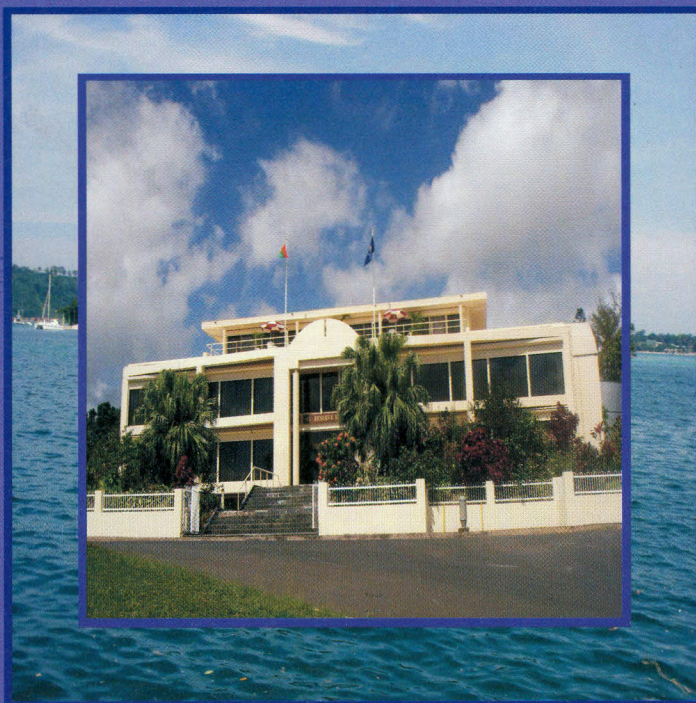




RESERVE BANK OF VANUATU



2004 ANNUAL REPORT AND STATEMENT OF ACCOUNTS

GOVERNOR & CHAIRMAN, BOARD OF DIRECTORS

The Honourable Minister of Finance
Government Building
Port Vila

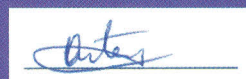
April 30, 2005

Dear Minister,

Pursuant to Section 42(1) of the Reserve Bank of Vanuatu Act [CAP 125],
I have the honour to transmit to you:

- (a) A report of the operations of the Reserve Bank of Vanuatu for the
Year 2004; and
- (b) A copy of the Bank's Annual Statement of accounts for 2004
certified by the Auditors.

Yours faithfully,



Odo Tevi
Governor and Chairman, Board of Directors

Private Mail Bag 062, Port Vila, Vanuatu. Facsimile: (678) 24231
Telephone: (678) 23333
email: resrvbnk@rbv.gov.vu. Website: <http://www.rbv.gov.vu>

PRINCIPAL OBJECTIVES

PRINCIPAL OBJECTIVES

The principal objectives of the Reserve Bank shall be:

- (a) to regulate the issue, supply, availability and international money exchange;
- (b) to advise the Government on banking and monetary matter;
- (c) to promote monetary stability;
- (d) to promote a sound financial structure; and
- (e) to foster financial conditions conducive to the orderly balanced economic development of Vanuatu.”

Section 3, Central Bank of Vanuatu Act [CAP 125].



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VISION & MISSION

OUR VISION

Providing the conditions for Vanuatu to build a strong economy by ensuring confidence and stability in our financial system.

OUR MISSION

1. Establish appropriate monetary conditions for price stability
2. Establish financial conditions and adopt policies that will ensure an adequate level of foreign exchange reserves to meet external obligations
3. Provide proactive and sound advice to Government
4. Develop an internationally reputable financial system
5. Inspire public confidence in the Reserve Bank
6. Meet the currency needs of the public
7. Disseminate timely and quality information
8. Recruit, develop and retain a professional team dedicated to the pursuit of quality practices
9. Ensure sound banking practices so as to provide protection of depositors



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BOARD OF DIRECTORS

Mr. Odo Tevi

Governor and The Chairman of the Board

Governor of the Reserve Bank of Vanuatu since 22 April 2003. Served as the Principal Economist in the Ministry of Finance and Economic Management (MFEM). Alternate Governor for Vanuatu in the International Monetary Fund. Mr. Tevi has a Masters degree in Economics from Sussex University in England.



Mr Geordie Mackenzie-Reur

Member since 27 June 2002. Managing Director, Fiberglass Vanuatu Limited. Managing Director, Pacific Polytanks Limited. Executive Member of Central School Council. Served as: Principal Agriculture Extension Officer, General Manager, Syndicat Agricol, General Manager, Vanuatu Chamber of Commerce. Mackenzie-Reur has a Masters in Agriculture from the University of Queensland in Australia.



Mrs. Anniva Tarilongi

Member

Member since 27 June 2002. Deputy Financial Controller, Telecom Vanuatu Limited (TVL). Formerly Administrative Accountant and Funds Accountant, Coopers & Lybrand Chartered Accountant (1991-1993). Has worked as an Accountant/Auditor with KPMG PEAT MARWICK from 1993 - 1995. Mrs. Tarilongi has a degree in Accounting from the University of New England in Australia, and carries with her a wealth of experiences



Mr. Simeon Malachi Athy

Member

Member since 14 June 2004. Director General in the Ministry of Finance and Economic Management (MFEM). Served as Director of the Department of Research at the Reserve Bank of Vanuatu. Mr. Athy has a Bachelor of Economics from the University of Papua New Guinea (PNG).



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MANAGEMENT COMMITTEE



Odo Tevi
Governor

The Governor is the Chief Executive Officer of the Reserve Bank of Vanuatu and he is responsible to the Board for the execution of its policy and the management of the Bank.



Peter Tari
The Deputy Governor

Assitant to the Governor and responsible for the Banking Supervision Department with the primary responsibility of regulating and supervising the domestic commercial banks and the offshore banks.



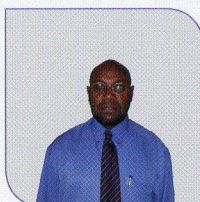
Michael Hililan
Chief Economist And Director of Research and Statistics Department

The department's core function are policy formulation; economic analysis and advice; publications, statistics and library; overseas representation and liaisons.



Heva Alilie
Director of Operations Department

function of the Operations Department are divided into three offices namely, the Currency Office, Foreign Exchange Office and Account and Customer Services Office.



Nelson Shem
Director of Corporate Services Department

The Service Department has the primary responsibility for providing internal support services including : information technology, the bank's current and future human resources needs, plant and properties, security, and general administration.

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GOVERNOR'S REPORT

I. GOVERNOR'S FOREWARD

Last year the Reserve Bank of Vanuatu faced many challenges. The Bank for the first time supervised the VNPF and saw the first round of the restructuring of the Bank, which was subsequently adopted by the Board. Moreover the market liquidity in the financial system was low at the beginning of 2004. The Bank managed these challenges well and this was made possible by the cooperation of staff and the technical assistance provided by the International Monetary Fund.

On the economic front the Vanuatu economy enjoyed another year of economic growth of 3.2 percent. This was partly attributable to growth in the agricultural and service sectors. The agriculture sector saw increases in the production of copra due to favorable world prices. The tourism sectors expansion was due mainly to the increase in airline capacity, which saw the introduction of Pacific Blue airline and an additional aircraft by Air Vanuatu.

The favorable economic performance was also underpinned by sound macroeconomic stability. Inflation was at 0.8 percent and this outcome was mainly attributable to sound monetary and exchange rate management pursued by the Bank and prudent fiscal management by the government. The level of official reserves rose from around 4 months of import cover in 2003 to a comfortable level of 5.5 months import cover in 2004. This was attributable to increase in donor inflows and receipts from the government and sale of foreign exchange proceeds to the Bank by a commercial bank. As a consequence of this improvement in reserves, the Bank amended its foreign exchange guidelines to revert to its normal dealings with the commercial banks.

As I have mentioned earlier, the market liquidity situation was low at the beginning of 2004. The Bank responded by reducing the liquid asset ratio from 15 percent to 12 percent and issued a guideline on 'Supervision of the Adequacy of Liquidity of Banks' to ensure that commercial banks have sufficient liquidity to meet customer demands. As a result of these measures and coupled with the improvement in the economic growth liquidity improved substantially towards the end of the year.

A Monetary Policy Committee was formally established within the Bank and constitutes the Governor as Chairman and senior management of Bank as members. The MPC meets bi-weekly to discuss monetary issues within the economy and what policy response the Bank should adopt. In terms of the monetary policy stance of the Bank, the Committee with the endorsement of the Board decided that it remained unchanged and therefore left the discount rate at 6.5 percent. This was mainly attributable to the fragile nature of economic growth and official reserves, and untenable monetary conditions resulting mainly from Government borrowings to RBV to finance its deficits.

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GOVERNOR'S REPORT

On the financial performance of the Bank, the Bank recorded an operating profit of Vt30 million in 2004. This profit was lower than last year and this was due to a number of factors such as the lower global interest rates, as most of the Bank's income is invested in global funds abroad; the overdraft facility with the Vanuatu commodities Marketing Board ceased; and the net position of the Government with the Bank improved dramatically. The RBV will provide Vt27 million to the Government, which constitutes 90 percent of profit to be transferred to Government, as required by the RBV Act.

In 2004 the Board approved the restructuring of the Bank. This is a first ever restructuring done by the Bank since independence. The first part of the restructuring saw the organizational structure of the Bank revised, new job descriptions and titles introduced and a new salary and benefit structure of the Bank was adopted. The Research and Administration Departments changed names to Research and Statistics Department and Corporate Services Department. Most of the restructuring, which will focus on modernizing the operations of the Bank, will be implemented in 2005.

In 2004 the RBV conducted its first on-site visit on the Vanuatu National Provident Fund (VNPF) after the Minister of Finance's directive in 2003 to extend the Bank's supervisory oversight to VNPF. The visit, amongst other things, covered areas in corporate governance, risk management and asset quality and complaint handling. This was achieved with support provided by technical assistance from the International Monetary Fund.

One of the main highlights of the year was when the Bank for the first time hosted a regional seminar for the Association of Financial Supervisors of Pacific Countries (AFSPC) in collaboration with the IMF Pacific Financial Technical Centre (PFTAC). This seminar gathered all bank supervisors from around the Pacific and focused on Economic Capital Issues, the Supervisory Review Process of Basel II and Problem Bank Resolution. Experts at the Financial Stability Institute provided technical advice and presentations.

Looking forward to 2005, the Bank will continue to focus its objectives on improving its standards and integrity in order to ensure that a sound and stable macroeconomic environment is maintained, a comfortable level of official reserves is always maintained, sufficient and quality currency is in place to meet the country's needs and a stronger and healthy financial system is in place.

I would like to take this opportunity to thank the Board of Directors for their support and guidance through out the year. Finally, I would also like to extend my deep appreciation to the management and staff of the Bank.



Odo Tevi
Governor and Chairman of the Board

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THE YEAR IN BRIEF

NO.	BRIEF OUTLINE OF MONETARY CONDITIONS AND POLICY DURING 2004	EFFECTIVE DATE
1	Following a review of the Liquid Asset Requirement (LAR), the Reserve Bank of Vanuatu reduced the requirement from 15 percent to 12 percent effective 2 January 2004.	January 2004
2	The Board approved the Bank's strategic plan and Risk Management Policies. This is the first time in the Bank's history to develop and implement a strategic plan.	January 2004
3	The RBV issued for the first time 14-days RBV Notes. The issue coincided with tight market liquidity in the first quarter of 2004, and as part of further development of money market intervention.	January 2004
4	At its annual meeting, the Bankers Association of Vanuatu elected Mr. Philip Tremethik, as its new Chairman. Mr. Tremethik, Acting CEO of the European Bank Limited, replaces Mr. Bob Hughes of the National Bank of Vanuatu for a period of 12 months.	April 2004
5	The Board approved the report on the independent review of the Bank. Subsequently the Governor met with staff and discussed the review.	April 2004
6	A Monetary Policy Committee (MPC) was established within the Bank. The MPC, comprising of senior management, is responsible for recommending the Bank's policy stance to the Board. The Committee held its inaugural meeting on May 19, 2004.	May 2004
7	In accordance with the RBV Act, the Bank paid the Vanuatu Government an amount Of VT66,569,025 representing the total amount of FNH currency.	May 2004
8	In June 2004, the RBV, as part of its regular policy assessment reviewed the weights of the basket of currencies. The weights are altered to reflect current developments	June 2004
9	The Bank agreed to rename the Administration of the Bank to "Corporate Services Department" effective June 03, 2004	June 2004
10	Following an order signed in December 2003 to give power to the Bank to supervise the Vanuatu National Provident Fund (VNPF), the Bank conducted its first on-site inspection of the VNPF in June and July 2004.	June -July 2004
11	The Board of Directors of the Reserve Bank of Vanuatu, after reviewing economic developments against the policy settings of the Bank, concluded that the policy objectives of the Bank were achieved in the first half of 2004.	July 2004
12	In light of these developments, the Board of Directors decided to maintain the current monetary policy stance and kept the official interest rates unchanged at 6.5 percent.	July 2004
13	A press release on the Bank Review was published in the local news papers. The Reserve Bank of Vanuatu undertook a major review of its structure and operations to strengthen the management of its responsibilities and improve the Bank's effectiveness and overall efficiency. The initiatives will strengthen the Bank's accountability and transparency. A financial markets unit will also be established within the restructuring. It will demarcate the responsibilities of policy formulation and policy implementation.	July 2004
14	The Board of Directors in its meeting on 07 July has approved a change of department name from Research Department to "Research and Statistics Department". The Research and Statistics Department is responsible for monetary policy formulation at the Reserve Bank of Vanuatu.	July 2004
15	The Bank revised the Bank Supervision Policy Guideline 3, 'Supervision of the Adequacy of Liquidity of Banks', it issued to commercial banks in 1998. The aim of the guideline is to ensure that all banks have sufficient liquidity to meet obligations as they fall due across a wide range of operating circumstances.	July 2004

THE YEAR IN BRIEF

NO.	BRIEF OUTLINE OF MONETARY CONDITIONS AND POLICY DURING 2004	EFFECTIVE DATE
16	The Board approved a revised copy of the Currency Office manual. The manual covers the general operation of the Currency Office. The revised manual became operational as from July 7, 2004.	July 2004
17	The Board approved the Reserve Bank of Vanuatu Email and Internet Policy. The policy is intended to provide ways to secure the usage of the electronic mail system and the internet resident at the Reserve Bank of Vanuatu servers.	September 2004
18	A Policy Coordinating Committee (PCC) was established in the Reserve Bank. The aim of the Committee is to provide advice to the Monetary Policy Committee through continuous monitoring the performance of key economic variables and assessing their impact on the broad objectives of the RBV – inflation and foreign reserves. The Committee held its inaugural meeting on September 24, 2004.	September 2004
19	The Bank amended the foreign exchange guidelines relating to foreign exchange deals with commercial banks to revert to normal dealing arrangements in line with improvements in official foreign reserves. The RBV had allowed banks to sell foreign exchange to the Reserve Bank within the full range of the buying and selling rate.	October 2004
20	Following discussions between the management and shareholders of GSP International Bank Limited and the Reserve Bank of Vanuatu in relation to comply with conditions imposed on its license, GSP International Bank Limited decided to voluntary surrender its license to conduct international banking business.	October 2004
21	Pursuant to section 11 (4) (b) of the International Banking Act, the Reserve Bank of Vanuatu revoked the license issued to GSP International Bank Limited effective 6 October 2004.	October 2004
22	The Bank, in collaboration with the Pacific Financial Technical Assistance Center (PFTAC), hosted a regional seminar for the Association of Financial Supervisors of Pacific Countries (AFSPC) on 25 - 27 October 2004. The seminar focused on Economic Capital Issues, the Supervisory Review Process of Basel II and Problem Bank Resolution. Participants were addressed by representatives of the Financial Stability Institute of the Bank of International Settlement and, a member of the Secretariat to the Basel Committee of Banking Supervision.	October 2004
23	The Board in its meeting of 22 October 2004 approved the reprint of VT1,000 and VT500 Notes by De La Rue.	
24	The Governor of the Reserve Bank of Vanuatu made a presentation, to the Business Forum in Santo, outlining the Bank's progress in the Business Forum recommendation matrix.	
25	The 2004 IMF Article IV consultation with Vanuatu took place between November 08 through 19, 2004. The 2004 mission is the 12th in the series of such consultations since Vanuatu joined the IMF in September of 1981.	November 2004
	The Reserve Bank of Vanuatu revoked the banking license issued to Abbey Mercy Bank Limited under the International Banking Act No 4 of 2002. Abbey Mercy Bank failed to comply with conditions imposed on its banking license and to supply information to the Reserve Bank of Vanuatu. In terms of section 11 (3) of the International Banking Act, the bank was given 14 days to respond to the Reserve Bank advising why its license should not be revoked. Abbey Mercy bank failed to respond to the Bank within the time frame provided for under the Act.	December 2004
	Pursuant to section 11 (4) (a) of the International Banking Act, the Reserve Bank of Vanuatu revoked the license issued to Abbey Mercy Bank Limited effective 6 December 2004. The Board of Directors of the Reserve Bank of Vanuatu, in its meeting on December 2004, decided to maintain the current monetary policy stance of the Bank. The Board decided to maintain the official interest rates at 6.50 percent.	December 2004

MONETARY POLICY FORMULATION

III. MONETARY POLICY FORMULATION

The Reserve Bank of Vanuatu is responsible for the formulation of monetary policy under the powers derived from the Reserve Bank Act (CAP 125 of 1980). Under the Act, the Bank is charged to ensure monetary stability.

