RESERVE BANK OF VANUATU

HALF YEAR MONETARY POLICY STATEMENT

SEPTEMBER 2022

Reserve Bank of Vanuatu

Half-Yearly Monetary Policy Statement

September 2022

1. Statement by Governor

Global conditions have deteriorated further in 2022 owing to added shocks which affected the already frail growth weakened by the Covid-19 pandemic. These shocks included; higher than expected global inflation, triggering tighter financial conditions especially in advanced economies, worse than expected slowdown in the Chinese economy, reflecting the Covid-19 outbreaks and lock downs and further negative spill over effects from the Russian/Ukraine war. Growth in all major economies, the US, Australia, New Zealand and the Euro-area have slowed, due to lower than expected consumer spending and investment and wider trade gaps. Inflation in all major countries have risen higher above expectations due to higher energy and food prices. Major central banks around the world have increased their policy rates to curb the increasing global inflation. Global commodity prices continued to increase as supply constraints caused by the pandemic were further worsened by the Russia- Ukraine war and sanctions imposed on the imports of Russia's oil and natural gas by most western countries.

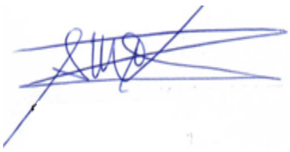
The overall domestic economy is estimated to have weakened over the first half of 2022 compared to the second half of 2021, due to the impact of higher inflation on domestic demand and supply. The overall outlook for 2022 however, is expected to improve slightly from 2021, mainly due to the re-opening of international boarders in early July, and other ongoing policy measures, anticipated to support overall consumption and production.

The Government's expansionary fiscal policy via its fiscal stimulus spending and investment in infrastructures, have helped maintain public consumption and has been an important component of the economic recovery. The fiscal expansion, funded through fiscal buffers of past budgetary surpluses in 2020 and 2021, is reflected in the monetary sector as a deterioration in its net lending position with the domestic banking system during the first six months of 2022.

Monetary conditions remain supportive of growth, with the banking system liquidity persistently maintained at high levels owing to the Reserve Bank's current accommodative monetary policy. The domestic banking sector remains sound, profitable and adequately capitalised, though non-performing loans remain a challenge as the loan moratorium period ends at the end of September 2022. However, the banks continued to make provisions for their loan books and the majority of their loan portfolios are standard loans. Overall financial sector stability has been maintained over the course of the pandemic and will remain intact over the short to medium term.

The Reserve Bank expects to achieve its twin monetary policy objectives over the medium term. Inflationary pressures expected during the second and third quarters of 2022, largely reflected foreign price shocks. These pressures are anticipated to subside towards the end of 2022 to early 2023 when global inflationary pressures are expected to recede; though the likelihood for further world economic disruption may still be likely. Inflation is forecasted to fall within the Reserve Bank's target range of 0-4 per cent over the near term. The official foreign exchange reserves are equivalent to VT70,966.9 million; which is sufficient to accommodate around 10 months of import cover in September 2022. It is forecasted to remain at an adequate level in the medium term.

The Reserve Bank judges that the current monetary policy setting remains appropriate, both to achieve tenable monetary conditions and to provide appropriate support to domestic economic recovery. The Reserve Bank will continue to monitor both international and domestic macroeconomic environment, macro prudential and financial developments in the coming months and will make necessary policy changes to safeguard macroeconomic stability.



Simeon M. Athy
Governor
Reserve Bank of Vanuatu

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.

Over the past six months of 2022, both these targets have been comfortably met; however, current forecasts suggest that rising inflationary pressures associated with the recent increases in global food and energy prices will remain a challenge to maintaining inflation within target during the second and third quarters of 2022. The Reserve Bank's foreign reserves target, by contrast, has largely been achieved during the first six months and is likely to remain comfortable over the next 6 months.

3. International and Domestic Overview

3.1 The International Economy

Since the Reserve Bank's last Monetary Policy Statement, global growth has significantly altered its course during the pandemic. Initial forecasts of a stronger growth to begin from 2021did not eventuate and even weaker growth outturn in early 2022 is now anticipated amidst increased mobility restrictions, rising energy prices and supply disruptions mainly in Europe, China and the US. The situation further worsened as Russia invaded Ukraine in February generating further spill over effects on supply disruptions, higher inflation, and tighter financial conditions, and consequently adding downward pressures on overall world output. According to the IMF July 20222 World Economic Outlook (WEO), global economic growth is estimated to have contracted over the second quarter of 2022 after performing better than expected in the first quarter.

