Small Pacific countries

Rising tourism-based activities supported growth in the Cook Islands, Palau, Samoa, and Vanuatu in 2007, while logging fueled growth in Solomon Islands. But economies contracted in the Federated States of Micronesia, Nauru, and Tonga owing to cuts in government spending; growth was low elsewhere in the subregion. The outlook is for growth in the better performing economies to ease in 2008. Inflation is generally projected at moderate levels. Renewed efforts are required across the Pacific to lift growth by strengthening the environment for private sector development. The need is greatest in the weaker economies, which would also benefit from a determined effort to raise standards of governance.

Cook Islands

Growth of 3% in 2007 was attributable mainly to a 5.1% upturn in tourist arrivals (Figure 3.34.1). Agriculture continued to recover from 2005 cyclone damage, but pearl and fish exports fell. The consequent widening in the merchandise trade deficit was largely offset by an increased surplus in services resulting from the expansion in tourism. The improvement in tourism was also reflected in growth in lending by commercial banks to the trading and hotel subsectors.

Use of the New Zealand dollar as the domestic currency means that inflation generally tracks the New Zealand rate, which decelerated in 2007. Also, the Cook Islands removed most import duties from July 2006, which helped offset the effect of higher global oil prices. Subsequently, inflation eased to 2.4% (Figure 3.34.2).

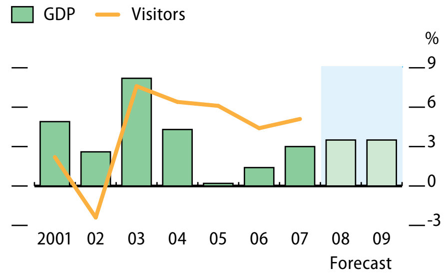
The Government's operating surplus declined in FY2007 (ended 30 June 2007) as the budget moved to near balance. Cyclone rehabilitation works lifted capital spending and most other expenditures edged higher. Public debt—all of it external—remained moderate at 19.1% of GDP and, accounting for reserves built up to meet loan repayments and cash holdings, net debt remained low at about 3% of GDP. A supplementary budget passed in November 2007 suspended a cost-of-living adjustment that would have increased the civil service wage bill by 12%, but it still projected an overall budget deficit for FY2008 (Figure 3.34.3), the first deficit since the mid-1990s.

The deficit is largely due to a projected decline in domestic revenues from 31.3% of GDP to 29.5% following the removal of most import duties. The fiscal outcome will depend on how the cost-of-living adjustments to civil service salaries are handled and the extent of a subsidy provided to Air New Zealand to help meet any losses on the direct air service between Rarotonga and Los Angeles that started in March 2007.

GDP growth in 2008 is expected to accelerate to 3.5% and to be

This chapter was written by Emma Ferguson and Craig Sugden of the Pacific Department, ADB, Manila; Anqian Huang of the Pacific Subregional Office, ADB, Suva; Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney; and Bruce Knapman and Sining Cuevas, consultants.

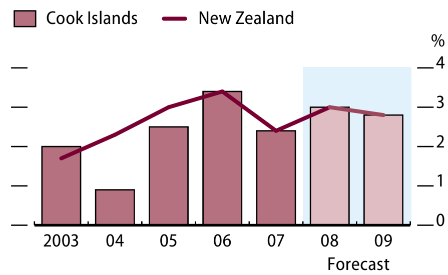
3.34.1 Growth in GDP and visitor arrivals



Sources: Cook Islands Statistics Office, *Annual Statistical Bulletin 2007*, available: http://www.stats.gov.ck/, downloaded 25 February 2008; staff estimates.

Click here for figure data

3.34.2 Inflation



Sources: Cook Islands Statistics Office, available: http://www.stats.gov.ck/, downloaded 21 February 2008; Government of Cook Islands, *Half Year Economic and Fiscal Update for Financial Year 2007/2008*, December 2007; New Zealand Treasury, *Half-Year Economic and Fiscal Update 2007*, December 2007; Reserve Bank of New Zealand, available: http://www.treasury.govt.nz/, downloaded 25 February 2008; staff estimates.

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maintained at this rate in 2009, while inflation is forecast rising slightly in line with the trend in New Zealand. The growth projection assumes that tourist arrivals continue to rise at the 2007 rate and that pearl exports grow by 10%, in reflection of stronger marketing efforts.

The solid fiscal position gives the Government the capacity to borrow in order to finance a backlog of infrastructure works. Deteriorating infrastructure, particularly water and sanitation, is straining to service increasing numbers of tourists. Substantial capital spending is provided for under a National Sustainable Development Plan and 20-year Infrastructure Master Plan adopted in 2007. These infrastructure works are central to protecting the natural environment and to ensuring that tourism-led growth is sustainable. The investments proposed under the infrastructure plan could see net general government debt rise to about 20% of GDP by 2026, and result in debt service payments rising to 2% of GDP. The Government should have the capacity to handle such an increase in debt, provided that the loan funds are used to support the economy.

A decline in the population of the outer islands remains a policy concern. The number of people on 11 smaller islands fell by more than 40% between the mid-1990s and a census in 2006, with many leaving for better jobs and services overseas. The population on the second-largest island, Aitutaki, also declined, although the development of a vibrant tourism industry there limited the fall to 13%. An overall recovery in the population since a financial crisis in the mid-1990s (Figure 3.34.4) is entirely the result of growth on Rarotonga. The outer islands are becoming more costly to sustain as working age people emigrate, leaving the elderly and their grandchildren (see also Box 3.34.1). The demographic changes also carry important repercussions for the future of the traditional Cook Islands culture.

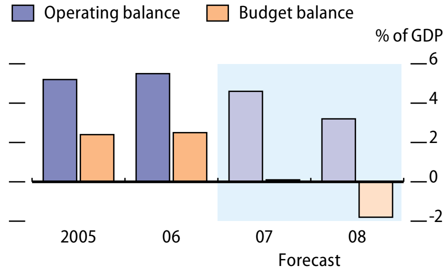
Kiribati

This economy is dominated by the public sector, with the general government subsector accounting for 47% of GDP in 2006 (up from 30% in 2000), and the public service and 25 public enterprises providing over two thirds of paid employment. In 2007, economic growth slowed to an estimated 0.5% (Figure 3.34.5). The slight expansion was supported by a 1% increase in government recurrent expenditures. Workers returning from employment overseas provided some demand-side stimulus. Remittances of ships' crews working overseas, tuna-fishing access fees, and earnings of the Revenue Equalization Reserve Fund (RERF)—an offshore investment fund established with royalties from a now-closed phosphate mine—contributed about 45% of gross national product (Figure 3.34.6).

Merchandise exports, mainly copra and seaweed, fell in 2007, and their earnings were dwarfed by merchandise imports, including fuel. Deficits in trade and services were substantially offset by external earnings from the RERF, fishing license fees, remittances, and donor assistance. The use of the Australian dollar as domestic currency helped maintain inflation at a modest rate of 3–4%.

