**Reserve Bank of Vanuatu**

# Half-Yearly Monetary Policy Statement

**September 2017**

**1.0 Statement by Governor**

The Reserve Bank of Vanuatu (RBV) is charged with the responsibility to formulate and implement monetary policy in Vanuatu. Following the RBV Board of Directors Resolution on the 3rd of October 2017, the Bank kept its policy interest rate unchanged at 2.85 percent[1] and the Statutory Reserve Deposits (SRD) and the Liquid Asset Ratio at 5.00 percent apiece.

In considering this decision, the Board of Directors noted that global conditions continued to improve. The IMF in its July projections expected global growth to pick up by 3.5 percent in 2017 and 3.6 percent in 2018 and to remain on track with IMF April World Economic Outlook (WEO) projections. Though growth in the United States was lowered, growth forecasts for Japan, the euro area as well as China have been raised. Moreover, economic performance and outlook within the region, particularly in Australia and New Zealand remained sound which has augured well for the region and Vanuatu.

Domestically, the macroeconomic fundamentals remain sound. Real economic output remains stable. Economic growth is forecasted at 4.0 percent in 2017, supported by growth in infrastructure developments. As the developments wrap up, economic growth is projected to recede to 3.4 percent in 2018. The agriculture and other services sectors are also fairing well.

Domestic inflation increased to 3.3 percent in Quarter 2 from 2.1 percent in the previous Quarter. It is expected to rise above 2 percent at the end of 2017 and 2018 due largely to the impacts of the donor-funded infrastructure projects and Cyclone Pam reconstruction activities. However, it is projected to remain within the policy target band of 0- 4 percent.

In addition, official reserves are at comfortable levels sufficient to cover 10.4 months of import cover at the end of September 2017. Furthermore, official reserves (excluding donor funds) remain secured at 9.5 months of import cover. Official foreign reserve is expected to remain comfortable above the threshold limit of 4 months of import cover throughout the rest of 2017. Funding from donors towards development projects and inflow of funds via the banking system, make up the main source of the reserve build-up. Nonetheless, the Board takes heed of Vanuatu's larger external public debt repayment obligations that are falling due in a few years time and its possible repercussions, especially the pressure on the official reserves.

Monetary and financial conditions continued to be well supportive of growth as evidenced by sound banking capital position and relatively high liquidity holdings. However, the Board also took into consideration the current weak private sector credit growth amidst the elevated level of excess reserves.

The Government's fiscal position remains favourable during the first half of 2017. The position is expected to remain unchanged by the close of 2017.

Based on the above assessment, the Board resolved that maintaining an accommodative monetary policy stance was necessary in order to support growth. The Bank will continue to monitor developments and adjust its monetary policy stance accordingly.

The next statement is expected to be released in March 2018.

Simeon M ATHY
*Governor*
**The Reserve Bank of Vanuatu**

[1] The policy interest rate is set at 100 basis points above the 91 days RBV notes during the first week of September 2017

**2.0 Monetary Policy Objectives**

The Reserve Bank of Vanuatu (RBV) is responsible for the formulation and implementation of monetary policy in Vanuatu. Through its conduct of monetary policy, the RBV seeks to promote monetary stability and economic growth by maintaining a stable value of the Vatu, both domestically and externally. Central to this is the need to maintain a low and stable rate of inflation and sufficient international reserves to meet the country's external obligations. More specifically, the Bank strives to keep year-ended inflation rate contained between 0 and 4 percent and to hold international reserves at a minimum threshold of 4 months of import cover. Over the past six months both these targets have been comfortably met and current forecasts suggest that the key targets will continue to be achieved over the remaining months of 2017.

**3.0 International and Domestic Economic Overview**

***3.1 The International Economy***

Global economic conditions have remained relatively firm over the course of the June quarter. The economic activity strengthened amongst the advanced economies including, United States, Europe and Japan. China's GDP also improved over the same period.

In Europe, GDP rose by 0.6 percent over the quarter and 2.3 percent over the year to June 2017. According to Eurostat, the positive contributors to GDP growth are; household consumption which had increased by 0.3 percent, gross fixed capital formation by 0.2 percent. The contribution of the external balance to GDP growth was also positive. Furthermore, the recovery was in line with recent low unemployment figures, coupled with improving economic sentiments. British economy, on the other hand, continued to face policy uncertainty post-Brexit.

