

# THE PACIFIC

During the first half of 2002, the economic performance of the Pacific was subdued, which highlights both its urgent need for sociopolitical stability and its vulnerability to external developments. The subregion is expected to record a more modest recovery over the medium term than anticipated in *ADO 2002*. However, recovery will largely depend on political stability in Melanesia and developments in the global economy.

## MACROECONOMIC ASSESSMENT

**A**ccording to revised official figures, the Pacific DMCs contracted by a weighted average rate of 1.2% in 2001, which is sharper than the *ADO 2002* estimated contraction of 0.8%. This reflected greater weakness in Melanesia<sup>1</sup>—which accounted for 85% of the subregion's 2001 GDP—because of a sharper than expected contraction in Solomon Islands that was only partially mitigated by an upward revision of estimated economic growth for the Fiji Islands; the contraction of the Papua New Guinea economy—the largest in the subregion—was about the same as previously estimated. In addition, growth estimates were revised downward in the Polynesia group (particularly Cook Islands, Samoa, and Tonga) while most of the Micronesia group's estimates (except for the Federated States of Micronesia) were unchanged. Overall, the picture remains of a subregion that suffered a second year of weak performance in 2001 with only a slightly slower contraction in Melanesia than in 2000 and slower growth in Micronesia and Polynesia.

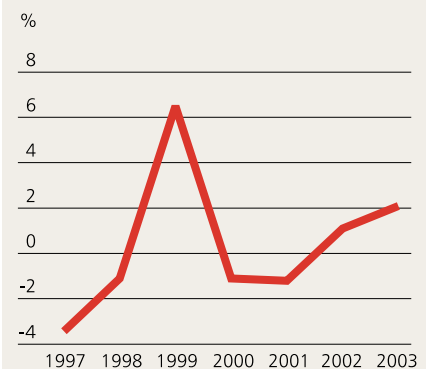
These trends generally continued in the first half of 2002 with Melanesian economic performance improving, but at a slower pace than forecast in *ADO 2002*. In Papua New Guinea, the agriculture sector remained subdued because of a delay in harvesting some major crops (mainly coffee), largely reflecting the disruptions accompanying the national elections, while the declining trend in minerals persisted. In Solomon Islands, weak economic management continued to forestall the rebuilding of the economy. A currency devaluation and quick revaluation in March–April 2002 highlighted policy uncertainties. In addition, delays in payments of wages caused unrest among government employees. In contrast, the Fiji Islands experienced a broad-based economic expansion, which exceeded earlier expectations and reflected sound economic management.

At the same time, economic activity was generally slower than expected in the relatively fast-growing Polynesian group. Samoa, the largest member of the group, witnessed a sharp and broad-based slowdown in economic growth during

<sup>1</sup> Melanesia refers to Fiji Islands, Papua New Guinea, Solomon Islands, and Vanuatu; Micronesia refers to Kiribati, Marshall Islands, Federated States of Micronesia, and Nauru; and Polynesia refers to Cook Islands, Samoa, Tonga, and Tuvalu.

**A more modest recovery than forecast in *ADO 2002* is expected over the medium term.**

**Real GDP Growth, Pacific DMCs, 1997-2003**



Sources: ADO database; staff estimates.

