RESERVE BANK OF VANUATU

HALF YEAR MONETARY POLICY STATEMENT

SEPTEMBER 2023

Reserve Bank of Vanuatu

Half-Yearly Monetary Policy Statement

September 2023

1. Statement by the Governor

The global economy continued to gradually recover from the lingering impact of the pandemic, the Russia Ukraine war and rise in the cost of living. The rebound in economic activities and the easing of annual global inflation indicated a level of resiliency in the global economy in the first half of 2023. However, growth remained weak, below past historical trends and uneven with increasing divergences amongst regions. Slower global recovery largely reflected tighter monetary policy and credit conditions, withdrawal of fiscal support amid high debt and extreme weather conditions. Global commodity prices have stabilized over the first half of the year. The International Monetary Fund's (IMF) food price index and energy price index have eased relative to previous year's level.

Domestic economic growth which rebounded in 2022 from a contraction in 2021, is projected to further improve in 2023 and 2024. Growth has become broad-based as the re-opening of borders in the second half of 2022 will likely have positive spill over effects to all other economic sectors. The overall growth outlook for 2023 looks positive, largely driven by the industry and the services sectors. The agriculture sector, by contrast, is projected to contract owing largely to the impact of damages on crop production from the dual cyclones in March 2023.

The Government operations continued an expansionary trend in light of policies to maintain domestic consumption and support economic recovery from the effects of the pandemic and two cyclones in March 2023. As a result, the Governments net credit position with the domestic banking system deteriorated during the first eight months of 2023.

Monetary conditions remained supportive of economic recovery. Banking system liquidity remained at high levels and private sector credit has gradually picked up relative to the previous year. The domestic banking sector remained sound, profitable and adequately capitalised. Although non-performing loans (NPLs) have accumulated, the majority of the loan portfolio remained standard. General loan provisioning has declined reflecting the current domestic economic recovery. Overall, financial sector stability is expected to be maintained in short to medium term.

The Reserve Bank (RBV) has tightened its open market operations in October to counteract rising inflation. Inflation is projected to remain above target until early 2024. The RBV is expected to further adjust monetary policy as it seeks to address continuing inflationary pressures. Official foreign reserves have remained above the minimum target level over the past eight months. The foreign reserves outlook remains positive with 9 months of import cover at the end of 2023.

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 between 0 and 4 per cent and sufficient international foreign reserves above a minimum threshold of 4 months of import cover.

Inflation remained the main monetary policy challenge during the past six months of 2023. In the March and June quarters of 2023, annualised rise in headline inflation tripled the Reserve Bank's upper target band of 0-4 percent. The rise reflected both international price shocks and supply constraints caused by the cyclones in early 2023. To address the rise in inflation, the Reserve Bank further increased the volume of new RBV Notes issue in open market operations in October 2023. Inflation is expected to remain above the Reserve Bank's target until early 2024. The Reserve Bank's foreign reserves target, by contrast, has largely been achieved during the first eight months and is likely to remain comfortable until the end of 2023.

3. International and Domestic Overview

3.1 The International Economy

The global economy continued to gradually recover from the persistent impact of the pandemic, the Russia Ukraine War and rise in the cost of living. The rebound in economic activities and the easing in annual global inflation indicated a more resilient global economy in the first half of 2023. However, growth remained weak and uneven with increasing divergences amongst regions. In emerging markets and developing economies, economic activities are still below pre-pandemic levels. Slower global recovery largely reflected tighter monetary policy and credit conditions, the withdrawal of fiscal support amid high levels of debt and extreme weather conditions.

Similarly, growth has gradually picked up and inflation has started to decline in Vanuatu's major trading partners. These developments reflected the impact of both fiscal and monetary policies within respective jurisdictions.