Geopolitical tensions and natural disasters increase short-term hurdles. Hurricane Harvey impact on US economic activity was estimated to be around USD$200 billion and is expected to weaken the September 2017 quarter economic activity mainly due to shutdown of refineries and business operations. Nonetheless, the slowdown from these sectors are expected to be offset by growth in other sectors, including construction, thus limited impact on GDP anticipated. The U.S. GDP is forecasted (advance estimate) to increase by 2.6 percent in the second quarter, up from a 1.2 percent in the March quarter. According to the BEA[2] the positive contributors to GDP growth are public consumption expenditure, non-residential fixed investment, exports, federal government spending and private inventory investment. Indicators which made negative contributions to growth includes; residential fixed investment, state and local government spending. Japan's economy expanded for the sixth consecutive quarter by 0.6 percent, driven by private consumption and business sentiment.

Growth in China continued to be firm at 1.7 percent quarter-on-quarter and 6.9 percent year-on-year over the June quarter fuelled by fiscal stimulus. The key contributors are retail sales and industrial production. The risk pertaining to build-up of leverage still remains despite People's Bank of China (PBOC) tightened monetary conditions. These tight policy conditions were to facilitate interbank interest rate growth and hopefully contain leverage.

The Australian economy expanded 0.8 percent over the June quarter following growth of 0.3 percent in the previous quarter. Accordingly, Australian economy expanded year-on-year by 2.0 percent. The growth was broad-based, supported by domestic demands and net exports. According to Statistics New Zealand, the New Zealand economy grew by 0.8 percent in the second quarter following a 0.6 percent growth recorded during the March quarter. The annual GDP over the year to June 2017 was 2.5 percent. Contributions to this surge were: retail trade and accommodation (2.8 percent), manufacturing (1.8 percent), exports of goods and services (5.2 percent), and household consumption expenditure (0.9 percent).

Across the major economies, labour markets have continued to tighten, but the unemployment rate continued to be lower by historical standards. Recent employment data for most advanced economies indicated unemployment rates falling and output gap narrowing. Labour market rate in Australia continued to be steady with an unemployment rate of 5.6 percent.

***3.2 The Domestic Economy***

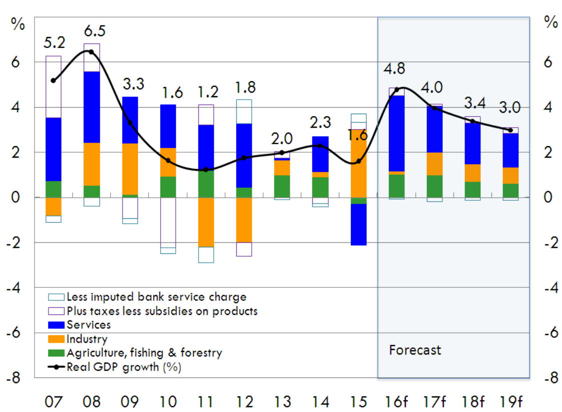
Economic indicators for the second quarter of 2017 showed further signs of gradual improvement in agriculture and a pickup in air arrivals-latter of reflects a gradually recovering tourism sector. Agricultural productivity remained high specifically for prime export commodities of copra, kava, cocoa, coconut oil and beef. This is attributed to increased international export prices and improved productivity. Cocoa production improved following high harvesting season. Air arrivals improved over the 2016 period reflecting the gradual recovery in tourism arrivals from post-TC Pam period and the

[2] United States Bureau of Economic Analysis (BEA)

continuous aggressive promotion and marketing of Vanuatu as a tourist destination. On the other hand, tourism activities through the cruise ship have started to slow down due to fewer cruise-ship calls as compared to the previous years.

The gradual improvement in economic performance in the second quarter of 2017 was also reflected in other partial economic indicators of domestic consumption and investment. VAT collections rose over the year (partially attributed to further enhancement of VAT revenue compliance) while imports for home consumption declined and private sector credit growth remained subdued.

**Figure 1: Vanuatu GDP**
**(Contribution to Annual Growth; Major Sectors)**




Source: VNSO 2015 National Account; MEC forecasts (25 August 2017)