**Selected Economic Indicators, The Pacific, 1999–2003**

	1999	2000	2001	2002		2003	
				<i>ADO 2002</i>	<i>Update</i>	<i>ADO 2002</i>	<i>Update</i>
<b>GDP Growth (%)</b>							
Average	6.5	-1.1	-1.2	1.9	1.1	2.6	2.1
Cook Islands	5.8	9.8	-3.3	2.5	1.4	3.3	2.4
East Timor	—	—	—	—	—	—	—
Fiji Islands	9.7	-2.8	2.6	3.5	4.4	4.7	4.7 <sup>a</sup>
Kiribati	2.1	-1.7	1.5	2.8	2.8 <sup>a</sup>	2.5	2.5 <sup>a</sup>
Marshall Islands	-0.2	0.7	0.6	0.7	0.7 <sup>a</sup>	—	—
Micronesia, Federated States of	0.2	4.4	1.1	3.3	0.3	0.7	-0.9
Nauru	—	—	—	—	—	—	—
Papua New Guinea	7.6	-1.3	-3.4	1.2	0.0	1.8	1.1
Samoa	2.6	6.9	6.5	5.0	2.0	5.0	3.0
Solomon Islands	-1.3	-14.0	-10.1	-5.0	-6.0	0.0	2.0
Tonga	2.9	6.5	0.5	2.9	1.6	2.6	2.5
Tuvalu	3.0	3.0	4.0	3.0	3.0 <sup>a</sup>	3.0	3.0 <sup>a</sup>
Vanuatu	-2.5	3.7	-0.5	0.7	0.7 <sup>a</sup>	1.9	1.9 <sup>a</sup>
<b>Inflation (%)</b>							
Average	9.3	9.6	7.0	6.0	7.6	3.1	6.6
Cook Islands	1.4	3.1	8.7	2.5	4.0	—	2.5
East Timor	—	—	—	—	—	—	—
Fiji Islands	2.0	1.1	4.3	3.0	2.5	—	3.6
Kiribati	1.8	0.4	6.0	2.7	5.0	2.7	4.0
Marshall Islands	1.7	-1.9	2.0	2.3	2.3 <sup>a</sup>	—	2.3
Micronesia, Federated States of	1.9	1.8	2.0	2.6	0.5	2.6	1.5
Nauru	—	—	—	—	—	—	—
Papua New Guinea	14.9	15.6	9.3	8.3	11.2	5.0	9.3
Samoa	0.2	1.0	4.0	3.0	7.0	—	4.0
Solomon Islands	10.4	8.6	8.0	8.0	8.5	6.0	7.2
Tonga	3.9	4.9	6.3	10.0	10.0 <sup>a</sup>	5.0	5.0 <sup>a</sup>
Tuvalu	3.8	5.3	1.8	1.5	1.5 <sup>a</sup>	2.1	2.1 <sup>a</sup>
Vanuatu	2.1	2.5	3.9	4.5	3.0	4.0	4.0 <sup>a</sup>

— Not available.

<sup>a</sup> *ADO 2002* forecast.Sources: *ADO* database; staff estimates.

this period, reflecting irregular weather conditions and the completion of many construction activities.

In sector terms, performance was uneven during the first half of 2002. Agriculture and fisheries generally across the subregion, and construction and public works particularly in the smaller economies, provided a positive stimulus to economic activity; on the other hand, the performance of the major tourism sector was modest, except for the Fiji Islands, which showed strong growth of about 20% in visitor arrivals during the first half of the year. However, declines in many other sectors offset these positive developments. Further, political instability and social unrest continued to constrain economic activities in Melanesia. Low international commodity prices also contributed to subdued economic performance.

Reflecting the weaker than expected economic growth in 2001, the subregional estimate for inflation has also been revised downward slightly to 7% for 2001, compared to the *ADO 2002* estimates. However, inflation is expected to have risen in the first half of 2002, largely reflecting a rise in Papua New Guinea, Samoa, and Tonga. While inflation in Samoa reflected irregular weather and food supplies, in Papua New Guinea and Tonga it partly reflected a depreciation of

their respective currencies. A sharp deterioration in the fiscal conditions in Papua New Guinea also contributed to a rise in inflationary expectations in the country. In contrast, inflation in the Fiji Islands fell, alongside an improvement in supply conditions and a reappearance of macroeconomic stability. There was no significant movement in inflation among the other countries.

