RESERVE BANK OF VANUATU

HALF YEAR MONETARY POLICY STATEMENT

March 2018

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Half-Yearly Monetary Policy Statement

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1.0 Statement by Governor

The Reserve Bank of Vanuatu (RBV) is charged with the responsibility to formulate and implement monetary policy in Vanuatu. The Reserve Bank of Vanuatu (RBV) Board of Directors (BOD) in its meeting of 11th April 2018 decided to slightly increase the policy interest rate from 2.85 percent to 2.90 percent[1] as well as increased the Statutory Reserve Deposits (SRD) by 0.25 percent to 5.25 percent, but maintained the Liquid Asset Ratio (LAR) at 5.00 percent.

In considering this decision, the BOD noted that the global activities continued to strengthen, supported by increased economic activities in both Advanced Economies (AEs) and Emerging Markets and Developing Economies (EMDEs). This growth comes at the back of stronger global household income, improved labour markets and demand. The global economy is projected to increase by 3.9 percent in 2018 and 2019. Growth for AEs is estimated to have improved by 2.3 percent in 2017 and to continue this trend in 2018. In EMDEs, growth is estimated to have improved by 4.7 percent in 2017 supported by key Asian economies, as well as notable recoveries in Russia and Brazil following recessions experienced in the previous year. EMDEs are projected to expand by 4.9 percent in 2018. Growth remains strong among certain Pacific island states and expected to expand by 3.3 percent in 2017 and by 3.4 percent in 2018 according to IMF Fall 2017, Regional Outlook. Risks to the global outlook remain and include amongst others; financial market corrections, high debt levels in some countries, policy and political uncertainties as well as extreme weather events. The current global economic conditions have created an opportunity for structural reforms including increasing the output levels to create inclusive growth.

Domestically, the macroeconomic fundamentals remained sound. The Real economic output remained stable. Economic growth is forecasted at 4.5 percent in 2017, supported by expansion in infrastructure development projects. As the infrastructure projects wind up, economic growth is projected to recede to 3.4 percent in 2018 and further drop to 3.2 percent in 2019. The agriculture and other services sectors are also performing well.

Domestic inflation decreased slightly to 3.2 percent in Quarter 4 2017 from 3.5 percent in Quarter 3. It is projected to exceed the policy target band of 0-4 percent in 2018 due to the increase in Value Added Tax (VAT) from 12.5 percent to 15.0 percent effective as of 1st January 2018. The inflation, is however, forecasted to naturally fall back within the target band at the end of 2019.

Official foreign reserves are at a comfortable level, sufficient to cover 11.2 months of import cover at the end of December 2017 and projected at 10.3 months at the end of March 2018. Furthermore, official foreign reserves (excluding donor funds) are forecasted to remain comfortably above the 4 months of import cover threshold throughout 2018. Accordingly, official foreign reserve is expected to remain comfortable above the threshold limit of 4 months of import cover throughout the rest of 2018. Funding from donors towards development projects and inflow of funds via the banking system, make up the main sources of the reserves build-up. Nonetheless, the BOD took heed of Vanuatu's looming larger external public debt repayment obligations and its potential repercussions, especially the pressure on the official reserves.

Monetary and financial conditions appear to be well supportive of growth. Banking sector continued to maintain a sound capital position, sustainable earnings and relatively high liquidity holdings. The BOD also took note of slight improvement in private sector credit growth and high interest rates spread amidst the elevated level of excess reserves.

The Government's fiscal position was favourable at the end of 2017[2]. The forecasted revenue and expenses for 2018 are set within the reasonable limits, thus, seemed to indicate that 2018 fiscal position will also be favourable.

Based on the above assessment, the BOD resolved that gradual withdrawal of liquidity is necessary going forward considering the continuous built up of excess liquidity in the banking system and to curb inflation.

The next statement is expected to be released in September 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 March 2018 was 1.9 %

[2] Data collected from Department of Finance and Treasury

2.0 Monetary Policy Objectives

The RBV is responsible for the formulation and implementation of monetary policy in Vanuatu. Through the 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 RBV strives to keep year-end inflation rate contained between 0-4 percent and to hold international reserves at a minimum threshold level of 4 months of Import Cover.

The monetary policy stance is reviewed bi-annually on the basis of international and domestic developments and their associating impact on RBV's outlook for inflation and foreign reserves.