The overall budget deficit in 2007 was kept moderate by increased RERF earnings from investments on the Australian stock exchange (Figures 3.34.7 and 3.34.8). Non-RERF revenue collections fell short of

3.34.3 Government fiscal position



Source: Government of Cook Islands, *Appropriation Bills*, various years.
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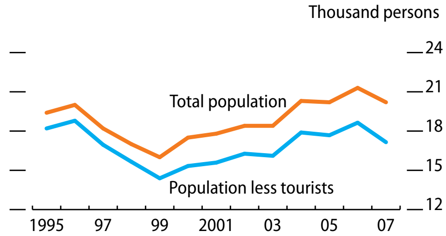
3.34.4 Population



Sources: Cook Islands Statistics Office, *Statistical Bulletin 2003* and *2006* and *Quarterly Statistical Bulletin*, June 2007; staff estimates.
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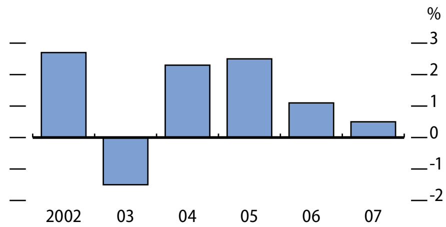
3.34.5 GDP growth



Sources: Kiribati National Statistics Office; staff estimates.
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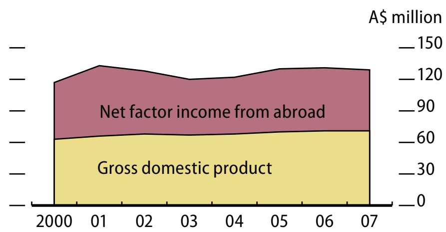
3.34.6 Real gross national product



Sources: Kiribati National Statistics Office; staff estimates.
Click here for figure data

3.24.1 Migration and remittances in the Pacific

Many of the Pacific island countries have long-standing links with Australia, New Zealand, or the United States (US), with significant implications for the small economies. In the north, residents of the Federated States of Micronesia, Republic of the Marshall Islands, and Palau can freely enter the US, while in the south Cook Islanders hold New Zealand citizenship, which also provides direct access to Australia. Fiji Islands, Samoa, and Tonga have developed deep links with Australia, New Zealand, and the US through extensive emigration. Kiribati and Tuvalu are also exporters of labor—their seafarers work on international ships.

The ability to emigrate has led to very low population growth rates in some Pacific countries. Only a few, however, receive large remittances. In Tonga, remittances have reached as high as 40% of GDP and remittances in Samoa also are relatively high. In these two countries, enduring community links are important in maintaining such flows. Remittances are also important in the Fiji Islands, and to a lesser extent in Kiribati and Tuvalu, but not elsewhere (at least not in official statistics).

These links to industrial economies and their labor markets have important flow-on effects. Some small Pacific economies face fiscal pressures from their need to compete with much higher salary levels in foreign labor markets, and this affects their ability to provide funding for essential public services. Some economies are now short of labor. In Palau, foreign workers now take up about half of all jobs as the growth of tourism has spurred employment, while the importance of foreign workers is increasing in the Cook Islands as tourism-based growth absorbs the supply of local labor.

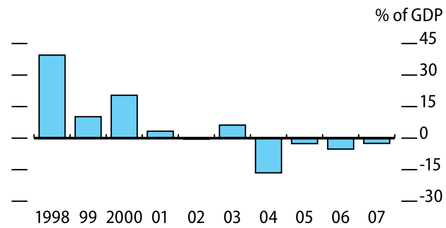
The prospect of migration or obtaining overseas employment also encourages local education systems to respond to the needs of overseas markets rather than their own. Families "invest" in selected children in the hope that they can secure opportunities abroad and provide a flow of remittances for the family. The safety net provided by remittances can dull incentives for those at home. But it can also help some take the risk of moving away from traditional forms of livelihood into formal sector activities such as small-scale retail or tourism-based activities.

original budget estimates because of declines in fishing license fees and import duties, while current expenditures came in slightly below budget estimates, largely because of lower than expected debt service payments. The civil service wage bill fell slightly, but subsidies to public enterprises rose. Little was budgeted for infrastructure maintenance.

Last year the Government sharply increased its drawdowns from the RERF to A$45.0 million, in order to help fund expenditures and repay loans from the Bank of Kiribati. While the RERF balance remained above an informal benchmark of the real per capita level in 1996, the increase in drawdowns since 2003 could undermine the fund's capacity to fulfill its role as a permanent source of budget support. Weaker global equity market returns will necessitate much lower drawdowns, likely requiring a more prudent approach to government expenditures in 2008 and 2009.

Kiribati, a low-lying atoll nation, faces numerous development challenges, including adaptation to the impact of climate change. Areas of risk over which the authorities have some policy control include rapid population growth, a narrow economic base, unplanned and poorly managed urban growth, and weak public sector performance. The Government has begun addressing these issues through a National Sustainable Development Plan that emphasizes the pursuit of economic growth through development of tourism and fisheries by the private sector. Special emphasis is placed on the relatively large but remote and lightly developed Kiritimati island. Achieving private sector-led growth will require considerable political will, in particular to address inadequacies in the public sector, notably loss-incurring public enterprises. Economic growth in the short and medium term is likely to remain low, as fiscal constraints are expected to tighten.

3.34.7 Fiscal balance (including Revenue Equalization Reserve Fund)



Sources: Staff calculations based on the Kiribati National Statistics Office, *Government Finance Statistics*, November 2001 and *Republic of Kiribati Budget*, various years.

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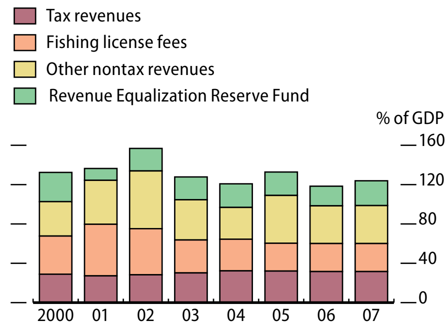
3.34.8 Government income



Source: Staff calculations based on the Kiribati National Statistics Office, *Government Finance Statistics*, November 2001 and *Republic of Kiribati Budget*, various years.

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Republic of the Marshall Islands

GDP growth edged up to 2.0% in FY2007 (ended 30 September 2007) (Figure 3.34.9). The economy is dominated by the public sector, which accounts for 45% of GDP and employment, and the 2007 expansion was driven primarily by an increase in government capital expenditures from United States (US) $14.5 million in FY2006 to US$21 million in FY2007. Emigration has accelerated over the past decade or so, but private transfer receipts fell from 0.5% of GDP in 1997 to 0.3% in 2006.

