ADB Pacific Economic Monitor

July 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

- **Recent developments.** Over the first half of 2012, Pacific economies performed largely in line with projections made at the start of the year. Growth in the Pacific region is still expected to average around 6.0% in 2012 compared with 7.0% in 2011. Despite declines in international commodity prices, 2012 growth projections for the region's larger resource-based economies—Papua New Guinea (PNG) and Timor-Leste—are unchanged. This is because near-term growth in these economies is more heavily dependent on ongoing infrastructure projects.
- Economic performance in the smaller Pacific islands has been mixed, relative to projections. Growth in the Cook Islands and Samoa has fallen short of expectations as capital expenditures have been below budgeted levels. Continuing declines in seafarers' remittances in Tuvalu and slower-than-expected implementation of infrastructure projects in Vanuatu have also resulted in modest downgrades of 2012 growth projections for these countries. In contrast, Fiji is expected to grow at a higher rate than projected at the start of the year due to growth in the mining sector and increased development-partner funded projects (despite the impact of successive floods). Economic growth in Palau now appears likely to be higher than projected due to robust tourism performance early in the year. Overall, growth in the Pacific islands (i.e., the Pacific region excluding PNG and Timor-Leste) is now expected to average 2.2% in 2012.
- Inflation in the Pacific region in 2012 is now expected to ease to 6.3% primarily due to declining commodity prices. In PNG, a stronger currency is also driving inflation expectations lower.
- **Outlook.** The International Monetary Fund (IMF)'s latest assessment reflects a more somber outlook for global economic growth. Lingering sovereign debt and banking sector concerns in Europe continue to weigh down the global economy. In response to the weakening growth outlook and the absence of clear directions on the fiscal front, monetary authorities in a few leading global economies are adopting (or continuing) accommodative policies in efforts to stimulate growth.
- The Pacific is expected to experience largely indirect impacts from slowing global growth. While regional growth is projected to moderate to about 4.2% in 2013, this is mostly driven by scheduled infrastructure developments in the region's larger economies rather than fallout from slower global growth. The relatively robust outlook for the Pacific would be affected if the Eurozone crisis deteriorates and adverse impacts on the People's Republic of China's (PRC) growth worsen. This is because PRC is a key export market for Australia, and Australian growth, in turn, is a primary driver of economic growth in most Pacific countries.
- **Economic policy and management.** The theme of the policy analysis section of this issue of the *Monitor* is private sector development in the Pacific. Three articles explore different aspects of current efforts to promote private sector development in the region. One article outlines the challenges to state-owned enterprise (SOE) reform and considers how Kiribati is working to transfer SOEs into private ownership. Two other articles from authors associated with ADB's Private Sector Development Initiative (with significant cofinancing from AusAID), examine the benefits of secured transactions reforms in improving borrowers' access to credit, and measures to enhance the roles women can play in inclusive private sector-led economic development in the Pacific.

Printed in the Philippines.
ISBN 978-92-9092-774-7 (Print),
978-92-9092-775-4 (PDF)
Publication Stock No: RPS124849-2

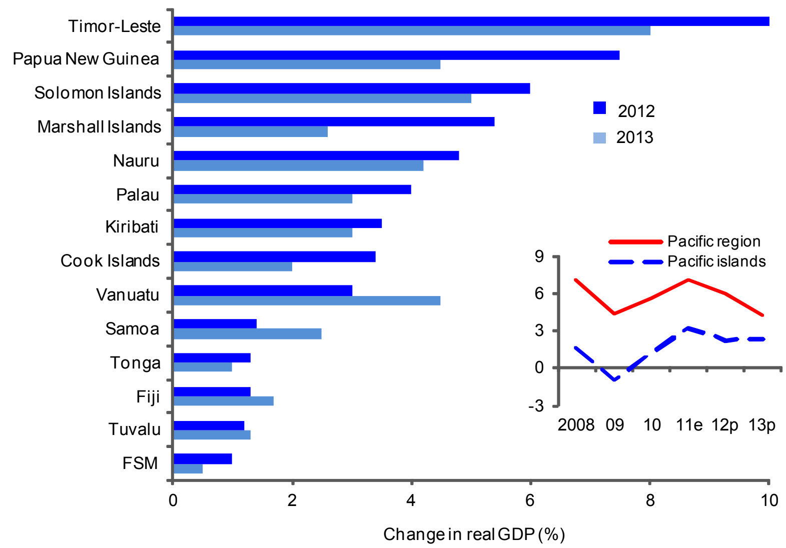
Cataloging-In-Publication Data
Asian Development Bank.
Pacific Economic Monitor, July 2012.
Mandaluyong City, Philippines: Asian Development Bank, 2012.

This edition of the *Monitor* was prepared by Aaron Batten, Robert Boumphrey, Caroline Currie, Christopher Edmonds, Joel Hernandez, Jolly La Rosa, Malie Lototele, Milovan Lucich, Rommel Rabanal, Craig Sugden, Cara Tinio, Laisiasa Tora, and Emma Veve of the Pacific Department. Desktop publishing assistance was provided by Cecil Caparas.