Over the past six months both these targets have been comfortably met. At the end of March 2018, foreign reserves is projected to sit above the minimum threshold of 4 months of import cover at approximately 10.3 months. The forecast for 2018 shows that import cover threshold will be met, however, domestic inflation is forecasted to exceed the 0-4 percent target range in 2018. Inflation is expected to increase further from 3.5 percent reported in Quarter 3 2017. This is mainly due to inflationary pressures beyond the RBV's control.

The RBV has kept its accommodative monetary stance and left its policy rate steady at 1.85 percent and Statutory Reserve Deposit (SRD) at 5.00 percent since 2015 to engender growth which had been adversely affected by natural disasters. In April 2018 the BOD signalled a change in policy and approved a change in the policy rate to 2.90 percent and SRD ratio to 5.25 percent.

3.0 International and Domestic Economic Overview

The global economic activities are estimated to have improved in 2017 compared to 2016. Economic growth for 2017 was revised upward owing to expected stronger performance in Europe and Asia.

In its January 2018 World Economic Outlook (WEO), the International Monetary Fund (IMF), revised upward estimated Global output to 3.7 percent in 2017[3] slightly higher than October 2017, WEO forecast of 3.6 percent. For Vanuatu, National Statistics Office (VNSO) revised downward 2015 growth from earlier 1.6 percent to 0.2 percent, and estimated growth for 2016 at 3.5 percent. The Vanuatu Macroeconomic Committee (MEC) forecasted 2017 growth at 4.0 percent.

3.1 The International Economy Development & Outlook

The global economic outlook continued to strengthen compared to earlier projections by IMF, as economic activities increased due to increasing demands. Risks remained tilted to downside in the medium and inflation expected to rise slightly

The global activities continued to strengthen, supported by increased economic activities in both AEs and EMDEs. This growth came at the back of stronger global household income, improved labour markets and demand. The global economy is projected to increase by 3.9 percent in 2018 and 2019, respectively.

Growth for AEs was estimated to have improved to 2.3 percent in 2017 from 1.7 percent in 2016, supported by the strong growth in US, Japan and Euro area. The US economy is expected to expand by 2.4 percent in 2017 and forecasted to expand by 2.7 in 2018 due to changes in its tax policies, especially corporate income tax cuts which may boost investment. Japan is expected to expand by 1.8 percent in 2017, but the growth is expected to recede to 1.2 percent in 2018. Similarly, the Euro area is expected to expand by 2.4 percent in 2017, however, will fall to 2.2 percent in 2018.

In EMDEs, growth is estimated to have improved to 4.7 percent in 2017 supported by key Asian economies, as well as notable recoveries in Russia and Brazil following recessions experienced in previous year. EMDEs are projected to expand by 4.9 percent in 2018. China is expected to expand by 6.8 percent in 2017 and to improve further to 6.8 percent in 2018. Nevertheless, China still faces a large credit gap. Asia's export is forecasted to grow on the back of the upswing in other regions including; US, Euro area, Japan and China.

The Pacific Island States growth forecast by IMF improved compared to 2.6 percent in 2016 to 3.3 percent in 2017. The growth for the region is forecasted to remain strong and forecast expand by 3.4 percent in 2018.

Risk and vulnerabilities facing global economy are tilted to downside.

Risks to the global outlook remain and include amongst others; tightening of financial conditions, retreat from global integration, geo political uncertainties, high debt levels in some countries, policy changes as well as extreme weather events. The current global economic conditions also created an opportunity for structural reforms including increasing the output levels to create inclusive growth.

[3] January 2018 IMF world economic outlook

Global Inflation remained muted throughout 2017, slight increase expected going forward

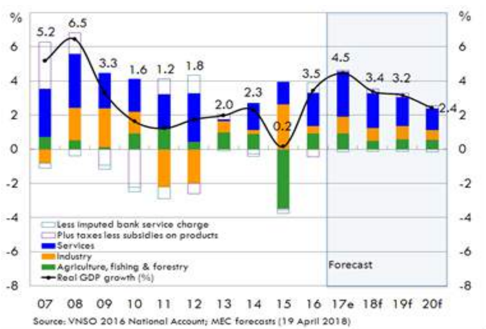
Crude oil prices have increased by 20 percent between August 2017 and mid-December 2017 and expected to further increase. This increase raised headline inflation in AEs, but wage and core price inflation remained weak. Headline and core inflation, among EMDEs picked up slightly compared to 2017 during early months of 2018. In the US, inflation is expected to be muted due to less sensitivity of core price pressures.

3.2 The Domestic Economy Development & Outlook

Domestic economic growth was revised downward for the year 2015 from 1.6 percent to 0.2 percent. 2016 growth is expected to be at 3.5 percent while improvement forecasted for 2017 compared to 2016.

