MONETARY POLICY STATEMENT BY THE GOVERNOR OF THE RESERVE BANK OF VANUATU. Mr. Odo Tevi

FEBRUARY 10, 2005

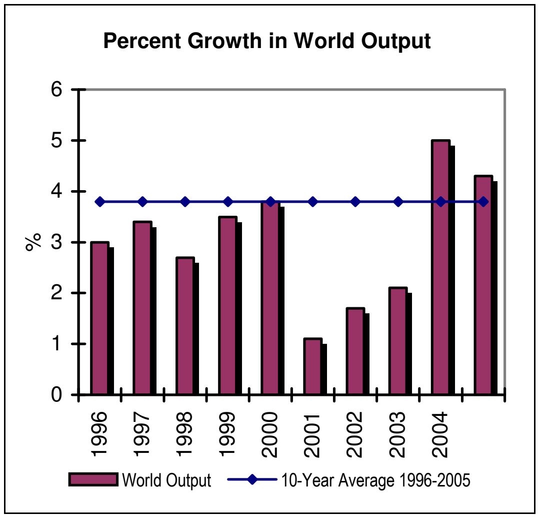
1. INTRODUCTION

The Board of the Reserve Bank of Vanuatu met on December 28, 2004, and decided to maintain the Reserve Bank's discount rate at 6.5 percent. The discount rate is the policy indicator rate of the Reserve Bank of Vanuatu

In making this decision, the Board took into consideration development in various economic variables that the Bank monitors against the policy setting of the Reserve Bank. It noted that the improvements in the international economy has been supportive of the current pick up in domestic economic activity, a strengthening of official international reserves, and deceleration in headline inflation which would have prompted a reduction in interest rates by the Reserve Bank. However, in maintaining the discount rate, the Board was concerned about the remaining risks in the economy that could potentially be disruptive to monetary conditions.

The principal objective of the Reserve Bank of Vanuatu is to maintain *monetary stability*. The Bank interprets this to mean, at the external level, the maintenance of an adequate level of official international reserves equivalent to a minimum of 4 months of import cover, and at the domestic level, low inflation at a maximum comfort level of 4 percent annual growth rate. These policy objectives were achieved in 2004.

2. THE INTERNATIONAL ECONOMY



The Board noted that the strength of the international economy has been supportive of the domestic economic recovery. It noted that the rate of world economic growth of 5 percent in 2004 has been broad-based, and well entrenched, surpassing trend growth to reach a high of three decades. In spite of recent weakening, notably in the U.S. and Japan, the expansion is expected to generally remain solid in 2005.

It was evident that growth prospects in Vanuatu's major trade-partner countries remain robust. The **Australian economy** maintained a solid pace of expansion of 4.1 percent over the year to June, amidst low inflation and high consumer confidence. The Reserve Bank of Australia left its key interest rate unchanged at 5.25 percent in November, making it the eleventh consecutive month the rates have been intact. The **US economy** appears well entrenched in its fourth year of recovery. Growth registered an annual 3.9 percent growth to September. Whilst employment data has not been as robust the outlook remained positive with unemployment down to 5.4 percent in September. General business conditions also remain positive. While core inflation picked up to 2.0 percent in the first five months there was deceleration in headline inflation, which indicated the modest effect of high world petroleum prices so far. The Federal Reserve continued to raise interest rates to more normal levels, by 25 basis points to 2 percent in November and may continue to do so in the months ahead. Growth of 5 percent over the year to June has particularly been strong in **New Zealand** with resources continuing to remain stretched. The labor market remained tight with the unemployment levels at 17 year lows. Inflation has been within the Reserve Bank of New Zealand's target range but there are continuing pressures on prices although the strength of the New Zealand dollar has been supportive of low inflation. In light of this development, the Reserve Bank of New Zealand raised interest rates in September by 25 basis points to 6.25 percent.

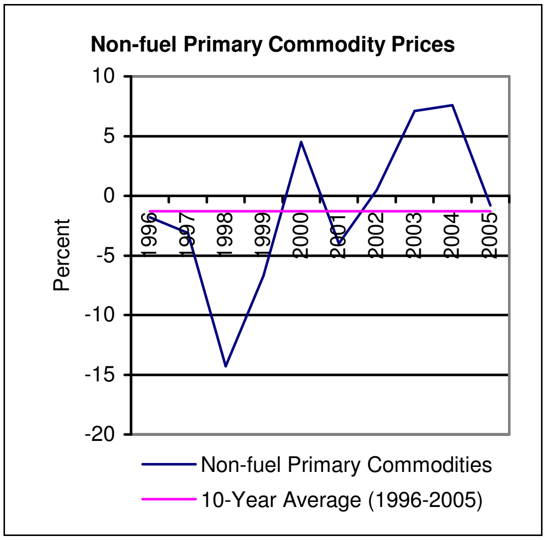
The rapid pace of growth in **Japan** at the beginning of 2004 has moderated but continues to recover from past recessions as real GDP registered 4.3 percent over the year to June 2004. The corporate sector is in much better health and business conditions have risen to decade-high levels. Annual growth has recovered to 2.0 percent to June in the **Euro zone** but remains uneven regionally. Among the region's economic powerhouses, growth has been highest in France. The recovery in the euro area looks likely to continue but with business sentiment still below average at the backdrop of reform-related uncertainties. The Europe-wide unemployment rate remains high at 9.0 percent. Whilst underlying inflation remains at about the ECB's 2 percent reference rate, high energy prices have pushed overall prices above that reference point. The policy rate of the ECB has remained unchanged at 2 percent since June 2003.

As a small open economy, vulnerable to external shocks, growth prospects in Vanuatu have relied on world prices for its key trade commodities.

The index of overall primary **commodity prices** rose by 27 percent in US dollar and SDR terms in 2004 reflecting sizeable movements in the prices for energy, raw materials and metals and a surge in global demand, notably from Asia. World oil prices rose sharply to record nominal highs, as much as US$53 per barrel in October, which is 75 percent higher than a year earlier. They have moderated since but remain high however. This development reflects a range of factors, including (i) global recovery in which demand for oil, particularly from China, have outpaced supply (ii) output reduction announced by OPEC in February followed by disappointing output of non-OPEC production in the US, UK, and Venezuela (iii) low level of inventories in OECD countries (iv) tight product markets where strong demand in oil was met with lack of refinery flexibility (v) Speculative activities (vi) geopolitical uncertainties and (vii) continued uncertainty regarding the status of the Russian oil firm OAS Yukos, responsible for 2 percent of world oil supplies and 10 percent of China's oil imports.

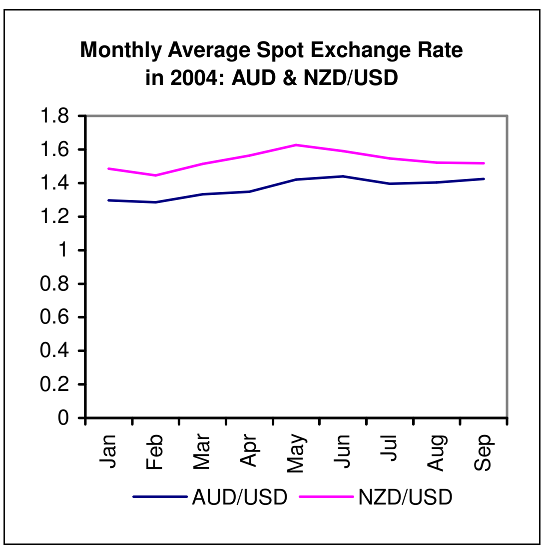
Non-fuel primary commodity prices also rose to high levels in 2004. The increase moderated in the latter part of the year and coincided with moves by the authorities to slow growth expansion in China and a range of supply side factors. Average world prices for copra and coconut oil were 61 percent and 23 percent higher than year-ago levels in September 2004, which contributed to pick up in the domestic economy. The index however shows some moderation in 2005.

The impact of high world petroleum prices on the domestic economy appears to have been modest so far, partly because it has somewhat been diminished by a corresponding rise in exports. While domestic petroleum prices have been rising this has not reflected significantly on the consumer price indices for Vanuatu.



Source: IMF World Economic Outlook: September 2004

The movement of the U.S dollar dominated the foreign exchange market in 2004 and had a large bearing on the movement of the Vatu against the currencies of Vanuatu's major trade partners. The concerns about the twin deficits in the U.S. led the US dollar to generally weaken against the currencies of Vanuatu's trade partners with the exception of the Japanese Yen.



Source: Bank of England

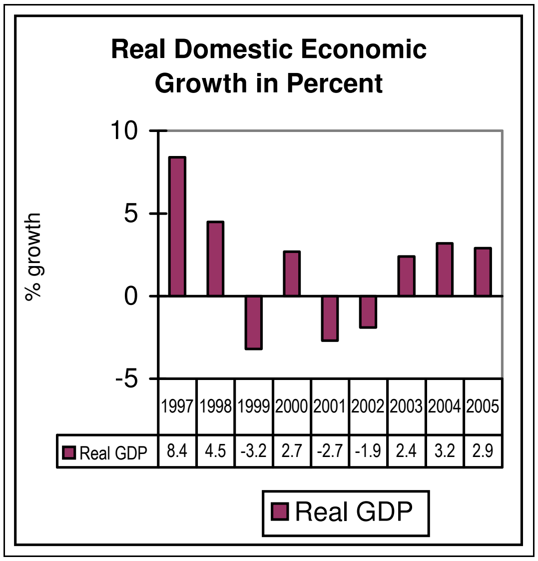
On the other hand, the Australian and New Zealand dollars strengthened against the U.S. dollar, assisted by high commodity prices and the interest rate differential between the U.S dollar, and the New Zealand and Australian dollars. The Yen was generally weak against the U.S dollar but rose briefly in August as concerns about growth in the U.S materialized. It depreciated in September from weakening in the Japanese economic expansion.

Long-term interest rates were general low in 2004.

3. DOMESTIC ECONOMIC DEVELOPMENT

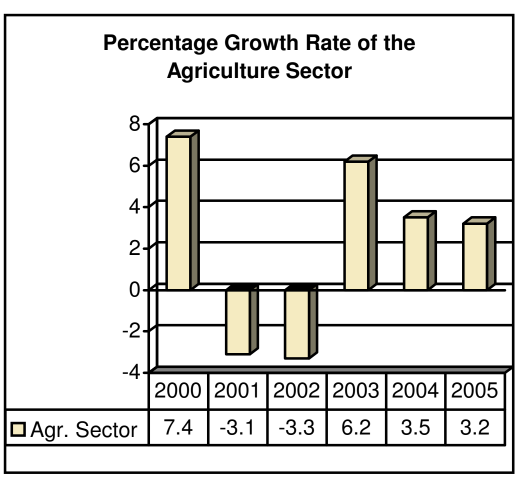
The Board noted that domestic real economic growth, now estimated at 3.2 percent in 2004, continued to register strongly with potential for this to continue, perhaps at a softer rate, in 2005. The strengthening is largely driven by external demand reflected in pick up in tourism and high world commodity prices as well as pick up in domestic private sector development and an open sky policy that contributed to an increase in airline capacity. Unlike in early 2003 when growth was confined mostly to the agriculture sector, the current pick up is broader based. It extended to the important Services sector, reflected by pick ups in the tourism, land and property development and the Industry sectors, as the manufacturing sub-sector begins to show signs of improvement. The overall growth level however is still lower than in certain high growth episodes of the past.

To support this recovery, the Reserve Bank has been accommodative in its monetary management at the same time that it has held the discount rate unchanged for some time. This has helped kept interest rates low and allowed a strong growth of private sector loans from commercial banks, which helped support consumer demand in recent years. The ability of the Reserve Bank to remain accommodative will depend on the risk outlook, which includes, not least the ability to maintain prudent fiscal policy.

