

The Pacific

Economic activity in the first half of 2003 suggests a slight recovery from the weak performance of the past few years, mainly reflecting improved weather conditions, continued strength in international commodity prices, and a resilient performance in tourism. The subregion is projected to achieve a modest economic recovery in the medium term. The main risks to this forecast arise from continuing political instability within the subregion and global economic uncertainties.

Macroeconomic Assessment

GDP Growth

According to revised estimates, aggregate GDP of Pacific developing member countries (PDMCs) actually contracted by 0.3% in 2002 compared to the 0.9% increase estimated in *ADO 2003*. Growth estimates for 2002 of five larger PDMCs—Fiji Islands, Federated States of Micronesia, Kiribati, Papua New Guinea, and Vanuatu—have been revised downward, with a particularly sharp decline for Papua New Guinea, the largest economy in the subregion. Overall, positive demand factors such as the strengthening of international commodity prices and some improvements in tourism seem to have been neutralized by supply constraints associated with adverse weather conditions and reduced production from natural resources. In particular, worse than previously estimated mineral production in Papua New Guinea and agricultural production in several other countries are among the major factors in the downward adjustment. On the other hand, growth estimates for the Cook Islands and Samoa have been revised upward due to country-specific factors. The net result is that the declining trend in average per capita real GDP in the Pacific continued for the third year in succession, adversely affecting poverty in the subregion.

A weak statistical database constrains economic reporting in the Pacific. Therefore, economic analysis relies substantially on qualitative information and is subject to cautious interpretation. Evidence collected in the first half of 2003 tends to confirm a slight increase in aggregate economic activity in the subregion, in line with the *ADO 2003* forecasts. Agricultural production generally improved in this period, reflecting higher international prices of most major agricultural exports of Pacific countries and relatively good weather conditions. Petroleum and mineral production, which is critical for Papua New Guinea, also gained from

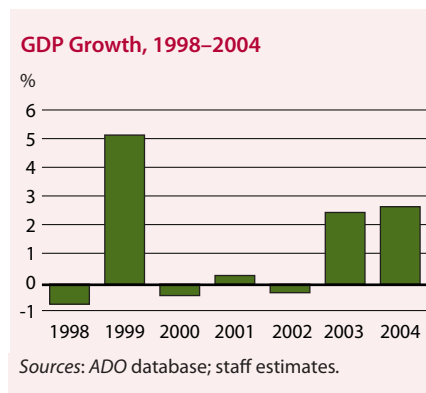


Table 2.5 Selected Economic Indicators, The Pacific, 2002–2004, %

Item	2002	2003		2004	
		ADO 2003	Update	ADO 2003	Update
GDP Growth					
Average	-0.3	2.4	2.5	2.5	2.7
Cook Islands	2.2	1.5	1.8	3.2	0.2
Dem. Rep. of Timor-Leste	-1.1	-2.3	-3.0	1.3	1.0
Fiji Islands	3.8	5.7	5.0	3.6	4.1
Kiribati	1.0	2.5	2.5	2.3	1.8
Marshall Islands, Rep. of	4.0	3.0	3.0	2.0	2.0
Micronesia, Fed. States of	-0.2	2.4	2.4	1.5	1.5
Nauru	-	-	-	-	-
Papua New Guinea	-2.7	1.0	1.5	2.0	2.0
Samoa	1.8	3.6	3.5	3.5	3.5
Solomon Islands	-4.0	2.0	5.0	3.0	5.0
Tonga	1.6	2.5	1.9	2.7	2.6
Tuvalu	2.0	2.0	2.0	1.8	1.8
Vanuatu	-2.8	1.3	1.3	2.2	2.2
Inflation Rate (CPI)					
Average	7.1	6.3	8.9	-	5.1
Cook Islands	3.9	3.4	2.4	3.4	1.8
Dem. Rep. of Timor-Leste	2.0	2.0	3.0	2.0	3.0
Fiji Islands	0.7	3.0	3.8	3.6	2.5
Kiribati	3.2	-	-	-	-
Marshall Islands, Rep. of	2.0	2.5	2.5	-	-
Micronesia, Fed. States of	0.2	1.5	1.5	-	-
Nauru	-	-	-	-	-
Papua New Guinea	11.8	9.0	13.8	5.0	6.9
Samoa	8.1	3.5	4.7	5.0	3.1
Solomon Islands	9.0	8.0	8.0	-	6.0
Tonga	10.0	10.0	10.5	-	7.5
Tuvalu	2.6	3.0	2.5	-	2.5
Vanuatu	2.0	2.5	2.5	2.5	2.5
Current Account Balance/GDP					
Average	0.5	-	-	-	-
Cook Islands	6.3	5.9	5.9	-	-
Dem. Rep. of Timor-Leste	10.0	-12.2	5.6	-7.3	-6.4
Fiji Islands	-3.5	-3.7	-3.7	-1.6	-1.6
Kiribati	7.7	1.1	-21.5	-	-12.5
Marshall Islands, Rep. of	29.7	-	-	-	-
Micronesia, Fed. States of	3.7	-	-	-	-
Nauru	-	-	-	-	-
Papua New Guinea	0.4	-	4.7	-	2.8
Samoa	1.8	-1.4	-1.5	-	-
Solomon Islands	-3.5	6.5	6.5	-	-
Tonga	5.3	-	-	-	-
Tuvalu	-	-	-	-	-
Vanuatu	-2.1	-0.3	-0.3	-1.1	-1.1