According to the recent 2016 National Accounts Reports published by the Vanuatu National Statistics Office (VNSO), the domestic economy grew 3.5 percent in 2016 from 0.2 percent in 2015. The Macroeconomic Committee in its April 2018 meeting projected the economy to grow by 4.5 percent in 2017, 3.4 percent in 2018 and 3.4 percent in 2019.

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



Domestic economy forecasted to expand in 2018 by 3.4 percent, largely supported by services and industry sectors

The projected 3.4 percent growth for 2018 is driven by on-going construction activities associated with public infrastructure investment projects. The industry sector is projected to increase by 7.0 percent in 2018 from 9.5 percent growth in 2017, with construction picking up by 9.4 percent in 2018 from 13.8 percent growth in the previous year.

Services sector is projected to increase 3.1 percent in 2018 supported by spill-over effect of ongoing donor-funded projects and tourism. Ongoing improvement in tourism activities is expected to be boosted by a projected increase in tourism arrivals, particularly air visitor arrivals driving activities in other services sector up.

On the other hand, the Agriculture sector is projected to increase by 2.7 percent in 2018 compared to 5.1 percent in the previous year. This is supported by persistently high demand; however, the trend may slow down from previous year due to weakening export commodity prices (beginning 2018) and unfavourable weather conditions and impacts of cyclones affecting productivity. The slowdown in Agriculture sector is driven by crop production (2.5 percent); animal production (3.2 percent), while forestry is projected to improve by 3.5 percent and fisheries to remain strong at a projected growth of 4.2 percent.

Table 1: Real GDP Growth (%)

Sector	2016	2017e	2018f	2019f
Agriculture, Fisheries and Forestry	5.1	5.1	2.7	3.1
Industry	4.2	9.5	7.0	7.0
Services	2.9	4.0	3.1	2.6
Total GDP	**3.5**	**4.5**	**3.4**	**3.2**

Source: VNSO 2016 National Accounts, Macroeconomic Committee Forecast (April 2018)

Private sector credit growth expected to remain weak in the medium term in view of current economic development

The banking system remained well supportive of growth as evidenced by high liquidity holdings and sound capital position. Money growth picked up at the end of 2017 relative to 2016. This increase was driven mainly by persistent accumulation of net foreign reserves, increase in government's spending towards the end of 2017 and a slight growth in loans extended to the private sector. The growth in private sector credit was driven mainly by loans extended to the household and individual sectors for commercial purposes remained low.

Fiscal surplus recorded for year 2017 and expansionary fiscal policy for 2017/2018 continued to support growth

The central government recorded a fiscal surplus over the year from January to December 2017. This good performances mainly reflected stronger tax collections and high non tax revenue mainly from the citizenship programs relative to 2016. Though government expenses in 2017 is higher than 2016, due mainly to spending associated with the severance package and other obligatory expenses, spending is controlled and in line with the 2017 budget target.

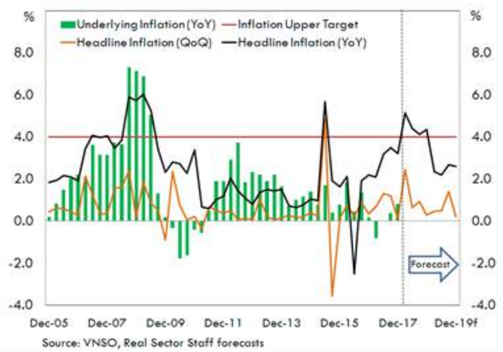
4.0 Monetary Policy Objectives: Results and Outlook

a. Inflation

In the medium term, annual inflation is projected to increase temporarily above 4 percent throughout 2018

Price stability is one of the monetary policy objectives of the RBV. The RBV aims to maintain inflation rate within the range between 0-4 percent. The fourth quarter year-on-year Inflation was 3.2 following a 3.5 percent increase in the third quarter of 2017. Inflation rose 0.1 percent relative to the September quarter 2017. (Refer to figure 3).

Figure 3: Inflation forecasts



Source: VNSO, Real Sector Staff forecasts

Annual inflation was mainly fuelled by increase in price of food and the recent pickup in fuel prices driving the prices for transport (mainly international airline tickets and petrol prices) up despite a decline in prices for electricity. On the other hand, recreation prices dropped while communication prices remained relatively low. The decline in imported commodity prices towards the third quarter had a lagged effect on domestic prices offsetting the increase in headline inflation, as domestic food prices started to ease off after months of high prices. The VATU exchange rate regime continues to provide cushion on imported costs.