This is interpreted to mean an adequate level of international reserves and low inflation at the operational level. In the daily monetary management the level of reserves is the key target in the Bank's policy consideration.

At the end of 2004, the level of official international reserves rose to 5.4 months of import cover and measured headline annual inflation fell to 0.8 percent. As such the Bank is of the view that over the year the key objectives of the Reserve Bank have been met whilst macroeconomic stability has by and large been maintained.

The Bank relies primarily on Open Market Operations in auctions of RBV notes in the money market and pursued a cautious but accommodating policy stance in 2004 in support of the growth that emerged from 2003 and continued into 2004 but was largely driven by external factors. The Bank was aware of the need to support growth while it remained cautious of the potential for disruption to macroeconomic stability. The policy stance took into consideration the comfort the Bank had in the level of official international reserves and the low turn-out in headline inflation. At the same time the Bank paid close attention to potential price pressures from high world petroleum prices in such an import dependent economy and fiscal pressures arising from various unbudgeted large fiscal expenditure undertakings in 2004 related to elections, cyclone relief and reconstruction. As it turns out pressures on measured inflation from international price movements have so far been muted and a large unexpected inflow of donor funding in direct support of the budget at the close of the year assisted in maintaining fiscal prudence in 2004.

In the Bank's assessment of monetary and economic conditions at the first half of 2004 the Bank concluded that the growth in output was beginning to become more discernable but at the same time, due to weaknesses in liquidity management, that there was tight market liquidity of commercial banks. In response to this the Bank:

- Reduced the Liquid Asset Ratio (LAR) requirement from 15 percent to 12 percent in January 2004. The LAR, as a prudential instrument, was introduced in 1999 at 15 percent in place of a Prescribed Reserve Asset ratio.
- The Bank decided to introduce for the first time a 14-day RBV note instrument as liquidity of banks became tight.
- Broadly maintained an accommodative stance in monetary management given the liquidity profile of commercial banks.
- Maintained tight foreign exchange guideline in the light of the then fragile external foreign reserve position.

The Bank assessment in the second half of 2004 was made during a period of broader base world economic and domestic economic expansion. The domestic agricultural sector and tourism were picking up strongly but at the same time there were continuing concerns about high world petroleum prices and from large unbudgeted fiscal expenditures related to cyclone relief efforts and a number of elections. The bank therefore decided to:

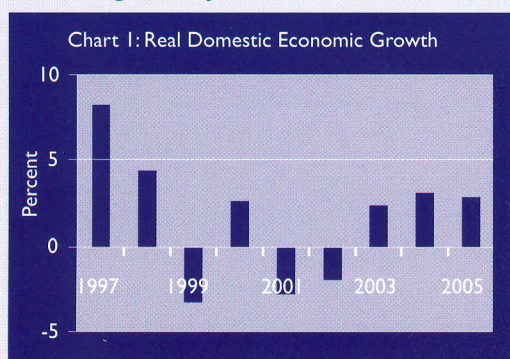
- Maintain the RBV discount rate at 6.5 percent in July 2004
- Review the weights of the basket of currencies to bring it in line with current developments in June 2004
- Establish the Monetary Policy Committee of the Bank with the role of recommending the stance of monetary policy to the Board of the RBV.

At the close of the year the Bank continued to maintain an accommodative but cautious approach to monetary management. The Bank was of the view that growth, inflation and reserves have improved markedly from the beginning of 2004. At the same time, foreign exchange of the commercial banks had improved from low levels at the beginning of the year in reflection of the pick up in economic activity and inflow of donor funds. As a result the liquidity of banks began to increase substantially. However, the Bank also felt that there were still substantial risks in the economy and decided to:

MONETARY POLICY FORMULATION

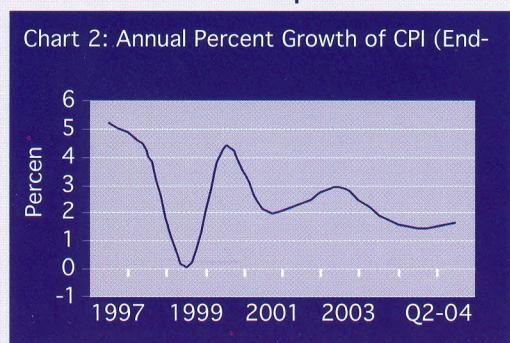
- Maintain the Reserve Bank's discount rate at 6.5 percent in December 2004.
- Continue with its guidelines on foreign exchange purchases but reverted to the normal dealing arrangement with the commercial banks in the light of improvements in the level of foreign exchange of the commercial banks.
- Broadly maintained an accommodative stance in monetary management given the nascent nature of economic growth.

There was a more favorable turn-out in Vanuatu's macroeconomic indicators than the past several years. Recent estimates reveal a real output growth of 3-3.2 percent, and also more broad based than before, extending to the agriculture, services and industry sectors. The strength of the economic expansion is reflected in the series of upward revisions made to real GDP through the year.



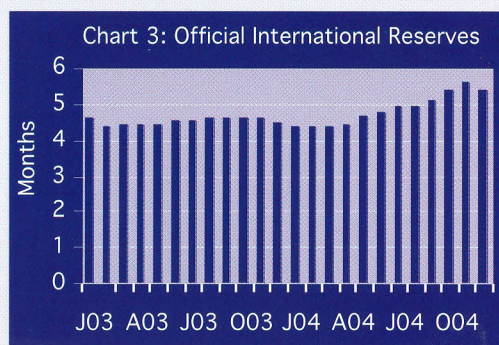
Source: Ministry of Finance and Economic Management

Measured headline inflation decelerated to 0.8 percent on an annual basis while measures of core inflation registered an increase of 1.2 percent.



Source: National Planning and Statistics Office

At the close of 2004 the overall balance of payments recorded a large surplus of VT870 million.



Source: Reserve Bank of Vanuatu

Months of import cover strengthened though out the year from a low of 4.4 in the first quarter to 5.4 in December, a high by regional comparison.

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ECONOMIC OVERVIEW

I. ECONOMIC OVERVIEW

In spite of geopolitical uncertainty, SARS, high world oil prices, global imbalances and a devastating tsunami, world economic expansion turned out strong in 2004, well above the trend of the last 30 years. Nonetheless, growth has moderated from the first half of the year and the expansion is expected to be lower but still above trend in 2005.

A rise in world commodity prices, including for those relevant to Vanuatu, copra and coconut oil, provided a significant driver for domestic output growth despite the effect of a cyclone on tree crops in the second half of 2004. The rise in world commodity prices included record high world oil prices. The effect of world oil prices on inflation was largely on energy-related components of price indices, suggesting its indirect impacts are still muted. Interest rate increases in countries like the US and New Zealand suggest that there are now concerns over pressures on inflation.

The strength of world economic expansion provided the driver for domestic growth through higher world prices for copra and coconut oil, a rise in tourism, and investment flows to housing and land development. The Ministry of Finance and Economic Management (MFEM) estimates a real GDP growth of 3.2 percent while estimates by the International Monetary Fund indicate a growth of 3 percent in 2004. Unlike past years growth appears to have registered in all major sectors of the economy but the source of growth is largely from the external economy and suggests the need for continuing with promoting growth-oriented policies to sustain longer-term growth.

A wide array of data that the Reserve Bank monitors indicates that the above estimate may be on the conservative side.

Visitor arrivals by air were up 18 per cent on last year. An expansion of airline capacity, assisted by the government's open skies policy, contributed to growth in the tourism sector. An influx of private sector investment in new accommodation and resort properties could increase room nights by up to 10 per cent by some estimates. High and rapidly rising coastal property prices in and around Port Vila suggest an ongoing interest by foreigners in the property markets.

The agriculture sector strengthened considerably as seen by the annual increase in copra production by 36 percent. Annual coconut oil exports are 122 percent above the 2003 level. The value of kava exports doubled from the level of 2003. Strong growth in the agriculture sector was assisted by high world prices for copra and coconut oil and a sudden rise in the number of nuts felled by a cyclone at the start of the year. Nevertheless, tree crop production has shown the adverse signs of the cyclone as copra and cocoa

production have moderated, which could be accentuated if world commodity prices decline from their current levels. At this stage however prices remain stable at high levels.

The Bank had expected pressures from higher petroleum prices to build on the inflation of 2.9 percent in 2003. As it turned out measured headline inflation decelerated to 0.8 percent in 2004 despite substantial increases in domestic petroleum prices, however, the measure of underlying inflation showed a 1.2 percent annual increase. Nonetheless, it is likely that the second-round effects of high petroleum prices could be felt in early 2005 in utility prices but the effect of this on consumer price indices will depend on the degree of cross subsidization of prices by utility firms.

The Government fiscal operations strengthened in 2004 despite a series of unbudgeted items related to elections, cyclone relief and reconstruction expenditure. These large expenditures took place in the middle of the year and were key considerations in the Bank's cautious policy stance in 2004. The fiscal position however improved considerably at the close of the year as a result of a large inflow of donor funds in direct support of the budget, continuing expenditure control measures and improvements in revenue collection. The strengthening gave rise to a significant improvement in the Net Credit to the Government (NCG) with the banking system, notably its position with the Reserve Bank at the close of 2004.

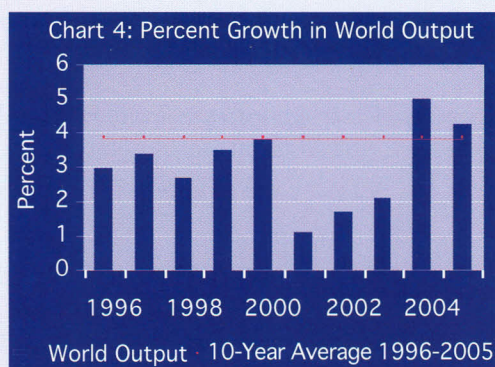
Compared to an average annual growth of 1.7 percent over the last seven years, the year witnessed a relatively high money growth of 9.8 percent, the highest since 1998. The growth was largely driven by inflows through the balance of payments from high exports and tourist arrivals and increased activity of the housing and property market from overseas buyers. These inflows led to increases in foreign reserves and liquidity of the commercial banks. Foreign exchange and the liquidity of commercial banks rose from low levels in the beginning of the year to reach peak levels before the Christmas festive period with a brief drop around Christmas associated with a rise in currency with the public and from a large land lease sale around Port Vila. In line with the increase in liquidity, interest rates decelerated to low levels in 2004 which was reflected by a drop in the yield on Reserve Bank of Vanuatu Notes at the end of 2004.

The overall balance of payments recorded a large surplus of VT870 million in 2004. The improvement in Vanuatu's balance of payments is reflected in the rise in months of import cover from 4.4 in the first quarter to 5.4 in December 2004, a high by regional comparison.

WORLD ECONOMIC DEVELOPMENT

2. WORLD ECONOMIC DEVELOPMENT

World economic expansion turned out considerably stronger than expected in 2004, well above the trend of the last 30 years. The world economic expansion of 5 percent in 2004 remains solid led by the United States, non-Japan Asia and Latin America but global growth has moderated from the first half of the year as third quarter GDP growth declined in many countries, and imbalances have widened further. The expansion is expected to be lower in the current climate of high world oil prices but still above trend in 2005.



Source: IMF World Economic Outlook: September 2004

Growth prospects in Vanuatu's main trade partner countries remained robust in 2004.

The **US economy**, in its fourth year of recovery, has continued with strong growth from robust household spending and an upswing in business investment. Real GDP growth rose by 0.8 percent in December or 3.7 percent over the year to date. The labor market improved with a monthly average of 160,000 jobs created in the second half of 2004 but with some remaining slack. Improvement in labor conditions, rising wealth and low interest have provided the strength to consumer spending, giving rise to a sharp increase in imports and a widening of the external trade deficit to 5.7 percent of GDP.

Core inflation rose by 2.2 percent over the year to December 2004 and the Federal Reserve has responded with the process of normalizing interest rates by raising interest rates consecutively in the last six meetings to 2.25 percent in December 2004.

Growth in the **Australian economy** slowed from the level of 2003 as demand and exports showed signs

of moderation. The decline in the net trade balance caused by a fall in exports and rise in imports was a significant contribution to growth moderation. Domestic demand continued to be strong but there has been a scaling back in housing investments. Business conditions remained favorable in 2004. Most recent business surveys such as the NAB survey and the ACCI-Westpac survey point to continuing strong business conditions including in corporate profitability and business investment. Improvement in the labor market conditions is shown in the growth in employment of 2.6 percent over the year to December and in the unemployment rate, which fell to 5.1 percent in December 2004. Share prices in Australia reached record highs and outperformed the S & P 500 and the MSCI World indices. The CPI rose by 0.8 percent on a quarter-over-quarter basis or 2.6 percent over the year to December. Indicators and business surveys suggest that inflation will rise over the next two years and the Reserve Bank of Australia has indicated the possibility of an interest rate increase ahead. For the moment the target cash rate has been held constant since December 2003 at 5.25 percent.

Growth in the New Zealand economy continued strongly in 2004 but the Reserve Bank of New Zealand has pointed to evidence that the turning point to slowing may be close as the housing market and net immigration have started to show declines. Compared to last quarter, GDP expanded by 0.6 percent in September and it rose 4.4 percent on an annual basis. The growth in GDP was largely driven by a rise in domestic demand by an annual growth rate of 8.3 percent, while on one side; there was considerable drag to growth by weak exports on the strength of the New Zealand dollar. The unemployment rate fell to the lowest level of 3.8 percent since the early 1980s and is one of the underpinnings of the current strong consumer demand. The strength of the economy is beginning to show as non-tradable inflation registered 4.3 percent over the year to December compared to 0.7 percent in the rate of tradable inflation. The Reserve Bank of New Zealand has raised interest rates in its last seven meetings, the last being in October 2004 when it was increased to 6.5 percent. The Bank does not envisage another rate increase until the effect of the last rate increase has fully worked itself through the economy.

