Small Pacific countries

Modest growth in the 2–5.5% range was recorded for most of the smaller Pacific island economies in 2005, reflecting contributions from aid flows, commodity exports, fishing, remittances, tourism, and trust funds. The rise in global oil prices reduced the gains from these favorable influences, because these mostly remote and import-dependent economies rely on oil products for their air and sea transportation as well as power generation.

International aid remained a key factor for several economies. The Marshall Islands and the Federated States of Micronesia benefited from funds provided by a renewed Compact Agreement with the United States. Compact funds also supported economic development in Palau and aid projects provided significant support for Solomon Islands and Tuvalu. The strength of international capital markets boosted the market value of trust funds that provide income for a number of countries, namely Kiribati, Marshall Islands, Federated States of Micronesia, and Tuvalu. Income from remittances remained at high levels in Samoa, Tonga, and Tuvalu.

Fish products are important exports for Samoa, Solomon Islands, and Tonga, and fish license fees are sources of income for Kiribati, Marshall Islands, and Tuvalu. However, fish harvests in 2005 were below usual levels in some countries, especially Cook Islands, Kiribati, and Tuvalu, generating concern about falling stocks of certain species. Other merchandise exports in the Pacific are largely commodity based, and buoyant prices for coconut oil and copra helped several countries. Solomon Islands' exports benefited from strong international demand for timber. Tourism provides significant income for Cook Islands, Palau, Samoa, Tonga, and Vanuatu as tourist arrivals in these countries recorded robust growth. Inflation was generally contained in the 2–3% range in year-average terms, but remained much higher in Samoa, Solomon Islands, and Tonga.

Slightly higher growth rates are expected for most of the economies in 2006, based on a continuation of the favorable environment for international tourism, commodity prices, financial markets, aid, and remittances. Weaker growth is expected for Samoa and Tonga. If oil prices are fairly steady, inflation should remain at low to moderate levels, though Solomon Islands and Tonga are expected to record inflation of 7–8%, reflecting fiscal and current account pressures. Economies facing fiscal pressures are expected to manage deficits with the assistance of aid flows.

Cook Islands

Gross domestic product (GDP) growth for FY2005 (ended 30 June 2005) was estimated at 3.0%, slowing from 4.2% in FY2004, mainly as a result of five cyclones in February–March 2005. The economy has been growing sustainably since 1998, with tourism, retail and wholesale trade, agriculture, fisheries, and transport and communications as the major contributing sectors (Figure 2.33.1). Activity at the Offshore Financial Center also picked up during 2005, after the country was removed from the blacklist of the Organisation for Economic Co-operation and Development Financial Action Task Force in February.

Inflation in FY2005 increased to 1.7%, mainly due to higher imported oil prices. Domestic commercial bank lending grew strongly by 11% over the course of the year, reflecting both the funding for cyclone-related reconstruction and the solid economic growth.

The planned removal of import levies from 1 July 2006 will, it is estimated, lead to a 2.2% one-time reduction in overall market prices. However, inflation is forecast to average 2% in FY2006–FY2007, largely mirroring inflation in New Zealand, by far the largest trading partner (the Cook Islands uses the New Zealand currency).

Tourism, the main industry, generated about NZ$108.5 million in FY2005, representing some 40% of GDP. In calendar 2005, total tourist arrivals and revenues strengthened by 8.9% and 10.7%, respectively, bolstered by competitive airfares and a new direct flight to and from Christchurch, New Zealand, by Pacific Blue. Tourist arrivals are likely to increase by about 4% annually in the next couple of years and, together with remittances, will be the mainstay of the economy.

Pearl farming is a growing industry. Its export revenue had increased in FY2004 by 84% to NZ$2.9 million, marking a continuing recovery from an algae outbreak in 2001. Although fishing exports have also grown in recent years (except FY2004), the sector faces problems associated with overfishing, adverse weather conditions at times, and seasonal fish migration. Most agricultural products are consumed domestically rather than exported, reflecting a lack of scale and relatively high local costs, though greater tourist numbers may well stimulate production in the local agro-industry.

Pearl export earnings are expected to rise to NZ$4.2 million and NZ$5.0 million in FY2006 and FY2007, respectively. Fish exports could increase by 20% in FY2005, returning to earlier years' levels following a decline in FY2004. Overfishing needs to be addressed at a regional level given the migratory nature of fish stocks. The lack of a regional strategy and agreement on a sustainable catch level is creating uncertainty about the long-run viability of the fishing industry.

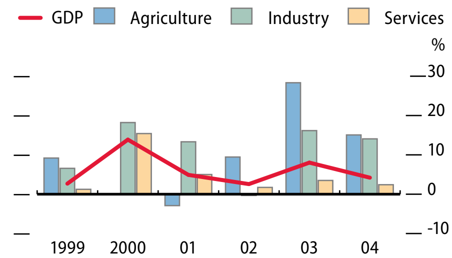
Imports were equivalent to about 50% of GDP in FY2005, mostly sourced from New Zealand. The trade and services balance recorded a surplus of NZ$46 million in FY2005, reflecting a 13.5% decrease in merchandise imports compared with the previous year.

A fiscal surplus of 3.1% of GDP was recorded in FY2005. In 1998, the Government made a commitment not to borrow commercially for 7 years under the terms of the Manila Agreement of 1998, which restructured the country's external debt. At end-June 2005, public debt was at a manageable level of 34.3% of GDP. The Government has not resumed commercial borrowing as yet.

GDP is forecast to grow by 3.5% in both FY2006 and FY2007 (Figure 2.33.2). The goods and services surplus is estimated to rise to about 18% of GDP in these years.

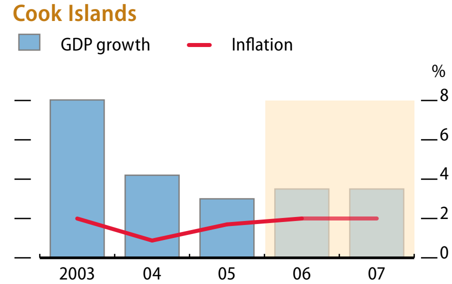
The economy is narrowly based, on a small scale, and subject to the risks of extreme weather. Emigration opportunities provide one of the strongest safety nets, since Cook Islanders have legal access to both the New Zealand labor market and its welfare benefits. Nationals living overseas provide substantial income support to their families still in the country. Tourism prospects are likely to stay robust, though the industry

2.33.1 GDP growth by sector, Cook Islands



Source: Cook Islands Statistics Office, available: http://www.stats.gov.ck/Economic/economics.htm, downloaded 9 December 2005.

