ADB Pacific Economic Monitor

December 2012 www.adb.org/pacmonitor

The *Monitor* provides an update of developments in Pacific economies and explores topical policy issues.

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Highlights

- **Mixed but modest impacts of weak global economy on the Pacific.** Global economic prospects remain weak due to persistent fiscal and banking difficulties in the Eurozone, coupled with emerging slowdowns in developing economies. However, the impact of this sluggishness on Pacific economies has, so far, been limited to declines in agriculture and forestry export earnings. Domestic infrastructure spending is seen as driving fluctuations in growth in the larger resource exporting economies—Papua New Guinea (PNG) and Timor-Leste. Tourism to the Pacific generally remains robust. Growth in Australia—the region's leading economic anchor—remains strong despite depressed global prices for its commodity exports. Weaker prices are due to lower demand from the People's Republic of China and other leading manufacturing economies.
- **Shifting fiscal trends across the region.** The December issue of the *Monitor* focuses on government budget outcomes and plans. In 2012, better than expected revenue collections have helped improve fiscal positions in several smaller Pacific island economies. Fishing license revenues were higher in Kiribati, Nauru, and Tuvalu due to both policy (a new licensing scheme) and transitory (the positive effect of El Niño on fish stocks) factors. Budget balances in Samoa and Tonga also improved due to higher revenues and continued progress in fiscal consolidation. Fiji is expected to achieve a narrower deficit than budgeted with the adoption of an advance payment scheme for company taxes. In contrast, revenue collections in PNG and Solomon Islands are tracking below budget, mainly due to lower commodity export earnings attributable to weak global demand. Lower revenue collections in Vanuatu have prompted measures to control expenditure and keep fiscal balances close to the budget target.
- The Cook Islands, the Federated States of Micronesia, Palau, PNG, and Solomon Islands all passed supplementary budgets in 2012. The Republic of the Marshall Islands also had extra off-budget expenditure to cover one-time expenses. In contrast, capital expenditures in Timor-Leste will be lower than planned in the country's historically large 2012 budget, as major projects have been postponed and funds reallocated to recurrent spending. PNG's 2013 budget plans a similar shift from new capital expenditure to recurrent spending on priority social sectors and infrastructure maintenance. In contrast, the Fiji's 2013 budget allocates a substantially higher proportion of expenditure to capital works. Both budgets project larger fiscal deficits for 2013—raising concerns about long term sustainability of their fiscal paths.
- **Economic policy and management.** The policy briefs in this issue focus on growth prospects in smaller Pacific economies. These economies generally face weak growth prospects, independent of current low global growth. Noting the limits of stimulus over the long-run, a brief contributed by International Monetary Fund's Resident Representative Office in the Pacific Islands argues structural reforms to complement short-term macroeconomic policy responses are critical. An analysis of evolving economic linkages in the North Pacific shows that these economies are increasing ties with Asia at different rates, but argues that Asian economies will likely become more important channels of resource and income flows to support future growth. The last brief reflects upon past development efforts in the small island states of the Pacific, concluding that these economies have growth potential—despite their small sizes and remote locations—but unlocking this requires the development of appropriate institutional environments.

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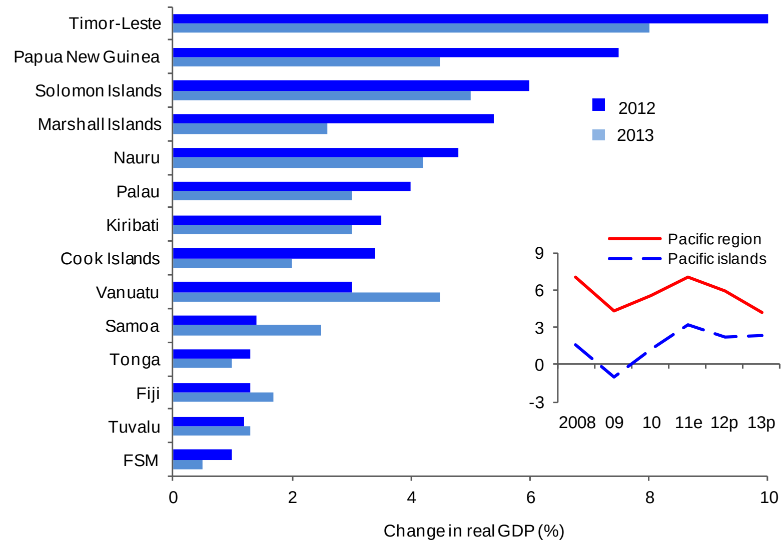
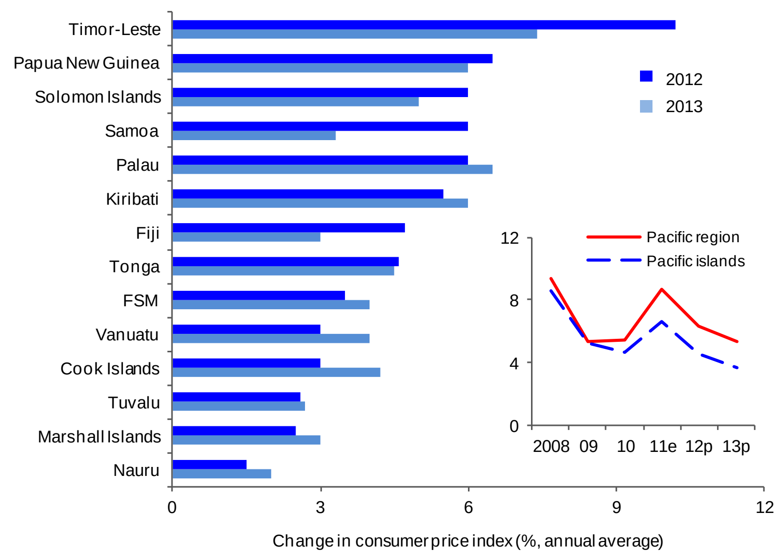
Abbreviations

$	US dollar, unless otherwise stated
ADB	Asian Development Bank
A$	Australian dollar
e	estimate
F$	Fiji dollar
fas	free alongside
FDI	foreign direct investment
fob	free on board
FSM	Federated States of Micronesia
FY	fiscal year
IMF	International Monetary Fund
GDP	gross domestic product
GNI	gross national income
K	PNG kina
lhs	left-hand scale
LNG	liquefied natural gas
m.a.	moving average
NZ$	New Zealand dollar
p	projection
RBF	Reserve Bank of Fiji
PNG	Papua New Guinea
PRC	People's Republic of China
r	revised
RERF	Revenue Equalization Reserve Fund
SI$	Solomon Islands dollar
rhs	right-hand scale
SOE	state-owned enterprise
ST	Samoan tala
RMI	Republic of the Marshall Islands
US	United States
VAT	value-added tax

Asian Development Bank Projections
GDP growth



Inflation



Note: Projections are as of July 2012 and refer to fiscal years. Regional averages of gross domestic product (GDP) growth and inflation are computed using weights derived from levels of gross national income in current US dollars following the World Bank Atlas method. Averages for the Pacific islands exclude Papua New Guinea and Timor-Leste. Timor-Leste GDP is exclusive of the offshore petroleum industry and the contribution of the United Nations.
Source: ADB estimates.

Notes

This *Monitor* uses year-on-year (y-o-y) percentage changes to reduce the impact of seasonality, and 3-month moving averages (m.a.) to reduce the impact of volatility in monthly data.

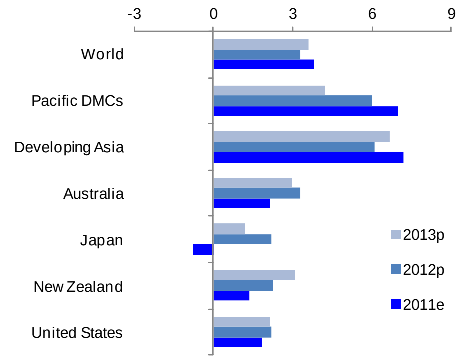
Fiscal years end on 30 June for the Cook Islands, Nauru, Samoa, and Tonga; 30 September in the Marshall Islands, the Federated States of Micronesia (FSM), and Palau; and 31 December elsewhere.

International and regional developments

Global economic growth prospects weakening

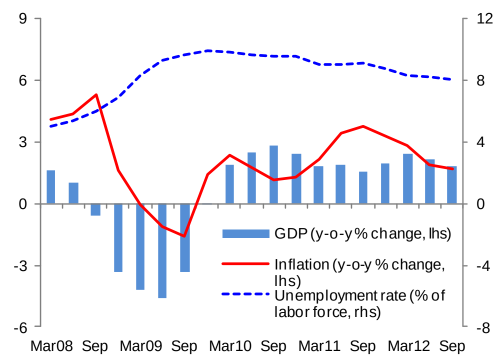
- For the second time in a year, the International Monetary Fund (IMF) has revised its global growth projections downward. In its latest *World Economic Outlook* (October 2012), IMF projects global growth to slow to 3.3% in 2012 and to 3.6% in 2013, due to increasing global uncertainties from the continued fiscal and banking problems in the Eurozone, and signs of economic slowdown in large emerging economies such as Brazil, the People's Republic of China (PRC), India, and Russian Federation.
- ADB's *Asian Development Outlook 2012 Update* (released in October) took a closer look at developing Asia and downgraded growth projections to 6.1% (compared with the earlier projection of 6.9%) in 2012 and to 6.7% (from 7.3%) in 2013. Weaker domestic demand and subdued external demand are expected to bring down growth in the PRC from 9.3% in 2011 to 7.7% in 2012, while in India, weaker investment and export demand is likely to reduce growth to 5.6% in 2012 (from 6.5% in 2011).
- The US economy showed some resilience during the three quarters of the year with growth at 2.1%, driven by improved private consumption and exports. The IMF expects US growth to accelerate from 1.8% in 2011 to about 2.2% in 2012 and 2013. The Federal Reserve Bank has announced plans to purchase $40 billion worth of mortgage-backed securities per month, and its intention to keep low interest rates in coming years barring significant changes in the economic outlook. Inflation was at 2.0% in September, in line with the bank's inflation target. The unemployment rate was at 7.8% in September, its lowest level since January 2009.
- Uncertainties remain on the possibility of sharp reductions in US government expenditures (about $109 billion per year starting in January 2013) under last year's debt ceiling deal. The US response to the 2008–2009 global financial and economic crisis entailed temporary fiscal measures (mostly tax cuts and some stimulatory spending) financed largely via deficit spending. Resulting increases in US debt prompted upward adjustment to the national debt limit, which proved to be highly politically contentious. If the US government cannot agree to a new budget and debt ceiling, and the budget cuts are made, ADB estimates the resulting fiscal contraction in 2013 to be equivalent to 4% of GDP. This would drive the US back into recession and spill over to the global economy (reducing growth in Asia by 0.8% in 2013).
- However, most analysts, including ADB, expect that a new budget and debt limit deal will be reached, and the budget cuts can be avoided. This would result in a smaller fiscal contraction, with less impact on US growth prospects in 2013 and beyond.
- Germany is projected to grow by 0.9% in 2012–2013, but deeper-than-projected economic contractions in Italy and Spain in 2012 and slower-than-expected economic growth in France still point to contraction in the Euro area for 2012 and anemic growth in 2013. European Union member countries are now considering a banking union with single supervisory mechanisms as a means of addressing their current economic difficulties. This would eventually pave the way for the European Stability Mechanism to have direct equity stakes in banks.

GDP growth
(%, annual)



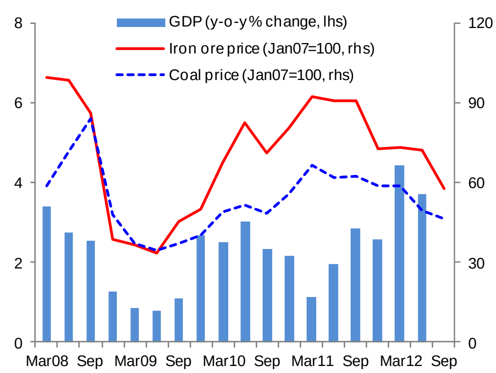
DMC=developing member country, e=estimate, p=projection
Sources: International Monetary Fund. 2012. *World Economic Outlook* (October); and ADB. 2012. *Asian Development Outlook Update*.

US economic indicators
(quarterly)



lhs=left-hand scale, rhs=right-hand scale
Sources: US Bureau of Labor Statistics and Bureau of Economic Analysis.

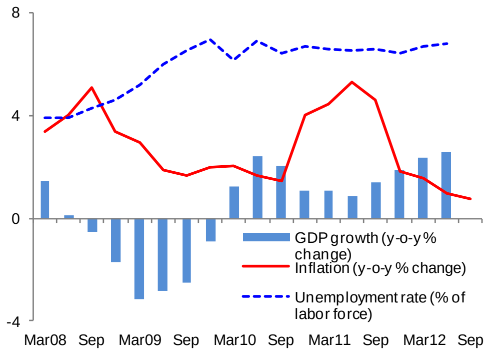
Australia GDP and commodity export prices
(quarterly)



Sources: Australian Bureau of Statistics and World Bank Commodity Price Data (Pink Sheets).

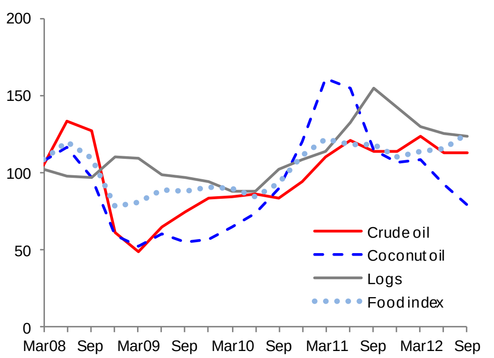
International and regional developments

New Zealand economic indicators (quarterly)



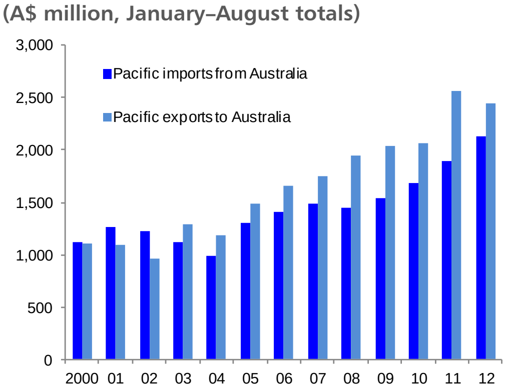
Source: Statistics New Zealand.

Commodity prices (Index: January 2008=100)



Source: World Bank Commodity Price Data (Pink Sheets).

Pacific trade with Australia (A$ million, January–August totals)



Source: Australian Bureau of Statistics.

- Japan's economy grew 2.1% through the first three quarters of the year (year-on-year), supported in part to demand related to reconstruction from the 2011 earthquake and tsunami, but is expected to slow down in the second half due to slowing export demand and weaker industrial production. The IMF projects growth of 2.2% for 2012, and further slowing to 1.2% in 2013. In response to the persisting deflationary environment, the Bank of Japan expanded its asset purchase program in September, but signaled it will still likely fall short of its inflation target of 1%, as consumer prices remain unchanged from a year ago.

- The PRC economy expanded by 7.7% in the first 3 quarters (y-o-y), supported by private consumption and investment, but growth in the third quarter was the lowest since June 2009. There are tentative signs of a moderate rebound in growth by the fourth quarter, based on some leading indicators of the PRC economy (e.g., retail sales, fixed asset investment). Slowing inflation allowed the People's Bank of China to ease its monetary policy by bringing down the bank reserve requirement and key interest rates, and also by providing temporary injections of liquidity.

- Growth of the Australian economy, mainly driven by strong commodity exports and mining investments, remained strong at 4.1% in the first half of the year. However, the slowdown of the PRC economy has led to price declines for Australia's major commodity exports, coal and iron ore. This has effectively put future mining investments on hold. The Reserve Bank of Australia has cut its policy interest rate by 100 basis points since the start of the year in an effort to boost economic growth. IMF expects growth to accelerate (up from 2.1% in 2011) to 3.3% in 2012, before trending lower in 2013.

- The New Zealand economy grew by 2.5% in the first half of 2012, driven by strong agricultural production and construction activity. Recovery from recession and natural disasters is well under way and the IMF expects growth to accelerate from 1.3% in 2011 to about 2.6% in 2012 and 2013. However, the weak economic outlook for New Zealand's main trading partners poses risks to growth. Unemployment remains near the high levels seen during the recent recession. Inflation is at a record low in September, and the key policy interest rate has been kept unchanged at 2.5% since March 2011.

- With limited demand in the global economy, prices of the Pacific's major commodity exports have fallen since the end of last year. The price of coconut oil fell by a third, while the price of timber declined by a tenth during the comparable period. However, unfavorable weather and production disturbances led to recent price food price increases, particularly soybeans, barley, maize, and wheat.

Pacific trade performance mixed

- Trade between ADB's 14 developing member countries in the Pacific and their largest trade partners has generally remained robust. The value of Pacific imports from Australia between January and August of 2012 grew by 12.6% compared with the same period last year. Increased imports of machinery and transport equipment in PNG drove the rise. While Pacific exports to Australia declined by 4.8% over the same period, this was from a historically high level achieved in 2011. A strong kina, which appreciated by as much as 10% against the Australian dollar, dampened PNG exports (mostly gold and petroleum).

International and regional developments

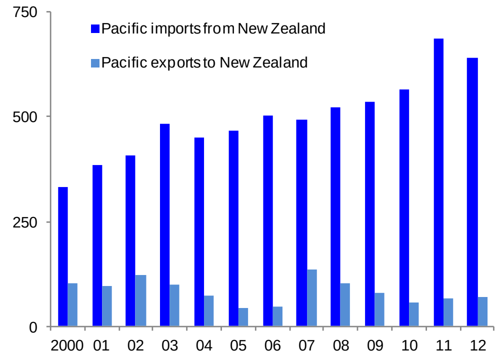
Recent years have seen a clear upward trend in Pacific exports to Australia, which has enabled the region as a whole to maintain persistent trade surpluses.

- The value of Pacific exports to New Zealand increased by 6.6% in January–August 2012, compared with the same period a year ago. Exports from Fiji, which accounted for more than half the total, decreased. However, continued increases in exports from other countries—most notably Nauru (phosphate) and PNG (coffee and food products)—more than compensated for the decline in Fiji's exports. Pacific imports from New Zealand decreased by 6.8% due to the return of the Republic of the Marshall Islands' imports to normal levels after a one-off importation of a ship in 2011. The Pacific region as a whole runs trade deficits with New Zealand due to its low volume of imports from the Pacific.
- Pacific's fuel imports from Singapore grew by 4.7% in January–August 2012 (relative to January–August 2011). Diesel comprises the bulk of the Pacific's fuel trade with Singapore, and diesel imports have been steadily rising in recent years.

Pacific destinations build on tourism gains

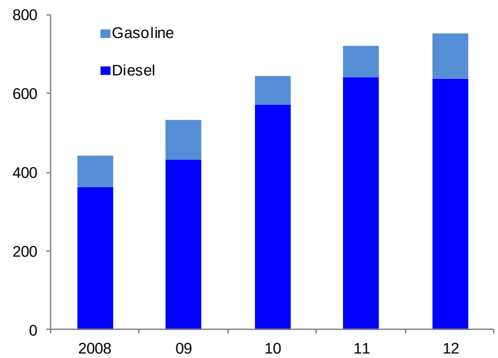
- Growth in the number of tourists from Australia and New Zealand, which together account for an estimated 60% to 80% of total visitors to South Pacific destinations (i.e., Cook Islands, Fiji, Samoa, Tonga, and Vanuatu), accelerated in mid-2012. Sharp increases in tourist departures bound for the South Pacific in the month of June (y-o-y) pushed up year-to-date gains.
- Total tourist departures from Australia to the South Pacific increased by 3.5% over the first 8 months of 2012, compared with the same period last year. Tourism to the Cook Islands continues to be boosted by reintroduced regular flights between Sydney and Rarotonga (up by more than 30%). Tonga's intensified advertising efforts also appear to be paying dividends, as indicated by the high tourism growth (over 23%) from the Australian market. Samoa and Vanuatu each recorded solid tourism growth (of around 9.0%), while growth in tourism to Fiji was flat, likely due in part to flooding early in the year. Australian departures to Fiji declined (y-o-y) in every month from April–August, except for June.
- Tourism from New Zealand to the South Pacific grew by 3.6% during the first 8 months of the year (y-o-y). Growth remains centered on Samoa (up by 11.1%), while the Cook Islands (3.9%) and Vanuatu (5.8%) achieved good gains. Tonga recorded a sharp rise in the number of New Zealand tourists over the June to August period, which offset declines from earlier in the year. However, the reverse is true for Fiji, where falls in tourist numbers in July-August reduced year-to-date results, leaving tourist numbers from New Zealand steady for the period.
- A recovery in US outbound tourism is also benefitting Pacific destinations. Departures from the US to the Oceania region, which includes the primary gateways to the Pacific, increased by 10.5% in from January–July 2012 (y-o-y).
- In Palau, high growth of arrivals from East Asian markets is driving the strong performance of the tourism sector. Over the first 7 months of 2012, tourist arrivals in Palau were 16% higher compared with the same period last year. This sustains the recent trend of high tourism growth but also pushes tourism facilities closer to the limits of their capacity.

