Small Pacific countries

Overall growth among the 11 small Pacific countries was faster in 2011 than in 2010. All of them except Tonga expanded. In three, the growth in gross domestic product (GDP) was 5.0% or more and the Solomon Islands—at 9.3%—was one of the fastest-growing economies in developing Asia.

The growth in tourism evident in 2010 continued in 2011, particularly in the Cook Islands, Palau, and Samoa, and the number of tourist arrivals hit records. Construction had an important influence on growth in many of the small economies, notably Cook Islands, Marshall Islands, Samoa, and Vanuatu, but in the Federated States of Micronesia a winding down of large public construction projects led to slower growth.

The outlook for these small economies is positive. Most of them are expected to have faster growth in 2012 than in 2011. The main exception is Solomon Islands where growth is likely to decelerate because of a decline in logging. All of them are expected to continue expanding in 2013, but all—apart from Vanuatu—at a slower pace than in 2012.

Stable oil and lower food prices will keep inflation generally lower in 2012 than in 2011, but several countries will have higher inflation on increased domestic demand and domestic constraints. In 2013 most of these economies face the prospect of slightly higher inflation, because food prices are expected to pick up.

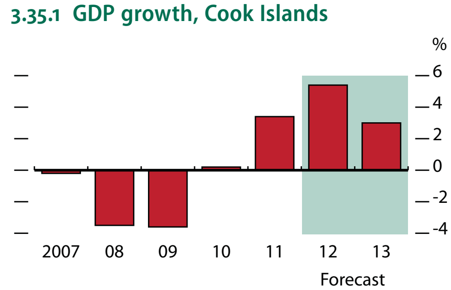
Improving government fiscal management and public sector efficiency, as well as maintaining basic public services by investing in vital infrastructure, are priority needs to support sustained growth in the small Pacific countries.

Cook Islands

After several years of negative or slow growth, the Cook Islands recovered in FY2011 (ended 30 June 2011) with GDP growth of 3.4% (Figure 3.35.1). This reflected expansion in tourism and fisheries, as well as increased construction associated with upgrading of Avatiu port. Tourism accounts for about two-thirds of GDP and an improved economic outlook in Australia and New Zealand (the source of four-fifths of arrivals) helped push visitor arrivals to over 108,000 in FY2011, a new fiscal year high. During July–December 2011, arrivals increased by 6.4% relative to the same 6 months in 2010 (Figure 3.35.2).

In FY2011, inflation slipped to 0.6% from 1.8% in FY2010, driven primarily by declines in housing and household costs, such as rent and utilities.

3.35.1 GDP growth, Cook Islands



Sources: Ministry of Finance. 2011. *2012/13 Budget Policy Statement* and *2011/12 Half Year Economic and Fiscal Update*. December; ADB estimates.

This chapter was written by Christopher Edmonds, Emma Veve, Rommel Rabanal, and Cara Tinio of the Pacific Department, ADB, Manila; Malie Lototele and Laisiasa Tora of the South Pacific Subregional Office, ADB, Suva; and Milovan Lucich of the Pacific Liaison and Coordination Office, ADB, Sydney.

Government operating revenue was 1.9% higher in FY2011 than in FY2010, primarily because of the increased receipts from tourism. With operating expenditure edging up by 0.1%, the fiscal deficit narrowed slightly to 1.4% of GDP.

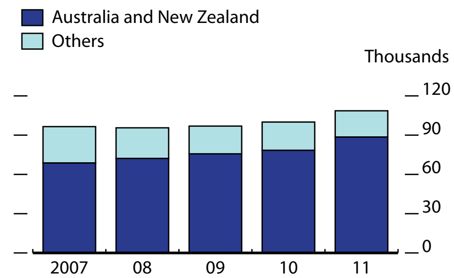
The trade deficit widened to US$286 million in FY2011. The value of merchandise imports increased by 7.7% but exports fell by 10.5%, largely owing to decreased pearl exports.

The economy is expected to grow at 5.4% in FY2012. This reflects increased visitor arrivals, particularly from Australia on the new Sydney–Rarotonga direct flights that began in July 2011. The start of large infrastructure works (roads, water, and energy) will help the expansion continue, with the economy projected to grow by 3.0% in FY2013.

In FY2012, government operating revenue is expected to increase by 3.2%. Tax revenue is forecast to rise by about 6.6% because of growth in tourism and the introduction of a withholding tax. Government operating expenses are expected to rise by 3.1% in FY2012. A budget deficit of 1.4% of GDP is forecast.

The government in 2011 carried out a functional review, which recommended that it should focus on its core business and its regulatory and enabling roles. The government will take a phased approach to implementing the recommendations for public sector reform, reflecting capacity constraints. Although the review was silent on the appropriate size of the public sector, it is an issue that the government will have to address if it is to manage spending.

3.35.2 Visitor arrivals, Cook Islands



Source: Cook Islands Statistics Office.

Kiribati

The economy grew by 3.0% in 2011 largely due to stronger retail activity. Inflation was 7.7% (compared with deflation of 2.8% in 2010) because of increased food and fuel prices (Figure 3.35.3).