2.33.2 GDP growth and inflation, Cook Islands



Sources: Cook Islands Statistics Office, available: http://www.stats.gov.ck/Economic/economics.htm, downloaded 9 December 2005; staff estimates.

has some problems recruiting employees. There are also concerns over a dilution of the Cook Islands-Maori culture, which could erode the unique attributes of the country as a tourist destination.

Kiribati

Economic growth slowed from an estimated 3.3% in 2004 to 0.3% in 2005, stemming from a fall in fishing license fees in previous years (Figure 2.33.3). In 2001, revenue from these fees amounted to A$46.6 million, dropping to A$24.5 million in 2004, reflecting a cyclical downturn in the catch from Kiribati's exclusive economic zone. Tourism remains limited, except on Christmas Island, where game fishing is popular. The public sector dominates the formal sector.

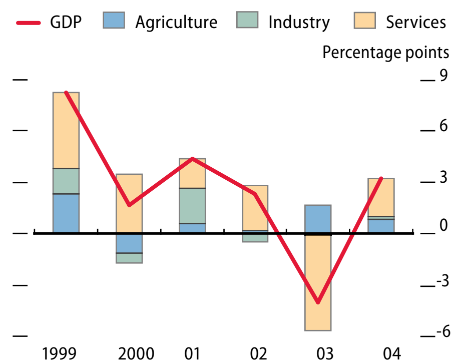
The overseas earnings received from fishing license fees, income from the Revenue Equalization Reserve Fund (RERF), and seafarers' remittances make the country's gross national product (GNP) about 70% higher than its GDP. The narrow production base renders the economy vulnerable to external shocks. At the same time, however, external earnings offer some buffer. The Government, through the RERF and the Kiribati Provident Fund, as well as the only commercial bank, Bank of Kiribati, holds substantial financial assets offshore. These have for the most part been invested prudently and have performed well. External debt was about 25% of GDP in 2005. In the first quarter of the year, official reserves, mainly the asset base of the RERF, remained significant, at the equivalent of more than 4 years of imports.

Public domestic revenue increased from A$55.7 million in 2004 to an estimated A$60.5 million in 2005, external grants-in-aid increased from A$49.7 million to about A$62.7 million, and overall government financial resources rose from A$105.5 million to A$123.2 million. However, this was exceeded by recurrent and development expenditures of A$145.8 million. Drawdowns from the RERF have covered the deficits, but this has led to apprehension that the RERF's value could be entering a long-term decline. The Government is reviewing the management arrangements of this fund.

In the medium term, the economy is vulnerable to climate change (rising sea levels) and fluctuations in global commodity prices (copra is a major source of export income, and the country imports most other commodities, including petroleum products). The atolls face a loss of causeway infrastructure and erosion of the coastline at high tide. Growth potential is limited to marine resources, agriculture, and tourism. Overall population growth and overcrowding on the main atoll must be tackled if living standards are to improve. Although the economy benefits from a strong external asset position, very limited growth of GDP is projected over the medium term.

Budget reforms are a focal point of the public sector reform program. The Ministry of Finance and Economic Development maintains a multiyear budget framework to link the development planning and budgeting processes, though the links between the two systems remain inadequate. As much as 30% of government expenditure, comprising aid agency contributions to the development budget, is outside the scrutiny of the Government, apart from auditor general reports. Little is known publicly about disbursements at local government level (island councils).

2.33.3 Contributions to growth (supply), Kiribati



Source: Republic of Kiribati, *2005 Budget*, 2 December 2004.

The accounts of public enterprises are subject to little oversight, except when they overspend.

The Government plans to establish standards for several public enterprises so as to improve their prospects for successful commercialization and privatization. On the revenue side, the introduction of a broad-based tax on wholesale and retail sales is proposed for 2007. There is also room to improve the effectiveness of donor funding, particularly by expanding commitment of government funds for development purposes and by increasing financing for basic infrastructure.

Republic of the Marshall Islands

Economic activity picked up in 2005 with GDP rising by 3.5%, largely reflecting an expansionary fiscal stance and some growth in agriculture (Figure 2.33.4). Growth has also been supported by increased funds from a new financial agreement with the United States (US) under the Compact of Free Association. Inflation is estimated to have risen to an annual rate of 3.5%.

The fiscal position deteriorated in FY2005 (ended 30 September 2005) to an estimated deficit of 2.4% of GDP, mainly because actual revenue was lower than expected. Current expenditure changed little but capital spending rose markedly, supported by aid disbursements. External debt stood above 75% of GDP in FY2005. Around 60% of the debt is on concessional terms, but total debt service payments were relatively high at around 24% of exports of goods and services and are expected to increase as grace periods on a number of loans expire. The current account surplus narrowed in FY2005, reflecting higher imports of capital goods and the late-2004 closure of the tuna processing plant in Majuro.

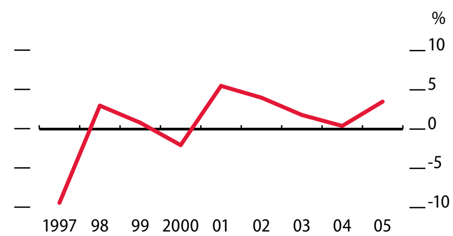
Growth, driven by external assistance, has been unstable over many years, which has done little to support private sector development. The private sector's share of GDP has fallen from 38% in 2000 to 35%. Although in 2000–2004 overall private employment grew, by about 20%, this was mainly attributable to the opening of the tuna loining plant in 1999, but the plant's subsequent closure led to the loss of around 600 jobs.

The public sector, including state enterprises, continues to dominate the economy, including ownership and operation of interisland shipping services, air transport, and utilities. Government expenditure is typically 70–80% of GDP. Tourism receipts are usually about 3–5% of GDP, as are fishing license fees. Copra income is around 1% of GDP. As with many Pacific island countries, it is likely that emigrants provide income support to their families still living in the home country, but the amount of such remittances is unknown.

Over the medium term, the economy will continue to be dominated by the public sector, supported heavily by Compact funds. The presence of the US Ronald Reagan Missile Test Site on Kwajalein Atoll also provides some demand for local goods and services. Economic growth of 3.5–4% is projected in FY2006 and FY2007, reflecting essentially increased public spending on capital projects.

