RESERVE BANK OF VANUATU

MONETARY POLICY STATEMENT

SEPTEMBER 2024

Reserve Bank of Vanuatu

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September 2024

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1. Statement by the Governor

Global growth has stabilized during the first half of this year to July 2024, reflecting slower investment growth amidst restrictive monetary policies conditions, increasing geopolitical tensions, and moderating consumption growth owing to declining savings buffers and decreasing fiscal support. Against these backdrops, the International Monetary Fund (IMF) has decided to keep its 2024 growth forecasts at 3.2 percent in July relative to its April forecast. Global trade has recovered during the first quarter, mainly driven by stronger exports in the technology sector within Asia. Aggregate commodity prices have shown signs of recovery during the year to August 2024, following drastic falls in late 2022 to 2023. This largely reflected tight supply conditions and signs of firmer industrial activity. The pace of global disinflation has slowed than earlier anticipated, owing to higher than average services inflation and rebound in energy prices during the first half of 2024.

Domestic economic activities weakened in the first nine months of 2024, driven by the combine impacts of the Air Vanuatu liquidation in May 2024, ongoing domestic labour shortages, delays in the implementation of the 2024 capital budget, the huge decline in fiscal receipts from the Citizenship by Investments initiative (CBI) and the blacklisting of Vanuatu by the European Commission. In terms of spending, domestic consumption has remained the key driver of economic activities.

The Government is projected to operate a fiscal deficit for the current fiscal year, due to rise in fiscal contingent liabilities and the need to fund a large and unbudgeted claim of the Vanuatu Teachers Union. Fiscal borrowing is therefore expected to increase in the short to medium term, both to address these fiscal challenges and to accommodate the implementation of the public sector capital projects expected to materialize towards the end of 2024 and beyond.

In the finance sector, the banking system remains highly liquid, sound and adequately capitalized on aggregate. Non-performing loans (NPL), issues in correspondent banking relationship (CBR) and corporate governance concerns remain major risks to maintaining financial sector stability in the short to medium term.

The Reserve Bank of Vanuatu (RBV) remained committed to a tightened monetary policy to address the ongoing high excess reserves and the high level of inflation. On the 3rd of September 2024, the RBV raised its policy rate by 0.5 percentage points to 2.75 percent and the Capital Adequacy Ratio (CAR) from 10 percent to 12.0 percent.

The RBV will continue to monitor international and domestic macroeconomic environments, macro prudential and financial developments in the coming months and will make necessary policy adjustments to safeguard macroeconomic stability.

RESERVE BANK OF VANUATU

AUGUST LETLET
Governor
Reserve Bank of Vanuatu

2. Objectives of Monetary Policy

The RBV is responsible for the formulation and implementation of monetary policy in Vanuatu. It maintains a pegged exchange rate regime as a nominal anchor for monetary stability. Monetary stability is translated as the maintenance of a low and stable domestic prices and adequate level of foreign reserves to meet the country's external obligations. More specifically, the RBV ensures that the annual inflation rate is kept within a target range of 0-4 percent and official foreign reserves are sufficient to finance a minimum of 4 months of projected import cover.

Since the March *Monetary Policy Statement (MPS)*, foreign reserves have continued to be maintained well above the RBV's minimum threshold, recording 7.0 months of projected import cover in August 2024. Official reserves are forecasted to remain adequate, financing approximately 6.7 months of imports by the end of 2024. Annual Inflation has returned to the RBVs target range, recording 2.2 percent during the June quarter 2024. This trend may imply that inflation has started to decelerate from previous high levels that exceeded the RBV's target band since the September quarter of 2022.

Despite inflation returning to target, continuing high levels of excess liquidity remain a risk to further inflationary pressures and foreign reserves. A more elevated monetary policy sterilization effort to reduce excess reserves through open market operations is ongoing although evidently ineffective due to the increasing level of monetary financing to address the ongoing fiscal challenges. Furthermore, ongoing pressures on foreign reserves are anticipated to be prolonged if domestic demand remains strong, pushing up import financing and for financing Government external obligations continues. In line with these developments, the RBV has further tightened its monetary policy stance. On the 3rd of September, the RBV has raised both the policy rate by 0.5 percentage points to 5.75 percent and the Capital Adequacy Ratio (CAR) to 12.0 percent from 10 percent. These measures were aimed at reducing the current high liquidity and the high level of non-performing loans in the banking system. In addition, the RBV has tightened its internal policy guidelines on commercial banks foreign currency dealings at the end of September 2024. These policy measures are undertaken to ensure the achievement of RBV's objectives of price stability and adequacy of foreign reserves, and to ensure continued financial sector stability in the short to medium term.

3. International Economic Developments and Outlook

Global activities have stabilized during the first half of this year to July 2024, reflecting slower investment growth amidst restrictive monetary policy conditions and increasing geopolitical tensions, and moderating consumption growth owing to declining savings buffers and decreasing fiscal support. Global trade has recovered during the first quarter of 2024, mainly driven by stronger exports, in particular in the technology sector within Asia. Services trade growth, in particular tourism has nearly recovered to pre-pandemic levels. Global growth was stable during the first quarter of 2024, owing to offsetting effects of improvements in growth in key economic region such as the Europe and China and weaker growth in Japan and the United states. Foreshadowing the likely spill over effects of the global tightening conditions, the International Monetary Fund (IMF)[1] has kept its 2024 growth forecasts constant at 3.2 percent in July relative to its April forecast.

Aggregate commodity prices have started to rise, following drastic falls in late 2022 to 2023. This largely reflected tight supply conditions and signs of firmer industrial activity. The IMF primary commodity prices have increased by 2.0 percent between January and August 2024. The rise was attributed to increases in both nonfuel primary commodity prices and energy prices by 1.4 percent and

[1] The World Economic Outlook July 2024

2.9 percent, respectively. High energy prices continue to reflect elevated oil prices from deep cuts by OPEC+ (the Organization of the Petroleum Exporting Countries, including Russia and other non-OPEC oil exporters) and to lesser extent price pressure from the Middle East conflict.

The pace of global disinflation has slowed than earlier anticipated, owing to higher than average services inflation and rebound in energy prices during the first half of 2024. Global financial conditions remain accommodative during the year to July 2024, mainly reflecting declines in risk premia amid still-elevated interest rates. Due to the slowdown in disinflation, Central Banks in both advanced economies and emerging market and developing economies are likely to remain vigilant in easing policy. As such, markedly higher interest rates than prior to the pandemic are set to sustain for an extended period.

3.1 Developments in Vanuatu's main trading partners

Growth in the *US* economy is estimated to have increased during the first half of 2024. Annual GDP pace is projected at 3.0 percent in the second quarter of 2024[2] up from 1.4 percent in the first quarter. Growth largely reflected the upward trends in private inventory investment, acceleration in consumer spending and nonresidential fixed investment. From January to July 2024, trade in goods and services deficit rose by 7.7 percent relative to same period in 2023, owing to a 3.4 percent increase in exports and 4.5 percent rise in imports. Unemployment rate reached 4.2 percent in August 2024 higher than 3.8 percent recorded over a year ago. Annual inflation rose 2.5 percent in August, lower than 2.9 percent for the year to July. High prices were recorded for all items less food and energy (+3.2%) and food (+ 2.1%) while energy prices declined (-4.0%). The Federal Reserve has lowered its federal funds rate by 50 basis points to a range between 47.5 – 5.00 percent on the 18th of September, as inflation moves towards the 2 percent target. Also risks to achieving its employment and inflation goals are roughly in balance.

