

Official Reserves Policy

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One of the main tasks of the Reserve Bank is promoting monetary stability, or in more common language, price stability. In order to achieve price stability the Reserve Bank conducts monetary and exchange rate policy. Closely connected with these policies is the target of keeping official reserves at adequate levels.

In this article, I will describe and analyze the developments of official reserves since early 1998. It will be shown that the developments are (not surprisingly) largely affected by demand for and supply of foreign exchange. However, the demand and supply factors are ever more subject to structural changes as a result of policy measures taken by the Government and the Reserve Bank. This led to a situation in which the role of the Reserve Bank in the foreign exchange market gradually decreased, while that of commercial banks increased proportionally. Despite the changed conditions in the foreign exchange market, the Reserve Bank's policy remains aimed at keeping official reserves at adequate levels.

Monetary and exchange rate policy and adequate levels for official reserves

One of the principle tasks of the Reserve Bank is 'to promote monetary stability'. Monetary stability can be translated in price stability. In order to achieve price stability the Reserve Bank conducts monetary policy and exchange rate policy.

Through its monetary policy the Reserve Bank tries to maintain the growth of the money supply within certain levels, i.e. levels that correspond with price stability. Too much money in circulation may cause the demand for goods and services to increase - money represents purchasing power - beyond the availability of the required goods and services, as a result of which prices may increase (inflation). Higher prices will lead to a deterioration of Vanuatu's competitive position and thus have a negative impact on exports, production and employment. Too little money in circulation could lead to declining prices (deflation). Lower prices will also disrupt the economic process. Exactly these disruptive effects explain why the Reserve Bank closely monitors the growth of the money supply. Through conducting monetary policy the Reserve Bank creates the conditions for balanced economic growth. Elsewhere in this book it is explained how the Reserve Bank conducted monetary policy in recent years and whether this policy was effective.

Through its exchange rate policy the Reserve Bank attempts to stabilize the exchange rate of the Vatu and thus the extent through which exchange rates contribute to changes in the general price level. If the exchange rate of the Vatu increases (strengthens) - the Vatu becomes more expensive compared to other currencies - then the prices of Vanuatu's exported goods will increase, which then will lead to lower production of the goods concerned and higher unemployment. On the contrary, if the exchange rate of the Vatu declines (weakens), prices of exported goods may decrease, which may positively affect production and employment. However, a side effect of a weaker currency is that prices for imported goods increase which then will add to the general price level. In order to stabilize the exchange rate of the Vatu, the Reserve Bank pursues a policy of linking the Vatu to an undisclosed transaction weighted (trade and tourism receipts) basket of currencies of Vanuatu's major trading partners. The composition and weights of the currencies in the basket are reviewed annually.

Closely connected with monetary and exchange rate policy is the external target of maintaining official reserves at adequate levels. Vanuatu has a small and open economy. The economy is too small to produce all the goods and services it needs.

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Therefore, it has to import a large part of the necessary goods and services from abroad. In order to pay for these imports the country needs foreign exchange (US dollars and other currencies which are used in international trade). The foreign exchange that a country officially has in stock to pay for imports and other transactions are called official reserves. In Vanuatu the Reserve Bank is the official caretaker of these reserves. Through its policy the Bank makes sure that the stock of foreign exchange is large enough to meet all obligations in foreign currency during a certain period. This is a necessary prerequisite for an undisturbed and healthy economic development. If the reserves are too small or if certain developments cause the reserves to decline quickly (for example political instability may result in capital flight) then this may have an undesirable effect on the exchange rate of the Vatu. Pressure on the exchange rate may lead to an increase of the demand for foreign currency, as a result of which the reserves may decline further. It is obvious that these developments do not support a sound and balanced economic development. Against this background, the Reserve Bank ensures that the reserves remain at adequate levels. Adequate levels are defined as reserves that ideally amount to (at least) 6 months of import cover i.e. the stock of reserves should pay for imports for a period of at least 6 months. However, the Reserve Bank is very much aware that it is difficult to meet this target (as has been shown in practice). Therefore, the Bank allows the reserves to amount to less than 6 months of imports, but on several occasions it has made clear that under no circumstances would it accept the reserves to drop below the 'critical level' of 4 months of imports. The next section will deal with the development of official reserves in recent years, the factors affecting the demand for and supply of foreign currency and the measures taken by the Reserve Bank to keep the reserves at satisfying levels.