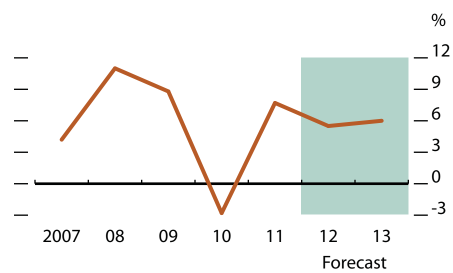
Government revenue collection in 2011 was about 20% lower than in the previous year and 9% below budget estimates. This fall stemmed from a decline in the value of income from fishing licenses and a poor fishing season. (Licenses are paid in United States (US) dollars, which depreciated against the Australian dollar, used by Kiribati as its currency.) Expenditure rose by about 10% because of increased spending on infrastructure projects.

The fiscal deficit thus widened from 8.1% of GDP in 2010 to 17.7% in 2011. The gap was partially funded by concessional borrowing, but also by a drawdown of capital from the Revenue Equalization Reserve Fund (RERF), a sovereign wealth fund, the earnings from which are intended to balance recurrent financing needs.

GDP is projected to climb by 3.5% in 2012 with the start of major development partner–funded infrastructure projects, such as road building, as well as airport and seaport reconstruction. In 2013 growth is expected to come off a little to 3.0% (Figure 3.35.4). Over the next 2 years, inflation is projected to drop to 5.5% and then increase to 6.0%, reflecting expected movements in international food prices.

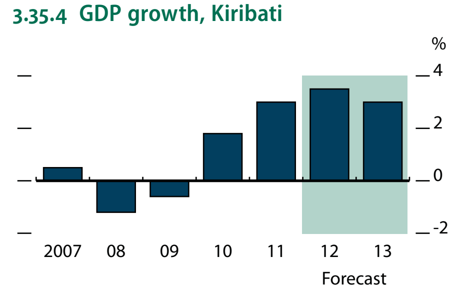
A new government took office in January 2012. Its first budget, which should be presented in April, is likely to see a widening of the fiscal deficit, reflecting a scheduled increase in infrastructure spending. The

3.35.3 Inflation, Kiribati



Sources: International Monetary Fund. 2011. *Article IV Consultation*. May. http://www.imf.org; ADB estimates.

3.35.4 GDP growth, Kiribati



Sources: International Monetary Fund. 2011. *Article IV Consultation*. May. http://www.imf.org; ADB estimates.

deficit will be partly funded by an RERF drawdown, raising concerns about the fund's long-term sustainability after drawdowns averaging around A$17 million in the last four years.

Growth of the RERF is the key to ensuring long-term fiscal sustainability. Reducing the annual demands on the fund to a level that can be met from its income will require extensive fiscal consolidation. Over the medium term, the government should aim to stabilize the value of the RERF, by keeping budget deficits to 5–6% of GDP. Stronger control of expenditure on personnel costs is one option it could investigate.

Republic of the Marshall Islands

Economic growth slowed slightly to 5.0% in FY2011 (ended 30 September 2011). This solid performance was supported by fishing activity, continued high spending related to US military operations under the Kwajalein Land Use Agreement, and the upgrade of the international airport in Majuro.

Inflation shot up to 9.5% (from 1.6% in FY2010). Steep rises in the prices of commodities (which have a weighting of nearly 50% in the consumer price index), high transport costs arising from the country's remote location, and the pickup in domestic demand drove this increase.

The fiscal surplus fell from 4.6% of GDP in FY2010 to 1.4%. Although grants declined, domestic revenue—mainly from fishing license fees—rose. Public expenditure climbed by 6.1%, reflecting, primarily, increased purchases of goods and services.

The current account remained in deficit (12.6% of GDP). Although merchandise exports expanded by 26.5% to US$40.8 million, imports reached US$114.5 million.

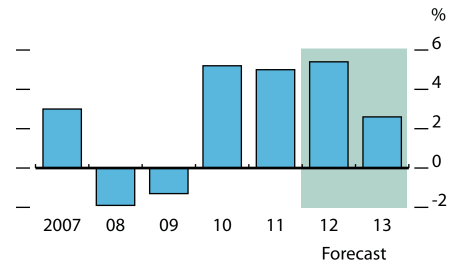
Economic growth is foreseen to reach 5.4% in FY2012, boosted by continued growth in fisheries and airport-related construction, before slowing to 2.6% in FY2013 (Figure 3.35.5). FY2013 is likely to see a fiscal surplus of slightly over 1% of GDP. A projected step-up in grants will finance about 70% of the budget and contribute to a 5.1% gain in total receipts. Total government expenditure will rise by 5.7%, partly due to greater subsidies to state-owned enterprises (SOEs).

Inflation is projected to slow to 2.5% in FY2012 before accelerating to 3.0% in FY2013, in line with expected trends in global food prices (Figure 3.35.6).

The current account deficit is forecast to widen to 30.3% of GDP in FY2012. Although merchandise exports will grow by 14.8%, imports are expected to jump by 29.8% owing to continued demand from the airport upgrade and expansion of fisheries.

