Pacific Economic Monitor

November 2009 www.adb.org/pacmonitor

The *Pacific Economic Monitor* provides an update of developments and policy issues in the Pacific economies.

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Highlights

- Fiscal stimulus packages and easy monetary policies have successfully limited the depth of the current global recession. Some signs of worldwide economic stabilization are now beginning to emerge. Nevertheless, considerable downside risk remains.

- There is also some positive news for the Pacific. Most tree-crop prices are improving, offering some relief for rural areas. Growing numbers of Australian and New Zealand tourists are further "green shoots" for the Pacific economies. Australian and New Zealand departures for the region are up over last, and are showing good prospects for continued recovery.

- Nevertheless, there is no room for complacency. Global economic growth is expected to stay low for some time. And lags mean it will take some time for a global recovery, when it does occur, to fully flow through to the Pacific. Notably, unemployment is still on the rise in key neighboring economies, and this will delay prospects for a much-needed turnaround in remittances.

- Pacific economies that have contracted may find they can only hope for a solid economic recovery by late 2010, or perhaps even 2011. Fiscal pressures have intensified in many Pacific Islands economies, and the stress is likely to build over 2010.

- Support from Samoans living overseas and the broader international community is helping the Samoan economy cope with the impact of the tsunami. Rehabilitation efforts may now see a small economic expansion over the year.

- The global economic crisis has seen the region lose ground in its efforts to reduce poverty. It is estimated that an additional 50,000 people will be living below the poverty line in the Pacific Islands in 2010 because of the global economic crisis. Many of the non-poor have also seen their livelihood deteriorate.

- The onus remains on governments to try and speed the economic recovery through extra effort on the economic and fiscal fronts.

- The potential gains from good economic policy are apparent in tourism. The reforms that opened international airlines to competition and spurred hotel developments appear to be contributing to an early pickup in tourism. However, much more can be done to build the region's competitiveness.

- Official reserves are likely to come under extra pressure over 2010 as the effect of higher oil prices feeds through the region. Policy makers will have to decide the appropriate time to tighten monetary policy as both higher import prices and reserves pressure reemerge. Consistency and closer coordination of fiscal and monetary policies will become increasingly important to ensure macroeconomic stability. Acting early to support export growth can lessen these pressures, while also enhancing prospects for medium-term growth.

Printed in the Philippines.
Publication Stock No: RPS090535

Cataloging-In-Publication Data
Asian Development Bank.
Pacific Economic Monitor,
November 2009. Mandaluyong
City, Philippines: Asian
Development Bank, 2009.

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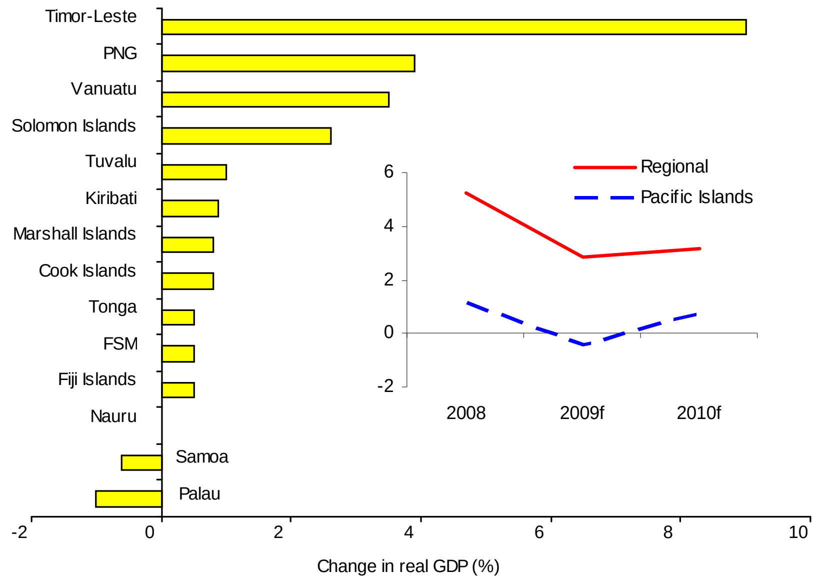
Abbreviations

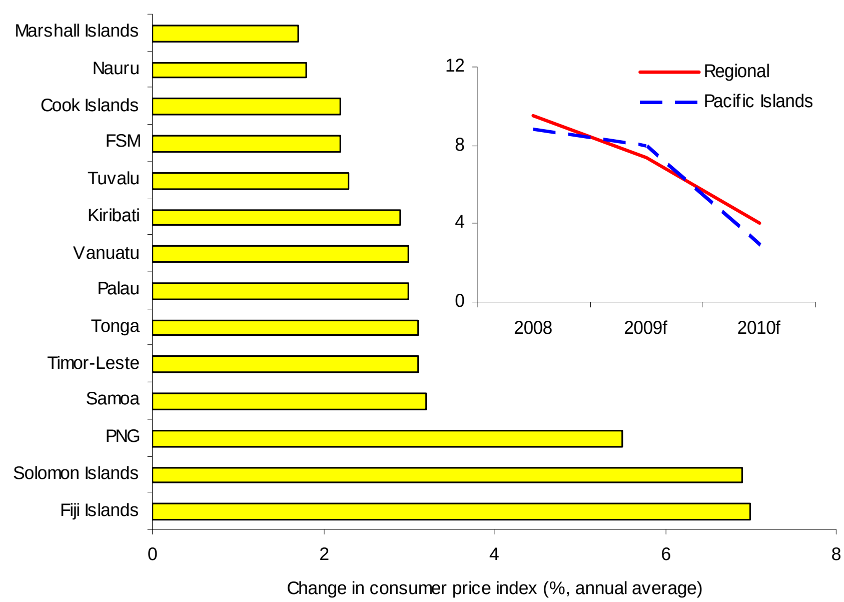
$	US dollars, unless otherwise stated
ABS	Australian Bureau of Statistics
ADB	Asian Development Bank
ADO	Asian Development Outlook
A$	Australian dollar
CPI	consumer price index
f	forecast
fas	free along side
fob	free on board
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
m.a.	moving average
NZL	New Zealand
PNG	Papua New Guinea
PRC	People's Republic of China
rhs	right hand scale
US	United States
y-o-y	year-on-year

Latest Asian Development Bank forecasts for 2010

Real GDP growth



Inflation

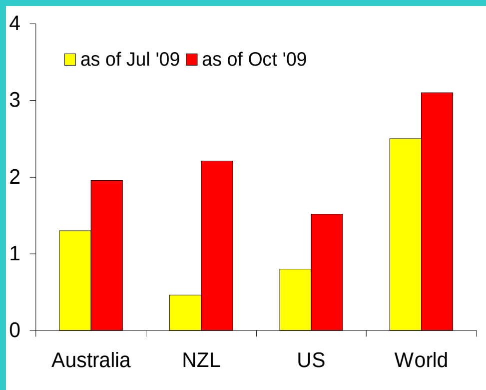


Note: Forecasts for the Cook Islands, FSM, Marshall Islands, Nauru, Palau, Samoa, and Tonga are for their fiscal years (year ended June or September 2009). Regional averages of GDP growth and inflation are computed using weights derived from levels of gross national income in current US dollars following the World Bank Atlas method. Averages for Pacific Islands exclude Timor-Leste and PNG.
Source: ADB staff estimates.

A note on methodology:
This *Pacific Economic Monitor* uses year-on-year percentage changes and 3-month moving averages. The use of year-on-year percentage changes reduces the impact of seasonality. The use of 3-month moving averages reduces the impact of volatility in monthly data.

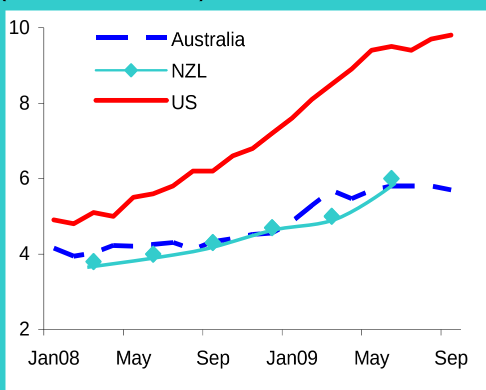
Developments overseas

GDP growth forecasts for 2010
(%, annual)



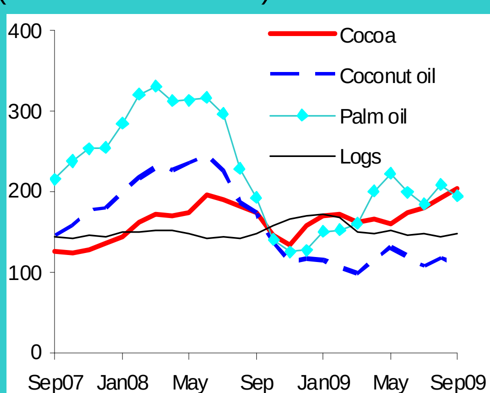
Source: International Monetary Fund. 2009. *World Economic Outlook*, July and October issues.

Unemployment in key economies
(% of labor force)



Sources: ABS, Reserve Bank of New Zealand, and US Bureau of Labor Statistics.

Key commodity prices
(Index: Jan 2005=100)



Source: Staff estimates based on IMF International Financial Statistics and International Cocoa Organization online databases.

Improved prospects for the global economy

- Fiscal stimulus packages and easy monetary policies have successfully averted a collapse of the global financial system and limited the depth of the current global recession. Signs of worldwide economic stabilization have emerged. The IMF's October 2009 *World Economic Outlook* forecast that global economic growth will turn positive in the December quarter 2009. Nevertheless, considerable downside risk remains.
- Asia is leading the global recovery. ADB, in its *Asian Development Outlook 2009 Update*, predicts that Asia will record 3.9% economic growth in 2009 and 6.4% in 2010. This is mainly due to the resilience of the economies of the People's Republic of China and India. The IMF projects that the global economy will grow by about 3% in 2010 after contracting by about 1% in 2009.
- The US economy contracted by only 0.7% in the June quarter 2009 after declining by a sharp 6.1% in the March quarter. The IMF predicts that US GDP will expand by 1.5% in 2010. Australia has managed to avoid recession by growing 0.6% in the June quarter of 2009. IMF now expects the Australian economy to grow by 2.0% in 2010. New Zealand came out of recession in the June quarter, and is expected by IMF to rebound with 2.2% growth in 2010.

High unemployment persists

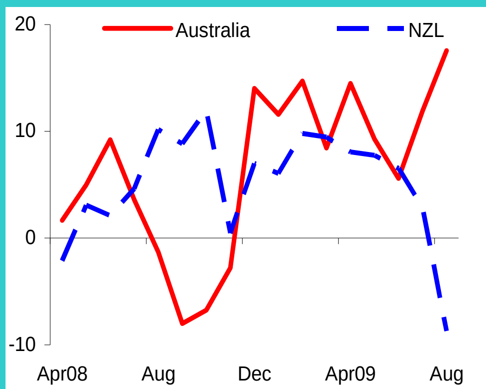
- Unemployment remains a major concern. The US unemployment rate reached 9.8% in September, the highest since June 1983. The Australian unemployment rate declined slightly to 5.7% in September as more than 40,000 new jobs were created, but remains high. Over the June quarter, the number of unemployed workers in New Zealand rose sharply, from 5.0% to 6.0% of the labor force.
- It will take considerable time for the slowly improving global economy to bring unemployment rates back to pre-crisis levels. For example, US manufacturing overtime hours, a leading indicator of labor demand, has been slow to improve. The National Association for Business Economics expects the US unemployment rate to reach 10.0% in the March quarter of 2010, before gradually declining to 9.5% by the end of the year.

Commodity prices generally up

- Improving economic sentiments have been reflected in a gradual rise in prices of some of the Pacific's key commodities. Increased production costs due to rising oil prices, and the weaker US dollar, are also likely to contribute to the general rise in commodity prices. Most international stock markets are also trending up.

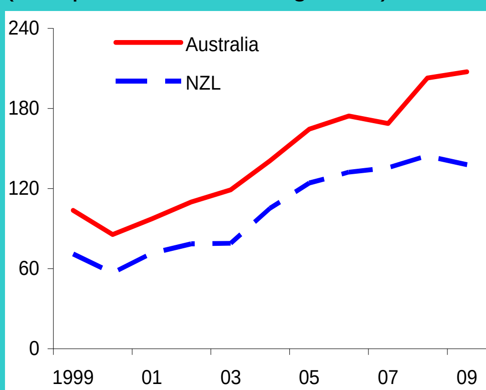
A view from neighboring economies

Non-fuel exports to the Pacific
(value; y-o-y % change, 3-month m.a.)



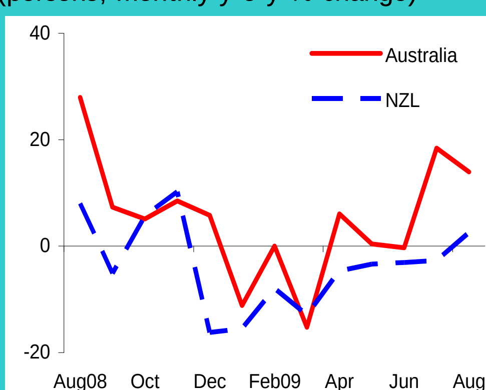
Sources: ABS and Statistics New Zealand.

Departures for the Pacific
('000 persons; Jan to Aug totals)



Sources: ABS and New Zealand Ministry of Tourism.

Departures for the Pacific
(persons; monthly y-o-y % change)



Sources: ABS and New Zealand Ministry of Tourism.

Pacific demand for exports mixed

- Total non-fuel exports from Australia to the Pacific are holding up, mainly because of rising demand from PNG. Demand from Vanuatu has also recently moved into positive territory. But Australian non-fuel exports are generally contracting elsewhere, suggestive of weak economic conditions in the main Australian markets. New Zealand non-fuel exports to Samoa continue to grow, while they are falling in Tonga.
- A similar pattern is evident in the demand for motor vehicles from Japan. Demand is still growing in PNG, Samoa, and Timor-Leste (although now at a lower rate in PNG). Demand is declining in most other Pacific economies.
- Export data point to aggregate demand remaining firm in the Cook Islands and FSM. However, the data for the former appears not to be representative of overall conditions there.

Tourism is improving

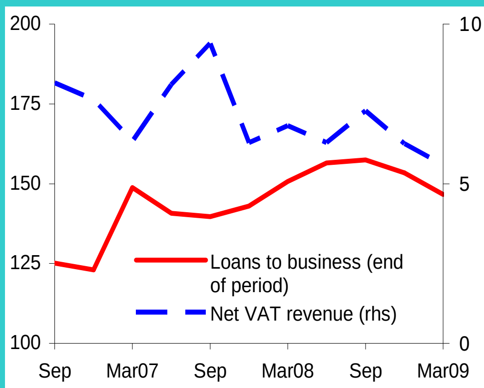
- Australian tourism to the Pacific increased by 16.1% over July and August 2009 relative to the same period of 2008. This sharp rise builds on the modest gains achieved in April and May. The overall improvement appears to mainly result from rebuilding in tourism activity in the Fiji Islands. Departures from Australia to the Pacific are now up by 2.3% for the year to date compared with the same period of 2008.
- Departures from New Zealand to the Pacific showed a slight increase of 2.6% in August 2009 on a year-on-year basis. This represents the first month of year-on-year growth in New Zealand tourism to the Pacific after 8 consecutive months of contraction.
- US tourism to Oceania increased by 1.9% in the June quarter, providing some optimism regarding the resumption of travel to Pacific destinations. Japanese tourism to Oceania and other northern Pacific islands, however, remains subdued.

Rising oil prices

- The international price of crude oil has increased by 72% from January to August 2009. Increased fuel prices and the higher cost of transport for imported goods will add to the import bill. This will, in turn, weaken the balance of payments and foreign reserves positions of the region's net fuel importers. Inflation will also rise after a brief lag, eroding economic prospects at a time when most are still in fragile economic condition.
- In contrast, the net petroleum exporters, PNG and Timor-Leste, will benefit from the much higher crude oil prices.