Development official reserves

Graph 1 shows the development of official reserves in terms of months of import cover. The graph covers the period 1998-2004. The financial crisis in early 1998 has been taken as the starting point of the analyses. The main reason is that the financial crisis marked a turning point for the Reserve Bank. Prior to 1998 monetary management was long underdeveloped and only as a result of the financial crisis did the Reserve Bank realize that it had to play a more active role. It was also forced to do so because in the aftermath of the crisis official reserves declined significantly (the payout of the savings to members of the VNPF resulted in high imports for which the Reserve Bank provided the foreign exchange); in the second quarter of the year official reserves fell dangerously to close to 3 months of import cover. Partly as a result of these developments pressure on the exchange rate of the Vatu mounted. The Reserve Bank reacted, among other things, by introducing regulations on the sale of foreign exchange (the regulations on foreign exchange sales will be discussed later in this article) and increasing the base lending rate by 5 percentage points to around 11 percent. Both measures led to restored monetary and financial stability and a restored confidence in the Vatu. This was reflected in an increase of the official reserves to more than 6 months of imports at the end of 1998. Since then the reserves moved between 4 and 6 months of import cover. In particular during the first years after the financial crisis, periods of declining official reserves were often sparked by (renewed) rumors of a possible devaluation of the Vatu².

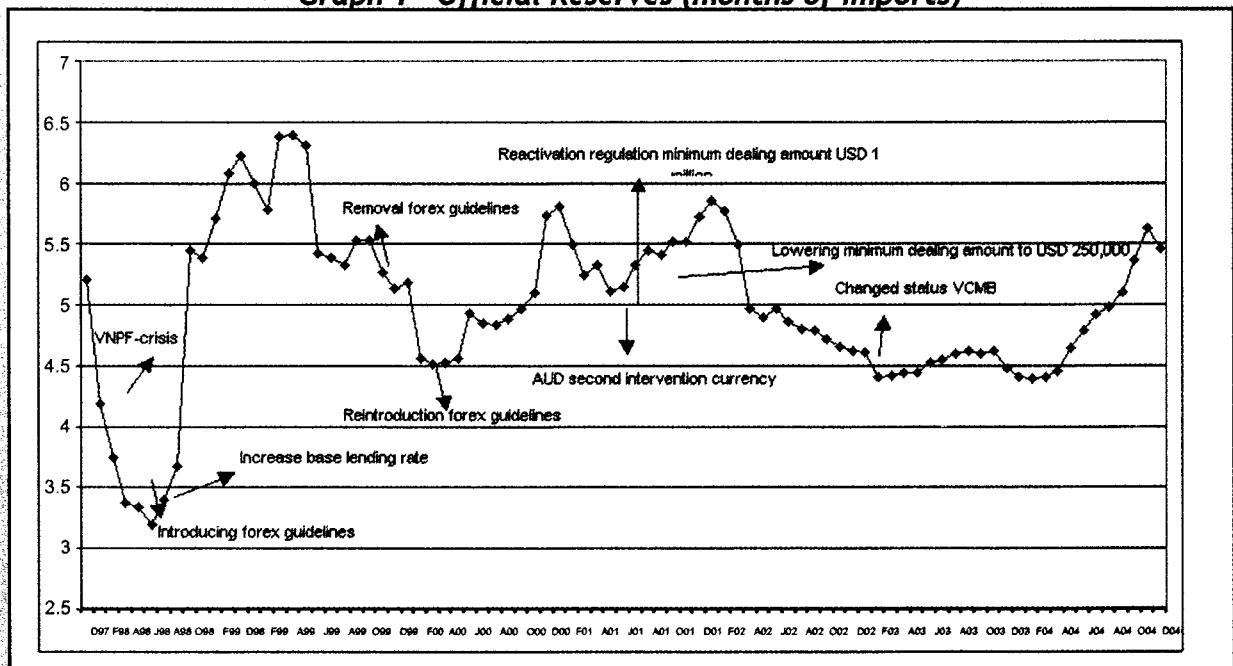
1. In January 1998 a financial crisis erupted in Vanuatu. Because of inadequate and inexperienced management, the financial position of the Vanuatu National Provident Fund (VNPF) deteriorated markedly. Riots in the streets of Port Vila followed. The Government then decided to permit member of the VNPF to withdraw retirement savings.