Although the medium-term fiscal position is likely to be relatively stable, Compact grant funding will decrease by $500,000 a year, and

2.33.4 GDP growth, Republic of the Marshall Islands



Sources: Economic Policy, Planning and Statistics Office, *Statistical Abstract 2001*, 24 April 2003; staff estimates.

consequently the Government will need to continue to improve its domestic revenue generation (and reduce expenditure by streamlining the public sector).

A long-term constraint relates to land tenure and lending security—there are few official records that provide clear legal evidence of ownership rights to land. Legislation was passed in 2003 to establish a land registry but minimal progress has been made in actually registering land. Nor is there an effective framework for secured lending.

In terms of risks, the economy remains vulnerable to the impact of such factors as delays in grant disbursements; the migratory nature of fish stocks, which was a factor in recent decreases of fishing and associated revenues; and increases in world fuel prices.

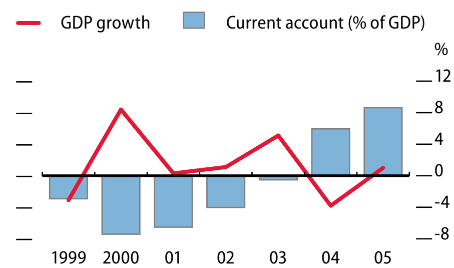
The Government faces a major challenge in ensuring that Compact funds contribute to economic development and poverty reduction. Unemployment has risen steadily since independence in 1986 and is estimated to have peaked at nearly 34% in 2004. Youth unemployment of 63% (1999 census) is the highest in the Pacific. It has been estimated that 20% of the population lives on less than $1 a day and that poverty and hardship have increased not only on the outer islands but also in the major urban centers of Majuro and Ebeye. Unemployment and social stress have contributed to an increasing incidence of violent crime, youth suicide, and substance abuse. If this continues, many of the remaining Marshallese may leave the country to seek better opportunities elsewhere. As for other Pacific island countries, the opportunity to migrate, in this case to the US, provides a valuable safety valve for the local population.

Federated States of Micronesia

The economy recorded growth of about 1% in 2005, reflecting a small increase in funds under the Compact of Free Association with the US, after contracting in 2004 when foreign grants fell (Figure 2.33.5). An expanded public works program, as well as some tourism, contributed to the recovery in 2005. The general government sector recorded a modest deficit. Government debt remained at comfortable levels, largely reflecting prudent fiscal policies in the past and reliance on grant funding. Inflation remained low, a consequence of the use of the US dollar as the domestic currency and continuing low inflation in the country's main trading partners. Low tax revenue is a source of weakness in government accounts, particularly in the states of Chuuk and Kosrae.

Over the medium and longer term, the economy is expected to remain heavily reliant on the public sector, supported by Compact revenue and grants. Although funds under new Compact arrangements are substantially lower in real terms than under the first Compact agreement (which ended in 2001, with an additional 2 years of economic assistance being committed by the US), grant funds are equivalent to about 40% of GDP (Figure 2.33.6). The amended Compact came into effect in FY2004 (ended 30 September), and provides grant funds of $92 million each year (partially indexed for inflation). Initially, $16 million annually is to be saved in a trust fund, but from FY2007 the amount saved will increase by $800,000 a year until trust fund contributions are about 30% of total Compact funding. There is also access to separate additional US program

2.33.5 GDP growth and current account, Federated States of Micronesia

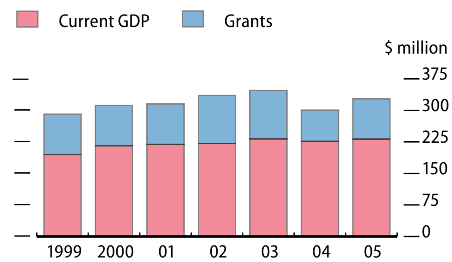


Sources: Department of Economic Affairs, *Economic Review*, October 2002; Federated States of Micronesia authorities in *International Monetary Fund Country Report No. 05/104*, March 2005.

assistance. The amended Compact requires adoption of a number of rules and performance measures for the use of public funds. The trust fund has been established to help replace reliance on annual Compact funding, though clearly such a mechanism is unlikely to provide a sustainable source of income if the Government borrows heavily while building up the fund. In this case, the rules associated with the use of public funds are notable for establishing controls that extend beyond the trust fund and recognize the need to take a "whole-of-government" perspective in determining the fiscal position of the Government and the country.

The economy needs to adjust to a lower level of grant funding and to become less reliant on public sector activity and public enterprises. Sizable budget surpluses will be required to build up the trust fund to the required level, which will create considerable pressure for fiscal reform. For several years, the Government has attempted to implement a program of public sector reform and private sector development, but progress is slow. No significant privatization of public enterprises has been carried out since initial reductions in Compact assistance in the early 1990s, though reliance of public enterprises on government subsidies has declined since then.

2.33.6 Grants and GDP, Federated States of Micronesia



Sources: Department of Economic Affairs, *Economic Review*, October 2002; Federated States of Micronesia authorities in *International Monetary Fund Country Report No. 05/104*, March 2005.

The federal system of government, with a national Government and four state governments, makes it hard for all parties to agree on policy priorities and on planning, coordination, and implementation. It is difficult to obtain legislative backing for planning initiatives, and infrastructure investment plans have not been integrated into sector development approaches. This is particularly important for tourism, where meeting infrastructure needs will be critical for its development.

Foreign investors could help the private sector to develop, but they are likely to be deterred by a lack of a clear and credible signal of federal and state government commitment to reform, including the changes required to improve access to land and to develop an environment conducive to investment. The introduction of a value-added tax (VAT), which is under consideration, would help improve the credibility of government policies and facilitate private sector development.

Adjustment to reduced grant funding is likely to be easier to the extent that remittances become a source of income. Emigration is an important part of the relationship with the US, with citizens having the right to seek employment there. The volume of migration has increased substantially since the second stepdown in US grant aid in 1997, and an estimated 30,000 nationals now live outside the country. As a result, population growth has slowed from about 2% in the mid-1990s to virtually zero.

Migration to the US is a useful escape valve that helps integrate the country into the world economy. Remittances provide income support and returning emigrants offer the prospect of bringing back newly acquired skills and capital. In this respect, policies to build up both the population's basic skills and links between emigrants and their homeland are likely to play a major role in supporting the economy.