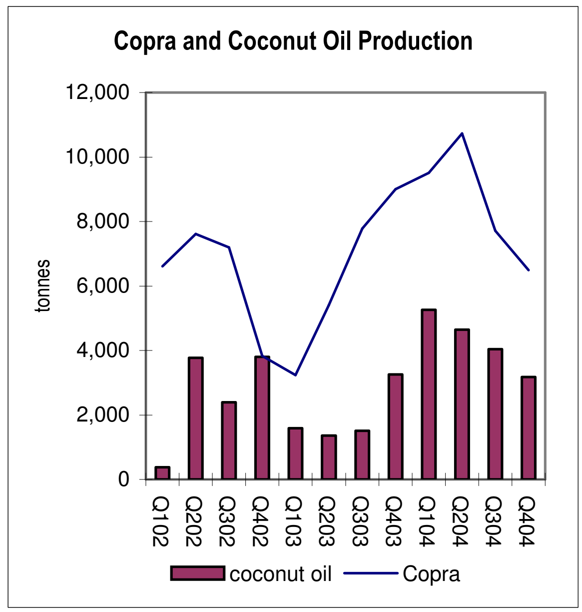


The Agriculture Sector

Amidst high world commodity prices, the agriculture sector continued to expand, albeit at a lower rate of 3.5 percent in 2004. Strong growth, notably in the first half of the year also reflected increases in the number of tree nuts felled by cyclone Ivy and improved intra-transport coverage. Activity in the sector is expected to moderate in the second half of the year and possibly into early 2005 as the effect of the cyclone begins to show on the productivity of tree crops particularly copra and cocoa. Beef production is forecasted to continue improving as overseas organic markets are opened up and other commercial agriculture is expected to improve in line with private sector initiatives into root crops and other commercial agriculture such as vanilla planting.



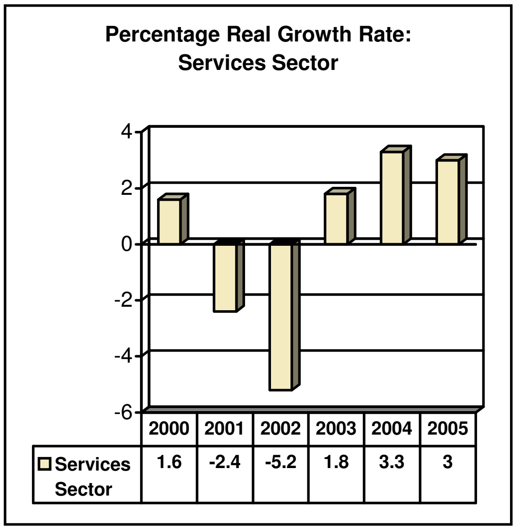
Copra and coconut oil production showed significant improvements in the first half of the year. Ouput of copra surged to 34,446 tonnes in 2004 compared to an annual production of 28, 925 tonnes in 2003. Although this improvement includes imports of copra the overall production level was higher , which implied larger income to farmers and the rural community. Coconut oil exports amounted to 17,111 tonnes in 2004 compared to an annual level of 7,722 tonnes in 2003.



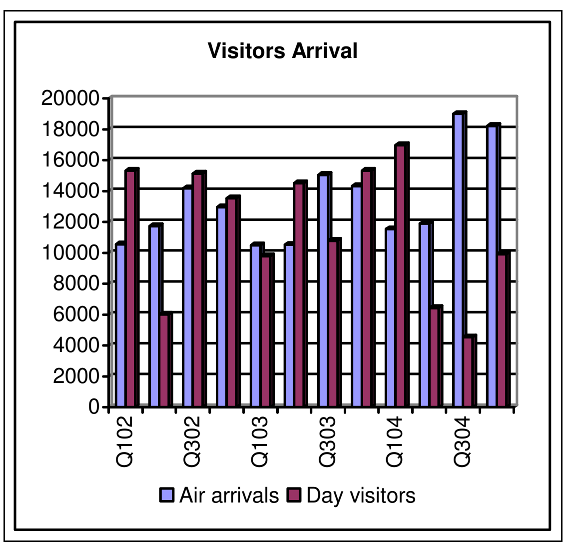
The Services Sector

The services sector is expected to grow by 3.3 percent in 2004 as well as in 2005. The growth in tourism, its large component and an important engine of growth for the economy, rose sharply in the second half of 2004 due to an addition of an aircraft by Air Vanuatu and the introduction of Pacific Blue services to Port Vila. These developments led to an increase in air arrivals by 22 percent over the 2003 level, whilst there were drastic falls in the level of cruise ship arrivals. The tourism sector contributed significantly to the current resumption in economic activity. Notwithstanding this, tourist arrivals will largely depend on Air

Vanuatu, the national carrier, continuing operations of sound footing.



There were some notable improvements in the services sector generally. Earnings of commercial banks were higher in 2004 and there were substantial developments in land and properties development that contributed significantly to the overall services sector activities.



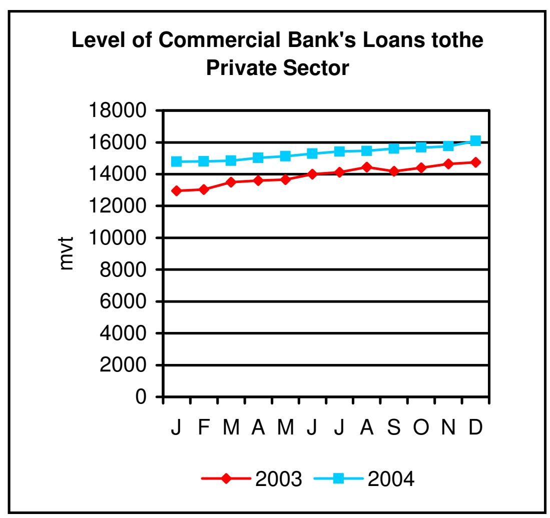
The Industry Sector

Compared to past dismal performances, growth of about 1.6 percent is now expected in the industry sector in 2004.

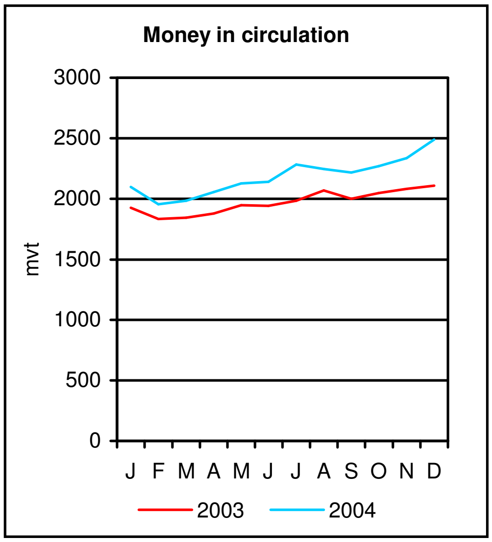
In particular, the manufacturing sub-sector has shown signs of improvements largely driven by manufacturing of coconut oil. Improvements were noted in the level of construction in line with public donor funded projects and the rise in commercial bank loans to the housing and land development sector. Energy sales are also up in line with the pick up in economic activity.

Other Indicators of Domestic Demand

The Board noted that the range of indicators for domestic demand the Bank monitors have broadly improved in 2004. There were major activities in housing & land development, which also relate to the booming international housing and properties market, including in neighbouring Australia and New Zealand. The level of trade (exports and imports) to September was 16 percent higher on the corresponding 2003 level. Commercial banks' lending to the private sector showed an annual growth of 9.2 percent in December 2004.



VAT collections have generally been higher in 2004 than previous years.



Currency with the public was higher by 18 percent in 2004 than the corresponding 2003 level.

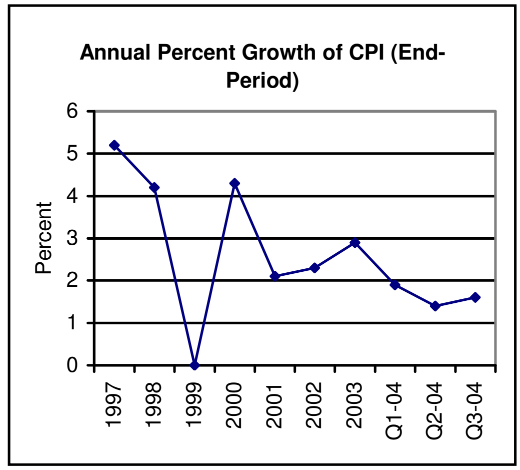
4. BUSINESS SENTIMENT

An indicator of business sentiment, which is available only for Luganville, showed that the broad pattern emerging in Luganville is a positive one with a large number of firms expecting production, sales, and investments to increase, and where business confidence is generally high.

5. PRICE DEVELOPMENTS

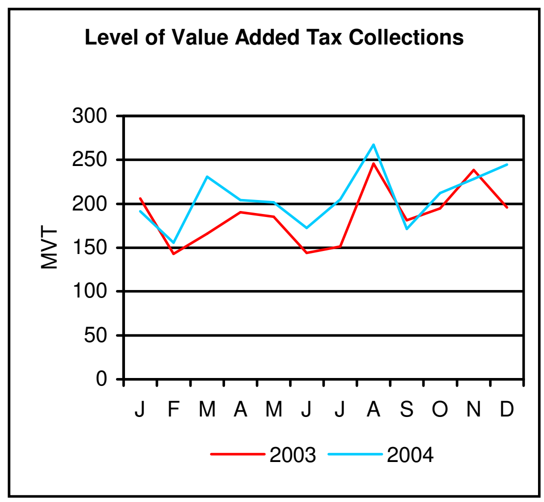
As an indicator of monetary stability, there has been a marked decline in measured headline inflation. It decelerated to 1.6 percent in the September quarter and has been shown to be even lower towards the year-end well below the 4 percent maximum threshold of the Reserve Bank.

Looking ahead the Bank will need to continue to be vigilant of the external and domestic pressures to inflation. In particular there will be second round effects of high world petroleum prices both because world petroleum prices continue to be high and because the effect of past increases may not yet have been fully factored by firms that buy in the forward market. The other key



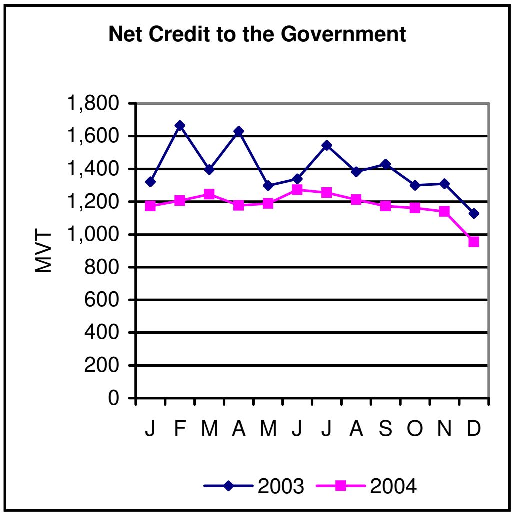
consideration is whether fiscal prudence can be maintained in the 2005 budget as was in 2004.

6. FISCAL DEVELOPMENTS



Fiscal development showed relative improvement in spite of having to accommodate a series of large unbudgeted expenditure undertakings in 2004 that included a snap general election, Presidential election and contribution to the building of the Pekoa International Airport. This demonstrated the extent to which control measures have been undertaken in expenditure management and increase in revenue in line with the pick up in economic activity. It also reflected a large external grant inflow. This then led to an improvement in the net credit position of the

Government with the banking sector, notably its net position against the Reserve Bank of Vanuatu. The fiscal cash flow however is still marred by continued use of an overdraft at the Reserve Bank of Vanuatu and rollover of maturing domestic debt.



