RESERVE BANK OF VANUATU

HALF YEAR MONETARY POLICY STATEMENT

March 2020

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Half-Yearly Monetary Policy Statement

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1. Statement by Governor

The global economic outlook has weakened significantly as the COVID-19 was declared a pandemic by the World Health Organization (WHO). The global growth momentum has been disrupted as countries implemented shutdowns and lockdowns to prevent the virus' spread. As a result, the global growth slowdown in 2020 will be more significant than previously anticipated. Major central banks have responded by relaxing monetary policy further to cushion the effect of the COVID-19.

On the domestic front, though Vanuatu has not recorded any positive cases of the COVID-19 to date, the preventive measures being implemented by the Government to protect its people from the virus is already having a significant impact on economic output and employment. The domestic economy is forecasted to weaken substantially however, the full impact of the COVID-19 is difficult to assess at the moment due to the uncertainties concerning the duration of its impact both on the domestic economy and the rest of the world. However, preliminary assessments in March 2020 showed that growth could fall significantly from a pre- COVID-19 forecast of 3.8 percent before recovering in 2021. The tourism sector has been the most affected and this could lead to a contraction of the important services sector of the economy in 2020. The agriculture, fishing and forestry sector and the industry sector appear to be less affected at the moment.

The Government's fiscal position has improved over the years, and sufficient fiscal buffers have been maintained. However, this position is expected to change with the forecasted weakening of the economy and the planned implementation of the Government's fiscal stimulus measures to counteract the impact of the COVID-19 on the economy. Monetary and financial conditions have remained supportive of growth. The domestic banking system liquidity remained at elevated levels. Also, the banking system is well capitalised, and commercial banks' asset quality remained healthy with standard loans dominating the total loan portfolios.

Regarding monetary policy, the Bank has continued to achieve its twin targets for monetary policy. Inflation has remained within the Bank's internal target range of 0-4 percent, registering 3.4 percent in December 2019 as compared with 2.9 percent in the previous quarter. The Bank expects the annual change in the consumer price index to remain within its target range in the medium term. The official foreign reserves are sufficient to cover around 13 months of the country's goods and services imports in February 2020 and will remain adequate over the medium term.

The Reserve Bank of Vanuatu and the Government together remain well positioned to respond to the threats to the domestic economy with ample scope to respond through monetary and fiscal policy. The Reserve Bank will continue to monitor economic and financial developments, both international and domestic, and will be ready to respond to safeguard macroeconomic stability.

Simeon M ATHY
Governor
The Reserve Bank of Vanuatu

2. Objective 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 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.

3. International and Domestic Economic Overview

3.1 The international Economy

The trade dispute between the US and China weighed heavily on the global growth momentum, affecting global trade, investments and manufacturing. After having decelerated during 2018, the pace of growth in the global economy has weakened further during 2019. The International Monetary Fund (IMF) had estimated that the global economy grew by 2.9 percent in 2019, down from a 3.6 percent growth in 2018.

The economic slowdown was broad based, affecting advanced, emerging market and developing economies including China. For the advanced economies, economic growth has stabilised in the first six months of 2019 after having weakened in the last six months of 2018. However, some countries have shown some weakening in their growth momentum especially the United States, United Kingdom and the Euro area. In the US, the economic boost from the tax cuts in 2018 have waned while in the UK, the ongoing uncertainties surrounding the Brexit continued to affect investments. Weak exports continued to be a drag on the Euro area. Amongst Vanuatu's trading partner countries, Australia's economy is slowly picking up from its low point in 2018 while New Zealand continued to see slow GDP growth in 2019 as business investment and household spending have been soft.

Financial market conditions have remained accommodative as major central banks continued to maintain easy monetary policy in response to slow economic growth and weak inflation data. A few major central banks have cut interest rates during 2019: the US Fed cut interest rates twice during the year after the rates were raised four times during 2018. With the continued supportive macroeconomic policy in major economies it was expected that the global growth will bottom out in 2019 and then pick up momentum during 2020.