Pacific trade with New Zealand (NZ$ million, January–August totals)



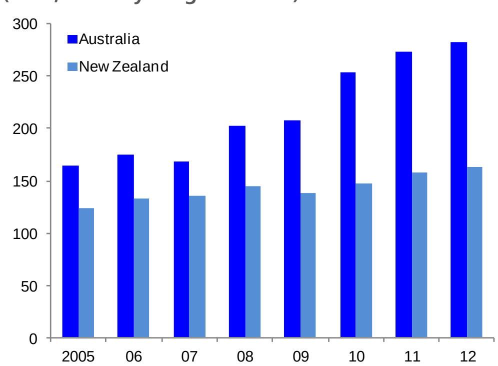
Source: Statistics New Zealand.

Pacific fuel imports from Singapore ('000 tons, January–August totals)



Source: International Enterprise Singapore.

Tourist departures to Pacific destinations ('000, January–August totals)

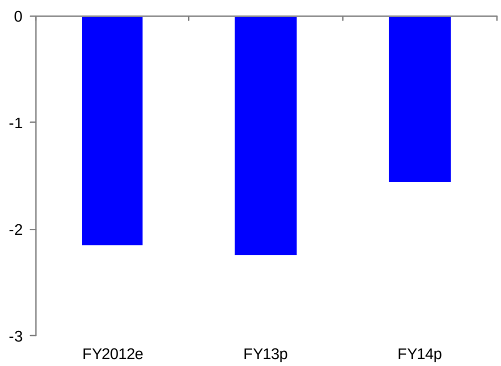


Sources: Australian Bureau of Statistics and Statistics New Zealand.

Lead authors: Christopher Edmonds, Joel Hernandez, Jolly La Rosa, Rommel Rabanal, and Cara Tinio.

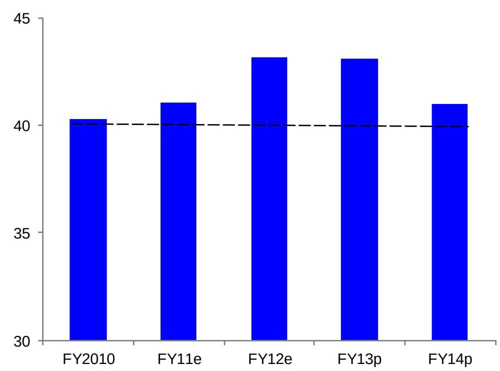
Cook Islands

Budget position
(% of GDP, annual)



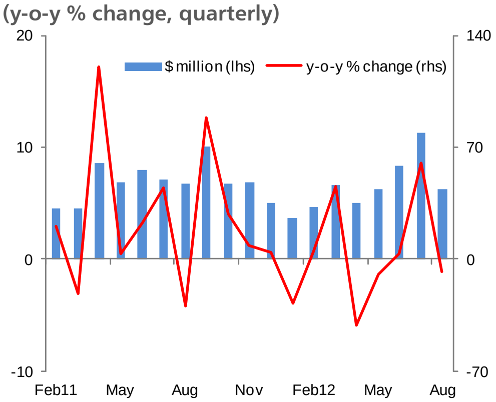
e=estimate, p=projection
Sources: 2012/2013 Budget Policy Statement and 2011/2012 Half Year Economic and Fiscal Update.

Government personnel expenses
(% of total revenue, annual)



e=estimate, p=projection
Sources: 2012/2013 Budget Policy Statement and 2011/2012 Half Year Economic and Fiscal Update.

Imports from New Zealand
(y-o-y % change, quarterly)



lhs=left-hand scale, rhs=right-hand scale
Source: Statistics New Zealand.

Lead author: Malie Lototele.

Budget performance FY2012

- In FY2012 (ended 30 June), the government recorded a deficit equivalent to 2.2% of GDP, which was above the government's target of 2.0%. Revenue was 2% above budget largely due to the reintroduction of a 15% withholding tax on interest from bank deposits. However, total expenditure exceeded the budget by 4% due largely to the higher cost of underwriting two Air New Zealand routes.

Budget FY2013

- The FY2013 budget projects a deficit equivalent to 2.3% of GDP. The government increased import levies on alcohol, cigarettes, and sweetened drinks, which is expected to generate an additional NZ$0.6 million in revenues. Fishing license fees are expected to increase by NZ$0.9 million as 20 additional licenses are assigned. Grants are expected to rise by 5.7% in FY2013 as unspent grants from the previous year are re-appropriated and development-funded infrastructure projects commence.
- Government expenditure is expected to increase by 3.3% in FY2013, driven by higher capital spending. The cost of underwriting Air New Zealand routes is expected to increase by NZ$1.1 million, to NZ$13.6 million. The government plans to reduce expenditures on government wages and salaries, and purchases of goods and services, during the next three years.
- Personnel expenditure accounted for 43.2% of government revenues in FY2012, which is above the 40% threshold. The government's medium term fiscal framework commits to reducing this ratio by 2% annually for FY2014 and FY2015.

Recent developments

- Despite the lingering sluggishness in the global economy, the tourism sector continues to propel growth. In FY2012, tourist arrivals increased by 3% compared with FY2011. Continuing growth in visitors from Australia and New Zealand offset a decline in tourists from Europe and North America. Tourism to the country also received a short term boost from the Pacific Islands Forum held in August.
- The trade deficit is estimated to have narrowed to NZ$53.0 million in the first half of FY2012, a 10% improvement over the same period last year.

Key issues

- The government's reform program includes empowerment of outer islands officials to manage their financial and human resources. A draft Pa Enua (local government) bill, which was finalized with technical assistance from ADB, was introduced to Parliament in early November.
- A second tranche of ADB's Cook Islands Economic Recovery Support Program was approved in November. Building on the reform momentum generated by the first subprogram (approved in 2009), the next phase of the program provides further funding for government budget priorities, while promoting public sector reforms and safeguarding fiscal sustainability. These reforms promise to facilitate the country's move toward higher—and more inclusive—growth.

Fiji

Budget performance 2012

- Fiji is projected to run a budget deficit equivalent to 1.6% of GDP in 2012. This is below the target deficit of 1.9% of GDP due to higher than expected revenue collections (i.e., higher corporate taxes due to the adoption of advance tax payment for companies) and achievement of the expenditure target. Recurrent expenditures dominate government spending, accounting for over 80% of total expenditures. Public sector wages and salaries account for about half of recurrent outlays.
- Overall, net VAT collections fell by 11.8% due to a sharp rise in tax refunds, partly due to expedited processing of refunds. Domestic VAT collections were strong in the first half of 2012, increasing by 10.5% (year-on-year, adjusted for inflation). This is compared with a 13.1% increase in the first half of 2011. VAT collections on imports, however, were flat during the first 6 months—indicating that import demand has leveled off following double-digit growth in 2011.

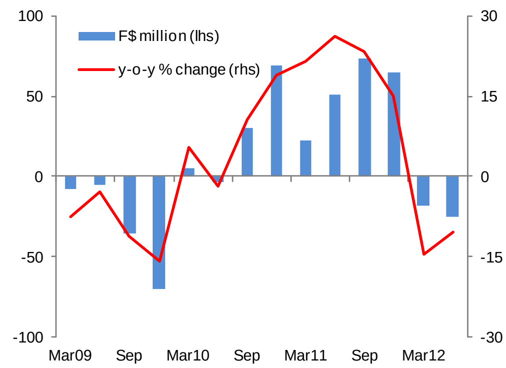
Budget 2013

- The 2013 budget projects a net deficit equivalent to 2.8% of GDP, due to increased expenditures to upgrade infrastructure (e.g., roads, renewable energy, water and sanitation, and information and communications technology). The deficit will be financed through domestic borrowing, and loans from the Export-Import Bank of China and the Export-Import Bank of Malaysia. This raises long-standing concerns about the sustainability of government spending and debt levels.
- The latest budget allocates 32% of total expenditure on capital works, compared with about 20% in previous budgets. However, the change in the operating to capital ratio has been funded by an increased deficit rather than through structural or administrative improvements. This may be difficult to sustain over the medium term, and pose a risk to the fiscal position.
- The government aims to reduce its deficit gradually, to 2.5% in 2014 and 1.5% in 2015, by boosting revenue through continued supply side stimuli (e.g., tax cuts and additional investment incentives), coupled with modest reductions in operating expenditure. Consumer and investor confidence is seen to improve as the planned general elections in 2014 approach, which would bode well for achievement of the government's deficit reduction targets.

Recent developments

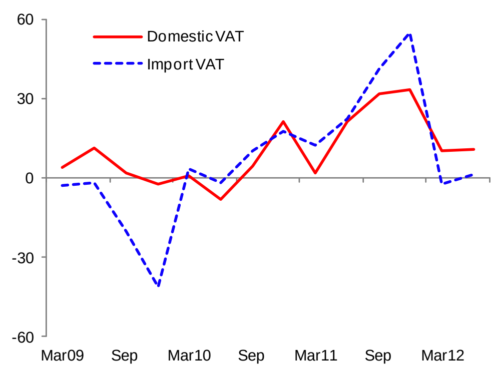
- Tourism continues to be the major source of economic growth and foreign exchange. Fiji's gross earnings from tourism in 2012 are expected to top $600 million, more than the combined revenues of the country's top five merchandise exports (fish, water, garments, timber, and gold). According to the Reserve Bank of Fiji (RBF), travel-related cash receipts increased by 7% during the first 7 months of 2012.
- The government has invested heavily in the sugar industry over the past few years and this appears to be aiding improved mill efficiency and sugar content of cane. The total sugar crop is estimated to have decreased by 14.3% in 2012 due to the January and March floods, but the government projects it will return to 2011 levels in 2013.

Change in net VAT revenues (constant 2008 prices, quarterly)



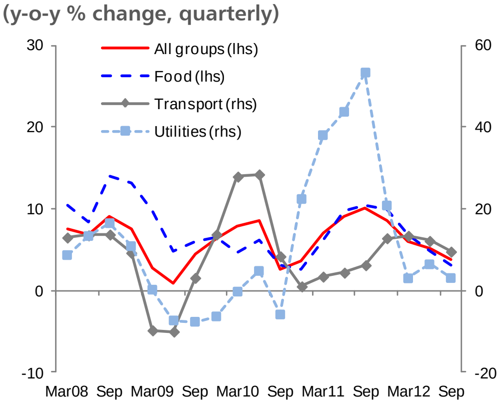
lhs=left-hand scale, rhs=right-hand scale, VAT=value-added tax
Source: Fiji Ministry of Finance.

Domestic and import VAT revenues (y-o-y % change, quarterly)



VAT=value-added tax
Note: VAT revenues are expressed in 2008 prices.
Source: Fiji Ministry of Finance.

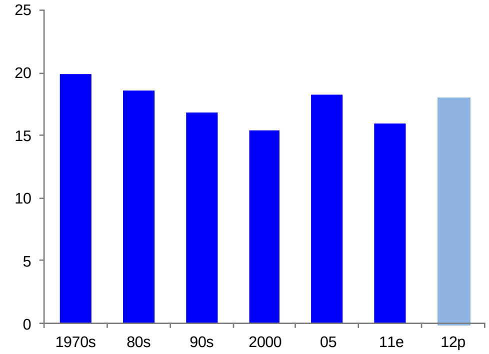
Consumer price index, by commodity group (y-o-y % change, quarterly)



lhs=left-hand scale, rhs=right-hand scale
Source: Reserve Bank of Fiji.

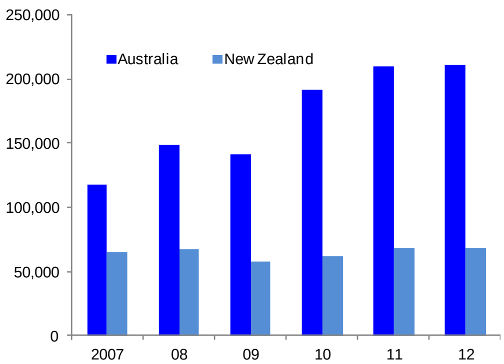
Fiji

Investment
(% of GDP)



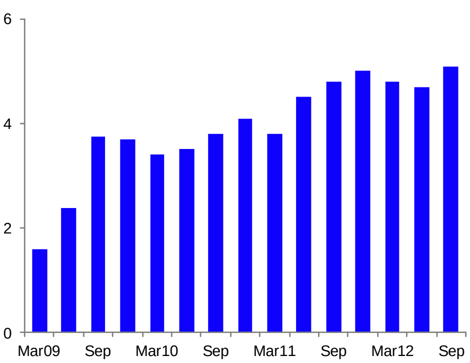
e=estimate, p=projection
Source: Reserve Bank of Fiji.

Departures from Australia and New Zealand
(January–August totals)



Sources: ABS and Statistics New Zealand.

Foreign reserves
(months of import cover, end of period)



Source: Reserve Bank of Fiji.

Lead author: Caroline Currie.

- The government projects that investment in 2012 will increase to around 18% of GDP from 16% in 2011. Through the first 7 months of the year, new lending for investment purposes increased by 12% (y-o-y). Strong investment activity is expected to continue. Investment Fiji received 110 investment proposals, valued at around $390 million, between January and September of 2012, and approved proposals valued at roughly $360 million. This was more than 90% of its annual target. These increases are due in part to streamlined approval processes—including online registration of companies—introduced earlier this year.
- Through June 2012, private sector credit to businesses increased by 9.4% (y-o-y). Loans to businesses in the transport and communication (13.1%), agriculture (7.0%), and hotel and restaurant (4.9%) sectors increased; while loans to the building and construction (–11.7%), and manufacturing (–5.2%) sectors declined. The overall increase in lending is encouraging in terms of suggesting increased commerce, but the impressive growth comes from a relatively low base level of lending.
- Private sector credit to households remained weak, growing by 1.4% (y-o-y) as of June 2012. However, consumption expenditure in the second half of 2012 has been aided by an increase in disposable incomes owing to the tax rate cuts. This mixed picture seems to indicate that the recovery in private sector lending is due more to a rebound from low lending levels, rather than improvements in overall domestic economic activity.
- The Bred Bank (part of the Banque Populaire Group of France) opened its doors in Fiji in November, increasing banking sector total equity by an estimated $22.5 million. The bank's presence has seen increased competition in retail banking, as evidenced by lower lending rates for home and new vehicle loans.
- Funds from the Fiji National Provident Fund are being used to partly finance the purchase of 3 new Airbus A330 aircraft at a total cost of roughly $600 million. The national airline intends to replace its current fleet of Boeing 747–400s. The first of the aircraft is scheduled for delivery in March 2013. In concert with the purchase, the national airline was renamed Fiji Airways (formerly Air Pacific) in October. The government hopes the purchase of these new aircraft will improve Fiji Airways' profitability by improving fuel efficiency and cargo capacity.

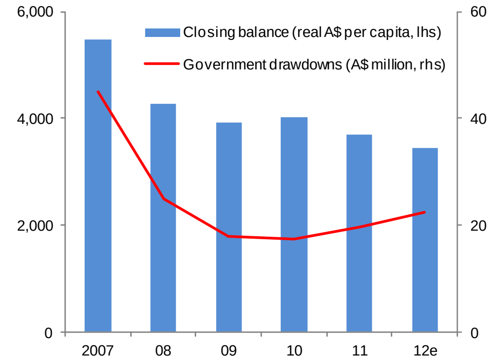
Key issues

- The 2013 budget is underpinned by the government's economic growth projection of 2.7%, which is based on expected expansion in the agriculture, financial intermediation, manufacturing, and mining sectors. Mining and quarrying production is expected to expand as the number of productive mines has increased to four. The government's GDP growth projections, forecast at 2.4% and 2.2%, in 2014 and 2015, respectively, also rely on sustained growth in mining production. However, actual GDP growth has been only about 0.5% over the last six years. Achieving growth targets will likely prove difficult unless the pace of structural reforms, particularly in the state-owned enterprise sector, progresses more quickly.

Kiribati

- In 2012, Kiribati is expected to have a budget deficit equivalent to about 10% of GDP (compared with the original estimate of 18.1% of GDP, largely because of higher fishing license revenue). As was observed in other small island states, the improved fiscal performance reflects an increase in the fish catch because of the El Niño effect and changes in the licensing scheme. However, the effect of El Niño on fishing revenues will be transitory.
- Expenditure is expected to be 14% above budget (A$110.3 million), largely due to the government's decision to pay its overdraft, which was funded by an A$15 million drawdown from the Revenue Equalization Reserve Fund (RERF).
- The RERF remains the government's main source of deficit financing. The government has an annual target of A$15 million drawdown from RERF from 2013-2015. However, in 2012, it is expected that total drawdowns will be A$37.5 million, which raises concerns on the long-term sustainability of the fund.
- The government and the European Union negotiated a new protocol to the Fisheries Partnership Agreement in June. The protocol has yet to be finalized as there are some inconsistencies between the protocol and the Nauru Agreement. Access under the protocol is based on catch tonnage but access under the agreement is based on vessel days.

Revenue Equalization Reserve Fund (annual)



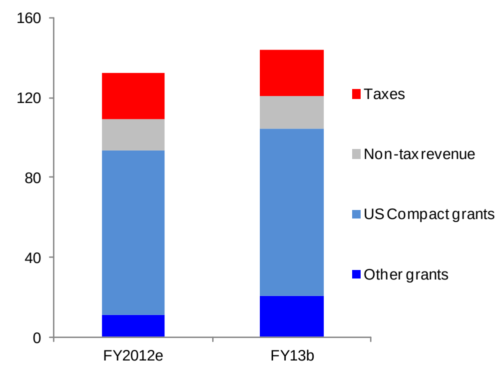
A$=Australian dollar, e=estimate, lhs=left-hand scale, rhs=right-hand scale
Source: ADB estimates using data from Kiribati national budget.

Lead author: Malie Lototele.

Marshall Islands

- Preliminary IMF estimates suggest that a fiscal deficit equivalent to 1.1% of GDP was realized in FY2012 (ended 30 September). Volatile domestic revenue collections, diminished foreign grants, and ad hoc off-budget spending all contributed to this reversal from the surplus (3.7% of GDP) realized in FY2011.
- Expenditure in the FY2013 budget amounts to $144.2 million, 9.1% higher than last fiscal year. Grants from the US will continue to be the major source of funding. Other sources will include internal revenues and funds from other development partners such as ADB, the European Union, and the World Bank.
- Apart from the expiration of US Compact grants in 2023, other constraints to the fiscal outlook are the drain on resources caused by subsidies to state-owned enterprises (SOEs) and increasing demands on the social security system. SOEs reportedly incurred losses in 2009–2011. Subsidies have doubled in the past decade and, despite recent progress, currently amount to about $8 million a year. Further, an FY2011 audit report indicates that, given growing unfunded retirement liabilities, reduced contributions from the labor force, and the poor performance of government-held assets, the social security program could be bankrupt within 10 years.
- Tax and SOE reforms, and rationalization of public sector personnel costs and retirement benefits, are all necessary to ease pressure on fiscal resources. Proposed legislation to modernize taxation, and improve SOEs' accountability and performance, have already been introduced to Parliament. These reforms, along with measures to reform the country's retirement system, are urgently needed.

Sources of revenue and financing ($ million, annual)

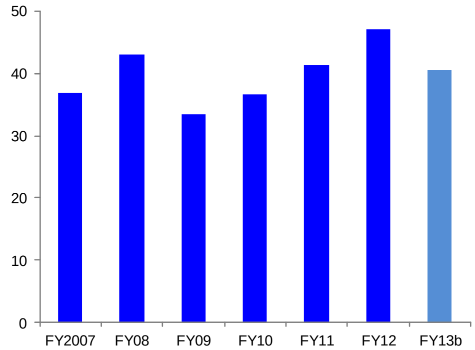


b=budget, e=estimate
Sources: Republic of the Marshall Islands budget documents, FY2011–12 and FY2012–13.

Lead author: Cara Tinio.

Micronesia, Federated States of

National government expenditure
($ million, annual)



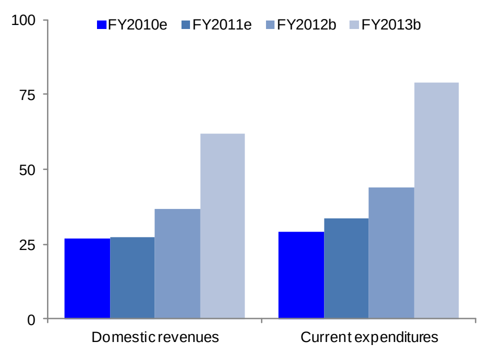
b=budget
Sources: Federated States of Micronesia national government budget documents (various years), from Congress of the Federated States of Micronesia website, www.fsmcongress.fm

Lead author: Rommel Rabanal.