The pace of the Japanese economic recovery has shifted downwards since late 2003 and early 2004 as growth registered 0.1 percent in the September quarter and 2.5

WORLD ECONOMIC DEVELOPMENT

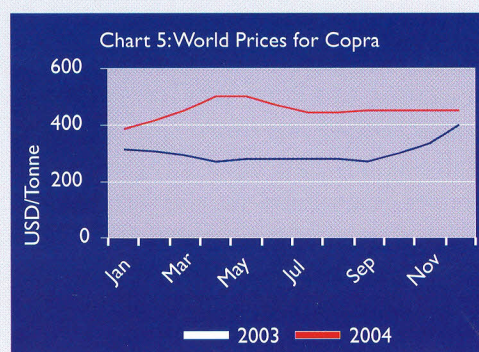
percent within the year to September compared to an annual growth of 4.3 percent in June. The downtrend has largely concentrated in the business and external sectors. Industrial production also fell by 1.4 percent over the year to December. Business surveys show an easing in business sentiment in December but remains healthy overall. The banking sector effort to reduce non-performing loans to 4 percent of total lending by March 2005 appears well on track. Labor market conditions continue to be favorable and the unemployment rate continues to trend downwards to 4.4 percent in December, partly because of the aging population and employment growth by about _ percent over the year. Deflationary pressures continue to ease. This is shown by domestic corporate goods prices which rose by the fastest growth rate since the 1990s of 1.9 percent. Food prices have risen in the wake of the Asian Tsunami and the GDP deflator also shows that deflation has lessened.

Recent economic data from the euro-zone has been disappointing. In the year to September GDP rose by 1.8 percent Euro-wide, with divergence in the growth rates of member countries: Germany (1.3 percent), France (1.9 percent), United Kingdom (3.1 percent), Italy (1.3 percent), Netherlands (1.5 percent), and Spain (2.6 percent). Industrial production has slowed driven by falling production in Germany and Italy. Domestic demand will need to be strengthened to aid growth recovery. Euro-wide measures of business sentiment, which are above trend levels, could provide the boost to strengthen the recovery but on the other hand, consumer sentiment is down due to unemployment concerns and the effects of reforms that are currently underway. The Euro-wide unemployment rate was 8.9 percent in December. The inflation rate has hovered around the ECB's 2 percent reference level. Consumer prices registered 2.4 percent or 1.9 percent in underlying terms over the year to December in the Euro area. Whilst there are risks from higher petroleum price feeding through to wages and inflation the ECB has kept its policy rate at 2 percent since June 2003 given the lackluster growth in output.

The index of overall primary commodity prices increased by 27 percent in both the US and SDR terms reflecting sizeable movements in the prices for energy, raw material and metals and a surge in global demand, particularly from Asia.

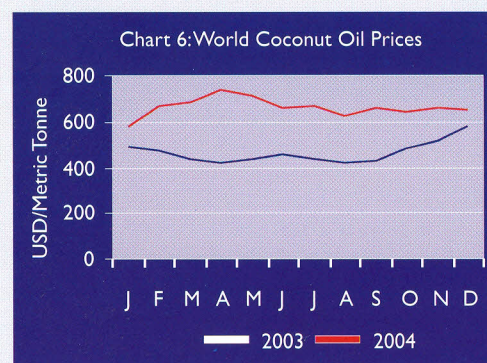
World oil prices peaked around US\$56 per barrel in October. However there has been easing in price pressures which saw crude oil prices fall to US\$41 per barrel in December 2004. This fall however has been interrupted by OPEC's decision on December 10th to curtail above-quota production owing to concerns about falling prices and from ongoing supply disruptions in Iraq in the lead up to general elections in the country as well as other technical difficulties.

The world price for copra rose to its peak in around April. Although they have moderated prices have been high and stable for some time. In the fourth quarter the world price for copra amounted to US\$448.3 per ton.



Source: World Bank

The average world price for coconut oil reached a peak of US\$736 per ton in April 2004. The average for the year was US\$650.3 per ton, which represents a decline by around 12 percent from April. On the whole world prices have remained broadly stable at high levels.

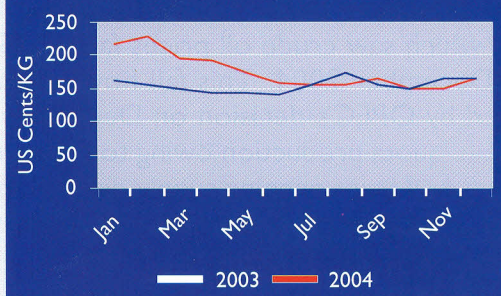


Source: World Bank

World prices for cocoa have been low in 2004 but saw a slight rise during the beginning of November 2004 from the impact of reduced harvests in major producing countries.

WORLD ECONOMIC DEVELOPMENT

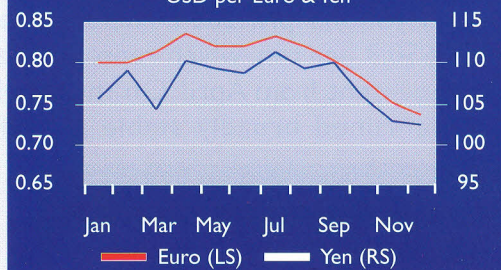
Chart 7: World Prices for Cocoa



Source: World Bank

The foreign exchange markets continued to be dominated by the depreciation of the US dollar against major currencies and in trade-weighted terms in 2004 as markets remained concerned about the large US external current account deficit. In the December quarter alone it depreciated against the Euro and Yen by 8 percent and 7 percent respectively. Even more spectacular is the fact that the US dollar has depreciated against a number of East Asian currencies such as the Korean Won. The expectation of a revaluation of the Chinese currency intensified towards the end of 2004 as a Chinese official stated commitment to flexibility in the exchange rate without committing to a timetable but the market has been of the view that a change is not yet eminent.

Chart 8: Monthly Exchange Rate in 2004:
USD per Euro & Yen

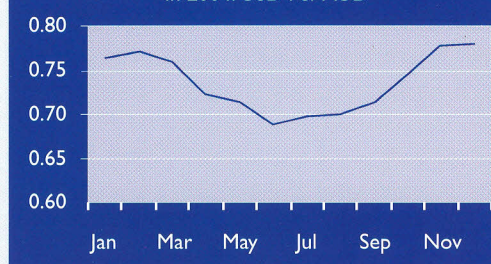


Source: Reserve Bank of Australia

Against a background of high commodity prices, including for metals, the Australian and New Zealand dollars strengthened against the U.S. dollar during 2004. The gap in the exchange rates has also been assisted by the interest rate differential between the three countries. The broad base fall of the US dollar saw the Australian dollar trading at US\$79.46 cents in late November which was a margin below the cyclical high of US\$80.05 attained in February 2004. The Australian dollar appreciated against most of the currencies of its trade partners driven largely by its offshore movements. There has been robust market sentiment in the Australian dollar and speculative positioning in the Australian dollar reached record levels,

which has added to net reserves of the Reserve Bank of Australia.

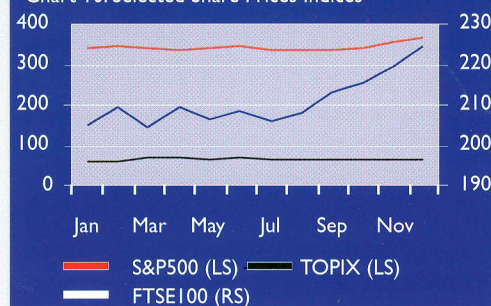
Chart 9: Monthly Average Spot Exchange Rate
in 2004: USD Per AUD



Source: Reserve Bank of Australia

Global equity markets, with exception in countries like Australia, have generally been down in the first half of 2004 but as growth of the US economy began to pick up, they registered a strong rebound in the December quarter. The US S&P 500 and the NASDAQ rose by 9 percent and 15 percent respectively during the quarter. The Japan TOPIX and the UK FTSE 100 have also shown improvements.

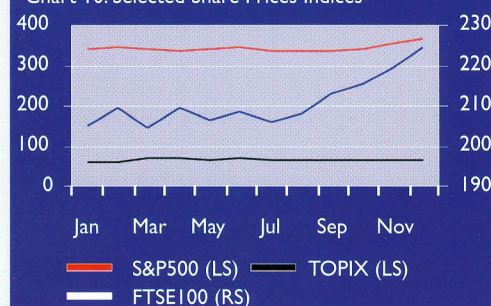
Chart 10: Selected Share Prices Indices



Source: Reserve Bank of Australia

The US 10-year bond yields remained within a narrow range and remain well below the level of June 2004 by 4.9 percent. The level has remained stable irrespective of recent tightening of interest rates by the US Federal Reserve and rise in short-term interest rates perhaps because of clearer projection of the intensions of the US Federal Reserve.

Chart 10: Selected Share Prices Indices



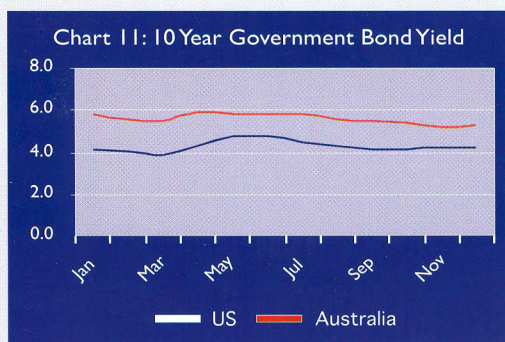
Source: Reserve Bank of Australia

DOMESTIC ECONOMY

3. DOMESTIC ECONOMY

3.1 Real Sector Development

Vanuatu's economy performed exceptionally well in 2004 compared to recent years, with an estimated growth in Gross Domestic Product (GDP) by 3.2 percent, this estimate is likely to be revised upwards in the coming months.



Source: Ministry of Finance and Economic Management

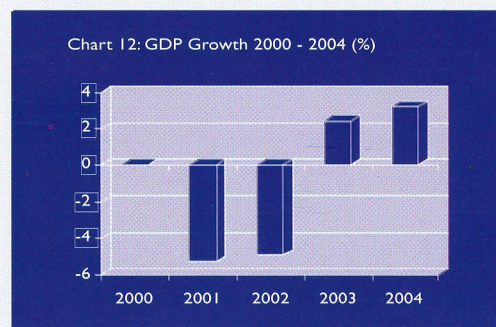
High world commodity prices during 2003 and throughout 2004 contributed immensely to positive growth in the domestic agricultural sector, although cyclone Ivy, in the first quarter of 2004, caused damage to some of the major producing areas in the northern part of Vanuatu.

In the tourism sector, there was an increase in airline seat capacity in 2004, due to the introduction of the Pacific Blue airline and an additional aircraft by Air Vanuatu.

3.1a Copra and Coconut Oil

Coconut oil production in 2004 has more than doubled since the level in 2003, with a total production of 17,114 tons.

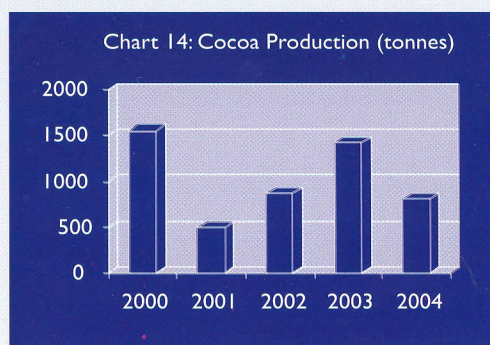
The only coconut oil producing plant in Vanuatu, Coconut Oil Productions Vanuatu Limited (COPV) reportedly made a profit for the first time since 2000. In contrast to previous years, COPV operated around 24 hours for the whole of 2005.



Source: Vanuatu Commodities Marketing Board

Given its high production capacity, COPV imported copra from the Solomon Islands and Kiribati to supplement the shortfall in Vanuatu copra.

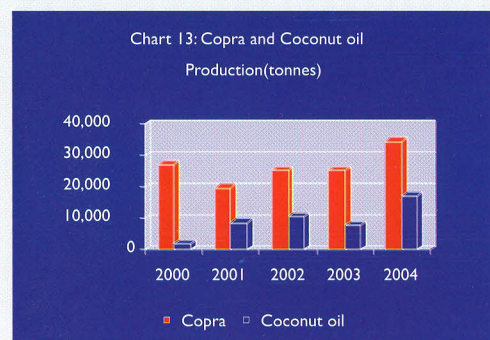
3.1b Cocoa



Source: Vanuatu Commodities Marketing Board

3.1c Beef

Beef production declined by 5 percent compared to 2003 when there was an increase in beef production by 38 percent. While Santo experienced an increase in beef production in 2004, production in Vila declined by 18 percent.



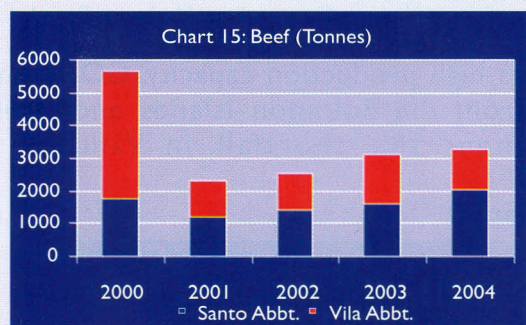
Source: Vanuatu Quarantine and Inspection Services

DOMESTIC ECONOMY

Domestic beef production, has been affected by ongoing live cattle exports. The potential for an increase in production in Santo was largely affected by the cattle exports.

3.1d Kava

Kava production for exports in 2004 increased by 56 percent to 825 tons compared to 529 tons in 2003.

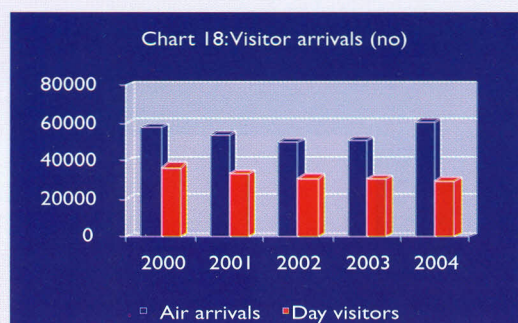


Source: National Statistics Office

The reduction in 2003 was due to a drastic decline in exports to Europe after the EU imposed a ban on Kava imports. The 2004 increase was due to an increase in exports to Fiji and New Caledonia, where both countries have large consumer markets.

3.1e Tourism

Air arrivals in 2004 increased by 20 percent compared to 2003. The increase in arrivals was due to an increase in flight capacity compared to 2003, with the addition of an aircraft by Air Vanuatu in July 2005, and the introduction of the Pacific Blue Airline in September 2005.

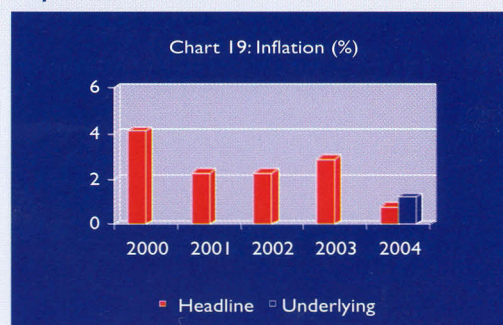


Source: National Statistics Office

The increase in air arrivals, was offset by a decline in day visitors by 27 percent, as a result of a decline in port calls by cruise ship, beginning in mid 2004.

3.1f Inflation

Preliminary headline inflation in 2004 was 0.8 percent, although the underlying inflation measure estimated it to be 1.2 percent.



Source: National Statistics Office

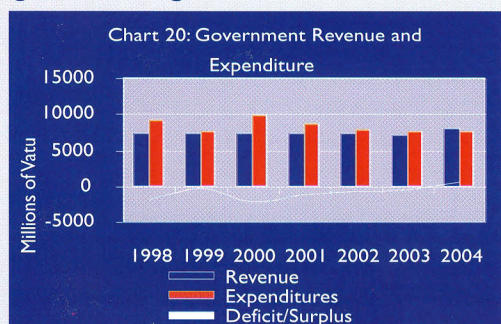
Initial expectations of inflation were higher than the actual figure. This was due to high fuel import prices but, prices in other import commodities such as clothing and household items, mainly from Asia, declined. This indicates a shift in the country of origin of imports of commodities towards Asian markets.

3.2 FISCAL OPERATION

The stance of fiscal policy was one of the key considerations in the Bank's policy stance in 2004. In particular, the expenditure pressures from the general, Presidential and Provincial elections falling within the year as well as expenditures relating to cyclone relief and reconstruction. These expenditures had threatened to derail the planned balanced budget of VT8,760 million in 2004. Notwithstanding these pressures, preliminary information is showing that the Government operated a budget surplus of VT443.9 million in 2004, equivalent to 1.2 percent of nominal GDP, compared to a deficit of VT620.7 million in 2003. This favorable turnout reflected expenditure restraint of 0.7 percent and improvements in revenue and grants by 3.7 percent from the budget levels. The budget consisted of recurrent expenditures (79.5%), development expenditures (4.3%) and amortization of public debts (16.4%).

