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.

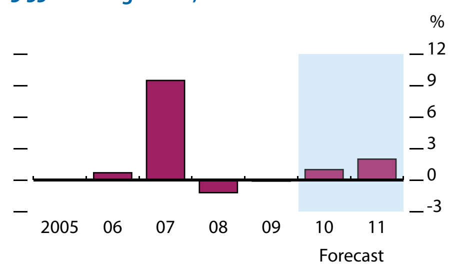
The slightly better performance last year compared with 2008 was partly a result of a 6.7% increase in tourist arrivals (Figure 3.35.2). Tourism was buoyed by some special events held in the country and extra tourism marketing efforts abroad. Arrivals from Australia and New Zealand grew by 7.8%, but 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.
Click here for figure data

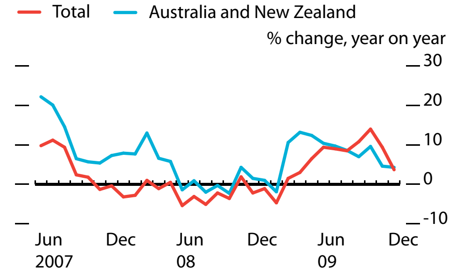
This chapter was written by Craig Sugden and Raquel Tabanao of the Pacific Department, ADB, Manila; Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva; and Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney; and Vivian Francisco, Joel Hernandez and Rommel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

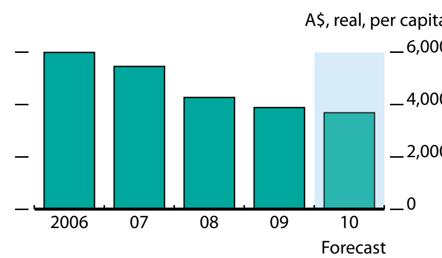
Unsustainable fiscal deficits over several years have required large drawdowns from the reserve fund. Coupled with the global decline in asset values, the fund has dropped below the government's 1996 benchmark level of A$4,500 in real per capita terms (Figure 3.35.3).

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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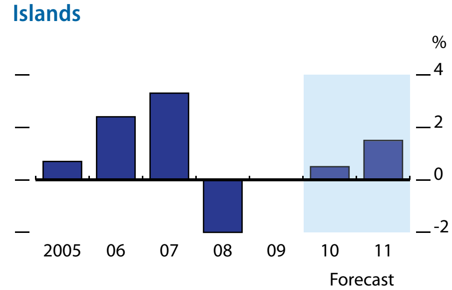
Republic of the Marshall Islands

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.

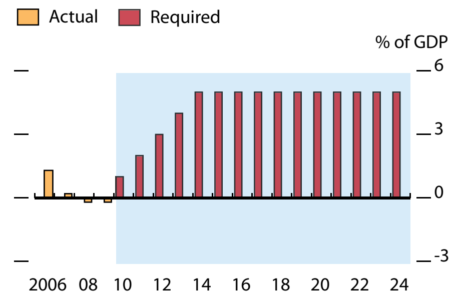
In the fiscal accounts, additional grants from donors and higher income from ship registration fees eased pressure on the budget from weak tax collections and a high level of budget assistance provided to state-owned enterprises. The fiscal balance remained in deficit, though, equivalent to 0.3% of GDP.

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.

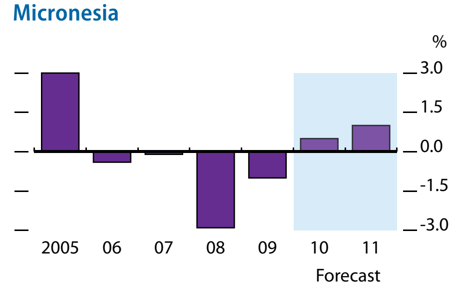
On the positive side, tourist arrivals and remittances rose and a new fish-processing plant generated some jobs in FY2009.

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

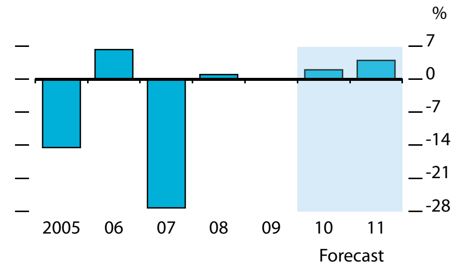
The introduction of a mobile telephone service last year offset a reduction in phosphate exports, leaving GDP flat. Within 2 weeks of the mobile phone starting operations, more than 40% of the almost 10,000 residents had bought a phone. As for phosphate exports, they took a hit from weaker demand and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

Click here for figure data

Republic of Palau

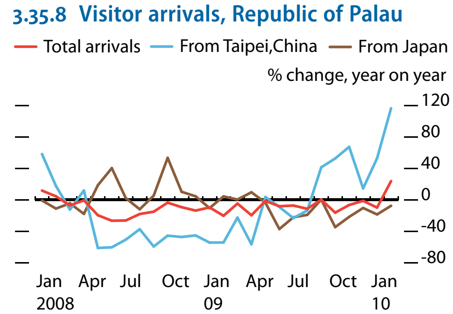
Visitor arrivals fell by 10% last year as a result of recession in some of the main markets. Delays in planned private investment in tourism facilities further eroded the contribution from the important tourism industry.

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.