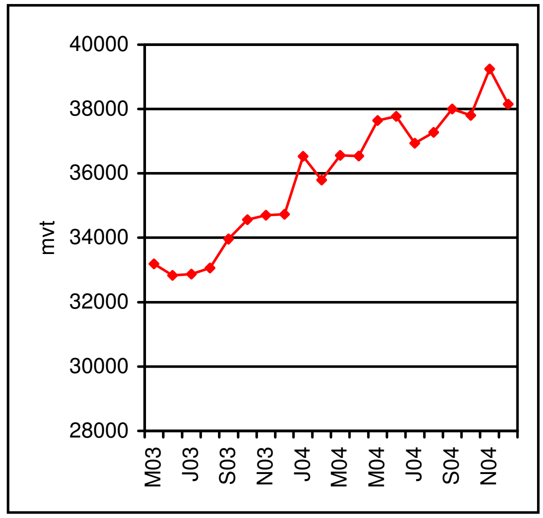
The Bank's decision to keep the discount rate unchanged largely reflects the uncertainties over the 2005 fiscal outlook, particularly because fiscal operations have been a key contributor to development in money and liquidity. It would therefore be prudent if any extra expenditure undertaking in fiscal year 2005 be financed through the budget or donor grants rather by than monetary financing.

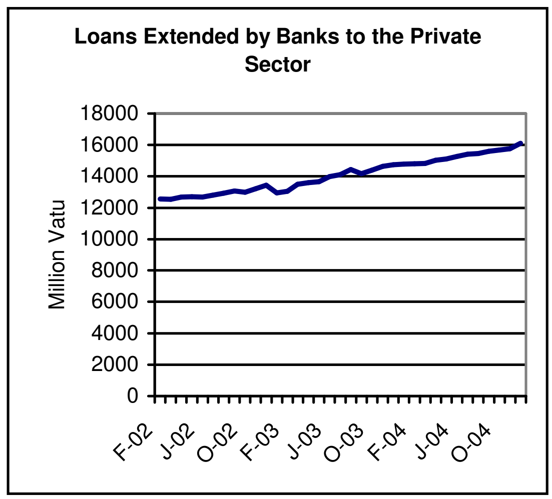
7. MONETARY DEVELOPMENTS

Through the conduct of monetary management, the Reserve Bank continued to create the appropriate conditions for monetary stability during 2004.

The year witnessed a period of relatively high money growth; though lower in magnitude than past high growth episodes. The growth, which was driven by inflows through the balance of payments and domestic credit, decelerated at the end of the year to an annual growth of 9.8 percent.

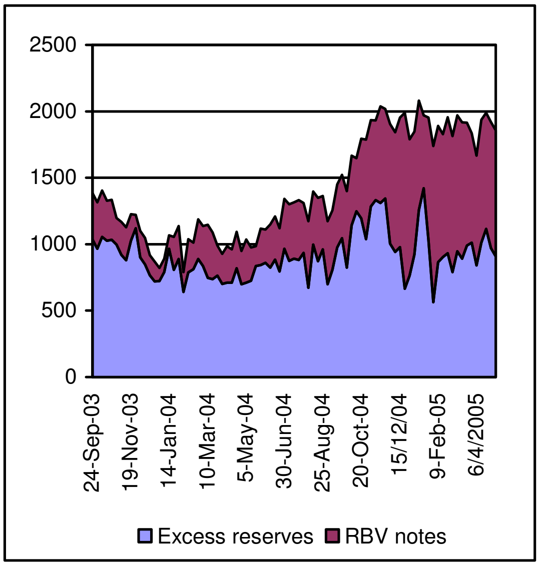
Domestic credit grew by 7.6 percent from the 2003 level. Of this the net claims of the Government improved by 15 percent while loans extended by the commercial banks to the private sector grew by 9.3 percent to VT16.1 billion.





Liquidity and Interest Rates

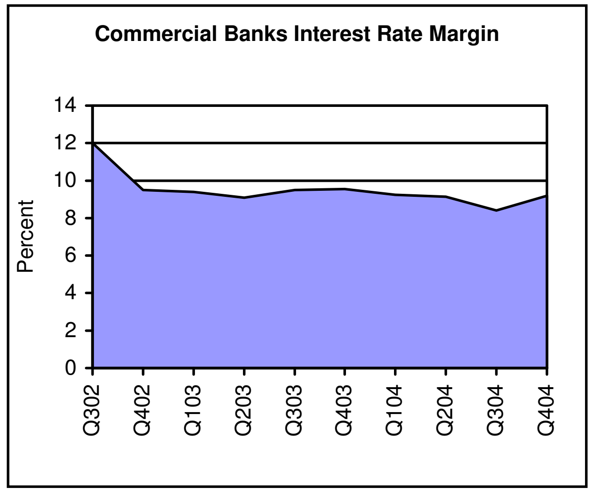
The Reserve Bank continued with its principal instrument of Open Market Operations, through the selling and purchase of RBV Notes, to achieve appropriate conditions for liquidity.



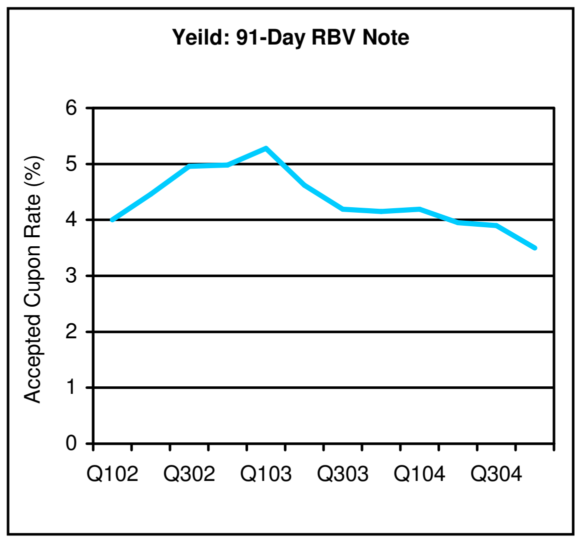
The year began with relative tight liquidity, which added upward pressure on interest rates. The Reserve Bank responded by allowing Reserve Bank Notes to decline and thereby injected liquidity to banks to ease pressures on interest rates and ensure there is ample liquidity to finance the investment needs of the community.

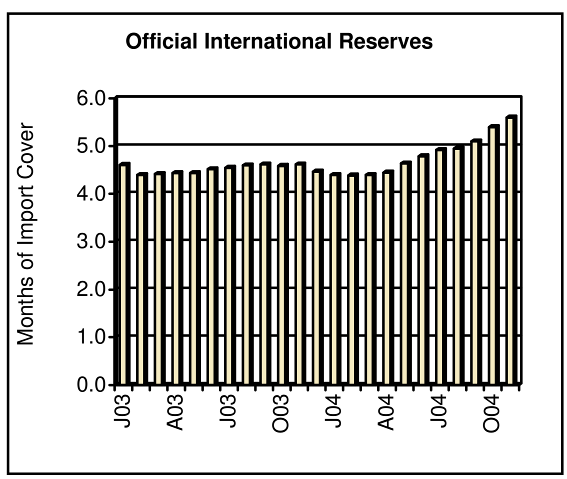
However, as economic expansion strengthened, it contributed to substantial foreign exchange inflows largely through proceeds of exports of copra and coconut oil in particular, tourism foreign exchange earnings, and inflows associated with land and properties development. At the same time the Reserve Bank maintained tight control on the sale of foreign exchange to safeguard official reserves. This gave rise to increase in the international foreign reserves of Vanuatu and rise in liquidity of the banking system. In line with the increase in liquidity, the Reserve Bank's operations in the money market rose towards the end of 2004 in a bid to ensure that conditions are always appropriate for monetary stability.

The large rise in liquidity exerted downward pressure on interest rates through the remainder of the year. As a result the yield on the Reserve Bank of Vanuatu Notes dropped quite markedly towards the end of 2004 and the interest margin of commercial banks was lower than in past periods.



8. DEVELOPMENT IN INTERNATIONAL RESERVES





A key component of monetary stability for the Reserve Bank is expressed in terms of adequate international reserves to meet Vanuatu's external obligations. At the end of 2004 the level of official external reserves of 5.4 months of import cover was comfortably above the Reserve Bank's minimum target level of 4 months of import cover.

The improvement in reserves mirrored the improving economic conditions reflected by a strong pick up in tourism and exports in the face of a rise in the imports bill, notably from high world petroleum prices, while at the same time, the Reserve Bank continued to maintain tight foreign exchange sales due to the drying up of the source of official reserves in the Vanuatu Commodities Marketing Board which was restructured away from marketing of copra and cocoa to regulation. Inflows associated with cyclone reconstruction/rehabilitation and official grant flows also contributed to improvement in reserves.

Looking ahead, the Bank expects reserves to remain comfortable but this could change if world commodity prices for copra and coconut oil in particular, shift adversely, and petroleum prices continue at the current levels. The outlook also depends on continuing high tourism inflows, which has largely depended on Air Vanuatu's operations and cruise ship arrivals.

9. IMPLICATIONS FOR MONETARY POLICY SETTING

Vanuatu's economy is expected to strengthen in 2004 and 2005 but this is largely as a result of external conditions. Nevertheless, the current strength of the international economy has provided an opportunity on which to build on this growth. To sustain the growth momentum, Vanuatu should continue to promote growth and export -oriented policies that should lead to longer-term macroeconomic stability.

The current level of international reserves and its outlook remain comfortable. As a small open economy however, the risks to this outlook can be considerable, not least from an adverse shift in the world economy, such as a reduction in world commodity prices, but also the need for the country to continue with prudent domestic policies.

The year also witnessed a deceleration in the overall headline inflation and there needs to be continued vigilance on the emerging risks to the inflation outlook both from continuing high world petroleum prices as well as from domestic sources of inflation.

The Board, after considering all relevant economic indicators, decided to maintain the Reserve Bank's discount rate at 6.5 percent. Indeed, when considering growth, inflation and international reserves, the Bank is of the view that Vanuatu's macroeconomic fundamentals have improved from past years and could remain favourable in the short -term. However, in maintaining the Bank's policy discount rate unchanged, the Bank is of the view that there are still uncertainties surrounding the 2005 budget especially the financing of any likely expenditure beyond the budget and donor grant flows. In the coming months, the Bank will continue to assess the economic outlook and make further adjustments as needed to continue with maintaining monetary stability.

CHALLENGES TO MONETARY POLICY IMPLEMENTATION: THE CASE OF VANUATU PRESENTED TO THE REGIONAL SEMINAR ON MONETARY POLICY IMPLEMENTATION

March 15-16, 2005
Reserve Bank of Fiji, Suva

Background

The Reserve Bank of Vanuatu (RBV)[1] is responsible for the formulation of Vanuatu's monetary policy. The power to conduct monetary policy is derived from the Reserve Bank Act[2]. The Act prescribes on the Reserve Bank a range of central banking responsibilities similar to other central banks in the region.

The RBV relies primarily on Open Market Operations. Like other central banks, the Reserve Bank of Vanuatu experienced different phases of development towards money market intervention. Following the trend initiated in the industrial countries in the 1970s, monetary management in Vanuatu shifted to market based indirect instruments in 1998. The decision rose from a domestic financial shock when the Government, pressured by civil unrest, decided to unconditionally pay out member contributions in the country's National Provident Fund (VNPF) ahead of retirement. The unrest was triggered by a report of the country's Ombudsman of corruption in the country's National Provident Fund by politicians. The large payout – to meet the financing need of the Government and the VNPF – led to a large increase in liquidity, and, coupled with the associated loss of confidence, gave rise to a large capital outflow and loss of reserves. The need to respond quickly to the crisis and finance the pay-out without the loss of monetary control was key to the adoption of the framework.