Economic activities in the *Euro area* continues to recover as its annual GDP growth rose by 0.6 percent in the second quarter of 2024, compared to 0.5 percent in the first quarter. The unemployment rate recorded 6.4 percent in July, down from 6.5 percent in June 2024 and 6.6 percent in July 2023. Annual inflation has decelerated from 5.2 percent in August 2023 to 2.2[3] percent in August 2024, with highest increase from service inflation (+4.2%), food, alcohol and tobacco (2.4%), non-energy industrial (0.4%). The offset is energy prices (-3.0%), signifying the strength of past monetary policy tightening by the European Central Bank (ECB). Due to the deceleration in inflation towards the ECB inflation target of 2.0 percent, the ECB lowered its three key ECB interest twice this year. The first was a cut by 25 basis points which was effected on the 12th of June and the second, on the 18th of September; thus the interest rates on the main refinancing operations, the marginal lending facility and the deposit facility have declined to 3.65 percent (4.25%; June), 3.90 percent (4.50%; June) and 3.50 percent (3.75%; June), respectively.

Growth in the *Australian* economy was slow recording 0.2 percent during the June quarter, and remaining static since December 2023. The annual growth from 2023-2024 financial year was 1.5 percent slower than 3.1 percent from 2022-2023. The slow growth reflected weak household spending, which more than offset government spending and positive net trade balance. The labour market remained tight. The unemployment rate in the month of July was 4.2 percent up from 3.7 percent in July 2023. Annual Inflation eased to 3.8 percent in June 2024 (+6.0%; June 2023), attributed to elevated prices of both services' inflation (+4.5%) and goods inflation (+3.2%). It has remained above the Reserve Bank's 2–3 percent target range, prompting the Reserve Bank of Australia (RBA) to leave the

2 According to the "second" estimate released by the U.S. Bureau of Economic Analysis
3 A flash estimate from Eurostat

cash rate target unchanged at 4.35 percent during its monetary policy decision on the 24th of September 2024.

Economic activity in *New Zealand* contracted by 0.2 percent in the June quarter relative to the same quarter of 2023. The majority of growth by production contracted over the year: agriculture, forestry and fishing (-1.4%), retail trade (-1.3%), wholesale trade (-1.3%), with the offset being manufacturing (+1.9%). In terms of expenditure, the decline was attributed to exports of goods and services (-0.8%), with the offsets in household consumption (+0.4%) and a decline in imports (-2.0%). The unemployment rate increased further to 4.6 percent in June 2024, up from 4.4 percent in March and 3.6 percent in June 2023. Annual inflation eased to 3.3 percent in June down from 6.0 percent in June 2023; from elevated prices of housing and household utilities, miscellaneous goods and services and prices of alcoholic, beverage and tobacco. However, it remained higher than the pre-pandemic levels and the Reserve Bank of New Zealand's (RBNZ) 1 to 3 percent target range. The RBNZ reduced its policy interest rate by 25 basis points to 5.25 percent on the 14th August, the first reduction in four years, as price pressures began to ease and the path of inflation was projected to return to its target band of 1-3 percent in the September quarter.

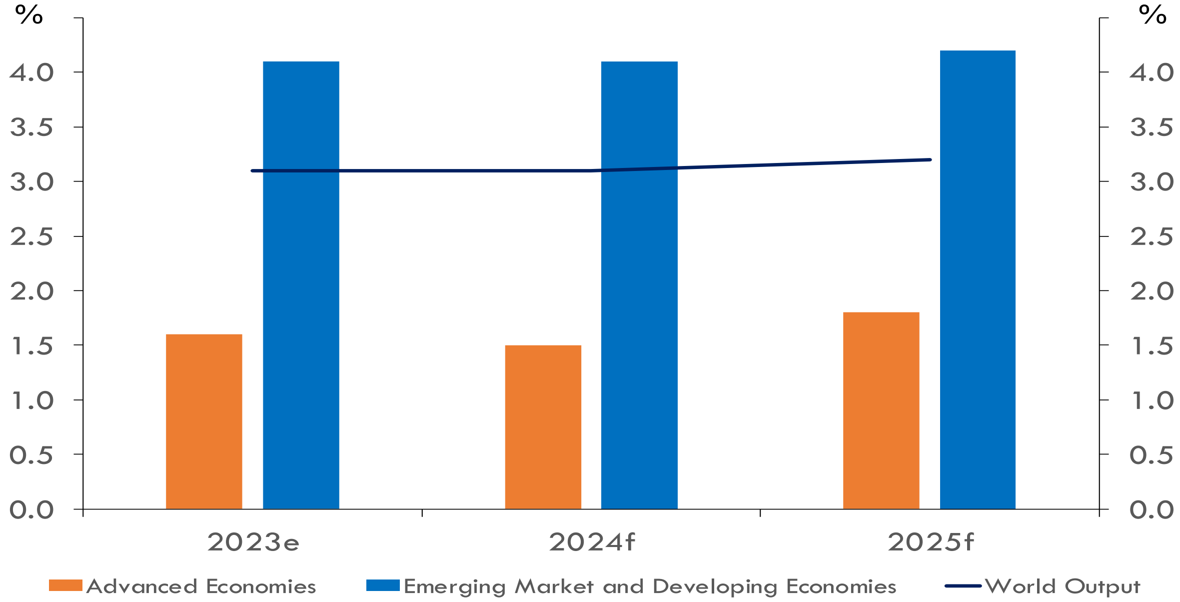
Growth in the *Chinese* economy was stable for the year to August 2024. Growth was broad-based, with industrial production expanding by 4.5 percent year-on-year, reflecting robust growths in equipment manufacturing and high-tech manufacturing. The services sector grew by 4.6 percent year-on-year. Accumulation of fixed assets and capital goods for high-tech industries were the main driver of the annual growth in investment. Consumption has steadily increased relative to August 2023, as reflected in the ongoing increase in market sales and online retail sales of consumer goods. Net exports were positive, as the value of exports went up by 8.4 percent year-on-year, driven by mechanical and electrical products. Imports remained stable over the year. The average urban surveyed unemployment rate for the year to August 2024 was 5.2 percent, 0.11 percentage points lower than the same period of 2023. Annual inflation rose to 0.6 percent while the annual producers price decreased by 1.8 percent in August.