DOMESTIC ECONOMY

The revenue items consisted of tax revenue (73.0%), non tax and aid grant (12.4%), with the remaining (14.6%) consisting of financing items.



Source: Ministry of Finance and Economic Management

3.2a The 2004 Fiscal Revenue

Fiscal revenue collection strengthened in 2004 to 99.8 percent of budget levels. The improvement was across a wide range of revenue items with some over performing budget levels. However, the rise in one of the key tax revenue items, VAT, was not as robust as expected and its component of total revenue amounted to 31.4 percent as compared to 39.2 percent in 2003.

Meanwhile, the component of international taxes of 38.1 percent was higher, in reflection of higher imports. Those of other taxes rose to 25 percent compared to 23 percent in 2003. Non tax revenue rose by 7.5 percent as administrative fees showed a large improvement of 51.6 percent.

One of the major fiscal developments in 2004 was in the area of external donor grants. Total grants received amounted to VT684.7 million, an increase of VT303.3 million from the level attained in 2003. This largely reflects grants from the EU and the Peoples Republic of China. Grants were one of the major factors contributing to the favorable fiscal turnout of 2004.

Table 1: Fiscal Operations of the Central Government (Millions of Vatu)

	2003	2004	Budget 2004
Receipts			
VAT			
I. Duties	23858.6	2475.3	2509.3
B. Licenses	2283.3	2519.6	2524.8
Turnover	124.7	150.0	149.2
Excise	98.1	122.8	105.0
Other taxes	322.7	392.0	350.0
Non tax	724.9	820.8	920.6
Grants	652.9	823.3	714.7
	381.5	684.7	375.0
Total	7055.9	8129.7	7785.0
Expenditure			
Goods			
Salary	5638.2	5580.9	5730.0
Interest	4070.1	4053.8	4063.9
Subsidies	352.6	369.2	405.7
Assets	1116.8	1163.1	1091.7
NR Transfers	84.9	159.3	38.6
Dev't	0.0	0.0	0.0
	381.6	413.3	375.0
Total	7574.1	7685.8	7641.0
Def/Surplus			
Financing			
T. Rev. & Grts	-518.2	443.9	144.0
T. Exp. & NL	7055.9	8129.7	7518.2
	7574.1	7685.8	7366.1
Def/Surplus	-518.2	443.9	144.0
Ext. Finance			
Dom. Finance	0.0	0.0	0.0
T. Finance	518.2	0.0	0.0
	518.2	0.0	0.0

Source: Ministry of Finance and Economic Management

These large inflows contributed to an improvement in government deposits and therefore its net position with the banking system. Within the balance of payments, the grants contributed to an improvement in official transfers and were also a factor in the strengthening of international reserves. The grants also affected the money supply and caused a large rise in domestic liquidity throughout 2004.

3.2b The 2004 Fiscal Expenditures

Despite the large pressures, recurrent expenditure was broadly brought under control in 2004 due mainly to prudent budget control by the Department of Finance.

It totaled to 98.7 percent of the budget of VT7,266 million. However, the wages and salaries component has been rising and is estimated to account for 56.5 percent of recurrent expenditures in 2004 which is high by

DOMESTIC ECONOMY

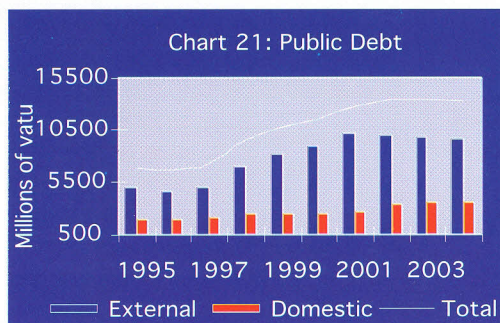
international standards; this estimate could understate the level of actual personal emoluments in the budget. Goods and services, accounted for 77.8 percent of recurrent expenditures.

There was a slight increase in total expenditures compared to the same period of 2003. Items that experienced increases were interest payments (4.8%), subsidies and transfers (4.0%) and acquisition of fixed capital assets (85.4%).

3.2c Financing

The Government did not undertake any external financing and resorted to domestic financing, largely bank borrowing in 2004. With continuing constraints on its cash flow position the Government rolled-over all maturing bonds of VT476.1 million in 2004 into one year bonds and operated an overdraft with a limit of VT400 million with the Reserve Bank. This had a large impact on liquidity creation in 2004.

As end of 2004, total outstanding public debt stood at approximately VT13.2 billion, equivalent to 36.7 percent of GDP, of which 26.4 percent comprised domestic debt.



Source: Ministry of Financial and Economic Management

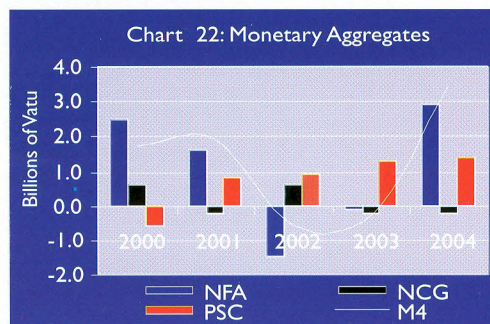
From the total bond holding at the end of 2004, corporate bodies have a share of 48.5 percent, the RBV 26.5 percent, commercial banks 24.9 percent and others 0.1 percent.

3.2d Debt Servicing

Debt servicing (interest and principal) showed a decrease from VT1,597.8 million in 2003 to VT646.9 million in 2004. The decline was attributed to a decrease in the level of bonds that came to maturity in 2004. In 2004 debt servicing amounted to 1.8 percent of GDP and 8.8 percent of recurrent revenue compared to 4.7 percent of GDP and 24.0 percent of recurrent revenue in 2003.

3.3 MONETARY CONDITIONS

The role of Monetary Policy is to establish appropriate monetary conditions for price stability. During 2004, total money supply increased by 9.8 percent. This increase was primarily due to increases in net foreign assets, especially those of the monetary authorities and also to the expansion of private sector credit. The Government net lending position with the banking system did however see an improvement on last year.



Source: Reserve Bank of Vanuatu

During the year, both broad and narrow money grew, by 12.7 and 4.6 percent respectively, growth in domestic credit picked up again registering a growth rate of 7.6 percent this year. Private sector credit also continued on its upward trend with a growth rate of 9.3 percent in 2004. The interest rate spread between commercial banks' lending and deposit rates dropped slightly from 9.55 at the end of last year to 9.19 at the end of this one. The year has also witnessed a gradual decline in the yield rate on the 91-day RBV note as a result of the increasing commercial bank liquidity.

3.3a. Determinants of Money

Net Foreign Assets

Total Net Foreign Assets saw an increase of 11.7 percent over 2004. Commercial Banks' NFA accounted for 76.7 percent of total NFA at the end of 2004 and their growth of 6.1 percent over the year was the driving force behind the growth in total NFA. The NFA of the monetary authorities did however also rise, by 35.4 percent this year.

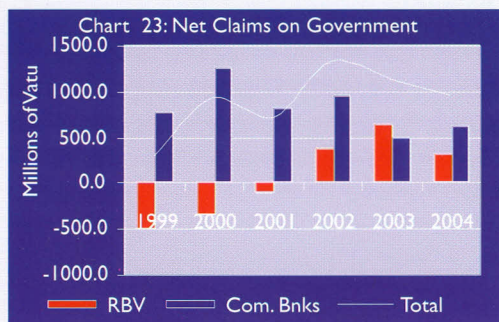
The increase in net foreign assets of the commercial banks was reflected in increases in the foreign currency elements of time and savings deposits in the commercial banks. This year also saw an increase in the claims on the non-resident banks by 2.9 percent and a decrease in foreign liabilities by 5.1 percent. Both of which will have caused commercial banks' NFA to increase.

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Domestic Credit

The growth rate of domestic credit accelerated from 5.3 percent last year to 7.6 percent this year, thus continuing on its upward trend. This year's increase in domestic credit was mainly caused by the increase in private sector credit and to a lesser extent by increases in net claims on Government and non financial public enterprises.

The Government's net lending position continued to improve this year with a growth rate of 15.4 percent. This growth was attributed solely to the improvement of the Government's position with respect to the monetary authorities which improved by 48 percent, its position vis-à-vis the commercial banks however worsened by 28 percent. The worsening in the position with respect to the commercial banks comes from the fact that the commercial banks bought VT40 million of Government bonds from the Reserve Bank in 2004. But this year also saw a decline in the deposits held by the Government with the commercial banks by 34.5 percent where as commercial bank's claims on the Government went up by 5.2 percent. The improvement in the Reserve Bank position comes from the aforementioned change in bond ownership coupled with a 31 percent increase in Government deposits with the Reserve Bank and a 3.6 percent decrease in the RBV's claims on Government. The improvement in the Government's deposits with the RBV has mainly come from aid inflows placed in the Government account with the RBV.



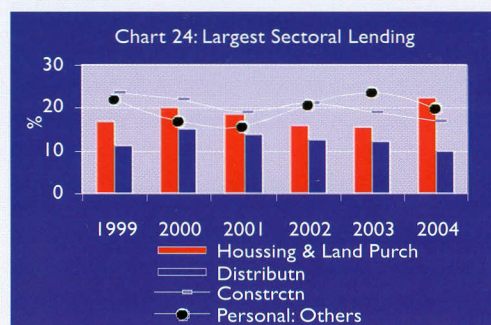
Source: Reserve Bank of Vanuatu

The growth rate of private sector credit decreased slightly from 9.7 percent last year to 9.3 percent this year. This represents an increase of VT1.36 billion and is an encouraging sign for future economic growth.

3.3b Sectoral Distribution of Credit

Total credit (including foreign currency) offered by commercial banks went up by 10.6 percent this year. This increase was mainly attributed to the 58.9 percent increase in loans for housing and land purchases. There were decreases however in loans to other sectors such as personal loans and loans to the manufacturing, construction and distribution sectors which declined by 8.08, 42.8, 0.78 and 10.11 percent respectively.

The largest sector in terms of percentage of total loans was Housing and Land Purchases, up from 15.5 percent last year to over 22 percent this year. It has now overtaken personal loans as the largest sector, personal loans is now second with a share of 19.61 percent followed by construction (16.89%), distribution (9.97%), tourism (8.19%) and professional (5.71%).



Source: Reserve Bank of Vanuatu

3.3c Components of Money Supply

The increase in total money supply over the year was reflected by increases in both Narrow and Quasi money.

Narrow money continued on its upward trend rising by 557 million vatu (4.6 %) to reach VT12,733.3 million. This increase in narrow money was caused by increases in both currency outside banks which went up by 18.1 percent and in demand deposits which went up by 1.7 percent. The foreign currency element of demand deposits did decline however by 2 percent.

Quasi money increased as well this year, by 12.7 percent. This increase stemmed from increases in both time and savings deposits which went up by 12.9 and 10.8 percent respectively. The foreign currency elements of both these items also went up by 8.5 and 47 percent respectively.

DOMESTIC ECONOMY

3.3d Interest Rates

The annual interest rates for 2004 saw, on average, a decline for advance rates but an increase for deposit rates; this is contrary to the trend of the recent rapid growth in money supply as we would expect interest rates to go down during periods of high liquidity.

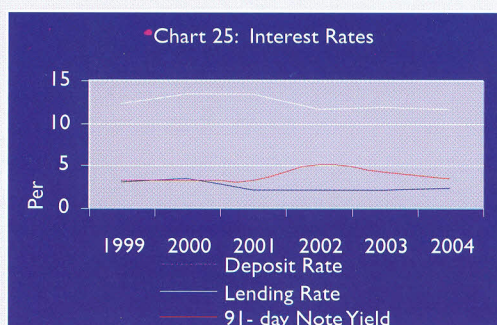
The weighted average deposit rate increased from 2.18 to 2.40 percent. This was caused mainly by the increase of the top level rate for deposits above six months; the spread went from 1.75-4.75 percent last year to 2.75-7.55 percent this year. The 1 month and 2-6 month rates both saw decreases in their spreads however and now stand at 2.00-5.00 percent and 2.00-6.00 percent respectively.

The weighted average savings rate declined from 11.73 to 11.59 percent. This decline stems from a decrease in the top level rate for housing loans from 18.50 percent last year to 14.75 percent this year. There were also declines in the spreads for commercial and personal loans which now stand at 8.5-16.0 percent and 12.0-25.0 percent respectively.

Interest Rates Spread

The interest rate spread between deposit and lending rates did however decline from 9.55 percent last year to 9.19 percent this year.

The yield for the Reserve Bank notes also all saw declines this year. The 91 day rate which stood at 4.15 percent last year has now fallen to 3.5 percent. The yield for the 63 day note now also stands at 3.5 percent having been at 4.16 percent last year. The decline in RBV note yields comes as a result of the continuing high liquidity in the banks which has been experienced since the start of 2004.



Source: Reserve Bank of Vanuatu

The chart shows that the yield for the 91 day RBV note has been on a steady decline since its peak in 2002 and that lending rates have been on a declining trend where as deposit rates have been increasing.

3.3e RBV Notes

At the end of 2004, total RBV notes outstanding stood at almost 1.2 billion vatu. This represents a dramatic rise from the level the 100 million vatu at the end of last year. This rise stems from the need to mop up the continually increasing commercial bank liquidity.

3.3f Reserve Money

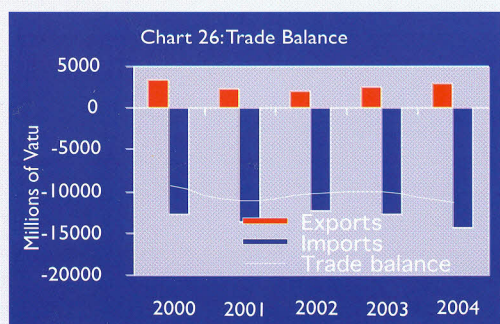
Reserve Money recorded an annual growth of 9.7 percent. This was due to increases in both currency in circulation and commercial bank deposits with the RBV which went up by 15.9 and 2.6 percent respectively. The large increase in currency in circulation was mainly due to the high cash withdrawals in December to cater for Christmas spending. The high levels of excess reserves reflect the high liquidity of the commercial banks.

3.4 External Conditions and International Investment Position

One of the key objectives of the Reserve Bank is to maintain a viable external balance of payments by ensuring that the official reserves are maintained at above four months of import cover with a target of 6 months of import cover. The 6 month target was not met although official international reserves remained comfortable at 5.4 months at the end of 2004.

The Bank closely monitored its reserve position through 2004. In March 2004, the level of months of import cover declined to 4.4 months from 4.5 months at the end of 2003. The Reserve Bank continued its policy of purchasing foreign exchange from commercial banks using the full range of buying and selling exchange rates while closely monitoring the amount of foreign exchange sold to the commercial banks. The government continued to sell foreign exchange to the Reserve Bank and official Reserves grew for the rest of the year to reach a comfortable level of 5.4 months of import cover by December.

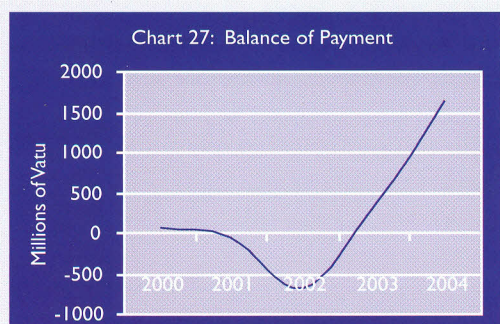
DOMESTIC ECONOMY



Source: National Statistics Office

Following past economic weaknesses, growth rebounded strongly in 2004 enhanced by huge inflows of grants from donor partners and extensive bilateral deals. Imports, tourism and land development showed expansions as anticipated. The level of official reserves showed an improvement to 5.4 months of import cover at end of December 2004.