- In FY2012 (ended 30 September), national government expenditure amounted to $46.9 million (about 15% of GDP). This represented a 14% increase from the previous year.
- Conversely, the FY2013 budget plans to cut national government expenditures by 14%. Expenditures will be financed from domestic sources and Compact sector grants.
- While the budgeted cut in national government expenditure offers at least some signal of a continuing commitment to fiscal consolidation, sustaining recent progress relies more heavily on the ability of state governments to build up fiscal surpluses. Kosrae and Yap both have had recent success in generating surpluses, but the fiscal situations in Chuuk and Pohnpei are more challenging.
- Achieving target levels of consolidated government fiscal surpluses requires intensified efforts by all 4 state governments. The IMF estimates that the Federated States of Micronesia needs aggregate annual savings equivalent to over 5% of GDP (recent surpluses average only about 1%) over the long term to generate replacement income for Compact grants set to expire in FY2023.
- The national government enacted revenue enhancing measures, including a standardized value-added tax, a net profits tax, and a Unified Revenue Authority in late 2012. Chuuk and Kosrae have approved these reforms at the state level, while similar measures are pending in Pohnpei and Yap. Improved expenditure management, operational efficiency in budget implementation, and investment prioritization are important complementary measures to support fiscal sustainability.

Nauru

Fiscal indicators
(% of GDP, annual)



b=budget, e=estimate
Source: Republic of Nauru budget papers (various years).

Lead author: Milovan Lucich.

- Revenues from fishing licenses in FY2012 (ended 30 June) reached around A$12 million. This is more than double the budget projection due to the implementation of a new licensing scheme for foreign vessels.
- The FY2013 budget forecasts current expenditure to increase by 75.8% to A$57.1 million, to be covered by higher projected domestic revenues and budget support, and carry–over of cash reserves from the last fiscal year. A supplementary budget passed in October forecast an extra A$8.0 million of revenue, mainly related to reopening of the refugee processing center. Most of these added revenues (A$5 million) have been allocated for extra current expenditure.
- The reopening of the refugee processing center provided a boost to the Nauru economy. The center currently accommodates around 400 refugees, directly employs 70 people, and is expected to spur growth in FY2013. The reopening of the refugee processing center has imposed costs on the economy, disrupting phosphate exports due to the relocation and use of mining equipment to clear land for the center.
- Phosphate exports continue to account for about 70% of GDP. Recent disruptions in phosphate operations are expected to cause significant underperformance relative to the record FY2012 production levels. Contracts Nauru negotiated in 2007-2008 locked in prices below international phosphate prices, but contracts negotiated more recently carry more favorable terms.

Palau

Budget performance FY2012

- The FY2012 (ended 30 September) budget document explicitly recognized that the original appropriation of $59.3 million (the national budget does not include public expenditure financed through non-Compact financial assistance and capital grants) would not fully cover expenditure requirements. Thus, a $4.4 million supplemental budget was passed in July, and another amounting to $2.3 million in September, to ensure continuing funding for government services. While revenue collections in FY2012 appear to have exceeded original budget estimates, expenditures under the supplemental budgets have slowed progress in fiscal consolidation and exerted pressure on government cash balances.

Budget FY2013

- As in previous election years, Congress has deferred passage of the current administration's proposed national government budget for FY2013. In the interim period, the Senate approved continuing budget authority that will be in effect until the FY2013 budget is passed. This authorizes expenditure at the same level as in FY2012. The next administration, which will assume office in January 2013, is expected to submit its proposed FY2013 budget by March.

Recent developments

- Palau remains relatively unaffected by the prevailing weakness in the global economy, as the tourism sector has so far maintained its robust performance. In the first 10 months of FY2012, momentum in tourist growth continued with visitor arrivals increasing by 19.3% compared with the same period last year. As of July 2012, tourist arrivals had posted 27 consecutive months of year-on-year growth. Increased arrivals from the Republic of Korea has supplemented the sustained growth in tourism from Japan and Taipei,China.

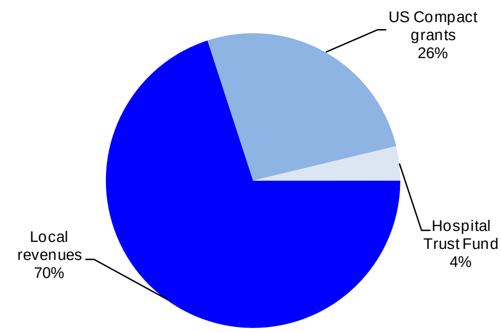
- The high growth in the value of imports from the US has tapered off in recent months. Slowing import growth may signal some moderation in domestic demand.

Key issues

- Legislation to address the financial sustainability of Palau's social security system is pending in Congress. Both the Civil Service Pension Plan Trust Fund and the Social Security Fund have considerable unfunded liabilities. Latest IMF estimates show that combined liabilities total as much as 60% of GDP. The Civil Service Pension Plan is projected to exhaust its funding reserves in less than 10 years. Reforms under review include adjustments in both benefits and contributions, which are considered necessary to financially stabilize these pension funds.

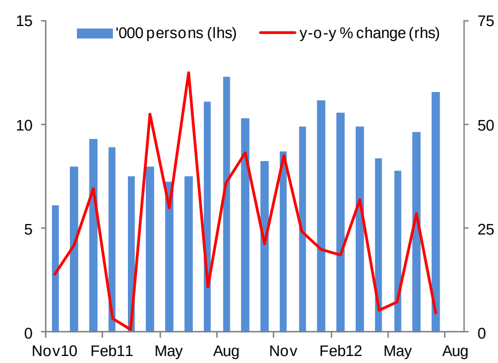
- General elections were held on 6 November. Among the key issues emphasized in the president-elect's platform is Palau's need to attract foreign investment to generate employment and to reduce the country's reliance on foreign assistance. Palau ranked 111th out of 185 countries in the World Bank's *Doing Business 2013* survey, indicating the challenging nature of the prevailing investment climate.

Financing the proposed FY2013 national budget (% share, by funding source)



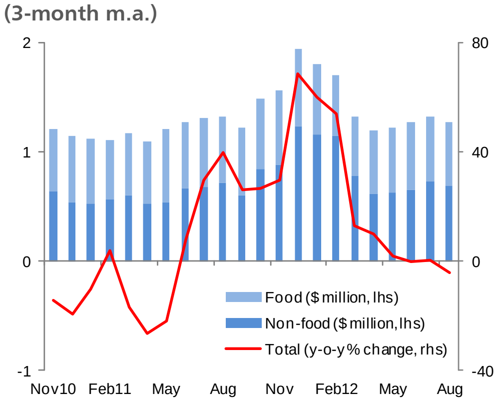
Source: ADB estimates based on the Republic of Palau Senate Bill No. 8-244 (proposed FY2012–2013 national budget).

Visitor arrivals ('000, monthly)



lhs=left-hand scale, rhs=right-hand scale
Source: Palau Visitors Authority.

Imports from the US (3-month m.a.)

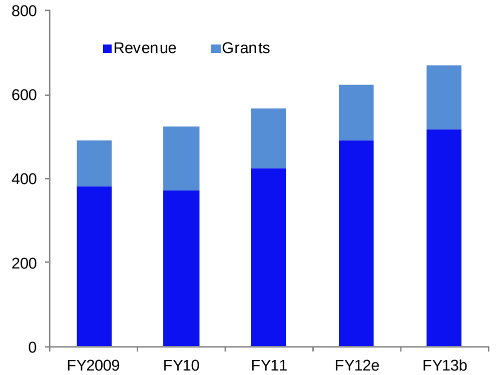


lhs=left-hand scale, rhs=right-hand scale
Source: US Census Bureau.

Lead author: Rommel Rabanal.

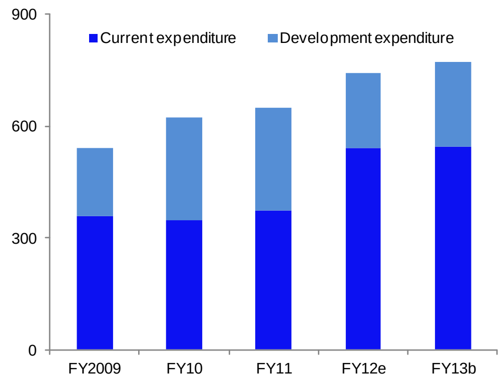
Samoa

Revenue and grants (million tala)



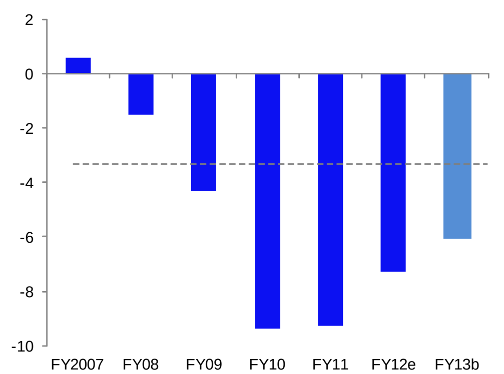
e=estimate, b=budget
Sources: Samoa Ministry of Finance. *Quarterly Economic Review*, Fiscal Strategy Statement – FY2013; and Budget Estimates FY2013, *Asian Development Outlook 2012 Update* database.

Government expenditures (million tala)



e=estimate, b=budget
Sources: Samoa Ministry of Finance. *Quarterly Economic Review*, Fiscal Strategy Statement – FY2013; and Budget Estimates FY2013, *Asian Development Outlook 2012 Update* database.

Overall fiscal balance (% of GDP)



e=estimate, b=budget
Sources: Samoa Ministry of Finance. *Quarterly Economic Review*, Fiscal Strategy Statement – FY2013; and Budget Estimates FY2013, *Asian Development Outlook 2012 Update* database.

Lead author: Caroline Currie.

Budget performance FY2012

- In FY2012 (ended 30 June), Samoa had a budget deficit equivalent to 7.3% of GDP. This was narrower than in FY2011 (9.3% of GDP), showing that the government continues to implement its fiscal consolidation program.
- Government revenue increased by an estimated 9.9% in FY2012, in spite of a 6.8% decline in external grants, and government expenditure increased by 11.5%. Although development spending declined by 26.5% as post-tsunami rehabilitation projects were completed, current spending was 44.1% higher.

Budget FY2013

- Although the FY2013 budget remains expansionary, the budget deficit is forecast to decline to about 6.1% of GDP. Government revenue and grants are expected to increase by 7.6%. Continued infrastructure spending will likely result in public expenditure growing by 3.4%. The government plans to fund the financing gap fully through external grants and concessionary borrowing.

Recent developments

- Samoa's economy remains heavily dependent on tourism, remittances, and aid. Despite prevailing global economic difficulties, tourism and remittances to Samoa have remained buoyant in FY2012.
- Tourism accounts for roughly 25% of Samoa's economy. For most of FY2012, visitor arrivals declined from all main source markets–American Samoa, Australia, New Zealand, and the US. Arrivals picked up in the last 4 months of the fiscal year, drawn by discounted accommodation rates, and total arrivals for the year were 3.7% higher. Tourist spending also increased at the end of the fiscal year, pushing up total tourism receipts by 8.5% for the year. Celebrations of the 50th anniversary of independence provided some economic stimulus.
- Remittance inflows, which generate about a quarter of GDP, rose by 10% in the first 8 months of FY2012. Remittances from main source markets, i.e., American Samoa, Australia, and New Zealand, all increased. This growth is expected to stall from late 2012 owing to subdued growth prospects in New Zealand, the main host country for Samoan workers overseas.
- Samoa runs a persistent merchandise trade deficit. The total value of domestic exports in the September quarter of 2012 was $22.9 million compared with imports of $84.8 million. The trade deficit decreased by 2.5% between the June and September quarters. Samoa's main imports are food and fuel, and its exports are focused on wiring harnesses for automobiles.

Key issues

- The Samoan economy has been slow to respond to the accommodative fiscal and monetary policy stimuli. A gradual rebalancing of the macroeconomic variables to protect foreign reserves and to improve export performance is under way.
- A priority for Samoa is to reduce its fiscal deficit and bring down public debt (currently over 50% of GDP) to a more sustainable level. Steady reductions in the fiscal deficits over the decade should stabilize government debt to manageable levels.

Solomon Islands

Budget performance 2012

- Government revenue growth in 2012 has decelerated, running well below forecast levels over the first 3 quarters of 2012. Overall, revenues are 10.4% below forecast levels for this period.
- Revenues from domestic taxes and fees, which account for two-thirds of total government revenues, were higher in the first half of 2012 compared with a year ago. However, these were still well below 2012 projections. In response, the government limited spending to mirror revenue shortfalls. As a result, the government realized a small recurrent surplus in the second quarter of the year.
- A supplementary budget of $35 million, including additional funding for overseas scholarships ($6.4 million) and the Festival of the Pacific Arts ($7 million), was approved in September. This additional spending was partly offset by reallocation of unexpended development appropriation, resulting in a smaller drawdown ($15.7 million) from cash reserves.

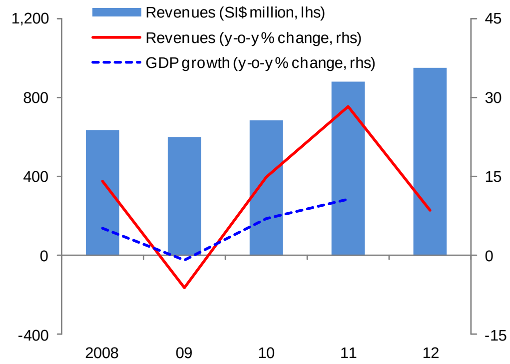
Budget 2013

- This year's budget was not approved until the early months of 2012. Similarly, the budget for 2013 is expected to be finalized only in late 2012 or early next year.

Recent developments

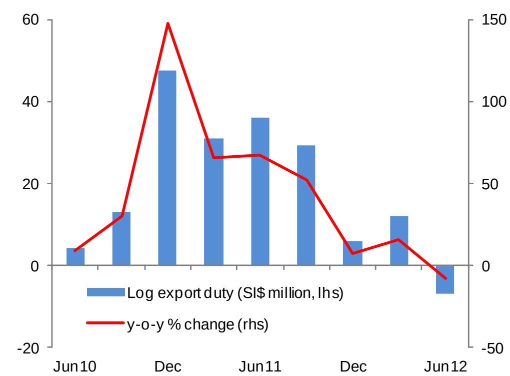
- Similar to other resource exporting economies in the region, the Solomon Islands' growth, trade, and fiscal position were adversely affected by weak global demand for commodities. In the second quarter of 2012, log production contracted due to heavy rainfall and flooding, and lower demand from Asia (which depressed international timber prices). Production growth rebounded in the third quarter. Through the third quarter production was 2.4% higher than the comparable period in 2011, but the government expects weakness in the final quarter. Unfavorable weather, lower crop yields, and falling international prices also dampened production of cocoa (falling by 35%) and copra (by 17%) over the first three quarters of the year.
- Higher gold production in the first 9 months of the year (51.1% higher than total 2011 output) offset lower production of logs and other agricultural commodities.
- Since suffering double-digit inflation in late 2011, inflationary pressures have eased. Inflation ran at 4.4% in September 2012—an 18-month low. The effects of flooding on food prices appear to have been minimal, with food inflation lower than overall.
- Lower log export revenues resulted in a trade deficit equivalent to 1.2% of GDP in the second quarter, the first trade deficit in the last 4 quarters.
- The latest ADB Business Expectations Survey showed that business sentiment remains upbeat in 2012. More than 80% of respondents expected that 2012 would be better than last year, due to the hosting of major events such as the Pacific Arts Festival and the British royal visit. Further, 75% of respondents indicated that sales were higher this year compared with last year. In addition, 70% of respondents expressed belief that

Government revenues and GDP growth (SI$ million at constant 2009 prices, Jan–Jun)



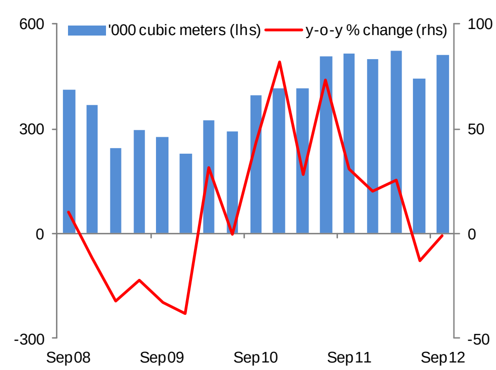
lhs=left-hand scale, rhs=right-hand scale, SI$=Solomon Island dollar
Source: Central Bank of Solomon Islands.

Change in log export duty (SI$ million at constant 2009 prices, quarterly)



lhs=left-hand scale, rhs=right-hand scale, SI$=Solomon Island dollar
Source: Central Bank of Solomon Islands.

Log exports (quarterly)

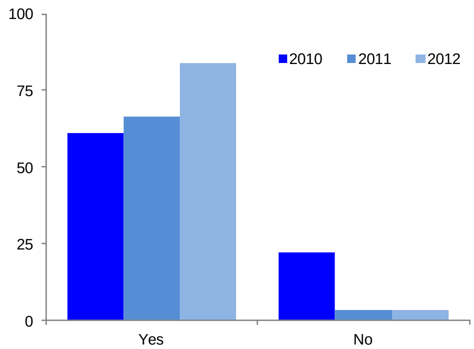


lhs=left-hand scale, rhs=right-hand scale
Source: Central Bank of Solomon Islands.

Solomon Islands

ADB Solomon Islands Business Expectations Survey

Do you expect your business this year to be better than last year?
(share of responses)



Source: ADB Business Expectations Survey.

Lead author: Milovan Lucich.

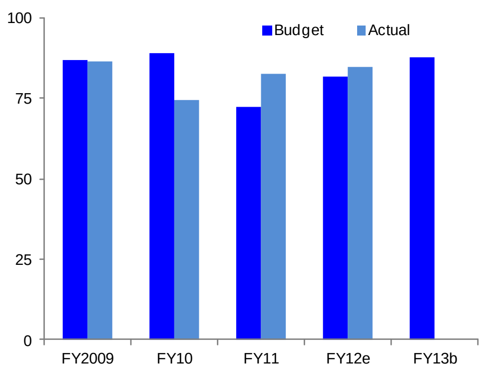
strong sales will continue through the end of 2012. Many respondents suggested that their firms were accumulating inventory in preparation for the year-end holiday season.

Key issues

- The Taskforce on Political Integrity and Stability in Solomon Islands presented its report to the 6th Premiers' Conference in October 2012. The report made four main recommendations: (i) direct administration and management of the Rural Constituency Development Fund (RCDF) be removed from the members of Parliament; (ii) relevant ministries, through provincial governments, take over administration and management; (iii) reports on the use of the RCDF funds be regularly prepared; and (iv) the RCDF be regularly audited and financial reports be made accessible to the public.
- The recommended changes would improve the transparency and accountability of constituency funds, reducing the level of discretion Parliament members exercise over the funds. The government has indicated its intention to increase allocations to the constituency funds in the 2013 budget.

Tonga

Revenue performance
($ million, annual)



b=budget, e=estimate
Sources: Tonga Ministry of Finance and National Planning and ADB *Asian Development Outlook* database.

Budget performance FY2012

- A fiscal surplus estimated at over 3% of GDP was achieved in FY2012 (ended 30 June), mainly due to budget support grants worth $22 million. Without grants supporting the budget, a deficit of over 1% of GDP would have been recorded.
- Tax revenue was 10.7% higher than originally budgeted, mainly due to improved tax compliance. Income tax collections increased by 19.2% and consumption tax collections by 10.7%. Donor-funded project spending in early FY2012 provided a boost to consumption.
- Capital expenditure fell by half as donor-funded construction projects, notably the Export-Import (EXIM) Bank of China road improvement project and the Japanese-funded hospital reconstruction project, wound down.

Budget FY2013

- The government projects a smaller surplus of almost 1% of GDP in FY2013, mainly due to a decline in budget support grants. Total expenditures are projected to increase by 7.7%, driven by higher capital spending, although donor-funded capital projects are expected to continue to wind down.
- The ratio of wages and salaries to expenditures was about 44% in FY2012 but is projected to fall slightly to under 43% in FY2013 due to ongoing measures to contain the wage bill, such as extending the hiring freeze until the end of 2012.

Recent developments

- Private sector credit continues to decline, with lending to businesses falling by 18.9% in July 2012 (y-o-y). The

Tonga

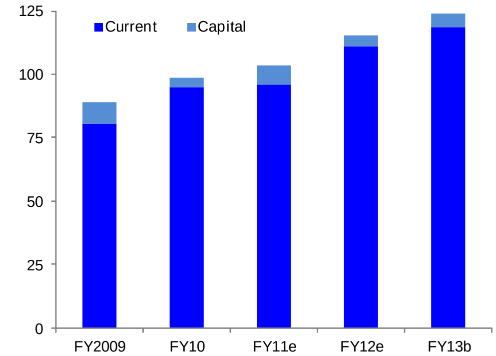
government has initiated discussions with multilateral development partners such as ADB and the World Bank on establishing a risk-sharing facility for commercial banks to help improve private sector lending. In addition, the government proposes to accelerate the pace of state-owned enterprise and business regulatory reforms.

