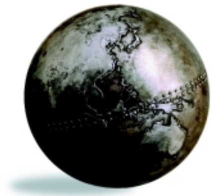


Cook Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu

In 1999, real GDP for the ten smallest Pacific countries increased by a weighted average of almost 1 percent, with the growth rate decelerating in Kiribati, Tuvalu, and Vanuatu and accelerating in the other countries. Inflation rates remained low, and the economic outlook indicates that growth will continue at modest rates.

Economic performance in 1999 improved in the ten smallest Pacific countries as GDP increased by a modest 1 percent. This was an improvement over the previous year when four countries (Cook Islands, Marshall Islands, Federated States of Micronesia, and Samoa) experienced negative growth. Growth outcomes were better in Cook Islands, Marshall Islands, Federated States of Micronesia, Nauru, Samoa, Solomon Islands, and Tonga. In Kiribati and Tuvalu growth slowed, and the Vanuatu economy went into recession. The inflation rates for Cook Islands, Nauru, Tuvalu, and Tonga increased, but decreased in all the other countries for which data were available. The overall balance-of-payments position in 1999 improved for Solomon Islands, Tonga, and Vanuatu, and deteriorated slightly for Samoa. In the six countries using American, Australian, or New Zealand dollars—Marshall Islands, Kiribati, Nauru, Tuvalu, and Cook Islands—merchandise trade deficits continuted to be covered largely by varied combinations of official transfers, overseas investment income, and workers' remittances. Fiscal and monetary policy parameters generally were consistent with macroeconomic stability.

Evidence suggests that human development indicators improved significantly during the 1980s and 1990s. Pacific island economies generally registered declines in infant mortality and increases in life

For Cook Islands, Nauru, Samoa, and Tonga, 1999 refers to fiscal year 1998/99, ending 30 June.
For the Marshall Islands and the Federated States of Micronesia, 1999 refers to fiscal year 1998/99, ending 30 September.
For Kiribati, Solomon Islands, Tuvalu, and Vanuatu, 1999 refers to the calendar year.

expectancy, school attendance, literacy, and per capita income. However, the Solomon Islands and Vanuatu remained low in measures of socioeconomic development, with relatively rapid population growth threatening to erode any gains made. Populations in these two countries had poor access to safe water and health services and high percentages of underweight children less than five years old. Cook Islands, Samoa, Tonga, and Tuvalu ranked higher in socioeconomic measures, and exhibited little poverty. Kiribati, Marshall Islands, Federated States of Micronesia, and Nauru ranked in the middle range of both socioeconomic development and poverty. In all cases—although to varying degrees—smallness, remoteness, geographic fragmentation and dispersion, and economic vulnerability imposed severe development constraints. Vulnerability to natural shocks, including the long-term effects of global warming on sea level, also remained a potentially devastating and largely unpredictable variable in the development equation. Nonetheless, in most cases, governments were committed to improving economic policy and governance, which are crucial but controllable variables. Because of this and an improving international economic environment, the outlook is for modest economic growth in 2000.

COOK ISLANDS

After three years of recession, the Cook Islands economy rebounded in 1999, despite migration and a resultant population decline from 17,400 in 1998 to around 16,000 (see figure 2.20). Real GDP grew by an estimated 2.8 percent, led by tourism, and visitor arrivals, which were up 6.5 percent compared with 1998. Canadians taking advantage of charter flights accounted for approximately one third of the increase in tourists. New flights by Air New Zealand brought additional visitors from Australia and New Zealand, and arrivals from Europe reached a record high. Black pearl production continued to grow, and commercial

Table 2.19 GDP Growth Rates and Inflation Rates, the Pacific, 1998-1999
(percent)

	GDP		Inflation	
Country	1998	1999	1998	1999
Cook Islands[a]	-3.8	2.8	0.8	1.4
Fiji Islands[b]	-1.3	7.8	5.7	1.7
Kiribati[a]	8.3	1.5	4.7	2.0
Marshall Islands[a]	-5.0	0.5	4.0	1.0
Federated States of Micronesia	-0.8	0.3	3.0	—
Nauru	—	—	4.0	6.7
Papua New Guinea	2.5	3.9	13.6	16.0
Samoa	2.6	4.0	2.2	0.3
Solomon Islands[a,b]	-2.2	1.0	12.3	8.0
Tonga[b]	0.1	2.2	3.3	4.4
Tuvalu[a,b]	14.9	3.0	0.8	7.0
Vanuatu[a]	0.2	-2.0	3.9	2.5

— Not available
a. Inflation data refer to the rate in the capital city.
b. GDP data refer to GDP growth at factor cost.

Sources: Country sources; staff estimates.

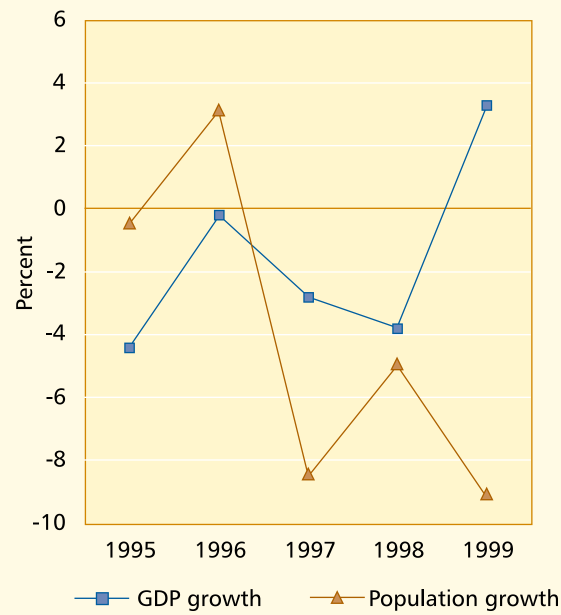
agricultural production—stimulated by tourism growth—recovered from the drought. Construction activity also increased from the relatively low levels of recent years. Business surveys revealed a substantial rise in business confidence, which was reflected in credit growth in the private sector and increased foreign investment. The inflation rate remained low, rising slightly from 0.8 percent in 1998 to 1.4 percent.

The merchandise trade deficit fell to 46.3 percent of GDP in 1998 as imports declined and pearl exports grew by 66 percent. In 1999, increased pearl exports offset import growth that resulted from the economic recovery, and the trade deficit remained around 46 percent of GDP. Tourism receipts, official transfers, and private remittances substantially covered the trade account imbalance, leaving a current account deficit of approximately 7 percent of GDP. The New Zealand dollar, the currency in circulation, depreciated slightly against the US dollar, almost 8 percent against the Australian dollar, and 10 percent against the yen. It appreciated 5 percent against the euro.

Government finances strengthened in 1999. Operating and overall surpluses were recorded; operating expenditure was kept to the budgeted level and revenues were above expectations. Development expenditure continued to hover around the NZ$10 million level of recent years. The debt-servicing burden eased because of the September 1998 restructuring of the external debt. Interest payments were a modest 12 percent of tax revenue, and the debt stock was equivalent to 78 percent of GDP. The 2000 budget aimed at a balance-on-operating account, with revenue rising 9 percent and operating expenditure 15 percent. Development expenditure was projected to rise to NZ$16 million as the government increased spending on infrastructure assets to support tourism.

