RESERVE BANK OF VANUATU

HALF YEAR MONETARY POLICY STATEMENT

SEPTEMBER 2021

Reserve Bank of Vanuatu

Half-Yearly Monetary Policy Statement

September 2021

1. Statement by Governor

Global economic conditions have improved although the global economic recovery is happening on two differing pathways triggered by access to COVID-19 vaccines and the pace of vaccinations rollout. Developed countries are leading the recovery since they made significant headway in vaccinating their populations. Economic growths in other countries remain subdued and are vulnerable to new waves of COVID-19 transmission due to slow pace of vaccination. Substantial fiscal and monetary policy supports, as well as easing of COVID-19 restrictions led the recovery in developed economies. Economic growth in the US, Australia and New Zealand have surpassed pre-pandemic levels in the first six months of 2021. Improvements in global demand have also led to upward pressure on global commodity prices. Global financial market conditions have remained supportive for growth. The major central banks kept very low policy interest rates and maintained asset purchases and lending programs.

On the domestic front, economic recovery is underway after the slump in 2020 following the emergence of the pandemic and Tropical Cyclone (TC) Harold hit. However, the pace of the recovery is expected to be weaker than expected in the previous monetary policy statement. Much of the revision affected construction activity as some infrastructure project implementations were deferred to 2022. Increased economic activity is forecasted for all sectors of the economy; led by the Agriculture and industrial sectors and non-tourism services sector.

The Government retained a positive fiscal position. As a result, the Government's net lending position with the banking system improved further since the last monetary statement. Supportive fiscal policy and monetary policies helped the domestic economy to recover. The Government recently rolled out its second phase of its economic stimulus package for affected businesses.

Banking system liquidity stayed at an elevated level owing to the Reserve Bank's current easy stance on monetary policy. The Banking sector remains sound, profitable and adequately capitalised. Though the quality of banks' loans deteriorated since the emergence of the pandemic, the majority of the loan portfolios are standard loans. The full impact of the pandemic on banks' balance sheet will become clearer once the loan moratorium period lapsed at the end of the year.

The Reserve Bank expects to achieve its twin objectives for monetary policy in the medium term. The inflationary pressures experienced over the past four quarters were forecasted to ease in the near term when the adverse domestic food supply shock fades. Inflation is forecasted to fall within the Reserve Bank's target range of 0-4 per cent in the near term. The official foreign exchange reserves are equivalent of around 12 months of import cover in June 2021; it is forecasted to remain at an adequate level in the medium term.

The Reserve Bank remains committed to achieving its twin targets for monetary policy over the medium term. The current monetary policy setting is seen as appropriate to continue to support the domestic economic recovery. The Reserve Bank will continue to monitor international and domestic macroeconomic, macro prudential and financial developments and stands ready to safeguard macroeconomic stability.

2. Objectives of Monetary Policy

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

Since the release of the March 2021 Half-Yearly Monetary Policy statement, the pace of global economic recovery has strengthened, though there was increasing consensus that the global recovery is happening on two diverging pathways; attributable to vaccine access and rollout. Countries that have better access and are ahead with vaccine rollout, in particular developed countries, are able to relax lockdown measures and have rebounded strongly. Growth in other countries remain subdued. In April 2021, the International Monetary Fund (IMF) upgraded its global GDP estimate for 2021 to 6.0 per cent, and maintained the forecast in July 2021 as the outlook for developed economies improved more than emerging and developing countries. Large fiscal support from developed economies and further improvement in vaccine roll out will stimulate the economic recovery.

The US economy has rebounded strongly in the first half of 2021 with real GDP growth expected to surpass pre-pandemic levels later in the year. Substantial fiscal and monetary policy supports, as well as easing of COVID-19 restrictions as a result of relatively high vaccination rates, led to the recovery. In Australia, real GDP surpassed its pre-pandemic level in the June quarter as supportive monetary and fiscal policies drove up private demand. Likewise, real GDP growth in New Zealand has strengthened led by strong household spending and demand for exports as economic activity in some sector have reverted to pre-pandemic levels. In the Euro area, though recovery is underway, output remained below pre-pandemic level due to lack of fiscal stimulus.

Global commodity prices continued to rise with agriculture commodities, particularly food, registering sharp price increases. Oil prices have also risen. Energy prices rose 9.0 per cent in the last 9 months. The pace of global economic recovery and vaccine rollouts in advanced economies drove demand upward. Supply restrictions for some commodities like oil, copper, and some food products also led to their upward price adjustment.