- Tourism has performed relatively well in recent months despite sluggish global growth. However, remittances, which account for around 30% of GDP, contracted by 22.8% in FY2012 and are unlikely to return to pre-2008 levels in the medium term.

Key issues

- Total public debt in FY2012 remains around 45.1% of GDP. This exceeds the 40% threshold recommended by the IMF and the World Bank for low-income countries. More than 90% of total debt is from external creditors (most of which are denominated in Chinese yuan).
- The government's debt servicing commitments over the medium term pose a fiscal challenge. Principal repayments on loans from the EXIM Bank of China are projected to account for around 18% of total expenditure in FY2013. The combination of a large wage bill and rising debt servicing commitments will reduce other essential services.

Government expenditure ($ million, annual)



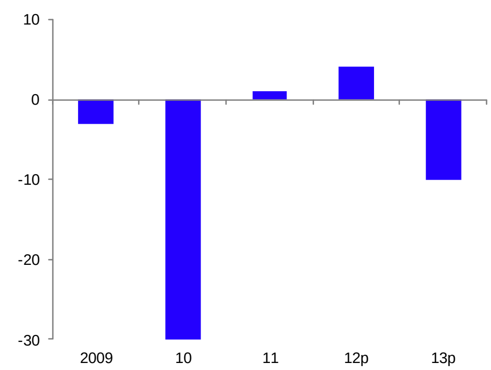
b=budget, e=estimate
Sources: Tonga Ministry of Finance and National Planning and ADB *Asian Development Outlook* database.

Lead author: Siosaia Faletau.

Tuvalu

- The first 9 months of 2012 showed an overall budget surplus of A$3.4 million (10% of GDP) compared with a budgeted deficit of A$4.6 million for the full year. Similar to the experience in other small island states, the fiscal position improved as fishing license revenues were higher than expected. This is because El Niño weather boosted fish catch, and the Vessel Day Scheme for charging foreign vessels was implemented. In addition, the government received a A$2.0 million budget support grant from the European Union and a A$4.0 million from AusAID as a contribution to the Consolidated Investment Fund.
- Government cost-cutting measures (e.g., reduction in government-funded scholarships and measures to contain expenditures under the Tuvalu Medical Treatment Scheme) were introduced in 2012, but the impact is expected to be felt more strongly in 2013.
- The market value of the Tuvalu Trust Fund (A$127.3 million as of the end of September 2012) remains below its maintained value because it has not recovered from the impact of the global economic and financial crisis.
- Improving the financial position of the National Bank of Tuvalu and the Development Bank of Tuvalu by improving their risk management capability, writing down nonperforming loans, and cleaning up their balance sheets would enhance their capacity to lend to the private sector.

Budget position (% of GDP, annual)

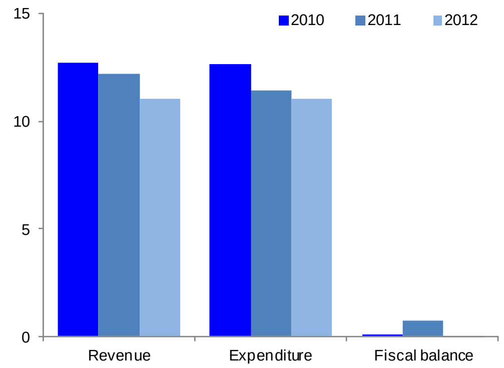


p=projection
Source: International Monetary Fund. 2012. *Tuvalu–Article IV Consultation Staff Report*. September.

Lead author: Malie Lototele.

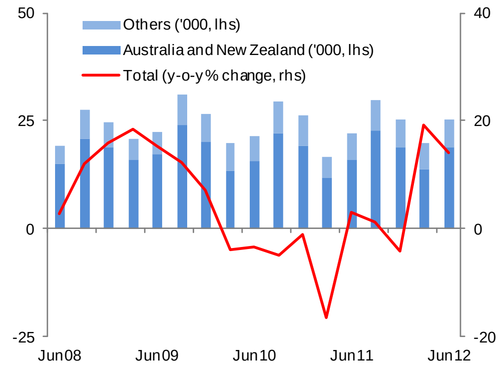
Vanuatu

Budget performance
(% of GDP, January–June)



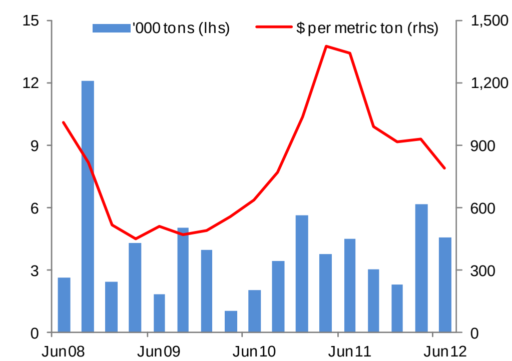
Source: Reserve Bank of Vanuatu.

Visitor arrivals, by source country
(quarterly)



lhs=left-hand scale, rhs=right-hand scale
Source: Vanuatu National Statistics Office.

Price and volume of copra exports
(quarterly)



lhs=left-hand scale, rhs=right-hand scale
Sources: Reserve Bank of Vanuatu and World Bank Commodity Price Data (Pink Sheet).

Lead author: Milovan Lucich.

Budget performance 2012

- The government posted a balanced budget in the first half of the year, compared with a budget surplus of 0.7% of GDP recorded in the same period in 2011. Revenues fell by 4.0% in the first half of the year (y-o-y) driven by a 13.3% drop in taxes on international trade (due to lower tariff rates) and a 24.3% decline in development assistance. Expenditures increased by 2.5% in the same period due to a 4.4% increase in public sector wages and a 72.4% rise in capital expenditures. Interest expenses increased by about a third in the first half of the year as a result of recent government bond issuances.

Budget 2013

- Vanuatu is not expected to finalize its 2013 budget before mid-December 2012. Due to continuing efforts related to Vanuatu's accession to the World Trade Organization, further adjustments to sources of revenues (away from a reliance on trade taxes) and level of expenditure will be needed to avoid rising fiscal deficits.

Recent developments

- Economic growth in 2011 was revised again, from 2.5% to 1.4%, as construction activity contracted by 39.4% with completion of projects financed by Millennium Challenge Corporation. The agriculture sector grew by 5.9%, lifted by higher production of kava, fruits, and vegetables. The service sector expanded by 3.6%, as strength in trade and information and communication sectors offset lower activity in accommodation and food services due to weak tourism.

- The government increased its borrowing from commercial banks to finance construction activity in 2012. By June of 2012, such lending was 13 times higher than in the same period a year ago (albeit from a small base). Overall, credit to the private sector increased by 9.7% during the same period.

- Falling international prices for copra, arising from weak global economic growth, prompted the government to provide subsidies to copra producers (worth about $50 per metric ton) in 2012. The subsidy fueled a 29.9% increase in copra production in the first half of the year (year-on-year) despite the international price of copra falling by a third.

- As in other Pacific destinations, tourism to Vanuatu grew despite the fragile global economic recovery. Tourist arrivals grew 16.3% in the first half of 2012, driven by strength in major markets such as Australia and New Zealand. This positive performance follows two consecutive years of decline.

Key issues

- It is vital that the government follows through on the state-owned enterprise (SOE) reform program. Earlier this year, the government issued its SOE policy and legal framework to place the SOEs on a firm commercial footing. This promises to increase transparency and accountability in the SOE sector, and to pave the way for improved SOE performance. These reforms should also enable the government to reduce fiscal pressures coming from operating losses of SOEs.

Papua New Guinea

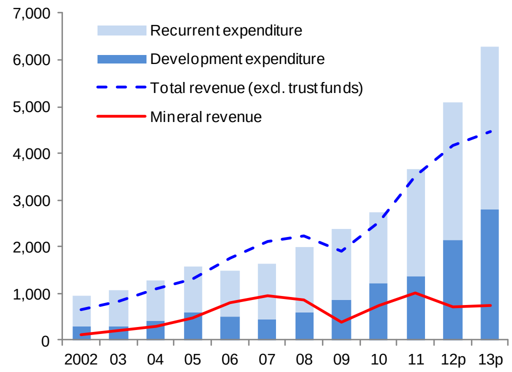
Budget performance 2012

- The government now expects a budget deficit equivalent to 1.2% of GDP in 2012, against an original balanced budget forecast. The deterioration in the 2012 budget outcome reflects lower than expected revenue collection as a result of declining international commodity prices, particularly for gold and copper, combined with overspending—mainly related to national elections and weak control of the government payroll.

Budget 2013

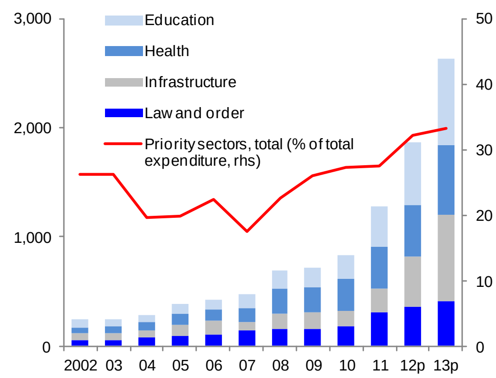
- The 2013 national budget projects a significant slowdown in government revenue growth over the medium term. In addition to falling revenues from mining and oil, modest expected growth in consumption, income, and corporate taxes give rise to the slowing revenue outlook. Despite the stagnant revenue growth, the $6.5 billion 2013 budget plans for a 23% increase in nominal expenditure. This is expected to increase the budget deficit to 7.2% of GDP. While public debt will remain within low-to-moderate risk category, in terms of debt sustainability, the high level of domestic borrowing required to finance additional expenditure is likely to add inflationary pressures in 2013. The government's success in following through with its medium term plans to rein in expenditure growth and return to budget surplus by 2017 will be integral to PNG's macroeconomic stability.
- In terms of budget priorities, the 2013 budget continues to scale up funding to the priority sectors of health, education, infrastructure, and law and order. The proportion of expenditure allocated to these four sectors has grown from less than 20% of total expenditure in 2007 to an estimated 31% in 2013. This will cause the recurrent budget to grow more modestly, at 18%, with growth driven by expenditures associated with the government's "free" education and health policies, along with increasing police force numbers.
- In particular, the budget increases spending in education—related to the implementation of the "free education" policy—and transport infrastructure. Over the medium term, significant recurrent budget savings are expected as a result of a plans to streamline government (reducing the number of departments and agencies).
- The 2013 development budget will increase by 31% due to larger allocations for sub-national grants and infrastructure spending. Grants to provincial, district, and local level government are increased by 87%. This constitutes a major shift in the government's approach to delivering services to rural and remote areas, delegating control of funds and responsibility for implementation to sub-national levels. While sub-national funding will channel resources more directly to constituents, improvements in the accountability and transparency of fund usage will be vital, if these funds are to positively impact the quantity and quality of service delivery.
- The 2013 budget also announces a number of significant changes in the way budgets will be formulated. The government plans to move towards multi-year budgeting and to unify recurrent and development budgets in a single national budget beginning in 2014. If implemented, these changes have the potential to improve the coordination, strategic focus, and

Government revenue and expenditure, by type ($ million, annual)



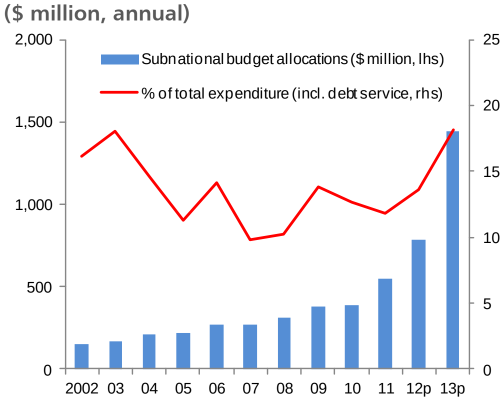
p=projection
Sources: PNG 2013 National Budget and ADB estimates.

Government expenditure by priority sector ($ million, annual)



p=projection, rhs=right-hand scale
Sources: PNG 2013 National Budget and ADB estimates.

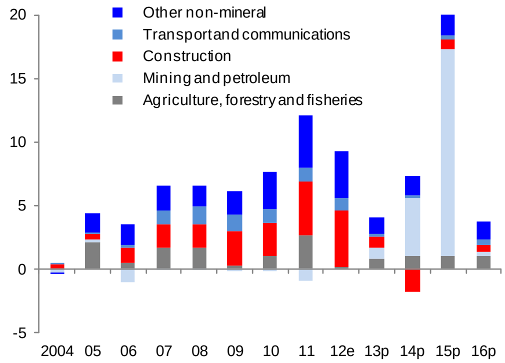
Government expenditure at subnational level ($ million, annual)



lhs=left-hand scale, p=projection, rhs=right-hand scale
Sources: PNG 2013 National Budget and ADB estimates.

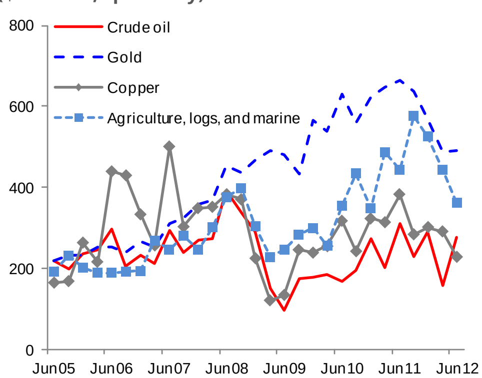
Papua New Guinea

Contributions to GDP growth
(% points, annual)



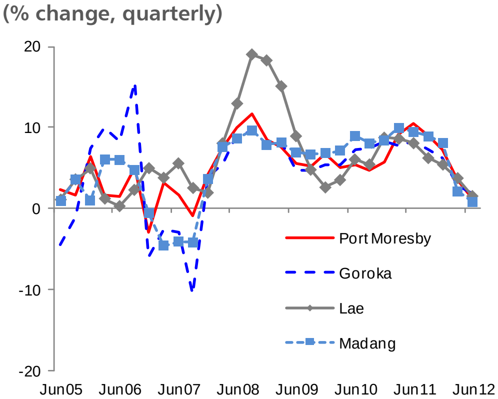
e=estimate, p=projection
Sources: PNG 2013 National Budget and ADB estimates.

Composition of exports
($ million, quarterly)



Source: Bank of Papua New Guinea.

Consumer price index, by region
(% change, quarterly)



Source: Bank of Papua New Guinea.

Lead author: Aaron Batten.

overall quality of PNG's future budgets. However, the real challenge lies in implementation, and converting lofty plans into tangible improvements in public services.

Recent developments

- PNG emerged as one of the fastest-growing economies in Asia and the Pacific in 2012. Preliminary GDP figures released by government show growth of 9.9% in 2012, against an original ADB forecast of 7.5%. While there were some declines in the international prices of PNG's exports, commencement of production at a new nickel and cobalt mine boosted output in the mining sector, even as petroleum output continued to fall due to declining oil reserves. All sectors of the non-mineral economy also performed strongly, led by construction and transport, as building of a new liquefied natural gas (LNG) pipeline reached its peak, and as a result of higher than expected government expenditure. As the construction phase of the LNG project nears its end, and production begins after 2014, the main engine of near-term growth in the PNG economy will shift from foreign direct investment and related infrastructure spending toward the resource export sector.
- The economy is also benefitting from lower inflation during 2012. The government expects headline inflation to average 4.1% in 2012, compared to the ADB forecast of 6.5%. Declining international commodity prices and continued strengthening of the kina (which has appreciated by 8.9% and 10.0% against the US and Australian dollars, respectively, so far in 2012), contributed to lower-than-expected inflation.
- The introduction of the government's free education policy, which set the price of education in the Consumer Price Index basket to zero, also contributed to lower-than-expected inflation. Continued implementation of the government's tariff reduction program reduced upward price pressures on imported goods. In response to the lower inflation, the Bank of PNG moved to ease its monetary policy stance in September 2012, by lowering its target interest rate from 7.75% to 6.75%.

Key issues

- Although the economy remains strong, a number of factors point to a more challenging economic environment in 2013. Maturing mining and oil operations, and the scaling down of LNG construction, are expected to contribute to slowing economic growth (forecast at 4.5%). Lower international agriculture prices and a persistently strong kina are also expected to depress rural incomes derived from the sale of export crops.
- A large reported escalation in the cost of the LNG project (from $15.7 billion to $19 billion) due to the high kina exchange rate, work stoppages, and land compensation issues may add unplanned pressures to the budget if the government is required to increase its equity contributions.
- A further fiscal risk is that while bank liquidity remains high, some commercial banks are approaching limits on their ability to lend additional funds to the government. This situation could require the government to forgo its debt strategy targets and increase exposure to foreign currency-denominated debt over the medium term, as domestic funds become scarcer.

Timor-Leste

Budget performance 2012

- The economic momentum generated by high levels of government spending has continued over 2012. Recurrent expenditure has the biggest immediate impact on economic activity because it feeds quickly into consumption. Excluding development partner-funded items, recurrent expenditure reached $509 million by the end of October 2012 (about 44% of nonpetroleum GDP), compared with the total recurrent expenditure of $516 million in 2011.
- Through October, expenditures on social transfers and goods and services have already exceeded the total for 2011, while expenditures on wages and salaries are just below last year's total. The increase in transfers was, in part, a result of an increase in the number of veterans recognized from the struggle for independence. Back payments of pensions have contributed to the increase in total transfer payments so far this year (equivalent to around 13% of nonpetroleum GDP).
- Capital expenditure is concentrated toward the national electrification program. Only a third of the 2012 capital expenditure budget had been spent by the end of October. Even allowing for the usual year-end surge in capital expenditure, the total capital budget will likely remain under-spent. However, the low rate of capital expenditure is having a muted negative effect on economic activity as the electrification program is import-intensive and has less flow-through effects on the economy than other forms of expenditure.
- In October, Parliament approved a $50 million rectification budget that reallocated funds set aside for the development of Timor-Leste's south coast to recurrent expenditure items. This is expected to provide a small additional boost to the economy in late 2012.
- High petroleum revenues will underpin another large budget surplus for 2012. The surplus is mainly saved in the Petroleum Fund, the balance of which had risen by $1.5 billion over the first 8 months of 2012 to reach $10.8 billion (more than 8 times nonpetroleum GDP).

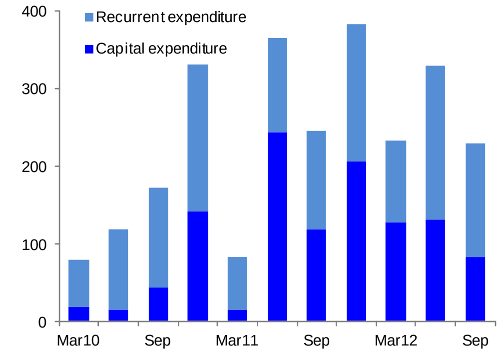
Budget 2013

- The level of spending under the 2013 budget will be the driving factor of economic growth in 2013. The new government, installed mid-2012, has deferred approval of the budget to early next year. Ministries have prepared new action plans to align with the government's 5-year program. These plans need to be incorporated into a revised budget. With the new government committed to its predecessor's ambitious strategic development plan, the 2013 budget is almost certain to be another large one. This, combined with a transition in capital expenditure away from electrification toward works with higher local content (e.g., roads, water, and sanitation), point toward continued high growth over 2013 and the medium term.

Recent developments

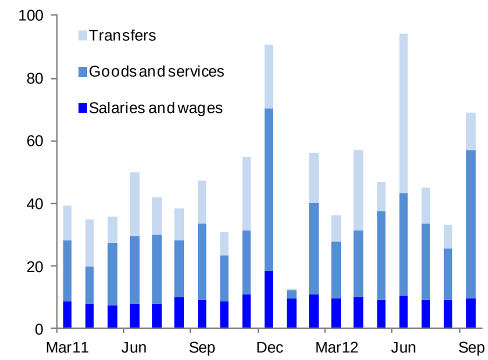
- The United Nations peacekeeping mission and security forces provided by an international stabilization force are in the final stages of their withdrawal. This will have a direct effect of

Government expenditure ($ million, quarterly)



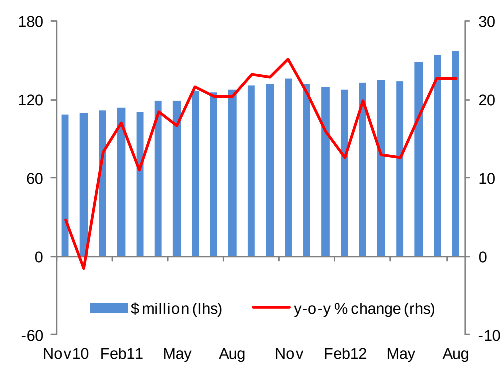
Note: Own-funded expenditure shown.
Source: Timor-Leste National Statistics Directorate.