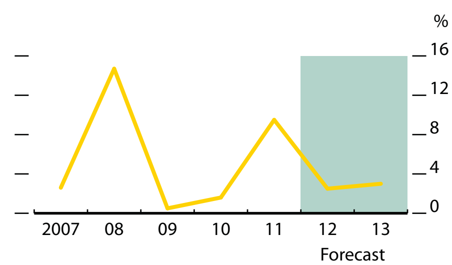
The country has to build up the Compact Trust Fund to prepare for fiscal self-sufficiency once US Compact grants expire in 2023, while paying down the high government debt. It also needs to generate sustainable economic growth. Fiscal and structural reforms are needed to stimulate private sector economic activity, generate domestic employment and income, and broaden the local tax base. Tax reforms are required to increase government revenue and offset planned reductions in grants. In addition, SOE reforms and cutbacks in public expenditure are needed to improve the fiscal balance.

3.35.5 GDP growth, the Marshall Islands



Sources: Republic of Marshall Islands Fiscal Year 2010 Economic Review. http://www.pitiviti.org; International Monetary Fund. 2011. *Article IV Consultation—Staff Report.* November. http://www.imf.org

3.35.6 Inflation, the Marshall Islands



Sources: Republic of Marshall Islands Fiscal Year 2010 Economic Review. http://www.pitiviti.org; ADB estimates.

Federated States of Micronesia

Public infrastructure construction continued to support economic growth in FY2011 (ended 30 September 2011). This was the third consecutive year of growth supported by airport improvement projects funded through US Federal Aviation Authority grants. However, as some projects reached their final stages, growth fell from 3.1% to 1.4% (Figure 3.35.7). Consumer spending appears to have recovered in FY2011, with the value of food imports from the US—the country's largest trading partner—increasing by about 8%.

Inflation rose to 7.9% in FY2011, due mainly to higher oil prices. The retail gasoline price was 30% higher in March 2011 than a year earlier.

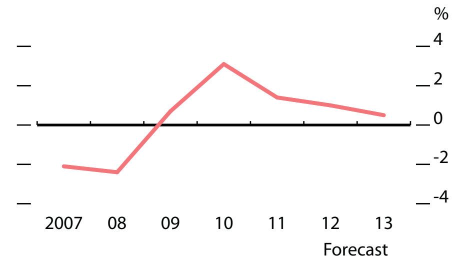
Progress in fiscal consolidation resulted in a small budget surplus, equivalent to about 0.4% of GDP in FY2011 (Figure 3.35.8). This is the third year of surplus following years of earlier deficits. Capital expenditure was cut by about 13% after the completion of some public works projects, and the reduction in government spending was about 2% for the year.

The modest pace of economic expansion is expected to moderate further to 1.0% in FY2012 as some infrastructure projects such as the Pohnpei airport runway extension are finished. In FY2013, GDP growth is forecast to tail off to 0.5% as more projects are completed. Weak private activity and annual declines in grants under the Compact of Free Association with the US also contribute to a subdued growth outlook.

Inflation of 3.5% is projected for FY2012 as prices of internationally traded commodities, other than oil, decline. In FY2013, inflation is expected to rise slightly to 4.0%, reflecting an assumed rise in global demand.

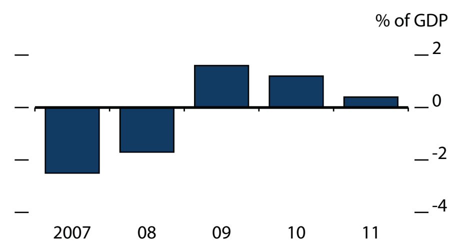
Small fiscal surpluses are projected for FY2012 and FY2013 but these fall short of target levels. In order to achieve savings in the FSM Compact Trust Fund to generate sufficient income to replace annual compact grants, which expire in FY2023, further fiscal consolidation is needed. This might involve a reduction in the public sector wage bill and revenue-raising measures (i.e., tax reforms and improvements in tax administration) to maintain fiscal surpluses over the long run.

3.35.7 GDP growth, Federated States of Micronesia



Sources: Pacific & Virgin Islands Training Initiatives. *Federated States of Micronesia Fiscal Year 2010 Economic Review.* http://www.pitiviti.org; ADB estimates.

3.35.8 Fiscal balance, Federated States of Micronesia



Sources: International Monetary Fund. *Federated States of Micronesia—2011 Staff Visit Preliminary Conclusions.* http://www.imf.org; ADB estimates.

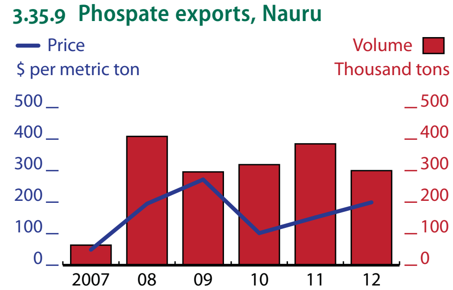
Nauru

The economy grew by 4.0% in FY2011 (ending 30 June 2011) largely because phosphate exports increased by more than 20% (Figure 3.35.9). The country has been experiencing deflation for the last few years and in FY2011 the consumer price index declined by 3.5%, in part because of appreciation of the Australian dollar (which Nauru uses as its official currency).

