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Reserve Bank of Vanuatu

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Q1 March 2005	What is the Balance of Payments?. How is it compiled in Vanuatu. What is its importance.
Q2 June 2005	Vanuatu Government Revenue Collection from Taxes

STATISTICAL ANNEX

TECHNICAL NOTES

Statistical data in the Quarterly Economic Review are based on the latest available information, and several statistical tables are substantially up-dated and amended from time to time to reflect figures revised by respective sources.

Abbreviations used are:

e	=	Estimated
n.a.	=	Not yet available
E	=	Estimated by Source
n.e.i.	=	Not elsewhere included
p	=	Provisional
-	=	Nil
r	=	Revised
..	=	Negligible/Almost
R	=	Revised by Source

1. Executive Summary

World economic growth and growth within our trade partners – China, Australia are moderating as a result of high petroleum prices and as cyclically advanced countries are under different phases of monetary and fiscal tightening. At the same time the domestic activity appears to be mixed. Within the domestic economy there appears to lower agricultural output compared to 2004 due to effect of Cyclone Ivy and having to compare to a high period in 2004. While the effects of cyclones should start to wane soon world commodity prices relevant to Vanuatu are beginning to moderate from past high levels. But because tourism growth has rebounded the services sector should have strengthened. Will we attain the 2005 growth forecast of 3.7%? This will depend on how the services sector (relatively large weight) will be able to pull up the economy if slack in the agriculture sector continues. In a monetary perspective we have seen the rate of growth in Narrow Money at a rate that conforms to the forecast of output with no let up in private sector credit growth (above trend growth).

The rate of inflation is still low but has edged up to 1.3% in the second quarter. The increase has largely been evident in Luganville and is partly due to increase in petroleum prices. This slow growth against high import prices of petroleum is indicative of the level of cross-subsidization in power charges away from household consumers (that is, the Consumer price index only captures inflation in the household sector). Partly because of this the price differential between Vanuatu and its main trade partners have been in favor of Vanuatu. That is if price levels are measured by the CPI alone. This development is reflected in the current depreciation of the real effective exchange rate of the Vatu. Nonetheless, inflation in our key trade partner Australia is edging up and coupled with the current appreciation of the Aussie against the Vatu should be an additional source of upward pressure on domestic price levels although in the past this has been matched by a depreciating US dollar.

We continue to witness a high level of money growth. The trend now is slightly below recent historical trend but Narrow Money growth -- the intermediate target of the RBV – continue to register high growth in September 2005. At the current forecast the growth in Narrow money is above what the DRS has anticipated in the annual reserve money program for 2005 and suggests a more active monetary management. At the same time however, the current improvement in fiscal operations contributes to liquidity destruction as reflected by rise in deposits of the government at the Reserve Bank. But the decline in excess liquidity is not entirely as a result of fiscal improvement – it is caused by increase in the Reserve Bank's monetary policy instrument reserve requirements and increase in the public's cash balances reflected in the component currency issued. Indeed interest rates are started to edge upwards but this is partly due to the concentration of liquidity on two banks (with only one bank participating in security auctions) and the fact that world interest rates are rising. Monetary management therefore needs to conform to high money growth above forecast target levels but at the same time mindful of the contractionary effect of fiscal operations on liquidity which is probably going to reverse towards the year-end as unbudgeted expenditure pressures have been accommodated or in the coming year because the 2006 budget has accommodated a large component of new initiatives (over VT 700 million).

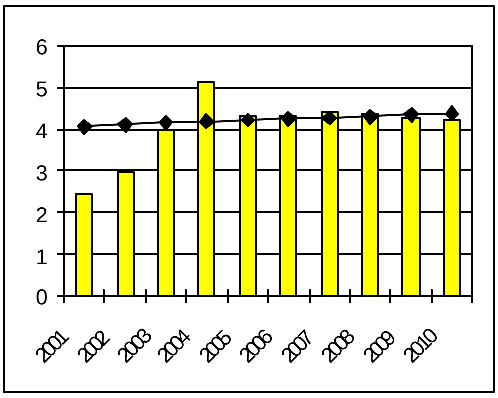
The period of high money growth that was experienced during the preceding two quarters has continued into the third quarter of 2005. This quarter's expansion of money supply by 2.3 percent, as compared to a 3.8 percent increase in the previous quarter, was attributed to a strong expansion in domestic credit and further increase in inflows through the balance of payments.

Regardless of further expansion in total money supply, commercial banks' liquidity have somewhat eased during this quarter. The decline in total banks' liquidity coupled with its unequal distribution among the banks, have triggered short-term interest rates to rise. Moreover, the Bank has allowed some notes to mature thus reducing the amount of outstanding notes substantially.

2. The International Economy

Global expansion remains on track with forecasts for world growth in 2005 and 2006 remaining at around 4.3 percent. This comes despite a softening of growth in the third quarter of 2005 due mainly to the high oil prices which resulted from Hurricane Katrina.

Figure 1: World Real Economic Growth



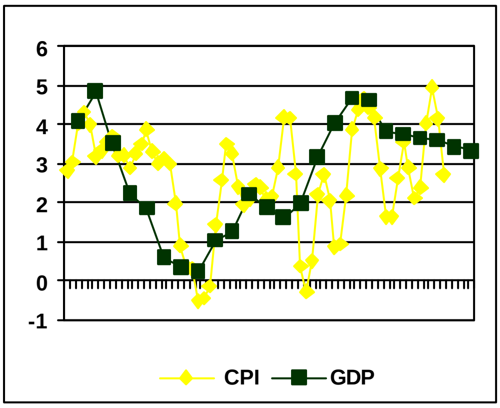
Source: IMF World Economic Outlook, September 2005.

The US Economy

It has been a mixed quarter for the US economy. Data from July and August pointed to continued strong growth as US home sales rose to a record in July as job growth and cheap financing kept Americans buying. Data from the manufacturing sector was also encouraging showing that the number of order backlogs had increased. Unemployment figures also decreased slightly in August.

However, this picture of strong growth suddenly changed towards the end of August when Hurricane Katrina hit, ravaging much of the Gulf Coast, causing large loss of life and displacement of people as well as shutting down many of the region's oil refineries. This further increased the price of oil and forced the US to dip into its strategic reserves. The aftermath of the Hurricane caused a large rise in unemployment figures, mainly due to the destruction of much of New Orleans, as well as large drops in consumer confidence.

Figure 2: US GDP and CPI



Source: IMF World Economic Outlook, September 2005

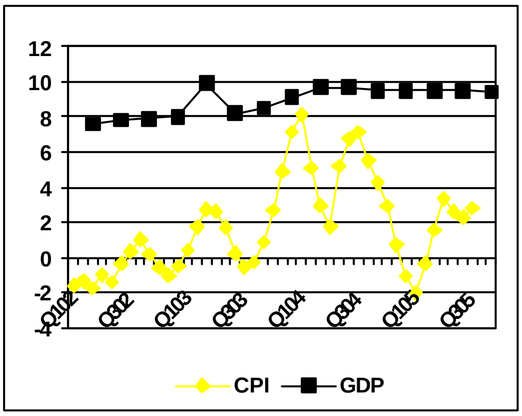
The impact of Hurricane Katrina has meant that many economists have revised their projections for growth of the US economy downwards for the end of 2005. Forecasts from ANZ bank have been lowered from 3.5 percent to 2.7 percent for 2005, they have also lowered their forecast for 2006 from 3.3 percent to 3 percent.

Asia

Asia is also likely to feel a negative effect from Hurricane Katrina as the slowdown in US demand will weaken the demand for Asian exports. Asia's other large export market, the EU, is also set to grow slowly for the rest of 2005 and 2006, which will more than likely lead to a slowdown in manufacturing which is the main engine to growth in many Asian economies.

The higher oil prices are also starting to have an effect on the Asian economies especially China which is starting to see a drop in the amount of fuel subsidies. Fuel prices in China have gone up only 22 percent in the last year where as the rest of the world has seen a 60 percent increase. The Chinese are now starting to believe that the high oil prices are here to stay and are beginning to cut subsidies accordingly, there has even been talk of the possibility of increasing electricity prices.

Figure 3: Chinese GDP and CPI



Source: IMF World Economic Outlook September 2005 and Chinese National Bureau of Statistics.

The growth slowdown triggered by the decreased American demand coupled with the increase in the price of fuel are likely to mean that growth in Asia is likely to slow towards the end of 2005 and into 2006.

Japan

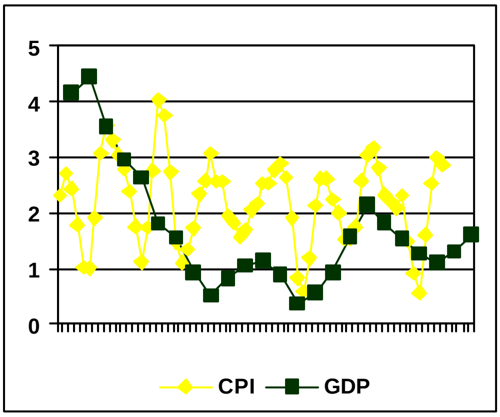
The performance of Japan's economy has remained solid in the third quarter aided by an upward revision in the second quarter GDP figures from 1.1 percent to 3.3 percent and a strong election win by the Liberal Democratic party. Japan's recovery has so far been based on domestic factors, shifting away from its past reliance on exports as an engine of growth and figures show that the domestic situation is continuing to improve.

Unemployment fell from a record high of 5.5 percent to 4.3 percent in August and wage growth remains positive. Progress has also been made in strengthening Japanese banks with the FSA exerting more pressure. This has led to a large decrease in the number of non-performing loans in Japan. If the pace of reforms can be maintained and the domestic situation remains strong then it is expected that Japan should grow strongly for the rest of the year and into 2006.

Europe

Growth in the Euro-zone continues to stagnate and the outlook for the euro-zone economies appears very uncertain. Growth is expected at 1.2 percent for this year although that figure is expected to rise slightly to 1.8 percent for 2006.

Figure 4: Euro-area GDP and CPI



Source: IMF World economic Outlook, September 2005.

The data coming from the EU continues to be very mixed, exports in most countries are still stagnant and show no signs of increasing, inflation remains high, there is growing dissatisfaction among citizens as unemployment remains high. This means that any more talk of badly needed reform has been shelved for the time being. The EU has also been unable to agree over a new budget which has led to further dissatisfaction.

But the manufacturing indicators have been strengthening and profitability has improved, there are also signs that inflationary pressure is easing due to the weak domestic demand. Firms however seem unwilling to invest their increased profits as confidence remains week.

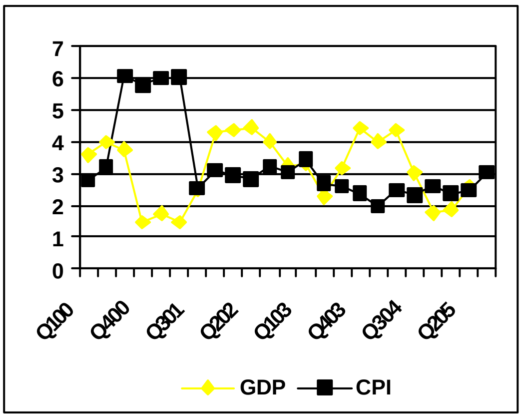
The UK has also recently been facing a downturn in its fortunes after having experienced a period of much stronger growth than many other European economies. GDP forecasts have been cut and there have been calls for a drop in the interest rate to try and boost flagging consumer demand.

Australia

The Australian economy continued growing in the second quarter of 2005 by 1.3 percent, the highest quarterly rate of growth since the fourth quarter of 2003. But there are signs that the growth is slowing to a more manageable level.

In the past Australian growth has mainly been based on asset prices with high house prices fuelling consumer spending. It now seems that this period of house price growth has come to an end with house prices registering a 0.1 percent decrease over the June quarter.

Figure 5: Australia CPI and GDP



Source: Reserve Bank of Australia

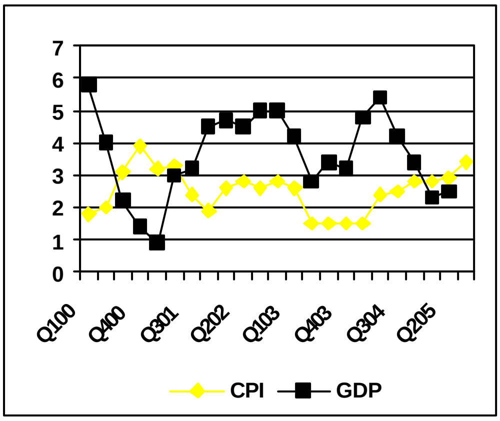
However this is not expected to cause too much of a slowdown as the prices of Australia's commodities are currently very high in world markets due mainly to increased demand from China. Increased export earnings should thus make up for any domestic fuelled growth declines.

Unemployment figures have started to creep back up again, to 5.1 percent but this was expected as the labour market had been too tight. Inflationary pressures remain subdued although there are expectations that they are to rise in the medium term which may force the RBA to increase interest rates sometime towards the end of 2005 or early 2006. The GDP growth expectation for this year remains at 2.6 percent.

New Zealand

The story remains unchanged for New Zealand in the third quarter of the year. Inflationary pressures are continuing leaving the RBNZ with little choice but to keep increasing the already very high rate of interest.

Figure 6: New Zealand CPI and GDP



Source: Reserve Bank of New Zealand.

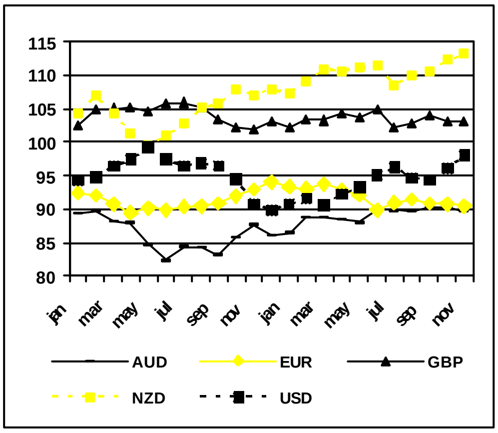
Exports continue to be very weak and the strong kiwi dollar continues to dampen tourist numbers. Business sentiment remains very low. Inflationary pressure in New Zealand was created by excess demand in the economy as is evident by the low unemployment rate of just 3.7 percent coupled with the fact that New Zealand is suffering from its highest rates of strikes in nine years. The high oil prices are also making matters worse.

The future for New Zealand is somewhat bright though as its economy appears well placed to weather the current storm. Growth this year is set to slow to 2.6 percent and inflation is expected to spike in 2006 but this is unlikely to hurt the economy too much and it should bounce back.

Financial Markets.

The pattern of monthly exchange rate movements of some of the world's larger currencies is shown below in trade weighted terms.

Figure 7: Exchange Rates



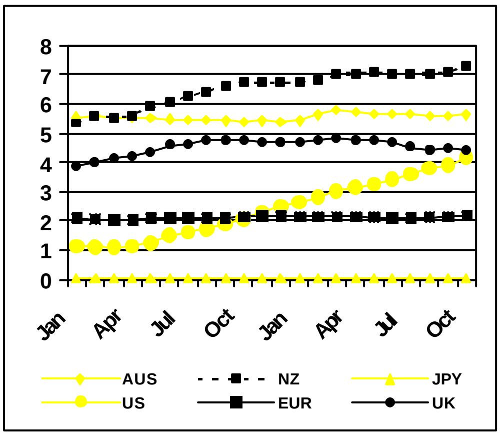
Source: Bank of England

The US dollar saw a very stable quarter, depreciating by just 0.06 percent to end at an index value of 96.38 in September. There was also very little change for the euro which appreciated by 0.6 percent over the quarter. The Australian dollar showed a slight depreciation, by 1.54 percent to reach 83.14. The biggest movers were the British pound and the New Zealand dollar with the pound depreciating by 2.42 percent and the kiwi appreciating by 2.68 percent.