The US GDP grew by 2.1 percent over the June quarter from a contraction of 0.6 percent in the same period of the previous year. Growth reflected pick-up in both business investment and consumption. Annual Inflation reached 3.7 percent in September 2023, down from 8.2 percent in September 2022. Growth in the Australian economy remained weak at 2.1 percent in the June quarter of 2023, lower than 3.1 percent during the same period of 2022. Inflation reached 5.4 percent over the September quarter, lower than 7.3 percent over the same period of 2022, but still at elevated levels from the pre-pandemic period. The New Zealand economy rose by 3.2 percent in the June quarter, compared to a 1.2 percent growth over the same period of the previous year. This upward trend was partly due to improved domestic consumption and high net immigration. Inflation has been declining since the end of 2022 amidst continuous monetary tightening. It reached 5.6 percent in September 2023, lower than 7.2 percent in September 2022.

In the Euro area, the economy grew at a subdued pace over the first half of the year amidst weak business and consumer confidence. Real GDP grew by 6.8 percent over the June quarter in contrast to 8.9 percent over the same quarter of 2022. Inflation is estimated at 2.9 percent[1]

[1] Eurostat Flash estimate October 2023

in October, way lower than 10.6 percent recorded in October 2022. Inflation has been decreasing since September 2022 but remained high compared to the pre-pandemic period. In China, the economy has rebounded over the September quarter, supported by policy measures inclusive of increased fiscal spending, interest rate cuts and financial sector reforms aimed to address the property crisis. Accordingly, quarterly GDP growth was estimated at 4.9 percent in September in comparison to 3.9 percent over the same period of 2022. Inflation was estimated at 0.10 percent for the month of September in comparison to 1.47 percent recorded in September 2022.

Global commodity prices have stabilized over the first half of the year. The IMF All Primary commodity index has declined from 220.0 in September 2022 to 168.4 in September 2023.

3.2 The Domestic Economy

Growth in the domestic economy is projected to rebound in 2022, registering a 2.7 percent increase from a contraction of 1.6 percent in 2021. Growth was broad-based reflecting mainly the re-opening of borders in the second half of 2022, with likely spill over effects to all the sectors of the economy.

Two economic assessments[2] carried out during the first half of 2023 estimated that the agriculture, forestry and fisheries sector of the economy had declined over the first half of the year. This predominantly reflected the negative impact of two cyclones experienced in early-March, in addition to constraints such as labour shortage, an outbreak of the coconut rhinoceros beetle, and the negative impact of El-Nino and climate change. Growth in the industry sector is projected to gradually expand over the first half of the year, owing to the implementation of major Government infrastructure projects and private sector construction activities. The proliferation in private sector construction reflected the Governments disaster recovery activities and the impact of cyclone recovery packages offered by the Vanuatu National Provident Fund to members. The services sector was estimated to have improved over the first half of the year as tourism activities picked up, with spill over effects on the other services sector. In addition, retail trade has expanded due to increasing demand of imported food to substitute for supply constraints in domestic root crops, fruits and vegetables that were damaged by the cyclones. Regular inflows of remittances also helped sustain growth in retail trade.

Partial indications of consumption, investment and net exports have improved and contributed to the overall economic performance during the first half of 2023. VAT collections increased by 62 percent in June 2023 from June 2022. Lending to the individual sector increased by 6 percent in June 2023 from June 2022. Credit to businesses (investment) and household and land purchases (private investment), rose by 8 percent and 0.7 percent, respectively, in June 2023 relative to June 2022. Net exports improved to VT (9,962) million in the March quarter 2023 from VT (14,181) million in the same quarter of 2022. Major sources supporting consumption, investment and net exports in Vanuatu include domestic workers' income, and income from abroad by both residents[3] and non-residents[4].

The Government's overall financial position remained sound during the first half of 2023. Fiscal revenue improved significantly, reflecting improvements in economic conditions and continuing government support to the economy. Recurrent revenue were in line with the 2023 budget target, reaching 50.8 percent of target as at end of June 2023.Value-added tax (VAT) remained the main contributor to strong revenue performance; reaching 50.0 percent of its 2023 budget target. This largely reflected the resurgence in economic activity and consumption, due to the re-opening of international borders, the impact of the 30 percent withdrawal of

[2] Economic assessments were carried in March and June 2023
[3] Includes short term workers abroad (Recognized Seasonal Workers/ Seasonal Worker Program) and domestic exporters
[4] Non-residents residing abroad permanently and remitting funds and tourists

VNPF member funds and advance salary payments for civil servants as recovery support measures. Furthermore, revenue components such as taxes on international trade and excise taxes, rose above the year budget targets; and, contributed to overall growth in revenue. In contrast, other revenue underperformed, reaching only 48 percent of its target and were lower by 5.2 percent relative to the same period in 2022. Overall, total revenue collections were assisted by a budget support of VT1.2 billion in the first half of 2023 following the aftermath of the two cyclones in early 2023.