Nauru

This economy, which depends heavily on foreign development assistance, remained in a critical condition in 2005. There is now little benefit from the Australian Offshore Processing Centre (for asylum-seekers to Australia), with operations at that facility substantially reduced. Income-earning opportunities are now very few.

For many years, Nauru has run chronic budget deficits to maintain the levels of expenditure of its high-income-earning years. Fiscal deficits were largely financed by offshore borrowings against the assets of the Nauru Trust Funds, which led to unsustainable levels of public debt. In 2005 though, the Government achieved a fiscal surplus of A$1.6 million, mainly because of income from an earlier investment in the Philippine Phosphate Fertilizer Corporation (Philphos) and a loan repayment from the Cook Islands. The Government is expected to receive approximately A$5 million a year until early in the next decade from its investment in Philphos. Against this, the net value of the Nauru Trust Funds has greatly diminished and they will likely provide only minimal income in the future.

Even though the FY2006 budget was originally expected to be in surplus, the Government has since forecast a significant deficit, reflecting continuing high expenditure and lower income as one-time revenue sources are exhausted (Figure 2.33.7). The budget deficit will also increase further once the revenue stream from the Philphos investment ends.

Reflecting its long-standing, dire financial position, Air Nauru's only aircraft was repossessed in December 2005 on behalf of the Export-Import Bank of the United States. Air Nauru has never recorded a profit and has been a long-term drain on the budget.

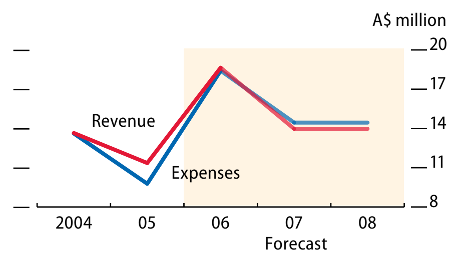
In June 2005, the Government appointed Astro Pacific of New Zealand to manage the Republic of Nauru Phosphate company (Ronphos). Ronphos has assumed operations of the Nauru Phosphate Corporation (NPC) with a view to increasing primary mining. It is also investigating "secondary" mining (i.e., mining of low-grade deposits). In November 2005, the Government agreed with an Australian fertilizer company for it to refurbish some mining facilities at a cost of up to A$6 million. It is estimated that, at most, 3 to 5 years of primary phosphate reserves remain.

Inflation in 2005 was an estimated 3–4%, driven by inflation in Australia (Nauru uses the Australian dollar as its currency) and transport cost increases stemming from higher global oil prices.

The first donor roundtable meeting for Nauru was held on 30 November 2005, attended by over 170 participants from government, business, civil society, and the donor community. At the meeting, the country's president announced the Government's ongoing reform agenda and a national sustainable development strategy. Short-term priorities include reviving phosphate mining, establishing a commercial bank, developing the private sector, and improving returns to commercial fisheries.

Macroeconomic prospects are gloomy. The economic base, mainly phosphate extraction, will remain static in the short term, and very few income-generating opportunities other than phosphate mining and fisheries are available. In 2004, earnings from the export of phosphate ($640,000), the only merchandise export, failed to cover the cost of production. Secondary mining is the only beacon on the medium-term

2.33.7 Budget aggregates, Nauru



Notes: Aggregates for 2004 are adjusted for capital transactions; includes capital transactions of A$5 million a year from Philphos and A$1.07 million loan repayments from the Cook Islands; 2006–2008 figures are government forecasts.
Sources: Government of Nauru, *Republic of Nauru Budget*, various years.

landscape. The physical environment of Nauru island has been devastated by the long-term phosphate mining. In addition, many of the assets that were bought with phosphate income have turned out to be poor investments, and many were sold to repay debt. Net assets consequently provide limited income.

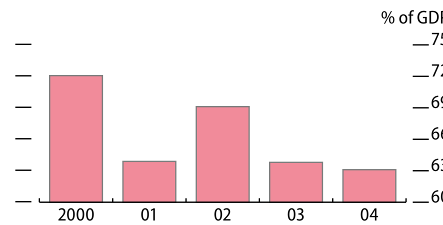
Agricultural production is constrained by inadequate rainfall and the low fertility of the scarce arable land. Substantial food imports are required, and rising transport costs have raised food prices. Food security will continue to be a great concern over the medium term.

Republic of Palau

Palau has the highest per capita income (per capita GNP of $6,870 in 2004) of the Pacific island countries. It receives substantial assistance from the US through the Compact of Free Association, with direct payments totaling about $410 million over 1994–2009. In recent years, annual disbursements have averaged about 20% of GDP, and have been used to create a Compact trust fund to enable Palau to provide perennial budget support after 2009, and to finance government operations.

The economy is dominated by the public sector. Public administration was estimated to account for 26–27% of GDP in 2005. Government businesses provide utility services and public sector demand is critical to construction, transportation, and trade. The ratio of public expenditure to GDP was estimated at 64% for FY2004 (ended 30 September 2004) (Figure 2.33.8).

2.33.8 Government expenditure, Republic of Palau



Note: FY2004 is a preliminary figure.
Source: Ministry of Finance.

Manufacturing is very limited, contributing around 1% of GDP. Construction is the most important industrial activity, at 8% of GDP, and is experiencing strong growth. The main projects are a Compact-funded, 85-kilometer highway on Babeldaob island and a new national capital in the state of Melekeok, also on Babeldaob. A loan of $20 million was obtained from Taipei,China to help fund the building of the new capital.

Tourism also provides a stimulus to the economy. The hotels and restaurants sector grew by 6% in 2004 and accounted for about 11% of GDP. Visitor arrivals totaled about 95,000 in 2004 and were estimated to have remained high in 2005. A US television series “Survivor: Palau” filmed over several months in 2004 and 2005 lifted the country’s tourist profile. A new Japan Airlines-affiliated hotel opened in 2005. Visitor receipts are estimated to have increased from about 40% of GDP in FY2002 to 80% of GDP in FY2004.

Merchandise exports are small relative to the size of the economy and are mainly fish, some agricultural products, and clothing. There is a high dependency on imports, with the ratio of imports to GDP in the range of 50–115% between 1998 and 2004. The US (including Guam) supplies about half of Palau’s imports. A wide trade deficit and net outflow of remittances have led to current account deficits in most recent years, despite a large services account surplus generated by tourism and official transfers. The overall balance of payments is reported to have been in surplus in most recent years.