4. Outlook for the International Economy

The IMF projected global growth to increase to 3.3 percent in 2025, owing to growth in emerging market and developing economies, mainly in China and India. Growth in major Advanced Economies is becoming more aligned as output gaps are closing. Global trade is projected to align with global GDP growth. Though a recovery was recorded during the first half of 2024, growth will be moderated towards the end 2024 as global manufacturing indicators remained weak. Global trade-to-GDP ratio is expected to emerged stable despite surge in cross border trade restrictions distorting trade between geopolitically distant blocs. Global commodity prices are projected to slowly ease in 2025 reflecting improved supply conditions. However, prices will remain well above the pre-pandemic levels. The near-term oil price forecast is notably uncertain, however, there is a potential for price increases resulting from conflict related supply disruptions.

Global inflation is projected to continue to decline in 2025 towards Central Banks targets in both Advanced and Emerging and Developing Economies, but at a slower pace owing to surge in services price inflation and rising energy prices. Slowing wage increases and projected decline in energy prices is anticipated to bring inflation to target levels by the end of 2025. Monetary policy rates in major central banks are still expected to soften in the second half of 2024, but with divergence in the pace of monetary policy normalization.

Figure 1: World Economic Growth
(Annual growth in percent)



Source: International Monetary Fund, July 2024 World Economic Outlook

4.1. Outlook for Vanuatu's major trading partners

According to the IMF projections, the *US* economy is projected to grow by 2.6 percent in 2024 before normalizing to 1.9 percent in 2025. This follows increasing unemployment and moderation in consumption, on the back of consolidating fiscal policy with fiscal space squeezed. Growth in the *Euro area* is projected to grow by a modest 0.9 percent in 2024 and projected to rise to 1.5 percent in 2025, owing to stronger consumption as a result of rising real wages and higher investment from easing monetary policy. Manufacturing remains weak. The *New Zealand* economy is projected to slow to 1.0 percent in 2024 owing to weak domestic demand before expanding by 2.0 percent in 2025. However, improving external conditions should provide some support to growth and narrow the trade deficit, especially in tourism spending. Growth in *China* is forecasted at 5.0 percent for 2024 but projected to slow to 4.5 percent in 2025 as deflationary pressures continues and persistent property crises remains a hindrance to growth. According to the IMF, growth will continue to decelerate over the medium term to 3.3 percent by 2029, due to challenges from aging population and slowing productivity growth.

The RBA projected growth in *Australia* to reach 1.7 percent at the end of December 2024 and increase to 2.5 percent in December 2025, driven mainly by household consumption resulting from automatic stabilizer measures introduced by the Federal Government and State Territory. Such Government transfers would boost real household disposal income and household wealth. However, high growth in imports and weaker growth in dwelling investments are projected to mitigate these growths. Underlying inflation is expected to return to RBA's target range of 2–3 percent in late 2025 and approach the midpoint of the band in 2026.

5. Domestic Economic Developments and Outlook

Recent estimates of domestic economic activity have further weakened since the March *MPS*. The key drivers are the following; (i) the negative impact of the liquidation on Air Vanuatu on growth in the services sector, and other tourism-related sectors, (ii) continuing domestic labor shortages from high demand for seasonal workers as a drag on growth in all economic sectors, (iii) the huge decline in fiscal receipts from the Citizenship by Investments initiatives and, (iv) the delay in the implementation of the capital budget projects anticipated for 2024. Growth in consumption has expanded, investment has moderated and negative net exports have further reduced growth. Businesses in Port Vila, share a similar sentiment of weak growth. The results of the recent Business Expectation Survey (BES)[4] indicated a slight contraction in economic activities for the first nine months of 2024. On a net basis, businesses perceived negative growths for the agriculture sector (-5%) and the industry sector (-2%) and stable growth (+0.3%) for the services sector. In general, overall economic activities have weakened for the first nine months of 2024 relative to the same period of 2023.

5.1. Economic activities by production

Since the March *MPS*, recovery has continued in the agriculture, forestry and fisheries sector, following a contraction of 0.9 percent projected in 2023. Apart from recovering from three cyclones in 2023, this sector is persistently facing challenges due to domestic labour drain, impact of climate change associated risks and recently the spread of the Coconut Rhinoceros Beetle (CRB) to Santo[5]. Available indicators suggest that copra production dropped significantly by 47.3 percent in the March quarter of 2024 compared to the same quarter in the previous year. This was driven by a reduction in production volume, despite higher domestic prices. Cocoa production rose significantly by 83.6 percent in the first quarter 2024, relative to the same quarter of 2023. The increase was in line with the rise in producer's price per tonne. Cattle production in terms of total weight slaughtered rose by 7.2 during the June quarter, and 1.5 percent over the June quarter of 2023. Findings from the BES indicated that during the first nine months of 2024, the overall net business performance for this sector has been weak and net profitability was stable, relative to the same period of the previous year. Lending to this sector was also weak during the year to July 2024. Annual growth of lending to the agriculture, forestry and fisheries sectors decreased by 13.8 percent, 15.0 percent and 56.6 percent, respectively, over the year to July 2024.

The industry sector is the fastest growth sector, estimated to have grown by 4.6 percent in 2023. Growth is estimated to have slowed through the first nine months of 2024, driven largely by ongoing delays in the implementation of the public infrastructure[6] as outlined in the RBV's March *MPS*. Implementation of public sector capital projects have slowed markedly as fewer projects were implemented than was anticipated. These included; the sealing and resealing of core road networks in Port Vila, the upgrading of local airports, including construction of a new local airport, the completion of feeder roads, the sealing of road networks in Luganville, the extension of Pekoa Airport in Santo, additional upgrade to the Norsup Airport and the Luganville water rehabilitation project. The implementation of the bulk of the projects has been pushed forward to forthcoming years. At the same time, the spin-offs associated with the ongoing construction of public infrastructure projects have spurred growth in other subsectors, such as private sector construction, mining and quarrying and electricity and water. However, partial indicators of construction activities portrayed weaker activity in this sub-sector. The annual growth in imports of cement decreased by 6.5 percent in the first seven months of 2024 compared to the same

[4] The Business Expectation Survey (BES) was conducted from the 13th-20th September in Port Vila
[5] Santo is the biggest island in Vanuatu and the main producer of Vanuatu main export commodities
[6] The ongoing projects include the South Santo, Pentecost, Tanna and Ambae roads and other infrastructure projects such as the Vanuatu Inter-Islands Shipping Support Project (South Paray wharf), the Vanuatu Energy Access projects (extension of electricity grid in Santo), the Sarakata hydro and the extension of the Norsup airport.

period in 2023. Commercial banks' lending to the construction sector, mining & quarrying and public utilities have declined by 1.1 percent, 6.5 percent and 96 percent, correspondingly, over the year to July 2024. Similarly, partial indicator of private investment, lending to housing and land loans have contracted by 2.9 percent compared to July 2023. Activities in the manufacturing sector have moderated in the first nine months of 2024 in line with the reduction in air arrivals as a result of the Air Vanuatu liquidation. The proxy indicator, from commercial banks' lending shows that credit to the manufacturing sector rose by 7.3 percent over the year to July 2024. Base on the BES results, businesses in the industry sector have indicated a weak net business performance, though a positive net profitability was achieved during the nine months of 2024, compared to the same period in 2023.