Prior to 1998, monetary policy under a pegged exchange rate arrangement was perceived as passive and relied on instruments that were based on the regulatory power of the Reserve Bank.

Stage One: The Period of Monetary Reform

From its inception (1981) to the mid-80s, the Reserve Bank's primary role involved currency issue when it took over the role of sole issuer from the Institut d'Emission d'outre-Mer. The new Vatu notes were issued to circulation in the first half of 1982 to replace the Australian dollar and the New Hebrides Franc (FNH), which circulated as legal tender at independence. The Bank issued its new Vatu coins to replace the FNH coins in the second half of 1983.

The Bank began to undertake monetary policy from the mid-1980s. The principal instruments were direct lending from the central bank, guidelines on direction of lending and interest rates and statutory reserve deposits.

Direct Credit and Interest Rate Controls

In 1983 the Reserve Bank issued guidelines on lending to the `productive sectors' and ceilings on lending interest rates but these were administered on an informal basis and enforced primarily through moral suasion. They were abandoned after 1986 due to concerns over non-performing loans and the distortions they created. In retrospect, the concerns about non-performing loans could have been addressed through appropriate supervisory oversight but the authority to undertake supervision was only added in an amendment to the RBV Act in 1989 and effective supervision only began in 1996.

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[1] The Reserve Bank of Vanuatu began operations in January 1981.
[2] Reserve Bank of Vanuatu Act CAP 125 of 1980, Laws of the Government of the Republic of Vanuatu

Standing Facilities

In 1985 the Port Vila Clearing House at the Reserve Bank of Vanuatu became operational to oversee clearing operations and paved the way for the RBV to act as account holders for the Government and financial institutions and banker, depository and fiscal agent of the Government in accordance with the Act of the Reserve Bank[3]. This enabled the RBV to provide the lender of resort facility secured by 75 percent of the nominal value of holdings of Government bonds at an interest charge determined by the Reserve Bank of Vanuatu. The commercial banks did not participate actively in direct borrowing because they had a large buffer of excess liquidity. The facility was extensively used by the National bank of Vanuatu due to its weak balance sheet, which prevented it from inter-bank borrowing because of perceived credit risk but the bank has since been re-capitalized, restructured, and strengthened during the Comprehensive Reform Program (CRP) of 1998.

The RBV's secured lending facility was transformed when it adopted money market intervention in 1998. The secured lending was changed to the rediscount window and repurchase agreement facilities and the underlying collateral was extended to RBV notes and short-term Government bonds of one year maturity and less. The RBV also adopted the Reserve Bank's benchmark rate as its discount rate.

Statutory Reserve Deposits (Reserve requirements)

The Reserve Bank issued the statutory reserve deposit (SRD) in 1988 which applied to 10 percent of commercial banks Vatu deposits. The SRD has undergone a series of transformation but the requirement has remained at 10 percent and is viewed as both a monetary and prudential policy instrument.

The SRD were initially partly remunerated as the banks satisfied part of the requirement through holdings of Government bonds at an administered rate of 1.5 percent that were continuously rolled-over and locked away at the Reserve Bank. This arrangement ended in 1998 when SRDs were temporary abolished to pave the way for a large Government financing exercise by requiring a 16 percent Prescribe Reserve Assets to commercial banks to pay out member contributions in the VNPF ahead of retirement[4].

The second phase of this pay-out coincided with a civil service redundancy pay-out from proceeds of an ADB loan under the Comprehensive Reform Program (CRP) with the Asian Development Bank. The large fiscal impulse led to recall of the SRD to sterilize the associated injection of liquidity.

The SRD was reintroduced at 6 percent in November 1998. To make way for this the PRA was reduced to 10 percent. In March 1999 the SRD was increased to 10 percent and was extended to 50 percent of demand deposits in foreign currencies. To create flexibility, the banks were required to maintain SRD on average holdings. At the same time the PRA was replaced by Liquid Asset Ratio at 15 percent as a prudential instrument following the Bank's establishment of a Banking Supervision Unit in 1996. The LAR allowed for a broader base of unencumbered liquid assets to be held by commercial banks including notes and coins, balances with the RBV (other

[3] Up to that the role was carried out by Banque Indosuez Vanuatu ltd, a commercial bank that had also performed on behalf of Institute d'Emission d'Outre-Mer issue of the FNH currency.

[4] Under section 33 of the Reserve Bank Act the RBV may require financial institutions prescribe to certain assets. In 1998 the RBV required banks to prescribe not below 16 percent of Government bonds of their Vatu deposits (excluding capital and overnight balances)

than SRDs), Reserve Bank of Vanuatu notes, and central government securities against Vatu liabilities (less the bank's capital bases and overnight settlement balances).

Currently the RBV does not remunerate the SRD and the commercial banks have cited this as a contributing factor to their high lending rates. However, a recent study undertaken by the RBV revealed that the most important single factor contributing to high lending rates in Vanuatu is country risk.

In the past the Bank has considered eliminating the SRD or remunerating the commercial banks on SRD holdings. Eliminating the SRD would allow the RBV to continue in its transition towards indirect monetary control as in certain ways the introduction of the SRD, may have discouraging effect on indirect monetary policy instruments, by reducing the required volume of security paper in the system. Elimination or remuneration of the SRD would need to be considered in the light of:

(i) The interest cost of sterilizing the increase in liquidity released by SRD if it was eliminated would double the current cost of open market operations. The release of liquidity through the elimination of SRD (VT 1,669 million) would more than double the level of current outstanding RBV notes (VT1.025 million in February 2005) in the system. The cost of open market operations (VT16.4 million) in 2004 comprised about 6 percent of total revenue of the RBV.

(ii) There is no indication that the banks will increase lending. Commercial banks' approach to business growth has been cautious and they increase lending only to businesses considered bankable. Thus release of the SRD funds will drive up liquidity which will lead to a further fall in deposit rates from the current low levels.

(iii) Assuming little extra lending takes place the extra excess liquidity will rise to the equivalent of 58 percent of official net foreign assets.

Stage Two: The Period of Money Market Operations

Vanuatu commenced the transition to market oriented policies in early 1998 following the VNPF financial crisis. Very little was known about open market operations and there was no experience in discretionary monetary policy interventions.

The VNPF was established in the late 1980s as a compulsory savings contribution. Over the 10 year period that it has been operating it has accumulated total member contributions of VT3.85 billion or 22 percent of GDP.

Financial assistance from the Government and the RBV was required to complete the pay-out but to avoid as much as possible the loss of monetary control.

In March 1998, the first issue of 91-day treasury bills and RBV notes was auctioned on public tender as part of the transition to indirect monetary control. In July, the Bank began auctioning 28 day Reserve bank paper for the first time. The 63-day RBV notes were issued in 2003 and in 2004, as the liquidity of banks became tight, the Reserve Bank introduced 14-day RBV notes for the first time.

The experience with 119-day and 182-day notes tested out in the market in 2002 was not successful because of issues to do with sovereign risk. The commercial banks indicate a preference for RBV paper with a maximum of 91-day maturity and are less inclined to take up Government paper. At this stage, the 63 and 14-day instruments are the most preferred among commercial banks, as seen from the volume of tender per RBV Note (below):

The primary market is currently limited to three banks which underscores the shallowness of the market. The total assets of banks have been growing steadily except in 1999 when the Banque d'Hawaii, withdrew its presence from Vanuatu. Total assets amounted to VT50221.4 million in 2004.

The RBV offers both competitive and non-competitive bids in the auctions. Non-competitive bids are offered with a maximum of VT 1 million to any bidder and the coupon is the weighted average of successful competitive bids. The minimum bid size of VT 1million appears to be low enough to attract other participants including the Vanuatu National Provident Fund which has a large pool of funds and others that may have sufficient funds available. This should encourage a more competitive bidding system and help further develop the financial markets. The non-participation of non-banks stems may from:

- Preference for long–term paper over short-term money market instruments by the VNPF
- Lack of investment knowledge and understanding of the tender process
- The need for companies to undertake cash and liquidity management associated with investing in money market instruments.

Registration and auction procedures have been established and papers are readily transferable, negotiable, and discountable. At the moment registration is done manually and the banks are then issued certificates but the Reserve Bank is thinking of fully automating its accounts and this could be extended to include automating the registration process to book entry. However, the need for this may not be that substantial given the thinness of the auctions. The average number of bids per auctions in January and February 2004 were 11 and 6 respectively depending on how liquid banks are.

The Bank's current framework centers on targeting a volume of excess transactionary balances and the bank manages bank reserves around that target by issuing and buy back to minimize volatility in bank liquidity and achieve greater stability in short-term interest rates. The RBV is now in a position to move further and establish a benchmark interest rate.

The stock of high quality RBV (and Government) paper has allowed for secured lending transactions. But it is recognized that substituting interest bearing securities for non-interest bearing cash reserves of banks has implications for the central bank's profitability. This calls for a sound balance sheet of the Reserve Bank and was a concern when interest bearing foreign assets fell during the 1998 financial crisis and when interest income fell in 2004 from low world interest. For example, the interest cost of RBV notes constituted around 6 percent of the total income of the RBV in 2004 and 4 percent in 2003. The balance sheet of the Reserve Bank should therefore be monitored closely. To assist in this direction, the RBV has considered fully automating its accounting system and is looking for the appropriate software to do so. It also intends to establish an internal audit within the RBV.

Secondary markets do not exist as yet and the inter-bank market is modest with occasional over-night advances at a fixed rate of interest. Maintaining bank liquidity at a minimum target should help foster inter-bank transactions in out-right, or repurchase and swap transactions.

Procedures have been developed to forecast reserve money using the IMF monetary management techniques. A Cash flow Committee comprising of the Department of Finance and RBV representatives (chaired by the Department of Finance) meets monthly to discuss fiscal cash flow. The information is fed to the reserve money program of the Reserve Bank.

Transmission mechanisms of monetary policy are limited by the large excess liquidity that the banks maintain and the Reserve Bank will need to continue to drive down liquidity to the desired transactionary excess balances. This is not an easy task. A substantial part of liquidity is created by fiscal operations thus driving down liquidity will depend on the government retiring some debt and the budget process is outside the control of the RBV. The other reason commercial banks maintain high liquidity is that they feel that there is an absence of projects that they consider bankable. Movements in excess liquidity lead to movements in commercial banks' interest rates which affect deposit rates in the first instance. Banks lending rates are more a function of how banks structure their credit risk and may therefore be unaffected. However, large movements in official short-term interest rates do have an impact on lending rates of commercial banks. This was evident in 1998 when the Reserve Bank undertook a large interest rate increase from 5.97 to 10.97 percent which led to a corresponding increase in the banks lending rates.

Stage Three: Diversification of Markets

Key challenges ahead.

Developing Secondary Markets

One of the key challenges of the RBV will be to develop a secondary market. This has proved to be a difficult task. Perhaps some of the key factors will be to continue to drive excess liquidity down to a desired level which will mean more cost to the RBV. The RBV will also need to find ways to introduce non-bank participants into the bidding process.

Institutional Building

The Bank will establish the Financial Markets Unit in 2005 which will be fully responsible for domestic market operations, foreign exchange and exchange rate management, managing the auction and open market operations, and daily liquidity forecasting. The RBV has asked the IMF to look at the domestic payment system and suggest ways in which it can be improved. In line with this the Bank is considering fully automating its accounts system and establishing an internal audit unit.