Fiscal expenditure by contrast fell by 1.0 percent in the first half of 2023, relative to the first half of 2022; reaching only 41.7 percent of its 2023 budget target. The decline reflected mainly the impact of the Supply Bill[5] which was in effect for the first quarter of 2023. This attributed to restrained fiscal expenditure in the first six months of 2023. Overall, the government operated a fiscal surplus in the first six months of 2023; due to favourable performance in major revenue components and lower expenses.

Domestic monetary conditions remained supportive of growth. Domestic liquidity, as measured by reserve money, remained at high levels, in light of the Reserve Bank's continued accommodative monetary policy. Money supply continued at a steady growth over the year to August 2023; reflecting net inflows of foreign reserves and increases in both net claims on the central government and private sector credit (PSC). The Government's net credit position with the banking system deteriorated over the year to August 2023. This largely reflected the rise in the Government's domestic borrowing[6] via commercial banks from VT1,000 million in August 2022 to VT3,300 million in August 2023. Growth in PSC remained gradual, due to the current economic recovery and is expected to be stable going forward. Generally, personal consumption remained the main driver for the annual growth in private sector credit.

The domestic banking sector remained liquid, profitable and adequately capitalised; though individual banks continue to face ongoing challenges. Asset quality of banks deteriorated in the first half of 2023; reflecting challenges related to the COVID-19 pandemic, the effects of the twin cyclones in early 2023 and on-going credit risks. However, the banking industry's general provisions contracted, while specific provisions rose over the year to June 2023. The contraction in general provision allocations indicated an expected improvement in credit losses, due to continuing recovery in the economy. Overall, financial sector stability was maintained during the past six months and is expected to remain stable in the short to medium term.

Annual headline inflation reached 14.4 percent in the second quarter of 2023 from 11.6 percent in the first quarter and 11.2 percent over the December quarter 2022. The surge in prices reflected both domestic and international factors, such as; disruption in domestic supply chains caused by the dual cyclones, high global food and energy prices, high imports and transport related cost and the impact of the minimum wage policy. Food prices continued to be the main driver of inflation followed by transport prices. In addition, other expenditure categories such as recreation, miscellaneous, clothing and footwear and health prices have noticeably increased over the past year.

In terms of Vanuatu's external indicators, the current account balance (CAB) improved over the first three months of the year, reflecting a similar trend over the same period of the previous year as inward foreign receipts outweighed outward foreign payments. The improvements were driven mainly by enhancements in both trade in deficit balances and income balances. Trade in goods balance improved by 17 percent owed by reductions in imports outweighing reductions in exports. Trade in services balance improved by 48 percent driven mainly by tourism receipts.

[5] The Supply bill was enacted by Parliament in early 2023 to cater for government expenditures in the first three months 2023; as the 2023 budget was not appropriated in November 2022, due to the dissolution of parliament. The bill stated that expenditures for the first three months of 2023 were to be the same amount as appropriated in first three months of 2022.

[6] Government domestic borrowing is mainly by issuance of government bonds

The primary income balance increased by 11 percent driven mainly by compensation of employees abroad while the secondary income balance increased by 36 percent due to inward transfers for recovery purposes related to the dual cyclones.

