Cook Islands

Supported by rising tourism activity, a high level of building activity, and firm consumer demand, the economy continued to grow in 2004. The overall fiscal position is sound and the Government's cash reserves increased further over the year. Medium-term prospects remain positive, with tourism expected to continue leading growth, and some rebuilding of other sectors in prospect.

Macroeconomic assessment of 2004

The economy achieved its sixth consecutive year of growth in 2004. Preliminary national accounts indicate that GDP grew by 3.4% in the 12 months to June 2004. It is expected to have remained firm in the quarters to September and December 2004 as tourist arrivals rose and building activity picked up.

Visitor arrivals in the quarters to March and June 2004 were only slightly above the same periods of 2003. Air New Zealand, the main international carrier, introduced cheaper airfares in June, and this led to a sharp rise in visitor arrivals over the second half of the year. Preliminary data suggest that total visitor numbers increased by 6% in 2004.

Like tourism, building activity appears to have leveled off in the first half of 2004. The value of building approvals fell over the first 2 quarters of the year, but approvals for commercial buildings recovered in the third. The total value of building approvals was 9% higher over the first 9 months of 2004 than in the same period of 2003.

Bank lending continued to grow. After rising by 41% in 2003, loans and advances increased by a further 13% by September 2004. Approximately half of the additional lending was provided in the personal services subsector, a reflection of firm consumer demand. Additional lending was also provided to the wholesale and retail trade and to hotels and motels.

Total merchandise export growth is expected to slow in 2004 relative to 2003. A contributing factor is a further contraction in the pearl industry. For the first 9 months of 2004, pearl exports were 28% below their value for the same period of 2003. On an annualized basis, pearl exports are now less than 15% of their peak value seen in 2000, a consequence of low international prices and the ongoing impact of disease that resulted from overcrowding in the main producing lagoon in 2000. In contrast, fish exports have surged in recent years and in 2003 replaced pearls as the main source of merchandise exports. However, adverse weather conditions and financial difficulties reduced their value by 72% in the first 9 months of 2004 compared with the same period in 2003.

Despite a large fall in imports of machines, transport, and equipment, total merchandise imports rose in the first 9 months of 2004 from the same prior-year period, in the process further widening the trade deficit. However, the surplus on the services account attributable to the vibrant tourism sector more than offset the trade deficit.

Inflation was low at 0.3% in 2004, a result of the overall sound fiscal position and the combination of low inflation in New Zealand, the main source of imports, and a nominal appreciation in the New Zealand dollar, the currency used by the Cook Islands. Broad money grew by 9.6% in FY2004 (ended 30 June 2004), slightly lower than the recorded 9.9% growth in FY2003.

The solid economic conditions helped further improve the fiscal position over the year. Revenues from the four main taxes (VAT, income tax, import duties, and company taxes) were 9% higher than in the previous year. Small increases in both the operating surplus and the level of net lending are projected.

Macroeconomic policy developments

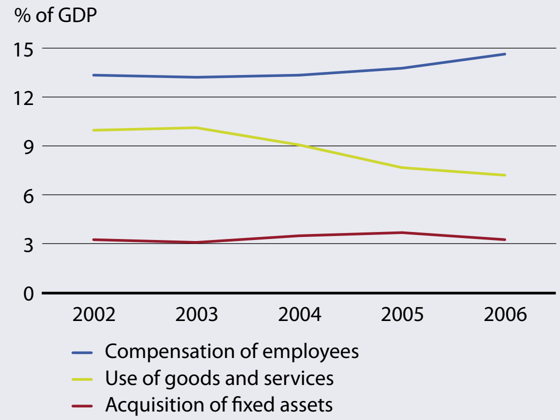
By the mid-1990s, the Cook Islands had accumulated an unsustainable debt position and an excessive wage bill. A wide-ranging economic reform program was adopted to correct these economic imbalances, and the overall objectives of the reform program of economic growth and fiscal stability are now firmly in place. The challenge now facing policy makers is to address the consequences of continued expansion.

The final component of a 1998 debt restructuring was settled in 2004 through the acceptance of an offer of concessions from the French Government. The debt-to-GDP ratio has fallen steadily since the debt restructuring, aided in 2004 by the appreciation of the New Zealand dollar and the continuation of budget surpluses. The gross value of public debt is approximately 40% of GDP, much of which is held on concessional terms. Cash reserves, equal to 14% of GDP, have been built up to cover certain future debt obligations and to be a financial safeguard in the event of a natural disaster or economic downturn.

The overall improvement in the fiscal position was recognized in October 2004 by Standard & Poor's, which raised the long-term rating to BB- from B+. This is the fourth upward revision to the rating since an initial B-/C rating was assigned in 1998. However, the Cook Islands was put on credit watch in early 2005 because of the threat to the economy from cyclone activity.

As part of the debt restructuring, targets were set for the ratio of the wage bill and other expenditures to GDP. There has been some slippage recently in the satisfaction of these targets, and a hoped-for shift in expenditures to capital and essential goods and services is yet to be achieved (Figure 2.25). At the same time, the burgeoning economy is placing greater demands on infrastructure. Roads, airports, water and sewerage systems, and the electricity network are

Figure 2.25 Government expenditures, Cook Islands, FY2002–FY2006



Sources: Staff estimates based on data from the Ministry of Finance and Economic Management, and Cook Islands Statistical Office.

candidates for higher capital and maintenance spending. A rebalancing of outlays toward infrastructure is increasingly important if the economy is to retain the capacity to grow in an ecologically sustainable and balanced manner.

Recent episodes of health problems arising from pollution in Rarotonga's lagoon have provided an early warning of the potential consequences of sustained growth. Such episodes may increase in frequency if infrastructure is not upgraded and if land-use planning is not improved. The pressures being placed on the natural environment have the potential to both impair the quality of life of residents and undermine prospects for the tourism industry.

A further challenge facing policy makers is a sustained population decline. High levels of emigration and a rising foreign presence have raised community concerns of a weakening of the Cook Islands–Maori culture. The tourism industry is also concerned that any loss of the uniqueness of the Cook Islands experience sought by visitors will have repercussions for its prospects.

The country's first National Development Plan is in preparation to help provide a national consensus on how to address these and other strategic issues. A national forum was held in late 2003 and sectoral working groups have been formed to prepare strategies for key sectors. Progress was slowed over 2004 by the national

election held in September 2004 and a delay of some months in forming a government. But an economic summit is to be held in early 2005 to take stock of work on the National Development Plan and to assist in budget planning.

Outlook for 2005–2007 and medium-term trends

Visitor arrivals had reached a plateau of some 50,000 a year in the mid-1990s, but subsequent economic reforms and favorable external conditions saw annual tourist arrivals climb to 83,000 in 2004. Investment and consumption have strengthened, and unemployment has fallen to such an extent that low-skilled labor is now being drawn in from neighboring countries. This upward trend in activity is expected to continue. The latest official forecast is for average annual GDP growth of 3.1% over the medium term. GDP per capita is forecast to grow at a similar rate.

In December 2004, air services provided by Aloha Airlines to the US ceased. However, in the same month Air New Zealand expanded its services to the Cook Islands to provide connections to additional airports. In addition, another carrier, Pacific Blue, commenced flights to the Cook Islands in early 2005. These developments will push up capacity while helping maintain downward pressure on airfares. A 13% increase in arrivals is expected over the 12 months to June 2005, slowing thereafter to 4% a year. Although the trend is for additional arrivals to be from lower-spending segments of source markets, tourism is expected to continue generating economic growth over the forecast period.

Hotel capacity continues to expand in anticipation of a rising number of arrivals. Large hotel projects at Vaima'anga on the main island of Rarotonga and on the main outer island of Aitutaki are currently undergoing environmental impact assessment, while small, family-run businesses that have entered the industry to supply bungalow-style accommodation also have considerable potential for expansion. Activity is expected to remain concentrated on Rarotonga and Aitutaki, but increasingly tourism is spreading to other readily accessible outer islands.

Merchandise exports are expected to improve over the medium term. Pearl industry analysts suggest that the main producer of black pearls, French Polynesia, is operating at around break-even. Stabilization in global prices is expected with some prospect of an improvement as supply growth slows. The latest official forecast is for an average annual rise of 20% in the nominal value of pearl exports over the medium term. Fish exports are also expected to improve by 2006 as the predicted El Niño season in 2005 lifts the potential catch in the country's waters.

An expansion of the Offshore Financial Centre is also in prospect over the medium term. This has stagnated in recent years as the Cook Islands remained one of the few Non-Cooperative Countries and Territories listed by the OECD Financial Action Task Force (FATF) on money laundering. Legislative and administrative changes had been made to comply with the requirements of the FATF, including the establishment of a financial supervision commission and new banking and financial transactions legislation. The country was removed from the list in February 2005 but will be subject to strict monitoring for at least 12 months.

Inflation is expected to stay low over the medium term. Local demand pressures have had little effect on the local inflation rate, and inflation in New Zealand and Australia remain the dominant influences. The Reserve Bank of New Zealand has an inflation target of 1–3% per annum, and a similar range is targeted by the Reserve Bank of Australia.

A potential risk is that liquidity constraints may push up interest rates over the forecast period. Deposits in the banking system have normally exceeded loans with the excess funds invested offshore. The very strong growth in loans and advances led to a reversal of this situation in December 2003. The commercial banking sector now needs to borrow offshore to help fund its domestic loan portfolios, and this is adding to the cost of funds and placing some upward pressure on interest rates.

Fiji Islands

Economic growth accelerated gently in 2004, inflation and interest rates remained low, and foreign reserves accumulated. A growth slowdown is expected over the medium term as concessional access to key export markets is lost and fiscal policy is tightened.

Macroeconomic assessment of 2004

Economic growth picked up to 3.8% in 2004 from 3.0% in 2003, stemming from a recovery in the agriculture, forestry, and fisheries sector, which rose by 3.7% after declining in 2003, and from a 7.5% expansion in industry, which in turn was driven by a surge in construction. A key element in the construction boom was private development of tourist resorts and residential complexes for overseas buyers. Mining was also a significant component in industry's strong performance. Though sugar production was stagnant, garment manufacturing grew slowly and mineral water production continued its healthy progress. The services sector as a whole expanded by 1.9%, with the wholesale and retail trade and hotels and restaurants subsectors registering faster growth in response to record tourism levels. Visitor arrivals in 2004 were up by about 13% from the 2003 level, led by an increase in Australian and New Zealand tourists responding to vigorous marketing and the availability of low airfares following greater competition in airline services to the Fiji Islands. On the demand side, economic activity was stimulated by private consumption, which was supported by private remittance inflows and reflected in a 14% rise in VAT revenues in 2004. Investment expenditures on buildings and higher recurrent and capital government spending also contributed to aggregate demand expansion, whereas the contribution of net exports was negative.

Labor market conditions strengthened in 2004, with a 7% increase in the number of newly registered taxpayers, most of whom were in services. Emigration of skilled workers was 4% lower than in 2003, but remained of major concern to employers and the Government. Output and employment growth appear to have been insufficient to reverse intensifying economic hardship for many people. Preliminary analysis of a 2002/03 household survey suggests that the proportion of urban households living in poverty increased from 28% in 1990/91 to 30–40% in 2002/03. Recent studies report community perceptions that hardship has become more prevalent in rural areas.

The domestically financed budget deficit in 2004 was 4.8% of GDP, down from 5.9% in the previous year. This outcome was in excess of the estimated deficit of 3.9% of GDP in the budget, largely because of two additional appropriations for funding costs of flash flooding in April and overbudget spending by three ministries. The level of public domestic debt consequently continued to rise, albeit more slowly, and at end-December 2004 stood at 46.4% of GDP, compared with 45.4% 12 months earlier. The ratio of external public debt to GDP remained low by international standards at less than 5%.

Inflation fell to 3.5% in 2004 from 4.2% a year earlier, largely because the nominal effective exchange rate remained stable and modest wage growth and excess capacity in some sectors helped offset the inflationary effect of higher oil

prices and strong domestic demand. Additionally, monetary policy was tightened in May 2004 in response to buoyant consumer demand, with official interest rates raised by 0.5%. The monetary policy stance was unchanged during the rest of the year, and commercial bank lending rates fell slightly to 7.05% at year-end, contributing to a 16.5% rise in credit to the private sector in the year to November. This additional credit was concentrated in personal loans and lending to the construction, trade, and transport sectors.

Merchandise exports were virtually stagnant in 2004 as reductions in sugar, fish, and "other" exports offset stronger gold, timber, and garment exports. Growth in aggregate demand generated a 2.6% broad-based rise in imports from the 2003 level, widening the trade deficit. Further, the deficit on the income account grew, such that the current account deficit widened to 5.3% of GDP. The balance on the capital and financial account was positive, though FDI remained subdued. At end-December, foreign reserves were US$456 million, sufficient to cover 3.5 months of imports of goods and nonfactor services. This was the first year since the 2000 political crisis in which foreign reserves had increased. Foreign exchange controls remained in force, but were relaxed slightly during the year.

Table 2.23 Major economic indicators, Fiji Islands, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	3.8	1.5	0.7	1.0
GDI/GDP	17.0	-	-	-
Inflation (CPI)	3.5	3.0	3.0	3.0
Money supply (M2) growth	7.3	7.3	7.3	7.3
Fiscal balance/GDP	-4.8	-4.3	-2.4	-1.4
Merchandise export growth	0.5	3.2	-5.0	17.5
Merchandise import growth	2.6	2.0	-0.2	4.6
Current account/GDP	-5.3	-4.1	-3.3	0.6

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Ministry of Finance, *Economic & Fiscal Update: Supplement to the 2005 Budget Address*; staff estimates.

Macroeconomic policy developments

After years of running substantial budget deficits and accumulating domestic debt, the Government has adopted a policy of fiscal tightening for 2005–2007. The policy target is to reduce the budget deficit to less than 2% of GDP by 2007, largely by cutting expenditures (Figure 2.26). Most of the progress toward the target is projected to be made in 2006–2007, with the 2005 annual budget estimating a budget deficit of 4.3% of GDP. Total expenditures and net lending at current prices are forecast to rise by 4.4% and revenues (exclusive of asset sales) by 6.3%.

The ratio of operating to capital expenditures is expected to fall slightly to 82:18 as the Government pursues its objective of contributing to a rise in the ratio of gross investment to GDP. However, this reallocation away from operating expenditures will not be achieved by reducing the relative size of the public service wage bill, which is estimated to actually increase its share of operating expenditures, marginally, to 49.4% in 2005 from 49.3% a year earlier. The Government plans to achieve control of the wage bill over the medium term, requiring it to be successful in replacing automatic cost-of-living adjustments with smaller, productivity-based wage increases. Improved controls on the engagement of staff by the education and health ministries and cuts in the size of the military are also programmed. If all of these plans are realized, the wage bill should fall to 47.9% of operating expenditures in 2007 or 9.8% of GDP, compared with 11.1% in 2005. Public domestic and external debt would be contained to a fiscally sustainable level of about 50% of GDP, though this is still well above the Government's target of 40%.

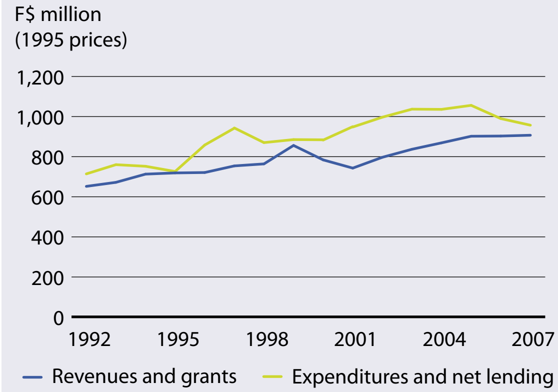
Most of the growth in revenues in 2005 is expected to come from indirect taxes, both VAT and customs duties. In addition to the revenue pickup occurring automatically as the economy expands, receipts are forecast to pick up as a result of improvements in tax administration and strengthened compliance, which are to be supported by amendments to the Income Tax Act and the Valued Added and Gambling Turnover Tax decrees. The 2005 budget lifted the income tax threshold from F$7,500 to F$8,840 and extended the Employment Taxation Scheme, which allows 150% tax deductions for first-time employees. More generally, measures are being taken to raise the efficiency of the civil service,

including the medium-term implementation of the 2004 Financial Management Act, which encompasses measurement of the performance of ministries and departments in delivering their core outputs. The Public Service Commission is also developing mechanisms for overseeing the performance of chief executive officers.

Following the monetary policy tightening in early 2004, the Reserve Bank of Fiji signaled its intention of maintaining a low interest rate regime to stimulate private investment, subject to the paramount aims of low inflation and balance-of-payments stability. The Reserve Bank also emphasized the importance of shifting the demand-side impetus for economic growth from consumption to exports. To facilitate such a shift, it began assessing small exporters' access to the credit export facility operated through the commercial banks and started investigating the viability of an export credit guarantee scheme. Deregulation of the superannuation industry is to be examined and, possibly, undertaken in the medium term, and an application for a commercial bank license from the Fiji Development Bank is to be assessed in 2005. The passage of the Financial Reporting Transactions Bill strengthened the country's antimoney laundering framework, and formalized the existence of the Reserve Bank's Financial Intelligence Unit.

