THE PACIFIC

Fiji
Papua New Guinea
Timor-Leste

Cook Islands
Kiribati
Marshall Islands
Federated States of Micronesia
Nauru
Palau
Samoa
Solomon Islands
Tonga
Tuvalu
Vanuatu

Fiji

After contracting in 2009 the economy achieved slight growth in 2010, based largely on a recovery in tourism and some goods exports, though the sugar industry weakened for a fourth consecutive year. Low levels of growth are forecast for 2011–2012, accompanied by moderate inflation. Reforms to improve the investment environment are key to generating stronger growth and reducing poverty.

Economic performance

Minimal GDP growth of 0.1% in 2010 continued the pattern of recent years—a period of contraction followed by slight growth—leaving GDP virtually unchanged since 2005. (Official revisions to GDP estimates for 2006–2009, due to rebasing, resulted in growth of 0.2% in 2008 and a contraction of 3.0% in 2009—Figure 3.32.1.)

In 2010, the impact of growth in tourism, mineral water exports, fisheries, and gold mining slightly outweighed downturns in agriculture; transport, storage, and communication; real estate and business services; health and social work; and other community services (these latter two on the back of reduced government expenditure).

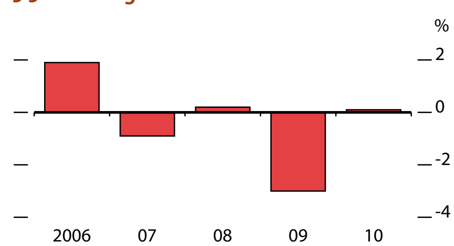
Visitor arrivals rose by 16.5% to a record 633,000 in 2010 (Figure 3.32.2). Increases were notable from Australia (helped by its buoyant economy) and from the People's Republic of China and India (reflecting marketing efforts). Despite a 20% devaluation of the Fiji dollar in April 2009, price discounting meant that growth in tourism earnings only kept pace with tourist arrivals.

Gold production from the Vatukoula mine rose by nearly 80% to 59,000 grams in the 12 months to August 2010, and is expected to reach an annual rate of 100,000 grams in 2011. Mineral water exports recovered from a downturn during the global recession, and fisheries benefited from favorable weather.

On the negative side, agriculture suffered from a cyclone in March 2010, then a drought. The sugar industry, which supports about a quarter of the population, has declined in recent years as the European Union phased out preferential prices it paid to certain nations, including Fiji. The European Union was to provide assistance to the country's sugar industry, but postponed the plan after a military coup in 2006.

Last year, the government initiated a sugar industry reform program that included funding for new cane planting, but farmers continued to leave the industry and cane production fell by 19%. Breakdowns at sugar mills caused production of raw sugar to slide by 20.8% (Figure 3.32.3). Fiji Sugar Corporation, after accumulating losses of more than F$200 million in 2009–2010, is being taken over by the government, and the firm's operations are now funded through the national budget.

3.32.1 GDP growth



Source: Fiji Islands Bureau of Statistics; Ministry of Finance. *Budget Supplement 2010* and *Budget Supplement 2011*. http://www.mfnp.gov.fj

Click here for figure data

3.32.2 Tourism growth

Sources: Fiji Islands Bureau of Statistics; Ministry of Finance. *Budget Supplement 2011*. http://www.mfnp.gov.fj

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This chapter was written by Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva.

Private consumption was supported by the increase in tourism and a rise in remittances. Remittances in US dollar terms rose by about 14% in the 7 months to July 2010. But investment remained low, reflected in a 0.5% fall in imports of investment goods and a 1.1% decline in new lending for investment.

Inflation accelerated early in 2010, propelled by the impact of the devaluation and then shortages caused by the cyclone, as well as by higher global oil prices. After peaking at 10.5% year on year in April, it slowed as the devaluation effect waned, but then picked up again to 5.0% in December, after some price controls on food were removed and electricity tariffs were put up. For the year, inflation averaged 7.8%.

The Reserve Bank of Fiji absorbed excess liquidity in the banking system by twice raising the statutory reserve deposit requirement for commercial banks in 2010, to 10.0%. It also implemented an overnight policy interest rate to signal the monetary policy stance. Late in the year it lowered that rate to 2.5% from 3.0% and relaxed exchange controls. The Fiji dollar firmed against the US dollar (by 4.5%) in 2010 and against the euro, but eased versus the yen and the Australian and New Zealand dollars.

Government data indicate that the budget deficit widened from the equivalent of 3% of GDP in 2009 to 3.6% in 2010 (Figure 3.32.4). Both revenue and expenditure targets were met, although it seems likely that some planned capital expenditure was used for operating expenses. Public debt rose to the equivalent of 58.0% of GDP, or 91.5% of GDP if government-guaranteed debt is included (Figure 3.32.5). The government took onto its books the debt of Fiji Sugar Corporation, a reminder of the risks posed by contingent liabilities.

Preliminary official figures indicate that merchandise exports rose by about 25% in 2010, assisted by higher output and prices of gold. Imports were subdued by slack domestic demand. On this basis, the trade and current account deficits likely narrowed. Foreign exchange reserves rose to US$672 million (about 4 months of imports).

Economic prospects

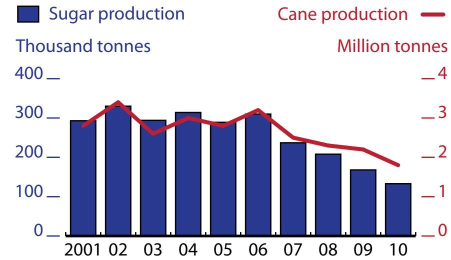
The outlook in the forecast period depends heavily on prospects for the sugar and tourism industries. Reforms in the sugar industry that started in 2010 are assumed to make slow progress, in view of capacity constraints in the government and the need to consult many stakeholders.

Visitor arrivals are influenced by marketing, and while it is assumed the government will continue to fund the Fiji Visitors Bureau, several other Pacific island economies have stepped up their marketing programs. The outlook also assumes no severe cyclones or other natural disasters.

Expected modest economic growth for many of the country's trading partners in 2011 clouds the prospects for both tourism (where deep discounting is set to continue) and merchandise exports. On the balance of these factors, GDP growth is forecast to remain low at 0.5% this year, picking up to 0.8% in 2012 if the sugar industry's reforms gain traction.

The 2011 budget targets a deficit of 3.5% of GDP (the same target set in 2010). It assumes a 16.0% revenue gain from actual levels last year, driven by an increase this year in the value-added tax to 15.0% from 12.5% and a new capital gains tax of 10.0%. It projects expenditure to rise by

3.32.3 Sugar and cane production



Sources: Ministry of Finance. *Budget Supplement 2008, 2009, 2010, 2011.* http://www.mfnp.gov.fj; Fiji Sugar Corporation.

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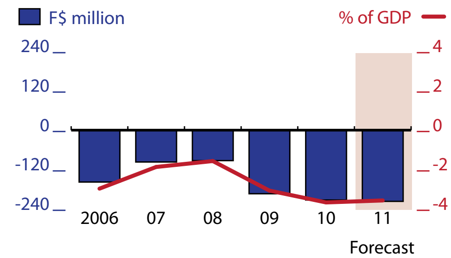
3.32.4 Budget balance



Source: Ministry of Finance. *Budget Supplement 2009, 2010, 2011.* http://www.mfnp.gov.fj

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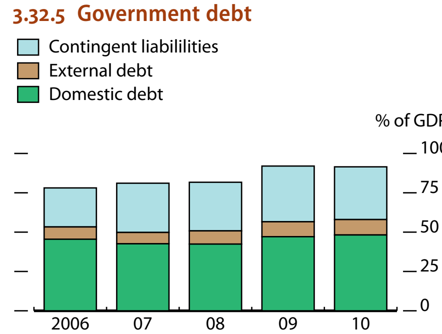
3.32.5 Government debt



Source: Ministry of Finance. *Economic and Fiscal Update. Supplement to the 2011 Budget Address.*

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14.4%, partly reflecting transfers to Fiji Sugar Corporation for operating expenses and mill repairs. The budget also assumes that GDP growth will quicken to 1.3% in 2011. Failure to meet this target would dent projected revenue and probably require spending cuts to be prolonged.

Ample liquidity is expected in the banking system in 2011, but growth in credit to the private sector will likely remain slow in view of forecast low investment levels. The Reserve Bank of Fiji lowered the overnight policy rate in February 2011, to 2.0% from 2.5%, to support growth in light of what it described as "still very weak domestic economic conditions."

Inflation rose to 5.9% in January 2011, from 5.0% in December 2010, mainly reflecting the increase in the value-added tax and higher global oil prices. For this year, inflation is projected to average 4.0% (Figure 3.32.6).

The government plans to roll over a US$150 million sovereign bond that matures in September 2011, which would delay the need to repay the bond (it represents 55% of total public external debt). Last year, the authorities discussed with the International Monetary Fund a possible stand-by credit arrangement that would bolster foreign exchange reserves, targeted primarily at debt repayment, but they put the idea of a program led by the institution on hold.