Palau does not operate an independent monetary policy and it uses the US dollar as its currency. Inflation has been about 3% in recent years.

Palau has enacted new financial sector legislation and implemented an antimoney-laundering policy in recent years, though gaps remain and implementation capacity is limited. The National Development Bank, credit unions, and 12–16 remittance companies are currently outside the scope of prudential regulation.

The fiscal position highlights the potential adjustment facing the economy. Annual current expenditure is around $60 million–$65 million. The Compact specifies that US grants—the main source of operating grants to date—will largely cease in FY2009. This will leave domestically raised revenue of $30 million–$35 million a year, annual drawdowns of $15 million from the Compact trust fund, and a small amount of operating grants. The result is a looming shortfall in funding for current revenue of $15 million at current expenditure levels. Unless new operating grants are secured, substantial adjustments will need to be made to expenditure levels or domestic revenue collection just to cover operating costs.

Inward remittances from Palauans working overseas (citizens have the right to work in the US) are likely to be more than offset by outward remittances from foreigners—mainly from the People's Republic of China and the Philippines—working in Palau.

Economic growth of 5.7% is forecast in both 2006 and 2007, supported by aid projects and tourism. After that, the economy is expected to weaken as US Compact assistance declines. Tourism and income from remittances seem to offer the best long-term prospects, but there is considerable uncertainty given the prospective decline in external assistance.

Samoa

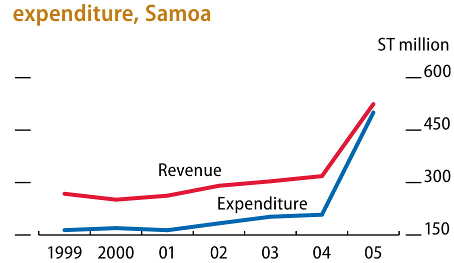
GDP grew by an estimated 5.5% in 2005, consolidating the growth of 3.7% in 2004. Tourism, agriculture, transport, communications, and construction contributed to the momentum. Export revenue increased by 18% in the second quarter of 2005 from a year earlier, on the back of higher exports of nonu juice, beer, and fish. Foreign reserves at midyear were ST231.6 million, equivalent to 5.9 months of import cover. Inflation remained high at about 8%, in part reflecting food price increases after Cyclone Heta in January 2004.

Agricultural production and fisheries grew by about 35% and 3%, respectively, in the second quarter of 2005 from a year earlier. Earnings from tourism continued to grow at about 4%. The Tourism and Hotel Development Incentive Act of 2003, which provides for investment tax credits, hotel income tax exemptions, and certain import duty concessions, has stimulated hotel construction. Lower production at Yazaki Samoa, which makes wire harnesses for vehicles, and which is the country's largest industrial venture, was the main reason for a decline in manufacturing in 2005.

The Government allocated more than ST14 million through May 2005 for construction of facilities for the 2007 South Pacific Games. Other infrastructure work under way includes roads, a seawall, and schools, financed with partner support.

Consideration is being given to allowing a second wireless operator to enter the market to compete against Telecom Samoa Cellular Limited,

2.33.9 Government revenue and expenditure, Samoa



Sources: Ministry of Finance, available: http://www.spc.int/prism/country/ws/stats/eco/eco_key_index.htm, downloaded 13 December 2005; staff estimates.

2.33.1 Pacific regional integration and cooperation

Regional integration and cooperation are important for Pacific island countries, especially the smaller islands, given their remoteness, small size, and narrow resource base. Governments of the Pacific have a mixed record in this area, but are making a renewed effort to address the issue. Heads of government of the Pacific Islands Forum (which includes Australia and New Zealand) approved a Pacific Plan for Strengthening Regional Cooperation and Integration (commonly known as the Pacific Plan) in October 2005. The plan is designed to improve cooperation among the 16 members, including 14 island member states (Timor-Leste is not a member) under four pillars: economic growth, sustainable development, good governance, and security.

An important aspect of the Pacific Plan relates to the benefits of greater labor mobility. Increasing quotas for temporary labor, equal to 1% of the workforces in Australia and New Zealand, would yield total estimated net benefits of about $1.4 billion over 3 years, mostly in wages paid to migrant workers from the Pacific. Although the Australian and New Zealand governments expressed reservations about the proposals for temporary labor migration, the Australian Government proposed the establishment of a Pacific Islands Technical College that would provide a technical qualification recognized in Australia.

Pacific island countries are beginning a long-term process of executing key elements of the Pacific Plan. Initiatives at various stages of development include: expansion of trade in goods and services within the region; improved fisheries management; cooperation on civil aviation; environmental and waste management cooperation; and harmonization of health policies. Cooperative arrangements to strengthen collective capacity for good governance are particularly important. In relation to trade, developments include a free trade agreement among island economies (Pacific Island Countries Trade Agreement [PICTA]), a closer economic relations agreement among all Forum members including Australia and New Zealand (Pacific Agreement on Closer Economic Relations [PACER]), and negotiation of an economic partnership agreement between the island economies and the European Union. Some Pacific countries are also involved in negotiations as part of the World Trade Organization Doha round, though membership and negotiations are expensive for small countries.

PICTA allows the retention of different levels of external tariffs, but tariffs within the free trade area (for countries that have signed the agreement) will decline to zero over a 10–12-year period. The free trade agreement would also entail trade diversion. This occurs when a trade agreement leads to imports from the lowest-cost source (exclusive of tariffs) from outside the free trade area being displaced by a higher-cost imports sourced from within. This happens because the lower-cost imports are still subject to a tariff while the higher-cost imports face lower or no tariffs. The result is a loss of tariff revenue and support of production that is economically inefficient and that may be unsustainable once wider trade liberalization takes place.

In contrast, trade creation occurs when lower-cost imports from within the free trade area displace higher-cost domestic production. This represents an increase in economic efficiency for the country reducing tariffs and for the free trade region. The net benefits of a regional free trade agreement essentially depend on whether the beneficial trade-creation effects outweigh detrimental trade-diversion effects and the administrative costs of establishing, promoting, and implementing the agreement. The net benefits of PICTA are estimated to be small and could easily be offset by the administrative costs. However, the smaller countries could minimize the problems associated with trade diversion by lowering trade barriers against all countries. PACER would increase the benefits of preferential trade liberalization by greatly increasing the size of the market and by substantially avoiding trade diversion.

