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

Growth improved in 2006 because of a pickup in sugar production, expansion in construction, and growth in services stimulated by consumption demand. However, exports were weak and the current account deficit widened, placing pressure on foreign reserves. Even before the Government was removed from office by a military coup in December, the outlook for 2007 was a concern. Recession is now forecast for this year, followed by a modest recovery. Development challenges are myriad, including a need to attract more private investment.

Economic performance

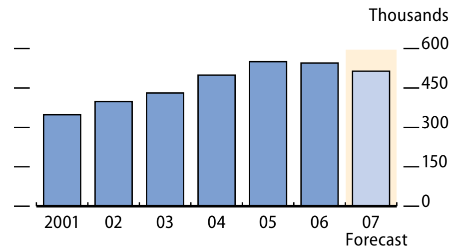
The economy grew by an estimated 3.4% in 2006, having averaged 2.4% growth in the 5 years following a coup in 2000. Growth last year was achieved despite a decline in tourism and the closure of the country's gold mine. Visitor arrivals fell slightly to 545,000 from 549,900 in 2005 (Figure 2.30.1), reflecting the impact of the 5 December military coup that removed the Government elected in May 2006. Several governments advised their citizens not to travel to the country and many December and forward bookings were canceled. An estimated 1,100 employees in tourism lost their jobs while others were placed on short working hours. As a result, growth in the wholesale and retail trade and hotel and restaurants sector was estimated at a modest 2.0%. The closure of the unprofitable Emperor gold mine, also in December, led to the loss of 1,800 jobs. The impetus for growth thus came from other sectors.

Construction powered forward at 12.3%, driven by major government projects as well as hotels and resorts. The electricity and water sector expanded by 5.0%. The agriculture, forestry, and fisheries sector grew by 3.9% as sugarcane production rose by 9.3%, and as both forestry and fisheries activity continued rising. However, the quality of sugarcane itself in 2006 was inferior to that of the previous year, and raw sugar production grew at the slower rate of 7.3%. Growth of 4–5% was recorded for services including transport and communications.

Following the loss of preferential access to some export markets over recent years, the steep decline of the clothing industry continued in 2006, with production dropping by 25%. In contrast, mineral water production for export expanded further.

On the demand side, credit-fueled consumption growth was reflected in a 4% increase in retail sales volume in 2006, and investment demand (helped by the construction projects) continued to expand, though private investment remained low at the equivalent of 8% of GDP. Public sector fixed capital formation was 10% of GDP. The deficit in trade in goods and services widened as domestic demand spilled over into imports and the export performance was disappointing. Imports (in US dollar terms) grew by 12.7% in 2006, while exports fell by 1.8%. The surplus on the services and transfers accounts climbed, with the increase primarily due

2.30.1 Visitor arrivals



Source: Reserve Bank of Fiji, *Presentation to the Fiji Employers Federation*, 21 February 2007.

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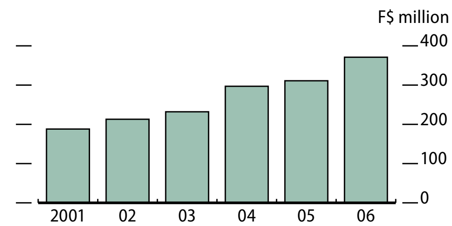
2.30.2 Personal remittances



Source: Reserve Bank of Fiji, *Presentation to the Fiji Employers Federation*, 21 February 2007.

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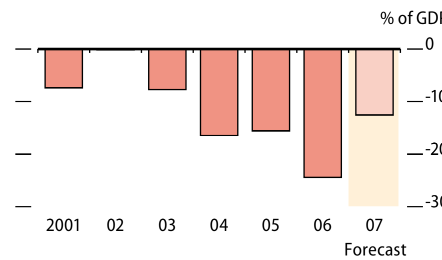
2.30.3 Current account balance



Sources: Ministry of Finance, *Economic and Fiscal Update*, 3 November 2006; staff estimates.

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to personal remittances (Figure 2.30.2), but this was insufficient to offset the broadening trade gap. The current account deficit widened to an estimated 24.4% of GDP from 15.6% in 2005 (Figure 2.30.3).

As a result of the deterioration in the current account, foreign reserves came under pressure. The Reserve Bank of Fiji (RBF), the central bank, raised its policy indicator rate twice in the first 6 months and increased the banks' reserve-deposit ratio. In September, the Government raised $150 million from its first international bond issue. Post-coup, RBF further tightened exchange controls, introduced credit ceilings on noninvestment lending, and raised interest rates on RBF lending to commercial banks. The bond issue and the other measures eased the pressure on foreign reserves, which totaled $476.5 million at end-2006 (3.3 months cover of goods imports), down slightly from 2005.

The nominal and real effective exchange rates of the Fiji dollar appreciated by 0.1% and 0.6%, respectively, in the year to December 2006. Monetary tightening and exchange rate stability contributed to moderate average inflation of 2.5% in 2006. The budget deficit was estimated at 2.9% of GDP if sales of government assets are included in revenues and 3.6% if asset sales are excluded (Figure 2.30.4).

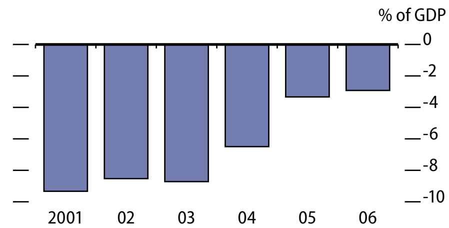
A policy framework for the 2007 budget reaffirmed the Government's intention of narrowing the deficit over the medium term to reduce its debt burden, which stood at 55% of GDP at end-2006 (inclusive of the international bond issue). Strategies included slowing the growth in operating expenditures by restructuring the public service over the period of the Strategic Development Plan 2007–2011. Following the December coup, the military-installed interim administration—the coup leader and commander of the Royal Fiji Military Force is prime minister—began formulating its own policies that incorporate elements of the 2007–2011 plan, such as restructuring the public service.

Economic prospects

The economic outlook was of concern even before the latest coup (and see Box 2.30.1). Growth from 2001 had been driven by unsustainable fiscal expansion and credit-based consumption, both of which put increasing pressure on the balance of payments. The previous Government's 2007 budget and the Strategic Development Plan projected that growth would slow to just over 2% in 2007 and 2008 as construction contracted from its 2006 peak, fiscal consolidation led to a shrinkage in public administration, and major export industries grew modestly. The sugar industry, which accounted for 6% of GDP and 26% of exports in 2005, faces a progressive reduction in preferential prices in the European Union (EU) market of 5% in the 2-year period 2006–2007, 12% in 2008, and 19% in 2009, as well as issues of renewal of land leases and declining productivity. Growth for this industry was predicated on the effective resolution of land lease issues and the implementation of reforms. It was expected that production in the clothing industry, which provided 14% of export income in 2005, would stabilize and that tourist numbers would rise by 6–8% in both 2007 and 2008.

Growth projections have been revised down since the coup and the closure of the Emperor mine. Previous coups in May and September 1987

2.30.4 Budget balance



Sources: Reserve Bank of Fiji, *Quarterly Review*, December 2006; Ministry of Finance, *Economic and Fiscal Update*, 3 November 2007.

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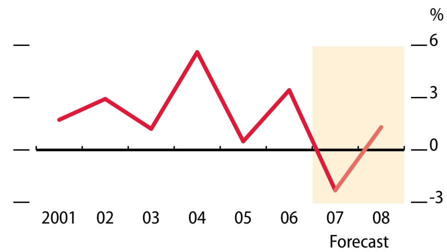
2.30.5 GDP growth



Sources: Fiji Islands Bureau of Statistics, *Key Statistics December 2006*; staff estimates.

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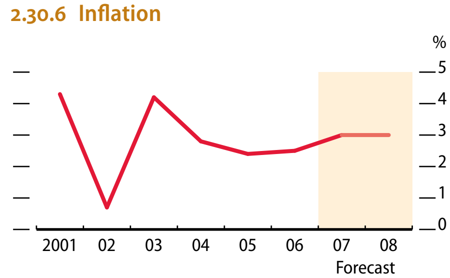
2.30.1 Selected economic indicators

	2007	2008
GDP growth	-2.3	1.3
Inflation	3.0	3.0
Current account balance (% of GDP)	-12.6	-

Source: Staff estimates.

2.30.6 Inflation



Sources: Fiji Islands Bureau of Statistics, *Key Statistics December 2006*; staff estimates.

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and May 2000 undermined investor confidence, damaged the country's tourism image, led to trade bans, and reduced international funding. GDP fell by 6.4% in 1987 and 1.7% in 2000. The December coup may have a similar impact. Several donors suspended most new aid proposals, although many existing projects have continued. The EU has announced consultations with Fiji Islands authorities that could result in suspension of new aid, including assistance crucial to restructuring the sugar industry. A return to democracy seems unlikely to happen soon, given that the prime minister has stated that a general election will not be held until 2010.

The official forecast is that GDP will contract by 2–4% in 2007. A decline of 2.3% is a plausible outcome (Figure 2.30.5 above). Tourist arrivals are now forecast at 514,000, down 5.7% from 2006. Regional airline Air Pacific reported a 40% drop in forward bookings for the first 3 months of 2007. A tourism action group formed after the 2000 coup was reestablished to strengthen marketing efforts, in the hope that hotel occupancy rates would pick up from 25% lows. However, accommodation capacity was earlier expected to increase by up to 1,500 new rooms in 2007–2008 as new hotels were completed. A much more severe contraction is now forecast in the construction sector as some projects are postponed or canceled.

Elsewhere, it is assumed that clothing production for export will decline only marginally in 2007, but this could prove optimistic if overseas buyers switch their orders to other countries, or if trade sanctions are imposed. About 1% growth in sugarcane and raw sugar production is forecast, but the medium-term outlook for the industry will sour considerably if the EU suspends subsidies and aid.

The public administration sector will probably contract more than envisaged in the 2007 budget. A revised budget announced by the interim Government has targeted a deficit of 2% of GDP in 2007. Given that the new administration has decided not to proceed with a rise in value-added tax, as well as the implications for revenue collection of a recession, arriving at that target has required proposing cuts in spending across all departments. The interim Government sought to cut the wages bill by reducing pay rates and the retirement age for public servants, but has confronted labor union opposition to the proposals.

The loss of gold export earnings in 2007 and a decline in clothing exports will be only partly offset by rises in exports of mineral water, sugar, and fisheries and forestry products. If the marketing efforts persuade visitors to stay longer and spend more, tourism earnings may not fall in lockstep with lower tourist numbers.

Recession and the tightened monetary and exchange rate policies will have a crimping effect on import growth in 2007, but official transfers will fall to an extent that partly depends on the decision regarding the EU aid program. The current account deficit is forecast to narrow to 12.6% of GDP. Foreign reserves, which fell further to $449 million in February 2007, will remain under pressure through the year, but tight fiscal and monetary policies should contribute to financial stability. Inflation is expected to remain moderate at about 3% (Figure 2.30.6 above). The economy is seen emerging from recession in 2008, with growth of 1.3%.

2.30.1 Development challenges

The historical drivers of growth have been sugar, clothing, gold, and tourism. All except tourism faced uncertain futures before the latest coup. Sugar had seen a decline in growing and milling productivity due to underinvestment; suffered from poor working relationships between mill management, unions, and farmers; and confronted the progressive loss of farmers as land leases ended without renewal. In consequence, sugar production fell by nearly half over a decade to 289,000 tons in 2005, after which a phased 4-year 36% reduction in the preferential price paid by the EU began.

Wide-ranging reform of the sugar industry remains a core challenge, as underlined by the fact that the country's unit cost of production is about four times that of best-practice sugar-producing countries.

A future for the clothing industry depends on the extent to which producers can shift from the past low-value-added "cut, make, and trim" approach to higher-value-added production for niche markets. Gold mining has stopped. And tourism has to engineer a recovery in a competitive market, a process that took 4 years after the 2000 coup. New industries also need to be identified. For example, pine and mahogany have potential, but need sustainable use of natural resources and substantial investment.

The broader challenge is to encourage private investment and export development that together generate faster, sustained economic expansion that is compatible with external balance. The Government has targeted an investment ratio of 25% and a GDP growth rate of 5% as minimal requirements if inroads are to be made into unemployment and a poverty rate of 30%. Yet to achieve these aims, the business environment has to be improved through legal and regulatory reform.