Recurrent expenditure ($ million, monthly)



Note: Own-funded expenditure shown.
Source: Timor-Leste Transparency Portal.

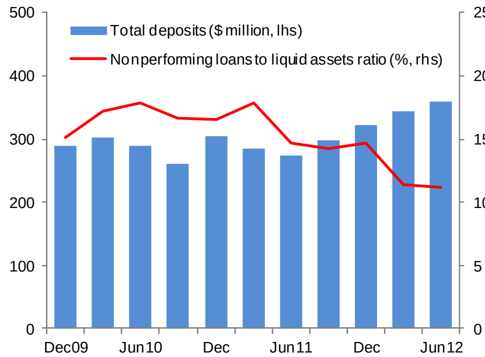
Credit to the private sector (monthly)



lhs=left-hand scale, rhs=right-hand scale
Source: Central Bank of Timor-Leste.

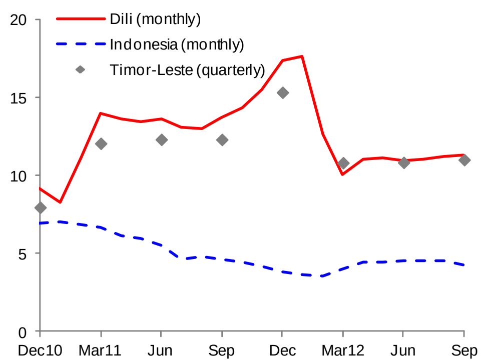
Timor-Leste

Banking indicators (quarterly)



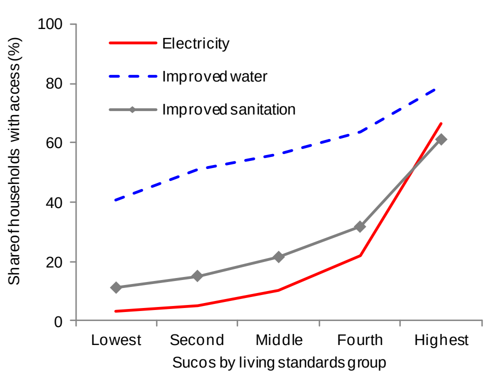
lhs=left-hand scale, rhs=right-hand scale
Source: Central Bank of Timor-Leste.

Consumer price index (y-o-y % change)



Sources: Bank Indonesia and Timor-Leste National Statistics Directorate.

Access to basic infrastructure (share of households with access, %)



Source: ADB. 2012. Timor-Leste's Least Developed Sucos. Pacific Studies Series. Manila; and ADB. 2012. A Pathway to Inclusive Opportunity in Timor-Leste. Pacific Studies Series. Manila.

Lead author: Craig Sugden.

cutting back nonpetroleum GDP by about 5.0% in 2013. But with the effect concentrated in the capital, Dili, and weighted toward higher-end consumer activities (e.g., travel, restaurants, and accommodations), the negative effect on the broader economy will be small. The main concern is the loss of work for the more than 1,000 Timorese employed by these missions.

- Economic activity is benefiting from greater lending to the private sector. Lending levels rose by 23% in August (year-on-year), boosted by revised lending practices at a major commercial bank. A large backlog of nonperforming loans remains, but these are sufficiently covered by bank assets and the level has been stable since the end of 2010.
- Inflation has stabilized at over 11% as of September 2012 (y-o-y), both in the capital and nationwide. Shortages of key items and lengthy queues of ships at Dili's international port have precipitated recent surges in inflation. Another end-of-year surge in inflation appears likely to be repeated this year as supply bottlenecks reemerge. Stocks of cement, for example, were nearly exhausted in late September, prompting a spike in the price. Inflation will remain an ongoing threat. There is potential to ease inflationary pressures by relieving congestion at the port: a quick impact could be achieved by streamlining operations and freeing up berthing space now used for permanent moorings. However, even with success on this front, rapid economic growth is likely to keep inflation in the high single digits.

Key issues

- The fifth Constitutional Government's program for 2012–2017has set a goal of creating "opportunities for all, in a fair and inclusive manner." This builds on the commitment of the Strategic Development Plan 2011–2030 to establishing "… a pathway to long-term, sustainable, inclusive development." These commitments, together with a target of achieving high economic growth, align Timor-Leste with the inclusive economic growth agenda now being pursed in Asia and the Pacific.
- Access to basic infrastructure is fundamental to expanding opportunities. At present, there is considerable inequality in access to basic infrastructure between wealthy and poorer *sucos* (villages). For example, in *sucos* with the highest living standards (i.e., in the top quintile), almost 80% of households had access to improved water in 2010. This compared with only 40% in the poorest *sucos* (i.e., lowest quintile). This inequality extends to access to other types of basic infrastructure, such as passable roads, electricity, and sanitation.
- Government initiatives, such as the national electrification program and a national road upgrading program (launched in October 2012), are closing these gaps. But the gaps between the better-off and the less well-off areas are large, and will take some time to close.
- A large expansion in infrastructure is planned over the next 5 years. The previous government had budgeted $3 billion for this expansion. Planned expenditure can target *sucos* with lower living standards to create fair and inclusive opportunity and to achieve inclusive economic growth.

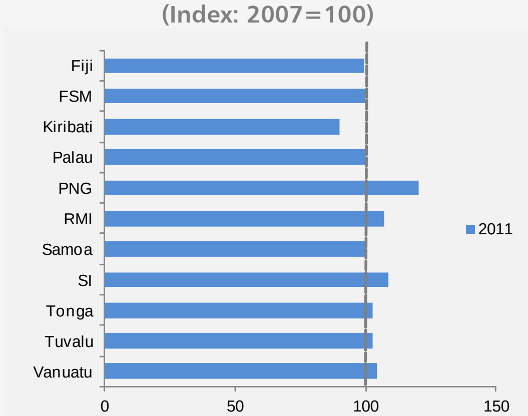
Growth and policy challenges in the Pacific

Pacific economies have by and large come out of the downturn following the 2008–2009 global financial crisis, but the growth prospects remain weak and uncertain for most countries. In the short run, macroeconomic policies should continue supporting economic activity while ensuring medium-term debt sustainability. Faster structural reforms, supported by more competitive exchange rates in some cases, are needed to raise growth potential.

The growth record and outlook

Economic growth in many Pacific economies suffered a major setback during the global financial and economic crisis of 2008–2009. The majority of the eleven IMF members in the region have barely or still not returned to their pre-crisis per capita GDP levels by the end of 2011 (Figure 1). These include the region's second-largest economy, Fiji, and a long-time star performer, Samoa. Papua New Guinea (PNG), riding on its resource boom, was hardly affected by the crisis, and Solomon Islands rebounded quickly from a dip in 2009 on account of log and gold exports. Even though all Pacific economies had resumed positive growth in 2011, growth rates were still low, averaging only about 2% among non-resource-based economies.

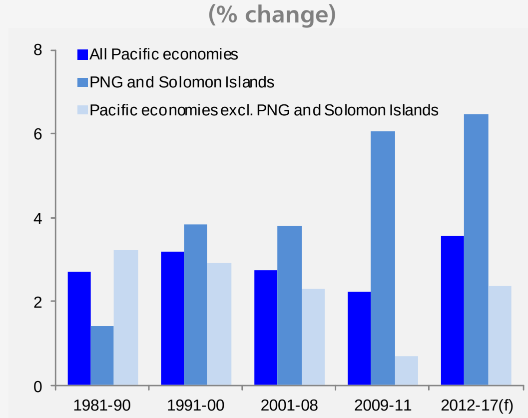
Figure 1: Pacific economies real per capita GDP (Index: 2007=100)



FSM=Federated States of Micronesia, PNG=Papua New Guinea, RMI=Republic of Marshall Islands, SI=Solomon Islands
Sources: *World Economic Outlook* and International Monetary Fund Asia Pacific Department.

The prospects for faster growth are not clear. Looking back at the past 3 decades, economic growth has slowed continuously. The last decade has been the slowest even if one takes into account of the impact of the global financial crisis (Figure 2). It therefore appears that the growth slowdown of the past decade in most Pacific economies was not cyclical; in other words, growth potential may have fallen over time to its present rates and countries have by and large come out of the downturn.

Figure 2: Pacific economies real GDP growth (% change)



PNG=Papua New Guinea
Source: *World Economic Outlook*.

Pacific economies' recent growth performance is in sharp contrast with other small states and low income countries—only economies in the East Caribbean Currency Union have experienced slower growth, largely dragged down by high public debt (Figure 3). The IMF forecasts that growth will average about 2% over the next 5 years for non-resource-based Pacific economies and 6% for PNG and Solomon Islands. With 2% growth, countries will find it difficult to achieve significant reductions in poverty.

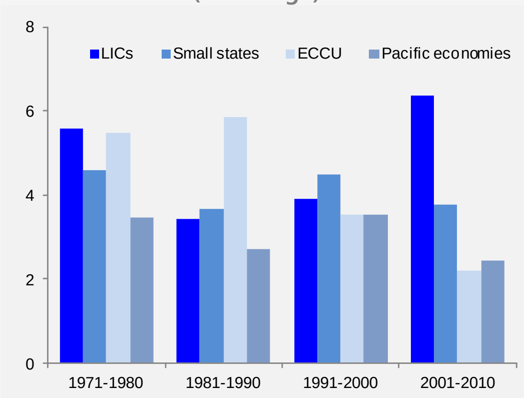
Small island states would face even greater challenges. Among the Compact countries, the Republic of the Marshall Islands (RMI) and the Federated States of Micronesia (FSM) had negative growth over the period 1996 to 2007 (Figure 4). Projected growth for the next five years is between 0.5% and 1.5%. Palau did much better in the past, growing at about 2% per year over the period 1996–2007 on account of a rising tourism industry. The expectation is that Palau will grow at a similar pace over the medium term. Tuvalu, the smallest IMF member, having grown at a pace similar to other non-resource-based Pacific economies over the past

This article is an external contribution from the International Monetary Fund's Resident Representative Office in the Pacific Islands. The views expressed in this note are those of the authors and do not necessarily represent those of the IMF or IMF policy. The authors wish to thank Hoe Ee Khor for helpful comments on the draft of this article. Due to data constraints, this note covers only the 11 members of the IMF in the region: Fiji, Kiribati, Republic of the Marshall Islands (RMI), the Federated States of Micronesia (FSM), Palau, Papua New Guinea (PNG), Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.

Consistent data from 1981 onward is available from the *World Economic Outlook* database for Fiji, Kiribati, PNG, Samoa, Solomon Islands, Tonga and Vanuatu. Data for Tuvalu is available from 2001 onward and shows a similar trend as Pacific island countries excluding Solomon Islands and PNG. For the purpose of this article, we consider the following countries to be small island states: Kiribati, RMI, FSM, Palau, and Tuvalu.

Growth and policy challenges in the Pacific

Figure 3: Growth comparisons
(% change)

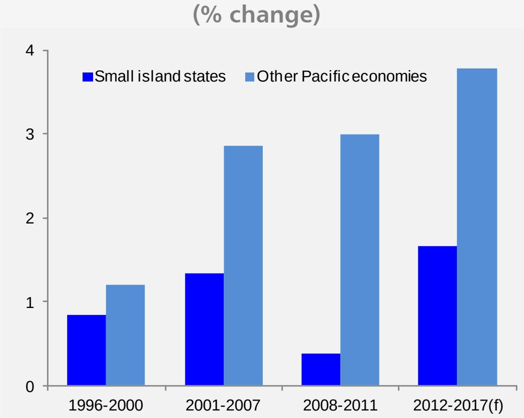


ECCU=East Caribbean Currency Union, LICs=low income countries
Source: *World Economic Outlook*.

decade, is expected to experience very slow growth, at about 1.2% per year over the next 5 years. Kiribati has grown very slowly over the past decade, at about 0.8% per year on average. The IMF forecasts that with donor-supported projects, growth in Kiribati is expected to pick up, averaging about 2% over the next 5 years.

There is considerable uncertainty over the growth forecasts for Pacific economies. Apart from the volatile global environment—which can significantly affect growth via linkages with larger regional economies such as Australia, New Zealand, and the People's Republic of China (see IMF 2011 and Sheridan et al. 2012)—Pacific economies are vulnerable to external shocks and natural disasters. Recent world food price increases, albeit not as widespread or steep as the 2007–2008 episode, have already raised renewed concerns about consequences for the vulnerable countries in the region. Perhaps more importantly, growth prospects for Pacific economies will depend on how forcefully they tackle their policy and structural constraints, both in the short and long run.

Figure 4: Small island states and other Pacific economies, growth comparisons
(% change)

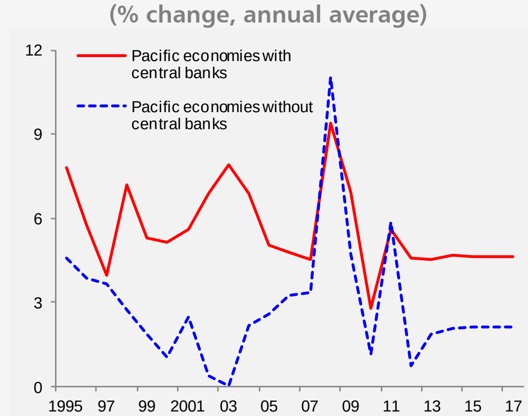


Source: *World Economic Outlook*.

Policy options in the short run

Macroeconomic policies to stimulate growth may be constrained by several factors in the short run. Should there be a need to further loosen monetary policy, which is already very accommodative, inflation is not a major concern at the moment. After sharp increases during 2007–2008, inflation has now stabilized in the region, converging to its long-run trend (Figure 5). Given the relatively weak domestic demand, the risk of rising inflation driven by excess demand is not high in the near term, though recent surges in some food prices on the world market should be closely monitored for their spillover effects. Of course, several Pacific economies do not have their own monetary policy at their disposal as they use foreign currencies.

Figure 5: Prices in Pacific economies
(% change, annual average)



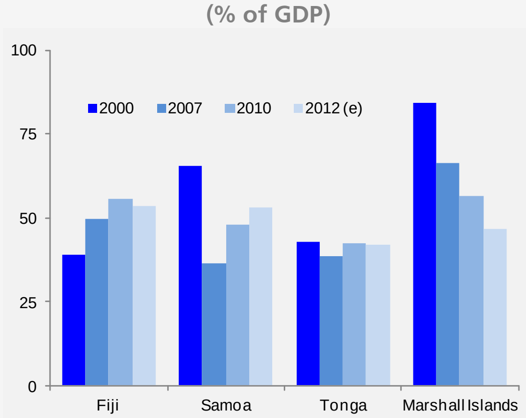
Source: IMF Asia Pacific Department.

While inflation may not be a major concern at the moment, further monetary easing is unlikely to be very effective in stimulating growth (Yang et al. 2012a; Peiris and Ding 2012). This is not to say the monetary policy easing during the crisis did not have any positive impact; the situation could have been worse without the monetary intervention. At the moment, however, policy rates in some countries (e.g., Fiji) are already very low and there is limited room for further cuts on interest rates. More fundamentally, it is not clear that there is any output gap (the difference between actual and potential growth) in many Pacific economies at the moment as potential growth may have fallen. So the current slow growth in bank credit is likely to have been driven largely by weak economic activity. In Tonga, however, banks have tightened lending standards after the rise in nonperforming loans following the 2004–2008 credit bubble. This seems to have contributed to slow growth in credit. Central banks' accommodative monetary policy has achieved the objective of injecting liquidity into the banking system, but it will take brighter growth prospects and risk reduction for credit demand to rise, and for banks to respond.

Growth and policy challenges in the Pacific

Nevertheless, there is much that central banks can do to strengthen monetary policy transmission over time. They should ensure that banks are competing with each other, pricing risk appropriately, and being transparent about interest rates and other charges. Some central banks have provided loans to state-owned financial institutions (e.g., development banks and housing authorities), which in turn are required to lend at subsidized rates to priority sectors. While there may be social grounds for directed lending, such support would be better suited for fiscal operations, which would avoid potential strains on the balance sheets of central banks and development financial institutions, with the added benefit of greater transparency.

Figure 6: Debt in selected Pacific economies (% of GDP)

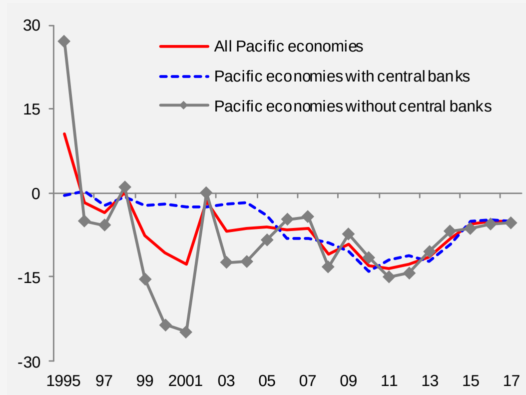


e=estimated
Source: IMF Asia Pacific Department.

Another key constraint on macroeconomic stimulus in several Pacific economies is high public debt. Overall, Pacific economies have managed their public debt reasonably well, avoiding crisis situations as seen in the East Caribbean Currency Union. However, prolonged increases in fiscal deficits to counter the effects of the global financial crisis and natural disasters (e.g., tsunami in Samoa in 2009) have pushed up public debt to high levels in some countries, and further increases would heighten the already significant risks of debt distress. As can be seen from Figure 6, public debt in Fiji, Samoa, and Tonga have increased significantly in recent years. The RMI has been consolidating its fiscal position for a number of years, but its public debt remains high. Barring major negative shocks to economic growth, there is no strong case to consider further fiscal stimulus in countries where debt levels are high. Some will in fact need to gradually bring down their debt to more sustainable levels over the medium term.

The balance of payments position is currently not a major constraint on an easing of monetary and fiscal policies. When Pacific economies had slowed in the

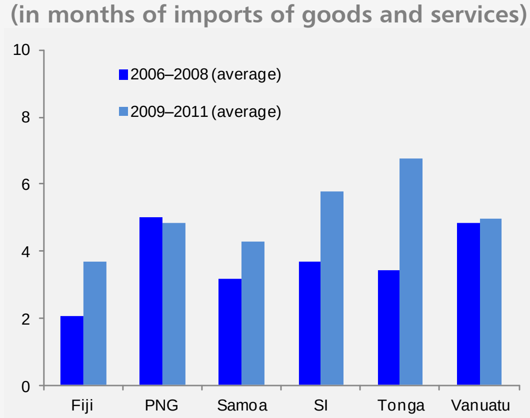
Figure 7: Pacific economies' current account balances (% of GDP)



Sources: *World Economic Outlook* and IMF Asia Pacific Department.

wake of the global financial crisis, concerns over the impact on the current account balance, and ultimately on foreign reserve holdings, were a major constraint on easing the monetary and fiscal policy stance. High ratios of imports to GDP in Pacific economies often led to large increases in imports and declines in foreign reserves following expansionary monetary and fiscal policies. This time around, however, most countries have a comfortable level of foreign reserves despite large and widening current account deficits in recent years (Figure 7). In fact, reserve holdings have improved in most Pacific economies as a result of slow economic growth (which leads to slower import growth) and generous donor support since the global financial crisis (Figure 8). Nevertheless, there is no room for complacency, particularly given volatile global food and fuel prices and weak export prospects. Countries should continue to monitor their reserve levels and ensure adequate holdings to deal with shocks.

Figure 8: Foreign exchange reserves (in months of imports of goods and services)



PNG=Papua New Guinea, SI=Solomon Islands
Sources: IMF Asia Pacific Department. *World Economic Outlook* and International Financial Statistics.

Growth and policy challenges in the Pacific

Most Pacific economies have maintained some form of pegged exchange rates, and this has precluded exchange rates as a regular shock absorber or a channel of monetary policy transmission. Nevertheless, several countries with pegged exchange rates have used exchange rate revaluations to dampen inflation pressures since the world food and fuel price shocks. However, few countries have used exchange rates as an active policy to stimulate economic activity when faced with terms of trade shocks and weak external demand. Fiji's 2009 devaluation was primarily driven by the need to rebuild foreign reserves. Arguably, exchange rate policy is less effective in countering weak external demand, but reluctance to adjust to adverse external shocks could lead to real exchange rate appreciation that could suppress a country's long-term growth potential, an issue we will discuss below.

Raising long-term growth

Pacific economies face some unique challenges in raising long-term growth because of their small size and remoteness (Becker 2012). Smallness is not a problem if small countries can access large overseas markets to overcome diseconomies of scale. However, when a small country is also remote and the resulting transport cost is high, then its growth disadvantage becomes significant. This is precisely the challenge facing the Pacific economies. Compared with other small states, Pacific economies are remote. It is estimated that because of their remoteness these economies suffer a growth disadvantage in the order of 1.5 percentage points on a per capita GDP basis (Yang et al. 2012b). This is a very large disadvantage considering that real per capita GDP growth averaged only 0.75% per year over the period 1992–2008. Given this, it is important for policy makers to have realistic expectations for growth to avoid overly ambitious targets. Moreover, small countries also tend to face greater growth volatility, which entails more prudent planning and maintaining large policy buffers in good times.