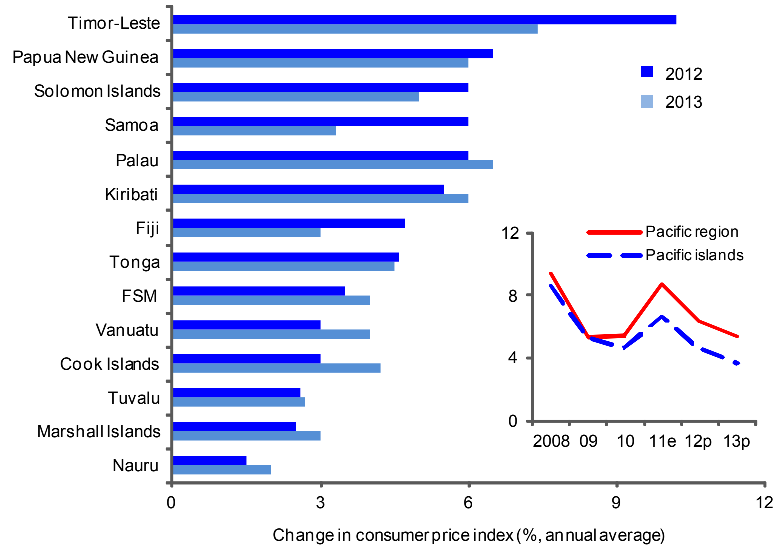
Abbreviations

$	US dollar, unless otherwise stated
ADB	Asian Development Bank
A$	Australian dollar
ABS	Australian Bureau of Statistics
e	estimate
F$	Fiji dollar
fas	free alongside
fob	free on board
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
KSCL	Kiribati Supply Company Ltd.
lhs	left-hand scale
LNG	liquefied natural gas
m.a.	moving average
MTFS	Medium Term Fiscal Strategy
NZ$	New Zealand dollar
p	projection
PNG	Papua New Guinea
r	revised
rhs	right-hand scale
SOE	state-owned enterprise
RMI	Republic of the Marshall Islands
US	United States
VAT	value-added tax
y-o-y	year-on-year

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

Slow economic recovery continues amid uncertainty

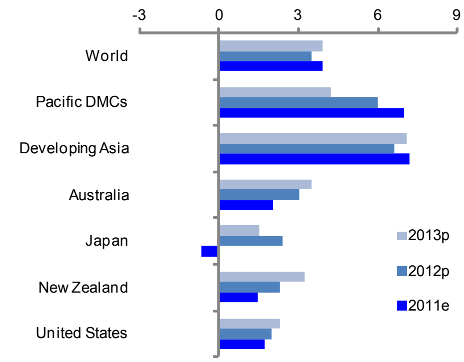
- World economic growth is expected to slow from 3.9% in 2011 to 3.5% in 2012, weighed down by poor growth prospects in the Eurozone driven by continuing fiscal consolidation and bank deleveraging, according to the IMF (*World Economic Outlook Update*, July 2012). However, several developed economies outside Europe, including Australia, Japan, New Zealand, and the United States (US), expect stronger growth this year. Recovery from natural disasters that adversely affected 2011 growth in most of these economies accounts for the upturns. Despite the continued slow recovery of the US economy, it is expected to expand by 2.1% in 2012 (up from 1.7% in 2011). ADB projects modestly lower growth for the Asia and Pacific region overall, with growth falling from 7.2% in 2011 to 6.6% in 2012.

- The economies of Germany, Japan, and the US expanded in the first quarter of 2012 despite heightened global financial instability. The US economy grew 1.9% (y-o-y) in the first quarter due to higher consumer spending and exports. Job creation slowed in May and unemployment stood at 8.2%. Japan's economy expanded by 4.9% (y-o-y) in the first quarter with robust recovery in public investment and exports following the March 2011 tsunami, and the stimulatory impact of a subsidy (approximately $3.8 billion) to encourage the purchase of more environment-friendly cars. Driven by strong export growth, Germany grew by 1.2% (y-o-y) in the first quarter and may have kept the Eurozone economy from slipping into recession. Italy, Portugal, and Spain (which together account for about 30% of Eurozone GDP) and the United Kingdom are all back in recession as of the first quarter of 2012.

- Uncertainty associated with European sovereign debt problems is expected to continue to weigh down global economic growth, particularly in economies with strong trade and financial linkages with the Eurozone, such as the People's Republic of China (PRC), Japan, and the US. The PRC's GDP growth in the second quarter of 2012 was at 7.6% (y-o-y), its lowest rate of growth since the first quarter of 2009. Slower growth in the PRC, in turn, is expected to reduce growth in the Australian economy–which is highly dependent on Chinese demand for its commodity exports. Japan's recovery could also be hampered by the soft performance of its stock market, a strong yen, and the end of the eco-car subsidy in August.