Papua New Guinea

Rising global prices for export commodities and strong supply responses from the agriculture and mineral sectors lifted economic growth in 2006. The outlook is for continued expansion with macroeconomic stability in the context of softer global prices for key commodities and sustained business and consumer confidence. Impediments to faster private sector-led growth are law and order problems, poor infrastructure, and inadequate service delivery by the public service and state-owned utilities.

Economic performance

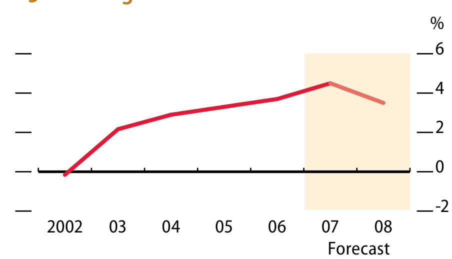
Economic growth accelerated for a fourth year in succession, reaching an estimated 3.7% in 2006 (Figure 2.31.1). A major contribution came from the agriculture, forestry, and fisheries sector, which accounts for about one third of GDP; it expanded by 2.9%. This rise primarily reflected increased production of logs for export and of palm oil. Global prices for both commodities, which were the country's two major agricultural export earners in 2006, trended upward through the year. The world price of coffee, the number three agricultural export, trended down and production declined, with producers continuing to suffer from inadequate transport infrastructure. Copra production is estimated to have risen in response to an improving world price, whereas cocoa production remained stable in the face of price volatility.

Other contributions came from construction, where expansion of 10.0% was stimulated by mining projects and public expenditure on infrastructure, and from oil and gas, where 13.7% growth reflected both the start of production at two new fields and improved extraction rates from existing fields. Climbing oil production was encouraged by the high world oil price. Manufacturing and services also made contributions to growth. However, despite rising world prices for copper and gold and the start of two new mines, mining (excluding oil and gas) contracted by 4.9%. This reflected disruption of production by a landslide at the major Porgera gold mine. On the demand side, net exports were a major driver, supported by increases in private and public investment and in consumption.

A relatively stable political environment facilitated the improved economic performance. The Government entered its fourth year in office under one prime minister and looked set to serve out its full term, with general elections scheduled for June–July 2007.

Higher economic growth fed through to formal private sector employment in agriculture, trade, manufacturing, construction, transportation, and finance and business services, which collectively increased by 4.6% in the 12 months to September 2006. Employment rose particularly fast in construction (13.3%). Over the same period, mineral sector employment (i.e., oil, gas, and mining) registered negligible growth. Only about one in 10 of the total labor force is in paid

2.31.1 GDP growth



Sources: Department of Treasury, *2007 Budget Volume 1: Economic and Development Policies*, 14 November 2006; Bank of Papua New Guinea, *Monetary Policy Statement*, 31 January 2007.

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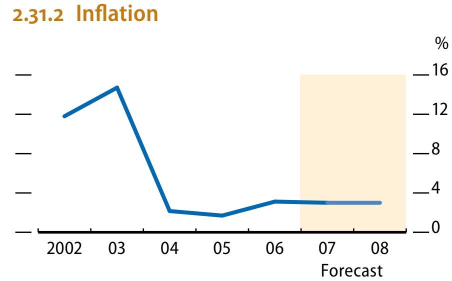
2.31.2 Inflation



Sources: Bank of Papua New Guinea (BPNG), *Quarterly Economic Bulletin September 2006*, available: http://www.bankpng.gov.pg, downloaded 7 February 2007; BPNG, *Monetary Policy Statement*, 31 January 2007; staff estimates.

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employment, so that formal sector employment growth, while important, is not the major determinant of the economic welfare of most Papua New Guineans, who are subsistence farmers and engage in supplementary cash crop production.

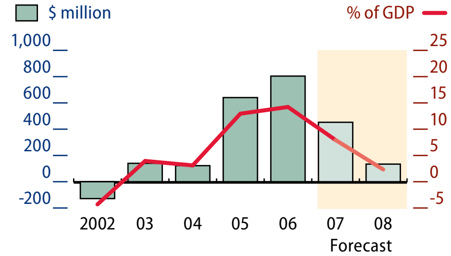
Inflation edged up to an estimated 3.1% (Figure 2.31.2). This good outcome was underpinned by exchange rate stability, which in turn reflected a strong external sector performance and the maintenance of sound macroeconomic management. In 2006, the kina appreciated by 2.1% against the US dollar and depreciated by 5.5% against the Australian dollar. In the first 9 months of 2006, exports (in nominal US dollars) shot up by 33.2% on the year-earlier period, imports rose by 16.0%, and the trade surplus widened by 8.3%. Copper, gold, and oil were the main boosts to export earnings, supplemented by palm oil and logs. The transfers account also improved, but deficits on the net services and income accounts widened. The current account surplus picked up to an estimated 14.2% of GDP (Figure 2.31.3). Gross foreign exchange reserves jumped by 90% to $1.45 billion, sufficient to cover 9.2 months of total imports (Figure 2.31.4).

The Bank of Papua New Guinea maintained a neutral monetary policy in 2006 on the basis that the macroeconomic environment was stable and that short-term, mostly imported, inflationary shocks could most effectively be dealt with through foreign exchange market interventions aimed at reducing exchange rate volatility, rather than through interest rate adjustments. The kina facility rate—the official interest rate—was left at the 6.0% set in September 2005. Credit to the private sector grew by 36.8% and, along with the 58.2% rise in net foreign assets, accounted for a 39.0% rise in the broad money supply (Figure 2.31.5). The high level of liquidity in the banking system posed a potential inflationary threat that the monetary authorities monitored closely.

The Government's fiscal position strengthened because of mineral tax revenue windfalls attributable to the high global prices for oil, copper, and gold. Total revenue collections were 60% above the level required to meet original budget estimates and permitted the passage of a supplementary budget in August approving the early retirement of some external debt, payment of outstanding state obligations, and the allocation of more resources to the priority expenditure program identified in the Medium-Term Development Strategy 2005–2010. The spending priorities include transportation infrastructure, promotion of income-earning opportunities in agriculture, basic education, HIV/AIDS prevention (Box 2.31.1), and law and justice. The Government's revised estimate was for a balanced budget in 2006 (Figure 2.31.6), instead of an earlier expected deficit of 0.6% of GDP, with a primary surplus run for the fourth year in a row. Public debt was reduced in line with the medium-term debt strategy, which provides for replacement of external debt by domestic debt and the restructuring of domestic debt from short-term treasury bills to longer-term government bonds. Total public debt is estimated to have fallen in 2006 by almost 1% in absolute terms, to 42.4% of GDP. External debt was 21.4% of GDP and was mostly on concessional terms (Figure 2.31.7).

In policy areas, the Government pursued implementation of a public sector reform program. Senior ministers endorsed the objectives of a

2.31.3 Current account balance



Sources: Bank of Papua New Guinea, available: http://www.bankpng.gov.pg, downloaded 7 February 2007; Department of Treasury, *2007 Budget Volume 1: Economic and Development Policies*, 14 November 2006.

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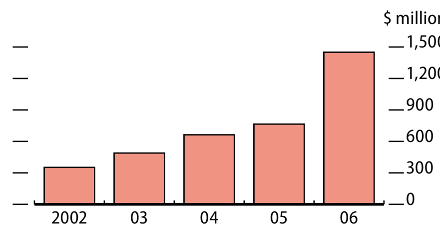
2.31.4 Foreign exchange reserves



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2.31.1 HIV/AIDS prevention and the economy

An immediate challenge in health policy that has long-term economic implications is the rising incidence of HIV/AIDS, since about 2% of the population is HIV positive. A 2002 report by the Australia-based Center for International Economics concluded that the country faced a serious epidemic, that the working-age population could be smaller than it otherwise would be in 2020 by 13–34%, and that GDP could be 2.6–7.5% lower. Although GDP per capita would increase as (largely foreign) capital substituted for labor, national per capita income could fall by 6–16%. Understanding the threat, the Government has made HIV/AIDS prevention a priority area of expenditure under the Medium-Term Development Strategy.

report on restructuring the public service, but deferred consideration of its recommendations for abolishing or merging departments and functions until after the 2007 general elections. Law and order and corruption remained priority issues. Unrest in the energy-rich Southern Highlands province led to a declaration of a state of emergency in August 2006.

Economic prospects

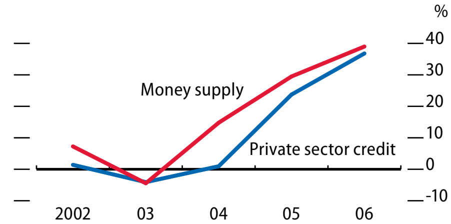
Economic growth is expected to accelerate further in 2007 before slowing in 2008 (Figure 2.31.1 above). Global prices for key commodities are projected to soften from the high levels of 2006, but mining production will recover from the contraction of 2006 as a result of earlier investments and the exploitation of higher-grade ore bodies. This recovery will offset an expected decline in oil and gas output resulting from depletion of fields. Mineral production overall is likely to grow by about 7% in 2007 before easing a little in 2008. The forecast is not affected by the cancellation in early 2007 of a planned gas pipeline from the Southern Highlands to Australia, since this facility would not have had an impact on output for several years. Energy companies involved in the project have indicated willingness instead to consider developing the gas fields for liquefied natural gas exports and petrochemical production.

Mining investment will stimulate construction, notably in the first year of building the Ramu nickel mine. The sector will also benefit from public expenditure on infrastructure and strong private demand in a low interest rate environment. Construction is forecast to grow by 10.0% in 2007 and 7.0% in 2008. Manufacturing, such as food and beverage processing, is expected to grow at a modest rate on the back of growth in consumer demand, which will also underpin growth in areas like transport and communications. The agriculture, forestry, and fisheries sector is expected to grow by 3.6% in both 2007 and 2008 as cash crop production rises in response to new investments and transport infrastructure improvements, as forestry output expands when new project areas are developed, and as fisheries production maintains a steady rate of increase. Palm oil and log production will be the major contributors to growth in the sector. Nonmineral GDP is forecast to grow by 4.2% in 2007 and 4.0% in 2008.

Growth at these rates will mean a continued increase in per capita GDP, given population growth of 1.8%. More important, growth in nonmineral GDP implies that the benefits will be more widely distributed, since mineral sector production is not labor intensive. Sustained and faster agricultural growth in particular will be the foundation for reducing poverty, since 85% of the population live in rural areas. An estimated 41.3% of the rural population live below the national poverty line, compared with 16.1% for the urban population.

Inflation is forecast to remain at 3.0% (Figure 2.31.2). Continued fiscal prudence and sound monetary management should maintain exchange rate stability, and a move to a productivity-based wages policy will be more effective in containing supply-side pressures, because inflationary expectations have fallen in 3 years of relatively low inflation. The 2007 budget targets a deficit of 0.2% of GDP (Figure 2.31.6), in accordance with objectives established in the Medium-Term Fiscal Strategy 2002–2007.

2.31.5 Growth in money supply and private sector credit



Sources: Bank of Papua New Guinea (BPNG), *Quarterly Economic Bulletin September 2006*, available: http://www.bankpng.gov.pg, downloaded 7 February 2007; BPNG, *Monetary Policy Statement*, 31 January 2007; staff estimates.
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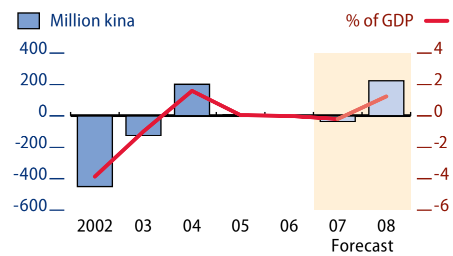
2.31.1 Selected economic indicators

	2007	2008
GDP growth	4.5	3.5
Inflation	3.0	3.0
Current account balance (% of GDP)	7.9	2.3

Source: Staff estimates.

