

25 Years of Monetary Policy Development

By Michael Hililan - Director of Research & Statistics & Chief Economist

1. FORWARD

The Reserve Bank of Vanuatu (RBV) is responsible for the formulation of monetary policy in Vanuatu. The power to conduct monetary policy is derived from the Reserve Bank Act (Reserve Bank of Vanuatu Act CAP 125 of 1980, Laws of the Government of the Republic of Vanuatu)

Central banks pursue certain objectives in monetary policy. A typical objective for developed economies is low inflation. Others such as the United States ascribe more importance to output and employment. In the case of open economies like Vanuatu with fixed exchange rates, a key objective is to maintain an adequate level of international reserves with which to anchor the exchange rate and therefore domestic price levels.

This paper looks at the evolution of monetary policy in Vanuatu since the Bank's inception in 1980. It categorizes two distinct periods of policy development - one where policy, using crude policy instruments, was passive; and the other where policy became more proactive, using market-oriented intervention. This change mirrored the changing trend in development theory which became centred on neo-liberal values of free markets (Todaro, M & Smith, S, Economic Development (8th Edition), Addison-Wesley, London, Toronto, etc, p110).

This paper provides an outline of how policy developed and discusses some of the monetary policy challenges in Vanuatu. The remainder of the paper is arranged as follows: section 2 and 3 provide a background of monetary policy development and how the country laid the ground work from which monetary policy would take place. Section 4 and 5 explores how monetary policy evolved from direct to indirect instruments of control and section 6 provides some of the issues and monetary policy challenges in Vanuatu.

2. BACKGROUND

Today, the Reserve Bank of Vanuatu (RBV) has a mix of direct and indirect policy instruments but relies largely on market-oriented policy intervention to achieve its objectives. It has experienced different phases of policy development. In line with the trend in development theory over the last two decades and following the trend initiated in the industrial countries in the 1970s, monetary management in Vanuatu began to shift to indirect market based instruments in 1998.

The change involved a need to respond to the 1998 financial shock, as the statutory reserve instrument at the Bank's disposal did not allow for a speedy response to contain the crisis. It followed a decision by the government to finance the Vanuatu National Provident Fund (VNPf) pay-out of member funds ahead of retirement. The pay-out led to a deterioration in the fiscal position, a surge in liquidity, and loss of confidence that gave rise to a large capital outflow and the depletion of the country's international reserves. The need to finance the pay-out without loss of monetary control was a key consideration in the adoption of a new framework.

The monetary policy regime prior to 1998 relied primarily on crude instruments that were based on the regulatory power of the Reserve Bank.

25 Years of Monetary Policy Development

3. LAYING THE GROUND WORK FOR MONETARY POLICY

The law establishing the Reserve Bank was enacted by Parliament in December 1980 and the Bank began operations from January 1981. For the first time the country had its own central bank that had powers to issue currency, determine the value and convertibility of its currency, deal with the financial institutions and the Government and conduct monetary policy.

The functions of currency issue were taken over from the Institut d'Emission d'Outre-Mer (French Treasury) prior to independence under which the prevailing arrangement was tantamount to a kind of currency board rather than a fully fledged central bank (20 Years of Central Banking in Vanuatu, Reserve Bank of Vanuatu, Port Vila, 2000, p35).

The Bank's role from the time of inception to around the mid-80s revolved primarily around currency issue promulgated by a Monetary Reform Statement issued by the Minister of Finance in December 1980 (*ibid.*, p 60). Under the phases of the monetary reform, new Vatu notes were issued into circulation in the first half of 1982 to replace the Australian dollar and the New Hebrides Franc (FNH), which circulated as legal tender at independence. The Bank issued its new Vatu coins to replace the FNH coins in the second half of 1983.

When the country, via the above monetary reform, adopted a fixed exchange rate regime, it basically set the framework under which monetary policy was to be conducted. It meant that the Reserve Bank has to vary monetary policy in such a way as to maintain the fixed (pegged) exchange rate. Under such a framework, what a central bank does is alter the domestic financial conditions - through the domestic level of interest rates - to be consistent with the exchange rate peg.