For most Pacific DMCs, the external accounts for the first half of 2002 were not available at the time of writing. However, domestic factors such as elections or delays and disruption in export-oriented activities are expected to have caused weak export performance in the first half of the year. In particular, Papua New Guinea recorded a current account deficit in the first quarter of 2002, having recorded surpluses for more than 10 quarters in a row. Low international commodity prices also contributed to weak export performance in the subregion during the first half of 2002. Some improvement in these prices was seen around the middle of the year, which is likely to be reflected in the outcomes for the second half of the year. Overall, with imports expected to have generally remained steady in most Pacific DMCs during the first half of 2002, trade balances remained under pressure. The Fiji Islands presented a notable exception, recording robust growth in exports, which was faster than growth in imports.

The overall balance on the external account manifested a mixed performance in the subregion. While the position in Solomon Islands reached a precariously low level, that in Tonga improved significantly with the release of the first tranche of an ADB program loan. Most other Pacific DMCs are expected to have maintained reasonable external reserves, though some at levels lower than at the end of 2001.

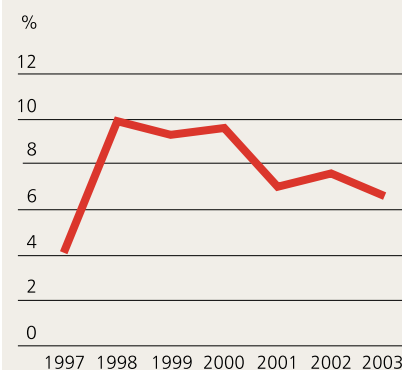
Weak global economic performance in 2001 and continued uncertainty surrounding recovery in 2002 led to an easing of fiscal and monetary policies in the Pacific. A major development in Melanesia during the first half of 2002 was a sharp deterioration in government finances in Papua New Guinea, mainly due to pre-election expenditures, which led to monetary easing and necessitated a supplementary budget from the new Government to control the overall budget deficit in 2002. Further, the fiscal position of Solomon Islands remained precarious, associated with significantly higher than budgeted expenditures, large payments arrears—domestic as well as international—and excessive easing of monetary conditions. The 2002 Solomon Islands budget, introduced in March 2002, proposed to substantially reduce payroll and recurrent expenditures, but implementation has, so far, been extremely weak. More positively, during the first half of 2002, new government budgets for 2002–2003 were introduced in three DMCs in Polynesia—Cook Islands, Samoa, and Tonga. All three budgets target modest budget deficits and reaffirmed government commitment to reforms.

## POLICY DEVELOPMENTS

A major policy challenge for the larger Melanesian economies in the first half of 2002 was the restoration of business confidence following periods of political instability and ethnic conflict. Weak economic management adversely affected the achievement of these goals in Papua New Guinea due to national elections, and in Solomon Islands due to lack of political commitment. A new Government was formed in Papua New Guinea in August 2002, which announced its commitment to fiscal responsibility and to removing barriers to investment and economic growth. However, the Government also initiated a review of the privatization process, which it temporarily suspended. Thus, there is an element of uncertainty in the business community in Papua New Guinea as the full policy direction of the new Government may take time to unfold. In contrast, business confidence in the Fiji Islands improved, due to broad-based growth and

**Inflation in early 2002 largely reflects price rises in Papua New Guinea, Samoa, and Tonga.**

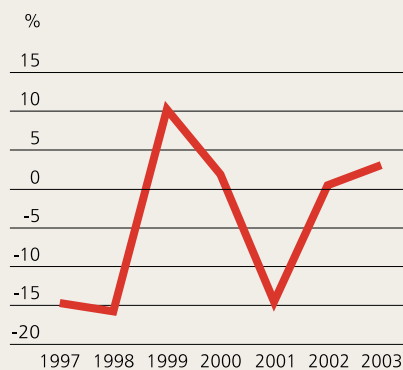
**Inflation Rate, Pacific DMCs, 1997-2003**



Sources: ADO database; staff estimates.

**Domestic factors and low international commodity prices contributed to weak export performance.**

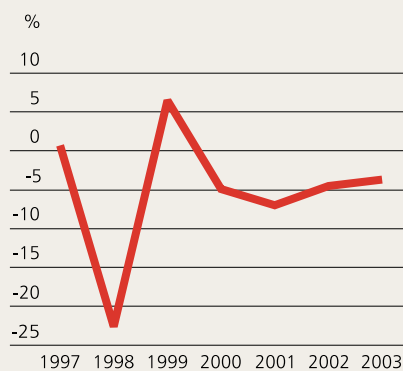
**Merchandise Export Growth, Pacific DMCs, 1997-2003**



Sources: ADO database; staff estimates.