Implementation of the budget was disrupted by a period of political instability in the latter half of 1999, caused by poor governance and corrupt government practices. However, a new coalition government took office in November and quickly made a public commitment to continuing the economic and public sector reform process begun in 1996. Six key strategies for improving fiscal governance included minimizing red tape, reducing government involvement in commercial activities, improving the corporate governance of statutory authorities, restructuring some government corporations to increase efficiency, refocusing the public administration on service delivery, and increasing reliance on local expertise.

Figure 2.20 Real GDP and Population Growth Rates, Cook Islands, 1995-1999



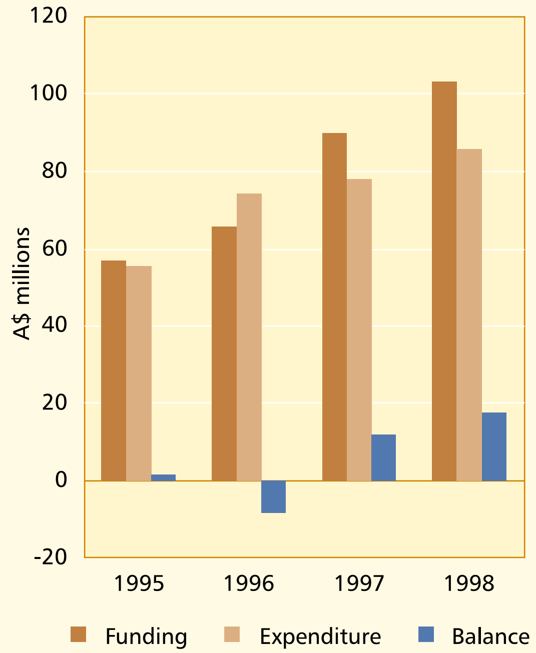
Sources: Statistical Bulletins; Appendix table A1.

Real GDP is forecast to grow by 4.2 percent in 2000. The decline in the resident population attributable to migration to New Zealand is expected to cease. Tourism is again predicted to be a driving force, with tourist arrivals forecast to increase by 6 percent, and production in agriculture and fisheries to rise 6.6 percent.

KIRIBATI

According to revised estimates, real GDP grew by 8.3 percent in 1998 because of recovery in copra production, aid-funded construction projects, and public administration expansion. Gross national product (GNP) was approximately twice the size of GDP because of fishing license fees, net investment income, and

Figure 2.21 Fiscal Balance, Kiribati, 1995-1998



Source: Ministry of Finance and Economic Planning.

seamen's remittances; GNP grew by 16 percent in 1998 in real terms because fishing license fees were doubled. The next year growth slowed, with GDP increasing an estimated 1-2 percent, primarily because of the Japanese-funded construction of a new wharf at Betio. The real GNP growth rate decelerated as fishing license fees fell because of declining fish stocks associated with changing climatic conditions. The inflation rate fell to around 2 percent, in line with the rate in Australia, the major source of imports. Growth in the money supply was less than 1 percent.

The temporary increase in fishing license fees in 1998 strengthened the external accounts. The current account deficit, exclusive of official grants, fell from 17.9 percent of GDP in 1997 to 3.3 percent in 1998. The strong growth in fishing license fees was reinforced by increases in seamen's remittances, to 11 percent of GDP, and in investment income, to 30 percent. When official grants equivalent to 43 percent of GDP were included, the current account position in 1998 was a surplus of 25.9 percent. The capital account in 1998 moved into surplus—10 percent of GDP—because of a rise in capital grants, and the overall balance of A$36 million was 89 percent more than the historically large surplus of 1997. Because of these surpluses and the valuation effects of a depreciated currency denominated by the Australian dollar, official external assets in the Revenue Equalization Reserve Fund (RERF), the Consolidated Fund, and the Development Fund reached A$606 million. External debt was modest at 13.2 percent of GDP, with external debt service equal to 1.4 percent of exports of goods and services. In 1999, however, the merchandise trade and current account balances worsened because of declining exports and fishing license fees, respectively.

The 1999 budget was presented three months into the year, and an overall deficit of 32 percent of GDP was estimated, unlike budget surpluses in the previous years (see figure 2.21). Fishing license fees were projected to fall from A$42.5 million in 1998 to A$12.8 million, while current and development expenditures were estimated to rise 2.7 percent and 39.5 percent, respectively. External concessional loans would finance almost one fourth of the deficit, and the remainder was to be covered by the Consolidated Fund (44 percent) and the RERF (31 percent). The accumulation of reserves during the past two years permits such a budget strategy, but care is needed over the medium to long term if the real per capita value of the RERF is to be maintained.

In the small finance sector, the sole commercial bank, the Bank of Kiribati—jointly owned by the government and the Australian-based Westpac—remains profitable. Like the Kiribati Provident Fund, it holds more than 90 percent of its assets offshore. In August 1999, credit of A$3.1 million to the private sector constituted barely 7 percent of assets, and no credit was extended to the government or public enterprises. Growth of private sector credit is constrained by limited domestic investment opportunities and the inability of the Bank of Kiribati to use land as collateral (the bank is partly foreign-owned, and foreigners are not permitted to own land). The interest rate spread increased slightly to 6 percent. Loans from the Development Bank of Kiribati totaled A$3.8 million at the end of 1998, but further lending was constrained by a small capital base, and nonperforming loans remained a problem.

Although the government's 1997 Medium Term Strategy presents an agenda of public sector reform and private sector development, little systematic progress had been made by early 1999. The strategies lacked broad support from politicians, officials, and the community at large. These groups must be educated and persuaded before change can occur.

MARSHALL ISLANDS

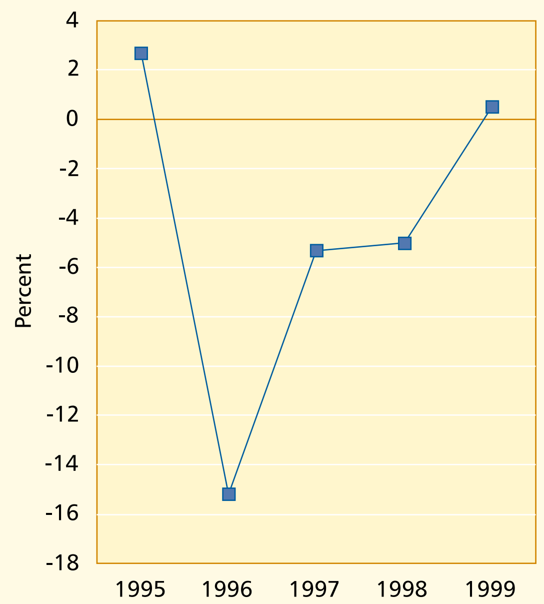
The Marshall Islands economy is estimated to have grown 0.5 percent in 1999. This modest recovery followed three years of recession (see figure 2.22) caused by cuts in government expenditure and employment under a reform program, and the impact of drought on agriculture and fisheries production. Real GDP remained approximately 25 percent below the 1995 level, and GNP and GNP per capita exceeded GDP figures more than 6 percent because of fishing license fees, which increased significantly in 1998 and remained high in 1999.