The construction of data on monetary aggregates and the monetary base began in 1981 and appeared in the Bank's Annual Reports in 1983 (RBV Annual Report and Statement of Accounts for 1983, The Reserve Bank of Vanuatu, Port Vila). The monetary data included different measures of money and in addition to the availability of statistics on consumer price levels, fiscal operations and balance of payments, were adequate both for purposes of surveillance and conducting monetary policy.

4. THE PERIOD OF MONETARY POLICY WITH REGULATORY CONTROL

The development of monetary policy began from early to mid-1980s using direct instruments that were based on the regulatory powers of the Reserve Bank. The principal instruments were direct lending from the central bank and guidelines on direction of lending and interest rates. In 1988, an indirect but equally crude instrument -- the statutory reserve deposit - was adopted by the Reserve Bank.

4-1. Direct Credit and Interest Rate Controls

In 1982 and 1983 the Reserve Bank issued guidelines on the direction and cost of lending (interest rate ceilings) to 'productive sectors' to introduce 'priority in banks' lending to the productive sectors and for development purposes' (*ibid.*, p18). The guidelines were administered on an informal basis and enforced primarily through moral suasion.

25 Years of Monetary Policy Development

The guidelines were:

- (i) "rates (a) in respect of lending to the productive sectors - agriculture, manufacturing and processing, including infrastructure in support of production, (b) for the financing of import-saving and export promotion projects, and (c) for the financing of tourist-oriented projects, should be in the range of 12-14% per annum except in very exceptional circumstances (e.g., unarranged overdrafts)
- (ii) The banks consider favorably the credit needs of small-size businesses and local enterprises and ventures in which there is Ni-Vanuatu participation
- (iii) Each banks' average (weighted) lending rate should not exceed 14% per annum;
- (iv) Each bank's spread between the average of its fixed deposit rates for 1-12 months and its average (weighted) lending rates should not exceed 4.5 percentage points
- (v) Growth in personal lending be restrained in order to allow for some increase in lending for the purpose set in (i) and (ii) above and to slow the growth of consumer imports" (Annual report and Statement of Accounts 1983, Reserve Bank of Vanuatu, p18).

At the start the guidelines produced certain beneficial effects which were discernible from the growth in Vatu lending to the major productive sectors in 1984 (Annual Report and Statement of Accounts for 1984, Reserve bank of Vanuatu, Port Vila, p21). However, they were abandoned after 1986 from concerns over non-performing loans and the distortions that they created. In retrospect, the concerns about non-performing loans could have been addressed through appropriate supervisory oversight but the authority to undertake supervision was only added in an amendment to the RBV Act in 1989 and effective supervision only began in 1996.

4-2. Standing Facilities

In 1985 the Port Vila Clearing House at the Reserve Bank of Vanuatu became operational to oversee clearing operations and paved the way for the RBV to act as account holders for the Government and financial institutions and banker, depository and fiscal agent of the Government in accordance with the Act of the Reserve Bank. This enabled the RBV to provide the lender of resort facility secured by 75 percent of the nominal value of holdings of Government bonds at an interest charge determined by the Reserve Bank of Vanuatu.

The facilities through which the Reserve Bank provides lending are considered part of the monetary policy instrument of any central bank through the cost and volume of credit available within the facility. They are called the discount window through which lender-of-last-resort functions are undertaken after commercial banks have exhausted the inter-bank market.

The Bank made notable changes to the facility when it adopted market-based intervention in 1998. The secured lending was changed to the Rediscount Window and the Repurchase Agreement facilities. Instead of outright credit extension the Reserve Bank can either rediscount or repurchase any RBV security (RBV notes) and short-term Government security of one year maturity and less. The RBV also adopted the Reserve Bank's benchmark rate as the discount rate for the facility.

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

25 Years of Monetary Policy Development

The effectiveness of lender-of-last-resort in Vanuatu has been limited by the large buffer of excess liquidity commercial banks maintain. In the past, it was utilized largely by a commercial bank with a (then) weak balance sheet which had prevented it from inter-bank borrowing.

4-3. Statutory Reserve Deposits (Reserve requirements)

An SRD requires commercial banks to hold a certain proportion of their asset in deposits at the Reserve Bank in order to control money growth. Central banks normally aim to vary the SRD between business cycles but it has essentially been at a fixed level in Vanuatu.