Imports will increase faster in 2011 than last year, according to official projections, while growth in exports will moderate. Foreign exchange reserves are likely to come under pressure.

These forecasts are vulnerable to external risks, including oil prices (every US$10 a barrel increase in oil prices raises the cost of oil imports by about US$50 million, or 26% of 2010's total import bill) and weaker than anticipated earnings from tourism. Lack of progress on sugar reforms poses a domestic risk to the outlook.

Development challenges

Weakness in investment confines the economy to a low-growth path. Public and private investment combined is estimated to have fallen to 14% of GDP in 2010, from an average of 18% in 2000–2005. Private investment is estimated at the low level of 3% of GDP.

The return of significant donor assistance for infrastructure and other projects, largely withheld since the 2006 coup, depends on new elections. The government is adamant, however, that it will not call them until 2014.

Investor concerns include an opaque and uncertain regulatory environment, as illustrated by foreign exchange controls, price controls, and unpredictable policy decisions. For example, a government decree in 2010 required media organizations to ensure that their directors and 90% of the beneficial shareholders are Fijian citizens permanently residing in the country, which forced a divestment by a foreign firm.

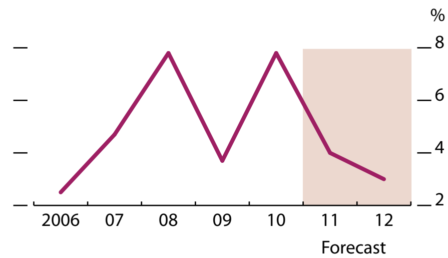
Deficiencies in infrastructure and the poor performance of government-owned enterprises also hurt the investment climate. The need to spur growth is pressing in light of rising poverty, estimated to affect 35%–40% of the population. The authorities have provided some targeted social welfare and have expanded price controls. But the sustainable remedy to poverty—job creation—is unlikely without higher rates of investment.

3.32.1 Selected economic indicators (%)

	2011	2012
GDP growth	0.5	0.8
Inflation	4.0	3.0
Current account balance (share of GDP)	-2.2	-2.1

Source: ADB estimates.

3.32.6 Inflation



Sources: Ministry of Strategic Planning, National Development & Statistics; Reserve Bank of Fiji. *Quarterly Review.* September 2010. http://www.reservebank.gov.fj; ADB estimates.

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Papua New Guinea

Economic growth accelerated in 2010 as construction started on the country's largest resource project and incomes benefited from the recovery in global commodity prices. Growth is forecast to quicken in 2011, underpinned by investment in resources and gains in production of metals and agricultural commodities. Reforms to public financial management and the business environment should be stepped up if the full benefits of a coming surge in revenue from resources are to be realized.

Economic performance

The start of construction on a $15 billion liquefied natural gas (LNG) project and recovery in global commodity prices benefited this resource-rich economy in 2010. GDP growth was estimated at 7.1%, marking almost a decade of uninterrupted expansion averaging about 4.4%.

Industry, including minerals, grew by an estimated 9.3% and was the major contributor to GDP growth (Figure 3.33.1). This mainly reflected a construction boom in Port Moresby and Lae, and an increase in mine production, after several years of contraction in mineral output. Services expanded by an estimated 8.5%, with strong growth in telecommunications and transport. Agricultural output rose by 3.5%.

Private consumption was supported by higher incomes, partly attributable to the recovery in commodity prices (most people are farmers who produce primarily for their own consumption plus some cash crops such as cocoa, coffee, and copra).

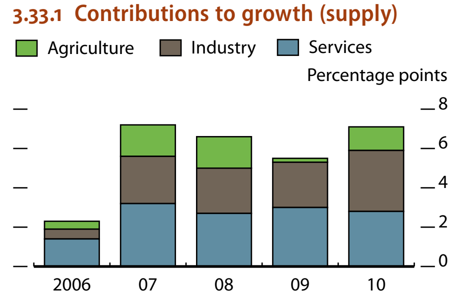
Progress on securing finance for the LNG plant and starting the construction bolstered private investment and buoyed investor sentiment. The plant is expected to begin production of LNG for export in 2014 or 2015, and full operating capacity will be 6.6 million tons a year. Strong investment helped to offset a decrease in government expenditure of 4.1% in real terms in 2010.

The rebound in commodity prices lifted the value of merchandise exports in US dollars by about 27% in 2010 (Figure 3.33.2). Mining (mainly copper and gold) and crude oil exports together climbed by about 30% in value, despite declines in export volumes of gold (4%) and oil (9%). Agricultural exports shot up in value by about 45%: palm oil 51%, coffee 20%, and copra 87%. (The increase was achieved despite a sharp fall in cocoa exports due to bad weather and disease.) The value of forestry products shipments rose, too, but fisheries and other marine exports fell.

After a highly expansionary fiscal stance in 2009, when the government drew down heavily on savings accumulated in public trust funds during past commodity boom years, the authorities reduced trust-fund drawdowns and spending in 2010. Revenue, including

This chapter was written by Dominic Mellor of the Viet Nam Resident Mission, ADB, Ha Noi.

3.33.1 Contributions to growth (supply)



Source: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*.

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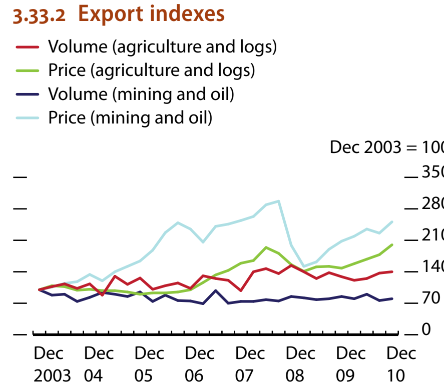
3.33.2 Export indexes



Sources: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg; ADB estimates.

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foreign grants, increased in real terms by 17%, mainly due to the higher commodity prices. As a result, the fiscal deficit narrowed significantly to 0.5% of GDP, including off-budget items (Figure 3.33.3). Excluding off-budget spending from trust funds, the budget again showed a near-balanced outcome.

Inflation eased for a second year to average 6.0% in 2010, in large part a result of a pullback in food-price inflation (Figure 3.33.4). However, there are concerns that the consumer price index might understate inflation because its composition is outdated. The index excludes housing costs, thus direct effects of surging rents in urban centers are not captured.

Growth in private sector credit slowed to a still high 17% in 2010 and broad money supply growth subsided to 12.5%. The Bank of Papua New Guinea raised the cash-reserve requirement for commercial banks in October 2010 to 4.0% from 3.0% to reduce excess liquidity, but kept its policy interest rate steady at 7.0% throughout the year. The kina exchange rate depreciated by 8% in 2010 against a trade-weighted basket of currencies, mainly due to the strength of the Australian dollar.

A surge in imports of equipment for the LNG plant, mainly funded by foreign direct investment, more than offset higher export receipts in 2010. The merchandise trade deficit widened to about 11% of GDP and the current account deficit to an estimated 27% of GDP. An increase in gross foreign exchange reserves to $2.6 billion (equivalent to 15.3 months of nonmineral imports of goods and services) was attributable to inflows of foreign direct investment.

The government in 2010 decided to move new public trust accounts to the central bank, a move that should give the monetary authorities better control over banking sector liquidity. Existing trust fund balances, however, remain in the commercial banking system.

In another important policy development, the government established a working group, chaired by the Treasury, to oversee establishment of a sovereign wealth fund. The plan is to manage revenue from resources through the offshore fund, with drawdowns to be channeled through the budget. This should help to shield the economy and the budget from the impact of swings in global commodity prices.

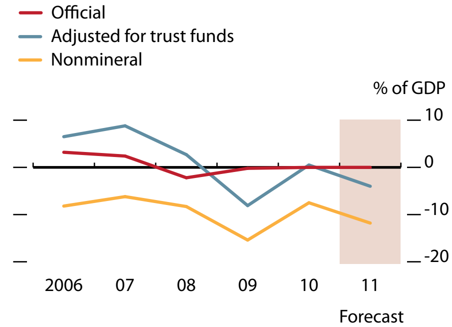
Economic prospects

Plans have been disclosed for a second LNG project, to cost $4 billion, and its developers have said construction could start late this year. Given uncertainty about the construction timetable, the outlook does not factor in any direct impact from this proposal.

Construction of the first LNG plant will accelerate this year (it faced some delays in 2010 owing to land access and compensation issues), thereby increasing activity in the construction and transport industries in particular. Still, the government estimates that only 4.5% of project investment will be retained in the domestic economy because most of the outlays are for imported goods and services.

The $1.4 billion Ramu nickel–cobalt mine, delayed last year over environmental concerns, is assumed to start production in 2011. Output from some operating mines is projected to rise, too. However, crude oil extraction rates will continue to fall as fields mature.