The ratio of gross investment to GDP reached 17% in 2004, the highest level for 17 years but still well below the government target of 25%. Further and substantial progress toward the target requires growth in private investment alongside the Government's shifting of expenditures from operating to capital expenditures. Policies aimed at facilitating private sector development have been presented in the current strategic development plan and the 2001–2020 affirmative action plan, and some actions were initiated in 2004 in the areas of foreign investment legislation and regulations, labor market reform, civil service reform, and restructuring of the sugar industry. However, the Government acknowledges that further improvements are needed in these areas, as well as in physical infrastructure, reliability and pricing of utilities services, and public enterprise performance. There is also room for reducing the costs of doing business through improving institutional infrastructure: according to the World

Figure 2.26 Government revenues and expenditures, Fiji Islands, 1992–2007



Sources: Ministry of Finance and National Planning; Reserve Bank of Fiji.

Bank's Doing Business Indicators for 10 Pacific island states, the Fiji Islands ranks second highest in days taken to start a business, joint highest in rigidity of employment, and third highest in time to enforce a contract.

Government commitment to trade liberalization was evidenced by continuing work on the implementation of the Pacific Island Countries Trade Agreement and the Pacific Closer Economic Relations, which includes Australia and New Zealand. An Economic Partnership Agreement is also being developed with the EU by the African, Caribbean, and Pacific nations, with negotiations scheduled to end in 2007.

Outlook for 2005–2007 and medium-term trends

Economic growth will slow substantially in the medium term, to less than half the rates achieved in the past 3 years. The major reason for the deceleration is a contraction in manufacturing, which accounts for about 16% of GDP. The largest garment producer, which generates 40% of garment exports and employs 5,000 people, is expected to close over the forecast period because preferential access to the US market ended on 1 January 2005. Preferential access to the Australian clothing and footwear market was extended for another 7 years in 2004, but the value of the preference is declining as Australian tariffs drop, and competition from the PRC

intensifies. The sugar industry, which provides a direct source of employment for more than 10% of the economically active adult population, is also expected to contract further in 2005. It faces various issues: the single sugar-milling company is insolvent and requires significant investment and government guarantees to continue operating; problems remain in managing the expiry of leases of sugarcane land; production practices are inefficient by world standards; and a fall in EU price subsidies can be expected in the next few years. The official forecasts factor in a recovery in sugar production in 2006 that is expected to result from externally assisted industry reforms begun in 2004. This expectation may not be realized in full.

The economy-wide impact of the manufacturing contraction in 2005 will be offset to a degree by a further surge in construction, forecast to expand by almost 18% before easing in 2006 and contracting in 2007. Mining, too, is expected to strengthen, by almost 8% in 2005 before slowing in 2006 and 2007. Expansion in agriculture, forestry, and fisheries is forecast to be modest in 2005, before a 2006 acceleration driven by increased sugarcane production, and then to slow in 2007. Forestry production is expected to grow at a strong and sustained rate, while production of other crops (including kava) could exceed expectations if recent health concerns in the EU are allayed and market access is renewed

The services sector is forecast to grow at annual rates of under 2% as contraction of the Government's wage bill has a negative impact, although the sector will still be the major contributor to aggregate growth in 2006–2007. The fastest-expanding subsector is expected to be transport and communications, with modest strengthening in finance and business services, wholesale and retail trade, and hotels and restaurants. Services will be underpinned by tourism: visitor arrivals are projected to increase by 7.2% in 2005 as the industry continues to benefit from airline deregulation; and as PRC; Hong Kong, China; and India emerge as source markets. Accommodation capacity is likely to set the ceiling on visitor numbers.

Whether the economy can do better than the official forecasts rests heavily on the rate at which structural obstacles to the growth of private sector activity are relaxed and on the subsequent private sector response. Key areas for immediate attention include means of slowing and correcting the ongoing emigration of skilled labor and resultant labor shortages, the performance of government utilities (the rate of return from government-controlled companies is less than 1%), and the regulatory environment for labor and product markets.

Some uncertainty hangs over the extent to which the Government will be able to successfully implement its medium-term fiscal strategy. The target of an 8% reduction in the level of expenditures and net lending by 2007 should be seen against an average annual increase of 4% over the past 10 years. The Government does not fully control the public service wage bill at present, with cost-of-living adjustments being decided by an independent arbitrator; and developing the systems to control expenditures in the military, education, and heath portfolios may take some time. Perhaps most important, an election is to be held in 2006 in an uncertain political environment. It is therefore possible that budget deficits and public debt will not be reduced as planned.

The foreign reserves level is likely to drop over the medium term as a result of the declining value of sugar and garment exports, which will more than offset projected growth in gold, mineral water, and timber exports. Tourism growth will bolster foreign exchange earnings, but an increase in the current account deficit is expected and a fall in foreign reserves may place downward pressure on the exchange rate.

The growth slowdown, and the imminent loss of jobs in manufacturing in particular, will cause a reversal in the reductions in the unemployment rate achieved between 2000 and 2004. Most probably therefore, the rise in both rural and urban poverty will continue, since accessible alternative occupations for all those displaced from the sugar and garment industries and expansion in formal employment will not keep pace with the population drift to urban areas. Job opportunities will appear in tourism, but significant training and retraining of the local labor force are required before these opportunities can be seized.

Kiribati

Economic growth in 2004 was lower than in the previous year, when economic growth was marked by the presidential election. Inflation remained low, and earnings from the Revenue Equalization Reserve Fund increased. For the next few years, effective implementation of the National Development Strategy will be key to sustainable economic growth.

Macroeconomic assessment of 2004

The domestic economy is estimated to have grown by 1.8% in 2004, a slowdown from 2.5% a year earlier when economic growth was driven by the presidential election and some large construction projects. Modest GDP growth in 2004 was backed by high copra prices and reasonable fish exports. Economic growth is limited by a shortage of skilled workers and a narrow production base consisting largely of subsistence agriculture, copra, and fish. Weak infrastructure is also an issue, especially since all islands are very remote from international markets.

Inflation has been low, owing to Kiribati's use of Australian dollars as its currency and the effective use of the Revenue Equalization Reserve Fund (RERF). Indeed, among the Pacific island countries, only Kiribati and Tuvalu have successfully managed to increase the real per capita value of their trust funds.

Kiribati's external sector is characterized by a large merchandise trade deficit; virtually all manufactured goods are imported. In 2003, this deficit came to US$69.5 million, and in 2004, US$51.1 million. Despite this, official reserves remain substantial, amounting to an estimated US$359.6 million or an equivalent of 4.7 years of import cover.

ANZ bank owns the only retail banking operation in the country. Foreign financial aid is a critical supplement to GDP. Japan and Australia, the country's two major donor countries, provided assistance valued at US$8.8 million and US$7.3 million, respectively, in 2002. Remittances from i-Kiribati are also sizable: receipts from those working on foreign fishing vessels or in foreign countries reached almost US$6.3 million in 2003.

Since Kiribati has a vast exclusive economic zone of about 3.5 million square kilometers, a major source of foreign income is fishing license fees. These fees were estimated to be equivalent to 35.2% of GDP in 2003, though they had started to decline in 2002.

Earnings from the RERF are an additional large source of income. The RERF was valued at A$513.3 million at end-2003, a figure that has been growing steadily since the new Government came into office on 10 July 2003. Due to its large foreign holdings in the RERF, Kiribati is a net creditor nation, and enjoys a strong international financial position. The large income from the RERF makes it possible for the Government to buffer year-to-year movements of the current account and to cover deficits on the fiscal balance. Investment income from the RERF, together with fishing license income and workers' remittances, makes GNP almost double GDP.

Most economic activities involve subsistence agriculture. Traditional land tenure, poor soil, and frequent droughts prevent the i-Kiribati from engaging in large-scale agriculture. Services dominate GDP at 84%. Vocational schools

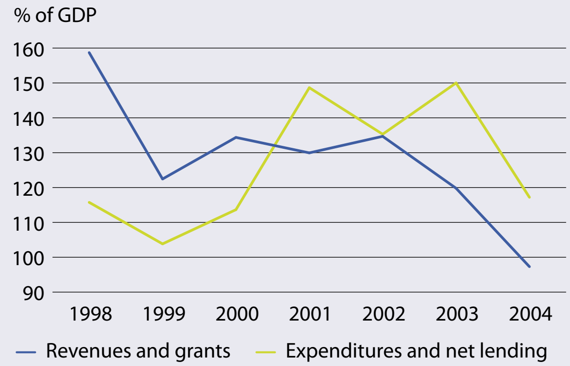
train commercial seafarers and fishers, though opportunities for occupational training as well as employment for women are limited. Due to minimal employment opportunities on the outer islands, many people have migrated to South Tarawa, which is congested and polluted.

Macroeconomic policy developments

The Government met with its development partners on 24–25 August 2004 to discuss its development strategies and project funding requirements contained in the National Development Strategy 2004–2007, which was released in November 2003. The strategy contains six key policy areas: economic growth, fair distribution, public sector performance, equipping people to manage change, conservation of physical assets, and sustainable use of financial reserves by the ministries.

Fiscal policy has remained firm and conservative (Figure 2.27). As formulated in the National Development Strategy, private sector development is a key area. In general, donors share much concern over a lack of government support for competitive private sector development, a poorly performing public service, and a heavily subsidized, inefficient, and extensive SOE sector. Economic development policy needs to be prioritized and focused for Kiribati to realize its domestic potential.

Figure 2.27 Government revenues and expenditures, Kiribati, 1998–2004



Sources: Staff estimates based on data from the Kiribati Statistics Office, *Kiribati Statistical Yearbook 2002*; International Monetary Fund, *Staff Report for the 2003 Article IV Consultation*; Reserve Bank of Australia exchange rate statistics.

Outlook for 2005–2007 and medium-term trends

Prospects for sustainable economic growth are greatly hampered by overdependence on the Government and on inefficient SOEs, by lack of private sector development, and by pressures of population growth and the associated sparse youth employment opportunities. There are few signs that these factors will be improved immediately, and low per capita GDP growth and dependency on the Government will likely continue in the medium term. Short-term prospects for economic activity and employment are determined by externally funded public sector projects.

GDP is projected to grow by 1.5% in 2005, which is roughly equivalent to the rate of population growth. Increasing youth unemployment is likely. Growth in GNP will continue to depend heavily on receipts from fishing licensing fees and the RERF.

Donors are interested in Christmas Island (Kiritimati), where game fishing and bird watching have been attracting tourists, as a potential economic growth center. In a different context, Japan is contributing to the development of Christmas Island: in 1999, its former National Space Development Agency, superseded by the Japan Aerospace Exploration Agency, announced that it would lease land there for 20 years to build a spaceport. According to the agreement, Japan will spend US$12.9 million over 13 years from 1999. In addition, the Japanese Government has announced that it will aid Kiribati's fishing industry by funding the construction of a new storage and handling area at Christmas Island's fishing port from January 2005.

Kiribati's potential for sustainable economic growth is constrained by its traditional land tenure, by weak policy and institutions, and by lack of resources. Policies for private sector development, as formulated in the National Development Strategy, need to be implemented for people to move away from overdependence on government-led projects and economic activities. New employment, especially for the younger generation, and new investment opportunities are badly needed.

Republic of the Marshall Islands

The economy contracted in 2004 because of delays in implementing an upgraded public works program and the closure of the single largest private sector employer. A large step-up in central government expenditures and net lending, funded through increased US grants, has been budgeted for the medium term. This has the potential to support the economy over the coming years.

Macroeconomic assessment of 2004

A new financial agreement with the US Government under the Compact of Free Association was effected in FY2004 (ended 30 September 2004). This increased government allocations to additional recurrent and capital expenditures by 20%. The US commitment to long-term financial support after an extended period of negotiation was also expected to raise the confidence levels of households and private businesses. Apart from this, a major hospital upgrade funded by a grant from the Japanese Government was under way in the capital, Majuro. These positive factors were initially projected to increase GDP over 2004. However, delays in implementing government capital projects and the closure of a tuna loining plant—the single biggest source of private sector employment—outweighed the expected boost in GDP, resulting in an overall contraction of the economy.

The main government projects to fall behind schedule were in education. The sector should have received 60%, or $12 million, of the year's capital and maintenance budget for work on four high schools and an elementary school. However, government departments had some trouble in adapting promptly to new procedures designed to strengthen accountability and increase value for money, which resulted in a large carryover of work to FY2005. The tuna loining plant closed in August 2004 because of financial difficulties. The plant had unsuccessfully pursued a switch from the production of tuna loins to tuna steaks, which would have reduced the workforce by about 50%. The closure will see the loss of annual exports that were worth $3.4 million in 2003, representing more than half of merchandise exports (excluding reexports). Employment at the plant ranged between 500 and 600 people, some 5% of the economically active population, most of whom were women. It is estimated that, once indirect linkages are taken into account, the plant contributed as much as 3% of GDP.

Another contractionary impact on the economy came from a decline in visitor arrivals to 74% of the 2003 level. Projected annual tourist arrivals of 1,400 people in the year to September 2004 continued to be less than the number of business travelers, which is estimated to have reached 2,250 people in 2004. A positive contribution to growth was made by copra, which provides one of the largest sources of merchandise exports and cash incomes for the outer islands. Copra export volumes rose by 14% over 2004 and, with producer prices rising slightly, producer income rose by 16%. Total producer income from copra of $1.2 million contributed approximately 1% of GDP.

Following budget surpluses in FY2002 and FY2003 aimed at generating savings for investment in the Marshall Islands Intergenerational Trust Fund, the Government planned

a substantial increase in expenditures and net lending in FY2004 and projected a small budget deficit of 0.6% of GDP. However, delays in capital works resulted in a budget surplus. Domestically raised government revenues, which accounted for a quarter of total revenues and grants, fell by 5% in FY2004 as income taxes and import duties declined by 12% and 6%, respectively, and receipts from the sale of fishing rights plummeted by 47%. These falls were offset by an increase in grants from the US and Taipei,China; but total revenues and grants nonetheless fell by an estimated 1% over FY2004.

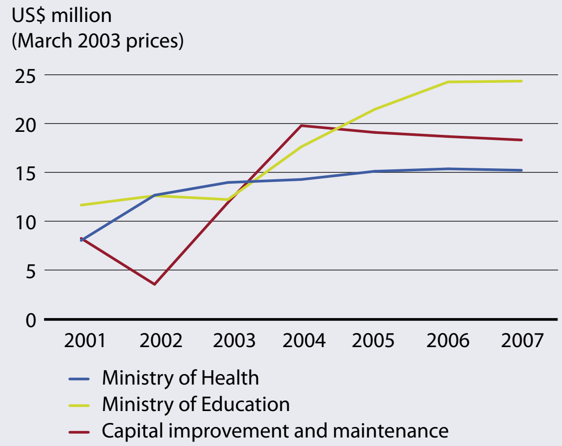
Inflation for the 12 months to September 2004 picked up slightly from the previous year but only to 2.4%. The increase was mainly a result of higher fuel costs and, to a lesser extent, higher alcoholic beverage prices following a rise in import duties. Commercial bank lending strengthened by 8% to $45 million in 2004, but remained substantially less than deposits, which rose by 3% to $81 million. Lending rates at the two commercial banks remained steady at approximately 20% for consumer loans and 15% for business loans, while deposit rates of 3% provided for a very large interest rate margin.

Macroeconomic policy developments

The amended Compact of Free Association financial assistance package as formally agreed with the US Government in December 2003 represents a major change in financial relations between the two countries. It affects the level of funding, the allocation of funds, and internal systems for managing public funds. With regard to allocation, the package provides for a large shift of expenditures toward the main sectors of health and education as well as for capital improvement and maintenance (Figure 2.28).

The environment and the private sector are also priority areas. This marks a substantial change in direction for the public sector and reflects concerns held in the Marshall Islands and the US as to the development impact of the initial assistance package provided under the Compact. Even with the additional grants provided by the new assistance package, funding to the priority areas must level off in FY2006 to stay within the budget constraint.

Figure 2.28 Government expenditures on priority sectors, Republic of the Marshall Islands, 2001–2007



Source: Staff estimates based on data from the Republic of the Marshall Islands Ministry of Finance and Economic Policy, Planning and Statistics Office.

The large increase planned in capital expenditures is important to correct for a backlog of projects. Capital spending has been curtailed for the past 5–6 years, initially by the need to repay high-cost government bonds and then by the need to save for investment in the Intergenerational Trust Fund. The rapid increase in capital expenditures requires an accompanying increase in recurrent funding (e.g., for teachers, medical staff, and medications) to make effective use of the facilities. The additional recurrent needs are yet to be fully factored into the medium-term fiscal framework, and some adjustments may be required to expenditure plans or internal revenue collection over the medium term to do this.

