RESERVE BANK OF VANUATU

HALF YEAR MONETARY POLICY STATEMENT

March 2021

Reserve Bank of Vanuatu

Half-Yearly Monetary Policy Statement

March 2021

1. Statement by Governor

The global economy is expected to recover strongly in 2021 after the largest downturn caused by the COVID-19 prevention measures across the globe in 2020 and into the first quarter of 2021. The approval and rollout of a number of COVID-19 vaccines and additional fiscal support from major economies further improved the global outlook. Global financial conditions remain supportive as major central banks pledged to keep their current monetary policy settings for an extended period. On the downside, there remains high uncertainty to the global economic prospects. As stated by the international monetary fund (IMF), the global economic recovery depends largely on the path of the health crisis, including whether the new COVID-19 strains prove susceptible to vaccines or they prolong the pandemic; the effectiveness of policy actions to limit persistent economic damage; the evolution of financial conditions and commodity prices; and the adjustment capacity of the economy.

Domestically, the economy is forecasted to recover strongly in 2021. The projected growth is expected to be broad based; however uneven, led by the industry sector with expected growth in construction activities related to implementations of delayed public projects and resumption of Tropical Cyclone (TC) Harold reconstruction and recovery projects. However, significant downside risks to this growth outlook remains, given that there are possible delays in the implementation of projects, delays in vaccination rollout program and re-opening of borders.

The Government continues to maintain a strong financial position with sufficient fiscal buffers. This is also reflected in the continuous improvement in the Government's net lending position with the banking system. Domestic monetary conditions remain supportive of growth with the banking system continuing to be sufficiently awash with liquidity and capital. Commercial banks' loan portfolio quality has remained healthy with standard loans making up the bulk of their total loan portfolios, albeit, with some edging up to the level of non-performing. The non-performing loans scenario will become clearer after the loan moratorium period ends in June or later this year.

The Reserve Bank has achieved its twin targets for monetary policy, and remains committed to achieving them over the medium term. The Reserve Bank is confident that the current monetary policy setting remains appropriate to support the recovery of domestic economic activities and will continue to monitor international and domestic macroeconomic, macro prudential 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 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 per cent and to hold international reserves sufficiently above a minimum threshold of 4 months of import cover.

3. International and Domestic Overview

3.1 The International Economy

World economic conditions continued to improve since September 2020 from the slump caused by the lockdowns that began in April 2020. In the last six months, the International Monetary Fund (IMF) revised its estimate for global GDP in 2020 upward twice: October 2020 (-4.4%) and January 2021 (-3.5%), indicating that the global economic downturn in 2020 is less severe than previously anticipated. Although the pace of the improvements differed across countries and regions, the upward revision reflected quick policy actions worldwide to suppress the severity of the COVID-19 depression.

Economic performances in major economies have been mixed. While some major countries have rebounded from the COVID-19 induced recession in the second half of 2020, others posted negative GDP growth in the fourth quarter as new waves of infections led to implementation of tighter restrictions. The US economy grew by 4.0 percent in December after recording 33.4 percent growth in September 2020 led by gains in consumer spending and private investments. Likewise, Australia's economy strengthened in the second half of 2020 after emerging from a recession. In the Euro area, fourth quarter GDP contracted by 5.1 percent after an expansion of 12.6 percent in the third quarter as new containment measures were implemented in several of its Zone countries. In New Zealand, the economy contracted in the fourth quarter of 2020.

Global financial market conditions remained accommodative to support the global economic recovery. Central banks reduced or maintained interest rates at record lows, with the European central bank reaching 0.0 per cent. These interest rate cuts were coupled with quantitative easing and large fiscal stimulus.

3.2 The Domestic Economy

Domestically, the economy is estimated to have contracted by less than previously expected in 2020. In February 2021, the Macroeconomic Committee (MEC) revised its 2020 real GDP estimate upward from -4.0 percent to -2.6 per cent reflecting growth in the agriculture, fisheries and forestry sector, led by increased fishing activities. Nevertheless, agricultural output was affected by damages caused by TC Harold. The fallout of the combined effect of the COVID-19 and TC Harold provided a negative economic outlook for the domestic economy for the year amid a persistently weak tourism-related services sector. Growth in the services sector weakened substantially mainly due to the decline in tourism related activities after March 2020 due to international border closure. The loss of jobs and business revenues from the combined disasters also had a weakening effect on domestic demand and rise of NPLs among banks. Although the industry sector activity was supported by the post-cyclone reconstruction, the sector was also adversely affected by major delays in implementation of major public projects owing to the border closures.