Activities in the services sector, in particular tourism related services, were significantly affected by the voluntary liquidation of Air Vanuatu; and were estimated to have contracted during the year to September 2024 and expected to be lower than the forecasted growth of 4.6 percent for 2023. Air arrivals declined by 55.8 percent during the year to July 2024, relative to the same period of 2023; which led to slower growth in accommodation and food services, air and land transport services. The reduction in air transport has also impacted postal services. Annual growth in postal services contracted by 13.3 percent owing to declines in both international outbound (-10.1%) and inbound (-21.7%) mails for the year to June 2024. Since the liquidation until September 2024, six international carriers[7] are currently providing weekly services to Port Vila, of which one airline has extended its international services to Santo.

Other services sector has portrayed better performance. Wholesale and retail, in terms of vehicle sales have performed better than last year despite a decrease in imported vehicles by 59.2 percent for the year to June 2024. Other Wholesale and retail trade expanded further in the first half of the year owing to rise in domestic consumption. Finance and Insurance sector performed better owing to increases in the number of new account openings, new loans and new insurance premiums issued, mostly to seasonal workers. Telecommunication coverage around Vanuatu is about 85 percent. Usage of network services including overseas call and roaming have increased to around 80 percent relative to a year ago. There is an increasing use of mobile money transfers, in particular by seasonal workers.

Performance for professional, scientific and technical services was better than previous year owing to high demand of technical skills following the implementation of several public and donor funded investment projects in the country. Education and administrative services have shown a positive performance owing to increasing activities on this sector funded through school grants from the Government and donations from sponsors. The real estate activities have performed better than the previous year due to more new investors tapping into land subdivision development. There is a high demand for residential property from foreign investors and increasing number of new commercial building are being advertised for office purposes. There is an increasing demand for accommodation in Port Vila, part of the reason relates to the preference for seasonal workers to settle in Port Vila rather than returning to their respective islands.

Crude indicators of credit from commercial banks have been mixed for the year to July 2024. Expansion in credit were noted for the following services sector; distribution (wholesale & retail) sector (+2.1%), transport (9.0%), and professional & other services (+24.5%). While the following sectors recorded decline in credit; tourism (-16.6%), communication (-75%) and entertainment & catering (-23.1%). According to the BES report, the services sector reported a positive net business performance and profitability for the year to September 2024, relative to the same period of 2023.

[7] Fiji Airways (7 days a week), Virgin Australia (5-7 days), Solomon Airlines (5 days), Air New Guinea (1 day), Qantas (1 day) and Air Calin (1 day)

5.2. Economic activities- by expenditure

Since the March *MPS*, the contribution of spending to growth has shown moderation, with apparent expansion in domestic demand translated into increasing imports and moderate activity in investment.

Growth in domestic consumption performed better during the year to July 2024. Value Added Tax (VAT) collections - a very closed proxy of consumption, recorded VT8384.1 million, for the year to July 2024, higher by 24.4 percent relative to the same period in 2023. However, collections have reached 47.4 percent of the estimated budget target for 2024[8]. Similarly, Government consumption, in terms of use of goods and services and compensation of employees have increased by 21.4 percent and 13.2 percent, each for the year to July 2024 relative to a year ago. Businesses in Port Vila have reported positive net sales of their goods and services for the year to September 2024, relative to the corresponding period of 2023, implying robust domestic consumption. Similarly, credit to other resident sectors (personal loans) remained robust, recording an annual growth of 21.5 percent in July 2024. The offset was energy consumption, which was down by 9.8 percent for the year to June 2024, relative to the same period in 2023.

Growth in the partial indicators of investment have been modest for the year to September 2024, majority of the ongoing implementation of major government infrastructure projects[9] and the implementation of few capital projects (see development under industry sector) have attributed largely to the growth in this sector. Although, the BES findings indicated a net increase in capital investment for businesses in Port Vila, notably in the services industry for the year to September 2024, growth in other partial indicators of private sector investment have remain slow. From the banking sector, private sector investment, represented by lending to businesses grew by a steady 0.3 percent over the year to July 2024. Household and land purchases (household investment) fell by 2.9 percent, over the year to July 2024.

Exports of goods increased by 16.0 percent during the year to July 2024, relative to the same period of the previous year. Increase in export earnings were recorded for cocoa (+208%), kava (+12%), copra (+8%) and coffee (+66%). The offsets were coconut oil (-28%) and beef (-23%). Exports of services is estimated to have contracted during the year to July 2024, owing to low number of tourists due to the liquidation of air Vanuatu. Base on the BES results, the agriculture and services sectors have indicated to record net increases in exports of goods and services for the year to September 2024 relative to the same period of the preceding year. Imports of goods have risen by 16.5 percent during the year to July 2024, relative to the same period of 2023. Imports of services is expected to have to have expanded during the year to June 2024 in line with increasing demand domestic demand. Moreover, businesses in Port Vila have reported net increase in imports of goods and services during the first nine months of 2024 relative to the same period of 2023.

5.3. Fiscal developments

The Government operated a recurrent fiscal deficit for the year to July 2024, as expenses outweighed revenue and receipts from the Citizenship by Investment initiative falling short of target. Revenue collected for the year to July reached 47.1 percent of the 2024 budget target, while expenses incurred have reached 63.6 percent. Though expenses are within the 2024 budget target it exceeded revenue, resulting in a net operating deficit of VT1,477.1 million for the year to July 2024. Collections for VAT, taxes on property and other revenue[10] have been slow, recording less than 50 percent of their 2024 budget targets, respectively. Excise tax and taxes on international trade have exceeded 50 percent

[8] VAT 2024 budget was raised due to expected VAT generated from the Governments capital budget, which were slower than anticipated
[9] Refer to footnote 6
[10] Approximately 80 percent are citizen by investment revenue

of their 2024 budget targets. All expenditure categories were within their 2024 respective budget targets, except other operating grants, exceeded its 2024 budget, reflecting financing associated with the liquidation process of the national airline. Inflows of donor funds recorded 46.7 percent of total budget target, while expenses on project grants reached 17.5 percent of total budget target. For the year to July 2024, the Government issued a total of VT3,928.6 million worth of domestic bonds and repaid a total of VT769.9 million in external debt payments. To date, the total level of outstanding Government bonds rose by 21.0 percent during the year to September 2024 (Quarter 1 2024; VT 13,709.8 million, September 2024; VT16,592.4 million).

5.4. Monetary and Financial developments

Money growth moderated at 1.2 percent for the year to July 2024, owing to slower growths in both net foreign assets (1.3%) and domestic credit (0.1%). Compared to a year ago, money growth was higher by 4.4 percent, largely driven by domestic credit (+24.0%), mainly the increase in net credit to the central Government (+51.4%). Net foreign assets contracted 4.0 percent, reflecting the persistent slow growth in net inflows amidst slow global conditions. The Government's net credit position with the banking system deteriorated during the year to July 2024 compared to the same period last year, this largely reflected the expansion in the Governments domestic borrowing[11] and the withdrawal of Government deposits with both the RBV and commercial banks throughout the year. The RBV recorded a substantial increase of 93.6 percent in its holdings of Governments bonds (July 2023; VT3,331.5 million, July 2024; VT6,460.9 million) while commercial banks holdings of Government bonds rose 22.5 percent (July 2023; VT3,300.0 million, July 2024; VT4,041.8 million). In August 2024, RBV held a total of VT6,355.8 million in Government bonds, while commercial banks VT4,740.7 million.