Global financial market conditions have remained conducive for growth. All major central banks around the world continue to keep very low policy interest rates and maintain asset purchases and lending programs to support economic growth.

3.2 The Domestic Economy

After the downturn in 2020, the domestic economy was forecasted to recover in 2021 with an initial real GDP forecast of 5.0 per cent; later revised down to 4.0 per cent in February 2021. At its meeting in September 2021, the Macroeconomic Committee (MEC) downgraded its forecast for 2021 to 2.4 per cent as the pace of the recovery was slower than expected. Much of the downward revision was attributed to construction activities as some major infrastructure projects implementation were deferred to 2022. Increased economic activities were forecasted for all sectors of the economy; driven by the agriculture and industrial sectors and non-tourism services sector. Tourism related services sector is still affected by the closure of Vanuatu's borders.

Government stimulus and public consumption and investment in infrastructures are supporting economic recovery. The first six months of the year saw Government revenues making up only 43.7 per cent of the 2021 revenue budget, 7.6 per cent less than revenues collected in the comparable period of last year. Value added tax (VAT) revenues significantly underperformed its budget in the first half of the year due to ongoing weak domestic demand. Likewise, Government expenses were less than budgeted level; at 41.9 per cent in the first six months. However, the Government continues to maintain a positive fiscal position from past budget surpluses.

Domestic monetary conditions have remained accommodative to growth. Domestic liquidity, as measured by reserve money, has remained elevated as the Reserve Bank maintains an easy monetary policy stance since March of 2020. However, money supply growth remains weak due to decline in domestic credit which more than offset the increase net foreign assets. Domestic credit continues to reflect weak private sector credit and continuous improvements in the Government's net lending position with the banking system.

The domestic banking sector remains liquid, profitable and adequately capitalised. Asset qualities of banks have deteriorated since the emergence of the pandemic; however, the full impact of COVID-19 on banks' balance sheet is yet to be determined. There is increase in general and specific provisions reflecting anticipated increase in non-performing loans.

Headline inflation hovered above 4.0 per cent in the last three quarters of 2020 and the first quarter of 2021. In the first quarter of 2021, year-on-year headline inflation was recorded at 5.2 per cent. The rise in headline Inflation was driven mainly by food inflation from supply disruptions attributable to TC Harold and COVID-19 preventive measures. The underlying inflation, which excludes food prices, was negative in the last four quarters.

Vanuatu's current account position fell to a deficit in the first quarter of 2021 following a significant surplus recorded in the fourth quarter of 2020. International border restrictions continued to affect the country's current account balance irrespective of improvements in remittances and grants. Despite this, the official foreign reserves remain amply above the minimum threshold of 4.0 months of import cover.

In its March 2021 Half-Yearly Monetary Policy Statement, the Reserve Bank maintained its monetary policy stance unchanged - the policy rate remained at 2.25 per cent and the other policy measures were maintained.

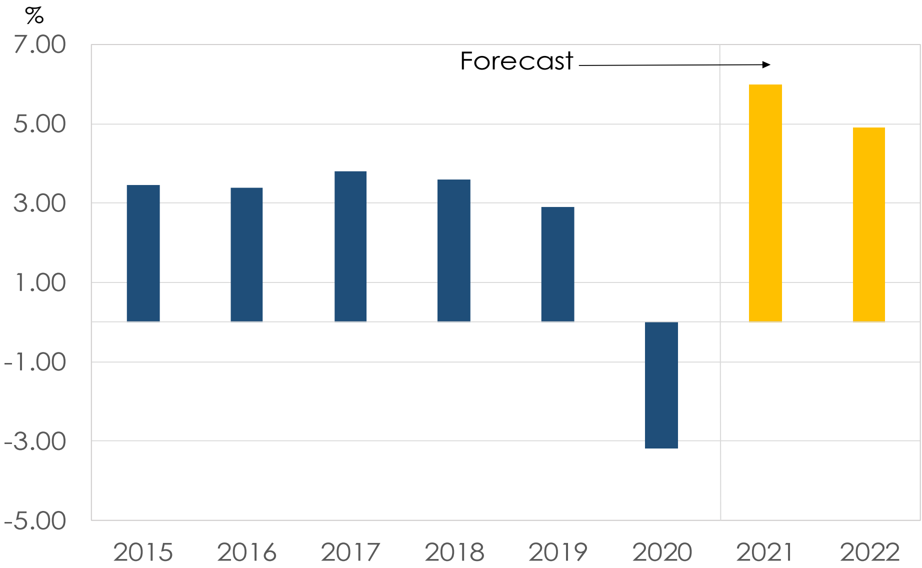
As part of its measures to address the impact of the pandemic, the Reserve Bank extended its suspension of prudential requirements on loan classifications from June 2021 to September 2021. This compliments the commercial banks' loan moratorium strategy.

