



The Formulation of Monetary Policy in Vanuatu

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The paper first discusses the organizational aspect of formulating monetary policy at the Reserve Bank of Vanuatu. It discusses the key objectives of the Reserve Bank and the policy variable that the Bank uses. It concludes by identifying some constraints and issues in monetary policy formulation.

The responsibility of conducting monetary policy rests with the Reserve Bank of Vanuatu. The power to conduct monetary policy is derived from the Reserve Bank Act. The Act also prescribes on the Reserve Bank a range of central banking responsibilities similar to other central banks in the region.

The Department of Research and Statistics (DRS) of the Bank is responsible for policy formulation. Formulation begins with regular surveillance of key economic variables in the international economy, domestic economic activity, price developments, fiscal policy, monetary developments, exchange rate movements and balance of payments. These variables are assessed in terms of their impact on inflation and international reserves, which are the ultimate policy objectives of the Reserve Bank. Assessments are made to the Policy Coordinating Committee (PCC), comprising of staff of the DRS and chaired by its Director. It meets once a month and its primary role is to provide advice on monetary policy to the Monetary Policy Committee (MPC) of the Reserve Bank.

The Monetary Policy Committee recommends the policy stance to the Board of the Reserve Bank. It comprises the Director of Research and Statistics, the Director of Operations, the head of Financial Markets Unit, the Deputy Governor and the Governor who is also the Chairperson of the Committee. The role of the MPC is to recommend to the Board the monetary policy stance of the Reserve Bank. The MPC meets fortnightly because it is also responsible for determining the level of auctions of Reserve Bank of Vanuatu Notes in the domestic money market.

The Board of the Reserve Bank is the ultimate decision making body. It comprises of four members, namely the Governor, who holds the chair and three other representatives, one of which is a representative of the Ministry of Finance and Economic Management. The Board approves the policy stance of the Reserve Bank. The Board can meet as many times as it considers necessary but not less than four times in one year.

Once the Board decides on a policy the Reserve Bank conveys the stance to the public and the reasons, in the Bank's view, as to why the decision was taken. This view is conveyed through regular meetings between the Governor and the Minister of Finance and Economic Management, the Governor's Quarterly Meeting with the Bankers Association of Vanuatu and through various publications, press releases, and the Reserve Bank website. The press release to the public comes in the form of a Governor's Monetary Policy Statement.

The principal objectives of the Reserve Bank Act, insofar as it relates to the monetary policy, requires the Bank to promote monetary stability and to foster financial conditions conducive to the orderly and balanced economic development.

1. Reserve Bank of Vanuatu Act CAP 125 of 1980

2. This will be called the Accounts and Customer Services Department under the current restructuring.

3. This is being set up in 2005.

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The Reserve Bank views monetary stability at two levels - the maintenance of an adequate level of foreign international reserves, and a low level of inflation. The focus on reserves reflects the importance of maintaining the exchange rate peg of the Vatu. The focus on inflation is triggered by a wide range of empirical evidence that supports the distorting effect of inflation on the decision making process of private agents on investment, savings and production, and ultimately economic growth. In effect this means the Bank's role in promoting growth, as specified by its Act, is best achieved by focussing on inflation that would create the appropriate conditions for growth to take place. The bank has specified 4 months of import cover as a minimum comfort threshold, and the annual rate of inflation of 4 percent and above as undesirable.

The Bank employs several monetary policy instruments but the key one is open market operations. The other instruments include the statutory reserve deposit (SRD) or reserve requirements. This is set at 10 percent of Vatu deposits of the commercial banks. This requirement also applies to 50 percent of demand deposits in foreign currencies. To create flexibility for liquidity management, the commercial banks are required to satisfy the requirement on average maintenance. In the case of a much more severe liquidity need the Reserve Bank operates the rediscount window and repurchase agreement facilities, secured by the commercial bank's holdings of short-term instruments such as the RBV Notes and government bonds. The Reserve Bank's discount rate is the interest charge for this facility. Its use however has been modest due to the high liquidity of commercial banks. The other instrument is the exchange rate policy, which is geared to maintaining a stable Vatu exchange rate. The Vatu is pegged to an undisclosed transactions weighted (trade and tourism receipts) basket of currencies of Vanuatu's major trading partners. The Bank has a foreign exchange guideline in place stipulating that it will only fund current foreign exchange transactions and sets minimum limits to each purchase of foreign exchange.

The principal tool of the Reserve Bank is open market operations, first introduced during the economic reforms of 1998. The decision for its adoption rose from a financial crisis, which required a huge Government bail out of the Vanuatu National Provident Fund to enable it to make payout of member contribution ahead of retirement. The payout led to a sudden increase in money and a sharp decline in international reserves. The need to respond quickly to such as crisis led to the Bank's decision to adopt the framework.

The key policy variable is reserve money, which comprises currency issued and the commercial bank's deposits with the Reserve Bank. These deposits comprise required reserves under the requirements of statutory reserve deposits, and excess reserves. Because there is a strong link between reserve money and broad money, via the money multiplier, the Reserve Bank can control money supply by changing the level of reserves. This relationship is explained by the equation:

$$MS = mRM,$$

Where MS refers to money supply, and m and RM relate to the money multiplier and Reserve money respectively. The money multiplier has been found to be stable in Vanuatu.