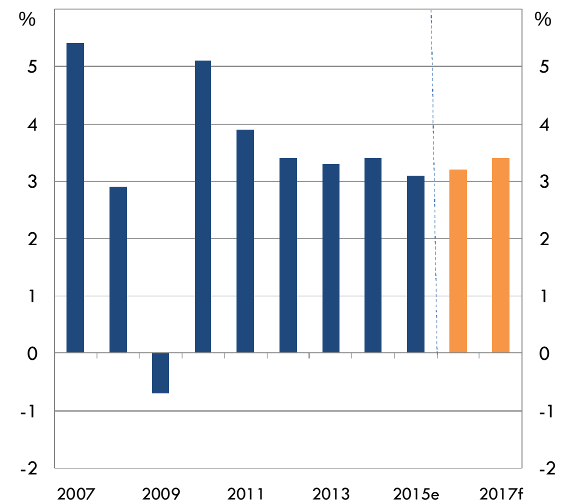
The banking system remains well supportive of growth as evidenced by high liquidity holdings and sound capital position. Money Supply (M2) expanded over the year to June 2017 by 10.9 percent owing to accumulation of net foreign reserves by both the RBV and Other Depository Corporations (ODCs). Credit growth, however, remained sluggish. The central Governments net credit position vis-a-vis the banking system improved further relative to the March quarter's level.

The central government recorded a recurrent fiscal surplus of VT455.8 million at the end of the June quarter of 2017. This improvement was reflected in the high recurrent revenue collection reaching VT4783.8 million, while recurrent expenses recorded VT4328.0 million. The development budget recorded a fiscal deficit of VT641.3 million as capital expenditure outweighed donor funds receipts. The government domestic financing through bonds reached VT7,569.7 million at the end of the June quarter.

## 4.0 International and Domestic Outlook

### *4.1 International Economic outlook*

**Figure 2: World Economic Growth (IMF World Economic Outlook, annual data)**




Source: IMF

According to the IMF[3], global growth will strengthen in 2017 and 2018. Growth forecast for 2016 was 3.2 percent which is slightly higher than 3.1 percent in the April 2017 World Economic Outlook (WEO). This growth reflect stronger economic activities in Iran and India following their national accounts revisions. The growth forecast for 2017 was 3.5 percent, unchanged from the April WEO forecast. This growth is related to a pickup in economic activities expected in both advanced and emerging and developing economies by 2.00 percent and 4.6 percent, respectively. Global growth forecast for 2018 remained unchanged at 3.6 percent as in the April WEO. Growth forecast for advance economies was lower by 0.1 percentage points from the April WEO to reach 1.9 percent. The growth forecast for emerging markets and developing economies remained unchanged at 4.6 percent. These growth forecasts reflected the macroeconomic implications of the changes in policy assumptions for the United States and China. However, the IMF is somewhat cautious in the medium term, as several risks would be detrimental to global recovery, such as the policy uncertainty in post-Brexit, the high credit growth in China, the rollback of financial regulations (central banks quantitative easing), protectionism and increasing geopolitical tensions.

### *4.2 Domestic Economic outlook*

**a. Economic Activity**

Recently published data from the Vanuatu National Statistics Office (VNSO) put 2015 real GDP growth at 1.6 percent, down from 2.3 percent in 2014. Accordingly, the Macroeconomic Committee (MEC),

[3] IMF July 2017 WEO

at its August 2017 meeting[4] revised downward its 2017 GDP forecast from 5.0 to 4.0 percent. The Committee, however, continued to maintain a positive outlook for economic growth with a forecasted 4.0 percent in 2017 and a gradual slowdown to 3.4 percent in 2018 and 3.0 percent in 2019, as donor and development partner-funded projects wrap up.

The latest MEC forecasts shows that the outlook for growth in 2017 is projected to be driven by stronger growth in the industry sector (projected to increase 9.9 percent) mainly in line with construction activities (a projected 15.2 percent growth). Furthermore, the Services sector is projected to increase 3.3 percent, driven by growth in government services (10.9 percent), professional, technical and administrative services (2.8 percent), finance and insurance (3.4 percent) and wholesale and retail trade (3.0 percent). The Agriculture, Fisheries and Forestry sector is projected to grow 4.7 percent in 2017 supported by growth in crop production (5.0 percent) and animal production (5.3 percent).

**Table 1: Real GDP Growth (%)**

| Sector | 2016e | 2017f | 2018f |
|---|---|---|---|
| Agriculture, Fisheries and Forestry | 4.9 | 4.7 | 3.1 |
| Industry | 1.4 | 9.9 | 7.5 |
| Services | 5.4 | 3.3 | 2.9 |
| **Total GDP** | **4.8** | **4.0** | **3.4** |

Source: MEC (25 August 2017)

Banking system will continue to support economic growth as indicated by sound capital position and high liquidity holding. However, private sector credit is forecasted to remain slow, going forward.

The fiscal position is expected to remain in surplus at the end of 2017 with increase in recurrent revenue collection and tighter expenditure control. It is also anticipated that there will be no further borrowing from now until the close of the year.

