RESERVE BANK OF VANUATU

HALF YEAR MONETARY POLICY STATEMENT

September 2020

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1. Statement by Governor

The global economy experienced the largest downturn in 2020 as a result of the outbreak of the COVID-19 and lockdown measures to contain the spread of the virus. Many developed countries experienced sharp economic contractions in the first half of the year, led by the US and Euro Area, where infection rates were highest. While global economic conditions have improved in response to relaxed lockdown measures in a number of countries, the global economic outlook remained uncertain as infection rates and the health risks have not decreased. However, conditions in the global financial markets have stabilized following significant volatilities during March 2020 and financial conditions have remained accommodative with major central banks maintaining interest rates at all-time lows.

While Vanuatu has remained COVID-19 free to date, the economic fallout that ensued from the preventative measures to avert transmission of the virus has been severe. International travel restrictions led to major delays in the implementation of key public infrastructure projects and a sudden stop in international tourists' arrival from March 2020, led to economic contraction and rise in unemployment. The impact was exacerbated by a category five cyclone Harold that inflicted massive devastations to Vanuatu's agriculture sector in the northern part of Vanuatu in April although reconstruction efforts have countered some of its adverse impact on the domestic economy. The domestic economy was estimated to have contracted by 4.1 in 2020. A quick turnaround has been forecasted for 2021, but significant downside risks to the economic outlook remain, especially since the infection rate of the COVID-19 internationally have not abated and the border shut downs may continue unless a vaccine is made available.

The Government's fiscal position has remained strong with sufficient fiscal buffers despite the Government's fiscal stimulus designed to counteract the twin shocks, has helped cushioned their economic impact. Monetary conditions have remained accommodative following the Reserve Bank's further relaxation of its monetary policy stance in March 2020. The banking system has been affected but remained resilient with sufficient liquidity, well capitalised and the quality of banks' loan portfolio healthy, with more than 80 percent of the total loan portfolio comprising standard loans as at end August 2020. However, a more complete picture of their loan portfolio will emerge after the banking industry's instigated loan repayment deferment has lapsed in March 2021.

The Reserve Bank continued to achieve its twin targets for monetary policy, and it remains committed to achieving them over the medium term. The Reserve Bank will continue to monitor international and domestic economic and financial developments and stands ready to safeguard macroeconomic stability.

Simeon M ATHY
Governor
The Reserve Bank of Vanuatu

2. Objectives of the RBV

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 Reserve Bank 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 Reserve 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.

3. International and Domestic Overview

3.1 The International Economy

The global economy weakened substantially since the release of the March 2020 half-yearly monetary policy statement. The harsh preventative measures, including travel bans and strict lockdown measures, implemented by countries across the globe to prevent the spread of the COVID-19 pandemic has significantly disrupted global economic activities and industrial production chains during the first six months of 2020. The International Monetary Fund (IMF) cut its global GDP estimate twice in a short period during April 2020 (-3.0%) and June 2020 (-4.9%) to reflect the slump in the global economy. According to the IMF, the COVID-19 induced global economic contraction is larger and more widespread than the global economic contraction during the Global Financial Crisis in 2008-2009. As the number of new COVID-19 infections continues to increase across the world, a number of major countries have started to ease lock down measures and allowed economic activities to resume.

Economic performances in Vanuatu's main trading partner countries have shown marked weaknesses in growth in the second quarter of 2020, some recording double digit contractions. In the US, the economy shrank by - 31.4 percent in the second quarter of 2020. In Australia, the economy contracted by -7.0 percent in the second quarter after it registered a -3.0 percent drop in the first quarter. New Zealand and the Euro Area both registered double digit negative GDP growth growths of -12.2 percent and 11.8 percent, respectively.

Conditions in the global financial markets have stabilized after sharp falls in the global equity markets and bond yields pushed to record lows due to fears generated by the COVID-19 pandemic. Financial market conditions have remained accommodative. After having cut interest rates aggressively in the first half of 2020 major central banks continued to keep interest rates at all-time lows to spur economic activities.