2. Rumours of a possible devaluation found their origin in the devaluation by 20 percent of the Vatu on 27 March 1998. The devaluation followed outflow of liquidity though the balance of payments as a result of the Government's decision to allow members of the VNPF to withdraw their retirement savings and decisions in neighbouring countries Fiji and the Solomon Islands to devalue their currencies by 20 percent. However, the Government disagreed with the devaluation and revoked the decision on 30 March.

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However, over the years these rumors gradually diminished and ultimately evaporated mainly as a result of the Reserve Bank's firm and consistent monetary and exchange rate policy. It regularly emphasized publicly that economic, monetary and exchange rate developments did not justify changes in the exchange rate of the Vatu and that the policies would be aimed unchanged at avoiding exchange rate adjustments.

Graph 1 - Official Reserves (months of imports)



Supply and demand of foreign exchange has been subject to structural changes. Changes on the supply side are often the result of Government decisions to liberalize trade (exports). Changes on the demand side are the result of measures taken by the Reserve Bank in the field of monetary and exchange rate policy.

Supply of foreign exchange

Since the establishment of the Reserve Bank in 1980, the main sources of foreign exchange were export proceeds surrendered by Vanuatu Commodities Marketing Board (VCMB) and (official) loan proceeds. VCMB coordinated the exports of Vanuatu's main export products, namely copra, cocoa and kava (prescribed commodities). The export proceeds were directly sold to the Reserve Bank. For this reason VCMB had an account with the Reserve Bank.