3.33.3 Budget balance



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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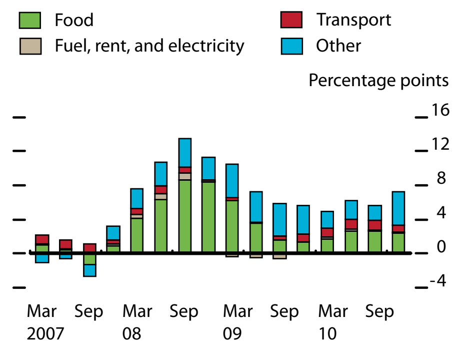
3.33.4 Contributions to inflation



Source: National Statistical Office.

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3.33.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.5	6.5
Inflation	8.0	7.5
Current account balance (share of GDP)	-35.9	-34.2

Source: ADB estimates.

High global prices for agricultural commodities will likely stimulate their production in 2011. Cocoa output is expected to rebound after it suffered from disease in 2010, and coffee production will rise, weather permitting.

On the balance of these factors, GDP growth is forecast to step up to 8.5% in 2011 (Figure 3.33.5), then ease to about 6.5% in 2012 when construction of the first LNG plant starts to taper off.

Price pressures will intensify this year in view of the demands on labor and resources from the first LNG plant. Supply-side constraints are apparent in construction and transport, the property markets in Port Moresby and Lae, and in skilled labor.

Higher global food and oil prices, coupled with last year's depreciation of the kina (against the Australian dollar especially) will fuel inflation, which is projected to accelerate to average about 8.0% this year and be near this rate in 2012. The central bank is expected to tighten monetary policy as inflation pressure builds.

The 2011 budget targets a balanced position, excluding trust fund expenditure. Nevertheless, there may be pressures on the government to spend more from trust funds ahead of elections expected in 2012. Further, a large portion of previous years' trust fund withdrawals may yet be spent. Such expenditure would result in a fiscal deficit and add to inflation pressures.

A buildup in net foreign assets has partially offset the impact of a reduction in net domestic assets on growth in money supply (Figure 3.33.6). This could add to inflation if the trend continues in 2011.

In the external accounts, higher levels of imports for resource projects will continue to widen the current account deficit, to around 35% of GDP in 2011 and 2012 (Figure 3.33.7). This gap will be largely financed by foreign direct investment. Foreign reserves are expected to remain adequate in terms of import cover.

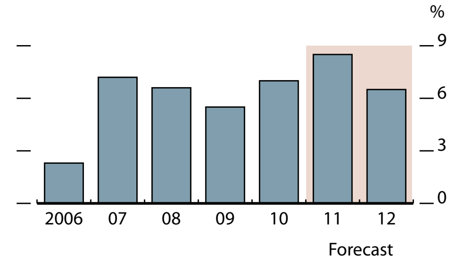
Risks to the forecasts on the upside would come from an early start to work on the second LNG plant or from higher than expected prices for export commodities. The main downside risk is seen in further delays to large resource projects from disputes over land and compensation for landowners.

In the medium term, production from the first LNG plant will underpin growth in GDP, but the likelihood of more such plants is uncertain. There are also uncertainties over mineral production: several large mines are forecast to close sometime in 2012–2015. It will be important that the authorities are cautious about committing to any substantial increases in expenditure, given that they will not receive significant revenue from the first LNG plant until 2018 and that receipts from mining depend on global prices and the life of the mines.

Development challenges

Although the economy has experienced sustained economic growth, driven primarily by development of minerals, the direct contribution of minerals to reducing poverty is limited. Few of the poor depend directly on mining and the links between mining and the rest of the economy are weak. There is currently no official measure of poverty but social

3.33.5 GDP growth



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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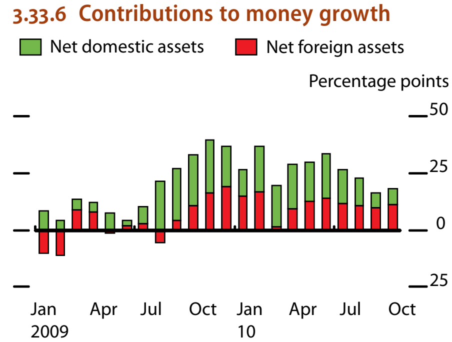
3.33.6 Contributions to money growth



Source: Bank of Papua New Guinea. *Quarterly Economic Bulletin*. Various issues. http://www.bankpng.gov.pg

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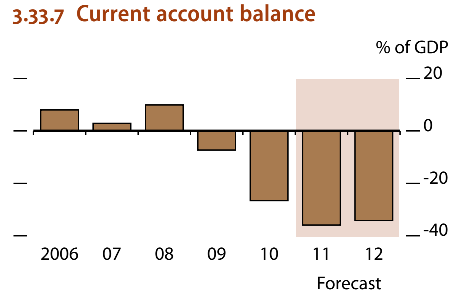
3.33.7 Current account balance



Sources: Papua New Guinea Department of Treasury. *2010 National Budget. Volume 1 Economic and Development Policies*; ADB estimates.

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indicators are below those of other countries with similar per capita incomes. Indeed, Papua New Guinea is not expected to meet any of the Millennium Development Goals by 2015, and is ranked 137 out of 169 countries in the 2010 human development index compiled by the United Nations Development Programme.

The government will have an opportunity to improve living standards by rehabilitating infrastructure and upgrading basic services when substantial revenue starts to flow to the budget from LNG projects. It will also have funds to meet adjustment costs of structural reforms to open business sectors controlled by state-owned enterprises, such as ports and electricity, to private competition.

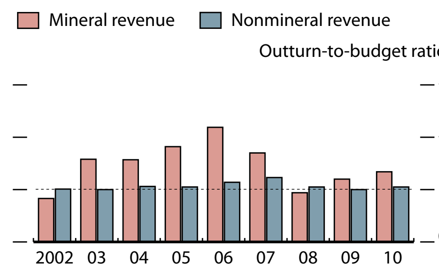
The government's medium-term development plan for 2011–2015 recognizes these challenges and paves the way for a stronger effort to address them. It puts more emphasis on policy achievements and results-based monitoring of the public service. Government commitment to the plan will be critical if agencies are to be held accountable for underperformance. Further, realizing the plan's goals will require marked improvements in the public service and public financial management.

Managing volatile flows of revenue from resources is a continuing challenge. The government has usually erred on the side of caution, under-forecasting commodity prices so that mineral revenue has tended to exceed budget targets (Figure 3.33.8). This generates large windfall revenue that has been directed to discretionary capital spending in supplementary budgets.

It would, though, be helpful if the supplementary budget process was more flexible, to allow some of these funds to be spent on rehabilitation and maintenance of public infrastructure. The plan to manage resource revenue through a sovereign wealth fund should help to smooth revenue flows to the budget.

Improvements to the business environment, including reforms of state-owned enterprises, are required to generate sustainable growth and employment in nonmineral sectors. The World Bank's *Doing Business 2011* report ranks Papua New Guinea 103 out of 183 countries, up from 108 in 2010. The improvement in the overall ranking stemmed from easier availability of credit (though its ranking dropped for other sub-indicators). The lack of enforcement of contracts is, in particular, a deterrent to investment.

3.33.8 Budget revenue forecasts



Note: If the ratio is greater than 1, the outturn is larger than the budget target.

Source: ADB estimates using Papua New Guinea budget documents, 2002–2010.

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Timor-Leste

Driven by increases in government expenditure, this petroleum-dependent economy grew rapidly in 2010 and is forecast to record double-digit growth in 2011 and 2012. Higher oil prices are positive overall for the country, but they have also fueled inflation. Longer-term prospects rest on using government investment to build human and physical capital and to trigger a transition to private sector–led growth.

Economic performance

Economic momentum generated by a rapid buildup in government spending has resulted in the preferred measure of GDP—excluding offshore petroleum production and the United Nations (UN) peacekeeping mission—averaging double-digit growth in 2007–2010. This measure of GDP rose by 9.5% in 2010, moderating from a very high rate in 2009.

Government expenditure, funded mainly by income from offshore petroleum production, increased steeply from about $220 million in 2006 to around $825 million in 2009, and was budgeted at $967 million for 2010 (although actual outlays probably fell short of the budget) (Figure 3.34.1).

Much of the additional government spending was on items that fed quickly into the local economy. Private consumption was boosted in 2010 by a continued rise in public sector wages and salaries, as well as cash transfers provided in rural areas through a wide-ranging social safety net. There was a further large expansion last year both in small, rural infrastructure projects and in larger public projects in the capital, Dili.

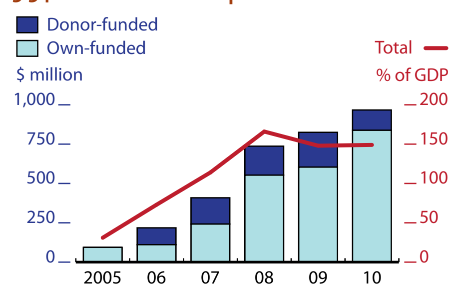
Private investment also climbed as local and overseas-owned businesses geared up to take advantage of the opportunities presented by rising public investment and buoyant consumer spending.