To be most effective for the smaller economies, PACER should go beyond trade in goods to include the scope for greater labor and capital mobility.

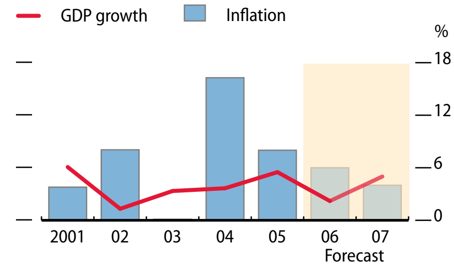
a joint venture between the Government of Samoa and Telecom New Zealand. Also in the communications sector, the installation of a fiber optic network and wireless local loop services improved Internet connection. In the airline industry, a joint venture between Polynesian Airlines and Virgin Blue, called Polynesian Blue, was set up in late 2005 to tap the operating strengths and brand of Virgin, and to save the Government some ST10 million a year in subsidies.

Total fiscal revenue and grants for FY2005 (ended June 2005) was ST524.41 million, while total expenditure was ST500.4 million (Figure 2.33.9). The FY2006 budget is projected to have an overall deficit of ST59.3 million, to be financed by soft loans of ST32.8 million and issuance of government securities of ST26.5 million. Official government debt outstanding at the end of June 2005 was ST455.7 million, down ST17.3 million than a year earlier.

The level of international reserves is expected to remain above the minimum target level of 4 months of import cover in 2006–2007. Remittances are likely to remain around 20% of GDP, providing strong support to the balance of payments. Inflation is expected to moderate as local food prices decline, but will probably remain above the Pacific average, reflecting the expansionary impact of government expenditure prior to elections in March this year.

GDP is forecast to grow by 2.2% in 2006 and 5.0% in 2007 (Figure 2.33.10). This will largely depend on positive outcomes in the tourism, construction, and agriculture sectors and a boost from the 2007 South Pacific Games. Manufacturing will decline in sectors that do not reflect Samoa's comparative advantage. Agricultural exports are expected to increase, led by expansion in organic farming and nonu exports. Cattle farming is likely to develop, to supply the domestic market and, possibly, some exports. These trends in farming are likely to offset a further decline in fishing revenue.

2.33.10 GDP growth and inflation, Samoa



Sources: Ministry of Finance, available: http://www.spc.int/prism/country/ws/stats/eco/eco_key_index.htm, downloaded 13 December 2005; staff estimates.

Solomon Islands

Growth in 2005 was 4.4%, similar to the rate in the previous year. Primary production (especially logs for export), construction, and the retail and wholesale trade sectors recorded robust growth. Copra production declined in response to a weakening in prices from about April. The tuna catch fell, though tuna prices were higher than 2004. Cocoa output also declined. Growth over the past 3 years follows an extended contraction of the formal economy in 2000–2002, when the country experienced an ethnic and political crisis. An Australian-led regional security force was deployed to restore law and order, boost public confidence, and facilitate economic recovery.

The reconstruction of the economy is a major challenge for the Government and donors. The country is one of the least developed in the Pacific, but has the third-largest population as well as rapid population growth of 2.6–2.8% a year. It is well endowed with natural resources, including timber, minerals, and fish, and has large areas of underused land. Around 80% of the population live in rural areas, in large part outside the formal economy. The main gauge of the performance of the informal economy is export income from copra and cocoa, which has been fairly strong in recent years, reflecting favorable external conditions and the restoration of public security. However, the economy may require another 20 years to return to preconflict levels of per capita GDP. There is little prospect of meeting many of the Millennium Development Goals.

In terms of the recent fiscal position, for the first 8 months of 2005, a budget surplus of SI$55.1 million (excluding grants and grant-supported expenditure) was realized. The budget outcome reflected higher revenue, improved tax and customs compliance, and lower expenditure than expected. However, the budget exhibits considerable variability from month to month, creating some difficulties for cash-flow management (Figure 2.33.11).

The external position weakened in 2005. Exports increased slightly, but imports surged by about 42%, leading to a large trade deficit of \$40.1 million. This led to a current account deficit of \$30.8 million (10.8% of GDP). Gross official reserves were estimated at \$79 million in 2005, equivalent to about 5 months of import cover.

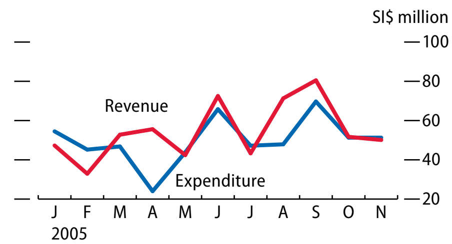
Substantial progress has been made in achieving a sustainable public debt position. Debt management has been strengthened, new terms on the majority of domestic debt have been agreed with creditors, and arrears to trade creditors have been largely paid. The Government has committed to undertaking appropriate economic and debt-reform measures, including no further borrowing or sovereign guarantees until the economy recovers to levels where more borrowing can be sustained. Nevertheless, further reductions in debt and continued efforts to improve debt management are needed.

Inflation eased to an estimated 6.9% in 2005. Relatively high economic growth, as well as high oil prices, have created inflationary pressures in the past few years. Solomon Islands has experienced higher than average inflation in the Pacific over a long time, which has required frequent adjustments to the exchange rate. The exchange rate policy is based on a trade-weighted crawling peg consisting of the Australian dollar, Japanese yen, United Kingdom pound, and US dollar. In 2001–2003, the Solomon Islands dollar depreciated against the US dollar by 30%, though the subsequent economic recovery was reflected in its appreciation against all of these currencies in 2005. The stated exchange rate policy stance now emphasizes relative price stability (thus attempting to minimize inflationary pressures and improving private sector confidence) rather than defending foreign reserves.

Growth of around 5% is expected in 2006. The rehabilitation of the Guadalcanal Plains Palm Oil, Gold Ridge Mine, and Pacific Timbers enterprises will make an important contribution to growth over the next few years. Aid-funded infrastructure projects are expected to underpin construction, while the Government's increased recurrent spending and external grant-funded development spending will allow for modest growth in services. Higher primary production and private sector development, supported by foreign investment in tourism, palm oil, and logging, should contribute to growth. Economic growth of 4–5% a year is achievable for 2007–2009, assuming favorable external conditions. Inflation is forecast to rise in 2006 and to remain at moderately high levels in the medium term, reflecting continuing expansion of some sectors of the economy but limited productive capacity.