The budget is heavily dependent on funds from the US under the amended Compact of Free Association FY2004–FY2023, with domestic revenues funding only 45.6% of current expenditures in FY2007. An overall budget deficit of 0.7% of GDP in FY2007, compared with a surplus in FY2006, reflected the increase in capital expenditures. Weaknesses in fiscal management remained apparent, with domestic revenues falling slightly and little reduction in a public service wage bill that accounted for 42.6% of current spending and involves pay rates that are higher than the private sector. The weak revenue performance was aggravated by a high noncompliance rate of 30–40% in tax payments, which causes annual revenue losses of US$8 million–10 million.

Although the amended Compact agreement specifies annual declines in Compact grants, there has been little advance planning for these adjustments in the country. A tendency to use Compact funds to support public sector activities and jobs, rather than to facilitate private sector development, has constrained economic growth, and thus the prospect of significantly reducing reliance on external support.

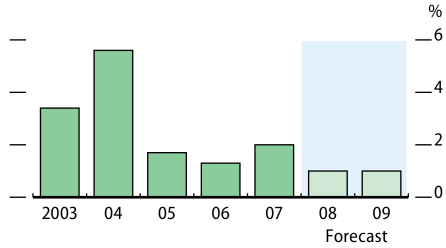
The International Monetary Fund considers the economy to be at high risk of debt distress, with a ratio of net present value debt to GDP of 75% in 2007, and debt service as a share of exports at 32.3% in 2006 (Figure 3.34.10). Scheduled debt service obligations are underbudgeted and repayments sometimes delayed. Furthermore, additional loans, albeit on concessional terms, fall due for repayment over the next 5 years. One option to reduce the fiscal pressures would be to reform and downsize the public sector.

Some noteworthy efforts to pursue private sector development in 2007 included the introduction of legislation to allow for competition in telecommunications with the Government's National Telecommunications Authority. Internet costs are among the highest in the Pacific, at US$190 for 50 hours. In other developments, construction started on a fish-processing plant, which should revive tuna loining this year; and the country was removed from the List of Uncooperative Tax Havens by the Organisation for Economic Co-operation and Development in mid-2007.

This economy usually runs a deep trade deficit (Figure 3.34.11), which is covered by inflows on the income and transfers accounts, especially Compact grants and payments associated with the US military base at Kwajalein atoll. The US dollar is the domestic currency, so inflation is influenced by trends in the US. In FY2007, inflation was 3.4% (Figure 3.34.12) and is expected to remain at around this level in FY2008.

Stumbling blocks to private sector investment include problems with access to finance and land, ineffective laws and regulations, poor infrastructure, and policy shifts. An election in late 2007 resulted in a change of government and some uncertainties in the policy environment. A decline in Compact grants scheduled for FY2008 and FY2009 will

3.34.9 GDP growth



Sources: Economic Policy Planning and Policy Office, available: http://www.spc.int/prism, downloaded 14 March 2008; staff estimates.

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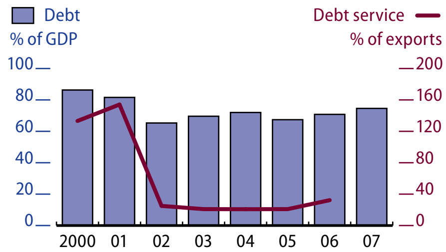
3.34.10 External debt indicators



Sources: Economic Policy Planning and Policy Office, available: http://www.spc.int/prism, downloaded 4 February 2008; US Department of Interior, *RMI FY2006 Economic Review*, August 2007.

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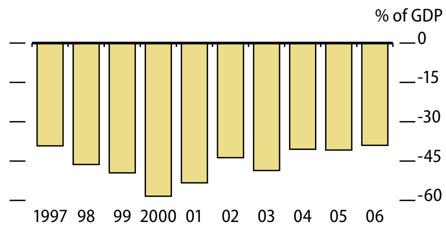
3.34.11 Merchandise trade balance



Sources: Government of the Republic of Marshall Islands, *FY 2006 Economic Statistics Tables*, June 2007; Economic Policy Planning and Policy Office, available: http://www.spc.int/prism, downloaded 22 February 2008.

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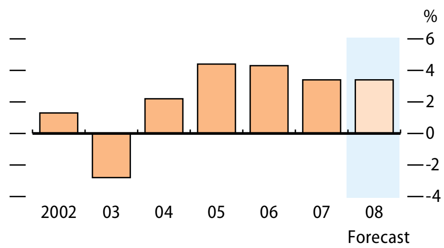
3.34.12 Inflation



Sources: Economic Policy Planning and Policy Office, *Majuro Consumer Price Index*, December 2006 and December 2007; staff estimates.

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have a damping effect on economic growth, offset in part by the new tuna-loining plant. Annual GDP growth of around 1% is projected.

Federated States of Micronesia

The economy contracted for a fourth year in a row, with GDP falling by 2.5% in 2007. The decline was most marked in the states of Chuuk and Kosrae, where past financial management deficiencies are now requiring severe fiscal contraction. The economic deterioration also reflects the impact on public current expenditures of cuts in US funding under the amended Compact of Free Association, of underspending of grants, and of difficulties on the part of national and state governments in meeting specific requirements to access infrastructure development and capacity-building funds provided by the Compact.

A contracting public sector also hurts private sector activity, given that government and public enterprises account for 38% of GDP and 51% of paid employment. The weak economy of recent years is reflected in a decline in living standards and in emigration. Between 2003 and 2007, GDP per capita fell from US$2,015 to US$1,840 (Figure 3.34.13), and emigration has averaged 1.8% of the population a year since 2001.

Inflation slowed to 2.8% in 2007 (Figure 3.34.14), after exceeding 4% for 2 years when taxes on alcohol and tobacco had been raised. The use of the US dollar as domestic currency kept domestic interest rate trends aligned with those in that country.

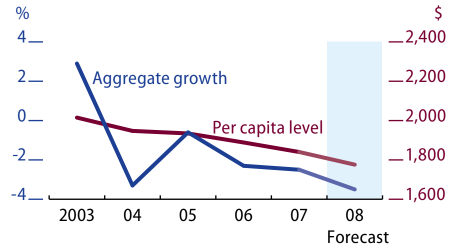
US Compact funding provides about 65% of revenues for the national Government and 75% of revenues for the states, and is the major component of the balance of payments. The decline in Compact funding is matched by a commensurate increase in US support to the FSM Trust Fund, which is to act as a post-Compact fiscal support mechanism. The country is now struggling to raise the revenues required to support public sector operations, which involve paying wages that are well above those in the private sector. Past efforts to reduce the size of the public sector have had limited success, and progress in adjusting to lower Compact funding has been minimal.