The amended assistance package provides for the adoption of financial accountability and management standards similar to those expected of US state and local governments. The Government recognizes that meeting these standards will require a sustained effort both to tailor systems and procedures to the circumstances of the Marshall Islands and to upgrade the capacity of its staff. Implementation of a government decision to move to performance-based budgeting is in its second year, with an initial emphasis on the ministries of Education, Health, and Environment. A medium-term budget and investment framework has also been established to shift budget planning to a 5-year rolling basis.

The Intergenerational Trust Fund had a balance of over $30 million at the end of FY2004, and this is to be built up in future years through $7 million in annual contributions by the US and ongoing contributions by the national Government. Ultimately, it is intended that the fund will provide a source of income sufficient to replace US grants. Against the assets in the fund, the Government held a debt of $100 million at end-FY2004, most of which was on concessional terms with ADB. The net debt of 65% of GDP should decline quickly over the medium term, as additional savings are made in the fund.

Outlook for 2005–2007 and medium-term trends

As the projected ratio of expenditures and net lending to GDP is more than 80%, the public sector will remain the dominant influence on the economy. Sufficient grants have been secured to maintain the high level of expenditures budgeted for FY2004, and this is expected to support the economy over the next few years. The Government's change in focus to the priority areas for development is also expected to enhance growth potential and help lift activity.

A planned catch-up in capital works in 2005, in addition to the ongoing upgrading program, has the potential to provide a short-term boost to the economy. However, there is some risk that the tighter procedures now applied to capital works will result in continued project delays. Feasibility studies are now being conducted for major projects. External project managers are appointed to oversee work, and new tendering and contracting processes are in place. The new procedures have already resulted in benefits such as the contracting of major works at figures substantially below estimated costs. However, the downside is the slow rate of project implementation.

Action is being taken to reopen the tuna loining plant. As guarantor of a $2 million loan to the business, the Government acquired control of the plant after its closure and began investigating potential market interest in reopening it. The previous operator argued the plant was only commercially viable with tax concessions and a wage below the legislated minimum. If a prospective operator shares this assessment, it may take some time to negotiate a new commercial arrangement and recommence operations.

In January 2005, Aloha Airlines of Hawaii canceled its services to the Marshall Islands as part of a wider withdrawal from the region. While the country is still serviced by three international carriers, this reduction in capacity and competition on the major US route is a setback for tourism. This follows the recent withdrawal of the international Outrigger Group from the operation of the country's main hotel.

The commercial banking sector remains constrained by the small private sector and an inability to use land and other assets as collateral for loans. However, revised land registry legislation and a strengthening of land management and administration are being pursued to ease the constraints faced by the sector.

Vocational training faces an uncertain future. A 2-year probation period set by US accreditation agencies for the College of the Marshall Islands was extended in January 2005 by 6 months, over which time the College must continue to correct shortcomings in financial management and strategic planning. If accreditation is removed, the College would lose approximately half of its revenues (via the loss of US grants) and require a substantial increase in local financial support to remain in business. Even if operations were continued, the loss of accreditation would reduce the ability of locally trained nurses, teachers, and business administrators to gain employment in the US.

Federated States of Micronesia

A reduction in foreign grants triggered a large contraction in the economy in 2004. Conditions are expected to improve in 2005, but prospects further out are highly uncertain. Foreign grants available for government expenditures are on a downward trend, and economic growth will be increasingly dependent on expansion of the small private sector.

Macroeconomic assessment of 2004

The economy contracted in 2004 as it adjusted to new arrangements with the US under the Compact of Free Association, as amended. GDP is estimated to have declined by 3.3% in FY2004 (ended 30 September), likely almost all attributable to a contraction in the public sector of 8.4%. Other sectors are also expected to have shrunk, but by less than 1% in aggregate. Dive tourism was firm, with the three main dive hotels reporting occupancy rates of more than 80%. However, other tourism activity was weak and occupancy rates at other hotels were typically less than 40%. Tourist arrivals in 2004 are estimated at more than 10% below the previous year's level and substantially below recent highs. The high cost of airfares relative to other regional destinations remains a major constraint on tourism. Even though airfares were reduced in the second half of 2004 following the July entry of a new carrier, Air Palau Micronesia, the existing operator matched these lower fares and the new operator had ceased flights by December.

The weak economic environment resulted in a poor revenue outcome for the year. Total tax receipts slipped by 2.3% in 2004, with import duty collection falling by 7% and revenues from the wages and salary tax weakening by 5% (in nominal terms). Improved enforcement led to a slight rise in revenues from the third-largest tax, a turnover tax. The declines in tax revenues were greatest in the states of Chuuk and Kosrae, of 15% and 7%, respectively, from the 2003 levels. In contrast, collection in Yap and Pohnpei rose by 3% and 4%, respectively. This pattern is consistent with the relatively larger fiscal adjustments that were required in Chuuk and Kosrae in 2004.

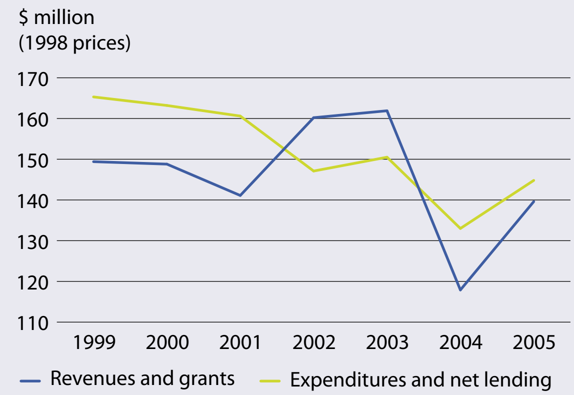
Grants also fell substantially during the year, stemming primarily from the end of a "bump-up" in funds provided by the US for the final 2 years of the previous Compact. The 27% fall in revenues and grants exceeded a 12% cut in expenditures and net lending, and the consolidated budget moved into deficit (Figure 2.29). This followed 2 years of surpluses, which had been achieved to meet a government commitment to invest in a trust fund, negotiated as part of the amended Compact.

Inflation is estimated to have stayed low in 2004 at 1.5%, as a result of the US dollar's use as a base currency and the low inflation rates in the country's main trading partners. Commercial bank lending remained low over the first half of 2004. Total lending was $53 million as of December 2001, but had fallen to $22 million by December 2003 following the closure of the operations of the Bank of Hawaii in the country and a tightening in the lending policies of the two remaining banks. Lending fell by a further 8% by end-June 2004. Commercial loans recorded a 23% rise over the first half, but this was more than offset by a fall in consumer lending. Lending by the other main source of finance, the FSM Development Bank, was stable. Indicative interest

rates on business loans from the commercial banks remained close to 7% while interest rates on consumer loans rose slightly to just above 15%. Deposit rates continued to hover around 1%. Deposits at the commercial banks of $110 million as of June 2004 remained well above total lending.

It is expected that exports were stable in 2004, representing about 15% of imports. While the easing in domestic demand is likely to have lowered non-oil imports during the year, higher fuel prices will have countered this, and the trade deficit is forecast to come in at close to recent levels. The large decrease in grants for 2004 is likely to have resulted in an overall deficit on the balance of payments.

Figure 2.29 General government revenues and expenditures, Federated States of Micronesia, FY1999–FY2005



Sources: Government of the Federated States of Micronesia, *Strategic Development Plan (2004–2023), The Next 20 Years: Achieving Economic Growth and Self-Reliance*; staff estimates.

Macroeconomic policy developments

The amended Compact with the US will provide $92 million in grants annually until FY2023. This is substantial, at the equivalent of 40% of current GDP, and will underpin the economy over the long run. The grant is only partially indexed to inflation and, what is more important for fiscal management, a portion of the grant is to be saved in a trust fund. Initially $16 million is to be saved each year, but from FY2006 this will rise by $0.8 million a year. The consequence is that grants available for general government expenditures are significantly below the $84 million received toward the end of the previous agreement (excluding the bump-up). The real value of grants available for the budget will continue to decline.

The Third FSM Economic Summit was held in early 2004 in Palikir, Pohnpei to build awareness of the new arrangements with the US and to develop consensus on an overall development strategy. The summit was attended by more than 400 people, representing the traditional leadership, the private sector, national and state governments, NGOs, churches, women's and youth groups, the civil service, and international donors. A consensus emerged at the summit to pursue a high economic growth strategy based on agriculture, fisheries, and tourism with the objective of achieving self-reliance over the term of the amended Compact. The summit also emphasized the importance of ensuring that Micronesians receive an equitable share of the benefits of growth.

The summit recognized that achieving the strategy would require a major public sector reform program, and agreed that a key element of the program would be the generation of revenues required to protect essential public services and investment. A redirection of expenditures to priority areas was also envisaged, including increased investment in airports, electricity, roads, and health facilities. It was also agreed that performance-oriented planning and budgeting systems would be adopted. The summit endorsed action to generate domestic and foreign investments through revised rules and laws, including the implementation of regulations to facilitate employment of the foreign technicians and managers needed for rapid growth. The overall intention of the public sector reform program will be to create a competitive investment environment to buttress private sector expansion.

Outlook for 2005–2007 and medium-term trends

The amended Compact provides for the adoption of a range of new performance requirements. These include new procedures for the specification, tendering, and contracting of major public works. The FY2004 budget anticipated administrative problems in adjusting to the new procedures and only budgeted for relatively low levels of

public investment. However, it was expected that these problems would be overcome by FY2005, when there would be a large expansion in the public works program. This boost in investment is expected to help the economy recover, and growth in GDP of 2.3% is projected in FY2005.

The revenue position is expected to improve in FY2005 as the firmer domestic economy pushes up tax revenues and $13 million is received from a US Special Education Grant (in addition to Compact funds). A small deficit is projected for the consolidated general government sector for the year. Despite a second consecutive year of deficits, gross external public debt is expected to remain low at approximately 26% of GDP, or less than 20% in net terms once offshore financial assets are taken into account.

The consolidated general government sector faces an ongoing need to control operating expenditures. In addition to the decline in grants available for general government spending, transition arrangements require a shift from operating to capital spending. Over the 5 years to FY2009, $6.3 million is to be redirected from operating expenditures. While the required correction is small relative to total expenditures and net lending, it is large relative to the expenditure base from which compensating cuts could be made. In the case of the state governments, the cut in locally funded operating expenditures would range from 16% to 37% if all the adjustment is to be made on the expenditure side.

The economic summit favored the pursuit of revenue reform to help alleviate fiscal constraints. A commitment was made at the summit to a revenue-neutral shift to a modern tax system within 2 or 3 years. Adjustment to existing taxes could cover the $6.3 million revenue shortfall—most of it, for example, by an increase in the gross revenue tax from 3% to 5% and in the general import duty rate from 4% to 10%. The introduction of a VAT to replace the gross revenue tax is also being considered. A VAT is also recognized as having the advantage of providing a sound basis for raising overall revenue collection.

A quick buildup in private sector activity is unlikely given its current low level. The economy is heavily consumption oriented, and export activities have been slow to establish themselves. Most families meet their own needs with regard to locally produced items, and consequently local trade in agricultural products is limited and agricultural exports are few. Attempts to establish export-based fishing operations have met with little success—any exports are almost entirely attributable to the efforts of distant-water fishing nations.

Tourist arrivals are now low at around 10,000 people a year, and there seems to be no ready solution to the hurdle imposed by a monopoly airline. This low base of private sector activity highlights the major effort required to raise the standard both of infrastructure and of the policy environment, if high growth is to be achieved.

Nauru

Nauru continued its reliance on Australian financial and technical assistance in 2004 as phosphate production contracted and trust fund assets went into receivership. A reformist administration elected in October has a strong public mandate to implement economic reforms but, in the absence of an alternative to phosphate mining, the medium-term outlook is for continued dependence on external assistance.

Macroeconomic assessment of 2004

Macroeconomic analysis of the economy is severely hampered by the virtual absence of economic statistics, but it was clear that the economy remained in a critical condition in 2004. Phosphate production, which historically has been the only significant domestic economic activity, was at an almost negligible level following years of exploitation and mismanagement, and allowed for only limited exports of relatively low-quality product to Asian markets. Agricultural output was stagnant, constrained by inadequate rainfall and low fertility of the limited arable land area. Coconut, breadfruit, and a few fruits and vegetables were harvested for household consumption. Fishing output was largely confined to subsistence harvesting, and was held back by a lack of equipment. Services sector activity recorded no growth, with public sector wages in arrears, tourism virtually nonexistent, provision of power and water dependent on external assistance, and returns on overseas investments dried up. Net assets in the trust funds administered by the Nauru Phosphate Royalties Trust (NPRT) had been valued at A$1,300 million in 1991, but the combined impact of excessive consumption spending, poor investment advice, and mismanagement reduced the value to an estimated A$138 million in 2002. Continued mismanagement culminated in early 2004 with the placement of the asset portfolio into receivership, following the Government's failure to meet the repayment deadline on a loan from General Electric Capital Corporation. Sale of NPRT's Australian property portfolio reportedly covered the $188 million owed on this loan, and left a relatively small pretax amount of about $78 million with which to meet other debt-repayment obligations.

In the absence of phosphate and trust fund revenues, the economy remained reliant on income from fishing licenses and foreign aid. The established Australian bilateral assistance program continued, as did the provision of project assistance under Australia's Rehabilitation and Development Cooperation Program begun in 1993. Additionally, assistance in health, education, and maintenance of public infrastructure was provided in return for Nauru hosting processing centers for asylum seekers, which held 82 people in September 2004. Under a February 2004 memorandum of understanding between the governments of Australia and Nauru, the former agreed to provide an A$22.5 million package of assistance to June 2005, which included the placement of Australians in three in-line positions in the Ministry of Finance (including the secretary) from late July. Australians also took up positions as director of police and special police advisor from late October. The finance team was tasked with improving public financial management, assisting in the formulation of the 2004/05 budget

and assessing Nauru's assets and liabilities. Assistance was also provided in late 2004 by the Pacific Islands Forum, which gave a cash grant for salaries and offered support for the judiciary, financial auditing and planning, and the health and education sectors.

Political instability in late 2003 disrupted the approval process for the 2003/04 budget, which was in any case quite unrealistic in its revenue and expenditure projections. Dividends to the Government from the state-owned Nauru Phosphate Company (NPC) ended in 1991 and the virtual standstill of phosphate production in 2004 prevented the Government from borrowing against phosphate sales revenues. Checks drawn on government accounts with the state-owned and technically insolvent Bank of Nauru remained worthless; and the shrinking of the NPRT investment portfolio meant that the Government could no longer rely on direct drawdowns from trust funds and collateralization of their assets as the principal means of funding a budget deficit.

In the event, government spending in 2003/04 was limited by the availability of revenues and authorized by the passage of three supply bills, with the result that a small surplus of A$37,600 was recorded. Actual expenditures were 35% of the budgeted level and involved a substantial shortfall in public service wage payments: only A$5 million was paid, compared with a salaries liability of A$13 million. The consequences for public service delivery were evident in education: the sector fell into crisis as expatriate teachers left Nauru without their back pay or their superannuation entitlements. Nauruan teachers were receiving incentive payments from the Australian Agency for International Development of $10 per week; but, like all government employees, they were receiving less than their full salaries and their productivity was reduced by inadequate supplies of complementary inputs such as teaching materials. Salaries for public enterprise employees were also in arrears, notably in NPC, which could neither pay nor immediately repatriate its foreign contract workers. Since almost all Nauruans in formal employment are in the public sector, economic hardship increased in 2004, with people using any public sector wages received, savings held offshore, and private remittances from relatives overseas to purchase essential supplies of rice and flour.

Given the use of the Australian dollar as the currency and Australia's position as the major supplier of imports, the inflation rate in the first 3 quarters of 2004 was probably around the Australian rate of 2.3%. With the Bank of Nauru insolvent, no effective commercial banking services were available; the contraction of economic activity inevitably discouraged financial development beyond cash-only exchange and barter. The merchandise trade deficit was covered primarily by official and private transfers.

Macroeconomic policy developments

Past budgets in Nauru have been characterized by overoptimistic revenue projections, underestimation of expenditure needs, and nontransparent funding of unsustainable deficits. The 2004/05 budget approved by Parliament in late October 2004 represents a fundamental change in approach to fiscal management. It explicitly acknowledges that the country is in financial crisis and accordingly aims at ensuring that expenditures are reduced and controlled within limits set by realistic, medium-term projections of revenues and grants.

Expenditure reduction is to be achieved through reducing the public service wage rate to an average of $75 every 2 weeks (pending completion of a review of public service salaries); cutting by 75% payments to landowners leasing land to the Government; scaling down diplomatic representation in Australia and the US; cutting expenditures on residential accommodation for Nauruans receiving medical treatment and studying in Australia; and transferring overseas Nauruan students from Australian to Fiji Islands institutions in 2005. Public service wages will account for 44% of reduced aggregate expenditures and there is provision for some reallocation of resources to education and health, as well as for the establishment of a price control board to prevent profiteering by merchants with monopoly power.