4. International and Domestic Outlook

4.1 Outlook for the International Economy

A strong global economic recovery is currently underway, buoyed by the progress in vaccination pace and large fiscal and monetary support in large economies. However, downside risks to the global growth outlook remain, and growth will be uneven amongst countries. The recent outbreak of the COVID-19 Delta variant and ensuing lockdowns as well as the slow progress in vaccination in less developed economies may affect the pace of the recovery.

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



Source: IMF World Economic Outlook, July 2021

In its July 2021 update of the World Economic Outlook (WEO) update, the IMF expects the global real GDP to expand by 6.0 per cent in 2021 and moderating to 4.9 per cent in 2022. Advanced economies, with the progress in vaccination rate, are set to drive growth.

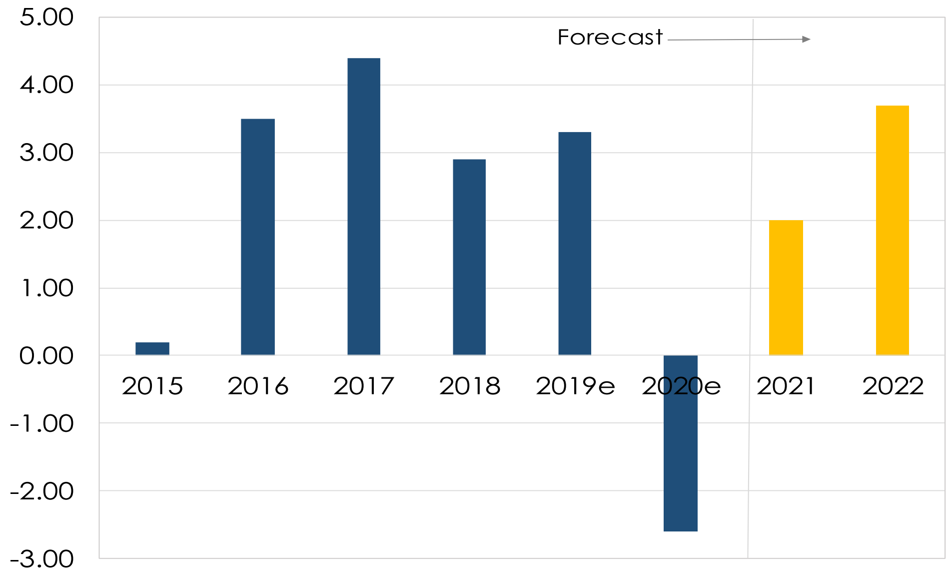
Financial market conditions are set to remain accommodative in the near term. Major central banks are expected to maintain very low policy interest rates, continue their asset purchase programs and other accommodative policy measures.

4.2 Outlook for the Domestic Economy

a) Economic Activity

The domestic economic recovery is underway; however, the level of economic output in 2021 was forecasted to be lower than expected in the March 2021 Monetary Policy Statement. According to MEC's forecast in September 2021, the domestic GDP will expand by 2.4 per cent in 2021 and 3.7 per cent in 2022. The growth is projected to be broad based led by the agriculture and industrial sectors and non-tourism services sector. Policy measures such as the Government's fiscal stimulus and tax relief, commercial banks' loan repayment moratorium, including the Reserve Bank's easy monetary policy stance, continue to support economic activities. The Government is currently rolling out a second stimulus package to support businesses. Nevertheless, significant downside risks to this growth outlook remain- major infrastructure project implementation may be delayed, the slow vaccination pace may lead to delays in border re-opening, and the continuous spreading of COVID-19 Delta variant in neighbouring countries.

