The Pacific

Fiji Islands
Papua New Guinea
Democratic Republic of Timor-Leste

Cook Islands
Kiribati
Republic of the Marshall Islands
Federated States of Micronesia
Nauru
Republic of Palau
Samoa
Solomon Islands
Tonga
Tuvalu
Vanuatu

Fiji Islands

The pace of economic contraction accelerated last year owing to damage done by floods, the impact of the global recession on tourism and exports, and political uncertainties. Production of sugar, a major export, fell for a third year. The outlook remains subdued, with a small contraction in GDP forecast for 2010, but growth may resume at low levels in 2011. Inflation is expected to be moderate in both years. Reforms to encourage investment are a prerequisite for stronger and sustained growth.

Economic performance

GDP contracted for a third year in a row in 2009, with the pace of contraction accelerating to an estimated 2.5% (Figure 3.32.1). In addition to the impact of the global recession, which hurt tourism and exports, severe flooding in January 2009 did damage to crops and infrastructure that cost around 5.3% of GDP, and further discouraged tourism.

These setbacks hit an economy already facing low investor confidence and a loss of assistance from traditional donors and multilateral agencies, resulting from a military coup in December 2006 that installed an interim government. The extended decline in GDP also reflects longer-term constraints to economic growth arising from problems with access to land, weaknesses in the public sector, and a decline in the important sugar industry.

Official estimates show that most sectors contracted in 2009, including wholesale and retail trading by nearly 16%; transport, storage, and communications by just under 9%; agriculture and forestry by about 5%; and even education, public administration, and defense by about 3%.

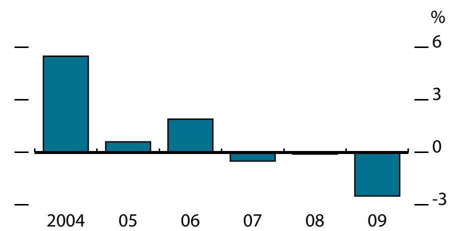
Sugar production dropped further (Figure 3.32.2), by an estimated 19% in 2009, mainly owing to continuing land tenure issues that have led to a reduction in sugarcane output and technical failures in upgrading sugar mills. The financial viability of the mill upgrades depends on cane throughput of 4.2 million tons, but in 2009 only about 2.2 million tons was crushed.

Tourist arrivals fell by about 25% early in 2009, reflecting weakness in global travel, the floods across a third of the country, and increased competition from other Pacific destinations. Full-year arrivals declined by nearly 8%, and tourism revenue fell by an estimated 12% on account of aggressive price discounting.

On the fiscal side, the interim government cut operating expenditure (nearly 80% of total outlays) by 10%, assisted by reductions in civil service jobs. Capital expenditure remained far below target (around half in 2009), due to deficiencies in civil service implementation capacity. While revenue fell by 5.6% due to the fall in economic activity, the aggressive cuts in spending kept the budget deficit to 2.5% of GDP, or below target.

This chapter was written by Emma Ferguson of the Pacific Subregional Office, ADB, Suva.

3.32.1 GDP growth



Sources: Fiji Islands Bureau of Statistics. http://www.statsfiji.gov.fj; Ministry of Finance. *Economic and Fiscal Update: Supplement to the 2010 Budget Address*. http://www.mfnp.gov.fj

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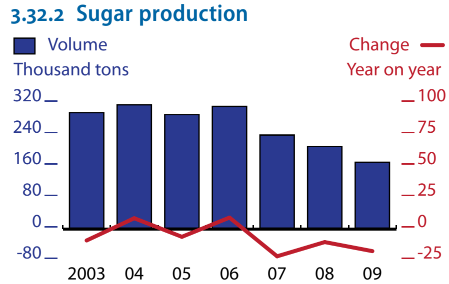
3.32.2 Sugar production



Source: Fiji Sugar Corporation *10-Year Statistical Review*. http://www.fsc.com.fj; Reserve Bank of Fiji. 2010. *Economic Review*. February. http://www.rbf.gov.fj

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When foreign exchange reserves fell in early 2009 to about US$300 million, the Reserve Bank of Fiji responded by tightening exchange controls and, to encourage exports of goods and services, devalued the Fiji dollar by 20% in April. The central bank also directed commercial banks to cap lending interest rates at December 2008 levels. However, lending slowed as banks became more cautious in the context of political and economic uncertainties. Later in 2009, the central bank removed the ceilings on lending rates, as well as credit ceilings that had been in place since 2006.

Weak external markets caused a 28% fall in merchandise exports in US dollar terms in 2009. Declines in exports of clothing, sugar, and timber more than outweighed gains in shipments of fish and gold. Merchandise imports dropped even more steeply, by 35%, with falls in most major categories including fuels (due to lower oil prices) and manufactured goods (due to the weak domestic economy).

The trade deficit shrank, contributing to a narrowing in the current account deficit to an estimated 8.7% of GDP. Foreign exchange reserves recovered by year-end to US$568 million, equivalent to 3.7 months of import cover (Figure 3.32.3). Reserves were bolstered by US$93 million from the general allocation of special drawing rights last year by the International Monetary Fund, and by a pickup in remittances that was stimulated by the devaluation.

Lower prices for imported food and fuel brought inflation down to an average of 3.7% from 7.7% in 2008. By December, however, year-on-year inflation had increased to 6.8% (Figure 3.32.4), largely a result of the devaluation.

Government debt rose (Figure 3.32.5), to the equivalent of about 52% of GDP. Most is domestic debt owed to the national pension fund. But once contingent liabilities of government-owned enterprises, such as Fiji Sugar Corporation, are included, debt is much higher, at around 70% of GDP.

The Bureau of Statistics last year rebased GDP data for 2006–2008 to reflect structural changes in the economy. It reduced the weighting for agriculture and increased that for communications and manufacturing, leading to revisions in the 2006 growth outcome to 1.9% (from 3.4%), and in the 2007 GDP contraction to 0.5% (from 6.6%).

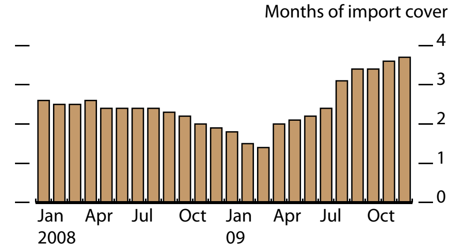
Economic prospects

Any significant rise in sugar output depends on extensive replanting to improve the quality of the sugarcane, on a substantial increase in the area planted, and on a successful upgrading of the sugar mills. However, land tenure problems for tenant cane-growers have yet to be resolved. The outlook for tourism income is also subdued this year. Furthermore, the interim government's position that elections will not be held until 2014 remains a hurdle for improvement of relations with development partners.

A preliminary assessment of damage inflicted by Cyclone Tomas, which hit northern areas of the country in March 2010, indicated that it had little impact on GDP but put some upward pressure on prices.

The 2010 budget, which targets a deficit of 3.5% of GDP (Figure 3.32.6), aims to stimulate growth through infrastructure spending and tax breaks to encourage investment, including a value-added tax refund system for tourists as well as investment incentives. Implementation of the budget

3.32.3 Foreign exchange reserves



Source: Reserve Bank of Fiji. http://www.reservebank.gov.fj

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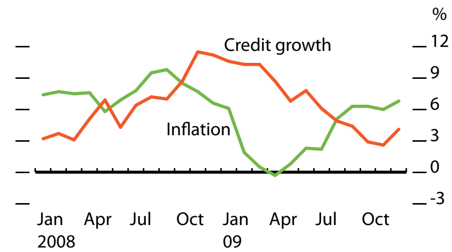
3.32.4 Monetary indicators



Source: Reserve Bank of Fiji. http://www.reservebank.gov.fj

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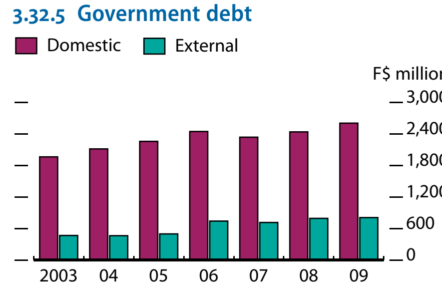
3.32.5 Government debt



Note: External debt comprises debts of the government, statutory bodies, and the private sector.

Source: Reserve Bank of Fiji. 2009. *Quarterly Review*. December. http://www.rbf.gov.fj

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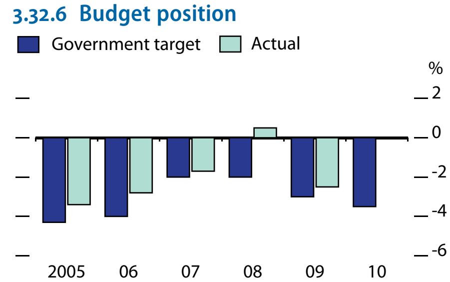
3.32.6 Budget position



Note: Excludes loan repayments.

