



HALF-YEAR ECONOMIC AND FISCAL UPDATE

31 July 2013

Ministry of Finance and Economic Management

Fiscal Responsibility

This Half Year Economic and Fiscal Update have been prepared in consistency with the Public Finance and Economic Management Act. The document has been prepared in accordance with the principles of responsible fiscal management as specified in the Act. The contents of the document were finalised on July 31st 2013.



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OVERVIEW

The Vanuatu economy is now estimated to grow by 4.5 per cent in 2013, higher than the 3.6 per cent projected at Budget. The upward revision largely reflects stronger activity in the industry and services sectors combined with the unexpected implementation of new public infrastructure projects funded through grants and aid in-kind, together with the usual recovery in private sector investments. For 2014, the domestic economy is forecasted to grow by 4.6 per cent.

For the second half of 2013, the global recovery is now projected to remain soft owing to weaker domestic demand and slower growth across major key emerging market economies and unexpected delay in growth recovery in the euro area. The impacts of the protracted growth of the euro area have affected confidence; with spillover effect to real domestic demand leading the downfall in major non-fuel commodity prices. Combined with improved supply conditions as a result new cheaper methodologies used to extract fuel from sources, the price of crude oil is now expected to fall by 2.3 per cent to level at US\$102.6 per barrel.

The global inflation is projected to ease as demand softens and commodity prices recede. Overall, the end of period consumer prices –proxy of inflation is expected to slip by 0.3 percentage points to about 3.7 per cent in the last quarter of 2013 from 3.9 per cent in the 2012.

Conditional data for the first half of the year suggests that economic activity was recovering with VAT netting in more receipts over the first six months of 2013 compared to what attained in 2012 and the highest so far comparing to previous years. However, import duties have gone down which reflects WTO related legislation changes.

The domestic average inflation rate measured by the average consumer price index (CPI) for the year to March 2013 recorded a decrease of 1.4 per cent; this represent an annual increase of 0.7 percentage point compared to the same period in 2012 with 2.1 per cent.

Table 1 Summary of fiscal aggregate 2013

	Actuals 2010	Actuals 2011	Prelim 2012	Budget 2013	Half Year 2013
Revenue (VT mn)	16,707	12,850	13,615	14,630	7,115
Expenses (VT mn)	15,109	13,333	13,913	13,884	6,876
Net Capital Acquisition (VT mn)	3,307	426	313	252	110
Net Lending/(Borrowing) (VT mn)	(1,708)	(483)	(298)	745	239
Per cent of GDP	(2.5)	(0.7)	(0.4)	0.9	0.3

Source: Department of Finance & Treasury

WORLD ECONOMIC OUTLOOK (WEO) UPDATE

The global economic environment continues to suffer setbacks following mixed developments across major industrialized economies. Despite attempts to stimulate global economic activities, fears of a prolonged recession in the euro area continue to derail investors' confidence. As a result of swift intervention by policy makers across the United States economy, recent economic indicators have shown signs of improvements. Across to Asia, the Japanese swift monetary quantitative action to remain very accommodative has spark fears of another recession. However, the move to widen the Bank of Japan's scope of purchase to include bond of all

maturities, and the planned purchase of private and real estate investment funds to stimulate activity directly had immediate positive effects on asset markets. In its July World Economic Outlook (WEO) update 2013, the International Monetary Fund (IMF) has once again downgraded its global economic growth forecast to 3.1 per cent for 2013 with a further improvement in growth forecast that is expected in 2014 at 3.8 per cent. The downward revision is underpinned by developments in the euro periphery on one hand; while development in emerging markets and developing economies is expected to remain buoyant led by activity in the BRICS economies on the other hand.

Continued policy dialogue including counter measures implemented by the richest nations of the Euro area have failed to rescue the region from the worst debt crisis ever with weak activities now extending to core countries. Meanwhile several rescue packages from the IMF and the European Central Bank (ECB) have boosted financial conditions across the board but economic activity remains very fragile combined with remaining traces of significant downside risks. Nonetheless, the IMF noted that the effect of the European bank deleveraging on the Asian financial systems has been comparatively minimal. Against the backdrop of easier financial conditions and stabilizing external demand in the Asia region, economic activity in Asia has regained momentum so far this year, after disappointing export growth throughout most of 2012.

Growth in China has started to pick up assisted by a confluence of factors including improved links in the supply chains and the recovery in external demand mainly across Asia and the US. With relatively favourable financial and labour market conditions, private demand remains robust in the Chinese economy assisting consumer confidence, rising investments and increasing retail activities. The slow recovery of the Chinese economy should revive trade ties in economies of trading partners including commodity producing economies of Latin America, minerals in Australia, natural gas and logging in the republic of Papua New Guinea and the Solomon Islands. As a result, the Vanuatu economy is expected to benefit from these spill overs raising expected domestic production. That said, Vanuatu's current fiscal stance in scaling up expected financing of public investment is expected to drive overall production going forward.