Capacity building

The regime of indirect monetary control is fairly new and there is need to continue to build capacity at the level of formulation of policy and in the financial market division when that is established in 2005.

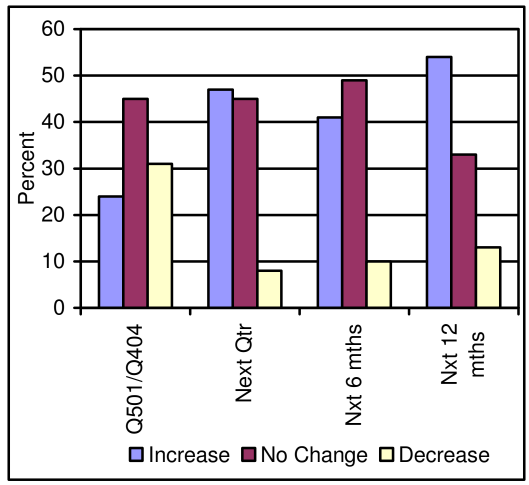
SUMMARY OF BUSINESS SURVEY MARCH 2005

The following summary report contains information on the outcome of the 2005 Business sentiment survey which was conducted in Port Vila in the first quarter of 2005. The survey was sent to a representative sample of businesses from around the capital asking for indications of future trends in 20 different areas from inflation to employment to GDP. The purpose of this survey is to give businesses an idea of how other businesses in the capital are faring by publishing these results but it is also a useful exercise for policy purposes as surveys of this kind give a good impression of how important factors in the economy (such as employment, inflation, production..) are likely to change over the coming months. This sort of information can be vital when formulating policy, especially monetary policy. The reason for this is that monetary policy can affect growth, with a tight monetary policy being likely to decrease spending and growth and a loose monetary policy having the opposite effect. But monetary policy can take several months or even a year or two to take effect. Therefore the monetary policy that is correct for the current economic situation may not the monetary policy that is applicable in two years time when the effects of the policy are actually felt. It is therefore important to try and grasp the way the economy is heading early in order to make the correct monetary policy decisions. The survey also provides the bank with information on how the different sectors of the economy are faring and therefore help to identify which of the sectors of the economy may need a boost and which sectors are growing well. The survey also offers the opportunity for businesses to make comments on the current progress and voice any concerns they may have.

General Business conditions

This shows that the prevailing mood is generally that the general business conditions are going to get better over the coming months. It also shows that conditions have decreased from last quarter, one possible explanation for this however is the time of year in which the survey was conducted as the first quarter is usually the most sluggish as people decrease their spending after the busy Christmas period.

Figure 1: All Business Conditions

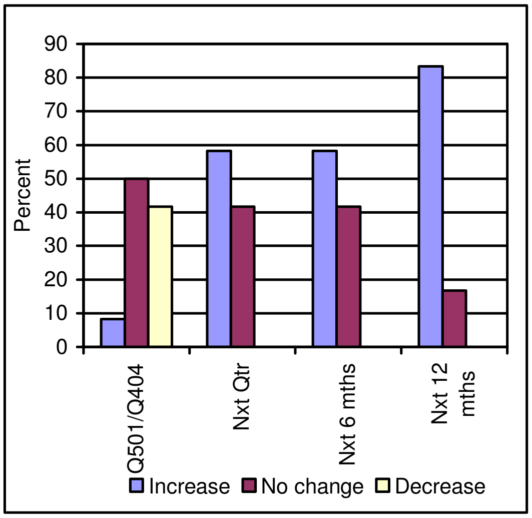


It is also the quarter of the year where there are fewer tourists. The figures for increase in the general business conditions are a lot brighter for the forthcoming quarters, especially the next 12 months.

From a sectoral perspective, the most optimistic sectors are the manufacturing, services and tourism industries. The answers from the tourism sector are particularly encouraging as they show that most tourism businesses are predicting increases in the future, with around 40% of GDP in Vanuatu made up of tourism, this bodes well for future growth.

The only sector that responded with a less optimistic perspective, was the utilities sector, this probably reflects the fact that there has been a current rising trend in oil prices; this will have affected the utility providers more than the other sectors of the economy so far. The other sectors all show a predominance of no change in business situation

Figure 2: Business Condition in Tourism

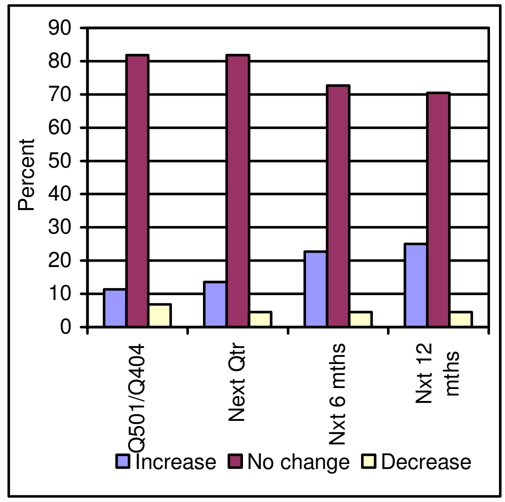


The picture in this question is generally good in that most respondents felt that the general business conditions is Port Vila are set to increase, the main reasons for this are conjectured to be the stabilizing new government of Ham Lini. If general business conditions are poor in an economy then this usually leads to under-investment mainly caused by business uncertainty which can lead to lower employment and lower productivity in a business which therefore entails lower growth. The current optimistic mood of the businesses in Vila should help to increase investment, productivity and employment. The survey did not take into account for possible changes in the minimum wage.

1. Temporary Employment

The pattern regarding temporary employment shows a predominance of no change. The major factor guiding these answers is that businesses sometimes indicated an answer of no change if they currently had no temporary workers and had no plans to employ any, this means that the no change response category captures the high number of business in Port Vila that do not employ temporary workers and have no plans to employ any. Therefore not too much can be read into these responses.

Figure 3: Temporary Employment



A more meaningful picture can be ascertained by looking at the qualitative responses that businesses were asked to make, this shows that out of those businesses who do have temporary workers then they are expected to employ more in the coming months, the average shows that temporary workers among the surveyed businesses increased 1% on last quarter, that they are expected to increase 7% next quarter and by 4% in the next 6 and 12 months.

A sectoral breakdown of the answers shows that the only sectors expecting increases in temporary workers are the tourism, manufacturing and services sectors with all other sectors expecting there will be no change, largely because they have no temporary workers.

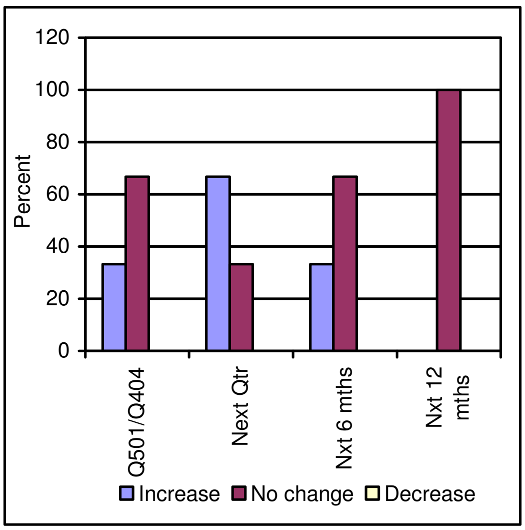
These figures can be interpreted as slightly encouraging although they are not very indicative.

There are a large number of companies in Port Vila who do not employ temporary workers but it is predicted that those that do will employ more of them in the coming months.

2. Permanent Employment

The pattern for permanent employment shows a very similar pattern to the one described above for temporary employment in that the predominant answer is no change also.

Figure 4: Permanent Employment



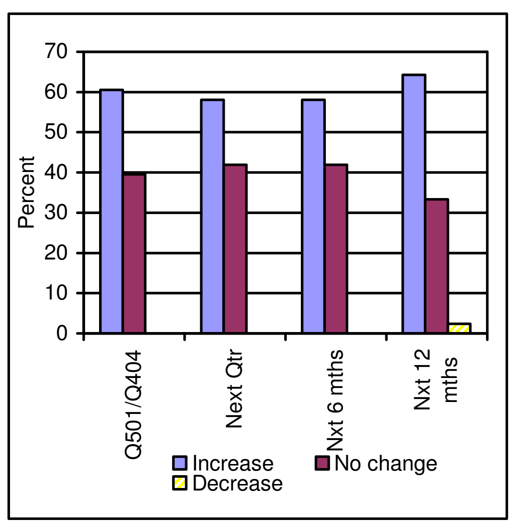
This shows that the expectation is that most businesses do not expect to take on any more staff over the coming months, there is some encouragement in the fact that there are very few businesses who expect to shed workers and also from the fact that the expected increase gets larger over time starting at 6 in the first quarter and climbing to 11 in the next 12 months, this shows that the economy does not seem to be stagnating and that the general trend for businesses will be to take on more staff in the long run.

Inflation

The graph below shows that the overwhelming pattern across time periods is for an expectation for inflation to increase. There are very few respondents who expect inflation to decrease over the coming 3, 6 or 12 months. There are also a large number of respondents who believe that inflation will remain the same over the coming months. This shows that there are currently strong inflationary pressures in the market; this is not surprising given the high rates of money supply growth and the recent oil price rises and subsequent announcement by Unelco that prices would be increased. This expectation for an increase in inflation is also reflected in the rest of the survey where many respondents have shown that they expect input and other costs to increase in the coming months.

This pattern for an increase in inflation is reflected in the forecast figures, although the figures are encouraging as the predicted increases in inflation are not too high. Responses range from 12% maximum to a minimum of 0% growth. It has to be noted though that the results cannot be deemed too reliable as few respondents actually stated expected percentage changes and of those that did many of them responded 0. However the expected inflation rate from this survey for next quarter is of 2%, this increase to 2.2% for the next six months and 2.9% for the next year. This shows a clear pattern that expectations are that inflation will rise over the short term with this increase getting larger over the long term.

Figure 5: Inflation

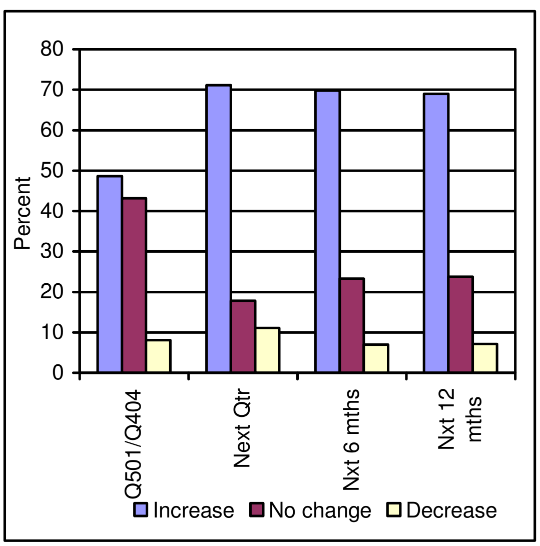


These figures therefore show that we can expect prices in the near future to rise by about 2 to 3% and that wages are also set to rise. This does however mean that the expectation is that real wages will remain unchanged over the period. The expected changes in inflation are also somewhat lower than the expected changes which means that one can expect an increase in nominal wages over the next 12 months which would be to the great benefit of many working ni-Vanuatu.

Input costs

The pattern depicted in the graph shows a very clear trend for increases in other input costs faced by firms. This shows that for most businesses costs are expected to increase over the next 3, 6 and 12 months. One possible reason for this is that other input costs contain the cost of utilities and Vanuatu's monopoly supplier Unelco has already announced price rises for the first and second quarters of 2005 with anticipation that they will rise further in the future.