Sources: Ministry of Finance. *Economic and Fiscal Update: Supplement to the 2010 Budget Address*. http://www.mfnp.gov.fj; Reserve Bank of Fiji. *Quarterly Review*. Various issues. http://www.reservebank.gov.fj

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depends heavily on meeting revenue targets (the tax breaks could erode revenue) and on improving civil service capacity to undertake capital projects (given recurring problems in meeting capital spending targets).

Efforts by the interim government to reform the civil service and inefficient public enterprises should benefit the economy over the medium term, but in the short term will likely lead to more job losses.

In view of these factors, GDP is forecast to decline by 0.5% in 2010. Growth could resume at low levels next year (about 0.5%), if the problems in the sugar industry start to be resolved and if global trade and tourism pick up as expected. (Analysis of the prospects, and of policy options, is hampered by restrictions on publicly available data, including budget information.)

The planned removal of price controls on many basic food items during 2010 should benefit the food processing industry, though their removal needs to be offset by targeted assistance to the poor. (Around 40% of the population is now below the income level needed to provide for essential consumption.)

Imports are forecast to grow faster than exports this year (higher prices for imported oil will be a factor), pushing out the trade deficit. This will contribute to a forecast widening in the current account deficit to about 11.0% of GDP in 2010. That gap could narrow to about 8.0% in 2011 as exports of goods and services benefit from the expected acceleration in global trade and tourism.

Inflation will moderate from the end-2009 rate, as the devaluation's impact on prices fades. Weak domestic demand will limit the upward pressure on inflation arising from higher prices for oil and commodities and from the removal of price controls on food. Year-average inflation is forecast at just over 3% in the next 2 years.

3.32.1 Selected economic indicators (%)

	2010	2011
GDP growth	-0.5	0.5
Inflation	3.4	3.1
Current account balance (share of GDP)	-11.0	-8.0

Source: ADB estimates.

Development challenges

Over recent years, the country has lost its preferential treatment in major export markets for clothing and sugar, owing to the expiration of trade agreements. A major challenge is to attract investment that will broaden the economic base to compensate for declines in those two industries. However, private investment is discouraged by political uncertainty (four coups since May 1987) and deficiencies in the regulatory and legal environments, as well as by a lack of skilled labor. The investment-to-GDP ratio has generally been low, at around 15%.

Foreign investment regulations were revised in February 2010 to allow for 100% foreign ownership of certain businesses. However, it will be important to address the deficiencies in the investment climate to achieve a sustained rise in foreign direct investment.

Increases in investment by the government require not only higher allocations for development outlays, as compared with operating expenses, but also improvements in budget implementation capacity. Capital expenditure needs to be protected at a time that fiscal consolidation efforts are being pursued to ensure macroeconomic stability and to stabilize public debt. In regard to the latter, the International Monetary Fund has encouraged the authorities to adhere to a target of reducing public debt to 45% of GDP by 2014.

Papua New Guinea

Lower global commodity prices trimmed economic growth in 2009. The government provided a large fiscal stimulus and ran down public trust fund savings. Inflation decelerated, but remains relatively high. GDP growth is projected to pick up this year and next, lifted by the planned construction of a large resource project. The surge in revenue from this project in the years ahead heightens the need to put in place systems to smooth government expenditure over time and to provide for transparent and well-designed public programs to reduce poverty.

Economic performance

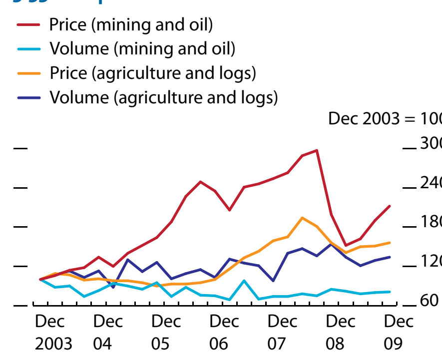
The economy proved fairly resilient to the global recession last year, even though it depends heavily on exports of minerals, crude oil, and agricultural commodities. Several factors cushioned the impact of the global recession: expectations that a $15 billion liquefied natural gas (LNG) project will in fact go ahead, a recovery in commodity prices in the second half of 2009 from a price plunge that started in late 2008, and a strong fiscal stimulus last year. GDP growth was estimated at 4.5%, marking 8 consecutive years of expansion averaging about 3%. Services grew by an estimated 7.0%, mainly reflecting expansion in the communications and construction subsectors; industry grew by 4.6%, and agriculture by 2.3%.

Private investment was bolstered as planning moved forward for the large LNG project, which will generate business opportunities across the economy. Government expenditure increased by 3.0% in real terms (despite a 20% drop in revenue caused by lower export commodity prices), as the government drew down heavily on savings accumulated in trust funds during the commodity boom years. Private consumption, however, likely softened because lower prices for agricultural commodities dented household incomes.

The decline in prices for export commodities (Figure 3.33.1) reduced the value of merchandise exports in United States (US) dollars by 26% in 2009. Mining (mainly copper and gold) and oil exports together fell by about 25% in value (Figure 3.33.2), despite an increase in export volumes of metals. The value of oil exports dropped by over 50%; the price fell by about 37% and volumes by about 13%. Agricultural exports declined in value by an estimated 30%: palm oil by 34%, coffee by 19%, cocoa by 6%, and copra by 66% (from largest to smallest in terms of 2009's export crop value). Most export commodity prices rallied in the second half of the year.

Employment in the private nonmining formal sector increased by 3.7% in the year to September 2009. The services sector saw particularly

3.33.1 Export indexes



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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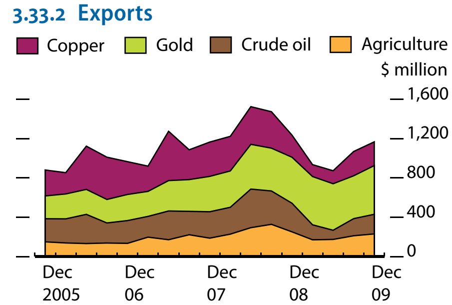
3.33.2 Exports



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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This chapter was written by Dominic Mellor of the Papua New Guinea Resident Mission, ADB, Port Moresby.

strong jobs growth, and employment in mining also rose. However, this formal sector accounts for only one fifth of the labor force. Many people are farmers who produce mainly for their own consumption, with some cash-crop production.

The government adopted a very expansionary fiscal policy stance in 2009, even with the economy continuing to grow moderately. The deficit likely exceeded 10% of GDP, including off-budget items (Figure 3.33.3). (Excluding off-budget spending from the trust funds, the budget showed a near-balanced outcome.) Gross and external public debt levels were little changed from 2008, at about 32% and 14% of GDP, respectively.

Following a sharp rise in private sector credit during the commodity boom years, credit growth pulled back in 2009, from 40% in November 2008 to about 20% a year later (Figure 3.33.4). Inflation eased to average 7.6% over the year, as the impact of lower global commodity prices slightly offset upward domestic pressure on prices.

After raising its monetary policy indicator interest rate in 2008, the central bank kept it steady until December 2009, when, after inflation eased, it lowered the rate by 1 percentage point to 7.0%. The kina exchange rate depreciated by 15% in 2009 against a trade-weighted basket of currencies.

The drop in the value of exports, coupled with a small rise in the value of imports, cut the trade surplus in 2009, and the current account fell into deficit (estimated at about 5% of GDP), the first external deficit since 2002. Gross foreign exchange reserves at year-end totaled $2.4 billion, equivalent to about 10 months of imports of goods and services (Figure 3.33.5).

Economic prospects

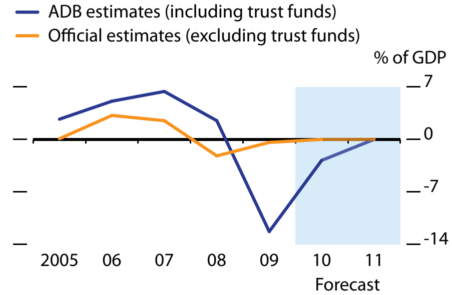
Financing for the LNG project was secured in March 2010. Tapping natural gas from the Highlands region, the project will have the capacity to produce 6.6 million tons of LNG a year for export, contributing as much as 20% of annual GDP when it starts operation, which could be as early as 2013.