VANUATU ECONOMIC OUTLOOK (VEO) UPDATE

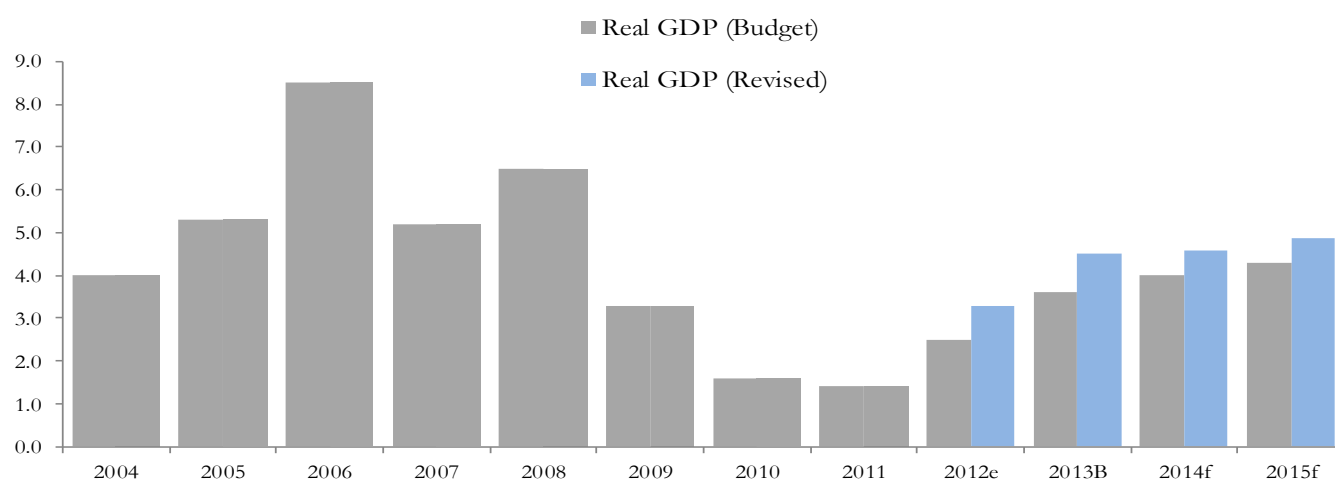
REAL SECTOR UPDATE

At home, fiscal policy has been modest with monetary policy remaining highly accommodative to stimulate economic activity. The Government fiscal primary balance is positive, supported by increased revenue inflows, particularly from VAT and other non-tax revenue. Real private sector credit continues to grow but comparatively low while developments in foreign direct investments (FDIs) are expected to normalise. The timely intervention of monetary policy to reduce its re-discount rate to 5.5 per cent has stabilize private sector investment but the incentive was short-lived given current tight credit conditions and the impacts of banks' deleveraging. The Vatu depreciation reflected a mixed of factors including current monetary easing, a widening trade deficit, and further prospects of weakening economic activity. The Vatu depreciation has boosted visitors' arrivals from neighbouring Australia injecting more foreign exchange earnings into the domestic economy.

Vanuatu's trade deficit (in goods) stretches out further this quarter due to a confluence of factors including weak external demand affecting Vanuatu's export of major commodities on one hand, and strengthening of real domestic demand on the other hand. This is revealed through the high volume of consumption goods and other durables – which are a good proxy for investment. Furthermore, the high value of imported construction related materials confirmed the recovery state of the economy. Finally, the annual inflation indicator of 1.4 per cent (measured by the change in consumer price index) has provided further support to suggest the growing strength of economic activity.

Against these backdrops of improved domestic demand conditions and stabilizing external demand, economic activity gained momentum during the first half of 2013 with an estimated growth of 4.5 per cent and further expansion in growth rates over the forecasts period averaging 4.8 per cent.

Chart 1 Real Gross Domestic Product (in per cent change)



Sources: National Statistics Office & Macroeconomic Committee estimates

AGGREGATE SUPPLY

Copra

Copra production over the first few months of the year was scaled back following improved supply conditions of closely traded commodities and substitutes. While current global economic environment remain comparatively weak, external demand for closely related substitutes of coconut oil – a by-product of copra has risen. These substitutes include production of non-food commodities such as fuel which has experience tremendous increase in global supply so far this year following new and cheaper methodologies used to extract fuel from sources. This process has led to an increase in global fuel production which on the other hand lowered international fuel prices affecting production of copra.

Following these developments, the spillover effect is seen in domestic production where farmers have responded decisively by cutting down production of copra. The downward trend in copra production is more pronounced during the first three months of 2013. Meanwhile, the average export prices of copra have given no incentive to farmers to expand output. Nonetheless, the low volumes of export reducing the average export prices over the first few months has led to a contraction in value adding from copra production. It is expected that production will normalise this year growing by less than 10 per cent with ageing coconut trees continuing to remain a challenge to future production albeit support received from the Vanuatu Agriculture Rural Training Centre (VARTC) in supplying farmers with nuts and seedlings.

Beef

Solid domestic demand for beef continued to drive production. However, beef production for exports contracted during the first few months of 2013 reflecting general weak real external demand from neighbouring trading partners. The recent development is not isolated from global economic activities, with the IMF forecasting beef production contracting by 1.6 per cent in 2013 and retrenchment expected to last for the next two years ahead until 2015. The expected contraction in beef production reflected weak developments in global construction and consumption activities while global confidence has impacted on the market price for beef. In return farmers responded by scaling back on cattle sales due in part to the average falling price of beef triggering

the declining value of beef exported so far this year. Accordingly, it is now expected for beef production to moderate and grow by around 5 per cent in 2013 before rebounding in 2017.

Furthermore, the expected slowdown in growth will be supported with improved supply conditions from close competitors and other unfavourable trade conditions such as sanitary and phytosanitary measures (in the Australian markets), exchange rates, higher fuel prices and geographical distant from major markets. All these factors continued to affect domestic production while intraregional trade with traditional markets such as PNG and the Solomon Islands remain strong. The weak supply of animals also reflects capacity constraints in the production processes ranging from underdeveloped infrastructure and remoteness to a low level of competition and lack of financial support to implement targeted policies.

Cocoa

Cocoa production was scaled up during the first few months of 2013 in respond to longer harvesting session and favourable trade conditions. This was possible, despite the IMF estimate of a declining price for international cocoa beans in the world market by 1.2 per cent this year. Over the year, domestic production rose significantly after few periods of declining growths following disputes over right to export license between the Cocoa Growers Associations (CGA) and the Vanuatu Commodity Marketing Board (VCMB) and negotiations over market access to the euro area. Recently the strength in production reflected increasing demand from Vanuatu's major trading partners for closely traded secondary products of cocoa beans underpinned by access to international markets (Germany) and approved export license.

The current trend in production is set to continue with growth forecasted at 4 per cent in 2013 and over the medium term following expected setback in external demand. The expected increase in production this year is due to the fact that the harvesting seasons are to be started earlier than usual and last even longer. Medium term prices are expected to remain stable following history of its price development which is in line with the IMF general forecasts for this commodity.

Kava

Partial indicators show increasing kava production over the first three months of 2013. The increasing production was in response to an increase in the average export price of kava stemming from external demand. The increasing production was recorded at 59.6 per cent for the first three months compared to the same period in 2012. Anecdotal evidence points to an increasing demand for Vanuatu kava in the international markets especially in Fiji, New Caledonia and other niche markets. Fiji currently accounts for the largest market share with kava imported from Vanuatu processed and re-exported to other countries. The strength in export prices emanating from real external demand has spilled over effects to domestic production igniting the high value of domestic exports growing by a massive 72.7 per cent during the first three months of 2013.