Short Term Interest Rates

The graph below shows the pattern for short term interest rates for some of the world economies relevant to Vanuatu, the rate shown in each case is a 3 month money market rate.

Figure 8: Short Term interest Rates



Source: Reserve Bank of Australia, Reserve Bank of New Zealand, European Central Bank, Bank of England

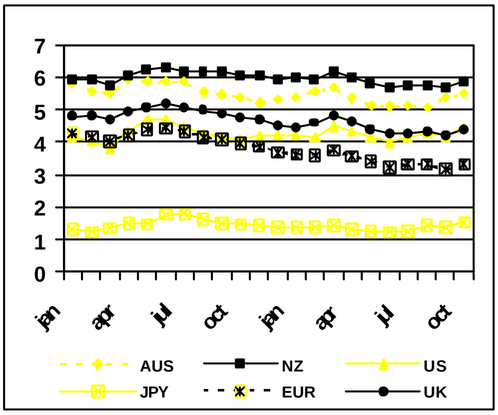
Interest rates in Australia have started to decline slightly after the increases seen in the second quarter, showing a level of 5.62 percent in September as compared to the RBA's 5.5 percent cash rate. The New Zealand interest rates have continued on their upward trend increasing from 7.03 percent at the end of last quarter to 7.08 percent at the end of this one, That represents an increase of 16.4 percent over the last twelve months. The RBNZ cash rate now stands at 7 percent. After twelve months of an interest rate at 0.05 percent, Japan has finally seen an improvement, albeit a very slight one, with rates rising to 0.06 percent in July and staying at that level until September. The US interest rates have also continued on their steady rise, increasing to 3.91 percent in September from just 1.9 percent at the same time last year, this reflects the Fed's continued period of monetary tightening.

The Euro has remained fairly stable, showing 2.14 percent in September, up slightly from the 2.11 percent at the end of last quarter. Rates in the UK however have started to decline as the Bank of England has cut rates to boost the slowing economy, they finished the quarter down to 4.44 percent from 4.69 percent at the end of last quarter.

Long term interest rates.

The graph below shows the changes in long term interest rates in some of the world's major economies.

Figure 9: Long-Term Interest Rates



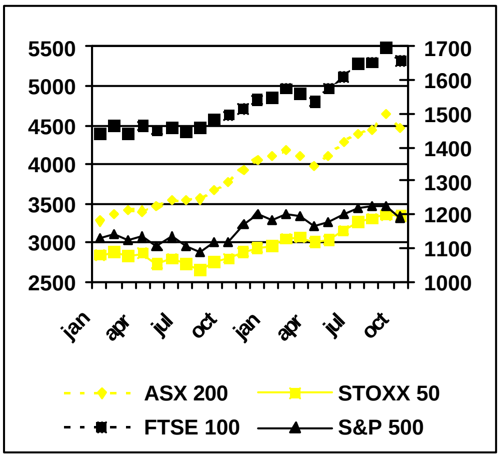
Source: Reserve Bank of Australia, Reserve Bank of New Zealand, Bank of England, European Central Bank.

Long term interest rates in Australia have increased from last quarter to reach 5.36 percent, although this is a decrease on last year's level of 5.47 percent. Rates in New Zealand have also increase slightly to 5.88 percent in the third quarter of 2005. Long term rates in the US have increased slightly from 4 percent at the end of quarter two to 4.19 percent at the end of quarter three. The European and British long term rates have both seen declines to 3.16 and 4.24 percent respectively.

Stock Markets

The following graph shows the movements in share indices from some of the world's largest markets.

Figure 10: Stock Markets



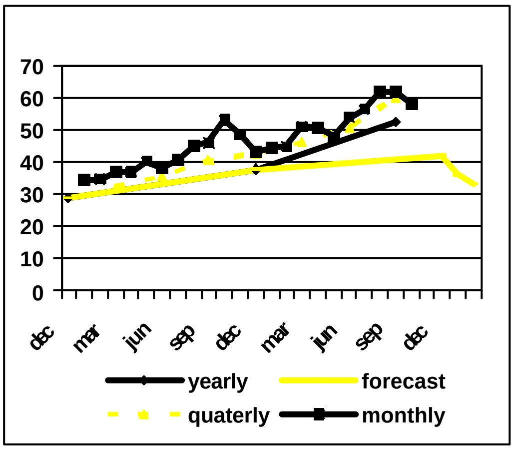
Source: Financial Times, European Central Bank, Reserve Bank of Australia.

All four of the featured stock indices increased over the third period from the second. The largest of these increases was seen in the Australian ASX 200 index, which increased by 8.5 percent over the period. The UK FTSE 100 also performed well showing an increase of 7.12 percent over the quarter. The European STOXX 50 also grew, by 6.34 percent. The worst performing index was that of the US, the S&P 500 which only managed an increase of 1.9 percent.

Oil Markets

The price of oil has continued on its upward trend this quarter.

Figure 11: Average Spot Price for Crude Oil



Source: World Bank Pink Sheet

The price of crude oil rose from $50.79 a barrel in quarter two to $60 a barrel in quarter three, a rise of some 18.1 percent. The highest monthly value was seen in August at $61.89 a barrel. This was as a result of the sharp price increases deriving from Hurricane Katrina. Prices began to decrease again in September as the US pledged to US some of its reserve stocks thus easing supply constraints and OPEC decided to make more supply available should it be required although they did not increased their daily production limits.

The future for oil prices does not look too good with many analysts predicting that high prices of oil are likely to be around for quite some time.

3. Domestic Economic Development

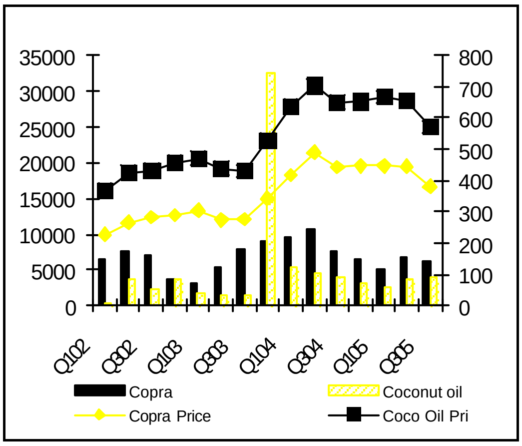
3.1. Real Economy

Growth in the domestic economy is projected to remain positive however, forecast real GDP growth in 2005 has been revised by the Ministry of Finance to 3.0%. 2005 GDP is still expected be lower than 2004 mainly due to the lower output by the agriculture sector.

The agriculture sector has picked up quite slowly seen mainly in the cocoa production; copra is the only agricultural commodity to have made a decline from the previous quarter. The cocoa sector has made grown significantly, increasing more than last year's level and in comparison to previous quarters.

The tourism sector has also seen an increase mainly due to an increase in cruise ship calls in the third quarter, which was much higher than in the same quarter, 2004. This follows the seasonal trend of tourist arrivals which increases towards the latter part of the year.

Figure 12: Copra & Coconut Oil Production



Air arrivals(no.)	57,591	53,300	49,462	50,400	60,611
Cruise arrivals(no.)	47,648	52,778	49,447	51,995	37,870
Hotel Occ. Rate	52.00%	49.80%	44.20%	46.50%	51.90%
Energy Consumption Quarterly		42,281	41,874	41,341	42,849
	2004				2005
	Q304	Q404	Q105	Q2 05	Q3 05
Real GDP Growth	-	-	-	1.3	0.6
inflation rate	2.9	0.8	1		
Production					
Copra(t)	9,434	6,587	5,017	6,601	6,310
Cocoa(t)	180	296	49	125	535
Beef(t)	819	875	676	963	Na
Coconut oil	4,038	3176	2457	3,700	4,016
Kava	269	283	113	227	256
Tourist arrivals(no.)	19,005	18,225	12,648	13,309	18,507
Cruise arrivals(no.)	4,540	9,909	19,454	12,686	17,017
Hotel Occ. Rate (room)	70.10%	78%	55.20%	49.4	72.40%
Energy Consumpti	9,968	10,319	12,664	10,920	10,059

3.1a. Copra

Domestic Data					
Annual					
	2000	2001	2002	2003	20044
Real GDP Growth	2.7	-2.7	-4.9	2.4	3.2
Annual inflation rate	2.5	2.3	2.3	2.9	0.8
Production					
Copra(t)	27,294	20,234	25,608	28,925	36,822
Cocoa(t)	1,557	797	868	1,346	865
Beef(t)	3,753	3,028	2,531	3,099	2,984
Coconut oil	8,733	8,733	9,856	7,725	17111
Kava	555	935	601	491	828

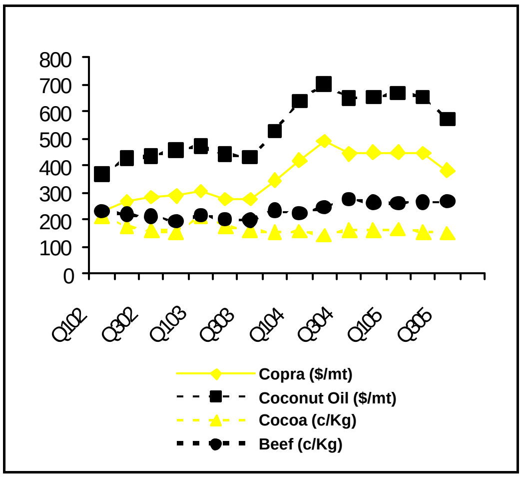
The copra sector has recorded a decline in production of 4.5 percent during the third quarter representing a decline of 33.1 percent from last year. Although coconut trees have recovered from the effects of cyclone Ivy last year, the current drought has had an effect on copra production. The third quarter has seen a decline in copra exports by 36 percent since the VCMB and other agencies are no longer exporting copra, but are selling it to COPV for processing into coconut oil

Copra exporters are buying copra at an average domestic price of 24,000Vt per ton compared to the range price of 26,000-27,000Vt per ton in 2004. The average world price for copra has declined by 15 percent on the previous quarter from $445.83 per ton to $380.7 per ton.

Due to the decline in the supply of copra, the Coconut Oil Product Limited (COPV) has recorded a decline in coconut oil production by 9.3 percent on the second quarter. However, Coconut oil exports have increased by 8.5 percent on last quarter representing a decline of 0.5% from third quarter 2004.

This is in contrast to the usual quarter to quarter seasonality trend which should have seen an increase in copra production in the latter part of the year. The current drought season has had an effect on copra production reducing production of coconut oil. World price for coconut oil has declined from $654.9 per ton last year to $571.1 per ton.

Figure 13: Commodity world prices



3.1b. Cocoa

Cocoa production registered a significant increase in the third quarter compared to the second quarter of this year. This makes cocoa the only agricultural commodity to see an increase on last year's level with production increasing from 180 tons in the third quarter last year to 535 tons this quarter, a 197 percent increase. This represents a 328 percent increase from the previous quarter. This increase was due to the recovery of cocoa plantations from Cyclone Ivy and strengthening of farmers' cooperatives in Malekula and Santo through POPACA. The average world price for cocoa is 149.1cent per Kg, a decline of 3.5 percent from the previous quarter average.

3.1c. Beef

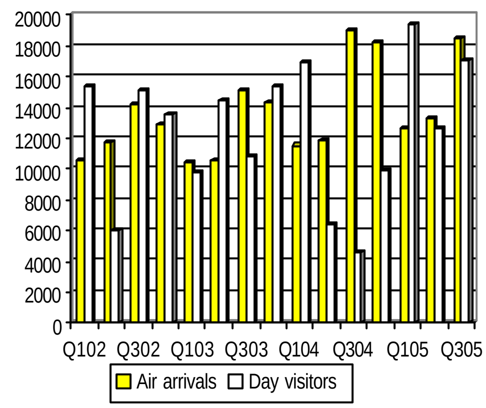
Information on beef production is not yet available. However beef export for quarter 3 revealed an increase from 279 tons to 298 tons, an increase of 6.8 percent. While the export markets still look favorable, Santo Abattoir still faces constraints in shipping cattle in from outer islands. The average world price for beef has increased from 224.8 cents per Kg to 266.8 cents per Kg, an increase of 19 percent from the previous quarter's average.

3.1d. Kava

Kava has made a decline from last year's level with exports decreasing by 4.8 percent. A major reason for this decline is the ban on Vanuatu Kava exports to Fiji effective since August, 2005. However, production has increased from last quarter from 227 tons to 256 tons in the third quarter, representing a 12.8 percent increase. Despite the ban, kava remains a high value commodity.

3.1e. Tourism

Figure 14: Visitor Arrivals



The tourism statistics for quarter three have now been compiled and the figures for cruise ship arrivals have seen an impressive increase all through the third quarter.

Total visitor arrivals in the fourth quarter are estimated to have increased by 34 percent from the previous quarter. This is higher by 51 percent from the same quarter last year. This observed increase is due to the increased number of cruise ship calls made to Port Vila and Luganville throughout the September quarter. Cruise ship arrivals increase 28 percent in the third quarter from the previous quarter which is a 275 percent increase from the same quarter last year. Air arrivals in the third quarter, saw a large increase on the second quarter, by 39.1 percent, however lower by 2.6 percent from quarter 3 2004. This has seen hotel occupancy increase to 72.4 percent in the third quarter.

3.1f. Inflation

Inflation for the third quarter was recorded at 0.5 percent change from the previous quarter and 0.6 percent change with the same quarter of 2004. Headline CPI in the second quarter of 2005 declined from 1.3 percent in quarter two to 0.6 percent in quarter three, whereas Headline inflation actually declined from 0.7 percent to -0.1 percent.

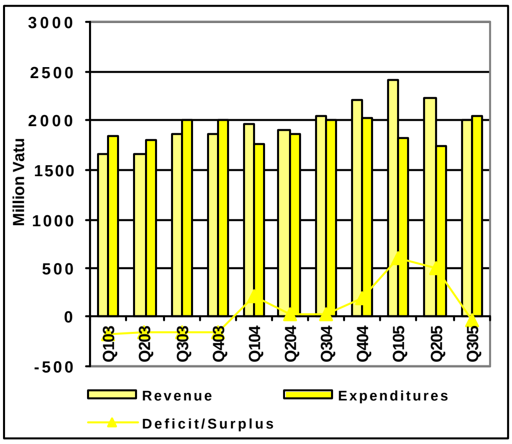
The main reason for the increase in CPI for this quarter comes from the increase in Drinks & Tobacco by (1.0%) and Housing & Utilities (0.9%). The reason for this is the increase in prices of cigarette, electricity and fuel. There was also a slight increase in other expenditure groups including Food consumption (0.6%), Transport & Communication (0.3%) and Household Supplies (0.2%) over the previous quarter. Food and Clothing expenditure group showed a decrease of -0.1% over the second quarter while Recreation, Education & Health remain stable during the same period.

3.2. Fiscal Operations

The Vanuatu Government fiscal position continued the improvement experienced during the first and second quarters of 2005. Despite this improvement, the quarter under review witnessed a small budget deficit as a result of increased expenditures over revenue collection.

The improved government position continued to contribute to an improvement in net claims on government resulting from improved government deposits compared to the same period of previous year. Apart from prudent fiscal control by the Department of Finance, this is also attributed to an improvement within the domestic economy.

Figure 15: Government Expenditures and Revenue.