Figure 6: Input Costs



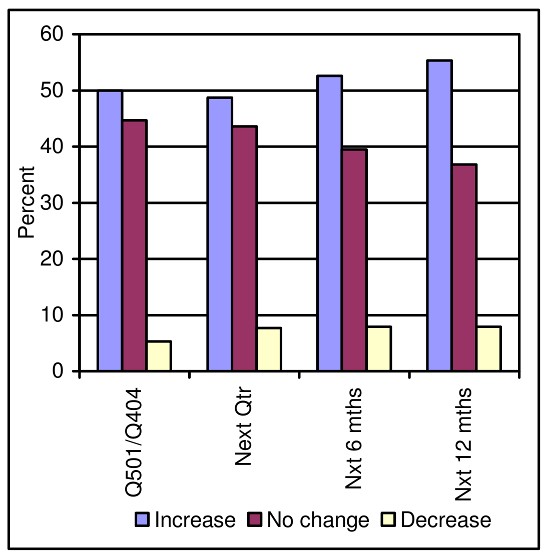
A look at the sectoral breakdown of responses shows that every single sector has a prominence of increase responses. The most notable sectors being utilities, tourism, services and agriculture as they have the largest amount of increase responses.

The picture from this graph sows that costs are increasing in the economy for every business and every sector.

Import Prices

The pattern here again shows that for every time period the most prominent answer is that import prices are expected to increase. This shows that most business expect the prices of imports to increase over the coming year or at best not to change with only a few expecting decreases. This is reflected in the pattern of answers which shows 79 increase responses, 63 no change responses and only 11 decrease responses.

Figure 7: Import Prices



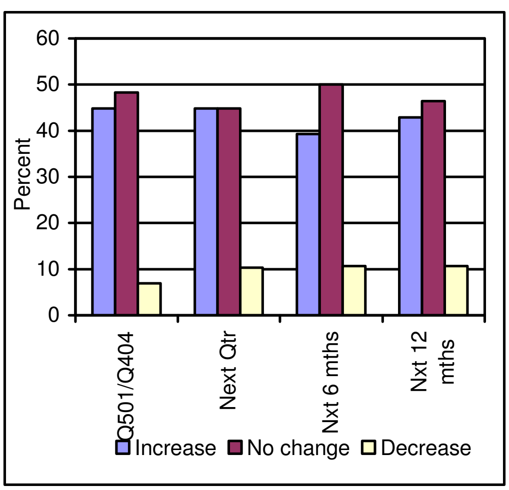
The quantitative data shows that the average forecasted increase for the next twelve months is of 4%, the sectors predicting the largest increases are utilities with 20% and retail with 7%. A sectoral breakdown of the response patterns shows that utilities also has the largest proportion of increase answers with no no change and no decrease answers at all, the only other sector which has more increase responses than any other is the retail sector, the sectoral response pattern therefore ties in exactly with the quantitative forecasts, all the other sectors showed a strong no change pattern with tourism, agriculture and services also showing high numbers of increase responses.

The overall picture therefore shows that import prices are expected to rise but not by alarmingly high levels, the sectors that are anticipating the largest import price rises are the retail and utilities sectors other sectors generally predicting that prices will remain the same.

Volume of production

The first thing to note is that not too many businesses answered this question, the reason for this is that the tourism sector were not asked to respond to this question as their occupancy rates were elicited in the last question, the question was also not applicable to the utilities sector who chose not to answer it. Of those that did they mostly answered no change which had 54 responses, this was closely followed by increase which received 49 responses where as decrease only received 28. This shows that the expectation is that for most businesses the volume produced is either expected to stay the same or increase over the next 12 months.

Figure 8: Volume of Production



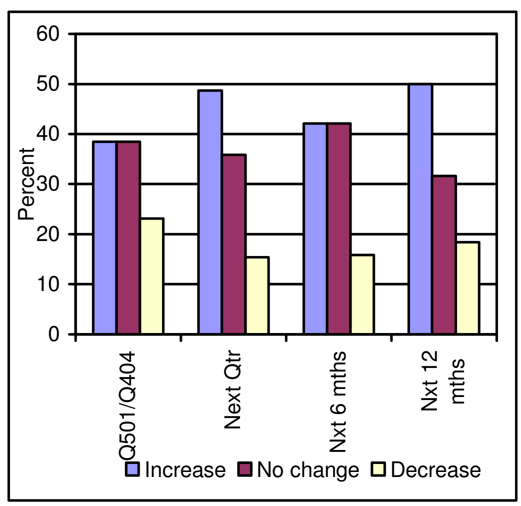
A look at the quantitative answers shows that the sectors expecting the largest increases in production are the manufacturing and agriculture sectors with 6% and 5% respectively. The predictions from the quantitative answers are borne out in the qualitative answers which show that agriculture and manufacturing are the two sectors which have a predominance of increase answers and that the other sectors have a predominance of no change answers. The only sector with a significant number of decrease answers was the

This shows that of the businesses that responded the expected pattern is that volume of production is likely to increase or stay the same over the next twelve months and that it is unlikely that it will decrease.

Volume of sales

The pattern of responses here shows that the majority of responses were for increases in the volume of sales. This means that most businesses expect there to be increase in the volume of sales over the coming months, particularly in the next 12 months were 19 of the responses were for increases as compared to only 7 for decreases.

Figure 9: Volume of Sales



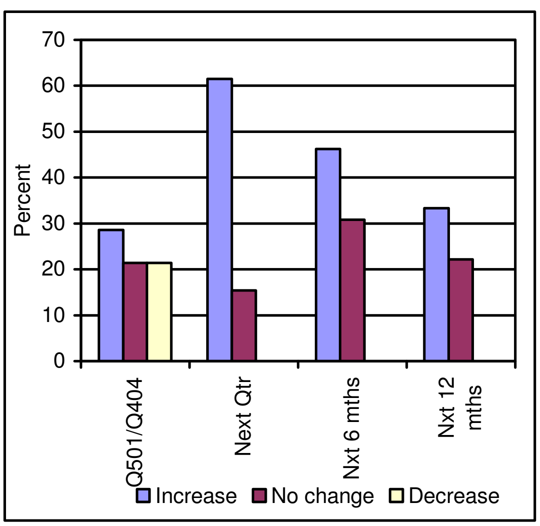
Very few businesses gave quantitative answers so the sectoral breakdown provides a more accurate picture, it shows that the most optimistic sector was again tourism. But that all sectors a part from agriculture and manufacturing had more increase answers than any other. With the former two having more no change answers, no sector had more decrease answers. It is interesting to note however the largest incidence of decrease responses came from the services and retail sector, the retail sector being particularly negative, having only one more increase than decrease answer.

This shows that on the whole sales are expected to rise over the coming months and that this is fuelled mainly by the optimism of the tourism sector. This matches with the figures of increased profits and increased production.

Hotel occupancy rates

A sectoral breakdown of the response pattern indicates that the two sectors which have more increase responses are the construction and tourism sectors; this means that in the tourism sector, hotels are predicting more occupants. All the other sectors have a prevalence of same answers.

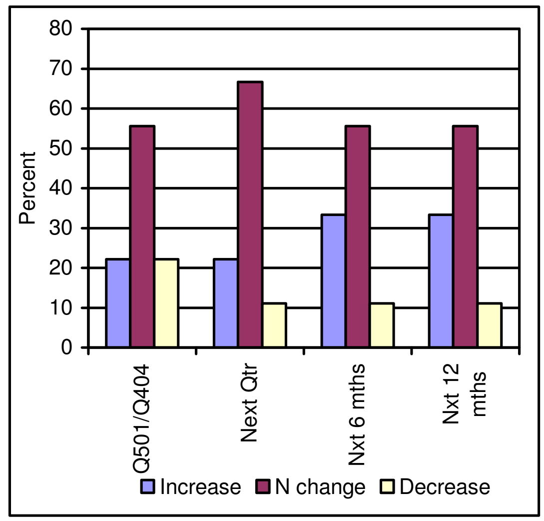
Figure 10: Hotel Room Occupancy Rates



Lending rates

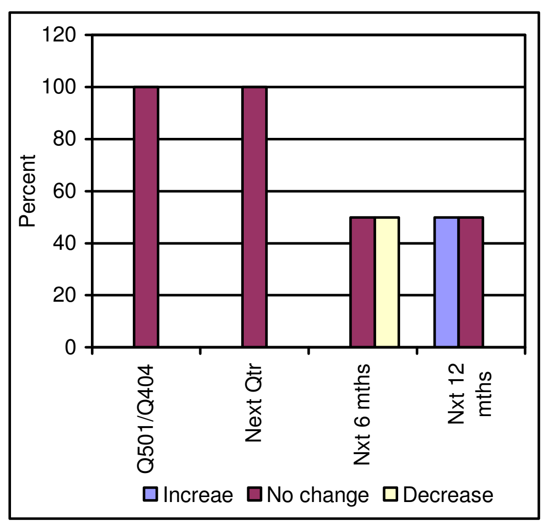
The pattern again is for a majority of same responses, especially in the near future but with an increasing trend for increase responses as time goes on.

Figure 11: View on Lending rates by Business Sector



This shows that the general expectation is that interest rates for lending will remain unchanged in the short term but will increase towards the end of the year.

Figure 12: View on Lending Rates by Banks



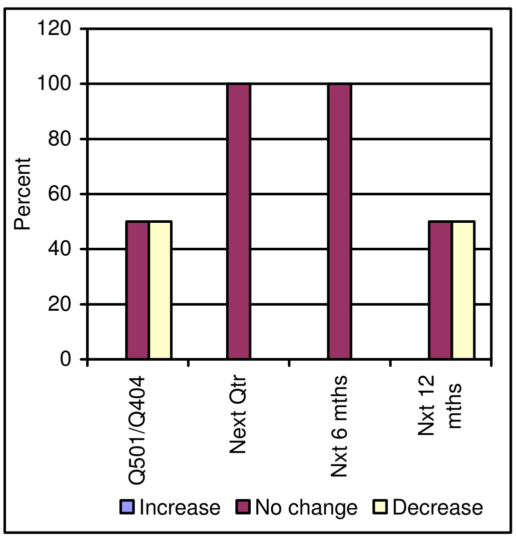
It interesting to note too that the banking sector has a large number of same responses.

The pattern therefore is that lending rates are expected to stay the same over the next few months but that they will begin to rise towards the end of the year.

91 Day RBV notes.

Views by commercial Banks are that, despite the current trend of a steady decline in the yield on Reserve bank notes, the banks are not predicting any further declines in the long run; they are currently predicting that rates will pretty much remain unchanged over the next 12 months.

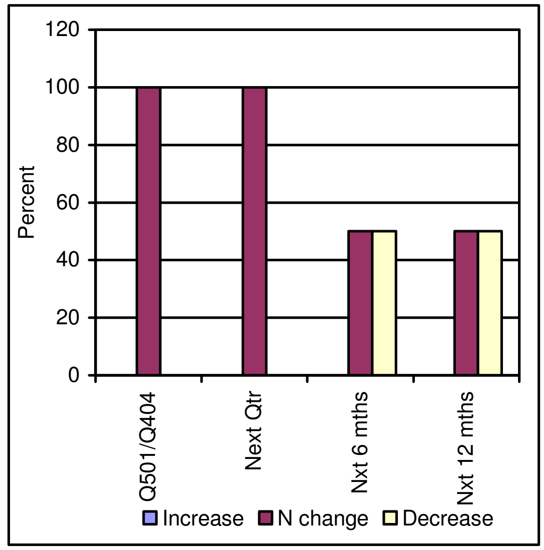
Figure 13: View by Banks (91 days RBV Notes Interest rates)



Mid Rate Vatu/US $

The rate of the Vatu against the US was predicted to stay the same over the next 6 months although there were a few decrease responses for the end of the year. Therefore the expectation among the banks is that the exchange rate against the dollar will either remain stable or decline over the coming months.