2.31.6 Fiscal balance



Sources: Bank of Papua New Guinea, available: http://www.bankpng.gov.pg, downloaded 7 February 2007; Department of Treasury, *2007 Budget Volume 1: Economic and Development Policies*, 14 November 2006.
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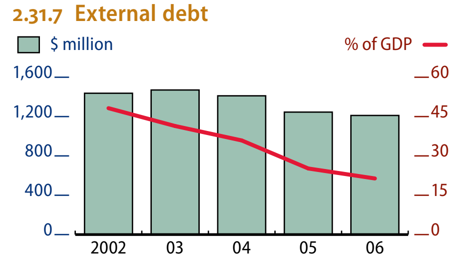
2.31.7 External debt



Sources: Bank of Papua New Guinea, available: http://www.bankpng.gov.pg, downloaded 7 February 2007; Department of Treasury, *2007 Budget Volume 1: Economic and Development Policies*, 14 November 2006.
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Pressures on the budget are expected in the lead-up to the elections, but responsible fiscal management is likely to be maintained. In 2008, a budget surplus of 1.2% is projected on the basis that revenues from the mineral sector will decline and that expenditures will be reduced accordingly. Public debt is expected to fall to 39.7% in 2008 as both domestic and external debt stocks come down from 2006 levels. Continued fiscal prudence and exchange rate stability will permit the central bank to maintain a neutral monetary policy stance, and interest rates are expected to be steady.

Softer prices for mineral exports and declining oil production are projected to reduce the current account surplus in 2007 and 2008. Moreover, imports for major mining projects will rise (Figure 2.31.8). The cancellation of the gas pipeline points to a smaller drop in the external surplus than earlier penciled in, since the pipeline-associated high level of imports will no longer be required. The decline in the current account surplus does not reflect excess demand pressures or structural imbalance. Imports arising from mining projects are fully funded by capital inflows related to private sector decisions to launch financially viable projects. Foreign reserves are forecast to provide over 9 months of import cover.

General elections scheduled for this year will be the first based on a limited preferential voting system, rather than a first-past-the-post system. This change is expected to reduce, to some degree, the large number of political parties in the parliament, but coalition governments still seem likely.

The major downside risks in the medium-term economic outlook are a sharper than expected weakening in global commodity prices, disruptions to mining and petroleum projects from civil unrest or natural disasters, political instability, and the abandonment of sound macroeconomic policies by the incoming government.

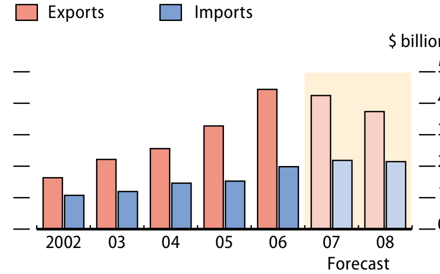
Development challenges

The Government acknowledges that much remains to be done to remove obstacles to greater domestic and foreign private investment, particularly in nonmineral sectors. The main concern is the longstanding problem of lawlessness and disorder (Box 2.31.2).

Other impediments to private sector development include corruption, weak service delivery from the public sector including state-owned power and water utilities, poor road maintenance, high transport costs, and inefficient telecommunications. In 2005, the country ranked 130 out of 158 surveyed for the Corruption Perceptions Index for degrees of corruption, scoring 2.3 out of 10, where zero is highly corrupt. Yet successes have been notched up in dealing with corrupt practices, notably in the pension fund industry. However, the challenge remains to ensure compliance with policies, laws, and regulations. In the forestry sector, for example, sustainable production is at risk from illegal logging, even though the necessary regulations are in place to prevent it.

The private sector also raises concerns that land tenure, access, and utilization issues impede business investment, and the Government has stated that it will at some stage review land legislation. However, this is a complex and sensitive area that is unlikely to be tackled in an election year.

2.31.8 Exports and imports



Sources: Bank of Papua New Guinea, available: http://www.bankpng.gov.pg downloaded 7 February 2007; Department of Treasury, *2007 Budget Volume 1: Economic and Development Policies*, 14 November 2006.

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2.31.2 Installing law and order

Issues of lawlessness and disorder damage the country's image as a desirable destination both for foreign investors and for tourists. In 2005, net foreign direct investment was only $27 million and about 18,000 tourists visited (less than 2% of total holiday visitors to the South Pacific and 10,000 below a 1999 peak).

The Enhanced Cooperation Program with Australia originally had a policing component intended to assist in dealing with law and order, but this was removed in 2005 following a dispute over whether or not Australian Federal Police would be subject to domestic law. (The 2007 budget papers indicate that future discussions with Australia will examine reintroducing the policing component of the program.)

In the long run, much faster economic growth that generates employment for young labor market entrants would contribute to curbing the law and order problem, but successful short- and medium-term interventions are needed, precisely in order to encourage the investment that generates faster growth.

Democratic Republic of Timor-Leste

Estimates show a contraction in non-oil GDP last year after an extended outbreak of civil unrest, though a sharp rebound is projected for 2007, based on increased spending by the Government and by international personnel deployed in the country. Achieving development objectives hinges on the state's ability to translate a strong flow of oil and gas revenues into capital spending, since the public sector's limited capacity restricts budget execution, hindering the growth of sectors that could generate employment and reduce poverty.

Economic performance

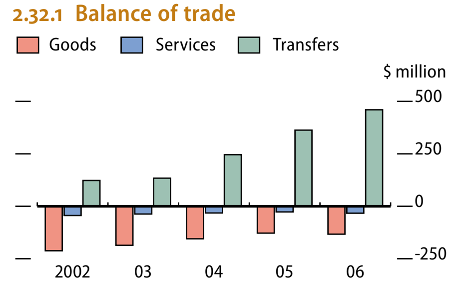
Economic activity in 2006 was severely hampered by civil unrest, which began in the capital, Dili, in April, culminated in armed conflict between the National Defence Force and the National Police, and continued until September, with occasional disturbances reported after that. About 2,200 houses were burned, which led to around 50% of Dili's population leaving the city, according to United Nations (UN) estimates. By the end of May, the UN and many foreign embassies had withdrawn nonessential staff. The Government requested external assistance to guarantee the peace, and by end-2006 more than 2,000 international forces were deployed. Somewhat earlier, in June, the prime minister had stepped down to be replaced by the former foreign minister. This year, a presidential election is scheduled for April and a parliamentary election in May.

Before the upsurge in violence, the economy was in an expansionary phase that indicated some success in meeting its major development challenge since independence in 2002: to use wealth from offshore oil and gas resources to generate growth that reduces severe poverty. About 40% of a fast-growing population of 1 million is estimated to live below the national poverty line, with three quarters living in rural areas and having limited access to safe water and sanitation. Two thirds of the rural population relies almost exclusively on subsistence agriculture, and coffee is the major cash crop.

In 2005, oil and gas income and non-oil GDP were approximately of equal size at $350 million, with oil and gas revenues paid into a petroleum fund that is invested abroad and supports government spending under a long-term fiscal sustainability policy that allows only "permanent" interest income from the fund to be appropriated annually. Non-oil GDP, which includes agriculture (32%), the public sector and the UN (35%), and nonfarm private sector activity (33%), was originally expected to grow by around 5% in 2006, boosted by higher public investment financed by income from the petroleum fund. The private sector should have benefited from planned public construction projects, and coffee exports were expected to increase.

The civil unrest, which occurred at the peak of the coffee harvest season, damaged production. Other agricultural products, notably

2.32.1 Balance of trade



Source: International Monetary Fund, *Article IV Consultation*, July 2005 and February 2007.

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livestock and dairy, also suffered. Public investment projects were suspended and commercial activity was heavily restricted. Capital left the country and banks were closed for a time, during which bad loans accumulated and new loans ceased being filed. One bank reported that the typical loan default rate of 5% jumped to 30% by year-end, as many borrowers fled.

These negative impacts were offset by the presence of the international forces and restart of some projects, which increased aggregate demand and thus imports. A surge in fund transfers to pay staff at international agencies injected an estimated \$40 million–\$50 million into the economy in December (Figure 2.32.1 above).

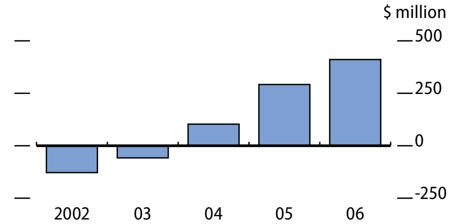
Official national accounts are not prepared, but the International Monetary Fund estimates a 1.6% contraction in non-oil GDP in 2006. Given population growth of 4.0%, per capita non-oil GDP declined significantly. In contrast, the offshore oil and gas sector was not directly affected by the civil unrest, with production increasing in the context of high global prices. Oil and gas revenues rose by an estimated 44% to \$492 million in 2006, increasing the current account surplus and foreign reserves (Figure 2.32.2). At year-end, the book value of the petroleum fund was \$1.0 billion, with the fund gaining an estimated \$80 million a month (Figure 2.32.3).

Growth in oil and gas receipts also ensured a considerable surplus in the Government's accounts for FY2006 (ended 30 June 2006), equivalent to 103% of non-oil GDP (Figure 2.32.4). While revenue growth exceeded budget estimates, both recurrent and capital expenditures fell short. Capital spending in the combined sources budget, which included donor-funded recurrent and capital projects equivalent to 59.0% of total expenditures, again fell short of planned figures, indicating a continuation of capacity constraints in executing budget projects. The FY2007 budget estimates that revenues will rise by 85.6% because of further growth in oil and gas receipts, while expenditures are estimated to more than double to \$309 million, leaving an overall surplus of \$424 million, or about 100% of non-oil GDP.

The increase in planned outlays includes spending on emergency assistance, urban reconstruction, and grants to rural communities, as well as civil service wages. Capital spending estimates are more than three times the FY2006 budget estimate as the Government substitutes its spending for that of declining donor-funds and seeks to accelerate implementation of sector investment programs formulated under the 2002 National Development Plan. The focus is on sector projects in the transportation, education, and power generation sectors. However, given past difficulties in budget execution, actual spending is likely to be below the planned level, which is within the sustainable level determined under a long-term fiscal expenditure and savings policy.

Timor-Leste uses the US dollar as the official unit of currency and consequently has no independent monetary policy. Inflation is largely determined by inflation rates in trading partners, but the civil unrest created some inflationary pressures last year. The consumer price index rose by less than 1% year on year in early 2006, but this rate of increase accelerated to about 6% from June through December (Figure 2.32.5). This reflected both limited supplies of goods caused by the violence and strong

2.32.2 Current account balance



Source: International Monetary Fund, *Article IV Consultation*, July 2005 and February 2007.

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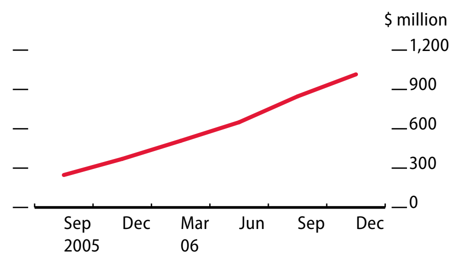
2.32.3 Petroleum fund assets



Source: Banking and Payments Authority, January 2007.

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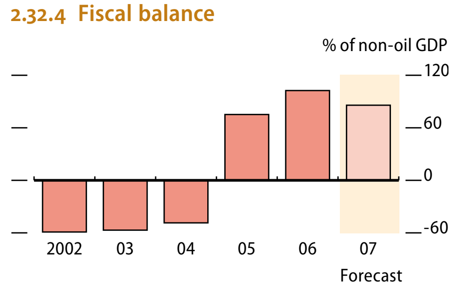
2.32.4 Fiscal balance



Sources: Ministry of Planning and Finance; International Monetary Fund, *2006 Article IV Consultation*, February 2007.

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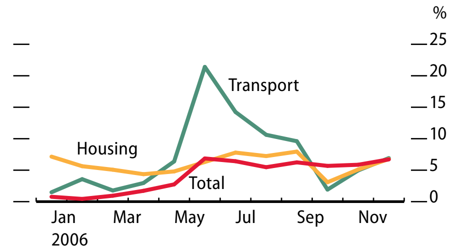
demand by international defense forces for goods and services, notably housing and transportation. For 2006 as a whole, inflation averaged 4.2%, up from 1.8% in 2005.

Efforts to strengthen the legislative framework and judicial system and to implement the National Development Plan continued in 2006, but the environment for the private sector remained poor. The country ranked second to last among 175 countries in the World Bank's *Doing Business* indicators. It takes 160 days to set up a business as against an average of 70 days in the Asia-Pacific region, and an overloaded court system means 175 days to enforce a contract. Weak infrastructure and utility services add to the difficulties.

2.32.5 Year-on-year CPI movements



Source: National Statistics Directorate, *Consumer Price Index*, December 2006.