A high level of aggregate demand is reflected in a range of indicators, including new vehicle registrations, electricity use, and mobile phone subscribers (Figure 3.34.2), albeit with some sign of an easing in growth in 2010.

Construction expanded alongside rising investment. Agricultural output, which contributes around 30% of GDP, barely rose in 2010 because of bad weather and continuing transport problems. This followed 2 years of 13% growth in the sector, when it was bolstered by government-led distribution of better seeds and of tractors, and by the introduction of extension services. The Ministry of Agriculture estimated that rice production declined by 6.4% in 2010. Maize production, though, rose by an estimated 10.5%, and coffee exports rose from an unusually low 10,000 tons in 2009 to 25,600 tons in 2010.

Merchandise exports, mainly coffee, represent less than 10% of the

3.34.1 Government expenditure



Note: Nonpetroleum, non-UN GDP.

Source: ADB estimates based on Government of Timor-Leste. 2009. *General Budget of the State* and *State Plan for 2010*. October.

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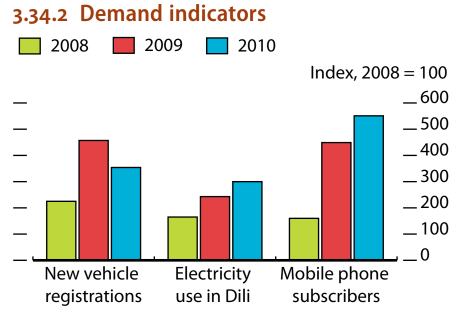
3.34.2 Demand indicators



Source: ADB estimates from Timor-Leste National Directorate of Statistics data.

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This chapter was written by Craig Sugden of the Special Office in Timor-Leste, ADB, Dili.

value of merchandise imports. The wide trade deficit, in the order of 65% of nonpetroleum, non-UN GDP, is outweighed by a surplus in the income account attributable to petroleum revenue. In 2010, such revenue rose to an estimated $2.1 billion, and provided for a current account surplus equivalent to 238% of nonpetroleum, non-UN GDP.

Growth in broad money supply slowed to a more normal 9.7% in 2010, from the exceptional 39.6% in the previous year when the banking system saw a buildup of unspent government funds. Bank lending remained constrained by a backlog of nonperforming loans and a continuing problem of securing land as collateral. Consequently, commercial bank credit to the private sector was unchanged in 2010 from 2009.

Inflation accelerated to average 6.8% in 2010 and was running at 9.2% year on year in December (Figure 3.34.3). Rising food prices were the main reason, themselves largely due to higher international prices. Inflation was lower for prices set by domestic rather than international conditions, suggesting that inflation was cost push rather than demand pull.

Economic prospects

Outlooks for the short and medium term rest heavily on developments in government expenditure. The government has budgeted to boost its own-funded spending by about 50% to $1.27 billion in 2011. Much of the increase is for a multiyear national electrification project and will not be fully spent in 2011, but a sizable increase in actual expenditure is projected for 2011. The government has foreshadowed that its own-funded spending will rise to about $1.45 billion by 2015. Total infrastructure investment over 2011–2015 is projected to exceed $3 billion.

This surge in government outlays will continue to support aggregate demand and construction. Barring disruptive shocks, economic growth is likely to remain high at around 10% over the forecast period (Figure 3.34.4).

The UN mission is phasing down toward a scheduled departure at end-2012, which will have a damping effect on growth, mainly in 2013. Until then, expansion in government expenditure will more than offset that effect.

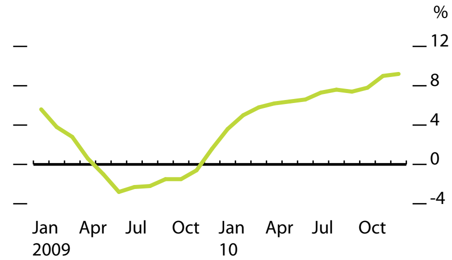
High world oil prices are boosting public saving, providing the financial resources to sustain the investment surge. The nation's Petroleum Fund held $6.9 billion in offshore investments at end-2010, and even with large withdrawals planned to finance the budget, the value of the fund is projected to rise above $14 billion by 2015.

Petroleum income exceeding $2 billion annually is likely to lead to further large budget and current account surpluses in 2011 and 2012. The budget surplus is, however, projected to decline this year as the expansion in government expenditure is expected to outweigh the additional revenue provided by higher world oil prices. From 2012, restraint in recurrent spending and a planned leveling off in public investment are seen easing the downward trend in the budget surplus (Figure 3.34.5).

Inflation is forecast to average 7.5% in 2011, before decelerating in 2012 as upward pressure on commodity prices eases.

While the rise in oil prices is a positive factor overall for this economy, the government needs to carefully manage the resultant

3.34.3 Year-on-year inflation



Source: Timor-Leste National Statistics Directorate. Consumer Price Index. http://dne.mof.gov.tl (accessed 25 February 2011).
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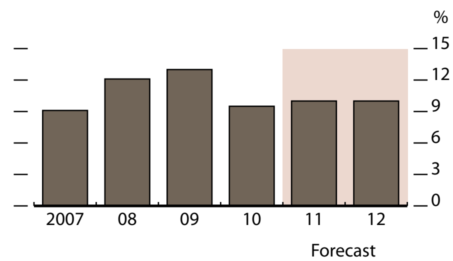
3.34.4 GDP growth



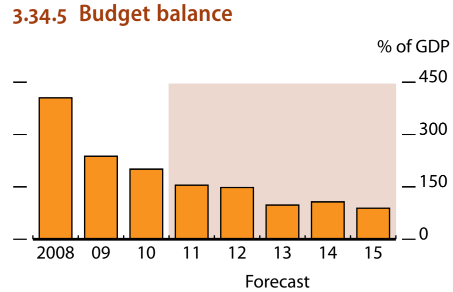
Note: Nonpetroleum, non-UN GDP, annual growth.
Sources: Government of Timor-Leste. 2010. *State Budget 2011: Budget Overview. Book 1.* November; ADB estimates.
Click here for figure data

3.34.1 Selected economic indicators (%)

	2011	2012
GDP growth	10.0	10.0
Inflation	7.5	5.3
Current account balance (share of GDP)	233.7	205.8

Source: ADB estimates.

3.34.5 Budget balance



Note: Ratio to nonpetroleum, non-UN GDP.
Sources: Government of Timor-Leste. 2010. *State Budget 2011: Budget Overview. Book 1.* November; ADB estimates.
Click here for figure data

inflation. It should avoid continually adjusting public sector wages to compensate for the higher cost of living, which could result in a wage–price spiral. That would have the potential to turn what is largely a problem of imported inflation into a deeper risk to macroeconomic stability.

The high rate of economic growth projected for the medium term will see further inroads into poverty. Average household incomes rose by about 20% in 2007–2009, helping to reduce the incidence of poverty from an estimated 50% to a still high 41%. The rate of progress in poverty reduction will rest on success in continuing to expand basic public services and in providing economic opportunities in rural areas.

Development challenges

Development is being fast-tracked through the conversion of petroleum wealth into physical and human capital. The surge in government expenditure funded from petroleum revenue is enabling a rapid expansion in public services and has provided a public social safety net for many. After ranking 150 of 159 countries in the United Nations Development Programme's 2005 human development index, Timor-Leste's position improved to 120 of 162 in the 2010 index.

Still, development challenges are daunting. Income from petroleum lifted Timor-Leste to lower-middle-income country status in 2007, but other indicators of development generally remain those of a low-income country. Of the 21 measurable Millennium Development Goals, about half are unlikely to be met by the target date of 2015, notably those relating to poverty and nutrition. The coverage of electricity, water, and telecommunications infrastructure has expanded, but access and service quality are below potential. Most of the road network is in poor condition.

Public investment needs are likely to stay high over the next decade and beyond (Box 3.34.1). Fiscal constraints will, however, ultimately limit public investment's ability to support the economy. Sustaining a high rate of economic growth will rest on a transition from public to private sector–led investment. As the domestic private sector is still emerging and not yet ready for major investments, there is likely to be a gap that will need to be filled by foreign inflows. The country's success in establishing itself as one of developing Asia's investment destinations will therefore be pivotal to its growth path.

Ideally the level of public investment will be responsive to the returns that it generates. The fundamental rule of public investment is that it should generate an economic return—broadly defined to capture the full range of factors that determine community welfare—at least as high as the economic cost of funding. Most public investment will need to be funded by withdrawals from the Petroleum Fund. Such investment should aim for a return that exceeds the cost of withdrawals, being the financial return that would have been earned if savings had remained in the fund.

The government has flagged the prospect of borrowing on concessional terms to fund public investment. Similarly, any public investment funded from borrowing should aim for a return higher than the interest rate paid, plus any other costs. Borrowing makes sense if it allows savings to be kept in the Petroleum Fund to earn a return higher than the cost of the debt.