From the above, the process of determining the appropriate level of reserve money is a key decision in monetary management. The process starts with the forecasts of the determinants of reserve money carried out by the Department of Research and Statistics. The determinants are net foreign assets, net claims on Government and Other Items (net) and are shown in the Reserve Bank balance sheet as:

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Balance Sheet

Net Foreign Assets	Reserve Money
Net Claims on Government	Currency Issued By Reserve Bank
Other Items Net	Deposits of Banks at the Reserve Bank
	Required Reserve (SRD)
	Excess Reserve (BDD)

The forecasts and the recommendations for issue or buy back are submitted to the Monetary Policy Committee on every second Wednesday. Decisions of the Monetary Policy Committee are then communicated to the Tender Committee for implementation.

In Vanuatu, the key determinant of reserve money is net foreign assets but in the 1990s the contribution of the net credit of the Government has grown in significance. This development reflects declining Government deposits in the banks and increase in its borrowing from the banking system as a result of past fiscal deficits.

A key component of reserve money that the Reserve Bank targets is excess reserves or banks' demand deposits (BDD) at the Reserve Bank above the minimum that commercial banks feel is necessary to undertake inter-bank transactions and satisfy daily customer withdrawals. By allowing excess reserves to rise above the minimum signals a loosening of policy and its reduction below the minimum implies a tightening bias. The transmission mechanism works through the cost of capital effects or short-term interest rates. This was evident in 1998 when the Reserve Bank defended the exchange rate peg with a large hike in interest rate as a result of which interest rate of commercial banks were also increased. Transmission can also work through the wealth effect, the exchange rate effect and issues to do with the credibility of the Reserve Bank. The Bank has also started daily liquidity forecasting that should further fine-tune the items that contribute to, or destroy liquidity. This will be taken up more fully by the setting up of the Financial Markets unit in 2005.

The forecast of the above items include fiscal operations, which requires some form of policy coordination between the Reserve Bank and the Ministry of Finance and Economic Management (MFEM). At the technical level this takes the form of the Cash Flow Committee, which is comprised of officials of the MFEM and the Reserve Bank. The Cash Flow Committee meets monthly and is chaired by officials of the Ministry of Finance. Information from the Cash Flow Committee is fed into the forecast of net credit position of the Government in the reserve money program of the Reserve Bank.

It is generally believed that monetary policy is ineffective in output determination in small open economies with fixed exchange rates. Any monetary dis-equilibrium leads to capital outflow rather than a change in prices or output even in the face of capital controls. Further, that capital flows will not respond to small changes in interest rates that does not compensate for the costs of foreign exchange transactions. In the experience of countries where monetary policy is based on some form of money market intervention like in Vanuatu, the International Monetary Fund has identified key conditions for effective monetary policy formulation. These include stable macroeconomic environment and sound fiscal policies; sound and competitive financial system and adequate supervisory oversight; and sufficient degree of institutional autonomy and operational capacity at the central bank.

4. In addition to the Macroeconomic Committee

5. *Monetary Policy Implementation at different stages of market development*, Staff of the Monetary and Financial Systems Department, IMF, Washington DC, 2004, p6.

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In Vanuatu the primary role of monetary policy is to maintain the exchange rate peg. The challenges associated with this are diverse. For some time macroeconomic stability has been maintained, thanks to a cautious approach to economic management. But the financing of fiscal operations, including at times for state-owned enterprises (VCMB) have hampered the effectiveness of money market operations through liquidity creation and reliance on Reserve Bank notes rather than government paper. The cost of undertaking open market operations is therefore borne by the Reserve Bank rather than directly by the Government. As it can be considerable in a small central bank, it requires close monitoring of the Reserve Bank's balance sheet. The primary money market is shallow and is mostly limited to three commercial banks with yet no secondary market. As the banks maintain high liquidity it severely affects interest rate transmission mechanisms. Further, the emergence of other non-bank financial institutions like the Vanuatu National Provident Fund has tended to distort the money market because of its sizeable deposits in the banks and its role as the main captive market for government bonds. In terms of institutional set-up the Bank has fairly operated independently⁶. The domestic payment system has also operated fairly efficiently and the Bank is thinking of fully automating its accounts and putting in place a financial markets unit for monetary policy implementation as well an audit unit. However, as the regime of indirect monetary control is fairly new, there is need to continue to build capacity at the level of formulation of policy. The Bank has an adequate supervisory oversight of the financial system and needs to continually monitor large non-performing loans that can potentially have an impact on liquidity of commercial banks. Finally, credibility of the central bank is critical when monetary management is aimed at defending an exchange rate peg and this can potentially be complicated when there are issues of sovereign risk involved.

6. The Reserve Bank Act states that the value of the Vatu in terms of other currencies is determined by the RBV in accordance with written instructions from the Minister of Finance. The Government has a representative in the RBV Board of Directors.