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



Source: VNSO, Macroeconomic Committee

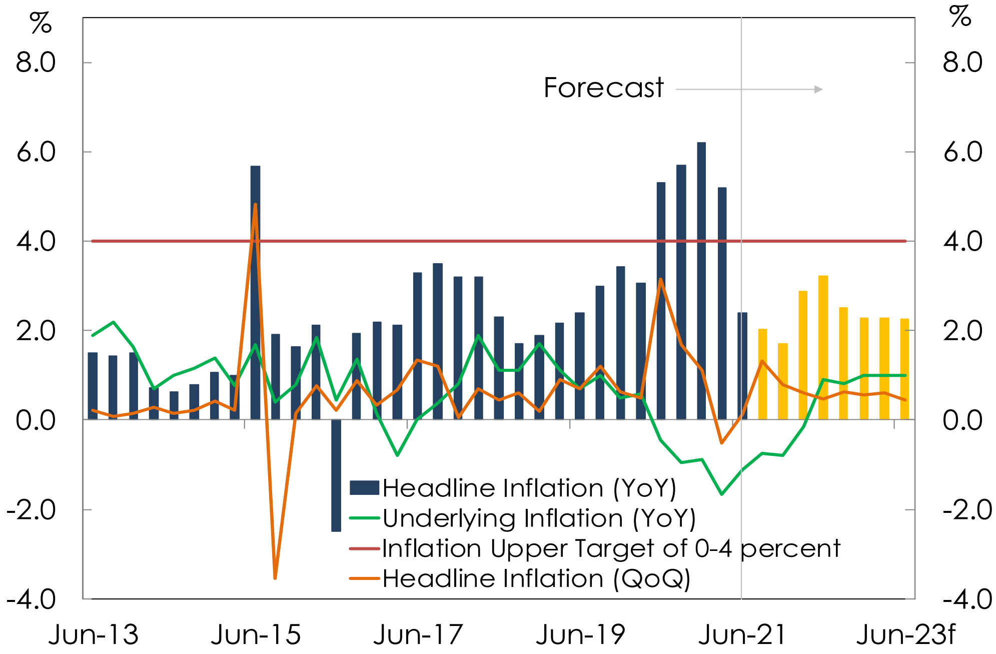
Activity in the Agriculture, Forestry & Fisheries sector has been projected to increase by 4.0 per cent in 2021 and 3.7 per cent in 2022. Growth in this sector is sustained by ongoing recovery from TC Harold, improvement in exports and Government policies to increase production in the primary sector. Coupled with increased international prices for export commodities, ongoing copra subsidy provides necessary stimulus for increased production. The fishing sector is expected to continue solid growth. The main cash crop production will improve as a result of Government policies as well as the support extended through the 11th EDF program. The impact of the COVID-19 pandemic has seen an increase in people resorting to farming activities.

The industry sector is projected to pick up by 6.7 per cent in 2021 and 13.7 per cent in 2022, reflecting current rebuilding and reconstruction activities following TC Harold and other projects including feeder roads. There has been continuous delay in implementation of a number of major projects as Vanuatu's international borders remain closed; therefore, projects implementations have been extended to 2022. Construction activities will boost the industrial sector and in turn lead economic growths in 2021 and 2022.

b) Inflation

Year-on-year headline inflation was forecasted to recede within the Reserve Bank's internal target range of 0 to 4 per cent in the near term. The revised outlook for inflation follows the recent CPI figures for 2020 and the first quarter of 2021 which saw inflation exceeding the Reserve Bank's target range. Much of the inflation outcome was driven by higher domestic food prices due to supply constraints caused by TC Harold and COVID-19 preventative measures. Hence, the current rise in inflation is driven by adverse supply shocks and deemed transitory. Underlying inflation was negative in the last four quarters and is forecasted to remain subdued in the near term.

