

Macroeconomic Analysis of the Domestic Economy

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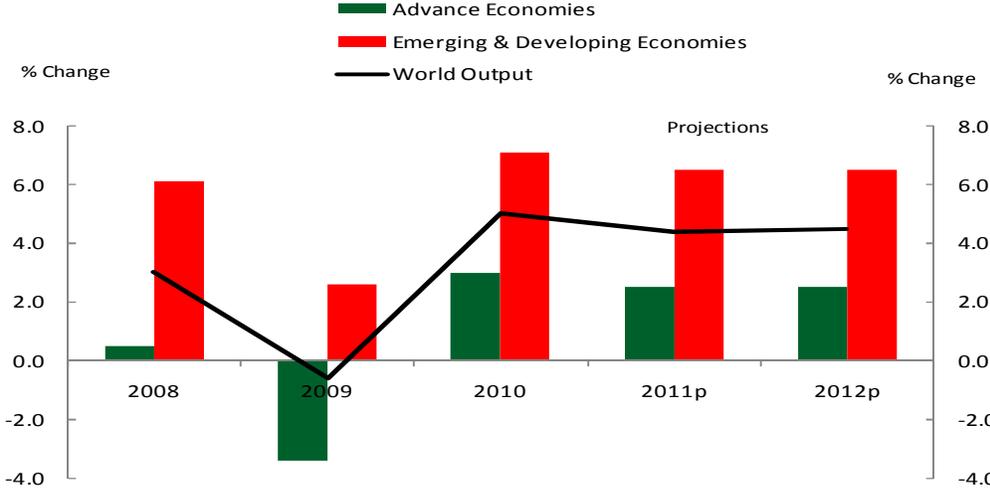
Overview and Macroeconomic Analysis of the Domestic Economy

This report discusses the performance of the economy and financial sector in Vanuatu. The set up of this report begins with an international overview of current economic developments and is followed by discussions on the domestic economy. Furthermore, the domestic economy is subdivided into the real sector, the monetary and financial sector, the external sector and the fiscal sector. The last section of the report is the summary. The macroeconomic analyses are based on published data.

INTERNATIONAL

The IMF has revised its global economic growth forecast upward by a ¼ percentage point from its prediction made in October to 4½ per cent for 2011. The growth rates are expected to be more pronounced in the emerging economies and sub-Saharan Africa at 6½ per cent and 5½ per cent respectively, against those of the advanced economies at 2½ per cent in 2011. Accordingly, the rapid growth in emerging and developing economies has narrowed or in some cases closed the *output gaps*¹ in these economies.

Chart 1: Growth in World Output (in Per cent Change)



Source: IMF WEO, January 2011

¹ Output gap is define as the difference between the level of actual output and potential output, usually expressed as a percentage of the level of potential output

Recent empirical IMF reports point to an imbalance path of the global recovery. With emerging and developing countries raising interest rates to attract capital inflows and at the same time managing the inflationary pressure through which to lower the cost at which these countries can borrow. This can be seen as challenging as economies managing the influx of capital at the same controlling for inflationary pressure. This, if not managed carefully may lead to overheating in the economies and another² asset price bubble. While in advanced economies, interest rates have been very low to stimulate investments and economic activities. Furthermore, the Real Effective Exchange Rate (REER)³ in emerging and developing economies continue to be misaligned; leading to excess reserves accumulation and stronger Balance of Payment (BOP) positions.

Current IMF discussions raises concern over the dramatic increase in the size and volatility of capital flows to emerging and developing countries. The interest rate parity condition clarifies key element affecting the portfolio choice of international investors. Typically, with the current period of low interest rates in advanced economies and taking exchange risk through a risk premium, this is expected to accompany by large capital flows into emerging markets as investors search for riskier but better-paying financial assets.

Global inflation risks remain to the downside in 2011 due to robust demand and a sluggish supply response to tightening market conditions, while unemployment in advanced economies remains high. Non-oil commodity prices are expected to increase due to weather related conditions reducing supply, in turn straining the budgets of low-income households and beginning to feed into overall price inflation of economies. However, this should fall back after the crop seasons in 2011.