The current account deficit improved significantly driven by the services and transfers account. The trade deficit expanded by 4 percent over the year with imports up by 12 percent, which offset the increase in exports by 31 percent. Proceeds from exports have been very volatile throughout the year, reflecting the high dependence on two or three key commodities. The growth rate of imported goods however has been fast and stable.



Source: Reserve Bank of Vanuatu

The capital and financial account recorded a surplus but it was 56 percent lower than the surplus in 2003. Foreign Direct investment in Vanuatu and other investment liabilities representing inflows of financing both increased in 2004 compared to a drop in 2003 of other investment liabilities by almost VT4 billion (US\$36 million dollars). 2003's decrease largely stemmed from the withdrawal of non-resident deposits. In 2004, liabilities rose by around US\$7,000 dollar.

The overall external balance of payments showed a consecutive surplus of a larger magnitude than the previous year. Net reserves (minus IMF position) stood at VT6018 million at the end of December 2004 compared to VT4339 million in 2003

International Investment Position (IIP)

Table 2: IIP Reconciliation statement -2004 (mvt)			
	2002	2003	2004
NET IIP	-3908	-8798	-9430
Assets	604325	55789	56970
Direct Investment	5	1324	1406
Portfolio	1242	1363	1364
Investment	1570	48148	47585
Other Investment	52766	4954	6615
Reserves	4854	64556	66400
Liabilities	64340	16710	19006
Direct Investment	14499	0	78
Portfolio	0	47876	47316
Investment	49841		
Other Investment			

Source: Reserve Bank of Vanuatu

The International Investment Position stood at VT-9439 million at end December, 2004, and showed an expansion of Vanuatu's net indebtedness by 7 percent. The increase in indebtedness was due to an increase in Direct Investment which caused liabilities to increase.

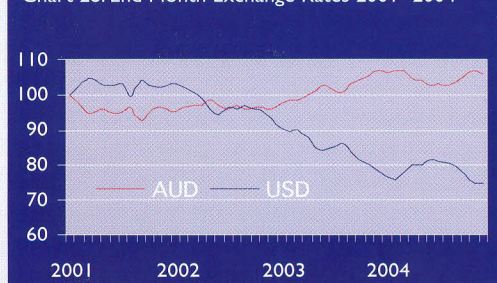
3.5 Foreign Exchange Development

Global economic developments, including in foreign exchange markets, impacted highly on the exchange rate of the Vatu against its major trading partners' currencies. The policy objective of the Reserve Bank is to maintain a stable exchange rate of the Vatu.

The foreign exchange market was dominated by broad depreciation of the US dollar in 2004 over concerns about the US current-account deficit.

DOMESTIC ECONOMY

Chart 28: End Month Exchange Rates 2001- 2004



Source: Reserve Bank of Vanuatu

On the other hand, the Australian dollar appreciated against the Vatu in 2004. Developments in exchange rates are a source of price pressures in Vanuatu due to the heavy reliance on imports.

Compared to the values at the end of 2003, the vatu depreciated against the New Zealand dollar by 4.6 percent and Euro by 3.6 percent. It appreciated against the Australian dollar by 0.8 percent, US dollar by 4.7 percent and Japanese Yen by 1.1 percent.

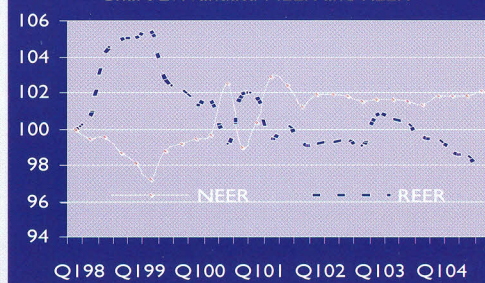
Nominal Effective Exchange Rate (NEER)

The NEER is defined as an index of Vanuatu's bilateral exchange rates relative to its major trading partners. In 2004, the NEER showed a slight appreciation. The appreciation was driven by the significant nominal appreciation of the Vatu against the US dollar and Japanese Yen which offset its nominal depreciation against the AUD, NZD and Euro.

Real Effective Exchange Rate (REER)

In December 2004, the real effective exchange rate of the vatu (REER), a measure of the Vatu exchange rate corrected for price differentials between its trade partners, showed a further depreciation.

Chart 29: Vanuatu NEER and REER



Source: Reserve Bank of Vanuatu

The depreciation in the effective exchange rates points to an improvement in Vanuatu's external competitiveness. This is most probably attributable to a weakening of the US dollar and to Vanuatu's low rate of inflation in comparison with its trading partners.

3.6 Other Activities of Research and Statistics Department

In 2004, the external sector undertook the first SIMSDI (Survey of Implementation of Methodological Standards for Direct Investment) coordinated by the International Monetary Fund and OECD. This survey was initiated for a comprehensive study of data sources, collection methods and dissemination and methodological practices for FDI statistics. The Reserve Bank of Vanuatu through the department of Research & Statistics completed the survey and furnished results to the International Monetary Fund in 2004. Results of the aggregate SIMSDI survey can be accessed from the IMF website.

MONETARY POLICY IMPLEMENTATION

IV. MONETARY POLICY IMPLEMENTATION AND RESERVE MANAGEMENT

In accordance with the Reserve Bank Act, the Reserve Bank continues to work towards achieving its primary objectives of 'monetary stability' by utilizing a range of monetary policy tools to implement its monetary policy.

The principle instrument of the Bank continues to be open market operations, through the auctioning of its Notes (RBV Notes) to influence reserve money.

1. Open Market Operations

The open market operations (OMO) undertaken by the Bank affect the level of liquidity in the banking system. The banking system has been very liquid compared to 2003 due mainly to an increase in inflows from balance of payments and domestic credit. The Bank keeps firm control over the liquidity level by issuing RBV notes regularly in such a way as to ensure that a desirable level is maintained to achieve its primary objective.

Table 3: Reserve Bank of Vanuatu Notes (VT Million)

	2002	2003	2004
Number of Issues	31	17	23
Flotation	2,720	1,300	4,450
Tenders	3,340	2,100	7,305
Allotments	2,465	2,065	4,250
Outstanding	330	100	1,075

Source: Reserve Bank of Vanuatu

VT 4,450 million of RBV notes were floated in 2004 and tenders amounting to VT 7,305 million were received for them. This means that the bank had to reject VT 2,855 million of all bids received: some 40%. This shows the very high level of excess reserves. During the year the Bank issued VT 4,250 million RBV Notes of which VT 1,075 million were outstanding at year end. This accounts for an increase of VT 975 million from the previous year. The Bank introduced the 14-day notes at the beginning of the year and this maturity came second in terms of popularity, just behind the 28-day notes. 63-day notes were in the third place and 91-day notes were the least popular and thus had the fewest amount issued.

Table 4 : Excess Reserves

Month	Excess Reserves	Month	Excess Reserves
Jan	692.0	Jul	886.8
Feb	832.9	Aug	815.5
Mar	701.9	Sep	894.5
Apr	711.3	Oct	939.2
May	750.4	Nov	963.1
Jun	966.2	Dec	763.6

Source: Reserve Bank of Vanuatu

2. Rediscount Facility and Repurchase Agreement

These facilities allow the Bank to provide short-term liquidity either by discounting or Repurchase Agreement. As previously seen, with ample liquidity throughout the year, there was no need for banks to avail of these facilities

The interest rate remained unchanged for these facilities at 6.50 percent.

3. Reserve Requirements

Section 33 of the RBV Act states that the Bank may prescribe the maintenance of special reserves to be maintained by each financial institution. Reserve requirements were first introduced in 1988, primarily for prudential reasons, under these requirements banks are obliged to maintain 10 percent of Vatu deposit liabilities with the Reserve Bank. During April 1999, the Bank included half of demand deposits in foreign currency in its calculation of Reserve Requirement. Commercial banks meet reserve requirements on a daily averaging basis. By daily averaging, banks are allowed to go below their reserve requirement any time given they meet the Reserve Requirement on average during the holding period. Throughout 2004, there has not been any change in the Reserve Requirement ratio.

4. External Reserves Management

The Bank continues to exercise prudence in its statutory role of external reserves management. The RBV Act

BANKING SUPERVISION

requires that the value of external assets shall not be less than an amount equivalent to 50 percent of the total demand liabilities of the Bank. The Bank strives to ensure that the value of external reserves is maintained above the stipulated benchmark and profits are maximized.

As at end of financial year of 2004, gross international reserves including IMF positions are valued at VT 6,615 Million, a 35 percent increase from the previous year. Over the year, net sales of foreign exchange totaled VT 373 million as compared to VT 1,602.7 million in purchases. Purchases were mainly donor funds, project funds and other government receipts.

As a result of an agreement between the Australian and Vanuatu Government, the Bank bought from the Australian Government a total of VT 300 million worth of foreign currency.

The Bank continued to maintain its Foreign Exchange Dealing Guidelines throughout the year in order to build up its reserves to a comfortable level of months of import cover. The Bank has retained the services of the two portfolio managers which accounted for 59 percent of the reserves while the Bank manages the balance for debt services and financing the balance of payments.

Table 5 : Distribution of foreign reserves by currency

Currency	Percentage Distribution
USD	37
AUD	35
EUR	17
GBP	8
NZD	3

Source: Reserve Bank of Vanuatu

V. BANKING SUPERVISION

The Reserve Bank of Vanuatu through its Banking Supervision Department continues to monitor and assess the performance of banks licensed under the Financial Institution Act of 1999 and the International Banking Act of 2002, through the off-site analysis of data collected from the financial institutions, conducting of on-site

inspections to the institutions and through the prudential consultation meetings held with the banks' senior management.

The supervisory work in 2004 was more focused on the compliances of the conditions of the offshore banks licences and in terms of the domestic banks, the focus was more on the loan quality of the industry.

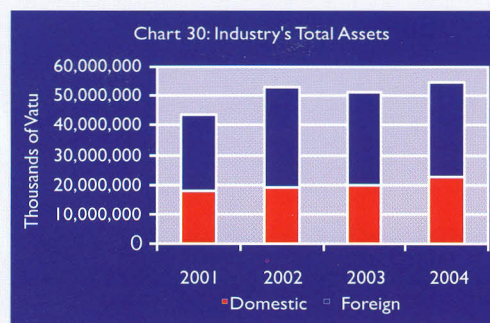
Two new statistical returns namely; country exposures and foreign exchange turnover were introduced to the domestic banks while a new capital adequacy return was introduced to the offshore banks. In addition, a new policy guideline was issued on outsourcing.

Licensed domestic banks supervised by the Reserve Bank in 2004 were; ANZ Bank (Vanuatu) Limited, Westpac Banking Corporation, National Bank of Vanuatu and European Bank Limited. International banks supervised include; United Investment Limited, National Deposit Bank Limited, Vianka Bank Limited, Garrison Bank Limited, IBA Bank Limited, Nautilus International Bank Limited and LMM & CIE Banquiers Privee Limited.

I. Domestic Banks

I.1 Balance Sheet

Total domestic banks' assets increased by 6 percent to VT54.7 billion at end December 2004 (VT51.5 billion in Dec-03). The increase sourced mainly from growth in domestic assets by 14 percent to VT22.5 billion over the year under review (see graph below).



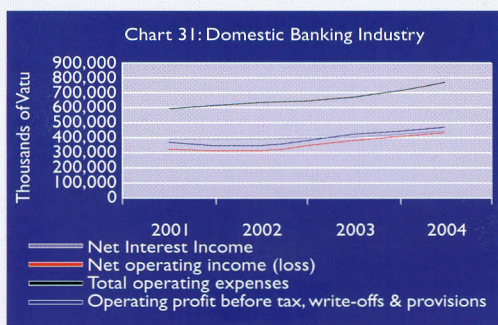
Source: Commercial Banks

Foreign assets grew by 1 percent to VT32.2 billion and represent 59 percent of total domestic bank's assets at the end of the period under review. On the liabilities side, the growth is attributed to an increase in domestic liabilities by 9 percent to VT37.4 million at the end of the same period.

BANKING SUPERVISION

1.2. Earnings

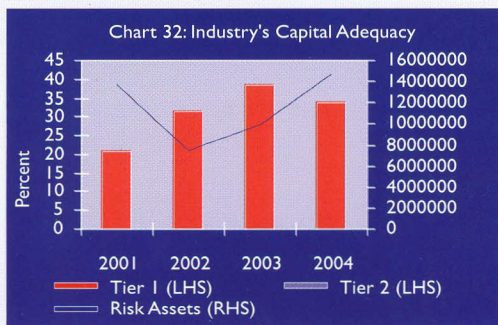
The domestic banking industry recorded a 12.5 per cent increase in net income over the twelve month period to VT429 million at the end of 2004. This increase was sourced mainly from a 11.3 per cent increase in net interest income to VT443 million over the year. Return on Assets (ROA) consequently improved to 1.70 percent from 1.63 in 2003.



Source: Commercial Banks

1.3. Capital Adequacy

The capital base for the domestic banking industry increased by 30 percent to VT5.1 billion at the end of 2004 (VT4 billion in 2003). This increase was sourced mainly from an increase in disclosed reserves and retained earnings and the general provisions by 40 percent and 53 percent to VT3.8 billion and VT169 million, respectively, over the financial year.



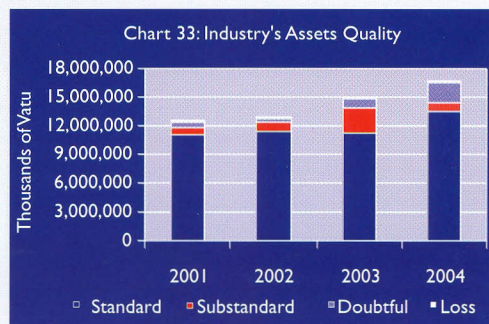
Source: Commercial Banks

Total domestic banks' risk weighted assets is valued at VT14.6 billion, up 48 percent in 2004 (VT9.9 billion in 2003). The industry's capital adequacy is recorded to be 33.8 percent.

1.4. Impaired Assets

Domestic banks' asset quality deteriorated further in 2004. Impaired asset level significantly increased by 73.8 percent to VT2.2 billion or around 43 percent of the consolidated industry capital over the year under review.

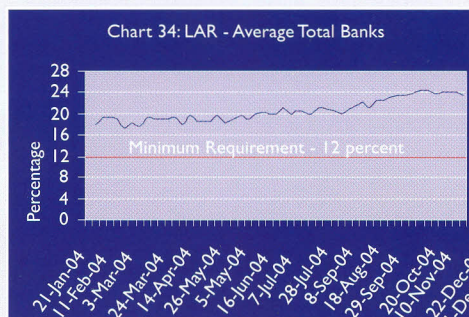
The deterioration in asset quality from 2003 was due to the downgrading of some large exposures over the year. The banks have in place appropriate strategies to improve the quality of their bad loans. It is worth noting that loan asset quality classified as loss dropped by 16 percent to VT194 million (VT231 million in 2003 and VT247 million in 2002).



Source: Commercial Banks

1.5. Liquid Asset Requirement (LAR)

The domestic banking industry maintained its liquid assets requirement (LAR) above the 12 per cent minimum requirement over 2004 (refer to chart below).



Source: Commercial banks

2. International Banks

The Reserve Bank in conjunction with the provisions of the International Banking Act No.2 of 2002 remains proactive in ensuring that international banks comply with the conditions of their licenses. As of 1st January 2004, the Reserve Bank issued under the new requirements of the International Banking Act, 9 licenses out of 34 international banks that were registered under the old Banking Act to conduct banking business in Vanuatu.

As part of the Bank's supervisory role over the year, the Bank conducted several anti-money laundering (AML) onsite visits to the banks. These visits were conducted in conjunction with the Financial Intelligence Unit (FIU), where the Bank reviewed and assessed the banks AML policies and procedures against the requirements of the

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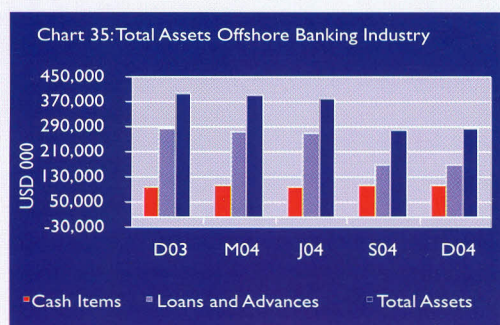
Financial Transactions Reporting Act No.4 of 2002 and Prudential Guideline No.9 on Customer Due Diligence issued by the Reserve Bank

The Bank also conducted similar visits to the offshore banks to ensure compliance of the banks' conditions on their license.