Construction is expected to start this year. During this construction phase, up to 1,500 local workers will be employed, and when the plant starts operating it will directly employ about 850 people, mostly locals. However, given that the project could yet be delayed by landowner compensation issues, the LNG project's contribution to growth this year might well be less than the officially forecast 3.0 percentage points of GDP.

In the construction sector, other projects associated with the LNG project are scheduled to start this year, keeping overall construction activity high, although growth of construction could be limited by the fact that many firms are already operating at full capacity.

Oil production will continue to decline owing to lower extraction rates from maturing oil fields, but mining output will be boosted midyear by production from a new Ramu nickel–cobalt mine. The Hidden Valley gold mine started operating last year and is expected to increase production, while the existing gold mines of Ok Tedi, Porgera, and Lihir are all expected to raise production this year.

3.33.3 Budget balance



Sources: Department of Treasury. *2010 Budget*. Volume 1. http://www.treasury.gov.pg; ADB estimates.

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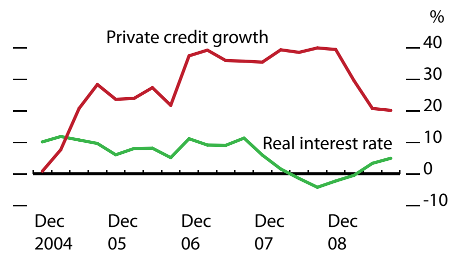
3.33.4 Credit growth to the private sector



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

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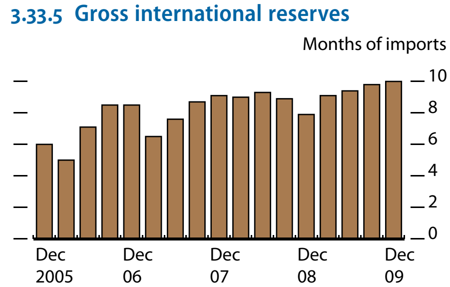
3.33.5 Gross international reserves



Note: Imports excluding mining and oil commodities.

Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

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Higher prices for agricultural commodities should stimulate their production, particularly as last year's cocoa crop was damaged by pod borer and coffee was hit by floods in the Highlands early in 2009.

Business confidence is underpinned by high levels of government expenditure and expectations that the LNG project will generate spillover benefits. In addition, two competing mobile telephone service providers plan further investments to increase network coverage.

Fiscal policy will likely be less stimulatory in 2010. The government is expected to moderate its drawdowns from the trust funds, so that the fiscal deficit, including off-budget spending, is forecast to narrow sharply to just under 3% of GDP. (The government targets a balanced budget, excluding off-budget items.)

On the balance of these factors, GDP growth is forecast to accelerate to 5.5% in 2010 and to 7.7% in 2011, when construction of the LNG project is stepped up (Figure 3.33.6).

Merchandise exports will increase in value terms, as will imports, given high levels of public expenditure and imports of machinery and equipment needed for the LNG project. The current account deficit is projected to widen to 15.0% of GDP in 2010 and then to 30.0% in 2011 (Figure 3.33.7). This gap will be largely financed by foreign direct investment.

Inflation is projected to remain relatively high at 7.1% and 7.7% over the next 2 years (Figure 3.33.8) in the context of higher global commodity prices and rising domestic demand. Shortages of residential and commercial properties in the main urban centers are also causing upward pressure on inflation through significant rent increases. Inflation pressures will constrain further easing of interest rates.

Domestic risks to the 2010 forecasts are largely on the upside: GDP growth could be higher than forecast if landowner compensation disputes for the LNG project are settled quickly and the equipment, materials, and skilled labor are available to ramp up plant construction. There are risks, too, for the 2010 inflation forecast if the momentum from last year's high fiscal expenditures is greater than anticipated.

Development challenges

Even with 8 consecutive years of economic growth, poverty incidence remains high (at about 50%), much public infrastructure is in poor condition, and human development indicators are low: Papua New Guinea is ranked 148 out of 182 countries in the human development index compiled in 2009 by the United Nations Development Programme.

When substantial revenue from the LNG project starts to flow, the government will have an opportunity to fund development projects that improve living standards. Managing the revenue flows prudently and sharing the benefits widely through well-designed public programs will be critical to avoiding the "resource curse" that mining- and energy-exporting countries often bear. This will require a fiscal framework that saves part of the resource revenue so that it can be spent over time, transparently and accountably.

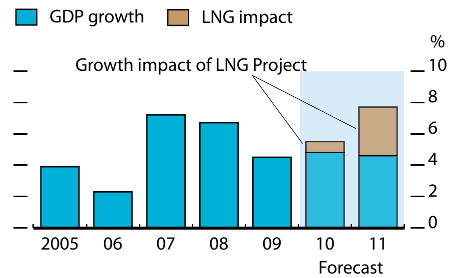
Although elements of such a framework are spelled out in existing

3.33.1 Selected economic indicators (%)

	2010	2011
GDP growth	5.5	7.7
Inflation	7.1	7.7
Current account balance (share of GDP)	-15.0	-30.0

Source: ADB estimates.

3.33.6 GDP growth



Sources: Department of Treasury. *2010 Budget*. Volume 1. http://www.treasury.gov.pg; ADB estimates.

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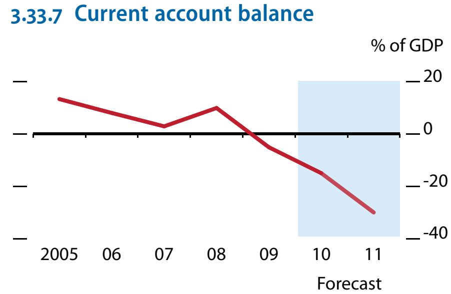
3.33.7 Current account balance



Sources: Department of Treasury. *2010 Budget*. Volume 1. http://www.treasury.gov.pg; ADB estimates.

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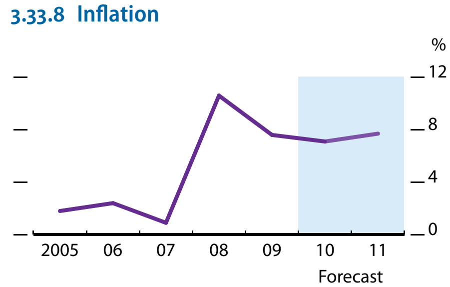
3.33.8 Inflation



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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policy statements and were previously followed, the system broke down in 2009 when large drawdowns were made from trust funds. Stronger governance arrangements and enhanced public financial management systems are now needed (Box 3.33.1).

3.33.1 Managing revenue volatility

The 1990s are often referred to as the "lost decade" in Papua New Guinea because the country did not translate significant public mineral revenue into improved living standards for the majority of people. In an effort to manage volatile resource revenue, the government set up a Mineral Revenue Stabilization Fund. But a lack of transparency and accountability caused those savings to be largely wasted.

During the recent commodity boom, disciplined fiscal policies enabled the government to accumulate windfall revenue, which was saved in trust funds earmarked for development purposes and public debt repayment. In 2009, though, this discipline weakened. Drawdowns from trust funds were far above a limit set in the medium-term fiscal strategy and did not appear justified given that the economy was maintaining solid growth.

Net expenditure from trust funds in 2009 equaled about 10% of GDP, and represented almost two-thirds of total trust fund expenditure since 2005. Moreover, spending was channeled outside the national budget and not integrated into the macroeconomic framework. A significant amount of trust fund monies is currently channeled through local administrations, which have limited capacity to implement development projects. It is unlikely that all the spending went to development priority projects, given the rapid pace of drawdowns and lack of transparency in the spending.

Public revenue to flow from the liquefied natural gas (LNG) project will provide the country with another chance to increase the productive capacity of the economy and raise living standards. This time, development objectives are more likely be achieved, and macroeconomic stability maintained, if the rules of the medium-term fiscal strategy are followed strictly, monetary and fiscal policies are closely coordinated, and a sovereign wealth fund is established and then integrated into the policy framework.

The government plans to channel LNG project revenue into three funds: a stabilization fund, an infrastructure fund, and a future fund. These funds should be saved offshore, to help minimize currency appreciation that would hurt domestic producers, including farmers. It is vital for drawdowns from all funds to be channeled through the national budget, strengthening stabilization efforts and helping ensure higher-quality spending aligned with development priorities. The rate of drawdown should also be calibrated on the capacity of the public and private sectors to efficiently and effectively utilize funds.

Improvements to the business climate are required to pave the way for developing the private sector. They include a more secure legal environment for doing business and encouragement of competition throughout the economy. The World Bank's *Doing Business 2010* ranks Papua New Guinea overall at 102 of 183 countries, down from 89 in 2008.