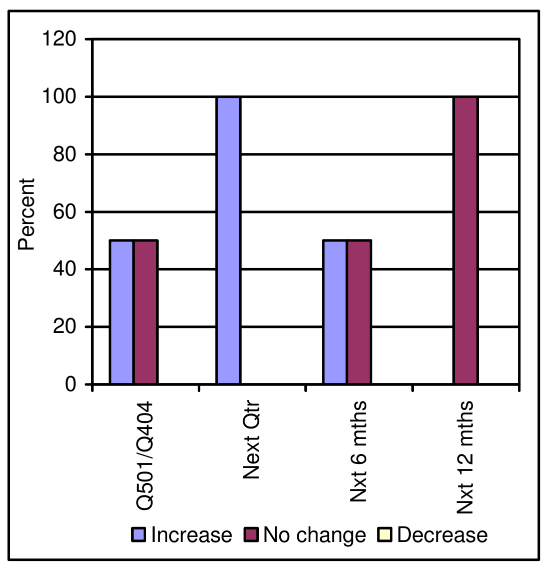
Figure 14: View by Banks on US$ mid rate



Money Supply

The banks here forecast that the money supply would continue to trend upwards in the coming 6 months and then stabilise and stay the same over 12 months.

Figure 15: View on Money Supply Trend by Banks



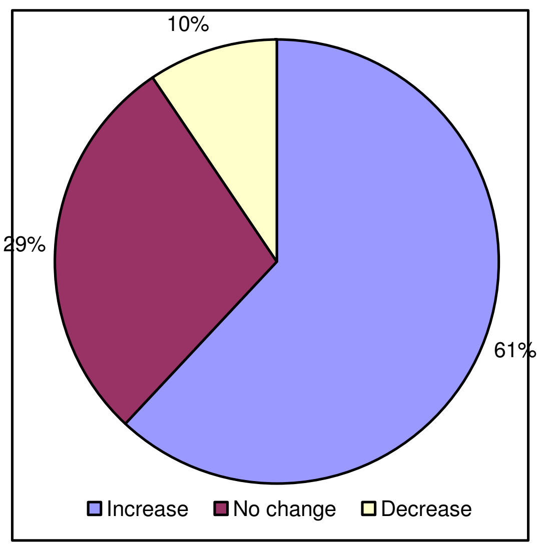
GDP Growth

As Vanuatu's GDP figures are only issued on an annual basis, only 12 month forecasts were elicited from the participants.

This graph shows that most business believe that Vanuatu's economy will continue to grow next year.

The quantitative answers show that the average estimated GDP growth is of 1.39% which is very low compared to the results from this year and the predicted forecast of 2.9%. The sector anticipating the highest growth is tourism which expects 2.7% growth on average. A sectoral breakdown of the answers reveals that every sector has more increase answers than any other a part from agriculture which has more same answers and manufacturing which has the same number of increase as same.

Figure 16: 2005 Expected GDP Growth



This therefore shows that GDP is expected to increase over the next year and that there are very few businesses who expect to increase, this figure is not surprising given the responses discussed above where many businesses have predicted that investment, production, sales and profits are showing generally positive trend.

The survey has therefore shown that the businesses around Port Vila are feeling confident at the moment and that many predict that their business will either grow or stay the same over the coming months with only very few predicting that their will be decreases in their situation. Analysis of the sectors has shown that tourism is currently the most optimistic and buoyant sector where as utilities and retail seem to be the most pessimistic, the predicament of the utilities sector is understandable given the rising price of oil but the negative expectations of the retail industry are harder to explain given that the tourism sector is so optimistic.

MONETARY POLICY INSTRUMENTS – THE CASE FOR VANUATU

1. Introduction

One of the main objectives of the Reserve Bank of Vanuatu is to promote monetary stability. This objective is stated in section 3 of the Reserve Bank of Vanuatu Act. The monetary stability objective requires that the Bank ensures that the value of the vatu remains broadly stable at all times. To achieve this objective of monetary or price stability, the Reserve Bank of Vanuatu formulates and implements monetary policy. Monetary policy formulation involves developing a plan to achieve the Bank's objective of price stability. In implementing the plan, the Reserve Bank utilizes monetary policy instruments. The Reserve Bank of Vanuatu has a number of instruments at its disposal to implement monetary policy. This article describes the various monetary policy instruments that the Reserve Bank of Vanuatu uses to implement monetary policy to achieve its ultimate objective of price or monetary stability.

2. What is a monetary policy instrument?

A monetary policy instrument is a tool that central banks around the world use to implement monetary policy. In Vanuatu, the Reserve Bank of Vanuatu, being the country's central bank, uses a number of monetary policy instruments. The Bank can implement monetary policy in two ways: directly through the regulatory powers that it has, or indirectly through its influence over reserve money. Thus, the Bank could use direct monetary policy instruments or indirect monetary policy instruments. Direct instruments refer to the one-to-one correspondence between the instruments and the objective, for example, credit ceilings to control the growth of domestic credit. Actually, direct instruments are aimed at the balance sheets of commercial banks. Indirect monetary policy instruments or market based instruments, on the other hand, are aimed at the balance sheet of the Reserve Bank, thereby; affects the balance sheet of the banks indirectly. The main tools used by the Reserve Bank of Vanuatu to implement monetary policy include Reserve Requirements, Open Market Operations, Standing Facilities – Rediscount and Repurchase Agreement and Interest Rates. These monetary policy instruments influence the availability of credit and money supply, which are the intermediate target variables that in turn affect the ultimate objectives of economic growth, price stability and viable balance of payments.

3. Evolution of Monetary Policy and Monetary Policy Instruments in Vanuatu

Monetary Policy Instruments influence the growth of the money supply which in turn affect prices and the level of economic activity. Determining the appropriate level of money in all its forms is one of the most important responsibilities of the Reserve Bank. An ideal position is to have neither too much nor too little money in the country. Therefore the focus of the Bank's monetary policy is to strike the appropriate balance.

The evolution of monetary policy around the world has shown that most central banks started with direct monetary policy and then moved on to adopt indirect monetary policy. This also was the trend in Vanuatu. During the period between 1980 and 1998, monetary policy was described as passive. During 1983, in a bid to develop the productive sector of the economy, the Bank employed direct monetary policy by issuing informal directives to commercial banks on the allocation and cost of credit. Nevertheless, the controls proved counter productive because of a rise in bad loans and were later abandoned. In 1988, the Bank introduced reserve requirement of 10% for the first time, a first move to indirect monetary policy. However, in March 1998, subsequent to the financial crisis involving the Vanuatu National Provident FUND (VNPF), the RBV abolished the SRD of 10% and replaced it with the Prescribed

Reserve Assets (PRA) at 16%. The PRA was introduced to raise funds for the government to help VNPF pay out its members' contributions, as well as to manage liquidity. Banks were required to hold PRA in the form of bonds, treasury bills and RBV Notes. In March 1998, Treasury Bills were issued for the first time. Also, during March the RBV issued the first Reserve Bank of Vanuatu (RBV) Notes to mop up excess liquidity in the system therefore marks the beginning of open market operations (OMO).

In May 1998 the Bank resorted to interest rate policy. It increased the minimum lending rate (MLR) by 5 percentage points to 10.97 percent. The minimum lending rate is the official interest rate at which the Bank charges commercial banks that borrow high powered money from the Bank. The increase in interest rates was a signal that the Bank was tightening monetary policy, an action that resulted in restored confidence in the Vatu. Towards the end of December 1998 the Reserve Bank introduced the re-discounting and repurchase agreement (repos) facilities at 7 percent. With the introduction of these two new facilities whereby banks can borrow from the Bank if they are short of liquidity, the minimum lending rate was abolished effective from the 1st May 1999. Effective 1st May 2001 the repo rate was reduced to 6.50 percent from 7.0 percent. This interest rate serves as the official interest rate of the Bank.

4. The Instruments of Monetary Policy in Vanuatu

a) Reserve Requirements/Statutory Reserve Deposits

Reserve requirements are a percentage of deposit liabilities that commercial banks must hold as reserves either as vault cash or deposits with the Reserve Bank. Reserve requirements work to remove certain percentages of deposit liabilities from being available for lending by banks. In other words, reserve requirements absorb liquidity from the system and they do this in a structured manner. Reserve requirements play two roles in monetary policy; one of which is to smooth market interest rates in the short term, and to influence the level of bank credits in the longer term.

In Vanuatu, the maintenance of reserve requirements is stipulated under the Reserve Bank of Vanuatu Act[5]. All commercial banks in Vanuatu are required to maintain 10% of the average of vatu deposits and half of demand deposits in foreign currency as reserves with the Reserve bank of Vanuatu. The reserve requirement was introduced in 1988 mainly for prudential reasons. When it was introduced, commercial banks were required to maintain 10% of their vatu deposit liabilities in a blocked account with the Reserve Bank. This ratio remained until 1998; following the financial crisis involving the VNPF when it was temporarily abolished and replaced with the prescribed reserve assets (PRA). The SRD was re-introduced at 6.0 percent towards the end of 1998. In April 1999, the Bank increased the reserve requirement ratio to 10% with half of demand deposits in foreign currency included in the calculation base. Following the reintroduction of the SRD in late 1998 and 1999, commercial banks now hold only one account with the RBV (comprising SRD and Excess reserves). SRD is maintained on a daily average during the maintenance period of one month.

b. Open Market Operations

Open market Operations is a process whereby central banks buy and sell securities in the market. Open market

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[5] The Reserve Bank of Vanuatu Act CAP 125, Laws of the Republic of Vanuatu, 1980.

operations are used by the Reserve Bank as a ‘fine tuning’ instrument compared to reserve requirements, which only absorb liquidity. Open Market Operations are perhaps the most important monetary policy tool currently used by the Reserve Bank of Vanuatu. In conducting open market operations, the Reserve Bank of Vanuatu buys and sells its own paper, the Reserve Bank of Vanuatu Notes (RBV Notes) in open market operations. It does this to fine tune the level of liquidity in the financial system. For example, in periods of high (low) system liquidity the Bank sells (buys) RBV Notes. When the Bank sells (buys) RBV Notes it absorbs (injects) liquidity in the system.

The Bank started to issue RBV Notes in March 1998 in response to the massive payouts of members’ contribution by the Vanuatu National Provident Fund (VNPF). The original Note had a maturity of 91-days while the 28-days RBV Note was introduced in June 1998. Currently, RBV Notes have maturities of 14-days, 28-days, 63-days, 91-days and 119-days. The Bank conducts open market operations twice a month and the scale of the operations are based on the results of the reserve money program.

c. Rediscount and Repurchase Agreement Facilities

Rediscount and repurchasing agreement facilities were introduced by the Reserve Bank to help commercial banks manage their liquidity. Commercial banks that are short on liquidity can obtain credit from the Reserve Bank through these facilities. The rediscount and repurchase agreement facilities were introduced by the Reserve Bank towards the end of 1998. However, prior to the introduction of these two facilities, commercial banks had, since 1980, been able to source overnight funds from the Reserve Bank through the Bank’s advance facility. Normally, Government bonds are pledged as collateral for the advances and the interest rate charged is equal to the minimum-lending rate. For the rediscount facility banks can sell (rediscount) short-term securities to the Reserve Bank for cash. By discounting the securities (treasury bills and RBV Notes) commercial banks obtain credit from the Bank at lower value than the face value of the security that was discounted. Repurchase agreement is also a collateralized loan. It is an agreement between the seller of the security and the purchaser of the security whereby the seller will repurchase the security at an agreed future date and price. In the event, the purchaser of the security provides a cash loan to the seller, which is repaid when the original owner repurchases the security. Therefore, a repurchase agreement is an agreement between two parties (Reserve Bank of Vanuatu and a commercial bank) and it involves cash, a security (bonds or RBV Notes) and two transactions of which one takes place at and agreed future date. The period of the agreement can range from overnight to two weeks.

d. Interest Rates

The interest rate on advances through the rediscount or repurchasing agreements also serves as the official interest rate or indicator rate for the Bank’s monetary policy stance. Currently, the official interest rate is maintained at 6.5 percent since 1 May 2001 when it was reduced from 7.0 percent. As an indicator rate, it gave a signal to the market about the monetary policy stance of the Bank. For example, an increase in the official interest rate would indicate that the Bank is tightening monetary policy, whereas a decrease in the rate means an easing of monetary policy.