The average kava export price is currently sold at VT 1,040 per kilo while the gate prices in Santo ranges from VT 600 to VT 700 per kilo for both chips and roots respectively. On the other hand, domestic kava consumption continues to remain strong in response to the growing demand and population size. Meanwhile, growth in 2013 is expected to normalise at 8 per cent and is forecasted to grow at the same rate over the medium term.

Forestry

Domestic timber production continues to be under reported by official statistics while the volume of production is under supply forcing local hardware stores to import timber from abroad to meet domestic demand conditions. There are potentials to exploit logging activity in the economy however, given that Vanuatu islands are dispersed and scattered coupled with poor and high transportation costs have forced potential and current investors to look elsewhere. Meanwhile domestic production will continue to struggle following difficulties to identify profitable market access for export. The sharp contraction in global commercial and property markets has implications for the logging sector with the IMF forecasting global activities to remain subdued over the

medium term. However, following an expected recovery in the domestic real estate sector coupled with expected improvement in the land registry issue in Port Vila and the predicted scaling up of both public and private sector construction, logging activity is forecasted to grow beyond 9 per cent this year and over the medium term.

Fishery

Vanuatu has a lot of potential to invest in this sector. This sector is under-utilized with the volume of marine resources such as fish and other sea foods currently under supply. Activity in this sector is quiet, despite persistent high demand for seafoods. While subsistence fishing is forecasted to grow by roughly 2 per cent in 2013, commercial fishing is expected to dominate overall production in this sector with a forecasted growth of over 7 per cent for 2013. Trade in fishing products occurs mainly in commercial areas of Vanuatu. Reports on fish demand for consumption confirm the disequilibrium in the fish market and other sea foods across the country supported by high selling prices. In the same sense, the high value of fish combined with domestic supply constraints in this sector has been reflected in the market prices on one hand, while access to main export markets remain a drag on growth, on the other.

Table 2 Major Macroeconomic Indicators (in per cent change, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2011	2012e	2013B	2014f	2015f
Agriculture, fishing & forestry	4.6	2.3	1.5	3.5	2.6	0.7	4.8	5.9	3.6	3.8	3.9	4.4
Industry	-2.2	5.3	25.0	-10.1	27.5	27.6	12.6	-20.9	-1.0	6.4	10.7	12.9
Services	3.9	6.6	9.1	4.4	5.0	3.3	3.1	3.6	4.2	5.0	4.3	4.2
GDP (2006 prices)	4.0	5.3	8.5	5.2	6.5	3.3	1.6	1.4	3.3	4.5	4.6	4.9
GDP Deflator	2.1	0.4	3.9	5.5	7.3	2.3	2.6	2.1	1.6	2.3	2.1	2.9
GDP (at current prices)	6.2	5.7	12.7	10.9	14.2	5.7	5.4	2.5	4.9	6.9	6.8	7.9
World growth	5.0	4.6	5.3	5.4	2.8	-0.6	5.2	4.0	3.2	3.1	3.8	4.4
Oil prices - USD per barrel	37.8	53.4	64.3	71.1	97.0	61.8	79.0	104.0	105.0	102.6	97.6	92.8

Sources: IMF July WEO 2013, National Statistics Office & Macroeconomic Committee estimates

AGGREGATE DEMAND

Public consumption

Following the formation of the current government, real consumption expenses are expected to rise substantially this year. The result will be a substantial increase in consumption growth, which is expected to boost overall GDP growth by approximately 1.9 percentage points. In future years, the contribution of public consumption growth to overall real GDP growth is forecasted to be relatively marginal; in contrast, private consumption growth is forecasted to be steady and a large source of real GDP growth, accounting for an average 2 percentage points of real GDP growth over the medium term. Meanwhile private consumption in 2013 is expected to account for 2.3 percentage points in overall GDP growth.

Public investment

Public investment is expected to regain momentum with the commencement of several public investment projects jointly financed by the Asian Development Bank (ADB) with AusAID and NZAID and other development agencies such as Japan International Corporation Agency (JICA) and China with other projects to be financed through grants. Public investment is expected to grow at a slow pace in 2013 before accelerating from 2014 onwards. From the viewpoint of measuring the impact of these big projects on aggregate demand and growth, the change in public investment matters: public investment is expected to lower aggregate demand

and growth in 2013 which is equivalent to an estimated negative growth of about 63 per cent, followed by a sizeable boost in aggregate demand and growth in 2014 and 2015 when most constructions are expected to commence. However, focusing only on the change in public investment will overstates the expected growth contribution of these projects because a substantial part of spending will be leaked out of the economy in the form of imports. Hence, the large forecasted negative growth contribution of imports in 2013 through to 2016 of roughly 56.8 per cent of GDP is partly attributable to the expected commencement of these projects. In sum, to arrive at the expected total growth contribution of these publicly funded projects it is necessary to partially offset the large positive contribution of the expected surge in public investment over the next few months.

Tourism

Tourism has been strong throughout the first few months of this year. For the aggregate supply, this was the key driver of growth in accommodation and food services sector which together with the effects of tourism on the retail sector accounts for a sizeable part of real GDP growth during this period. Regarding the consumption side, growth in tourism is expected to benefits net exports in 2013—however, these were not a significant growth driver in the last three years—and indirectly private investment.

The forecasted strong growth in tourism this year and over the medium term will be attributed to a number of causes: the foremost cause is probably the expected recovery of the Australian economy, especially because Australia is the main source of visitor arrivals in Vanuatu. Given Australia's status as a major commodity exporter and investment hub for the Asian markets, its economy is expected to benefit significantly from the stabilization of external demand and easier financial condition from the Asian region. Hence, Vanuatu is forecasted to benefit indirectly from these positive developments through increased travel by Australians to Vanuatu. Looking back, Australia weathered the sharp downturn in international commodity prices in 2008/09 comparatively well, which shielded Vanuatu from the full fallout of the Global Economic Crisis (GEC). Meanwhile visitor arrival growth rebounded strongly in 2012; however, this was driven by a surge in day visitors arriving on cruise ships, which is less beneficial for Vanuatu's economy than air arrivals who stay longer.

Over the medium term, tourism is likely going to be a major driver of growth because the IMF projection for real GDP growth in Australia point to sustained strong growth, with growth averaging about 3.1 per cent over 2013-16, close to the strong growth performance during the boom period 2004-08. Empirical estimates of a tourist demand equation for Vanuatu point to a long-run elasticity of about 3, which would imply annual visitor arrival growth of approximately 9 per cent. However, this is expected to be partially offset by a loss in price competitiveness, which would peg the medium-term visitor arrival growth rate at around 6-7 per cent per annum, which would still make a strong driver of growth.