Inefficient state-owned enterprises hold dominant market positions in many sectors and are a drag on economic growth. Competition in the telecommunications and aviation sectors shows what can be achieved: a new firm in the mobile telephone market led to notable improvements in phone services in rural areas, while a new airline servicing the route between Papua New Guinea and Australia has cut airfares.

However, more needs to be done, particularly with those state-owned enterprises that will see considerable increases in demand from the LNG project. Still, the government's commitment to implementing a public–private partnership policy is encouraging and could potentially facilitate significant private investment in infrastructure. There is scope for such partnership investments in the utility and transport sectors, both critical to reducing the costs of doing business.

Democratic Republic of Timor-Leste

High government expenditure, largely funded by revenue from petroleum production, supported moderate but slower growth in 2009. The economy is forecast to pick up in 2010, again driven by government spending. Inflation is likely to rise from last year's low levels. The government plans to borrow, for the first time, to accelerate investment in infrastructure. Sound investment of borrowed funds and prudent management of national savings are central to the achievement of sustainable economic growth.

Economic performance

Momentum from a buildup in government spending over recent years underpinned economic growth in 2009. GDP, excluding offshore petroleum production, expanded by 5.0% (Figure 3.34.1). That was around half the 10.5% average expansion in the preceding 2 years because the rate of increase in government expenditure slowed.

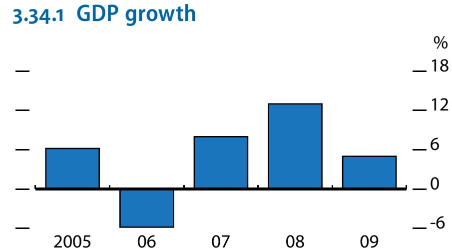
Government spending dominates this economy, with its ratio to nonpetroleum GDP close to 168% (Figure 3.34.2). A large portion of the buildup in public outlays has been in public sector wages, minor capital works, and cash transfers to the elderly, internally displaced persons, ex-combatants, and others. Such expenditure has fed quickly into the economy and generated multiplier effects that have further lifted aggregate demand. Poverty, however, remains widespread.

Up-to-date economic data are limited, though the uptrend in various indicators of demand suggests a significant rise in private consumption in recent years. For example, there was one cell phone subscriber for every 9.3 adults in mid-2007; by end-2009, there was one for every 1.7 adults. Over 11,000 new motor vehicles were registered in 2009, more than double the number in 2008. Private electricity consumption is also on a rising trend (Figure 3.34.3).

While aggregate demand rose on average in 2009 relative to 2008, it softened during the year, as illustrated by a trending down in imports (Figure 3.34.4). By December 2009, their real value was down by 38.1% from the prior-year period. The value of merchandise exports, mainly coffee and excluding petroleum, fell by around a third, as the volume of coffee exports fell sharply. Exports are less than 3% of the value of merchandise imports, leaving a huge trade deficit.

The government allocated $681 million of its own funds for budget spending in 2009, up 23% from its own-funded spending in 2008. But continuing problems in carrying out budget projects meant that actual spending, of about $500 million, fell short of the allocation. Including donor-funded activities, total government expenditure is estimated to have declined slightly in 2009 from 2008.

3.34.1 GDP growth



Note: Nonpetroleum, non-United Nations, annual GDP growth.

Source: Ministry of Finance. *General Budget of the State*. Various issues. http://www.mof.gov.tl

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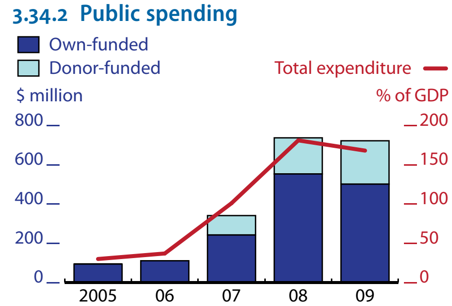
3.34.2 Public spending



Source: ADB estimates based on Ministry of Finance. 2009. *General Budget of the State and State Plan for 2010*. October. http://www.mof.gov.tl

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This chapter was written by Craig Sugden of the Pacific Department, ADB, Manila.

The government's income from offshore petroleum production in 2009 was $1.65 billion. That amount lifted savings held in the nation's Petroleum Fund to almost $5.4 billion by year-end, equivalent to about nine times annual GDP (excluding petroleum production). The annual sustainable drawdown is estimated at about $500 million, which is enough to fund 80% of the government's own contribution to the budget. Still, the authorities budgeted to draw down more than the sustainable income in 2009. The estimate of sustainable income was revised up later in the year as higher energy prices were factored in, to levels close to the 2009 drawdown rate.

Owing to the large inflows of petroleum income, the budget surplus was about 145% of nonpetroleum GDP in 2009, and the external current account recorded a very large surplus equivalent to nearly 300% of GDP.

Lower global oil and food prices suppressed inflation to just 0.1% on average last year, as it decelerated from about 8% in 2008. The consumer price index fell on a year-on-year basis from May through November. The direction of inflation has generally followed that of Indonesia, Timor-Leste's primary trading partner, in the past 2 years (Figure 3.34.5).

Large deposits by international agencies and rising incomes continued to inject liquidity into the banking system. Broad money supply expanded by about 30% in 2009. Bank lending, however, was sluggish and the ratio of nonperforming loans remained high at about 28% of total loans. (Banks hold adequate provisions against nonperforming loans.)

The climate for development of the private sector remains very difficult. Timor-Leste is one of the weakest performers in the World Bank's *Doing Business 2010* report, with a rank of 164 out of 183 countries in 2010 (a slight improvement from 170 in 2009). Issues concerning land, credit, contracts, and setting up a business are paramount concerns. In one area, tax reform, considerable progress has been made. A reduction in taxes on business boosted the ranking in this indicator from 79 in 2009 to 19 in 2010.

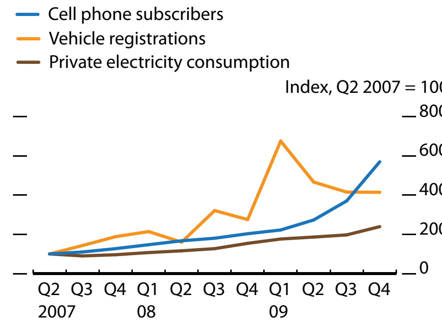
Economic prospects

The economic outlook remains highly dependent on the budget. In this context, a budgeted increase of 27.3% in own-funded government expenditure (all funding excluding donor support) in 2010 over actual spending last year (Figure 3.34.6) is expected to more than offset a decline in donor funding, leaving a small overall increase in budgeted expenditure.

As in earlier years, the own-funded part of the budget is unlikely to be fully spent. But the higher level of funding, coupled with gradual improvements in implementation capacity, will likely lead to an increase in spending in 2010. This is forecast to lift economic growth slightly to about 7.0% this year. Capital expenditure by the government is expected to gather momentum in 2011, helping to maintain growth at about 7.0%.

The presence of international police and security forces in Timor-Leste under the auspices of the United Nations has been extended until at least early 2011. This will help safeguard security, and spending by the United Nations forces will support aggregate demand. Next year, though, their presence is scheduled to decline, with a reduction in the number of police personnel from 1,608 to 1,280 by midyear.

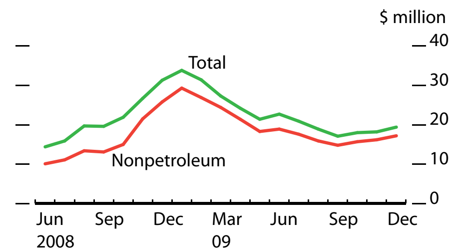
3.34.3 Indicators of private consumption



Source: ADB estimates based on the National Statistics Directorate. *Quarterly Statistical Indicators*. Various issues. http://dne.mof.gov.tl

Click here for figure data

3.34.4 Real value of imports



Note: US$ million deflated by consumer price index; 3-month moving averages.

Source: ADB estimates based on the National Statistics Directorate. *Quarterly Statistical Indicators*. Various issues. http://dne.mof.gov.tl

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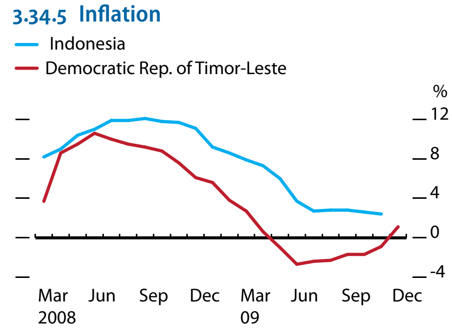
3.34.5 Inflation



Sources: National Statistics Directorate. *Consumer Price Index*. Various issues. http://dne.mof.gov.tl; Bank Indonesia. http://www.bi.go.id (accessed 17 February 2010).

