

Macroeconomic Environments

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Two observations concerning the relationship between the macroeconomic environment and financial sector development have universal application. The first was made in the introductory chapter: economic growth promotes the emergence of savings and investment and the financial intermediation that links them. The second observation is that macroeconomic stability is a necessary condition for successful and durable financial sector development:

A reasonable degree of price stability is possibly the most crucial prerequisite for effective and efficient domestic resource mobilization and allocation through the financial sector (Fry 1988, 326).

Modest and stable inflation rates require responsible monetary policies, which in turn require fiscal discipline combined with credible exchange rates and tariff policies. Financial development in PDMCs therefore depends fundamentally on economic growth outcomes and on the ability of governments to adopt and implement sound growth-promoting and macroeconomic stabilization policies. This chapter briefly reviews the macroeconomic performance of the seven PDMCs during the 1990s and assesses what progress has been made in improving economic policies, governance, and macroeconomic management.

MACROECONOMIC PERFORMANCE

An examination of growth performance must acknowledge that, to varying degrees, PDMCs' growth potential is constrained by remoteness from world markets, small domestic markets, and narrow production bases. They exhibit a high degree of openness, which has brought the benefits of specialization and trade (Table 1.1), but which also has left them vulnerable to external economic changes. Aid dependency is high, especially in the Micronesian states. In addition, many PDMCs are susceptible to natural disasters: cyclones, droughts, and volcanic eruptions have at times devastated economies and populations. PDMC governments therefore have a long-standing familiarity with the forces of nature and of globalization, and specifically with adjustment to economic and export instability.

The key macroeconomic aggregates for the period 1994–1999 are presented in Tables 2.1 and 2.2. The general impression is of low and erratic growth, modest inflation outcomes, a slight improvement in overall fiscal balances, and little sustained change in external (current account) balances.

An examination of individual country statistics reveals economic slowdowns during the period 1994–1998 for all PDMCs except Kiribati and Samoa, followed by economic recovery in 1999 (except for Vanuatu). This recovery stalled in 2000, when PNG's real GDP virtually stagnated, and political instability and social unrest in Fiji and Solomon Islands saw respective real GDPs fall by an estimated 13.0 percent and 14.0 percent, respectively. Real GDP in Kiribati also fell (by 4 percent) in 2000; but positive growth rates were recorded in Samoa (7.0 percent), Tonga (5.3 percent), and Vanuatu (2.8 percent). Following its recovery from the impact of taro blight in 1994, Samoa is the only PDMC showing significant and reasonably steady growth through the late 1990s and into 2000. This in part reflects the impact of tax, tariff, and financial liberalization policies implemented from 1996. Growth in the largest economy, PNG, was especially disappointing, given its natural resource endowments and location; the Asian financial crisis and severe drought had major adverse impacts.

The low level of development of financial sectors in PDMCs and the limited progress in financial deepening documented in chapter 3 reflect these low growth rates. Among the reasons for the low growth are large, inefficient public sectors, and excessive regulation and price and wage controls that have distorted market signals and discouraged investment. Cumbersome foreign investment regulations have also discouraged foreign investment.

The inflation record varies considerably between countries. Annual consumer price increases were kept to less than 6 percent in Fiji, Kiribati, Tonga, and Vanuatu, and were lowered substantially in Samoa towards the end of the 1990s. Inflation rates in PNG and Solomon Islands were much higher, reflecting monetary financing of expansionary fiscal policies and currency depreciations forced by external economic shocks, most importantly the Asian financial crisis of 1997–1998. The latter hit log exports very hard in Solomon Islands and adversely affected PNG to a lesser extent. In 2000, inflation rates were less than 3 percent for Fiji, Kiribati, Samoa, and Vanuatu. Rates rose to 5.3 percent for Tonga and almost 18 percent for PNG, and fell to 6.6 percent for Solomon Islands (ADB 2001).