The Reserve Bank first issued the statutory reserve deposit (SRD) in 1988 which applied to 10 percent of commercial banks Vatu deposits. A number of transformations have been added since.

Initially the SRD's were partly remunerated as banks satisfied part of the requirement through holdings of Government bonds at an administered rate of 1.5 percent. These bonds were continuously rolled-over and kept separate from other Government accounts at the Reserve Bank. The arrangement ended in 1998 when SRDs were temporarily abolished to pave the way for a large Government financing of the Vanuatu National Provident Fund. The financing was through a 16 percent Prescribe Reserve Assets (PRA). The PRA required commercial banks to hold a proportion of their assets in Government securities (essentially 10-year bonds) and which then financed the payment of member funds at the VNPF ahead of retirement².

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

The SRD was reintroduced at 6 percent in November 1998. To make way for its re-introduction, the PRA was reduced to 10 percent. In March 1999 the SRD was increased to 10 percent and was extended to 50 percent of demand deposits in foreign currencies. To create flexibility, the banks were required to maintain SRD on average holdings. At the same time the PRA was replaced by Liquid Asset Ratio at 15 percent as a prudential instrument following the Bank's establishment of a Banking Supervision Unit in 1996. The LAR allowed for a broader base of unencumbered liquid assets to be held by commercial banks including notes and coins, balances with the RBV (other than SRDs), Reserve Bank of Vanuatu notes, and central government securities against Vatu liabilities (less the bank's capital bases and overnight settlement balances).

The Reserve Bank does not remunerate the SRD and the commercial banks cited it a factor in high interest margins in Vanuatu. This connection is true if the banks are competitive. A recent study by the Reserve Bank revealed that the most important single factor contributing to high lending rates in Vanuatu is country risk.

The Reserve Bank is currently at a juncture where it has to decide whether to fully embrace indirect instruments and do away with crude instruments like the SRD. If the Reserve Bank wishes to advance fully to a purely indirect system of monetary control it would have to consider eliminating the SRD.

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

25 Years of Monetary Policy Development

5. THE PERIOD OF MARKET-ORIENTED INDIRECT MONETARY CONTROL

Market-oriented indirect control, or open market-type operations, involves the buying or selling of bonds, bills and other financial instruments in the open market that leads to the expansion or contraction in the amount of reserves in the banking system and can ultimately influence the country's money supply (see the article on 'How Monetary Policy is Conducted in Vanuatu').

According to the International Monetary Fund (IMF) 'open market operations are the major instruments of monetary control in industrial countries and are becoming important to developing countries and countries in transition. (They) allow central banks great flexibility in the timing and volume of monetary operations, encourage an impersonal and business like relationships with participants in the marketplace, and provide a means of avoiding the inefficiencies of direct controls' (Transformation to Open Market Operations, S Axilrod, The International Monetary Fund, Washington DC, 1996, p1).

Vanuatu commenced the transition to market oriented policies in early 1998 following the Vanuatu National Provident Fund (VNPF) financial crisis. A key factor in the decision to move to open-market type operations arose from the draw-back in using reserve requirements (SRDs) to contain the sudden rise in liquidity and outflow of capital associated with the early retirement of member funds held by the Fund. In Vanuatu, the SRD holdings by banks for the proceeding month are calculated from the average deposit of commercial banks from the previous two months. In effect the SRD requirements have a lag of about a month which, in the circumstances of that time, was considered too long to contain a sudden capital outflow. At its inception, very little was known about open market operations and there was no experience in discretionary monetary policy interventions.

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

Due to issues of sovereign risk, the commercial banks indicate preference for securities of 91-day maturity or less but have recently been active in the 119-day instruments. The 119-day and 182 day instruments were not that successful when they were first tendered in 2002. Expanding the market to non-bank participants should increase the range of maturities of RBV notes and provide a broader indication of short-term market interest rates. The VNPF has indicated a preference for long-term assets that probably best matches its liabilities. Within the commercial banks, it appear there is a high preference for 63 and 14-day instruments.

The primary market is currently limited to three banks and underscores the shallowness of the market. The total assets of banks of VT51, 595 million in March 2005 have been growing steadily from the early 1990s and at an average growth rate of 5.8 percent over the last 24 years.