Click here for figure data

3.34.1 Selected economic indicators (%)

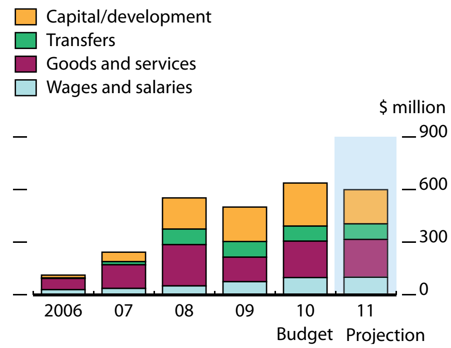
	2010	2011
GDP growth	7.0	7.0
Inflation	3.2	3.8
Current account balance (share of GDP)	271.7	-

Source: ADB estimates.

Higher prices of imported commodities are forecast to contribute to a step up in inflation to 3.2% in 2010 and to 3.8% in 2011. Inflows of petroleum income will produce another large current account surplus in 2010.

Savings in the Petroleum Fund are projected to rise steadily to about $9 billion by 2013 (Figure 3.34.7), providing substantial funding for the budget in the years ahead. Initial steps were taken last year to increase the return from the Fund by diversifying a small part of its investments from US government bonds into other governments' bonds and into various other currencies.

3.34.6 Own-funded government expenditure



Source: ADB estimates based on Ministry of Finance. 2009. *General Budget of the State and State Plan for 2010*. October. http://www.mof.gov.tl

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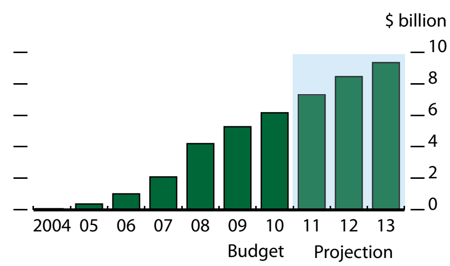
3.34.7 Petroleum Fund balance



Sources: Ministry of Finance. 2009. *General Budget of the State and State Plan for 2010*. October. http://www.mof.gov.tl; International Monetary Fund. 2009. *Article IV Consultation*. July. http://www.imf.org

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Development challenges

The main challenge is to use revenue generated from petroleum production to develop the human and physical capital needed to generate private sector–led growth, which should expand employment and reduce poverty. At the same time, substantial national saving of petroleum revenue need to be preserved for future generations. A national strategic plan being prepared will provide for an integrated approach to development, and will be central to guiding decisions on the use of petroleum revenue.

The latest national poverty survey shows that the share of the population living below the poverty line increased to about 50% in 2007, from 36% in 2001. Most of the population relies on agriculture, but low output, high postharvest losses, and limited alternative sources of income have resulted in rising numbers of poor people in rural areas. High population growth rates of over 3% annually, rapid urbanization, and a small formal sector have resulted in slow rates of job creation in urban areas and have also pushed up poverty rates there.

In an effort to bring forward public investment and accelerate the rate of development, the government has initiated plans to secure concessional loans. In September 2009, Parliament approved legislative amendments that enable the government to borrow, for the first time. (Assets in the Petroleum Fund cannot be used as security, however.)

Also in September, the government agreed to a credit line from the Government of Portugal. The 5-year line will, with parliamentary approval, enable concessional borrowing of up to €100 million a year. The funds will be used for construction and rehabilitation of health care and education facilities and for infrastructure. The 2010 budget foreshadows total borrowing of as much as $3 billion over the medium to long term.

Projections of petroleum revenue suggest that future budgets will have the capacity to service a prudent level of concessional borrowing. To ensure that the fiscal and debt positions are sustainable, borrowed funds must be used efficiently to raise the productive capacity of the economy, and not for consumption purposes.

Achieving this outcome will require a sound process for selecting high returning investment projects; an emphasis on investment in human capital and productive physical capital; and efforts that investments pay for themselves through user charges, as much as feasible. The formulation of the national strategic plan provides an opportunity to lock in these three elements of a successful fiscal and debt strategy.

Small Pacific countries

The global recession hurt these 11 small economies by eroding their tourism receipts, remittances, commodity export earnings, and tax revenues. GDP shrank slightly, or was flat, in most of them (and for half of them it was the second year of contraction). Inflation decelerated from 2008's exceptionally high levels, when these import-dependent economies faced surges in global oil and food prices, but still came in above 5% for the majority.

The outlook is brighter for 2010, as a result of better global prospects. Nearly all the countries are forecast to grow this year, although by just 2% or less (except for Vanuatu, which is an outperformer). Encouragingly, in 2011 growth is forecast to quicken. Inflation is seen easing for eight of the countries this year and staying at around these levels in 2011.

For the longer term, the small Pacific countries need to renew their efforts to boost growth by strengthening the environment for private sector development.

Cook Islands

This economy has contracted over the past 2 years (Figure 3.35.1), signaling the end of a growth dividend from earlier economic reforms. The pace of contraction in GDP slowed to an estimated 0.1% in 2009, from 1.2% in 2008.

Reflecting the decline in GDP, commercial bank lending to business fell by 10% in the third quarter of 2009 from the year-earlier period, and value-added tax receipts in real terms declined by about 8% in the first 3 quarters.

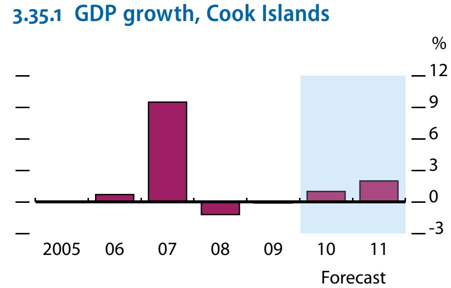
The slightly better performance last year compared with 2008 was partly a result of a 6.7% increase in tourist arrivals (Figure 3.35.2). Tourism was buoyed by some special events held in the country and extra tourism marketing efforts abroad. Arrivals from Australia and New Zealand grew by 7.8%, but those from the northern hemisphere fell by 2.2%. Tourism receipts grew by an estimated 7.9% in 2009.

Lower fuel prices brought down costs of transportation and electricity in the second half. Inflation eased to 6.6%, and is forecast to slow further, to 3.5% in 2010.

Economic growth is projected to resume at 1.0% in 2010, supported by infrastructure construction, which will be financed by development partners. Growth is forecast to pick up to about 2.0% in 2011 as external demand improves and as infrastructure construction gathers pace.

Increased seat capacity on the Rarotonga to Los Angeles air route, and the expected start of a direct air link to Sydney, should assist tourism.

3.35.1 GDP growth, Cook Islands



Sources: Cook Islands Statistics Office; ADB estimates.

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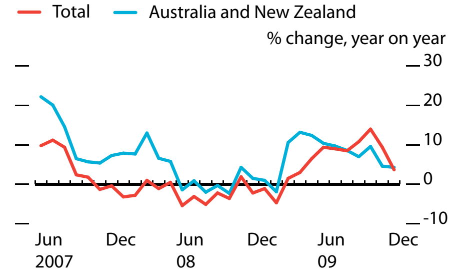
This chapter was written by Craig Sugden and Raquel Tabanao of the Pacific Department, ADB, Manila; Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva; and Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney; and Vivian Francisco, Joel Hernandez and Rommel Rabanal, consultants.

These routes, however, rely on government subsidies, and this dependence poses a risk to their long-term sustainability. The need to fund the subsidies also imposes a cost on other parts of the economy.

Increased government capital spending in FY2009 (ended 30 June 2009) resulted in a fiscal deficit estimated at nearly 12% of GDP. A large budget deficit is also planned for FY2010, to be financed by loans that will increase government net debt to 25% of GDP. This funding may add to productive capacity if it is spent on the priority investment set out in the infrastructure master plan.

To provide a lift to the economy, the government adopted an economic recovery support program in October 2009, committing to support infrastructure expenditure, to maintain a responsible fiscal stance, and to take targeted actions so as to support vulnerable groups in society. Nonetheless, it has extended the practice of directly negotiating airline subsidies, instead of adopting an open, competitive process for allocating subsidies which, as advocated by the support program, would offer better prospects for ensuring the best value for public moneys.

3.35.2 Visitor arrivals, Cook Islands



Source: Cook Islands Statistics Office.

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Kiribati

GDP contracted by an estimated 0.7% in 2009, as copra prices fell, demand waned for the country's seafarers due to the global downturn (reducing remittances from them), and returns declined on investments held offshore in the Revenue Equalization Reserve Fund. Subsectors that contracted included transport and storage, manufacturing, and hotels and restaurants.