The Reserve Bank revoked two of the international banks' licenses, namely GSP International Bank Limited in October 2004 and Abbey Mercy Bank Limited in December 2004 for failing to comply with the requirements of the Act. This reduces the total number of offshore license banks to seven; however, the Reserve Bank has received a number of inquiries from parties interested in establishing an international bank in Vanuatu under the International Banking Act.

2.1 Balance Sheet

The offshore banks' balance sheet footings declined significantly over the year recording a 28 percent fall to USD283 million (USD395 million, Dec-03). The reduction was mainly due to the exit of a number of banks from the market and a drop in loans and advances by 41 percent to USD170 million (USD285 million, Dec-03).



Source: Offshore banks

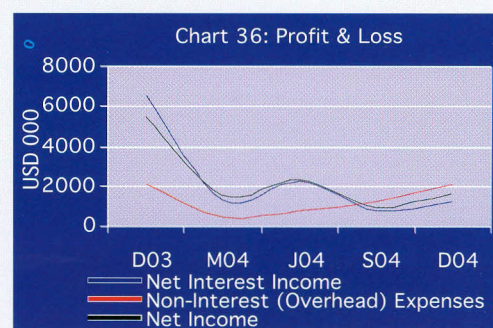
Loans and advances and cash items remain the major components of the industry's assets, accounting for 59 percent (USD170 million) and 37 percent (USD104 million) of total assets respectively. Refer to chart 1 below.

On the liability side, the bulk of offshore banks liabilities are deposits from corporations, accounting for 83 percent (USD236 million) of total liabilities.

2.2 Earnings

The industry's net operating income fell significantly over the year by 70 percent to USD1.6 million at the end of

the December 2004 (USD5.5 million, Dec-03). The decline reflects mainly the exit of banks from the market and a drop in interest income by 67 percent to USD5.9 million over the year (USD17.9 million, Dec-03). Net interest income recorded a fall of 82 percent to USD1.2 million (USD6.6 million, Dec-03). Refer to Chart 2 below.



Source: Offshore Banks

3 VNPF Supervision

The Reserve Bank, through the Banking Supervision Department, undertook its first on-site visit to the Vanuatu National Provident Fund from 29 June to July 2004. This visit was undertaken in line with the Minister of Finance's directive in December 2003 for the Reserve Bank to extend its supervisory oversight to the VNPF under the provisions of the Financial Institution Act of 1999.

The visit assessed areas relating to corporate governance, risk management, the role of internal and external auditors, policy developments in relation to investment guidelines, asset quality and complaint handling procedures. A report on the visit is submitted also to the Management and the Board of VNPF.

4. Policies

The Bank introduced a new Prudential Guideline (PG 11) in December 2004 on outsourcing requirements. The Bank, having consulted with the industry finalized the new policy.

5. Training and Workshop

Two members of the Department staff attended a week long banking supervision workshop, initiated by AFSPC and it was co-sponsored by APRA and PFTAC in Sydney from 29 March to 2 April 2004. This was followed with another week of attachment with APRA attended by one staff on Operations Risk Management. Other international seminars and trainings were attended by

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respective officers in July in Japan and Singapore at the IMF Center on Money Laundering. The year ended with most of the supervision staff attending the Association of the Financial Supervisor for the Pacific Countries [AFSPC] seminar that was conducted by the Financial Stability Institute at the Reserve Bank of Vanuatu.

6. Attachment with the Department

This year the Department accommodated for the first time a supervisor, Mr Bob Williams from the Cook Islands Financial Supervisory Commission on a one month attachments program in September 2004. The attachment was funded by PFTAC, some of the activities the supervisor was engaged in were; the reviewing of the reports from institutions and compiling of reports, attending in-house trainings and being involved in on-site visits to banks.

7. Hosting of the Association of Financial Supervisors of Pacific Countries [AFSPC] Workshop

The highlight of the year was the hosting of the 2004 Regional Banking Supervision Workshop at the Reserve Bank of Vanuatu from 25 to 27 October 2004.

The workshop was jointly sponsored by the Reserve Bank of Vanuatu, Vanuatu Financial Services Commission and the Pacific Technical Assistance Centre. It was attended by representatives from 11 Pacific Island Countries, namely Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Palau, Papua New Guinea, Republic of Marshall Islands, Samoa, Solomon Islands, Tonga and Vanuatu. Resource people at the workshop were from the Financial Stability Institute from Basel Committee, Switzerland, ANZ Melbourne, Australia, the Australian Prudential Authority [APRA] and Pacific Financial Technical Assistance Centre.

Key areas covered at the workshop were on 1) Economic Capital Issues 2) the Supervisory Review Process of Basel II; and 3) Problem Bank Resolution. Participants through out the workshop shared and learnt from their experiences.

The workshop ended with a one day Heads of Banking Supervision Meeting on 27 October 2004. The meeting was chaired by the chairman of AFSPC, Mr, Peter Tari, (Deputy Governor of the Reserve Bank of Vanuatu). Secretary to the meeting was Mr. Barry Whiteside from the Reserve Bank of Fiji, Judy Lau, Advisor, PFTAC and John Craig, project Coordinators, PFTAC. The meeting

heard progress supervisory reports from each country's representative and identified key areas that members of the Association of Financial Supervisors of the Pacific Countries will need to work towards before the 2005 annual meeting and beyond.

8. Farewell of IMF Banking Supervision Advisor – Mr Andrew Milford

Mr. Andrew Milford's contract as the IMF resident advisor with the Banking Supervision Department ended at the end of 2004. Mr. Milford commenced his role as an advisor to the Banking Supervision Unit (then) in 1998 on an adhoc basis until 2000 when he assumed the role as IMF resident advisor. Mr. Milford advisory role included the department's capacity building. Mr. Milford left to join the Pacific Technical Assistance Centre (PFTAC) as Banking Supervision and Regulation Advisor.

9. Anti-Money Laundering

The Reserve Bank through the Bank Supervision Department has been working very closely with the Financial Intelligent Unit and the various institutions that come under the FIA and the IBA to ensure Vanuatu complies with the FATF 40 recommendation.

This year the Bank as part of its contribution to the development of the Financial Intelligent Unit has engaged a representative of the Financial Intelligent Unit to a number of AML on-site visits to the domestic and offshore banks. The AML visit assessments were conducted against the requirements of the Financial Institution Act of 1999, the International Banking Act of 2002, Prudential Guideline No. 9 (Customer due diligence) and the Financial Transaction Reporting Act.

VI. BANKING AND CURRENCY OPERATION

I. ASSET AND PROFITS

The downward trend continues in the Bank's net operating profits for the year showing yet another all time low of VT30.9 million compared with VT36.6 million for the previous year. International interest rates and the level of official international reserves have just started to improve towards the end of the year but this was not enough to significantly change the amount of interest earned on external investments in comparison to 2003. On the other hand, interest on Vatu accounts have registered substantial changes, in particular, interest on the Staff Loan account. Due to an interest rate hike in housing loans, interest income increased from VT1.8

BANKING AND CURRENCY OPERATIONS

million to VT6.6 million while interest on Secured lending fell from VT35.1 million to VT 16.8 million due to the repayment of VCMB borrowing.

An additional loss to the profit and loss account is the profit on foreign exchange deals. The year saw a 73 percent reduction of profit due to fewer deals following the imposition of the Foreign Exchange Guideline by the Bank in order to build up its reserves to a comfortable level.

The Bank continues to keep a tight rein on expenditures resulting in an overall reduction of VT3.0 million even though some budget overheads like electricity increased by 43 percent and interest paid on Reserve Bank Notes increased by 43 percent to VT16.4 from VT11.5 in 2003. The Bank paid VT9.4 million in costs of production of currency notes and VT 3.9 million for restructuring consultancy. The Governor's commitment to reducing costs is evidenced by a 34 percent reduction in Official Travel.

2. BANKING

2.1 Currency Operations

At year-end of 2004, the total value of Vatu notes and coins issued by the Bank peaked at VT2,967.5 million representing an increase of 15.9 percent from the previous year. The increase of cash issued into circulation is in line with the increase in foreign currency inflows from the balance of payments indicating greater cash activity in the economy during the year. In contrast to preceding years, VT5,000 now has the highest value of notes issued at 46.6 percent in comparison to 42.7 percent in 2003. The VT1,000 takes second place at 44.8 percent compared to 47.9 percent followed by VT 500 and VT 200 with insignificant changes. There are no significant changes in the value of coins in circulation with the same order of VT 100, VT 20, VT10, VT 50, VT 5, VT2 and VT1.

Table 6 : Notes Examination

Denomination	Quantity Examined	Fit for Reissue	Unfit for Reissue	Rejection Rate
5000	313,419	298,781	14,638	5%
1000	1,218,840	1,017,84	200,991	16%
500	123,647	9	78,233	63%
200	167,257	45,414	102,561	61%
100	14	64,696	14	100%
		0		
Total	1,823,177	1,426,740	396,437	22%

Source: Reserve Bank of Vanuatu

In continuing to perform its fundamental role as the sole issuer of the country's currency, ensuring sufficient stock is available and maintaining the quality of notes and coins, the Bank examined a total of 1,823,177 notes during the year, 641,277 notes short of the previous year's total. Of the total notes examined, 24 percent were rejected as unfit for reissue. The lower denomination notes have the shortest circulation life with all of the VT100 deposited notes being cancelled for destruction.

Prior to independence, the New Hebrides Francs (FNH) and the Australian Dollar co-circulated until March 1982 when the first Vatu currency notes were introduced to replace the existing currencies. By April 1983, the FNH legal tender status was withdrawn and the Australian currency was treated as foreign currency. The Bank mounted a monetary reform and had successfully withdrawn 87 percent of the total FNH currency in circulation. The Bank felt that a period of 15 years is sufficient time for citizens to exchange their FNH currency into Vatu currency. In May 2004 and in accordance with the RBV Act, the Bank paid the Vanuatu Government an amount VT66,569,025 representing the total amount of FNH currency still at large.

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2.2 Counter Operations

Table 7 : Cash Counter Transactions			
Period (Year)	With draws	Deposits	Total
2000	4,143	4,136	8,281
2001	4,098	3,980	8,078
2002	3,902	3,873	7,775
2003	4,235	3,965	8,200
2004	2,864	3,390	6,255

Source: Reserve Bank of Vanuatu

Counter operations continued to be extended to customers such as the Vanuatu Government and the commercial banks. The year registered a decline in counter transactions from a total of 8,200 in 2003 to 6,255.

2.3 Payment System

Payment instruments such as cheques and bank orders are exchanged at the start of each business day at the clearing house. The year saw an increase in both the number of effects and the total value exchanged through the system.

Table 8: Operation of Clearing House		
Period (Year)	No. of Effects	Value (MVT)
1999	370,352	34,224
2000	398,286	32,622
2001	378,016	34,995
2002	335,462	33,878
2003	263,664	28,230
2004	264,859	31,985

Source: Reserve Bank of Vanuatu

VII. INTERNAL MANAGEMENT

1. Board of Directors

A new addition to the composition of the Board of Directors of the Reserve Bank of Vanuatu came about on 14 June 2004 with the appointment of a representative from the Ministry of Finance as required under the Reserve Bank of Vanuatu Act, Cap 125, as amended, after it was left vacant for several years. The newly appointed member was the Director General to the Ministry of Finance & Economic Management Mr. Simeon Malachi Athy. Mr. Athy was a former Director of the Research Department of the Reserve Bank of Vanuatu. The other two members are Mr. Geordie Mackenzie-Reur and Mrs. Anniva Tarilongi, who were appointed on 27 June 2002 with a term of 5 years. The Chairman of the Board is

Governor Tevi.

There were seven ordinary meetings and one extra ordinary meeting of the Board during the year, which is within the requirement of the Act for the Board to meet not less than 4 times in a year. Major Board resolutions during the year saw the approval of the Bank Review in March 2004 and its implementation. The Board approved the budget for 2004 and the 2003 annual accounts. The Board noted the Interest rate study of Vanuatu conducted by the Bank and adopted the monetary policy stance of the Bank. Two new policies were also approved on the Bank's Email and Internet Policy and the Currency office Manual. Due to the low stocks for the VT1, 000 and VT500 Notes, the Board approved reprints of the two notes.

2. Management Committee

The Management Committee comprises of the Directors of the four departments who sit in as members namely, the Director of Bank Supervision who is also the Deputy Governor, Director of Operations Department, Director of Research & Statistics Department and Director of Corporate Services Department. The newly appointed Director of Corporate Services joined the Management team in September 2004. The Governor sits as chairman of the Management Committee.

The Management meets weekly on Mondays to discuss issues concerning the management and development of the Bank.

3. Strategic Plan

2004 saw for the first time the development of the Bank's strategic plan which was later approved by the Board. The plan sets out the Bank's vision, mission and value statements. The Bank's strategic plan will be reviewed annually and should translate into departmental work plans and outputs.

It is intended that the planning cycle would commence early in the year and be finalized in November each year together with the following year's budget. The budget should reflect the Bank's overall work plan relating to a financial year.

4. Independent Review of the Bank

The Bank, in 2004, has undertaken a major review of its structure and operations to strengthen the management of its responsibilities and improve the Bank's effectiveness and overall efficiency. The review was conducted by

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William Davies from 1 March to 2 April 2004.

A major consideration has been the closer integration of monetary policy with indirect and market based instruments. Also, the growth in global markets and financial deregulation generally has meant that the effects of financial conditions abroad need to be more clearly addressed in the Bank's policy framework.

The Board agrees that financial markets require a much closer focus if the Bank is to have a more active role in the future. In addition, there should be a clearer separation of policy formulation from policy implementation. Some improvements in internal procedures were also necessary.

Consequently, the Board has approved the following changes to the Bank's structure:

A new **Financial Market Department** is to be established which will have primary responsibilities for monetary policy implementation, auctions of Reserve Bank of Vanuatu Notes, short term bank liquidity forecasts and other domestic market operations. The Department will also be responsible for exchange rate management, foreign exchange transactions, market monitoring and the investment of Vanuatu's foreign exchange reserves.

The Research Department was renamed to Research and Statistics Department and continues to have the major role in formulating monetary policy based on assessments of internal and external conditions to meet the Bank's objectives of low inflation and comfortable levels of foreign reserves. The Department undertakes economic and financial analysis, research, forecasting, statistics and publications covering economic and financial developments. Some internal changes are also being made to streamline a database within the Statistics Unit and to allow staff to conduct more in depth analysis and research into economic developments.

The operations of **Bank Supervision Department** remain unchanged but the Department will require some additional resources to supervise a broader range of institutions. The Department complements Financial Market Department by implementing prudential policies to achieve financial stability and an effective core payments system.

The **Operations Department** was renamed to **Accounts and Customer Services Department** and will absorb the remaining functions of Operations Department including Registry, settlements and payment system issues and some additional responsibilities for communications and community relations. The Bank is also taking steps to improve its accounting function. The **Administration Department** will now be called

Corporate Services Department, covering human resources and personnel policies, building and other internal services to support the Bank's day-to-day operations, and Information Technology. Personnel policies will be reviewed to meet up-to-date practices and standards. The Department is also responsible for budget preparation, monitoring and review to improve the efficiency of departments, management control and planning. It will also have a major role in the implementation of the Bank's Strategic Plan, vision and mission statements and departmental work plans. The initiatives will strengthen the Bank accountability and its transparency.

The **Internal Audit** function is being strengthened under a technical assistance program with a regional central bank.