This deteriorating fiscal situation is masked by increases in bilateral grants from the People's Republic of China and, to a lesser degree, Japan. Despite the extent of the public service sector, the Government lacks the capacity to adequately monitor and report on Compact expenditures and performance, which holds back access to some funds, particularly those for infrastructure. Moreover, its ability to implement infrastructure works is limited, even if funds become available.

The consolidated budget deficit narrowed to 2.7% of GDP in FY2007 (ended 30 September 2007) (Figure 3.34.15), but the financial positions of Chuuk and Kosrae states remain precarious. Chuuk has planned an adjustment strategy but there has been little progress in its implementation. Kosrae has adopted a strategy to reduce state employment.

The external debt position remained sustainable in FY2007, with gross external debt equivalent to 25.1% of GDP and debt service equivalent to 6.0% of exports of goods and services. There are concerns, though, that state government contingent liabilities might be significantly

3.34.13 GDP indicators



Sources: Department of Economic Affairs, *FSM Statistical Yearbook 2007*; US Department of Interior, *FSM FY2006 Economic Review*, August 2007; staff estimates.

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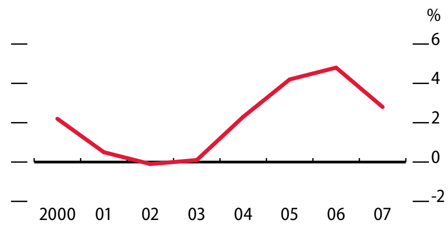
3.34.14 Inflation



Sources: Department of Economic Affairs, *FSM Statistical Yearbook 2007*; US Department of Interior, *FSM FY2006 Economic Review*, August 2007.

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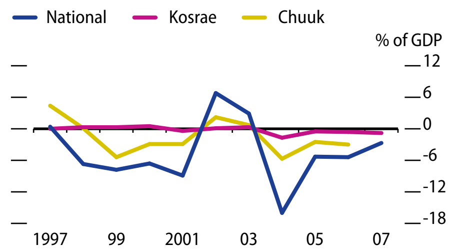
3.34.15 Fiscal balance



Note: 2007 figure for Chuuk state is not yet available.

Sources: Department of Economic Affairs, *FSM Statistical Yearbook 2007*; US Department of Interior, *FSM FY2006 Economic Review*, August 2007.

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underreported and that expected additional debt could place further pressures on fiscal stability.

The economic decline is likely to continue in 2008 and 2009, with GDP contracting by 3.5% and 3.0%, respectively. The outlook could improve in the medium term if Compact infrastructure funds were released. Achieving sustainable growth will depend on the Government's ability to drive reforms that support new private sector development in the face of opposition to liberalization of investment policy. In particular, tourism and fisheries have development potential, provided that barriers to mobilizing land and to allowing foreign investment can be overcome.

Nauru

A sharp contraction in the public sector, which dominates this small economy, and reduced construction spending on phosphate facilities triggered a 27.3% drop in GDP in FY2007 (ended 30 June 2007) (Figure 3.34.16). Furthermore, phosphate mining, which had resumed the previous year after several years of no production, was suspended for several months because of storm damage to port infrastructure.

The contraction in the public sector involved reining in the budget deficit to 17.4% of GDP in FY2007. Deep deficits in the previous 2 years were largely funded by underpaying civil service salaries (and accumulating salary arrears). The narrower deficit in FY2007 was largely achieved by cutting pay rates. The budget for FY2008 estimates a small surplus, to be achieved through cuts in capital expenditures, with a slight surplus also budgeted for FY2009.

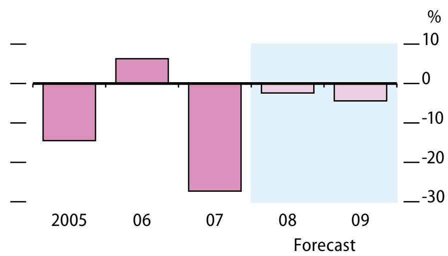
Inflation eased to an estimated 2.9% in FY2007. The use of the Australian dollar as the legal tender and the sourcing of about 60% of imports from that country sees inflation usually tracking the Australian trend. The merchandise trade deficit narrowed slightly to 82% of GDP in FY2007 (Figure 3.34.17) and a small current account deficit was recorded.

The economy will get some help in FY2008 by a full year of phosphate mining. Remaining primary phosphate reserves total about 1.9 million tonnes, enough to last 2–3 years. Reserves of secondary phosphate (found at a deeper level) have the potential to support mining for up to 30 years, according to a 2006 feasibility study. Against this, the closure in the second half of FY2008 of an Australian refugee processing center on the island will hurt. The center directly employs about 100 Nauruans and indirectly perhaps another 900. The Australian Government has committed to maintaining its aid program, which is worth about A$1,000 per person per year. Nevertheless, GDP is projected to decline by 2.4% in FY2008 and by a further 4.4% in FY2009 as the full effect of the center's closure is felt. After that, a slight economic recovery is foreseen.

The foremost financial management issue is the need to develop a response to the high level of public international and domestic debt (equivalent to about 30 times GDP). Attempts to repay even a small share of the external debt could place severe pressure on the budget, potentially absorbing any fiscal surplus from the renewal of phosphate mining, and compressing public expenditures on essential services.

Government reform efforts are yielding some success, with state-owned enterprises and utilities undergoing initial reforms. Government

3.34.16 GDP growth



Sources: Asian Development Bank, *Nauru Country Economic Report*, August 2007; staff estimates.
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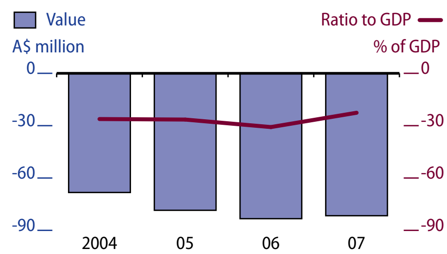
3.34.17 Merchandise trade balance



Source: Asian Development Bank, *Nauru Economic Report*, 2007.
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wages have been cut to more affordable levels and overstaffing in government departments has been reduced. In addition to phosphate mining, industries that offer growth potential include fisheries, small-scale agriculture, construction, finance (Nauru has been removed from the blacklist of the Financial Action Task Force on Money Laundering), and tourism. A turnaround in the performance of public utilities and the domestic airline would also help lift economic performance.

Republic of Palau

Driven by an increase in tourist arrivals (Figure 3.34.18) and expansion in construction, economic growth accelerated to 5.7% in 2007. Tourism received a fillip from the weakening US dollar, which is also Palau's currency. Arrivals from the Republic of Korea rose by 21% and from Europe by 13%, providing welcome diversification from the main tourist sources of Japan and Taipei,China. The hotels and restaurants, and transport and communications subsectors, both related to tourism, grew by about 15% and 7%, respectively. Investment in tourist accommodation remained strong, with the construction of two resorts and a hotel, and renovation of other hotels and restaurants.