WHAT IS THE BALANCE OF PAYMENTS. HOW IS IT COMPILED IN VANUATU. WHAT IS ITS IMPORTANCE

Introduction:

The purpose of this article is to provide a brief explanation of the concept of balance of payments and how it is compiled in Vanuatu. The article also shows why the balance of payments statistics as a set of accounts provide a useful tool in economic management.

The article is arranged as follows. It first explains the concept of the balance of payments and introduces the different accounts within the balance of payments statistics. It then outlines how the balance of payment accounts are compiled in Vanuatu. Finally, the article attempts to show that balance of payment accounts can be a useful tool in macroeconomic management.

What is the balance of payments

The balance of payments statistics are designed to summarize a nation's financial transactions with the rest of the world during a particular period. Before proceeding further some clarifications are required.

As a summary account the balance of payments aggregates all transactions into sets of categories; it does not contain individual or detail transactions. By international transactions, it implies the exchange of a good, service, or asset for which payment is usually required between residents of one nation and the rest of the world. Gifts and transfers, for which payments are not made, are also recorded. The notion of resident requires explanation. Diplomats, military personnel and tourists are residents in the country in which they hold citizenship. Corporations may be resident of a country where they are incorporated but their branches may not. Since these are arbitrary the balance of payments manual recommends a general rule based on *centre of economic interest*[6]. This rule has a special application in Vanuatu because of the treatment of the offshore financial centre.

The balance of payments is usually divided into two major accounts:- The *Current* and *Capital/Financial* Accounts. Table I below depicts the summary of the balance of payments sub- accounts and their major items.

The *Current Account* measures exports and imports of goods and services and investment income, which includes debt service payments, remittances and transfers. While these accounts involve the receipt and making of payments .to non-residents, many receipts recorded in the transfers account do not incur any form of counter payment and are referred to as unrequited transfers. An example is aid in kind or aid without cash provided by donors.

The Current Account balance is derived by adding all the above transactions together (or in table 1 as the sum of A B C D E and F). If the inflows (receipts) fall short of outflows (payments) it gives rise to an imbalance in the Current Account of the balance of payments, or current account deficit. If the result is positive then it is referred to a Current Account surplus. To relate the magnitude of the current account to the rest of the economy, the imbalance or balance in the current account is usually shown as a ratio of the gross domestic product (GDP). In Vanuatu, this ratio amounted to 8.1 percent of nominal GDP in 2004.

[6] See Balance of Payments Manual (Fifth Edition), The IMF, Washington DC, 1993

Table 1. **The Balance of Payments Account**	
Export of goods and services	A
Import of goods and services	B
Investment income receipts	C
Investment income payments	D
Transfers receipts	E
Transfers payments	F
Current Account (A-B+C-D+E-F)	**G**
Portfolio Investment assets	H
Portfolio Investment liabilities	I
Direct Investment assets	J
Direct Investment liabilities	K
Other investment assets	L
Other investment liabilities	M
Capital/Financial Account(H+I+J+K+L+M) = N	
Errors and omissions = Reserves- (G+N)	

Source: External sector- Department of Research & Statistics, RBV

In Vanuatu, the merchandise trade account has a large imbalance totaling VT-8,228 million in 2004 and signifies an economy that is highly import dependant. The services account is usually in surplus because of relatively large tourism inflows. The current transfers account relies largely on the level of official bilateral donor flows to Vanuatu and is usually in surplus given the magnitude of aid flows. The income account however is usually in deficit.

The current account allows us to analyze the impact of various commercial policies, primarily in the merchandise trade of goods and services which may also indirectly impact on investment income, debts and transfers. Since the current account summarizes all sales and purchases of currently produced goods and services, investment income, and unilateral transfers, it provides the link between a country's international transactions and its national income.

The Capital Account and Financial Account measures flows (or change in stocks) relating to external assets and liabilities. The current account deficit is financed in the capital account. Thus the use of the term *transactions* is restricted to exchanges involving changes of ownership including the creation and liquidation of claims[7]. Flows in the Capital and Financial Account can broadly be categorized into Portfolio, Direct Investment and Other investments. This break down is recommended by the latest Balance of Payments Manual (fifth manual) and Vanuatu has conformed to this recommendation by having a separate Capital and Financial accounts in its balance of payment statistics.

The Portfolio investment covers transactions with the nature of investing through non equity securities like bonds, bills, negotiable certificate of deposits, shares, etc. Portfolio investors are primarily concerned with the safety of their investment, the likelihood of an appreciation in the value of that investment and the return they will obtain from their investment. If circumstances change, the portfolio investor can easily shift his investment around. When an investor purchases securities, his portfolio asset increases and when issuing, his liability increases. Because of the absence of a well developed money market in Vanuatu transactions tended to be one way which involves resident entities' undertaking of investment in offshore assets.

The Direct investment item covers assets and liabilities of investors that have effective voice in the management of an enterprise. This investor normally owns a significant percent of the equity capital invested in the enterprise. In determining what is a foreign direct investment for the purpose of balance of payments surveys the Reserve Bank gives

[7] Vanuatu Bop compilation is conform to International Monetary Fund manual BPM5..

consideration to equity participation where the non-resident component is 10 percent and over. It is also the case that foreign direct investment companies with less than VT10 million capital tend to have little or an insignificant volume of balance of payment-related transactions.

Other Investment is a residual category within the Capital account and includes all kinds of financial transactions such as bank deposits, loans, trade credits, etc.

The Capital account also records external debt, both public and private. In Vanuatu public external debt take the form of multi-lateral concessional debt draw downs and repayments. The majority of external debt, however, has been incurred by the private sector due to the fact that there is no control on capital flows in Vanuatu.

Official international reserve or reserve assets form part of the Financial Account although the treatment in other countries can differ. In some countries it can be part of Other Investment Assets (item L in table 1). The role of the reserve assets in the balance of payments statistics is special. All transactions of the Current and Capital Accounts take place independently of this item but add up to it. In a way the Current and Capital Accounts can be considered as ‘‘above the line’’. Changes in the Current and Capital account reflect and equal movements in reserve assets and any discrepancy shows up as errors and omissions. In Vanuatu Errors and Omissions have been large in the past but this has improved with the new series of balance of payment statistics.

The compilation of the Balance of Payments Statistics in Vanuatu.

The Reserve Bank of Vanuatu is the agency responsible for the compilation of the country’s balance of payments. This responsibility is derived from the Act of the Reserve Bank of Vanuatu[8].

The Bank undertakes quarterly surveys of about 30 entities. This comprises all major companies including banks, and international companies, major donor countries and government departments. Data collected is compiled into various accounts and items of the balance of payments and reported in the Reserve Bank‘s Quarterly Economic Review and the RBV Website[9]. The Bank also conducts an annual survey of around 200 companies in Santo and Efate. The annual survey acts as bench mark to the Bank’s quarterly survey. The purpose of the annual survey is threefold:

- To identify all enterprises that contribute to the balance of payments statement;
- To identify companies that qualify to be included in the quarterly survey;
- To estimate balance of payment activities of companies that are not captured in the Bank’s quarterly survey.

The contents of the annual survey is general and is geared towards obtaining an idea of the level of enterprise operations, equities and international transaction of companies.

The return rate of the quarterly survey is about 90 percent.

The role of balance of payment statistics in macroeconomic management

Vanuatu is usually faced with a large current account deficit which reflects the savings-investment gap in the economy. This raises a crucial policy question as to how the country should finance this deficit in a

[8] The Reserve Bank of Vanuatu Act, CAP 120, Laws of the Republic of Vanuatu, 1980.
[9] See www.rbv.gov.vu

manner that does not destabilize macroeconomic stability.

As an import dependent economy imports far exceeds exports and the trade deficit in Vanuatu is usually large (part A of table 1). This deficit is partly financed by the export of services (*part of B*), mainly though tourism earnings.

The Income account on the other hand is usually in deficit. To improve the current account the country needs to promote exports, limit imports, or undertake a combination of both, and promote tourism or the services sector generally.

However, persistent deficits in the Current Account, or a deterioration in its level will require that this be financed in the Capital Account. Financing in the Capital Account can take the following forms (i) the encouragement of foreign direct investment, (ii) the undertaking of an external borrowing (loan) or (iii) seeking of more foreign assistance to finance the deficit. Obviously, the different ways to finance the current deficit has different policy implications.

Borrowing implies the necessity of future repayments of principal and interest. Direct productive foreign investments in say, building factories and stores entail the potential repatriation of profits of these foreign owned enterprises. But it is important to note that the promotion of foreign direct investment in Vanuatu has broader development applications than the mere transfer of capital resources.

The balance of payments also has implications for overall macroeconomic management. This is done by relating the balance of payment accounts to the macro-economic framework of the economy.

In this framework, the gross domestic product of a country is defined as:

$$\mathbf{GDP = C + I + G + X - M} \qquad \mathbf{(1)}$$

where C = consumption both private and government; I = Investment for both private and government, G= Government consumption, X = Exports and M = Imports.

Further, the gross national income **GNI = GDP + Y** whereby Y denotes the Income within the Current Account of the balance of payments.

$$\mathbf{Thus\ GNI = C{+}I{+}G{+}X{-}M{+}Y} \qquad \mathbf{(2)}$$

The Gross National Disposable Income

$$\mathbf{GNDI = GNI + Trf.} \qquad \mathbf{(3)}$$

Where, Trf stands for transfers in the Current Account of the balance of payments;

$$\text{Thus, } GNDI = C+I+G+(X-M+Y+Trf) \qquad (4)$$

From equation (4) the items in bracket are items in the Current Account of the balance of payments (items A, B, C, D, E, F in table 1). Equation (4) states that the Gross National Domestic Product = Consumption + Investment + the current account of the balance of payments.

Equation (4) has powerful policy implications with simple re-arrangements.

Since national savings (S) amounts to national disposable income (GNDI) less consumption (C) and government consumption (G):

$$S = GNDI - C - G \qquad (5)$$

It follows that equation (4) can be re-written as:

$$S - I = X - M + Y + Trf \qquad (6)$$

Or, alternatively:

$$S - I = \text{the Current Account of the BOP} \qquad (7)$$

Equation (7) states a condition that the Current Account Balance of a country's balance of payments must equal the savings (S) of both the public (Government) and the private sector, minus that country's Investment (I). If there is a Current Account surplus it corresponds to the excess of savings over investment or if there is a Current Account deficit, it corresponds to an excess of investment over savings. Thus:

- If a country wants to increase its level of investment it must be done through an increase in private or public (Government) savings, or a deterioration in the Current Account balance;
- An increase in the Government budget deficit must be reflected in an increase of savings in the private sector, or a decrease in investment, or a deterioration in the Current Account balance;
- If a country has a high savings rate, both private and public (Government), it will either have a high level of investment or a surplus in its Current Account of the balance of payments.