Research also shows that despite Pacific economies' geographical disadvantage, economic policy can make a significant difference to growth. In the past, Pacific economies' growth was partly dragged down by low investment. On average, the investment to GDP ratio in the Pacific was about 20% from 1992 to 2008, significantly lower than the 25% in other small states. While it is possible that lower investment may be partly related to smallness and remoteness, there are more obvious and significant impediments in many countries: cumbersome investment regulations, inadequate infrastructure, political instability, underdeveloped financial markets, and uncertainty resulting from land tenure systems. Significant progress has been made, such as increased investment in infrastructure and improvements in doing business indicators in several countries, but much more needs to be done.

While all these impediments are important, underdeveloped financial markets deserve some elaboration because they also have implications for monetary policy transmission. At a basic level, financial depth in the Pacific, as measured by broad money relative to GDP, is low compared with other small states. More broadly, collateralized interbank lending is not widely available and secondary markets for government and central bank paper are almost nonexistent. Markets for commercial paper, corporate bonds, and foreign exchange products are underdeveloped, while the capital market is in its infancy. This affects the monetary transmission mechanism, namely through asset prices and balance sheets (of both the corporate sector and households). While it is difficult to develop a deep financial market in small economies like those in the Pacific, there are steps that can be taken to improve the financial infrastructure, such as establishing credit bureaus and taking measures to make land tenure more secure as collateral for bank lending.

Another weak spot in Pacific economies' growth performance is their low export levels. On average, export openness in the Pacific, as measured by the exports-to-GDP ratio, is significantly lower than in other small states. Moreover, in the past decade, exports (including service exports) in the Pacific have declined relative to GDP and in real terms have experienced the slowest growth among small states and low-income countries. With the exception of PNG and Solomon Islands, Pacific economies, unlike other small states and low-income countries, have not been able to tap into the rapidly growing emerging markets in Asia, particularly the PRC. Recent data have shown some encouraging signs of increasing tourism demand from East Asia and other emerging Asian markets, though this started from a very low base in most countries.

While there are undoubtedly other important factors in explaining slow export growth in the Pacific, exchange rate policy should be closely examined for its role. Over the past decade, a number of Pacific economies have experienced sharp real exchange rate appreciation. Despite more rapid increases in domestic prices than those in trading partners, most Pacific economies have seen limited movements in their nominal effective exchange rates over time, leading to episodes of considerable real appreciation in some, such as Fiji, Samoa, Tonga, and Vanuatu, even before the hikes of global food and fuel prices. In the case of PNG and Solomon Islands, the appreciation since 2008 has been

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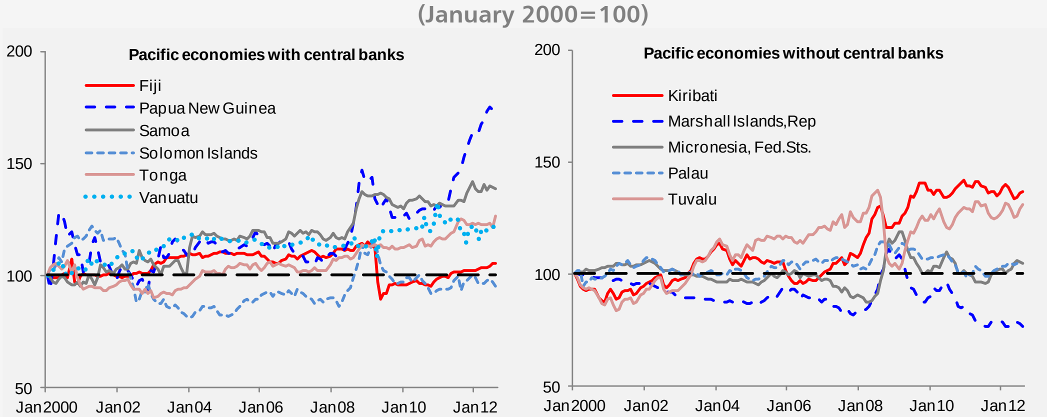
largely driven by the commodity booms, which have boosted export earnings and foreign direct investment inflows. In the five countries that do not have their own currencies, those that use the Australian dollar (Kiribati and Tuvalu) have experienced sharp real appreciation while those that use the US dollar (Micronesia, Marshall Islands, and Palau) have seen limited changes in their real effective exchange rate (Figure 9).

Exchange rate levels can have an important impact on long-term growth and external stability. As mentioned earlier, most Pacific economies have comfortable levels of foreign reserves, so external stability is not a key consideration in exchange rate policy formulation at the moment. However, this does not mean that such exchange rate levels are optimal for long-term growth and stability. There is anecdotal evidence, at least in some countries, that the current levels of exchange rates may have weakened their export competitiveness, including in tourism. It is true that real exchange rate appreciation over the past decade is often a result of external shocks, and the resulting real exchange rate appreciation may not adversely affect competitiveness as it may not raise the price of exports relative to foreign goods and services. However, given the weak performance of the agricultural sector, the slow recovery of tourism in a number of countries, and the decline in export openness, countries need to monitor their exchange rate developments closely.

It is worth noting that the role of exchange rate policy differs across the Pacific. To start with, countries face varying degrees of supply response because of different levels of productive capacity and transport constraints. In the tourism sector, for example, even though most Pacific economies have some sea-based resources for tourism, it would be extremely difficult for most of the small island states to attract and accommodate large numbers of tourists because of infrastructure constraints. Moreover, many Pacific economies do not have their own currencies, and any attempt to produce a competitive exchange rate would require a tighter fiscal policy. The extent of policy adjustment required to this end could be very large, making it extremely difficult to implement, and could be even counterproductive. Large aid inflows can also lead to currency appreciation that can reduce competitiveness of export sectors. It is well known that Pacific economies attract high levels of aid (relative to GDP, for instance), even compared with other small states, and this has helped alleviate poverty. However, there is some evidence that aid did not, on average, boost growth in the past, possibly because it has not been targeted at raising domestic productive capacity, and perhaps more importantly, because it has resulted in real exchange rate appreciation to the detriment of exports.

For small island states, a more practical strategy is perhaps to make the best use of marine resources and increase exports of labor services. Although income generated from these resources and services is still small in some of these states, all of them have significantly large economic exclusive zones and considerable fisheries resources. Small domestic markets and high utility costs (e.g., transportation and fresh water supply) make it costly to catch and process fish locally on commercial scales. Instead, measures to maximize resource rents from fishing rights to foreign vessels are likely to be the most effective and prudent way of exploiting the fisheries resources. Considerable progress has been made in this area, most notably through the Parties to the Nauru Agreement, but the potential remains large, including for employment of locals in foreign vessels and higher fees for fishing rights. Moreover, countries should continue to push for

Figure 9: Real effective exchange rates (January 2000=100)



Sources: *World Economic Outlook* and IMF Asia Pacific Department.

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further expansion and improvements in the current temporary workers schemes with advanced economy partners to increase remittances and job opportunities.

Concluding remarks

After a decade of slow growth, most Pacific economies—with an important exception of resource-rich countries—will find it difficult to grow much faster over the medium term. Moreover, the road ahead is likely to be a bumpy one given the current global situation and the Pacific economies' vulnerability to external and domestic shocks. Should the external environment deteriorate drastically, some Pacific economies would have fiscal resources to respond, but those that have high levels of public debt would face a tough challenge in providing short-term support while maintaining medium-term fiscal stability. Monetary policy has proven to be not as effective as desired because of the weak transmission mechanism, but this should not prevent countries from trying monetary stimulus when inflation and financial stability are not a major concern.

Despite pegged exchange rate regimes, countries could consider exchange rate adjustment as a part of the countercyclical policy toolkit and of the strategy to boost long-term growth. Although this policy option is not available to all Pacific economies and its effectiveness would vary from country to country, those that have experienced significant real exchange rate appreciation over the past decade should review their exchange rate policy with a view toward improving external competitiveness.

Structural reforms will be critical to raising long-term growth. In the long run, countries cannot stimulate out of slow growth. A stable macroeconomic environment and a competitive exchange rate would only help long-run growth if structural constraints are relaxed to allow strong supply response, be it in agriculture, tourism, or manufacturing. For small island states, policy options are more limited, but there is potential to generate significant rents from marine resources and returns from exports of labor services.

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Changing tides–Evolving North Pacific economic linkages?

ADB's Pacific Department is planning a detailed study of the evolving economic linkages between Pacific developing member countries (DMCs) and their economic partners. These linkages span a number of areas including trade, finance, and other resource flows. Prevailing understanding is that the North Pacific economies are oriented principally toward the US and, to a lesser extent, Japan, while the South Pacific is oriented toward Australia and New Zealand.

This article offers a preview of the types of analyses that the broad stream of research will provide, focusing on the case of the three DMCs in the North Pacific—the Republic of the Marshall Islands (RMI); the Federated States of Micronesia (FSM); and the Republic of Palau. The current analysis is limited to an exploratory review of readily available data covering merchandise trade, financial and investment flows (including official development assistance), tourism, and migration and remittances.

The North Pacific economies offer a good starting point for examining evolving Asia–Pacific economic linkages due to their geographic location, relatively undiversified economies (i.e., trade and other linkages generally focused on a few goods and economic partners), and well-established historical ties to the economies of Japan and the US. However, there is increasing anecdotal evidence that the North Pacific's linkages with emerging Asian economies have also increased in importance in recent years.

Historical context

The North Pacific states' strong economic linkages with the US and, to a lesser extent, Japan trace their roots to historical geopolitical factors. Spain first claimed dominion over these economies in the late 19th century, but shortly thereafter ceded administration of these territories to Germany. After World War I, the RMI, the FSM, and Palau (along with the Northern Mariana Islands) came under Japanese administration under the League of Nations' South Pacific Mandate. After World War II and the establishment of the United Nations, the US took over administration of the North Pacific under a 1947 trusteeship agreement, which formed the Trust Territory of the Pacific Islands. Strong relations with the US were cemented over 40 years of trusteeship and have persisted since independence (RMI and FSM in 1986, Palau in 1994), supported by Compacts of Free Association (hereafter the Compacts).

Emerging trends in key linkages

Merchandise trade. North Pacific economies are generally strongly import dependent, and run persistent trade deficits financed by development assistance, tourism revenue, and remittances. Merchandise exports correspond to only a small fraction of merchandise imports, and annual trade deficits range from 40%–50% of GDP in all three economies. North Pacific imports grew by an average of 3% per annum in 2001–2008. This is low compared with the 15% average growth in imports recorded by all ADB developing member countries. Exports from the RMI increased by 4% and from Palau by 13% in 2001–2008, while the FSM's exports contracted by about 20% per year in 2004–2006.

Table 1: Merchandise trade indicators for the North Pacific

	Marshall Islands, Rep. of				Micronesia, Fed. States of				Palau			
	Initial	*Year*	Latest	*Year*	Initial	*Year*	Latest	*Year*	Initial	*Year*	Latest	*Year*
Merchandise exports												
$ million	2.8	*1990*	32.5	*2008*	3.7	*1990*	8.9	*2006*	13.9	*1995*	6.8	*2011*
% change	23.5	*1990*	14.7	*2008*	62.5	*1990*	-31.3	*2006*	10.2	*1995*	-5.6	*2011*
Merchandise imports												
$ million	55.6	*1990*	158.3	*2009*	83.9	*1990*	170.4	*2010*	60.4	*1995*	124.3	*2011*
% change	27.6	*1990*	15.0	*2009*	15.3	*1990*	-2.8	*2010*	36.6	*1995*	23.6	*2011*
Trade balance												
% of GDP	-66.2	*1990*	-57.3	*2010*	-66.9	*1990*	-41.4	*2011*	-77.6	*2000*	-53.2	*2011*
Direction of trade												
Exports to (% of total):												
Asia	…		…		88.9	*1991*	4.1	*2007*	97.8	*2000*	99.8	*2011*
US[a]	…		…		10.7	*1991*	91.2	*2007*	0.0	*2000*	0.0	*2011*
Rest of the world	…		…		0.4	*1991*	4.7	*2007*	2.2	*2000*	0.2	*2011*
Imports from (% of total):												
Asia	18.5	*1990*	16.2	*2006*	19.7	*1990*	25.8	*2010*	98.5	*2000*	90.5	*2011*
US[a]	76.0	*1990*	71.7	*2006*	77.7	*1990*	71.6	*2010*	0.0	*2000*	0.0	*2011*
Rest of the world	5.5	*1990*	12.2	*2006*	2.6	*1990*	2.6	*2010*	1.5	*2000*	9.5	*2011*

…=data unavailable, GDP=gross domestic product

[a] Including trade with US territories (e.g., Guam)

Note: For merchandise exports and imports, % change refers to growth rates from previous year.

Source: ADB. 2012. *Key Indicators for Asia and the Pacific*. Manila.

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The US is the most important import supplier to the RMI and the FSM. In 1990, about three-quarters of total imports in both countries were from the US, but this has since fallen substantially (to 46% in the RMI as of 2006 and 38% in FSM as of 2010, according to ADB's *Key Indicators 2012*). However, these declines coincide with corresponding increases in imports from other sources, such as Guam and other neighboring US trust territories. Including trade coursed through these associated territories, the US still likely accounts for about 70% of total imports in the RMI and the FSM. In contrast, nearly all of Palau's merchandise imports came from Asian markets in 2000. By 2011, this share had fallen slightly to 90%. Palau's exports (largely tuna) are almost exclusively destined for Asian markets (export shares data for the RMI and the FSM require further scrutiny before reporting).

According to data from the United Nations Commodity Trade (UN Comtrade) database, North Pacific trade with emerging East Asian economies, such as the People's Republic of China (PRC) and the Republic of Korea, has gradually increased in recent years. For example, PRC imports from the RMI (mostly of tuna) increased from almost nil to an average of more than $11 million a year in 2009–2011. Republic of Korea exports to the FSM (mainly petroleum products and industrial inputs) grew from an average of $5.9 million in 2006–2008 to $9.8 million in 2009–2011.

Import flows from select Southeast Asian countries are also gaining significance. For example, exports from the Philippines to the FSM and Palau averaged almost $3 million and $4 million per annum, respectively, during the 2000–2011 period, from less than $1 million in the late 1990s. Indonesian and Malaysian exports to the RMI were both generally below $1 million annually from 2000 to 2008, but have reached around $2 million in the past 3 years.

Considering the largest import items, the RMI is sourcing some key merchandise imports, such as fuels and vehicles, from emerging East Asian partners. Food and machinery imports are still from traditional partners, Japan and the US. The FSM also imports food from the US, cars from Japan, fuel from the Republic of Korea, and appliances from the PRC. Palau imports food and machinery from the US (note that such trade, which is also documented by official data from the US, appears to be undervalued in the direction of trade data reported above); beverages, fuel, and vehicles from Japan; industrial inputs (as well as some food and vehicles) from Republic of Korea; and clothing, consumer appliances, and furniture from the PRC.

North Pacific exports consist largely of tuna. The RMI exports fish to a more diversified set of buyers compared with the FSM and Palau. In 2011, RMI fish exports were valued at $16.5 million for the PRC; $9.3 million for Japan; $7.8 million for the US; $3.2 million for the Philippines; and $1.4 million for Singapore.

The FSM used to have large tuna exports to Japan, but these have collapsed since the mid-1990s. The value of Japan's fish imports from the FSM has fallen from $70 million in 1995 to only $11 million in 2011. Palau's exports of tuna are more concentrated toward Japan. After peaking at almost $40 million in 2006, Japan's fish imports from Palau were only about $18 million in 2011. Palau also used to export clothing items to the US. Their value peaked at about $16 million in 2002, but these ceased in 2003.

It seems likely that trade linkages between the North Pacific and Asia will continue to expand, with savings arising from lower transport and production costs from Asia. This preliminary examination of the merchandise trade data shows the value of trade between the North Pacific and the region's leading trading partners have risen significantly, while traditional and emerging partners have evolved. However, the analysis has also made clear that different data sources reveal apparently contradictory pictures of how trade is evolving in the region. The broader research study will provide a much more detailed analysis of merchandise trade trends. This will include greater exploration of alternative data sources and triangulation to arrive at the best set of indicators.

Finance and investment. The North Pacific economies use the US dollar as their currency. While adopting a foreign currency precludes independent monetary and exchange rate policy, latest IMF assessments indicate that the use of the US dollar remains appropriate for the RMI, the FSM, and Palau given their small size and strong financial links to the US. Some also argue that this facilitates international trade (mostly invoiced in US dollars), particularly with economies using the same currency (e.g., Guam, Northern Mariana Islands).

Three US-based banks (Bank of Guam, Bank of Hawaii, and Bank Pacific) are the main providers of banking services in the North Pacific. These banks are covered by the US Federal Deposit Insurance Corporation up to $250,000 and are subject to standard US banking sector regulations and oversight.

With limited revenue bases, North Pacific governments have traditionally relied on grants to support public spending. US grants (mainly under the Compacts) accounted for about 40%–50% of government spending in the last 5 years. Together, the US and Japan accounted for more than 90% of development assistance (on average) to the North Pacific states in 2004–2010 (Figure 1). This average hides significant differences across the countries. In the RMI and the FSM, the US accounted for about 80% of total grants,

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while development assistance from Japan averaged only 10%. These proportions are more balanced in Palau, where Japan accounts for roughly 30% of the total. Further, Palau has recorded significant grants from the US outside of their Compact agreement. Assistance flows have been volatile, suggesting the importance of project-related disbursements. Data on development assistance from other countries appears less reliable, so will not be discussed here (but will be considered in the larger study to follow).

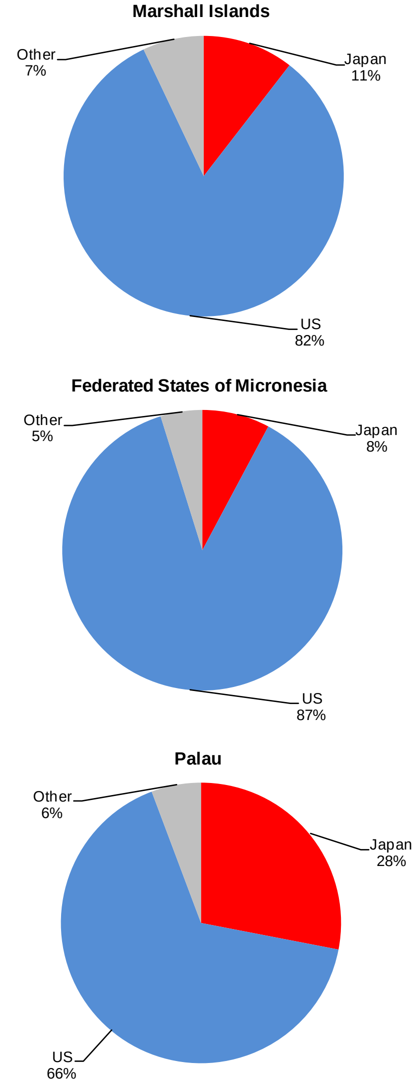
To support long-term fiscal sustainability in the RMI and the FSM, the US serves as the major contributor for the Compact Trust Funds (CTFs) for those two countries. At the end of FY2011 (ended 30 September), total contributions to the RMI CTF were $116.5 million, two-thirds of which was from the US; 25% from the RMI; and the rest from Taipei,China. Total contributions to the FSM CTF were $180.5 million, 83% of which was from the US and 17% from the FSM. Funds are mostly invested in US assets (equity, bonds, real estate). Pension funds of the North Pacific (e.g., Marshall Islands Social Security Trust Fund, Civil Service Pension Fund of Palau) are also invested in US assets.

Tracking foreign direct investment (FDI) is generally one of the more challenging areas in international economic statistics, particularly in the North Pacific where investments tend to be small and fluctuate wildly from year to year, making consistent recording more problematic. In general, opportunities for FDI in North Pacific economies remain limited due to these economies' small, remote, and physically dispersed markets. Rigid investment regulations exacerbate these structural weaknesses and contribute to relatively muted private sector activity.

Initial analysis of FDI trends in the North Pacific relied on data from the UN Conference on Trade and Development (UNCTAD)—which closely reflects the IMF International Financial Statistics data. These data show the North Pacific states have realized smaller net inflows of FDI compared with other Pacific DMCs. Following a period of volatility at the start of the millennium, RMI realized FDI inflows averaging only 4.7% of GDP in 2003–2011. FSM has had FDI inflows of about 2.5% of GDP in 2005–2011. Palau's FDI flows averaged 2.4% over the years 2000 to 2011, but decreased sharply from 10% of GDP to 0.9% across these years.