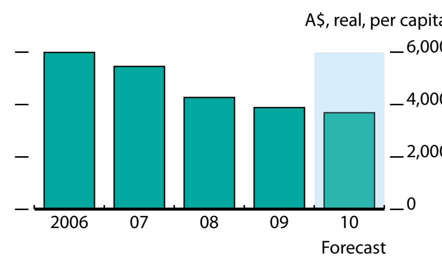
Unsustainable fiscal deficits over several years have required large drawdowns from the reserve fund. Coupled with the global decline in asset values, the fund has dropped below the government's 1996 benchmark level of A$4,500 in real per capita terms (Figure 3.35.3).

The economy is forecast to pick up a little in 2010, benefiting from higher copra prices, an expected increase in demand for seafarers, and better returns from the offshore investments. GDP growth is forecast at 0.8% this year, accelerating to 1.2% in 2011 as global demand continues to improve and recent reforms in economic management start to show benefits.

A decline in international fuel prices paved the way for inflation to slow to 6.6% in 2009, from double-digit rates in 2008. In 2010, inflation is forecast to subside further, to 5.9%.

Improving the economic outlook over the medium and longer term will depend in large part on better management of the reserve fund. In this regard, an Australian-funded study will look at ways to improve the fund's governance.

3.35.3 Revenue Equalization Reserve Fund balance, Kiribati



Source: ADB estimates based on 2010 budget.

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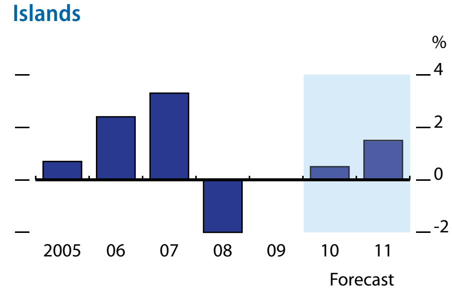
Republic of the Marshall Islands

After a 2.0% contraction in FY2008 (ended 30 September 2008), GDP was estimated to be flat in FY2009 (Figure 3.35.4). This outcome was partly the result of new construction work, the opening of a fish-loining factory, and some increase in remittances.

Consumption benefited from a sharp deceleration in inflation, to 2.8% in FY2009 from a high 14.8% in the prior year, as prices of imported

3.35.4 GDP growth, Republic of the Marshall Islands



Sources: US Department of the Interior Office of Insular Affairs. 2009. *Republic of Marshall Islands Fiscal Year 2008 Economic Review.* August; ADB estimates.

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fuel and food fell. These positives were partly offset by job losses due to a reduction in personnel at the United States (US) military base in Kwajelein.

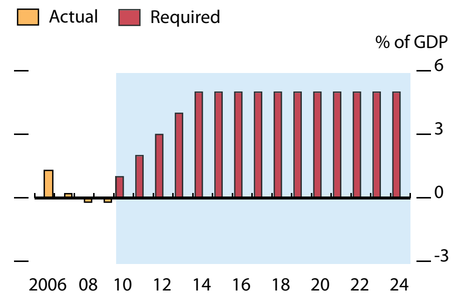
In the fiscal accounts, additional grants from donors and higher income from ship registration fees eased pressure on the budget from weak tax collections and a high level of budget assistance provided to state-owned enterprises. The fiscal balance remained in deficit, though, equivalent to 0.3% of GDP.

Grants from the US under the Compact of Free Association, the main source of government revenue, are being phased down ahead of the expiration of the Compact agreement in 2024. Last year, however, the value of assets in both the Compact Trust Fund and the Social Security Fund rose when global financial markets recovered.

The economy is projected to grow slightly this year, by about 0.5%. Underpinning the forecast is an expected further expansion of fish processing and additional government expenditure made possible by grants from Taipei,China and the European Union. The FY2010 budget provides for a 9% increase in spending to US$137.7 million.

To avert a fiscal crisis when the Compact agreement expires, fiscal surpluses equal to about 5% of GDP are needed during the period 2014–2023 (Figure 3.35.5). This would allow for savings to be accumulated in the Compact Trust Fund, which could then be drawn on to provide a sustainable source of budget financing. Achieving those surpluses will require cuts in operating expenditure and a more efficient tax system. In this area, a large government payroll that absorbs 22% of the budget is a concern.

3.35.5 Fiscal balance, Republic of the Marshall Islands



Note: Data for 2010–2024 are annual fiscal surpluses required to offset expiring Compact grants.

Source: International Monetary Fund.

Click here for figure data

Federated States of Micronesia

For a fourth consecutive year, GDP contracted in FY2009 (ended 30 September 2009), by an estimated 1.0% (Figure 3.35.6). The decline primarily reflected delays in the disbursement of infrastructure grants under the Compact of Free Association with the US. High inflation (estimated at 7.4%) damped consumption spending.

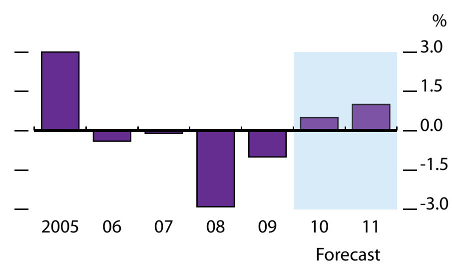
On the positive side, tourist arrivals and remittances rose and a new fish-processing plant generated some jobs in FY2009.

The government contained the fiscal deficit to 1.0% of GDP in FY2009, assisted by tighter controls on spending in the states of Chuuk and Kosrae, increased revenue from fishing licenses, and a new financial management information system.

Still, more needs to be done to secure long-term fiscal sustainability, given that the Compact with the US expires in 2024 and that Compact grants are declining. The budget needs to move into surplus soon, if savings in the Compact Trust Fund are to reach target levels and provide a replacement for US grants when the Compact ends.

The economy is forecast to grow by about 0.5% in FY2010, supported by donor-funded construction, including extension to the airport runway in Pohnpei, and refurbishment of tuna-processing facilities (with a concessional loan from the People's Republic of China). The airport will assist tourism by enabling larger, charter aircraft from Japan to land. Inflation in FY2010 is forecast to be a moderate 3.5%.

3.35.6 GDP growth, Federated States of Micronesia



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

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Nauru

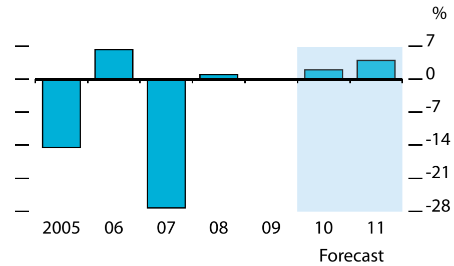
The introduction of a mobile telephone service last year offset a reduction in phosphate exports, leaving GDP flat. Within 2 weeks of the mobile phone starting operations, more than 40% of the almost 10,000 residents had bought a phone. As for phosphate exports, they took a hit from weaker demand and from storm damage at the port.

Economic growth is projected to resume in 2010, at about 2.0%, following an anticipated recovery in phosphate demand and repairs to the port scheduled for May 2010. In 2011, growth is forecast to rise to 4.0%, if planned improvements in the dilapidated infrastructure allow for a further increase in phosphate exports.

Inflation slowed sharply in the second half of 2009, mainly owing to the decline in international fuel prices. The average inflation rate for the year was estimated at 2.2%. Slightly higher inflation is projected for 2010 and 2011, on the back of higher fuel prices.

Although the GDP performance has been weak in recent years (Figure 3.35.7), the economy has potential for growth in the medium term. Primary phosphate reserves are estimated to be enough for 3–4 years of production, and deeper, secondary reserves might last 20 years. An intergenerational trust fund is being established so that income from phosphate mining can be saved for when the reserves are exhausted. However, full exploitation of the phosphate requires considerable investment to refurbish the necessary infrastructure. Improved governance, especially of the state-owned enterprises that dominate the economy, is also needed to encourage the public and private investment required.

3.35.7 GDP growth, Nauru



Sources: Asian Development Bank. 2007. *Country Economic Report*. August; ADB estimates.

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Republic of Palau

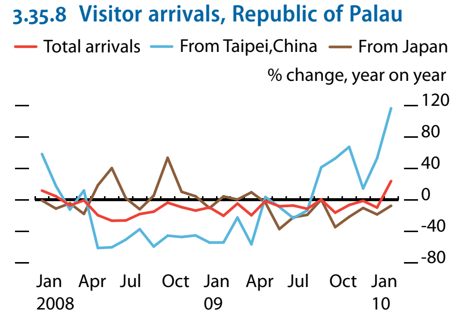
Visitor arrivals fell by 10% last year as a result of recession in some of the main markets. Delays in planned private investment in tourism facilities further eroded the contribution from the important tourism industry.