On the downside, the forecasted visitor arrival growth in Vanuatu during the tourism boom of 2004-09 benefitted from a number of one-off factors such as the deregulation of the airline industry that led to a one-time ramping up of visitor arrivals. In the absence of such factors, it could be unlikely that Vanuatu will be able to repeat the strong growth performance in 2004-09 in the projection period.

Private investment

Private investment is estimated to be one of the key determinants for future economic growth. Specifically, such anticipated recovery will be driven by strong domestic demand that in turn is to be attributed to strong growth in private investment. On the supply side, the expected increase in investment will drive the expansion of the construction sector going forward. One of the expected key factors will be activity in the real estate, which is also visible in real GDP growth contributions of the finance and insurance sector that represents two types of services that are often required in the purchase of real estate. The likely contribution of finance and insurance is estimate at 0.2 per cent for 2013 and a further 0.2 per cent average growth contribution is forecasted for the medium term. It is highly probable that the recovery in the real estate sector is expected from external inflows from neighboring Australia, New Zealand, New Caledonia and possibly Asian investors. These investors are likely to invest part of their gains in Vanuatu following similar trends in the past and Vanuatu's favorable

investment climate. Similarly, the expected boom in tourism and growth in real estate investments probably has the same sources, both are expected to be driven significantly by these investors' economic fortunes.

An internally generated forecast for Vanuatu's international investment position (IIP) supports this hypothesis because it forecast that foreigners are likely to built-up substantial holdings in Vanuatu in 2013 and over the medium term, which is recorded as liabilities in Vanuatu's IIP. Looking at the growth rates, it seems that expected external inflows would be a major driver for real private investment growth rising by an estimated 5.7 per cent this year and a further 7.2 per cent on average over the medium term. Of course, the expected buildup of holdings by foreigners in Vanuatu reflected not only real estate related inflows but also expected foreign direct investment (FDI) more generally. The above mentioned tourism activity was probably one major driver of FDI inflows. Another was the likely boom in information and telecommunication services, culminating the expected launching of the Submarine Cable operation in 2014. The process of deregulating Vanuatu's telecommunication industry started in 2006 with the start-up and launching of Digicel Vanuatu which led to sizeable investment as well as growth in this sector. The annual growth contributions of the information and telecommunication sector averaged almost one percentage point during 2007-09.

Going forward the FDI is forecasted to hold up relatively well, probably reflecting the expected strength of the tourism industry in Vanuatu, but other investment liabilities in the IIP are expected to remain soft. Meanwhile the expected net effect will be a stabilization of IIP liabilities measured in US dollars in 2012 with forecasted return to growth starting in 2013.

Table 3 Selected Economic Indicators (in per cent of GDP)

	2004	2005	2006	2007	2008	2009	2010	2011	2012e	2013B	2014f	2015f
Consumption	84.0	81.4	77.1	75.6	72.9	74.0	75.0	75.6	74.4	75.2	73.7	72.4
Public	15.8	15.0	14.1	14.9	13.9	15.3	15.7	15.4	14.4	15.6	14.7	14.0
Private	66.9	65.1	61.5	59.8	57.8	57.4	57.9	58.8	58.5	58.2	57.6	56.8
Gross fixed investment	21.7	22.3	27.5	31.8	40.7	39.1	36.7	29.1	25.5	23.5	24.9	28.0
Public	0.5	0.9	0.7	1.2	6.1	6.4	5.3	3.0	1.7	0.6	1.7	3.5
Private	21.2	21.4	26.8	30.7	34.5	32.7	31.4	26.1	23.8	22.9	23.2	24.5
Net Exports	-9.4	-7.4	-7.0	-7.6	-18.3	-13.6	-11.9	-5.8	-1.0	0.2	0.4	-1.4
Exports of goods and services	43.9	44.7	41.3	41.5	42.4	46.9	46.3	50.4	55.0	55.6	56.3	56.4
Imports of goods and services	-53.3	-52.0	-48.3	-49.1	-60.7	-60.5	-58.2	-56.3	-56.0	-55.4	-55.9	-57.9

Sources: National Statistics Office, Department of Finance & Treasury and Macroeconomic Committee estimates

Inflation

Inflationary pressures has emerged over the year with annual inflation growing by 1.4 per cent in the March Quarter 2013. The increase was associated with increases in the overall price of food (mainly dairy and related products) and men's clothing, stationery, tertiary education and furniture and furnishings. Over the year to March 2013, the Consumer Price Index (CPI) rose by 1.1 per cent. This was driven by increased prices for housing and utilities (mainly high rent prices), food, education, household supplies, recreation and communication. The rise in the price of major food items specifically reflects deteriorating supply-side conditions in major trading partners' economies. The decline in fuel prices in the world market continued to have a downside effect on domestic prices, particularly transport and electricity costs. The IMF expects commodity prices to decline over the next two years with fuel prices projected to remain soft averaging at USD100 per barrel in the next two years. Ideally the expected external price pressures will be on the downside, while a few noted increases in food import prices may be contributing to the increase. Despite these expected developments, the projected inflation rate for year-ended 2013 is projected to grow by roughly 2 per cent which is well within the RBV's annual inflation target range of 0-4 per cent.

Despite increased inflation recorded in the March quarter 2013, some inflationary pressures from abroad has eased off, as commodity prices weaken, a slight shift in direction country of consignment of imports in the region where prices could be relatively low.

FISCAL UPDATE 2013

Revenue

Total Government revenue to the end of June recorded VT 7,114.8 million. This represents 49 per cent of the Budget 2013 target. It is a significant increase of 10 per cent above the equivalent level recorded for the same period in 2012 and 14.8 per cent above the equivalent level recorded in the first six months of 2011. Total Government revenue (including grants) is slightly below target level with VT 8,237 million collected to the end of June, representing 43 per cent of the 2013 target and a slight increase by 2.8 per cent compared with its level a year ago and 4.2 per cent higher than its level two years ago.