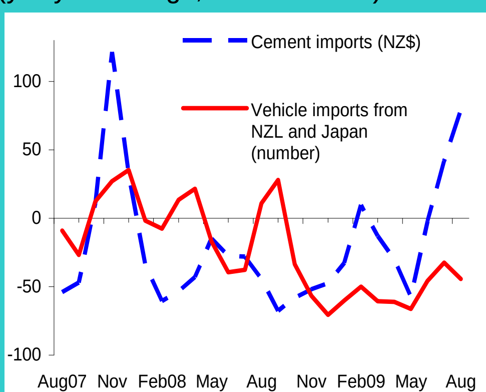
Cook Islands

Key indicators
(NZ$ million, quarterly)



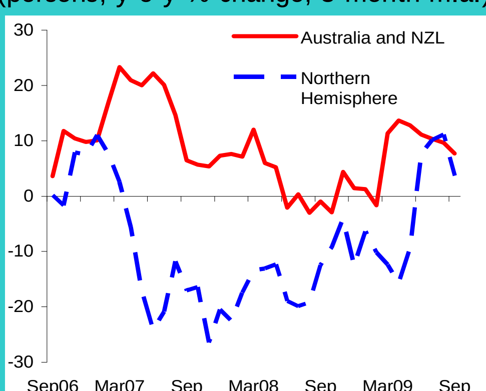
VAT=value-added tax
Source: Cook Islands Statistics Office.

Key imports
(y-o-y % change, 3-month m.a.)



Sources: Japan e-Stats website and Statistics New Zealand.

Visitor arrivals
(persons; y-o-y % change, 3-month m.a.)



Source: Cook Islands Statistics Office.

Key developments

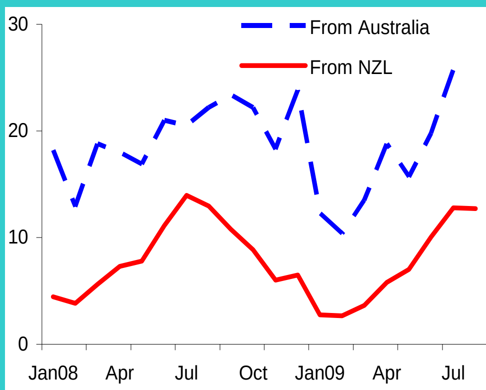
- The Cook Islands' economy will receive a boost over the second half of 2009 from the Pacific Mini Games and other special events. But the benefits will be temporary, and the data suggest that underlying demand remains weak.
- Commercial bank lending to business was down by 8.3% in the June quarter of 2009 from the same quarter of 2008. The Cook Islands Statistics Office reports that net value-added tax revenue, a good indicator of the strength of an economy, is down by 10.0% in the 12 months to June 2009. This equates to a very large real decline of 18.5%.
- Inflation, which averaged 7.8% in 2008, remains high at 11.2% on a year-on-year basis as of June 2009. High inflation, largely due to higher transport costs, is adding to the economic deterioration.
- The overall weak condition is despite moderate growth in residential construction and a continued improvement in tourism. Arrivals from the Northern Hemisphere have recently begun to rise following a 2-year downward trend. As of August 2009, departures for the Cook Islands from New Zealand were 7.7% above the level of a year earlier, while departures from Australia were up 15.0%.

Key issues

- The weak revenue performance is putting key government programs under pressure. Notably, the 2009 budget was unable to make a cost-of-living adjustment to the welfare payments received by the destitute, the infirm, caregivers, and other vulnerable members of the community. Those dependent on these payments for their income are under ever-rising financial stress.
- The poor growth performance since 2004 highlights the need to rejuvenate economic management. In its 2010 budget, the government has substantially increased funding for capital expenditures and infrastructure rebuilding projects. Complementary actions to ensure that this expansion is fiscally sustainable are now needed.
- The government has recently committed to new loans from ADB ($10 million for an economic recovery support program) and the European Investment Bank (approximately NZ$6 million for concessionary loans for small and medium-sized businesses). It is important that processes are in place to use these loan funds to maximum effect. It will be particularly important that concessionary loans provided to businesses follow prudent assessments of credit risk. This will help avoid such risks being passed on to the budget. Ensuring openness and transparency in decisions on the use of loan funds is paramount.

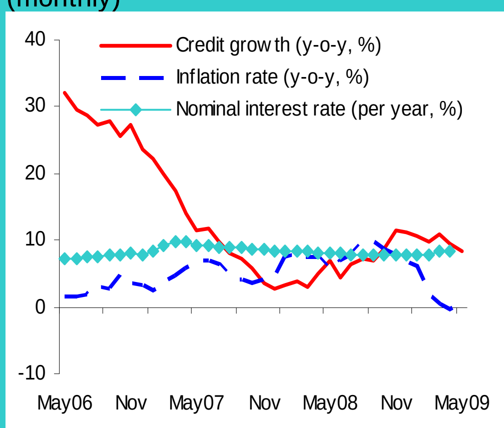
Fiji Islands

Departures to Fiji Islands
('000 persons; monthly)



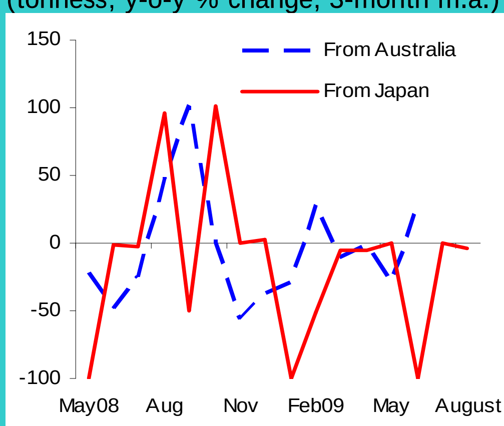
Sources: ABS and New Zealand Ministry of Tourism.

Monetary indicators
(monthly)



Source: Reserve Bank of Fiji.

Cement imports
(tonness; y-o-y % change, 3-month m.a.)



Sources: ABS and Japan e-Stats website.

Key developments

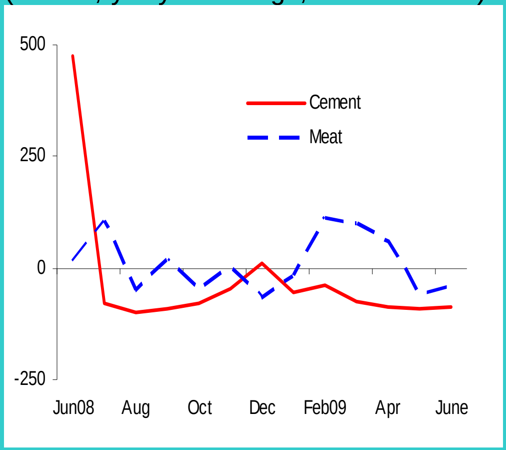
- The third quarter has been mixed for Fiji Islands' economy. Tourism arrivals are now showing firm growth; however, all other income-earning sectors continue to perform poorly. Indicators of business outlook are also mixed—credit growth remains in positive territory but is declining, and lower export earnings have been reported from sugar, mineral water, timber, and garments.
- Fiji Islands has passed the turning point in tourism trends. Australian departures for Fiji Islands this year were down on a year-on-year basis in June. But departures rose in July (up 25.3% from 2008) and August (12.6%). A significant and sustained recovery in Australian tourism would be fortuitous for Fiji Islands' tourism industry. However, tourism volumes do not tell the whole story, and expectations are that tourism receipts will remain flat given heavy discounting in the industry.
- At the household level, times continue to be tough, although remittances experienced strong growth (34.0% in July). Employment conditions remain weak. The latest data show fewer new taxpayer registrations and job vacancies. Inflation was 5.1% in August, up from 2.2% in July (y-o-y), led by an increase in prices across all categories—particularly in food prices, which increased by 5.7%.
- Total exports from January to July 2009 fell by 13.0% compared to the same period last year due to lower earnings from major sectors, while imports dropped by 16.4% over the same period. This provided a slightly more favorable balance of payments.
- Foreign reserves are publicly stated to be at relatively healthy levels—3.5 to 4.0 months of import cover. This is in part due to weak demand. Any recovery in imports would quickly put pressure on foreign reserves.

Key issues

- The Reserve Bank of Fiji's directive for banks to reduce their spread to 4.0% by the end of 2009 is having at least one negative impact—banks are increasingly risk-averse in their lending. New investment credit continues its downward trajectory.
- Lack of investment is not just a private sector phenomenon. The government has again failed to advance its capital investment plans set out in the 2009 budget. Just how the 2010 budget will address the continued bottlenecks to project implementation will be an important determining factor in 2010 growth prospects.

Kiribati

Key imports from Australia
(tonnes; y-o-y % change, 3-month m.a.)

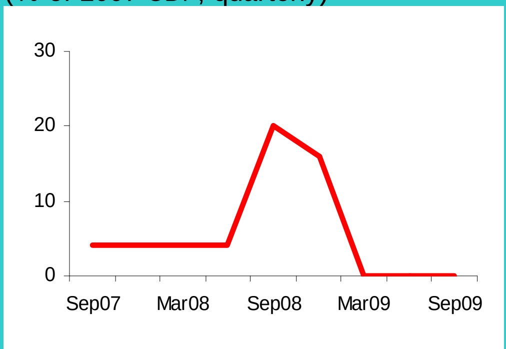


Source: ABS.

- Kiribati has been faring somewhat better than expected in the face of the global economic crisis. The drop in world trade volumes has had a negative effect on the employment of Kiribati seafarers and their remittances. But economic growth is still projected for 2009, attributable to slight expansion in fisheries (9.8% of GDP) and public administration (13.7% of GDP).
- Partly as a result of lower remittances, domestic demand remains subdued. This is reflected in the declines in June imports from Australia in cement (an 86.6% drop, year-on-year) and beef (down 38.8%).
- Fiscal restraint is needed to avoid further strain on the weakened Revenue Equalization Reserve Fund. A rebalancing of expenditure toward capital is also needed; capital expenditure in the 2009 budget was down 11.5% from the previous year.

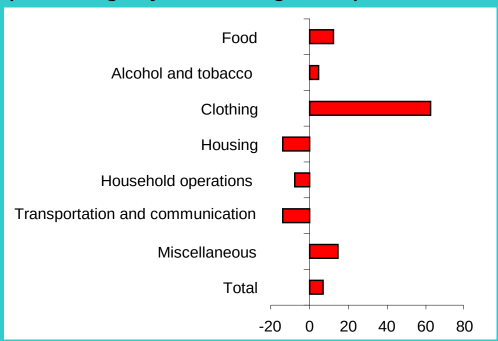
Nauru

Australian imports from Nauru
(% of 2007 GDP, quarterly)



Note: Mostly consists of phosphate.
Source: ABS.

Nauru CPI
(% change, year to Aug 2009)

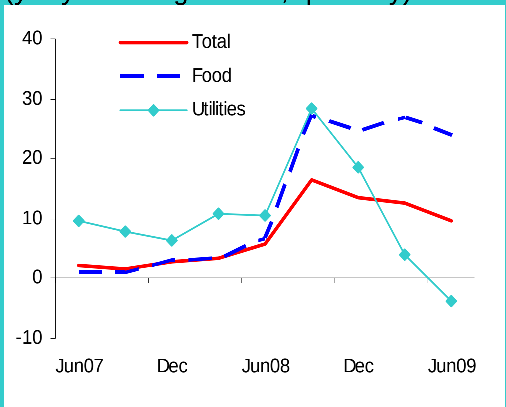


Source: Bureau of Statistics, Department of Finance in Nauru.

- There were no sales of phosphate from Nauru to Australia in the first 8 months of 2009. This was due to port damage in Nauru (which has prevented large vessels from docking to pick up phosphate) and weak demand and low prices for phosphate. The weak export performance puts downside risk on ADB's latest forecast of flat growth for Nauru for fiscal year 2010 (ending 30 June 2010).
- The Australian consumer price index (CPI) has previously been used as a proxy measure for Nauruan inflation. Recently, the Nauru Bureau of Statistics in the Department of Finance has begun compiling its own CPI series, which shows a much higher rate of inflation than that measured by the Australian CPI. For January to August 2009, prices as measured by the Nauru CPI increased by 7.6%. The latest available Australian CPI data (for January to June 2009) shows a 1.5% increase.
- Within the average 7.6% increase in prices, there has been considerable variation in price changes among expenditure categories. Clothing increased by 62.5% and food by 12.5%. However, this was offset by falls in housing, household operations (due to a decline in electricity prices with the introduction of pre-paid metering), and transport and communications (due to lower oil prices).
- Nauru’s long-term economic future remains dependent on making good use of phosphate income, reducing indebtedness, and developing viable alternative sources of income.

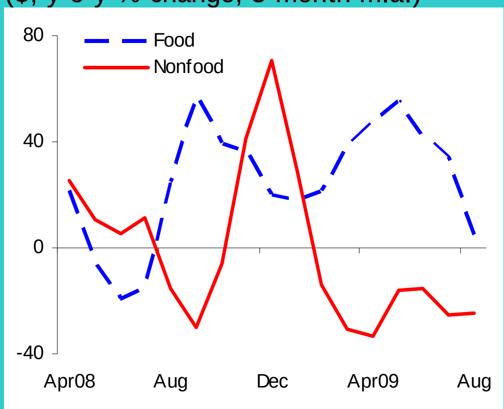
Northern Pacific States

FSM Inflation
(y-o-y % change in CPI, quarterly)



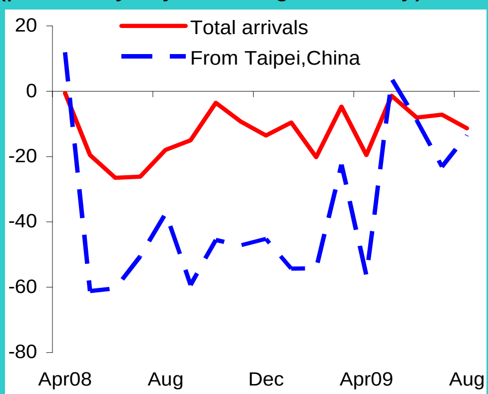
Source: US Department of the Interior Office of Insular Affairs. 2009. *Federated States of Micronesia Fiscal Year 2008 Economic Review*. August 2009.

RMI imports from the US
($; y-o-y % change, 3-month m.a.)



Source: US Census Bureau.

Palau visitor arrivals
(persons; y-o-y % change, monthly)



Source: Palau Visitors Authority.

Federated States of Micronesia

- Imports from the US remain firm, a result of high import requirements for major donor-funded infrastructure developments.
- Inflation fell to single digits in the June quarter of 2009 but food inflation remains persistently above 20%, further hurting those in hardship. To ease the pressures and promote food security, the government is encouraging the development of domestic food products.
- Payments under the Compact of Free Association grants are declining by $0.8 million annually. It is important to offset this by broadening the revenue base. The longer corrective action is delayed, the more critical the situation will become.

Marshall Islands

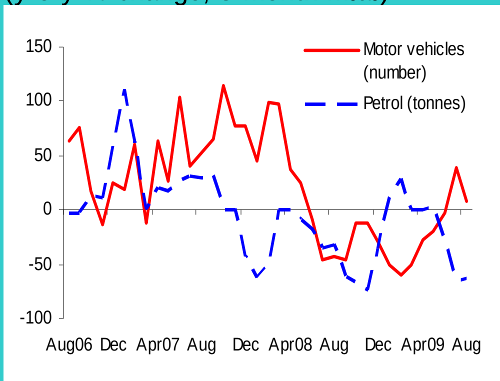
- Scarce public resources are being drained by a rising government wage bill and large subsidies to public enterprises, such as the electricity utility and the domestic air carrier. This highlights the urgent need for public sector reform. The difficult fiscal situation forced potentially harmful expenditure cuts in the fiscal year 2010 budget (ending 30 September 2010), notably to education funding.
- The urgency of the situation is acknowledged and plans are being developed by the Public Service Commission to rationalize the government wage bill. The reform process is potentially complicated by an unstable political situation; there was a successful vote of no confidence against the government in late October.
- A recent slowing in the growth in food imports, in addition to a continued fall in nonfood imports, suggest that domestic demand is now weakening.