Consumption spending was subdued, as reflected in a declining value of monthly food imports from the US, and government revenue fell by about 10%. A reduction in public infrastructure outlays, from recent high levels, also damped economic activity. Consequently, GDP fell by about 3.0% in 2009, following a 1.0% contraction the previous year. Inflation eased to 2.4% in 2009 as fuel prices declined.

Economic recoveries in Japan and Taipei,China—two important tourist markets for Palau—bode well for 2010. Indeed, arrivals from the latter market rose steadily from September 2009, on a year-on-year basis. As of February 2010, arrivals were close to levels seen prior to the global recession (Figure 3.35.8). This recovery in tourism is expected to support economic growth of 0.5% in 2010. Higher global fuel and commodity prices are expected to lift inflation to 3%–4% in the next 2 years.

The budget for 2010 proposed a 10% cut in public spending and new revenue measures. Fiscal reforms adopted included actions to reduce operating expenditure, to increase utility rates, and to offer a tax amnesty that would bring errant taxpayers back into the tax base. Temporary relief of the fiscal pressure was subsequently provided by the preparation of an updated financial agreement with the US. The agreement, which would extend grant assistance under the Compact of Free Association

3.35.8 Visitor arrivals, Republic of Palau



Source: Palau Visitors Authority. http://www.visit-palau.com

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until 2024, is awaiting US Congressional approval. It would see grants rise in 2010, but then gradually decline. The agreement prompted the government to propose a partial reversal of the 10% spending cut. Given US grants will soon decline, however, it would be prudent to proceed with fiscal reforms as a step toward achieving fiscal sustainability.

Samoa

A weakening in exports and construction, lowered GDP by an estimated 0.8% in 2009 (Figure 3.35.9).

A tsunami in September 2009 caused 143 deaths and displaced more than 5,000 people, or 1 in 40 of the population, from their homes. The fiscal cost of infrastructure rehabilitation, resettlement, and additional social services was estimated at about 25% of GDP. One of Samoa's most popular tourist destinations bore the full brunt. About 10% of tourist accommodation was damaged and up to 20 kilometers of beach and reef degraded. Tourism is a key economic driver, with tourism receipts often accounting for 20% of GDP.

The government responded to the tsunami with a supplementary budget in December 2009. This provides additional expenditure equivalent to US$27 million for priority tsunami relief and reconstruction, to be largely funded through additional grants.

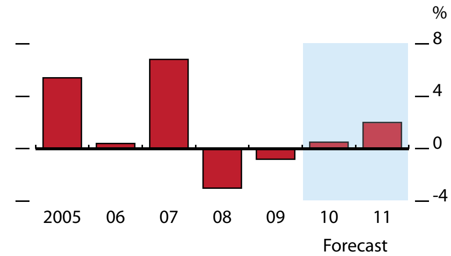
Tourist arrivals rose before the tsunami, then fell, to be up 6% for the year. Arrivals are expected to grow by about 4% in 2010. A contributing factor to this slower rate of growth is that many family reunion visits appear to have been brought forward to 2009 in response to the tsunami.

Remittances rose in the last 3 months of 2009 (Figure 3.35.10) in response to the tsunami, but probably at the expense of some remittances this year. National foreign exchange reserves remain at comfortable levels, assisted by US$9.3 million in balance-of-payments support from the International Monetary Fund (IMF).

GDP is forecast to grow by about 0.5% this year, buttressed by reconstruction spending. Next year should see it rise further on the back of continued reconstruction efforts and a stronger global tourism and trade environment. Inflation is expected to slow to 2.5% in 2010, from 6.6%.

Budget deficits of about 10% of GDP are planned for each of the next 3 fiscal years. These will need to be financed through debt, which will raise public debt above the government's target ceiling of 40% of GDP. While large deficits are necessary to fund reconstruction, the fiscal position will only be sustainable if the deficit is reined in to around 3% of GDP in the medium term.

3.35.9 GDP growth, Samoa



Sources: Samoa Bureau of Statistics; Central Bank of Samoa. *Selected Economic Indicators*. Various issues; ADB estimates.

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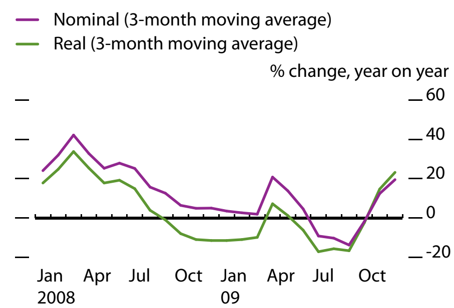
3.35.10 Remittances, Samoa



Note: Real remittances are nominal remittances deflated by consumer price inflation in Samoa.

Source: Central Bank of Samoa.

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Solomon Islands

Declines in exports of logs, copra, and fish caused a sharp economic slowdown in 2009. After several years of economic growth in the 5%–10% range, GDP last year was estimated to be flat.

The volume of log exports dropped by 33%, copra by 39%, and fish by 25% in the first 11 months of 2009 from the prior-year period. Palm oil export volumes continued to rise, while cocoa volumes were little changed. The fall in logs reflected both a weakening in external demand

and the phasing out of logging in the depleted original forests. Floods early in 2009 inflicted damage in some agricultural areas.

While the government raised its payroll spending by more than 5% in 2009, it sharply cut other spending, including that for infrastructure maintenance and some social services. Overall spending on both the recurrent and development budgets fell in 2009, exacerbating the impact of the economic slowdown. Bank lending to the private sector slowed markedly during the year.

Inflation eased from a peak of 25% year on year in August 2008 (Figure 3.35.11), averaging 8.3% in 2009, a result of lower fuel and food prices and the slack economy. Higher oil prices in 2010 are expected to keep inflation relatively high, at 7.3%.

The current account deficit widened further to an estimated 20% of GDP in 2009, in part a result of weakness in exports. But foreign reserves rose to the equivalent of nearly 5 months of imports, owing to a general allocation of special drawing rights by the IMF last year and a one-time transaction between one of the commercial bank's onshore and offshore operations.

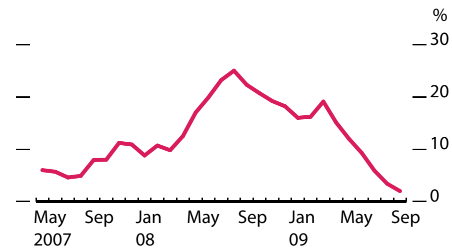
Stronger international commodity markets will underpin growth in exports this year, and the rate of decline in logging is expected to slow from the 2009 rate. A pickup in building approvals points to a likely increase in construction. Government expenditure, too, is expected to rise in real terms, helped by additional support from development partners. These factors will contribute to forecast growth of 2.0% in 2010, rising to 3.0% in 2011 (Figure 3.35.12) as a result of expected increased investment in mining and telecommunications.

Progress has been slow on reopening the Gold Ridge gold mine, such that production is not expected to resume until 2012.

The 2010 budget goes some way to reversing last year's cuts in spending on social services and infrastructure. It gives priority to education, health, and law and order, and to national elections this year. The government's contribution to the development budget also increased substantially.

However, there are risks to the budget—the revenue projection is at the upper end of plausible estimates, and there may be pressures ahead of the ballot to raise spending. Some early slippage is evident. The budget provided for a 5.0% general increase in public service wages, but the independent Trade Disputes Panel issued a 7.5% pay raise after the budget was sent to Parliament. Tight expenditure management will be required if such a pay increase is to be absorbed by the budget without compromising service delivery.

3.35.11 Inflation, Solomon Islands



Source: Central Bank of Solomon Islands.

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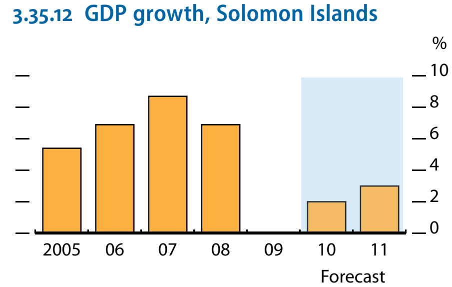
3.35.12 GDP growth, Solomon Islands



Sources: International Monetary Fund; ADB estimates.

Click here for figure data

Tonga

Remittances fell by nearly 20% in real terms last year as a result of weak labor markets in source countries, particularly the US and New Zealand, reducing household incomes. Earnings from tourism declined, too, by about 6%, even though visitor arrivals rose by 4%. Moreover, a rise in nonperforming loans in 2008 prompted banks to tighten lending in 2009. These factors contributed to a 0.4% decline in GDP in FY2009 (ended 30 June 2009).