Government revenue in FY2012 is expected to be A$31.6 million and expenditure A$32.5 million, yielding a small deficit of A$0.9 million. Cash reserves brought forward from FY2011 will, however, result in a small surplus.

The Australian Agency for International Development estimated that in 2006 government debt obligations to external and internal debt holders were A$371.4 million, and A$264.8 million respectively, an enormous burden relative to GDP. By September 2010, overall debt had been reduced—external A$69 million and internal A$481 million. Nauru generally runs large current account deficits funded by development-partner inflows.

3.35.9 Phospate exports, Nauru



Note: Fiscal year ending June. FY2012 figures is for the first 7 months only.

Sources: Republic of Nauru Phospate Company; The World Bank. Pink Sheet. http://go.worldbank.org/4ROCCIEQ50 (accessed 6 February 2011).

Recently improved phosphate-loading facilities are expected to lift phosphate exports to 450,000 tons in FY2012 from 350,000 tons in FY2011, taking economic growth to 4.8% in FY2012 and 4.2% in FY2013.

The level of national debt precludes sovereign borrowing, so Nauru will maintain near-balanced budgets in the forecast period. Recent reforms to the phosphate export enterprise may improve fiscal performance gradually. Inflation is expected to turn positive, as currency appreciation effects wash through, and average 1.5% and 2.0% in the next 2 fiscal years.

The limited growth prospects for very small Pacific countries, such as Nauru, was acknowledged in a recent review of Australia's official development assistance (ODA). A planned increase in ODA, to offset the lack of private sector activity, is likely to be delivered through program-based approaches. This will require improvements to the country's public financial management strategies in order to efficiently absorb and manage higher ODA levels and translate this into economic growth.

Republic of Palau

The economy grew by 5.8% in FY2011 (ended 30 September 2011), up from 0.3% the previous year. Growth reflected strong data for tourism, which accounts for about half GDP. Arrivals from Asia, particularly East Asia, rose steeply (Figure 3.35.10), aided by the addition of Delta Airlines flights between Palau and Japan. In FY2011, visitor arrivals increased by over 25% and exceeded 100,000 for the first time.

Rising food and transport costs raised inflation to 2.1% in FY2011, from 1.2% in FY2010. Inflation largely tracks price developments in the US—Palau's primary trading partner—in the absence of any major domestic inflationary factors.

The government continued to reduce expenditure (by 3.1% during FY2011), with cuts focused on publicly provided goods and services. Public sector wages and salaries, which account for over a third of total government spending, rose by about 5% FY2011. The fiscal deficit widened to 2.3% of GDP as lower grants from the US outweighed an increase in domestic revenue associated with the economic recovery.

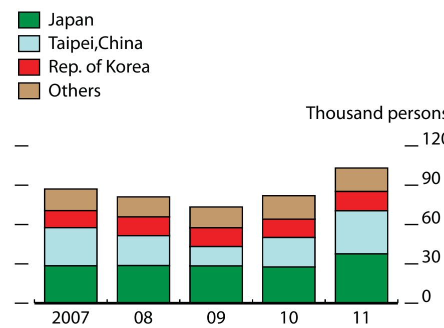
Tourism will remain the key source of growth for the foreseeable future, and visitor arrivals will continue to depend on developments abroad—particularly in Japan; Republic of Korea; and Taipei,China. Palau's visitor arrivals are projected to go up by 7.5% and 6.0% in the next 2 fiscal years, supporting GDP growth of 3.0% and 2.0% (Figure 3.35.11).

Inflation is projected to fall to 2.0% in FY2012 and to edge up to 2.5% the following year, in line with expected international commodity price trends.

The government is expected to maintain its contractionary fiscal stance on concerns about its fiscal position. Comprehensive civil service reform is needed to reduce the public sector wage bill. New revenue-raising measures, including increased tax rates for high-income earners and a steeper hotel-room tax, are under consideration and are likely to be adopted this fiscal year. Further tax reforms, such as a value-added tax, may also be required.

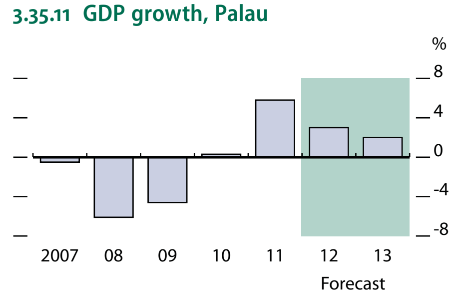
Palau's tourism-oriented economy relies heavily on basic public

3.35.10 Visitor arrivals, Palau



Source: Palau Visitors Authority. http://www.visit-palau.com (accessed 16 March 2012).