25 Years of Monetary Policy Development

The RBV now offers competitive and non-competitive bids in fortnightly auctions. The average number of bids per auction ranged from 11 to 16 a month in early 2004. Non-competitive bids are offered with a maximum of VT 1 million to any bidder and the coupon is the weighted average of successful competitive bids although the Reserve Bank has discretion to consider lower priced bids. The minimum bid size of VT 1 million appears to be low enough to attract other participants including the Vanuatu National Provident Fund which has a large pool of funds and others that may have sufficient funds available. This should encourage a more competitive bidding system and help further develop the financial markets. But given the lack of investment knowledge and understanding of the tender process among potential non-bank participants the Reserve Bank needs to explain the tender procedures to the public regularly.

The Reserve Bank has established registration and auction procedures. It has now done away with manual registration which required issuing of certificates to successful bidders. With the assistance of the IMF, the Bank fully automated the registration process to book entry in 2005. The RBV securities are transferable, negotiable, and discountable.

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

The stock of high quality RBV (and Government) paper has allowed for secured lending transactions. But substituting interest bearing securities for non-interest bearing cash reserves of banks have implications for central bank profitability. This calls for a sound balance sheet of the Reserve Bank. For example, the interest cost of RBV notes constituted around 6 percent of the total income of the RBV in 2004 and 4 percent in 2003. To assist in budget monitoring, the RBV intends to fully automate its accounting system and establish an internal audit as early as 2006.

Due to the thinness of the market the secondary markets does not exist and the inter-bank market is modest with occasional over-night advances at a fixed rate of interest below the discount rate of the Reserve Bank. Maintaining bank liquidity at a minimum target should help foster inter-bank transactions in out-right, repurchase and swap transactions.

The Reserve Bank developed a framework of forecasting reserve money in 1998 using the IMF monetary management techniques. A Cash flow Committee comprising of the Department of Finance and the RBV representative (chaired by Department of Finance) meets monthly to discuss fiscal cash flow which is fed to the reserve money program of the Reserve Bank.

The transmission mechanism in Vanuatu is limited by a large liquidity overhang among commercial banks. The financial market is not yet fully developed which means market signals are unable to work properly. A substantial part of the current liquidity overhang was created by fiscal operations through 10-year bond issues for the VNPF that will mature in 2008. The other factor that contributes to high excess liquidity is what banks have argued as an absence of projects that they consider bankable. It has been observed that movement of excess liquidity usually affects commercial bank's deposits rates in the first instance. Movements in the commercial banks lending rates are more a function of how banks structure their credit risk. However, large movements in official short-term interest rates do have an impact on lending rates of commercial banks as evident by the large rate hike by the Reserve Bank from 5.97 to 10.97 percent in 1998 which led to a corresponding increase in the banks lending rates.

25 Years of Monetary Policy Development

6. POLICY CHALLENGES

The Reserve Bank currently employs a mixture of direct and indirect instruments and is at a juncture where it will decide whether to continue the path to fully indirect monetary management or retain the current mix.

The four main policy instruments, that is the rediscount/repurchase facility (interest on overnight lending facility), the statutory reserve deposit (reserve requirements) open market operations and exchange rate policy have been used to varying degrees of success.

The effectiveness of the rediscount window is limited by the large excess liquidity (cash balances) of commercial banks. The SRD is a blunt instrument that has not been actively utilized to counter changing economic or monetary conditions.

6-1. Should the Bank do away with the Statutory Reserve Requirement?

The SRD is a blunt instrument that can affect market interest margins and can therefore work against what the Reserve Bank is trying to achieve. In a study undertaken by staff of the Reserve Bank, it was concluded that 'banks factor the SRD in their interest rate calculation' (Interest Rate Study For Vanuatu, P. Arubilake, S. Welegtabit, B. Karae, Port Vila, 2004. p19) but at the same time banks also maintain large non-interest bearing excess reserves.

As noted earlier, substituting non-interest SRD holdings for interest-bearing RBV securities associated with open market operations have implications for Reserve Bank profitability. Staff of the Reserve Bank have determined that a suitable level of excess liquidity among banks amounts to around VT500 million. In early September 2005, excess and required (SRD) reserves amounted to VT762 million and VT1842 million respectively. If the Reserve Bank decides to rescind the SRD it would need to mop up excess reserves of VT2, 606 million, which at an interest rate of 2.5%, would imply cost of well over Vt50 million, against a profit of VT30.8 million in 2004.