3.34.1 How much investment does Timor-Leste need?

An economy's longer-term investment needs can be understood through growth accounting, which decomposes growth into its components: the accumulation of capital and labor, and productivity improvements.

For Timor-Leste, projections prepared in this way highlight the economy's potential to grow robustly over the next two decades. Factors in Timor-Leste's favor include a growing labor force, an ability to fund a high rate of public investment from petroleum revenue, and the potential for a quick catch-up in education and technology.

A continuation of recent double-digit rates of economic growth would probably require investment rising above $1 billion annually within 5 years and above $1.5 billion within 10 years (in 2010 prices). This would be a very large increase on the 2010 investment level of about $300 million.

Projections made using the growth accounting framework show that lower, but still internationally high, rates of economic growth could be achieved if investment was around half these levels. This lower estimate of annual investment—at least $500 million and $750 million—sets a minimum target.

Source: C. Sugden. Forthcoming. *Timor-Leste: Economic Growth to 2030.* Asian Development Bank, Manila.

Small Pacific countries

Seven of the 11 small Pacific economies grew in 2010, albeit slightly, and GDP was estimated to be flat in three. GDP fell in one (Tonga), in contrast to 2009 when the global recession contributed to contraction in seven economies.

The pickup in global travel in 2010 helped some countries. Government infrastructure projects, mostly donor financed, also supported economic activity, notably in the Cook Islands, the Marshall Islands, and the Federated States of Micronesia. Export receipts remained weak, however (except for Solomon Islands). Inflation decelerated from 2009 levels for most economies.

The economic outlook is more positive for 2011 on the back of continued global recovery. This will contribute to increased tourism earnings, export receipts, and remittances. Several economies will benefit from greater spending on public infrastructure. Growth is forecast to pick up in eight countries this year and, and for about half of them, edge still higher in 2012.

Inflation is projected to increase in all 11 countries this year, primarily owing to higher global food and fuel prices for these import-dependent economies, before price pressures ease for most of them in 2012.

Cook Islands

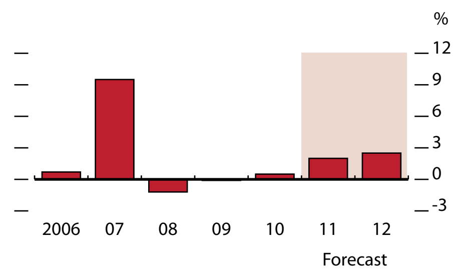
After 2 years of contraction, this economy grew by 0.5% in FY2010 (ended 30 June 2010), supported by expansion of tourism and fisheries, as well as the start of construction on some donor-financed infrastructure projects.

Visitor arrivals and expenditure rose by 2.7% and 2.6%, respectively. Exports of fish (54% of total exports) increased by 15.9%. These performances offset a 10.1% decline in pearl exports caused by a shortage of skilled pearl-seeding technicians.

Growth is projected to pick up to 2.0% in FY2011 (Figure 3.35.1), as infrastructure projects, including development of Avatiu port, gain momentum. However, tourism is subdued because of softness in consumer spending in New Zealand, the main source of visitors. Growth prospects are more positive for FY2012, on the expectation that tourism will pick up and infrastructure investment will increase. GDP growth is forecast to rise to 2.5% that year.

Inflation moderated to 3.5% in FY2010, but will likely quicken to average 4.0% in FY2011. Higher prices for imported oil and commodities, coupled with increased construction activity, have pushed up prices for food, housing-related costs (including electricity), and transport.

3.35.1 GDP growth, Cook Islands



Sources: Ministry of Finance and Economic Management. *Budget Estimates 2010/11: Part 1 Appropriation Bill Appropriations and Commentary*. http://www.mfem.gov.ck; ADB estimates.

Click here for figure data

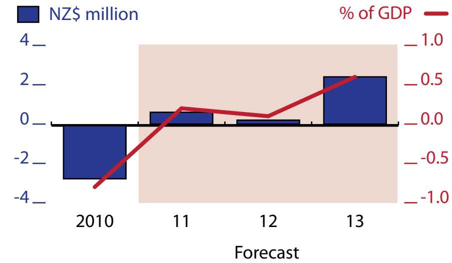
This chapter was written by Stephen Pollard and Elbe Aguba of the Pacific Department, ADB, Manila; Emma Ferguson and Laisiasa Tora of the Pacific Subregional Office, ADB, Suva; Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney; and Rommel Rabanal, consultant.

Merchandise exports fell by 21% in FY2010, largely owing to the problems with pearl production, while imports rose by 42%. The trade deficit widened, and is expected to worsen as import growth, driven mainly by materials for projects that donors are financing, outpaces exports.

Government revenue exceeded budget estimates by 4.3% in FY2010, a result of better than expected receipts from company tax and one-time revenue from fines for illegal fishing. Expenditure was 9.6% over budget, partly on account of supplementary appropriations to cover cyclone recovery expenses and subsidies for Air New Zealand flights from Rarotonga to Sydney and Los Angeles. Still, the budget deficit of NZ$2.7 million (0.8% of GDP) narrowed sharply from 11.7% in FY2009.

The FY2011 budget projects an operating surplus of 0.2% of GDP (Figure 3.35.2), but this was framed against an earlier backdrop of a more positive tourism outlook. Consequently, revenue collections will need to be revised down. The government is aiming to trim expenditure by 1.5% relative to FY2010. Public debt is projected to fall by NZ$30 million to NZ$114.8 million in FY2011 (equivalent to 34% of GDP), mainly due to movements in exchange rates.

3.35.2 Fiscal balance, Cook Islands



Source: Ministry of Finance and Economic Management. 2010. *The Cook Islands Half Year Economic and Fiscal Update for the Financial Year 2010/2011*. December. http://www.mfem.gov.ck

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Kiribati

This economy, too, performed better in 2010, following 2 years of contraction (Figure 3.35.3). Estimated GDP growth of 0.5% was attributable mainly to additional spending by the public sector and to some pickup in private sector activity, especially in construction and retailing. This performance offset a fall in remittances and copra production.

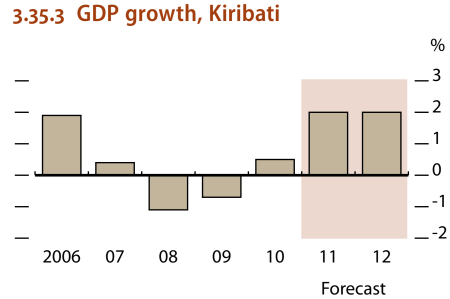
Remittances from the country's seafarers, which account for about 7% of GDP, fell by an estimated 13% in 2010 because of weakening demand for the country's seafarers and greater supply of such workers from other nations. Production of copra declined owing to bad weather.

Wage increases for the public service and higher subsidies for copra production were major factors in widening the budget deficit to an estimated 15% of GDP in 2010. The 2011 budget projects a further rise in public service wages, and in infrastructure investment, pushing the deficit out to 19% of GDP. The gap is to be financed from the country's wealth fund and short-term loans.

The value of the wealth fund—the main source of deficit financing—declined from A$637 million (420% of GDP) in 2007 to A$571 million (350% of GDP) in 2009, primarily due to losses on investments, as well as drawdowns that averaged around 19% of GDP annually from 2007 to 2010. Although the fund's investments recovered marginally last year, concerns remain about its sustainability. The International Monetary Fund recommends that the budget deficit be limited to 6.0% of GDP to preserve long-term financial sustainability.

Fiscal risks are likely to worsen if the government undertakes substantial external borrowing to fund capital works, and if drawdowns from the wealth fund remain high. The government has adopted a medium-term fiscal framework that should help to maintain fiscal discipline.

3.35.3 GDP growth, Kiribati



Sources: International Monetary Fund. *Kiribati: 2009 Article IV Consultation—Staff Report*; ADB estimates.

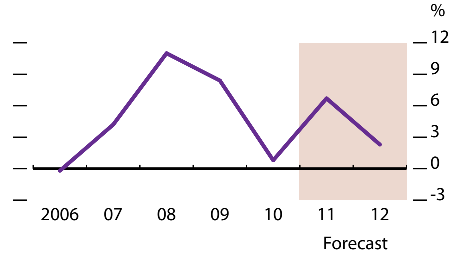
Click here for figure data

Economic growth is likely to pick up to about 2% in 2011 and 2012 as large, mostly donor-funded, capital works get under way. These include revamping the international airports in Tarawa and Kiritimati, upgrading the South Tarawa Road, and extending Betio port.

Inflation slowed to average 0.8% in 2010 (Figure 3.35.4), reflecting appreciation of the Australian dollar and the lagged pass-through from international to domestic prices. This year, though, inflation is expected to accelerate to 6.7%, driven by higher prices for imported fuel and food.

The current account deficit is set to widen from about 14% of GDP in 2010 to about 23% in 2012, in part a result of lower investment income from the wealth fund as drawdowns become smaller.

3.35.4 Inflation, Kiribati



Sources: International Monetary Fund. *Kiribati: 2009 Article IV Consultation—Staff Report*; ADB estimates.