### Inflation

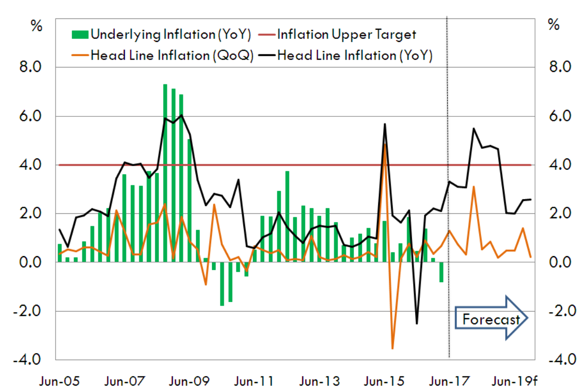
Price stability is one of the monetary policy objectives of the RBV. The Bank aims to maintain inflation rate within the range between 0-4 percent. Year-on-year Inflation rose to 3.3 percent in the second quarter of 2017 following a 2.1 percent increase in the first quarter of 2017.

[4] MEC meeting (August) took place before the publication of June quarterly review, thus the August-2017 forecasts used here; MEC will review the forecast figures in the next meeting in November

Inflation rose by 1.3 percent relative to the March quarter 2017. This upward trend was mainly fuelled by increase in price of transport, food (in particular high prices of fruits and vegetables in both Port Vila and Luganville) and housing utilities (mainly high electricity supply charges in Port Vila). Recreation prices on the other hand, dropped. The higher transport and electricity prices reflected the lagged effect of higher fuel prices in the first half of 2017. However, the high fuel price is expected to ease off over the course of the September quarter considering the weak international fuel and food prices over the June quarter. The Vatu exchange rate regime continues to provide cushion on imported costs.

Projected domestic inflationary pressures is mainly sourced from expected increased food prices and the impact of the proposed implementation of the increase in Value-Added-Tax (VAT) on goods and services from 12.5% to 15% effective January 2018. In the medium term, inflation is expected to remain within RBV's annual inflation target range of 0-4 percent, and increasing temporarily above the target range in 2018. Annual inflation is projected around the 3 percent level range for the year-ended 2017 period, increasing to above 4 percent in 2018 before receding to a projected 3-4 percent level range in 2019.

**Figure 3: Inflation forecasts (given their respective q-o-q% change projections)**



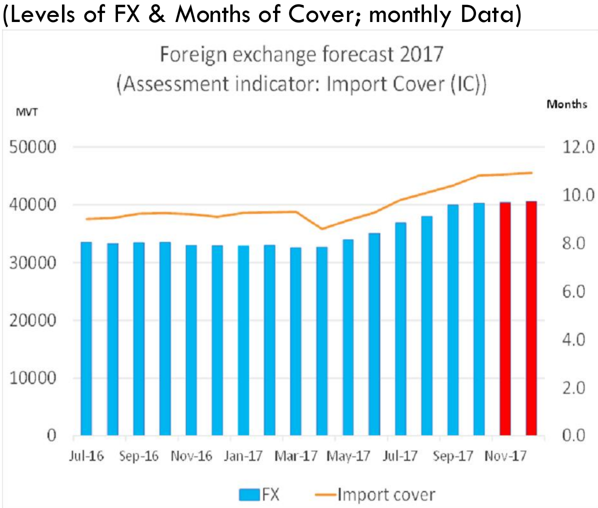

Source: VNSO, Real Sector Staff forecasts

#### b. Balance of Payments and International Reserves

Due to Vanuatu's small open economy and high dependency on import, the Reserve Bank is mandated to maintain an adequate level of foreign reserves, thus a threshold of at least 4 months of import at any one time. Official foreign reserves are sourced mainly from donor funding towards development projects and other inflows. Over the last six months build-up in net foreign assets by Other Depository Corporations (ODCs) and the RBV helped to offset the trade deficit. *Figure 4*, depicts a conservative forecast for Vanuatu's official foreign exchange holdings and months of import cover. It is expected that months of import cover will remain above the threshold of 4 months at the end of 2017.

The outlook for the rest of 2017 remains favourable. Pressures on foreign exchange are expected to increase, both to finance imports relating to infrastructure projects and for servicing external public debt. It is also worth noting that even if the inflows associating with donor funded projects are excluded from the total foreign reserves, the months of import cover will remain sufficient and above the threshold of 4 months of import cover.

