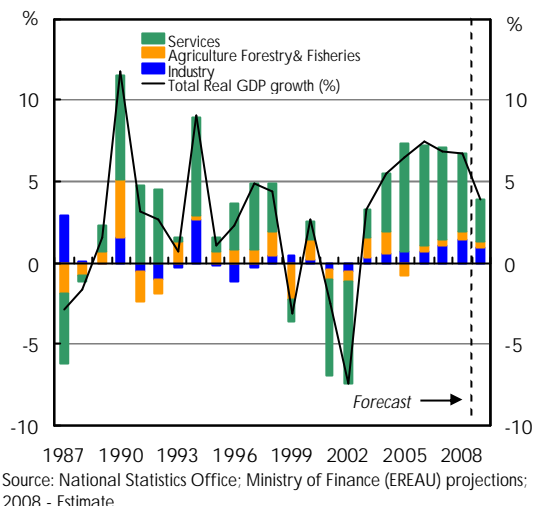
Vanuatu's major trading partners are likely to be negatively affected by the downturn. The New Zealand economy is already in recession, and may fall further as unemployment starts to climb, while the Australian economy has slowed sharply in recent quarters. The Australian Government currently forecast the economy to grow by 1 percent in 2008/09 and to then slow further to $\frac{3}{4}$ percent growth in 2009/10. However, with growth having already slowed beyond the forecast, and unemployment set to rise substantially through the rest of the year, it is likely that the Australian economy will end up being weaker than this forecast.

Outlook for the Vanuatu Economy

a. Economic Activity

The Vanuatu economy is expected to continue to expand through 2009, though at a slower pace than seen in recent years (Figure 2). Both the IMF and the Vanuatu Government forecast that growth in 2009 will be around 3½ percent, which is down on the expected 6.6 percent growth in 2008. Domestic economic activity should remain somewhat resilient in the medium term, underpinned by construction activity from continuing work on the round-island road projects, and the recent strength in private sector credit growth. Additionally, the fact that the domestic banking sector has only limited linkages with global financial markets, should mean that there is limited transmission of the problems in global financial markets into the Vanuatu economy – though this largely depends on the banks maintaining appropriate lending standards.

Figure 2: Vanuatu Real GDP
(Contribution to Annual Growth, Major Sectors)



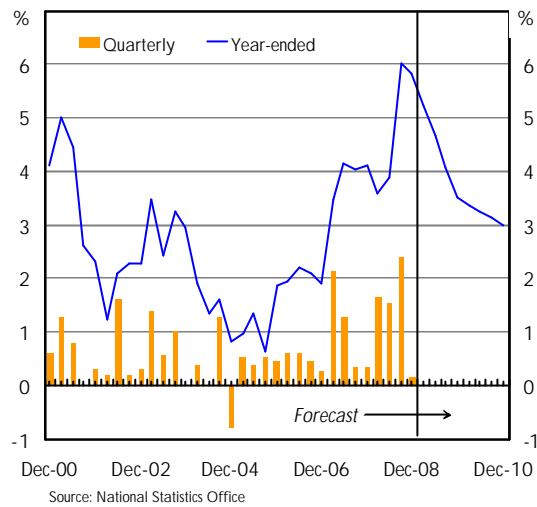
Those sectors of the economy that are linked to the international economy are likely to experience some negative effects of the global downturn. For example, the tourism industry – the industry most directly linked to the global economy and the most important for the Vanuatu economy, both in terms of economic activity as a source of foreign exchange – is likely to come under pressure as consumer demand in the major tourist markets of Australian and New Zealand continues to slow. Additionally, the recent appreciation of the Vatu against both the Australian and New Zealand dollars is likely to reduce the amount spent by each tourist, as domestic goods are now more expensive to them. There is also a risk that new foreign direct investment into Vanuatu may slow, or investment projects that are currently in the planning stage may be delayed or cancelled, as private investment slows around the world.