Palau

- Tourism activity remains depressed, with visitor arrivals falling by 11.3% in August 2009 (y-o-y). This is the 18th consecutive month of year-on-year contraction in tourist numbers. The expected downturn for Taipei,China—a major market—means the decline in tourism may be longer than originally expected.
- A $53.7 million budget has been approved for fiscal year 2010 (ending 30 September 2010). The budget has cut government spending by 10% and dropped a proposed financial assistance program for low-income families.
- Uncertainty about the pending release of additional US funding, and ongoing renegotiations for a long-term extension of US financial assistance, is also dampening economic activity. The need to expand local revenue sources to mitigate the impacts of diminishing US financial support remains high.

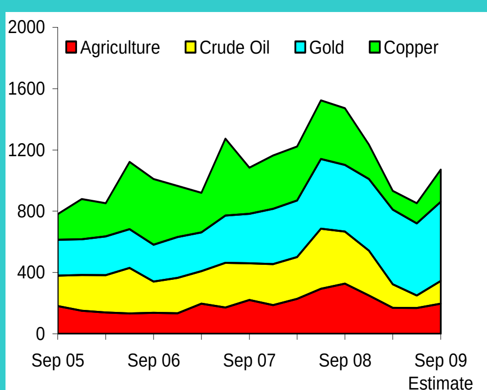
Papua New Guinea

Key imports
(y-o-y % change, 3-month m.a.)



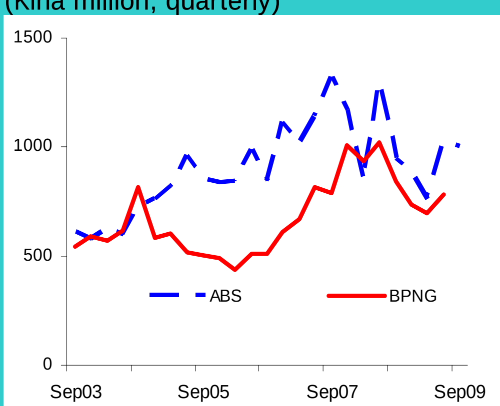
Note: Motor vehicles from Japan; petroleum from Australia.
Sources: ABS; Japan e-Stats website; PNG Department of Treasury; and ADB staff estimates.

Agricultural and mineral exports
($ millions, quarterly)



Source: Bank of PNG and ADB staff estimates.

Imports from Australia
(Kina million, quarterly)



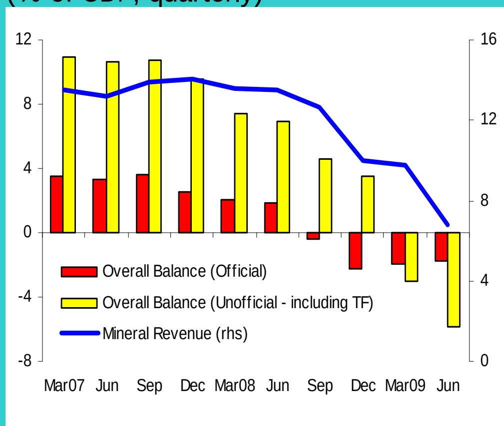
Sources: Bank of PNG.

Key developments

- The Bank of Papua New Guinea revised its real growth forecast for 2009 down to 6.2% from 7.6% in the September Monetary Policy Statement. The bank's growth forecast for 2010 is 5.2%. Even with the decreased expectations for 2009, the forecasts are more optimistic than ADB's latest forecasts of 4.5% for 2009 and 3.9% for 2010. The Bank of PNG is also somewhat more optimistic than the latest forecasts by the PNG treasury and the IMF.
- Declines in sales and lower employment growth in the first half of 2009 support the view that economic activity has moderated this year. Despite the recent recovery in commodity prices, year-to-date export earnings through the end of September 2009 are around 32% lower than in the corresponding period of 2008. Lower export income in turn lowers both government revenues and private consumption.
- Motor vehicle imports from Japan, a good indicator of aggregate demand, continue to drop dramatically. Year-to-date import volumes at the end of August 2009 were 23% lower than the corresponding period in 2008. Against this, the volume of petrol imported has recently trended up; which could be a response to a drop in pump prices over the first half of 2009.
- Import data suggest that consumption is indeed slowing. Year-to-date total imports from Australia, PNG's largest trading partner, declined by 9.3% through the end of September 2009 compared with the corresponding period in 2008. Official trade data, as reported by the Bank of PNG, show a decline in total non-mining imports of 1.4% in the first 6 months of 2009 compared with the same period in 2008.
- The government reported a deficit of 395.3 million kina in the 12 months ending June 2009, about 1.8% of GDP. However, this includes the use of 423 million kina from the Gas Commercialization Trust Account (held at the central bank) that was treated as revenues. The actual deficit is estimated to be closer to 6.0% of GDP if adjusted for trust fund account payments of K905 million during the first 5 months of 2009 (as reported in the *Mid-Year Fiscal Economic Outlook*). This compares with an estimated budget surplus of around 7.0% in the 12 months ending June 2008.
- The non-mineral budget deficit is also widening as mineral revenues decline.
- Government recurrent expenditures represented 47.7% and the development budget only 12.7% of the budgeted amount for the first 6 months of 2009. The poor performance reflects deterioration

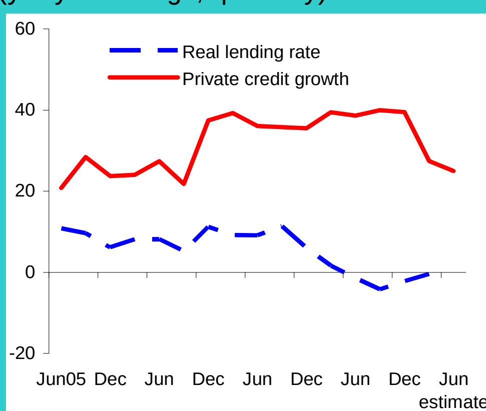
Papua New Guinea

Central government balances
(% of GDP, quarterly)



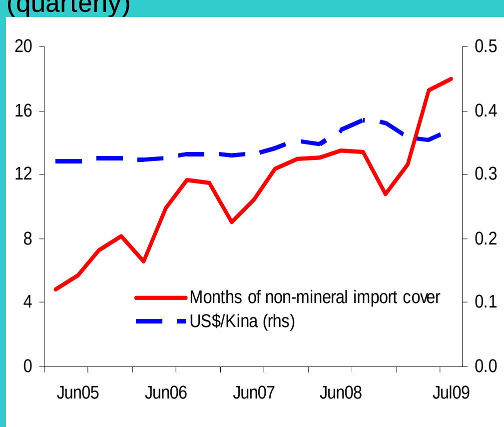
TF = Trust Funds
Source: PNG Ministry of Treasury.

Monetary indicators
(y-o-y % change, quarterly)



Source: Bank of PNG and commercial banks.

Exchange rate and reserves
(quarterly)



Source: Bank of PNG.

in the external economic environment as well as ongoing capacity issues in implementing agencies.

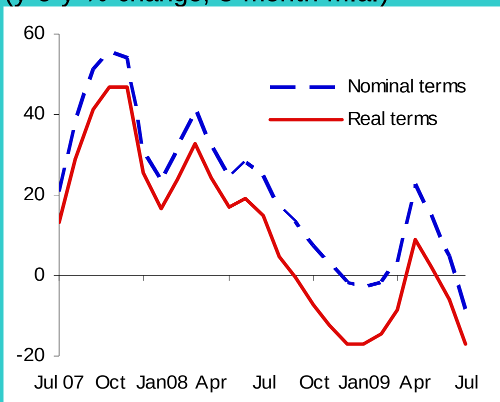
- Inflation is trending down, reaching 6.7% in June 2009 on a year-on-year basis. The Bank of PNG has nonetheless signaled that it intends to maintain a tight monetary policy stance until inflationary pressures have eased further. Its policy rate has remained unchanged, at a high 8% between December 2008 and October 2009.
- The Bank of PNG is particularly concerned that the government's trust fund accounts remain with the commercial banks, despite an understanding with the government that the funds would be transferred to the central bank. In response, the central bank has been actively absorbing excess liquidity and containing inflation by issuing substantial amounts of central bank bills in the 9 months to September 2009.
- Monetary and credit aggregate growth rates nonetheless remain high, although they are no longer accelerating. Annual private sector growth in July 2009 was about 21%, compared with 41% in the corresponding period in 2008.
- The recent recovery in export earnings and slowdown in import demand have slowed the pace at which the current account deficit was widening in 2009. At the end of August 2009, the level of gross foreign exchange reserves was $2.3 billion, estimated to be sufficient for about 18 months of non-mineral import cover.
- The kina depreciated by 2.5% against the US dollar and 8.9% against the Australian dollar between June and September 2009. The strength of the Australian dollar is likely to now contribute to import price pressures.

Key issues

- There remains some inconsistency between monetary and fiscal policies. The government should rapidly move the remaining trust fund accounts over to the central bank to reduce banking sector liquidity and support the Bank of PNG's effort to contain domestic inflation.
- Although macroeconomic performance remains strong, translating extractive industry revenues into a broader improvement in living standards remains a key challenge. Ensuring the integrity of public financial management, improving efficiency of sector spending, ensuring adequate infrastructure expenditure, and strictly controlling the size and performance of the public sector will be crucial to convert revenue from a PNG liquefied natural gas project into improved service delivery for the majority of Papua New Guineans.

Samoa

Remittances
(y-o-y % change, 3-month m.a.)

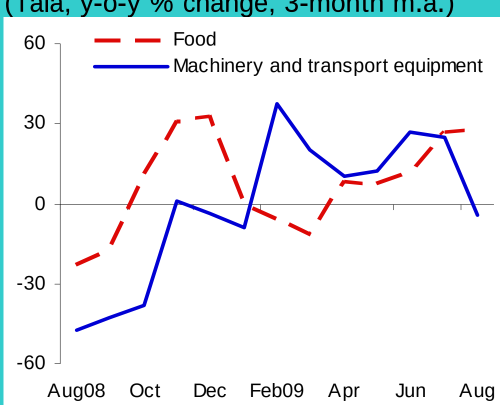


Note: Real values derived using consumer price index.
Source: Central Bank of Samoa.

Tourism
(y-o-y % change, 3-month m.a.)

Note: Real values derived using CPI.
Source: Central Bank of Samoa.

Key imports from US and NZL
(Tala, y-o-y % change, 3-month m.a.)



Sources: International Enterprise Singapore and US Census Bureau.

Key developments

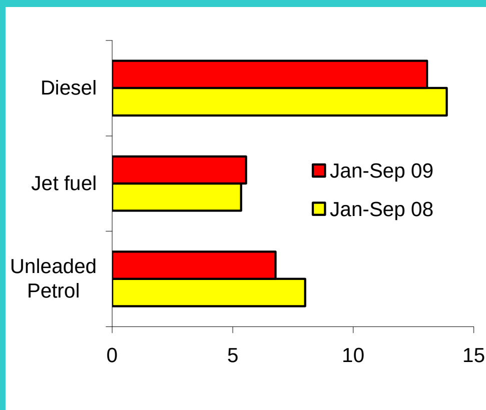
- ADB's pre-tsunami projection was for an economic contraction of 0.6% in 2009/10 due to rising unemployment and declining remittances (following the 5.5% contraction of 2008/09). Remittances picked up temporarily around April, a pick-up that appeared to be linked to the need to buy right hand-drive vehicles for the road switch. But by July, the underlying downward trend had re-established itself, and the real value of remittances was down by 17.0% on a year-on-year basis.
- The projection of an overall economic contraction was inspite an expected improvement in tourism. Tourism has showed signs of improvement, with increased arrivals from Australia and New Zealand in June and July—a peak tourism period. In nominal terms, tourism receipts were 8.3% higher in August compared than in the same month of last year.
- Against this background of an overall contraction for the year, there were some signs that the economy had bottomed and was beginning to recover. Notably, August food imports from the US and New Zealand was 27.2% above that of a year earlier, and the July volume of petroleum imports from Singapore was up by 23.0% on a year-on-year basis.
- Inflation has continued to ease, measuring 3.7% in August. The growth slowdown is reducing government revenue. A 5.2% fall in tax revenue had been projected for FY2010, and there now appears to be added downside risk.

Key issues

- The indications are that the tsunami may only have a small, negative impact on tourism (as discussed further below). And support from Samoans living overseas and the broader international community for those affected by the tsunami is now helping the Samoan economy. These factors suggest the economy can cope with the shock from the tsunami. Rehabilitation efforts may indeed result in a small economic expansion over the year.
- Even before the tsunami hit, government debt was projected to rise to high levels. The financial demands from rebuilding after the tsunami will cause the debt position to deteriorate further; the reconstruction cost alone has been estimated by some as at least $90 million (around 15% of GDP).
- This reinforces the importance of firming up the medium-term fiscal outlook, planning early for sensible reconstruction and advancing the economic policy agenda. This will help build prospects for an early and sustainable economic recovery.

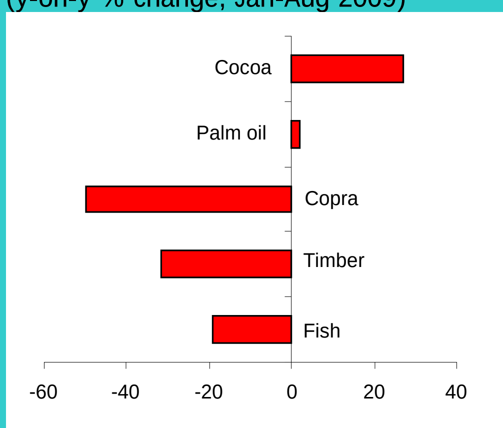
Solomon Islands

Volume of non-electricity fuel sales
(million liters, Jan-Sep)



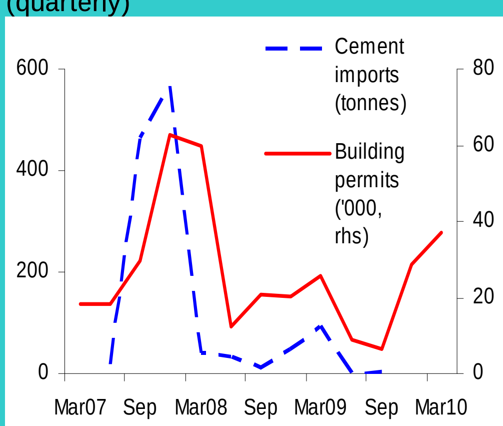
Source: South Pacific Oil.

Production of key commodities
(y-on-y % change, Jan-Aug 2009)



Source: Central Bank of Solomon Islands and ADB staff estimates.

Building activity
(quarterly)



Note: Building permits are lagged by 3 quarters.
Source: ABS and Central Bank of Solomon Islands.

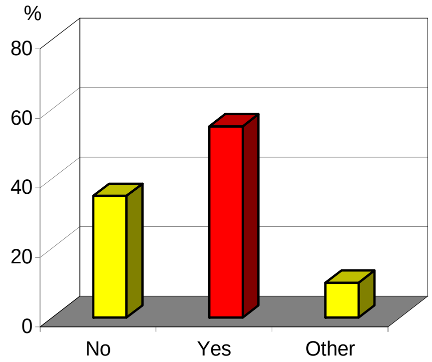
Key developments

- Economic developments in Solomon Islands continue to be consistent with no overall GDP growth for 2009. For example, non-electricity petroleum sales volumes, an indicator of overall activity, were down by 10% over the first 9 months of the year (compared with the same period of 2009).
- Economic data suggest the rural economy will contract over 2009. During the first 8 months of 2009, volumes are down for logging (32%), copra (50%), and fishing (19%), while palm oil is stable. Only cocoa volumes are up substantially. Commodity prices are generally down.
- An ADB business expectations survey undertaken in September suggests the Honiara economy is continuing to grow, albeit at a much slower rate. This is in contrast with the contraction expected in the rural economy.
- Of the 20 Honiara businesses surveyed, more than half reported that sales in the September quarter of 2009 were up compared with the same period in 2008. Almost 70% of the respondents expected revenues to increase over the next 3 months, and half of the respondents rated 2009 as better for their business than 2008. The relatively upbeat results of the Honiara business survey are likely to reflect high levels of government and aid-related spending in the capital. The business expectations survey will become a regular feature of ADB's monitoring of the Solomon Islands economy and the results will be published quarterly in future editions of the *Pacific Economic Monitor*.
- Cement imports from Australia have tracked downward over the past year as the economy has slowed. However, an increase in building permits—a leading indicator of construction activity—points to some prospect for improved construction activity in late 2009 or early 2010.
- After inflation surged to 16.5% in the March quarter of 2009 due to flooding in Guadalcanal, it fell back to 5.9% in July. This is primarily a result of an easing of fuel and food prices linked to softening demand. The key upside risk to inflation is the recent rise in international oil prices, which is yet to fully feed through the economy.
- The foreign reserves position is noticeably better than expected earlier in the year, with reserves rising to more than 5 months of imports in September. This has been partly due to one-off factors such as increased aid disbursements and increased special drawing rights held with the IMF.

