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

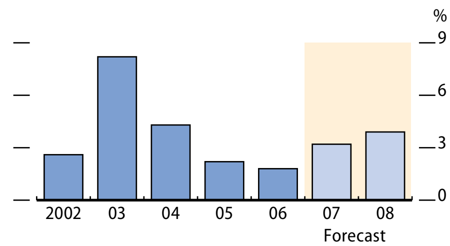
Gross domestic product (GDP) growth for FY2006 (ended 30 June 2006) was estimated at 1.8%, slowing from 2.2% in FY2005 (Figure 2.33.1). The agriculture sector was hurt by five cyclones that hit the islands in early 2005. Fisheries income was little changed from a year earlier, but the value of pearl 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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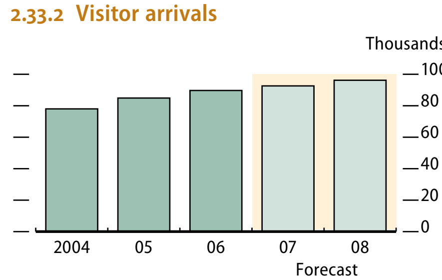
2.33.2 Visitor arrivals



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.

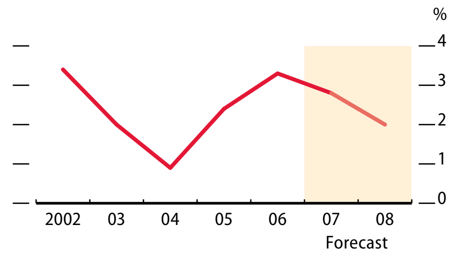
Kiribati

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

2.33.3 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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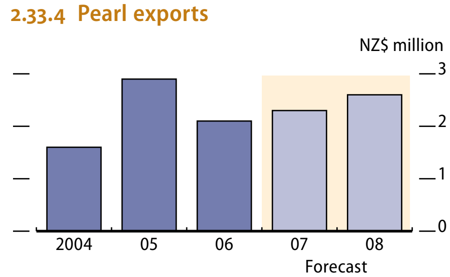
2.33.4 Pearl exports



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

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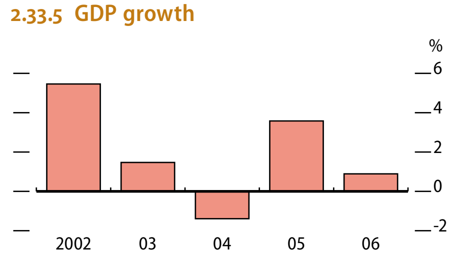
2.33.5 GDP growth



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.

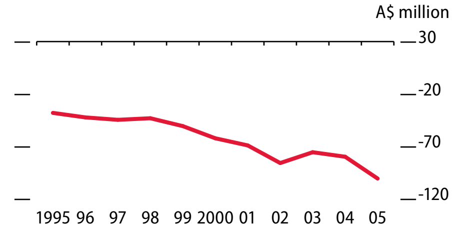
Tourism could be an avenue of development, especially in Kiritimati, which offers game fishing, natural beauty, and has potential for bird-watching and diving, but it is held back by the high cost of travel and inadequate infrastructure.

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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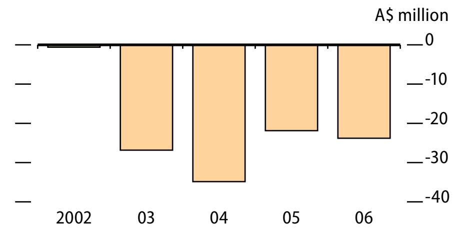
2.33.7 Budget balance



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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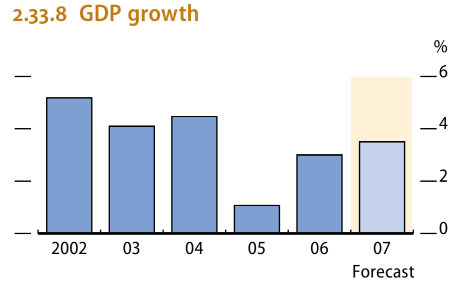
2.33.8 GDP growth



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.