Revenue-raising measures include the introduction of a 10% import duty on goods (except for rice, flour, and fresh fruits and vegetables) previously imported free of duty; increased import duties on alcohol and tobacco; the transfer of fishing license fees from the Nauru Fisheries and

Marine Resources Agency to the Government; and increases in various fees and charges.

Income from investments, dividends, and fishing license fees and from customs and excise duties is estimated to account for 35% and 26%, respectively, of total revenues. A budget deficit of A$497,000 is projected for 2004/05, to be followed in the next 2 years by budget surpluses in excess of A$2 million. The 2004/05 budget papers are silent on how the projected deficit is to be financed, implying that, in the absence of a revenue windfall, expenditures will have to be reduced to ensure budget balance. The probability that the 2004/05 budget and associated economic reforms will be implemented effectively is high because of the strong parliamentary majority held by the reformists and because technical assistance will help ensure sound cash management as well as expenditure control.

A key element in introducing responsible public financial management was the initiation of an assessment of assets in the trust funds administered by NPRT. Remaining trust fund assets will need to be restructured away from a heavy property orientation toward a properly managed portfolio of secure income-generating financial assets. The task of restructuring is complicated by the fact that the various trusts are owed millions of dollars by the Government and by the state-owned Republic of Nauru Finance Corporation (RONFIN), which has been technically bankrupt for at least a decade. The reform of the 11 major SOEs other than NPRT itself is a demanding medium-term requirement and will need to include an assessment of the state of NPC's finances and future prospects. The 2004/05 budget affirms the Government's commitment to public enterprise reform, beginning with the winding up of RONFIN.

Following the decision to close Nauru's internationally notorious offshore banking sector, antimoney laundering legislation was passed in 2004. This is expected to culminate in Nauru's removal from the Non-Cooperative Countries and Territories (NCCT) list of OECD's Financial Action Task Force (FATF) on money laundering. In October 2004, FATF withdrew countermeasures against Nauru because of the passage of the legislation, but awaits evidence of implementation before complete removal from the NCCT list. The 2004/05 budget provides funding for the establishment of a financial investigations unit to support the implementation process. Setting up a viable domestic banking system is another major task to be addressed in the economic reform program.

Outlook for 2005–2007 and medium-term trends

Continued exploitation of phosphate deposits, which are almost exhausted, offers no prospect of medium-term economic growth. Even the extraction of remaining reserves is hampered by the deterioration of infrastructure and equipment due to past neglect of maintenance. Aid-funded rehabilitation of mined land will generate economic activity at a relatively low level over the medium to long term, and will thus indirectly generate some government revenues, as will other aid-funded projects. However, there is no obvious alternative to phosphate mining as a means of creating GDP. National income will be heavily reliant on external sources. Pelagic fish are abundant in Nauru's exclusive economic zone, and revenues can be expected from fishing licenses issued to several deepwater fishing nations, though this is an inherently volatile revenue source that is difficult to predict. Revenues could also be generated by restructured trust funds, though the authorities do not expect them to be substantial.

The Government acknowledges that fiscal reform entails increased financial hardship for the population in the medium term. Nauruans employed in the public sector—almost everybody in formal employment—will bear the brunt of unavoidable wage cuts that will have flow-on effects in the rest of the economy. The mostly ethnic Chinese retailers who depend on public servants' purchasing power will experience further reductions in business, and some may join other expatriates departing the country on Air Nauru's solitary aircraft, which offers the only available commercial service and which will continue to struggle for financial viability.

Republic of Palau

Economic growth accelerated slightly in 2004 as a result of strong tourism expansion. However, the economy remains heavily dependent on US assistance and the Government needs to curb public expenditures. This is a key element of a general reorientation toward encouraging private sector-led development, which is essential to sustainable economic growth in the post-Compact era starting in 2009.

Macroeconomic assessment of 2004

Palau became independent on 1 October 1994 in free association with the US, and joined ADB on 29 December 2003 as the 63rd member. Historically, Palau was a part of the UN Trust Territory of the Pacific under US administration. A Compact of Free Association—an economic, political, and strategic treaty between Palau and the US—was approved in 1986 but was not ratified until 1993. Under this Compact, which covers the 15-year period FY1994–FY2009, Palau conducts its own domestic and foreign affairs, while the US retains control of defense and security matters (for which it has exclusive access to Palau's waterways); pays for health services; and provides about $600 million in economic development assistance, including grants for direct budget support (of around $13 million annually) and disbursements for the creation of a Compact Trust Fund (CTF). Palau consequently has enjoyed one of the highest living standards in the Pacific, though this has largely been generated by an aid-dependent public sector.

Based on the limited data available, Palau's GDP increased by 2.0% in 2004, compared with contraction of 0.1% in 2003 and 4.7% in 2002. The growth was attributable to the continued revival of tourism following the downturn induced by the 1997–98 Asian financial crisis. In FY2003 (ended 30 September), visitor spending almost reached the precrisis level, and in FY2004 visitor arrivals grew to a record of nearly 80,000. This tourism growth boosted the retail trade sector, which continued to benefit also from expansion in public sector activity. The relatively small agriculture sector generated some subsistence income, but its development has been hampered by lack of infrastructure, while revenues from fishing license fees remained at the fairly low level of recent years. Tuna harvesting by fishing fleets from Japan; US; PRC; and Taipei,China failed to produce the catch levels characteristic of the late 1980s.

With GDP and population growing at almost the same rate in 2004, per capita income grew slightly but remains at 6% below the 2000 level. Moreover, income disparities have reportedly widened in the last 5 years. According to census figures, the share of the non-Palauan resident population increased from 16.8% in 1990 to 25.6% in 1995 before reaching 30.1% in 2000. The 1990–2000 increase accounts for four fifths of the increase in the country's total population.

Government expenditures increased to 66.3% of GDP in FY2004 from 57.5% in FY2003, and revenue collection was poor. The overall budget deficit was estimated at 9.9% of GDP and was again financed by drawdowns from the CTF. The balance of the CTF had already dropped from a peak of $162 million at end-FY2000 to $136 million at end-FY2003.

The high level of consumption relative to domestic production was reflected in a large trade deficit equivalent to almost two thirds of GDP: merchandise exports were estimated at $11.9 million in 2004, compared with merchandise imports of $108.8 million. The current account deficit increased from $5.3 million in FY2003 to $22.5 million in FY2004. Use of the US dollar as the currency precludes an independent monetary policy and means that inflation tends to track that in the US, which has been low over the last 3 years.

Macroeconomic policy developments

Fiscal deficits in most recent years have been the highest among Pacific island economies and have been a major drain on the CTF, which has also been adversely affected by trends in international equity markets. FY2005 marks the 11th year of the Compact and Palau will receive $12.8 million in direct assistance during the year, but Compact grant disbursements are expected to decline over the remainder of the Compact period. There is therefore an urgent need to formulate and implement a medium-term fiscal strategy that ensures long-term fiscal sustainability. This strategy must involve a reprioritization of a reduced level of government expenditures and augmentation of the CTF as a source of sustained revenues. The policy challenge is substantial, given that the Government provides utilities, communications, and health services in addition to the usual public services, making it the single largest service provider and employer in the country. It is critical that the Government improve its management of service provision, including the adoption of innovative financing options and mutually beneficial partnerships with the private sector.

Additionally, the Government will need to promote private sector-led development that generates greater benefits to the domestic economy. At present, it relies heavily on grant-funded public sector construction activities that have limited multiplier effects on total output: many construction workers are temporary foreign workers, largely from the Philippines (61% of foreign workers) and the PRC, who remit their salaries to their home countries. Economic activities with greater output and employment multiplier effects need to be promoted through structural reforms, including the creation of a leaner, results-oriented civil service, tax and tariff reform, and public enterprise reform. The costs of doing business in Palau are generally high by international standards, as is the case in other Pacific island countries, and are especially high for closing a business. Bringing these costs down is an essential component of an improved enabling environment for the private sector.

Outlook for 2005–2007 and medium-term trends

In the medium term, growth is forecast to be about 2% and to occur in a low-inflation environment, with a large trade deficit offset by inflows on the services, income, and transfers accounts. This growth will be driven in part by tourism, with economic recovery in Japan and continued economic growth in the PRC ensuring that tourist arrivals and spending exceed the 2004 level. Public sector infrastructure projects will be the other driver of growth, as two major construction projects will be completed in 2005 to early 2006.

The larger project is the construction of a 53- mile two-lane highway on the island of Babeldaob, which will be the second longest after a highway in Guam in the Micronesian region. Included as a special economic development project in the Compact financial package from the US, this project is known as the Compact Road. Substantial delays have occurred due to problems with the technical implementation design and bad weather, but completion is expected by mid-2005. This will make tourist attractions and many commercial facilities more accessible, strengthening the foundations for future private sector growth.

The second major project is the construction of the new national capital complex at Melekeok, again on Babeldaob. The project is funded by a $23 million concessional loan from Taipei,China and will be completed in early 2006 when the Government will move about half of the administration from the highly populated and urbanized center of Koror on Babeldaob, which will retain health and policy development among other

functions. The development of a new, modern capital symbolizes Palau's emergence as an independent state, but this has significant implications for the budget. It is estimated that the recurrent cost of the new facilities will add $2 million a year to government spending.

A third project that will contribute to growth is the establishment of a central market in Babeldaob, which is intended to support agricultural development by improving marketing facilities. A feasibility study by the Bureau of Agriculture with the Food and Agriculture Organization of the United Nations included an investigation of central market systems in several Pacific countries and concluded that, once completed, the central market will have a capacity to handle an annual output of some 420 tons of fruits, vegetables, and root crops, and 160 tons of fish. Construction is scheduled to start in April 2005.

Over the medium to long term, the Government faces the twin economic challenges of managing the fiscal adjustment to a decline in sector grants and encouraging broad-based private sector development in a small domestic economy. At present, there is an overdependence on aid and tourism and a consequent uncertainty about sustained growth prospects in the post-Compact period.

Papua New Guinea

The economy grew at a modest rate in 2004, inflation fell substantially, and financial conditions improved. The outlook is for continued modest economic growth, provided that fiscal gains are consolidated and structural reforms aimed at stimulating private sector-led growth in nonminerals are implemented.

Macroeconomic assessment of 2004

GDP increased by 2.6% in 2004, slightly down from 2.8% in 2003. The agriculture, forestry, and fishing sector was the primary engine of growth, expanding by 3.0% as weather and commodity prices remained generally favorable. Within the minerals sector (mining plus oil and gas), the mining subsector grew by 3.3%, stimulated by higher gold and copper prices and aid-funded road maintenance and upgrading projects. However, the oil and gas subsector contracted by 5.8% despite higher oil prices because reserves extraction fell. The minerals component of GDP therefore increased by just 0.1%. Manufacturing expanded by 2.8%, construction by 3.2%, and electricity, gas, and water by 2.5%. The services sector as a whole grew by 2.0%, but there was variation in subsector performances: transport grew fastest at 3.0%, followed by trade at 2.6%, finance, real estate, and business services at 2.5%, and community, social, and personal services at 1.5%.

Economic growth barely kept pace with that of the population. Similarly, although the relatively labor-intensive nonminerals component of GDP rose faster in 2004 (2.8%) than in 2003 (1.7%), job growth did not match the growth in labor supply. Formal private sector employment in the quarter to June 2004 was barely 0.1% higher than that in the year-earlier period. The only significant expansion in nonminerals employment was seen in the manufacturing, retail and finance, and other business sectors, with declines in all others. Minerals sector employment increased by 8.2%, but this was entirely because of expansion at one gold mine. On a regional basis, the most worrying outcome in 2004 was the decline in employment in the two rural regions (Momase and the Highlands) that together hold approximately three quarters of the poor in Papua New Guinea.

The 2004 budget balance officially was expected to be a surplus of 1.1% of GDP, compared with an original budget target of a deficit of 1.5%. Total revenues and grants exceeded the budget projection by 11.6%, largely because of unexpectedly high mining and petroleum tax and dividend receipts. The temporary 1% import levy introduced in the 2004 budget also raised more revenues than anticipated, but only partly offset a decline in receipts from log export duties. Total expenditures and net lending exceeded the original budget estimate by 2.4%, with total recurrent spending in line with the budget projection, and development spending exceeding the projected level by 7.0%. Lower interest rates meant that government servicing of its debt was 40% below the budget projection. The consequent savings permitted a reallocation of public resources toward development expenditures, and were also used to pay off arrears and cover the costs of certain verified legal claims against the Government.

Spending on goods and services was over a

third higher than the budget projection, while, accounting for 42.9% of total recurrent spending, the wage bill was 2.9% above the projected level. In accordance with the Public Finances (Management) Act, 90% of the unexpectedly strong mining and petroleum revenues were used to retire government debt. Total public debt was projected to be 54.6% of GDP at the end of the year, compared with 59.7% at the end of 2003. Domestic debt fell to 22.5% of GDP at end-2004, with a lengthening of the maturity of the debt as the Government implemented its Inscribed Stock Issuance Program and retired short-term treasury bills. External debt fell from 35.5% of GDP at end-2003 to 32.1% at end-2004, reflecting the valuation effect of currency appreciation and an outflow on net external financing.

Inflation in 2004 fell sharply to 2.9%, compared with 14.7% in 2003. This drop was largely attributable to the lagged effects of currency appreciation in late 2003 and, in 2004, the combined effect of higher commodity prices and tighter fiscal management on the exchange rate, which appreciated further (with the latter damped by central bank intervention). The strengthening of the kina prompted Standard & Poor's to raise its country rating from stable to positive at year-end. Falling inflation in the context of balance-of-payments strength encouraged the Bank of Papua New Guinea (BPNG) to ease monetary policy through the first 10 months of 2004. Official interest rates dropped substantially, with interest rates on 182-day treasury bills down from 17.0% in January 2004 to 3.1% in November. However, commercial bank lending rates declined only marginally from 13.9% to 13.1% during this period, indicating a lack of competition in the banking sector. Broad money supply increased by 17.7% because of a rise in net foreign assets. Domestic credit fell by 1.0% because of a 2.5% decline in credit to the private sector, suggesting a lack of effective demand for funds from business.

Official budget projections show a 15.1% rise in the trade surplus in 2004 and the current account surplus remaining virtually unchanged as a share of GDP at 3.7% against 3.8% in 2003. Balance-of-payments data for the first 3 quarters suggest that the projections may have overestimated the trade and current account surpluses

Table 2.24 Major economic indicators, Papua New Guinea, 2004–2007, %

Item	2004	2005	2006	2007
GDP growth	2.6	2.9	1.7	2.6
GDI/GDP	-	-	-	-
Inflation (CPI)	2.9	3.8	4.8	4.9
Money supply (M2) growth	17.7	-	-	-
Fiscal balance/GDP	1.1	-1.0	-0.6	-0.2
Merchandise export growth	12.7	5.1	-7.1	3.5
Merchandise import growth	10.7	6.2	-2.9	5.6
Current account/GDP	3.7	2.5	0.5	-0.8

CPI = consumer price index, GDI = gross domestic investment, GDP = gross domestic product.

Sources: Government of Papua New Guinea, *2005 National Budget*; staff estimates.

because of unexpectedly strong growth in general imports and mining-related investment expenditures. The current account in the first 3 quarters recorded a small deficit of US$18 million, equivalent to approximately 0.5% of GDP, though during this period there was a net inflow on the financial account of US$61 million, as mineral producers drew down their foreign currency accounts, trade credits to domestic residents rose, and foreign investment flowed into a mining venture. The overall balance-of-payments surplus in the first 3 quarters thus increased over the corresponding period in 2003, and foreign reserves rose to US$589 million at end-September, equivalent to 4.6 months of total import cover and 5.3 months of nonmineral import cover. The domestic currency, the kina, appreciated by 2.5% against the US dollar and 1.2% against the Australian dollar in 2004.

Macroeconomic policy developments

The 2005 budget passed by Parliament in November 2004 continues the implementation of the Government's medium-term fiscal strategy, which aims at progressively reducing the deficit until budget balance is achieved in 2008, and at reallocating expenditures to the five priority areas identified in the Medium Term Development Strategy, 2005–2010, namely rehabilitation and maintenance of transport infrastructure, generation of income-earning activities, basic

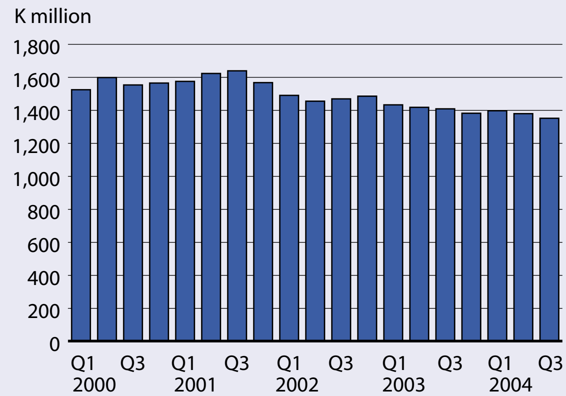
education, primary and preventive health care, and law and justice. The fiscal strategy also aims at reducing the Government's outstanding liabilities, maintaining existing tax levels without introducing new taxes, and sustaining institutional and policy reform.