There were marked differences in fiscal performance between countries. Fiji ran overall budget deficits throughout the late 1990s (if privatization receipts are excluded from the 1998 “headline” balance). The deficit blew out in 1997 as a result of the costs associated with restructuring the State-owned National Bank of Fiji (NBF), which was declared insolvent in 1995; generous tax incentives also resulted in low effective tax rates, thus restricting revenue growth. The accumulation of domestic debt as a result of financing consistent deficits inevitably increased expenditure on interest payments and, with the wages bill (Table 2.3), left less room for other expenditure.

PNG was plagued by bouts of macroeconomic instability and governance problems in the 1994–1999 period. The overall fiscal position deteriorated from a small surplus in 1997 to deficits of 2.2 percent and 1.8 percent of GDP in 1998 and 1999, respectively. The deficits largely were funded by borrowing from the central bank in excess of legal limits, resulting in inflationary, balance of payments, and currency pressures. There was some recovery in the fiscal and external accounts in

the latter half of 1999, following the formation in July of a new administration committed to macroeconomic stabilization and implementation of a Structural Reform Program. This recovery continued into 2000.

In Solomon Islands, governments ran unsustainable budget deficits from the late 1980s and throughout the 1990s, despite favorable external economic conditions in the first half of the decade. By 1995, the legal limit on borrowing from the central bank had been exceeded and trading in Government securities was suspended, leaving commercial banks and the National Provident Fund with large holdings of nonperforming assets. The election of a reformist government in August 1997 led to improvements in fiscal management in 1998 and 1999, but these were disrupted by civil unrest in 2000. An October 2000 peace accord provided some hope of economic recovery.

Samoa achieved a sustained improvement in the overall fiscal balance through the 1990s, on the back of a relatively strong growth performance and sound economic management. In contrast, Tonga recorded fiscal deficits in most years, as a result of economic recession and slow growth combined with growth in the wage bill (Table 2.3). Vanuatu's budget deficit reached almost 8 percent in 1998. This was the result of civil unrest following an Ombudsman's report on anomalies in the Vanuatu National Provident Fund (VNPF), and the Government's subsequent decision to allow unconditional withdrawal of retirement savings from VNPF. Since VNPF itself could provide less than half the required funds, the Government as guarantor had to make up the shortfall. A new Government committed to implementation of a Comprehensive Reform Program began to restore fiscal discipline in 1999.

For Kiribati, Table 2.1 shows very large fluctuations in fiscal outcomes in the 1990s, but the figures are exclusive of drawdowns from the country's Revenue Equalization Reserve Fund (RERF). This fund was established in the late 1950s with colonial Government savings from phosphate mining revenue and subsequently grew through sound investment management and prudent fiscal policy. RERF now explicitly serves as a mechanism for smoothing variability in Government revenue, returning an investment income of about one third of GDP. Recurrent expenditure, which includes a large wage bill (Table