- = data not available; CPI = consumer price index; GDP = gross domestic product.

Sources: ADO database; staff estimates.

higher international prices. After an initial global decline due to the conflict in Iraq and the outbreak of SARS, tourism picked up by the end of June, favoring growth in the subregion. While other sectors manifested a mixed performance, in aggregate terms, demand conditions remained moderately firm and forecasts for GDP growth have been lifted slightly to 2.5% for 2003 and to 2.7% for 2004.

Several country-specific factors contributed to economic growth in the Pacific in the first half of 2003. In Papua New Guinea, activities increased in the mineral and petroleum sector due to a solid response by producers to continuing higher international prices and tax incentives related to exploration. Generally strong consumer demand in the Fiji Islands was associated with intensified construction activities and a resilient performance in tourism. In the first quarter of 2003, the economy in Solomon Islands showed signs of a reasonably strong rebound as many conflict-affected activities gradually resumed, despite continuing law and order problems. Reflecting these developments, labor market conditions improved slightly in these three countries. At the same time, however, economic activities continued to slow in Timor-Leste due to a drought and to the scaling-down of the international presence associated with United Nations activities, worsening already critical unemployment conditions. On the positive side, work started on the Bayu-Undan liquefied natural gas project, which is likely to become a major source of foreign exchange earnings for Timor-Leste. The smaller Pacific economies that depend on trust funds and external sources of revenue, particularly Kiribati and Tuvalu, witnessed a fall in government spending and domestic demand due to reductions in income from international financial markets and lower licensing fees, such as from fishing and for the use of the “.tv” Internet domain address (in Tuvalu). In Kiribati, Nauru, and Tuvalu, political uncertainty contributed to weaker economic activity in the first half of the year. The remaining PDMCs exhibited varying performances.