The recovery in economic activity in 1999 reflected the direct and indirect effects of aid-funded road works and construction, the private sector construction of a tuna processing factory, and more onshore spending by crews of an expanded foreign fishing fleet. The agriculture sector increased production as it continued to recover from the 1998 drought. Additionally, further planned contractions in public sector activity were forestalled, at least temporarily, by grants from Taipei,China and optimism about renegotiations regarding the Compact of Free Association. The compact with the United States provides annual block grants that run from 1986-2001, with $40 million per year in the final five years. It also furnishes additional grant assistance to education, health, energy, and communication services; some free US Federal services such as postal and weather services; and unrestricted access for residents to live and work in the United States.

The inflation rate continued its downward trend from almost 10 percent in 1996 to around 1 percent in 1999. Use of the US dollar as domestic currency precludes an independent monetary policy, and the inflation rate tends to track that of the United States, the major source of imports. During 1995-1998, merchandise imports fell an estimated 24 percent in current prices while exports dropped almost 6 percent. The trade deficit declined, and the current account surplus, including declining official transfers, rose from 1.5 percent of GDP in 1995 to an estimated 22.2 percent in 1998. The capital account remained in deficit after the government ceased borrowing in 1995 and loans were repaid in 1996-1998. Overall, the balance of payments was in deficit throughout these four years. External debt stood at $125 million at the end of 1997, equivalent to 122 percent of GDP, and government holdings of dollar reserves fell to three weeks of merchandise import cover. Balance-of-payments data for 1999 are not available, but the current account surplus likely increased because of grants from Taipei,China.

An absence of timely, reliable, and comprehensive statistical information extends to government

Figure 2.22 Real GDP Growth Rates, Marshall Islands, 1995 - 1999



Source: Appendix table A1.

finances. However, public finances have been strengthened under the Policy Reform Program. Several ministries have been rationalized, and the number of government employees was reduced 33 percent between late 1995 and March 1999. A 1995 wage freeze remained in place, following a 5 percent pay reduction for salaries higher than $10,400 per year. Subsidies to some state-owned enterprises have been reduced or eliminated, the tariff system has been rationalized, and efforts to strengthen tax and customs administration continued. These measures, combined with a large drop in capital expenditure, moved the overall budget balance into surplus in 1996, 1997, and 1998.

The 1999 budget was passed one month into the fiscal year, before revised estimates for the budget outcomes of the previous year were available. A small deficit of $1 million was budgeted for General Fund accounts, with increased total appropriations to subsidize government agencies. After nine months, it appeared that the deficit would reach $9 million, approximately 9 percent of GDP. Expenditure exceeded the budgeted level, and revenue fell short, in large part because of the March 1999 decision to lower the general import duty from 12 percent to 5 percent. The government, concerned with the November 1999 elections, apparently did not consider the budget implications of this policy and the decision to increase the copra subsidy. Both reversed earlier policy actions under the Policy Reform Program, but did not save the incumbent government, and the new United Democratic Party won office.

Interest in early 2000 centered on whether a new administration would consolidate the gains made under the Policy Reform Program and complete the agenda of reform actions. Public expenditure management is essential. Fiscal discipline may have weakened before the elections, when grants from Taipei,China became available and confidence grew in a successful outcome to Compact funding renegotiations. Whether this optimism proves justified or not, the quality of economic management will be crucial in determining future development outcomes. Other areas requiring attention are public service performance, public enterprise reform, and an improved environment for private sector development. Legislation concerning investment approval, business licensing procedures, issuance of work permits, and improved security of land leases was being considered. Once passed, and if effectively implemented, the legal framework for increased private sector activity will improve growth prospects.

FEDERATED STATES OF MICRONESIA

The real GDP of the Federated States of Micronesia (FSM) rose an estimated 0.3 percent in 1999. This slight increase in the aggregate level of economic activity ended two years of recession (see figure 2.23), but it was not evenly spread across the four states. The rise in GDP was attributable entirely to an increase in economic activity in Chuuk, where the private sector expanded enough to more than offset a continued decline in government contribution. Real GDP was stagnant in Kosrae and Pohnpei and declined in Yap, although in the latter two states private sector activity increased.

No data are available on the inflation rate, but it tracked the US rate of 2.6 percent, as the US dollar is the currency in circulation and the United States is the dominant source of imports. Commercial banking deposits and loans changed little from the levels since 1993. Deposits dropped and both consumer and commercial loans increased marginally; consumer loans, primarily to public servants, dominated bank portfolios. The loan-to-deposit ratio fell to 43 percent at the end of 1999, as banks continued to invest offshore because of the ongoing lack of domestic commercial lending opportunities. This reflected a specific limitation on mortgage-secured lending caused by laws against land ownership by foreign banks. It also reflected a combination of constraints to private sector development in general, most notably high wage costs, inadequate economic infrastructure, and an incomplete regulatory framework lacking transparency and predictability.

Under the Public Sector Reform Program, easing these and other constraints began through public service downsizing, public enterprise reform, foreign investment legislation, banking deregulation, business support services, and attempts at improving land titling and leasehold arrangements. However, as observed at the national economic summit in September 1999, much policy formulation remains to be done, and implementation must be effective. Regulations, particularly those about attracting foreign investment, must be applied quickly, and must be transparent and nondiscriminatory.

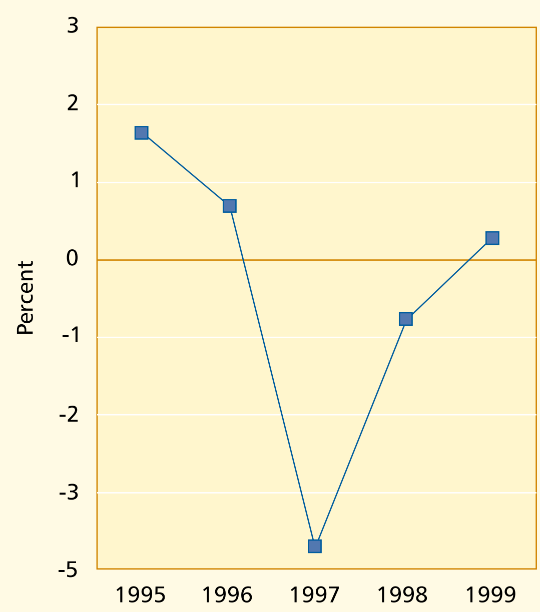
The aid-dependent, public-sector-dominated nature of the FSM economy is well documented. This has altered slightly as reductions in transfer grants under the Compact of Association with the United States forced cutbacks in government expenditure. Staff retrenchment and wage reductions caused national and state government expenditures to fall from 80 percent of GDP in 1993 to 70 percent in 1998, and simultaneously caused a decline in private sector activity, excluding subsistence production.