3.35.11 GDP growth, Palau



Sources: Pacific Financial Technical Assistance Centre; ADB estimates.

goods like transport infrastructure and reliable service delivery. These facilities are, though, approaching full capacity and need to be expanded. Sustaining tourism growth would also benefit from improvements in the business environment, such as simplifying licensing procedures and expanding access to skilled labor and credit.

Samoa

Growth picked up to 2.1% in FY2011 (ended 30 June 2011), from 0.2% the previous year (Figure 3.35.12), reflecting growth in construction as infrastructure projects were continued or initiated. Higher consumer spending also contributed, fueled by rising remittances (particularly from Australia and New Zealand). Construction-related industries like transport and communications posted modest growth, as did tourism.

Average annual inflation rose to 2.9% in FY2011, driven by higher prices for imported food (mainly rice, flour, and chicken) and fuel.

Government revenue and expenditure were generally in line with budget targets, except development spending. This category was underspent by 18.9%, given slow activity at several construction projects. The fiscal deficit was 6.5% of GDP, lower than the budget estimate of 9.6% and the FY2010 outturn of 7.4%. The narrower deficit was in line with the recommendation of the International Monetary Fund to move toward a medium-term target of no more than 3% of GDP by FY2013. Although Samoa remains at low risk of debt distress, public debt is rising and is close to 40% of GDP in present value terms. Accelerating the pace of fiscal consolidation would ensure adequate capacity to absorb shocks in the future and accommodate rising debt repayments.

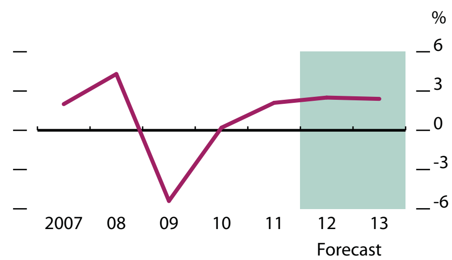
The Central Bank of Samoa continued easing monetary policy to stimulate economic activity and stabilize the economy. It reduced its policy rate, and through its credit line facility lowered lending rates to the Development Bank of Samoa and the Samoa Housing Corporation. Credit to the private sector recovered but grew by only 6.5% in FY2011, in line with weak economic activity and despite ample financial sector liquidity and low nonperforming loans.

The current account deficit remained at about 9.3% GDP in FY2011 (Figure 3.35.13) as some recovery in incomes from tourism and remittances offset a wider merchandise trade deficit (due to higher petroleum payments and increased imports associated with post-September 2009 tsunami reconstruction). Total imports rose by 11.4% (in US dollar terms), and exports of fresh fish, beer, and nonu juice fell by 5% due to weakening demand in major markets, including Japan and New Zealand.

The economy is expected to grow by 2.5% and 2.4% in the next 2 fiscal years, driven mainly by tourism and remittances. Tourism earnings in the first 6 months of FY2012 were 2% higher than the equivalent FY2011 period. Private remittances rose by 3% to US$86.7 million during the same period. This expansion, however, will not be enough to fully offset the withdrawal of fiscal stimulus.

Medium-term prospects will depend on how the US, Australian, and New Zealand economies perform; these countries are Samoa's largest trading partners and main sources of remittances and tourist arrivals. Also, manufacturing output is likely to decline given the scaling down

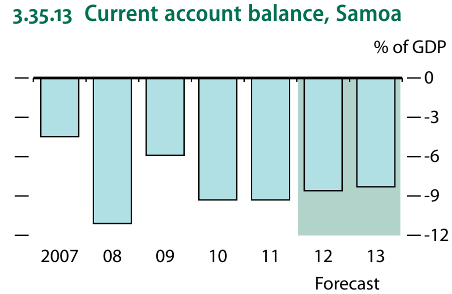
3.35.12 GDP growth, Samoa



Note: Fiscal year ending June.

Sources: Samoa Bureau of Statistics; ADB estimates.

3.35.13 Current account balance, Samoa



Sources: Central Bank of Samoa; Samoa Ministry of Finance. 2011. *Fiscal Strategy Statement 2011/12*. May.

of production at the Yazaki auto-part plant due to a reduction in wire harness orders from Toyota Australia.

The FY2012 budget projects the fiscal deficit to remain at 6.5% of GDP.

Inflation is expected to continue rising to about 5.0% in FY2012—as strong domestic demand counteracts increased local agricultural production and falling international commodity prices—but then to fall back to 3.3% in FY2013.

The balance of payments is projected to record an overall surplus in FY2012 due to the anticipated heavy influx of donor funds (about US$100 million in external grants and loans). Exports of artesian water, fish, and nonu juice are likely to benefit, as the People's Republic of China phases in duty-free entry of a greater range of Samoan products in line with a July 2010 trade agreement.

Continued efforts to advance fiscal consolidation and to lower public debt are essential to create the fiscal flexibility necessary to enable the government to respond to external shocks.

Solomon Islands

The economy grew at 9.3% in 2011–the fastest of the Pacific island countries. As in previous years, the major contributor to growth was log production, where output was more than 1.9 million cubic meters, around one-third more than in 2010. This reflected continued high demand in Asia. The country also benefited from high international prices for other commodities such as palm oil, cocoa, copra, and fish, as well as renewed gold exports from the Gold Ridge mine in Guadalcanal, which resumed production after closing in June 2000 due to civil conflict.