Studies by the IMF notes that reserve requirements can serve as either an alternative to open market operations or as a way of enhancing their effectiveness for monetary control purposes, but there are now less recourse to reserve requirements (SRDs) as a tool by central banks and as a result they have been lowered in many countries, or eliminated in some cases. The experience of countries like the United Kingdom suggest that they are not really needed, although in the case of Mexico, which also abolished them, there were questions whether they have played a useful role in the financial crisis of 1994, especially in giving unambiguous, quick and strong signal to the market (Transformation to Open Market Operations, S Axilrod, The International Monetary Fund, Washington DC, 1996, p4).

6-2. Liquidity Overhang

The issue of liquidity overhang is prevalent in Pacific island economies. In Vanuatu it has been persistently over what the Reserve Bank has identified as the minimum comfort level.

25 Years of Monetary Policy Development

The important determinants of money in Vanuatu are net foreign assets and net credit to the Government (the excess of government advances over its deposits in the domestic banking system). Because of absence of short-term capital flows⁴, balance of payments flows have been driven largely by services receipts (tourism) and current transfers (donor grants) that essentially balance the usual trade deficit whilst the capital and financial accounts largely reflect concessionary borrowing and offshore deposits⁵.

Under the above setting, a key determinant of the supply of funds in the domestic financial market is fiscal operations. Particularly since the 1990s, fiscal operations have operated on an overall imbalance. Most of the current liquidity overhang date back to 1998 when the Government issued 10-year bonds to finance the VNPf member funds pay-out.

On the flip side, the demand for funds has been driven by what banks consider as credit-worthy bankable projects. The growth of private sector credit average about 7.6 against 11.7 percent in money growth over the last twenty-three years to 2004.

6-3 The Exchange Rate Policy

Flows through the balance of payment are key determinants of money in Vanuatu. Because of the fixed (pegged) exchange rate regime, the role of the central bank is that of clearing the market for the supply and demand of foreign exchange, by buying and selling whatever that the market does not clear. This activity subtracts from or adds to money supply. Under situations of large inflows, central banks undertake 'sterilization', by mopping up the large inflows to prevent a destabilizing growth of money

The role of clearing the foreign exchange market or acting as a residual player in that market cannot be effectively carried out by the Reserve Bank of Vanuatu with its small balance sheet. In the 1980s excess demand was addressed through lowering the price of foreign exchange (devaluation) and over supply was addressed through lifting its price (revaluation). This policy was reversed in 1998 when the Reserve Bank tried to devalue the Vatu in the face of a large capital outflow⁶. In its place the Reserve Bank put up guidelines that set the level of foreign exchange request from the Reserve Bank at a high minimum level.

The guideline has contributed to build up of foreign international reserves from below 3 months of import cover in 1998 to around 6 in September 2005. But the controls have also contributed to distortions in the foreign exchange market, as seen in the widening of the buy and sell exchange rate margin of commercial banks and the development of alternative foreign exchange arrangement between exporters and importers.

4. Due to relative undeveloped capital markets

5. Vanuatu operates a finance centre that dates back to the early 1970s.

6. Instead the Government undertook a large external debt for which repayment will begin in 2008 that filled the gap in the foreign exchange market. The Reserve Bank itself undertook a large interest rate increase in defense of the Vatu exchange rate.

25 Years of Monetary Policy Development

6-4. Developing the Secondary Market

An aspect of small economies with thin and undeveloped financial markets is the absence of secondary markets. This is a feature of the economy that is given and the Reserve Bank will need to pursue ways in which it can try and induce the functioning of a secondary market in future.

6-5. Capacity and Further Institutional Strengthening

The Reserve Bank continues to further develop capacity and undertake institutional strengthening. In 2005 it established the Financial Markets Department responsible for domestic market operations, foreign reserve and exchange rate management, managing the auction and open market operations, and daily liquidity forecasting. The unit of foreign reserve management has been separated into a 'back-office' and a 'front-office'. The RBV has asked the IMF to look at the domestic payment system and suggest ways in which it can be improved.

The regime of indirect monetary control is fairly new and there is need to continue to build analytical capacity especially at the level of policy formulation.