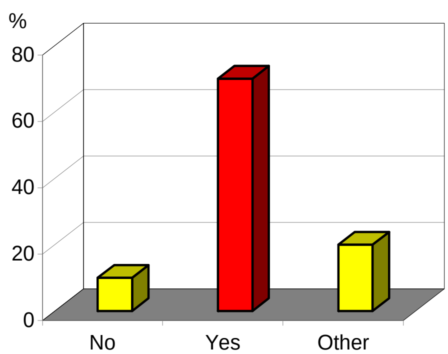
Solomon Islands

ADB Solomon Islands Business Expectations Survey (Sep 2009)

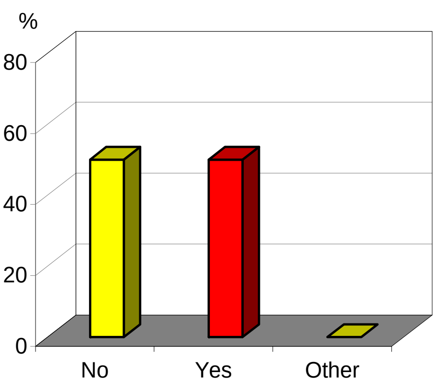
Were sales over the last three months up on last year?



Do you expect sales to improve over the next three months?



Do you expect 2009 to be better than 2008 for your business?



Source: ADB Business Expectations Survey.

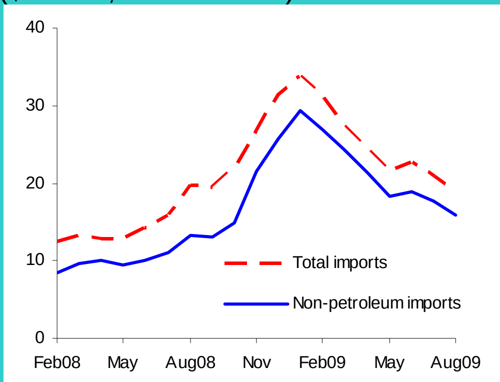
- So long as the budget remains in overall balance, official reserves could remain above or at least close to the central bank's target of 4 months of imports into 2010. Key risk factors on the balance of payments are the fiscal position and the recent increase in world oil prices.
- Excessive overall expenditure growth and a revenue shortfall arising from the economic slowdown have led to a fiscal crunch in 2009. According to figures released by the central bank, domestically sourced revenues in the first 7 months of the year were 7% below budgeted levels. Together with lower-than-expected cash reserves carried forward from previous years, this has resulted in significant cash flow pressure. In response to the deteriorating fiscal situation, most government-funded development spending were deferred, government hiring was suspended, and funding for goods and services was cut by 35%.

Key issues

- Economic stagnation looms in the absence of a concerted government response to the economic deterioration. The rural economy is likely to be hit much harder than Honiara. This is because the deterioration is led by a fall in international prices for tree crops and logging activity, which are key drivers of the rural economy. In contrast, high aid levels will continue to support economic activity in the capital. The fiscal situation is also expected to remain difficult given the current expenditure pressures and those likely to arise from the 2010 election, along with poor revenue performance.
- With government revenue underperforming, and the government committed to not borrowing, it will be necessary for the government to trim expenditures. Ideally, unnecessary expenditures would be cut and resources would focus on priority needs. Additional revenue could also be raised through improved administration and a tightening of the granting of exemptions.
- Additional planned spending on entitlements for members of Parliament poses a significant fiscal risk, even with the October refinement. This is both because of the direct cost (estimated at $3 million to $4 million in 2010, rising annually thereafter) and the indirect pressures it will create (e.g., for an excessive pay increase for public servants).
- As many formal sector businesses are directly or indirectly dependent upon the government, it is important that the government not fall into arrears with its bills and other obligations. Otherwise, the decline in government finances will quickly flow to the private sector and undermine business confidence.

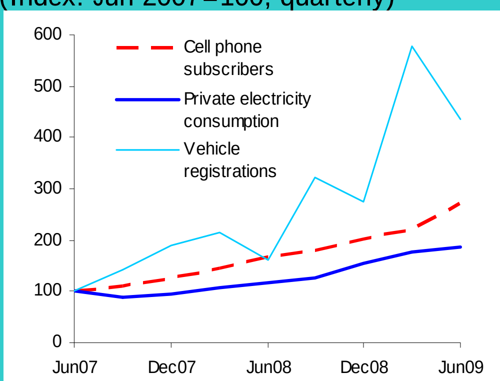
Timor-Leste

Real value of imports
($ million, 3-month m.a.)



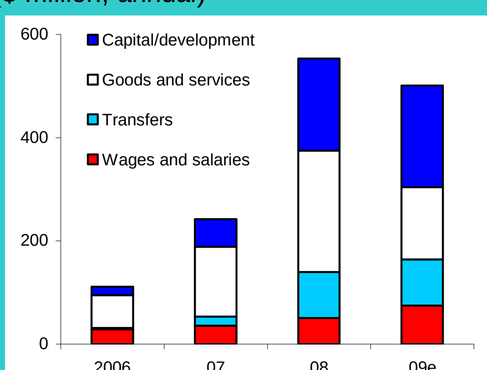
Note: Real values derived using CPI.
Source: Staff estimates based on Timor-Leste National Statistics Directorate quarterly statistical indicators, various quarters.

Indicators of aggregate demand
(Index: Jun 2007=100, quarterly)



Source: Timor-Leste National Statistics Directorate quarterly statistical indicators, various quarters.

Own-funded government expenditure
($ million, annual)



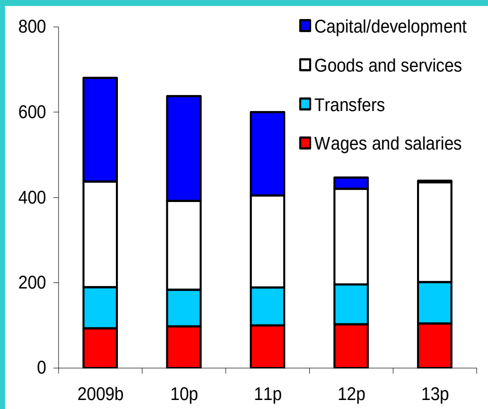
Notes: e=estimate; excludes donor-funded expenditure.
Source: Staff estimates based on Government of Timor-Leste. 2009. General Budget of State and State Plan for 2010, October; and Ministry of Finance. 2009. *Budget Execution Report up to the Second Quarter, Fiscal Year 2009.*

Key developments

- Economic activity has remained high in recent months. While imports are reported to have passed their peak, which points to some easing in aggregate demand since the start of 2009, imports have remained well above the levels of the same time last year. Alternative indicators of aggregate demand, notably the number of cell phone subscribers, private electricity consumption, and vehicle registrations, also suggest that economic activity is up substantially in 2009. The recent data are consistent with earlier projections of a high rate of economic growth in 2009.
- The developments in mobile telecommunications highlight the dramatic rise in consumer spending power. In mid–2007, there was one cell phone subscription for every 9.3 adults. By mid–2008, there was one subscription for every 5.7 adults. As of mid–2009, the figure had fallen to 3.6. Vehicle ownership also shows the rise in spending power. There were almost 6,000 vehicles registered in 2008. This number was registered in the first 6 months of 2009 alone.
- The economy is driven by high levels of government expenditure. The IMF estimated that in 2008 the ratio of self-funded central government expenditures (i.e., exclusive of donor-funded expenditures) to non-oil GDP rose close to 100%. This is almost double the 2007 ratio and very high by international standards (less than 50% is typical). The 2009 budget provided for another large increase in government spending; the 2009 budget allocated $681 million in self-funded expenditures, compared with an estimated actual spending of $553 million in 2008.
- As in previous years, the budget will be substantially underspent in 2009. The extent is still not clear, but the 2010 budget papers suggest that self-funded central government expenditures will be roughly $500 million in 2009. Excluding the UN, donors were originally budgeted to spend an additional $221 million in 2009, against $184 million in 2008.
- Much of the additional expenditures have been provided as transfers (e.g., to internally displaced persons and ex-combatants) and wages and salaries. These forms of expenditure feed quickly into the local economy. Spending on goods, services, and capital have also risen quickly, adding to the buildup in domestic demand.
- Spending power is also being boosted by the quick reversal in inflation, which was –0.1% in August on a year-on-year basis.

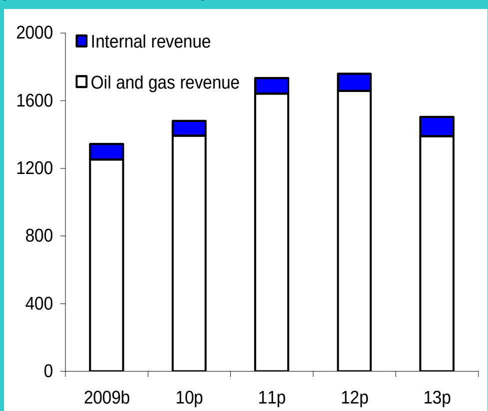
Timor-Leste

The 2010 budget: key aggregates
Own-funded government expenditure
($ million, annual)

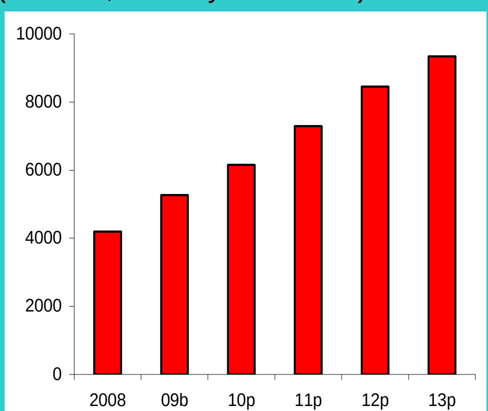


Note: Excludes donor-funded expenditure.

Own revenue
($ million, annual)



Petroleum Fund
($ million, end-of-year balance)



b=budget, p=projection.
Source: Government of Timor–Leste. 2009. General Budget of State and State Plan for 2010. October.

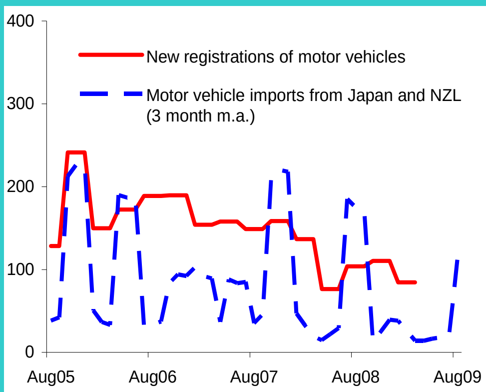
- The economy will be bolstered by the October decision of the United Nations Security Council to extend the presence of the United Nations mission to mid–2010. This will support spending in the economy and enhance security.
- On the downside, bank lending remains flat and nonperforming loans remain high at $31 million, out of total lending of $111 million.
- The economic outlook remains highly dependent on the government budget. The 2010 budget plans for total expenditures of just below the 2009 level. Again, underspending is likely. But the rate of budget execution is improving, and actual expenditures could rise during 2010. The rate of expenditure growth is nonetheless likely to slow, resulting in an easing in economic growth in 2010.
- Budget projections point to a drop-off in public spending beyond 2010, in both self- and donor-funded expenditures. This primarily results from a lack of information on future spending plans, rather than a firm change in spending. An increase in spending is more likely than a decline, with the government considering a large increase in capital expenditure in order to speed up the development process.

Key issues

- The 2009 budget was originally expected to make the first drawdown from the Petroleum Fund in excess of the estimated sustainable income. The actual drawdown (that was less than budgeted) is likely to match the recently upgraded estimate of sustainable income. The sustainable income estimate has risen from $408 million to $502 million, mainly because of the expected increase in gas prices). The IMF's latest Article IV staff report urged moderation of government spending to bring it in line with the estimated sustainable income. Such a fiscal discipline remains central to Timor-Leste's economic future.
- Parliament has recently approved the commencement of borrowing by the government. An agreement has been reached with the Government of Portugal on a $750 million concessional loan, and the 2010 budget foreshadows total borrowing of $3 billion from other sources. A good outlook for petroleum revenue provides comfort that future budgets will be able to service moderate levels of debt. Debt sustainability will, however, only be achieved if the debt is used well. The key is to ensure (i) a sound process for selecting investment projects, (ii) an emphasis on conservative investment in human capital and productive physical capital, and (iii) efforts to ensure investments pay for themselves through user charges, as much as feasible.

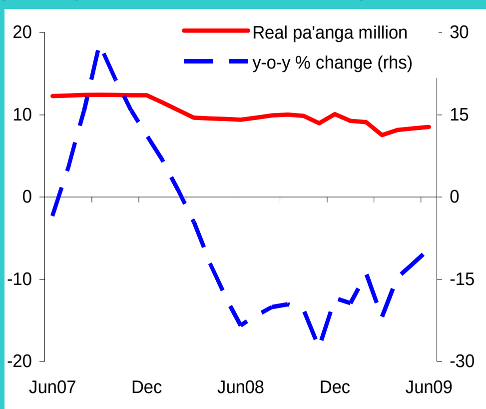
Tonga

Motor vehicles
(number, monthly)



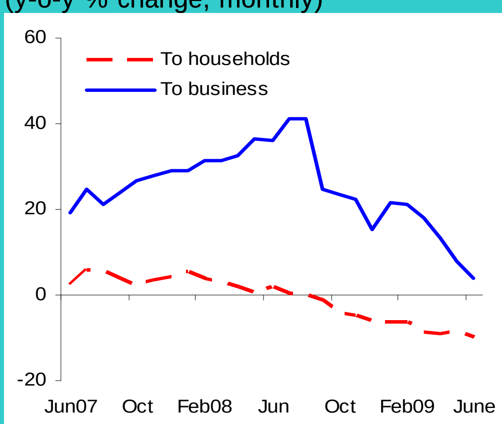
Sources: Japan e-Stats website, National Reserve Bank of Tonga, and Statistics New Zealand.

Private remittances
(Pa'anga million, 3-month m.a.)



Sources: National Reserve Bank of Tonga and Tonga Ministry of Finance and National Planning.

Private sector credit
(y-o-y % change, monthly)



Source: National Reserve Bank of Tonga.

Key developments

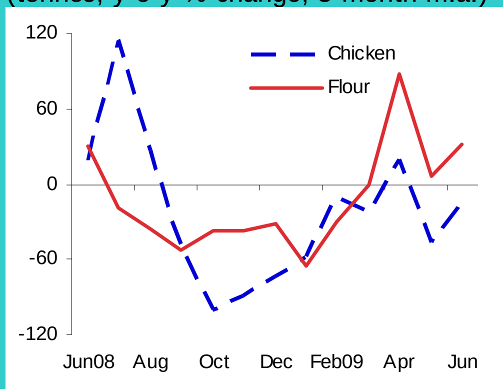
- The impacts of the global economic crisis are being felt in Tonga more swiftly and deeply than foreshadowed in the latest budget. Total revenue in the first 2 months of the September quarter was down 8.7% from the previous year, driven by a 23.8% decline in trade taxes. Year-end revenue projections have been downgraded as a result.
- Remittances, which normally account for more than 30% of GDP, have now been in decline for 15 months. As of June 2009, the real value of remittances was 9.5% below the same period in 2008. This poses a serious risk to living standards, as incomes decline, and also on business activity.
- Imports fell further, by 9.8% in August (y-o-y) from 0.1% decline in July. Exports also continued the downtrend in August, declining by 45.3%. Imports of new motor vehicles from Japan and New Zealand fell by 36% in August.
- Private sector credit growth declined by 7.8% in July on a year-on-year basis, following a fall of 2.9% the previous month. Tightened lending practices caused credit to fall in July by 8.6% for households and 6.4% for businesses.
- The one economic bright spot has been agriculture. Production for the domestic market has continued to grow as farmers have shifted away from export-based agriculture. This is likely a response to both low export prices and the recent episode of high import prices. This domestic refocusing will lead to import substitution.
- Tourism has also weakened (tourism receipts are typically around 10% of GDP). Tourist arrivals at the end of July 2009 declined by 2.0% on a year-on-year basis, while tourist receipts fell by 13.5% over the same period.