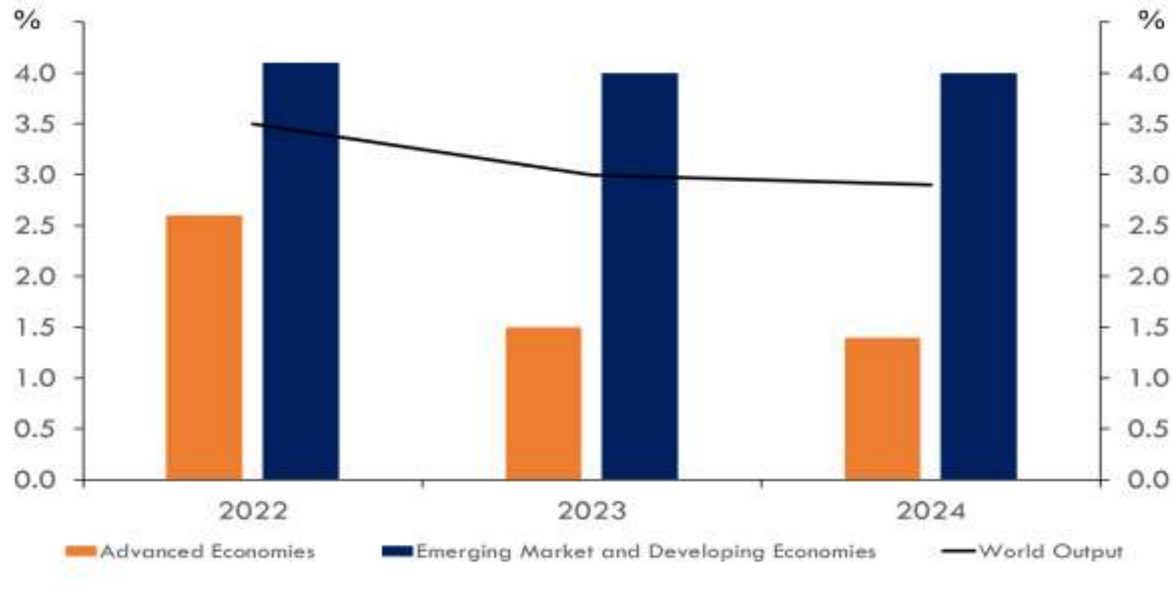
Accordingly, official foreign reserves remained high, sufficient to finance approximately 9 months of import cover in September 2023, well above the Reserve Bank's minimum threshold of 4 months.

4. International and Domestic Outlook

4.1 Outlook for the International Economy

According to the IMF (October 2023), global growth is forecasted to continue a downward trend in 2023 (3.0 percent from 3.5 percent in 2022) and further decline to 2.9 percent in 2024 amidst tighter policy conditions, increased regional divergences, high debt and extreme weather events. Furthermore, the persistent effects of the pandemic, war and geo-economics fragmentation remain, further attributing to the slower recovery. Global inflation is projected to decline from 8.7 percent in 2022 to 6.9 percent in 2023 and 5.8 percent in 2024. Global prices of fuel and non-fuel commodities are projected to fall on average by 36 percent and 6.3 percent, respectively; due to the slowdown in global economic activity and real estate crises in China. Though food commodity prices are expected to decline by 6.3 percent in 2023, prices remain well above their 2021 levels.

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



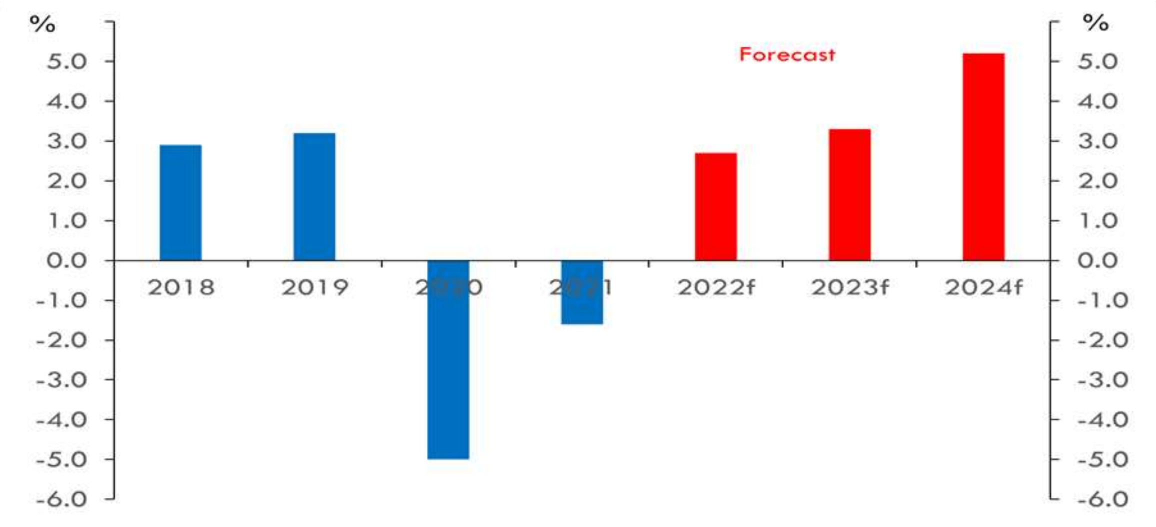
Source: International Monetary Fund, October 2023 World Economic Outlook