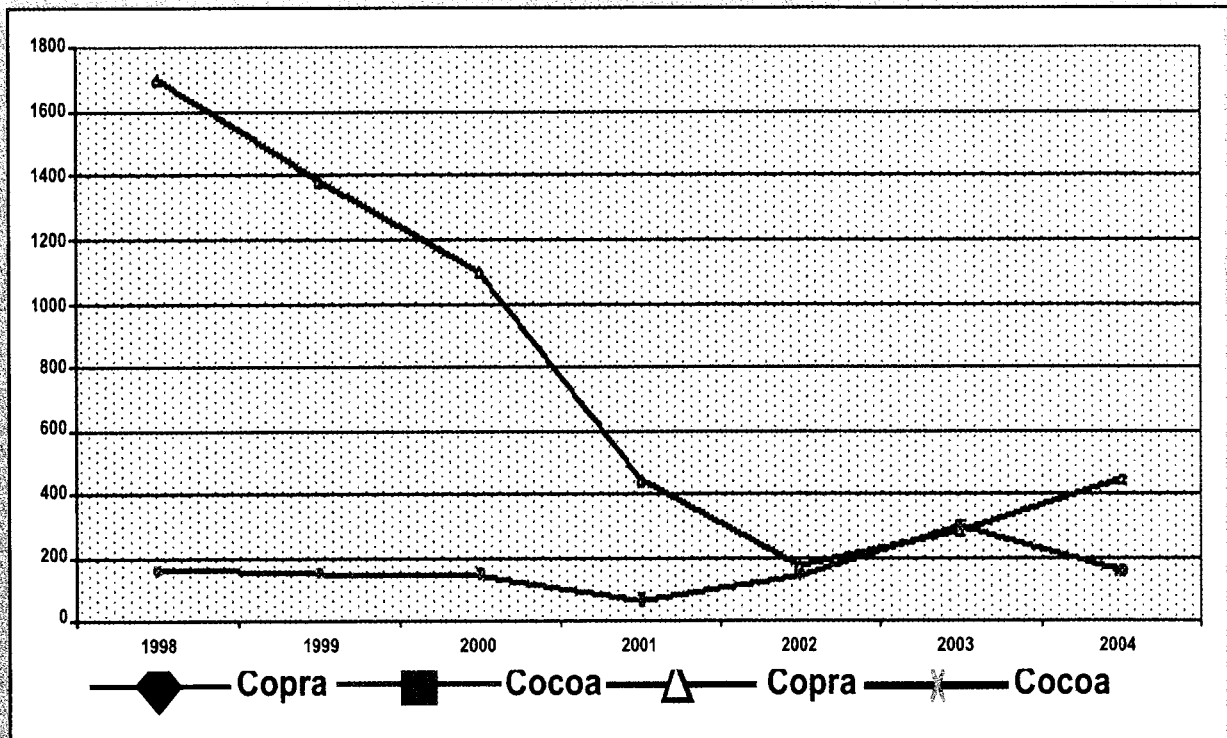
However, in 1998 kava became a free tradable good; private companies were allowed to export the commodity and sell the export proceeds to commercial banks. Consequently, export revenue from kava no longer contributed to the official reserves.

In 1998/99 world market prices for copra and cocoa were relatively high. Since then prices of in particular copra declined significantly. Due to declining prices, production of these commodities decreased (graph 2). Export revenue and thus the sales of foreign exchange by VCMB to the Reserve Bank were seriously negatively affected (price and volume effect). Moreover, in late 1999 in Santo a new facility for the production of coconut oil, Coconut Oil Production Vanuatu (COPV), started operating. Much of the production of copra was delivered directly by farmers to the new oil mill. At some stage VCMB also provided COPV with large quantities of copra. These developments resulted in ever lower exports of copra through VCMB and thus increasingly lower supply of foreign exchange to the Reserve Bank.

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In fact, coconut oil was not a prescribed commodity, which means that the export proceeds could be sold by COPV to commercial banks. In order to ensure that at least part of the revenue from commodity exports would flow in the direction of the Reserve Bank, the Bank agreed with COPV that it would sell the export proceeds directly to it. However, only very few sales of foreign exchange resulting from exports of coconut oil materialized. Technical and administrative problems caused the agreement to fall through.