The US economy has remained sluggish over the year as spending and production have weakened, though the labour sector remained robust, showing job gains and low unemployment in recent months. Inflation has soared over the Fed's monetary policy target of 2 percent over the past seven months, and the Fed has increased its policy interest rates on four (4) occasions from March to August. The Australian economy has picked up gradually over the first half of the year. This was supported mainly by private consumption, driven largely by a strong labour market, income growth, from wage increases due to the rising cost of living and rise in non-resident spending in the domestic economy as travel restrictions were eased. In New Zealand, the economy in terms of annual GDP growth rate fell over the first half of the year from the same period of the previous year. However, spending levels were supported by a robust labour market, continuous fiscal support, higher terms of trade and sound household balance sheets in aggregate. The Reserve Bank of New Zealand increased its official interest rates 4 times since February 2022 to maintain monetary stability as inflation continued to rise. The Euro area economy has picked up in 2022 compared to 2021, driven mainly by a positive external balance and private sector expenditure. Inflation has remained high, recording consecutive increases over the past ten months and the European Central Bank raised its official interest rates during its July monetary policy meeting. China's economy has remained weak in 2022 as consumption and production were affected by continued lockdown measures, a deteriorating housing market and rising cost of living.

Global commodity prices have remained high, reflecting major supply disruptions from the Ukraine/Russia war   combined with the continuous surge in demand which began in mid-2020, driven by the COVID-19 pandemic. Price increases were mainly from commodity exports from Russia and Ukraine, in particularly energy, fertilizers, certain grains and metal prices. Among the agricultural commodities, wheat prices were higher by almost 30 percent in March 2022, compared to December 2021. Energy prices, in particular Brent crude oil, rose by 55 percent compared to December 2021. The metals and minerals index rose 24 percent higher than a year ago.

Global financial conditions continued to remain tight as major central banks raised interest rates to combat inflation.

3.2 The Domestic Economy

Domestic economic growth improved in 2021 by an estimated 2.8 percent, mainly driven by the industry sector and the agriculture, fishing, and forestry sectors, compared to a contraction in 2020 from lockdown measures related to the pandemic. Generally, overall economic activity in consumption, production and investment, has been negatively affected by higher domestic prices over the first half of 2022 compared to the second half of 2021. The domestic labour market was affected by higher labour mobility following easing of travel restrictions and from higher demand for workers from abroad. The government's expansionary fiscal policy, through a series of fiscal stimulus expenditure from 2020-2022 has been a key element of economic recovery, particularly to tourism- related sub sectors that are affected by border closures related to the global pandemic. External donor financing from Vanuatu's major donor partners has also been supporting both the government sector and the private sector. In addition, inward transfers from the increase in the number of Vanuatu workers abroad also supported private sector consumption and investment activities. More extraordinarily, the social setting in Vanuatu's economy which comprises of Melanesian values and Christian principles does have an impact in the economy creating social cohesion and hence resilience and perseverance during times of economic distress caused by both domestic and international crisis.

The Government's expansionary fiscal policy via its stimulus expenditure programs and investment in infrastructures has helped maintain public consumption and provided a much-needed support to economic recovery. However, fiscal revenue fell short of budget targets in the first six months of 2022 on account of weaker economic conditions. Government revenue made up only 40.6 per cent of the 2022 revenue budget target and fell by 18.0 per cent from the same period of 2021. All components of revenue with the exception of value-added tax (VAT), such as excise taxes, taxes on property, taxes on international trade and transactions and other revenue items were lower in the first half of 2022, compared to the comparable period a year ago. VAT collections remained stable as domestic consumption is maintained via the Governments economic stimulus programs. Similarly, Government recurrent expenditure fell from budgeted levels in the first six months of 2022 by 44.5 percent, although higher by 8.3 percent than the corresponding period of 2021. This increase reflected the Government's expansionary fiscal policy to support economic recovery.

Overall, the Government's fiscal position deteriorated in the first six months of 2022 from budgetary targets, as it continued to utilise its fiscal buffers from past budget surpluses in 2020 and 2021.

Domestic monetary conditions have remained supportive of growth. Domestic liquidity, as measured by reserve money, remained elevated as the Reserve Bank continued an accommodative monetary policy since 2020. Furthermore, money supply growth remained robust over the year to June 2022, reflecting continuous accumulation of net foreign assets (NFA) and the increase in net claims on the Central Government with the banking system; as the Government increased its domestic bond holdings with the Reserve Bank. Private sector credit has shown a gradual improvement over the year to June 2022, partly reflecting the Government's Special Covid-19 Banking Facility (SCBF) in assisting business recovery. Overall, personal consumption remained the main driver for the annual growth in private sector credit.