Key issues

- Weaker revenue collections are creating intense pressure on the budget. Significant expenditure cuts are likely to be forced on the budget. In the deteriorating economic environment, it is helpful to pay close attention to minimizing social impacts. A priority is to ensure that services provided to the most vulnerable members of the community are given preference when expenditure cuts are made.
- Tonga's high debt levels constrain government's ability to buoy the economy through increased capital investment. Indeed, taking on new debt would be inadvisable as it would add to an already high risk of debt distress.

Tuvalu

Imports from Australia
(tonnes; y-o-y % change, 3-month m.a.)

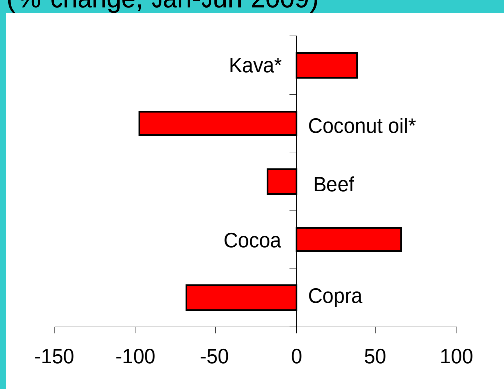


Source: ABS.

- The impact of the global economic crisis on Tuvalu's fiscal situation—which is a major determinant of growth—has been somewhat mitigated by the provision of donor funds and distribution of reserves held in the Consolidated Investment Fund.
- However, a general decline in the level of seafarer remittances, coupled with the introduction of various revenue reform measures (such as a consumption tax introduced in July), appear likely to negatively impact domestic revenues in the short term. This will, in turn, place pressure on the government's expenditure programs.
- Reforms in public financial management are now picking up the pace, with an emphasis on state-owned enterprises. These reforms are expected to offer a range of benefits, including improved resilience to external shocks.

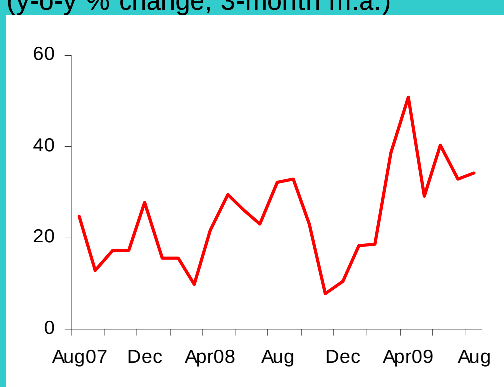
Vanuatu

Production of key commodities
(% change, Jan-Jun 2009)



* Exports used as proxy for total output.
Source: Reserve Bank of Vanuatu.

Cement imports from Australia
(y-o-y % change, 3-month m.a.)



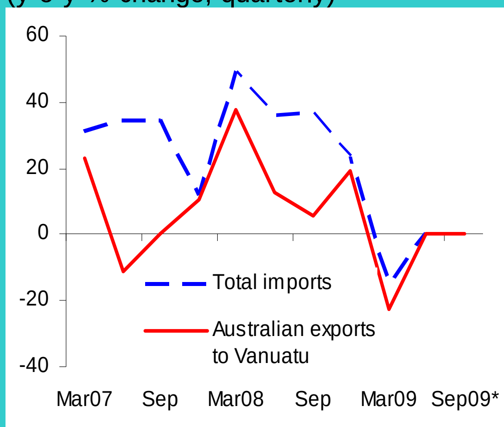
Source: ABS.

Key developments

- Economic developments in Vanuatu continue to be consistent with the growth forecast of around 4% in 2009. Continued strength in services (especially tourism) and industry (driven by construction) is more than offsetting weakness in agriculture.
- Tourism activity continues to rise. For the first 8 months of 2009, cruise ship visitors increased 43% to 90,920 and air arrivals rose 12% to 63,359 compared with the same period in 2008.
- But tourism’s rate of growth is slowing as Fiji Islands recover lost ground. After falling sharply over the first half of 2009, Australian tourist departures to Fiji Islands were 25.4% higher in July and 12.6% higher in August on a year-on-year basis. In contrast, Australian departures for Vanuatu were up by only 13.2% in July and by 10.2% in August on a year-on-year basis.
- Low commodity prices have muted production of key commodities such as beef and copra. The coconut oil mill in Espirito Santo suspended production in the first two quarters due to low stocks of copra. Cocoa and kava, however, have grown strongly in the first half of 2009. Kava production has been encouraged by strong local demand.
- Millennium Challenge Account–related construction activity and refurbishments of tourism facilities have lifted construction-related expenditures. This strength in construction is reflected in the growth in cement imports from Australia in 2009.

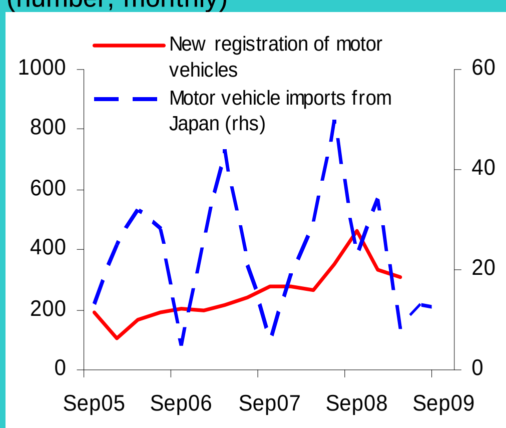
Vanuatu

Imports
(y-o-y % change, quarterly)



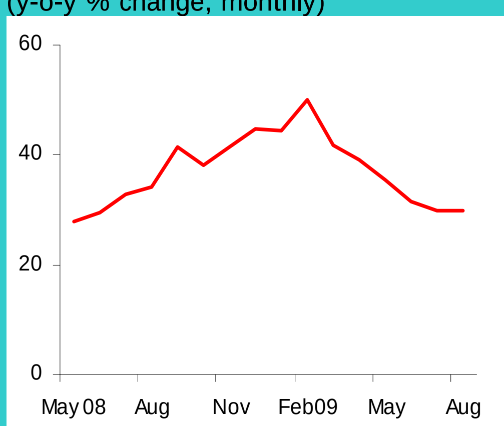
* Based on the first 2 months of the September quarter.
Sources: ABS and Vanuatu Statistics Office.

Motor vehicles
(number, monthly)



Sources: Japan e-Stats website and Vanuatu National Statistics Office.

Credit to the private sector
(y-o-y % change, monthly)



Source: Reserve Bank of Vanuatu.

- Nevertheless, there are signs of a leveling off in aggregate demand, reflecting weakness in the economy outside of the tourism and construction sectors. Total import growth and Australia's overall exports to Vanuatu are flat. Motor vehicle registrations have also softened since early 2008, although there has been some improvement in imports of motor vehicles from Japan in recent months.
- In the June quarter of 2009, the current account deficit narrowed to 1.0 billion vatu ($10.0 million) from 1.6 billion vatu ($15.6 million) in the March quarter. However, the central bank expects the current account deficit to widen over the next 18 months, driven by an increasing trade deficit and net income outflows, which are expected to more than offset any increase in tourism earnings. The reserve bank also expects imports to increase as large amounts of capital investment are injected into the Millennium Challenge Corporation project.
- Growth in credit to the private sector softened to 29% over the year to August 2009. This is down considerably from the peak of 50% growth recorded in February 2009. The current level of credit growth, however, is still more than three times the forecast nominal GDP growth rate and is unsustainably high. It raises the prospect of an increase in nonperforming loans if the economy slows, which appears likely.
- Inflation as measured by the CPI was 5.5% as of the June quarter of 2009 (y-o-y). This was down from an earlier peak of 6.1% in September 2008. The decline reflected the lagged effect of lower fuel prices finally feeding through, although it was somewhat offset by increased vegetable and cereal prices. Further moderation in the rate of inflation is expected over the remainder of 2009, but will likely remain above the Reserve Bank's target rate of 0–4% for the rest of 2009.

Key issues

- Amendments to the Employment Act passed in late 2008 have resulted in extremely generous provisions for those in formal employment. The amendments will substantially increase labor costs at a time when formal employment is at a premium and the imperative is to create new jobs. ADB's 2009 private sector assessment concluded that the new provisions will threaten the viability and existence of small businesses, result in increased unemployment, exclude women from the workforce, reduce the competitiveness of the economy, slow economic growth, and lead to the substitution of capital equipment for labor where such substitution is possible.

Rising hardship

Growth elasticity of poverty

The growth elasticity of poverty indicates how effectively growth has translated into poverty reduction. The elasticity is the percent change in poverty with respect to a 1% change in per capita GDP (or mean income or expenditure per capita), where poverty is any of the Foster-Greer-Thorbecke poverty measures, but usually the headcount index.

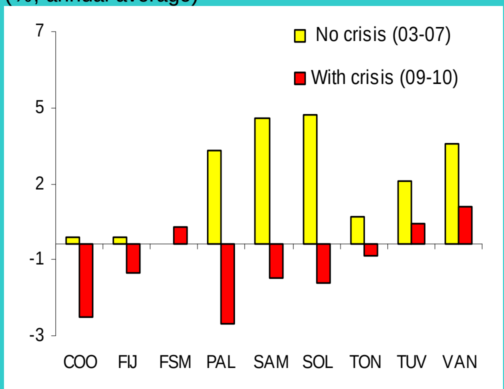
The elasticity can be constructed using either household unit record data or distributional data from household income and expenditures surveys. For the latter, expenditure shares of deciles of households ranked by per capita expenditure can be used to estimate a parameterized (generalized quadratic or Beta) Lorenz curve. The parameters of the Lorenz curve can be used to estimate the point elasticity of the poverty measure with respect to mean consumption. Because simplified assumptions are necessary to estimate elasticity in this way, the elasticity should be used with care.
Source: World Bank (www.worldbank.org).

Estimated elasticities

FSM	-2.47
Palau	-4.84
Solomon Islands	-2.53
Vanuatu	-2.29
India	-1.87
Philippines	-1.49
Viet Nam	-1.76

Source: ADB staff estimates using published distributional data.

Per capita GDP growth rate
(%, annual average)



COO=Cook Islands, FIJ=Fiji Islands, GDP=gross domestic product, PAL=Palau, SAM=Samoa, SOL=Solomon Islands, TON=Tonga, TUV=Tuvalu, VAN=Vanuatu
Note: "With crisis" refers to *Asian Development Outlook 2009 Update* forecasts for 2009 and 2010. "No crisis" refers to actual growth rates from 2003 to 2007.
Source: ADB, *Asian Development Outlook 2009 Update*.

Key risks

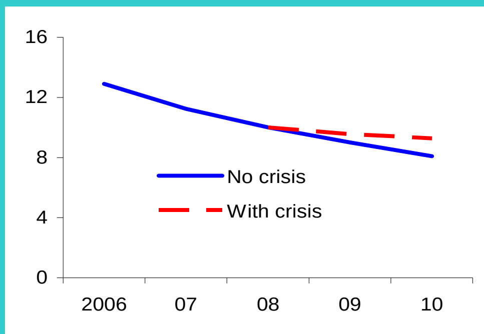
- The impact on livelihoods of the region's economic slowdown is still unfolding. Key sources of negative impact on livelihoods are the loss of jobs, rising underemployment, lower incomes from cash crops, and falling remittances due to weakening offshore labor markets. Indirectly, cuts to government spending on essential services will also compromise living standards.
- But how large are these impacts? How big is the risk of an increase in the vulnerable population? Understanding the magnitude of the impacts on the vulnerable is an important policy issue. It will help inform consideration of the policy response needed by governments and an appropriate level of support to the region from the international community.

Methodology

- The likely magnitude of the impacts can be estimated by reference to the extent of the economic slowdown. Many of the direct impacts manifest in lower rates of economic growth. Lower rates of economic growth mean more people will be living below the poverty line than would otherwise have been the case. The additional number of people living below the poverty line provides one estimate of the human impact of the economic slowdown.
- It is possible to use the results of the Household Income and Expenditures Survey to estimate the "growth elasticity" of poverty. This shows the relationship between economic growth and measures of the extent of poverty. Preliminary estimates of the growth elasticity of poverty for a range of countries suggest that a 1% increase in economic growth would reduce the share of the population living below the poverty line by 2% to 5%. These preliminary estimates suggest that poverty rates in the Pacific may be somewhat more responsive to economic growth than in Asia.
- The growth elasticity of poverty can then be applied to estimates of the economic growth lost because of the economic slowdown. This provides an estimate of the number of people living below the poverty line that would otherwise have been non-poor.
- A key issue in preparing such an estimate is the economic growth that would have been achieved without the global crisis. The average growth rate from 2003 to 2007 is used to represent what would otherwise have been achieved.

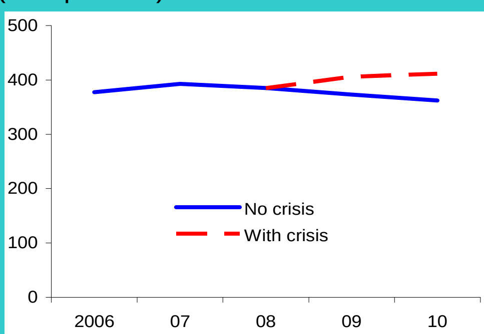
Rising hardship

Poverty incidence in Vanuatu
(% of population)



Note: The results assume an elasticity of poverty of 3.0 and per capita GDP growth projections.
Source: ADB staff estimates.

Pacific Islands poverty incidence
('000 persons)



Note: Pacific Islands excludes Kiribati, Nauru, Palau, PNG and Timor-Leste. The results assume an elasticity of poverty of 3.0 and per capita GDP growth projections.
Source: ADB staff estimates.

Poverty incidence

Country	Initial estimate (% of population)	Change due to crisis 2010[a]	
		% of population	Number of persons
Cook Islands	12.0 *(1998)*	1.0	232
Fiji Islands	28.8 *(2002/2003)*	1.9	15,996
FSM	22.4 *(2005)*	(0.9)	(948)
Samoa	20.3 *(2002)*	3.5	6,374
Solomon Islands	18.8 *(2005/2006)*	4.2	22,941
Tonga	22.3 *(2002)*	1.5	1,505
Tuvalu	29.2 *(2005)*	2.1	211
Vanuatu	12.9 *(2006)*	1.2	2,906
Pacific Islands			49,215

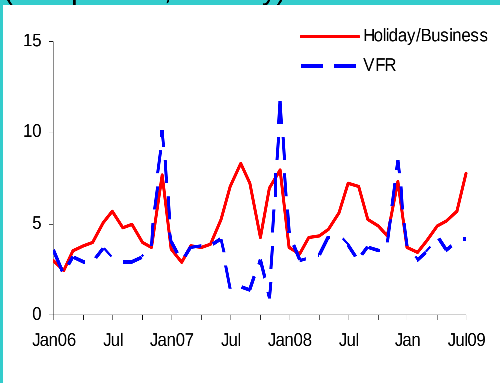
Note: Figures refer to the population living below the poverty line.
[a] Relative to projected poverty incidence in 2010 using pre-crisis growth rate.
Sources: ADB staff estimates drawing on data from analytical reports on household income and expenditure surveys for various years, prepared jointly by the countries' statistics offices and the United Nations Development Programme–Pacific Centre.