Historically, this sector evolved largely as a subsidiary goods and services provider to public servants, centering on importing, wholesaling, and retailing, rather than export-oriented agriculture, fisheries, and tourism. The public expenditure reductions contributed substantially to strengthening state government finances, but expenditure remained high by Pacific and international standards, with wages and travel accounting for 85 percent of operating expenditure. Fiscal discipline will be needed to prevent expenditures rising and to allow ongoing reduction in the external debt burden. External debt continued to decline in 1999, reaching 38 percent of GDP, compared with a high of 66 percent in 1993. The debt-service ratio was estimated at 25 percent of exports. Official projections indicated that the country was on track for a debt-to-GDP ratio of 21 percent and a debt-service ratio of just 3 percent by 2002.

The continued reliance of the government on Compact transfers reveals the extent of the long-term economic adjustment that would be required if large aid flows were not continued. These transfers accounted for 47 percent of total government revenue while tax collections provided just 14 percent. Major reform to improve efficiency and effectiveness is required if taxation revenue is to rise without jeopardizing private sector development. This will involve possible replacement of the current gross revenue tax with a value-added tax, greater efficiency in collection, and greater use of service charges and user fees. Revenue sharing between state and national governments was addressed in a July 1999 referendum, which proposed that the national constitution be amended to divide fishing license revenue equally among the five governments, instead of it all going to the national government. It also suggested allowing 70 percent of tax collections rather than 50 percent to go to the states, but the proposal did not receive the required support of three fourths of voters in at least three states.

The obvious uncertainty confronting FSM governments is the outcome of renegotiations of the US Compact. From an FSM perspective, successful renegotiations will ensure a long-term source of financial support that will ease the pressure for economic restructuring. Micronesians may experience less compulsion to emigrate to Guam, Hawaii, and US mainland in search of employment. If the renegotiations are unsuccessful, provision still exists for grant transfers in 2002 and 2003 at the average level of the 15-year-period from 1986 to 2001. In this event, the government will need to accelerate efforts to design and implement policies that will allow development led by the private sector to flourish.

Figure 2.23 Real GDP Growth Rates, Federated States of Micronesia, 1995-1999



Source: Appendix table A1.

NAURU

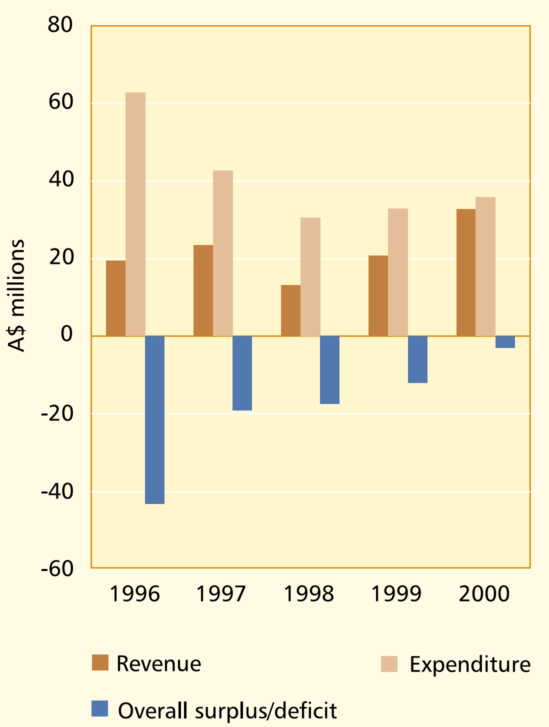
The factors that caused concern for the economic situation in 1998 continued to be worrisome in 1999. The exhaustion of the phosphate resource, which has provided the main source of income and employment for many years, drew closer. Fiscal planning and discipline continued to be poor, and the financial system was still in a state of collapse. The diminished asset base of the Nauru Phosphate Royalties Trust (NPRT) had not yet been given a reliable value as a basis to assess sustainable consumption levels. Government commitment to an economic and financial reform program weakened noticeably, partly because of an unconditional loan from Taipei,China. In addition, Nauru's international image was tarnished by allegations of involvement in money laundering.

Although there are no national accounts, real GDP probably increased in 1999. Real government expenditure rose 15 percent compared with 1998, the volume of phosphate exports rose 38 percent, the Japanese-funded construction of Ainabare boat harbor began, and fisheries production for the domestic market increased. About 30 percent (450 people) of the public sector workforce was retrenched beginning in April 1999, but a lump-sum payout funded by the Asian Development Bank (ADB) significantly ameliorated the impact on aggregate demand. In addition, the Nauru Phosphate Corporation reportedly hired around 200 casual laborers, and a significant number of retrenched public servants went into coastal fishing and the retail trade. A rise in inflation to 6.7 percent in 1999 corresponded with a rise in economic activity.

The reformist 1999 budget projected an overall surplus, but the actual outcome was officially reported as an A$12 million deficit (see figure 2.24). The real figure was probably larger, because recorded revenue included A$4 million in dividend payments from the bankrupt Bank of Nauru, and expenditures did not capture all payments made by government. The deficit was more than covered by external loans, with A$3.5 million (US$2.3 million) from the ADB and A$29 million from Taipei,China. Of the A$29 million, A$14 million remained unspent at the end of the year.

Preliminary estimates indicated that at the end of March 1999, the republic's stocks of consolidated domestic and external debt totaled A$524 million and A$129 million, respectively. During 1999, NPRT obtained a US$99 million loan from General Electric Capital to pay dividends to landowners and to refinance and restructure the investments of NPRT, the Nauru Finance Corporation, and the Nauru Superannuation Board. The 2000 budget was presented to Parliament three months into the year. The budget speech clearly identified the country's economic difficulties, gloomy outlook, and necessary courses of action. However, the budget estimates did not represent an adequate attempt to move toward long-term fiscal sustainability. A deficit of A$3 million was projected, assuming 32 percent growth in nominal domestic revenue, A$5 million in external grants, and an 8 percent increase in nominal expenditure. The deficit was to be financed with A$2.7 million in surplus loan funds from 1999, plus A$7.8 million in proceeds from asset sales, with provision for a net repayment on the foreign loan account of A$7.6 million. The government

Figure 2.24 Fiscal Balance, Nauru, 1996 - 2000



Source: Republic of Nauru Annual Accounts.

intended to sell and lease back Air Nauru's only aircraft, using the proceeds to pay an outstanding loan.

Actual budget outcomes, however, probably will depart significantly from these estimates. Fishing license revenue may not be forthcoming, as legally the National Fisheries and Marine Resources Authority retain it. Dividend income of A$3 million from the Nauru Phosphate Corporation is uncertain, and sale of the aircraft for the expected amount is far from guaranteed. On the expenditure side, overruns can be anticipated because of poor governance and deficiencies in the budget execution system.

For a brief period in 1999, a long-term and difficult reform program was begun. Substantial public service downsizing occurred in an economy where almost all paid jobs were in the public sector. Unfortunately, political instability, substantial and unconditional external loan funds, unwillingness to confront harsh economic realities, combined to stall reform. This process must be revitalized quickly to minimize the harshness of an unavoidable fiscal and economic adjustment.