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Marshall Islands

Supported by grant-financed increases in government spending and expansion in fish processing, the economy grew by an estimated 0.5% in FY2010 (ended 30 September 2010). This represented a turnaround after 2 years of declining GDP (Figure 3.35.5). Higher global prices of copra and coconut oil—the country's major agricultural exports—contributed to some increase in export receipts.

The fiscal balance improved, posting a surplus of about 0.3% of GDP in FY2010 (compared with a deficit the previous year), owing to improved tax collection and an increase in fishing fee income. Inflation quickened to 1.0% on higher prices for fuel, electricity, and transport.

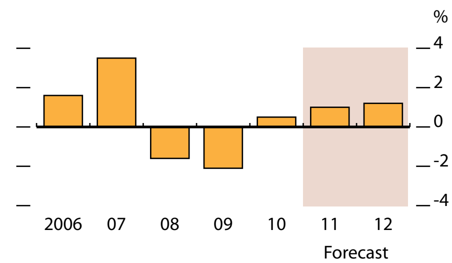
In preparation for when grants under the Compact of Free Association with the United States (US) expire, scheduled for 2024, the government is implementing tax reforms this year that aim to improve the fiscal position, including by raising revenue. It has taken some measures to trim expenditure, but needs to make more cuts for long-term fiscal sustainability. Such reductions could include allowances for civil servants and public officials and assistance to state enterprises.

Economic growth is expected to pick up marginally to 1.0% in FY2011 and 1.2% in FY2012. The outlook is supported by additional grants from Taipei,China and the European Union, which will partly offset the impact of a 5.5% cut in government spending this year. Fisheries, a key source of income, could benefit from planned subregional collaboration on managing fish-stocks.

Inflation is forecast to accelerate to about 5.0% in FY2011 on rising food and oil prices, coupled with some renewed demand-side pressures as the economy grows, before moderating to 3.8% in FY2012 as global commodity price pressures subside (Figure 3.35.6).

Risks to the outlook center on rising prices for commodities, a possible further downsizing of the US military base on Kwajalein, and the pace of phasing down compact-related grants from the US.

3.35.5 GDP growth, Marshall Islands



Sources: Republic of the Marshall Islands Fiscal Year 2009 Economic Review; ADB estimates.

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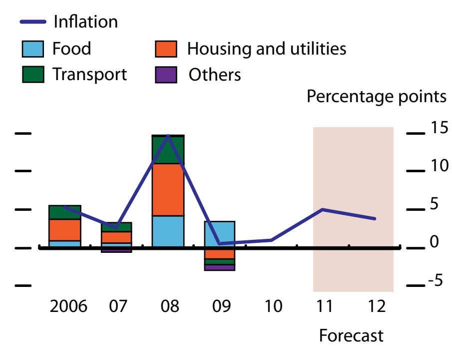
3.35.6 Contributions to inflation, Marshall Islands



Sources: Republic of the Marshall Islands Fiscal Year 2009 Economic Review; ADB estimates.

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Federated States of Micronesia

Growth of an estimated 0.5% in FY2010 (ended 30 September 2010) followed a similar increase in GDP in FY2009 (revised from a previously estimated slight contraction).

The modest expansion was driven by public infrastructure projects,

including extension of Pohnpei airport and the expansion of the fiber-optic communications network. The reopening of a fish-processing plant in Kosrai and an increase in small-scale agriculture stimulated by rising commodity prices helped the economy, as did some uplift in remittances and tourism receipts.

Inflation subsided to about 3.5% in FY2010, owing to lower prices for imported food and energy in the early part of the year.

Reflecting a general weakness in consumption spending, food imports from the US, the main trading partner, fell by 6.7% in value in FY2010.

The government trimmed expenditure by 3.6% in FY2010, cutting capital spending by almost 20% while raising current spending by 2.1% (for the public wage bill and subsidies). Tax revenue growth of 7.9% helped to generate a small fiscal surplus.

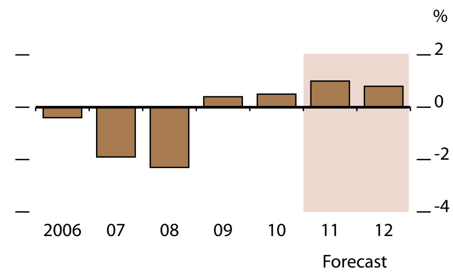
The fiscal situation has improved markedly since FY2009, in part because of efforts by state governments to raise revenue collection and cut spending. Nevertheless, much further progress is needed before FY2023, when grants expire under the Compact of Free Association with the US.

GDP growth is expected to pick up to 1.0% in FY2011 (Figure 3.35.7), based on a pipeline of infrastructure projects and the release of infrastructure funds delayed in previous years. With the Pohnpei airport extension scheduled for completion in mid-2011, improved direct flight connections could expand opportunities for tourism and exports. GDP growth is forecast at 0.8% in FY2012.

Inflation will likely inch up to 4.0% in FY2011 owing to higher global commodity prices, before easing to 3.0% in FY2012.

Sluggish development of the private sector, which is hindered by inadequate infrastructure, lack of skilled labor, and investment restrictions, remains an impediment to growth.

3.35.7 GDP growth, Federated States of Micronesia



Sources: Federated States of Micronesia Fiscal Year 2009 Economic Review; ADB estimates.
Click here for figure data

Nauru

GDP was likely flat in FY2010 (ended 30 June 2010) (Figure 3.35.8) because storm damage to the port and weak demand restricted exports of phosphate.

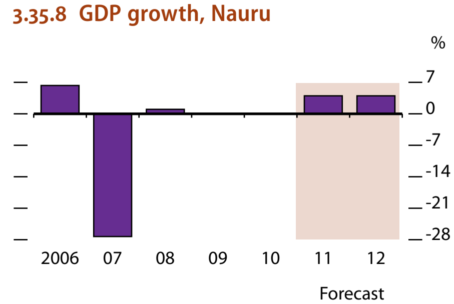
Repairs to the port, funded by the Russian Federation, with modest recovery in world phosphate demand, are expected to support a return to economic growth in FY2011 and FY2012. GDP growth of about 4% is forecast for each year.

Consumer prices declined by an estimated 0.5% in FY2010. The cost of telecommunications fell as a result of the entry of a new mobile telephone and Internet service provider. In FY2011 and FY2012, however, higher global food and fuel prices are expected to induce inflation of 2.5%.

The FY2010 budget outturn was a net cash position of A$7.7 million, with the surplus achieved after own-funded expenditure of A$20.2 million and donor-funded expenditure of A$11.2 million. This fiscal year's budget maintains the prudent fiscal management adopted since 2004. Spending in FY2011 is budgeted at A$29.0 million (excluding donor-funded projects), down by 9% from FY2010. Donor-funded expenditure is expected to total A$31.0 million. Without donor support, per capita GDP (estimated at US$2,240 in 2009) would fall by more than half.

Nauru faces an enormous debt burden as a result of poor

3.35.8 GDP growth, Nauru



Sources: Asian Development Bank. 2007. *Country Economic Report*. August; ADB estimates.
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decisions by previous governments. Total government external debt in 2010 was estimated at A$261 million. In addition, A$265 million is owed domestically by the government, mainly to depositors at the insolvent Bank of Nauru, and state-owned enterprise debts total about A$368 million. Total external debt is more than eight times GDP.

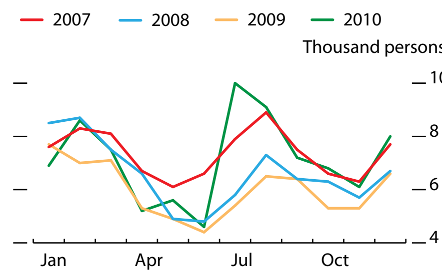
Over the medium term, the economy will remain heavily dependent on donors. Longer-term prospects depend on government reforms both to improve public financial management and the performance of state-owned enterprises, and to revitalize mining and quarrying, which now include coral aggregate used in construction (as well as phosphate). Tourism and fisheries offer untapped opportunities for greater economic self-sufficiency.

Palau

An upturn in tourism compensated for cuts in public expenditure to drive growth estimated at about 2.0% in FY2010 (ended 30 September 2010). This was the first year of growth after 4 consecutive years of contraction.

Tourism, which accounts for around half GDP, had seen visitor arrivals drop by a cumulative 16.5% over the previous 2 years. In FY2010, arrivals picked up by 11.7% as a result of the global economic recovery, new airline and charter connections to Palau, and intensified advertising and promotion. Growth was particularly strong in arrivals from Taipei,China. Arrivals from Japan, the largest source of visitors, rose sharply during the northern summer months. Total monthly arrivals recovered to 2007's levels by the second half of 2010 (Figure 3.35.9).

3.35.9 Visitor arrivals, Palau



Source: Palau Visitors Authority. http://www.visit-palau.com (accessed 16 March 2011).