There are wide-ranging reforms of the international monetary and fiscal systems that are still needed to secure a well-balanced and sustainable recovery, including the utilization of the IMF's Special Drawing Rights (SDRs) to address influx of capital to ways to ensure liquidity in times of extreme volatility and sheer political will to implement what all the G-20 countries have signed on to in the past two years such as reducing the budget deficits, reduce unemployment rate and reforming the financial system by 2015.

DOMESTIC

Real Sector

The domestic economy is estimated to have slowed down in 2010 as a result of unexpected shocks in both the services and the construction sectors. Growth eased across all sectors and the GDP projection for 2010 was revised downward to 2.2 per cent from 3.0 per cent at Budget.

² A similar asset price bubble emerged in Asia around 1997

³ REER is an important determinant of external imbalances

Activity was held up in the agriculture sector, particularly copra and cocoa which took advantage of the high commodity prices abroad. Tourist arrivals to Vanuatu have slowed in 2010 due to improvement in conditions and preferences abroad, particularly in Fiji and in Asia. The recent impacts of the natural disasters striking Vanuatu's main tourist destinations, Australia and New Zealand is likely to hamper tourist arrivals and services but thanks to the latest launching of the new tourism brand campaign which should boost activities in this sector in the near term.

The Consumer Price Index (CPI), an indicator and measure for inflation rose in 2010 by 2.8 per cent on average to level at 135.8 with annual inflation rate reaching 3.4 per cent relative to 2009. The rise in price level was in response to external forces and improved economic conditions abroad driving Vanuatu's import prices higher. Accordingly, it is also a reflection of the monetization of the budget deficit in 2010.

Real economic growth is expected to pick up moderately to 3.0 per cent in 2011 driven by several new major construction projects. However, given imbalances in global growth there are downside risks to the GDP forecast. With unemployment remaining high in advanced economies coincide with political turmoil in oil exporting countries, the misalignment of exchange rates in developing countries and the economy been subject to natural disasters, pose further uncertainties about the recovery of the domestic economy. More importantly inflation risks are to the downside, sourced from abroad and the financing of the budget deficits in 2011; will put further pressure to the path towards a balanced recovery.

Monetary and Financial Sector

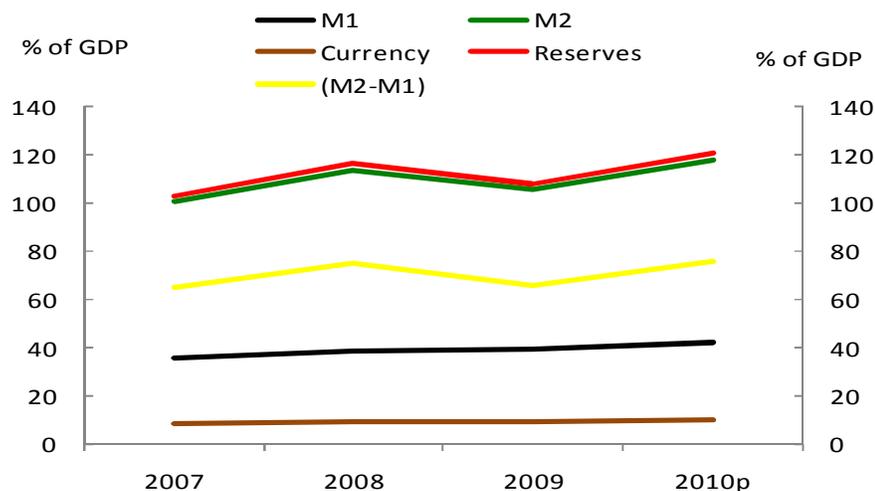
The monetary indicators presented in Chart 2 amply illustrate the extent to which monetary shocks could have a negative impact on the real sector's performance. A number of inferences regarding the domestic economy monetary parameters can be drawn from the data. The monetary base had dominated the money supply and domestic credit during those periods, as indicated by the high ratio of the monetary base to GDP in 2007-2010, compare with the money supply/GDP ratio. The high level of monetary base/GDP ratio is predominantly accounted for by the high level of foreign direct investment (FDI) and official grants, particularly the Millennium Challenge Corporation (MCA), as net foreign assets of commercial banks were remain sound during those periods.