SAMOA

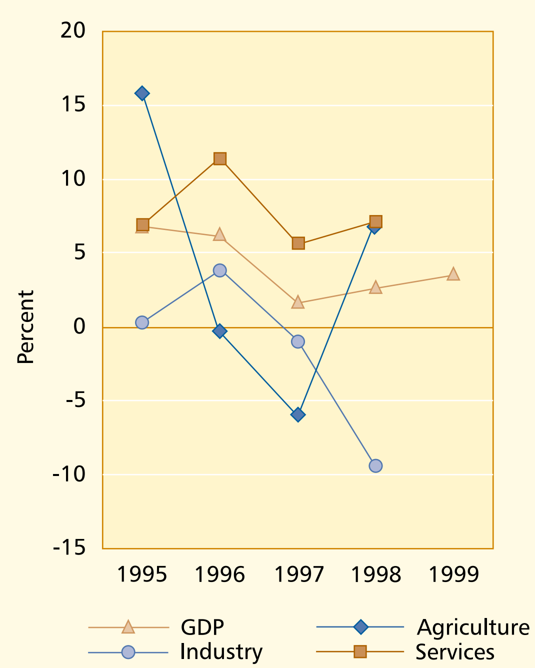
The growth performance of the Samoan economy exceeded expectations in 1999. After increasing 1.6 percent in 1997 and 2.6 percent in 1998, real GDP in 1999 rose by 4 percent, led by the fisheries and commerce sectors (see figure 2.25), compared with an original budget forecast of 2.5 percent. From 1998 to 1999, value added in fisheries rose 41.8 percent, increasing its share of GDP to 7.4 percent. Value added in the commerce sector rose 29 percent. The construction sector also recorded strong growth, increasing value added by 12.9 percent. The hotels and restaurants sector expanded 4.9 percent, stimulated by almost 9 percent more tourist arrivals. Public administration increased 4.1 percent, but food and beverage manufacturing grew sluggishly, and value added in agriculture and other manufacturing declined.

Employment growth occurred at a modest 2 percent between 1998 and 1999, according to incomplete National Provident Fund figures. Increased employment in public administration, accommodation and restaurants, personal services, and food manufacturing sectors accounted for most formal sector employment growth, with the rate of female employment growth more than double that of males. Although there was some growth in private sector employment, creating additional job opportunities in that sector remains an ongoing challenge.

A reduction in inflation accompanied the acceleration in output growth in 1999. The average annual rate in June 1999 was 0.8 percent—compared with 5.5 percent in June 1998—and reflected decreased local food prices; low inflation rates in Australia and New Zealand, the major sources of imports; and tariff reductions. Money supply growth was modest: in 1999, the broad money supply increased 10 percent. Increased net foreign assets accounted for 28 percent of this increase, and net domestic assets for the remaining 72 percent.

As the government continued to increase its net deposits with the banking system, credit to the private sector in 1999 increased 16 percent, reaching 27

Figure 2.25 Real GDP and Sectoral Growth Rates, Samoa, 1995 - 1999



Source: Appendix tables A1, A3, A4, A5.

percent of GDP compared with 25 percent in 1998. Credit to nonfinancial public enterprises also increased almost fourfold, albeit from a small base. Credit extended to the private sector by nonmonetary financial institutions increased 12 percent. During 1999, the composition of financial institution portfolios with the private sector shifted away from personal and manufacturing sector loans toward loans to the primary sector, construction, trade, transportation and communication, and business and professional services. The weighted average lending rate of commercial banks dropped half a percentage point during early 1999, reducing the interest rate spread to 7.5 percent. The central bank continued to use its own securities as the monetary policy instrument to meet the inflation target of about 2 percent per year.

The balance of payments remained in overall surplus in 1998, equivalent to 3.7 percent of GDP. Net foreign assets rose to ST177.7 million (US$68 million) at the end of the year, or 5.7 months of goods and services imports. The external debt was 74 percent of GDP, of which 69 percent was official government debt. External debt-servicing costs were manageable regarding their demand on revenue from exports of goods, nonfactor services, and private remittances. In the first half of 1999, the balance of payments recorded an overall deficit equivalent to 3.1 percent of GDP, resulting in a decrease in net foreign assets to ST167.2 million (US$64 million), or 4.4 months of goods and services. This reflected a widening in the trade deficit that was primarily attributable to growth in private sector imports, to be expected with the increase in economic activity. During the same period, the nominal exchange rate depreciated 0.3 percent and the real effective exchange rate depreciated 4.4 percent, reflecting the drop in Samoa's inflation rate to below that of its trading partners. This last development reversed the trend of real appreciation that had emerged over 1991-1997 and had threatened a loss of international competitiveness.

Provisional government finance statistics showed that in 1999, for the fourth fiscal year in succession, government ran an overall budget surplus. It was equivalent to 0.5 percent of GDP, a significant improvement over the budgeted deficit of 1.3 percent. Revenue was slightly below the original budget estimate because of a shortfall in tax revenue. However, current expenditure was also lower, as was externally funded development expenditure because of delays in starting some projects. Because of the surplus, government increased its net deposits in the banking system, further reducing the crowding-out pressure on the private sector.

In 2000, an overall deficit of 5.1 percent of GDP is budgeted. Revenue is projected to rise 8.2 percent, and current expenditure is budgeted to be 6.6 percent higher than in 1999, primarily because of increased spending on education and health and a higher wage bill. A current surplus of 3.4 percent of GDP is projected, and external grants are expected to fall 32.7 percent. Development expenditure will be down 2.1 percent, so external borrowing will increasingly be relied on for funding capital investment projects. This budgetary projection is consistent with Samoa's economic strategy, and the increased official external debt is well within debt-servicing capacity. There will again be a negative domestic borrowing requirement, which will consolidate government's net credit position with the banking system.

The government reaffirmed its commitment to economic reform in its *Partnership for a Prosperous Society: A Statement of Economic Strategy 2000-2001*. This statement emphasizes the importance of ensuring that reform benefits the community as a whole, and includes among its objectives invigorated agriculture and fisheries and a revitalized village economy. Provided the economy is not subject to severe external shocks, the forecast 2000 growth rate of 3-4 percent can be achieved. The government has demonstrated its capacity to deliver a stable macroeconomic environment, and is set to continue to do so through a firm fiscal stance and a sound monetary policy.

In addition, it continues to improve the microeconomic policy environment within which the private sector operates. Several state-owned enterprises were privatized in 1999 and further privatization is planned for 2000. Agriculture, however, continues to pull down the aggregate growth rate. The revival of this sector from the long-term damage caused by the 1994 taro leaf blight is a central medium-term concern. Success in this sector would considerably improve the prospects of increasing the growth rate, and of ensuring that the benefits of growth are more broadly spread.