For the third quarter of 2005, the central government overall fiscal operations depicted a deficit of VT38.0 million as compared to a surplus of VT26.7 million recorded during the corresponding quarter of 2004. This deterioration stemmed mainly from an increase of 1.7 percent in expenditures, with a decrease of 1.5 percent in revenue and grants, both over the corresponding quarter of 2004.

3.2a. Revenue

During the quarter under review, overall revenue (including grants from abroad) amounted to VT2008.2 million, 1.5 percent lower than the level attained in the corresponding quarter of 2004. This decrease is attributed to an overall decrease in tax revenue by 3.6 percent over the corresponding quarter of 2004. Import duties had decreased by 8.9 percent over the corresponding period of 2004.

Of the budgetary account, actual recurrent revenue collection for the nine months of 2005 accounted for 74.7 percent, which is approximately on target as expected for this period.

Figure 16: Revenue and Grants

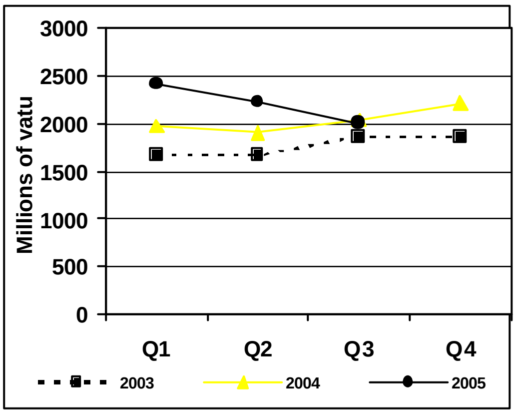
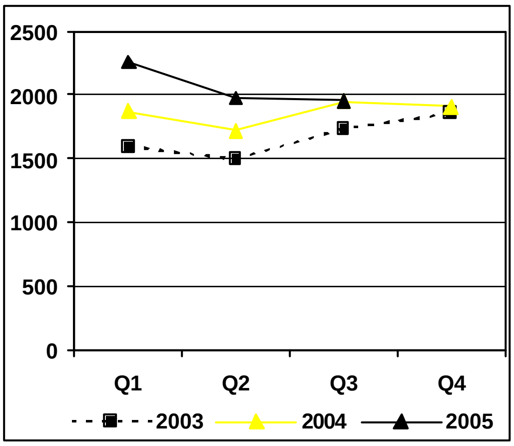


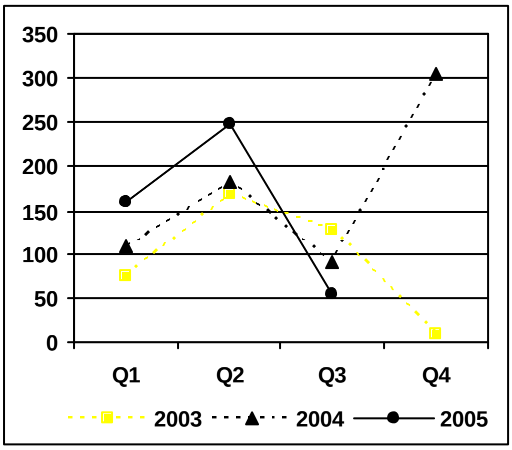
Figure 17: Domestic Revenue



Revenue from non-tax sources which constituted the remaining 14.7 percent of total recurrent receipts, decreased by 5.2 percent from the corresponding quarter of 2004.

Grants received for this quarter totaled VT53.5 million, which is 40.1 percent and 78.6 percent from the corresponding quarter of 2004 and second quarter of 2005, respectively. Total aid for this quarter is the lowest amount of aid received for third quarter since 2000.

Figure 18: Grants



3.2b. Expenditures

Total outlays displayed an increase of 1.7 percent when compared to the corresponding quarter of 2004. This is attributed to increases in both recurrent and capital expenditures by 0.8 percent and 15.6 percent, respectively. Total expenditures and net lending totaled 76.2 percent of the budget which is slightly higher than the expected expenditures for this period of the year.

By economic classification, salary and wages which accounted for 57.4 percent of total recurrent expenditures for this period increased by 7.8 percent from the corresponding quarter of 2004. This increase is attributed to three Government paydays during the month of July.

3.2c. Financing

A fiscal deficit of VT38.0 million was recorded during the third quarter of 2005. This deficit was financed by the Government own revenue means without resorting to other means of financing. There is an overdraft arrangement for a limit of VT400 million with the Reserve Bank of Vanuatu, for any short term cash shortages.

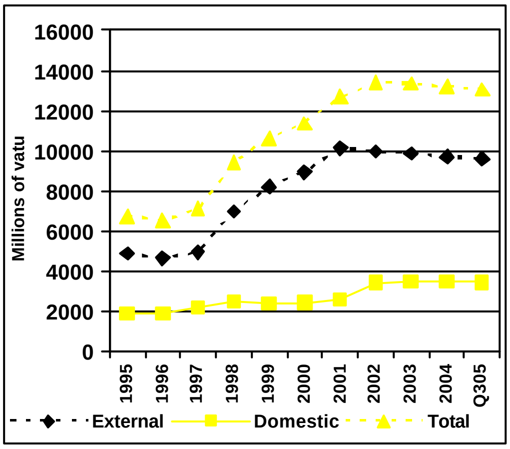
During the quarter under reviewed, there was no major undertaking in terms of Government domestic debts. As a result commercial banks net claims on the Government deteriorated by 20.9 percent and 25.6 percent from the corresponding quarter of 2004 and second quarter 2005, respectively. This declined stemmed mainly from the decrease in government deposits with commercial banks.

3.2d. Outstanding Government Debt

As at end-September 2005, total outstanding public debt was estimated at VT13.1 billion, of which 26.4 percent or VT3.4 billion is domestic debt. Total estimated outstanding public debt represents 35.4 percent of projected nominal GDP for 2005.

Domestic debts in terms of bond holding total VT3,219.1 million. From this total bond holding, the RBV has a share of 26.8 percent, commercial banks 26.0 percent, corporate bodies 47.1 percent and others 0.1 percent.

Figure 19: Public Debt



Total external debt of the country stood at approximately VT9.6 billion and representing 73.6 percent of total public debt.

3.3. Monetary Developments

The period of high money growth that was experienced during the preceding two quarters has continued into the third quarter of 2005. This quarter's expansion of money supply by 2.3 percent, as compared to a 3.8 percent increase in the previous quarter, was attributed to a strong expansion in domestic credit and further increase in inflows through the balance of payments.

Regardless of further expansion in total money supply, commercial banks' liquidity has somewhat eased during this quarter. The decline in total banks' liquidity coupled with its unequal distribution among the banks, have triggered short-term interest rates to rise. Moreover, the Bank has allowed some notes to mature thus reducing the amount of outstanding notes substantially.

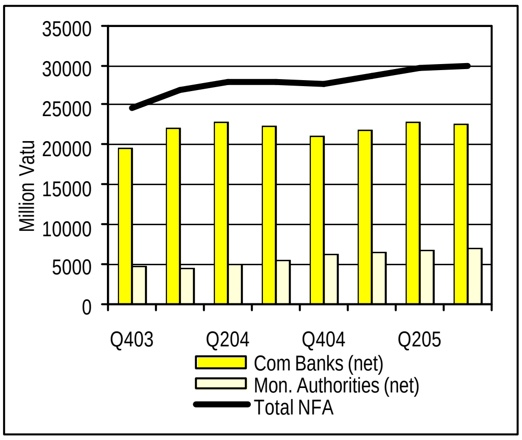
3.31. Determinants of money supply

3.31a. Net Foreign Assets

Total net foreign assets expanded for the third consecutive quarter, adding VT104.1 million or 0.4 percent. Growth in total net foreign assets (NFA) was slow during the quarter, as expansion in the monetary authorities' NFA position by 3.3 percent was offset by a decline in commercial bank's NFA position by 0.5 percent. Total NFA grew by 6.6 percent against the corresponding quarter of last year.

Monetary authorities' NFA position continued to increase in the quarter under review, adding VT225.8 million or 3.3 percent. The growth during this quarter is the sixth successive quarterly growth since last year. The uptrend in the NFA position of the monetary authorities was yet driven mostly by net foreign exchange purchases from the Reserve Bank, and Others. Following this increase, the level of foreign reserves in September was sufficient to cover 5.57 months of import cover.

Figure 20: Net Foreign Assets



Commercial banks' NFA, on the other hand, have indicated a minor decline by 0.5 percent from the previous quarter; however an annual growth rate of 1.2 percent was recorded. The downtrend in growth mainly reflected a reduction of VT660.6 million in commercial banks holdings of foreign assets with non-resident banks. The decline in banks' foreign assets more than outweighed the decline in banks' liabilities to non-residents. Furthermore, commercial banks' domestic liabilities in foreign currency especially demand and savings deposits have shown negative growths.

3.31b. Domestic Credit

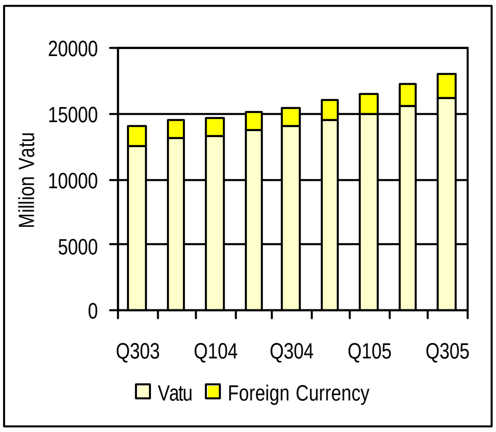
Total domestic credit expanded further by 3.1 percent or VT545.7 million during this quarter. This increase was largely contributed by loans to the private sector. Alternatively, net credit to Government and credit to non-financial public enterprises and municipalities indicated decreases from the previous quarter. Over the year to September 2005, domestic credit rose by 7.7 percent.

The Government's net lending position vis-à-vis the banking system continued to improve considerably from June quarter to this quarter, as net claims on Government declined by a hefty 125.9 percent. The quarter–to-quarter improvement was attributed to the Governments' net lending position with both the monetary authorities and the commercial banks. The Government's net position with the banking system moreover improved from the same quarter of the previous year by a vast 103.7 percent.

The main reason for the decline in the Government's net lending position with the banking system is improvements in Government revenue over its outlays during the quarter. Consequently Government deposits with the Reserve Bank grew by 87.7 million. Improvement in VAT collection and a pick up in "entrepreneurial and property income" were the main contributing factors to the positive trend in Government finances. In addition the Government refrained from operating an overdraft with the Reserve Bank since April 2005 up till the end of this quarter.

Loans granted to private sector expanded further by 4.4 percent during the September quarter, while a growth of 16.1 percent was recorded against the same quarter of last year. These trends portrayed positive signs of growth in the economy over a year ago. Of all the loans extended to the private sector, 63.8 percent are purposely of business nature, indicating investors are more confident in the economy, and 34.2 percent are of personal requirement while the remaining 2.0 percent goes to others category.

Figure 21: Private Sector Loans



In terms of the economic activity of each borrower, the sectors which noted increase in loans include; agriculture sector with 12.9%, growth in loans were noted for copra, livestock & dairying, cocoa, food crops and others. Fisheries recorded a 2.7% growth. Loans to the manufacturing sector increased by 16.5 percent, notably for edible oil processing, alcoholic beverages, building materials, and furniture and wood products. The distribution sector recorded a 6.9% rise in credit, particularly for retail and wholesale trading. Increase in credit to hotels, apartments and other tourism related activities contributed the 17.3% increase in credit to the tourism sector. Credit to financial institutions increased by 0.3%, housing and land purchases (2.3%), other personal sectors (8.0%) and miscellaneous sectors (4.2 %).

Of the total loans and advances granted to the private sector, housing and land purchases claimed 23.0 percent, other personal sectors followed with 20.4 percent, while loans for construction claim third position of 15.9 percent. Loans for distribution constitute 10.2 percent, while 8.4 percent was claimed by tourism sector. Of the minor sectors, 1.5 percent was consumed by the agriculture sector, 0.1 percent goes to fisheries, 6.1 percent for manufacturing, 0.8 percent for entertainment and catering sector, 3.3 percent for transport, 0.7 percent for financial institutions and 5.0 percent for professional and other services.

3.32. Components of Money Supply

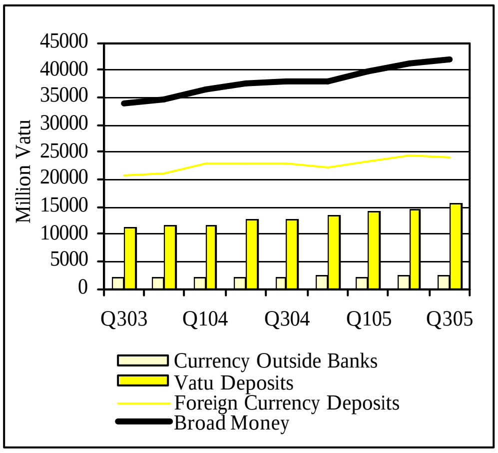
Money supply growth during the review quarter was largely driven by quasi-money, which expanded by 7.1 percent from the previous quarter, while an annual growth rate of 9.5 percent was recorded. Narrow money, on the other hand, contracted by 6.1 percent from the preceding quarter. However, despite the quarter-to-quarter decline, narrow money expanded by 13.5 percent from the same quarter of last year.

Among the components of narrow money, demand deposits contracted by 9.1 percent while currency with the public increased by 10.1 percent. The main driver for the decline in total demand deposits is demand deposits in foreign currency which declined by 16.0 percent. This may have been caused by: a) residents converting demand deposits in foreign currency to demand deposits in local currency in connection with the current increase in activities taking place in the economy, hence contributed to the growth in demand deposits in local currency and currency with the public; b) residents converting demand deposits in foreign currency to time and saving deposits in foreign currency and c) importers utilizing their foreign currency demand deposits to cater for the surge in imports during the quarter under review.

The other components of narrow money, currency outside banks and demand deposits denominated in local currency, recorded increases of 10.0 percent and 4.2 percent, respectively. The increase in currency outside banks indicated that currency is quite slow in re-entering the banking system since July 2005; this either implies that currencies may have been hoarded by residents or economic activity has increased therefore currencies changes hands within the community itself.

Residents are at the same time investing in longer-term interest bearing deposits during the quarter. For that reason, time and savings deposits denominated in both the local and foreign currency recorded growths of 9.3 percent and 5.7 percent respectively.

Figure 22: Money Supply



3.33. Deposits with Commercial Banks

Total deposits of residents (excluding Government deposits) held with the commercial banks at the end of the quarter expanded at a slower rate of 1.8 percent or an additional VT699.4 million from the previous quarter to reach VT39527.3 million. While local currency deposits expanded by 7.7 percent, therefore contributing to the overall growth in deposits. Foreign currency deposits, on the other hand, recorded a negative growth of 1.7 percent.

In terms of ownership of deposits, individuals still consume the largest share of total deposits with 46.9 percent though their share declined from 47.0 percent from the previous quarter. Private Business followed with 39.1 percent. Deposits of non-financial public enterprises (NFPE) and others claim 7.1 percent and 5.9 percent, respectively.

3.34. Interest Rates

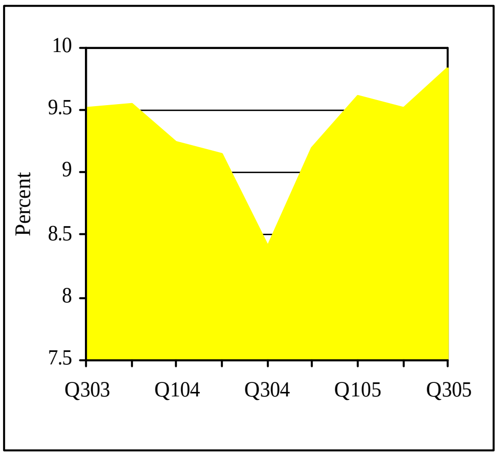
During the September quarter, commercial banks interest rates ranges, in terms of deposits and lending rates, were maintained as in the previous quarter (see table 8). Though the interest rate range for deposits remained unchanged as in the previous quarter, the weighted average rate of interest for total bank deposits indicated a minor decline of 0.02 percentage points to 2.12 percent.