The annual changes in high-powered money (reserves) and money supply is in the range of 6 and 12 per cent. In particular, monetary base money has been volatile throughout the period growing at 13 per cent in 2008 and fell to negative 3 per cent in 2009 and is then projected to rise to around 12 per cent in 2010. The volatility in the monetary base is partially explained by the movement in net foreign assets of commercial banks and the need for a manageable liquidity level in the economy. However, equally relevant has been the MCA grant inception in 2008, the

growing economy and the IMF Special Drawing Rights (SDR) which mitigated liquidity pressures in 2009.

Looking at Chart 2, the ratio of the difference in M2-M1 to GDP is very high owing to the preference in holding interest bearing financial assets with longer maturities. Other indicator ratios M2 and M1 to GDP continue to improve during these periods. The currency component of M2 (currency/M2 ratio) followed a similar pattern, leveling at around 9 per cent every year, pointing to large currency holdings of money compared with holdings in bank accounts⁴. The increase in the ratio of M2/GDP is also due to the increased in the money multiplier and the reserves. It is noticeable that the money multiplier was constant at 98 per cent during the period 2007-2010⁵.

Chart 2: Monetary Indicators (in Per cent of GDP)



Source: Reserve Bank of Vanuatu

External Sector

The current account balance of the economy in Chart 3, with heavy reliance on foreign goods, services, income and grants has shown gradual improvement between 2007 and 2010 and is expected to reach negative 6.0 per cent of GDP in 2010 from a negative 8.0 per cent of GDP recorded in 2007. The improvement is attributed to improve exports, tourist arrivals and services, constructions, financial income and current transfers. Both the financial income and the current

⁴ The ratio of currency to M2 can be estimated by comparing the currency/GDP ratio with the M2/GDP ratio in Chart 2

⁵ The traditional approach to monetary policy has been to assume that the multiplier is constant or at least predictable, so that Central Bank could set reserve money in order to achieve a targeted level of money supply.

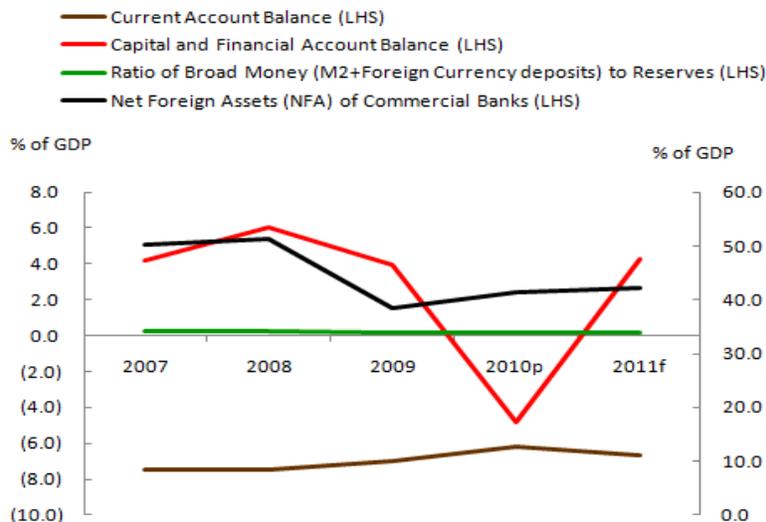
transfers continue to improve in 2010 where as services remain volatile. There are risks that the current account worsen with imports growing (in value) faster than expected to meet domestic demand. Similarly, both the annual growth in total visitors arrival and the current transfers eased to 5 and 1 per cent respectively in 2010 compared with the growth rates registered in 2009 of 21 and 13 per cent, respectively. This has affected the current account balances during these years.

The capital and financial account is expected to grow to about negative 5 per cent of GDP in 2010 after peaking at 6 per cent of GDP in 2008 thanks to improvement in capital transfers (investment grants to build roads, schools or hospitals) and direction sets by the Reserve Bank of Vanuatu (RBV) in maintaining the rediscount rate at 6 per cent which attracted foreign direct investment (FDI). On the other hand, the portfolio investment is showing signs of easing with outward investment growing faster indicating the likelihood of domestic investors acquiring long-lasting and controlling interest in foreign companies or using their fund to create subsidiary in foreign firms⁶. Other investments which comprises of trade credits, bank loans and other non-tradable financial transactions have been volatile but shot up in 2009 owing to the purchase of foreign currency from the IMF (SDR to help cushion liquidity pressure in the domestic economic) and is now a liability of residents. Similarly, other investment liabilities have been growing owing to the liabilities of residents to foreigners, specifically foreign currency liabilities and loans. The foreign currency liability can be treated as an indicator of confidence with foreigners keeping their cash in demand and time deposits in Vanuatu's commercial banks. This is captured in the higher reserves/GDP ratio in Chart 2 during those years.