The reorganization of functions involves the transfer of some staff, and recruitment of staff to a number of positions including senior management appointments. Appointments to the new position of Director Financial Markets Department and to a number of senior positions in Corporate Services and Accounts and Customer Services Departments have been deferred while the Bank advertises these positions to broaden the list of applicants for consideration.

The above proposals outline a comprehensive reform program to the Bank's operations since its establishment.

It will take some months to implement. Some matters will spillover into 2005. The changes involve a major commitment by the Governor Odo Tevi and the Board of Directors to strengthen the Bank's role in policy formulation and policy implementation. Initiatives are also being taken to modernize some areas of the Bank's operations so that internal management practices are improved.

5. Risk Management

In early 2004 the Board of the Reserve Bank of Vanuatu approved that the Bank's Management would review and strengthen the Bank's risk management policies. The increased focus on the Bank's risk management systems is a precursor to the establishment of an internal audit department and the appointment of an internal auditor.

The Bank has requested assistance from the Reserve Bank of Australia to establish an internal audit function. As part of the excise, the Bank has developed a risk register identifying potential key risks with the view to put in place policies and procedures to minimize losses of disruption to its activities. Based on the risk register, the Bank will look at developing a Business Continuity Plan.

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6. Official Representation

During 2004, the Bank participated in several international meetings, maintained relationships with other central banks and international institutions and received technical assistance from international institutions. The Bank continued its relationship with the International Monetary Fund (IMF), the World Bank and in October 2004 the Governor accompanied the Minister of Finance to the Commonwealth Finance Ministers' meeting in Saint-Kitts and the International Monetary Fund and World Bank Annual meeting that was held in Washington DC. The IMF provided some technical assistance to the Bank during the year. The assistance was in the form of long term advisors in Banking Supervision and a short term general advisor on monetary policy.

The Governor and the Deputy Governor represented the Bank at other international meetings such as APG Annual Meeting, Thirteenth International Conference of Banking Supervisors (ICBS) in Madrid, Spain and South Pacific Central Bank Governors' meeting in Sydney, Australia. The Bank also hosted the Association of the Financial Supervisors of Pacific Countries (AFSPC) on Banking Supervision with participants from all member countries.

7. 2004 Budget

2004 was the first time the Bank introduced a budgetary system. The budget was approved in early 2004 and it was based on respective department's plans and needs for the financial period. The RBV 2004 total consolidated expenditure budget of 254 million vatu. Though it was the first exercise for the departments and the Bank as a whole, the departments did spend well within their budgets. For the overall performance of the budget, the Bank's spending exceeded the budget figure by around 3 million vatu in 2004.

8. Plant and Properties

One of the urgent needs of the Bank is space. Currently, the Bank has limited space for growth and future expansion. The current building is now 24 years old and would not cater for future growth.

Accordingly, in 2004 the Board agreed to the construction of a new Bank building. The proposed building is to be 4 stories high, to be built behind the existing building and is to be designed by the Kramer Group, one of the South West Pacific's leading consulting engineering and project management groups. The construction of a building this size would normally take 16 – 18 months excluding the ground survey and design stages.

The conceptual design has been completed and presented to the Board and Management for comments and it is envisaged that the design and construction phase will commence in mid 2005. The design is based on the needs and requirements of the bank allowing for growth for the next 10 to 20 years.

Other major developments include the complete installation of the electronic window shutters on the Bank building and the complete renovation of the Governor's residence.

9. Security

The Bank in 2004 recruited its own security personnel and discontinued the use of security services from external security companies. Currently, the Bank has 4 security officers who provide effective 24-hour surveillance and it has also adopted additional measures to prevent unauthorized access into the premises. With the construction of the new Bank building in 2005, a comprehensive review of the Bank's security system will be undertaken with a view to upgrading.

10. Information Technology Unit - Developments in 2004

During the year, the Information Technology Unit continued to provide support to users on the Bank's computer systems.

In order to continue to review and strengthen the security framework of the bank's system, a computer security baseline was developed for the desktop systems and some initial work began in the year on adopting this baseline. Software programs were reviewed and a standard was adopted to tie in with the computer baseline of the Bank.

All desktop computers went through a thorough analysis and most were upgraded to Windows 2000 while the newer ones adopted Windows XP operating system.

IT training was in the area SWIFT Net migration and post migration needs. Other areas of training were in understanding the fundamentals of network security.

The SWIFT system's X.25 to pure IP network migration process was successfully completed in August of 2004. The Netware system that was running parallel to the Windows 2000 network platform was completely phased out. The IT Unit was also involved in developing small applications to automate repetitive user tasks.

INTERNAL MANAGEMENT

A review of IT policies was conducted during the year and some recommendations were implemented. For example specific Internet and email policies were drawn up and implemented.

11. Library

The library continues to maintain its relationship with other libraries through the exchanging of the bank's publications. The library hosted a library week from the 30th August to 3rd September 2004. The theme for this year's library week was "Knowing your library. Information is power, Use it and Share it". The librarian made a PowerPoint presentation to visiting staff and explained the different kinds of libraries established in a society, and the role of cataloguing in a library. A group of year 12 students from Vila City College were also invited to listen to a presentation on the Role of the Reserve Bank of Vanuatu, presented by one of the Research Officers from the Research and Statistics Department.

12. Legal Issues in 2004

Two major legal issues arose during the year. Firstly, the qualification of the 2003 annual accounts based on the application of the International Accounting Standards (IAS 39). The IAS 39 and the RBV Act were clearly in conflict over the computation of any losses and gains arising from the value of assets or liabilities held in the foreign currencies. The IAS 39 required that it is shown in the profit and Loss statement of the Bank while the RBV Act provides that it must be shown in the revaluation reserve account of the Bank. As such it follows that the Act prevails over the application of the IAS 39 & 21 as they are only standards adopted by the International Federation of Accountants, which are not recognized by the Act or laws of Vanuatu. Secondly the legal implications arising from the Review of the Bank that was conducted in March 2004 by Mr. Bill Davies. The Davies review recommended some changes that the Bank was recommended to adopt in terms of organizational structure, salary structure and job descriptions. With these changes there are legal implications which will see a variation of the current employees' contract that needs the consent of both parties.

13. Human Resource

The number of staff at the end of 2004 dropped from 56, from the preceding year, to 55, of which 54 were Ni-Vanuatu and 1 expatriate, advisor to the Banking Supervision Department. Expatriate advisors who, from time to time visited the Bank, also reduced to one in 2004 from the preceding year.

A total of 7 staff left the Bank in 2004. Two resigned on medical grounds, 2 took early retirement, 1 was terminated, and the Advisor to Banking Supervision Department's contract also ended at the end of 2004. Also during the year, 6 new staff were recruited, 1 in Corporate Services Department, 2 in Research and Statistics Department, 2 in Operations Department and 1 in Banking Supervision Department. The appointment of the new Director of Corporate Services Department was also made in 2004.

14. Training and Development

As in previous years, the Bank continued to invest in staff training and development. Bank staff attended courses at the IMF Singapore Training Institute and other types of training that included in-house training, full-time training and other short courses with regional central banks. One staff was on attachment with the Australian Prudential Authority.

15. Work Experience

The Bank continues to provide on the job training to students during the Christmas vacation. The bulk of the trainees are the continuing students at the USP Campus in Port Vila while others are from other secondary schools around the country. In 2004 the Bank offered work experience placements to a total of 10 students who were each allocated to different departments within the Bank. The duration of the attachments was two months commencing in December 2004 through February 2005.

In addition, the Bank in 2004, hosted an attachment for a Bank Supervisor from the Cook Islands Financial Services Commission for a month. This was part of the PFTAC technical assistance to the Cook Islands in the area of Banking Supervision. The Bank also welcomed a ODI Fellow under the ODI Fellowship Scheme who will be attached with the Bank as a Macroeconomic Analyst for a period of two years ending in 2006.

14. Acknowledgments

The Board and the Governor of the Reserve Bank of Vanuatu wish to convey their gratitude for the continuous commitment of staff during 2004. This appreciation is also extended to the International Monetary Fund (IMF) for the advisors provided to the Bank under its technical assistant program.

RESERVE BANK OF VANUATU
FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2004

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HAWKES LAW

CHARTERED ACCOUNTANTS

a KPMG correspondent firm

Independent Auditors' Report to the Government of the Republic of Vanuatu

Scope

We have audited the financial statements of the Reserve Bank of Vanuatu ("the Bank") for the financial year ended 31 December 2004 consisting of the statement of profit and loss, statement of movements in equity, balance sheet, statement of cash flows and accompanying notes set out on pages 4 to 17. The Bank's Directors are responsible for the preparation and presentation of the financial statements and the information they contain. We have conducted an independent audit of these financial statements in order to express an opinion on them to the Government.

Our audit has been conducted in accordance with International Standards on Auditing as promulgated by the International Federation of Accountants to provide reasonable assurance as to whether the financial statements are free of material misstatement. Our procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the financial statements are presented fairly in accordance with applicable International Accounting Standards and statutory requirements so as to present a view which is consistent with our understanding of the Bank's financial position and the results of its operations and its cash flows.

We believe that our audit provides a reasonable basis for our opinion.

Qualification

We refer to note 1 (c) to the financial statements, wherein there is a conflict between the Reserve Bank Act (CAP125) and International Financial Reporting Standards with regard to the accounting treatment for gains and losses, both realized and unrealized, arising from the conversion of foreign currencies and the changes in the fair values of treasury notes and bonds denominated in foreign currencies. In accordance with Section 25 of the Reserve Bank Act (CAP 125), the Bank recognizes the said gains and losses in the Revaluation Reserve. However, according to IAS 21 foreign exchange gains and losses are to be included in the computation of the annual profits or losses of the Bank. In addition IAS 39 requires the Bank to include any gains and losses arising from changes in the fair values of treasury notes and bonds in the computation of annual profits or losses of the Bank. Had the Bank adopted IAS 21 and 39 the result for the year ended 31 December 2004 would be an operating loss of Vt38,156,000 (compared to an operating profit of Vt30,855,000 as disclosed in the profit and loss account) and the net assets (capital and reserves) as at 31 December 2004 would be Vt626,047,000 (compared to net assets (capital and reserves) of Vt673,282,000 as disclosed in the balance sheet).

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Audit opinion

In our opinion, except for the above qualification, the financial statements of the Reserve Bank of Vanuatu have been properly prepared in accordance with the provisions of the Reserve Bank Act [CAP 125] of the Republic of Vanuatu and applicable International Financial Reporting Standards as adopted by the International Accounting Standards Board, so as to give a true and fair view of:

- i) in the case of the balance sheet, the state of the Bank's affairs as at 31 December 2004;
- ii) in the case of the statement of profit and loss, the Bank's result for the financial year ended on that date; and
- iii) the Bank's cash flows for the financial year ended on that date.

Hawkes Law
HAWKES LAW
Chartered Accountants

Port Vila
2 May 2005

(Qualified auditors under Section 166
of the Companies Act [CAP 191] of the
Republic of Vanuatu)

STATEMENT OF PROFIT AND LOSS FOR THE YEAR ENDED 31 DECEMBER 2004

(Expressed in 000's Vatu)

	Note	2004	2003
Operating revenue			
Interest income		285,482	292,502
Other income		2,524	4,254
		-----	-----
Total revenue		288,006	296,756
		=====	=====
Operating expenses			
<i>Personnel expenses</i>			
Salaries and wages		85,909	92,041
Superannuation contribution (VNPF)		3,263	4,990
Staff training		4,769	7,796
Severance pay, long service leave and gratuity expense		12,494	19,437
Other		36,861	29,053
		-----	-----
		143,296	153,317
<i>Other operating expenses</i>			
Auditor's remuneration	7	1,576	2,321
Depreciation and amortisation	11	16,446	15,322
Funds managers' fee		4,754	7,775
Interest expense		16,541	11,655
Loss on sale of bonds		342	-
Cost of production of coins		9,367	3,755
Communication expenses		17,034	15,239
Other expenses		47,795	50,729
		-----	-----
		113,855	106,796
Total expenses		257,151	260,113
		-----	-----
Operating profit		30,855	36,643
		=====	=====
Appropriations	2		
Transfer to general reserve		3,085	3,664
Due to Government of Vanuatu		27,770	32,979
		-----	-----
Unappropriated profits as at 31 December		NIL	NIL
		=====	=====

This statement of profit and loss is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 9 to 17.

STATEMENT OF TRANSFERS TO GOVERNMENT OF VANUATU

(Expressed in 000's Vatu)

	Note	2004	2003
Appropriation of profits		27,770	32,979
Transfer from revaluation reserve	3	-	5,444
		-----	-----
Total transfer to Government of Vanuatu		27,770	38,423
		=====	=====

The statement of transfers to Government of Vanuatu is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 9 to 17.

STATEMENT OF MOVEMENTS IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2004

(Expressed in 000's Vatu)

	Note	Issued & paid up capital	General reserve	Revaluation reserve	Total
2004					
Balance at beginning of the financial year		100,000	570,197	21,776	691,973
Transfer from profit and loss account					
- Current year profit		-	3,085	-	3,085
Net loss on foreign exchange and changes in fair value		-	-	(69,011)	(69,011)
		100,000	573,282	(47,235)	626,047
Non interest bearing securities issued by the Government		-	-	47,235	47,235
1/5 of the total foreign exchange gain transferred to Government		-	-	-	-
Balance at the end of the financial year		100,000	573,282	-	673,282
2003					
Balance at the beginning of the financial year		100,000	629,737	38,493	768,230
Change in accounting policy with respect to:					
- Gratuity provision	6	-	(63,204)	-	(63,204)
		100,000	566,533	38,493	705,026
Transfer from profit and loss account					
- Current year profit		-	3,664	-	3,664
Net loss on foreign exchange and changes in fair value		-	-	(11,273)	(11,273)
		100,000	570,197	27,220	697,417
1/5 of the total foreign exchange gain transferred to Government		-	-	(5,444)	(5,444)
Balance at the end of the financial year		100,000	570,197	21,776	691,973

The statement of movements in equity is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 9 to 17.

BALANCE SHEET AS AT 31 DECEMBER 2004

(Expressed in 000's Vatu)

	Note	2004	2003
Capital and reserves			
Issued capital	13	100,000	100,000
General reserve	2	573,282	570,197
Revaluation reserve	3	-	21,776
		-----	-----
Total capital and reserves		673,282	691,973
		-----	-----
Liabilities			
Currency issued	12	2,967,486	2,559,506
Due to commercial banks		2,327,919	2,269,417
Due to Government of Vanuatu		656,919	413,421
Due to international institutions and agencies		201,764	215,891
Due to statutory body		3	758
Employee provisions		91,111	99,387
Accrued expenses		9,117	8,041
Other creditors		29,554	26,725
		-----	-----
Total current liabilities		6,283,873	5,593,146
		-----	-----
Employee provisions		6,108	6,554
Reserve Bank of Vanuatu notes		1,068,615	99,132
		-----	-----
Total non-current liabilities		1,074,723	105,686
		-----	-----
Total liabilities		7,358,596	5,698,832
		-----	-----
Total capital, reserves and liabilities		8,031,878	6,390,805
		=====	=====

The balance sheet is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 9 to 17.



Odo Tevi
Chairman, Board of Directors and Governor



Director

Port Vila, 2 May 2005.

BALANCE SHEET AS AT 31 DECEMBER 2004

(Expressed in 000's Vatu)

	Note	2004	2003
Assets			
International Monetary Fund (IMF)	5		
Reserve tranche position:			
Subscriptions to IMF		434,523	434,523
Less: subscriptions held on behalf of Government of Vanuatu		(434,523)	(434,523)
		-----	-----
		-	-
Special drawing rights department	14(a)	161,844	154,381
Treasury notes, bonds and bills	14(a)	2,919,081	1,662,705
Cash and cash equivalents	14(a)	2,376,795	1,632,140
Due from Government of Vanuatu		226,935	204,774
Interest receivable		57,594	49,916
Government securities	8	375,790	333,406
Other receivables	10	156,118	308,071
		-----	-----
Total current assets		6,274,157	4,345,393
		-----	-----
Property, plant and equipment	11	79,775	59,358
Treasury notes, bonds and bills	14(a)	747,435	1,020,631
Interest receivable		68,011	62,923
Vanuatu government bonds	9	862,500	902,500
		-----	-----
Total non-current assets		1,757,721	2,045,412
		-----	-----
Total assets		8,031,878	6,390,805
		=====	=====

The balance sheet is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 9 to 17



Odo Tevi
Chairman, Board of Directors and Governor



Director

Port Vila, 2 May 2005.