Click here for figure data

Domestic demand appears to have picked up a little last fiscal year. Consumption spending, as measured by the value of monthly food imports from the US, was just above the previous year's level. However, public investment on infrastructure projects remained low.

Inflation slowed to an estimated 3.8% on average from 5.2% in FY2009, due primarily to lagged effects of lower international prices of fuel and other commodities early in the year. Transport and household costs declined in the first quarter before climbing steadily.

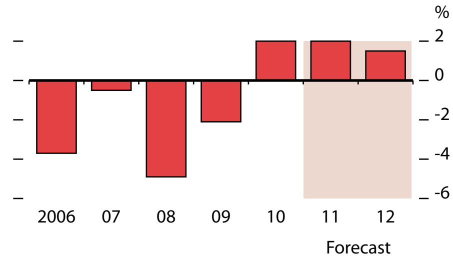
The original budget for FY2010 intended to reduce public expenditure by about 10%, as a start toward bringing outlays down to more sustainable levels. In a reversal of a recent trend of overoptimistic revenue projections, which had led to drawdowns in cash reserves and accumulation of public debt, the revenue shortfall was budgeted to narrow in FY2010.

However, a supplementary budget passed later in the year partly reversed the spending cuts and restored current expenditure to about the FY2009 level. Given the scheduled ending in FY2024 of grants from the US under the Compact of Free Association, it will be important to gradually reduce current expenditure to more sustainable levels, particularly the wages bill for the public service and purchases of goods and services. Otherwise, more severe spending cuts will be needed later. These reductions should be put through in parallel with increases in government revenue. Raising utility charges to eventually reflect the cost of service delivery would help.

Economic prospects remain largely dependent on the outlook for tourism. Visitor arrivals are projected to increase by around 7% in FY2011 (the first-quarter performance was strong), followed by another 5% gain in FY2012. Such expansion in tourism would help take GDP growth to 2% in FY2011 and 1.5% in FY2012 (Figure 3.35.10).

Inflation is projected at about 4.0% in FY2011, lifted by higher global food and fuel prices, easing to 2.5% in FY2012 as commodity price increases moderate.

3.35.10 GDP growth, Palau



Sources: International Monetary Fund. 2010. *Country Report* No. 10/116. May; ADB estimates.

Click here for figure data

Samoa

Declines in agriculture, tourism receipts, and remittances offset growth in construction, manufacturing, and transport and communications in FY2010 (ended 30 June 2010), leaving GDP flat.

Even though visitor arrivals rose by 3.5% to 131,300, earnings from tourism fell by 6.0% to $130 million owing to a decrease in tourist spending per head. Remittances fell by 5.3% to $148.8 million.

Merchandise exports increased by 18.8% to $12.2 million in FY2010, led by strong performances from nonu fruit and coconut oil. Merchandise imports picked up by 14.1% to $261.6 million, reflecting higher costs of petroleum and food. A wider trade deficit, coupled with reduced remittances, saw the current account deficit worsen to 8.1% of GDP.

However, the overall balance of payments was in surplus due to net disbursement of government loans for tsunami reconstruction (a tsunami hit coastal areas in September 2009). Foreign exchange reserves of $165.7 million at June 2010 were equivalent to 7.6 months of import cover.

Inflation slowed to average 1.2% in FY2010. The deceleration was a result of falling commodity prices and subdued domestic economic activity.

Fiscal policy was exceptionally expansionary in FY2010, with a budget deficit equivalent to 8.1% of GDP. Spending was boosted by measures to counter the impact of the global recession on the domestic economy, coupled with post-tsunami reconstruction. These steps were largely funded by grants and concessional borrowing. External debt levels went up to about 43% of GDP by end-FY2010 (Figure 3.35.11), exceeding the government's 40% target.

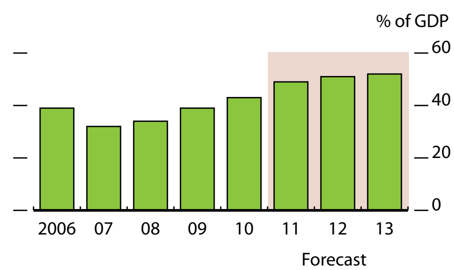
The FY2011 budget continues high levels of expenditure, reflecting the reconstruction effort and increases in public sector wages and pensions. The fiscal deficit is projected to widen to 9.3% of GDP.

The rise in government spending, and in private consumption to a lesser degree, are expected to produce a return to economic growth in FY2011, forecast at 2.1%. A stronger tourism marketing effort is likely to have some positive impact in FY2011, and private remittances should benefit from economic growth in Australia. For the first 7 months of FY2011, earnings from tourism and remittances rose by 4.0% and 1.1%, respectively.

Growth is seen rising to 3.0% in FY2012 on continued post-tsunami reconstruction and an expected increase in tourism.

Inflation is projected to increase to around 3.0% this year as domestic economic activity picks up and as a result of higher global food and fuel prices.

3.35.11 Total debt, Samoa



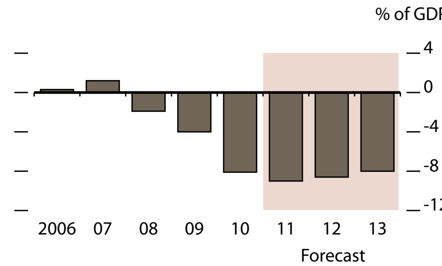
Source: Ministry of Finance. 2010. *Fiscal Strategy Statement Budget 2010/11*. 28 May.

Click here for figure data

The government intends to run fiscal deficits of over 8% of GDP through FY2013 (Figure 3.35.12). Although the deficits are to be financed through concessional borrowing and grants, sustaining such a stance holds risks—the government would find it hard to adjust to any external shocks, for example.

Structural reforms to improve the commercial focus of state-owned enterprises and to increase access to, and economic use of, customary land are needed for the potential benefits of public investment to be realized.

3.35.12 Budget balance, Samoa



Source: Ministry of Finance. 2010. *Fiscal Strategy Statement Budget 2010/11*. May.

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Solomon Islands

This economy recovered in 2010, growing by an estimated 4.0% after contracting by 1.2% in 2009 (Figure 3.35.13). Logging led the upturn. After a poor year in 2009, log export volumes rose by about 30% in 2010, a result of recovering demand in Asia that also helped to lift international log prices. Production of palm oil and cocoa, as well as the size of the fish catch, also increased, although copra production declined.

The services sector was sluggish in the first half of 2010, but business conditions improved in the second half according to a business expectations survey. Building activity indicators suggested expansion in construction as well.

GDP growth is forecast to accelerate to 7.5% in 2011, when the Gold Ridge mine in Guadalcanal is due to start producing and exporting gold. Logging is expected to decline during the forecast period, owing to falls in logging resources, but stronger global demand for other commodity exports, such as palm oil and copra, will bolster growth. Other positive factors include an expected rise in foreign investment in mining, including a new copper mine, and in telecommunications. Growth of about 4.0% is projected for 2012.

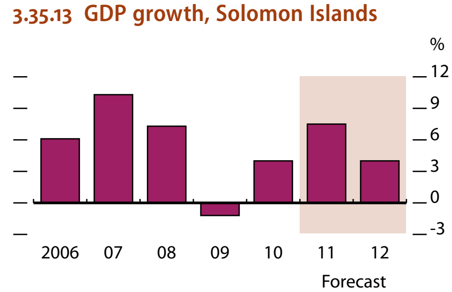
Inflation eased to average about 3.0% in 2010, largely due to a 40% fall in the price of rice caused by greater competition in food imports (rice constitutes around 18% of the consumer price index). Looking ahead, though, inflation is expected to accelerate to 4.2% this year and 6.3% in 2012, as a result of higher global prices for fuel and commodities and stronger domestic demand as the economy grows.

At an estimated 20% of GDP, the current account deficit remained wide in 2010, reflecting high levels of imports of mining and telecommunications equipment. The start of gold exports this year, coupled with growth in agricultural exports, is seen pulling back the deficit to 15% of GDP.

Despite the trade and current account deficits, foreign reserves rose to the equivalent of about 9 months of import cover, a consequence of large inflows of donor funds and the first tranche of a US$18.3 million stand-by credit facility approved by the International Monetary Fund in June 2010. Half this credit was disbursed in 2010 and the rest is scheduled for 2011. Foreign reserves are expected to remain strong in 2011, at about 6 months of import cover.

A tight fiscal situation for much of 2010 led to restrictions on expenditure until the fourth quarter and a government recruitment freeze. Budget support from donors, including large sums in the

3.35.13 GDP growth, Solomon Islands



Sources: Central Bank of Solomon Islands. *Quarterly Review September 2010*. http://www.cbsi.com.sb; ADB estimates.

Click here for figure data

second half of the year, together with a better than expected revenue performance, resulted in a budget surplus.

After elections in August 2010, the incoming government was unable to draft a full budget before year-end, and instead passed a supplementary appropriations bill that enabled spending to continue in the first 3 months of 2011, at no higher than in the same period of 2010.