The ratio of broad money to reserves remained flat at 0.2 per cent of GDP during these years. This ratio indicates the extent to which the Reserve Bank is able to meet the demand for converting highly liquid assets into foreign currency through its reserves as the economy evolves overtime. It may also be an indicator of the Reserve Bank of Vanuatu withstanding speculative attack on its exchange rates. The Net Foreign Assets (NFA) of commercial banks is expected to recover to 40 per cent of GDP in 2010 after only being 38 per cent of GDP in 2009 following a decline in foreign assets. The decline in foreign assets was more pronounced in 2009 as resident investors feared the negative impacts of the global economic crisis. Domestic demand gaining momentum in 2009 and coinciding with the appreciation of the domestic currency against that of its major trading partners, translated into higher imported bills have forced the commercial banks to drawdown on residents' foreign assets which also reduces the commercial banks net foreign assets in 2009. Furthermore, the deterioration of the financial account in 2009 and most probably in 2010 will place further pressure on the NFA of commercial banks.

⁶ The reinvestment of retained earnings in a foreign firm is also an example of outward direct investment.

Chart 3: Indicators of External Vulnerability (in Per cent of GDP)



Source: Reserve Bank of Vanuatu

In a small open economy like Vanuatu, the current account position is closely linked to the level of its real exchange rates. Any movements in the real exchange rates are indicative of shifts in the relative cost of different national output baskets, which may result in changes in the demand of these baskets. More important is the Real Effective Exchange Rates (REER)⁷ which measures the extent to which the purchasing power of the Vatu has changed over the years 2007-2010 relative to a group of major trading countries⁸. As presented in Chart 4, with the appreciation of the REER⁹ between 2007 and 2009, domestic consumers and investors preferred foreign goods relative to domestic goods. So, imports have been rising in volume terms, worsening the trade balances and the current account during those years. There is also a value effect, however. Because of the real appreciation of the Vatu, the value of total imports measures in terms of domestic goods fell between these periods¹⁰, which tends to improve the trade balance and the current account. Given that imports respond strongly to relative price changes, (*having high price elasticity*); the volume effect had been dominating, leading to deterioration in the current account balances during those years.

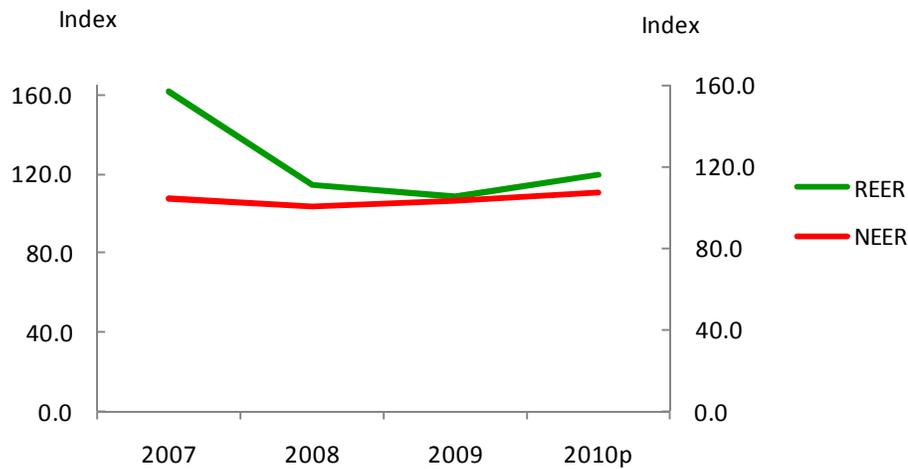
⁷ REER is calculated by deflating each component of the NEER index by the associated measure of relative price or cost movements of major trading partners

⁸ Due to data availability, the trading partners are Australia, New Zealand, Japan and New Caledonia

⁹ Vatu been stronger than currencies of major trading partners

¹⁰ NSO QSI 4 2010: Table 6.8 Total value of ten Selected item column.