On the lending arena, the weighted average interest rate for total bank loans has increased by 0.31 percentage points to 11.96 percent.

3.35. Interest Rate Spread

After having declined in the previous quarter, the interest rate spread, as depicted in figure 7, increased from 9.51 percent to 9.84 percent during the current quarter as the weighted average rate of interest on total loans increased against a decline in weighted average rate of interest on total bank deposits.

Figure 23: Interest Rate Spread



3.36. Reserve Money

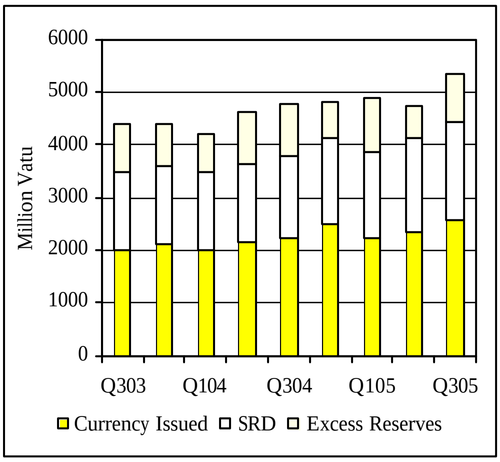
After a decline in growth recorded in the previous quarter, reserve money [1] grew strongly against the previous quarter and the same quarter of the previous year by 11.3 percent and 11.8 percent, respectively. The quarter-quarter growth was contributed by all its components, of which currency outside banks expanded by 10.1 percent, statutory reserve deposits (SRD) increased by 4.5 percent while excess reserves grew substantially by 46.2 percent. On annual view, currency outside banks grew by 16.4 percent, SRD by 19.5 percent while excess reserves fell by 9.5 percent.

The expansion in currency outside banks signified that residents prefer cash that is readily available to satisfy their immediate needs or accommodate for other economic activities. The quarterly increase in excess reserves was particularly contributed by a substantial reduction of VT472.9 million in outstanding RBV notes at the end of September. However excess reserves declined over a year ago due to improvement in net credit to the Government from the Reserve Bank. The increase in SRD

[1] Reserve Money comprises of currency outside banks, statutory reserve deposits (SRD) and excess reserves.

reflected the increase in residents' deposits denominated in the local currency as well as their demand deposits in foreign currency over the period of July and August 2005 as well from the same period over a year ago.

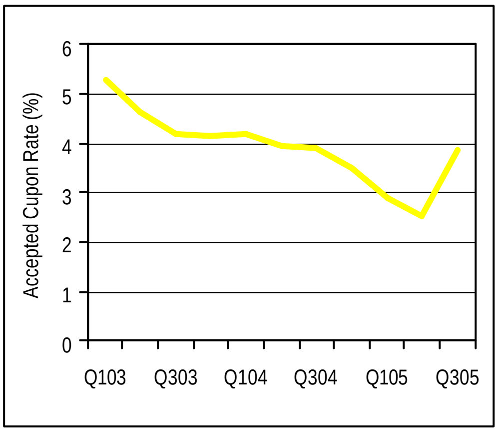
Figure 24: Components of Reserve Money



3.37. RBV Notes

Total RBV notes awarded during the quarter was VT815 million, all of which are held by the commercial banks. Out of the VT815 million RBV notes awarded, VT230 million, VT165 million, VT195 million, VT 185 million and VT40 million were allotted to 14-days, 28-days, 63-days, 91-days and 119-days maturities respectively. Also during the quarter, the Bank decided to temporarily suspend the issue of 119-days maturity RBV notes. By quarter end, outstanding notes stood at VT550 compared to VT1,025 million at the end of second quarter, 2005, causing the general liquidity level within the banking system to rise above the previous quarter.

Figure 25: 91-days RBV Notes Yield



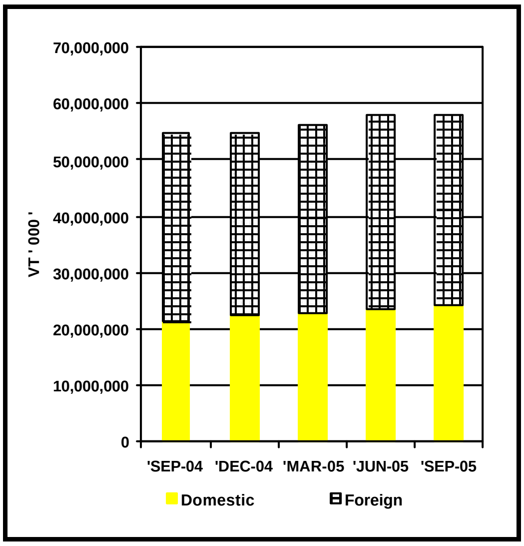
The weighted average yields for each, 14-days, 28-days, 63-days and 91-days maturities were 2.83 percent, 3.02 percent, 2.87 percent, 2.85 percent and 2.73 percent respectively. The yield on 91-days maturity note increased from 2.24 percent at the beginning of the quarter to 3.85 percent by quarter end while the weighted average yield on all RBV notes has moved up to 2.87 percent from 2.65 percent in the previous quarter.

3.38. Domestic Banks

3.38a. Balance Sheet

The industry's balance sheet recorded a slight movement over the quarter under review. Total assets fell from Vt58.1 billion to Vt58 billion. The decrease mainly reflects a 2 percent decline in foreign assets to Vt33.8 billion over the quarter. The bulk of the industry's assets are foreign assets which accounts for 58.2 percent of total assets. Refer to Figure 26.

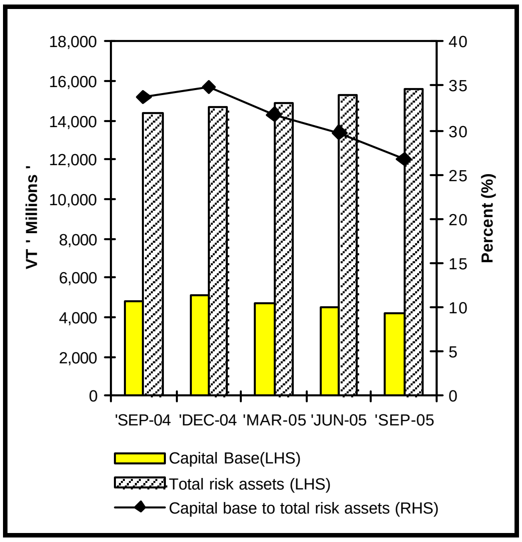
Figure 26: Asset Position Industry



3.38b. Capital

The industry is well capitalized with capital adequacy ratio recorded at 26.7 percent down from 29.7 percent in the previous quarter. The decrease mainly reflects an increase in total risk assets recorded over the reviewed quarter by 2 percent to Vt15.6 billion. The industry's capital base declined by 8.1 percent to Vt4.2 billion, as a result of a decrease in disclosed reserves and retained earnings recorded over the quarter by 28.8 percent to Vt1.8 billion. Refer to Figure 27.

Figure 27: Capital Position Industry

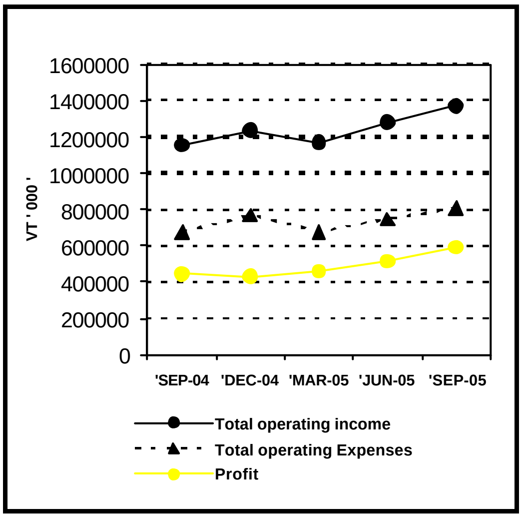


3.38c. Profit

Profit of the industry this quarter increased by 14.8 percent to Vt590 million. The increase is driven from an increase in total operating income recorded over the reviewed quarter by 6.9 percent to Vt1.4 billion. This increase is also related a decline in the charges for provisions by 234 percent to a negative Vt26 million.

Total operating expenses on the other hand increased by 7.8 percent to Vt806 million. Much of this is tied to an increase in the industry's' operating expenses and interest expenses recorded over the quarter by 9.2 percent and 6.2 percent respectively. Refer to Figure 28.

Figure 28: Profit Industry



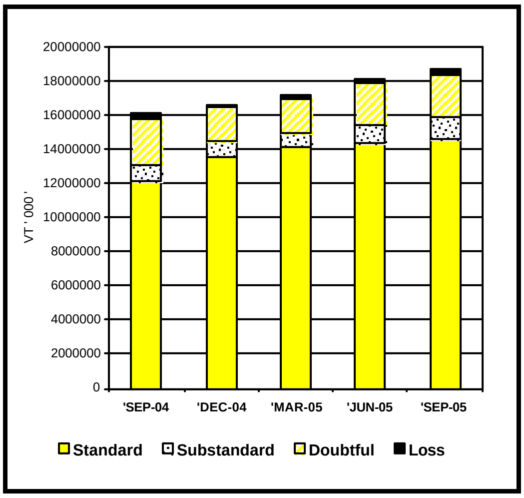
3.38d. Asset Quality

Total lending of the domestic banking industry increased by 3.1 percent over the quarter to Vt18.7 billion. Of this total, standard loans represents 77.8 percent, substandard loans 7.1 percent, doubtful loans 13.3 percent, and loss 1.8 percent of total loans respectively. Refer to chart 4

The industry's level of impaired assets increased slightly over the quarter by 3.1 percent to Vt2.8 billion. The increase mainly reflects loss loans recorded over the quarter by 43.5 percent to Vt329 million (Vt229 million, Jun-05).

The industry's general provisions declined significantly this quarter by 151.2 percent to a negative Vt613 million. However this is backed by the increase in specific provisions by 4.1 percent and security held by 2.8 percent to Vt614 million and Vt11.7 billion respectively.

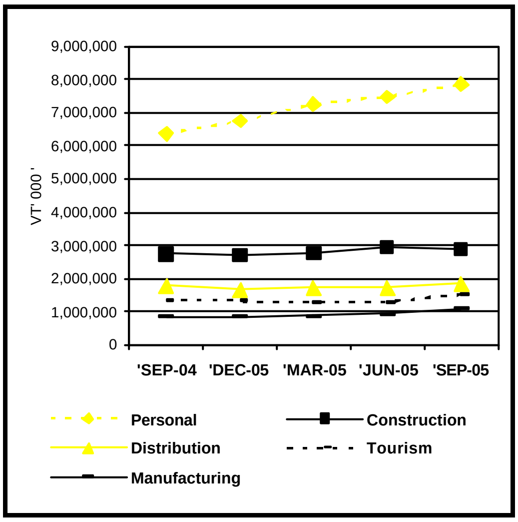
Figure 29: Asset Quality Position Industry



3.38e. Sectoral Lending

The industry continues to record high lending to personal and construction sectors. As of end September 2005, personal lending increased by 4.9 percent and construction increased by 6.9 percent to Vt7.8 billion and Vt2.9 billion. The other major lending sectors are to distribution (Vt1.8 billion), tourism (Vt1.5 billion) and manufacturing (Vt1.1 billion). Refer to Figure 30.

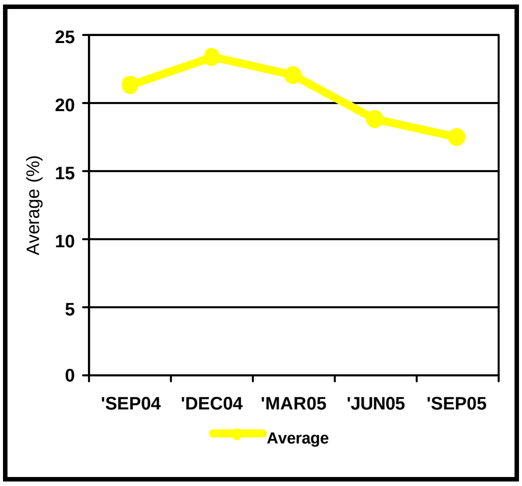
Figure 30: Sectoral Lending Industry



3.38f. Liquidity

The industry's liquidity position as expressed by its Liquid Asset Ratio (LAR) continues to remains well above the regulatory requirement at 17.5 percent down from 18.8 percent in the previous quarter. Refer to Figure 31.

Figure 31: Liquidity Position Industry



3.39. International Banks

3.39a. Overview

The Reserve Bank of Vanuatu under the provisions of the International Banking Act No.4 of 2002 continues to ensure that the banks comply with the conditions of their licences. This is done through maintaining a close relationship with the local directors of the banks to ensure compliance with the requirement of the Act.

The quarter ended September 2005 showed two onsite visits to all offshore banks operating from Vanuatu. The first visit was made in collaboration with the Financial Intelligence Unit (FIU) to verify the banks' compliance with the Anti – Money Laundering and Combating the Financing of Terrorism requirements. RBV also contacted another onsite inspection to review individual bank's overall compliance of the Act.

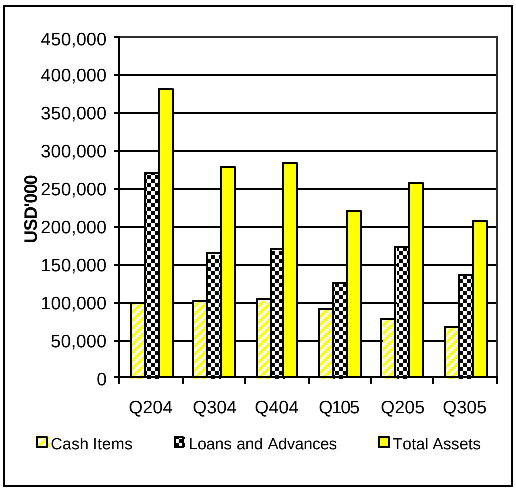
There have been a number of inquiries to set up international banks in Vanuatu, while two applications have been submitted for the international banking licence. Out of the two applications, one was rejected by the Bank due to insufficient information supplied and another is in the process of assessment.

3.39b. Balance Sheet

The industry's balance sheet footings continued to fluctuate over the 12 months period ended September 2005. Despite an improvement over the previous quarter, the industry's total assets declined slightly by 19.4 percent to USD207.8 million (USD257.9 million, Jun'05). This resulted mainly from the drop in the offshore banks' cash items and loans and advances by 15.3 percent to USD66.9 million (USD79.0 million, Jun'05) and 21.8 percent to USD136.2 million (USD174.1 million, Jun'05) respectively. Against the drop was a growth in the industry's marketable securities by 11.9 percent to USD0.5 million.

The two major components of the industry's assets still remain to loans and advances and cash items which account for 65.5 percent and 32.2 percent of the total assets respectively. Refer to figure 32 below.

Figure 32: Total Assets – International Banking Industry



On the liability side, deposits from corporations make up the bulk of the industry's liabilities over the last quarter. Total deposits accounted for 74.4 percent (USD145.5 million) of the total liabilities. However, term debt and other borrowings of the industry have significantly increased by 159.2 percent to USD48.7 million increasing its share of the industry's liabilities at the end of the reviewed quarter. A majority of this increase was contributed from one of the bank in the industry whose term debt and other borrowings have increase by 166.2 percent during the period. Reserve Bank will monitor these debts very closely. Refer to Figure 33.