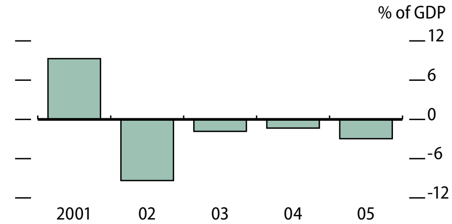
The current account surplus continued to decline in FY2006 to 4.8% of GDP (Figure 2.33.10). Official reserves of $1.5 million at end-2006 were sufficient to cover just 1 week of imports. However, a guaranteed flow of Compact funds reduces pressure on the Government to act on the external account weakness. 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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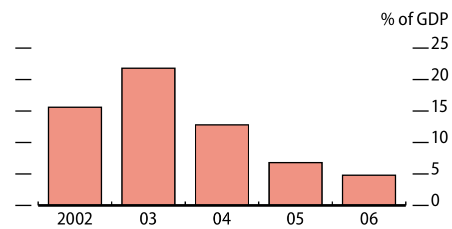
2.33.10 Current account balance



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

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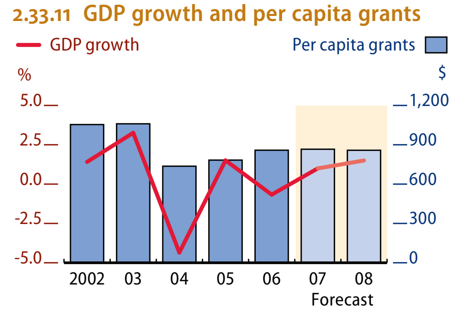
2.33.11 GDP growth and per capita grants



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.

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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.

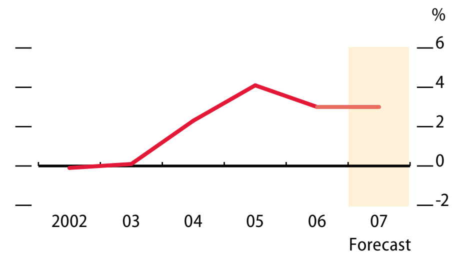
Inflation slowed to an estimated 3.0% in 2006 (Figure 2.33.12). External debt service indicators suggest that external debt is manageable (Figure 2.33.13), but this, too, is expected to come under pressure as Compact grant receipts decline from FY2007. The federal and state governments may seek alternative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

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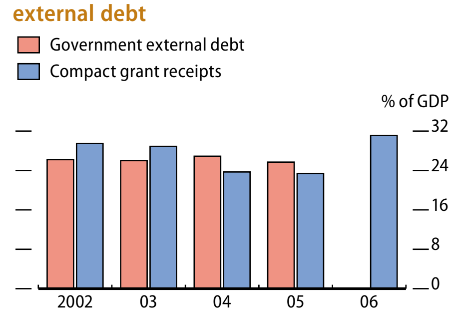
2.33.13 Compact grant receipts and external debt



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.

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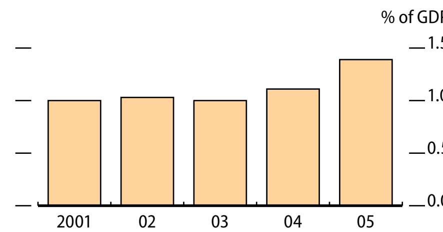
reforms in the Strategic Development Plan 2004–2023 and, in effect, FSM is at least 2 or 3 years behind in its plan for self-sufficiency by 2023. The public appetite for reform needs to be developed so that difficult decisions that the Government has to take, which will affect employment and provision 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.

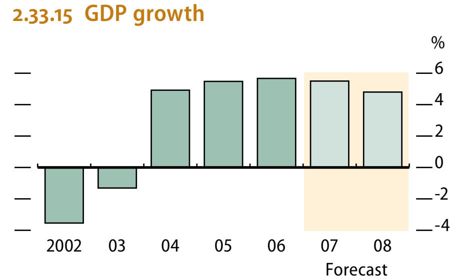
Achieving economic growth in the medium term will depend on the phosphate industry. Primary phosphate reserves are expected to last until 2009 or 2010, and a recent study suggested that it may be economically viable to mine residual phosphate reserves, in conjunction with the rehabilitation of mined 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.

Click here for figure data

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.