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Economic prospects

Hydrocarbons production is expected to grow substantially and provide funding for development spending. The petroleum fund set up in 2005 is managed in a transparent manner, is subject to independent audit, and is integrated into the government budget in a way that ensures that the fund's asset base is protected while fund income supports public spending. Potential revenue flows in the medium term are boosted by high global prices, and in the long term by an agreement with Australia to share royalties from exploitation of the Greater Sunrise gas field, which could start production in 2013 and generate $10 billion in revenues over its productive life. The Timor Sea has other potential fields that are under 100% Timorese jurisdiction. Oil and gas income is projected to more than double in 2007–2008 as production from existing fields increases.

The non-oil economy is expected to rebound from the 2006 contraction and expand by about 32% in 2007 and 3.5% in 2008 (Figure 2.32.6). The sharp recovery seen for this year reflects a jump in government spending in FY2007 (though probably not to the planned level), and the establishment of a UN Integrated Mission (to stay until February 2008) to support recovery and improved governance. The presence of more than 2,000 international personnel for peacekeeping and to assist in the conduct of the elections will generate high demand for housing, goods, and services that will put some upward pressure on prices, but will contribute to the maintenance of law and order and the expected smooth completion of the elections, which are prerequisites to a revival of investor confidence.

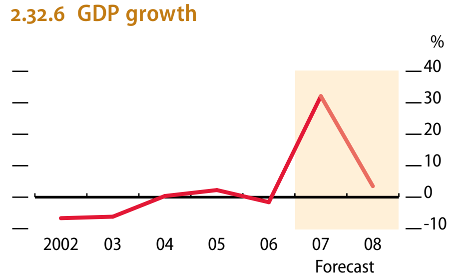
The growth and inflation projections assume that a new government will be formed after the elections and will adhere to the economic policies of the previous administration. These include the fiscal sustainability policy, implementation of sector investment programs, continued use of the US dollar as the official unit of currency, and efforts to stimulate private sector investment through legal and regulatory reform and infrastructure development. It is also assumed that commercial bank lending will gradually improve as borrowers return to Dili. In this scenario, macroeconomic stability is ensured, with inflation anchored by the use of the US dollar and likely to run at about 5.0% in 2007, slowing to 4.0% in 2008 (Figure 2.32.7). The modest growth forecast for 2008 reflects both some recovery in private investment and further expansion in public spending (on the assumptions of continued legal and regulatory

2.32.1 Selected economic indicators

	2007	2008
GDP growth	32.1	3.5
Inflation	5.0	4.0
Current account balance (% of GDP)	-	-

Source: Staff estimates.

2.32.6 GDP growth



Sources: Ministry of Planning and Finance; International Monetary Fund, *2006 Article IV Consultation*, February 2007.

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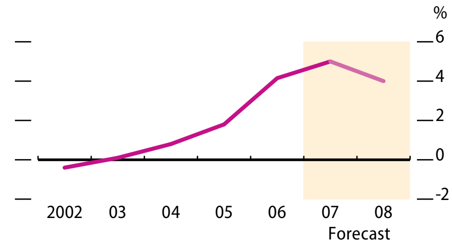
reform and of improved budget execution). Growth could be faster if public investment in infrastructure accelerates further because of funding available under the United States Millennium Challenge Account. The Millennium Development Corporation is expected to approve a compact with the country by the middle of this year.

Downside risks to the forecasts would emerge if the elections were marred by civil unrest that proved difficult to subdue, if oil and gas prices dropped below forecast levels, or if the new administration adopted an irresponsible fiscal policy. A surge in public spending that was not in alignment with the priorities of the National Development Plan and involved, for example, public service wage rises beyond those granted in the 2007 budget, would jeopardize efforts to facilitate rural development, push up inflation, and retard the restoration of investor confidence.

Growth needs to accelerate significantly to make inroads into poverty. In turn, that requires a substantial rise in private investment in agriculture, fisheries, and tourism, complemented by improved implementation of public investment projects in infrastructure, health, and education.

2.32.7 Inflation



Sources: Ministry of Planning and Finance; National Statistics Directorate; staff estimates.

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Development challenges

Near-term challenges are to ensure political stability, prevent civil unrest, and maintain macroeconomic stability. Longer term, the effort to reduce poverty and develop the economy faces two major tasks. One is to ensure that oil and gas wealth is managed to protect the interest of future generations while supporting current investment for essential social and economic development. Fiscal sustainability and intergenerational equity are being achieved through the long-term fiscal expenditure and savings policy, whereby the Government's annual sustainable spending is equal to domestic revenues plus the estimated permanent income from petroleum fund assets. However, actual public capital expenditures fall short of planned levels because of weak budget execution. The Government intends to improve this by outsourcing large infrastructure projects internationally, carrying out a donor-supported financial management reform program, and using rural development and education cash grants more frequently (though these will need to be carefully targeted and reported).

The second task is to encourage private investment by reducing the costs of doing business. A low, uniform tariff regime is in place, but there is room for tax reforms, especially given the strong growth in oil revenues. Such reform would involve the passage of pending consolidated tax legislation and would be aimed at reducing administrative costs and encouraging compliance through reducing rates, increasing minimum thresholds, and simplifying procedures. Foreign investment would be encouraged if legislation were passed permitting long-term leasing of state-owned land. Investment in general would be encouraged if business licensing procedures could be streamlined, dispute resolution through arbitration introduced (to relieve the burden on the court system), and contract enforcement strengthened.

Small Pacific countries

The smaller Pacific Island economies recorded divergent performances in 2006. Several benefited from an expansion of tourism and remittances, while others suffered from declines in aid or in farm output. GDP growth increased in about half the economies, mostly to modest levels, although rates above 5% were achieved by Palau, Solomon Islands, and Vanuatu. Inflation generally increased as a result of higher costs for imported fuel. The outlook is for a similar mixed growth performance in 2007. External conditions are mostly favorable. However, a pickup in development requires many economies to create a more hospitable climate for the private sector, to strengthen governance, and to improve delivery of public services.

Cook Islands

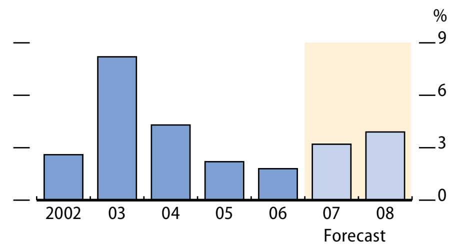
Gross domestic product (GDP) growth for FY2006 (ended 30 June 2006) was estimated at 1.8%, slowing from 2.2% in FY2005 (Figure 2.33.1). The agriculture sector was hurt by five cyclones that hit the islands in early 2005. Fisheries income was little changed from a year earlier, but the value of pearl exports fell by 28% from NZ$2.9 million in FY2005, reflecting lower world prices and increased production costs. Tourism remained the key growth sector, with visitor arrivals rising by 5.7% in FY2006 (Figure 2.33.2), with over half coming from New Zealand, the Cook Islands' largest trading partner.

Inflation in FY2006 was estimated at 3.3% (Figure 2.33.3), in line with that of New Zealand (the Cook Islands uses the New Zealand currency). The removal of most import duties from July 2006 is expected to lower inflation to 2.8% in FY2007.

The merchandise trade deficit was NZ$107.5 million in FY2006 and is projected to widen to NZ$114.6 million for FY2007. The deficit is caused by the high import dependency and the narrow export base of this small economy. This is redressed by a high level of service receipts, primarily from tourism, which provided for a current account surplus last fiscal year.

Budget operating surpluses have been achieved since 2000. In FY2006, the operating surplus was estimated at NZ$8.9 million, largely due to higher than expected tax revenues. In June 2006, the Government settled an outstanding external debt incurred in the mid-1990s to fund a major hotel project, more than halving the net public debt to NZ$30.1 million. The debt level is at a point where the Government could tap commercial loans for infrastructure projects. The Government intends to take a cautious approach to new debt and has stated that debt servicing should be met through user charges or operating income. Progress also was made in reducing excess employment in the public service, reforming the state bank, improving banking supervision, and encouraging foreign investment and foreign workers.

2.33.1 GDP growth



Sources: Cook Islands Statistics Office, available: http://www.stats.gov.ck, downloaded 9 January 2007; Ministry of Finance and Economic Management, *Half-Year Fiscal and Economic Update*, December 2006; staff estimates.

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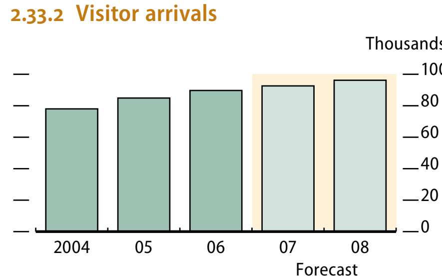
2.33.2 Visitor arrivals



Source: Ministry of Finance and Economic Management, *Half-Year Fiscal and Economic Update*, December 2006.

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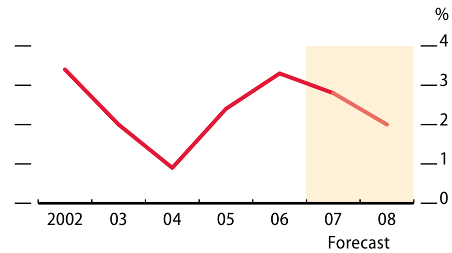
In FY2007 and FY2008 economic growth is projected to recover to about 3.5%. Visitor arrivals are expected to grow by 3.2% and 3.9%, respectively, with FY2007 growth partially attributable to the filming of the "Survivor Cook Islands" United States (US) television series on the island of Aitutaki in 2006. Pearl exports are expected to increase by about 10% annually from FY2007 through FY2009 as the industry recovers from a period of consolidation when many small producers left the industry (Figure 2.33.4). This growth will be supported by the Government's reestablishment of the Cook Islands Pearl Authority, which will coordinate and improve marketing, and by the removal of fuel levies on the industry.

A balanced budget is expected in FY2007—a change from the surplus of FY2006—the result of an expected increase in expenditures and a fall in revenues induced by the removal of import duties on many products. This action on duties is aimed at stimulating development of the private sector and is consistent with obligations under the Pacific Island Countries Trade Agreement.

The absence of a clear planning framework for infrastructure has contributed to a backlog of public works. Inadequate roads, water supplies, sewerage, electricity, and ports on Rarotonga and Aitutaki are likely constraints on growth over the medium term. Existing infrastructure imposes high costs on users and, in some cases, is unable to meet the demand at a reasonable standard. The Government is preparing an infrastructure master plan that will involve examining the shortcomings and development requirements. A decline in population also poses a development challenge. Cook Islands' residents hold New Zealand citizenship and can access the New Zealand and Australian job markets and the New Zealand health, education, and social security systems. More than three times as many Cook Islanders live overseas as at home. An improvement in social services, notably education, could help stem emigration. Private sector development has picked up on Rarotonga and Aitutaki, but not elsewhere. Another issue requiring attention is protective tariffs retained on some locally produced goods, especially food and agricultural products, which raises costs for the important tourism industry.

2.33.3 Inflation



Sources: Cook Islands Statistics Office, available: http://www.stats.gov.ck, downloaded 9 January 2007; Ministry of Finance and Economic Management, *Half-Year Fiscal and Economic Update*, December 2006.

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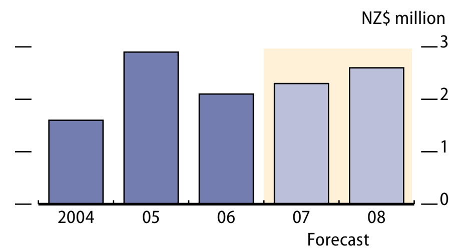
2.33.4 Pearl exports



Source: Ministry of Finance and Economic Management, *Half-Year Fiscal and Economic Update*, December 2006.

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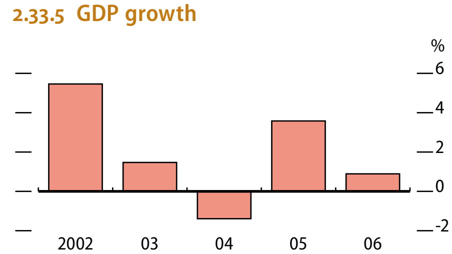
Kiribati

Economic growth slowed to an estimated 0.9% in 2006 (Figure 2.33.5). Small increases in government activities (which contributed about 40% of GDP) and in wholesale and retail sales were nearly offset by declines in financial services and public transportation. Construction activity leveled off. The country uses the Australian dollar as its domestic currency, so there is no independent monetary policy. The inflation rate in 2006 was estimated at 1.5%.