**Trade balances remained under pressure in the first half of 2002.**

**Merchandise Import Growth, Pacific DMCs, 1997-2003**



Sources: ADO database; staff estimates.

macroeconomic stability in the first half of 2002. While the business climate improved in the Fiji Islands, it has yet to be reflected in investment levels. Overall, investors across Melanesia still seem to be watching developments. Vanuatu has also been facing major sociopolitical unrest in 2002, which represents a serious threat of economic crisis.

The Polynesian economies made good progress in continuing or launching economic and public sector reform programs during the first half of 2002. Samoa, with good results from reforms in the last few years, launched its 2002–2004 Strategy for the Development of Samoa to enhance the sharing of the benefits of reforms by the community at large. Tonga reaffirmed its commitment to recently initiated reforms, which include measures in the areas of civil service, taxation, private sector development, and privatization of public enterprises. The Cook Islands and Tuvalu continued the reforms and prudent management of their economies.

The key policy issue for the small Micronesian economies, as well as Tuvalu, was the building up and careful management of trust funds that can provide long-term support for essential public expenditures. However, the value and returns from trust funds suffered during the first half of 2002 in the wake of uncertain and often weakening global financial markets. In the case of the Marshall Islands and the Federated States of Micronesia, progress was made in the Compact of Free Association negotiations with the US during this period. Significant aid from Australia is helping Nauru finance some essential activities and develop a strategy to address its myriad problems, including weak economic management, large government debt, and continuing budget deficit.

At the subregional level, progress was made on the Pacific Island Countries Trade Agreement (PICTA) during the first half of 2002. By August 2002, 11 out of 14 PICTA countries had signed the agreement and four had ratified it. Subregional policy discussions focused on sustainable development, public-private partnerships, a ban on kava-based pharmaceutical products by some European countries, global climate change and greenhouse gas emissions, transnational crimes, and two OECD initiatives related to money laundering and harmful tax practices.

## OUTLOOK FOR 2002–2003

The general trend forecast in *ADO 2002* was for a return to positive growth for the subregion in 2002. However, economic performance in most Pacific DMCs in the first half of the year is expected to have been weaker than forecast, with the Fiji Islands a notable exception among the larger economies. Economic activity in Papua New Guinea remained subdued and the fast-growing economy of Samoa slowed during this period. These developments, coupled with continued uncertainty about the global economic outlook, led to a downward revision of the subregion's 2002 forecast to a modest weighted average growth rate of 1.1%. Recovery in agriculture is expected to lead growth. Overall, almost all economies are expected to record real GDP expansions in 2002; Solomon Islands is the only one likely to record a significant decline.

The forecast for weighted average inflation in the subregion in 2002 has been revised upward to 7.6%, which reflects largely the significant upward revisions for Papua New Guinea and Samoa. Exports are expected to pick up and the current account position to improve in Papua New Guinea in the second half of 2002, following the end of the election process, while some improvement in commodity prices was seen around the middle of the year. The Solomon Islands economy faces a major risk of further macroeconomic instability in 2002 due to continued weakness in economic management. Papua New Guinea may also face

macroeconomic instability this year if the new Government cannot contain the fiscal deficit to the level projected in the supplementary budget introduced on 28 August 2002.

Because of these developments and continued uncertainty about the global economy, the growth forecast for the subregion for 2003 has been revised downward slightly to a weighted average rate of 2.1%. However, this still represents a modest strengthening relative to 2002, as expected in *ADO 2002*. The inflation forecast for the subregion has been revised upward to a weighted average rate of 6.6% in 2003. The balance of payments performance for 2003 remains highly uncertain and vulnerable to external developments.