Chart 4: Effective Exchange Rates



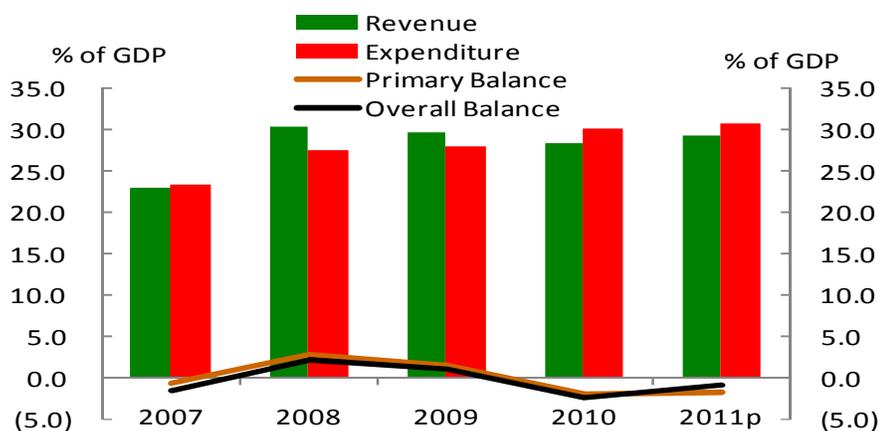
Source: IMF, NSO and Treasury Staff Calculations

The international investment position (IIP) of the economy reflects changes in the country's stocks of foreign assets and liabilities during these periods. Vanuatu being a net importer of goods and services from the rest of the world cannot sustain this forever. The economy's net IIP is a concern for policy makers recording negative 22 per cent of GDP in 2009 and is forecasted to deteriorate further to 24 per cent of GDP in 2010 after only peaking at negative 9 per cent of GDP in 2007. At some point, the economy will be forced to halt the deterioration of its net IIP as the willingness of foreign residents to acquire domestic assets become limited, implying sustained changes in the exchange rates or equally the Reserve Bank of Vanuatu rediscount/policy rate.

Fiscal Sector

During these periods, fiscal developments and policies have played central roles in determining the overall economic developments for the country. Some government policies have directly affected the usage of its economic aggregate resources and the level of aggregate demand.

Chart 5: Primary Balance of the Central Government (in Per cent of GDP)



Source: Department of Finance and Treasury

With economic fundamentals improving, the Government recorded its highest primary surplus as compared to all periods under review in 2008 at 2.8 per cent of GDP after coming low at negative 0.6 per cent of GDP in 2007. This is attributed to much improved performance in all sectors of the economy and the inception of the MCA grant which boosted revenue during that year. We have seen that both the monetary and external indicators improved during this period. On the other hand growth in revenue fell in 2009, reaching 29 per cent of GDP but expenditures were also creeping in at 28 per cent of GDP, posting another primary surplus of 1.7 per cent of GDP. However, the impact of the global economic crisis in 2007-2008 and the changes in the tax administrations in 2010 has affected Vanuatu's economic performances in 2010. The negative impacts weigh heavily on consumption and confidence resulting in lower than expected revenue receipts with public expenditures remained under control and translated to a primary deficit of 1.9 per cent of GDP and similarly a budget deficit of 2.4 per cent of GDP.

Evidently, the primary and budget deficit was financed through printing of paper notes by the RBV. Monetizing this budget deficit and combined with imported food prices have generated inflation during the year reaching 3.4 per cent in 2010 relative to the 2.8 per cent recorded in 2009. Furthermore, given the increasing pressure of fiscal expansions in 2011 albeit non-performing revenues, a budget deficit of significant proportions has to be financed by borrowing from the market; which will affect the private sector¹¹. Importantly, there are signs of inflationary risks in the domestic economy which will affect expectations in the near term and

¹¹ Crowding out of private sector

distorts agents' economic behavior with resource allocations. With both the microeconomic and macroeconomic fundamentals at play, the fiscal development will again be translated into another modest or even slower economic growth in 2011.

Summary

The only recommended advice drawn from this macroeconomic analysis is better fiscal disciplines. Although monetary indicators remain sound, current fundamentals point to further uncertainties about the already fragile paths to economic recovery. A sheer political will for fiscal control is a necessary and sufficient condition for a sound and stronger economic growth.

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