In recent years the trade deficit has widened (Figure 2.33.6). Exports comprise a small amount of coconut products and some marine products, while the economy imports a wide array of essential goods from food to vehicles.

Fishing license fees are a major foreign exchange earner and contributed 87% of nontax income last year. Import duties constituted the

2.33.5 GDP growth



Source: Ministry of Finance and Economic Development, 24 January 2007.

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second largest source of government revenues. Civil servants' salaries and benefits accounts for almost half of total government expenditures, which exceeded revenues by A$23.8 million, representing an 8.7% widening of the deficit from 2005 (Figure 2.33.7). Most of the gap was financed by an A$18.5 million drawdown from the Revenue Equalization Reserve Fund, created to provide a cushion for fiscal shortfalls. The market value of this fund has increased from A$97.1 million in 1984 to about A$666 million in October 2006. The 2007 budget projects an underlying deficit of A$20.5 million, to be funded entirely from the Revenue Equalization Reserve Fund.

Kiribati, a low-lying atoll nation, is highly vulnerable to climate change and natural disasters, including coastline erosion. Furthermore, it is susceptible to fluctuations in fishing license fees, which currently make up 43% of total government revenues. In addition, returns on the revenue fund that supports essential government spending depend on the performance of international stock and bond markets.

Infrastructure development is a key challenge. Telecommunications costs are high. Air Pacific, Air Marshall Islands, and Our Airline (formerly Air Nauru) provide international air connections to the capital, Tarawa, but at high cost, deterring tourism. Internal travel also is costly, and domestic air and sea services are irregular.

Performance in the public sector has been weak, illustrated by low profits and high staffing levels in public enterprises. Line ministries need technical assistance to improve their capacities. The level of tax evasion, particularly of import duties, is significant, hurting government revenue collection. Like many other small Pacific island nations, Kiribati also faces relatively high costs of imported fuel, due to its small volume shipments and limited storage facilities.

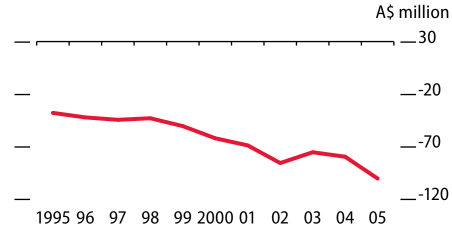
Tourism could be an avenue of development, especially in Kiritimati, which offers game fishing, natural beauty, and has potential for bird-watching and diving, but it is held back by the high cost of travel and inadequate infrastructure.

Republic of the Marshall Islands

GDP expanded by an estimated 3.0% in FY2006 (ended 30 September 2006), driven largely by increased government capital expenditures (Figure 2.33.8). Nonetheless, the continued fast rate of population growth saw GDP per capita decline by 0.53%. This economy depends heavily on funds from the US under the Compact of Free Association. Compact payments have led to substantial increases in government spending in infrastructure, but have also fed into higher public sector employment and wages. The reliance on government spending is high and the private sector contribution to GDP has remained at 30–40% for a decade. Key productive sectors comprise wholesale and retail trade, fishing, construction, transport, and copra. Fishing license fees are an important revenue source for the Government.

The beneficial impact of Compact funds has been constrained by a tendency to give priority to creation of public sector jobs and support of public sector activities, over management for public service delivery and to support development of the private sector. The long-term implications

2.33.6 Trade balance



Source: Ministry of Finance and Economic Development, 24 January 2007.

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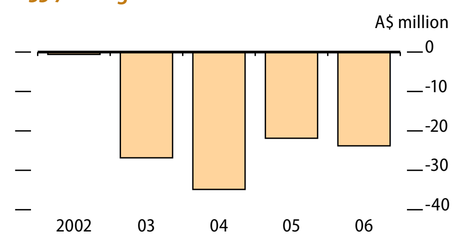
2.33.7 Budget balance



Sources: Kiribati National Statistics Office, *Statistical Yearbook 2002*, June 2002; Ministry of Finance and Economic Development, *Kiribati Government Budget*, various years.

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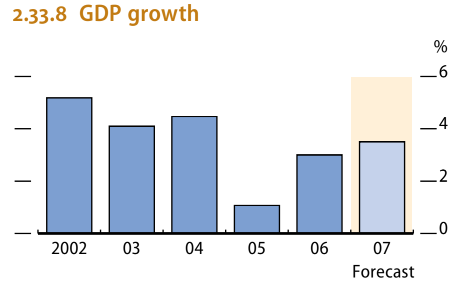
2.33.8 GDP growth



Source: Republic of the Marshall Islands, *FY2005 Economic Review*, June 2006.

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of such prioritization are evident from the education system: education spending is among the highest in the Pacific, but education outcomes are among the worst. This contributes to an unemployment rate of 30% (with youth unemployment estimated at about 60%) as well as to social problems.

Fiscal management continues to be weak, with little growth in domestic revenues, unmanaged expenditures (particularly in wages bills), and planned declines in compact grants. The central government overall budget was in deficit by 3.0% of GDP in FY2005 (Figure 2.33.9). Manifestations of a problematic fiscal situation include the imposition of a budget freeze on nonessential expenditures in February 2006, difficulties in meeting the Government's payroll, and an inability to meet all debt service requirements.

Estimates of debt sustainability put the net present value debt-to-GDP ratio at 60–80%, and debt service as a share of exports at 78%. Both indicators suggest the country is well beyond a safe debt threshold. Debt service payments for FY2006 were budgeted at $1.0 million (considered to be lower than the levels required), with actual repayments likely to be below this because of revenue shortfalls. Even if no further borrowing is undertaken, debt service payments will increase over the next 5 years, and debt repayment will remain a concern. This may strengthen pressures for structural reforms in the public sector.

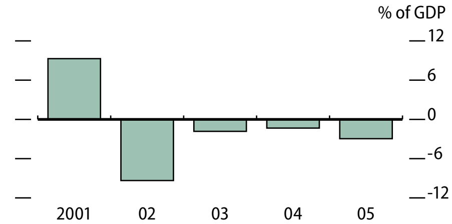
The current account surplus continued to decline in FY2006 to 4.8% of GDP (Figure 2.33.10). Official reserves of $1.5 million at end-2006 were sufficient to cover just 1 week of imports. However, a guaranteed flow of Compact funds reduces pressure on the Government to act on the external account weakness. Inflation has become a less pressing concern, slowing to 3.0% in FY2006, and is forecast to ease further to 2.4% in FY2007 because of lower global oil prices.

Economic stress has been signaled over recent years by various problems, such as: the failure of two local retailers that led to a government-sponsored rescue package; the end of international flights by Aloha Airlines owing to insufficient returns on the route; and cash-flow difficulties at the Marshalls Energy Company. Two continuing issues limit the economy's growth potential—a weak environment for private sector activity and a tendency for the Government to seek to attract private investment through use of incentives. Private sector constraints include problems with access to finance and land, ineffective laws and regulations, poor infrastructure, and abrupt changes in government policy. Investments attracted through incentives such as tax holidays may prove to be transient. Implementation of reforms may be delayed until after elections scheduled for November 2007. Economic growth forecast at 3.5% in FY2007 is expected to be supported by continued high public expenditures. In FY2008, though, a decline in compact grants could damp growth.

Federated States of Micronesia

The economy contracted by an estimated 0.7% in 2006, continuing a trend of poor economic performance despite significant per capita levels of financial grants (Figure 2.33.11). The country is heavily dependent

2.33.9 Fiscal balance



Source: Republic of the Marshall Islands, *FY2005 Economic Review*, June 2006.

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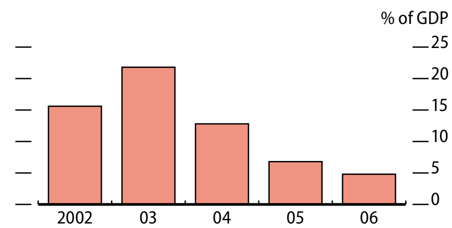
2.33.10 Current account balance



Sources: Republic of the Marshall Islands, *FY2005 Economic Review*, June 2006; International Monetary Fund, *2005 Article IV Consultation*, January 2006.

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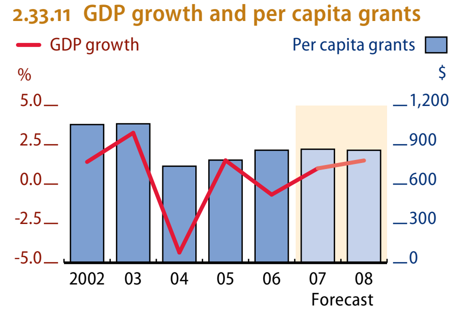
2.33.11 GDP growth and per capita grants



Sources: Department of Economic Affairs, available: http://www.spc.int/prism/country/fm/stats/, downloaded 3 January 2007; International Monetary Fund, *2004 Article IV Consultation*, March 2005.

Click here for figure data

on aid (predominantly from the US) and performance has been driven by public sector expenditures. Services account for about 70% of total employment and agriculture and fisheries for less than 10%. Indeed aid flows have contributed to some poor habits going unchecked—limited financial responsibility, limited monitoring of performance, reliance on the public sector, reduced pressure for raising domestic revenues, and no strong pressure for policy change. The amended Compact of Free Association with the US came into effect in FY2004 (ended 30 September 2004) and goes some way to addressing issues of financial responsibility and performance monitoring through requiring quarterly financial and performance reports as well as providing the US with the ability to withhold or suspend funds.

The recent weakness in the economy reflects partly a reduction in funding under the terms of the amended Compact. Fiscal pressures have also been created by stricter controls on the use of Compact funds and will further build from FY2007 when grants decline as more of the funds are channeled into a trust fund. The Government has struggled to find funds for many functions that do not fit readily into the Compact-supported sectors, while available funds for other sectors have not always been fully used. For example, the inability of the Federated States of Micronesia (FSM) and the US to agree on a mechanism to disburse an infrastructure grant, budgeted at $17 million, meant this resource was not tapped during 2004–2006. Capacity constraints also prevented the economy from fully using five operational grants provided under the Compact.

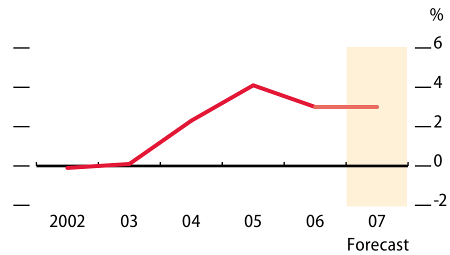
Inflation slowed to an estimated 3.0% in 2006 (Figure 2.33.12). External debt service indicators suggest that external debt is manageable (Figure 2.33.13), but this, too, is expected to come under pressure as Compact grant receipts decline from FY2007. The federal and state governments may seek alternative sources of funds, such as from donors or further debt, to finance expenditures.

Like many Pacific nations, FSM has a persistent trade deficit because it is highly import dependent and produces few exports. High costs and irregular transport limit export potential. The development of exports and, more broadly, of the private sector, is also hindered by certain policy settings, in particular in access to land and in restrictions on foreign investment. The regular flow of Compact funds reduces pressures to promote potential growth sectors and develop revenue sources.

Overall economic difficulties are magnified at the state level where governments are more heavily reliant on grant funding to support expenditures (grants formed around 75% of state revenues in FY2005), and where fiscal discipline has been uneven. The fiscal situation is particularly precarious in Chuuk and Kosrae states. A fiscal adjustment and transition plan has been developed, based largely on tax reform, but it will take an estimated 3 years to fully implement. Measures are needed in the short term to manage a situation in which some states could be unable to meet wage bills or debt repayments to the national Government.

Core issues for the medium term include public enterprise reform, implementation of tax reforms, strengthening of accountability and transparency, and creation of a supportive environment for private sector development. To date there has been little progress in implementing

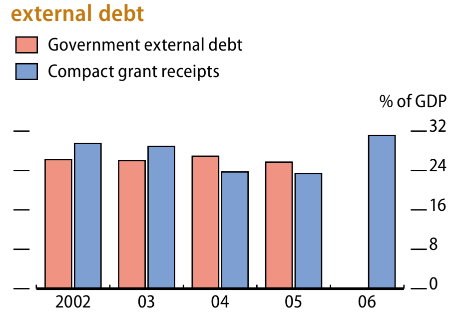
2.33.12 Inflation



Sources: Department of Economic Affairs, available: http://www.spc.int/prism/country/fm/stats/, downloaded 3 January 2007; Department of Economic Affairs, *Consumer Price Index*, January 2006.