Unsustainable rates of logging have been a long-standing concern, despite current (and proposed additional) legislation to curb the practice. Unless effective action is taken, the country will be faced with a degraded environment, and export income from logging will evaporate. Medium-term fiscal management presents a concern. On the revenue side, foreign budgetary support is likely to decline once donors believe that reasonable public security and economic stability are achieved. However, debt-servicing costs are high and fiscal consolidation requires continuing economic growth and secure revenues. Moreover, the scale of

2.33.11 Government revenue and expenditure, Solomon Islands



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

rehabilitation, combined with limited institutional and local workforce capacities, will continue to require substantial donor assistance.

National elections are scheduled for the second quarter of 2006. The incoming Government will face the challenge that, while law and order have been restored, financial discipline reinstated, and major reforms initiated, underlying causes of tension and conflict need to be addressed if the social fabric is to be healed. Equitable distribution of resources, as well as access to opportunities and basic social services, should be important priorities for the new Government.

Tonga

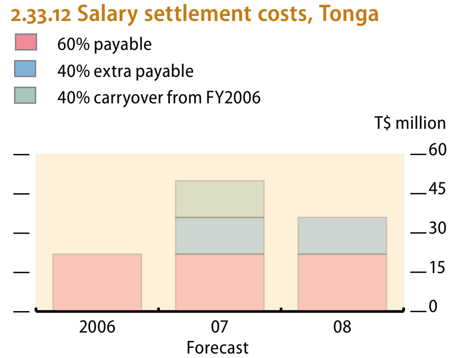
A public service strike and associated political demands culminated in September 2005 with an agreement for a 60–80% salary increase for public servants, which will likely create serious fiscal and development pressures. GDP growth of 2.5% was recorded in FY2005 (ended 30 June 2005), up from 1.6% a year earlier. The stronger performance was mainly attributable to agriculture. Construction activity remained buoyant, underpinned by several large projects. The commerce, hotels, and restaurants sector recovered from subdued growth in the previous 2 years.

Inflation was 8% in March 2005, decelerating slightly from above 10% in 2002. However, inflationary pressures have remained because of rising food and oil prices, as well as salary increases due to the public sector wage settlement. A trade gap of T$173.1 million was recorded in FY2005, widening from T$140.8 million in FY2004. The country's merchandise exports include fish, squash, root crops, kava, nonu juice, and vanilla. Remittances amounted to T$200 million in FY2005, continuing to provide a main source of funding for imports. Foreign reserves were T$85.4 million, or 4.8 months of import cover, in February 2005, up from 3.4 months of import cover 12 months earlier. Tourist arrivals, an important source of foreign exchange, rose slightly to 30,646 in the first half of FY2005.

A small budget surplus was seen in FY2005 following a surplus of around 1.4% of GDP the previous year. This fiscal consolidation followed several years of small deficits. Total debt at mid-2005—most of it external—was about 42% of GDP. For FY2006, the additional salary cost is estimated at T$21.9 million, or 4.8% of GDP. Even with adjustments, including additional allocations (some from the contingency reserve), expenditure reductions, and borrowing, a T$3.7 million shortfall is foreseen, which could lead to a budget deficit of around 2.8% of GDP in FY2006. However, it is uncertain that the Government will be able to make these adjustments.

The salary increases for FY2007 and FY2008 amount to around 11% and 7.8% of GDP, respectively, suggesting that fiscal deficits will widen and causing other macroeconomic pressures (Figure 2.33.12). These pressures could be reflected in a mix of higher interest rates and inflation, exchange rate stress, cuts in public services, and further external borrowing. There is also a risk that the Government will be unable to meet its salary commitments at some stage. Such stresses could well divert the Government's attention from implementing its Economic and Public Sector Reform Program, which started in 2002.

2.33.12 Salary settlement costs, Tonga



Source: Asian Development Bank, *ADB TA6245-REG Social and Economic Update and Pro-Poor Policy Formulation*, 2005.

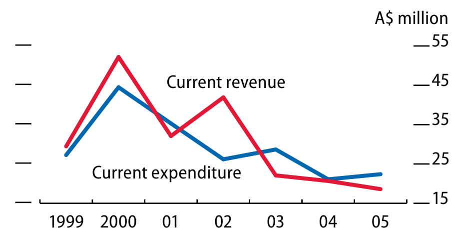
In this context, there are major risks and uncertainties associated with the medium-term outlook. GDP growth of 1.6% is forecast for FY2006, but growth in the following 2 years is based on assumptions that the fiscal position can be effectively managed and that substantial donor assistance will be forthcoming. If these assumptions prove correct, growth of around 2.5% could be recorded.

The medium-term focus for industry and trade policies should be on sectors with a comparative advantage, such as agriculture, fisheries, and tourism. Emigration has been important in providing income support through remittances, which are likely to help cushion adverse effects of the likely fiscal imbalance. The number of Tongans living overseas has been estimated at 35,000, but anecdotal evidence suggests that the figure is much higher. Policies should aim to build workforce skills and contribute to successful emigration, while maintaining links between the overseas workers and their families in Tonga, if standards of living are to be maintained.

Tuvalu

GDP growth slowed to 2% in 2005, from estimated average rate of 4.0% in 2003 and 2004. Construction activity declined after a hospital and a government office block were completed. Revenues from fishing licenses, telecommunications licenses, and the ".tv" domain name all fell. An El Niño weather pattern led to a migration of fish out of Tuvalu's waters. Remittances from seafarers working on foreign-owned vessels are the most important source of income for the country, supporting construction, school fees, and other household consumption. Historical trends show that, at any given time, around 350 graduates of the Tuvalu Maritime Training Institute work as seafarers, out of the 1,000 nationals registered for seafaring employment.

2.33.13 Government revenue versus expenditure, Tuvalu



Source: Treasury Department.

The Tuvalu Trust Fund (TTF), with a total endowment value of $99.4 million, plays an important role in maintaining financial sustainability, supported by the policy of using the Australian dollar as the legal tender. With a real average annual return exceeding 6% since 1978, distributions from TTF have amounted to A$58.9 million, or an average of A$3.1 million a year. Drawdown amounts from the Consolidated Investment Fund, a depository of TTF investment income, have enabled the Government to balance the budget. In 2005, TTF contributed 17% of total recurrent fiscal budget revenue and 18% of fiscal expenditure.