3.2 The Domestic Economy

Vanuatu's economy continued to achieve positive economic performances, recording an estimated 3.4 percent growth in 2019. All sectors of the economy contributed positively to the overall expansion of the economy. The services sector, which accounted for around 65 percent of the domestic gross domestic product (GDP), continued to be the main source of growth. Activities in the services sector expanded by 2.3 percent. Air visitor arrivals have been slow throughout 2019, but picked up in August with Air Vanuatu's additional flights to Brisbane and New Zealand, and new additional flights to Melbourne at the start of the second half of 2019. The industry sector, supported by infrastructure constructions, expanded by 9.2 percent. Construction activities were led by public-sector infrastructure projects and a few private sector projects. The Agriculture sector, which recovered from natural disasters in 2018, grew by 3.7 percent. The sector's growth was driven by a steady pickup in kava production, a pickup in cocoa production, and positive impacts of major ongoing and new Agriculture-related programs.

Private sector credit growth has been weak. At the end of 2019, private sector credit growth grew by negative 1.1 percent, caused by negative growths in loans received by the communications, personal, distributions and tourism sectors. The negative growths were also reflected in lending to both the individuals and households and lending to businesses. Despite the decline in private sector credit growth, the commercial banks' lending portfolio quality have remained healthy with the bulk of the bank loans assets being standard loans. Domestic inflation has remained within the Bank's target range of 0-4 percent. During the fourth quarter of 2019, the annual change in the consumer price index rose to 3.4 percent, up from 2.9 percent in the September quarter. Strong increases in food prices (due to increased prices of domestic market produces) remain the main driver of inflation in Vanuatu. Food inflation rose by 7.2 percent and was very high in the December quarter.

For the last two years, Vanuatu has been recording current account balance surpluses although the goods balance continued to be in deficit as the total value of the country's imports continued to outweigh its exports. The overall balance of payments was in surplus, thanks to the surpluses recorded in the services balance, the primary and secondary income balances. As a result, the level of official foreign exchange reserves has increased to a record level at the end of 2019.

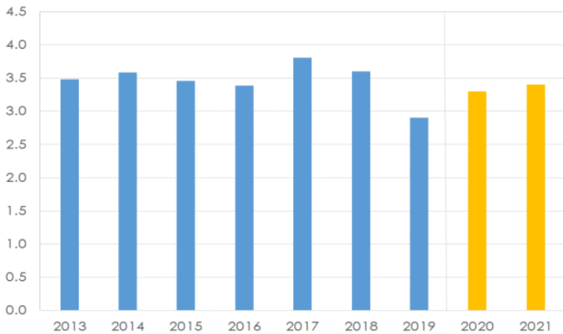
The Reserve Bank has maintained its monetary policy stance unchanged during 2019. The Bank kept its official interest rate, the discount/rediscount rate, unchanged at 2.9 percent. Commercial bank's reserve requirement ratio was also maintained at 5.0 percent, with banks' minimum liquid asset ratio (LAR) also maintained at 5.0 percent and Capital Adequacy Ratio (CAR) maintained at 12 percent.

4. The International and Domestic Outlook

4.1 Outlook for the international Economy

At the start of the year, indications were that the global economic slowdown, seen in the past two years, had stabilized and the global growth is set to pick up pace, supported by diminishing trade tension between the US and China, and decreasing fears of a no Brexit deal. Also, global financial conditions were supportive for growth to pick up as major central banks continued to maintain accommodative monetary policies. Consequently, the IMF expected the global economy to grow by 3.3 percent during 2020. However, the emergence of the COVID-19 in China and its rapid spread inside china and globally has quickly changed the global economic outlook for 2020.

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



Source: IMF World Economic Outlook

To stop the spread of the COVID-19 epidemic, countries across the world implemented very harsh measures; including travel bans which effectively affected global tourism and travels, and strict lockdowns that led to a total halt in major industrial productions chains. Also, fears generated by the rapidly spreading COVID-19 had affected global financial markets, causing sharp falls in the global equity markets as investors became nervous and sold stocks in favour of bonds, thus pushing bond yields lower to record levels. The global economic slowdown due to the COVID-19 will be significant, however, the extent of how far the global GDP will fall and how long the impact of the COVID-19 will last remains uncertain. According to the Organisation for Economic Cooperation and Development (OECD), the global economy could grow at its slowest rate since 2009 this year as a result of the covid-19 outbreak and recover in 2021.