The Domestic Economy

The closure of Vanuatu's boarders to international travel to prevent the spread of the COVID-19 pandemic into the country led to delays of planned implementations of major public infrastructure projects and a sharp fall in international visitor arrival numbers that led to closure or reduction in activities of businesses and lay-offs especially in the hotels and tourism sector. On top of the impact of COVID-19 pandemic, the norther part of Vanuatu, which hosts the majority of Vanuatu's agricultural production and export commodities, was hit by severe Tropical Cyclone (TC) Harold, inflicting significant damages to the country's agriculture sector. In March

2020, the Macroeconomic Committee (MEC) revised its 2020 forecast for the domestic economy downward from 3.8 percent to 1.9 percent, to 0.6 percent in May, and -4.1 percent in September following the devastation caused by TC Harold. The fallout from the combined effect of the COVID-19 and TC Harold[1] provided a negative economic outlook for the domestic economy for the remainder of the year. Growth in the services sector weakened substantially led by the decline in activities in tourism-related services sectors from the fall in visitor arrivals after March 2020 following the closure of Vanuatu's border to international travel. The loss of jobs and business revenues from the combined disasters had a weakening effect on domestic demand. Likewise, the agricultural output was significantly affected by damages to the productive sectors of northern provinces following TC Harold. Although, support to the industry sector proceeded from construction activities related to post-cyclone reconstruction, the industry sector was also adversely affected by delays in implementation of major public projects owing to the border closures.

Domestic monetary conditions have remained conducive to growth, though the money supply growth has stabilized due to offsetting weak growth of private sector growth and improving Government net lending position with the banks. Private sector credit continued to register negative year ended growth, reflecting both ongoing book management by banks and weak demand for credit. The quality of the banking industry's loan book deteriorated in the second quarter of 2020 as non-performing loans (NPLs) increased by 5.3 percent to VT9.6 billion. However, the majority (83.6%) of the industry's total loan portfolio remained as standard loans. In response to the COVID-19 induced crisis, commercial banks in Vanuatu implemented a 6 months' loan repayment holidays for their clients which partially ends in September 2020.

The year-on-year inflation rate dropped to 3.0 per cent in the March quarter of 2020 from 3.4 percent in the December quarter of 2019, reflecting weaker food prices. Inflation is expected to remain stable at around 3.1 per cent in the June quarter. As a result of the post-cyclone supply effect of the TC Harold, food price inflation, mainly driven by root-crops, fruits and vegetable, rose momentarily to a projected 7.6 per cent from 6.7 per cent in the previous quarter. The underlying inflation rate remains subdued from 0.6 per cent in the first quarter of 2020 reflecting the stable prices of other consumer categories and weak demand in the economy.

The external sector continues to be sustained by significant inflows through two major accounts over the first six months of 2020. These were inflows through the Government's Citizenship Program and Tropical Cyclone Harold relief, cushioning the severely affected flows from Trade, Tourism and Foreign Direct Investment (FDI) sectors due to the border closure. As of August 2020, the official reserves stood at around VT60 billion and sufficient to finance around 13 months of import of goods cover.

The Reserve Bank has relaxed its monetary policy stance during March 2020 by cutting its official interest rate, the discount/rediscount rate, from 2.9 percent to 2.25 percent. In addition, the Bank reduced the Capital Adequacy Ratio (CAR) from 12 percent to 10.0 percent and re-activated its credit facilities, the Disaster Reconstruction and Credit Facility (DRCF) and Import Substitution and Export Finance Facility (ISEFF). The

[1] Assessments of the impact of Tropical Cyclone Harold (a Category 5 Cyclone occurred on 4 April 2020 affected mainly the Northern Province) came after the release of March 2020 Monetary Policy Statement.

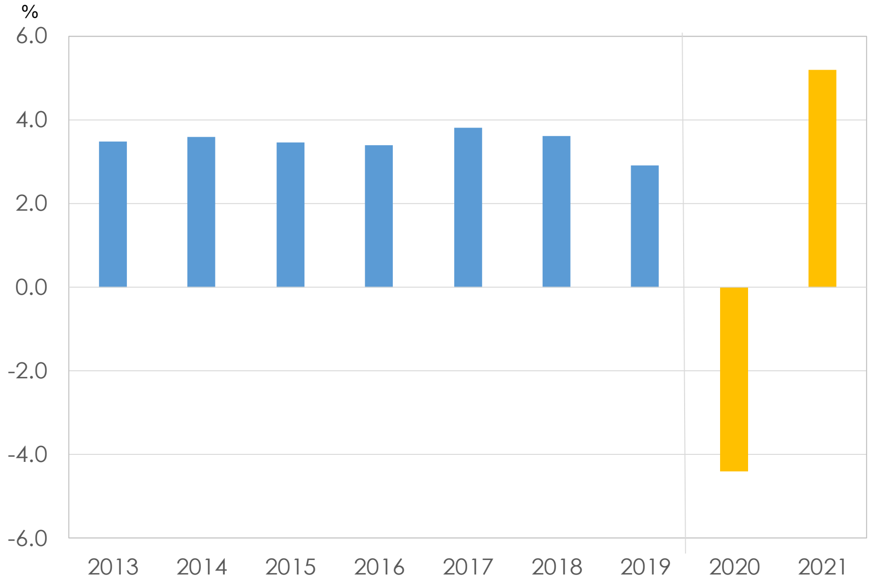
Reserve Requirement Ratio was maintained at 5.25 percent, with commercial banks' minimum Liquid Asset Ratio (LAR) also maintained at 5.0 percent.