4.2 Outlook for the Domestic Economy

a) Economic Activity

The domestic economy is expected to recover over the short to medium term amidst the lingering impact of the pandemic, high prices and the dual cyclones. According to the Vanuatu Macro-Economic Committee's (MEC) latest projections in October 2023, the domestic economy will expand by 3.3 percent in 2023 and 5.2 percent in 2024, led by the industry and services sectors whilst the agriculture sector will gradually recover from the devastating impact of the twin cyclones in early March 2023.

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



Source: Vanuatu Bureau of Statistics, Macroeconomic Committee Forecast

The industry sector is expected to grow by 8.5 percent in 2023 and 12.2 percent in 2024. Growth is projected to be driven by the implementation of major government infrastructure projects such as hydro projects in South Santo and Sarakata; tar sealed roads in Pentecost, Malekula and Tanna; South Paray wharf, building construction for the Ministries of Finance and Foreign Affairs, the re-development of the Cook and Tiroas Barracks, and the construction of the presidential palace. The 2024 growth also reflected the governments capital project funds. Private sector investment is also projected to pick up supported by the governments recovery efforts and income from abroad. Electricity production is projected to expand. A major hydro power station in the Brenwei river in Malekula will be completed in October 2023 and a new electricity grid is currently in progress connecting Turtle Bay to Port-Olry in Santo. These are positive developments in the utility sector. The manufacturing sector is forecasted to improve, supported by observed increased trainings[7] provided and establishments of new offices in the Penama and Malampa provinces to facilitate growth of agro-industry in the respective provinces.

The services sector is projected to pick up by 4.4 percent in 2023 and 4.6 percent in 2024, driven by the ongoing recovery in tourism and non-tourism services related activities. Tourism related activities such as accommodation and food services, information and communication services, and transport services are expected to grow reflecting both recovery in tourism arrivals and the increasing domestic demand for these services. The retail businesses are booming reflecting expansion of businesses and the continuous inflows of income from abroad to households. In the non-tourism related activities, real estate businesses have picked up due to high demand from domestic and international investors. The final subcomponents of the services sector; finance and insurance and public administration sectors; are expected to strengthen reflecting recovery in economic activities and expansionary fiscal policy.

Growth of the agriculture sector is forecasted to decline by 1.0 percent in 2023 and slightly improve by 2.8 percent in 2024 driven by recovery in crop production. Although production of fruits and vegetables have gradually recovered from the impact of the cyclones, exports of

[7] Online reports showed trainings mainly organised by the Department of Industry and provided by Vanuatu Skills Partnerships, Vanuatu Chamber of Commerce and other related stakeholders and supported financially mainly by donor partners.

major commodities such as coffee, cocoa and copra have declined. Fish and animal production are expected to increase reflecting the recovery in domestic demand for beef and fish within restaurants and bangalows and for household consumption. Additional support from the EDF11 and the government's 90/10 and 80/20[8] agricultural subsidies will support farmers to recover from production and other losses following the recent natural disasters.