Click here for figure data

2.33.13 Compact grant receipts and external debt



Note: No data available for 2006 government external debt.
Sources: Department of Economic Affairs, available: http://www.spc.int/prism/country/fm/stats/, downloaded 3 January 2007; International Monetary Fund, *2004 Article IV Consultation*, March 2005.

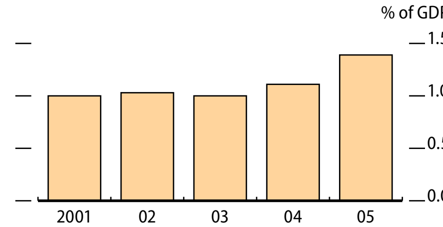
Click here for figure data

reforms in the Strategic Development Plan 2004–2023 and, in effect, FSM is at least 2 or 3 years behind in its plan for self-sufficiency by 2023. The public appetite for reform needs to be developed so that difficult decisions that the Government has to take, which will affect employment and provision of services, are widely understood and supported. The lack of progress is also symptomatic of capacity constraints. Weak public sector capacity hampers basic functions, including the formulation of policies and the resolution of problems.

Some pressure has been eased by a slowing in population growth, reflecting emigration to neighboring US territories and the US mainland, where FSM citizens have the right to seek employment. However, gross private transfer receipts totaled only an estimated $3.3 million in FY2005, or 1.4% of GDP (Figure 2.33.14). This figure, which included inheritances and support payments as well as remittances, amounted to just $80 annually from each of the estimated 30,000 FSM nationals living overseas. Policies should aim to build both the skills of potential migrants and links between emigrants and their homeland.

Low levels of growth of about 1.0–1.5% are expected in 2007 and 2008 because of the fiscal pressures. The difficult adjustments required suggest that the economy will continue to face important budgetary and economic constraints over the medium term. Yet it will be crucial to push ahead with reforms as otherwise the private sector will remain stagnant and the economy heavily reliant on the public sector, supported by aid. Without a significant upturn it is unlikely that the economy can be self-reliant on trust fund income by 2023, given low trust fund returns received to date and a likely lack of a budget surplus to build the fund.

2.33.14 Gross private transfers



Source: Department of Economic Affairs, available: http://www.spc.int/prism/country/fm/stats/, downloaded 3 January 2007.

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Nauru

The Government and public enterprises dominate this small economy. Public administration accounted for an estimated 41% of 2005 GDP, and there is little in the way of private sector activity other than a declining retail trade sector. Phosphate mining was the main economic activity, with production running at around 2 million tons a year until the early 1980s, after which it declined and then ended in 2003. An Australian phosphate company, Incitex Pivot, has invested in repairing basic mining infrastructure, so that phosphate exports restarted in September 2006. GDP growth in FY2006 (ended 30 June 2006) was estimated at 4.5%, primarily reflecting investment in transport and mining. Gross national income was boosted by A$33 million of aid in FY2006, of which A$20 million came from Australia. Other inflows included A$7 million for a refugee processing center, A$7 million in fishing licenses issued to foreign fleets, A$6 million in repatriated capital, and A$1.7 million under a land rehabilitation settlement.

Nauru uses the Australian dollar as its currency, and imports almost all its basic requirements, mainly from Australia. The inflation rate is therefore determined largely by the rate in Australia, and is estimated to have been about 4.0% in FY2006. The merchandise trade deficit widened to A$31 million in FY2006, and the services account was also likely to be in deficit on account of such imports as education and freight services. A small current account deficit was covered by repatriation of capital.

A budget surplus of A$571,800 was run in FY2006. Total revenues of A$27.0 million included capital transactions and cash grants from donors. The main source of domestic receipts was fishing license fees. Total expenditures of A$26.4 million included several one-time items, including port refurbishment that allowed larger ships to moor for phosphate loading, and funds from Taipei,China that were allocated to Air Nauru (now Our Airline) to cover charter flight costs following repossession of its solitary aircraft. The FY2007 budget estimates a small surplus of A$62,600. Domestic revenues are projected to decline 15% because of falling fishing license receipts, which has required some new revenue-raising measures as well as expenditure cuts. The budget projects A$800,000 in dividend income from state-owned phosphate company RONPhos as a result of the resumption of phosphate mining. Expenditures will fall by about 16% because of the completion of major projects and also cuts in areas that were not identified as priorities in the National Sustainable Development Strategy launched in FY2006. These cuts involve abolition of the Department of Works in favor of contracting out of public works, abolition of the Computer Bureau, and the reduction or cessation of subsidies to some public enterprises.

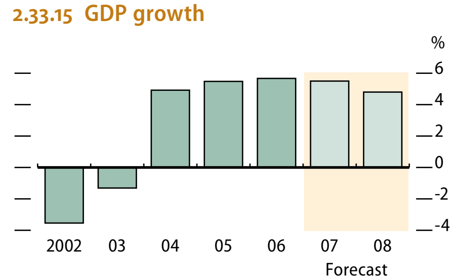
Achieving economic growth in the medium term will depend on the phosphate industry. Primary phosphate reserves are expected to last until 2009 or 2010, and a recent study suggested that it may be economically viable to mine residual phosphate reserves, in conjunction with the rehabilitation of mined lands, for up to 30 years. Phosphate production in 2007 and 2008 is projected to increase, on the assumption that a new management team will be able to raise sufficient operating capital and find enough workers. However, in the absence of new construction projects and with the planned contraction in the public sector, GDP is forecast to fall by 9.2% in FY2007 and fall by a further 4.5% in FY2008. Inflation is expected to be about 3.5% in both years. Further contraction is expected in the public sector as the Government adjusts to stagnant domestic revenues and targets a larger budget surplus in order to pay off debt.

The Government has announced its intention to move ahead with public sector reform, including that of inefficient public enterprises responsible for water and power supply, and of public financial management. The reestablishment of a domestic financial system and of credibility in international markets is critical to improving the business environment.

Republic of Palau

Economic growth has averaged 5.4% since 2004, reaching an estimated 5.7% in FY2006 (ended 30 September 2006; Figure 2.33.15). Solid growth in recent years has been supported by externally funded infrastructure projects and increased tourist arrivals (Figure 2.33.16). The expansion of tourism has been assisted by new air services and hotel construction. In 2006, visitor arrivals totaled 86,400 (mainly from Japan and Taipei,China), the equivalent of over four times a resident population of 20,000 that includes about 7,000 guest workers employed mostly in unskilled work. Tourism contributes significantly to economic growth

2.33.15 GDP growth



Sources: Bureau of Budget and Planning, *2002–2003 Statistical Yearbook*; International Monetary Fund, *Republic of Palau Selected Issues and Statistical Appendix*, March 2006.

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through employment, and tourism receipts are estimated to amount to about 45% of GDP.

Inflation accelerated to 4.4% in calendar year 2006 from 3.9% in 2005. The current account surplus (including grants) fell to 2.5% of GDP, or $3.9 million, in FY2006 because of the importation of capital equipment to redress power failures and goods associated with construction. Since the currency is the US dollar, there is no independent monetary policy. The fiscal deficit in FY2006 was estimated at 0.4% of GDP, narrowing from 3.9% in FY2005. Growth in current expenditures was contained to 3.6%, while capital spending soared by 74% and grants increased by 44%. Grants accounted for 56% of total revenues and grants. Under a 1994 Compact of Association with the US, Palau receives $447 million in grants over the 15 years from 1994 to 2009. Also under the Compact, $70 million has been set aside in a trust fund for use after the expected ending of Compact grants in 2009. This fund had increased to $170 million by February 2007. Provision was made to fund major infrastructure projects and to continue some US federal programs at no cost to Palau, including health services.

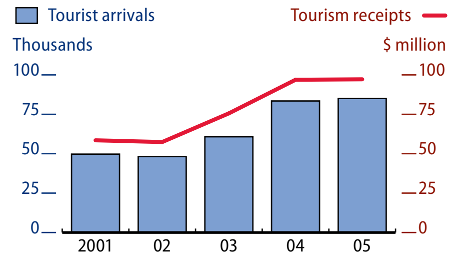
The Government is hopeful that it can renegotiate the Compact so that it provides for grants beyond 2009, but it has to achieve greater fiscal self-reliance in preparation for potential funding shortfalls. The official target is to cut annual recurrent expenditures from about $60 million–$65 million now to a more fiscally sustainable $50 million–$55 million. Reducing recurrent expenditures by this amount is problematical, though, given difficulties in controlling the wages bill and rising maintenance costs following an expansion of public infrastructure over 1994–2004. For instance, the annual maintenance cost of the Compact road in the new capital, Babeldaob, alone is estimated at $2.0 million–$2.5 million. The Government is facing additional operation and maintenance costs of the facilities at the capital. It will be also difficult to pursue savings in the capital expenditure budget since the infrastructure network is incomplete. The FY2007 budget estimates an expenditure level of $57 million.

In the near term, tourism and infrastructure projects look likely to be drivers of economic expansion. Growth in small-scale agriculture will be stimulated by tourism and demand from construction. The economic impact of the closure in November 2006 of the locally owned Pacific Savings Bank Ltd. is uncertain. Small and medium enterprises without collateral could be most directly affected, as larger enterprises usually do business with other banks. However, there will be flow-on effects if small and medium enterprises are seriously damaged. The Government needs to restore confidence in the financial sector to minimize the impact, and it was reported to be planning to inject funds into a revitalized Pacific Savings Bank. GDP growth is forecast to slow to 5.5% in 2007 and 4.8% in 2008, assuming fiscal adjustment is limited as Compact renegotiation proceeds. Inflation is expected to be about 4.0% in both years.

Samoa

GDP growth was estimated at 4.6% for FY2006 (ended 30 June 2006), down 1 percentage point relative to FY2005 (Figure 2.33.17). Among the

2.33.16 Tourism: Arrivals and receipts



Source: International Monetary Fund, *Republic of Palau Selected Issues and Statistical Appendix*, March 2006.

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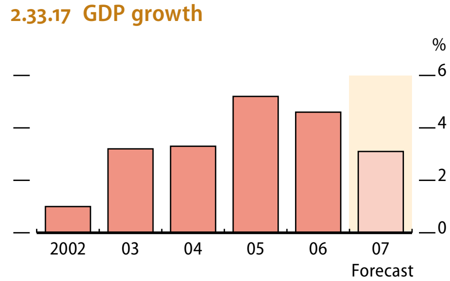
2.33.17 GDP growth



Sources: Ministry of Finance, *2005 National Accounts Report*, June 2005; Ministry of Finance, *Quarterly Economic Review Issue No. 34*, February 2007.

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stronger sectors, construction expanded by 9.0%, commerce by 7.2%, public administration by 6.9%, and finance and business services by 5.7%.

Inflation accelerated through the second half of 2006, lifting the year-average rate to 3.8%. The trade deficit widened as a result of higher global prices for imported oil as well as reduced export earnings from fish, coconut cream, taro, and nonu fruit. Increases in remittances and tourism receipts helped narrow the current account deficit slightly to $29.2 million in FY2006 (Figure 2.33.18). A deficit in the overall balance of payments was caused in part by the settlement of substantial external debts for Polynesian Airlines. As a result, foreign reserves declined to $65.3 million at end-FY2006, equal to 3.9 months of import cover, down from 5.4 months a year earlier.

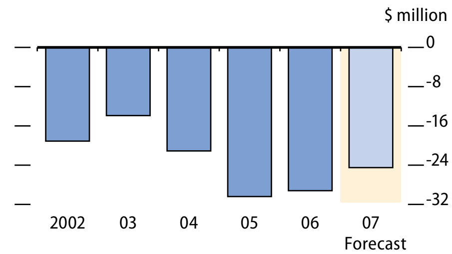
An overall budget deficit representing 0.4% of GDP was recorded in FY2006 (Figure 2.33.19), compared with a deficit target of 4.3% of GDP. The Government financed the deficit from its reserves, and reduced its external debts from the equivalent of 41.3% of GDP in June 2005 to 40.2% of GDP in June 2006.