Growth in private sector credit moderated during the first half of the year recording 0.4 percent in July, though the annual growth over the year to July 2024 rose by 5.2 percent. Personal consumption remains the main driver of annual growth in private sector credit, following an increase of 21.5 percent in personal loans, investment loans grew slower by 0.3 percent, reflecting the moderate growth in economic activities.

The banking sector's financial performance remained satisfactory depicting on-going recovery in the economy. During the June quarter 2024, the banking sector recorded an underlying profit of VT1.2 billion, (-12.7%; Mar-24, +19.7%; Jun-23). The quarterly decline reflected a contraction in net interest income by 4.3 percent to VT1.6 billion and increase in total operating expenses by 21.0 percent to VT1.7 billion. However, non-interest income increased by 19.6 percent to VT1.3 billion. On the other hand, the yearly growth reflected increases in net interest income and other operating income by 11.3 percent and 11.8 percent, respectively. Operating expenses recorded a lower increase by 6.3 percent.

The industry's loan book showed an improvement in quality over the June quarter as non-performing loans (NPLs) slowed by 8.2 percent to VT13.6 billion, however, remain high at 20.5 percent over the year. Total NPLs to gross loans ratio decreased compared to the previous quarter to 16.7 percent (18.4%; Mar-24, 14.7%; Jun-23). Net NPLs to capital ratio remained high, albeit decreasing to 48.3 percent at the end of the reviewed period (52.9%; Mar-24, 39.5%; Jun-23). This is the result of a decline in NPLs over the quarter, coupled with the growth in capital. Majority (83.3%) of the lending book remained as performing loans, i.e., standard and special mention loans. Standard loans rose over the quarter and year by 4.1 percent and 2.4 percent, respectively, to VT61.8 billion. Whilst special mention loans recorded a quarterly decreased of 2.1 percent to VT6.3 billion, however annually increased by 21.8 percent. The movements within these performing loan categories resulted mainly from increase in credits and reclassification of loans over the reviewed period. The private sector credit

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

(PSC) showed growth, registering both quarterly and yearly increases of 1.8 percent and 4.8 percent, respectively to VT68.7 billion. The expansion is attributed to general increase in demand for credits within the economy despite banks continuing to maintain tight book management. The domestic banking industry's liquidity position remained high with a liquid asset ratio (LAR) of 48.3 percent at the end of June 2024 (52.3%; Mar-24, 56.6%; Jun-23) which is well above the minimum regulatory threshold of 5 percent.

5.5. Domestic price development

Annual headline inflation has returned to the RBV's inflation target range in the June quarter 2024. This follows persistent acceleration in inflation exceeding the RBV's target band ever since the September quarter 2022 until the March quarter, 2024. Annual headline inflation recorded 2.2 percent in the June quarter of 2024, lower than the 5.3 percent (March quarter) and 14.4 percent (June quarter 2023).

According to the Vanuatu Bureau of Statistics (VBOS), the highest increase in prices was from Lenakel (+5.9%), followed by the Luganville index (+2.6%) and Port Vila recorded the slowest increase of 1.8 percent. The following expenditure categories recorded upward prices; food (+3.3%), drinks and tobacco (+3.5%), clothing and footwear (+8.4%), household supplies (23.8%), health (+3.0%), transportation (+2.1%), recreation (+7.4%), education (+6.9%) and miscellaneous (+0.1%). The offsets were reduction in prices for housing utilities (-12.0%) and communication (-2.7%). Particular items within these categories which recorded increased prices included: dairy and related products, cigarettes, men's clothing, other household supplies such as batteries and candles, health diagnostic services, motor vehicles repair and services, sea fare for domestic routes, school stationaries and primary school contribution fees. Underlying annual inflation rose by 4.8 percent in the June quarter 2024, lower than 7.4 percent recorded in the March quarter 2024.

In general, domestic prices have drop significantly from the high peak in 2023, reflecting lagged effects of decline in global commodity prices, deceleration in inflation rate for Vanuatu's main trading partners and easing of local food inflation. The deceleration in local food prices reflected the joint effort from the monitoring of local food prices in the Port Vilas central market by the Vanuatu's Price Monitoring and Consumer Affairs (PMCA) and favourable weather conditions which boosted production of local root crops, fruits, and vegetables. Prices of imported food have come down while still remain volatile reflecting the variability in shipping/freight cost. Business in Port Vila have indicated a net moderate increase in prices of their goods and services in the first nine months of 2024 relative to the corresponding period of last year.

5.6. External conditions and official reserves

The Vanuatu current account balance (CAB) is estimated to have experienced further deterioration in the June quarter (-VT4.3 billion), relative to the March quarter (VT-2.1 billion). Similarly, weakened by 204.8 percent compared to the same period in 2023. This worsening position stemmed from weaker growth in services exports[12] reflecting reduction in travel receipts, due to the voluntary liquidation of Air Vanuatu and the strength of domestic demand driving up import volumes.[13] The offsets are improvements in both the primary and secondary income balances, reflecting moderate growth in compensation of employees (COE) for seasonal workers abroad and improvement in government inward transfers.

Official reserves recorded VT70,297.4 million in August. The annual growth contracted by 3.5 percent compared to August 2023. Similarly, the average growth for the year to August 2024 fell by 2.1 percent relative to the same period of the previous year. The continuous downward trend in official reserves reflected high outflows; via import financing and external debt financing versus slower growth

[12] Services exports decreased by 30.4 percent year-on-year
[13] Total imports (goods and services) increased by22.5% in Jan- Jun 2024 from Jan-Jun 2023.

in inflows; particularly government inward transfers via the citizenship by investment receipts, donor funds and budget support. Official foreign reserves remained sufficient to finance approximately 7.0 months of import cover in August 2024, 3-months above the Reserve Bank's minimum threshold of 4.0 months.

Since the March *MPS*, Central banks of Vanuatu's main trading partners have kept their interest rates as inflation rates have started to decelerate towards their respective targets. Since the Vatu is pegged to a trade weighted basket of currency, the movement of the vatu exchange rate is influenced by bilateral movements of the major currencies in line with global financial conditions. From January to July 2024, the USD and Euro have appreciated on average by 0.4 percent and 0.2 percent, relative to the Vatu, respectively. In contrast, the AUD and NZD depreciated on average against the Vatu by 0.2 percent and 0.6 percent, respectively. The appreciation of USD against the Vatu has added to high import costs and external debt repayments which partially led to a decline in foreign reserves. The official reserves contracted by 3.8 percent over the year to July 2024.