Figure 33: Total liabilities – International Banking Industry

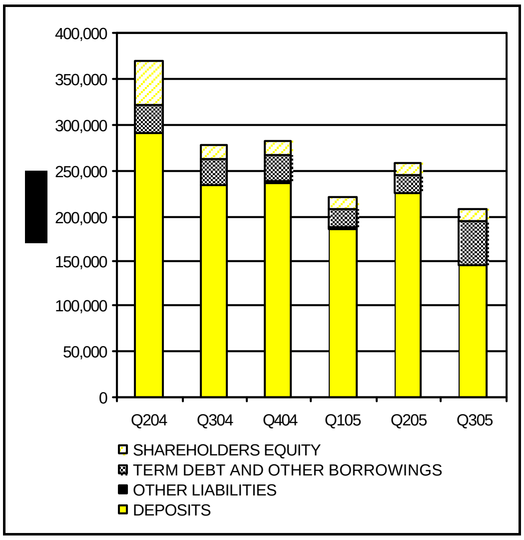
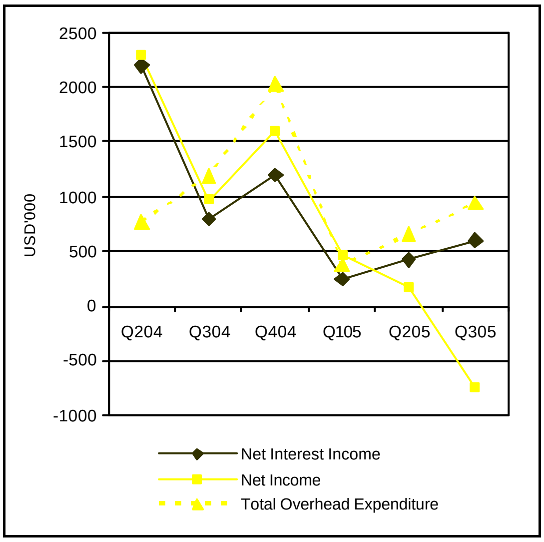


Figure 34: Income – International Banking Industry



3.39c. Earnings

September 2005 quarter witnessed further deterioration in the industry's earnings. The industry's net income continued to decline significantly by 545.8 percent to negative USD0.7 million (USD0.2 million, Jun'05).

The drop was driven mainly from a significant decline in the industry's other non interest income component of the non interest income by 198.2 percent to negative USD0.5 million and a 42.7 percent rise in the industry's overhead expenses to USD0.9 million over the last quarter. Although there has been a decline in the net income of the industry, the industry's net interest income improved further over the September 2005 quarter by 42.0 percent to USD0.6 million (USD0.4 million, Jun'05). Refer to figure 34.

3.4. Financial Development

3.41. Total Local Expenditures

Total estimated local expenditures of Finance Centre institutions recorded decreases of 26.1 percent and 11.8 percent from previous quarter and corresponding quarter of 2004, respectively. This decline was attributed to quarterly decreases of 28.3 percent of total recurrent expenditures and 47.2 percent in total taxes and levies.

From the estimated total expenditures of VT673.6 million, the banking sector continues to dominate with 37.8 percent, followed by trust and insurance companies with 33.0 percent, accounting firms with 19.5 percent and legal firms and offshore institutions with 9.7 percent.

Estimated taxes and levies paid by Finance center institutions and other private companies, showed annual and quarterly decreases of 16.8 percent and 47.2 percent, respectively. This decline came from decreases of 47.9

percent in central government fees and 38.3 percent in local government revenue.

There was an increase in total estimated capital expenditures of finance institutions and other private sector institutions by 16.4 percent from the previous quarter and 8.2 percent from the corresponding quarter of 2004. This increase was recorded in only the banking sector with 29.3 percent.

Estimated Value of total assets of finance Centres and other private sector institutions decreased by 0.6 percent from the previous quarter but recorded an increase by 7.5 percent from the corresponding quarter of 2004.

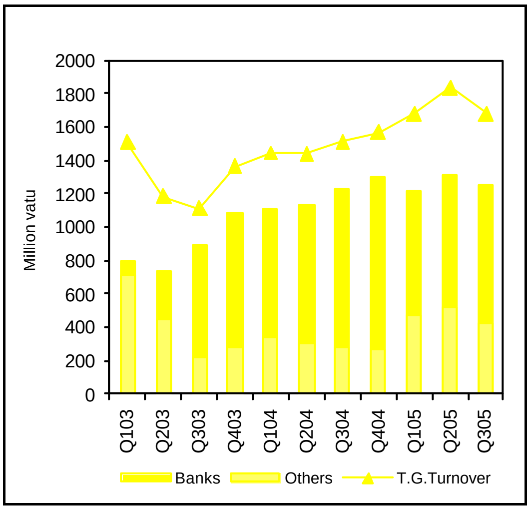
Estimated number of employees in finance centre institutions increased to a new high of 614 from 611 recorded during the second quarter of 2005. Ni-Vanuatu employees made up approximately 88.1 percent of this total.

3.42. Total Gross Turnover

Estimates of total gross earnings of Finance Centre Institutions declined by 8.7 percent from the previous quarter but recorded an increase of 11.1 percent from year ago level. This quarterly decline was attributed to decreases in total earnings of commercial banks by 4.5 percent, gross income of trust and insurance companies by 9.1 percent and gross income of accounting, legal and offshore institutions by 30.2 percent from previous quarter.

Total estimated net foreign exchange earnings recorded declines of 43.5 percent from the corresponding quarter of 2004 and 50.4 percent from previous quarter. This decline was attributed to decreases of net foreign exchange earnings of commercial banks by 59.9 percent, trust & insurance companies by 29.0 percent, accounting, legal and offshore institutions by 5.0 percent. And government's foreign exchange receipt by 79.3 percent.

Figure 35. Total Gross Turnover (Finance Centre Institutions)



3.43. Shipping Registrations

The shipping registry did not record any changes in the number of ships which remain at 601 vessels, compared to 587 recorded during the corresponding quarter of 2004. Despite the addition of 30 new ships to the registry, another 30 ships de-registered during the reviewed quarter.

There was a decrease in net shipping fee figures by 62.3 percent from VT14.3 million recorded during the corresponding quarter of 2004. The average sized vessel at the registry had remained slightly larger than 4,500 GRT.

There remain certain issues to resolve between the Vanuatu government and registry in New York regarding reciprocal port tax treaties, Chile's ban of open registry vessels whose flag state has not entered into agreement with Chile, fishing legislation and regulations, regional fishing oversight bodies and sanitary certification of the fishing fleet, rescission of Ministerial Order 13 of 2005 and substantive revisions of Ministerial Order 35 of 2005. According to the international shipping registry office in New York, action on the above is needed to ensure the growth of the registry if not in gross tonnage but in the number of vessels.

3.44. Company Registration

The number of companies registered with the Vanuatu Financial Services Commission (VFSC) recorded a total of 6,179 companies during the reviewed quarter. This represents net increases of 229 from the same quarter of 2004, and 115 from previous quarter. The number of new registrations was 141 companies, while 27 companies deregistered with the VFSC.

From the total number of companies, international[2] companies represent 75.5 percent, local companies made up 22.1 percent, while exempt[3] and overseas[4] companies accounted for 2.4 percent.

3.5. Balance of Payments.

By end September 2005, the official reserves stood at an adequate level of 5.5 months of import cover which is comfortably above the Reserve Bank's minimum target level of 4 months. This is one of the key component of monetary stability for the Reserve Bank. The improvement in reserves reflected the improving economic conditions reflected by an improvement in the current account which consist of a strong pick up in tourism and exports, while at the same time, the Reserve Bank continued to record inflows through government transfers from Donor partners.

3.51. Merchandise trade

The trade deficit improved in September quarter with exports grew by 21 percent while imports dropped by 9 percent from the previous quarter.

Exports - most major commodities such as cocoa beef, timber and kava recorded increase. The latter was exceptional despite being banned by the Fiji Government. Low copra earnings was mainly caused by low prices and drought which also effected the marginal dropped in exports of coconut oil. It is important to note that majority of Vanuatu's major commodities are exported to the European community and the neighbouring Melanesian Spearhead Group countries.

Imports- despite a tight supply and strength in global demand for oil, imports continue to be at higher levels. All import items dropped during the September quarter except for machinery and transport equipment which further increase by 3 percent in September.

3.52. Services Account

Vanuatu's main foreign exchange earnings is tourism which is one of the main factor contributing to the surplus of this account. In the quarter review, inward travel (tourism earnings) rose by 34percent as compared to the 13

[2] Companies incorporated under the international Companies Act and do not operate business in the country.
[3] Companies registered or re-registered as exempt companies and do business overseas.
[4] Companies incorporated outside Vanuatu and do business in the country.

percent dropped in June. This was contributed by seasonal factors and the continuous promotion of Vanuatu Tourism internationally. The slight appreciation of the Australian dollar against the vatu in September quarter also contributed to the high earnings spent by Australian tourists during the period.
An increase was also recorded from the financial sector through receipts of financial services.
On the debit side, freight was down and as usual reflecting reduction of imports in September. Transportation was also down by 10 percent.

3.53. Income Account

Foreign direct investment reinvested earnings is the major item contributing to the deficit nature of this account. Although payments of this item are not leaving the country, they are regarded as earnings of foreigners and treated as interest paid to liabilities. When the stock of foreign liabilities is expanded, reinvested earnings is expected to increase likewise, however the economic and political stability in Vanuatu do also contribute a lot to this item.

Income receipts from investment rose by 12 percent which was mainly caused by income through currency and deposits. Income payments were up by 6.4 percent reflecting an expanded repatriation of funds abroad by foreign enterprises through direct investment.

3.54 Current Transfers Account

As a large proportion of current transfers represent official grant flows the level is driven by donor grants to the government of Vanuatu. In the June quarter there was an increase in grants offsetting decreases in other official transfers which led to an expansion of the whole government transfers.

3.55 Capital and Financial Account

The capital account measures the transfers of non financial assets in and out of Vanuatu, as well as the purchase and sale of intangible assets. The June quarter saw an increase in project goods provided by donors while continuous net outflows of migrant's transfers was recorded by the private sector.

The Financial account registered an increase in other investment assets as compared to a huge reduction last quarter and a further increase in the Reserve Bank foreign holdings. Other investment liabilities also increased in addition to FDI inflows creating a surplus in the quarter review. However, this level was not capable of meeting the current accounts deficit so the balance of payments statement produced an estimated error and omissions – a difference of the financing value.

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produced an estimated error and omissions – a difference of the financing value.

Income receipts from investment dropped by 13 percent which was probably due to the low returns earned from foreign currency denominated assets especially on currency and deposits. The fall could also reflect a reduction in the stock of foreign assets during the quarter.

3.56. Current Transfers Account

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3.57. Capital and Financial Account

The capital account measures the transfers of non financial assets in and Looking forward, the Bank expects reserves to remain comfortable but this outlook may change if official transfers is low and world commodity prices for copra and coconut oil in particular, shift adversely, and petroleum prices continue at the current high level. The outlook also depends on continuing high tourism inflows, which has largely depended on Air Vanuatu's operations, promotions and pick up in cruise ship arrivals.

The current account deficit improved in 2004 from the 2003 level however, the first half of 2005 showed a deteriorated level not anticipated. This was due to the high imports figure in June 2004 in particular, vehicles for the Silver Jubilee Celebration dignitaries. The Current account is expected to contract by 22 percent in 2005, stemmed from high imports, while 2006 and 2007 should record a turn around. Improvement in the services sector, inflows of investment income, and official transfers in the next two years should be able to contribute to this swivel and may also assist in financing the current account deficit.

The traditional merchandise trade deficit is projected to continue to deteriorate in 2005 and the coming years, reflecting high oil prices, high demand for consumption and capital project goods. Exports has been depicting minor growth in our major export commodities and this is expected to develop moderately in the coming years. In addition, the agriculture sector has come up with number of propose developments that may contribute to the export growth in 2006 and beyond. High imports demand should be able to enhance expansion in the services sector in particular the tourism industry. Inflow of tourism should record high in the Pacific including Vanuatu due improvement in airline capacities and airfares, to recent bomb attacks in Bali and the impacts of bird flue and natural disaster in Asia. Investment income is traditionally in deficit because of the re-invested earnings of foreign enterprises in Vanuatu, which record high in 2005 . Vanuatu, as a developing nation, record surpluses in the current transfers, through inflow of grants from donor countries and other international organizations.

The Capital and Financial account, which comprises external loans, project expenditures and investments including international reserves, are utilized as external financing, particularly directed to the Current account deficit. Financing can also be in the form of foreign enterprises' reinvested earnings and withdrawal of foreign assets. Given this, the net reserves (less IMF positions) is expected to be around 5 months of import by end 2005, just about the same level of financing imports of 2004.

Within the medium term (2006/2007), the current account is expected to further improve. Imports will continue to grow, reflecting expansion of the economy as large amount of capital investment are injected into capital projects. The projected improvement in tourism earnings will continue to provide a boost to the services account while reinvested earnings of foreign enterprises will continue to create deficits in net factor income. The capital and financial account is forecasted to continue in surplus into the medium term. Barring adverse unforeseen circumstances, official international reserves are therefore expected to remain healthy at around five months of import cover into the medium term.

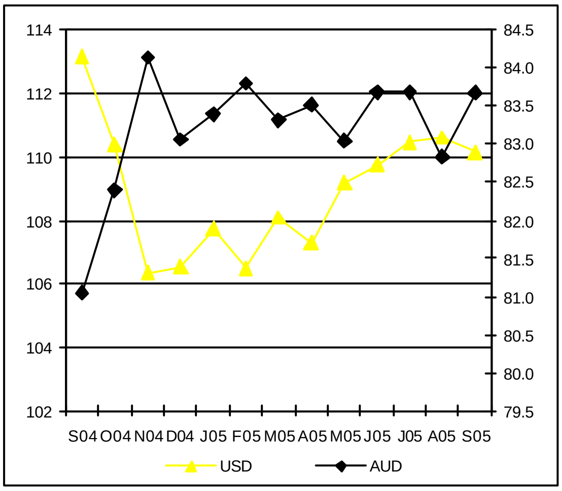
3.6. Exchange Rate Development

Events in international financial markets over the nine months had various impacts on the movements of major currencies relevant to the exchange rate of the Vatu. The foreign currency market was relatively flat in the second week of October ahead of the much-anticipated (and highly debated) interest rate decision by the Federal Reserve. Although the dollar is marginally weaker across the board today, it has been supported by mounting market expectations of a further 25 basis point hike in interest rates.

As investors focus on interest rate and growth differentials favouring the United States, the USD dollar rebounded against its major international currencies. The month of September and October saw an average fluctuations of the US dollar against the vatu. The US dollar is also expected to strengthen moderately against the vatu however by the time of writing this report the US dollar has been fluctuating around the September average. These developments averaged the US dollar rate by 0.3% down from last month and 3.7% percent down from September last year.

Mean while, the Australian dollar fluctuated around the average and closed at 83.67. By the time of writing this report the Australian dollar stumbled week following the decision by the Reserve Bank of Australia to leave its benchmark interest rate unchanged at 5.50%.However, it is believed that declining consumer confidence and slower spending played a role in the decision. Most analysts expect the Australian dollar to come under downward pressure as the interest rate differential with respect to the US narrows.