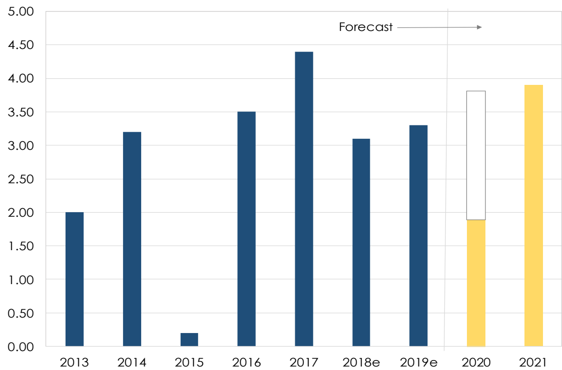
Many major central banks have responded by cutting interest rates further and quite sharply recently to cushion the macroeconomic impact of the COVID-19. The US FED reduced rates to 1-1.25 percent its biggest single cut in more than a decade on 04 March 2020. The RBA cut its interest rate by 25 basis point to 0.5 percent. The Bank of Canada also cut its benchmark rate by 50 basis points, from 1.75 percent to 1.25 percent.

4.2 Outlook for the Domestic Economy

a) Economic Activity

The domestic economy was initially forecasted to grow by 3.8 percent during 2020. Economic activity in all sectors of the economy are expected to pick up led by the services sector and industry sectors based on scheduled implementations of major projects such as the 2020 shared vision and major infrastructure construction projects. However, the expected economic fallout due to the COVID-19 has also significantly changed the economic outlook for the domestic economy. Consequently, the Macroeconomic Committee (MEC) revised its 2020 domestic real GDP forecast down from 3.8 percent to 1.1 percent. However, with the scheduled implementation of the Government's economic stimulus package, the full impact could be mitigated therefore the MEC estimated that the domestic economy will grow by 1.9 percent during 2020. The domestic GDP growth is expected to pick up in 2021 to 3.9 percent with all sectors resuming normal growths.

Figure 2: Vanuatu GDP
(Annual Growth in percent)



Source: VNSO; MEC projections

The downward revision of overall growth in 2020 is sourced primarily from the services sector which is expected to grow by a negative 0.7 percent. Vanuatu's services sector, which is largely comprised of tourism activities, makes up more than 60 percent of the domestic GDP. Tourism related services such as hotels in Vanuatu have closed their doors and momentarily laid off staff due to Australia, New Zealand, and Vanuatu closing their respective borders to international travel.

Australia and New Zealand make up more than 60 percent of Vanuatu's tourism market, and the recovery of this sector will depend on how fast these markets can recover from the shock and international travels are resumed. The industry sector will continue to drive economic growth in 2020, supported by construction activities. The agriculture sector is not expected to be affected by COVID-19 and will continue to grow as previously anticipated.

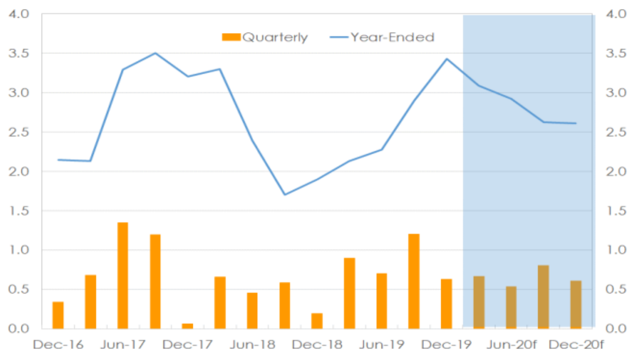
During 2020, the Government is expected run a recurrent budget deficit due to anticipated high expenditures for acquisitions of fixed assets. Major sources of recurrent revenue will continue to be Value Added Tax (VAT), revenues from Citizenship Programs, Taxes on International trade and excise duty. However, with the Government's planned fiscal stimulus, it is possible that the projected budget deficit for 2020 will increase. The Government has built sufficient fiscal buffers from past fiscal surpluses and continues to have the capacity to borrow should it be deemed appropriate.

Monetary conditions have remained conducive for domestic economic growth. The current high level of liquidity in the banking system will remain in the medium term. Private sector credit growth is expected to be gradual, however, it is likely it will slow further.

b) *Inflation*

Current projections indicated that inflation will remain within the Reserve Bank's internal target range of 0 – 4.0 percent in the medium term. Year-on-year inflation is forecasted to recede from its current level to below 3.0 percent from the June quarter to September quarter of 2020.