4. International and Domestic Outlook

4.1 Outlook for the International Economy

Global economic conditions have started to improve from the major downturns experienced in the first half of 2020 caused by the COVID-19 pandemic and the associated lock down measures to contain the virus. Many countries have eased their lock down measures as they successfully reduced the virus' infection rates. In its release of the October 2020 WEO, the IMF revised its 2020 global GDP forecast up from -4.9 percent in June to -4.4 percent. Regardless of the slight upward revision, the global economic slump in 2020 remains significant.

Figure 1: World Economic Growth (Annual Growth in Percent)



Source: IMF World Economic Outlook, October 2020

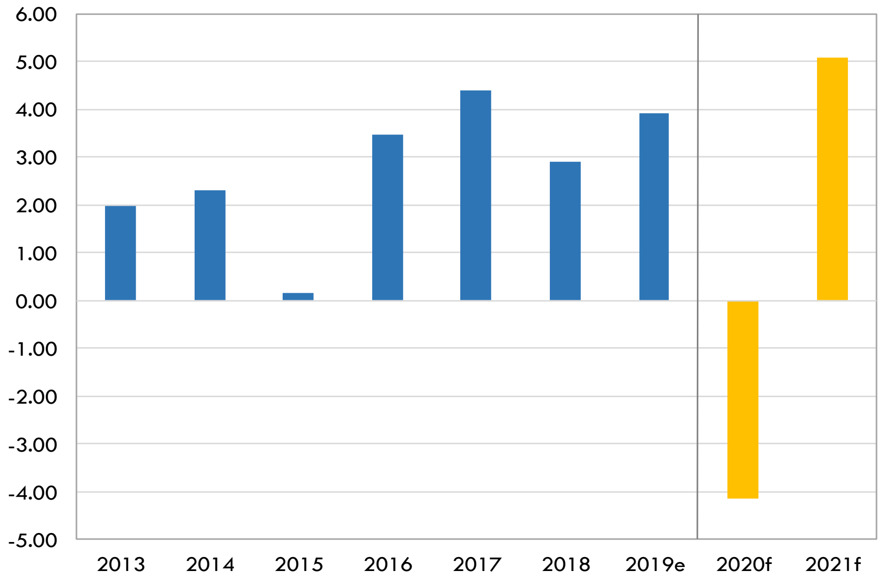
The IMF also anticipated a turnaround of the global economy during 2021, with the global GDP estimated to expand to 5.2 percent. However, significant downside risks to the global economic outlook remain as the health risks have not abated. The COVID-19 infection rate and spread have not decreased. Also, there has been varying degrees of success in controlling the virus, and countries that have eased lock down measures experienced increased infection rates again prompting lockdown measures to be imposed again. However, on the more positive outlook, a number of COVID-19 vaccines are in their final stages of developments testing.

4.2 Outlook for the Domestic Economy

a) Economic Activity

Although Vanuatu has remained COVID-19 free, the shutdown of Vanuatu's international borders has led to a significant drop in tourism activities, limited trade and travel, and caused major delays in the implementation of the majority of major public sector projects as professional personnel such as contractors and engineers were not able to enter the country. The agriculture sector severely impacted by the devastation caused by TC Harold. Consequently, the Macroeconomic Committee revised its 2020 domestic growth forecast down further from 0.6 percent to -4.1 percent on 22 September 2020.

Figure 2: Domestic GDP Growth (Annual Growth in Percent)



Source: VNSO, Macroeconomic Committee

The downward revision primarily affected the services sector which was revised downward to -6.4 percent from a previously projected 0.4 percent growth. Due to the shutdown of Vanuatu's international borders, both air and cruise-ship visitor arrivals dropped significantly by 68 percent in 2020. A number of tourism related services such as hotels and resorts in Vanuatu, including small tourism businesses remained closed and laid off their employees. This had a negative trickled down effect on other sectors of the economy leading to a weakening in domestic demand. On the upside, domestic activity was supported by impulse from the fiscal stimulus and other services. Despite solid growth in the fisheries and forestry sectors, the agriculture sector is expected to contract by -2.0 percent, led by falls in crop and animal productions from TC Harold-related damages. The industry sector is expected to grow by 1.5 percent led by construction activities.