The domestic banking sector remains liquid, profitable and adequately capitalised. Asset quality of banks improved over the year to June 2022; however, the accumulation in non-performing loans during the period of the pandemic remains a challenge as the moratorium on loan classification, put in place during the pandemic, ends in September 2022. However, banks have increased their specific and general provisions reflecting any anticipated increase in non-preforming loans. Overall, financial sector stability has been maintained over the short to medium term.

Headline inflation reached 3.6 per cent in the second quarter of 2022 from 2.7 percent in the first quarter, mainly driven by the expenditure categories - drinks and tobacco, food, miscellaneous, education, housing and utilities, transport, health, recreation and communication. These upward price movements mainly reflected the spill over effect of foreign price shocks on domestic prices via the goods and services trade and capital flow channels.

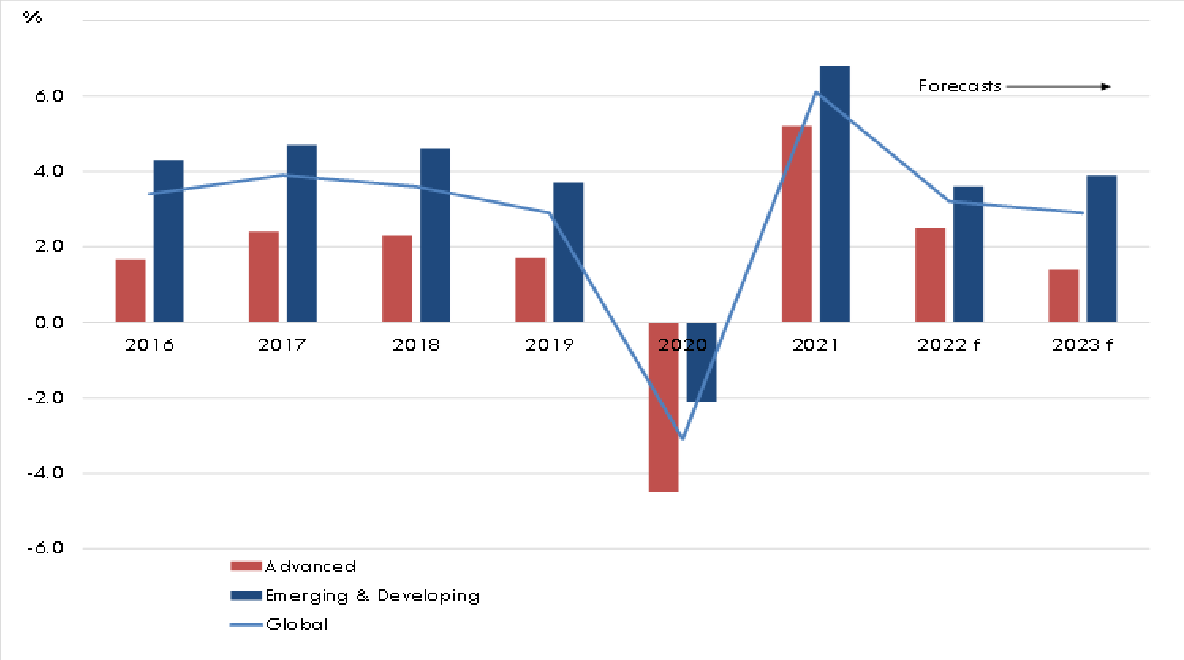
The demand for goods and services from abroad has declined since 2021 due to the current economic weaknesses. Similarly, despite the impact of the pandemic, the Russian-Ukraine war and other global disruptions, a sound external position has been maintained from a continuous inward receipt from abroad in terms of government revenue, export and income earning flows. Accordingly, official foreign reserves remained high, sufficient to finance approximately10 months of import cover in September 2022, well above the Reserve Bank's minimum threshold of 4 months.

4. International and Domestic Outlook

4.1 Outlook for the International Economy

According to the IMF, the global economy is forecasted to decline further as most countries showed high risks of a global recession particularly driven by the US and China and the ongoing humanitarian crisis. Global inflation is also expected to remain elevated due to surge in energy and food prices and demand-supply imbalances. Risks to the outlook projections are on the downside; inclusive of the ongoing humanitarian crisis with its spill over effects of higher inflation and tighter financial conditions, renewed COVID-19 outbreaks and further acceleration of China's property crisis.