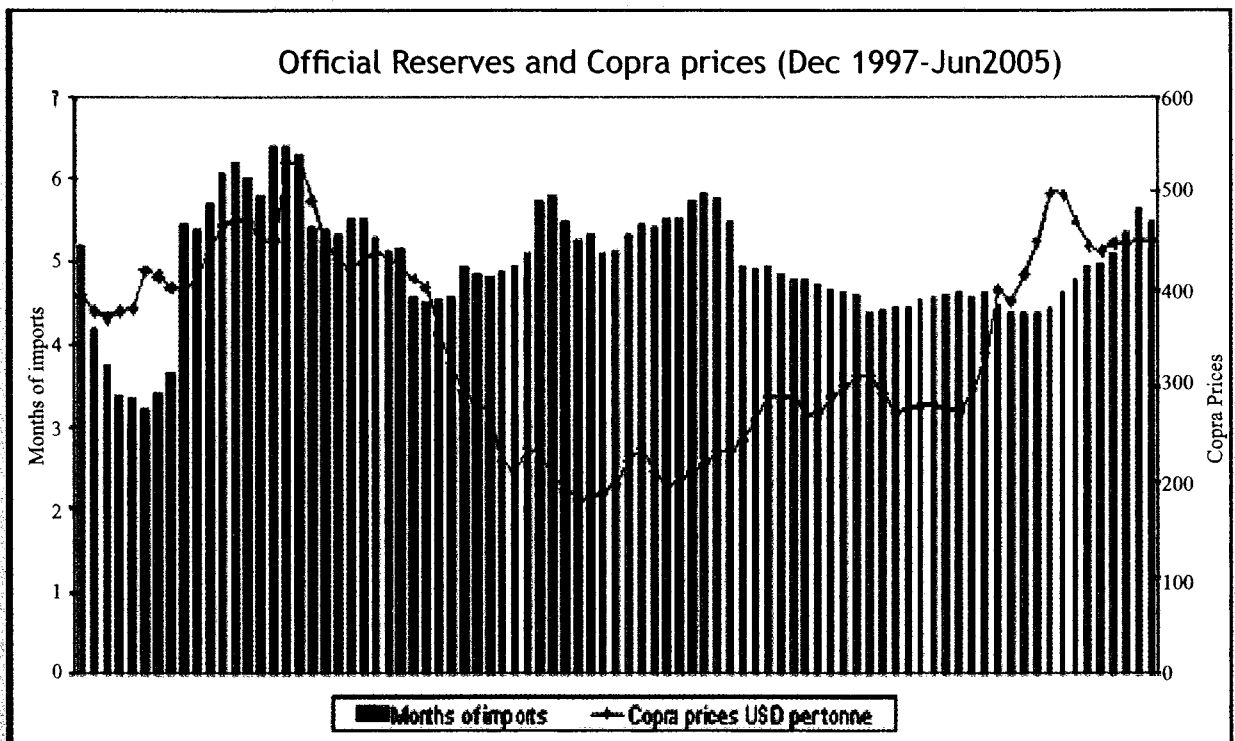
Graph 2 - Export revenue of copra and cocoa (millions of Vatu)



In March 2003, the Government decided to terminate VCMB's role as a coordinator for copra and cocoa exports. It now is the institution responsible for regulating the export market for the commodities concerned (issuing licenses to private exporters). Consequently, the Reserve Bank no longer receives foreign exchange resulting from commodity exports.

3. The changed role for VCMB followed a period of increasing financial problems for the organization as a result of the Government's decision to subsidize copra. The subsidies were financed from loans provided by the Reserve Bank. When the credit line was exhausted, VCMB found itself in an irreversible difficult financial position. The Government then decided to change its role into that of a regulator.

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From the previous description it will be clear that there was a close link between official reserves and price (and volume) developments of copra in 1998 and 1999 (graph 3). After 1999 this relationship did no longer exist.

The drying up of export revenue leaves loan proceeds and grants in foreign currency as the main (and only) sources of official reserves. The loan proceeds originate from loan disbursements by international organizations (Asian Development Bank, World Bank, European Union etc.) and (bilateral) donor countries. The loans and grants in foreign currency are converted and the Vatu equivalent is deposited in the Government's account with the Reserve Bank. In the first few years after the financial crisis loan disbursements made up a relatively large part of the reserves. In particular the disbursements of an ADB loan (US\$ 20 million) within the framework of the Comprehensive Reform Program (CRP) contributed to a large extent to the favorable development of official reserves. Although in recent years the amounts of foreign currency loans and grants gradually declined, until today they remain the main source of the Reserve Bank's official reserves.

One supply factor of official reserves has not yet been mentioned and that is the sale of foreign exchange by commercial banks to the Reserve Bank. Banks may consider selling foreign exchange if, for example, the purchase of foreign exchange from exporters or buyers of properties in Vanuatu would exceed certain (internal) limits set for their net foreign assets position. The bank could sell the surplus funds to another bank or the Reserve Bank. However, in the period concerned purchases of foreign exchange by the Reserve Bank from the banks were small in number and amount.