Scenarios

- Scenarios are prepared that estimate the headcount measure of poverty (i.e., the share of the population living below the poverty line) with and without the crisis. The scenarios use a poverty growth elasticity of 3.0, the average elasticity for the Pacific islands for which data are available.
- The methodology is illustrated for the case of Vanuatu. The analysis of the 2006 Household Income and Expenditure Survey found that 12.9% of the population was living below the basic needs poverty line.
- Vanuatu's robust economic growth since 2006 is likely to have further reduced the incidence of poverty. Applying the growth elasticity of poverty of 3.0, the headcount measure of poverty is estimated to have fallen to 10.0% in 2008. Had growth continued unabated, the incidence of poverty would have been projected to decline further to 8.1% by 2010. But the slowdown in economic growth is expected to result in 9.3% of the population living in poverty by the end of 2010. An extra 2,906 people are estimated to be living below the poverty line in Vanuatu because of the global economic crisis.
- Across the Pacific Islands, it is estimated that an extra 50,000 people will be living below the poverty line by the end of 2010 because of the global economic crisis. This amounts to 2.4% of the Pacific Islands population.
- It is worth emphasizing that this is only the impact on the most vulnerable members of the Pacific community. It shows the additional number of people unable to meet their basic needs, in terms of food and nonfood expenditures. Coping mechanisms will differ, but likely consequences of living below the poverty line include inadequate diets, malnutrition among children, low attendance at school, and an inability to afford health care.
- The adverse impacts of the global economic crisis also extend beyond those living below the poverty line. The living standards of the non-poor have also been reduced by the economic slowdown. While they are better placed to cope than the most vulnerable members of the community, many would be facing hardship because of the economic slowdown.
- Impacts on petroleum and mineral-rich Papua New Guinea and Timor-Leste are not estimated, as the reasonable rates of economic growth achieved even in the presence of the global economic crisis would have muted poverty impacts.

The tsunami's impact on tourism

Visitor arrivals
('000 persons; monthly)

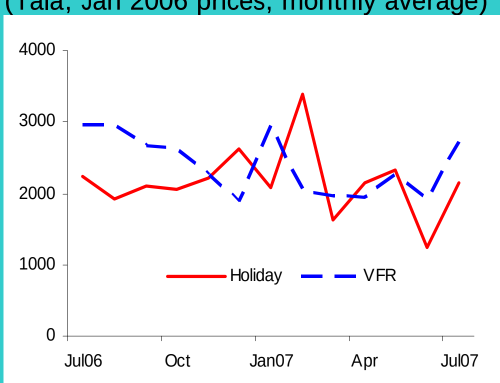


VFR=visiting friends and relatives
Source: Central Bank of Samoa and Statistics New Zealand.

Visitors staying in hotels and motels
('000 persons, monthly)

Note: Data are only available to July 2007.
Source: Central Bank of Samoa.

Expenditure by type of visitor
(Tala; Jan 2006 prices, monthly average)



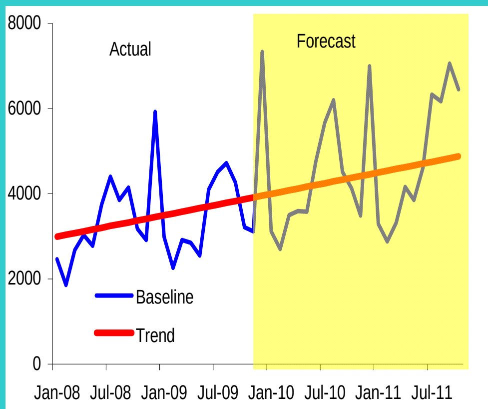
VFR=visiting friends and relatives.
Note: Data are only available to July 2007.
Source: Central Bank of Samoa.

Risks

- Tourism is a large part of the Samoan economy, with the ratio of tourism receipts to GDP having grown to 20% (tourism's share of total value added, or GDP, is much less than this because some of the receipts are spent on imports). The September tsunami therefore has the potential to have a significant macroeconomic impact on the Samoan economy via lost tourism. Many holiday bookings for October and forward bookings were cancelled immediately after the tsunami. The question is how quickly it will take to reverse the situation.
- The tsunami had its main impact on the southeast coast of Upolu, which is one of Samoa's most popular destinations. Three deluxe and one superior resort, and another 7 accredited operations on this section of coast were affected. It is estimated that 128 rooms and 322 beds were destroyed or partially damaged. In total, around 10% of tourist accommodation accredited by the Samoa Tourism Authority has been affected. And up to 20 kilometers of beach and reef were at least partially degraded.
- The extensive damage to tourism and other infrastructure will need to be repaired and debris now littering beaches and marine areas removed before tourism levels can be restored to pre-tsunami levels.
- The tsunami will also damage the tourism industry by changing perceptions about the desirability of Samoa as a holiday destination. This impact is harder to quantify, but nonetheless needs to be factored in. Extra marketing efforts and discounting may be required to recover lost ground, further eroding tourism's contribution to the economy.
- Visitor arrivals to Samoa are highly seasonal. Two peaks are evident. Peak arrivals are around Christmas, driven by a surge in Samoans returning for the holiday season. There is a flatter but more extended mid-year peak, which coincides with the southern hemisphere winter. This is a popular time for visits by vacationers from Australia and New Zealand, the main source of Samoa's visitors.
- The tsunami hit just after the mid-year peak, but before the Christmas peak when the majority of visiting friends and relatives arrive. It is likely that visiting friends and relatives will not be deterred by the tsunami. Indeed, there are early indications that there may be more arrivals than usual this year as friends and relatives return to provide support. The key concern is the approaching mid–2010, when the number of tourists arriving for a holiday would normally peak.

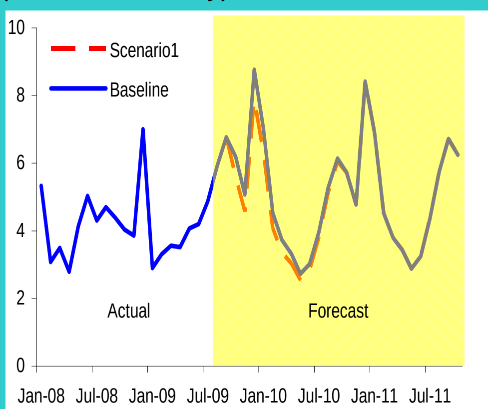
The tsunami's impact on tourism

Tourist forecasts without tsunami
(persons; monthly)



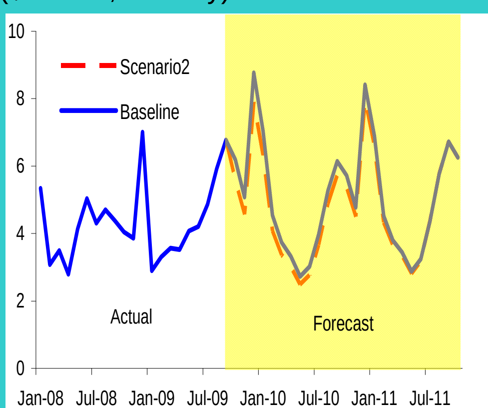
Source: ADB staff estimates.

Scenario 1: Tourism earnings
($ million; monthly)



Source: ADB staff estimates.

Scenario 2: Tourism earnings
($ million; monthly)



Source: ADB staff estimates.

- The hotel industry focuses on holiday makers and business travelers (this can be seen from the mid-year peak in hotel and motel occupancy). While the damage to tourist accommodations is unlikely to be a constraint on near-term visitor arrival numbers, because they are approaching a low period, this constraint could begin to bind in mid-2010.

Scenarios

- Experiences from other countries (e.g., the experiences of Indonesia, the Maldives, and Thailand after the 2004 tsunami) suggest that it can take 1 to 2 years for a tourism industry to recover from the effects of a natural disaster. There are however special factors that may allow a faster recovery in Samoa's tourism.

- One is the loyalty of Samoa's past guests. One of the deluxe resorts is already receiving assistance from past guests to rebuild, and is expected to be operating with upgraded and expanded facilities before the next mid-year. The fales can be rebuilt quickly, and this is already under way. There is also the potential for tourists to stay and/or visit the unaffected areas of Samoa, such on as the second large island of Savaii. A further factor is the boost to demand expected from the release of the Survivor series recently filmed on Samoa.

- Tourism earnings from vacationers are projected under three scenarios. The baseline scenario is a continuation of the tourism growth since the national airline's restructuring. Two scenarios then look at the impact of an initial 10% contraction in the arrivals of vacationers. Scenario 1 assumes a recovery after 1 year, and scenario 2 is for a slower recovery that takes 2 years. All scenarios allow for seasonal effects. Tourism earnings foregone for each arrival is assumed to be $960, a recent average level of expenditure for holiday visitors. Visiting friends, relatives, and businesspeople are assumed to not be impacted by the tsunami (early indications are they will instead rise over the year).

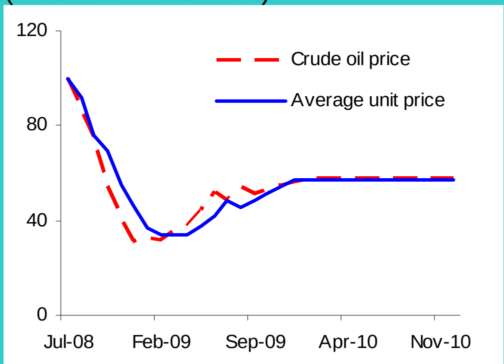
- The estimated direct loss in tourism earnings is $4.6 million under scenario 1, and $7.5 million under scenario 2. Using an economic multiplier of 0.7 (from ADB. 2009. *Taking the Helm.* Manila) the income lost because of the the tsunami is estimated at around 0.6% of GDP for a 1-year recovery period, or around 1.0% of GDP spread over a 2-year recovery period.

- Initial indications are these are upper estimates of the potential impacts on the economy, and could well be offset by positives elsewhere (e.g., the stimulus from reconstruction).

The rising price of oil

Oil and fuel prices

(Index: Jul 2008=100)



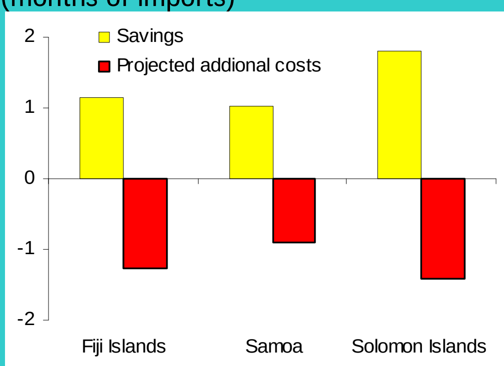
Note: World crude oil prices from September 2009 onwards are projections based on the IMF's latest oil price forecasts in *World Economic Outlook*, October 2009. Average unit price is derived from monthly values and volumes of fuel exports to the Pacific Islands. Average unit price is projected to increase by 25% by the end of 2009 due to observed lags in price transmission to the Pacific before converging with world crude oil price movements in 2010.
Source: Staff estimates using data from International Enterprise Singapore's monthly oil statistics, and IMF. 2009. *World Economic Outlook.*

Change in fuel import bill

($ millions)

	Jul 2008–Feb 2009 (Savings)	May 2009–Dec 2010 (Projected additional costs)
Fiji Islands	190.9	214.9
Samoa	21.5	18.8
Solomon Islands	34.3	27.2

(months of imports)



Note: Savings are derived using changes in unit fuel prices (i.e., from its peak in July 2008 to its low in February 2009) and actual import volumes. Projected costs are derived using the assumed path of fuel prices from the low in May 2009 and typical fuel import volumes.
Sources: Staff estimates using data from International Enterprise Singapore's monthly oil statistics, and the ADB Asian Development Outlook database.

Risks

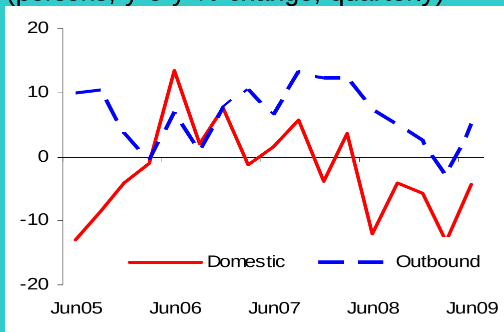
- To understand the reasons behind the recent increase in the international price of oil, it is helpful to briefly revisit longer term developments. The oil price shocks of the 1970s and 1980s had reduced the growth in oil demand by triggering substitution to other fuels and improvements in energy efficiency. A reduction in inefficient oil consumption in the former Soviet Union as it adjusted to market-based prices also slowed growth in the demand for oil. On the supply side, high levels of excess capacity, combined with a reduction in the market power of the Organization of Petroleum-Exporting Countries, also put downward pressure on international prices. Low prices in turn reduced investment in supply capacity. The result was the historically low prices of the 1990s that extended into the early 2000s.
- The rise in international oil prices from the early 2000s to mid-2008 was a result of a rebuilding in demand growth in the face of low supply growth. A structural break occurred in the international oil market over the period. The demand and supply pressures that raised prices then were only temporarily suppressed by the global economic crisis. Higher oil prices were always expected once international demand rebuilt, unpinned by commodity-intensive growth in Asia. Long lags in developing supply capacity and the rising marginal cost of extracting crude oil were also expected to add to upward pressure on prices.
- The higher prices seen recently are thus a sign of what can be expected over the longer term. What could this mean for the Pacific?

Scenarios

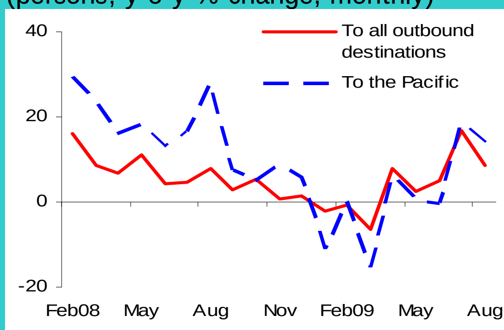
- The fall in international oil prices in mid-2008 had provided a small boost for the weakening Pacific economies. It is estimated that the savings offered by the drop in oil prices were the equivalent of 1 to 2 months of imports in the Fiji Islands, Samoa, and Solomon Islands. The fall in oil prices helped lift official reserves into the comfort range set by the central banks.
- The recent increase in the price of oil has the potential to largely undo these benefits. Notably, in the Fiji Islands and Solomon Islands, the higher oil prices is enough to bring reserves below target levels by the end of 2010 (all else being equal).
- Higher oil prices represent a permanent terms-of-trade loss for the Pacific. They will lift the cost of the region's imports. The loss adds impetus to act to lift the region's export performance, so the larger import bill can be funded.

Green shoots in Pacific tourism

Australian tourism
(persons; y-o-y % change, quarterly)

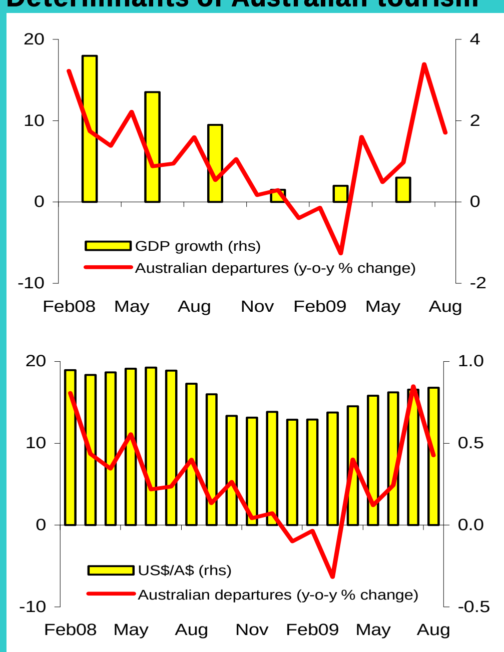


Australian outbound tourism
(persons; y-o-y % change, monthly)



Sources: ABS and Tourism Research Australia.

Determinants of Australian tourism

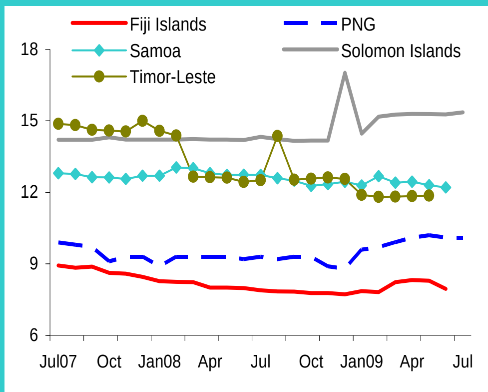


Note: GDP growth is seasonally adjusted year-on-year % change in quarterly output. The US$/A$ exchange rate is as of month's end.
Sources: ABS and the Reserve Bank of Australia.