VT 2,552.5 million worth of VAT has been collected to date and this represents 48 per cent of the Budget 2013 target. It is 15.4 per cent and 18.7 per cent above its equivalent levels for the same periods in 2012 and 2011, respectively. This is due to compliance operations and subsequent collection of arrears. In contrast import duties for the year so far total up to VT 1,219.4 million which is 43 per cent of budget target and 8.0 per cent more than the level collected in 2012, though it is 6.9 per cent less than collections in the first six months of 2011. The increase in tax collections compared with the previous year in part reflect the higher than expected government expenditure so far this year, which has driven higher private consumption and filtered through to VAT, import duties and excise tax receipts.

The Government's Development Fund received total receipts of VT 1,122.1 million from donor partner support. The major contributing partner is Australia (VT 659.1 million) followed by New Zealand (VT 121.3 million) and Japan (VT 71.7 million). Contributions from other donor partners are also acknowledge.

Expenditure

To date, government expenses remain broadly in line with budget target (VT 13,884.1 million) at VT 6,875.5 million. This represents 50 per cent of the budget target and 6.7 per cent below the level of spending (VT 6,922.3 million) during the same period in 2012 due to implementation of expenditure control measures approved by Council of Ministers in the last financial year.

Generally, the largest portion of Government expenses was consumed by compensation of employees at VT 3,798.3 million. This represents 55.2 per cent of the governments' expenses and 47 per cent of the 2013 budget target (VT 8,029 million). However, it represents a 1.9 per cent increase from the VT 3,726 million recorded over the same period last year. The same reasoning from the previous year still remains as new Departmental structures continue to increase in size and salary scales.

The next leading category of government expenses is use of goods and services which was worth VT 1,460.5 million at the end of June. This represents 21 per cent of the government's expenses and 45 per cent of the budget 2013 provision, but is 13.3 per cent below what was spent (VT 1,683.9 million) in the same period last year. This reduction is partly due to expenditure control measures put in place by the government.

Expense on grants is VT 841.6 million at the end of June representing 12 per cent of the government expense and 66 per cent of 2013 budget target. Expense on grants increased by 6.3 per cent more than what was recorded (VT 791.2 million) a year ago.

The other categories of government expenses include interest payments, social benefits and other expenses. Interest payments and Social benefits recorded VT 310.7 million and

VT 105.2million at the end of June, representing an increase in spending of 33 per cent and 23 per cent lower respectively, when compared to same period last year. Other expenses, on the other hand recorded VT 359.2 million, representing 74 per cent of the budget target (VT485.3 million) and this is 2.5 per cent lower than what was spent (VT 350.6 million) during the equivalent period of 2012.

Total Government expense (Government and Donor) at the end of June stands at VT 7,656.2 million. This represents 42 per cent against the Budget target of VT 18,195 million and equates to 1 per cent below what was spent (VT 7,655.3 million) during the same period last year.

Financing

The net operating balance for the government operations, excluding donor funds, at the end of June was a surplus worth VT 239.3 million, equivalent to 0.3 per cent of GDP. This is an improvement from the deficit of VT 456.2 million recorded during the same period last year.

To date, the Government did not issue any new domestic bonds or external loans. However, the Government has retired VT 100 million worth of domestic bonds and VT 212 million worth of external loans to date. The overall government's fiscal position acquired a surplus of VT 129.3 million at the end of June; however it helped to meet the governments' external amortization payments.

MONETARY UPDATE

Money Supply

Banking sector activities during the first five months of 2013 continued to slow relative to the previous year. Annual growth in total money supply (M2) contracted by 2.1 per cent throughout the first five months of 2013 reaching VT58,200.4 million in May. The decline in M2 was contributed to declining growths in both private sector credit and net foreign assets (NFA). Private sector credit rose by 5.0 per cent over the first five months of 2013, attributing to current subdued economic conditions. Likewise, the declining growth in net foreign assets over the first five months of 2013, imply that the banking system continues to experience outflows of foreign exchange with the desire to hold foreign exchange deposits over Vatu deposits. The declining growth in NFA reflected fears of Australian Tax Office (ATO) intervention in the domestic money markets and declines in foreign interest rates which has impacted on domestic foreign currency deposit interest rate. At the end of May 2013, NFA contracted by 14.7 per cent compared to same period in 2012. The Government's net credit position with the banking system depends largely on the movement in its budget position. Within the first four months of 2013, the government's net credit position improves relative to last year's position, however at the end of May 2013 it's net credit position deteriorated, implying that the Governments has been drawing down its deposits within the banking system to finance the increasing demand for social services and other operational related expenses.

Moreover, both components of M2 depicted declining growth rates over the first five months of 2013 compared to the previous year's level. Quasi-money in particular, contracted throughout January to May 2013 reflecting low global and domestic interest rates. Growth in narrow money (M1) moderated this period relative to last year's level mirroring the slowdown in economic activities.

Interest rate

Developments in interest rates during the first quarter of 2013 were characterized by the widening of interest rates spread between commercial banks weighted average interest rates on total bank loans and the weighted

average interest rates on total banks' deposits. Over the first three months of 2013, interest rates spread widen further to 8.4 per cent compared to 7.2 per cent at the end of 2012. Furthermore, the rise in interest rate spreads confirm to earlier discussion of banks' impact of deleveraging while at the same time imposing very tight credit conditions due to the high level of uncertainties in the economy. Despite the high level of liquidity on aggregate, there are possibilities that the uneven distribution of liquidity within the banking system is holding up interest rates. The uneven distribution of excess liquidity is also reflected in the composition of RBV notes issued so far this year; with the yield on the 91 days RBV notes rose by 1.0 per cent at the end of March and increases further to around 1.6 per cent at the end of May 2013 compared to a low of about 0.9 per cent recorded over the same period last year.

The Reserve Bank of Vanuatu's rediscount rate was reduced from 6.0 per cent to 5.5 per cent in March 2013.

EXTERNAL SECTOR UPDATE

Balance of Payment (BOP)

In the first quarter of 2013 Vanuatu's external trade in goods balance reached its highest first quarter deficit since 2008. This record high deficit is an indication that external demand remains relatively weak dampen domestic agricultural goods export, driving down the value of production. On the other hand, the rising volume of imports suggested a recovery in domestic demand. As a result, the trade deficit reached 31.4 per cent over the year to March. Partially offsetting this decline is the 9.8 per cent growth in net trade (in services) over the same period. This is only possible because of increasing visitor arrivals over the first half of the year, in particular day arrivals. Meanwhile development in tourism arrivals are expected to remain strong underpin by improved economic prospects in countries of origin.