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



Source: IMF World Economic Outlook, July 2021

Accordingly, the IMF expects the global real GDP to decline to 3.2 per cent in 2022 and moderating to 2.9 per cent in 2023.

Financial market conditions are set to remain tight in the near term. Major central banks are expected to maintain higher interest rates, and continue with other policy measures to achieve their respective monetary policy goals.

4.2 Outlook for the Domestic Economy

a) Economic Activity

Domestic economy is expected to recover over the short to medium term. According to the Macro-Economic Committee's (MEC) latest forecast in September 2022, the domestic economy will expand by 3.2 per cent in 2022 and 5.3 percent in 2023. The growth is projected to be broad based, led mainly by the industrial and services sectors.

The pick-up in the industrial sector reflects ongoing construction activities of the Government's development needs. The industry sector is predicted to grow by 12.7 percent in 2022 and 13.6 percent in 2023, reflecting the current rebuilding and reconstruction activities following Tropical Cyclone Harold in 2020 and other government projects, including, feeder roads, construction of a hydro power and new government buildings. Minor contributions to growth include an expected pickup in manufacturing activities and electricity production following an anticipated increase in demand as borders re-open.

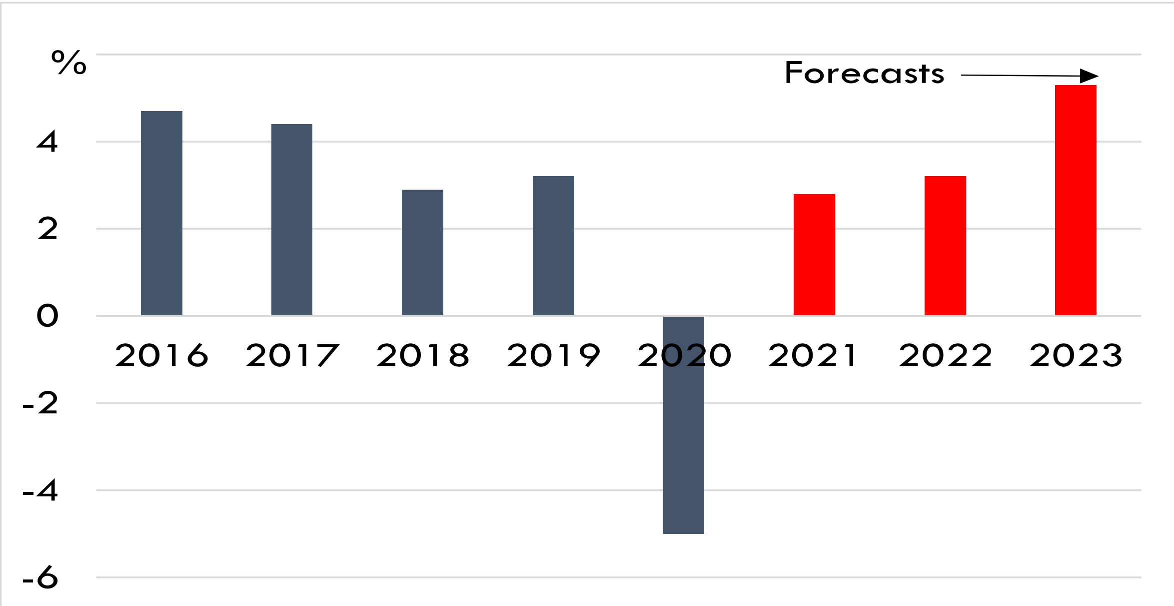
The Services sector is also expected to improve further due to the re-opening of borders, with likely spill over to other sub service sectors and the agriculture sector in 2022 onwards. Accordingly, the services sector is expected to grow by 2.2 percent in 2022 and 4.1 percent in 2023 based on the resumption of tourism related services. This recommencement is expected to have a positive indirect impact on the non-tourism related services, thus contributing to the overall growth in this sector.

Growth in the Agriculture sector will also benefit from the Government policy to encourage and support domestic production to meet the increasing demand of a growing population and foreign demand as borders reopen. Activity in the Agriculture, Forestry & Fisheries sector is therefore projected to grow by 2.1 percent in 2022 and 4.7 percent in 2023.

A number of policy measures have been put in place to support resumption of economic activities, together with external donor financing and a stronger inward transfer from abroad. These measures include the Government's fiscal stimulus, tax relief, the Special Covid-19 Banking Facility, other fiscal policy measures, the Reserve Bank's accommodative monetary policy and its other policies that aims to ensure financial sector stability.