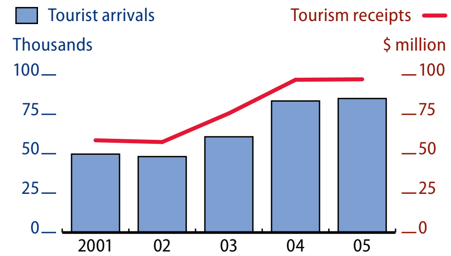
The Government is hopeful that it can renegotiate the Compact so that it provides for grants beyond 2009, but it has to achieve greater fiscal self-reliance in preparation for potential funding shortfalls. The official target is to cut annual recurrent expenditures from about $60 million–$65 million 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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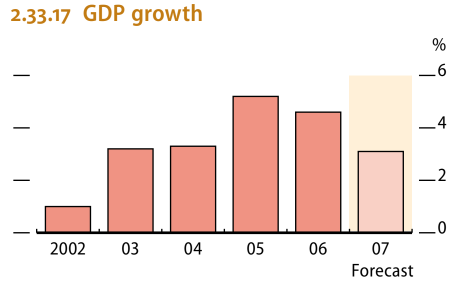
2.33.17 GDP growth



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

Click here for figure data

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.

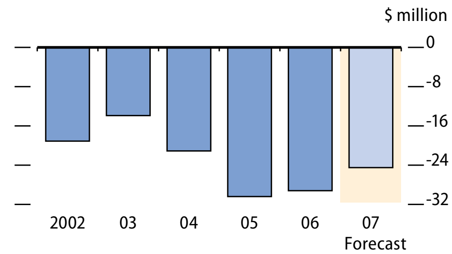
An overall budget deficit representing 0.4% of GDP was recorded in FY2006 (Figure 2.33.19), compared with a deficit target of 4.3% of GDP. The Government financed the deficit from its reserves, and reduced its external debts from the equivalent of 41.3% of GDP in June 2005 to 40.2% of GDP in June 2006.

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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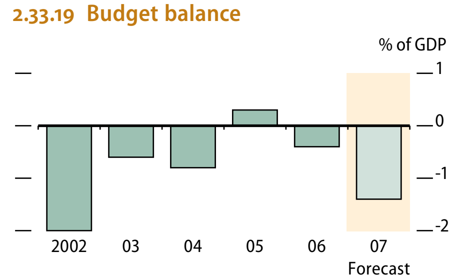
2.33.19 Budget balance



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

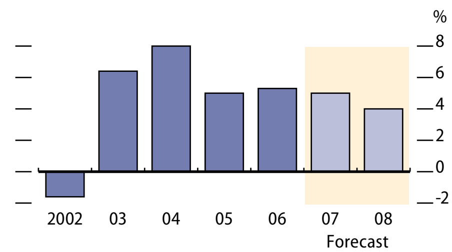
A short period of civil unrest following elections in April 2006 had a fairly small impact on the overall economy. Riots broke out in the capital, Honiara, after a new prime minister was named, resulting in serious damage to property. The Regional Assistance Mission to Solomon Islands (RAMSI), an initiative 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.

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.

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%,

2.33.20 GDP growth



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

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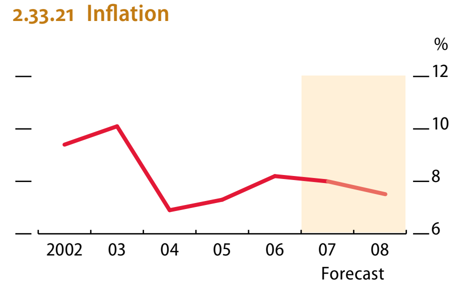
2.33.21 Inflation



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

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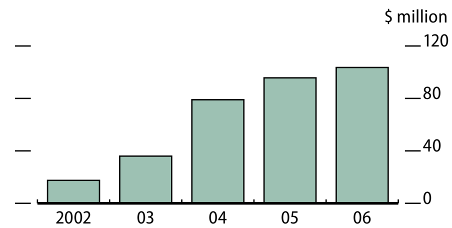
through a pickup in donor-funded project expenditures and a doubling of government-funded capital outlays. Administrative and technical capacity constraints will make it difficult to fully spend the development budget allocations.

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.