Development in the income account is insufficient to finance the existing gap in the trade deficit. However, the secondary income responded relatively well so far in the year owing to large inflows particularly earned-marked for donor funded projects. These developments combined yielded the deteriorating current account deficit, rising by 41.7 per cent over the year. Going forward, the current account deficit is expected to expand further due to anticipated scaling up of publicly funded projects that are donor funded – of which bulk of construction materials will be imported. Services are also expected to increase in line with the expected increase in tourism activity which could provide cushion to the current account deficit.

Inflows on the capital account moderated in this quarter following weaknesses in general government transfers due to no major development projects during the quarter while development in the financial account remain softer as a result of more FDI inflows mainly from re-invested earnings. This has resulted in the capital account contracting by 51.5 per cent over the year to March 2013. The financial account deficit deteriorated further this period as a result weighing down on the overall balance.

In summary, the contraction in the current account supported from the built-up in domestic demand has led to the rising volume of goods imports coupled with softer development in the capital account combined with growing pressure from the financial account has resulted in the drawdown on the level of gross official reserves. Although remain comfortably higher than the RBV minimum threshold of 4 months, the level of gross official reserves is now projected to stand at VT16,166 million in April 2013 - sufficient to finance 6.7 months of imports. This is slightly lower than the 7.2 projected months of import cover accumulated over 2012. The current projected level of official reserves is sufficient to maintain Vanuatu's external commitments for the rest of the year.

Exchange rate

Over recent months the RBV has noted some significant movements in the Vatu exchange rates against some of Vanuatu's main trading partners. In the three months to June, the Vatu appreciated significantly against the Australian Dollar (AUD) and New Zealand Dollar (NZD), but depreciated against the US Dollar (USD) and Euro (EUR).

The movement in the AUD against the Vatu reflected significant weakening in the AUD against most major currencies, including the USD. This movement has been driven by a combination of slowing of demand for Australian goods in major export markets, the expected weakening in the overall economic activity in line the peak in mining investment and the impact of falling interest rates driven by the Reserve Bank of Australia's recent policy decisions. Over the longer term, the AUD is expected to continue to depreciate.

In contrast, the outlook for the New Zealand economy remains relatively strong with the Reserve Bank of New Zealand deciding to hold back on fully loosening its monetary stance due to price pressures. Nevertheless, we saw depreciation over the past quarter, perhaps reflecting some spill over from developments in Australia. The EUR appears to have bottomed out and has started to see a recovery against the Vatu. This continues to reflect the overall improvements in financial market sentiment seen since the second half of 2012. Nevertheless, these improvements remain fragile.

Table 4 Statement of Government Operation excluding Donors

	STATEMENT OF GOVERNMENT OPERATIONS EXCLUDING DONORS									
GFS Code	GFS Description	Budget 2013	Total (VT mn)	%	January	February	March	April	May	June
	TRANSACTIONS AFFECTING NET WORTH:									
A1	Revenue	14,629.5	7,114.8	49%	1,798.9	1,177.9	828.8	1,114.0	1,075.1	1,120.1
A11	Taxes	13,165.9	6,413.3	49%	1,663.8	1,073.7	685.7	946.7	994.5	1,048.9
A111	Taxes on income, profits, and capital gains	-	-	-	-	-	-	-	-	-
A112	Taxes on payroll & workforce	-	-	-	-	-	-	-	-	-
A113	Taxes on property	550.3	176.5	32%	32.9	29.4	35.1	31.5	23.5	24.1
A114	Taxes on goods & services	9,811.6	5,017.5	51%	1,392.4	855.8	533.3	700.4	744.1	791.6
A115	Taxes on international trade & transactions	2,803.9	1,219.4	43%	238.5	188.6	117.3	214.8	227.0	233.2
A116	Other taxes	-	-	-	-	-	-	-	-	-
A12	Social contributions	-	-	-	-	-	-	-	-	-
A13	Grants	-	-	-	-	-	-	-	-	-
A14	Other revenue	1,463.6	701.5	48%	135.1	104.2	143.1	167.3	80.6	71.3
A2	Expense	13,884.1	6,875.5	50%	1,008.4	1,120.4	1,432.4	1,229.9	1,021.0	1,063.4
A21	Compensation of employees	8,029.0	3,798.3	47%	430.0	604.1	890.7	628.6	630.4	614.5
A22	Use of goods and services	3,258.6	1,460.5	45%	193.4	182.5	274.1	311.7	296.0	202.8
A23	Consumption of fixed capital	-	-	-	-	-	-	-	-	-
A24	Interest	603.1	310.7	52%	14.1	51.8	84.6	72.2	6.1	81.8
A25	Subsidies	108.0	-	0%	-	-	-	-	-	-
A26	Grants	1,267.5	841.6	66%	191.7	253.2	105.1	147.7	58.8	85.2
A27	Social benefits	132.6	105.2	79%	19.9	13.8	7.8	6.5	17.8	39.4
A28	Other expense	485.3	359.2	74%	159.4	15.0	70.1	63.2	11.9	39.7
GOB	Gross operating balance (1-2+23+NOBz)	745.3	239.3		790.5	57.5	(603.5)	(115.9)	54.1	56.7
NOB	Net operating balance (1-2+NOBz) ^{c/}	745.3	239.3		790.5	57.5	(603.5)	(115.9)	54.1	56.7
		% of GDP	0.3%							
	TRANSACTIONS IN NONFINANCIAL ASSETS:									
A31	Net Acquisition of Nonfinancial Assets	251.8	110.0	44%	11.4	7.0	28.8	19.6	15.8	27.2
A311	Fixed assets	251.8	110.0	44%	11.4	7.0	28.8	19.6	15.8	27.2
A312	Change in inventories	-	-	-	-	-	-	-	-	-
A313	Valuables	-	-	-	-	-	-	-	-	-
A314	Nonproduced assets	-	-	-	-	-	-	-	-	-
NLB	Net lending / borrowing (1-2+NOBz-31)	493.5	129.3		779.0	50.4	(632.3)	(135.5)	38.3	29.5
	TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):									
A32	Net acquisition of financial assets	0.0	(182.7)	0%	779.0	26.0	(715.0)	(251.6)	16.9	(37.9)
A321	Domestic	0.0	(182.7)	0%	779.0	26.0	(715.0)	(251.6)	16.9	(37.9)
A322	Foreign	-	-	-	-	-	-	-	-	-
A323	Monetary gold and SDRs	-	-	-	-	-	-	-	-	-
A33	Net incurrence of liabilities	(493.5)	(312.0)	63%	-	(24.5)	(82.7)	(116.0)	(21.4)	(67.4)
A331	Domestic	-	(100.0)		-	-	-	(100.0)	-	-
A332	Foreign	(493.5)	(212.0)	0.4	-	(24.5)	(82.7)	(16.0)	(21.4)	(67.4)