Nevertheless, significant downside risks to this growth outlook remain; such as further delays in the implementation of major infrastructure projects, decline in consumption and investment activities from continuing rise in the cost of living, further supply chain disruptions, natural disasters, renewed transmission of Covid-19 and/or the emergence of new variants, decline in Government revenue from abroad, and any adverse impact of labour migration on labour markets.

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

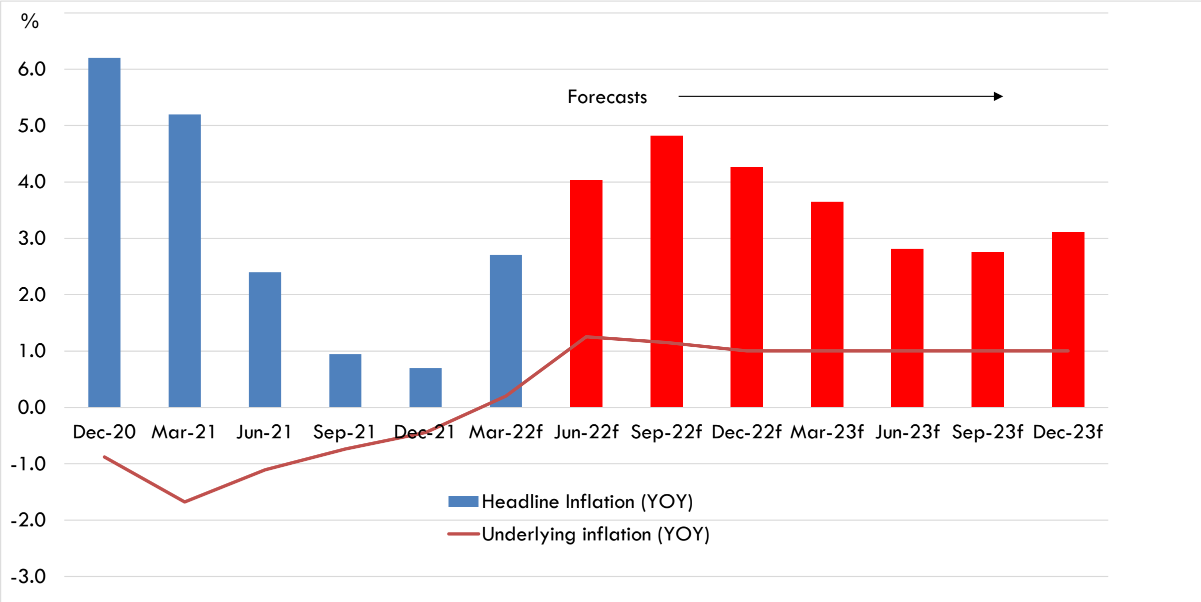


Source: VBoS, Macroeconomic Committee

b) Inflation

Year-on-year headline inflation is forecasted to increase above the Reserve Bank's internal target range of 0 to 4 per cent over the second half of 2022. This is mainly due to slight increases in demand due to border reopening in July 2022, along with spill over effects of the increasing international food and energy prices. This peak is expected to subside by end of 2022 and towards early 2023, when global international food and energy prices are expected to recede. However, the upside risks to these forecasts remain; these include the ongoing Russia-Ukraine war, a strong pickup in economic activity and other unforeseen supply shocks.