Overall, the risks to the economic growth outlook remain tilted to the downside. The risks to output in the agriculture sector include; the spread of the coconut rhinoceros beetle, domestic labour shortages, and the impact of natural disasters, climate change and El Nino. The risks to growth forecasts for the industry and services sectors include; surge in global and domestic prices, domestic labour shortages, the impact of Air Vanuatu's operational and financial distress and the loss of correspondent banking relationships. Political instability remains a major risk to all sectors of the economy.

Monetary conditions will remain supportive of growth in the short to medium term. Net claims on the central government with the banking system is projected to increase and will be the main driver for domestic credit in the short to medium term; as the government is expected to increase its domestic borrowing to fund capital projects in 2024 and beyond. The RBV will continue to monitor growth in money supply and implement policy measures where appropriate to ensure money growth remains sustainable.

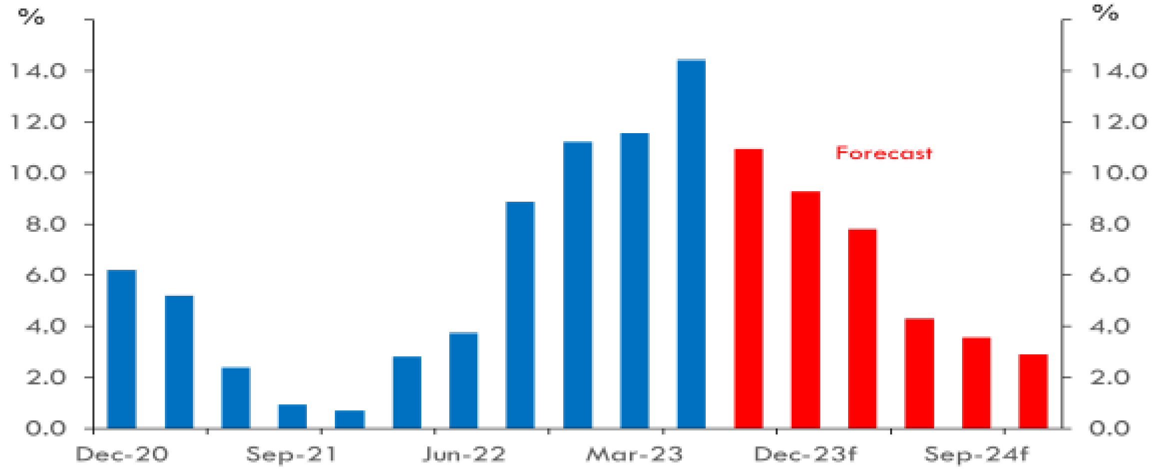
Financial sector stability is expected to be maintained in the short to medium term. However key challenges remain in continuing high levels of NPLs, high levels of excess reserves and the threat of further de-risking of corresponding banking relationships and the on-going impact of natural disasters, especially tropical cyclones.

b) Inflation

Vanuatu's overall headline inflation is estimated to remain above the RBV's internal target (0-4 percent) over the second half of the year to early 2024. Annual average inflation in 2023 is estimated to rise to11.6 percent from 6.7 percent in 2022. The contributing factors from domestic sources include; recovery in the domestic economy, the effect of planned major Government projects, and the impact of weather patterns and natural disasters. The risks to the outlook from the external environment include; geopolitical tensions, further cuts in oil production by Saudi Arabia and Russia, the impact of natural disasters and weather patterns, for instance; the recent flooding in Libya and the recovery of China's economy, which will contribute to volatility in global commodity prices. Recent Government policy measures to reduce import duty and adopt clean energy technologies should help mitigate against rise in domestic inflation. The RBV's fixed exchange rate regime has helped anchor inflation. The Reserve Bank will remain vigilant in monitoring inflationary pressures in the economy over the short to medium term.

[8]The 90/10 and 80/20 are government policies to help farmers, foresters and fishers recover after the tropical cyclones in early March 2023. These two subsidies are financed by the Vanuatu government, through the Ministry of Agriculture, Livestock, Forestry, Fisheries and Biosecurity (MALFFB) and its partners. The 90/10 applies to farming and fishing tools and equipment whose cost is over VT60,000. MALFFB will cover 90% of the cost of the item while farmers and fishers will pay only 10%. 80/20 applies to equipment costing less than VT60,000. MALFFB will pay 80% and farmers will cover the other 20%.