Tonga

Weakness in remittance and tourism contributed to a 1.2% contraction in GDP in FY2010 (ended 30 June 2010). Remittances fell by 10.0% and earnings from tourism fell by 13.3% owing to slow recovery in source countries, particularly New Zealand and the US. GDP has contracted in 3 of the past 4 years (Figure 3.35.14).

Private sector credit fell by around 13% in December 2010, in part reflecting consolidation in the banking sector and the write-off of bad debts.

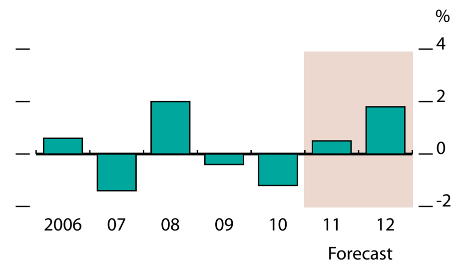
The government trimmed its nonwage operating costs and own-funded capital spending in FY2010, in response to a 4.0% decline in revenue (it fell short of the target by more than 20%). Budget support from donors limited the deficit to about 1.0% of GDP; without that support the gap would have been 2.3%.

In the external accounts, increased receipts from exports of sea cucumber more than made up for declines in fish and agricultural products in FY2010, so that total exports grew by 2.2%. Imports fell sharply, by 21.0%, reflecting weak domestic demand. The current account deficit narrowed to $16.6 million from $24.8 in FY2009. Official foreign reserves amounted to $98 million at end-December 2010, equivalent to 7.9 months of imports (Figure 3.35.15).

Donor-funded infrastructure activities are expected to support a return to economic growth of about 0.5% in FY2011. Government spending is budgeted to rise by 14.9%, based on commitments from donors, and will contribute to aggregate demand through higher public sector wages. Revenue, excluding grants, is to remain weak.

Inflation eased to 2.0% last year, mainly the result of better supplies and a related fall in prices for domestically produced food, as well as lower school fees. It is forecast to rise to about 3.0% in FY2011 on upward pressure from world oil prices and higher prices for imports from New Zealand, in part a result of exchange rate movements.

3.35.14 GDP growth, Tonga

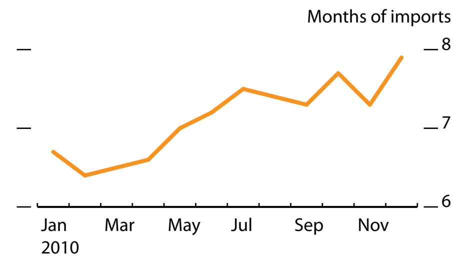


Note: Fiscal year ending June.

Sources: Ministry of Finance. *Budget Statement: Review of the Tongan Economy and Outlook*. Various years. http://www.finance.gov.to; ADB estimates.

Click here for figure data

3.35.15 Official foreign reserves, Tonga



Source: National Reserve Bank of Tonga. *Official Foreign Reserves December 2010*. http://www.reservebank.to

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Tuvalu

This economy continued to feel the impact of the global recession in 2010. Even with higher government spending, GDP was estimated to be unchanged from 2009.

Seafarer employment—a significant income source for households—was weak and is likely to remain so due to subdued demand for Tuvaluan seafarers. Income from the ".tv" domain name and fisheries licenses fell as the Australian dollar (which Tuvalu uses) gained parity with the US dollar. The Australian dollar's strength also had an impact on

consumer prices: they eased from mid-2009, with the average decline in 2010 estimated at 1.9%.

The government continued to support the economy through spending. It approved three supplementary appropriation bills, together accounting for about 10% of GDP, in 2010. These were used to pay for the government's guarantee of an Air Fiji loan (Tuvalu is the biggest shareholder in the airline) and to increase capital spending by 15.7% from the original estimate.

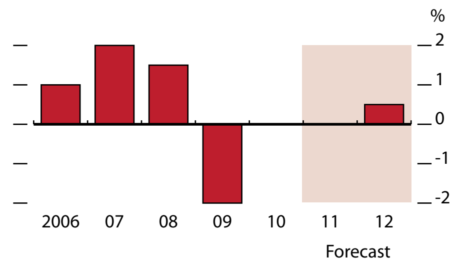
The fiscal deficit is estimated to have widened sharply to almost 30% of GDP in 2010, owing to lackluster domestic revenue and increased expenditure. Revenue is estimated to have declined by 17%, in part due to weak offshore income from all sources. Public debt (including guarantees) is about 44% of GDP, which is high for this small economy.

The value of the Tuvalu Trust Fund likely stabilized in 2010, after falling during the global recession. However, no distributions from this fund to the budget were made or are expected while international financial markets are volatile.

The economy is projected to stay flat in 2011 (Figure 3.35.16) as fiscal adjustments, mainly spending cuts, are made to ensure longer-term fiscal sustainability. Growth is expected to resume at about 0.5% in 2012 when donor-financed public works employing local workers are scheduled to start. Rising global food and fuel prices are likely to rekindle inflation, forecast at 1.5% in 2011 and 2.0% in 2012.

The number of households living in poverty has increased to about 20%, based on a 2010 household survey, from 14% in 2004. Declining remittances is the major cause. One way to ensure that funds are available to meet basic health and education needs for the poor would be selective cuts to other spending, such as medical insurance and scholarship programs, that benefit only a narrow section of the population.

3.35.16 GDP growth, Tuvalu



Sources: Central Statistics Division, Government of Tuvalu; ADB estimates.

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Vanuatu

Growth slowed to an estimated 3.0% in 2010 from an average of 5.7% in the previous 7 years. Agricultural production and construction increased, but tourism and retailing were soft.

The prolonged period of growth (8 years in a row) is attributable to increases in private investment, underpinned by policy reforms that included the opening of the aviation and telecommunications markets.

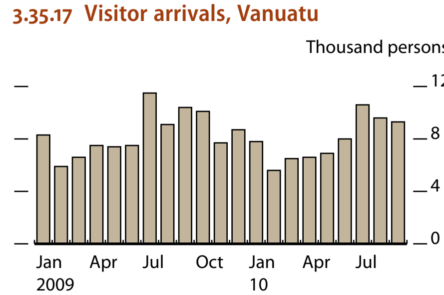
Last year, tourist arrivals declined by an estimated 2.6%, from record numbers in 2009 (Figure 3.35.17). The decline was largely due to a recovery in tourism to Fiji, which had lost market share to Vanuatu in 2009 (because of flooding and political uncertainty in Fiji).

Construction benefited from projects funded by the US Millennium Challenge Corporation as well as from some work on tourist facilities. Buoyed by higher prices for copra, coconut oil, and beef, agriculture recovered from a poor performance in 2009.

Inflation eased to average 3.4% last year. In the external accounts, the current account deficit likely widened to 2.4%, a result of lower tourism receipts.

The Reserve Bank of Vanuatu began to withdraw stimulus measures that it had implemented during the global financial crisis. It lifted

3.35.17 Visitor arrivals, Vanuatu



Source: Vanuatu National Statistics Office. *Tourism and Migration July 2010*. http://www.spc.int/prism/country/VU/stats

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the statutory reserve requirement for banks to 6% from 5% in August (still below the 8%–10% range of 1999–2008) and foreshadowed further monetary tightening as global economic conditions improve.

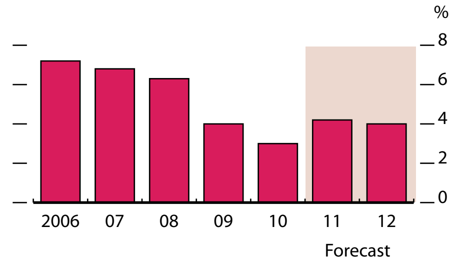
A near balanced budget was anticipated for 2010. Fiscal policy will likely remain broadly neutral in 2011, as the government is required under law to target budget surpluses.

GDP growth this year is forecast to rise to 4.2% (Figure 3.35.18), based on an expected increase in tourist arrivals—particularly from Australia—driven by robust economic conditions, a strong Australian dollar, and increased flights from that country. Agriculture is expected to pick up owing to high commodity prices. GDP growth of around 4.0% is expected in 2012, on continued gains in tourism and agriculture.

Higher food and fuel prices are forecast to raise inflation to 5.0% in 2011, before it eases to 4.0% in 2012. The current account deficit is expected to widen in 2011 and 2012 to 3.8% and 4.7% of GDP, respectively, as the pickup in domestic demand lifts imports.

Inadequate transport infrastructure and services hinder development of rural areas and outer islands, where income-generating opportunities are scarce. These areas need improved ports, wharves, and jetties, as well as more reliable and affordable shipping services. The country's road network is also inadequate: out of about 1,800 kilometers of roads, less than 100 kilometers is paved and about 400 kilometers is gravel surfaced.

3.35.18 GDP growth, Vanuatu



Sources: Reserve Bank of Vanuatu. 2010. *Quarterly Economic Review*. September. http://www.rbv.gov.vu; ADB estimates.

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