UNCTAD data are aggregated across investor countries, but the PRC Ministry of Commerce reports FDI flows from PRC to the North Pacific. These data show that PRC investment in the RMI has been sizable, averaging 11% of GDP in 2006–2010. In contrast, PRC-sourced foreign direct investment in the FSM and Palau were much smaller (less than 1% of GDP for each).

Figure 1: Official development assistance (% of gross disbursements, 2004–2010 average)



Source: Organisation for Economic Co-operation and Development–Development Assistance Committee online database.

Tourism and migration. Among these three North Pacific states, only Palau has an established tourism industry. Tourism accounts for about 50% of Palau's GDP, and relies heavily on visitors from East Asian markets. Of the record-high 109,000 arrivals achieved in 2011, about 84% were from Japan; the Republic of Korea; and Taipei,China (Figure 2). Tourists from the US (including Guam) accounted for only about 7% of total arrivals in 2011. This share has declined from around 20% in the late 1990s. In contrast, the share of East Asian markets increased from just over 60% in the late 1990s to about 80% in the past 5 years. Tourist arrivals to Palau declined by 19% during the global financial and economic crisis (2008–2009), driven by a 24% decline in the number of tourists from East Asia.

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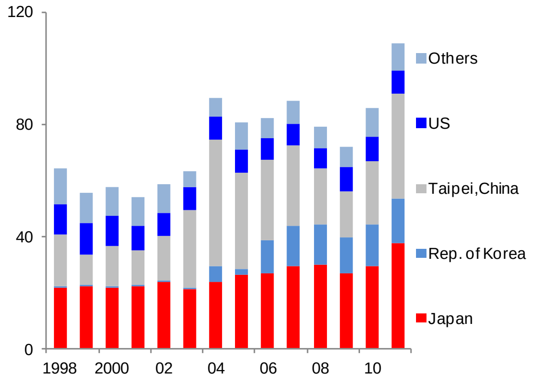
Figure 2: Palau visitor arrivals
('000 persons, by source country; annual)



Source: Palau Visitor's Authority.

Both the RMI and the FSM have underdeveloped tourism sectors, which are highly dependent on US arrivals. The RMI's tourism base is particularly small, averaging only about 3,500 total arrivals per annum in 2006–2010. The FSM receives about 15,000 tourists annually. Japan is the largest Asian market for both, but accounts for only about 20% of total arrivals in both countries.

Outward migration from the North Pacific generally flows toward the US and its associated territories, as citizens have rights to live and work in the US indefinitely without visas under their Compacts of Free Association. In the 2010 US Census, more than 38,000 persons residing in the US identified themselves as being of North Pacific ethnicity (Marshallese, 22,434; Chuukese, 4,211; Kosrean, 906; Pohnpeian; 2,060; Yapese, 1,018; and Palauan, 7,450), up from 12,000 in 2000. There is also anecdotal evidence that there are significant numbers of these migrants in Guam and the Northern Mariana Islands. Marshallese residents in the US are concentrated in Arkansas, California, Hawaii, and Oregon.

Over the past 5 years, average remittances to the RMI totaled about $3 million annually. Remittances to the FSM were substantially larger at about $15 million per year—almost the same level as fishing license revenues, which are a principal source of domestic revenue). Balance of payments data indicate that remittance inflows to Palau are more than offset by outward transfer flows from Asian migrants. However, it is worth noting that there is a general trend of underreporting of remittances in international statistics.

Concluding remarks

This article previewed the analyses that a broader stream of planned ADB research will provide. Deeper analysis, including greater efforts to refine available data, detailing the evolution of economic linkages between the North Pacific and its economic partners is planned for 2013. Among the three North Pacific economies considered in this article, Palau has established relatively strong linkages with Asia in terms of tourism, merchandise trade, and official development assistance. While the RMI and the FSM remain heavily linked to the US economy, their economic linkages with Asia are also gaining importance. Stronger linkages with Asia will be both inevitable and necessary for all three North Pacific economies, especially as they prepare for the eventual expiration of their respective Compacts. In the longer-term, it appears likely that the North Pacific's economic prospects will depend more heavily on their capacity to seize opportunities in a changing global landscape.

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The potential for reform and growth in small island states

Around half of ADB's Pacific developing member countries (DMCs) can be classified as "small island states"—countries typically made up of one small main island or a grouping of dispersed islands and atolls. These include Kiribati, the Republic of the Marshall Islands (RMI), and the Federated States of Micronesia (FSM), which have populations of around 100,000; the Cook Islands and Palau, with populations of around 20,000; and Nauru and Tuvalu, with populations of only around 10,000. All are highly dependent upon aid and there is a long-standing debate over whether they can ever become economically independent. Ultimately, the answer to this question depends upon the payoff from economic reform.

The economic disadvantages of the Pacific island countries are well known: the small size of the domestic market and their remoteness from major markets, which together make it extremely difficult to realize economies of scale in production and to be competitive in international markets; for many, a lack of natural resources (apart from ocean resources including fishing and tourism) that could be profitably exploited; and frequent natural disasters. These disadvantages have convinced many that the potential for economic independence is negligible. Is this the case, and is it futile to pursue economic reforms that work in other countries? Or is it possible that certain economic reforms or different international arrangements could remove or sharply diminish the need for development assistance while allowing living standards to reach acceptable levels? Here we outline the relative scarcity of resources in these small countries, identify those that are most likely to remain aid-dependent, and examine the possibilities for economic independence in the small Pacific states—particularly with respect to the potential impacts of economic reforms.

Relative scarcity of natural resources

Most of the small Pacific island states are made up of low-lying coral islands or atolls and therefore are extremely limited with respect to agricultural practices. Their topography also means that they face significant threats from sea-level rise—including inundation of fresh water lenses that provide much of their potable water. Kiribati and Nauru possessed deposits of phosphate, but apart from secondary mining on Nauru, these have been largely depleted. The existence of seabed mineral deposits in the Pacific has raised some commercial interest—particularly in the Cook Islands—but exploitation is only a possibility at present.

Coastal and deep-water fishing are important economic activities for most of the Pacific DMCs, particularly fishing for tuna. The potential for tuna fishing depends on the size of the countries' exclusive economic zone (EEZ) and their location. Tuna are migratory fish and spend much of their life in the northern areas of the Pacific near the equator. Therefore, with their large EEZs (Table 1), Kiribati, the FSM, and the RMI are in a favorable position.

Tourism has become a much more important economic activity in recent years in some small states because of the introduction of competition in international airline services, with the resulting reduction of airfares encouraging the development of resorts. The Cook Islands and Palau are now heavily dependent upon tourism (see Table 1 for some information on recent visitor arrivals). A direct air connection to a metropolitan hub is vital for Pacific tourism. For example, the Cook Islands subsidizes a direct air connection to Los Angeles. Although they possess enviable tourist attractions, the RMI and the FSM have not been able to exploit tourism opportunities to the same extent as other Pacific island countries because international airlines services to these countries are under monopolistic control. Visitor arrivals into Kiribati, Nauru, and Tuvalu are few and the prospects for significant increases that would make the increased frequency of airline services viable are not bright.

So for some of the small states, their labor force is the main resource available for exploitation; but their ability to do so depends upon the nature and extent of domestic investment, the level of education and training of the labor force, and the potential for working offshore if jobs are not available onshore. Except for the Cook Islands and Palau, domestic investment is not a strong feature of the Pacific small states. As a sovereign nation in free association with New Zealand, the Cook Islands is also in the fortunate position that its people are citizens of New Zealand and are free to live and work there.

The RMI, the FSM, and Palau are in free association with the US and, under the Compacts negotiated with the US, have the right to live and work in the US—at least until the Compacts expire (in 2023 for the Marshall Islands and the FSM, and depending on the approval of the renegotiated Compact in the case of Palau). But while people from the RMI and the FSM have taken advantage of the opportunity to emigrate to the US, the poor outcomes from education and training facilities in their home countries have meant that their economic performance in the US has been poor. Therefore, remittances do not play an important role in these countries. In fact, the flow of funds is more likely to go in the opposite direction.

The potential for reform and growth

Kiribati and Tuvalu have so far lacked substantial domestic investment and do not have international relationships, such as those of the Cook Islands with New Zealand and of the Micronesian states with the US, which would allow them to emigrate easily in search of employment. Moreover, their generally poor educational outcomes have inhibited both domestic and overseas employment. Both countries have maritime training facilities to equip trainees for work on international merchant vessels, which takes advantage of the traditional seafaring skills of these islanders. Remittances, largely from this source, contributed 8% of GDP in Kiribati in 2009 and around 6% in Tuvalu.

Which small Pacific states are most likely to remain aid-dependent?

As can be seen from Table 2, the Cook Islands and Palau have achieved reasonably high per capita gross national incomes (GNI), largely on the back of tourism and aid. However, it could be argued that the amount of aid that they receive is unnecessarily large and that they could continue to grow through tourism—as well as other income sources such as tuna fishing fees—and that they could soon become independent of aid. As a recipient of US Compact aid, how well Palau manages the renewed Compact aid flow could well determine whether it is needed in the long term.

The RMI and the FSM also receive large US Compact aid flows but have done poorly in economic growth terms. Tuvalu is near the top of the list in terms of per capita aid, and while its per capita GNI is relatively large, this is likely largely due to the aid that it receives. Kiribati receives relatively low levels of aid in per capita terms and has done poorly in economic growth terms. Nauru's per capita GNI is similar to that of Tuvalu's. Its GNI has recovered significantly in recent years as a result of the recommencement of phosphate mining and large levels of aid from several donors.

Thus, looking at the likelihood of aid dependency through the lenses of per capita GNI and aid does not give a clear picture. A clearer picture comes to light through the use of the measure "Distance from External Balance" proposed by Stewart and Wood (2012). The measure is defined as follows:

Distance from external balance = current account balance + capital & financial account balances – aid flows + foreign debt

This measure gives an estimate of the foreign exchange needed to return the country to external balance while maintaining current income levels. In other words, it is a measure of the extent to which the country is currently living beyond its means. Stewart and Wood calculate the measure for several of the Pacific island states, and, as shown in Table 2, the Kiribati, the RMI, the FSM, and Tuvalu were the furthest from external balance in 2007. This ranking also holds true when measured over time. The absence of data does not allow a consideration of whether Nauru belongs in this group.

Thus, among the small Pacific states, Kiribati, the RMI, the FSM, and Tuvalu may well be the most likely to remain dependent upon aid.

Table 1: Small Pacific island states statistics on natural resources

	Population ('000, mid-2011 est.)	Land area (sq. km)	EEZ (million. sq km)	Visitor arrivals ('000)
Cook Islands	25.6	237.0	1.8	112.6
Kiribati	105.3	811.0	3.6	3.4
Marshall Islands, Rep. of	55.0	181.0	2.1	
Micronesia, Fed. States of	120.6	701.0	2.9	21.1
Nauru	10.2	21.0	0.3	
Palau	20.8	444.0	0.6	83.8
Tuvalu	11.2	26.0	0.8	

EEZ=exclusive economic zone
Note: Visitor arrivals data are for the following years: Cook Islands (2011); Kiribati (2008); Fed. States of Micronesia (2007); and Palau (2009).
Sources: Population—ADB Key Indicators 2012; Land area— Pacific Regional Information System (PRISM); Exclusive economic zones—Forum Secretariat; Tourism—Cook Islands Statistics Office, Palau Ministry of Finance, and PRISM.

The potential for reform and growth

Opportunities for reform in small Pacific states

The understanding of the process of economic growth that has underpinned the development agencies' approach to assisting developing countries has been that the accumulation of capital (both physical and human) and improvements in the productivity of capital and labor are the most important driving forces of economic growth. For investment in physical and human capital to take place, investors need to have the expectation of receiving adequate returns on their investment. At one time it was thought that countries were lacking development because they did not save enough to fund the investment needed. Hence, international donors could support economic growth by sending their savings to poor countries. But it is now realized that if the necessary economic institutions needed to support investment (primarily secure property rights, the rule of law, and impartial enforcement of contracts) are not in place, then investment will not take place. Moreover, savings are scarce in poor countries because those able to save send their savings to countries where the economic institutions support profitable investment ("capital flight"), rather than save and invest in their own country.

Is it the lack of the appropriate economic institutions and unwillingness to put them in place that is inhibiting private investment in the small states of the Pacific and preventing aid from helping to promote growth? Some argue that aid has failed to help these countries because the international and bilateral donors are following guidelines set by the above understanding of the economic theory of growth. It is argued that the small states are special and that a different approach to development assistance is needed. Some go as far as to argue that the disadvantages faced are so inhibiting that they can never develop in the way that other countries have and will be permanently reliant on outside assistance (see, for example, Hezel 2012).

Besides continuing to receive aid in perpetuity, it has been proposed that the small Pacific states should also integrate more closely with each other and with larger economies to overcome the disadvantages of smallness (particularly by removing barriers to labor mobility and improving policy and regulatory settings) and pooling resources to reduce the costs of providing public services and regional public goods. Aid would therefore be focused on long-term support of government functions and support in the use of pooled resources.

This focus on the disadvantages of "geography" goes against much recent thinking about economic growth, which sees the development of appropriate economic institutions as being the most important factor in a country's growth. Following the seminal writings of Douglass North on institutions, there has been considerable economic research testing the relative importance of institutions, "geography," and trade integration in economic growth. The evidence is convincing that the existence and enforcement of appropriate economic institutions dominates "geography" and trade integration as far as being a facilitator of growth is concerned. Of course, the political economy of the country will determine whether the appropriate institutions and policies are adopted and effectively implemented.

Table 2: Income and external balance indicators for small Pacific island states

	GNI per capita ($; Atlas method, 2011)	Aid per capita ($; 2006-2010 average)	DEB (% of GDP; 2007)
Cook Islands	9,587	547	
Kiribati	2,110	209	–46
Marshall Islands, Rep. of	3,910	1,103	–91
Micronesia, Fed. States of	2,900	1,067	–63
Nauru	4,792	2,410	
Palau	7,250	1,551	–35
Tuvalu	5,010	1,148	–69

DEB=distance from external balance, GDP=gross domestic product, GNI=gross national income
Note: GNI per capita for Cook Islands and Nauru are preliminary and are for 2010.
Sources: GNI per capita and population—ADB, *Key Indicators 2012*; Aid per capita—Organisation for Economic Co-operation and Development–Development Assistance Committee, Development Indicators database; Distance from External Balance—Stewart and Wood (2012).

The potential for reform and growth

The traditional societies of the Pacific present considerable obstacles to the introduction of institutions that will provide a business-enabling environment. Security of property rights to land is one of the fundamental requirements for private enterprise. The system of customary land ownership has made it very difficult to develop a tenure regime—such as long-term leasing of customary land holdings—that will allow individual entrepreneurship to blossom. Without secure access to land, it is also impossible to develop a mature financial system that will effectively link savers and investors. Impartial enforcement of contracts through the law and justice system is also fundamental to the effective operation of markets. A pervasive problem facing the development of markets in the region is the loose enforcement of contracts, which can be traced to traditional systems of reciprocity in Pacific societies.

The reciprocity system is also an obstacle facing indigenous entrepreneurship. The evidence from the Pacific is in conformity with evidence from elsewhere that entrepreneurship is more associated with individualistic societies than with collectivist societies (Hofstede 1980). This does not mean that the individuals within these different kinds of societies differ in their abilities. Individuals who move out of collectivist societies into individualistic societies can be just as entrepreneurial and risk-taking as the people born into individualistic societies. This appears to be just as true for immigrants from the Pacific as from elsewhere. It is the institutional rules that determine their behavior; or, as Hofstede says, it is the society that is individualistic or collectivistic, not the individual.

Whether this view is a realistic assessment of the future of the small Pacific island states depends upon whether it is possible for them to overcome the disadvantages that they face. But the provision of long-term aid also raises serious questions about its impact.

Aid that is seen as permanent raises various problems, some of which are similar to the "resource curse" problems that we see associated with the windfall revenues from the exploitation of minerals and petroleum. Politicians contest for control of the aid to exploit patron-client relations with their voters at the expense of their energy being directed to the provision of public goods that benefit the whole community. Government's attention is also directed away from the design and operation of efficient tax revenue systems. Further, as the literature on the political economy of taxation shows, as aid is not raised from taxes the community has little incentive to demand transparency and accountability in the expenditure of the aid.

There has been recent acknowledgment of the dependency that can develop from the provision of long-term aid by past Presidents of the three north Pacific states being funded under the US Compact. Giff Johnson and Ben Graham ("Presidential perspectives on political economy in Micronesia," Chapter 6 in Ron Duncan, ed. 2011. The Political Economy of Economic Reform in the Pacific. *Pacific Studies Series*. Manila: ADB) interviewed five past presidents of the RMI, the FSM, and Palau about their experiences with attempts at economic reform. As illustrated by the following quote, the implications for long-term aid are sobering:

> A welfare state . . . became an institutional expectation . . . We've been stuck with all these freebies for a long time. The problem today is twofold: (i) lack of resources and money [to sustain the subsidies]; and (ii) it is hard to eliminate these freebies—even though they may be able to live without them, people now seem to expect them. That's the transformation that needs to take place. (p.117)

Options for economic reform to spur growth in the small island states

It is agreed that the small Pacific DMCs face considerable obstacles in achieving economic growth. But recent experience in other Pacific island countries shows that there is potential for growth through tourism. Moreover, given an appropriate institutional environment, it is possible that other economic activities will grow up around tourism, such as agriculture, handicrafts, water sports, etc.

A resource of these countries that has been largely unexploited is their longitudinal position. Prior to the recent sharp reduction in global telecommunication costs, their remoteness was considered in all ways to be a disadvantage. The reduction of telecommunication costs and the international fragmentation of business activity encouraged by the lowering of telecommunication costs could not be exploited by the Pacific island states until recently because telecommunication activities were under the monopoly control of governments. However, Fiji, Samoa, Tonga, Solomon Islands, and Vanuatu have now introduced mobile phone competition, leading to substantial reductions in costs. But the small states have not followed suit. Thus they have not been able to participate in opportunities opened up by the ICT revolution and international business fragmentation. Is it too late for these countries to participate in this "second industrial revolution"? In this area, as in all others, the potential for exploiting resources for

The potential for reform and growth

economic growth and improved welfare depends ultimately upon the innovativeness of entrepreneurs who are prepared to invest in the countries.

But while appropriate economic institutions are essential for the development of the private sector in the Pacific, there are institutional impediments in place. The continuing tendency of local traditional leaders to exercise authority over economic matters is perhaps the most important institutional impediment to the flourishing of entrepreneurship and the private sector. Whether it is possible for these countries to move away from the traditional system, and how and when, are questions for political economists to come to grips with. In the meantime, the development of the private sector may have to depend upon foreign investment and on finding ways for indigenous entrepreneurs to "quarantine" their assets and incomes from traditional social obligations. Failing such developments, the best opportunities for employment and increased incomes will lie overseas.

The situations of the RMI and the FSM on the one hand, and Kiribati and Tuvalu on the other, offer clues about the possibilities for economic reform and economic progress. The RMI and the FSM have free access to the US with respect to labor. Kiribati and Tuvalu have only recently established arrangements with Australia and New Zealand that allow easy movement of labor for the purpose of earning remittances. The RMI and the FSM continue to receive relatively large inflows of US aid, and Kiribati and Tuvalu have also become highly aid-dependent. The public sector tends to be the largest employer in these small island states.

Therefore, in looking at the futures of the four countries, unless conditions leading to welfare dependency can be unwound, the prospects for economic independence are poor. The RMI and the FSM are locked into US Compact agreements for quite some time.

Opportunities for changing the conditions under which aid is delivered cannot be easily or soon seized. In the case of Kiribati and Tuvalu there is the opportunity for Australia to offer them labor movement on much the same terms as the Micronesian countries have with the US (i.e., access to live and work in Australia but without citizenship). Similar to many other Pacific states, Kiribati and Tuvalu are keen to have easy labor access to metropolitan countries. Increases in sea level could become a serious problem for the low-lying islands of Kiribati and Tuvalu, necessitating substantial movement of people off the islands. In this case, the arrangements for movement to Australia may be forced to change.

One of the issues that makes economic development so difficult for these small states is that they are essentially in a common currency area—the RMI and the FSM use the US dollar while Kiribati and Tuvalu use the Australian dollar. Thus they have no monetary policy means of adjusting to economic shocks. Their only means of adjusting to adverse economic shocks is for unemployment to increase, real wages to decline, and in the case of the RMI and the FSM, to emigrate. The situation is even more dire because productivity growth is so poor that the economies cannot maintain or increase real wages through that means. Thus, economic reforms that will lead to productivity increases, such as opening internal telecommunication and airline services, opening trade and investment channels, and improving education and training, become even more critical.