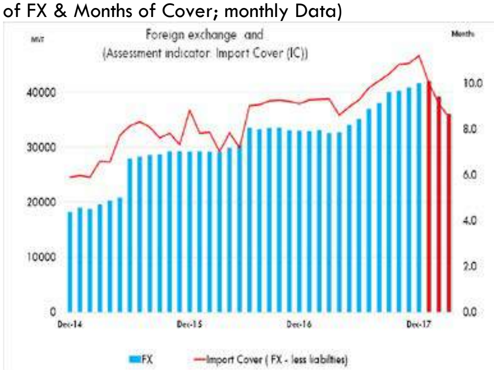
Projected domestic inflationary pressures in 2018 is mainly sourced from the impact of the implementation of the increase in Value-Added-Tax (VAT) on goods and services from 12.5% to 15% effective as of January 2018. In the medium term, annual inflation is projected to increase temporarily above 4 percent throughout 2018 before receding to a projected 2-3 percent level range in 2019.

b. Balance of Payments and Foreign Reserves

Foreign reserves continued to grow and outlook for 2018 as well as in medium term remained favourable

Due to Vanuatu's small open economy and high dependency on import, the RBV is mandated to maintain an adequate level of foreign reserves, a minimum threshold of at least 4 months of import at any one time. The excess of foreign currency in the overall banking system over the last six months, has contributed to an accumulated stock of VT40 billion worth of foreign exchange at the end of March 2018, supported largely by the accumulation of net foreign assets by Other Depository Corporations (ODCs) and the RBV. Most inflows came through the Government development project financing and other services. It is expected that months of import cover will remain above the threshold of 4 months at the end of 2018.

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



The outlook for the rest of 2018 and for medium term remained favourable. Pressure on foreign exchange are expected to increase, both to finance imports relating to infrastructure projects and for servicing external public debt. Nonetheless, the months of import cover will remain sufficient and above the threshold of 4 months of import cover even if the inflows associating with donor funded projects are excluded from the total foreign reserves.

5.0 Monetary Policy Stance Decision

The RBV envisages gradual withdrawal of excess liquidity from the system

Since the last meeting of MPC and Board of Directors in September 2017, monetary policy stances in both the AEs and EMDEs generally remained accommodative. The US Federal Reserve raised the target range for the federal funds rate by 25 basis points to 1.50-1.75 percent. The

European Central Bank (ECB), on the other hand, has maintained its benchmark interest rate at 0.0 percent. Similarly, both the Reserve Bank of Australia and the Reserve Bank of New Zealand made no changes to their policy cash rates.

Considering the recent international and domestic economic developments, the BOD agreed to a gradual tightening of monetary policy stance:

- The Statutory Reserve Deposit (SRD) was increased by 0.25 percent to 5.25 percent from 5.0 percent;
- The 91 days RBV Notes interest rate was increased to 1.90 percent;
- Interest paid on Government current account deposits changed and aligned to 91 days RBV Notes interest rate of 1.90 percent;
- The RBV rediscount rate, charged at 100 basis points above the 91 days RBV Notes interest rate, has been raised to 2.90 percent;
- The RBV secured advance facility interest rates changed and set at 250 basis points above the 91 days RBV Notes interest rate;
- Government overdraft is based on the secured advance facility interest rates;
- Liquid Asset Ratio (LAR) continued to be maintained at 5 percent;
- The Import Substitution and Export Financing Facility (ISEFF) & the Disaster Financing Credit Facility (DRCF) remained active.

The Reserve Bank will remain vigilant to changes in international and domestic developments that may have a potential impact on the Vanuatu economy and the monetary policy settings of the RBV.

6.0 Conclusion

Global growth continued to strengthen in 2017 while short term risks remained broadly balanced. The IMF outlook for 2018 expected world economic conditions to maintain the growth momentum from 2017. Advanced economies are expected to continue a positive performance, largely supported by Euro area. Activities in the EMDEs are expected to strengthen, supported largely by China and other key Asian countries.

On the domestic front, the Vanuatu economy is expected to perform better in 2017 and forecasted to expand by 4.5 percent and to stabilise above 3 percent in 2018/2019.

Of the two main policy targets, inflation is forecasted to exceed 4 percent in 2018, however, foreign reserves are anticipated to remain well above the minimum threshold of 4 months of import cover in 2018.

The RBV will continue to monitor both domestic and international developments and bring into line monetary policy where necessary.

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