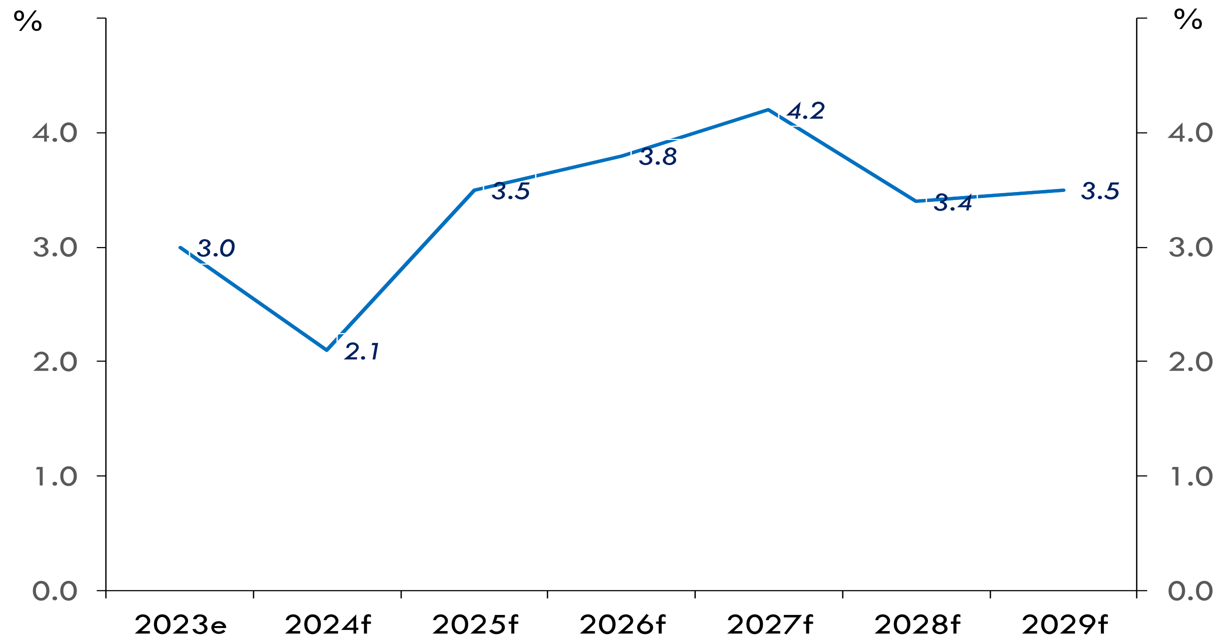
Following the announcement by the US Federal Reserve in August to lower interest rates, and up until the actual cut in its official rates in September 2024, the relative value of the USD against the Vatu has weakened. From August to September 2024, the USD and Euro depreciated against the Vatu by 1.7 percent and 0.4 percent, respectively, while the AUD and NZD appreciated by 0.9 percent and 2.0 percent, each.

6. Outlook for the Domestic Economy

Since the March *MPS*, the economy has been slowing, driven by the combine effects of the liquidation of Air Vanuatu in May 2024 and ongoing domestic labour shortages which has direct and indirect impact across all sectors. The recent spread of the CRB to Santo is a major threat to the agriculture sector. Furthermore, with the current fiscal challenges, the implementation of the major projects as per the capital budget anticipated for this year has been delayed. Based on these factors, the Macro-Economic Committee (MEC) downgraded its growth forecasts in September 2024; 0.7 percentage points slower to 2.1 percent than the July (2.8 percent) forecasts for 2024, before accelerating to 3.5 percent in 2025. Going forward, the economy is projected to grow by 3.7 percent on average over the medium term (2026-2029). Growth will be broad based, driven mostly by the services sectors followed by the industry and the agriculture sectors. In terms of expenditure, growth is projected to be driven by investment and consumptions, exports of goods and services is estimated to moderate. In addition, imports of goods and services are estimated to further increased (reduces growth) in 2024.

Correspondingly, businesses in Port Vila who have participated in the BES have estimated a net growth of roughly 4 percent in their business performances for the nine months ahead.

Figure 2: Domestic GDP Growth Forecast
(Annual growth in percent)



Source: Vanuatu Bureau of Statistics, Macroeconomic Committee Forecast- September 2024

6.1. Economic Outlook- by production

Growth in the agriculture sector is projected to moderate by 2.2 in 2024 and increase to 2.5 percent in 2025, with an average growth of 3.3 percent in the medium term. All subsectors are expected to slow in 2024. Crop production is projected to slow owing to the major threat of the CRB reaching Santo affecting the coconuts and copra production. Production of cocoa and coffee are expected to improve reflecting favourable global commodity prices. Based on current trend, growth in kava exports[14] is projected to slow, reflecting high domestic demand. In general labour shortages have significantly affected crop production. Animal production remains weak owing to less production to meet international demand. Domestic demand for beef remains strong, thus is projected to sustain growth for the beef industry. Local production of egg and chicken has declined but is projected to increase in line with the recovery in tourists' numbers and high domestic consumption. Though, shortage of chicken feeds and chicks to the farmers in the islands remains a challenge. In terms of forestry, logging activities are projected to slow due to the Government's policy of replanting. Growth in fishing activities are estimated to decelerate this year reflecting the decline in tourist demand.

The industry sector is estimated to slow to 2.1 percent in 2024, before expanding by 9.8 percent in 2025. The average growth of 7.0 percent is projected in the medium term. This reflects the rollout of the Governments capital budget expected to be fully implemented in 2025 until 2027. This is in addition to the ongoing government infrastructure projects.[15] The mining and quarrying, water and electricity sectors are projected to grow in line with these projected construction activities. Growth in the manufacturing sector is expected to moderate reflecting low demand from tourists, but will be sustained by robust domestic demand. Private sector construction activities are also ongoing which will add to the overall growth in the sector.

[14] Due to limited information on kava production, exports of kava is used as proxy for production
[15] Refer to footnote 6

Growth in the services sector is projected at 2.8 percent in 2024 and to increase by 3.2 percent in 2025, and an average growth of 3.0 percent is forecasted over the medium term. These projections were lower than previous year's growth estimates. The key driver to the slower growth was the liquidation of air Vanuatu which is estimated to have impacted all tourism related sectors, such as air transport, land transport, accommodation and food services, wholesale and retail trade and information and communications. Tourism arrivals is expected to remain below pre-pandemic level in 2024, with six international carriers serving Port Vila since May up to September, including one expected to start at the end of the year. Tourist arrivals is projected to increase further to 2025, aided by the Vanuatu Tourism Office (VTO) new marketing strategy for 2025-2027[16] to boost tourist inflows. The number of cruise ships visits is projected to remain stable in 2024 compared to 2023, but will increase by 4 percent in 2025. Activities of the finance and insurance sectors are projected to be positive in 2024 and 2025, in line with the recovery in tourism related sectors and increasing demand for real estate activity. Real estate is projected to increase owing to the extension of residential and commercial leases to 99 years bringing confidence in the sector. Social services, in particular education services is forecasted to slow due to the teacher strike, reducing the number of classroom hours taught.