An overall budget deficit of 1.0% of GDP is targeted for 2005, and is to be funded by domestic borrowing, with the Government continuing to shift the debt balance from short- to longer-term securities. Net external financing is an outflow equivalent to 1.3% of GDP, with anticipated new concessional and commercial loans more than offset by amortization on existing loans. Revenues (including grants) are projected to be 8.3% greater than in 2004, primarily because of an anticipated increase in project grants mainly associated with the Enhanced Cooperation Program with Australia. Nontax revenues are projected to rise as dividends from BPNG and the National Fisheries Authority accrue, but tax revenues are projected to fall by 4.6% because of the ending on 1 January 2005 of the temporary import levy as planned, the continuing phased reduction of the mining levy, and lower oil and copper prices. There are no asset sales included in the budget projections, but if any occur, the proceeds would be used to retire debt and rehabilitate state assets. The sale of 51% of Telikom PNG Limited that was to occur in 2004 was delayed and then canceled in mid-December, signaling some government hesitancy in the implementation of the privatization policy and provoking a legal response from the overseas tenderer.

Total expenditures and net lending are projected to rise by 15.7% in 2005. Total recurrent expenditures are budgeted to go up by 4.6% from the 2004 level, largely because of a 9.2% rise in the wage bill, which is presented as a calculated and responsible component of the public expenditure review and rationalization program. Expenditures on goods and services are projected to increase by less than 1% from the unusually high level of 2004, when outstanding state liabilities were settled; but there is provision for structural adjustment payments arising from public sector reform and for increased resource allocation to provincial departments so as to improve service delivery.

Development expenditures are projected to rise by 38.3% from the estimated 2004 level as a result of grant-funded expenditures under the Enhanced Cooperation Program, project grants from the Japan International Cooperation Agency, increased government drawdowns of concessional loans, and increased provision of tax credits for infrastructure expenditures. As in the past, the real issue is whether the budget is implemented as planned in a fragile political environment characterized in 2004 by threats of no-confidence motions in the prime minister, suspension of Parliament, and major cabinet reshuffles.

Figure 2.30 Credit to the private sector, Papua New Guinea, March 2000–September 2004



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, September 2004.

In 2004, BPNG continued to demonstrate its capacity to conduct an independent and prudent monetary policy aimed at protecting foreign reserves and stabilizing the kina. The kina's stabilization contributed to an increase in business confidence, according to an independent business survey *(Economic Insights 2004)*, but midyear BPNG predictions of significant growth in private sector credit during the second half of 2004 seemed overoptimistic. Correspondingly, excess liquidity likely did not pose an imminent threat to exchange rate stability. Nonetheless, BPNG strengthened its capacity to control liquidity through open-market operations by introducing an additional policy instrument in August. The new "central bank bill" has the same features as treasury bills and is traded at weekly auctions. The insolvent Rural Development Bank underwent a change of management and an external review in 2004, with the intention of formulating and implementing a financial recovery plan.

Reversing the decline in lending to the private sector is crucial to improving medium- to long-term growth prospects (Figure 2.30). A reduction in lending rates in line with official interest rate falls would facilitate such a reversal, as would reductions in the costs of doing business. According to the World Bank's Doing Business Indicators, the country rates poorly in the time taken to start a business (56 days), the costs of establishing a business (30.7% of per capita income), the time to enforce a contract (295 days), and the time to process an insolvency (2.8 years).

More fundamentally, it is likely that a sustained turnaround in private sector borrowing requires political stability and significant progress in addressing long-standing law-and-order and governance problems. The survey referred to above showed that the cost of finance was seen as a constraint to business, but one that rated below weak private sector demand, poor security, and general uncertainty. Major new natural resource development projects would also boost investment. The presence of Australian police, defense personnel, and technical advisors under the Enhanced Cooperation Program is expected to reassure investors, but how much this reassurance will translate into actual borrowing and investment remains to be seen.

Outlook for 2005–2007 and medium-term trends

On the assumptions that global economic growth will slow in the medium term, that commodity prices generally will weaken from the historical highs of 2004, and that the Government's economic and public sector reform strategies will be implemented successfully within a stable macroeconomic and political environment, GDP growth is forecast to be 2.4% over 2005–2007, though subject to volatility because of the vagaries of weather, commodity prices, and natural resource discoveries. This aggregate growth forecast was made by government officials in the 2005 budget papers and by external agencies, including IMF and ADB.

Export-led growth in agriculture is expected to accelerate to over 3% a year as improved law and order and transport infrastructure increase producers' access to markets; and fisheries production is forecast to grow in response to expanded domestic processing capacity. However, log exports are likely to decline as governance of the sector improves, so that agriculture, forestry, and fishing as a whole is forecast to grow at an average annual rate of 3.2% in 2005–2007.

The oil and gas subsector is expected to recover from its 2004 contraction in 2005 as investment in the Moran oil field increases access to resources. Thereafter, depletion of reserves at the Kutubu and Gobe fields will cause a drop in production, with the impact of any new projects likely to be felt in the longer term. The decision by Exxon Mobil to proceed with a US$100 million front-end engineering and design study of the Southern Highlands gas project is encouraging, but there are still insufficient customers at the Queensland, Australia end of the proposed gas pipeline to ensure project viability. In the absence of this project, oil and gas is forecast to decline at an average annual rate of 4.0% in 2005–2007.

Mining production is expected to stagnate over the medium term after expanding significantly in 2005 as a result of increased production of copper and gold, the latter reflecting the start of production at two new, relatively small gold mines and the expansion of existing mines (except Misima). In 2006, reserves depletion at the Porgera gold mine and Ok Tedi copper mine, and the impact of an expected declining copper price, are forecast to cause a contraction in sector output.

The net result for the oil and gas and mining subsectors together is that output in 2007 is expected to be 0.6% below the 2004 level.

Manufacturing is forecast to grow at annual rates of just below 3% in 2005–2007, on the basis that domestic demand will strengthen in the context of a stable macroeconomic environment and improvements in law and order and governance. Construction is forecast to grow at rates slightly in excess of 3% annually as a consequence of increased public expenditures on transport infrastructure development and a pickup in private investment. The electricity, gas, and water subsector in services is also expected to make a positive contribution to growth as SOEs invest in the rehabilitation and expansion of infrastructure. The services sector as a whole is forecast to grow at an average annual rate of 2.3%, with growth in transport heavily reliant

on an increase in agricultural production for domestic and export markets.

The main risks to the growth forecasts are that the macroeconomic policies, public sector reform plans, and development strategies of the incumbent administration will not be implemented for political reasons, or will not elicit the expected response from the private sector. The Enhanced Cooperation Program offers some insurance against economic mismanagement and further deterioration in the law-and-order situation, but cannot by itself guarantee the private investment that underpins sustained and broad-based economic growth. These forecasts may be exceeded on the upside if commodity prices turn out higher than expected, and if major natural resource development projects such as the Ramu nickel and cobalt project are under way within the forecast period.

The official government medium-term fiscal outlook is for a reduction in the budget deficit to 0.2% of GDP in 2007. A fall in tax revenues from the oil and gas sector is the main reason for a projected drop in revenues and grants from 31.2% of GDP in 2004 to 29.7% in 2007, while expenditures and net lending are projected to fall from 30.1% of GDP in 2004 to 29.9% in 2007. The latter fall requires substantial savings still to be identified through the public service rightsizing and public expenditure review process, so that there is a possibility that budget targets could be overshot. However, provided that the targets are met, total public debt is forecast to decline to 50.9% of GDP in 2007, with declines in domestic public debt to 23.3% and external public debt to 27.6%.

Monetary policy is expected to remain broadly accommodative in the medium term, on the assumption that sound fiscal management and modest wage rises underpin exchange rate stability and inflation below 5%. The current account on the balance of payments is forecast to weaken in the medium term as merchandise import growth outpaces export growth, and increased deficits on the services and income accounts outweigh a rise in transfers. Export growth will be reduced by the impact of lower oil and copper prices and production, and would be even lower in the absence of an increase in agricultural exports, which are forecast to exceed mineral exports by 2007. Forecasting capital account transactions is difficult because of uncertainties over flows of concessional finance, but it is expected that balance-of-payments strength will be maintained and that foreign reserves will remain high enough to provide at least 4.5 months of nonmineral import cover.

The ability of the economy to generate agricultural growth in the context of declining petroleum output is crucial to the macroeconomic outcomes forecast for 2005–2007. Nonmineral output growth is essential for employment generation, but even if the forecasts prove accurate, growth remains too slow for substantial inroads to be made into the un- and underemployment problems. The country's growth rate needs to at least double before this can happen.

Samoa

The economy expanded by more than 2% in 2004 as construction strengthened and tourism continued to grow, though the loss of agricultural production due to cyclone Heta pushed inflation up to 16% by year-end. The FY2005 budget provided for a 60% increase in expenditures and net lending, much of which is allocated to additional public works. Continuing high levels of construction activity are expected to support the economy over the medium term.

Macroeconomic assessment of 2004

The year got off to a bad start due to the widespread damage wrought by cyclone Heta in January. While the destruction was not as severe as in earlier cyclones, it had an immediate adverse effect on the supply and price of agricultural products. In the quarter to March, the overall volume of supply to the main fresh produce market fell by 52% and the overall price index at the market rose by 71%. Fishing activity was also adversely affected and the need to repair damaged infrastructure impacted the budget, requiring reallocation of funds.

The economy recovered quickly though, and GDP over the first 3 quarters of 2004 came in at 2.3% higher than in the same period of 2003. While agriculture and fishing declined by 9.2% over the period, industry expanded by 2.6% and services rose by 5.2%. Growth for the whole year is estimated at 2–3%.

Greater construction activity led growth in the industry sector in 2004, supported by several large private and public sector projects, in addition to reconstruction work required by the cyclone. New office buildings were under construction for the government-owned telecommunications operator and the Development Bank of Samoa. Preparations continued for the hosting of the 2007 South Pacific Games. Construction of roads, bridges, seawalls, and schools continued, and work was under way for a new 140-room hotel at Faleolo, a temple, and a shopping mall. The increase in construction more than offset a drop in manufacturing as output from the automotive wire harness plant fell and a garment factory closed temporarily to relocate premises. The growth in services was attributed mainly to increased output from financial and business services and from personal and other services.

Visitor arrivals continued to rise in 2004, in part due to the holding of Pacific Forum meetings in Apia. Preliminary estimates are that arrivals increased from 93,000 in 2003 to 97,000, and that total tourism revenues picked up by some 20%.

Merchandise exports declined in 2004. Preliminary data indicate that the value of fish exports, which is the main commodity export, weakened by more than 10% following a 46% fall in 2003. Exports of garments, which are the second-largest commodity export, fell by more than half over the year. International reserves remained above the Central Bank of Samoa's target of approximately 4 months of imports (Figure 2.31). As of end-November 2004, international reserves were the equivalent of approximately 5.2 months of import cover, down from 6.0 months as of end-2003.

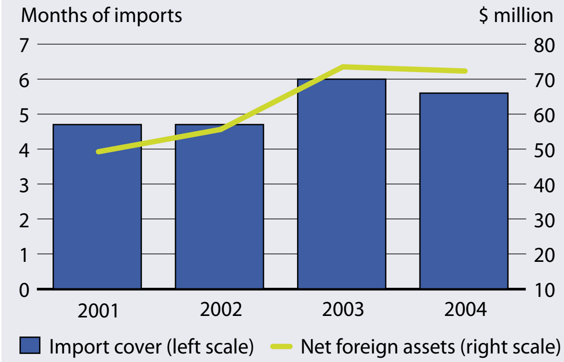
Despite the extra costs imposed by cyclone Heta, the budget deficit for FY2004 (ended June 2004) was less than budgeted at 0.9% of GDP. A similar deficit is targeted for FY2005. If this target is achieved, it would represent the

third year of a tight fiscal position. The ratio of official government debt to GDP (excluding government guarantees) has fallen from 62% in 2001 to 46% as of end-September 2004. Debt service costs accounted for 5% of FY2004 expenditures and net lending.

Inflation rose over the course of 2004 as the full effect of the cyclone on local produce supplies fed through to retail prices, and as higher international fuel prices raised transport costs. The annual inflation rate was 11.7% as of end-September, reflecting a 26.8% increase in the price of local goods and services and a 2.7% increase in the price of imported goods.

The central bank adopted an accommodative stance in 2004 in an effort to generate economic growth. The one-time inflationary effect of the cyclone was allowed to pass through the economy without any offsetting action. The combination of a slight fall in interest rates, an easing in May 2004 of foreign exchange controls on capital transactions, and a firm economy led to a 14.2% increase in credit to the private sector in 2004. Money supply (M2) grew by 12.7% by end-September compared with the same period in the previous year.

Figure 2.31 Net foreign assets and import cover, Samoa, 2001–2004



Sources: Central Bank of Samoa, Selected Economic Indicators, January 2005; Ministry of Finance, *Quarterly Economic Review*, issue 26, July–September 2004.

Macroeconomic policy developments

The FY2005 budget provided for a tripling of grant-funded development spending to $259 million. Combined with an 8% increase in other expenditures, a 59% increase in expenditures and net lending is budgeted for FY2005. The additional outlays provided in the budget are very large at the equivalent of 20% of GDP. Some of the increase in development spending is due to the recording of on-budget scholarship assistance provided by bilateral donors and additional outlays on institution-strengthening projects. However, much of the additional spending is for construction.

Long-standing problems remain in implementing capital programs in line with budget schedules. Acknowledging these problems, the Central Bank of Samoa has prepared a revised forecast of development spending for FY2005 of $57 million. This alternative forecast is for a 28% increase in total expenditures and net lending during FY2005, an increase equivalent to 9% of GDP. If all currently budgeted projects are to be pursued, carryover spending would continue the high level of public expenditures in FY2006.

Although inflation rose in 2004, the underlying rate remains low and is forecast by the central bank to be 2.1% by end-FY2005. The low underlying rate, together with small budget deficits and a secured foreign reserve position, has allowed the central bank to retain its accommodative monetary policy stance. In its September 2004 monetary policy statement, the central bank advised that interest rates should be maintained at prevailing levels in FY2005, if not reduced further; it also targeted a 13% increase in bank credit to the private sector and a 9% rise in the money supply for the year.

Outlook for 2005–2007 and medium-term trends

A boom in construction is expected to support the economy through 2005 and into 2006. Most major projects under way in 2004 have continued into 2005 and construction of a new hotel at Taumesina is envisaged. The hosting of the South Pacific Games is providing an ongoing source of construction activity, including a new aquatic center to be built with assistance from the PRC Government. Also to commence in 2005 is construction at the National University of Samoa and Samoa Polytechnic, with assistance from the Government of Japan.

The economy is expected to benefit as well from an expanding tourism industry and rising remittances from the large Samoan communities in Australia, New Zealand, and US. In real terms, remittances have risen by 10% a year since 2001 and are now equivalent to 20% of GDP. Remittances provide the single largest source of foreign exchange and are expected to reflect the economic expansion of the source countries. The latest official projection for remittances is growth of 3% in FY2005.

Visitor arrivals have advanced steadily in recent years, at an average annual rate of 3.1% since 2001. The rising demand for tourism across the region and expanding hotel capacity in Samoa underlie forecasts of continued expansion in tourism. The latest official forecast is for net travel earnings to grow by 15% in FY2005. The hosting of the South Pacific Games is likely to lead to a temporary surge in visitor arrivals.

A further boon for tourism is a proposed joint venture between Polynesian Airlines and an Australian airline, Virgin Blue. The joint venture would operate as Polynesian Blue on the existing international routes of the national carrier. The new arrangements are potentially important for tourism if they help retain capacity in Samoa, as well as competition. The joint venture is also important to the budget as Polynesian Airlines has been operating at a loss since 2001 and has required subsidies to sustain operations: its FY2004 subsidy of $7 million accounted for 6% of expenditures and net lending.

An improvement in commodity exports is forecast over 2005 relative to 2004 following the reopening of the relocated garment factory in the quarter to September 2004 and the expected reopening of a desiccated coconut plant in early 2005. A new heat treatment plant for fruit such as papaya recently received its certification and will likely help expand a range of exports over the forecast period. There is also some prospect of continuing rapid growth of exports of nonu and a rebuilding of kava exports to Europe based on improved consumer sentiment there, following a positive report on the health impact of kava. Some improvement in the fishing catch is also expected, given better weather conditions. Despite these potential gains, commodity exports are likely to remain a relatively minor part of the economy.

The longer-term sustainability of the current high levels of construction is open to question. Most major developments have a substantial public sector role or, in the case of the hotel at Faleolo, rely heavily on funding from the National Provident Fund. Construction's sustainability would be more assured if there was a larger role for the private sector, with its ability to draw on overseas capital. The presence of large government-backed projects also carries the risk of crowding out the private sector.