Total money supply growth continued to decelerate in reflection of weak domestic economic conditions. The deceleration stemmed principally from fall in net domestic assets which more than offset the continuous increase total net foreign assets. Weak private sector credit and continuous improvement in the Government's net lending position with the banking system both contributed to the decline in net domestic assets. Private sector credit continued to record negative year ended growths, reflecting both ongoing book management by banks and weak demand for credit. The quality of the banking industry's loan book deteriorated in the third quarter of 2020 as non-performing loans (NPLs) to gross loans rose to 17.3 per cent, compared to 14.9 percent in the third quarter of 2019. Nonetheless, the majority (82.7%) of commercial banks' total loan portfolio remained as standard loans. Domestic monetary conditions have remained supportive of growth as the domestic banking system remained awash with liquidity and banks are well capitalized.

The Government's fiscal position continued to remain strong with sufficient fiscal buffers. The Government achieved a budget surplus in 2020 despite of the twin shocks that affected the economy. Government revenues were boosted by budget supports received from donor partners and other revenues which more than offset a decline in tax revenues due to a weaker domestic economy.

The year ended headline inflation rate in June 2020 overshot the Reserve Bank's target range at 5.6 percent, up from 3.0 per cent in the March quarter of the same year, and higher than previously forecasted. The increase reflected a significant increase in food price inflation which rose 12.1 percent on a year-on-year basis from 7.6 per cent in the previous quarter, driven by higher price of root crops, fruits and vegetables in Port Vila. However, the increase is expected to be one-off effect of increased demand as people prepared for the COVID-19 as well as a temporary fall in supply during the quarter due to domestic lock downs and the state of emergencies. Headline inflation is expected to gradually subside in the last two quarters of the year as supply of root-crop, fruit and vegetables improved in line with the Government policy to improve productions in the primary sector. Also, existing weak economic conditions due to COVID-19 and reduced income in affected sectors of the economy continue to drive down pressures on demand. Despite the pickup in headline inflation, the underlying inflation rate continues to remain subdued at low levels recording -0.4 per cent in the June quarter of 2020 from 0.6 per cent in the March quarter. This low rate continues to reflect the stable prices of other consumer-good categories and weak demand in the economy.

The lock-downs and International border restrictions led to deterioration in the current account balance despite improvements in remittances and grants provided for COVID-19 and TC Harold assistance. Nevertheless, the country continued to maintain a healthy balance of payment position. At the end March 2021, the official foreign reserves is estimated at VT64.7 billion, sufficient to finance around 12 months of imports.

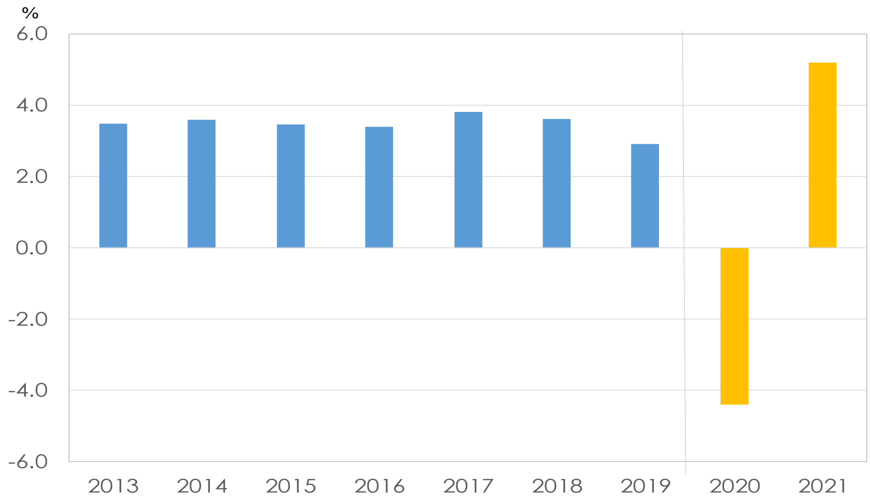
The Reserve Bank held its monetary policy stance unchanged in September 2020 to continue to support the economy. The official interest rate was kept at 2.25 percent. As part of its response to the COVID-19 induced crisis, the Reserve Bank also approved an extension of commercial banks' loan moratorium for their clients to June 2021.