Table 2.1

Key Macroeconomic Indicators, 1994–1999

	1994	1995	1996	1997	1998	1999
Real GDP Growth						
			(percent change)			
Fiji Islands	5.1	2.5	3.1	-0.9	1.4	8.0
Kiribati	7.2	3.5	4.3	1.0	7.3	2.3
Papua New Guinea	5.2	-3.3	7.7	-3.9	-3.8	3.2
Samoa	-0.1	6.4	7.3	1.0	3.4	5.3
Solomon Islands	5.2	10.5	3.5	-2.3	1.1	-1.3
Tonga	2.9	-0.2	-0.1	1.6	3.1	6.2
Vanuatu	1.3	-2.9	4.8	0.2	-0.1	-3.0
Consumer Price Inflation						
			(period average)			
Fiji Islands	0.6	2.2	3.1	3.4	5.7	2.0
Kiribati	5.3	3.6	-0.2	1.5	3.7	0.4
Papua New Guinea	2.8	17.2	11.9	3.9	13.5	14.9
Samoa	12.1	-2.9	5.4	6.8	2.2	0.6
Solomon Islands	13.3	9.6	11.8	8.1	12.4	8.0
Tonga ^a	0.4	2.8	2.0	3.0	3.9	5.3
Vanuatu	2.3	2.2	0.9	2.8	3.3	2.0
Growth in Broad Money						
Fiji Islands	0.1	4.3	0.9	-8.7	-0.3	14.2
Kiribati	10.1	-0.9	11.7	-3.1	11.1	5.1
Papua New Guinea	2.4	10.7	32.0	6.9	1.8	8.8
Samoa	13.0	21.8	5.1	13.3	4.9	9.1
Solomon Islands	24.1	9.9	15.7	6.3	4.8	15.4
Tonga ^a	17.1	2.8	14.1	2.4	15.0	8.3
Vanuatu	3.5	11.4	11.1	-0.3	12.6	-9.2
Overall Fiscal Balance^b						
			(percent of GDP)			
Fiji Islands ^c	-1.5	-0.6	-5.0	-6.6	4.6	-0.7
Kiribati ^d	-1.5	-10.2	-40.5	5.1	24.6	-6.4
Papua New Guinea	-2.2	-0.5	0.5	0.1	-2.2	-1.8
Samoa	-7.7	-2.8	0.9	1.1	1.1	-1.5
Solomon Islands	-5.5	-5.3	-4.4	-4.8	-2.5	-2.4
Tonga	-3.5	0.8	-4.8	-2.5	-0.2	-0.4
Vanuatu	-1.6	-2.7	-1.8	-0.7	-7.5	-1.3
Grants						
Fiji Islands	0.2	0.2	0.2	0.2	0.1	0.04
Kiribati	30.8	27.7	31.7	39.2	47.2	39.1
Papua New Guinea	2.9	4.0	2.5	4.4	6.1	5.8
Samoa	11.3	16.9	15.0	10.8	11.2	10.2
Solomon Islands	18.4	11.3	14.8	10.7	12.7	15.7
Tonga	14.5	15.7	8.9	9.1	13.3	10.4
Vanuatu	1.1	2.9	1.7	2.0	1.3	1.9
Average Grants	11.6	11.8	11.6	11.2	14.2	10.8

Sources: National income accounts and Ministry of Finance data; IFS.

Notes: a. Data refer to the fiscal year beginning 1 July and ending 30 June of the following year; b. Including grants; c. Including NBF restructuring costs and privatization receipts; d. Excluding Revenue Equalization Reserve Fund drawdown.

2.3), has been underpinned by the RERF without a decline in the real value of the fund, although a sustained increase in Government spending would threaten to undermine its value.

Because of their narrow production base, PDMCs are all dependent on imported goods, mainly from Australia and New Zealand. Except for PNG and Solomon Islands, trade deficits are a regular feature of PDMCs' balance of payments. Private transfers and remittances from nationals living overseas have made a major contribution to offsetting trade deficits, particularly in Kiribati, Samoa, and Tonga. Official transfers have provided substantial import coverage in all PDMCs, and in PNG have been necessary to offset deficits on net services that result from high interest and dividend payments. Table 2.2 shows current account balances as a percentage of GDP for the period 1994–1999. Fiji moved from deficit to surplus, largely as a result of tourism growth. Kiribati exhibited large fluctuations in line with windfall rises in fishing license fees followed by falls. PNG's position deteriorated, while Samoa's showed a sustained rise in the current account surplus. Solomon Islands' current account moved into deficit as log exports fell dramatically in 1997. Tonga's current account remained in deficit throughout, as did Vanuatu's, except in 1998 when tourism receipts expanded.