Inflation is expected to ease in 2005 as agricultural production returns to normal patterns. However, a slow rate of adjustment has led to official projections of inflation remaining as high as 8% in June 2005, well above the central bank's target of 3%. The large increase in government expenditures under the FY2005 budget and the accommodative monetary policy stance present some risk that inflationary pressures will remain higher than targeted over the medium term.

Solomon Islands

Against a background of improving political stability, primary product exports led economic growth of almost 5% in 2004, while inflation fell to single digits, public finances improved further, and financial sector stress declined. However, the short-term outlook is for a growth slowdown followed by an acceleration in 2007.

Macroeconomic assessment of 2004

GDP decelerated slightly to an estimated 4.6% growth in 2004 from 5.3% in 2003. Agriculture, forestry, and fishing (inclusive of subsistence production) was the major source of the expansion, contributing 63% of the aggregate figure. Logging of the natural forests continued (at an unsustainable rate), and fisheries, cocoa, and copra production all grew. The small industry sector was driven by construction, as externally funded infrastructure rehabilitation and development began, while there was no recovery in mining, slow growth in electricity and water, and a modest pickup in manufacturing.

Services contributed 24% of the aggregate growth rate, with the trade subsector in particular responding to increased consumer demand within the context of improved law and order under the ongoing (and largely Australian) Regional Assistance Mission for Solomon Islands. The rise in consumption was fueled by the Government's payment of arrears to trade creditors and public service employees, and by public servant pay rises. The consequent favorable impact on labor demand was augmented by the ending of a freeze on public service recruitment, but the rapid growth in labor supply, especially in urban areas, and the mismatch between required and available skills remained problematic.

With the population expanding at roughly 3% each year, income per head rose by 1.6% in 2004. However, the average figure conceals considerable inequality of income distribution. According to studies from the early 1990s, urban household incomes were almost four times as high as those in rural areas. More recent research by the Solomon Islands Development Trust (a nongovernment organization) reports the perception of villagers and the urban poor that living standards have not improved since the Regional Assistance Mission arrived in July 2003, though it acknowledges that the restoration of peace is a fundamental achievement. For the 85% of the population living in villages, hardship appears to have increased as cash income generation has been outpaced by rising costs of basic goods and services such as salt, rice, soap, kerosene, school fees, and ship transport.

The fiscal objective of ensuring a recurrent budget balance was achieved in 2004. Domestically sourced revenues rose by 36.2% from the 2003 level to SI$497 million, largely because of better than expected tax compliance, though the granting of goods tax exemptions reduced the potential tax take. Revenues from customs and excise also exceeded original 2004 budget expectations, partly because logging companies accelerated their activities in anticipation of new legislation aimed at reducing the rate of exploitation of natural forests. Strong domestic revenue growth was supplemented by budget support of SI$111.1 million, bringing total revenues to SI$608.1 million. Total recurrent expendi-

tures in 2004 were estimated at SI$559 million, or 1.6 times the 2003 level. Expenditures on goods and services accounted for the bulk of the rise, with spending concentrated as planned in education, health, and law and justice. Debt service expenditures increased almost threefold, while the public service wage bill rose by 14%. In addition to recurrent spending, an estimated SI$300.2 million was available in 2004 for funding development expenditures: 94.3% of this amount was from external cash grants and 5.7% from overseas loans, with a negligible amount funded by the Government. (No details are available on implementation of this development budget.)

The Government continued to address current and future debt obligations in 2004. Total public domestic and external debt was estimated to be about SI$2.1 billion at the end of 2004, down slightly from the level of SI$2.2 billion in late 2003. The public debt consisted of about SI$1.6 billion in "official" public sector debt and SI$0.5 billion in contingent liabilities and guarantees and informal debt obligations (e.g., unpaid superannuation contributions, debts to trade creditors and public enterprises, and payments to the National Provident Fund). The official debt was reduced from the 2003 level as a result of debt servicing, exchange rate stability, and domestic debt restructuring. The Australian Government's servicing of ADB and World Bank loans ended at midyear and was taken over by the Government. Under the domestic debt restructuring, the three commercial banks and the National Provident Fund agreed to forgive 60% of the Government's interest arrears on treasury bills and to accept long-term amortizing bonds in their place. These bonds carried much lower annual interest rates and provided for a grace period of 7 years on half of the principal amount, but offered a monthly repayment of interest and principal where none had been forthcoming in recent years. The Government also made a partial payment of trade creditor arrears and unpaid public service pay contributions owed to trade unions, insurance companies, health funds, and the Home Finance Corporation.

Inflation in 2004 was estimated at virtually half its previous year's level, at 6.5%; the inflation rate for domestically produced food slowed as a result of the supply of fresh fruit and vegetables to the Honiara market continuing to improve, and of the relative stability of the exchange rate, which ensured that low inflation in the major source countries for imports flowed through to the domestic economy. The Solomon Islands dollar depreciated by just 4% against a strengthening Australian dollar in 2004 and by 1% against the Japanese yen, while remaining steady against the US dollar. Broad money supply expanded by 21.2% in 2004, with an increase in net foreign assets more than offsetting a decline in net domestic assets that resulted from a fall in net credit to government (Figure 2.32). Credit to the private sector rose by 8.6%, mainly in telecommunications, distribution, and professional services. The commercial banks' weighted average interest rate margin edged down from 13.71% to 13.69%, but was still high by regional standards, indicating limited competition in the banking sector.

Strong export growth in the first half of 2004 and a rise in official transfers lifted foreign reserves to US$57.8 million by June, enough to cover 5.6 months of imports of goods and services. This balance-of-payments improvement was maintained in the second half of the year, with foreign reserves reaching US$73.2 million in December, equivalent to about 7 months of import cover.

Macroeconomic policy developments

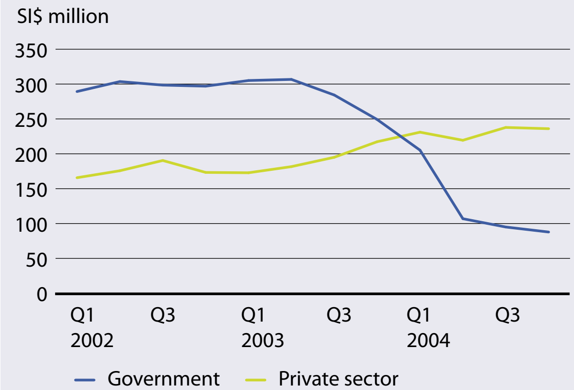
The 2005 recurrent budget estimates a deficit of SI$80 million to be funded out of cash balances accumulated in 2003–2004. Total revenues are forecast to fall by 3% from the 2004 level to SI$590 million. Budget support from bilateral agencies will drop to 36% of the 2004 amount because of the cessation of Australian budget assistance, and the remaining New Zealand aid (SI$40 million) will be earmarked for education. However, domestically sourced revenues are estimated to rise by 10.7% on the basis that increased revenues from the goods tax, import duties, and ministerial fees and charges will more than offset falls in company and withholding tax and log export duties. Achievement of this outcome assumes nominal economic growth of 10.5% and effective elimination of the tax exemptions that reduced the 2004 revenues from the goods tax. However, such a growth assumption may be optimistic and the removal of tax exemp-

tions requires legislative reform in a situation where legal capacity is stretched.

Total recurrent expenditures are projected to rise by 19.9% from the 2004 level, with the public service wage bill and expenditures on goods and services surging by 31.3% and 21.9%, respectively. These figures reflect the Government's commitment to continuing its program of rebuilding public administration and service delivery. In particular, it is making a strategic reallocation of resources toward improving service delivery in the health and education sectors; revitalizing the productive sectors; supporting law and justice and good governance; and promoting the country internationally (as a destination primarily for tourism, but also for FDI). The budget also has an increased provision for debt servicing that includes amounts for payment of arrears, but the provision is still insufficient to cover all debt service obligations. The Government has stated its intention to pursue debt negotiations with bilateral lenders and domestic trade creditors in 2005, to further reduce its debt burden. The 2005 development budget estimates a high, probably unrealistic level of project expenditures of SI$585.6 million; over 97% of this spending is funded externally, mostly through grants, and is allocated to the key strategic areas of the National Economic Recovery, Reform and Development Plan, 2003–2006.

The July 2004 restructuring of the Government's domestic debt reduced stress in the financial sector and increased the capacity of the Central Bank of Solomon Islands (CBSI) to use open-market operations as a policy instrument, though it still had the capacity to use reserve requirements and impose credit limits. The strong foreign reserves position permitted CBSI to remove exchange rate controls on current account transactions; the central bank also continued to address the problems of key nonbank financial institutions under its supervision. In addition, CBSI prepared a report on the financial condition of the National Provident Fund, and took over as provisional manager the bankrupt Development Bank of Solomon Islands, initiating a process of liquidation. Finally, it initiated supervision of the insurance industry. However, while the legal framework for dealing with antimoney laundering was established in 2002, the institutional

Figure 2.32 Domestic credit, Solomon Islands, March 2002–December 2004



Sources: Central Bank of Solomon Islands, *Quarterly Review*, June 2004, available: www.cbsi.com.sb/About_CBSI/eco/monetary_statistics.htm.

framework for effective implementation is still to be created, and antiterrorism legislation remains in draft form.

Some progress was made in 2004 in implementing the structural reforms needed to promote both good governance and sustained, broad-based private sector-led economic growth. However, much more of the same is needed since few of the elements for successful private sector-led growth are in place yet: a large residual of uncertainty from the civil tensions of 2000 to mid-2003 remains; public service delivery is generally poor; property rights and the legal system are weak; the financial sector is not functioning effectively; physical infrastructure is underdeveloped; the quality and reliability of water, electricity, and communications services are poor; and the costs of establishing, running, and closing a business are high by regional standards.

The cabinet has committed itself to reform, but this commitment must be translated into effective, innovative actions supported by coordinated donor assistance. In 2004, an Economic Reform Unit was established within the Ministry of Finance, National Reform and Planning, in order to facilitate the design and implementation of economic reforms. The process of simplifying the legislation and procedures governing foreign investment began, but this has to be finalized and implemented. A tax and customs reform strategy has been presented by the Pacific Financial

Technical Assistance Center in response to a government request and needs to be acted upon. Improving utilities services requires a medium-term process of public enterprise reform that has barely begun. To round off, the long-delayed new forest legislation needs to be passed and implemented. This will be a litmus test of the Government's real commitment to good governance in this key sector of the economy.

Some sector-specific signs of a restoration of foreign investor confidence appeared in late 2004, with the signing of a memorandum of understanding between the Government and a Papua New Guinea-based palm oil company on the reconstruction of a palm oil operation on Guadalcanal, and a reported increase in foreign interest in minerals exploration. However, the key Gold Ridge gold mine remained closed, and there was no evidence of a general improvement in foreign investor confidence.

Outlook for 2005–2007 and medium-term trends

In the context of a slowdown in global economic and trade growth, economic activity in 2005–2007 will largely be determined by the balance between two opposing factors. On the one hand, short- and medium-term growth will be reduced to the extent that new and entirely appropriate forest legislation—aimed at reducing logging rates to sustainable levels—is introduced and implemented. On the other hand, private investment and economic growth will be stimulated if the following three conditions are met: gains from improved law and order and public finances are consolidated, structural reforms are designed and implemented promptly, and major economic activities disrupted by the ethnic tensions of 2000–2003 are restarted. With regard to the last point, a major boost to the economy can be expected by 2007 if the rehabilitation of the Guadalcanal palm oil operation proceeds as planned. A start to palm oil production on Malaita could add to this stimulus, as could the revitalization of the Gold Ridge gold mine. Aid-funded physical infrastructure projects are expected to drive the construction sector, while manufacturing production is likely to do no more than nudge up until palm oil processing gets under way in 2007. Modest growth in the services sector will be fueled by the Government's increased recurrent spending and by external grant-funded development expenditures.

The official budget forecast is for growth of 4.5% in 2005, but this seems either to discount the impact of declining log production or to assume that the new forest legislation will be ineffective. Aggregate growth rates of about 3% for 2005 and 2006 appear more realistic if logging is curtailed substantially, with a possible acceleration toward 6% in 2007 as palm oil production recommences. In the absence of such an acceleration, income growth will barely keep pace with that of the population, and so living standards will stagnate.

With a reduction in bilateral budget support and the need to spend on the essential revitalization of public administration and service delivery, pressure on the recurrent budget will intensify in 2005 if the official growth forecast indeed turns out to be too high or if efforts to reduce tax exemptions fall short (or both). However, this pressure will be met with a government commitment to aggregate fiscal discipline and to the continued implementation of the public debt management strategy, which will lead to a reduction in the ratio of public debt to GDP.

Inflation is projected to moderate slightly to about 5%, on the assumptions that monetary policy will control any inflationary pressures arising from excess liquidity in the banking system, and that the exchange rate will remain relatively stable.

The current account is expected to weaken in 2005 as log exports drop and imports rise in line with increased development expenditures, but to improve over the medium term as palm oil exports restart. It is anticipated that the level of foreign reserves will provide in excess of the central bank target of 4 months of import cover.

Democratic Republic of Timor-Leste

The economy contracted in 2002–2003 but there are indications of an increase in activity in 2004. A rapid rise in petroleum revenues has helped generate a substantial fiscal surplus that is expected to grow over the medium term and to provide the basis of a large intergenerational investment fund. Prospects for the local economy remain dominated by the public sector, with the private sector continuing to face significant hurdles to achieving international competitiveness.

Macroeconomic assessment of 2004

The country's first multiyear national accounts were finalized in 2004. They show an overall contraction in the economy from 2000 to 2003, attributable to a reduction in the contribution from the UN (excluding military and diplomatic expenditures) and, to a lesser extent, from the oil and gas sector (due to the natural depletion of a small field operational since 1998). Non-oil, non-UN GDP is estimated to have increased by 22% over the period, though most of the growth was in 2001.

The latest official projections are for a decline in GDP over FY2004 (12 months ended 30 June 2004) and again in FY2005, on the basis of the continued winding-down of the operations of the UN and the peacekeeping forces ahead of their scheduled pullout in May 2005, and a decline in expenditures by some bilateral aid programs. These negative factors are projected to outweigh an expected improvement in the agriculture sector underpinned by better weather conditions and ongoing rehabilitation of the sector.

These forecasts may prove pessimistic. The growth projections were prepared before the consequences of an early start-up in a major new petroleum project, the Bayu-Undan field, were fully appreciated. Gas recycling to extract liquids began in February 2004 and the project will provide a substantial boost to GDP during 2004. The available indicators suggest that the local economy improved over 2004.

Deposits with commercial banks have risen strongly since 2000, with a 16% increase in 2004 to $84 million by end-December. The commercial banking sector aggressively pursued new loans, and lending to the private sector grew from $22 million to $70 million in 2004. This is a release of funds equivalent to 16% of non-oil, non-UN GDP. New vehicle registrations rose by almost 50% to 7,000 vehicles in 2004, a contributory factor being the greater availability of credit. With most vehicles limited to Dili district, with its population of 170,000, the large increase in registrations points to considerable spending power in the capital.

Preliminary data indicate an 11% rise in taxable imports during 2004, only a minor share of which was attributable to higher petroleum prices. Domestic revenue collections also went up, assisted by improved enforcement.

Non-oil exports picked up but remained very low. Preliminary data suggest that coffee, which accounts for almost all non-oil exports, increased from $4.0 million in 2003 to $6.6 million in 2004. This compares with a preliminary estimate of imports for the year (excluding for aid or peacekeeping activities) of $113 million. The large trade deficit will be offset by inflows of international assistance and petroleum revenues.

Inflation remained low at 3.2% in the

12 months to December 2004, with the largest price rises recorded in transportation (12%) and food (4%).

The major fiscal development during the year was a substantial upward revision in petroleum revenues to the Government. The combination of higher world oil prices, a change in tax treatment favorable to the Government, and an early start-up of the Bayu-Undan field increased petroleum revenue collections for FY2004. Revenues rose from the budgeted level of $31 million to $41 million, and expected collections for FY2005 have nearly tripled from $44 million to $130 million. Even without these upward revisions, the central government budget was projected to be in surplus in both FY2004 and FY2005. The sound fiscal position has now been entrenched. As of end-December 2004, the Government was holding net deposits of $168 million with the Banking and Payments Authority.

Macroeconomic policy developments

The key macroeconomic issue to be resolved over the medium term is the management of the considerable petroleum revenues now coming in. Receipts from the Bayu-Undan field are projected to peak in FY2011 at $380 million and, over the 20-year life of the project, to total $3.8 billion ($2.2 billion in net present value terms). There are also other petroleum developments in prospect, notably the Greater Sunrise field. In comparison, non-oil, non-UN GDP was estimated at $300 million for 2003.