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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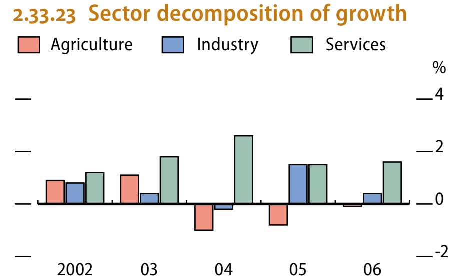
2.33.23 Sector decomposition of growth



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

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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

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.

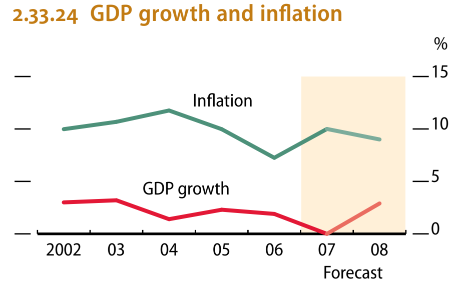
Given the fall in exports, a 21% jump in credit, partly to fund housing, raised concerns about a possible rundown in foreign reserves to less than the target of 3–4 months cover of goods imports. In January 2006, the National Reserve Bank of Tonga moved to protect foreign reserves by imposing credit 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

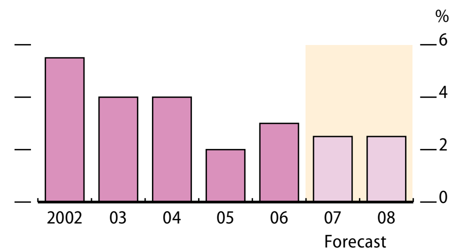
GDP growth was estimated at 3% in 2006, up 1 percentage point from 2005 (Figure 2.33.25). Public sector expenditures jumped by about 25% to A$30.6 million in 2006, largely a result of increased donor assistance. Of particular importance were injections of aid for construction of the Funafuti power station 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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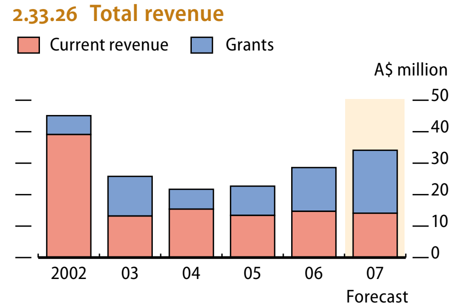
2.33.26 Total revenue



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.

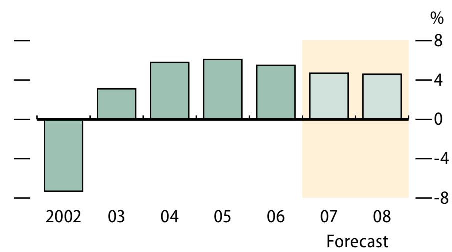
Vanuatu

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.

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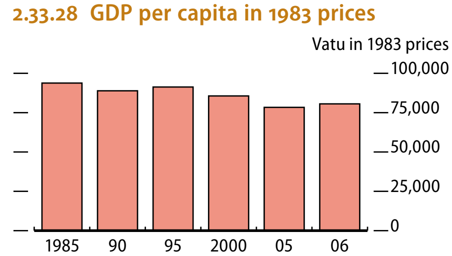
2.33.28 GDP per capita in 1983 prices



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.

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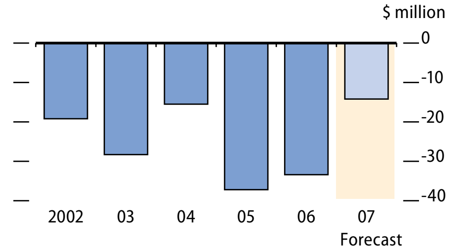
Another concern is a long-standing current account deficit (Figure 2.33.29), which reflects the economy's narrow base and susceptibility to global developments such as increases in prices of imported oil. External debt remained stable at around 31% of GDP in 2006 and is forecast to drop to 18% of GDP 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.

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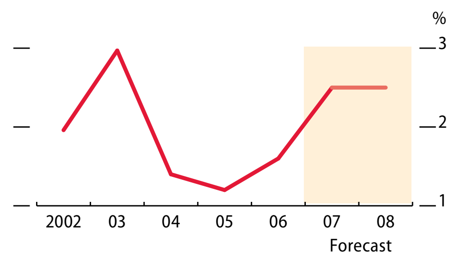
2.33.30 Inflation



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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