Five of the six PDMCs issuing their own currencies continued to peg their exchange rates to a basket of major trading partners' currencies, while PNG adopted a floating exchange rate system in 1994 and a screen-based interbank trading system. Maintenance of international competitiveness through real effective exchange rate stability was a guiding principle of exchange rate policy in the Fiji Islands, Samoa, and Solomon Islands; but required nominal devaluations, backed by domestic wage and price restraint. The latter was not achieved for much of the 1990s in Solomon Islands, where the real exchange rate appreciated despite substantial nominal devaluations (ADB 2000c). PNG's floating exchange rate has reflected the country's economic performance, with the currency depreciating during periods of macroeconomic instability and remaining stable during periods of tighter fiscal conditions. Limited adjustment in pegged exchange rates may have led to overvaluation of exchange rates in the cases of

Vanuatu and Tonga; in the latter case, this had a potentially serious dampening effect on flows of remittances and private capital coming into the country.

Table 2.2
Current Account Balances, 1994–1999^a

	1994	1995	1996	1997	1998	1999
	(percent of GDP)					
Fiji Islands	-3.5	-0.9	3.0	1.6	-0.4	1.5
Kiribati	3.0	-5.3	-33.0	1.2	29.7	-14.0
Papua New Guinea	11.0	18.0	5.4	-2.8	0.4	1.5
Samoa	2.0	4.5	5.1	8.4	10.3	8.0
Solomon Islands	0.4	4.1	3.4	-10.2	5.5	9.9
Tonga	-13.2	-5.9	-0.8	-11.1	-0.6	-6.3
Vanuatu	-9.7	-8.0	-1.8	-7.7	2.1	-4.9

a. Inclusive of official transfers.

Sources: Central Banks (Fiji Islands, PNG, Samoa, Solomon Islands Tonga, Vanuatu); Ministry of Finance (Kiribati).

The importance of foreign aid to PDMCs is evident from data presented in Tables 1.1 and 2.1. Official transfers have provided the import coverage already referred to, and also have been a major source of finance for public investment, which has been maintained or increased while private sector investment has dwindled. The concern in this context is that aid in the Pacific has had perverse effects, substituting for rather than supplementing domestic savings.

The extent of foreign aid dependence varies widely, as shown in Table 2.1. The Fiji Islands is the least dependent on external grants and Kiribati the most dependent, with grants averaging almost 40 percent of GDP over the period 1994–1999. Samoa, Solomon Islands, and Tonga are also substantially dependent on grants to the budget. In general, however, as concern over declining aid and the desire for greater self-reliance increase, PDMCs will need to do more to foster domestic savings and channel them into productive investment. This does not preclude encouraging foreign direct investment. Most PDMCs (with the exception of Kiribati and Vanuatu) still

maintain some controls over capital receipts and outflows, including investment liquidation, though these controls are gradually being relaxed.

The size of the public sector is relatively large in every PDMC, accounting for between 25 and 50 percent of GDP, and absorbing a disproportionate share of resources, including skilled labor. Fiscal situations reflect the large public sector wage bills (Table 2.3) and numerous public enterprises often drawing budget support and enjoying monopoly privileges. These enterprises are involved in commercial activities, competing (sometimes with unfair advantage) against private enterprises. Their operations are generally inefficient and lack transparency and accountability. In particular, poor public enterprise performance has contributed to high water, power, and telecommunications charges that discourage private sector investment. Some corporatization, liquidation, and privatization of public enterprises occurred in the late 1990s, particularly in the Fiji Islands, PNG, and Samoa. However, for the most part it has been difficult to find private sector buyers, and so-called "privatization" has actually meant sales of 51 percent of enterprises to provident funds. Where privatization of a monopoly has occurred, new demands for effective regulation have had to be addressed.

Table 2.3
Public Sector Wages and Salaries, 1994–1999

	1994	1995	1996	1997	1998	1999
	(percent of GDP)					
Fiji Islands	11.1	11.7	11.0	11.7	11.7	11.3
Kiribati	22.4	28.5	30.9	31.3	27.8	32.3
Papua New Guinea	7.9	6.5	8.7	9.3	9.0	9.2
Samoa	9.8	9.4	8.8	10.2	9.7	9.2
Solomon Islands	12.6	10.9	10.4	11.1	10.9	8.7
Tonga	—	—	—	15.1	14.9	14.2
Vanuatu	11.6	12.0	11.8	11.5	12.2	12.0

Sources: Ministries of Finance.