The Government has adopted a policy of pursuing intergenerational equity by maintaining the real value of petroleum wealth. This is to be achieved by limiting spending to the "sustainable income," i.e., the amount of petroleum revenues that could be spent every year indefinitely. Based on current projections, the sustainable income from the Bayu-Undan field is $70 million. Spending this amount would allow government expenditures to grow from the FY2005 level of $75 million to $113 million by FY2008.

The new savings policy marks a substantial shift in fiscal management. The previous intention was to spend petroleum taxes and save only the "first tranche petroleum" (a de facto royalty payment). The previous policy would have seen annual expenditures increase to the order of $500 million within 10 years and savings accumulate to $1.5 billion by 2030. The new policy will instead lead to lower annual expenditures and is projected to result in approximately $4.5 billion being accumulated in the investment fund by 2030.

Achieving the objective of maintaining the real value of petroleum wealth rests on the overall fiscal surplus being large enough to allow for sufficient savings. This in turn rests on the future financial support of the international donor community.

Grants fund more than $150 million in annual public expenditures. UN expenditures were estimated at $77 million in FY2004, but most financial support is scheduled to cease in FY2005. Current commitments to budget support of $30 million–$35 million made under the Transitional Support Program are also scheduled to end then. Multilateral and bilateral projects are budgeted at $135 million–$155 million for FY2005–FY2007.

The Government has the fiscal capacity to replace much of the existing grants and to self-fund most, if not all, essential activities. This is because revenues and grants to the government are projected to be substantially above the current budget for expenditures and net lending (Figure 2.33). However, self-funding by Timor-Leste of all or much of the essential expenditures currently funded from grants would be at the expense of saving petroleum revenues.

The Government has proposed saving petroleum revenues in a petroleum fund based on the Norwegian model. Funds would be invested abroad in low-risk assets and be subject to accountability and transparency measures. A public discussion paper was released in late 2004 and enabling legislation is to be passed in time for the fund to be operational from FY2006.

Continued progress was made during 2004 in reducing electricity subsidies to the main urban areas. A new management team and the introduction of prepaid meters are projected to reduce subsidies by more than half by FY2008, from their current level of approximately 10% of government expenditures.

Outlook for 2005–2007 and medium-term trends

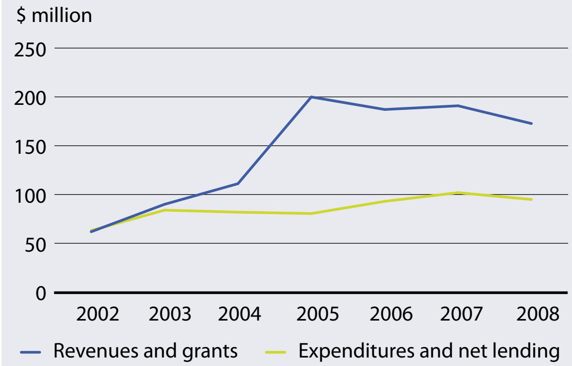
As the ratio of public expenditures to GDP approaches 100% and the formal private sector is still emerging, developments in the local economy will continue to be dominated by the public sector.

The UN presence was to have ceased in May 2004. A further extension beyond May 2005 is unlikely, and the pullout will in itself have a negative effect on economic activity in the short term. But there is a large carryover of public expenditures from FY2004, and the budget provides for a 17% increase in spending under bi- and multilateral programs during FY2005. The greatest short-term risk is that long-standing delays in implementing public programs arising from difficulties in procurement and capital project planning will continue, so damping the potential fiscal stimulus.

The medium-term fiscal projection is for only slightly higher government expenditures by FY2008, though this projection was made before petroleum revenues were revised substantially upward. In late 2004, the Government declared its intent to spend some of these additional revenues and to raise the level of spending beyond those currently budgeted. It also indicated that the rate of increase in expenditures would be constrained by capacity for the funds to be spent well. A 19% rise in expenditures from currently budgeted levels could be funded while still meeting the objective of only spending the sustainable income from petroleum revenues.

The ability of the Government to secure donor funding will play a major role in determining the GDP outcome over the medium term. The FY2005 budget projected that bi- and multilateral aid programs will fall by almost half to $81 million by FY2008, but this projected decline is in part a consequence of the limits of the planning cycle and may be reversed as budget planning proceeds. Sector investment programs are being prepared to help orient expenditures toward implementation of the National Development Plan and achievement of the Millennium Development Goals; the Government is seeking substantial donor support to help implement these programs. In addition, Timor-Leste is expected to become eligible for the US government-financed Millennium Challenge Accounts in 2006 (if not late 2005), a source that could provide as much as $20 million–$30 million a year in grants.

Figure 2.33 Revenues and expenditures, Democratic Republic of Timor-Leste, FY2002–FY2008



Sources: Ministry of Planning and Finance, *The Democratic Republic of Timor-Leste Combined Sources Budget 2004–2005*, Budget Paper No. 1, 1 July 2004; Ministry of Planning and Finance, *Supplementation of the General Budget of the State 2004–05*: Information Document; staff estimates.

The private sector continues to face significant hurdles to achieving international competitiveness. Wages in Timor-Leste are substantially higher than in neighboring countries, and the state of infrastructure is poor in general. Low productivity of key sectors and gaps in the regulatory environment, such as a few unresolved issues with business registration and customs administration, have made it difficult for new private sector activities to emerge. The rapid expansion in commercial bank lending in 2004 suggests that at least some industries are ready to grow despite these obstacles. With local financing provided by domestic deposits now largely committed, the private sector will increasingly need to rely on foreign investment to grow.

Considerable progress has been made in developing the regulatory environment that foreign investors usually require. A Law on Commercial Societies is in place, and draft laws on domestic and foreign investment, insurance, and bankruptcy have been prepared. However, the draft investment legislation carries the downside of a potential loss of substantial revenues through the provision of concessions. Such legislation, if implemented, may reduce the initial economic stimulus from additional investment.

Tonga

Economic activity saw widespread weakening over the year to June 2004, and inflation rose. Nonetheless, progress was made in stabilizing the macroeconomy with the budget moving to surplus and international reserves rising to comfortable levels. The Government is continuing to pursue economic and public sector reform with the aim of achieving sustainable growth.

Macroeconomic assessment of 2004

Tonga experienced widespread weakening in economic activity in FY2004 (year ended 30 June 2004). Difficult trading conditions were reported by businesses across a range of industries, including wholesale and retail trade, manufacturing, transportation, power, and telecommunications. A shift to a budget surplus reduced the demand stimuli provided by the general government sector; the government-owned airline went into liquidation; the fish catch declined; the main agricultural export, squash, suffered a large fall in the international price; and there appears to have been an increase in the direct importing of household items at the expense of local traders. GDP growth is estimated to have slowed from 3.1% in FY2003 to 1.6% in FY2004.

The main areas of the economy to expand over FY2004 were tourism and construction. Tourist arrivals rose by 6% in the first 3 quarters of the year (relative to the corresponding period of the previous year), and over the same period tourism receipts are estimated to have risen by 15%, equivalent to 8% of GDP. The construction sector benefited from the continued reconstruction required by the 2001 cyclone, work on new church and cinema complexes, EU-funded projects, the Tonga High School project, and other residential buildings.

Inflation continued at the double-digit rate of 11.0% in 2004, compared with 11.6% in 2003. This was attributable mainly to a rise in the price of imported items of 15.1% (compared with a 5.3% increase in the price of locally produced goods). Other factors were the substantial depreciation of the pa'anga against the currencies of New Zealand and Australia (the main sources of imports), higher world oil prices, a rise in the electricity price, and an increase in the tariff rates on alcohol and tobacco.

Despite the low growth and high inflation, efforts to stabilize the economy bore fruit. The FY2004 budget had provided for an overall deficit of 1.6% of GDP following a deficit of 3.1% in FY2003. However, tax collection was better than expected, a hiring freeze on nonessential vacant positions contributed to a wage bill 16.5% below budget, a large cut was made in capital expenditures, and other nonessential outlays were controlled. The preliminary outcome is for an overall surplus of 1.2% of GDP in FY2004. A further important change over the year was a shift from large domestic financing to a net repayment of domestic debt made possible by the surplus and substantial drawdowns of external financing.

International reserves had started the year at 2.4 months worth of imports, below the National Reserve Bank of Tonga's comfort level of 3–4 months worth of imports. However, the receipt of loan funds from ADB, an increase in official development assistance, overseas borrowings by commercial banks to fund their domestic lending, and the refinancing of a

large telecommunications project resulted in an increase in international reserves in November 2004 equivalent to 5.6 months worth of imports.

The Reserve Bank maintained a tight monetary policy stance in view of its concerns over the state of the macroeconomy. It kept its minimum lending rate at 12% in FY2004 and left the reserve deposit rate unchanged. Commercial bank lending rates registered a slight increase over the course of the year.

Total credit to the private sector contracted by 4.3% after rising by 12.6% in FY2003. The contraction was related to the refinancing of one major project and a decline in lending to transport and storage, fishing, and hotels and restaurants. The overall asset quality of the banking system weakened, mainly because of the downgrading of some large exposures. Nevertheless, the financial system remained sound. The risk-weighted capital base of the banking system improved and stayed above the Reserve Bank's minimum level.

The Government put Royal Tongan Airlines into liquidation in May 2004 given its inability to continue financial support. One month earlier, financial difficulties had required the airline to return the aircraft used on international routes. The first 14 months of the aircraft's operation had absorbed a government capital injection of $9 million, the equivalent of 20% of FY2004 expenditures and net lending.

As of end-FY2004, external public debt was the equivalent of 39% of GDP and domestic public debt 8%. Government-guaranteed debt was an additional 7% of GDP, most of which is provided to public enterprises.

Macroeconomic policy developments

The FY2005 budget sets a vision of achieving sustainable growth with social equity. It recognizes that low inflation, adequate international reserves, and a sustainable overall budget position will be required to achieve this, which in turn requires a continuation of the economic and public sector reform that began in 2001.

Improved methods of financial management are being introduced under the provisions of a new Finance Management Act. Medium-term initiatives include expanded coverage of a new accounting system, the placement of heads of department on contract, and revised arrangements for the payment of wages. Reforms to the tax system and public enterprises are also being pursued to strengthen the fiscal position and raise the efficiency of the economy.

The main revenue initiative proposed is the introduction, in April 2005, of a 15% VAT, to be called the Consumption Tax. This will replace a 5% sales tax, a fuel sales tax, and a 20% port services tax, and will allow for a reduction in individual and corporate income tax rates. Administration costs are to be kept low by requiring only businesses with a minimum annual turnover of approximately $50,000 to register for the tax, and this is expected to cover 260 or so businesses. Complementary administrative changes are being made to strengthen the revenue performance.

Implementation of public enterprise reform has been delayed until the financial implications of the liquidation of Royal Tongan Airlines are addressed. Once this matter is resolved, government attention will shift toward the privatization of three of the smaller public enterprises and the delayed corporatization of the post office and printing departments. Work is to continue on integrating funding requests from the public enterprises into the budget and on implementing new public enterprise management legislation.

The Government plans to adopt new legislation to strengthen the supervision of financial institutions by the Reserve Bank. It is also considering legislative changes to assist the bank in implementing monetary policy. Key issues to be faced are the bank's recapitalization, its current ability to finance deficits, its independence in managing interest rates, and the method for setting the reserve requirements of the commercial banks. The Reserve Bank is also working with the Ministry of Finance to issue treasury bills that would allow the management of liquidity through open-market operations.

Outlook for 2005–2007 and medium-term trends

The latest official forecast is for growth of 2.8% over FY2005. The construction industry is estimated to have expanded by 5.0% in FY2004

and is expected to remain firm, buttressed by donor-funded projects, notably the rebuilding of the main hospital, and by an increased allocation of the Government's own funds to capital. Continued expansion in tourism is foreseen, despite the loss of services from Royal Tongan Airlines, leading to overall growth in the services sector. Remittances are expected to increase and to underpin private consumption as source economies grow.

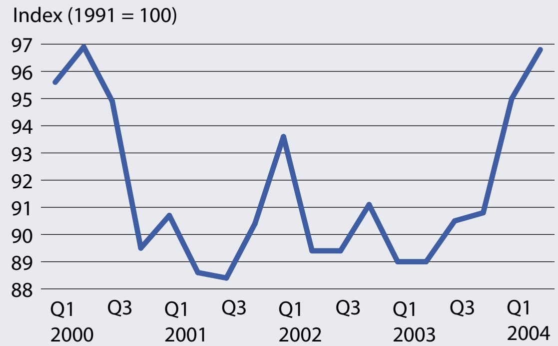
Agriculture and fishing are also expected to strengthen in FY2005. Greater volumes of squash, root crops, and kava are projected in response to better market conditions. Vanilla has the capacity for continued growth, provided that recent high prices are sustained, given that export volumes in FY2004 were half of the level achieved in FY1999. The fishing industry remains hampered by high transportation costs and a lack of capital for investment. Nonetheless, a reversal of the El Niño weather conditions is expected to help raise the catch over the medium term.

The Government's intention was to have inflation under control by the time the Consumption Tax is introduced. This is unlikely as inflation was still high at 10.6% as of November 2004. The introduction of the Consumption Tax is expected to lead to an overall increase in prices, but the impact is intended to be one-off and not have a lasting inflationary effect.

The Reserve Bank's monetary policy objectives have been to maintain an adequate level of official foreign reserves and to promote price stability. Concerns over the sustainability of the foreign reserves position and the continuing high level of inflation are likely to see monetary policy remain tight over the forecast period.

Medium-term prospects for the economy will be influenced by any loss in international competitiveness arising from high inflation. After macroeconomic stability had been eroded in FY2001, the Reserve Bank allowed the pa'anga to depreciate to compensate for rising inflation and to protect official reserves. The real effective exchange rate as measured against its basket of currencies fell by approximately 9% in FY2001, and this depreciation was largely maintained until FY2004. However, the depreciation in the real effective exchange rate was unwound in FY2004 (Figure 2.34), suggesting a significant loss of competitiveness.

Figure 2.34 Real effective exchange rates, Tonga, Q1 2000–Q2 2004



Sources: National Reserve Bank of Tonga, 2004, *Annual Report 2003–04*; National Reserve Bank of Tonga, 2004, *Quarterly Bulletin*, vol. 15, no. 1, March.

A key risk to be managed over the next few years is the potential for a relaxation of the fiscal position. The FY2005 budget provides for a 23% increase in expenditures and net lending. Most of the additional spending is to be allocated to an 18% increase in wages and a fivefold increase in capital expenditures. Revenues and grants are budgeted to rise by only 8%, leading to a projected budget deficit for the year of 2.2% of GDP. Some 30% of the deficit is to be financed domestically. These estimates exclude the cost of shutting down Royal Tongan Airlines, which was not known at the time of budget preparation.

However, the actual outcome for FY2004 was substantially better than budgeted for the year, and continuing expenditure control can be expected to lead to a better than budgeted outcome in FY2005 as well. Planned improvements to the management of public enterprises offer considerable potential to strengthen the fiscal position. In FY2003, dividends of only $25,000 were received on the Government's equity of $35 million, and half of the government-guaranteed borrowing to public enterprises was nonperforming. Even a small improvement from these levels could have a relatively large impact on government revenues.

Tuvalu

Reflecting the completion of major construction projects, the economy contracted. This coincided with a second year of relatively low offshore revenues for the Government, generating a large budget deficit. Over the medium term, new construction projects are expected to result in increased activity. However, even with an expected pickup in revenues, expenditure control will be required to stabilize the fiscal position.

Macroeconomic assessment of 2004

Economic activity subsided in 2004 following the completion of major construction projects. These included a hospital renovation and extension, and a government office block, both donor funded and on the main island of Funafuti. The total value of these two projects alone almost equaled the value of GDP in 2002. Construction had created substantial casual employment opportunities in 2003 and labor income rose by more than 10% that year. Preliminary estimates suggest that in 2004, labor income fell back to the 2002 level.

Internal revenue collection was boosted in 2003 by the surge in economic activity but fell by 12% in 2004 as activity slowed. Import duties, the main source of internal revenues, were projected to decline by 20% to 2002's level, indicating a large fall in consumption in 2004. Sales tax revenues and income tax collection were projected to decline by 20% and 13%, respectively, over the year. The fall in internal revenues corresponded with the second consecutive year of low offshore revenues. In 2001, the Government sold its investment in the operator of the country's ".tv" Internet domain name and now only receives a small ongoing royalty. Revenues from the foreign fishing fleet operating in Tuvalu's exclusive economic zone were considerably higher than in 2003 but well below trend. An improvement in world equity markets allowed the first distribution since 2001 from the Tuvalu Trust Fund, one of the Government's two offshore investment funds (the other being the Falekaupule Trust Fund). However, distribution was also well below trend (Figure 2.35).