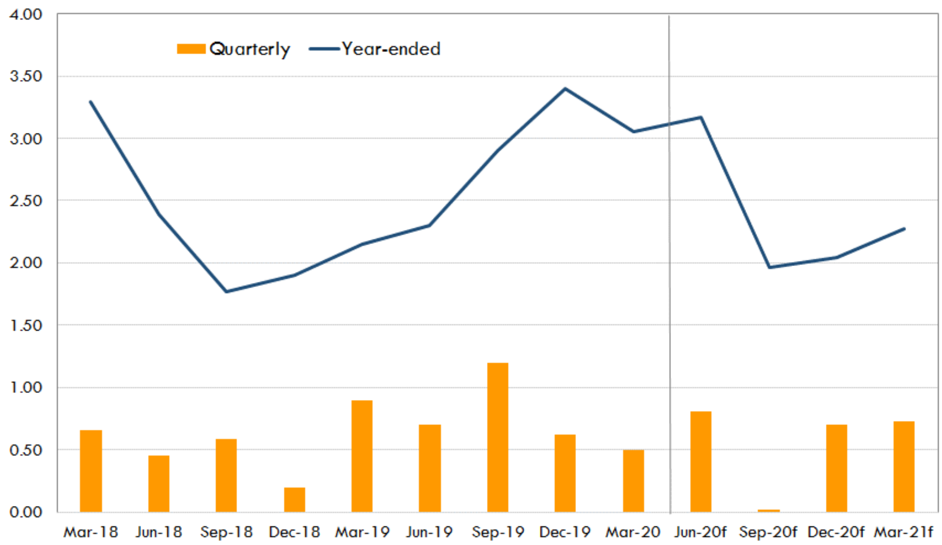
Recovery in 2021, as forecasted by the MEC is projected to be V-shaped with the domestic GDP growth expected to pick up to 5.1 percent as public sector projects are pushed forward to 2021. This projected growth is expected to be broad based with all sectors forecasted to pick up, led by the industry sector with expected growth in construction activities related to implementations of delayed public projects and resumption of TC Harold reconstruction and recovery projects. However, significant downside risks to this growth outlook remains given that the infection rate and health risks of the COVID-19 have not disappeared.

b) Inflation

Vanuatu's annual headline inflation is forecasted to remain within the Reserve Bank's target range of 0 to 4 per cent. Inflation is projected to recede from the current level to below 3.0 percent as from the June quarter, driven by the lagged effect of reduced fuel prices translated into utility and transport costs and the expected recovery phase of increase domestic supply of vegetables and fruits post-cyclone, could ease domestic food prices. Although crude oil prices rose from the level of $20 per barrel in

April 2020 to $41 per barrel in September 2020, the level declined by 34 percent over a year ago.

Figure 2: Vanuatu Consumer Price Index (Percent change, quarterly data)



Source: VNSO; RBV Forecast

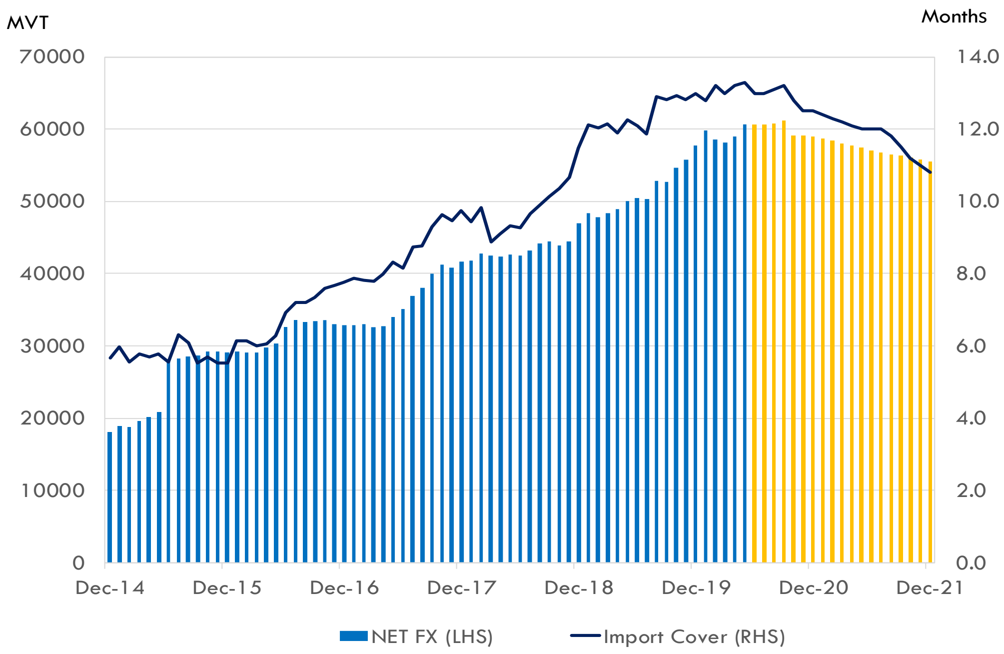
The year-on-year headline inflation is projected to remain between 2 and 3 percent until 2021. Vanuatu's fixed exchange rate regime continues to anchor inflation well and the recent depreciation of the US dollar may offset some pressures from import costs. Inflation risks are broadly balanced. On the upside, a pickup in major project implementation in 2021 will temporarily boost demand pressures from construction-related activities in the domestic economy, thus adding upward pressures on inflation temporarily; however, on the downside, fuel and food prices are projected to remain stable.