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



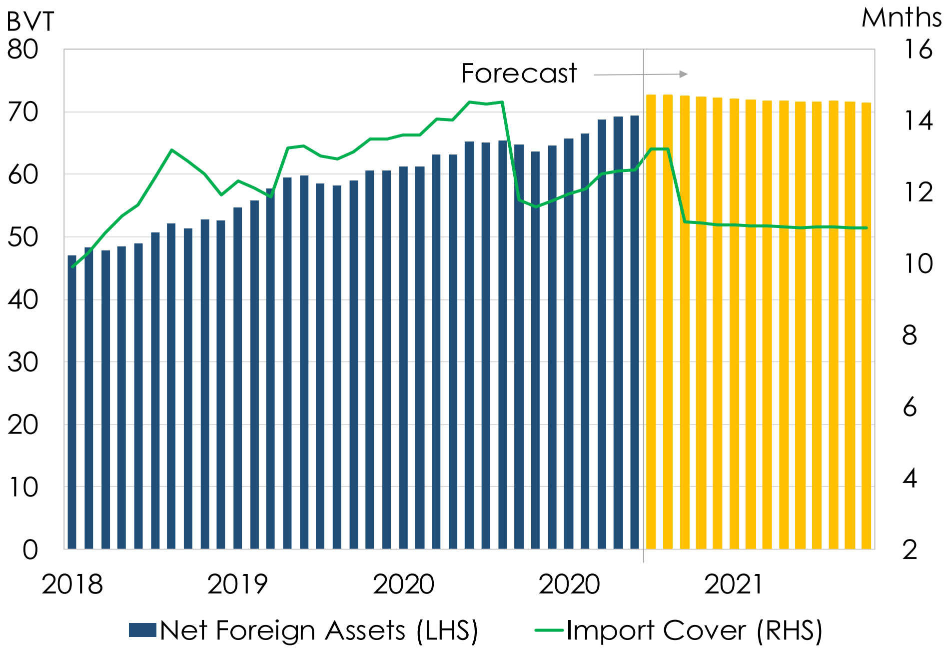
Source: VNSO, RBV Forecast

The Reserve Bank is cognizant of its objective of anchoring inflation; hence it is closely monitoring inflationary pressures in the economy. While aggregate demand is projected to improve, it is still weak and below pre-pandemic levels. The current inflationary pressures, seen in the last four quarters, are due to adverse supply shocks and are expected to be temporary. Year-on-year headline inflation is forecasted to recede within the Reserve Bank's target range in the near term. The country's fixed exchange rate regime continues to anchor inflation well.

c) Balance of Payments and International Reserves

The ongoing International border restrictions continued to affect the country's current account balance. International tourism receipts that used to be a significant foreign exchange earner before the pandemic, have decreased to practically zero. On the other hand, remittances flows are estimated to improve as the number of labor force joining the RSE and SWP have increased. Also, inflows through the Government's citizenship programs continued in the last six months. As a result, the official foreign reserves rose by 1.0 per cent in the first half of 2021 and the months of import cover remained amply above the Reserve Bank's minimum threshold of 4.0 months.

Figure 4: Foreign Reserves and Months of Import Cover (Levels, monthly data)



There remain some downside risks to the medium term balance of payments outlook. A prolonged international border closure may continue to adversely affect the major balance of payment accounts. Nevertheless, the official foreign reserves are expected to remain adequately above the Reserve Bank's minimum threshold in the medium term; supported by expected inflows through exports of goods, Government financing and remittances.

5. Monetary Policy Stance

The domestic economy has started to recover, supported by Government's fiscal stimulus and public sector spending and investment, though the pace of the recovery remains below pre-pandemic levels although the outlook is positive in the medium term. Despite implementing fiscal stimulus, the Government's fiscal position remains positive as reflected by an improving net lending position with the domestic banking sector. Domestic monetary conditions have been conducive to growth though money supply growth has stabilised due to offsetting developments in net foreign assets and net domestic assets. Continuous increases in total net foreign assets were offset by reductions in domestic credit as both net claims on Government and private sector credit declined. The domestic banking sector has remained liquid, profitable and adequately capitalised. Though the asset quality of banks has deteriorated, the bulk of banks' loan portfolios are standard loans. Inflation has exceeded RBV's target range but is expected to fall within the target range in the near term. The official foreign exchange reserves remain adequately above the minimum threshold.

Rising inflationary pressures remain the key challenge to the Reserve Bank's current monetary policy setting. However, the inflationary pressures seen in the past four quarters are expected to be temporary. In addition, there are ongoing downside risks to the domestic economic growth outlook, including: a protracted delay in project implementations, vulnerability to natural disasters and climate change, an extended closure of international borders and the uncertainty on the sustainability of the Government's Citizen Program. Private sector credit growth remained subdued, and while the majority of banks' loan portfolios are standard loans, the full impact of the COVID-19 on banks' balance sheet is yet to be realised. Commercial banks' loan repayment moratorium has been extended to end December 2021. Despite the ongoing challenges, risks to the macroeconomic fundamentals appear to be contained until the end of 2021.

At its meeting on 22 September 2021, the Reserve Bank Board of Directors agreed to maintain the Reserve Bank's current monetary policy stance as follows:

- The Reserve Bank's official interest rate (rediscount rate) is kept 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 per cent and 5.25 per cent, respectively.
- The Imports Substitution and Export Finance Facility (ISEFF) and the Disaster Recovery Credit Facility (DRCF) remained.
- The Reserve Bank also extended its suspension of prudential requirements on loan classifications from September 2021 to December 2021.

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

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Governor
The Reserve Bank of Vanuatu

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