6.2. Economic outlook- by expenditure

Consumption will remain the main driver of economic activities in 2024 and 2025, led by private consumption. The key drivers are ongoing implementation of infrastructure projects, favourable commodity prices of export commodities such as kava, cocoa and copra, income received from seasonal employment and the recovery in tourist numbers; with seven international carriers towards the end of 2024 and into 2025. The demand for credit from households and individuals is projected to further increase following the trend in consumption. Government consumption in terms of wages and salaries and use of goods and services are expected to remain steady this year and next year owing to the current fiscal challenges. The ongoing projects implemented by non-profit institution serving households (NPISH) will continue to support the livelihood of communities, maintaining consumption growth in the next six to nine months.

Investment will remain moderate in 2024 but increased in line with the implementation of the capital budget from 2025-2027. Similarly, the BES findings have indicated that businesses in Port Vila have estimated a net increase in capital investment for the forthcoming nine months. Anecdotal sources indicated a reduction in domestic prices for cement in recent months due to greater supply and lasting stocks from the main cement importer; a proxy to boost construction activities going forward.

Exports of services in particular visitor arrivals, are forecasted to increase further towards the end of 2024 with seven international carriers operating weekly flights to Port Vila. This will further boost air arrivals. Imports of services are projected to further increase in 2024 and 2025 owing to the increase in the number of foreign workers expected by NPISH, international agencies and private schools.

6.3. Risks to the growth outlook

The risk to the growth outlook is tilted to the downside. These includes the continuing spread of the CRB to other islands if not well contained, the persistent impact of climate change and another economic shock due to the start of the cyclone session in November to April next year, land disputes, worsening fiscal receipts from the Government CBI which will affect the implementation of public sector projects, shortage of skilled and unskilled labour force, high shipping and freight costs, high borrowing costs and cyber security.

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[16] Source: Vanuatu Daily Post 20 September 2024.

6.4. Fiscal outlook

Since the March *MPS*, there was a slowdown in fiscal receipts than earlier anticipated. VAT and revenue via the citizenship by investment have underperformed as per their respective 2024 budget targets. The Government has increased its contingent liabilities by a significant amount in the form of Government guarantees for the Air Vanuatu debts. Furthermore, addressing few of the outstanding claims of the Vanuatu Teachers Union. As a result of these fiscal challenges; a deficit is projected for the fiscal year of 2024. The Government is also expected to increase its borrowing in the short to medium term, to address these fiscal challenges and to accommodate the implementation of the public sector capital projects towards the end of 2024 and beyond.

6.5. Monetary and financial outlook

Money growth is projected to be driven by domestic credit in 2024 and 2025, owing to the projected increase in the Governments domestic borrowing and a moderate growth in private sector credit; consistent with expected increase in economic activities. Growth in net foreign assets is projected to moderate in 2024 and 2025; in line with stable global economic conditions and high imports financing. The RBV will continue to monitor growth in money supply and implement appropriate policy measures to ensure money growth remains sustainable.

The general outlook for the domestic banking sector is positive. Overall, the banking system remains highly liquid, sound and adequately capitalized. Non-performing loans (NPL) has increased from past periods and remain a concern but projected to improve as the economic activities continue to pick up. On average, the banking sector has also been well provisioned for asset impairment; though individual banks continue to face on-going challenges with insufficient level of provisioning. Credit risk, continuing issues in correspondent banking relationship (CBR) due to de-risking, and corporate governance concerns remain a major risk to maintaining financial sector stability in the short to medium term.

6.6. Inflation outlook

Vanuatu's overall headline inflation is forecasted to continue to ease to the RBV's target range over the remaining months of 2024. Since the March *MPS*, recent developments, both external and domestic have supported these downward forecasts. The appropriate external factors included the following:

i) The further deceleration in global inflation, energy and non-energy commodity prices. The IMF has projected global inflation to slow to 5.9 percent in 2024 and 4.5 percent in 2025. Energy prices are projected to contract by 3.0 percent in 2024 and 4.0 percent in 2025. Similarly, non-energy commodity prices are projected to decline by 2.0 percent and 3.0 percent in 2024 and 2025, respectively,
ii) Inflation in Vanuatu's main trading partners have decelerated towards their inflation target band; thus, majority of their central banks have since reduced their respective policy rates[17] except Australia.
iii) Findings from the BES indicated a moderate decline in freight/shipping costs projected for the forthcoming nine months, however, owing to the persistent fluctuation in international fuel prices, imported food prices are projected to be moderate though volatile until the end of the year. While international fuel prices are expected to slow down over 2024 and 2025, the ongoing conflict in the Middle East and geopolitical tensions remain a major upside risk on the overall forecasts.

Domestic factors which forms the basis of these forecasts includes:

[17] Refer to the section on international development and outlook

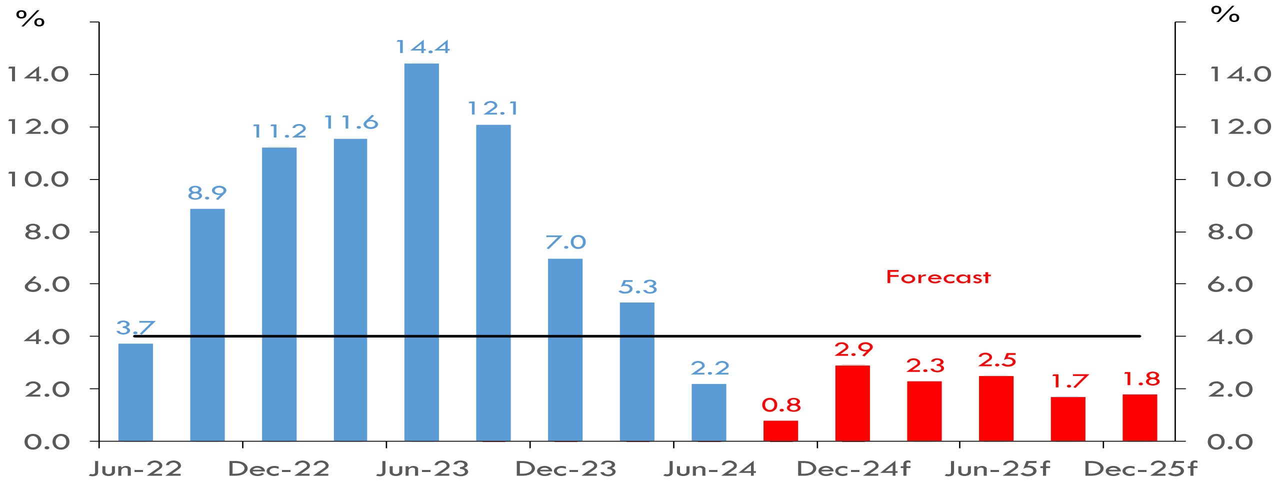
(i) Deceleration in local food inflation. This was mainly due to favourable weather conditions boosting production of local root crops, fruits and vegetables and the close monitoring of local food prices through the use of scales in the Port Vila central market by the PMCA. PMCA has plans to expand the use of scales to Luganville and Lenakel markets, towards the end of 2024 and early 2025. Thus, local food inflation is projected to remain within the RBV target range until 2025. However, the upcoming cyclone seasons starting in November this year to April 2025 poses further upside risk to the forecast;

(ii) Slowing but volatile trend in domestic fuel and utility prices in line with expected decline in global energy prices. On average domestic fuel prices have recorded a decline of 3.2 percent over the first nine months of 2024, compared to the same period of 2023. Fuel prices are expected to continue to trend downwards but remain volatile depending largely on global energy developments;

(iii) Findings from the BES indicated an overall net result of stable domestic prices of goods and services in the forthcoming nine months.