SOLOMON ISLANDS

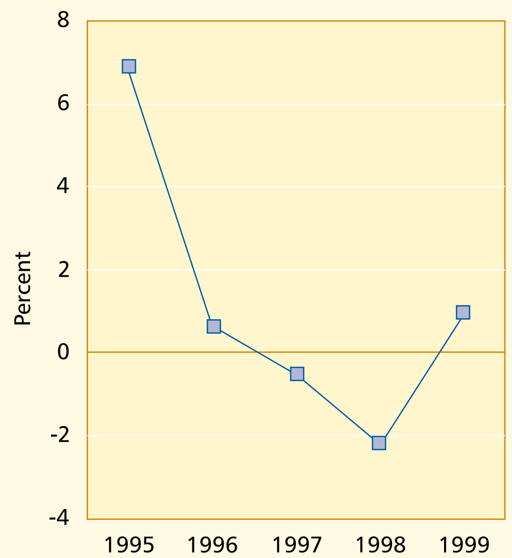
After two years of recession, the Solomon Islands economy began to recover in 1999 (see figure 2.26). Real GDP is estimated to have increased around 1 percent, largely because of increased gold and log production, and aid-funded road construction in the capital city. Unfortunately, an insurgency on the island of Guadalcanal prevented a stronger recovery. The government was forced to declare a state of emergency between June and October and 25,000 Malaitans who had settled on the island were displaced. The country's major oil palm producer, Solomon Islands Plantations Limited, closed indefinitely because of the insurgency. Several tourist resorts also closed, cocoa and copra production was disrupted, and market gardening was severely curtailed. Business confidence sank further, diminishing medium-term growth prospects.

The insurgency derailed the expected privatization of Solomon Islands Plantations Limited and threatened the rehabilitation of public finance, which is central to the government's economic and public sector reform program, and where substantial progress had been made. The cost to the budget in lost revenue and increased expenditure on security operations and resettling displaced persons was estimated at SI$30 million ($6 million). However, additional aid from Taipei,China was offered to cover these costs, and actual total recurrent expenditure was kept to just 3 percent above the original budget estimates. Domestic revenue exceeded the budget estimate by 3 percent as revenue collection improved, resulting in a small recurrent surplus. Total domestic public debt at the end of December 1999 had fallen to SI$378 million ($75.6 million), almost 6 percent below the level at the end of 1998. External public debt rose 9 percent to SI$580 million ($116 million), but this was on concessional terms and provided the financial means for the reform program. The government borrowed in external markets to pay off domestic arrears and most foreign arrears, and fund the increase in development expenditure.

The growth rate of the money supply accelerated slightly from 4.8 percent in 1998 to 7 percent in 1999 because of a 16 percent expansion in net foreign assets. Domestic credit declined 2 percent as government continued to reduce its net indebtedness to the banking system, and credit to the private sector expanded a modest 1.3 percent. The government securities market was reactivated in May 1999 following a restructuring of government debt that involved converting frozen Treasury bills into medium-term bonds. Commercial banks invested some of their excess reserves in bills offered at auction, but retained 10 percent of free liquid assets at the end of the year. The interest rate spread remained at 10 percent, with average deposit rates negative in real terms. Monetary policy was tight throughout 1999. The rates on central bank short-term securities and Treasury bills remained unchanged as the emphasis shifted to bills as the main monetary policy instrument.

In 1999 the inflation rate decelerated to 8 percent, from about 12 percent the previous year, because of tight macroeconomic policies and slowed growth in import prices. The impact of the 20 percent devaluation of December 1997 dissipated without generating the price-wage spiral of earlier years. The

Figure 2.26 Real GDP Growth Rates, Solomon Islands, 1995-1999



Source: Appendix table A1.

exchange rate remained relatively stable in 1999, with the Solomon Islands dollar depreciating 2.2 percent and 4.2 percent against the US and Australian dollars, respectively, and appreciating slightly against the New Zealand dollar. The balance-of-payments position strengthened in 1999 because of a 4 percent rise in merchandise export receipts, a 13 percent decline in imports, and an increase in capital receipts attributable to official bilateral and multilateral inflows. The rise in export receipts reflected greater earnings from gold, copra, and log exports, while imports in all categories declined. External reserves amounted to about 3.5 months of import equivalent. This represented a substantial improvement on the two weeks of cover early in the year, but was still less than the five or six months needed.

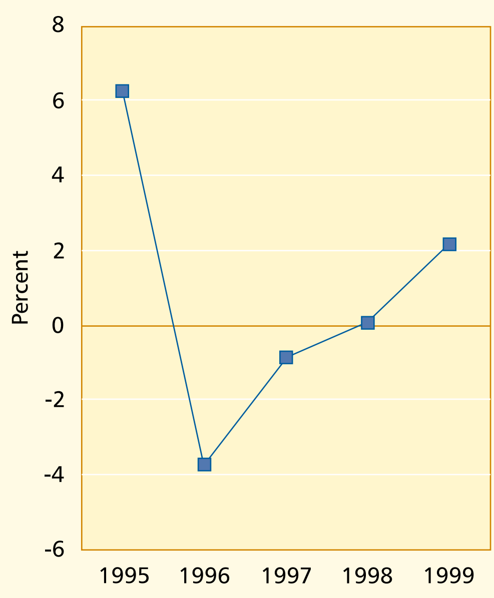
The government was hopeful that economic growth would accelerate to 3-4 percent in 2000 and inflation would decline to 6-7 percent. This, however, is predicated on an improved international economic environment and, more importantly, on an effective resolution of the social unrest that disrupted primary sector production and depressed investor confidence. Such a resolution will be difficult, and to be durable will require a long-term strategy that addresses the causes of economic inequality between regions and ethnic groups. In the meantime, although the government progressed toward restoring macroeconomic stability and continues to implement its reform program, investor confidence apparently has not revived.

The tax administration and public expenditure management still need work, particularly to improve allocative efficiency. The 2000 budget aims at zero growth in the nominal wage bill, while providing for an overall increase in recurrent expenditure of 10.5 percent, which largely reflects increased spending on health and education. Domestic revenue is projected to rise nearly 8 percent, and a small recurrent surplus is again budgeted. Personal and company income tax rates will be lowered; export duties on palm oil, copra, cocoa, and reef fish removed; and the maximum import tariff rate reduced from 40 to 20 percent. Increased revenue is expected from improved compliance and increased taxes on log exports, alcohol, and tobacco. Deductions allowed for calculating taxable personal income will also be reduced. Development expenditure is projected to increase 58 percent, to be financed largely by an expected 81 percent increase in external grants. A budget deficit of SI$71 million ($14.2 million) is to be financed by external borrowing. These figures are exclusive of Stabex funds (a European Union stabilization system of financial assistance) that total 42 million euros, which could be used to finance government expenditure and establish a trust fund.

TONGA

Following three years of recession and stagnation, the economy rebounded in 1999 (see figure 2.27). Revised national accounts estimates show that real GDP fell 3.7 percent in 1996 and 1.4 percent in 1997, and increased only 0.1 percent in 1998. However, the provisional official estimate is that real GDP grew by 2.2 percent in 1999. This modest growth largely reflected several construction projects, expanded kava manufacturing, and moderate growth in the service sectors: trade, transportation and communications, finance

Figure 2.27 Real GDP Growth Rates, Tonga, 1995-1999



Source: Appendix table A1.

and business services. Output in the major productive sector of agriculture, forestry, and fisheries declined for the fourth year in a row, as the effects of drought were compounded by crop damage from Cyclone Cora in December 1998. GDP per capita of the approximately 98,500 population was an estimated T$2,487 ($1,574) at the end of 1999. The inflation rate had edged up to 4.4 percent because of the effects of drought on domestic food prices and currency devaluation.