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2004

(Expressed in 000's Vatu)

	Note	2004	2003
Cash flows from operating activities			
Interest received		285,472	296,559
Interest paid		(16,541)	(11,655)
Other operating receipts		2,534	4,254
Other operating payments		(205,232)	(238,500)
Net cash provided by operating activities	14(b)	66,233	50,658
Cash flows from investing activities			
<i>Net (increase)/decrease in:</i>			
Subscription to IMF		-	10,500
Special drawing rights department		(7,459)	(4,048)
Treasury notes and bonds		(936,510)	(549,121)
Government securities		(10,569)	5,147
Other receivables		68,227	(12,315)
Purchase of property, plant and equipment		(36,863)	(18,211)
Net cash used in investing activities		(923,174)	(568,048)
Cash flows from financing activities			
<i>Net increase/(decrease) in:</i>			
Subscriptions held on behalf of the Government		-	(10,500)
Currency in circulation		407,980	285,851
Due to commercial banks		55,502	63,961
Due to Government of Vanuatu		258,517	(12,240)
Due to international institutions and agencies		(14,127)	(33,006)
Due to domestic institutions		(755)	22
Reserve Bank of Vanuatu notes		969,483	(224,770)
Transfers to Government of Vanuatu	2,3	(27,769)	(38,423)
Net cash provided by financing activities		1,648,831	30,895
Net increase / (decrease) in cash and cash equivalents		791,890	(486,495)
Cash and cash equivalents at the beginning of the financial year	14(a)	1,632,140	2,126,278
Effects of exchange rate changes on foreign currency			
Balances	1(c), 3	(47,235)	(7,643)
Cash and cash equivalents at the end of the financial year	14(a)	2,376,795	1,632,140

The statement of cash flows is to be read in conjunction with the notes to and forming part of the financial statements set out on pages 9 to 17.

**NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR
ENDED 31 DECEMBER 2004**

(Expressed in 000's Vatu)

1. Statement of significant accounting policies

The significant accounting policies adopted in the preparation of the financial statements are set out below:

(a) Basis of preparation

The financial statements of the Bank have been prepared in accordance with International Financial Reporting Standards (IFRS) adopted by the International Accounting Standards Board (IASB), interpretations issued by the Standing Interpretations Committee of the IASB and the requirements of the Reserve Bank of Vanuatu Act [CAP 125]. They are prepared under the historical cost basis and do not take into account changing money values or, except where stated, current valuations of non-current assets.

The accounting policies have been consistently applied and, except where there is a change in accounting policy, are consistent with those of the previous year. There have been no changes in accounting policies during the year.

The financial statements are presented in Vanuatu currency (Vatu) rounded to the nearest thousand.

(b) Revenue recognition*Operating revenue*

Operating revenue includes interest income, profit on foreign exchange dealing with commercial banks and sundry income.

(c) Foreign currency assets and liabilities*Foreign currencies*

Transactions in foreign currencies are converted to Vatu at the rates of exchange prevailing on transaction dates. Year-end assets and liabilities denominated in foreign currencies are converted at the rates of exchange ruling at the year-end.

Treasury notes, bonds and bills

Treasury notes, bonds and bills that are denominated in foreign currencies are valued at fair value ('market value').

All gains and losses, both realised and unrealised, arising from the conversion of foreign currencies and changes in the fair value are taken to the Revaluation Reserve (Note 3) in accordance with the provisions of Section 25 of the Reserve Bank of Vanuatu Act [CAP 125] and are not included in the computation of the annual profits or losses of the Bank.

Losses arising from the conversion of foreign currencies and changes in the fair value are set off against any credit balance in the Revaluation Reserve. If the balance of this account is insufficient to cover such losses they are set off against any net profit remaining after the transfer to the General Reserve Account has been made in terms of Section 7 of the Reserve Bank of Vanuatu Act [CAP 125]. If these transfers are not adequate to cover such losses, the Government is required to transfer to the ownership of the Bank non-negotiable non-interest bearing securities to the extent of the deficiency.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2004

(Expressed in 000's Vatu)

(c) Foreign currency assets and liabilities (con't)

Any credit balance in the Revaluation Reserve Account at the end of each year is applied first to the redemption of any non-negotiable non-interest bearing notes previously transferred to the Bank by the Government to cover losses; thereafter one-fifth of any remaining balance is payable to the Government.

(d) Coins sold as numismatic items

The Bank sells, or receives royalties on, coins which are specially minted or packaged as numismatic items. These coins have not been accounted for as currency in circulation as they were not issued for monetary purposes.

(e) Non-current assets

The carrying amounts of all non-current assets are reviewed to determine whether they are in excess of their recoverable amount at balance date. If the carrying amount of a non-current asset exceeds the recoverable amount, the asset is written down to the lower amount. In assessing recoverable amounts the relevant cash flows have not been discounted to their present value.

(f) Property, plant and equipment*Acquisitions*

Items of property, plant and equipment are recorded at cost and depreciated as outlined below. All items of property, plant and equipment are carried at the lower of cost less accumulated depreciation, and any recoverable amount.

Disposal of assets

The gain or loss on disposal of assets is calculated as the difference between the carrying amount of the asset at the time of disposal and the proceeds on disposal, and is included in the result in the year of disposal.

Depreciation

Depreciation is charged on a straight line basis over the estimated useful lives of the assets. The rates of depreciation used are based on the following estimated useful lives:

<input type="checkbox"/> Leasehold land	- 50-75 years
<input type="checkbox"/> Reserve Bank building	- 10 years
<input type="checkbox"/> Plant and equipment	- 3-10 years

Assets are depreciated from the date of acquisition. Expenditure on repairs or maintenance of property, plant and equipment incurred to restore or maintain future economic benefits expected from the assets is recognised as an expense when incurred.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2004

(Expressed in 000's Vatu)

(g) Notes and coins

All purchases of notes and coins are written off in the year of payment.

(h) Income Tax

The Bank is exempt from income tax in accordance with Section 42 of the Reserve Bank of Vanuatu Act [CAP 125].

(i) Employee entitlements

The provision for employee entitlements comprises severance allowance, gratuity and annual leave and represents the present liability resulting from employees' services to the balance sheet date. The provision has been calculated at nominal amounts based on current wage and salary rates.

Vanuatu National Provident Fund

Employers contributions to the above fund are charged against income as incurred.

(j) Cash and cash equivalents

For the purpose of the statement of cash flows, cash and cash equivalents includes coins, notes, cash at bank, money at call and cash held on short term deposits.

(k) Vanuatu Government bonds

Vanuatu Government bonds are valued at cost.

(l) Comparatives

Where necessary, comparative information has been reclassified to achieve consistency in disclosure with current financial year amounts and other disclosures.

2. General reserve and distribution of profits

The requirements of Section 7 of the Reserve Bank of Vanuatu Act [CAP 125] are:

- (a) that half the net profit be transferred to the general reserve until the balance thereof is equal to the authorised capital.
- (b) that once the balance of the general reserve is equal to the authorised capital, 10% of the net profit be transferred to the general reserve.
- (c) that after allocation of the net profit as above, the balance be applied towards the redemption on behalf of the Government of any securities held by the Reserve Bank which have been issued in accordance with Section 25 (2) in addition to those issued pursuant to Section 5 (4).
- (d) that the balance of the net profit for the financial year remaining after all deductions as above be paid to the Government.

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2004

(Expressed in 000's Vatu)

3. Revaluation reserve

At the balance sheet date any credit balance in the Revaluation Reserve is to be applied first towards the redemption of Vanuatu Government securities issued to the Reserve Bank in respect of previous years' losses. If the remaining balance is greater than VT5 million, 20% of that balance is to be paid to the Vanuatu Government, to be used for such purposes as the Government, after consultation with the Reserve Bank, may decide. However, if the remaining balance does not exceed VT5 million, it is to be paid in full to the Government. Accordingly, the amount due to the Government of Vanuatu at 31 December 2004 of VT656,919 (2003: VT413,421) includes VTNil (2003: VT5,444) transferred from the revaluation reserve.

4. External assets

External assets are defined by the Act as including any internationally recognised reserve asset. In these financial statements, external assets also include fully convertible foreign currency balances equivalent to VT18,850 (2003 – VT41,768) held with local banks in Vanuatu.

5. International Monetary Fund

- (a) Vanuatu is a member of the International Monetary Fund (IMF) and the Reserve Bank has been designated as the Government of Vanuatu's fiscal agency (through which the Government deals with the IMF) and as the depository for the IMF's holding in Vatu.
- (b) Vanuatu's subscription to the IMF has been met by:
 - (i) payment to the IMF out of the Reserve Bank's external assets which have been reimbursed by the Government of Vanuatu by issue of non-interest bearing securities;
 - (ii) the funding of accounts in favour of the IMF in the books of the Reserve Bank by the Government of Vanuatu.

6. Change in accounting policy in 2003 – gratuity provision

During the 2003 financial year, a new policy was introduced entitling all staff to a gratuity. The change in accounting policy was accounted for retrospectively. In the 2003 year an amount of VT63.2 million relating to the prior year's provision was adjusted against the opening balance of the general reserve account.

**NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENT FOR THE YEAR
ENDED 31 DECEMBER 2004**

(Expressed in 000's Vatu)

7. Auditor's remuneration

	2004	2003
Amounts received or due and receivable by the Auditors of the bank for:		
- Auditing the financial statements	1,576	1,564
- Other services	-	757
	<u>1,576</u>	<u>2,321</u>

8. Government non-negotiable securities issued to the bank

Balance at beginning of the financial year	333,406	338,552
Net purchase / (encashment) of notes	42,384	(5,146)
	<u>375,790</u>	<u>333,406</u>

9. Vanuatu government bonds*Maturities of securities are summarised as follows:*

Not later than 1 year	-	40,000
Between 1 and 2 years	-	-
Between 2 and 5 years	562,500	562,500
Later than 5 years	300,000	300,000
	<u>862,500</u>	<u>902,500</u>

10. Other receivables**Current:**

Advance to commercial bank	-	100,000
Loans to staff	26,055	26,778
Sundry debtors	5,636	8,777
Others	39	19,751
	<u>31,730</u>	<u>155,306</u>

Non-current:

Loans to staff	124,388	152,765
	<u>156,118</u>	<u>308,071</u>

**NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENT FOR THE YEAR
ENDED 31 DECEMBER 2004**

(Expressed in 000's Vatu)

11. Property, plant and equipment

	2004	2003
Building and land		
At cost		
Building	199,624	175,727
Land	12,702	12,702
Residential properties	20,924	15,989
	-----	-----
	233,250	204,418
Accumulated depreciation	(181,547)	(178,112)
	-----	-----
	51,703	26,306
	-----	-----
Plant and equipment		
At cost	148,909	140,878
Accumulated depreciation	(120,837)	(107,826)
	-----	-----
	28,072	33,052
	-----	-----
Total property, plant and equipment	<u>79,775</u>	<u>59,358</u>
<i>Movement in property, plant and equipment</i>		
Opening written down value:	59,358	56,469
Additions	36,863	18,211
Depreciation	(16,446)	(15,322)
	-----	-----
Closing written down value	<u>79,775</u>	<u>59,358</u>

12. Currency issued

Notes	2,520,306	2,133,795
Coins	447,180	425,711
	=====	=====
Total currency issued	<u>2,967,486</u>	<u>2,559,506</u>

13. Share capital

Authorised capital of 400,000,000 ordinary shares	<u>400,000</u>	<u>400,000</u>
Issued and paid-up capital of 100,000,000 ordinary shares	<u>100,000</u>	<u>100,000</u>

**NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENT FOR THE YEAR
ENDED 31 DECEMBER 2004**
(Expressed in 000's Vatu)

	2004	2003
14.		
(a) External assets		
Cash	3,040	3,338
Current and call accounts	1,308,513	708,332
Short term deposits	1,065,242	920,470
	-----	-----
Total cash and cash equivalents	2,376,795	1,632,140
Investment securities at market value - current	2,919,081	1,662,705
Investment securities at market value - non-current	747,435	1,020,631
	-----	-----
Special drawings rights department	161,844	154,381
	-----	-----
Total external assets	6,205,155	4,469,857
	=====	=====
For the purpose of the statement of cash flows, cash and cash equivalents includes cash on hand and at bank and short term deposits. Cash and cash equivalents at the end of the financial year as shown in the statement of cash flows is reconciled to the related items in the balance sheet as noted above.		
(b) Reconciliation of operating profit to net cash provided by operating activities		
Operating profit	30,855	36,643
<i>Non cash items</i>		
Depreciation	16,446	15,322
Severance pay	12,494	19,437
<i>Net (increase)/decrease in:</i>		
Interest receivable	12,766	4,057
Other receivable	(1,511)	(1,281)
	-----	-----
	71,050	74,178
<i>Net increase/(decrease) in:</i>		
Accrued expenses	(4,817)	(23,520)
	-----	-----
Net cash provided by operating activities	66,233	50,658
	=====	=====

15. Related parties

Ultimate parent entity

The Bank's ultimate parent entity is the Government of the Republic of Vanuatu.

Directors and executive officers remuneration

The directors were paid a sitting allowance for services rendered. The Bank also provides non-cash benefits to the Executive Director and executive officers in addition to their salaries.

**NOTE TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR
ENDED 31 DECEMBER 2004**

(Expressed in 000's Vatu)

15. Related parties (con't)

Total remuneration is included in 'personnel expenses' as follows:

	2004	2003
Directors' fees and remuneration	6,195	4,642
Executive officers	14,332	13,978
	-----	-----
	20,527	18,620
	=====	=====

16. Employees

The number of full time permanent employees as at 31 December 2004 was 55 (2003: 54).

17. Contingent liabilities

The directors are aware of no contingent liabilities at balance sheet date (2003: nil).

18. Financial instruments

Exposure to credit, interest rate and currency risk arises in the normal course of the bank's operations.

The material financial instruments to which the bank has exposure includes:

- (i) external assets
- (ii) other liabilities.

Credit risk

The bank does not require collateral in respect of financial assets except in respect of loans to staff. Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis.

Credit risk on financial assets is minimised by dealing with recognised monetary institutions.

At balance sheet date there were no significant concentrations of credit risk. The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the balance sheet.

NOTE TO AND FORMING PART OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2004

(Expressed in 000's Vatu)

18. Financial instruments (con't)*Interest rate risk*

The bank's exposure to interest rate risk and the effective interest rates of financial assets and liabilities at the balance sheet date are as follows:

Financial assets:

Cash and current accounts	-	floating interest rates.
Short term deposits	-	fixed interest rates, maturing in 90 days or less.
Treasury notes and bonds	-	fixed interest rates, maturing in 9 years or less.
Vanuatu government bonds	-	fixed interest rates, maturing as detailed in note 10.
Staff loans	-	fixed interest rates, maturing in 20 years or less.
Statutory bodies/banks	-	fixed interest rates, maturing in 30 days or less.
Government of Vanuatu	-	fixed interest rates, payable in 30 days or less
- Account No.1		
- Redemption of bonds.		

Financial liabilities:

Domestic Institutions	-	fixed interest rates, payable in 30 days or less.
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All other financial assets or financial liabilities are non-interest bearing.

Foreign currency risk

The bank incurs foreign currency risk on holdings of financial assets (principally external assets) that are denominated in a currency other than Vatu. The currencies giving rise to this risk are primarily Australian dollars, New Zealand dollars, British pounds, Euro and United States dollars.

The bank does not hedge its exposure to exchange fluctuations in these currencies.

19. Post balance sheet events

No events have occurred since the balance sheet date which would require either disclosure or adjustments in the financial statements (2003: nil).



RESERVE BANK OF VANUATU