Overall, the Vanuatu's exchange rate regime continues to act as a nominal anchor for domestic inflation. With these assumptions, the headline inflation is forecasted to reach 0.8 percent during the September quarter, and 2.9 percent in December 2024. The annual average inflation is now projected to slow from 11.3 percent in 2023 to 2.8 percent in 2024.

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



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

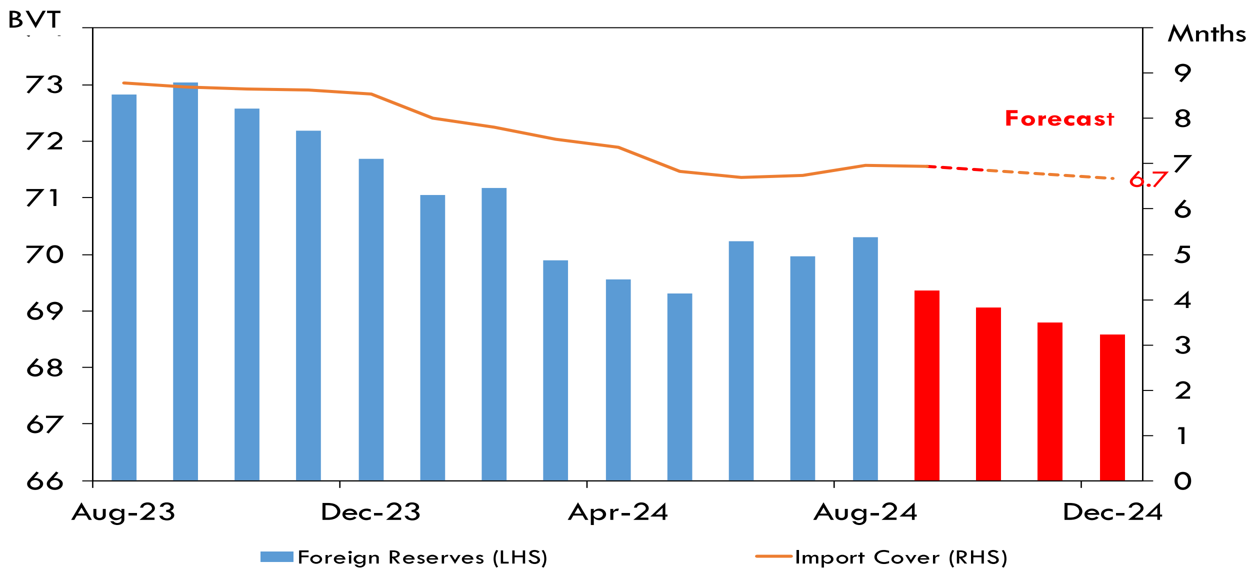
6.9. External conditions and official reserves outlook

Vanuatu's overall trade balance is projected to deteriorate by 27.3 percent in 2024, the key drivers are the worsening position in both trade in services and trade in goods balance. Trade in service deficit largely reflected slower travel credits, as tourist arrivals are projected to remain below pre-pandemic level this year. The continuous trade in goods deficit reflected high imports associated with increasing domestic demand. The income balances are projected to moderate owing to a gradual decline in the number of seasonal workers abroad and the slight improvement expected in receipts from development partners in terms of budget support, infrastructure projects, citizenship by investment programs, and other Government priorities.

Vanuatu's official foreign reserves is forecasted with a gradual downward trend in 2024, but will remain above the RBV's minimum target range over the short to medium term. High import payments, payments of Government obligations abroad, along with continuous slow growth in net inflows remain the crucial drivers to the declining trend on foreign reserves. Slow global economic conditions and lower than expected Government revenue from abroad will remain until the end of the year. Though improvement in primary income receipts and exports of goods and services will continue to sustain foreign reserves. Against these developments foreign reserves are forecasted to cover approximately 6.7 months of imports at the end of 2024.

Over the short to medium term, Government revenue from abroad, primary income receipts and exports of goods and services will remain the main sources of inflows, and the main sources of outflows are to finance the import of goods and services and Government obligations abroad (external debts and other payments).

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



Source: Reserve Bank of Vanuatu

Due to the current easing of interest rates by Central Banks of Vanuatu's main trading partners, the relative values of the USD and the Euro are expected to weaken against the Vatu while the relative value of the AUD and NZD against the Vatu are perceived to increase in the short term (holding all other factors constant). These offsetting movements of the major currencies against the vatu will have counter balancing effects on the trade balance and inflationary pressures.

With the current low relative value of the USD and Euro against the Vatu, USD and Euro related imports would become cheaper thus leading to further improvements in trade balance. Import related costs in terms of USD and Euro are expected to moderate thus add to downward pressure on inflation. Earnings in foreign investments denominated in USD and Euro are assumed to weaken, though projected to be offset by lower import costs.

With the current appreciation of the AUD and NZD relative to the Vatu, tourism earnings and remittances in respective currencies are expected to increase while AUD and NZD denominated imports will be costly thus translated to domestic prices. In addition, foreign investments denominated in AUD and NZD will rise, however offset by the recent cut in the interest rates by RBNZ.

7. Monetary Policy Stance

Since the March *MPS*, domestic inflation has reverted to below the RBV's target range. However, ongoing elevated levels of excess reserves remain a risk for further inflationary pressures. Official foreign reserves have declined from the previous year's level, owing largely to high import financing. Fiscal challenges have added to further pressures on foreign reserves and excess domestic liquidity. The outlook on inflation up to the end of 2024 is broadly tilted on the downside. Although foreign reserves have slowed, the outlook for the level of foreign reserves for the reminder of the year remains favorable and for it to remain above the RBV's minimum threshold. The financial sector remains liquid, profitable, adequately capitalized and stable. Despite the positive developments in the financial system, high NPLs, continuing issues in correspondent banking relationship and corporate governance concerns remain a challenge to maintaining financial sector stability in the short to medium term.

The RBV Board of Directors noted that the key challenges undermining monetary policy and financial sector stability have remained. The Board therefore judged that a further tightening of monetary policy is appropriate to address the current high liquidity in the banking system.

During its meeting on the 3rd of September 2024, the Board resolved to further tighten monetary policy stance as follows:

- It increased the RBV policy rate from 2.25 percent to 2.75 percent.
- It raised the Commercial Banks Capital Adequacy Ratio (CAR) from 10 percent to 12 percent.

The Board noted that these policy measures are; to ensure that the Reserve Bank's objectives of price stability and adequacy of foreign reserves are achieved, and to safeguard financial sector stability in the short to medium term.

The Reserve Bank will continue to monitor international and domestic economic developments and make necessary policy adjustments when appropriate.