**Figure 4: Reserves and Months of Import Cover**
(Levels of FX & Months of Cover; monthly Data)




## 5.0 Monetary Policy Stance

Monetary policy remains accommodative even though policy tightening has begun in some advanced economies and signs of gradual tapering in the United States and the Euro Area. At its July 2017 Federal Operations Market Committee (FOMC) meeting, Fed deliberated on the timing of reducing its securities holdings with an aim to reducing balance sheet. There is expectation that Fed will increase its interest rate by 25bps rate before end of 2017. In Europe, moderate improvements in economic conditions and an appreciation of Euro exerted downward pressure on inflation and weighed heavily on European Central Bank (ECB)'s monetary stance going forward. Accordingly ECB has maintained its benchmark interest rate at 0.0 percent. Similarly, both Australia and New Zealand made no change to their cash rates.

Considering the international and domestic economic developments, the Board of the Reserve Bank of Vanuatu made no changes in its monetary policy stance and agreed as follows:

- The rediscount rate is now set at 100 basis points above the 91 days RBV Notes interest rates as during the first week of September.
- The secured advance facility interest rates is set at 250 basis points above the current 91 days RBV Notes.
- Government overdraft is based on the secured advance facility interest rates.
- The interbank rate is 50 basis points below the rediscount rate based.
- Interest paid on Government current account deposits is aligned to the interest rates on the 91 RBV notes rate during the first week of September which is at 1.85 percent. SRD and LAR were maintained at 5 percent, respectively.
- The ISEF & DCIR remained active.
- The RBV has tighten its open market operation to sterilize excess liquidity in the system.
- That the RBV reviews its policy rate again in December 2017.

The Reserve Bank will be monitoring conditions and will respond appropriately if macroeconomic and financial conditions change.

**Reserve Bank of Vanuatu, Monetary Policy Stance**
**A Chronology (in reverse order)**

| Effective Date | Financial/Economic Situation | Monetary Policy Stance |
|---|---|---|
| September 2016 | Maintain March 2016 policy stance | • Accommodative Policy stance |
| March 2016 | Aligning interest rate policy changes approved by the Board in March 2015 meeting. | • The rediscount rate is now set at 100 basis points above the current 91 days RBV Notes interest rates.<br>• The secured advance facility interest rates is set at 250 basis points above the current 91 days RBV Notes. |
| March 2015 | Major Monetary Policy changes were undertaken following damages from Cyclone Pam: | - Reduced reserve requirements from 7 percent to 5 percent.<br>- The RBV policy rate reduced from 5.5 percent by linking the rate to the RBV 91-day rate. As the 91-day rate stood at 1.9 percent, this amounted to a large reduction in the policy rate. |
| | - The extent that losses arising from the impact of TC Pam were expected to erode a significant component of the sources of economic growth in 2015. | - The RBV expanded collateral for borrowing under the RBV secured advance facility so that banks that are affected can be assisted with liquidity |
| | To address a liquidity constraint in some of the banks following the Government decision to pay out 20 percent of members fund in the Vanuatu National Provident Fund. | - RBV called the banks to assess the domestic banking sector immediately following the cyclone. |
| | To safeguard stability and market confidence. | - RBV assured the banking system that it stood ready to meet their currency needs immediately after the cyclone.<br>- The RBV agreed with the IMF for balance of payment support under the IMF's Rapid Credit Facility and Rapid Financing Instrument. |
| | To safe guard foreign reserve levels. | - The RBV developed a disaster credit facility under which it can lend to all businesses to assist with reconstruction. |
| | To support business sector recovery after TC PAM. | Total of VT40 million was approved, of which VT30 million was given to the |
| | The RBV also approved and provided financial assistance to the Government for | Government for Pam reconstruction and rehabilitation of schools, while VT10 million was administered by the RBV as direct |