Financial Policies and Prices

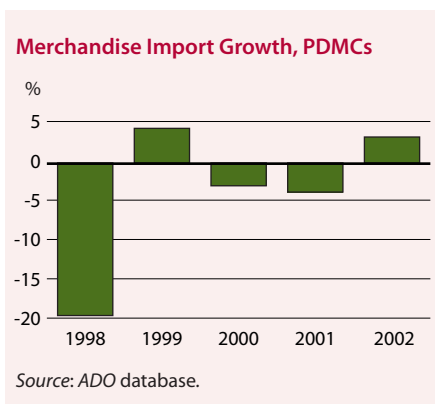
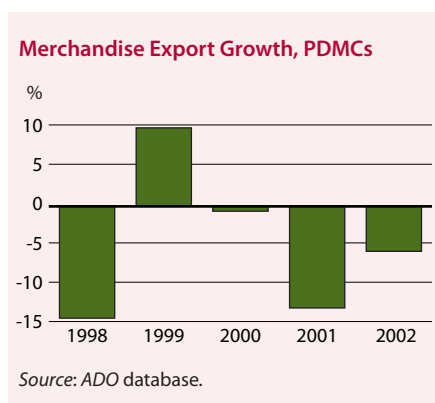
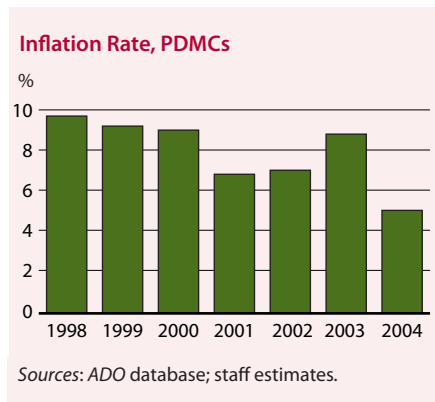
Although data are sketchy, official government statistics suggest that in the first few months of 2003, actual fiscal balances were better than expected in some of the larger PDMCs, including Fiji Islands, Papua New Guinea, Samoa, Timor-Leste, and Vanuatu. With some exceptions, revenue performance was stronger than forecast and, in some cases, expenditures were slightly lower than budgeted. The better than projected revenue performance reflected improvements in the production and export bases of several countries—particularly agriculture, minerals and, in the case of Papua New Guinea, petroleum—and increases in indirect taxes, while the lower expenditure levels mainly reflected start-up delays in planned activities, cash constraints, and, at times, improved controls over the use of public money. In Solomon Islands, the Government made some effort to improve fiscal management, and revenues exceeded their budgeted level in the first quarter of 2003. However, much remains to be done to restore fiscal stability, and the country continues to face a substantial budget deficit, huge arrears, and high official debt.

In contrast, the smaller PDMCs experienced fiscal constraints and generally higher than expected budget deficits in the first quarter of

2003, mainly due to their reliance on external sources of revenue, such as licensing fees and trust funds.

While official fiscal data for the first half of 2003 are still not available for the majority of PDMCs, in view of the improvements in some larger countries, the overall picture of the Pacific subregion in the first quarter of 2003 suggests a slight reduction in the fiscal deficit. However, great caution should be exercised in interpreting this trend, since data refer only to the first few months of the year.

Available data covering the first 6 months of 2003 suggest that inflation accelerated in many PDMCs, especially in Papua New Guinea, for which the annual estimate included in *ADO 2003* has now been revised from 9.0% to 13.8%. Price dynamics were mostly determined by factors such as increases in some indirect tax rates, the lagged effect of currency depreciation, and high petroleum prices. On the other hand, improved food supply conditions helped inflation to decelerate in Samoa in 2003 from the 2002 level, although by a lesser extent than estimated in *ADO 2003*. Inflation in the remaining PDMCs, particularly those which use foreign currencies such as the US or Australian dollar, generally remained low. Overall, the subregional average inflation rate is revised to 8.9% in 2003, against the forecast of 6.3% given in *ADO 2003*.



External Sector Developments

The overall balance of payments for PDMCs presented a varied picture in the first few months of 2003. Reflecting the good agricultural season and higher international prices of primary commodity exports, the trade balance showed some improvement in Fiji Islands, Papua New Guinea, Solomon Islands, and Vanuatu in the first quarter of 2003 compared to the previous quarter. However, the picture changes when compared to the same period of 2002. In Papua New Guinea, for which data for the first 6 months of 2003 are available, exports rose sharply while imports declined significantly. At the same time, the kina, as well as most other PDMC currencies, appreciated in nominal and real effective terms against the US dollar. Earnings from tourism improved in the Cook Islands and Samoa, while they remained comparable to those of 2002 in the Fiji Islands, reflecting the fact that the Pacific subregion continues to be regarded as a relatively safe destination. While external reserves improved in Solomon Islands and Tonga from the 2002 level, the position declined in Cook Islands, Fiji Islands, Papua New Guinea, Samoa, and Vanuatu.