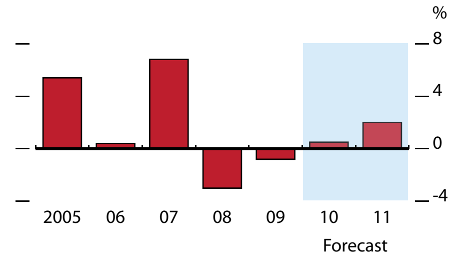
Tourist arrivals rose before the tsunami, then fell, to be up 6% for the year. Arrivals are expected to grow by about 4% in 2010. A contributing factor to this slower rate of growth is that many family reunion visits appear to have been brought forward to 2009 in response to the tsunami.

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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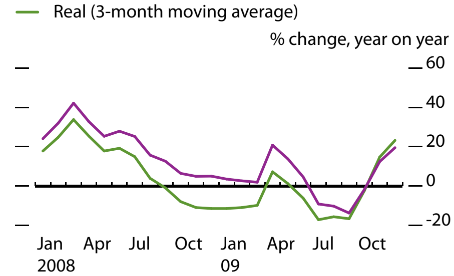
3.35.10 Remittances, Samoa



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.

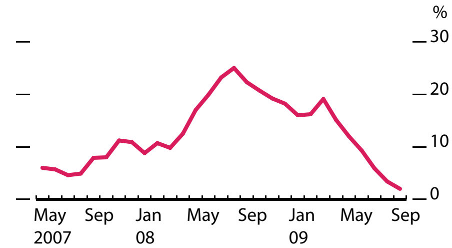
Stronger international commodity markets will underpin growth in exports this year, and the rate of decline in logging is expected to slow from the 2009 rate. A pickup in building approvals points to a likely increase in construction. Government expenditure, too, is expected to rise in real terms, helped 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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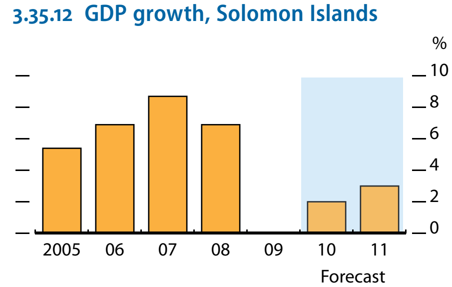
3.35.12 GDP growth, Solomon Islands



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.

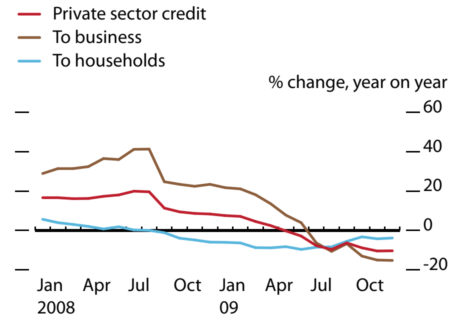
Cash reserves in the Consolidated Investment Fund (CIF), acccumulated during the years prior to the global crisis, allowed the government a considerable degree of flexibility to manage fiscal shocks. Sustainable CIF drawdown helped financed budget shortfalls in 2008 and 2009, that were kept to high levels 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.

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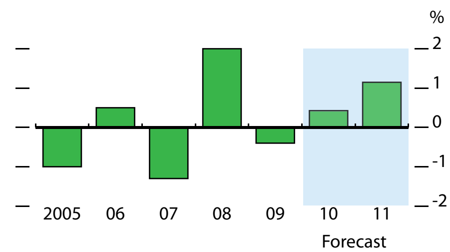
3.35.14 GDP growth, Tonga



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

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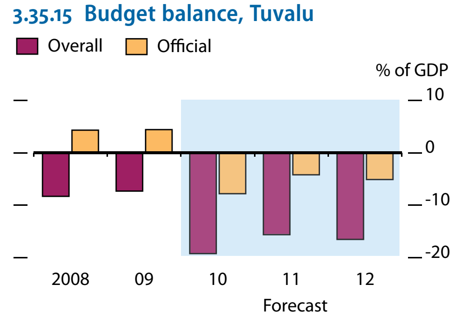
3.35.15 Budget balance, Tuvalu



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.

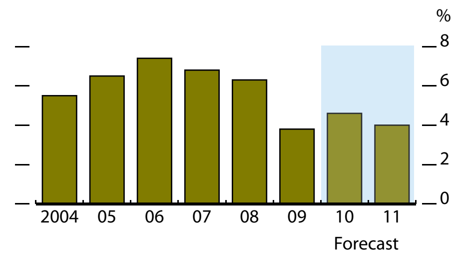
In 2010, growth is forecast to accelerate to 4.6%, based on tourism (bookings are strong) and a pipeline of planned construction projects. Agriculture and retailing are expected to pick up modestly. Emerging capacity constraints in tourism will likely see economic growth ease to about 4.0% in 2011.

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.

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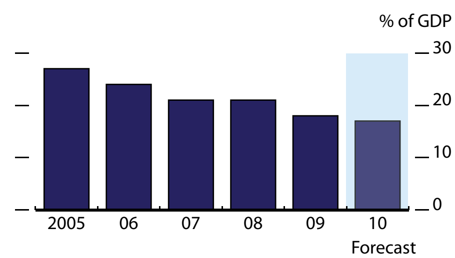
3.35.17 Public debt, Vanuatu



Source: Vanuatu government budget papers.

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