4. International and Domestic Outlook

4.1 Outlook for the International Economy

After the contraction in 2020, as a result of the COVID-19 related lockdown measures across the world, the global economy is expected to recover strongly in 2021. The global economic outlook has improved further following the approval and rollout of a number of the COVID-19 vaccines in a number of countries and additional fiscal stimulus in a few large economies.

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



Source: IMF World Economic Outlook, April 2021

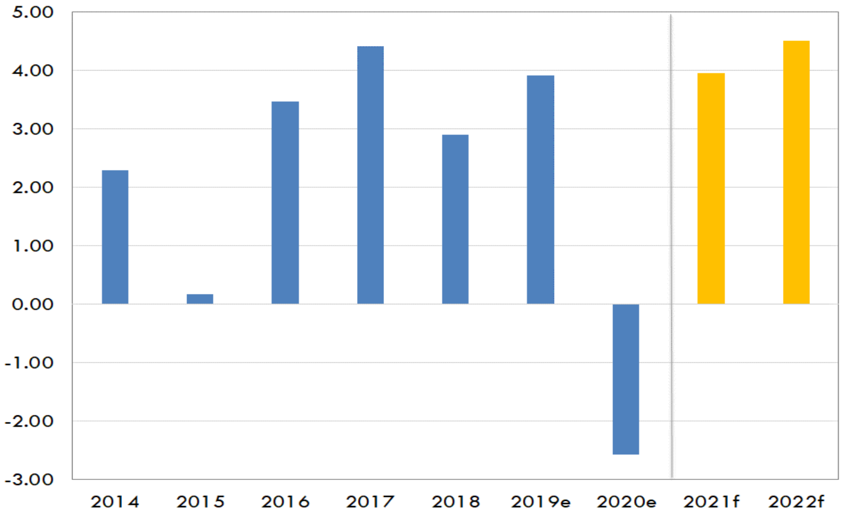
The IMF expects the global GDP growth to rebound strongly from the negative growth in 2020 to 5.5 percent in 2021 and moderating to 4.2 percent in 2022. The projected turnaround in the global economy is led by advanced economies, particularly the US with a projected growth at 6.4 percent this year. Amongst the emerging markets and developing economies, China is projected to grow at 8.4 percent. Financial conditions are expected to remain accommodative as major central banks continue to maintain their current monetary policy settings to support the recovery. However, downside risks to this positive outlook remain as the virus continues to spread with new variants which may lead to renewed lockdown measures.

4.2 Outlook for the Domestic Economy

a) Economic Activity

The domestic economy is forecasted to recover in 2021 after the downturn in 2020; however, the strength of the recovery is expected to be less than previously anticipated. At its meeting in February 2021, the Macroeconomic Committee also revised the 2021 GDP estimate to 4.0 percent, down from a previous estimate of 5.0 per cent. This projected growth is expected to be broad based; however uneven, led by the industry sector, in particular expected growth in construction activities related to the 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 implementation of projects may be further delayed, and delays in vaccination rollout program causing delays in the re-opening of borders.

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



Source: VNSO, Macroeconomic Committee

Although Vanuatu does not record any community transmission of the COVID-19 to date (only border cases), the current international boarder shutdown continued to limit tourism activities and delaying the recovery of the services sector. A number of tourism related services such as hotels and resorts, including small tourism businesses, remained closed. This has 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 impulses from the fiscal stimulus, tax relief measures, bank loan moratorium, and other policy measures such as the Vanuatu National Provident Fund hardship loan.