GDP growth is expected to slow to 3.1% in FY2007, as agricultural expansion moderates after a recovery from hurricane damage in FY2006 and construction growth eases as a result of the completion of facilities for the South Pacific Games in August–September 2007 and of other buildings and infrastructure. Tourism is seen expanding, which will boost areas such as hotels, restaurants, and transport and communications. An inflation rate of 3.6% is projected for FY2007, reflecting a one-time impact of an October 2006 rise in the value-added goods and services tax. Imports will likely decline slightly from the FY2006 level, assuming world oil prices do not surge. Tourism earnings are projected to grow by 6%, and the export of automotive parts by Yazaki EDS Samoa Ltd., one of a few export-oriented manufacturers, is projected to increase by 8%. The current account deficit is forecast to narrow to $24.5 million.

An overall fiscal deficit of 1.4% of GDP is targeted in FY2007, to be financed by external borrowings. Previous government domestic borrowing prompted concerns about crowding out the private sector, so the FY2007 budget expressly aims at reducing the state's financing demands on the banking system. The official external debt stock in September 2006 was reduced further to the equivalent of 36.6% of GDP. Still, the economy is vulnerable to external shocks, particularly with its persistent trade and current account deficits. A debt-sustainability analysis in 2005 by the International Monetary Fund showed that isolated shocks to the economy might not seriously affect debt ratios, but a combination of shocks could return the debt-to-GDP ratio broadly to the level before a mid-1990s macroeconomic stabilization program was implemented. Prior to that, that ratio was exceedingly high, at over 100%.

Reducing the economy's vulnerability to such shocks as possible cuts in aid flows and in remittances requires the nurturing of a business environment and growth in exports. Tourism is a promising sector. Moreover, infrastructure development for the fishing industry is expected to encourage a reversal of a decline in commercial fishing in recent years, although it will need to be complemented by management for sustainable harvesting. Samoa ranks 39th of 155 countries in the 2006 World Bank

2.33.18 Current account balance



Sources: Ministry of Finance, *Statement to Support the 2006/07 Budget*, June 2006; Ministry of Finance, *Quarterly Economic Review*, February 2007; Central Bank of Samoa, *Monetary Policy Statement*, September 2006.

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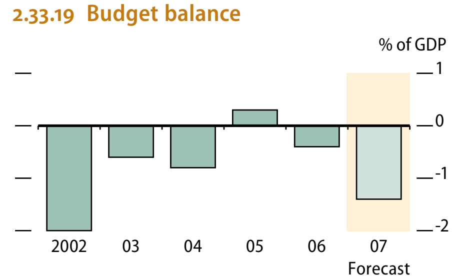
2.33.19 Budget balance



Sources: Ministry of Finance, *Statement to Support the 2006/07 Budget*, June 2006; Ministry of Finance, *Quarterly Economic Review*, February 2007; Central Bank of Samoa, *Monetary Policy Statement*, September 2006.

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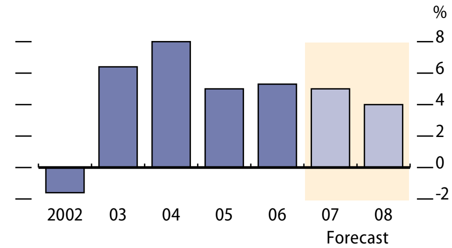
Doing Business indicators, but there is room for improvement in the time taken to start a business, acquire licences, and enforce contracts.

Solomon Islands

A short period of civil unrest following elections in April 2006 had a fairly small impact on the overall economy. Riots broke out in the capital, Honiara, after a new prime minister was named, resulting in serious damage to property. The Regional Assistance Mission to Solomon Islands (RAMSI), an initiative of the 16-country Pacific Islands Forum in 2003, was reinforced with police and army personnel, who restored order. The prime minister resigned following a vote of no confidence and a five-party Grand Coalition for Change Government took office in May. Subsequently, RAMSI's military component was scaled down and urban reconstruction began.

The economy grew by an estimated 5.3% in 2006 (Figure 2.33.20), with log production continuing at a high (and unsustainable) rate, fish production expanding, and palm oil making a contribution for the first time since 1999. Services sectors also expanded and there was new investment in the Gold Ridge gold mine. Inflation accelerated to 8.2% in 2006, with high oil prices and rapid credit expansion the main causes (Figure 2.33.21). The pegging of the Solomon Islands dollar to a weakening US dollar led the domestic currency to depreciate by 5–9% against its major trading-partner currencies. However, the relatively high inflation rate kept the real effective exchange rate stable.

2.33.20 GDP growth



Sources: International Monetary Fund, *2006 Article IV Consultation*, October 2006; staff estimates.

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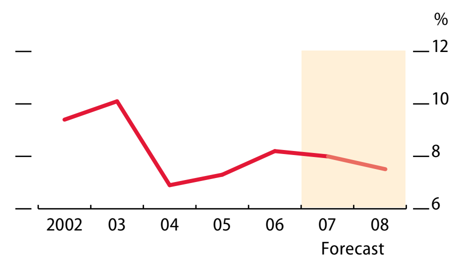
Firm international prices for major commodity exports (logs, fish, and palm oil) stimulated export growth of 13.5% in 2006, but imports expanded by 26.9%, primarily as a result of greater fuel- and investment-related imports. The merchandise trade gap widened and the current account deficit worsened to 15.8% of GDP from 10.8% in 2005. Increases in aid inflows equivalent to over 25% of GDP and in foreign direct investment (mostly into the palm oil and gold industries) contributed to an improved overall balance of payments. Gross official reserves rose to $103.6 million at end-2006 (Figure 2.33.22), providing 5 months cover of imports of goods and nonfactor services.

2.33.21 Inflation



Sources: Central Bank of Solomon Islands, *Annual Report 2005*, May 2006; staff estimates.

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A budget surplus of 0.6% of GDP was recorded, and progress made in addressing the heavy public debt burden resulting from fiscal mismanagement in the 1990s. Loans with international financial institutions were serviced on time, efforts continued to reduce the stock of expenditure arrears, and in February 2006 an agreement was signed for the restructuring of SI$183.7 million in government debt to the central bank. No new debt or government guarantees were issued, though the Government has indicated that it would consider taking over debts of provincial governments. In December 2006, the total public debt stock (inclusive of arrears) was equivalent to 70% of GDP, down from 80.0% at end-2005. External debt accounted for approximately 72% of the total public debt stock. The 2007 budget passed by the parliament in February 2007 estimates substantial rises in revenues and expenditures from levels budgeted in 2006. Revenues and grants are estimated at SI$949 million, with recurrent spending of SI$944 million, leaving a small surplus. Development spending is estimated to increase by 24%,

through a pickup in donor-funded project expenditures and a doubling of government-funded capital outlays. Administrative and technical capacity constraints will make it difficult to fully spend the development budget allocations.

Solomon Islands is one of the least developed Pacific island countries. It lacks adequate social infrastructure and services, and does not generate enough income-generating opportunities for a fast-growing population (2.8% annually), of whom about 50% are below 25 years and 85% live in rural areas. There is little formal employment outside Honiara; unemployment is rising, particularly among the young; malaria displays a high incidence; and HIV/AIDS has become a serious issue. If poverty is to be reduced, a substantial improvement in delivery of basic social services is required, tied in with economic growth that engages the rural population.

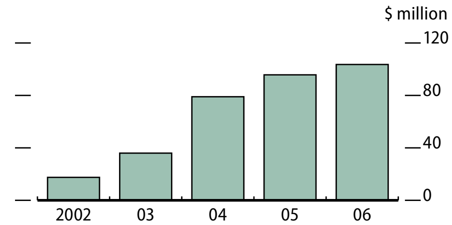
Three major barriers to sustained growth are identified in the latest budget. The first is poor domestic transport infrastructure and services provision to rural areas. The second is an inefficient regulatory and high-tax environment. The third is inadequate capacity for Solomon Islanders to start up a business, including poor business skills, and limited access to capital. In an effort to begin dismantling these barriers, the Government adopted a National Transport Plan in September 2006 and permitted competition in the monopolized telecommunications sector. The 2007 budget also has tax and tariff reforms, including the reduction of the top rate of import duties from 20% to 10%, and the ending of duty exemptions on log exports. A new Foreign Investment Act was approved in June 2006 and reforms of business laws are expected to make it easier to do business. Solomon Islanders will be encouraged to engage in businesses through provision of training and establishment of credit guarantees operated by the central bank.

The economic outlook for 2007 and 2008 is positive, on the assumptions that investor confidence is sustained by political stability and a continued RAMSI presence, and that the Government implements its public sector and economic reform agenda at a moderate pace. Economic growth is forecast at 5.0% in 2007, easing to 4.0% in 2008, because a slowdown in logging is expected, partly attributable to the ending of export duty exemptions. Nontimber activities are forecast to grow at higher rates, with agriculture and mining leading the way. Inflation is projected to decelerate to 8.0% and 7.5%, as domestic credit expansion eases and the pegging of the exchange rate to the US dollar is maintained. Export growth is forecast to weaken in 2007 with a decline in log exports. The current account deficit is expected to be about 16% of GDP in 2007 and 10% in 2008. Aid and foreign direct investment inflows should ensure that foreign reserve levels provide 5 months of import cover. The Government is expected to target small budget surpluses of about 1% of GDP to reduce the public debt burden.

Tonga

Economic growth slowed to an estimated 1.9% in FY2006 (ended 30 June 2006), from 2.3% in FY2005. The commerce, restaurants, and hotels sector was the main driver. Agriculture, forestry, and fisheries contracted

2.33.22 Gross official reserves



Sources: International Monetary Fund, *2006 Article IV Consultation*, October 2006; Central Bank of Solomon Islands, *Monthly Economic Bulletin*, December 2006.

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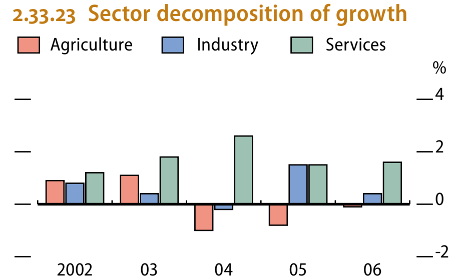
2.33.23 Sector decomposition of growth



Sources: Statistics Department, *National Accounts Statistics 2005*, June 2005; Ministry of Finance, *Budget Paper No. 1*, June 2007.

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for a third successive year because weaker squash prices hurt production of this crop and the tuna catch was low (Figure 2.33.23). Construction growth decelerated after a boom year in FY2005 when major public projects were undertaken and when housing construction was strong. Prospects overall were severely damaged as a result of a pro-democracy demonstration in November 2006 that led to the burning and looting of many businesses in the capital, Nuku'alofa, and the loss of life. Though law and order was quickly restored with external assistance, political and social divisions have deepened and investor confidence has been undermined.

Inflation moderated from 10% in FY2005 to 7.2% in FY2006, reflecting slower rises in food prices, but remained at a regionally high level because of the demand stimulus from significant inflows of private remittances and rapid credit growth. Trade and current account deficits widened in FY2006 (the latter to 6.2% of GDP) as imports rose and exports fell, especially exports of squash. Official foreign reserves fell to T$77.4 million at end-March 2006, equivalent to 4.2 months of import cover.

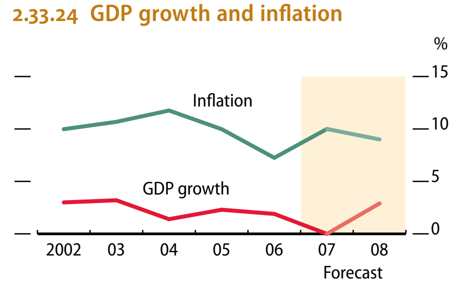
Given the fall in exports, a 21% jump in credit, partly to fund housing, raised concerns about a possible rundown in foreign reserves to less than the target of 3–4 months cover of goods imports. In January 2006, the National Reserve Bank of Tonga moved to protect foreign reserves by imposing credit ceilings on the banks, and in March it reintroduced central bank notes as a market-based policy instrument. Official reserves recovered to T$85.7 million by end-2006, or 4.5 months of import cover.