Figure 36: Bilateral Exchange Rate Movement of the Vatu against USD & AUD (End of Month Sep'04 – Sep'05)



Balance of Payments (millions of vatu)

-	2002	2003	2004	2005	2006	2007
Current Account balance (CAB)	**-2940**	**-3356**	**-1730**	**-2528**	**-1500**	**-1550**
Trade balance	-8088	-7912	-8228	-9,674	-9,800	-9,900
exports (fob)	2793	3249	4264	4,270	4,300	4,350
imports (fob)	-10881	-11161	-12492	-13,944	-13500	-13700
Services	5004	4919	6079	6800	7,300	7,500
credit	11302	11537	12675	13500	13700	14,000
debit	-6298	-6618	-6596	-6,700	-6,400	-6,670
Investment Income **(Y)**	-1344	-1254	-1162	-1666	-1200	-1200
credit	3115	2960	3038	3,155	3300	3500
debit	-4459	-4214	-4200	-4,821	-4500	-4700
Current transfers (net) **(Tr)**	1488	891	1581	2,202	1600	1,700
Capital & Financial account	**3615**	**3381**	**1639**	**1407**	**2000**	**2000**
Gross Official Reserves (vatu)	**4854**	**4954**	**6615**	**7,200**	**6,000**	**5,800**
Gross Official Reserves (USD)	*35*	*41*	*59*	*64*	*52*	*48*
Net Reserves (minus IMF positions)	*4259*	*4339*	*6018*	*6,700*	*5,500*	*5,300*
Months of Import Cover	*5.0*	*4.5*	*5.6*	*5.6*	*5.0*	*4.6*
Average Exrate: Vatu/USD	*139.0*	*122.2*	*112.9*	*113.0*	*115.0*	*120.0*

CHRONOLOGY OF MAJOR EVENTS

NO.	BRIEF DESCRIPTION OF EVENTS	EFFECTIVE DATE
1.	The ANZ Bank has introduced the country's first Currency Express section. The Currency Express offers local and overseas travelers a fast and suitable one-stop of foreign exchange services in a professional environment. The features of the currency express include buying and selling foreign currency cash, sale and purchase.	6 July, 2005
2.	The National Statistics Office has released its quarterly statistics news for the consumer price index for the second quarter of 2005. During the second quarter of 2005, the CPI registered 0.4% changes over the first quarter of 2005 and 1.3% over the second quarter of 2004. The expenditure groups contributing to the increase over the quarter were housing and utilities (1.1%), food (0.6%), drinks and tobacco (0.5%), and recreation, education and health (0.2%). The increases in the housing and utilities were due to increase in price of electricity. However, household supplies indicated a decrease of 1.7%, and transport and communication with -0.3% over the same period. The decrease was due to the fall in the prices of durable goods and household appliances.	6 August, 2005
3.	Prices on domestic Air flights were raises slightly due to the increasing world fuel prices. Air Vanuatu has introduced a fuel surcharge on its domestic network effective on 15th August, 2005 and applicable on all Domestic flights.	11 August, 2005
4.	Fiji announced that it has formally banned kava imports from Vanuatu for the next six months; the measure comes in retaliation against a ban imposed last year by Vanuatu on Fijian biscuits. The ban was repealed earlier this year but replaced with a 50% duty and a quota system. Kava exports to Fiji from Vanuatu amount to roughly 6 million Fijian dollars a year (VT 400m a year).	19 August, 2005
5.	Shefa Provincial council has made a stand to introduce domestic department tax. As revealed by the Shefa Province President that the establishment of this by-law is to assist its revenue rising. Their sea port departure tax was VT200 per person with new cargo departure tax prescribed at 50VT per group.	28 August, 2005
6.	The Vanuatu Government has made a start on its VT1 billion project to extend it main wharf. This project also included funding of heavy equipment purchases. The wharf holds a greater number of containers and this year there will	28 August, 2005

estimate 4000 with a tendency for larger ones to be used.

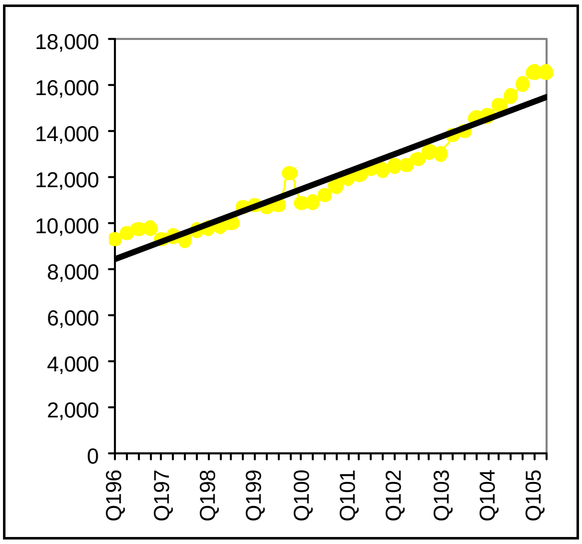
7.	Talk underway to find middle ground on proposed changes to the reserved list of investments which will strengthen and widen local participants. Progresses have also been made by substituting the total value of investment or the annual turnover with Capital investment. The proposed amendments to award Ni-Vanuatu with all investments on bungalows and guesthouses of any type or hotel or motels with an annual turnover of less than VT100 million were substituted with Capital Investment up to VT50 million.	7 September, 2005
8.	Government has embarked on a plan to conserve and manage the country's coastal resources through the help of the Japan International Cooperation Agency. The Project dubbed 'Promotion of the Grace of Sea in the Coastal Villages' is worth 400 million Vatu. The overall goal of the project is to improve livelihood of coastal communities through community-based coastal resource management and resource propagation effect around models sites in the six provinces of Vanuatu helping communities to address problems they are facing with their marine resources.	9 September, 2005
9.	Recently, the Vanuatu Tourism Office (VTO) entered an agreement with Hawkes Law and Telecom Vanuatu Limited to support the launch and distribution of four of the Tourism offices' four emailers developed to improve the distribution of information related to Vanuatu Tourism. The Vanuatu Tourism Association (VTA), the Vanuatu Hotel & resorts Association (VHRA) and Airlines (Air Vanuatu and Pacific Blue) have launched 40% off accommodation deals with substantial airlines savings on airfares. The program is designed to fill gaps in occupancy across the pre Christmas period and the period from the end of January until the end of March 2006. Funding will be provided by parties to the agreement to our Australian Wholesalers advertising through campaigns schedules on Sydney and Brisbane radio and a direct email campaign initiated by empowered in Australia.	September, 2005
10.	Vanuatu has been rated 49th out of the 155 countries in the World Bank's latest edition of 'Doing Business' report. Ratings of the Pacific island countries in the report compared to 155 other countries: Fiji (34), Tonga (36), Samoa (39), Kiribati (45), Marshall Islands (48), Vanuatu (49), Micronesia (56) and Papua New Guinea (64). The doing business indicator allow the Pacific islands to benchmark themselves against global or regional best practice to identify reforms to promote domestic business or attract foreign investments. The Doing Business methodology has standard features to ensure quality.	16 September, 2005

DEVELOPMENT IN PRIVATE SECTOR CREDIT

Article contributed by Cynthia Ala[5]

Private sector credit is an important indicator for economic growth. Private sector credit covers loans, advances and overdrafts extended to the private sector by the banking system. Over the ten year period private sector credit has indicated an upward growth trend as illustrated in Chart 1, in recent years from 2004 to the first half of 2005, total loans lies consistently above the 10 year trend line.

Chart 1: Total Loans from March 1996 to June 2005 (In Millions of Vatu)



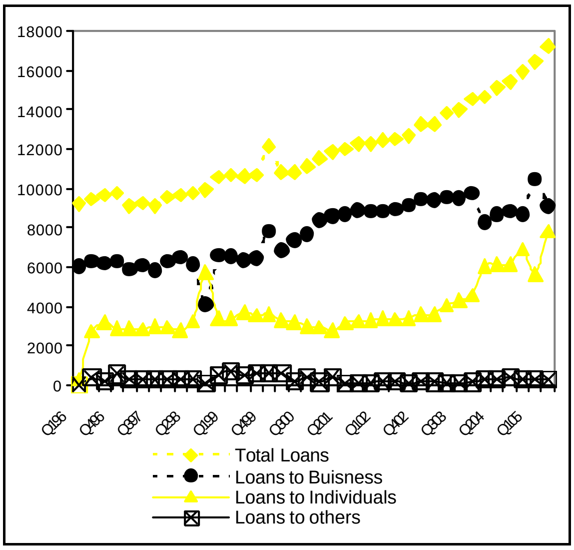
When analyzing private sector credit, it is helpful to classify the loans according to the borrowing sectors, such as businesses, households and individuals and others category. Loans and advances to these various are then further classified according to the main economic activity of the borrower. This paper analyses the contributing factors to the growth of total loans over the 10 year period from March 1996 to June 2005.

Components of Private Sector Credit

Private sector credit comprises loans to business (this includes incorporated and unincorporated entities, including firm's partnerships and individuals conducting business for profits), loans to individual and households for personal requirement and lending to others category (including non-profit entities).

Chart 2 shows the components of private sector credit for the ten year period. From the graph it can also be seen that total loans closely follows the same pattern as loans to business and individuals and household until in recent years when loans extended to businesses and individuals and household fluctuated against each other.

Chart 2: Composition of Loans and advances to the Private Sector (In Millions of Vatu)



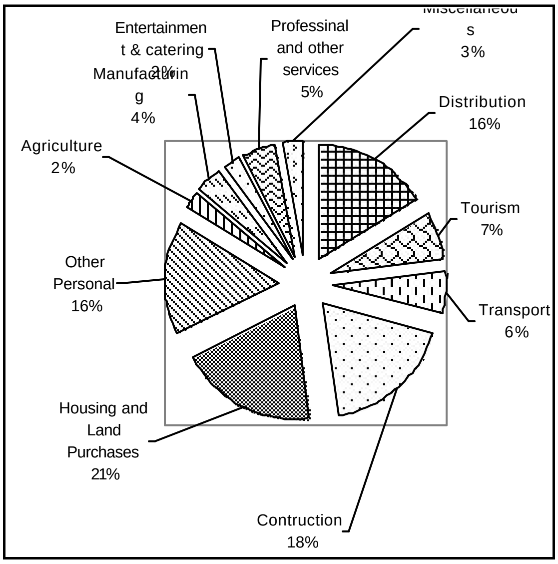
Loans extended to Businesses make up around 66 percent of total loans, while loans to individual and households followed with 34 percent. Regression analysis moreover proved that there is some correlation between total loans and its two main components. The correlation between total loans and loans to Businesses is (R square of 0.7058) percent and the correlation between total loans and loans to individuals and household is (R square of 0.6352).

[5] The author is an Economist with the Department of Research & Statistics at the Reserve Bank of Vanuatu. All views expressed are those of the author and do not necessarily represent the official view of the Reserve Bank of Vanuatu.

Outstanding loans and advances extended to business, individual and household and others are classified according to the main economic activity of the borrower.

Chart 3 displayed the different categories of loans in terms of the main economic activity granted to residents only. The chart depicted that loans granted for housing and land purchases consumes the largest share of total loans for the ten year period with 20%, loans for construction activities followed with 18%, while credit to other personal and distribution sector comprised 16 percent, respectively. These three main components of private sector loans are discussed subsequently.

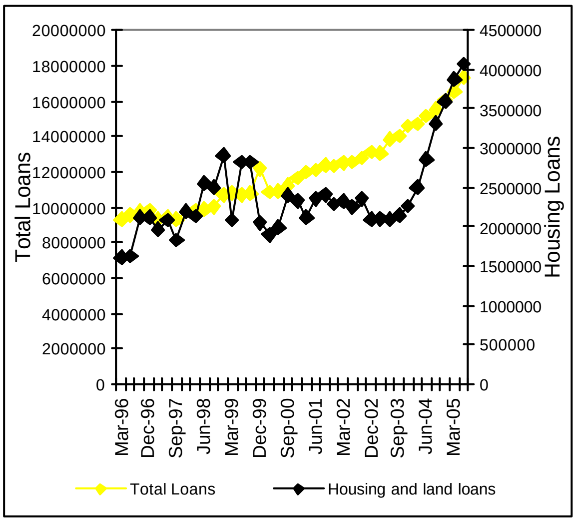
Chart 3: Distribution of Loans



(I) Loans for Housing and land purchases

Housing and land purchases loans are granted particularly towards purchasing land, building, repairing, extending and modernizing a house purposely for owner occupation. Loans for housing and land purchases constituted the bulk of the share of total credit to private sector. Not only that these loans make up the large share of total loans, this category also explains the large part the development in private sector credit.

Chart 4: Total Loans and Housing Loans (in thousands of Vatu)

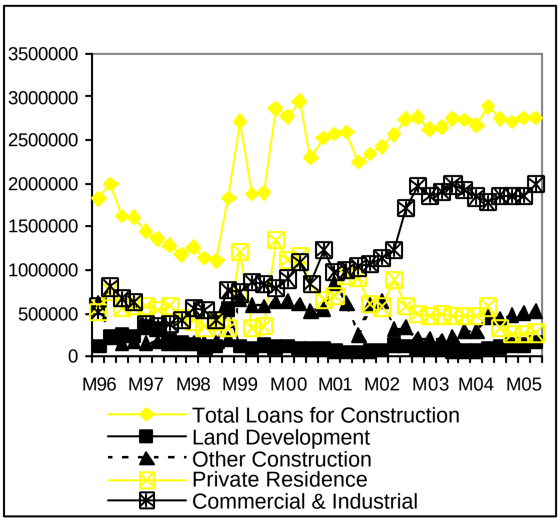


From chart 4 it can be seen that total loans and housing loans follow a similar pattern, though housing loans fluctuate a little from 1996 to 2000, it accelerated in the recent years. Regression analysis shows a very strong relationship between the two credit aggregate with an R Square of 0.9744. The growth trend in loans to this category during this period reflected the upsurge in the development in subdivision of hectares of land which was once wholly owned to smaller diverse plots which are purchased or leased by residents for owner's occupation.

(ii) Credit to Construction Sector

Credit granted for construction activities consumes the second largest share of total loans. Loans to construction sector generally refer to lending to general and special trade contractors primarily involved in contract construction. This may involve building, altering, repairing or demolishing; building roads, bridges, sewers, drains, harbors, airports, houses factors, hotels etc. Loans for Construction are classified into three categories. These are a) credit for land development b) other construction c) private business residences and d) commercial and industrial.

Chart 5: Categories of Loans to Construction Sector (In Thousands of Vatu)



As illustrated in Chart 5, bulk of the credit to construction activity was contributed by credit for commercial and industrial development. Regression analysis also shows a very strong relationship of (R Square of 0.9125) between the two aggregates. This development clearly indicated that apart from housing loans, credit granted to promoters and building contractors engaged in the business of erecting structures for commercial and industrial activities over the ten year period was also strengthen to support the nascent level of investment in the country.

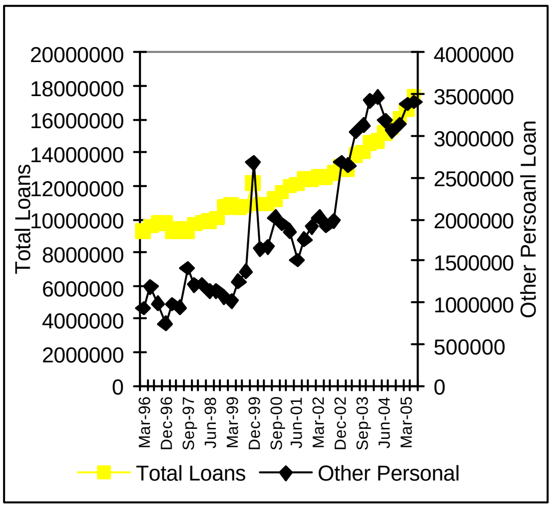
The two sectors which consume the third largest share of total loans are credit to other personal sector and distribution sector.