There are however, some key factors working in Vanuatu's favour, which may limit the extent of any weakness in tourism spending. To date, tourism arrivals have been resilient despite the fact that global economic conditions have been weakening for some time. Some recent one-off factors, such as political instability and adverse weather conditions in some of Vanuatu's key competitor markets are also likely to have aided Vanuatu's attraction as a tourist destination. Crucially, the proximity of Vanuatu to key markets of Australia and New Zealand, combined with increased international promotion and discounting in the airline industry, in addition to regular cruise ship calls should support tourism numbers. The recently-added capacity on key travel routes should also expose Vanuatu as a tourist destination to more potential travelers.

b. Inflation

One area where Vanuatu is expected to benefit from the downturn is prices. Inflationary pressures are likely to continue to ease in coming quarters as falling world prices are passed on. Additionally, the recent appreciation of the Vatu against major trading partners' currencies is likely to cushion imported inflation as importers will find overseas goods have become cheaper. However, the depreciation of the Vatu against the US dollar is likely to offset some of the price falls of those goods denominated in US dollars (such as oil, capital equipment and some foods). The weakness in global demand has caused raw materials prices to fall significantly in recent months, which should also reduce business costs. Consequently, the rate of year-ended inflation in Vanuatu is forecast to head down toward the Bank's target range of 0-4 percent in coming quarters, falling to around 3½ percent by the end of 2009 (Figure 3).

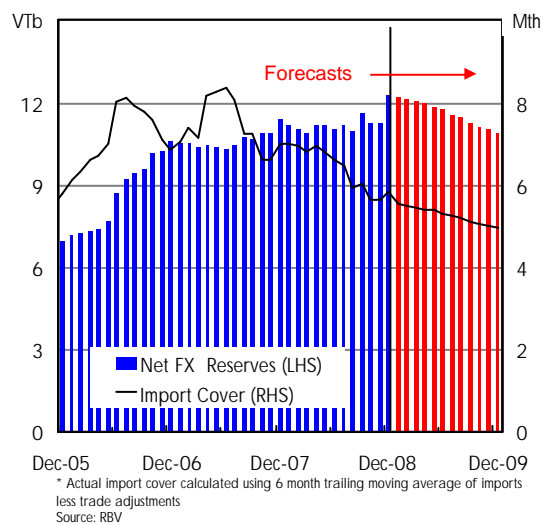
**Figure 3: Consumer Price Index
(Percentage Change)**



c. Balance of Payments and International Reserves

The current account deficit is forecast to increase to VT 10.5 billion (approximately 16.9 percent of nominal GDP) by the end of 2011, up from VT 4.3 billion in 2008. This reflects a widening of the trade deficit as exports weaken in line with global demand, while the value of imports should continue to increase through the forecast period, albeit at a slower pace than in previous years, in line with the slowing in domestic demand. Much of the growth in imports is likely to come from capital goods required to sustain major construction projects already in the pipeline. The services account is expected to remain in surplus over the forecast period. However, in line with the forecast decline of the Australian and New Zealand economies, tourism earnings are expected to weaken, which should narrow the overall surplus. The income account is expected to head into deficit in the medium term. As interest rates in most countries have fallen sharply, the interest income on overseas investments is expected to fall. In contrast, the sharp appreciation of the US dollar should mean that loan repayments denominated in US dollars will increase. However, official transfers should remain healthy as major donor countries have pledged to maintain their development assistance for the next few years.

**Figure 4: Net Foreign Exchange & Import Cover
(Levels of FX & Months of Cover; Monthly Data)**



A widening current account deficit is likely to place downward pressure on the stock of foreign exchange (Figure 4). However, foreign exchange reserves are expected to remain above the statutory minimum in the medium term, and be sufficient to finance around 4.8 months worth of imports of goods by the end of 2009. This is expected to be funded by tourism flows and remittances. Falling import prices should also mean that less foreign exchange is required to fund a given amount of imports. Moreover, commitments by development partners to continue increasing aid flows to Vanuatu should also help maintain the reserve position.

5. Monetary Policy Stance

The RBV remains committed to maintaining financial stability in Vanuatu. By maintaining price stability, as well as ensuring that there remains sufficient liquidity in the banking sector, the RBV aims to ensure that conditions remain conducive to continued economic activity. The recent decisions of the RBV to relax the Statutory Required Deposits and the Liquid Asset Ratio of the commercial banks should help with the flow of domestic credit going forward. To the extent that these credit flows continue to be channeled to productive investments, this should help alleviate some of the difficulties emanating from overseas.

In all, Vanuatu remains well placed to deal with this global economic downturn. The Government's fiscal position remains sound, with a string of recent surpluses available in the event that expansionary fiscal policy is required, while the RBV has proved that it can respond quickly when required to free up liquidity. Currently the RBV's monetary policy stance remains unchanged, though we will remain watchful of world economic developments, and their effects on the domestic economy, and stand ready to respond quickly when required.