After falling to 1.0% in 2010, inflation jumped to 7.4%, largely reflecting strong growth and higher global food and energy prices. In 2011, the central bank allowed the Solomon Islands dollar to appreciate vis-à-vis the US dollar by 8.7% in an explicit effort to contain inflation. It also resumed issuing its own short-term bills to reduce liquidity in the banking system. After contracting in 2010 and the first 9 months of 2011, credit growth increased to 7.2% in the last quarter of the year.

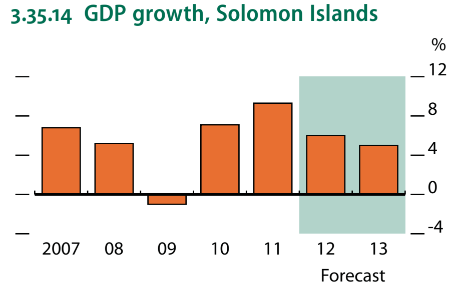
A budget surplus equivalent to 2.1% of GDP was recorded in 2011. Revenue increased by almost 25% from 2010. Strong production of logs and favorable prices in 2011 boosted customs duties, while strong economic activity and elevated fuel prices led to higher inland revenues (i.e., goods and sales taxes, personal and corporate income taxes).

Overall recurrent expenditure grew by 1.2% in 2011, with payrolls growing by 4.2% owing to cost-of-living adjustments to public service salaries. Development expenditure grew by 54% during the year. Public debt declined from 24.0% of GDP in 2010 to 21.6% in late 2011, related to debt repayments and an increase in nominal GDP.

The current account deficit narrowed to 11.2% of GDP, from 27.6% in 2010 on higher exports and reduced imports of capital equipment following the reopening of the Gold Ridge mine. The deficit has been funded through donor inflows and foreign investment. Foreign reserve cover improved to over 9 months of imports as of December 2011.

Growth is expected to moderate to 6.0% and 5.0% over the next 2 years (Figure 3.35.14). Reduced logging output, due to overexploitation

3.35.14 GDP growth, Solomon Islands



Sources: Solomon Islands National Statistics Office; ADB estimates.

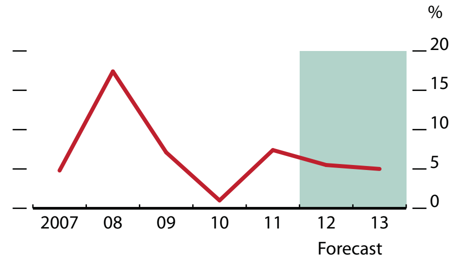
of the native forest, will be partly offset by increased value of gold output, as the Gold Ridge mine reaches full output, and by strengthening commodities such as palm oil, copra, and vanilla.

The 2012 budget is balanced. Expenditure is to increase by 47%, which will be covered by a 22.4% gain in revenue, a drawdown on the National Transport Fund for development projects, and by using grants from the Regional Assistance Mission to Solomon Islands (RAMSI). To help preserve the budgetary position if the strong revenue growth does not continue, much of the increase in spending is in one-time items such as the hosting of the Pacific Arts Festival, or items that can be scaled back, including a planned doubling of debt repayments in late 2012.

This rate of expenditure growth, however, is unsustainable and will need to be reduced in future budgets.

Inflation is expected to moderate over the next 2 years as growth and global commodity prices ease. Average inflation of 5.5% and 5.0% are forecast (Figure 3.35.15). The central bank will likely continue to let the exchange rate appreciate modestly if inflation does not moderate.

3.35.15 Inflation, Solomon Islands



Sources: Central Bank of Solomon Islands; ADB estimates.

The current account deficit is forecast to widen to around 15.0% of GDP in 2012 and 2013 as a result of slower export growth. The gap will be funded through continued donor inflows and foreign investment. Foreign reserves should remain at around 7–8 months of imports.

The private sector faces numerous challenges to doing business. It must compete with SOEs, which receive preferential access to resources and operate in markets reserved for them, such as power and water supply. The SOEs hold nearly a quarter of the nation's fixed assets, absorb large amounts of scarce capital, and generally yield negative returns on their fixed assets and investments, thereby increasing costs for private enterprises.

A State Owned Enterprise Act, passed in 2007, and its accompanying regulations, issued in 2010, now provide a robust framework for SOE governance and monitoring. Implementation of this act—including improving the accuracy and timeliness of the financial information prepared by SOEs as well as requiring proper costing, funding, and documentation of all community service obligations—is essential to improving efficiency and accountability.

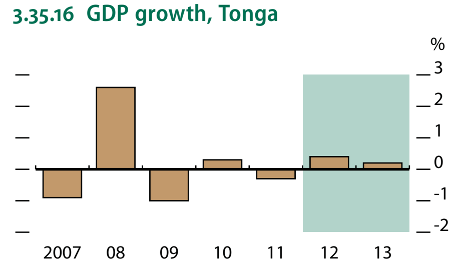
Major gaps exist in access to infrastructure across the country. A majority of the nation's rural population does not, for example, have access to paved roads, regular electricity supplies, or telecommunications.