Table 5 Statement of Government Operation which are funded by Donors through the Central Treasury

STATEMENT OF GOVERNMENT OPERATIONS WHICH ARE FUNDED BY DONORS THROUGH THE CENTRAL TREASURY ACCOUNT										
GFS Code	GFS Description	Budget 2013	Total (VT mn)	%	January	February	March	April	May	June
	TRANSACTIONS AFFECTING NET WORTH:									
A1	Revenue	4,310.9	1,122.1	26%	59.8	113.3	96.4	400.7	110.8	341.2
A11	Taxes	-	-	0%	-	-	-	-	-	-
A111	Taxes on income, profits, and capital gains	-	-	-	-	-	-	-	-	-
A112	Taxes on payroll & workforce	-	-	-	-	-	-	-	-	-
A113	Taxes on property	-	-	0%	-	-	-	-	-	-
A114	Taxes on goods & services	-	-	0%	-	-	-	-	-	-
	of which									
	Value-Added Tax	-	-	0%	-	-	-	-	-	-
	Excise	-	-	0%	-	-	-	-	-	-
A115	Taxes on international trade & transactions	-	-	0%	-	-	-	-	-	-
A116	Other taxes	-	-	-	-	-	-	-	-	-
A12	Social contributions	-	-	-	-	-	-	-	-	-
A13	Grants	4,310.9	1,122.1	26%	59.8	113.3	96.4	400.7	110.8	341.2
A14	Other revenue	-	-	0%	-	-	-	-	-	-
A2	Expense	4,310.9	780.6	18%	60.8	153.0	105.7	96.1	250.1	114.9
A21	Compensation of employees	530.4	136.2	26%	10.3	19.1	18.3	15.6	52.9	20.0
A22	Use of goods and services	3,083.0	571.8	19%	50.8	94.5	70.9	78.3	203.3	74.1
A23	Consumption of fixed capital	-	-	-	-	-	-	-	-	-
A24	Interest	-	-	0%	-	-	-	-	-	-
A25	Subsidies	-	-	0%	-	-	-	-	-	-
A26	Grants	669.3	33.4	5%	(0.1)	26.0	11.9	2.2	(7.3)	0.7
A27	Social benefits	5.1	19.6	385%	(0.1)	-	-	-	-	19.8
A28	Other expense	23.2	19.6	85%	-	13.3	4.7	-	1.2	0.4
GOB	Gross operating balance (1-2+23+NOBz)	-	341.5		(1.0)	(39.7)	(9.4)	304.6	(139.3)	226.4
NOB	Net operating balance (1-2+NOBz) ^{c/}	-	341.5		(1.0)	(39.7)	(9.4)	304.6	(139.3)	226.4
		-	0.4%							
	TRANSACTIONS IN NONFINANCIAL ASSETS:									
A31	Net Acquisition of Nonfinancial Assets	168.7	229.4	136%	70.1	27.2	38.2	13.4	59.2	21.4
A311	Fixed assets	168.7	229.4	136%	70.1	27.2	38.2	13.4	59.2	21.4
A312	Change in inventories	-	-	-	-	-	-	-	-	-
A313	Valuables	-	-	-	-	-	-	-	-	-
A314	Nonproduced assets	-	-	-	-	-	-	-	-	-
NLB	Net lending / borrowing (1-2+NOBz-31)	(168.7)	112.1	-66%	(71.1)	(66.8)	(47.5)	291.2	(198.5)	204.9
	TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):									
A32	Net acquisition of financial assets	0.0	112.1		(71.1)	(66.8)	(47.5)	291.2	(198.5)	204.9
A321	Domestic	0.0	112.1		(71.1)	(66.8)	(47.5)	291.2	(198.5)	204.9
A322	Foreign	-	-		-	-	-	-	-	-
A323	Monetary gold and SDRs	-	-		-	-	-	-	-	-
A33	Net incurrence of liabilities	168.7	-	0%	-	-	-	-	-	-
A331	Domestic	-	-	0%	-	-	-	-	-	-
A332	Foreign	168.7	-	0%	-	-	-	-	-	-