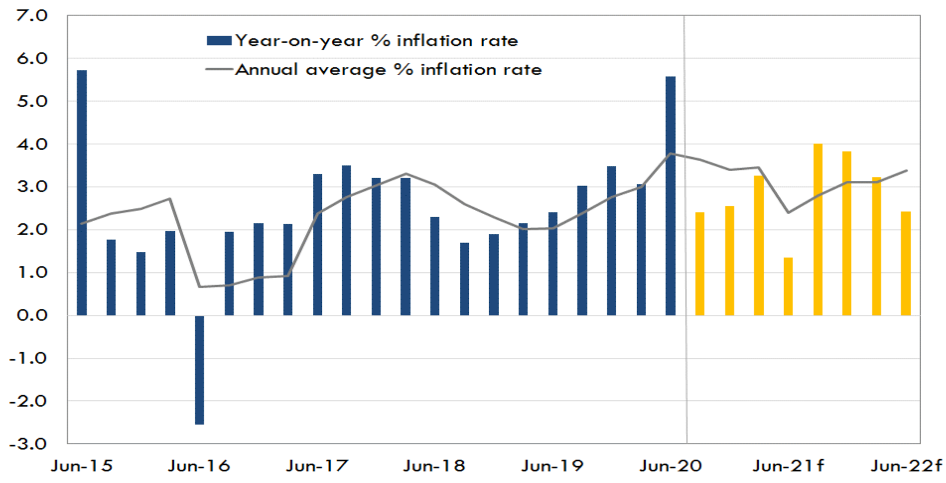
The industrial sector, especially construction activities, is expected to drive economic growth in 2021, as major projects that were delayed from 2020, as well as new projects, are implemented. The restrictions on inbound travel were eased in the last quarter of 2020 to allow professional personnel such as contractors and engineers to enter the country to re-start the implementation of major public sector projects in 2021.

The agriculture sector is expected to recover further in 2021 led by the Government's agriculture direct subsidy program, post TC Harold recovery programs, and increased output from the fisheries and forestry sector. Exports of major commodities such as kava, fish, copra, coconut oil and root-crops improved towards the last quarter of 2020. This trend is projected to continue in 2021.

b) Inflation

Vanuatu's annual headline inflation is forecasted to remain within the Reserve Bank's internal target range of 0 to 4 per cent. Inflation is projected to increase to the upper end of the Reserve Bank's internal target reflecting the current level of high domestic food prices and possible lagged effect of recovery in international fuel prices, translated into utility and transport costs. Despite increasing risks associated with the effect of recent rise in international food prices, the recovery phase of post-cyclone domestic supply of root crops, fruits and vegetable is expected to put some downward pressures on domestic food prices. Crude oil prices which followed a trajectory recovery trend post-COVID-19, rose to US$63.8 per barrel in March 2021.