Tonga

The economy contracted by 0.3% in FY2011 (ended 30 June 2011) after growth of 0.3% the previous year (Figure 3.35.16). Remittances, coming largely from the US, continued to decline, and, coupled with banks' steps to repair their balance sheets, affected both business and household investment and consumption. Tourism, and particularly the cruise liner market segment, was the bright spot in the economy, with tourism receipts growing by 14.8% (in real terms) in FY2011 from the previous year.

Inflation rose to about 6.1%, reflecting the surge in global fuel and food prices and higher excise taxes on tobacco and alcohol.

3.35.16 GDP growth, Tonga



Sources: Ministry of Finance and National Planning; ADB estimates.

Revenue in FY2011 was 5.8% more than in FY2010, but despite this and receipt of budget support grants from development partners, the FY2011 fiscal deficit widened to 7.9% of GDP, financed mainly by loans from the EXIM Bank of China and drawdowns on domestic cash balances. The share of public debt to GDP rose to 56.1% (including the undisbursed portion of loans) by end-FY2011, exceeding the government's target ceiling of 40%.

To boost commercial bank lending, the central bank continued to ease monetary policy, although lending to businesses and households in 2011 continued declining, by 11.1% and 4.6%, respectively.

In the external account, fish and squash exports (which account for more than half of all exports) grew by only 1.9% in FY2011 (after more than doubling in FY2010) given problems in meeting quarantine requirements for New Zealand, and unfavorable weather. Imports, dominated by basic consumption goods, increased by 16.6%, largely due to higher oil prices as well as increased imports of wholesale and retail goods and construction materials.

Foreign reserves remained at comfortable levels, reaching 7.7 months of imports, reflecting receipts of development-partner funds, ample liquidity in the financial system, and weak business and household activity.

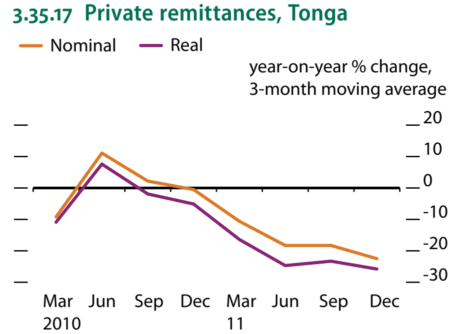
The economy is forecast to show virtually zero growth in the next 2 years. Domestic economic activity is expected to remain weak despite donor-funded public construction, in view of declining remittances and flat credit growth, which will affect household consumption and private sector investment.

A bleak outlook on remittances is also foreseen given the slow recovery in the US and continuing high unemployment in other source economies such as New Zealand. Government analysis suggests remittances are likely to be permanently lower than in the past (Figure 3.35.17). Exports, which are around 3% of GDP, could, however, lead a stronger expansion of the economy if supply-side constraints are addressed and compliance with export market quarantine standards improves.

The central bank is expected to continue its loose monetary policy stance, unless global commodity prices rise further. Inflation is likely to hover around 6.0% in FY2012.

Tonga is classified by the International Monetary Fund as at high risk of debt distress. The high public debt and its composition pose serious challenges. Debt repayments are expected to increase by 70% in FY2014, when repayments start on a loan from the EXIM Bank of China. It is critical that the government uses year-end cash surpluses, reprioritizes expenditure, and raises the tax effort to build cash reserves, which could provide a buffer against cross-currency foreign exchange risks and safeguard the government's expenditure programs.

3.35.17 Private remittances, Tonga



Source: National Reserve Bank of Tonga.

Tuvalu

After 2 years of contraction, the economy grew by 1.0% in 2011 (Figure 3.35.18), largely due to higher remittances. The consumer price index increased by 0.5% in 2011, which was lower than in most other Pacific economies, reflecting the appreciation of the Australian dollar (which Tuvalu uses as its currency) against the US dollar.

Total revenues and grants for 2011 were slightly below budget but about 20% higher than in 2010. The increase was mainly due to the grants. Government expenditure fell by more than 7% as subsidies were reduced and spending on capital projects declined. These developments led to a reduction in the fiscal deficit from over 30% of GDP in 2010 to about 8% in 2011. However, weakly controlled spending on the Tuvalu Medical Treatment Scheme remains a heavy drain on the budget with actual expenditure 70% above budget in 2011. Total government debt was estimated at 44.3% of GDP in 2010, and may be higher with the status of contingent liabilities from joint-venture fishing companies to be determined (Figure 3.35.19).

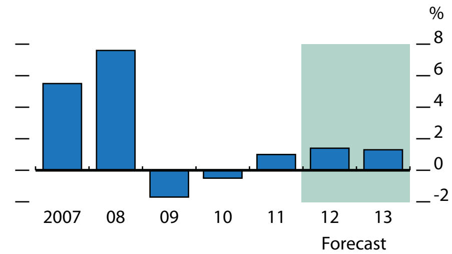
The market value of the Tuvalu Trust Fund stood at A$115.1 million as of 30 September 2011. As this was 9.7% below its prescribed maintained value, nothing was distributed from the fund to the Consolidated Investment Fund (CIF—the vehicle through which budget deficits are financed).