Figure 3: Consumer Price Index
(Percent change, quarterly data)

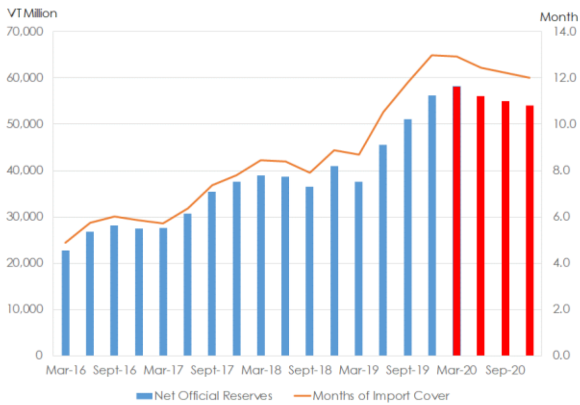


The impact of COVID-19 is not expected to exert sufficient pressure to push domestic prices up since there are no disruptions in the supply of imported goods and local fruits and vegetables at this stage. However, the current fall in international crude oil prices, due to weak international demand, are expected to feed through into domestic transport and utility prices, usually with a three months' lag. Over the last two months, crude oil prices have declined from the level of $50 per barrel to around $20 per barrel as of 1 March 2020. The current inflation outlook is also supported by decreasing prices for other imported commodities including wheat.

c) Balance of Payment and International Reserves

During the course of 2019, Vanuatu's overall balance of payments remained in surplus due to surpluses recorded in the services balance and the primary and secondary income balances. Vanuatu has achieved a positive current account balance although the goods balance continued to be in deficit as the total value of the country's imports continued to outweigh its exports. As a result, the level of official foreign exchange reserves has increased to a record level.

Figure 4: Net international reserves and Imports cover
(Level of FX and Import Cover, Quarterly Data)



The outlook for the next 6 months is clouded by the current tourism shutdown to prevent the spread of the COVID-19 to Vanuatu, leading to the overall services sector estimated to grow by negative 0.7 percent. Nevertheless, the overall current account balance is projected to remain in a surplus position during 2020, although a lower surplus compared to 2019 as earnings from abroad are all expected to decrease. As a percent of GDP, the current account surplus is estimated to fall from 18.2 percent in 2019 to 7.2 percent in 2020.

In line with the forecasted developments in Vanuatu's current account balance, the Bank expected a downward pressure on the overall foreign exchange reserves given that earnings from abroad (exports of goods and services, primary income earnings, and current transfers) are all expected to decrease in 2020. Despite this, the official foreign reserves will remain comfortably above the Bank's minimum threshold of 4.0 months of import cover in the medium term.

5. Monetary Policy Stance

Vanuatu's economy has achieved robust economic growth over the past years, as domestic monetary conditions have been supportive for growth. The Banking system liquidity remained at an elevated level, and commercial banks' loan portfolio quality has remained healthy with standard loans making up the bulk of their total loan portfolios. The Government's fiscal position has improved over the years, and sufficient fiscal buffers have been maintained. The official foreign reserves have remained elevated and were sufficient to cover around 13.3 months of the country's imports of goods and services bills during February 2020. Domestic inflation has remained within the Bank's internal target range between 0 and 4 percent. In light of the above, the Bank is confident that its current monetary policy stance remains appropriate.

The key challenges currently facing Vanuatu's economy and the Bank's current monetary policy setting are the growing uncertainties and risks associated with the global spread of the COVID-19 and its disruptive effects on domestic economic activities, especially through delays of planned implementations of major public infrastructure projects, and its negative impact of Vanuatu's tourism sector and employment due to the ban on inward and outward travels. In light of the perceived risks, the Board of Directors of the Reserve Bank decided to relax the Bank's current monetary stance. At its meeting held on Friday 27 March 2020, the Bank's Board of Directors reduced the Bank's official interest rate (rediscount rate) from 2.9 percent to 2.25 percent. During its meeting on March 30th, 2020, the Board of Directors also approved additional supportive policy measures, including the reduction of banks' Capital Adequacy Ratio (CAR) from 12.0 percent to 10.0 percent, reactivate the Bank's Imports Substitution and Export Finance Facility (ISEFF) and the Disaster Reconstruction Credit Facility (DRCF) for the banks to utilise in this challenging period. The Bank will continue to monitor international and domestic economic developments and stands ready to respond as appropriate.