Declines in electricity consumption, new car registrations, and imports

(which fell by 10% in the first half of the year) illustrated the overall weakness in the economy. Key subsectors contracted —agriculture (by 1.3%), construction and commerce (7.8%), and restaurants and hotels (4.1%).

Lower food prices helped bring down inflation to 5.0% in FY2009, and then to 0.4% in November 2009. The central bank began to ease monetary policy in June 2009 to facilitate credit to business. However, lending to the private sector remains low (Figure 3.35.13), reflecting the weak economic climate and deterioration in bank loan portfolios.

In the external accounts, the current account deficit widened to 12.9% of GDP in FY2009. Official reserves rose to the equivalent of 5.3 months of imports, in part owing to a US$10 million general allocation of special drawing rights by the IMF.

A slight rebound of 0.4% of GDP is expected in FY2010 as the injection of budget support from development partners helps to improve domestic demand.

Public debt (estimated at 37% of GDP in February 2010) and other debt indicators are above threshold levels set by the IMF and World Bank, which restricts the government's options for managing the fiscal deficit.

Capacity to service the public debt would be improved if efforts to reform the public sector and public enterprises were pursued vigorously, and if loans secured for the reconstruction of areas damaged during civil unrest in 2006 were to increase the productive capacity of the economy.

Tuvalu

Economic growth of about 1.5% in 2009 was in line with the historical trend, a worthy performance given the weak global environment. Government spending on administration, construction, and social development more than offset a decline in remittances from the country's seafarers.

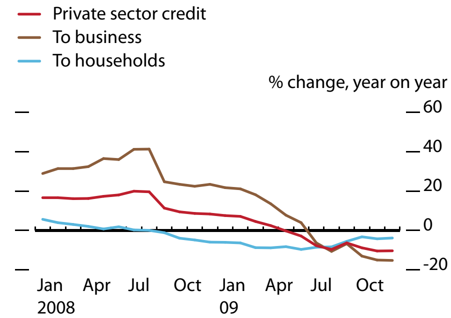
Cash reserves in the Consolidated Investment Fund (CIF), acccumulated during the years prior to the global crisis, allowed the government a considerable degree of flexibility to manage fiscal shocks. Sustainable CIF drawdown helped financed budget shortfalls in 2008 and 2009, that were kept to high levels by fishing license revenues and donor contributions. Revenue collections for 2010 are forecast at A$24.9 million and the government's core expenditure program at A$32.5 million (an increase of 0.6% over the 2009 budget), giving a budget deficit of A$7.6 million. The estimate of the budget deficit, that factors in A$4.5 million in financing from the CIF is A$3.1 million for FY2010.

The economy is forecast to grow by 1.6% in 2010, supported by global economic recovery that will increase demand for seafarers (raising remittances) and planned increases in government spending. Inflation is seen at about 3.5% this year, a touch lower than is estimated for 2009.

There are risks to the fiscal position, given the volatility of fishing license income in particular, and, on the spending side, from persistent cost overruns in the government's scholarship and medical insurance programs.

Moreover, the CIF relies in the medium term on distributions from the Tuvalu Trust Fund, which is mainly invested in offshore financial markets. There was no distribution from the fund last year because of low investment valuations and exchange rate fluctuations. Indeed, distributions are unlikely for some years.

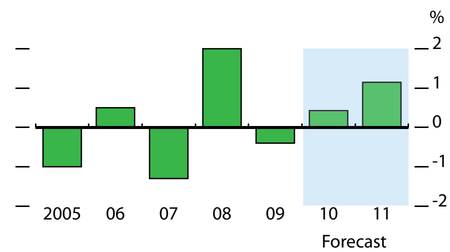
3.35.13 Private sector credit, Tonga



Source: National Reserve Bank of Tonga.

Click here for figure data

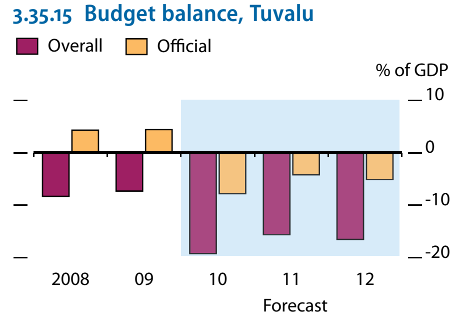
3.35.14 GDP growth, Tonga



Sources: Ministry of Finance. *Budget Statements: Review of the Tongan Economy and Outlook*. Various issues; ADB estimates.

Click here for figure data

3.35.15 Budget balance, Tuvalu



Note: Official includes financing from CIF drawdowns.

Source: Ministry of Finance and Economic Planning. *2010 Budget Speech*.

Click here for figure data

The cumulative impact of projected budget deficits (Figure 3.35.15) is likely to completely drain the CIF by 2012. Yet without the financing buffer that this fund provides, the economy will be more vulnerable to even relatively small economic or fiscal shocks.

Vanuatu

In a seventh consecutive year of growth, the economy expanded by an estimated 3.8% in 2009, driven by tourism and construction. However, agriculture and retailing were soft. The net effect was that the pace of growth was well below the average of 6.5% recorded in the previous 5 years (Figure 3.35.16), driven largely by private sector investment and underpinned by policy reforms that included the opening of the aviation and telecommunications markets.

The number of cruise-ship visitors increased by 43% to 90,920 and air arrivals by 12% to 63,359 in the first 9 months of 2009, compared with the prior-year period. This reflected a relatively buoyant economy in Australia, the main source of tourists, as well as flooding and other problems in the Fiji Islands, which prompted some tourists to vacation instead in Vanuatu.

Construction received a fillip from projects funded by the US Millennium Challenge Corporation, and from refurbishment of tourism facilities. Growth in agriculture, fishing, and forestry slowed to an estimated 1.7%, from over 5% in 2008. Production of copra, coconut oil, coffee, and beef all fell in the first 9 months of 2009. Cocoa and kava increased, encouraged by high prices and strong local demand.

Inflation moderated in the second half of 2009 to average 5.6% for the year. Nevertheless, this was above the Reserve Bank of Vanuatu's target to keep inflation under 4.0%. The current account deficit likely narrowed to 3.7% in 2009, as tourism receipts rose while imports eased.

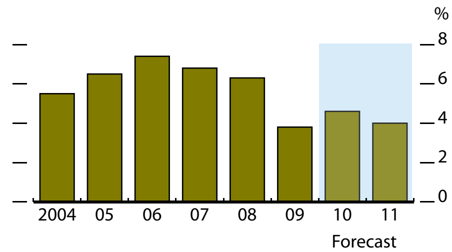
In 2010, growth is forecast to accelerate to 4.6%, based on tourism (bookings are strong) and a pipeline of planned construction projects. Agriculture and retailing are expected to pick up modestly. Emerging capacity constraints in tourism will likely see economic growth ease to about 4.0% in 2011.

Inflation is projected to remain above the central bank's target, held up by higher oil prices. The current account deficit is expected to widen in 2010 and 2011, as the pickup in domestic demand lifts imports.

The government forecasts a near-balanced budget for 2010, after small surpluses in recent years. Total recurrent revenue is expected to increase by more than 12% in real terms. Donor budget support has also increased, allowing for an almost 20% real increase in total spending, including the introduction of fee-free education. Budget papers describe the expenditure and revenue estimates as being at the "limits of the level consistent with fiscal prudence," given targets of balanced or surplus budgets.

Despite success in raising the pace of growth in recent years, progress toward the Millennium Development Goals has tended to lag. With public debt below 20% of GDP (Figure 3.35.17) and generally favorable economic prospects, the country now has the fiscal capacity to increase borrowing for investment and accelerate progress toward those goals.

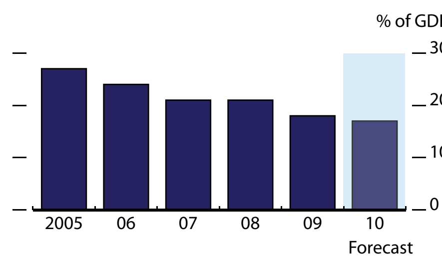
3.35.16 GDP growth, Vanuatu



Sources: Vanuatu National Statistics Office; Government of the Republic of Vanuatu. 2009. *Budget 2010 Volume 1 Fiscal Strategy Report*. December; ADB estimates.

Click here for figure data

3.35.17 Public debt, Vanuatu



Source: Vanuatu government budget papers.

Click here for figure data