Growth is expected to edge up to 1.4% and 1.3% in the next 2 years, supported by development partner–financed upgrading of the Tuvalu airfield and airport. Increases in remittances are also expected.

Total revenue and grants are budgeted at A$24.1 million in 2012, 7% less than the 2011 outturn, due to a projected 3.3% reduction in receipts from fisheries licenses and lower grant funds. Government expenditure is estimated at A$29.2 million (13% below the 2011 projected outturn) as the government tries to control spending. At A$5.1 million, the budget deficit is forecast at 14.3% of GDP. The CIF held A$3.1 million in December 2011 and, given the expected deficit, is likely to be exhausted this year. Further distribution from trust fund earnings is not expected until 2014 at the earliest.

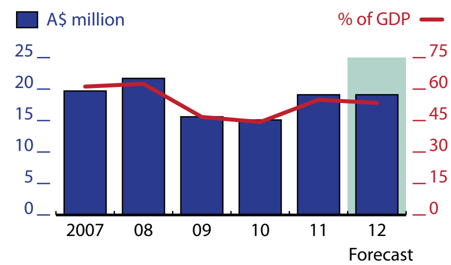
The fiscal situation remains precarious. With the likely exhaustion of the CIF in 2012, development partners will become the primary avenue for budget financing, underlining the importance of reforms and expenditure controls.

3.35.18 GDP growth, Tuvalu



Sources: International Monetary Fund. 2011. *Article IV Consultation*. August. http://www.imf.org; ADB estimates.

3.35.19 Total government debt, Tuvalu



Sources: International Monetary Fund. 2011. *Article IV Consultation*. August. http://www.imf.org; ADB estimates.

Vanuatu

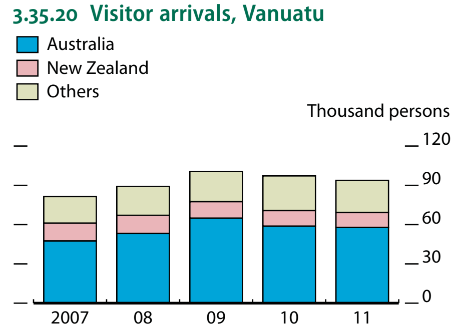
Growth nearly doubled in 2011 to 4.3%, reflecting strong agricultural exports (notably copra and coconut oil), high international commodity prices, and growth in construction. Tourist arrivals fell, however, by 3.5% from the 2010 level, which had been inflated because flooding in Fiji diverted tourists to other destinations (Figure 3.35.20).

Despite high global energy and food prices, the consumer price index rose by just 0.8% in 2011. This was partly explained by a slowdown in growth of private credit.

The current account deficit was steady at 5.9% of GDP in 2011, and was more than covered by foreign investment and donor inflows. By December 2011, foreign exchange reserves had risen to 6.3 months of import cover, from 5.8 months in March 2011.

Economic growth of 4.5–5.0% is forecast over the next 2 years (Figure 3.35.21). This will be driven by increasing construction, continuing strength in agricultural production, and recovering tourism (additional flights are planned from Australia and Fiji).

3.35.20 Visitor arrivals, Vanuatu



Source: Vanuatu National Statistics Office.

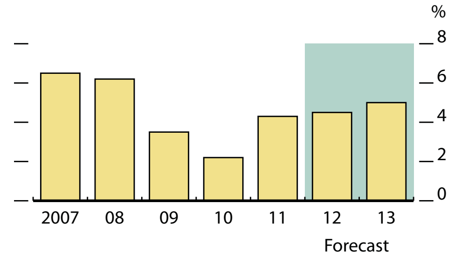
Small fiscal deficits of 1.5% and 2.7% of GDP are expected as the government increases borrowing to fund improvements to infrastructure. Public debt as a share of GDP is expected to remain around 20%, as higher debt is offset by growth in nominal GDP. If, however, contingent liabilities associated with past losses of some of the poorer performing SOEs were included, debt as a share of GDP would likely exceed the government's ceiling of 40%.

Inflation is expected to pick up as the economy grows, to around 3.0–4.0%.

The current account deficit is forecast to widen a little to 6.3–6.5% of GDP over the next 2 years, as a result of stronger imports related to infrastructure projects. The gap will be funded through continued donor inflows and foreign investment. Foreign exchange reserves are expected to remain at levels needed to finance 5–6 months of imports.

Vanuatu became WTO's 154th member in November 2011. Joining required reductions in tariffs but the resulting loss in revenue will be partly offset by excise increases. Taxes as a share of GDP are already relatively low at around 19% of GDP. Thus, as the indirect tax base erodes, the government will need to consider bringing in measures to broaden the tax base, such as a progressive income tax.

3.35.21 GDP growth, Vanuatu



Sources: Vanuatu National Statistics Office; ADB estimates.