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



Source: Vanuatu Bureau of Statistics, Reserve Bank of Vanuatu staff Forecast

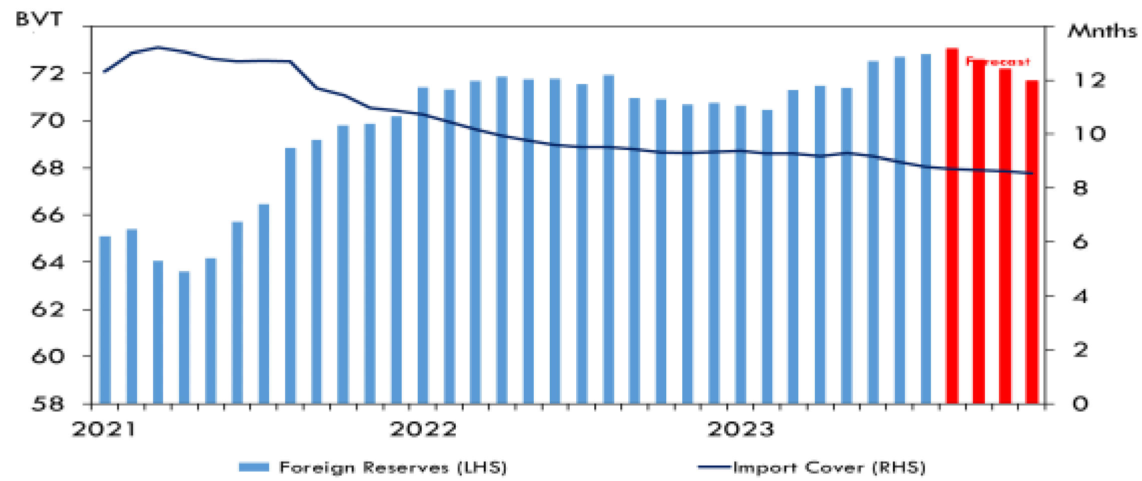
The Reserve Bank is mindful of its objective of anchoring inflation; and will continue to closely monitor inflationary pressures in the economy.

c) Balance of Payments and International Reserves

The current stock of foreign reserves is sufficient to cover Vanuatu's external obligations over the short to medium term. Recent data shows that the overall trade balance is expected to improve, underpinned mainly by improvements in the services account; while downward risks factors lie in the goods account mainly from high import costs. Overall, the income balance is expected to remain in surplus given the continuous increase in number of workers employed abroad and expected external receipts from donor partners for disaster related assistance and Government priorities.

Official foreign reserves are expected to remain above the Reserve Bank's threshold of 4 months of import cover over the short to medium term. The downside risks to foreign exchange projections over the short to medium term include; higher Government debt servicing, political instability, appreciation of the US Dollar, high private sector import financing, price volatilities and any disruptions to Government revenue from abroad.

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



Source: Reserve Bank of Vanuatu

5. Monetary Policy Stance

The Reserve Bank's current monetary policy stance remains appropriate under the current economic environment to support a nascent domestic economic recovery; but the emergence of high inflation has become a major concern for monetary policy this year. Domestic inflation is projected to remain above RBV's internal target over the second half of the year to early 2024. The level of foreign reserves has been maintained at high levels and will remain above the RBV threshold from short to medium term. To counteract price pressures and ensure the achievement of objective of price stability over the short to medium term, the Reserve Bank Board of Directors, during its meeting in early October 2023, resolved to tighten conditions through increase in the volume of open market operations. The Reserve Bank's other policy instruments remain unchanged, 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 raised the volume of new notes issued in its open market operations (OMO) from VT100 million per month to VT200 million per month starting in early October 2023.

The Reserve Bank will continue to monitor international and domestic economic development likely to impact its policy settings and will make further changes as and when appropriate.