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



Source: VBoS, RBV Forecasts

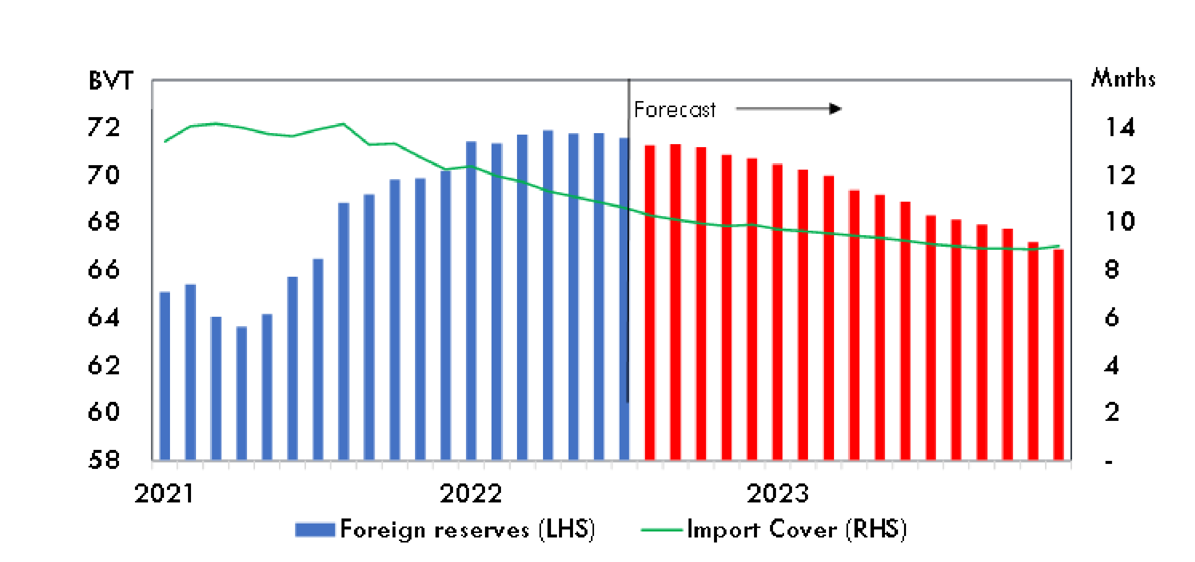
The Reserve Bank is mindful of its objective of anchoring inflation; and will continue to closely monitor inflationary pressures in the economy. While aggregate demand is projected to improve, it is still weak and below pre-pandemic levels. The current inflationary pressures estimated over the recent months are largely associated with the surge in global energy and food prices which are beyond the Reserve Bank's control. These global prices are expected to subside by the end of 2022 to early 2023. Similarly, domestic inflation is projected to recede within the RBVs internal target range by the end of 2022 to early 2023. Overall, the country's fixed exchange rate regime has helped cushion the impact of foreign prices and anchored domestic inflation well.

c) Balance of Payments and International Reserves

The current stock of foreign reserves is sufficient to meet the country's external obligations over the short to medium term. Accordingly, primary income receipts are forecasted to continue to grow given the high demand from both Australia and New Zealand, respectively for seasonal workers. Government transfers from abroad is also expected to increase over the short to medium term given the Government's ongoing development priorities.

Conversely, external payments are expected to increase and would exert further pressure on official foreign reserves, given the border re-opening, the appreciation of US Dollar exchange rate against the Vatu, and higher world prices. Official foreign reserves however, are expected to remain above the Reserve Bank's threshold of 4 months of import cover by the end of 2022 and into 2023. The downside risks to the foreign exchange projections over the short to medium term include; higher Government debt servicing, appreciation of the US Dollar, high private sector import financing, and any disruptions to Government revenue from abroad.

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



Source: RBV

5. Monetary Policy Stance

The economy is estimated to have performed slightly better in 2021 and 2022 from a contraction in 2020 following the Covid-19-related lockdowns. Economic recovery has been supported by the Government's expansionary fiscal policies via a series of stimulus package roll outs and investment in infrastructures and an accommodative monetary policy. Overall, growth is forecasted to rebound over the medium term as the re-opening of international borders in July 2022 has contributed to a more robust and positive outlook. The Government's expansionary fiscal policy is reflected in the deterioration in the its net lending position with the domestic banking system. Domestic monetary conditions have remained supportive of growth, as growth in money supply has picked up due in particularly to the accumulation of net foreign assets and the increase in the Governments net credit vis-à-vis the banking system. The domestic banking sector has remained liquid, profitable and adequately capitalised. Though the asset quality of banks showed some deterioration, the banks have made specific and general provisions within their books and the majority of loan portfolios are standard loans. While inflation is expected to exceed the Reserve Bank's target during the second and third quarter, it is expected to recede within target towards the end of 2022. The official foreign exchange reserves remained sufficiently above the minimum target.

Increasing inflationary pressures remain the key challenge to the Reserve Bank's current monetary policy setting particularly as they begin to become entrenched in domestic prices. However, these are expected to recede to the RBV's target level at the end of 2022. Although the outlook for the domestic economy has improved, risks to growth are still tilted to the downside. Private sector growth remains subdued, while the need to continue to manage non-performing loans remains a key consideration as the period of the moratorium imposed on loan classification ends in September 2022. The RBV will closely monitor these challenges/risks with a view to ensuring stable macroeconomic outcomes in Vanuatu.

At its meeting on the 7 October 2022, 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 effective.
- The RBV has elevated open market operations to mop up excess liquidity.

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.