The balance of payments recorded an overall surplus of 4.2 percent of GDP in 1999, compared with a deficit of 6.4 percent the previous year. Total official foreign reserves rose from 2.5 months of import cover to 3.9 months. The improvement in the balance of payments reflected a reduction in the current account deficit from 10.4 percent of GDP to 1 percent, and a slight increase in the capital account surplus from 4 percent of GDP to 5.3 percent. The change in the current account balance largely was attributable to fewer merchandise imports. Export performance was disappointing, with the principal exports of squash, fish, and root crops all declining, and growth only in vanilla and other agricultural products. Private remittance flows remained buoyant. The nominal and real effective exchange rates depreciated 8.2 percent and 6.7 percent, respectively, during 1999. This was an overdue adjustment after three years of appreciation, and it continued in the beginning of 2000.

Despite an increase in the money supply of nearly 20 percent in 1999 because of an increase of foreign reserve, net domestic credit expanded just 1.6 percent. Lending to public enterprises increased, while credit to the private sector remained stagnant and the government reduced its borrowing. The Reserve Bank maintained a tight monetary policy, but the weakness of its balance sheet continued to constrain the effective use of monetary policy when balance-of-payments pressures developed.

The fiscal situation in 1999 improved over 1998. Official estimates suggested an overall budget surplus of T$2.6 million (US$1.625 million), or approximately 1 percent of GDP, while International Monetary Fund estimates suggested a deficit of T$4.2 million (US$2.674 million), or 1.8 percent of GDP. The overall outcome reflects lower levels of public expenditure than in the original budget estimates, with an increase in the nominal wage bill. In addition, the government's underlying fiscal capacity as measured by the current balance remained weak. The current deficit in 1999 was T$7.1 million, or 2.9 percent of GDP. The government's total outstanding debt at the end of 1999 was 37.4 percent of GDP, with more than 80 percent consisting of external loans at concessional interest rates.

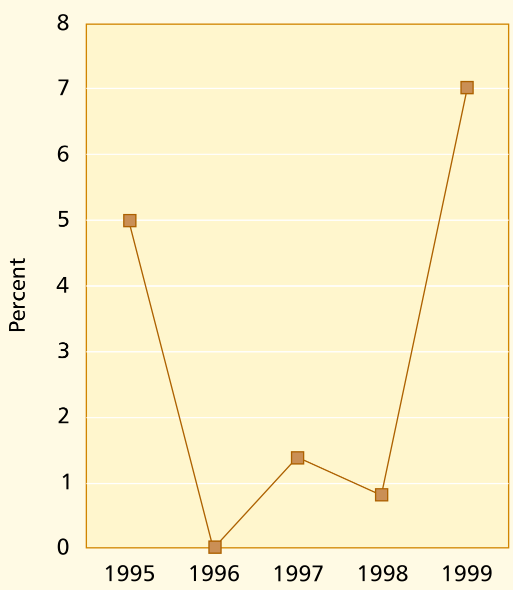
The wage bill is estimated to rise 4.4 percent, and a smaller overall annual budget surplus of T$0.9 million is projected. These budget estimates, however, are not fully consistent with the stated policy objectives of fiscal tightness, ongoing civil service reform, and improved allocative efficiency, nor are they grounded in a convincing medium-term macroeconomic framework. The budget hopes that growth will accelerate to double-digit figures by 2001, but the source of more rapid growth is unclear. In the early months of 2000, there were signs of a domestic credit expansion. Lending to the private sector rose almost 7 percent, and the government increased borrowing. The budget deficit in 2000 is projected to be T$12.4 million (US$7.75 million), with current expenditure set to grow 9.4 percent and current revenue to rise only 1.7 percent. Debt servicing for 2000 was estimated as a manageable 2.7 percent of GDP.

The 2000 budget contains some significant initiatives, including a new contributory retirement scheme for civil servants and a commitment for tax reform to shift the balance from trade to indirect taxes. Major reforms targeted at enhancing the efficiency of the large and diverse public enterprises sector are desirable. In addition, the economic policy environment needs improvement, as its lack of transparency and predictability seriously discourages domestic and foreign private sector investment. The Industrial Development Incentives Act remains in effect, with all its discretionary provisions. A new Companies Act of 1995 finally became law in April 1999, but was poorly received by the business community and requires immediate amendment. The cumbersome system of granting business, trade, and development licenses also needs reform. This system, combined with ongoing difficulties in obtaining work permits for foreign skilled labor, constitutes a major obstacle to the direct foreign investment needed if Tonga's undoubted development potential—especially in the agriculture, fisheries, and tourism sectors—is to be realized.

TUVALU

A new set of national accounts reveals that the real GDP growth rate in 1998 was 14.9 percent. This rapid growth was led by the government sector, which expanded by almost a third and accounted for one fourth of GDP. In addition, public construction grew by 28.5 percent. This growth reflected the impact of increased public service employment, wages, and physical infrastructure projects on national income. In contrast, agriculture, forestry, and fisheries grew by less than 1 percent. The real GDP growth rate was estimated at 3 percent in 1999, with public administration and public construction again the leading sectors. Official estimates of GNP are not made, but real GNP grew faster than real GDP in 1999 because of rapid growth in fisheries license fees and revenue from passport sales. In addition, the first revenue from leasing Tuvalu's Internet domain address to a foreign company was received, although it was much less than originally anticipated. Income from the Tuvalu Trust Fund and private remittances remained at the levels of recent years. The inflation rate in 1999 rose to 7 percent from less than 1 percent in 1998 (see figure 2.28). This reflected higher prices in the transport and miscellaneous categories of the consumer price index.

Figure 2.28 Inflation Rates, Tuvalu, 1995-1999



Source: Appendix table A9.

A substantial trade deficit continued to be financed by remittances, investment income, fishing license fees, and official transfers. Net foreign assets, including the Tuvalu Trust Fund, reached A$90 million at the end of the year (approximately seven years of import cover). An automatic distribution from the trust fund to the Consolidated Investment Fund provided 11.5 percent of the government's total recurrent revenue in 1999. Fishing license fees provided 40 percent and taxation 17 percent, while telecom license fees fell to 4 percent. Because of an unexpected surge in fishing license fees, total recurrent revenue was 30 percent more than the budget estimate. Total operating expenditure was 24 percent below the budgeted level, primarily because of a shortfall in expenditure on goods and services.