Table 6 Statement of Total Government Operation

	STATEMENT OF TOTAL GOVERNMENT OPERATIONS									
GFS Code	GFS Description	Budget 2013	Total (VT mn)	%	January	February	March	April	May	June
	TRANSACTIONS AFFECTING NET WORTH:									
A1	Revenue	18,940.4	8,238.6	43%	1,858.6	1,291.2	925.2	1,514.7	1,185.8	1,463.0
A11	Taxes	13,165.9	6,414.2	49%	1,663.8	1,073.7	685.7	946.7	994.5	1,049.7
A111	Taxes on income, profits, and capital gains	-	-	-	-	-	-	-	-	-
A112	Taxes on payroll & workforce	-	-	-	-	-	-	-	-	-
A113	Taxes on property	550.3	176.5	0%	32.9	29.4	35.1	31.5	23.5	24.1
A114	Taxes on goods & services	9,811.6	5,018.3	51%	1,392.4	855.8	533.3	700.4	744.1	792.4
	of which									
	Value-Added Tax	5,353.3	2,553.4	48%	594.8	318.1	282.5	432.1	460.5	465.3
	Excise	2,143.8	902.5	42%	166.1	127.7	116.9	153.6	145.8	192.4
A115	Taxes on international trade & transactions	2,803.9	1,219.4	43%	238.5	188.6	117.3	214.8	227.0	233.2
A116	Other taxes	-	-	-	-	-	-	-	-	-
A12	Social contributions	-	-	-	-	-	-	-	-	-
A13	Grants	4,310.9	1,122.1	0.3	59.8	113.3	96.4	400.7	110.8	341.2
A14	Other revenue	1,463.6	702.3	48%	135.1	104.2	143.1	167.3	80.6	72.1
A2	Expense	18,195.0	7,656.2	42%	1,069.2	1,273.4	1,538.1	1,326.1	1,271.1	1,178.3
A21	Compensation of employees	8,559.4	3,934.5	46%	440.3	623.2	909.0	644.3	683.3	634.5
A22	Use of goods and services	6,341.6	2,032.3	32%	244.2	277.0	344.9	390.0	499.4	276.9
A23	Consumption of fixed capital	-	-	-	-	-	-	-	-	-
A24	Interest	603.1	310.7	52%	14.1	51.8	84.6	72.2	6.1	81.8
A25	Subsidies	108.0	-	0%	-	-	-	-	-	-
A26	Grants	1,936.8	875.0	45%	191.6	279.2	117.0	149.9	51.4	85.8
A27	Social benefits	137.7	-	0%	19.8	13.8	7.8	6.5	17.8	59.2
A28	Other expense	508.5	-	0%	159.4	28.3	74.8	63.2	13.1	40.1
GOB	Gross operating balance (1-2+23+NOBz)	745.3	582.4	78%	789.4	17.8	(612.9)	188.7	(85.3)	284.7
NOB	Net operating balance (1-2+NOBz) ^{c/}	745.3	582.4	78%	789.4	17.8	(612.9)	188.7	(85.3)	284.7
	% of GDP		0.7%							
	TRANSACTIONS IN NONFINANCIAL ASSETS:									
A31	Net Acquisition of Nonfinancial Assets	420.6	238.5	57%	20.9	22.0	46.3	27.0	73.7	48.6
A311	Fixed assets	420.6	238.5	57%	20.9	22.0	46.3	27.0	73.7	48.6
A312	Change in inventories	-	-	-	-	-	-	-	-	-
A313	Valuables	-	-	-	-	-	-	-	-	-
A314	Nonproduced assets	-	-	-	-	-	-	-	-	-
NLB	Net lending / borrowing (1-2+NOBz-31)	324.8	343.9		768.6	(4.1)	(659.2)	161.6	(159.0)	236.0
	TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES (FINANCING):	0.4%	0.4%							
A32	Net acquisition of financial assets	0.0	31.9	0%	768.6	(28.6)	(741.9)	45.6	(180.4)	168.7
A321	Domestic	0.0	31.9	0%	768.6	(28.6)	(741.9)	45.6	(180.4)	168.7
A322	Foreign	-	-	-	-	-	-	-	-	-
A323	Monetary gold and SDRs	-	-	-	-	-	-	-	-	-
A33	Net incurrence of liabilities	(324.8)	(312.0)	96%	-	(24.5)	(82.7)	(116.0)	(21.4)	(67.4)
A331	Domestic	-	(100.0)	-	-	-	-	(100.0)	-	-
A332	Foreign	(324.8)	(212.0)	0.7	-	(24.5)	(82.7)	(16.0)	(21.4)	(67.4)

Table 7 Statement of Government Operation using GFS01 Classifications

STATEMENT OF GOVERNMENT OPERATIONS Using GFS01 classification		Actual 2011	Preliminary 2012	Budget 2013	Half Year 2013	Budget 2014
GFS Code	GFS Description*					
TRANSACTIONS AFFECTING NET WORTH:						
A1	Revenue	12,850.0	13,615.3	14,629.5	7,114.8	15,092.1
A11	Taxes	11,629.7	11,999.6	13,165.9	6,413.3	13,704.0
A111	Taxes on income, profits, and capital gains	0.0	0.0	0.0	0.0	0.0
A112	Taxes on payroll & workforce	0.0	0.0	0.0	0.0	0.0
A113	Taxes on property	430.6	548.3	550.3	176.5	574.6
A114	Taxes on goods & services	8,327.6	8,871.1	9,811.6	5,017.5	10,202.0
A115	Taxes on international trade & transactions	2,871.4	2,580.2	2,803.9	1,219.4	2,927.4
A116	Other taxes	0.0	0.0	0.0	0.0	0.0
A12	Social contributions	0.0	0.0	0.0	0.0	0.0
A13	Grants	0.0	0.0	0.0	0.0	0.0
A14	Other revenue	1,220.3	1,615.7	1,463.6	701.5	1,388.1
A2	Expense	13,333.0	13,913.2	13,884.1	6,875.5	13,863.8
A21	Compensation of employees	7,651.1	8,163.9	8,029.0	3,798.3	8,021.3
A22	Use of goods and services	3,101.9	2,944.9	3,258.6	1,460.5	3,193.8
A23	Consumption of fixed capital	0.0	0.0	0.0	0.0	0.0
A24	Interest	397.8	464.8	603.1	310.7	603.1
A25	Subsidies	0.0	353.0	108.0	0.0	108.0
A26	Grants	1,283.7	1,109.8	1,267.5	841.6	1,319.7
A27	Social benefits	239.7	309.8	132.6	105.2	132.6
A28	Other expense	658.8	567.0	485.3	359.2	485.3
GOB	Gross operating balance (1-2+23+NOBz)	-483.0	-297.8	745.3	239.3	1,228.3
NOB	Net operating balance (1-2+NOBz) ^{c/}	-483.0	-297.8	745.3	239.3	1,228.3
TRANSACTIONS IN NONFINANCIAL ASSETS:						
A31	Net Acquisition of Nonfinancial Assets	426.0	312.9	251.8	110.0	251.0
A311	Fixed assets	426.0	312.9	251.8	110.0	251.0
A312	Change in inventories	0.0	0.0	0.0	0.0	0.0
A313	Valuables	0.0	0.0	0.0	0.0	0.0
A314	Nonproduced assets	0.0	0.0	0.0	0.0	0.0
NLB	Net lending / borrowing (1-2+NOBz-31)	(909.1)	(610.7)	493.5	129.3	977.2
TRANSACTIONS IN FINANCIAL ASSETS AND						
A32	Net acquisition of financial assets	(266.1)	441.6	0.0	(182.7)	383.9
A321	Domestic	(266.1)	441.6	0.0	(182.7)	383.9
A322	Foreign	0.0	0.0	0.0	0.0	0.0
A323	Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0
A33	Net incurrence of liabilities	643.0	1,052.3	(493.5)	(312.0)	(593.3)
A331	Domestic	950.2	1,388.6	0.0	(100.0)	0.0
A332	Foreign	(307.2)	(336.2)	(493.5)	(212.0)	(593.3)