| | | |
|---|---|---|
| | reconstruction and rehabilitation purposes after Cyclone PAM. | assistance towards designated needs. |
| June 2014 | To address the uneven distribution of Liquidity in the Banking system | Reduction of liquid Asset Ratio from 7 percent to 5 percent. |
| March 2014 | Three policy changes were approved:<br>- Change in the level of excess reserves of commercial banks which the RBV targets in its conduct of monetary policy<br>- Review the average import figure used to calculate months of import cover to reflect current developments in the trade sector<br>- Maintained the current inflation framework of the Bank to achieve annual growth in the CPI- based inflation within the range of 0.4 percent. | Rediscount Rate remained at 5.5 percent |
| March 2013 | Relaxation of monetary control to accommodate for low inflation, private sector credit and economic activity | Rediscount Rate reduced to 5.5 percent. |
| August 2011 | Still too much excess liquidity in the domestic banking system<br>- World economy begins to show tentative signs of recovery | SDR requirements increased from 6 percent to 7 percent, Rediscount rate remains at 6.00 percent |
| August 2010 | High level of liquidity in the system – domestic sector recovery is happening | SRD requirements increased from 5 percent to 6 percent, Rediscount rate remains at 6.00 percent |
| January 2009 | Low level of liquidity in the system coupled with possible slowdown in some sectors of the economy given the continued world economic meltdown | SRD requirements reduced from 8 percent to 5 percent, Rediscount rate remains at 6.00 percent |
| November 2008 | Monetary Policy Loosening with the aim of increasing liquidity in the market | SRD requirements reduced from 10 percent to 8 percent rediscount rate remains at 6.25 percent. |
| September 2008 | | Rediscount rate increased 25 basis points to 6.25 percent |
| November 2007 | | Rediscount rate reduced to 6.00 percent. LAR reduced further to 8%. |
| February 2005 | | Rediscount Rate reduced to 6.25%. |
| January 2004 | | LAR reduced from 15 percent to 12 percent. |
| December 2001 | | Rediscount rate reduced to 6.50%. |
| February 2000 | | Reintroduction of the foreign exchange guidelines. |

| | | |
|---|---|---|
| October 1999 | | Removal of guidelines of foreign exchange dealings. |
| May 1999 | | Secured Advance Facility was abolished. Rediscount facility and Repurchase Agreement amalgamated, rate remained 7.00 percent. |
| April 1999 | Liquidity falls back to comfortable level after the crises. | SRD requirements rose to 10 percent. PRA abolished. LAR introduced at 15 percent. |
| February 1999 | Excess liquidity rose, the aftermath of the VNPF riots. | RBV gradually phasing out the PRA and introduced SRD again. SRD remains at 6percent and PRA at 10 percent |
| December 1998 | Still a result of the VNPF Liquidity crises | The RBV introduced the Rediscount and Repurchase Agreement facility at an interest rate of 7.00 percent |
| November 1998 | VNPF Crisis cools down and liquidity almost return to normal | RBV starts gradually phasing out the PRA and reintroduce SRD. PRA was lowered to 10 percent and SRD was reintroduced at 6.0 percent. |
| April 1998 | VNPF payout financed by issuance of Government bond. Too much Liquidity in the system due VNPF riot and withdrawals of member funds – approximately VT3.3billion liquidity injection | 16 percent Prescribed Reserve Asset (a special form of Liquid Asset Ratio) replaces the 10 percent SRD<br>The secured advance facility increased to 11.97 percent. |
| March 1998 | The VNPF crises raises fear of capital outflows. This saw months of import cover reduced to less than four months. | Devaluation of Vatu currency by 20 percent. Three days later the Vatu currency was revalued.<br>The RBV commenced its first issue of 91-day RBV note.<br>RBV introduced temporary guidelines on foreign exchange dealings to Banks, that foreign exchange request would be honoured for current transactions while capital transactions are to be settled by the Bank. |

| | | |
|---|---|---|
| January 1998 | Vanuatu National Provident Fund Crisis begins | SRD remained at 10 percent. |
| 1991-1997 | Presumable the most stable period in the monetary and financial history of Vanuatu – relatively high economic growth | SRD remained unchanged at 10 percent |
| February - June 1988 | Wide fluctuations in liquidity and other difficulties faced in the banking sector. Excess liquidity is a concern | First minimum reserve ratio introduced at 10 percent |
| March 1987 | Commercial Banks tended to think the informal guideline was fully abolished that interest rates rise again | Issuance of firmer informal guideline to control interest rate spread –especially in productive sectors of the economy |
| 1985-1986 | Need to encourage export (copra & cocoa and other services including tourism) | Series of Currency Devaluation |
| February 1985 | Increasing number of doubtful debts in the banking sector and absence of bankable projects | Intended to gradual abrogate the informal guidelines by first revoking restrictions to interest rates spread |
| 1981 -1985 | After Independence - A period of low liquidity, low economic growth and high interest rates spreads – RBV need to channel credit into productive sectors of the economy | Direct control/guidelines to credit rather than market-based policy instruments implemented (informal guidelines adopted)<br><br>The secured advance facility was at 10.97 percent |

We will continue to update this table in our next issue of Monetary Policy Statement