Capital expenditure, which for the first time was largely domestically financed, was 32 percent below the approved level. Consequently, instead of a projected budget deficit of approximately 24 percent of GDP, the budget surplus was 9 percent. Such conservative projections of revenue and overestimates of expenditure have been characteristic of Tuvalu government budgets in the 1990s. A new administration introduced the 2000 budget and continued the post-independence tradition of fiscal prudence. It projected a 15 percent increase in revenue, largely attributable to increased distribution of income from the Tuvalu Trust Fund and external grants. Operating expenditure was projected to rise a substantial 72 percent because of increased expenditure on personnel, goods and services, and special items that included contributions to the Falekaupule Trust Fund to finance outer island development projects. This fund was established in late 1999 with ADB loan funds, community contributions, and matching government funds. Capital expenditure is projected to rise the same percentage as operating expenditure, as new government offices are built and outer islands are provided with electricity supplies. The overall budget is officially presented as balanced. In fact, in 2000 Tuvalu will receive ADB concessional loans of A$1.8 million, and A$3.2

million will come from government's financial reserves in the Consolidated Investment Fund. The total A$5 million matches a planned augmentation of the capital in the Tuvalu Trust Fund.

In 1999, the government began to devolve administrative responsibilities including some expenditure management to Falekaupule, the outer island councils. This was in line with the medium-term development strategy's focus on ensuring greater equality of income distribution between the capital island of Funafuti and the outer islands. The Falekaupule Trust Fund is expected to reach a capital base of A$14.6 million in 2000, and to generate annual development finance of A$590,000 for an outer island population of approximately 5,000, the same number of residents as Funafuti.

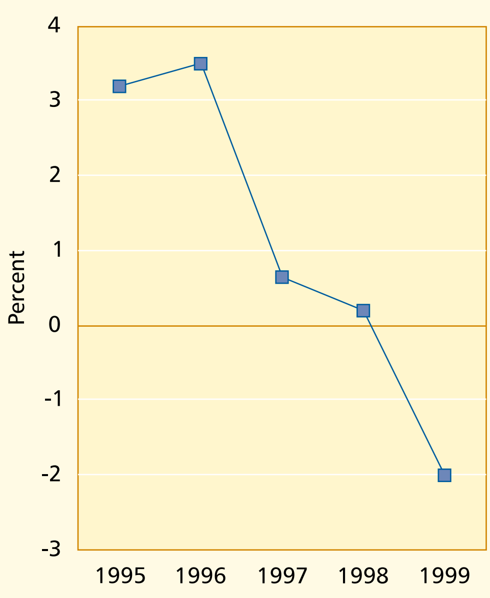
The government also began negotiations with Japan for acquiring a multipurpose inter-island vessel to supplement the services of the old existing vessel, and to ease the transport constraint on outer island commercial activity. However, activity in the market economy will continue to be concentrated in Funafuti and will be dominated by the public sector. In 2000, construction of government offices, road reconstruction, slightly increased public service employment, and a 10 percent wage rise for public servants will stimulate private sector activity and significantly accelerate the aggregate economic growth rate. Plans have been announced for accelerating public sector reform through (a) corporatizing inter-island shipping and the Tuvalu Maritime School, (b) commercializing service provision by some ministries, and (c) introducing a performance orientation in the public service and public enterprises. Implementing the reforms can be expected to be a slow process. Meanwhile, private sector development that is not a direct function of public sector expansion remains limited by location, difficulties of access to land, and poor international transport links.

VANUATU

National accounts show that real GDP increased by 0.2 percent in 1998, a year characterized by political instability and disarray in macroeconomic policy. Output of the agriculture, fisheries, and forestry sector grew by 6.9 percent, primarily because of greater copra and kava production. Industry sector output fell 7 percent, while service sector output declined 0.7 percent, largely because of reduced wholesale and retail trade.

In 1999, real GDP fell an estimated 2 percent, despite a 7.6 percent growth in industry sector production from a substantial increase in aid-funded construction (see figure 2.29). Agriculture sector output declined 9.3 percent, with production slowed by a cyclone in February. The government sector reportedly contracted 5 percent, while the overall decline in the service sector was 1.2 percent. Visitor arrivals in the first half of 1999 were lower for various reasons. A Sydney hailstorm grounded the Air Vanuatu aircraft for more than six weeks; a domestic air crash damaged Vanuatu's image; and competition increased from other tourist destinations such as Fiji Islands, New Caledonia, and Tahiti. However, the frequency of flights from Australia increased in comparison with 1998, and the number of visitors began to climb in the latter half of the year.

Figure 2.29 Real GDP Growth Rates, Vanuatu, 1995-1999



Source: Appendix table A1.

Along with stagnation in tourism receipts in 1999, cocoa, copra, and kava exports fell from their 1998 levels. However, revenue from beef and timber exports rose as export volumes increased. Import expenditure dropped from the high level of 1998, as tourism and the aggregate level of economic activity fell. The deficit on the current account remained around 8 percent of GDP, and was matched by a capital account surplus from long-term public borrowing, notably disbursement of an ADB program loan. Through 1999, the vatu, which is pegged against a group of currencies, appreciated 0.5 percent against the US dollar and depreciated almost 6 percent against the Australian dollar in both nominal and real terms, as Vanuatu's inflation rate was nearly the same as Australia's. No balance-of-payments pressure was evident, with official foreign reserves at the end of 1999 equivalent to 6.5 months of imports. No significant policy-induced changes in the nominal effective exchange rate were anticipated.

Given the openness of the economy and the pegged exchange rate system, the scope for an independent monetary policy is limited. Up to September 1999 the money supply grew by only 0.3 percent from the corresponding quarter in 1998, entirely because of growth in domestic credit. This growth reflected increased loans to the private sector, particularly for land and house purchases. Net foreign assets fell 1.2 percent. Considerable scope existed for credit expansion, with commercial banks' actual reserve holdings 76 percent higher than the prescribed Statutory Deposit Ratio, which was reintroduced in November 1998. At the end of the third quarter of 1999, the weighted average lending and deposit rates had declined slightly to 12.5 percent and 3.3 percent, respectively, so that the interest spread had widened from 9 to 9.2 percent.

Following an overall budget deficit of 10.3 percent of GDP in 1998, the target outcome in 1999 was a deficit of 5.4 percent of GDP. The actual outcome was estimated to be an overall deficit of 1.2 percent of GDP. This was attributable largely to development expenditure of 39 percent of the budgeted level, which reflected delays in implementing major infrastructure projects. Total expenditure and net lending fell 24 percent from 1998. Revenue and grants reached 95 percent of the budgeted level, despite an economic growth rate well below expectations. The restructuring of the tax system from trade tax to a value-added tax showed encouraging results, with 96 percent of budgeted value-added tax revenue collected.

External concessional loans financed 92 percent of the budget deficit. The total stock of debt stood at Vt9,657.1 million, or 35 percent of GDP, and one fourth was domestic debt. The 2000 budget provided for a balanced recurrent budget, an increase in development expenditure, and an overall deficit of 3 percent of GDP to be financed by external concessional loans. The revenue estimate was a realistic 0.3 percent below the 1999 budget level, while the recurrent expenditure estimate was 2.2 percent below the 1999 level. The latter may prove difficult to achieve unless public service staffing is consistent with budget provisions.

Restoring investor confidence is crucial, and the Foreign Investment Act was amended in April 1999 to be less restrictive of foreign investment. However, a sudden change of government in November 1999 introduced uncertainty into the policy environment. The new prime minister, who headed a coalition of five parties with a slender parliamentary majority, indicated an intention to review the roles of the previous administration and the role of external funding agencies.