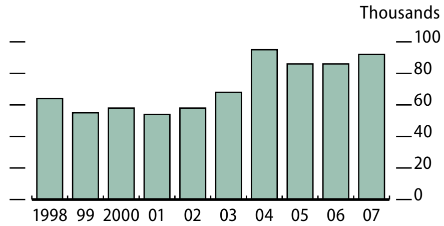
Inflation decelerated to 3.8% in 2007, primarily due to the decline in prices of clothing, footwear, and housing (Figure 3.34.19). On the fiscal side, domestic revenue collection rose by 2.5%, but growth in current expenditures quickened to 9.6%, and capital spending grew by 20.3%. As a result, the budget deficit in FY2007 (ended 30 September 2007) widened sharply to 7.0% of GDP from 1.0% in FY2006. External grants continued to dominate government revenues, providing 56% of the total.

With the ending in 2009 of the 1994 Compact of Free Association with the US, alternative financial sources will be needed to sustain public spending if negotiations for an extension of the Compact are unsuccessful. Tax reforms proposed by a Tax Review Task Force last year included increasing existing tax rates and introducing new taxes and fees. However, the FY2008 budget made provision for only two out of 19 proposed tax measures, while still providing for a 2.8% increase in public spending. It is likely that future infrastructure maintenance will be inadequately funded, given the completion of projects in 2007, including a major Compact-funded road. Palau's external debt was low, in the order of 10% of GDP, in FY2007.

The business environment improved in 2007 as a result of greater competition in telecommunications, which reduced costs, and regulatory reform, which somewhat strengthened the rights of foreign investors. In August 2007, new legislation extended land leaseholds by non-citizens from not more than 50 years without right of renewal to 99 years, consisting of 50-year leases with an option of renewal for another 49 years. Another new law removed a restriction that only Palauan citizens could register a ship and operate it within the country's territory. New legislation was also introduced to combat money laundering.

Further growth in tourism is expected in 2008 after favorable publicity in the international media about Palau's strong stance on environmental protection and from the filming in the country of a new series of the US "Survivor" television show. Benefits of growth in visitor

3.34.18 Total visitors



Sources: Palau Office of Planning and Statistics, available: http://www.palaugov.net/stats/, downloaded 14 March 2008; Palau Visitors Authority, available: http://www.visit-palau.com/, downloaded 13 March 2008.

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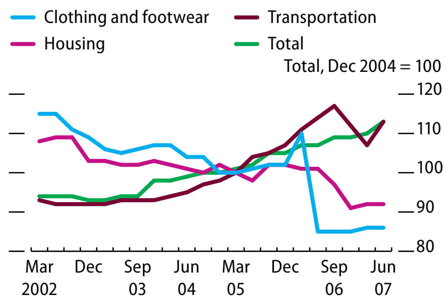
3.34.19 Consumer price index



Source: Palau Office of Planning and Statistics, available: http://www.palaugov.net/stats/, downloaded 19 February 2008.

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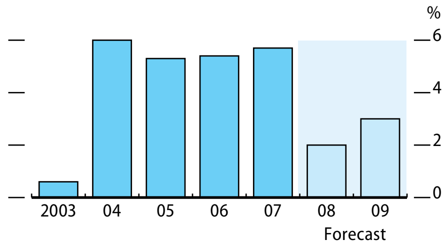
arrivals will again be spread over a range of services and in construction. The new land leasehold regulations, if implemented effectively, should complement recent improvements in economic infrastructure and encourage long-term investment, especially if foreign investment restrictions are eased.

Little fiscal adjustment is expected, at least until Compact renegotiations are further advanced. GDP growth is nonetheless forecast to slow to around 2% this year (Figure 3.34.20), because construction activity will decline from a peak reached last year, when the sector accounted for 17% of GDP, and because uncertainty about the outcome of Compact renegotiations could damp investor confidence. Inflation is expected to remain at 3–4%.

3.34.20 GDP growth



Sources: *12th Annual Palau Compact of Free Association Report for FY2006*; staff estimates.
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Samoa

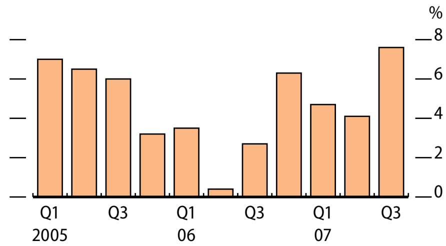
GDP expanded by 4.0% in FY2007 (ended 30 June 2007) and accelerated in the third quarter of 2007 when Samoa hosted the South Pacific Games (Figure 3.34.21). In the 9 months to September 2007, the economy grew by 5.7% from the year-earlier period. An increase in visitor arrivals and growth in tourism-based projects spurred double-digit expansion in the hotels and restaurants, transport and communications, construction, and manufacturing (excluding food and beverages processing) subsectors in that 9-month period. More favorable weather and migratory patterns of tuna allowed fishing to continue recovering from recession.

The FY2007 budget projected an overall deficit of 1.4% of GDP, but the actual outcome was a surplus of 1.2%. This reflected unexpectedly strong growth in revenues, particularly from taxes. Total expenditures came in slightly under the budget estimate because of delays in public investment projects, whereas current expenditures were higher than estimated and covered a second stage of a three-stage 42% civil service pay rise begun in the previous fiscal year. For FY2008, an overall budget deficit of 1.0% of GDP is projected. The ratio of external debt to GDP has been gradually declining from 54.3% in 2002 to 35.9%. In net present value terms, the debt is expected to decline from less than 30% of GDP at end-FY2006 to around 22% by FY2011.

Inflation picked up to average 6.1% in 2007 (Figure 3.34.22), largely driven by a 2.5% rise in the value-added goods and services tax and a 9.9% price hike for alcohol and tobacco products. Domestic prices for petroleum products were also raised. Monetary policy was tightened slightly in the last quarter of 2007 to reduce demand-side inflation pressure. The Samoan tala, which is pegged to a basket of six currencies of major trading partners, depreciated by 4–5% against the Australian and New Zealand dollars and the euro in 2007, but appreciated by almost 6% against the US dollar, leaving the real effective exchange rate relatively stable.