c) Balance of Payments and International Reserves

The border restrictions have also affected Vanuatu's balance of payments (BOP). After having achieved positive balances in the past two years, Vanuatu's current account balance has returned to deficit during 2020 as a result of the international border restrictions. Despite this, the official foreign reserves have continued to increase. As of August 2020, the official reserves stood at around VT60 billion, and sufficient to finance around 13.0 months of import of goods cover. The sustainability of the current account balance is important to be achieved.

The external sector has been partially sustained by significant inflows of two major accounts over the first six months; these were inflows through the Government Citizenship Program and TC Harold relief. These inflows continue to cushion the severely affected trade, tourism and foreign direct investment sectors. Vanuatu's external sector has also been sustained by the Government's fiscal policy response through proportioning stimulus packages to effected sectors.

Figure 3: Official Foreign Exchange Reserves and Months of Import Cover



Vanuatu's BOP outlook remains uncertain as the risks of new waves of contagion may continue to negatively affect the major BOP accounts. As long as international borders remain close, the current account balance will continue to be in deficit. However, the official foreign reserves are still expected to remain above the minimum threshold level of 4.0 months of import cover in the short and medium term mainly due to expected further inflows through the Government Citizenship Program.

5. Monetary Policy Stance

The domestic growth contracted sharply in 2020 and was adversely affected from the combined effect of the shut-down of Vanuatu's borders, to prevent the COVID-19 pandemic from entering the country, and the devastating impact of Tropical Cyclone Harold. To mitigate the impacts, both the Government and the Reserve Bank of Vanuatu implemented supportive expansionary fiscal and monetary policies. Consequently, domestic monetary conditions have remained supportive for growth. The banking system liquidity continued to remain at elevated levels and the banking industry remain well capitalised with capital adequacy ratio (CAR) stabilising at 19.6 percent at the end of June against a minimum threshold of 10.0 percent. The Government's fiscal position has remained strong with sufficient fiscal buffers in spite of a large fiscal stimulus. Official foreign exchange reserves continued to remain well above the Reserve Bank's minimum threshold of 4.0 months of import cover; equivalent to around 13.3 months of import cover as at September 2020 and is forecasted to remain sufficient over the medium term. Domestic inflation has remained within the Reserve Bank's target range between 0 and 4 percent as at March 2020 and is expected to trend lower in the next six months due to moderation in the level of domestic demand and falling international crude oil prices.

The key challenge and ongoing downside risks emanates from health risks associated with another wave of the COVID-19 pandemic which would prolong a re-opening of the economy. At the same time, while indicators of resiliency of the banking sector has remained, a full picture of their loan portfolio will only emerge after loan repayment holidays have lapsed. In light of these perceived risks, the Reserve Bank has decided to continue to maintain its current accommodative monetary stance. The Bank's official interest rate (rediscount rate) is maintained at 2.25 percent. Commercial banks' Capital Adequacy Ratio(CAR), Liquid Asset Ratio (LAR) and

Statutory Reserve Deposits (SRD) were maintained at 10.0 percent, 5.0 percent and 5.25 percent, respectively. Nevertheless, a key policy measure taken by the Reserve Bank to date was to approve an extension of commercial banks' loans repayment holiday for their clients beyond September 2020 to end-March 2021. The Reserve Bank's Imports Substitution and Export Finance Facility (ISEFF) and the Disaster Recovery Credit Facility (DRCF) remained active.

The Reserve Bank will continue to monitor international and domestic economic developments and stands ready to respond to any changes in policy settings as and when appropriate.