Policy Developments

Political instability and weak governance continued to beset the Pacific subregion in the first half of 2003. Among Fiji Islands, Papua New Guinea, Solomon Islands, and Vanuatu, common policy issues were related to fiscal management and macroeconomic stability, governance, and social development. Timor-Leste progressed slowly but steadily in building new institutions and capacity, and in establishing a national legal and regulatory framework. The governments of the Fiji Islands and Papua New Guinea pursued special measures to promote investments and boost activities in their key sectors by offering tax and nontax incentives. As a result, these countries experienced some acceleration in private investment (Fiji

Islands) and exploration activities (Papua New Guinea). Solomon Islands struggled to overcome its huge fiscal problems as well as the need to restore law and order, while political uncertainty persisted in Vanuatu, due to continuing threats to the stability of the Government.

The governments of Samoa and Tonga continued to make progress on reforms, but with varying degrees of depth and success. While Samoa initiated reforms to reduce the size of government, improve financial sector supervision, and offer government land intermediation, the focus of reforms in Tonga was on public enterprises and improved management of public finance. In the Cook Islands and Tuvalu, some gains from recent reforms were lost due to policy reversals associated with political instability and fiscal difficulties.

In the first half of 2003, the primary focus of the governments of the Marshall Islands and Federated States of Micronesia was on negotiations related to the finalization of the new Compact of Free Association with the US. The negotiations, relating to both countries, include a 20-year package involving assistance in key sectors such as health and education, the establishment of a sustainable trust fund, and new accountability measures. During these 6 months, Kiribati faced problems related to fiscal management, while Nauru continued to be characterized by severe political instability, in the context of increasing economic and financial problems.

Some important developments in terms of Pacific subregional integration occurred in the first 6 months of the year. In particular, the Pacific Island Countries Trade Agreement (PICTA), which provides for a gradual move toward free trade among 14 Pacific island countries over a 10-year period, came into force in April. Economic ministers of Pacific countries agreed at the 2003 Forum Economic Ministers Meeting that a core aim of economic policies in the Pacific should be to address poverty. While the meeting highlighted the need for improving governance, institutional development, and macroeconomic stability, without strong political will in each country substantial progress will be unlikely.

Outlook for 2003–2004

Agriculture, mining, and marine-based primary commodities are the main production and export bases of the PDMCs. With the exception of the smaller countries, the subregion is expected to continue receiving a positive stimulus from the likely strengthening in commodity prices. Papua New Guinea in particular is expected to benefit from relatively firm oil prices. Tourism, another critical income-earning sector for the Pacific, is likely to continue expanding in 2003 and 2004, following the end of the conflict in Iraq and (apparently) the SARS epidemic. Tourism-related industries are also expected to contribute to economic growth in the months ahead. Earnings from trust funds could also improve, with an expected rebound in the major stock markets. Accordingly, the forecasts for economic growth in 2003 and 2004, which include a projection for both Papua New Guinea and Solomon Islands to emerge out of recession, have been marginally upgraded from those in *ADO 2003*.

Factors in the rise in inflation in the first half of 2003 are unlikely to change significantly over the rest of the year. Accordingly, the subregional average inflation forecast for 2003 has been revised upward to 8.9%, along

with a sharp upward revision in the case of Papua New Guinea. However, in 2004, the inflationary trend in that country is expected to subside with some improvements in macroeconomic stability; most other PDMCs could experience lower inflationary pressure, as oil prices may decline somewhat and prices in the PDMCs' main trading partners may remain low. Thus, the forecast is for moderate inflation in 2004. The pressures on the current account that were seen in 2002 are expected to ease in 2003, based on improved export performance in the larger PDMCs and the slightly improved outlook for the global economy, regional trade, and—particularly—tourism. However, the current account outlook for 2004 remains highly uncertain, due to major risks associated with continuing global economic uncertainties and subregional political instability.