Foreign reserves increased by 13.3% to SAT$212 million in the 12 months to November 2007, or 4.3 months of import cover. Comparing the first 5 months of FY2008 with a year earlier, exports rose by 28% because of increased fresh fish and nonu juice exports, which more than offset declines in exports of coconut products, taro, nonu fruit, and beer. Imports fell by 8% in the 5 months, narrowing the trade deficit by 14%. Earnings from tourism increased by 17%, which contributed significantly

3.34.21 GDP growth



Source: Ministry of Finance, *Quarterly Economic Review*, various issues.
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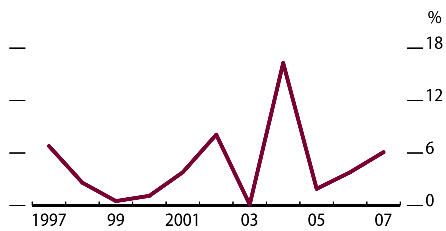
3.34.22 Inflation



Sources: Samoa Statistics Department, Ministry of Finance, available: http://www.spc.int/prism, downloaded 28 January 2008; Ministry of Finance, *Quarterly Economic Review*, July–September 2007 and *Monthly Economic Performance*, December 2007.
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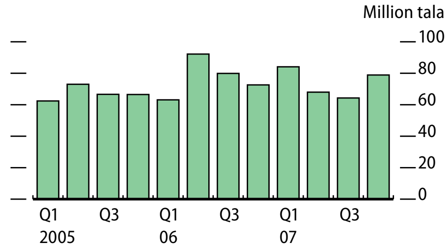
to an improvement in the current account balance, and remittances remained high (Figure 3.34.23).

GDP growth is projected to slow to 3–3.5% in FY2008 and FY2009 as the economy comes off the peak of pre-South Pacific Games construction activity and as manufacturing declines with cutbacks at an automotive-parts assembly plant, which employs about 2,000 people. Tourism and remittance flows will be the main drivers of growth, supplemented by fish exports. Inflation is expected to ease to 5.1% in FY2008 as the inflation effects of some tax increases dissipate.

The forecasts assume that the Government refocuses on economic and public sector reforms, particularly those that reduce the costs of doing business. These include reform of the commercial legal framework and facilitation of leasehold access to customary land, and ensuring access to reliable utility services at reasonable prices. Revamping state-owned enterprises has generally been slow and the enterprises have often failed to comply fully with new regulatory requirements. The merits of reform and of stimulating competition have been demonstrated by a reduction in airfares since the introduction in late 2005 of Polynesian Blue Airlines—a joint venture between Virgin Blue and government-owned Polynesian Airlines—and liberalization of the mobile telephone market in 2006, when a new entrant slashed the costs of international mobile phone calls by about 50%.

3.34.23 Gross remittances



Sources: Ministry of Finance, *Quarterly Economic Review*, various issues; *Selected Economic Indicators Report*, January to December 2007.

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Solomon Islands

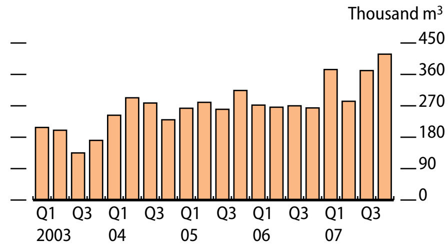
At 10% in 2007, the Solomon Islands recorded the strongest growth in the Pacific. It was driven by unsustainably high logging rates, which increased by 25% (Figure 3.34.24), and strong aid flows. Palm oil production also made a contribution, as did retailing and other services that were stimulated by demand from the presence of the Regional Assistance Mission to Solomon Islands, a partnership between the Government and 15 Pacific countries. An earthquake and tsunami that struck Gizo and Western Choiseul provinces in April 2007 caused considerable local damage and left many villagers homeless, but the economic impact was more than offset by increased aid flows.

Average inflation eased in 2007, but remained high at 7% because of higher fuel prices and a depreciation of the domestic currency against the Australian dollar. A slight tightening of monetary policy by the central bank reduced excess liquidity over the year, which led to a small increase in lending interest rates.

The current account recorded a deficit equivalent to 37% of GDP in 2007. Strong official and private inflows in the capital account raised foreign exchange reserves by about US$12 million, to US$115.8 million in the 12 months to January 2008, although reserves remained moderate at 4 months of imports of goods and nonfactor services (Figure 3.34.25). A surplus on the balance of payments contributed to strong growth in money supply. Credit to the private sector grew by 56% in 2007, mainly for personal loans and lending to the tourism, fisheries, transportation, and construction industries.

The budget moved into deficit last year to an estimated 1.2% of GDP from a surplus of 1.5% of GDP in 2006 as higher spending on

3.34.24 Log production



Sources: Central Bank of Solomon Islands, *Monthly Economic Bulletin*, various issues.

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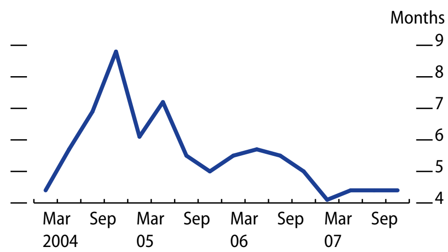
3.34.25 Import cover



Sources: Central Bank of Solomon Islands, *Monthly Economic Bulletin*, various issues; International Monetary Fund, *Article IV Consultation*, September 2007.

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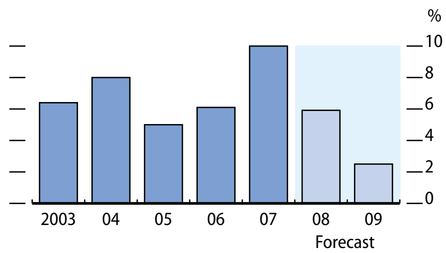
wages and on goods and services outweighed an increase in domestic revenues. Public sector debt continued to decline, but debt remains at uncomfortably high levels, equivalent to approximately 55% of GDP at the end of 2007, and mostly external. This is of particular concern in view of expected medium-term budget pressures from lower logging revenues, an eventual decline in donor support, and the need to fund infrastructure spending and tsunami rehabilitation work.

Economic and public sector reforms aimed at improving the environment for private sector development and the performance of state-owned enterprises continued at a slow pace, as the Government's focus naturally shifted to post-tsunami recovery efforts. A civil aviation act was prepared that, if passed in 2008, would make Solomon Islands a partner in a Pacific air services agreement and open the aviation sector to greater competition. Comprehensive reform of commercial law was initiated and legislative drafting continued for the introduction of competition in telecommunications. However, corruption and poor governance, weak infrastructure, expensive and unreliable utilities, and land tenure issues still constrain economic growth. In 2007, the country was ranked 162 of 178 in terms of the ease of registering property according to the World Bank's *Doing Business* indicators.

Economic growth is expected to moderate to 6.0% in 2008 as the Government curbs the upward trend in its spending in an effort to prepare for future declines in logging revenues. Further expansion of palm oil production will contribute to growth, and development of infrastructure for the Gold Ridge gold mine will continue. The current account deficit is expected to narrow to around 28% of GDP as growth in gold mine-related imports slows. Foreign reserves will be supported by inflows of aid and foreign direct investment in palm oil and gold mining. Inflation is projected to remain high in 2008.

Years of unsustainable logging and the anticipated depletion of natural forests by 2013 are projected to force a decline in logging rates from 2009. GDP growth is expected to fall to less than 3% in 2009 (Figure 3.34.26), even though gold production is expected to start by then. Failure to implement economic reforms could then see per capita GDP decline after 2010 because annual population growth of 2.8% may outpace that of GDP. Urban unemployment, especially of youth, is a major challenge.