(iii) a. Other Personal Loans

Credit granted to other personal sector refers to all lending to individuals for the benefit of themselves and their household. Chart 6 depicted that though personal loans fluctuated a lot it continued to accelerate over the ten year period

The upward trend in loans to this category indicated that there is a raise in consumption of goods whether durable or non- durable amongst the borrowers over the period. An R Square of 0.9360 also proved that there is a strong correlation between the two variables.

Chart 6: Total Loans and Other personal loans (in thousands of Vatu).



(iii) b. Loans for Distribution Sector

The other sector which also consumes the third largest share of total loans is distribution sector. Credit to Distribution here refers to loans and overdraft to companies or individuals engaged primarily in the import and export of goods or in the local distribution of goods by commission agents, wholesalers or retail, and others. Credit to distribution are categorize into a) commission agents b) wholesale trade and c) retail trade

Chart 7: Categories of Credit to Distribution Sector (In thousands of Vatu)

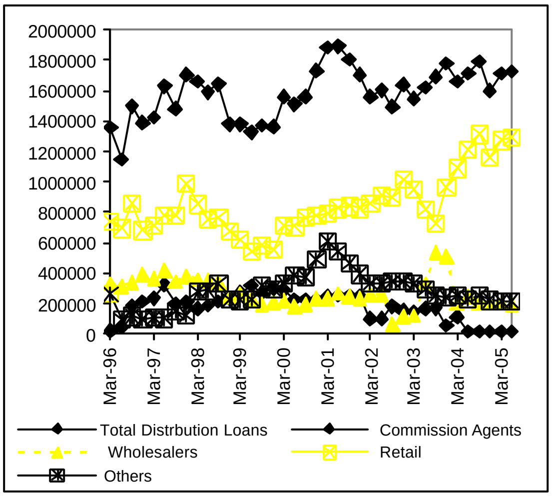


Chart 7 depicted that loans to retail trade closely follow the trend in total loans to distribution sector, therefore can be justified that loans to retail trade mainly explained the development in credit to distribution. Retail trade also consumes 55% of the total distribution loans share. This trend indicated that over the 10 year period, the economy has noted a rise in department stores, supermarkets, shops, petrol filling stations, motor vehicle dealers and others selling new or used goods to the general public. This development signified that investment in retail trade is growing given that investors are more confident in the economy.

Conclusion

Private sector credit is a good indicator for economic development. From the analysis housing loans are the main explanatory factor for the development in total loans and advances. Credit for commercial and industrial development followed, with other personal loans and retail trade claiming third position, respectively.

The analysis can also be concluded that out of the composition of loans and advances granted to the private sector, 66 percent of them are utilized for business purposes while 34 percent are intended for personal use.

INTEREST RATE STUDY FOR VANUATU

This study was undertaken in 2004 by Mr. Branan Karae, Mr. Philip Arubilake and Mr. Shadrack Welegtabit[6]

EXECUTIVE SUMMARY

Interest rates are a measure of risk and driven by a number of factors. Findings from this study indicated that for a small open economy like in Vanuatu, country risk is rated high when interest rates on lending are considered. Several factors contribute towards the high country risk rating of Vanuatu such as political instability of the Government, weak economic performance of the economy, land tenure system, natural disasters, etc… The other factors that this study indicated are customer risks and this is to do with individual's credit history.

Like any other businesses, the banks are mandated by shareholders to meet certain rate of return with their investments. Charging a high interest rate is also regarded as a means to meet this target. Other factors that lead banks to charge high interest rates are the occasional shortages of liquidity, which arises from lack of liquidity management by banks, requirements of the Reserve Bank of Vanuatu in terms of Statutory Reserve Deposit (SRD), Liquid Asset Requirement (LAR), Capital Adequacy Requirement, the small size of loans particularly personal loans and the impact of non-performing loans on a bank's profits.

INTRODUCTION

In rural areas, the study aimed to find out the demand for borrowing from the banking sector or lending agencies and also to assess the potential of debt repayment by investigating the products that could generate cash income and access to markets for these products. The study also found out why people are borrowing or not borrowing from lending agencies and the general feeling about using the banking system.

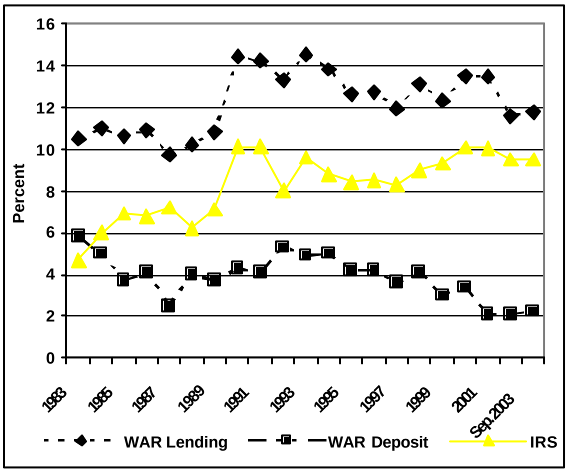
In urban areas, lenders, borrowers and non-borrowers were interviewed. This was to find out why interest rates are behaving as they are, from lenders such as commercial banks, Government, credit unions and non-government organizations (NGO). The study also covers borrowers and those using the banking system, such as service providers in terms of utility and hospitality, supermarkets, manufacturers, exporters, companies, firms, regulators and the Government.

[6] Mr. Karae is the Director of Accounts & Customer Services with the Reserve Bank of Vanuatu. Mr. Aru is the Deputy Director with the Department of Research & Statistics and Mr. Welegtabit is an Economist with the Department of Research & Statistics of the Reserve Bank of Vanuatu. All views expressed in this study are those of the authors and do not represent the official views of the Reserve Bank of Vanuatu.

INTEREST RATE DEVELOPMENT IN VANUATU

The margin between lending and deposit rates is a common trend in the banking sector anywhere in the world. However, the margin also known as the interest rate spread (IRS) varies between countries. Likely causes of this spread as indicated by studies (Jayaraman and Sharma, 2003) undertaken in other Pacific countries are, lack of adequate competition, scale diseconomies due to small size of markets, high fixed and operating costs, high transportation costs of funds due to expensive telecommunications, existence of regulatory controls and perceived market risks.

Figure 1: Weighted Average Lending and Deposit Rates in Vanuatu



Source: Reserve Bank of Vanuatu.
Note. WAR – Weighted Average Rate
IRS – Interest Rate Spread

Interest rate spread (IRS) between lending and deposits has been observed in the above graph to be increasing from a modest 4.7 percent in 1983 to 9.5 percent as of September 2003. Weighted average lending and deposits rates show a somewhat parallel between them during this same period. The lowest IRS was experienced in 1983 with 4.7 percent and highest in 1990 and 1991 of 10.1 percent. Weighted average lending rates have shown a gradual decline since recording the highest rate of 14.5 percent in 1993. Weighted average deposit rates are displaying a declining trend since 1992, with the lowest rate of 2.1 percent recorded in 2002. Although, latest data shows that weighted average deposit rates has been increasing, likewise weighted average lending rate also trended upward as banks seek to maintain the IRS at the same level.

An important feature of interest rates in Vanuatu is that real savings deposit interest rates is negative. For example, take the current savings interest rate in Vanuatu of 0.5 percent and less the inflation of 2.9%, therefore, real savings interest rate is negative 2.4%. As can be seen in table 1, over the last 4 years real weighted average deposit rate is negative whereas real weighted average lending rate ranges between 8.55% and 11.03%.

RESEARCH FINDINGS

WHAT DRIVES INTEREST RATES?

The study undertaken by the Reserve Bank of Vanuatu on interest rates identified several factors that are contributing to interest rates movements in Vanuatu. Some of these factors are outlined below.

a. Risk factors.

Risk is identified as the main driver of interest rates in Vanuatu. In other words, commercial banks set the interest rates on loans based on their assessment of the risks involved with lending. Commercial banks are in a business of selling a service such as credit. If borrowers default on repayments, the banks suffer loss of capital. Furthermore, a bank will not give out credit to a customer if it considers that the customer cannot repay the principal plus interest from future earnings. Credit risk is the risk that borrowers will not repay their debt as scheduled. There are certain risk factors that banks consider when approving loans. In a small country like Vanuatu with an open economy, two main risks factors are:

i) Country risk

This covers the risks associated with having to invest in Vanuatu. The following factors contributed to these risks;

a) Limited investment options and opportunities,
b) Small export sector,

c) Very little household savings,

d) No sovereign debt rating,
e) The economy is not growing,
f) Law and order problems,
g) Political instability,
h) Natural disasters,
i) Land tenure problems,
j) Prudent fiscal management.

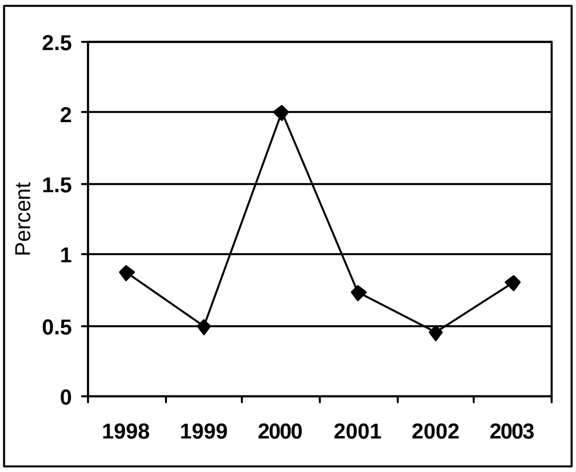
ii) Customer risks

These are risks associated with business interest of customers, their reputation and track record with the banks. Interest rates are driven by a bank's perception of the risks, level of complexity of the customer's business (i.e. ability of management to manage the risk) etc. In other words, the creditworthiness of the customer is reflected in the interest rates they pay. A more credit worthy customer will receive a better rate than the one with low credit rating. Banks lose money if customers do not pay their loans. In essence, well established and managed businesses with a strong track record receive better ratings. This is an important contributing factor. Ni-Vanuatu business borrowers need to ensure that they develop sound business plans/borrowing proposals.

b. Return on investment/Assets.

Banks, like any other business, are required by shareholders or head office to make certain return on investments. Making a return on investment is what business is all about and banks must make a profit to continue to stay in business. Commercial banks, especially foreign owned banks have these requirements to meet or shareholders will look elsewhere to invest. In setting up a banking business in Vanuatu or anywhere else in the world, shareholders expect to achieve a certain return on their investment. Those managing such a business are tasked to meet this target.

Figure 2: Total Banks – ROA Ratio

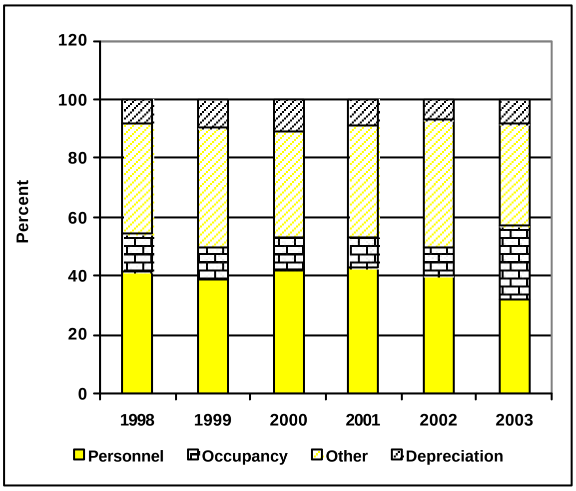


Source: Reserve Bank of Vanuatu

c. Overhead costs.

The overhead cost of a company depends on the nature of business. For the manufacturing sector, electricity is the most expensive item on the company's expenditure list. For banks, utility cost accounts for the second highest share of total expenses after personnel costs as shown in the chart below. Clearly overhead costs associated to energy consumption and water does not impact much on the rates, as this is included in other costs.

Figure 3: Total Banks – Breakdown of Operating Expenses (%)



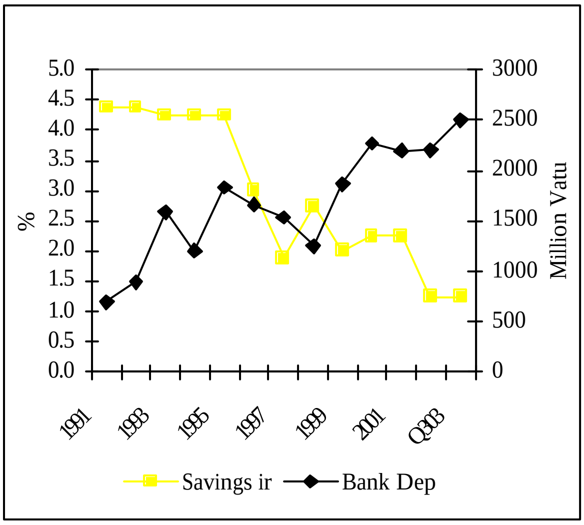
Source: Reserve Bank of Vanuatu
Note: Other includes utility costs, etc.

d. Liquidity.

Commercial banks in Vanuatu derive their funds mostly from customer deposits. Whenever there is high liquidity in the banking system relative to the demand for loans, interest rates on deposits are expected to fall. However, when banks are short on liquidity they increase interest rates on deposits, a signal that banks want people to give them their money. Figure 6 below shows the movements in commercial bank liquidity, which comprises Statutory Reserve Deposits (SRD) and excess reserves, versus the nominal interest rates on savings deposits.

Liquidity is much sought after commodity by banks. Recently banks have suggested that market liquidity is drying up and there is now increased competition in the market to attract liquidity. Increased competition could drive deposit interest rates up which in turn could translate to higher lending rates as banks seek to maintain their interest margins. The majority of banks maintain a very high level of liquidity, which means banks do not have to incur high costs of attracting liquidity (i.e. offer high deposit interest rates) to lend.

Figure 4: Average Nominal Savings ir Vs Liquidity



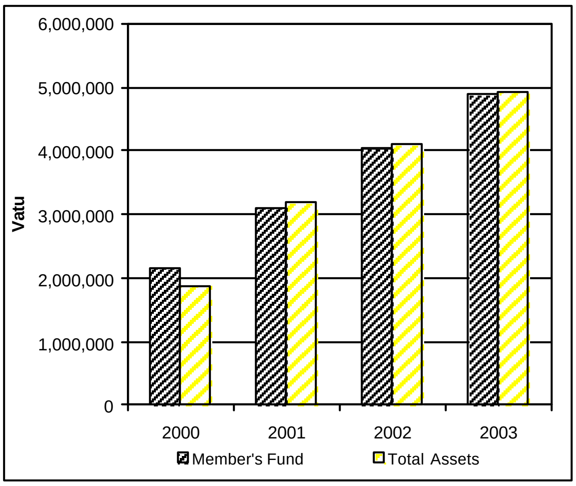
Source: Reserve Bank of Vanuatu

e. The Vanuatu National Provident Fund

The Vanuatu National Provident Fund investment strategy is believed to play a major influence on the commercial banks' pricing strategy. The Fund's total number of contributing members since inception in 1987 have grown from 11,793 to 17,222 at the end of 2003. The Fund is said to be one of the largest financial institutions within the financial system of Vanuatu with total assets of 4,930 million vatu at the end of 2003. Figure 7 presents growth in the members' contribution and total assets since 2000.

The Fund has continually looked at investment opportunities both within the domestic and offshore markets to invest members' funds to obtain highest returns. Investing within the local economy is ranked very important as this will stimulate the much-needed economic growth. However, this is not easy given the limited investment opportunities. Investing to the banking sector appears to offer the most secure form of investment for the Fund; the Fund's deposits with domestic banks totalled Vt1.68 billion at end December 2003.