Demand for foreign exchange

As already mentioned earlier in this article, the payout of retirement savings by the VNPF in early 1998 and the resulting decline of official reserves to close to 3 months of imports in the second quarter of the same year, led the Reserve Bank to take some drastic measures.

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The first measure was the introduction of guidelines on foreign exchange dealings with the banks⁴. The guidelines provided for the sale of foreign exchange for current transactions only. The Reserve Bank would not sell foreign exchange for capital transactions and forward exchange contracts. If banks wanted to deal with customers regarding capital and forward transactions they were (and still are) free to do so, but they should use their own resources for such deals. In the first year and a half when the guidelines were in place, in particular the provision that the Reserve Bank would not sell foreign exchange for capital transactions caused 'misunderstanding' by the banks and the public; the guideline was wrongly interpreted as would the Reserve Bank prohibit such transactions, which was certainly not the case. The second measure was the increase of the base lending rate by 5 percentage points to almost 11 percent on 15 May. Both measures contributed to restored monetary and financial stability, which was reflected in an increase of the official reserves to 6.2 months of imports at the end of 1998 (part of the increase of the increase of official reserves resulted from the disbursement of half of the CRP-loan granted by the ADB). In the first few months of 1999, the reserves reached even slightly higher levels of 6.4 months of imports. In fact, in the period under review, these were the only months in which official reserves met the official target of at least 6 months of import cover.

Partly because the regulations were (wrongly) seen as restricting banks in their foreign exchange operations and therefore having a disturbing effect on the foreign exchange market in Vanuatu, the banks and other organizations regularly requested the Reserve Bank to remove the guidelines. However, the Reserve Bank thought it necessary to have them in place until monetary and financial stability were sufficiently restored and official reserves had improved significantly. In the course of 1999, official reserves tended to decrease slightly from the higher levels earlier in the year, but remained at satisfying levels of around 5.5 months of imports. The Reserve Bank abolished the (high) base lending rate and replaced it with the rediscount and repurchase rate, which were both fixed at 7.0 percent. By doing so, the Reserve Bank showed its confidence in monetary and exchange rate developments. Partly because of these developments rumors about a devaluation of the Vatu, which often for no reason raised their heads, gradually diminished. In October, the Reserve Bank thought that the time was ripe to remove the guidelines and on the 13th of that month the Bank indeed informed the banks of this decision. However, the Reserve Bank requested the banks to take their responsibility in maintaining and even further improving the restored confidence in the monetary system by showing restraint regarding requests for foreign exchange and even sell foreign exchange to the Reserve Bank more frequently than had been the case. If the banks would fail to do so and, as a result, official reserves would fall below 4 months of import cover, the Reserve Bank would consider the introduction of a surrender system for foreign exchange for selected export commodities (the commodities involved would comprise at least copra, coconut oil, cocoa and kava). The banks agreed with the removal of the guidelines and promised to do their utmost to sell more frequent foreign exchange to the Reserve Bank. The only problem, according to the banks, was that the buying and selling rates for the US dollar (the intervention currency) was not competitive compared to the rates quoted by the banks. The Reserve Bank reacted immediately by declaring that it was willing to buy US dollars within the full range of its daily published buying and selling rate (18 October 1999).

4. It should be noted that the banks were notified of the new regulations on 30 March 1998, which was the day when the earlier mentioned devaluation of 20 percent of the Vatu was revoked.

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Immediately after the removal of the guidelines, the Reserve Bank lost significant amounts of reserves. The reserves, which amounted to 5.5 months of imports at the end of October 1999 dropped quickly to around 4.6 months of imports in January/February the following year. The Reserve Bank discussed the alarming fall of the reserves in several meetings with the banks. In the meetings, several options to solve the problem were discussed, among other things the

earlier mentioned introduction of a surrender system. The banks, however, opposed such system and, knowing that the Reserve Bank was seriously considering taking drastic measures, preferred having the former guidelines on foreign exchange dealings (the Reserve Bank would sell foreign exchange for current transactions only) reintroduced. On 23 February 2000, the Reserve Bank indeed reintroduced the guidelines.