Box 2.1**Best Practice for Macroeconomic Policy**

The pursuit of a sound macroeconomic policy is essential for maintaining strong financial systems and for the development of stable capital and long-term debt markets. PDMCs should adopt well-coordinated economic policies that foster financial stability and encourage long-term confidence in the economy.

PDMCs should undertake wide-ranging structural reforms to deal with practices that distort financial-real sector linkages, such as price and wage controls and large public sector enterprises. PDMCs should encourage separation, in terms of ownership, between real and financial sector entities, and regulatory authorities should be provided with complete independence in pursuing any violations. PDMCs also need to remove policy distortions in the real sector that cause problems in the financial sector.

ECONOMIC MANAGEMENT

At the beginning of the 1990s, "economic management was in disarray and disrepute in most Pacific island states" (Hughes 1998, 51). However, the tide turned during the decade. Fiscal crises, concern over sluggish economic growth and/or increasing inequality, and widespread public disillusionment with the quality of governance all contributed in varying degrees to a new commitment to sound economic management (Knapman and Saldanha 1999). Small groups of reformist politicians and officials sought to adapt global ideas to local circumstances, specifically ideas about the role of the state in economic development as a facilitator of private sector development. These local champions of reform drew technical and financial support from external development agencies for the formulation and implementation of economic and public sector reform programs, many of which placed their initial emphasis on macroeconomic stabilization.

Fiji Islands

During the 1990s, the Fiji Islands “made reasonably good progress in achieving a more flexible, more competitive, market-friendly economy” (ADB 2000d, 1). A new Government elected in June 1999 committed itself to poverty alleviation and better social outcomes, but emphasized the importance of private sector-led economic growth as the central means to these ends. The civil unrest and political instability of 2000 at least temporarily dashed any hopes of a revival of private investment, which averaged just 5 percent of GDP during the 1990s. But the interim Government maintained fiscal discipline in the face of a substantial fall in revenue, and the central bank tightened monetary policy to protect international reserves and the exchange rate (ADB 2001a). The 2001 budget presented a comprehensive structural reform program that included reduced tariffs on business inputs, lower business taxes, a review of price controls, removal of rice import quotas, and compliance with World Trade Organization guidelines. There was also a commitment to a public financial management reform project. Political stability was a prerequisite for effective action on all these fronts.

Kiribati

The medium-term development strategy adopted by the Government of Kiribati in late 1997 identified three key macroeconomic issues: near-static GDP per capita since independence in 1979, the need to create employment for the 60 percent increase in the workforce expected during the 15 years to 2012, and the capacity to sustain growth in public services. Five strategies for addressing these issues were proposed: a reduction in the relative size of core government, public enterprise reform, facilitation of private sector development, encouraging foreign investment, and ensuring consistency between sectoral and national policies. The Government confirmed its commitment to these reforms in the next medium-term strategy (2000–2003). Implementation of the reform program has been slow, investment opportunities are extremely limited, and it is likely that growth and financial

sector development will also be modest. The main challenge for macroeconomic management will be to ensure that the real per capita value of RERF is not eroded.

Papua New Guinea

The PNG Government originally committed itself to economic and public sector reform in 1994, and outlined medium-term reforms in its development strategy for 1997–2002. The Structural Reform Program (SRP) 2000 was presented when a new Government won office in July 1999. Domestically designed and subsequently endorsed by the World Bank, the IMF, and ADB along with other external agencies, the SRP has the following objectives and associated policy actions:

- Promoting good governance, through improving policy-making procedures; making decision making more transparent; strengthening capacity for drafting legislation; presenting legislation on the Government's web site; reviewing and enforcing Government procurement procedures; extending and enforcing requirements for public sector agencies to report to Parliament; strengthening key governance agencies (Auditor-General, the Ombudsman Commission, the Parliamentary Accounts Committee); strengthening the capacity of the National Statistics Office; enforcing a Code of Conduct for the public service; and introducing a moratorium on all new forestry licenses, extensions and conversions.
- Sustaining macroeconomic stability, through strengthening debt management, enacting legislation ensuring the independence of the central bank to manage monetary policy and the exchange rate, and improving public financial management and expenditure controls.
- Improving public sector performance, through reviewing public expenditure, designing and gradually implementing a public service reform program, reviewing and strengthening provincial and local government roles, increasing coordination between all levels of government, and narrowing the scope of the Rural Development Fund and linking it to District Development Plans.

- Removing barriers to investment and economic development, through continuing tariff reform and trade liberalization, deregulating to stimulate agriculture and informal sector activity, completing a taxation review, simplifying and streamlining business registration and work permit approvals, increasing the scope for competition in coastal shipping and aviation, privatizing public enterprises, and reforming the financial sector, including actuarial reviews of the National Provident Fund and the Public Officers' Superannuation Fund, and introduction of legislation to improve regulation and supervision of the banking and insurance industries.

Samoa

In 1996, the Government of Samoa revived a previous commitment to economic reform, issuing the first of a series of statements of economic strategy. These statements emphasized macroeconomic stability, public sector efficiency, improved education and health standards, and a range of measures to support private sector development (agriculture, tourism, fisheries, and village economy). Considerable consultation occurred in the preparation and implementation of the statements. In this context, an ADB-supported Financial Sector Program was begun in 1998 that aimed at establishing and promoting sustainable market-based financial sector policies, and at corporatizing or privatizing public enterprises. Key actions were financial sector liberalization and the strengthening of the Central Bank of Samoa (CBS), the National Provident Fund, the Development Bank of Samoa (DBS), and the prudential and regulatory framework. The Samoan reform program is deservedly regarded as exemplary in that it is designed, owned, and driven by Samoans (Knapman and Saldanha 1999). There is still a need for faster public enterprise reform, improved access to land and its use as collateral, and simplification of regulatory and administrative requirements for domestic and international business (ADB 2000e).

Solomon Islands

The Solomon Islands' Public Sector Reform Program (PSRP) began in 1998 and covered macroeconomic stabilization, public

service reform (including the mitigation of the social impact of civil service downsizing), public enterprise reform, and improved public sector governance. PSRP was supported by a loan from ADB and technical assistance. ADB's 1999 review of the PSRP's implementation concluded: "Progress has been made in difficult circumstances and against considerable resistance from opponents of reform" (Knapman and Saldanha 1999, 140). Ethnic unrest derailed the reform process in 2000, but it is expected that the October 2000 peace accord will lay the foundation for reconstruction and a return to effective economic and public sector reform. A core requirement is the need for fiscal management that supports price stability and adequate international reserves.

Tonga

The Government of Tonga was the only PDMC not to formally commit itself to, or begin implementation of, a wide-ranging reform program in the 1990s. However, a commitment to a reform program was reaffirmed in mid-2001. The program encompassed civil service and public enterprise reform, and a range of measures to encourage private sector-led development.

Vanuatu

The Vanuatu Government began implementation of its Comprehensive Reform Program in 1998, with financial and technical support from ADB. The CRP encompasses governance, fiscal management, public service reform, reform of public financial institutions, private sector development, and the mitigation of the social impact of reforms. It is expected to deliver improved public financial management

Thus there was in the 1990s a strengthening commitment from PDMC governments to redefining the role of the public sector, improving the enabling environment for the private sector, and ensuring sound macroeconomic management. Some of the reforms aimed specifically and directly at financial sector development. Effective implementation of the vast range of policy actions promised to improve economic growth outcomes in stable macroeconomic environments, and thereby to facilitate financial sector development, within the constraints imposed by smallness.