- To understand the immediate prospects for the Pacific tourism industry, it is necessary to understand the likely developments in Australia and New Zealand. Australian tourists account for about 35% of arrivals in major Pacific destinations, and are the most likely to show a pickup in activity. This is because of the relative strength of the Australian economy—Australia has managed to avoid recession and is the lone advanced economy projected by the IMF to register positive growth over 2009. New Zealand accounts for a further 25% of arrivals, and is the key source for the most southern destinations.
- Overall Australian tourism activity is still down, consistent with the still-low level of economic activity. For every Australian taking an overseas holiday, around 10 take a domestic holiday. Domestic holidays by Australians are still falling (albeit at a lower rate). But outbound tourism by Australians has recently begun to increase, and the Pacific has shared in this turnaround.
- The overall resurgence of outbound tourism can be expected to continue. Economic growth rates are an important determinant of Australia's outbound tourism, and the prospects for higher economic growth in Australia bode well for outbound tourism.
- Will outbound tourism continue to outperform domestic tourism? The recent strength of the Australian dollar is probably contributing to the relatively better performance of outbound tourism, and this also looks likely to continue. This alone suggests the answer is probably yes.
- Similar, though less pronounced, trends are also evident in New Zealand. Total New Zealand tourist departures recovered to 2008 levels in August 2009. This appears to be linked to some improvements in the economy, a stronger currency, and the effects of marketing and promotional discounts.
- It is therefore reasonable to conclude that Australian tourism, and probably also New Zealand tourism, are "green shoots" for the Pacific.
- Importantly, the Pacific economies can act to maximize the potential benefits. The apparent sensitivity of Australian and New Zealand tourists to exchange rates point to the importance of maintaining competitive exchange rates in the region. Keen pricing of air travel and accommodations is also important to maintaining competitiveness. The growth in budget airline travel is also likely to contribute to the growth in outbound tourism from Australia and New Zealand. The Pacific will benefit from continuing to keep pace with these emerging industry trends.

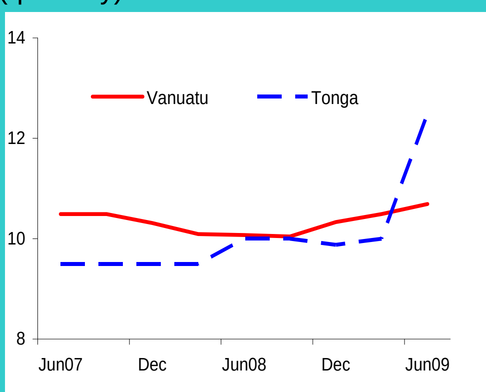
Monetary management in the Pacific

Average lending rates
(monthly)



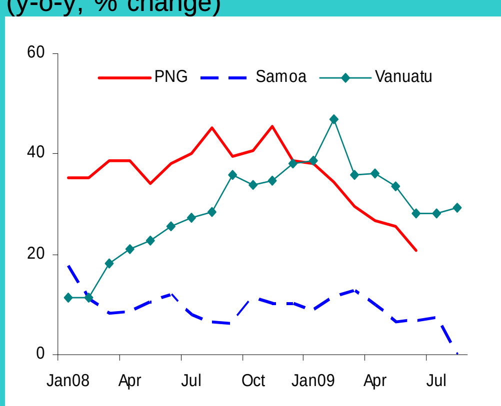
Note: Weighted average lending rates of commercial banks shown.
Source: Various reserve banks of Pacific countries.

Average lending rates
(quarterly)



Note: Weighted average lending rates of commercial banks are shown.
Source: Various reserve banks of Pacific countries.

Domestic credit
(y-o-y, % change)



Source: Various reserve banks of Pacific countries.

Monetary management in the small open economies of the Pacific operates in a constrained environment. Financial markets are shallow, underdeveloped, and often dominated by large publicly-owned pension (provident) funds. Pegged exchange rates generally provide the nominal anchor, meaning that central bank efforts to achieve external stability rest heavily on monetary policy and financial market intervention. Price based instruments, such as treasury or central bank bills, are either nonexistent or compromised by shallow markets and the dominance of the provident funds. In some countries, expansionary fiscal stances place a heavy requirement on domestic credit, complicating monetary management.

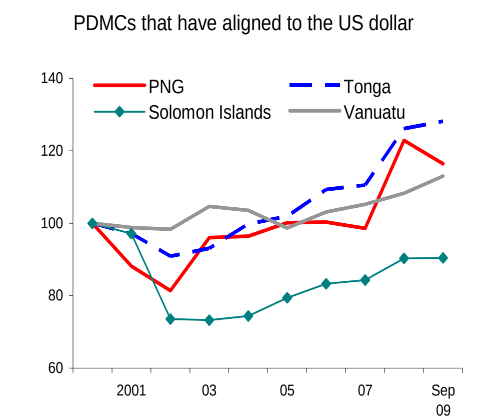
In the context of a fixed exchange rate arrangement, monetary policy is primarily aimed at preserving international reserves. IMF analysis, although constrained by data availability, suggests that the exchange rate pegs in the Pacific tend to be overvalued. This contributes to narrow export sectors and trade balances generally been in deficit. Although most countries enjoy a surplus in the services account due to tourism and remittances, current account deficits are very high. Capital inflows, both private and official, needed to offset the current account deficits, are volatile. Monetary policy therefore needs to err on the side of caution to contain import demand and discourage capital outflows. Speculative capital inflows are not a significant issue in the Pacific.

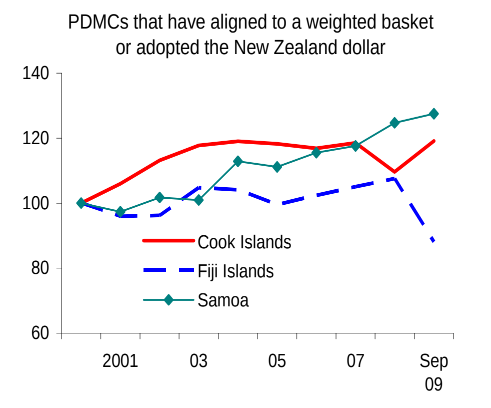
Price stability is also a key objective. However, movements in world commodity prices and domestic supply factors, mainly in agriculture, play a dominant role in determining inflation. Information on second-round effects and inflation expectations is difficult to obtain from official statistical agencies with very limited capacity. Monetary managers must therefore make decisions based on judgment, with the knowledge that monetary policy actions to influence domestic demand often have limited impact on headline inflation.

Transmission mechanisms to growth are weak. Many central banks in the region do not explicitly include promotion of growth in their monetary policy objectives. However, most do react to threats to growth by loosening policy. Central bankers understand that the effects of monetary demand management on GDP growth are weak; with a small base of domestic production, credit growth translates largely into raising import demand with limited pass-through into the domestic economy.

Monetary management in the Pacific

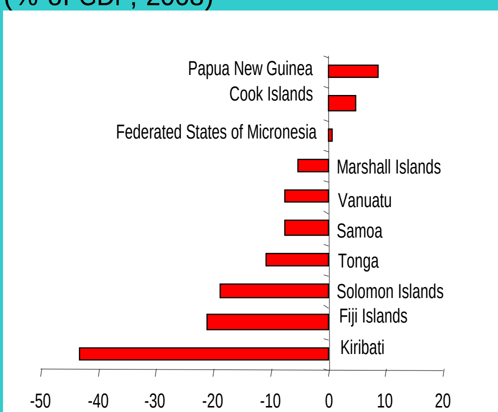
Real exchange rate
(Index: 2000=100, annual)





PDMCs=Pacific developing member countries.
Note: Real exchange rate derived as the nominal weighted basket adjusted for inflation differentials.
Source: ADB staff estimates.

Current account balance
(% of GDP, 2008)



Source: Various reserve banks of Pacific countries.

The past year provides an interesting case study of the delicate balance between ensuring stability and supporting and safeguarding growth. Before the global crisis, monetary managers were struggling with inflation and balance-of-payment pressures due to rising oil and food prices. As a result, central banks across the region maintained a tight stance through selling central bank papers (Solomon Islands and Tonga), selling treasury bills (PNG), and direct controls such as credit ceilings (Fiji Islands). Nevertheless, in most countries, inflation remained high at the beginning of 2009 and international reserves were declining; as a result, liquidity in domestic banking systems began to decrease.

The onset of the global crisis in the Pacific increased uncertainty for policy makers. The global crisis initially reduced pressures on prices and international reserves as high commodity prices receded. However, inflation remained stubbornly high in a number of countries due to lags in the pass-through of international price reductions and domestic demand pressures. The prospect of significant declines in commodity incomes, tourism receipts, and remittances threatened both reserves and growth. Asset quality in the financial system also began to decline as domestic borrowers' incomes came under pressure, hampering the system's ability to service loans. In addition, government revenue collections fell off, widening the budget deficits.

Central bankers had to strike a fine balance between moderating the impact on growth without prejudicing price stability (i.e., inflation) and external stability (i.e., the overall balance of payments outcome). Monetary policy initially remained tight in a number of countries, reflecting the overriding priority of protecting foreign reserves and controlling inflation. As the effects of the crisis fed through, reserves stabilized as a result of weak import demand and low commodity prices and gradually began to increase with contributions from official and private capital flows, including issuance of IMF special drawing rights. Inflation was generally muted, aided by appreciation against the key food importing markets of Australia and New Zealand.

Countries gradually loosened their stance in order to maintain a flow of credit to productive sectors and ease pressures on existing borrowers. Monetary policy was eased through ceasing sale of paper into the market (Tonga), easing reserve ratios (Fiji Islands, Tonga, and Vanuatu), and depreciating exchange rates (Fiji Islands, Solomon Islands).

Monetary management in the Pacific

However, with commercial banks taking a lead from their parents in Australia and tightening lending standards, credit responses were muted. Monetary easing in these circumstances was also targeted at reducing the burden on domestic borrowers through interest rate reductions. Central banks occasionally sought to reinforce this through further regulation on commercial banks' interest rates (Fiji Islands) or less binding agreements on spreads (Tonga).

Looking forward, the challenge is to identify the right time to shift to a tighter stance as imported inflation and reserves pressures reemerge. In many Pacific Island nations, increases in reserves appear to be supported by one-off factors, and the risks to reserves from underlying current account deficits will remain. Key risks are (i) the return of high commodity prices as part of the global recovery, (ii) continued pressure on tourism demand, and (iii) decreased remittances due to high unemployment in key economies (unemployment tends to be one of the last indicators to recover as economies exit from recession). Expansionary fiscal stances also pose a potential risk to reserves, particularly if deficits are not externally financed.

Central banks will need to implement early warning signals to help them maintain stability without unduly threatening growth. In addition to monitoring international flows and markets, central banks need to keep a close watch on domestic indicators and act preemptively to deal with emerging pressures. Important indicators include wage levels and major settlements (particularly in the public sector); excess liquidity in the banking system (for instance, in Tonga there is evidence that excess liquidity feeds into credit growth with a lag of around 9 months); interest rates on new loans; nonperforming loan levels; and monthly credit patterns (year-on-year growth figures are likely to be misleading). Business expectations surveys can also provide crucial forward-looking information.

The choice of policy instruments will be important. Up to now, central banks have used a combination of direct and market-based controls in their monetary management to respond to the impact of the global crisis.

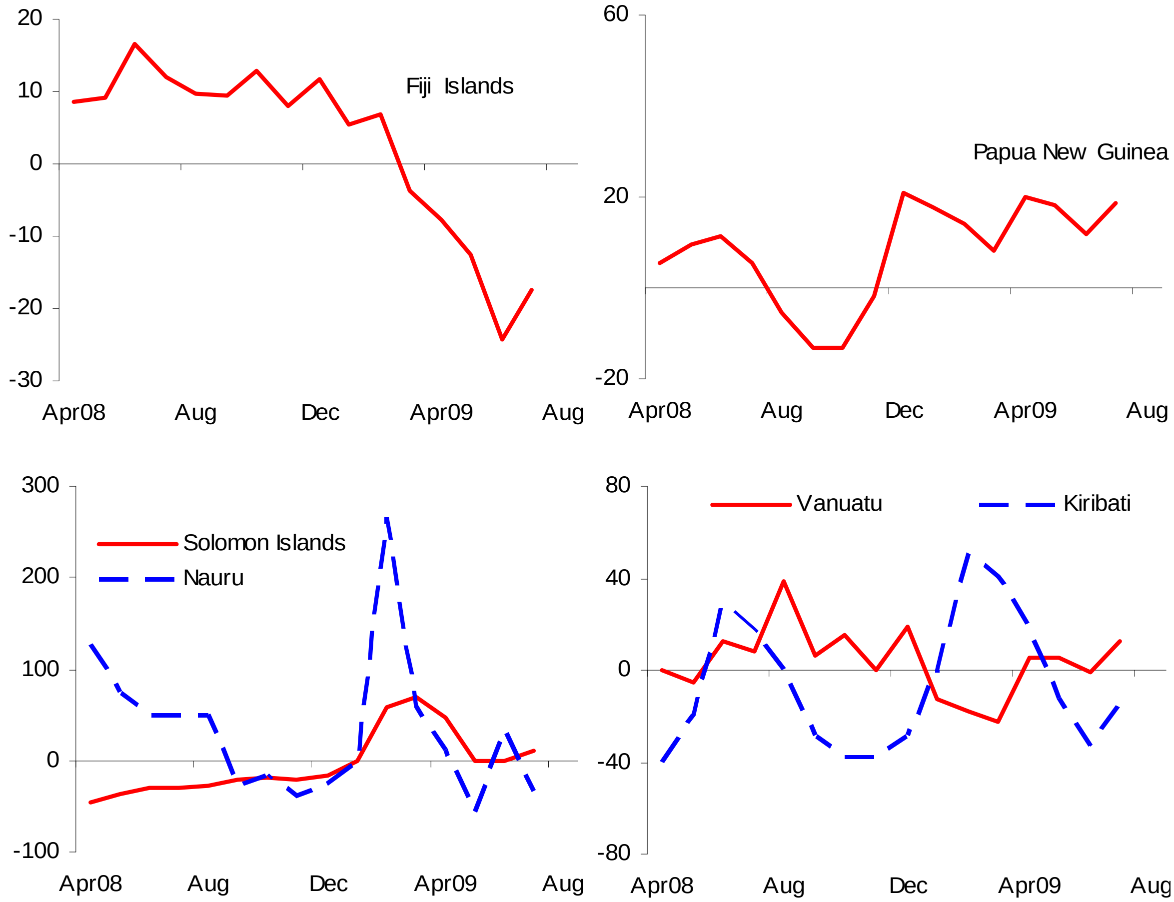
In determining the most effective mix of policy measures for the future, due care should be taken to minimize impacts on the efficiency of intermediation, maintaining the consistency of these measures with long-term development goals, and safeguarding confidence in the financial system. Where possible, direct controls should be removed and central banks should return to relying on market operations.

Close coordination with fiscal policy is very important to ensure a cohesive macroeconomic policy mix. Countries need to coordinate policies and pool scarce technical resources for economic projecting and forecasting. Central banks are key stakeholders in the macroeconomic policy debate and should be closely consulted in strategic fiscal policy discussions, irrespective of whether the budget has direct implications for the domestic credit market.