The Government was already under fiscal pressure prior to the November riot from a 2005 agreement to raise civil service salaries by a huge 60–80%, and from payout packages resulting from a consequent 18.5% cut in the civil service in mid-2006. The FY2006 budget deficit was estimated to have deteriorated to 6.1% of GDP (inclusive of payouts), and required financing by the sale of state assets as well as foreign borrowings. Fiscal pressure later intensified because of the need to support economic recovery and reconstruction of the capital.

November's riots damaged many businesses that were uninsured against civil unrest, as well as infrastructure. Reconstruction costs will probably exceed $50 million and reestablishing businesses and confidence in the sector will be a medium-term exercise. The impact on aggregate expansion will depend on the speed with which plans for urban reconstruction and business recovery are formulated and implemented, and on the private sector response. The economy is likely to show no change in output in FY2007 as public service reductions and the damage caused by the riot are offset by the start of urban reconstruction. Growth is expected to resume at 2.7% in FY2008 as construction continues to pick up and services strengthen (Figure 2.33.24). The inflation rate is forecast to accelerate to 10.0% in FY2007, reflecting public service wage rises feeding into the private sector and post-November 2006 supply shortages. A deceleration of inflation to 9.0% is expected in FY2008.

The Government has requested significant donor assistance and the fiscal outlook will depend largely on the appraisal of reconstruction needs. It is anticipated that the current account deficit will widen as urban reconstruction gets under way, but that the provision of donor funds for this purpose will support foreign reserves. Remittances will

2.33.24 GDP growth and inflation



Sources: Statistics Department, *Statistical Bulletin on Consumer Prices*, December 2006; Ministry of Finance, *Budget Paper No. 1*, June 2007.

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take on a new importance in this regard and are expected to provide an informal social safety net during reconstruction. A new strategic development plan approved by the Cabinet prior to FY2007 budget formulation will continue to serve as the key document identifying development objectives and strategies, despite an inevitably greater emphasis on urban reconstruction. Core objectives include strengthening the weak governance environment and promoting private sector-led growth. The latter involves a move away from trying to pick winners and offering special incentives toward improving the business environment by providing a stable macroeconomic environment, investing in physical infrastructure, improving the legal and regulatory framework, and investing in education and health. The momentum for economic and public sector reforms elaborated in the plan needs to be maintained if medium-term growth prospects are to improve.

Tuvalu

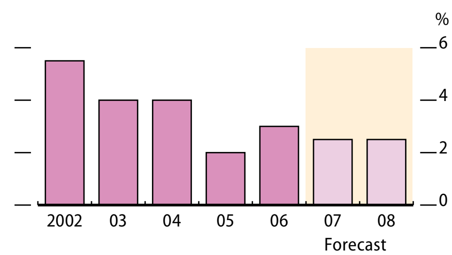
GDP growth was estimated at 3% in 2006, up 1 percentage point from 2005 (Figure 2.33.25). Public sector expenditures jumped by about 25% to A$30.6 million in 2006, largely a result of increased donor assistance. Of particular importance were injections of aid for construction of the Funafuti power station and an upgrade of the Tuvalu Maritime Training Institute for seafarers. Remittances from seafarers working on foreign-owned vessels are a vital source of income and contributed about A$4 million in 2006. Fishing license fees were less than expected because of lower catches and telecommunications license fees declined. Income from the country's ".tv" domain name was projected at A$2.9 million in 2006, similar to 2005. Tuvalu uses the Australian dollar as legal tender and inflation tends to track the Australian rate. In 2006 Tuvalu recorded inflation of 3.8%.

Fiscal revenues, including grants, totalled A$28.6 million last year (Figure 2.33.26), and expenditures A$30.6 million. The deficit of A$2 million was financed from the Government's Consolidated Investment Fund, which is augmented with earnings from the Tuvalu Trust Fund (TTF) provided that the trust fund's market value exceeds its inflation-adjusted value, as measured by the Australian consumer price index. The TTF, valued at about $77 million in September 2006, plays an important role in maintaining financial sustainability. It contributed A$11.4 million last year to the Consolidated Investment Fund. Government revenues are projected to rise to A$34 million in 2007, including A$20 million of grants. Expenditures are forecast to rise sharply by 27% to A$39 million. The A$5 million deficit will be financed from the Consolidated Investment Fund.

Donors are a key source of funding for the public sector. In 2007, Taipei,China and the European Union are expected to contribute A$2.6 million and A$2.2 million, respectively. A project to upgrade the Funafuti port facilities will also be supported by external assistance.

The TTF is expected to distribute A$6.9 million to government resources this year, a third successive distribution after no distributions in 2002–2004, when returns on TTF assets were insufficient to both protect the real value of the fund and allow for a distribution. This

2.33.25 GDP growth



Sources: Ministry of Finance and Economic Planning, *Tuvalu National Accounts Report*, January 2004; staff estimates.
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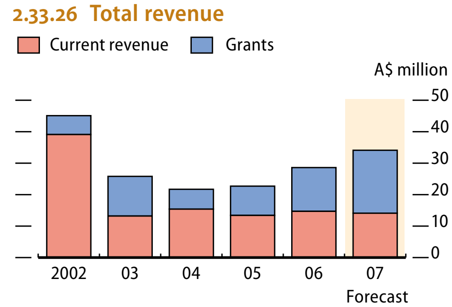
2.33.26 Total revenue



Sources: Ministry of Finance and Economic Planning, *Tuvalu National Accounts Report*, January 2004; staff estimates.
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flow of funds to the Government depends on the performance of international capital markets.

Economic growth of 2–3% is projected for 2007 and 2008, driven largely by donor-funded public investment projects. Inflation is forecast at about 3% annually. Earnings from the TTF are expected to allow for a distribution in 2008, but income from telecommunications and fishing licenses is unlikely to increase significantly.

Seafaring provides an important employment opportunity for Tuvaluans, particularly those from outer islands. The equivalent of 15% of the adult male population was working on ships in early 2006. However, this source of employment has been at risk owing to instances of on-board discipline problems in 2006, as well as unreliable air services to transport the seafarers from Tuvalu. These issues need to be resolved if remittances are to be maintained.

The new Government elected in August 2006 is concerned about disparities in living standards between Funafuti and the outer islands. While more than half the population lives on the outer islands, they account for 76% of the households in the bottom fifth of the income scale, though there is little absolute destitution in Tuvalu. Efforts to improve living conditions in the outer islands will put pressure on the budget.

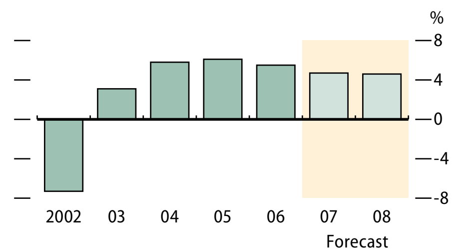
Vanuatu

The economy grew by an estimated 5.5% in 2006, a fourth straight year of growth (Figure 2.33.27) but at a reduced pace compared with 2004 and 2005. Growth moderated in the services sector, where solid expansion still was recorded in tourism-driven transport, hotels, and restaurants, and the real estate subsectors, and in the small industry sector. Agriculture lifted production, recovering after a contraction in 2005. Vanuatu's economy is based primarily on small-scale agriculture, which provides a livelihood for about 65% of the population (primarily in the informal sector). Fishing, offshore financial services, and tourism are other mainstays. Tourist arrivals rose by about 6% in the first quarter of 2006.

The fiscal position in 2006 (a deficit estimated at 0.5% of GDP), rate of inflation (about 1.6%), and level of international reserves (7.5 months of import cover) were noteworthy outcomes given that the Government needed to fund an increase in public sector wages resulting from a late-2005 decision of the Government Renumeration Tribunal, despite there being no provision for the additional expenditure in the 2006 budget. This apparently was achieved through greater fiscal discipline, improved tax collection, and a reduction in unbudgeted spending. The downside is that cuts in recurrent and capital expenditures exacerbate a basic problem, namely, improving the strategic allocation of public resources to productive uses.

Even with what is a respectable level of growth by Pacific standards, Vanuatu is struggling to move ahead as its annual population growth is 2.6%, one of the highest rates in the subregion. GDP per capita is lower now than 20 years ago (Figure 2.33.28) and the population outside the towns has not seen a rise in the standard of living. Unlike many other Pacific nations, Vanuatu does not have easy access to migration and/or overseas work opportunities to reduce this population pressure.

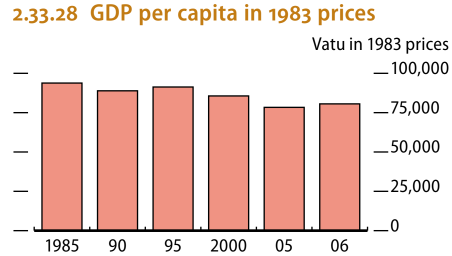
2.33.27 GDP growth



Sources: Vanuatu Statistics Office, *National Accounts of Vanuatu 2005*, November 2006; International Monetary Fund, *2006 Article IV Consultation*, March 2007; Ministry of Finance and Economic Management, *Half-Year Economic & Fiscal Update*, 30 July 2006.

Click here for figure data

2.33.28 GDP per capita in 1983 prices



Sources: Vanuatu Statistics Office, *National Accounts of Vanuatu 2005*, November 2006; International Monetary Fund, *2006 Article IV Consultation*, March 2007; Ministry of Finance and Economic Management, *Half-Year Economic & Fiscal Update*, 30 July 2006.

Click here for figure data

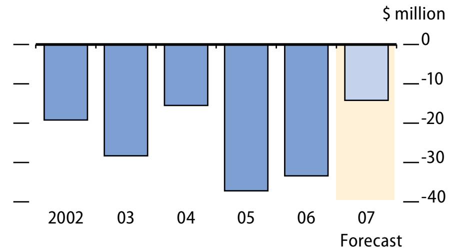
Another concern is a long-standing current account deficit (Figure 2.33.29), which reflects the economy's narrow base and susceptibility to global developments such as increases in prices of imported oil. External debt remained stable at around 31% of GDP in 2006 and is forecast to drop to 18% of GDP by end-2008, as loans are repaid (no new borrowing is planned).

Stronger economic growth is required to generate employment and ensure access to basic social services. Areas requiring attention include enhancing the performance of public enterprises and facilitating private sector development. In particular, the private sector is hampered by political instability and weak governance; the high costs of doing business (high input costs as well as high risks and transactions costs); weaknesses in the commercial legal framework; difficulties in mobilizing land for productive uses; and capacity constraints in the private and public sectors. The Government is tackling these issues through a Priorities and Action Agenda, but turning it into practical action is an ongoing challenge.

Development of rural infrastructure will be supported through a Millennium Challenge Corporation Compact of $65.9 million, expected to be spent between 2007 and 2011. The compact will include funding for 11 transportation infrastructure activities designed to benefit poor rural agricultural producers and providers of tourism-related goods and services.

The Government forecasts growth of 4.6–4.7% in 2007 and 2008. Tourism is expected to benefit from an expansion of air services and the completion of tourism projects, construction will gain from Millennium Challenge Corporation spending, and agricultural production is forecast to pick up further. Small budget surpluses or near-balance positions are expected, and inflation is projected to accelerate to 2.5% (Figure 2.33.30). Domestic risks to this outlook include political instability, which could lead to ineffective public policy and harm investor confidence; lack of progress in implementing and enforcing antimoney-laundering laws, which could expose the country to financial sanctions; and vulnerability to natural disasters.

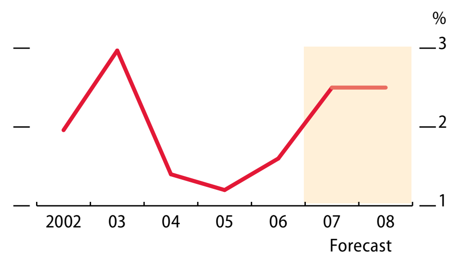
2.33.29 Current account balance



Sources: Reserve Bank of Vanuatu, available: http://www.rbv.gov.vu/, downloaded 29 June 2006; Ministry of Finance and Economic Management, *Half-Year Economic & Fiscal Update*, 30 July 2006.

Click here for figure data

2.33.30 Inflation



Sources: Vanuatu Statistics Office, available: http://www.vanuatustatistics.gov.vu/, downloaded 29 June 2006; International Monetary Fund, *2006 Article IV Consultation*, March 2007; Ministry of Finance and Economic Management, *Half-Year Economic & Fiscal Update*, 30 July 2006.

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