3.34.26 GDP growth



Sources: International Monetary Fund, *Article IV Consultation*, October 2006; Central Bank of Solomon Islands, *Annual Report 2006*, 21 June 2007; *Solomon Islands Budget 2008, Budget Strategy and Outlook*.

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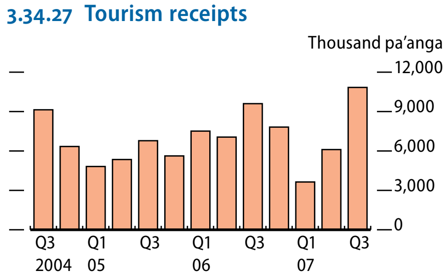
Tonga

A 20% cut in the civil service in mid-2006 and riots that destroyed a large part of the business district of the capital, Nuku'alofa, in November that year led to a 3.5% contraction in GDP in FY2007 (ended 30 June 2007). The need to cut civil service staffing and government spending on goods and services was a result of a 2005 agreement to boost civil service wages by 60–80%. As for the consequences of the riots, a range of subsectors were hurt, including commerce, hotels and restaurants, transport and communications, financial and real estate services, and manufacturing. Tourism receipts in FY2007 dropped by 10.4% (Figure 3.34.27). Production of the major merchandise export—squash—also fell. (The state of emergency declared for the main island of Tongatapu in late 2006 as a result of the disturbances was still in force in March 2008).

3.34.27 Tourism receipts



Source: National Reserve Bank of Tonga, *Quarterly Bulletin*, September 2007.

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Inflation eased by about 2 percentage points to 5.1% in FY2007, though it then picked up to 5.8% in the first half of FY2008 on rising prices for food and oil, and currency depreciation against the Australian and New Zealand dollars.

The cuts in civil service staffing and in spending enabled the Government to run a budget surplus of T$7.3 million in FY2007. Expenditure reductions of 15.1% outweighed revenue losses of 6.6%. For FY2008, an overall fiscal deficit of T$4.4 million is targeted, with external grants projected to be more than double FY2007's level. Current expenditures are being raised by about 35%, mainly for purchases of goods and services, particularly technical assistance. Funding for internal security is also boosted.

Tonga's public debt was about 55% of GDP in FY2007, with external debt accounting for 86% of the total (Figure 3.34.28). The net present value of the public debt (excluding contingent liabilities) was an estimated 35% of GDP. An agreement in November 2007 for the Government to borrow US$50 million from the People's Republic of China to finance urban reconstruction added to concerns about debt sustainability. In addition, a planned takeover by the Government of an unprofitable and debt-burdened power company involves a purchase price estimated at more than 4% of GDP.

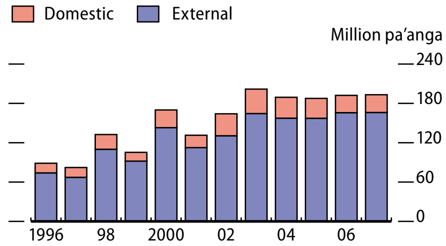
Major accomplishments have been seen in trade liberalization and revenue reforms: in July 2007 the country joined the World Trade Organization; and in recent years reliance on trade taxes has been reduced and the income tax threshold and highest marginal rate have been raised, while the maximum customs tariff was lowered to 20% in 2007. Another achievement last year was a reduction in the time required to enforce a contract from an estimated 510 to 350 days, made possible by the computerization of all criminal, commercial, and land cases at the Supreme Court. The environment for private sector development would be further improved by reform of state-owned enterprises and by better public service delivery.

The National Reserve Bank of Tonga, acting to assist in reconstruction and business recovery after the November 2006 civil disorder, reduced the reserve ratio of commercial banks and lifted ceilings that had been imposed on bank credit after unsustainable growth in borrowing by households in late 2006. The money supply grew by 14.1% in 2007, with credit to the private sector expanding by 11.4%. New legislation passed last year strengthened the central bank's institutional capacity and its independence in conducting monetary policy.

Merchandise exports fell by 14.2% in FY2007, pulled down by lower earnings from squash. Merchandise imports also slid, by 11.7%, as economic activity contracted. The services account deficit widened and remittance inflows declined, pushing out the current account deficit. Increased net inflows of official and private capital contributed to a balance-of-payments surplus of T$8.4 million. Foreign exchange reserves rose (Figure 3.34.29) and were equal to 5.1 months of import cover by end-2007.

GDP growth is expected to resume in FY2008, at a low rate of 1%, reflecting urban reconstruction and a pickup in tourism supported by improved air services between the Fiji Islands and Vava'u in Tonga. However, growth will remain hampered by low business confidence and

3.34.28 Public debt



Sources: National Reserve Bank of Tonga, *Quarterly Bulletin*, September 2007; Budget Statement for the Year ending 30th June 2008.

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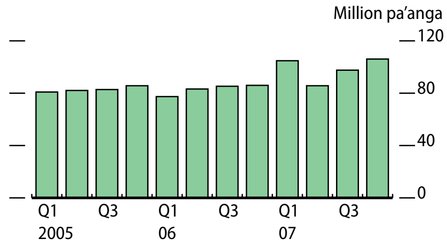
3.34.29 Official foreign reserves



Source: National Reserve Bank of Tonga, *Quarterly Bulletin*, September 2007, available: http://www.reservebank.to, downloaded 29 January 2008.

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difficulties in the squash industry induced by low export prices. Inflation is projected to remain at about 5%, as reconstruction activity builds demand pressures and higher fuel and electricity prices feed through the economy.

Risks to the outlook arise from political uncertainties and the sociopolitical impact of limited job opportunities, particularly for young people who make up about half the population. The final session of Parliament prior to general elections in April this year ended in late-2007, before the Government's proposed political reforms to broaden representation in Parliament were enacted.

Tuvalu

Economic performance is primarily determined by trends in government expenditures and by offshore earnings. These latter come from the Tuvalu Trust Fund, fishing license fees, fees from leasing the country's ".tv" Internet domain name, remittances from overseas workers, and external grants (Figure 3.34.30). GDP in 2007 grew by an estimated 2–3%, supported by an 18.0% increase in public spending. The Trust Fund distribution to the budget fell by 15.5% and ".tv" receipts were down by 19.8%. Overall revenue levels were sustained by a 34.4% rise in fishing license fees and a 14.3% rise in external grants. Inflation was about 3%. The Australian dollar is used as domestic currency, so inflation usually tracks the trend there.