A note on the authors:

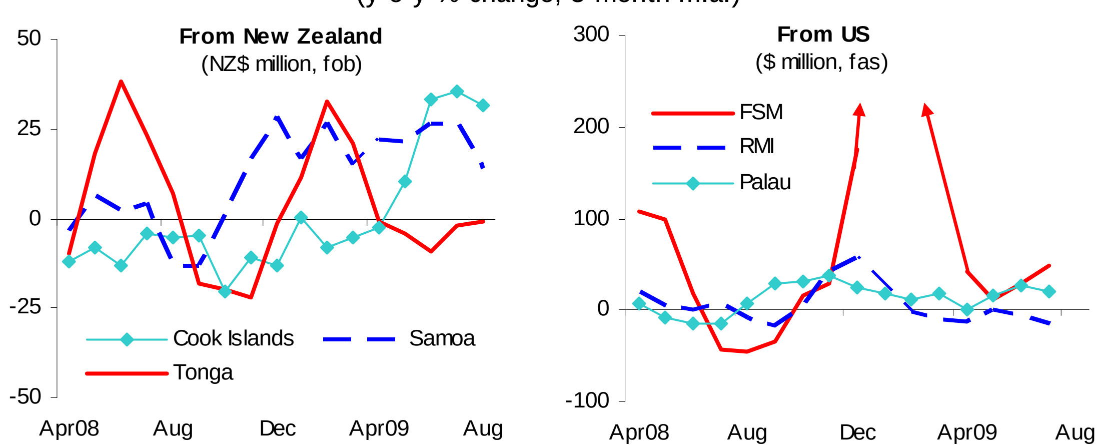
This article was contributed by Matthew Davies, coordinator for the Pacific Financial Technical Assistance Centre, and Savenaca Narube, economist and lead consultant for the ADB technical assistance project, Pacific Economic Management—Response to the Global Crisis.

Non-fuel merchandise exports from Australia
(A$; y-o-y % change, 3-month m.a.)



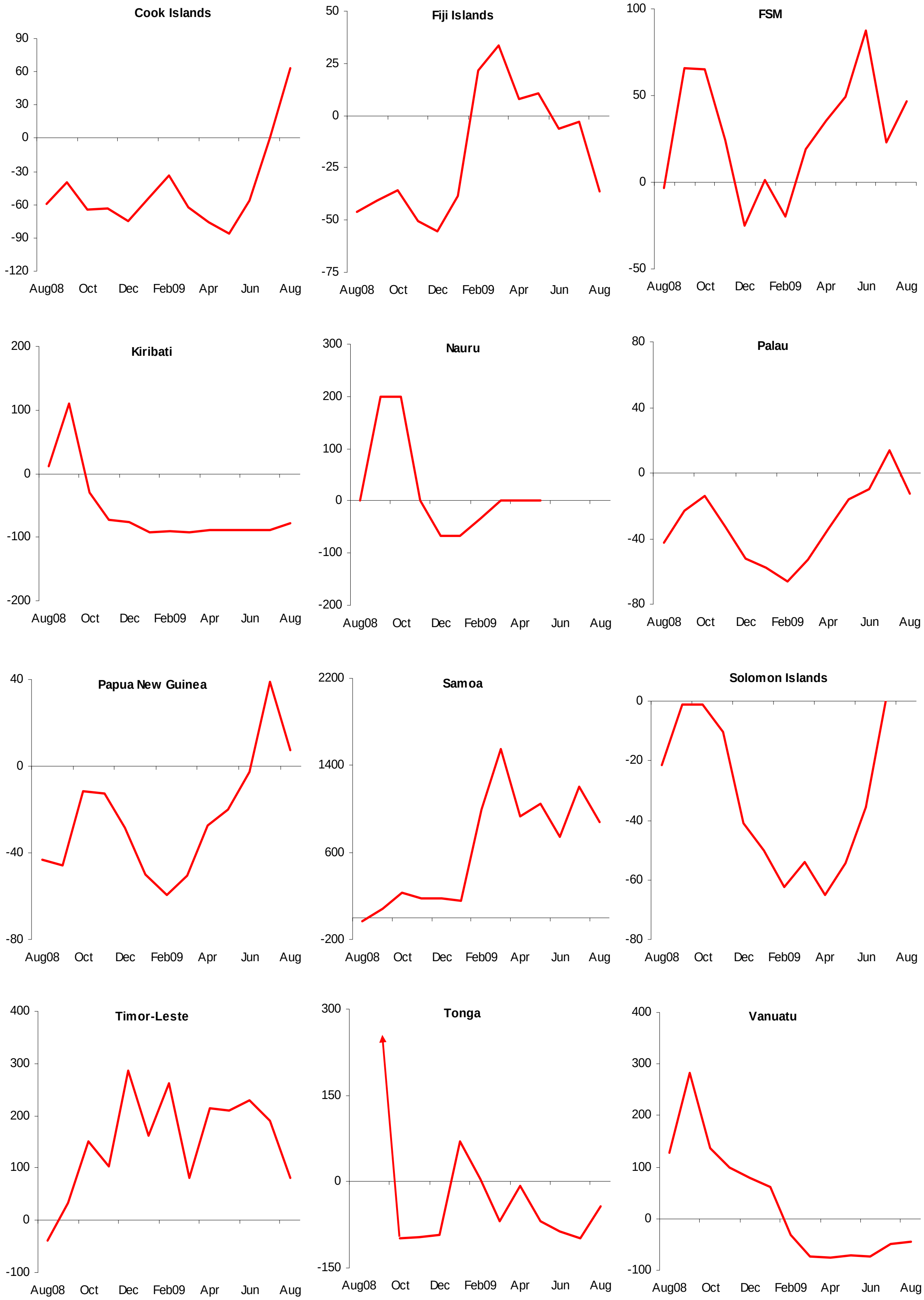
Source: ABS.

Non-fuel merchandise exports from New Zealand and the United States
(y-o-y % change, 3-month m.a.)



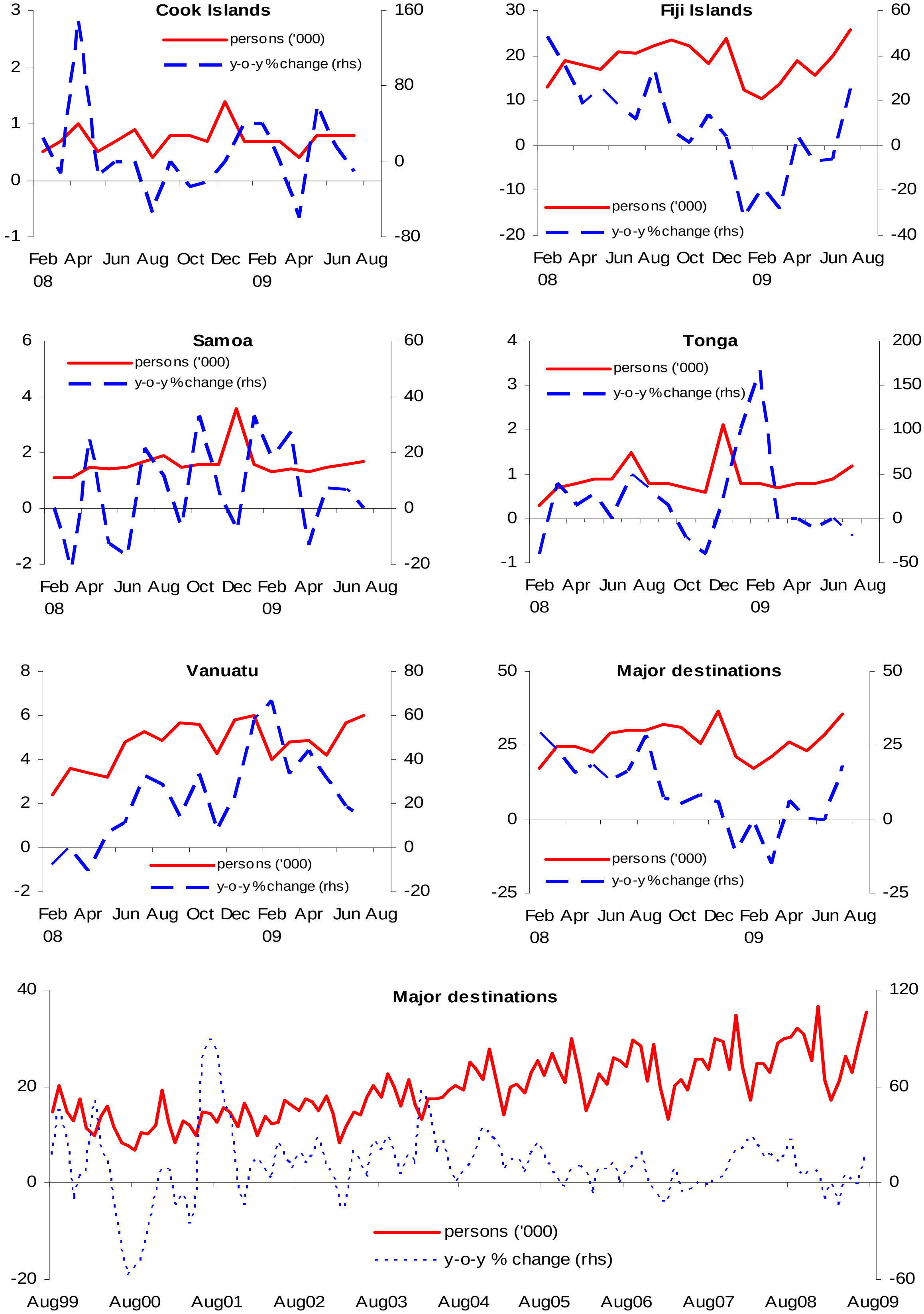
FSM=Federated States of Micronesia, RMI=Republic of the Marshall Islands.
Note: The Cook Islands–Fiji Islands shipping route was lost during 2009 and into 2010, with only the New Zealand route remaining.
Sources: Statistics New Zealand and US Census Bureau.

Motor vehicle imports from Japan
(number; y-o-y % change, 3-month m.a.)



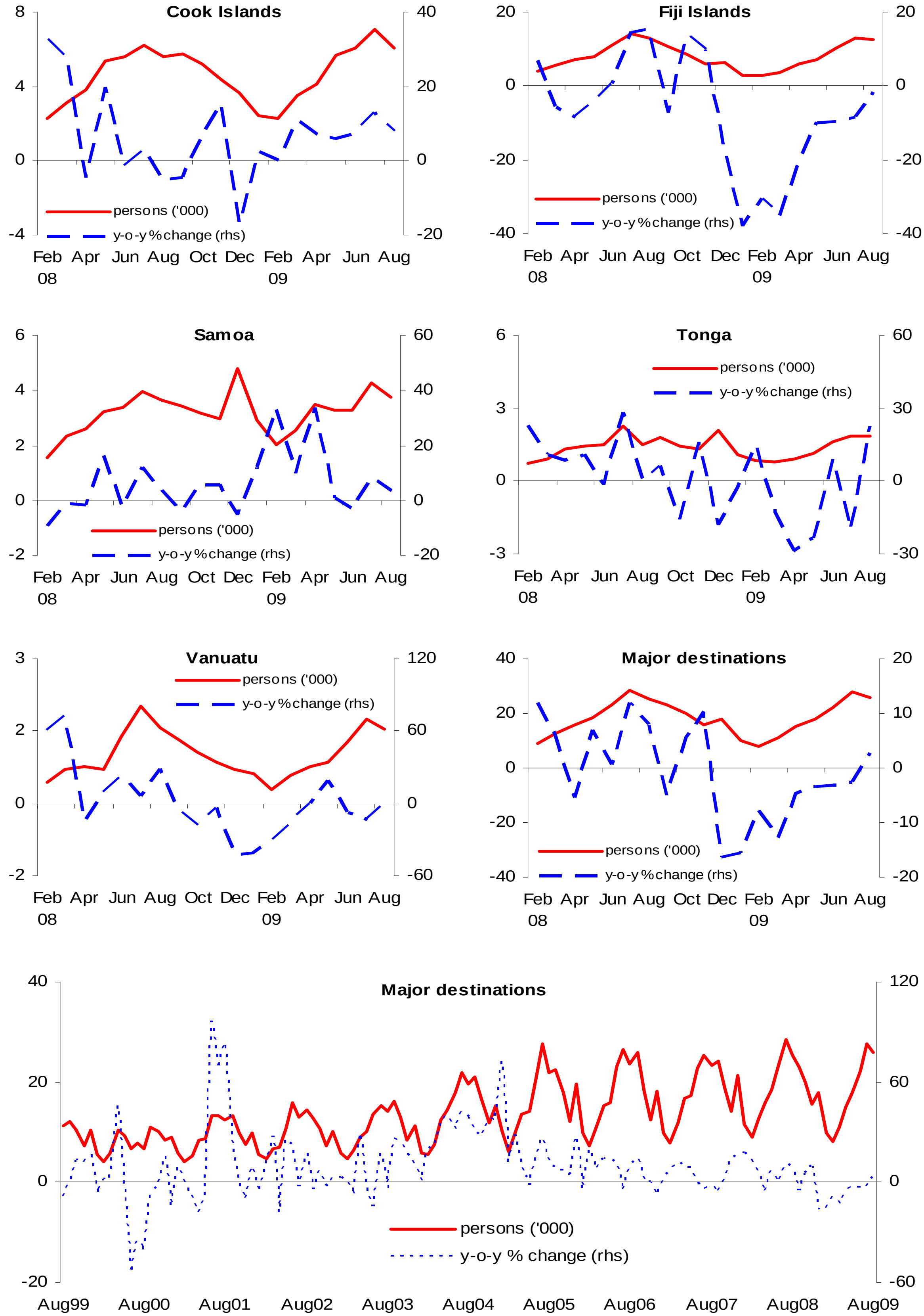
Source: Japan e-Stats website.

Departures from Australia to the Pacific
(monthly)



Source: ABS.

Departures from New Zealand to the Pacific
(monthly)



Source: New Zealand Ministry of Tourism.

Latest Pacific Economic Updates

	GDP Growth	Inflation	Credit Growth[a]	Trade Balance	Import Cover	Fiscal Balance
	(%, 2010f)	(%, y-o-y)	(%)	(% of GDP)	(months)	(% of GDP)
Cook Islands	0.8	11.2 (Jun-Q 2009)	-8.3 (Jun-Q 2009)	–5.2 (2009F)	-	-11.0 (FY2009f)
Fiji Islands	0.5	5.1 (Aug 2009)	12.5 (Jul 2009)	–30.0 (2008)	3.5 (Sep 2009)	–3.0 (2009f)
FSM	0.5	9.7 (Jun-Q 2009)	-	-51.8 (2009F)	3.8 (2008)	3.0 (FY2009f)
Kiribati	0.9	6.6 (2009f)	-	–57.6 (2008)	-	–13.0 (2008)
Marshall Islands	0.8	5.6 (Mar-Q 2009)	-	–46.9 (2008)	-	3.8 (FY2008)
Nauru[b]	0.0	7.6 (Aug 2009)	-	-	-	0.4 (FY2009f)
Palau	-1.0	1.7 (Jun-Q 2009)	-	-	-	–4.8 (2008)
PNG	3.9	6.7 (Jun-Q 2009)	21.0 (Jul 2009)	32.5 (2008)	11.8 (Jun 2009)	–3.3 (FY2009f)
Samoa[c]	-0.6	3.7 (Aug 2009)	4.9 (Aug 2009)	–43.2 (2008)	6.5 (Aug 2009)	–4.2 (FY2009f)
Solomon Islands	2.6	5.9 (Jul 2009)	-0.3 (Aug 2009)	–28.1 (2008)	4.7 (Aug 2009)	–3.7 (2009f)
Timor-Leste[c]	9.0	–2.1 (Jul 2009)	–5.2 (Jun 2009)	54.0 (2008)	-	90.1 (2009f)
Tonga	0.5	1.2 (Jul 2009)	-7.8 (Jul 2009)	–44.2 (2008)	6.7 (Sep 2009)	1.0 (FY2009f)
Tuvalu	1.0	5.3 (2008)	-	-	-	–5.4 (2008)
Vanuatu	3.5	5.8 (Dec-Q 2008)	35.3 (May 2009)	–35.9 (2008)	5.0 (May 2009)	2.3 (2008)

Q=quarter.
[a]Credit growth refers to growth in total loans and advances to the private sector.
[b]Inflation for Nauru is on a year-to-date basis.
[c]Credit growth includes loans and advances by commercial banks to both the public and private sectors.
Notes: Period of latest data shown in brackets; import cover for PNG is months of non-mining and oil imports.
Sources: ADB. 2009. *Asian Development Outlook 2009 Update*. Manila; and statistical releases of the region's central banks, finance ministries and treasuries, and statistical bureaus.

Key data sources:

Data used in the *Pacific Economic Monitor* are in the ADB PacMonitor database, available in spreadsheet form at www.adb.org/pacmonitor.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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