The measure brought temporary relief. The official reserves increased from 4.6 months of imports early in 2000 to around 5.0 months of imports towards the end of the year. In December the reserves increased significantly to 5.7 months of imports due to a foreign currency loan disbursement. However, as from the beginning of 2001 the reserves tended to decline again. In order to stem this development, on 2 May the Reserve Bank also declared the Australian dollar an intervention currency in the hope that banks would sell surplus funds of this currency to the Reserve Bank. These sales then would replenish the declining reserves. Unfortunately, purchases of Australian dollars never occurred. In June, the reserves had dropped to 5.1 months of imports. Despite the fact that the Reserve Bank was aware of the depressed price of copra in the world market (which also affected copra production), in a letter dated 28 June 2001 to the Bankers' Association of Vanuatu, the Governor of the Reserve Bank expressed its disappointment of the lack of interest from the side of the banks to sell foreign exchange to the Reserve Bank. The Reserve Bank, therefore, felt 'obliged to reactivate the already existing, though passive policy guideline issued earlier, to cushion the current discrepancy between demand and supply of the official foreign currency'. The guideline referred to is the one introduced on 5 February 1988 stating that the Reserve Bank would only deal foreign exchange in minimum amounts of US\$ 1,000,000. The limit of US\$ 1,000,000 is restricted to one importer, though may be waived by the Reserve Bank at its own discretion. The new guideline on foreign exchange sales is in addition to the earlier introduced guideline which refers to foreign exchange sales for current transactions only. It does not apply to foreign exchange sales on behalf of the Government. The Reserve Bank is the fiscal agent of the Government and therefore carries out all banking business for it.

The new guideline immediately had the desired effect; there were no requests for foreign exchange from the banks. In meetings with the banks in August and September the banks pointed to the possible disruption to the economy of the limit set by the Reserve Bank. Against this background, the Reserve Bank decided to amend the limit from US\$ 1,000,000 to US\$ 250,000 as from 10 September 2001. However, the Reserve Bank indicated that it would waive or reject transactions that do not meet the limit at its own discretion. In the second half of 2001, the reserves gradually increased again to close to the official target of 6 months of imports. This was followed by a period in which the Reserve Bank gradually lost reserves. The period was marked by small foreign exchange purchases from the Government, no purchases in connection with export revenue from VCMB (the organization ended its export activities) and absence of purchases from the banks, while (at its own discretion) the Reserve Bank irregularly sold foreign exchange. By mid-2003 the reserves had fallen to below 4.5 months of imports. Since then the reserves tended to increase again and at the June 2005 the reserves stood comfortably at 6.0 months of imports.

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Conclusion

From the developments of demand for and supply of foreign exchange it will be clear that since the beginning of 1998 the role of the Reserve Bank in the foreign exchange market gradually declined. On the supply side, the already declining amounts of foreign exchange surrendered by VCMB ended with the termination of the organization's export activities in 2003. The remaining role of the Reserve Bank is that of buyer of foreign exchange from the Government mainly in connection with (foreign currency) loan disbursements and grants. On the demand side the possibilities for the banks to buy foreign exchange are limited by guidelines stating that the Reserve Bank will sell foreign exchange for current transactions only and in amounts of at least US\$ 250,000. The Reserve Bank makes an exception for foreign exchange sales on behalf of the Government. In practice this means that most transactions by the Reserve Bank in the foreign exchange market concern deals on behalf or at the request of the Government (the Reserve Bank acts as the fiscal agent of the Government). As such, the foreign exchange market has gradually developed into market in which mainly commercial banks operate and in which the Reserve Bank only participates in exceptional circumstances (sell foreign exchange to the banks if there is structural shortage of foreign exchange). The changed conditions in the foreign exchange market resulted in, among other things, favorable developments of official reserves.