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



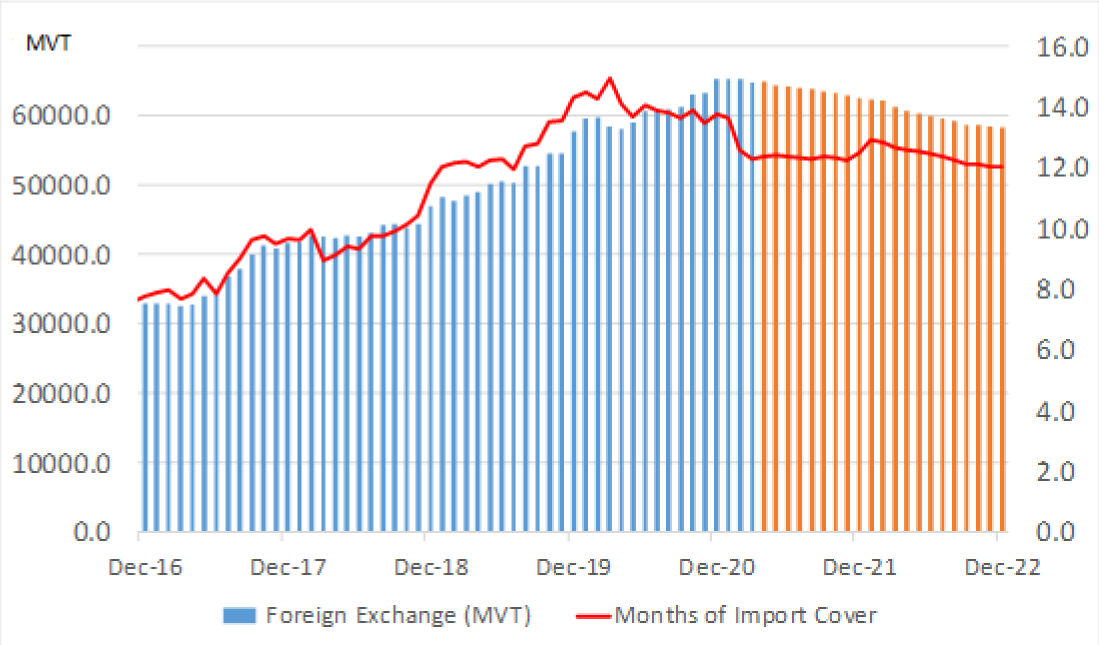
Source: VNSO, RBV Forecast

With the pick-up in domestic food prices and increased pressures from international prices, the year-on-year headline inflation is projected to remain between 3 and 4 per cent in 2021. Coupled with the fixed exchange rate regime which continues to anchor inflation well, the recent depreciation of the US dollar may offset some pressures from import costs. Thus, inflation risks are broadly balanced. On the upside, a pickup in construction activities associated with major project implementation in 2021 may temporarily boost demand pressures in the domestic economy, thus adding upward pressures on inflation, and lagged effect of rise in international food and fuel prices remain as global demand recover. However, on the downside, increase in production of domestic food supply-chains may exert downward pressures on domestic food prices.

c) Balance of Payments and International Reserves

The twin shocks to Vanuatu's economy in 2020 have also affected the country's balance of payments. The COVID-19 pandemic prevention measures led to a sharp decline in the number of international tourist arrivals. From April to December 2020, the number of international tourists arriving in Vanuatu fell by 96 per cent, compared to the same period in 2019. International trade of goods and services were also disturbed due to international lockdowns, and worsened by the destructions following TC Harold although trade in goods picked up somewhat in the September and December quarters of 2020. Nonetheless, very low tourism earnings, due to the current international border restrictions, led to a deficit in Vanuatu's current account balance (CAB), despite improvements in remittances and grants provided by donor partners as COVID-19 and TC Harold assistance. With the macroeconomic readjustments over the last 3 quarters of 2020, the CAB reported a surplus over the December quarter; however, a 72 per cent current account deficit was still reported over the year. The sustainability of the current account is an important policy consideration. As at end March 2021, the official foreign reserves stood at around VT64.7 billion, which is estimated to finance around 12 months of imports.

Figure 4: Foreign Reserves and Monthly Import Covers
(Million Vatu and month, monthly data)



Vanuatu's BOP outlook remained subject to some uncertainty as the risks of new waves of infection may prolong international border restrictions and continue to negatively affect the major BOP accounts. As long as international borders remain closed, the current account balance will continue to face challenges. However, the financial account is expected to remain positive. Hence, the official foreign reserves are projected to remain adequately above the minimum threshold in the short to medium term, mainly due to expected further inflows through exports of goods, Government financing and remittances.

5. Monetary Policy Stance

The domestic economy is expected to recover to 4.0 percent in 2021, and remain positive in the medium term. Monetary conditions have been supportive for growth. The banking system remains well capitalized and liquidity has remained at an elevated level. The quality of commercial banks' loan portfolio has remained healthy with standard loans making up the bulk of their total loan portfolios. The Government's fiscal position continued to improve over the years, and sufficient fiscal buffers have been maintained. The official foreign reserves were sufficient to cover around 12 months of import cover at the end of March 2021. Inflation is expected to fall within the Reserve Bank's internal target range owing to recovery in root crop, fruit and vegetable supplies, the existing weak economic conditions due to COVID-19 and the reduced income in affected sectors of the economy.

The key challenges facing the economy and the Reserve Bank's policy settings are the uncertainties surrounding global growth forecasts owing to the new strains of the COVID-19. Similarly, downside risks to domestic growth included prolonged delays in project implementations, vulnerability to natural disasters and climate change and closure of international borders is an ongoing risk to the sustainability of the CAB. The viability of the Government Citizen Program sustaining CAB in the near future is uncertain. The ending of the loan moratorium in mid-2021, would require Government support for MSMEs and Individuals. Furthermore, private sector credit remained subdued amidst the high excess liquidity in the banking system. Despite the current challenges, risk to the macroeconomic fundamentals appears to be contained until the end of 2021. The Reserve Bank has therefore decided to maintain its current monetary policy setting unchanged.

The Reserve Bank's official interest rate (rediscount rate) remained unchanged at 2.25 percent. Commercial banks' Capital Adequacy Ratio (CAR), Liquid Asset Ratio (LAR) and Statutory Reserve Deposits (SRD) were maintained at 10.0 per cent, 5.0 percent and 5.25 per cent, respectively. However, a key policy measure taken by the Reserve Bank was to approve an extension of commercial banks' loans repayment moratorium and suspension of prudential requirements on asset quality beyond September 2020-March 2021 to end June 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.