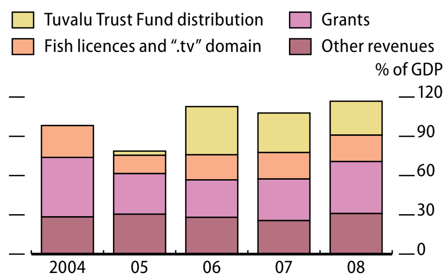
The Government raised spending on maintenance and capital projects in 2007 (the latter by an estimated 50%), although it also reduced outlays on goods and services. The net increase in spending reduced the overall budget surplus to 4.2% of GDP (Figure 3.34.31).

Net public debt was estimated at 45% of GDP at end-2005 in net present value terms and including cash holdings. Mainly due to an increase in returns from the Trust Fund (with a market value of A$110 million at end-2007), the Government had become a net lender by the end of last year. Nevertheless, the fiscal position remains volatile. There is a risk that the Government will again accumulate unpaid bills and also crowd out private sector lending by overusing its overdraft with the National Bank of Tuvalu. Improved management of the Consolidated Investment Fund, which holds drawdowns from the Trust Fund as a financial buffer, expenditure controls, and the completion of plans to introduce a broad-based consumption tax would help stabilize the fiscal position. Revenue reforms are needed to offset a progressive reduction in import duties planned for the next 10 years under Tuvalu's ratification of the Pacific Island Country Trade Agreement.

The merchandise trade deficit runs at around 50% of GDP and is balanced by income from license fees, external grants, workers' remittances, and investment income from the Trust Fund and another fund established for the outer islands. Over the years, these flows of income from abroad have fluctuated and given rise to considerable volatility in the economy.

Further moderate economic growth is expected in 2008 on an expansion in fisheries; outer island development projects; construction of a Parliament complex, new police station, and prison; and port refurbishment. A slight rise in inflation is projected in line with that in Australia. Further ahead, climate change looms as a major challenge.

3.34.30 Government revenues



Sources: Staff calculations based on Tuvalu National Budget documents, various issues; staff estimates.

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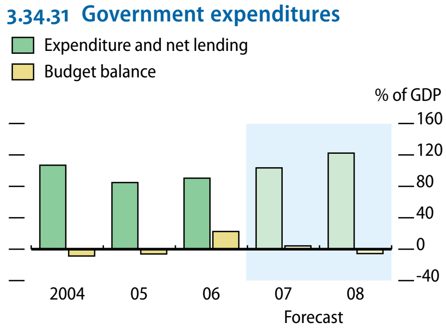
3.34.31 Government expenditures



Sources: Staff calculations based on Tuvalu National Budget documents, various issues; staff estimates.

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Vanuatu

In its fifth consecutive year of growth, GDP increased in 2007 by an estimated 6.6%. This reflected strong expansion in tourism, real estate, and finance, as well as an improved contribution from agriculture. Continued political stability supported business confidence, while tourism was helped by new air services by Air New Zealand and Solomon Airlines. Total visitor arrivals rose by 8.4%, with arrivals by air climbing by 19.3%: the latter were at their highest in 5 years in the third quarter.

Government revenue collection was aided by improved compliance and the buoyant economy. This helped offset an increase in civil service wages, leaving a balanced budget for the year. The civil service wage bill in 2007 rose to 62% of total recurrent expenditures and limited ministries' ability to buy goods and services for public service delivery. The official intention is to ensure that the recurrent budget balances in 2008, but this may be difficult with a general election scheduled for July this year. Public debt has declined to less than 30% of GDP, from 40% in 2002.

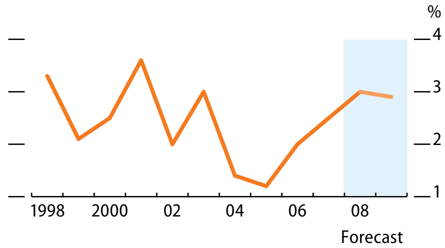
Inflation has remained in the 0–4% target range set by the Reserve Bank of Vanuatu in recent years, though increases in fuel and food prices led to a pickup in inflation in the first quarter of 2007, which prompted the central bank to tighten monetary policy. The year-average inflation rate for 2007 was 2.5%, and is expected to edge up to 3% in 2008 (Figure 3.34.32).

The central bank forecast an overall balance-of-payments deficit for 2007 and a decline in foreign reserves to 7.5 months of import cover, still well above a target level of 4 months. This reflected an increase in the current account deficit to 9.5% of GDP from 7.5% in 2006 (Figure 3.34.33). The current account deficit is expected to remain at similar levels in 2008 but is being largely covered by foreign investment.

The economy remains fragile, with a growing population scattered across many, often isolated island communities. GDP per capita is at levels similar to those of 20 years ago, with growth having failed to exceed population growth. In addition, the rural population has seen few benefits of economic growth. Internal migration continues to fuel the expansion of urban squatter settlements and unemployment. Unlike many other Pacific nations, Vanuatu does not have easy access to migration or overseas work opportunities to reduce this population pressure, so that rural development is an imperative.

GDP growth is projected to ease to 5.7% in 2008 (Figure 3.34.34), moderating to around 4.3% in 2009. This expected slowing reflects structural constraints, which, though being addressed by the Government, make recent growth rates difficult to sustain. A historically high rate of growth is nonetheless projected, with tourism likely to benefit from expansion of air services and new public development projects. Planned infrastructure spending, largely for rural areas and funded by a $65.9 million US Millennium Challenge Corporation Compact, is expected to be key source of increased economic activity through 2011.

3.34.32 Inflation



Sources: National Statistics Office, Government of Vanuatu, available: http://www.spc.int/prism/country/vu/stats/, downloaded 4 March 2008; *World Economic Outlook* database, October 2007; Ministry of Finance and Economic Management, *Budget Policy Statement 2008*; staff estimates.

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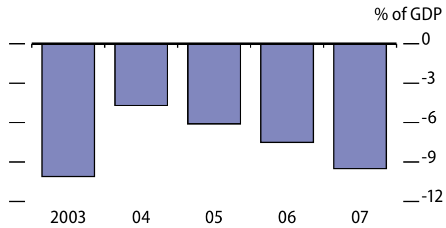
3.34.33 Current account deficit



Sources: Reserve Bank of Vanuatu, *Quarterly Economic Review*, March 2005; Ministry of Finance and Economic Management, *Half-Year Economic and Fiscal Update*, 27 July 2007 and *Budget Policy Statement 2008*, Volume 1.

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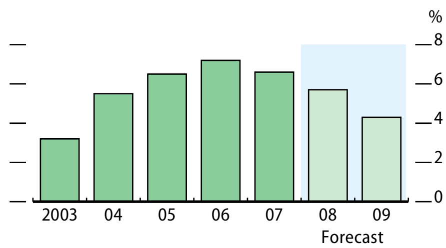
3.34.34 GDP growth



Sources: National Statistics Office, *National Accounts of Vanuatu 2005*; Ministry of Finance and Economic Management, *Half-Year Economic and Fiscal Update*, 27 July 2007 and *Budget Policy Statement 2008*.

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