Windfall revenues from TTF investment, fishing license fees, and ".tv" domain name receipts led to budget surpluses in 2000 and 2002 that in turn contributed to significant fiscal expenditure expansion that proved difficult to reverse in the deficit years, including 2005. Fiscal revenue in 2005 was estimated to be A$18.6 million and expenditure A$22.4 million (Figure 2.33.13). Donors increased grants in 2005 in view of the reduction in expected revenue. With the support of a drawdown from the Consolidated Investment Fund, the budget deficit was A$1.2 million, or 4% of GDP in 2005, representing a substantial improvement over deficits of 9% of GDP in 2004 and 11% of GDP in 2003. The gross value of government debt is around $16 million, or 80% of GDP. As almost all of the debt is concessional, the net present value of the debt is much lower, at some 40% of GDP.

For 2006, budget revenue is forecast to be A$19 million, consisting of domestic revenue and external grants totaling A$8 million, and ".tv" and fishing license fees of A$11 million. Target recurrent expenditure for 2006 is A$21.9 million, implying a fiscal deficit of A$2.9 million, equivalent to 9.3% of GDP. While fiscal prudence is of paramount importance to financial stability, a TTF automatic distribution of A$11.4 million for 2006 provides a comfortable cushion to finance the deficit.

The Government is exploring options to raise additional income through taxation and user charges, and to privatize certain government entities to finance the core budget deficit. It also plans to freeze hiring and salaries and to propose cost savings on medical treatment and overseas travel. Still, budget deficits for 2007 and 2008 are projected to widen substantially, to A$6.2 million and A$5.7 million, respectively.

Te Kakeega II, the Government's national development strategy, identifies eight strategic areas for the near term. The ability to finance these objectives depends on the performance of TTF, as receipts from fishing licenses and the sale of rights to the ".tv" domain name will be below trend in the medium term. Foreign aid is likely to continue to provide significant support.

The economy is highly dependent on income from overseas. In the medium term, more frequent occurrences of El Niño and La Niña, both of which precipitate a decline in fish stocks in Tuvalu's exclusive economic zone from levels seen in a normal season, will put fishing license income at risk. Although TTF has substantial net assets, distributions to the budget can only be available to the extent that TTF's current market value exceeds what is termed its "maintained" capital value, as based on Australian consumer price inflation. If market returns exceed Australian inflation, as in the past 2 years, such distributions will be possible.

A plan to expand the Tuvalu Maritime Training Institute would considerably increase the number of graduating seafarers, and so increase remittances. The expansion has been delayed, but a more important risk to the country's outlook would be loss of the Institute's accreditation with the International Maritime Organisation, which currently underwrites the country's status as a supplier of high-quality seafarers. (The next round of assessments is due by November 2006.)

Vanuatu

Growth came in at 3.1% in 2005, lower than in 2004 but much better than the recessionary years 2001–2003 (Figure 2.33.14). Cocoa and cattle production recovered from weakness in 2004. Tourism and construction continued to grow. Tourism was boosted by the launch of Pacific Blue airline in September 2004.

However, agriculture, forestry, and fisheries together contracted by 0.8%, mainly reflecting substantial declines in copra and kava production. During the year, the Fiji Islands banned imports of kava from Vanuatu in retaliation for Vanuatu's banning of imports of Fijian biscuits.

The fiscal position deteriorated slightly, to show a small deficit of 0.3% of GDP. The current account deficit also widened, reflecting weakness in commodity exports and high demand for consumer and capital goods imports. Foreign reserves remained at comfortable levels of 5–6 months of import cover. Government external debt is around 30% of GDP. The inflation rate also remained relatively low, at 2.6%.

A comprehensive reform program has been implemented since 1997 but with mixed results, for while financial management and the transparency of public policy making have improved, little progress is evident in improving the performance of public enterprises and facilitating private sector development. One consequence is that most of the population outside the towns have not seen a rise in living standards.

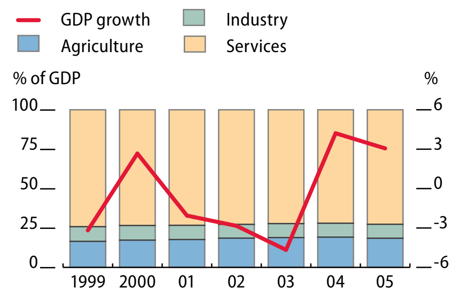
The private sector remains hamstrung by relatively high costs and policy uncertainty. An example of the latter is that in September 2005, the Government placed kava on a list of commodities that can only be exported by indigenous citizens, despite the fact that foreign investors have been heavily involved in establishing markets for Vanuatu's kava, particularly in powdered form. On the issue of costs, the monthly minimum wage was raised from Vt16,000 ($146) to Vt20,000 in September, which may deter the development of labor-intensive activities. Traditional, community-based land arrangements are a constraint to development, too. Furthermore, the Government is considering policies to restrict the conversion of agricultural leases to commercial subdivisions.

In an effort to improve the performance of public enterprises, the Government is developing an economic regulatory framework for electricity, telecommunications, and water. Although the services of utilities in the main population centers of Port Vila and Luganville are of good quality compared with elsewhere in the Pacific, they are relatively costly, and services outside these centers are basic or nonexistent. Only 25% of the population have access to electricity. The proposed framework should help improve efficiency and lower costs in the main towns, but it does not involve an extension to unserviced areas. The US Millennium Challenge Corporation has determined that the country is eligible for assistance and has approved a 5-year grant of $66 million to finance a range of infrastructure projects and supportive reforms designed to improve the living standards of the rural population.

Achieving broad-based growth is a major challenge for the Government, especially when per capita income levels are low, the population is dispersed over numerous islands, and population growth is more than 2%. Despite recent growth, GDP per capita is lower now than 20 years ago. The Government forecasts growth of around 3% over the medium term, supported by continued expansion of agriculture, tourism, and aid-funded projects. Small budget surpluses or near-balance positions are expected, and annual inflation should remain at around 2.5%.

Risks to the 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; financial weakness at Air Vanuatu; vulnerability to cyclones; and weak commodity prices.

2.33.14 GDP growth and sector shares of GDP, Vanuatu



Sources: National Statistics Office, *National Accounts 1997–2002*, July 2003; Government of the Republic of Vanuatu, *Budget 2006 Fiscal Strategy Report Volume I*, November 2005.