From the mid-1990s to 2002, a strong upward trend in revenues had been seen and, while some of the "windfall" revenues received over the period were placed in the Tuvalu Trust Fund, capital projects and the wage bill also surged. The buildup in expenditures and community expectations has therefore made it difficult to quickly trim back spending as the revenue position has weakened, with the result that large budget deficits emerged in 2003 and 2004—the overall deficit in 2004 was estimated to be approximately 9% of GDP. The deficits have been financed by a rundown of cash reserves, and the tight cash position for much of 2004 necessitated a midyear review of expenditures: cuts fell heaviest on allowances, maintenance, basic supplies, and capital projects, though a 5% wage increase that was provided for at the start of 2004 was preserved, and the number of government employees continued to rise over the year.

The gross net value of government debt is estimated at $16 million, equivalent to 80% of GDP. As almost all of the debt is concessional, the net present value of the debt is much lower at 40% of GDP. Against this, $2 million was held as cash

reserves as of September 2004 and $63 million was invested in the two offshore investment funds.

Macroeconomic policy developments

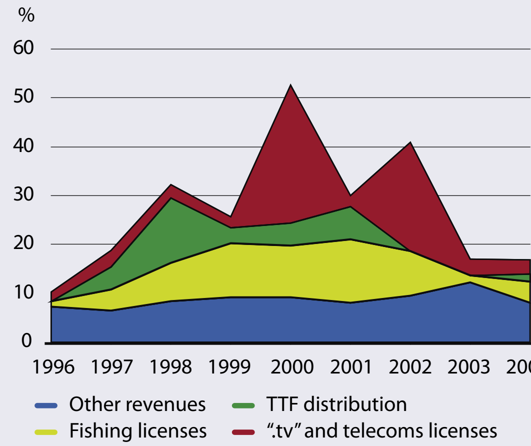
Fiscal management in Tuvalu is greatly complicated by the volatility of the main revenue items. Income from the sale of rights to the ".tv" domain name will remain below trend, but other revenue items have the potential to rebuild. The issue to be faced in framing a budget is whether to cut expenditures to fit the low levels of the last 2 years or whether to be less aggressive in cutting spending in the hope that revenues increase. Budget management also has to deal with the difficulties created by one of the largest revenue items, fishing licenses, coming in over the last month of the financial year. Not only are these revenues received late, but it is difficult to predict changes from year to year. The likely income is only known with confidence well into the second half of the financial year.

Cash reserves had been built up in the Government's buffer fund, the Consolidated Investment Fund, to help manage the volatility and uncertainty in revenues. However, the buffer has declined recently, and once a government overdraft equivalent to 9% of GDP is taken into account, net cash holdings as of end-2004 will only be sufficient to fund the planned 2005 deficit.

One of the main pressures on the budget is the growing wage bill. This has increased by 17% in real terms since 2001, and by 146% since 1996. As of late 2004, 1,100 public servants—some 10% of the population—were on the payroll. If the recent growth in wages continues, personnel costs will inevitably put pressure on the overall budget outcome and displace other expenditures, with an adverse impact on the quality of government services. Budget management faces the additional challenge of providing the funding to maintain and make effective use of recent investments. This includes equipping and staffing the new hospital facility, and maintaining new buildings and newly surfaced roads on Funafuti. These investments create a new, ongoing need in a difficult fiscal environment.

Public debt consists of loans from ADB, the European Investment Bank, and the government-owned (and country's only) National Bank of Tuvalu. There is some doubt as to whether the two loans secured from the National Bank of Tuvalu will generate any income to cover debt service costs. These loans were used to purchase a share of the only airline operating to Tuvalu and for the National Fishing Corporation of Tuvalu; however, these loans represent less than 10% of gross public debt. The largest single loan, secured to provide funds for the Falekaupule Trust Fund (for the outer islands), is fully invested offshore. The remaining large loans are for economic activities and are at least partly backed by revenue flows, either directly or indirectly. Current debt service costs are 2% of the trend level of revenues and grants, and are projected to rise steadily over the next 10 years. They should remain relatively low at no more than 3% of this trend level, provided that the debt stock remains close to current levels.

Figure 2.35 Revenues and grants, Tuvalu, 1996–2004



TTF = Tuvalu Trust Fund.
Source: Original data from the Ministry of Finance.

Outlook for 2005–2007 and medium-term trends

The economy is dominated by a public sector supported by a high level of foreign grants and offshore income. The main sources of the latter for the Government are returns from the Tuvalu Trust Fund invested in international financial markets, the sale of access to fishing resources, and the country's ".tv" domain name. Households earn offshore income from seafarers who are working for international shipping companies; their remit-

tances amount to some 20% of GDP. Prospects for the economy and the limited private sector will remain dependent on changes in these inflows.

The Government anticipates receipt of a grant from the Japanese Government to rebuild the electricity generation and distribution system on Funafuti in 2005–2006. At an expected cost of approximately 75% of 2002 GDP, construction would provide another temporary, but major, boost to the economy. Grants, excluding those provided for major building projects, are projected to remain steady over the medium term.

Economic activity will also be boosted over the forecast period with the launching of a second major project, the upgrade of the Tuvalu Maritime Training Institute. This is in part motivated by the need to ensure that the institute retains its accreditation from the International Maritime Organisation. Loss of accreditation would put at risk continued growth in seafarers' remittances, which not only represent an important source of aggregate demand for the overall economy, but are particularly important for the outer islands, which offer limited alternative income-earning opportunities.

A distribution from the Tuvalu Trust Fund to the budget is only possible when the market value of the fund exceeds the maintained value, being the real value as measured by the Australian CPI. The market value was below the maintained value in 2002 and 2003, but a 13% gain over the first 9 months of 2004 saw the positions reverse. As long as market returns continue to exceed the low Australian inflation rate, a distribution will be possible.

Fishing revenues have shown signs of recovering from the very poor outcome of 2003. Long-run weather trends are now more favorable to fishing in the exclusive economic zone, and the Government has forecast revenues for the medium term close to the 2004 level. Past experience suggests that there is significant potential for revenues to exceed this forecast.

Current official forecasts are for a deficit rising in 2006 to about 15% of GDP (excluding the effect of the large construction projects which are off budget), mainly because of a poor revenue performance. These forecasts appear too cautious. The likely pickup in economic activity and a more favorable outlook for offshore revenues suggest that the budget position should improve over the next few years, provided that expenditures are controlled. Additionally, a proposal is being considered to introduce a VAT to help generate revenue, and provide for a more efficient tax system. Introduction of such a tax will become increasingly important if the Pacific Island Countries Trade Agreement is ratified as expected, since Tuvalu would forgo duty revenues on imports from the region under the agreement. If large deficits are incurred in the medium term, cash-flow difficulties can be expected to continue. This may require the development of new methods of deficit financing. Options include the sale of government businesses, the main candidate being the National Bank of Tuvalu.

The sharp rise in the Government's overdraft at the National Bank of Tuvalu since 2001 has necessitated a substantial fall in lending to the private sector. Consumer lending for housing has been frozen, assistance to seafarers (to cover traveling costs, etc.) has been curtailed, and the maximum size of other loans has been reduced. This is despite a continuing demand for such loans, particularly to fuel growth of the small private sector. Such crowding-out effects are likely to persist until the Government's overall fiscal position improves.

Vanuatu

Growth in 2004 was modest in a macroeconomic environment of low inflation, improving public finances, and rising foreign reserves. The outlook is for further growth at a rate that barely keeps pace with population expansion.

Macroeconomic assessment of 2004

GDP growth accelerated slightly from 1.6% in 2003 to an estimated 2.2% in 2004, led by the agriculture, forestry, and fishing sector, which expanded by 3.3%. Cocoa production fell because of cyclone Ivy in February and cattle production was sluggish, but copra and kava producers responded strongly to the higher farm-gate prices that resulted from stronger world market prices and from greater competition in commodity marketing following the ending of the Vanuatu Commodities Marketing Board monopoly. Forestry production also picked up from the level seen in 2003. In industry, manufacturing grew because of a substantial rise in coconut oil production, while electricity and commercial construction crept up at less than 2%. After registering zero growth in 2003, the services sector expanded by an estimated 1.9% in 2004 in response to a rise in domestic demand, in turn generated by stronger incomes from agricultural exports, real estate development in Port Vila, and tourism growth. Visitor arrivals in the first 3 quarters of 2004 were 17.5% above the corresponding prior-year period, reflecting the combined impact of an increase in cruise ship visits, an expansion in Air Vanuatu's carrying capacity, and price competition after the entry of the airline Pacific Blue into the market.

Following an overall budget deficit in 2003 of 1.7% of GDP, the 2004 budget targeted a surplus of 0.4%. Although unbudgeted expenditures were made, associated with the snap general election in July, a surplus equivalent to 0.6% of GDP was recorded over the first 3 quarters of 2004, with internal revenue collection exceeding expectations and control exercised over spending. Some reduction in the surplus is to be anticipated as a result of fourth quarter spending, but the aggregate fiscal outcome for the year nonetheless was set to improve significantly on the 2003 result (Figure 2.36). Less progress was made in shifting the allocation of public resources away from meeting the public service wage bill and toward operation, maintenance, and capital expenditures, with the latter at less than 75% of the 2003 level in nominal terms. Spending on wages and salaries was 56.6% of expenditures and net lending in the first 3 quarters of 2004, compared with 38% of actual expenditures and net lending in 2000. In the intervening years, the number of public servants rose in line with population growth and their average real wages grew faster than total real government spending. Public debt declined from 39.2% of GDP in 2003 to 37.6% in 2004 as a result of a reduction in external debt to 27.0% of GDP, while domestic debt remained steady at 10.6% of GDP. In 2004, debt service costs were 13.4% higher than in 2003 and were equivalent to 7.5% of budgeted revenues and grants.

Inflation diminished from 3.0% in 2003 to 1.8% in 2004 as the domestic currency appreciated slightly against the Australian dollar (1.6%) and New Zealand dollar (0.7%), and substantially against the US dollar (13.0%). Food prices regis-

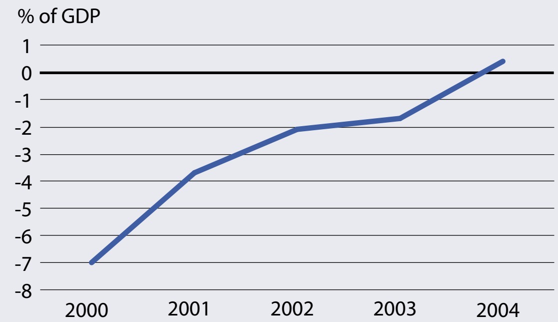
tered the largest rise of almost 4% because of cyclone Ivy's impact on domestic food supplies, with all other expenditure groups showing moderate increases. Broad money supply in October 2004 stood at 9.4% above the October 2003 level because of a 12.8% rise in net foreign assets and a 7.4% expansion in domestic credit. The growth in domestic credit consisted of a 10.6% decline in net credit to government and a 9.0% rise in private sector credit that was concentrated in the transport sector. Commercial bank efforts to encourage deposits and then promote lending culminated in a narrowing of the interest rate spread from 9.6% at end-2003 to 9.1% in mid-2004. Increasing liquidity in the banking system was reflected in a rise in excess reserves held at the Reserve Bank and in a declining yield on 91-day Reserve Bank of Vanuatu notes, which fell to 3.75% by October.

The level of official foreign reserves rose to $51.0 million by mid-October 2004, equivalent to 5.2 months of import cover compared with 4.4 months a year earlier. This resulted largely from a 40% rise in merchandise exports in the first 3 quarters of 2004 compared with the same period in 2003, and substantial inflows of official transfers in the wake of the cyclone and earthquake damage. The bulk of the rise in exports was accounted for by copra and coconut oil to European markets, but this was insufficient to prevent a worsening trade balance as postcyclone imports of food and basic manufactures rose, as did imports of machinery, transport equipment, and mineral fuels. Tourism growth contributed to a rise in the services account surplus, and the current account deficit in the first 2 quarters of 2004 was almost 14% below that of the same period in 2003. Direct investment flows made a positive contribution to the balance-of-payments financial account and, with tourism accelerating in the second half of 2004, foreign reserves were projected to rise further by end-December.

Macroeconomic policy developments

Political instability in 2004 hampered policy development and implementation of the Prioritized Action Agenda, which is intended to link the long-term Comprehensive Reform Program with the Government's medium-term investment

Figure 2.36 Budget balance, Vanuatu, 2000–2004



Sources: National Statistical Office, *National Accounts of Vanuatu 1997–2002* and *Quarterly Statistical Bulletin*, September 2004; Government of Vanuatu, *Fiscal Strategy Report*, Budget 2004; staff estimates.

program and annual budget. In particular, the intensification of political instability in the second half of the year constrained the formulation of fiscal policy. The July general election was called to forestall an opposition motion of no confidence, but the incumbent Government lost office to a shaky coalition. This coalition itself was soon subject to a no-confidence motion and another coalition administration took office in December.

The new administration's budget was presented for parliamentary approval in February 2005. An overall budget deficit of 0.2% of GDP is projected, with revenues and grants in 2005 rising by 8.0% from the 2004 budget level and total expenditures and net lending rising by 11.4%. The bulk of the rise in revenues and grants is expected to come from external grants, supplemented by improved collection of tax revenues. All of the projected increase in total expenditures and net lending is attributable to increased recurrent spending, most notably an 8.4% rise in the public service wage bill. There is therefore little prospect in the short term of improving the strategic allocation of public resources.

Tightened liquidity conditions led the Reserve Bank to reduce the liquid assets ratio from 15% to 12% in January 2004. The stance of monetary policy remained unchanged for the rest of the year as liquidity increased and policy targets for inflation (4%) and international reserves (4 months of import cover) were met comfortably. The weights used in the basket of major trading partner currencies, against which the vatu is pegged, were reviewed and adjusted in June 2004,

but remained confidential. The Vanuatu Financial Sector Assessment Group continued its work on ensuring that the regulatory and supervisory framework for offshore and domestic banks met international standards.

The most worrying policy issue is still that of how to deal with the long-term decline in income per head, particularly in rural areas. In 2004, real GDP per head was below the level of 20 years earlier, with the benefits of economic growth largely captured by those in urban employment in the public, tourism, and financial sectors. Real value added in the primary sector has grown at below the rate of aggregate GDP during this period, leaving village populations in a situation of worsening economic hardship. Reversing this trend requires, among other interventions, improving rural producers' access to credit through the development of a secured lending framework, as has been done informally in a rural finance project administered by the National Bank of Vanuatu. In addition, the Government has made a major commitment to the development of a formal secured transactions framework, which will permit a broader distribution of credit via nonbank financial intermediaries.

The private sector remained hampered by the relatively high costs of utility services and of carrying out business activities. The costs of starting a business, the rigidity of employment conditions, and the costs of firing employees are the highest in the region, according to the World Bank's Doing Business Indicators.

Outlook for 2005–2007 and medium-term trends

GDP growth in 2005–2007 is forecast to remain in the modest 2–3% range, edging up to 2.5% in 2005 as cocoa and cattle production recover from their 2004 decline and then tapering off to 2.2% in 2006–2007. Agriculture is foreseen as the driving force, while services expand at about 2% annually and industry at 1.5%. The outlook for agriculture assumes favorable weather conditions, some easing in agricultural commodity prices and, crucially, a sustained aggregate supply response to the recent deregulation of export marketing, as opposed to the switching of production between different crops. Growth in services depends on continued tourism expansion, which is expected from the ongoing provision of competitive international air services and more effective marketing, though its pace will be constrained by accommodation capacity. In industry, little improvement is anticipated in manufacturing, while electricity and construction are expected to expand at annual rates of 2.5% and 1.5%, respectively. Given an annual population growth rate of 2.7%, these forecasts imply a further medium-term decline in per capita income, increased under- and unemployment, and little alleviation of hardship in rural areas.

The Government will target budget surpluses of around 0.5% of GDP in 2006 and 2007, on the basis that improved compliance will generate sufficiently stronger tax revenues to cover growth in nominal total expenditures at about the forecast inflation rate of 2.5%. Fiscal prudence may be under threat from political instability, but if maintained will involve a stagnation of aggregate government spending in real terms and a decline in the per capita provision of government services. Limited progress is likely in improving the strategic allocation of public resources because of the relatively heavy weight of the wage bill in total spending and because of the political difficulties of reducing public sector employment and real wages. The achievement of budget surpluses and a policy of no new external borrowing will reduce the stock of public debt from 38% of GDP in 2004 to an estimated 32% in 2007. Continued fiscal discipline and moderate inflation will enable the Reserve Bank to maintain a neutral monetary policy stance in the medium term.

Domestic export volumes are forecast to rise at modest rates in line with agriculture, but—with some weakening in commodity prices—little growth is expected in the value of exports. The value of imports is projected to continue rising faster than that of exports, such that the trade deficit will widen. The net surplus on the services account is expected to increase as a result of tourism growth and, with official transfers, will ensure a virtual balance on the current account. This outcome and the maintenance of a capital and financial account surplus will keep foreign reserve levels above target, at approximately 5 months of import cover. Official external debt is forecast to drop to 22% of GDP in 2007.