Figure 5 : Members fund and Total assets of the VNPF



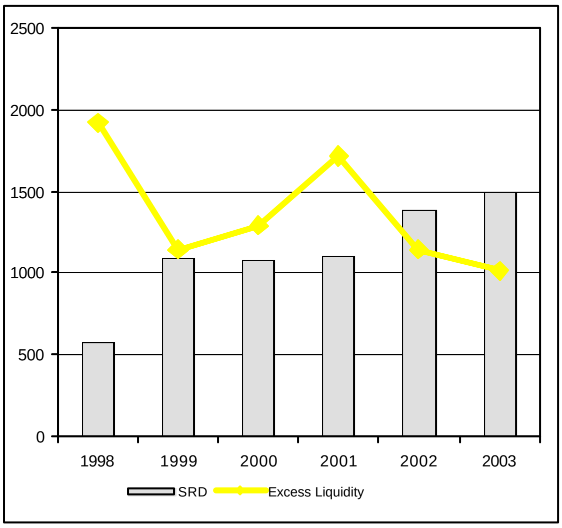
Source: Vanuatu National Provident Fund

f. Statutory Reserve Deposit (SRD).

Statutory Reserve Deposit (SRD), also known as Reserve Requirement, was introduced in 1988 at a rate of 10 percent of Vatu deposit liabilities. It was first introduced as a prudential tool and overtime it has also become an important tool for monetary policy of the Bank. At its introduction, all commercial banks are required by the Reserve Bank to keep 10 percent of total Vatu deposits in a blocked account with the Reserve Bank. In April 1999, the Bank reformulated the SRD requirement to include 50 percent of the demand deposits in foreign currency in the calculation base, and allowed banks to average their reserve holding during the maintenance period of one month. Therefore, unlike the prior arrangement whereby banks held reserves in two separate accounts with the RBV, in the current arrangement banks are holding both SRD and reserves in only one account.

SRD, which amounted to VT1.5 billion in December 2003, is kept as an interest free deposit with the Reserve Bank. As a result, SRD is seen as a tax and therefore adds to the cost structure of commercial banks since it is not earning any interest, while commercial banks are paying interests on the total deposits they received from depositors. Commercial banks would have earned an interest on these deposits if they had lent it out. Therefore, to make up for this requirement, banks structured some of this opportunity costs into their interest rates on lending. There is anecdotal evidence that banks are factoring SRD and other requirements of the Reserve Bank in their interest rates calculation.

Figure 6: Commercial Banks Reserves

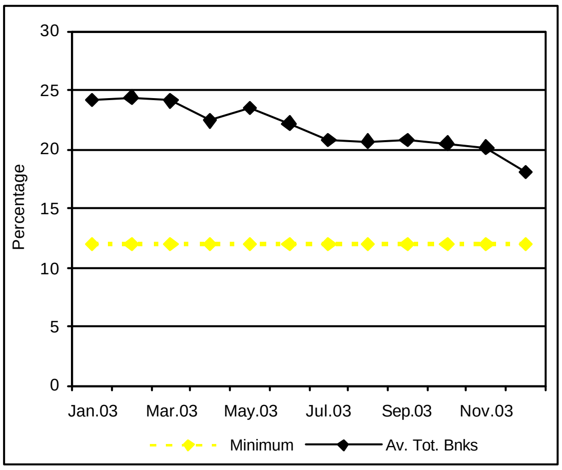


Source: Reserve Bank of Vanuatu

g. Liquid Assets Requirement (LAR).

Commercial banks are required by the Reserve Bank of Vanuatu for prudential purposes to maintain 12 percent of LAR. This was changed in late December 2003 from 15 percent in light of market conditions and the Reserve Bank of Vanuatu continues to monitor developments to ensure that this, and other requirements, are not hindering market growth. To satisfy the LAR, banks are required to maintain 12% of their liquid assets in specific liquid assets. The reason for this requirement is to ensure that banks have a stock of cashable, undoubted assets, which, with the Reserve Bank approval, can be quickly converted into cash in extreme circumstances. Such stock (exclusive of Statutory Reserves Deposits) is additional to the liquid assets, which each bank needs for the management of its day-to-day liquidity. Banks LAR are tied in Government Bonds, RBV Notes and cash.

Figure 7: Banks – Liquid Assets Requirement (%)



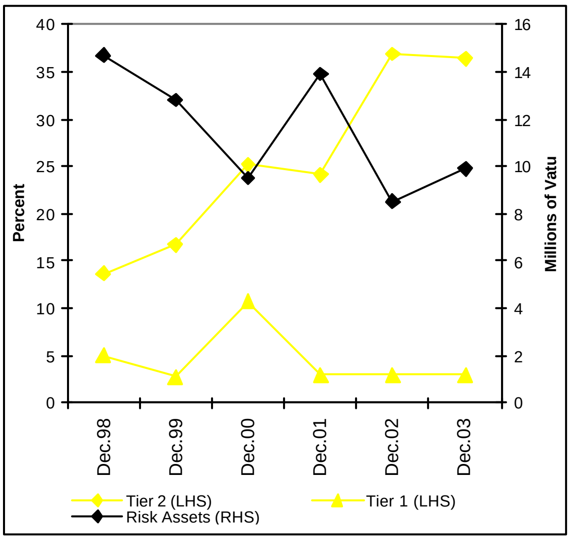
Source: Reserve Bank of Vanuatu

h. Capital Adequacy Requirement

In 1998, in line with the Basel Committee on Banking Supervision requirements, the Reserve Bank of Vanuatu introduced the capital adequacy requirement on the operations of commercial banks operating within the domestic banking industry of Vanuatu. Under the capital adequacy framework banks are required to assign a certain amount of capital to support assets written by the banks. The more risky the asset the greater the capital requirement.

The introduction of the Capital Adequacy Requirement by the Reserve Bank is seen by the industry as putting more financial pressure on the operations of the bank. Banks with low capital base have been forced to increase their capital while others see this as engaging resources that cannot earn any return. The process of raising capital and maintaining the level has a direct impact on the lending strategy of the banks. Figure 11 below presents the industry capital adequacy position over the last five years to 2003. It must be noted that at present, banks are holding considerably more capital than they are required to by the Reserve Bank of Vanuatu under the capital adequacy framework. Growth in a bank's capital resources can occur through either increases in issued capital or retained earnings. The high level of capitalisation of domestic banks may reflect management decisions to hold higher levels of capital to cover unforeseen business risks, e.g. the impact of a natural disaster on their operations. Typically banks would return excess capital to shareholders through dividend payments and this will then reduce a bank's capital position.

Figure 8: Capital Adequacy Total Banks



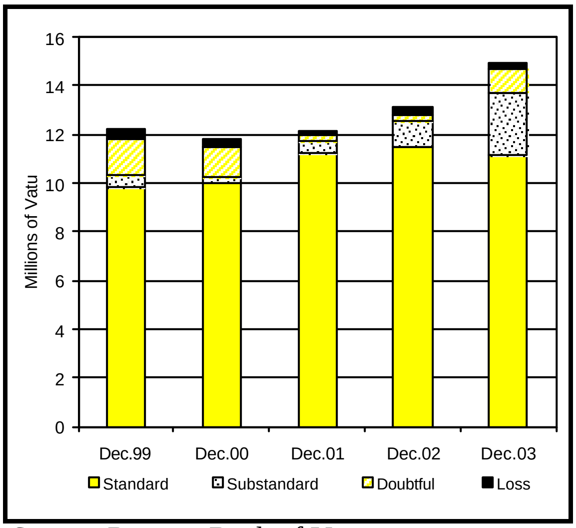
Source: Reserve Bank of Vanuatu

i. Non-Performing loans

This is a major issue for some banks because they have very high non-performing loans that are not earning any money. To make up for this loss, banks charge higher interest rates on lending to recoup some of these losses. Not only that, the classification of non-performing loans by sectors and products gives the bank on the level of risk it takes on these sectors and products and therefore the bank must adjust its pricing strategy accordingly to reflect this. Banks in Vanuatu basically know the various sectors of the economy and products with high risks and have priced their lending to these sectors to reflect these risks.

Asset quality has been good. However, banks have tended to quit certain markets (e.g. lending to buses/taxis) because of concerns about the future of the industry and/or increasing bad debts. This has resulted in a number of institutions being restructured with the phasing out of some of the key products like lending to the transport sector. In the case of lending to the agriculture sector, there is a feeling that bank's do not provide and have the necessary skills in products that reflect the industry. Although the industry's lending books have improved substantially following the restructuring and the increased supervisory role that the Reserve Bank of Vanuatu has placed on its supervision of the domestic market, non-performing loans will continue to present a key area on the calculation of bank's lending and deposits rates spread. Figure 9 presents the industry's loan asset quality over the five years period to 2003.

Figure 9: Total Banks Composition of Lending Assets



Source: Reserve Bank of Vanuatu

FINDINGS FROM BORROWERS

a. They all acknowledged that interest rate charges are high on borrowings and low on deposits.

b. They also acknowledged the presence of bank charges. The assumption is that with lowering interest rates, the banks are expanding their bank charges and fees to cover more products. Bank charges and fees are taking up a bigger share of banks income.

c. Both individual and businesses houses would like to borrow but do not do so because of interest rate charge on borrowings.

d. Only established businesses and those in employment want to borrow amounts in excess of 500,000 vatu.

e. Both individuals and business houses in urban areas acknowledge the cost of conducting business in urban areas. Costs associated with utility (electricity and water) varies with nature of business.

f. While many individuals and businesses houses acknowledge the poor performance of the economy, most are optimistic about the future as new developments are anticipated such as export potential for the country of traditional primary products such as copra, cocoa, kava, beef, food crops, marine resources and timber.

g. Some areas of Vanuatu, where there are established infrastructures such as a NBV branch, roads, airports, telephone it will be easy for lenders to lend money and be able to monitor and also collect money from borrowers.

h. High demand for loans from the banking sector but many customers cannot access the loans because of the tough lending policies of the bank. Strong feeling that the banks have become more difficult to deal with these days.

i. High cost of overhead in Vanuatu is way over the top. Compared with the other business in town, banks return on investment (ROI) is much higher to the others.

j. Security requirements are too tough. The 100/100 percent cash collateral requirement is not promoting investment.

k. Bank charges related to operating a loan facility and the use of the banking services in general are way beyond the customers' capacity. These should be regulated by the Government.

l. Deposit rates offered to the public are way too low. Customers maintain their deposits with the banks only for security reasons. Should there be another investment option, it is likely customers will opt for this instead.

m. There is very little difference in the loan product pricing from one bank to the other. Most banks offer cheaper rates in one product and offset the shortfall by increasing rates in other products.

n. Political instability of the Government has not helped the situation. Continued changes in the Government policy on the copra industry and other key industries is not presenting Vanuatu as a good investment opportunity for both domestic and foreign investors. This impacts the general welfare of the economy. The Government needs to focus on the key economic sectors of the country to ensure that these sectors are protected.

o. Various other institutions in the similar line of business (Ni-Vanuatu developments projects, VANWOODS etc), have not provided enough competition in the market. There is a call for the strengthening of these institutions.

p. There is need for more competition in the market to take place. Introduction of additional players is viewed as being healthy. This will drive lending rates down, encourage borrowings from the market yet allowing banks to still meet their profit targets. National financial institution should take the lead on this.

q. In rural Vanuatu, people tended to borrow small amounts of money to meet commitments and social obligations such as school fees, marriages, funerals, etc. The amount of money that they would normally borrow range from 5,000 – 100,000 vatu.

r. In rural Vanuatu there are still a lot of people who do not understand how to use the banking system. People would like to have access to credit but they generally lack the knowledge of negotiating with lending agencies to successfully access funds for development purposes.

s. Some areas where there are no established infrastructures, it will be difficult for both lenders and borrowers to come to a compromise. Lenders are reluctant to lend to people in such areas and repayment of borrowed funds may also be delayed due mainly to market oriented problems to sale products to earn income.

t. Banks do not really understand their customers. Call for banks to recruit officers with skills in the area of Agriculture, Fisheries and other specialized sectors to help provide loan packages to customer that are in line with the business activities of the customer.

u. Establishment of a debenture market in Vanuatu would be a positive move forward as it would give opportunity for viable businesses to raise funds from the public. It is likely that such issues could be beneficial to both issuers and investors in term of interest paid and received.

FINDINGS FROM LENDERS.

Demand for loans in the market is very high compared to the number of actual loans that are approved. There are only a handful of viable loan investments opportunities that are competed for by the respective banks. The key issue tied to this is the small size of the market and the flow on effect of the weak economic performance of the country to date.

On the sectoral distribution, demand for loan is concentrated only to a number of key sectors. Mostly this is to the sectors with secure and with a history of businesses generating revenues. [Lending to Personal sector currently tops the position]. This is reflected in the banking industry sectoral lending distribution, which is skewed to a few sectors only.

On the issue of currency lending, vatu currency constitutes the bulk of the industry's lending. Banks lending to non-Vatu currencies are mainly in USD, Yen, and AUD. No pricing strategy difference exists between lending to Vatu and non-Vatu currency.

Customers responds to changes in the different pricing strategy of the banks is inelastic. Only a handful of customers response swiftly.

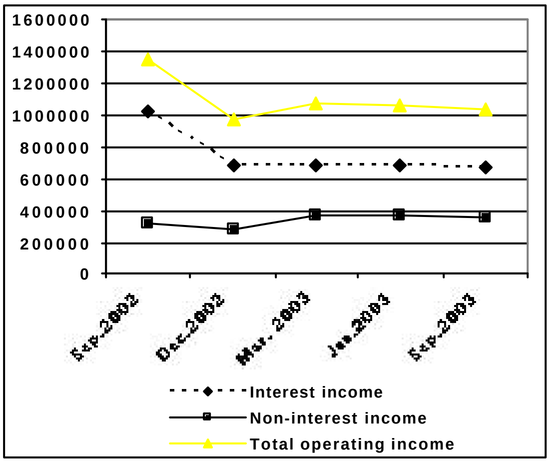
All customers feel that they are being overly charged on loan interest rates. Whilst most customers' cases may be similar in nature, a number of cases particularly from the low educated population confirmed that banks' have overcharged them based on the bank's IT system error.

In the absence of any other funding vehicle, access to huge amount of borrowing can be source from the commercial banks only.

FEES AND CHARGES

Fees and charges have recently become an important part of commercial banks' income. According to banks, fees and charges are necessary because they are seen as a shift to value added and not so much as a means for profit making. Fees are user based and enable banks to provide quality service to their customers, for example, the introduction of ATMs, Electronic Funds Transfer at point of sale (EFTPOS), etc. Banks have indicated that they will further increase the level of fees in order to further improve the quality of services they provide to their customers. If banks do not charge fees, interest rates would increase instead.

Figure 10: Revenue Base of Banks



Source: Reserve Bank of Vanuatu

CONCLUSIONS

Of all the factors that drive interest rates, the research team found that country risk and customer risk are the principal determinants of interest rates in Vanuatu. The Government should look at these risks and identify ways to reduce the risks associated with it. For example, the Government should look at growing the economy, find ways to attract more investors and keeping them here, and improve law and order for security of people. Consideration also needs to be given to ensuring that there is the development of infrastructure and markets to enable producers to market their products. This will generate cash flow and enable loans to be serviced.

Another main factor for the size of the spread, which appears to stand out strongly from the rest, is the high rate of return imposed on banks by shareholders, particularly in the case of foreign-owned banks. Whilst there are some justifications in why banks continue to maintain such high return, there is a general feeling that the country risk rating is manipulated to the advantage of the banks.