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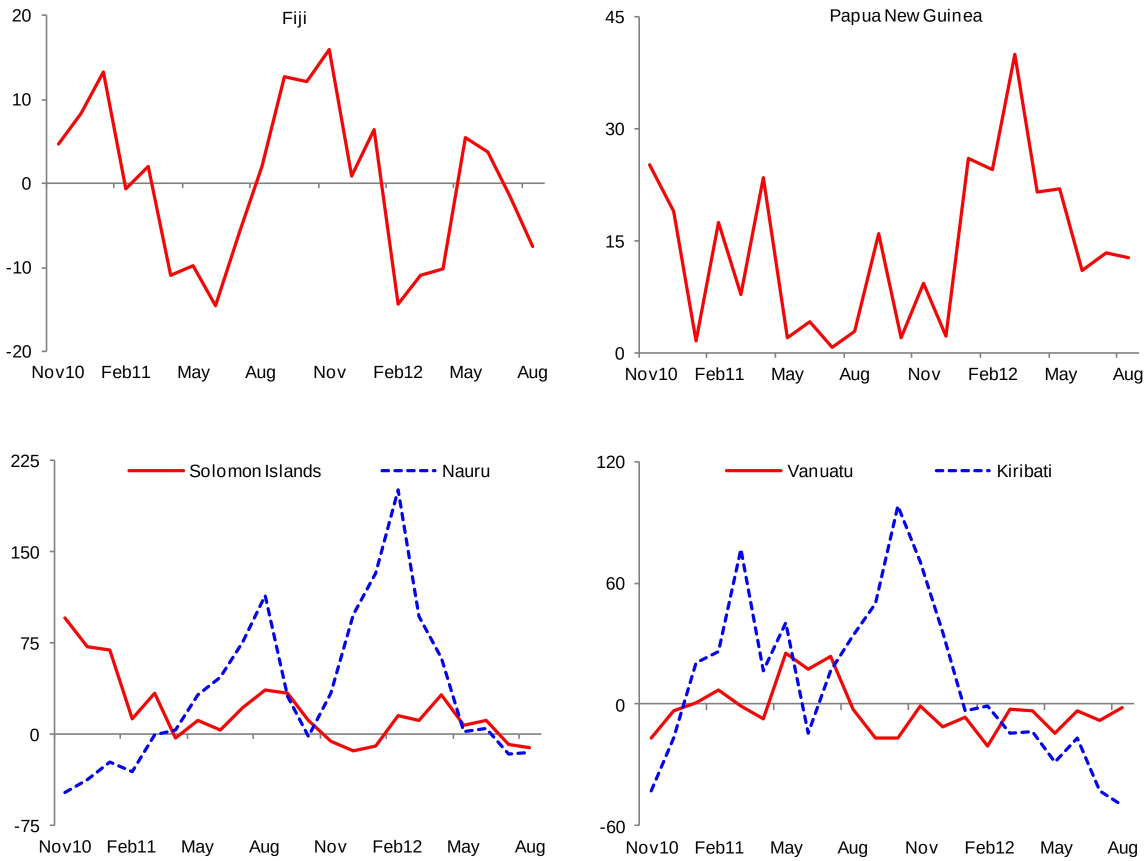
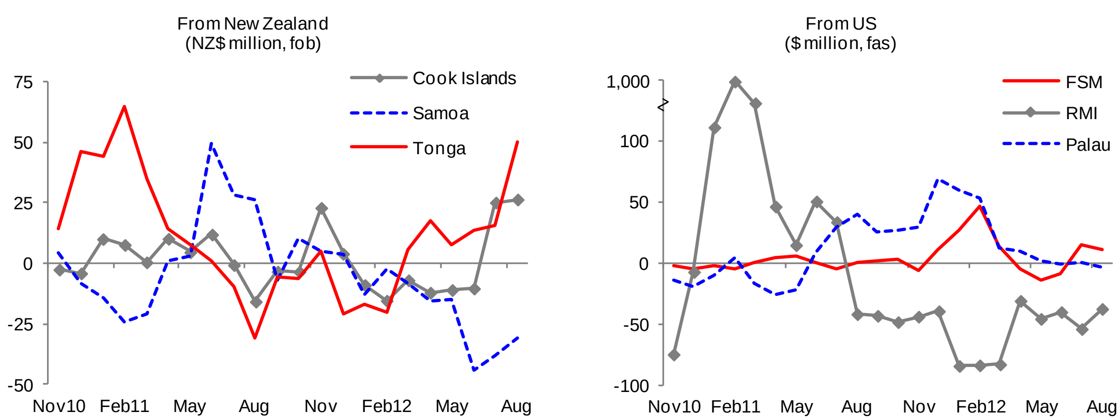
Nonfuel merchandise exports from Australia
(A$; y-o-y % change, 3-month m.a.)



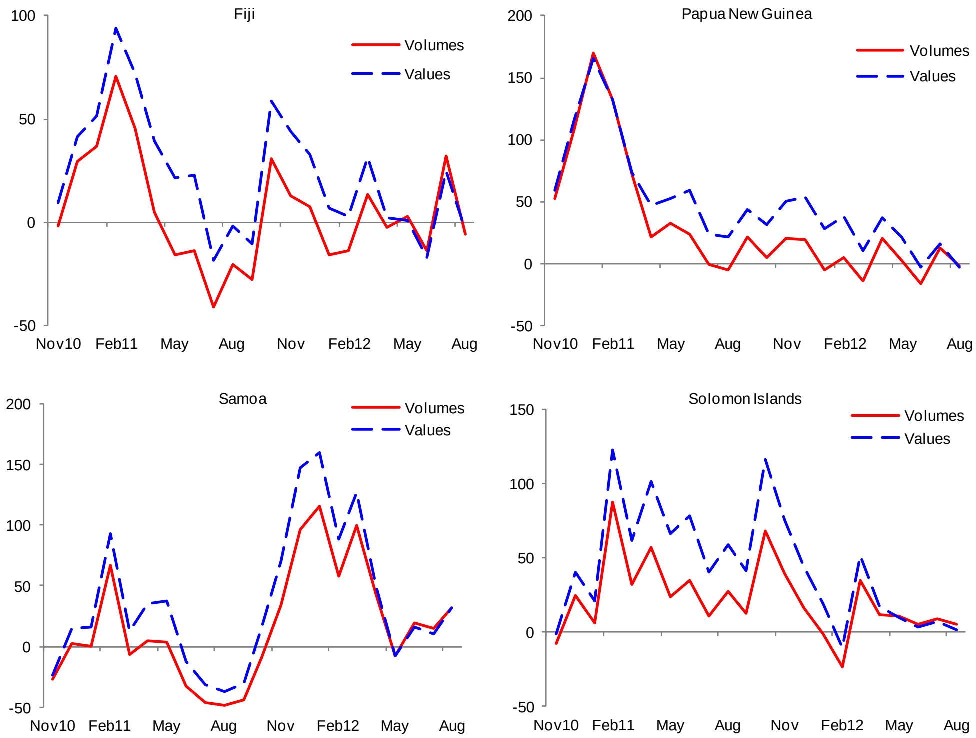
A$=Australian dollars, m.a.=moving average, y-o-y=year on year
Source: Australian Bureau of Statistics.

Nonfuel merchandise exports from New Zealand and the United States
(y-o-y % change, 3-month m.a.)

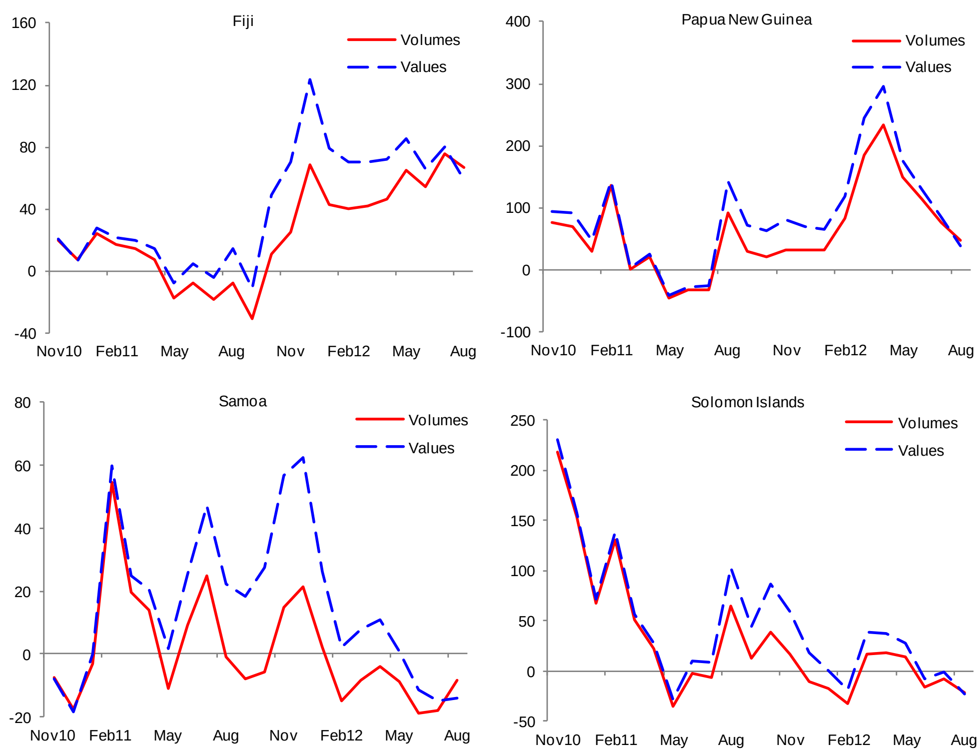


FSM=Federated States of Micronesia, fas=free alongside, fob=free on board, m.a.=moving average, NZ$=New Zealand dollar, RMI=Republic of the Marshall Islands, US=United States, y-o-y=year on year
Sources: Statistics New Zealand and US Census Bureau.

Diesel exports from Singapore
(y-o-y % change, 3-month m.a.)

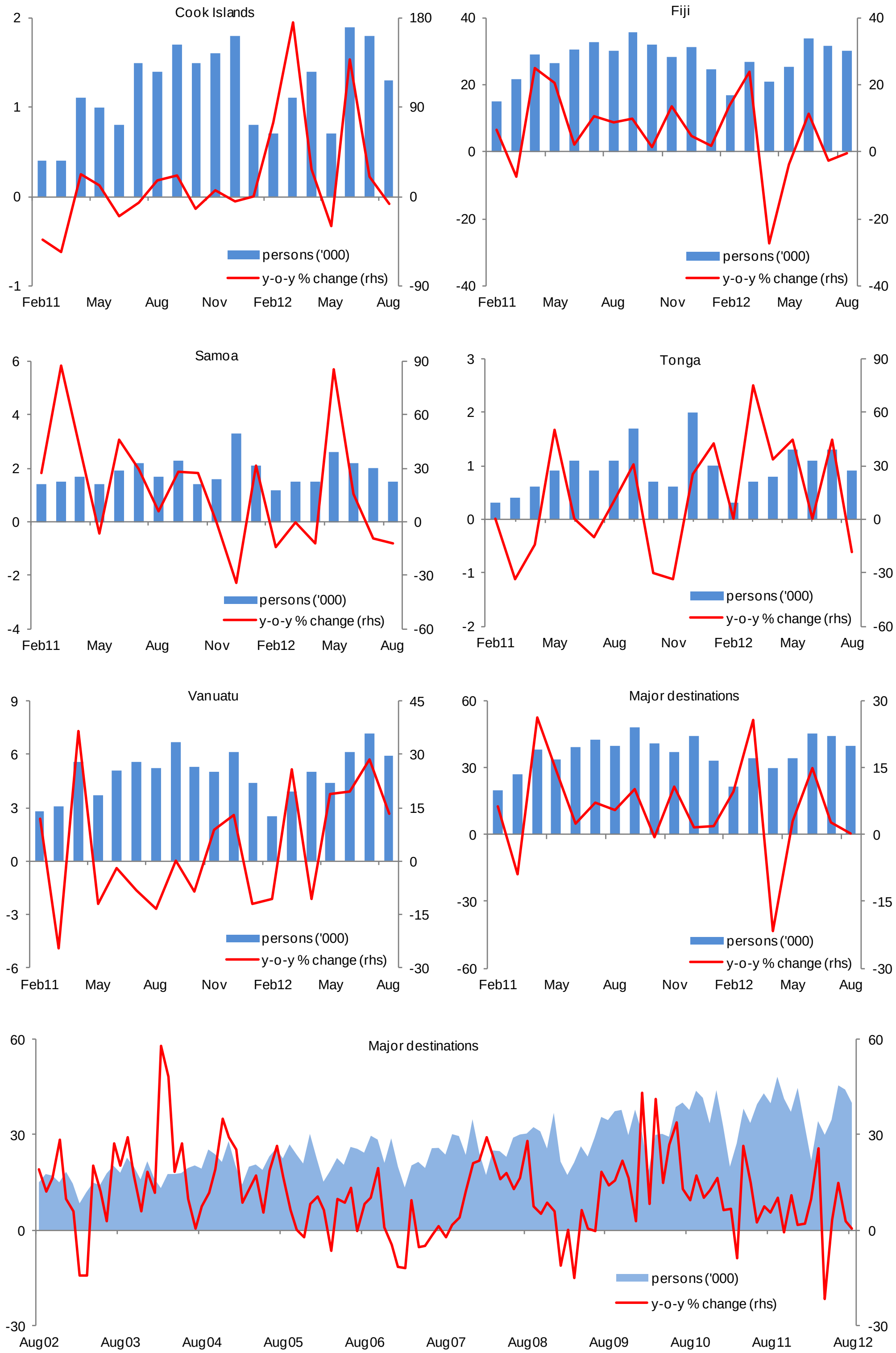


Gasoline exports from Singapore
(y-o-y % change, 3-month m.a.)



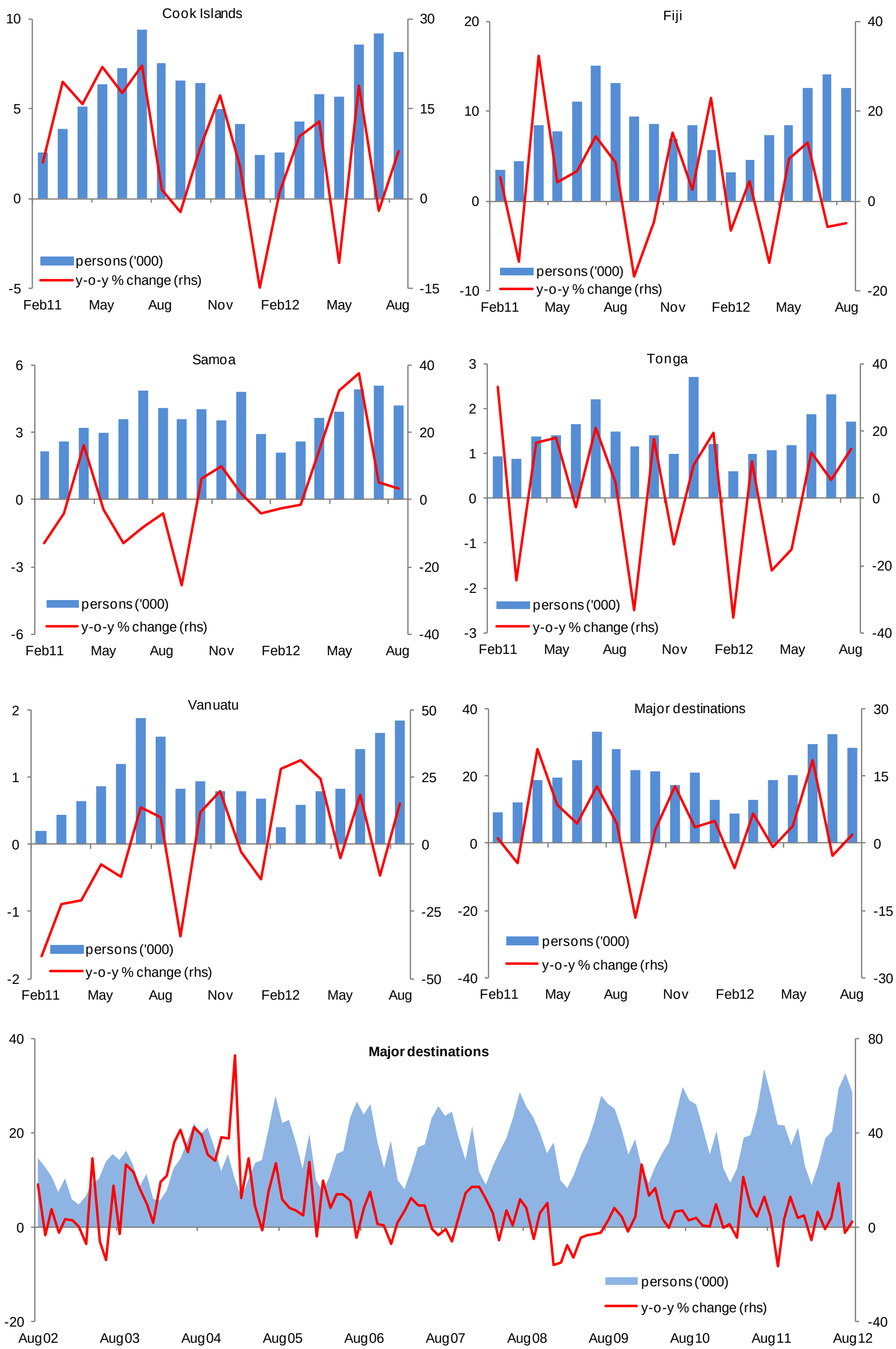
m.a.=moving average, y-o-y=year on year
Source: International Enterprise Singapore.

Departures from Australia to the Pacific (monthly)



rhs=right-hand scale, y-o-y=year on year
Source: Australian Bureau of Statistics.

Departures from New Zealand to the Pacific (monthly)



rhs=right-hand scale, y-o-y=year on year
Source: Statistics New Zealand.

Latest Economic Updates

	GDP Growth	Inflation	Credit Growth[a]	Trade Balance	Import Cover	Fiscal Balance
	(%, 2012p)	(%)	(%)	(% of GDP)	(months)	(% of GDP)
Cook Islands	3.4 (FY2012e)	3.2 (Sep-Q 2012)	–6.5 (Mar-Q 2012)	–19.9 (Jul-Dec 2011)	—	–2.2 (FY2012e)
Fiji	1.3	3.7 (Sep 2012)	7.1 (Jun 2012)	–26.1 (2011e)	5.1 (Sep 2012)	–1.6 (2012p)
Kiribati	3.5	5.5 (2012p)	—	–48.0 (2010e)	—	–10.0 (2012p)
Marshall Islands	5.4	2.5 (FY2012p)	10.4 (FY2011e)	–42.4 (FY2011e)	—	1.4 (FY2011e)
FSM	1.0	3.5 (FY2012p)	–0.9 (FY2011e)	–41.4 (FY2011e)	—	0.4 (FY2011e)
Nauru	4.8	0.9 (Dec 2011)	—	—	—	0.6 (FY2011e)
Palau	4.0	7.9 (Mar-Q 2012)	—	–53.2 (FY2011e)	—	–2.3 (FY2011e)
PNG	7.5	1.4 (Jun-Q 2012)	8.5 (Jul 2012)	4.2 (Jan-Jun 2012)	10.7 (Jun-Q 2012)	–1.2 (2012p)
Samoa	1.0 (FY2012e)	5.5 (Sep 2012)	2.5 (Sep 2012)	–42.1 (Sep-Q 2012)	5.3 (Sep 2012)	–7.3 (FY2012e)
Solomon Islands	6.0	4.4 (Sep 2012)	8.6 (Jun 2012)	1.8 (Jan-Jun 2012)	9.4 (Sep 2012)	6.0 (2011e)
Timor-Leste[b]	10.0	11.4 (Sep 2012)	22.7 (Aug 2012)	–56.1 (2011e)	—	135.2 (2012p)
Tonga	1.3 (FY2012e)	-0.6 (Sep 2012)	–9.8 (Sep 2012)	–27.3 (FY2012e)	8.1 (Sep 2012)	3.0 (FY2012e)
Tuvalu	1.2	2.6 (2012p)	—	–19.5 (2011e)	6.7 (2011e)	10.0 (Jan-Sep 2012)
Vanuatu	3.0	1.1 (Sep-Q 2012)	9.1 (Aug 2012)	–21.9 (Jan-Sep 2012)	6.9 (Jun-Q 2012)	0.0 (Jan-Jun 2012)

— =not available, e=estimate, GDP=gross domestic product, FSM=Federated States of Micronesia, PNG=Papua New Guinea, p=projection, Q=quarter

[a] Credit growth refers to growth in total loans and advances to the private sector.

[b] Timor-Leste GDP is exclusive of the offshore petroleum industry and the contribution of the United Nations.

Notes: Period of latest data shown in parentheses; import cover for PNG is months of nonmining and oil imports.

Sources: ADB. 2012. *Asian Development Outlook 2012 Update*. Manila; and statistical releases of the region's central banks, finance ministries and treasuries, and statistical bureaus.

Key data sources:

Data used in the *Pacific Economic Monitor* are in the ADB PacMonitor database, which is available in spreadsheet form at www.adb.org/pacmonitor.

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