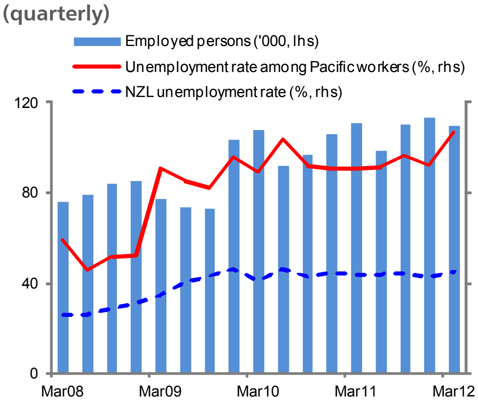
- In response to dimming growth prospects, a number of central banks are undertaking measures to stimulate the economy. The US Federal Reserve extended its program of purchasing long-term bonds using proceeds from the sale of short-term bonds until the end of 2012. The People's Bank of China cut its benchmark deposit and lending rates in June and again in July, while the Reserve Bank of Australia slashed its key policy rate by 50 basis points in May and another 25 basis points in June to 3.5%, in efforts to stimulate growth. The unemployment rate in Australia stood at 5.2% in June. Five consecutive quarters of economic growth in New Zealand have failed to significantly lower the unemployment rate in the country, which remained high at 6.7% by the end of the first quarter of 2012. Unemployment among Pacific workers in New Zealand was posted at a record high of 16.0% in the same period.

GDP growth (%, annual)



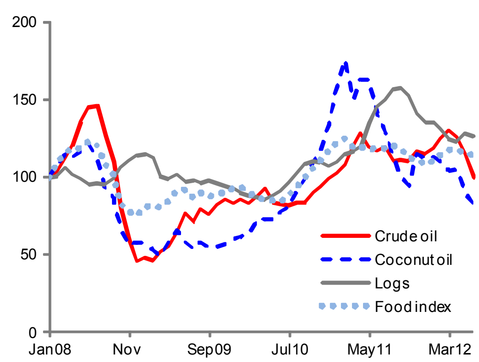
DMC=developing member country, e=estimate, p=projection
Sources: IMF.2012. World Economic Outlook (April and July); and ADB. 2012. Asian Development Outlook Supplement.

Employment of Pacific workers in New Zealand (quarterly)



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

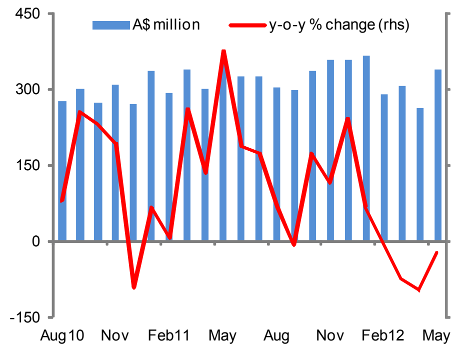
Commodity prices (Index: January 2008=100)



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

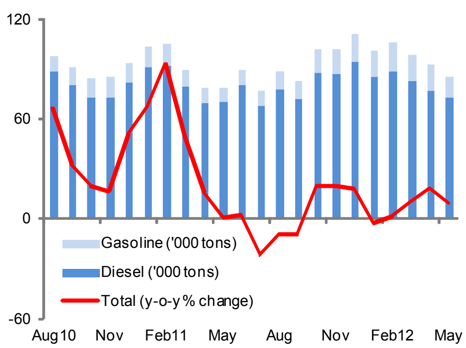
International and regional developments

Pacific exports to Australia (3-month m.a.)



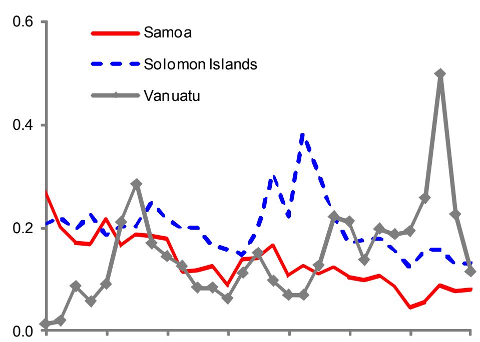
Source: Australian Bureau of Statistics (ABS).

Pacific fuel imports from Singapore (3-month m.a.)



Source: International Enterprise Singapore.

Trade costs indicator (annual)



Note: Trade costs are defined as the difference between c.i.f. (cost, insurance, and freight) and f.o.b. (free on board) valuations, as a proportion of f.o.b. values, of imports from a particular economy.
Source: ADB estimates using data from Statistics New Zealand.

- Uncertain global economic conditions have led to some volatility in international commodity prices. The price of crude oil has fallen in recent months, due to both economic (slow global economic recovery) and political (Iran's decision to negotiate regarding its nuclear program, which eased concerns about supply disruptions) factors. However, crude prices are still 2.6% higher in January–June 2012 (y-o-y). In contrast, food prices over the first half of 2012 are 4.6% lower than they were in the same period last year.

Pacific trade performance tracks global trade trends

- The value of exports to Australia of the 14 ADB developing member countries in the Pacific were 6.1% lower in the first 5 months of 2012 than the same period in 2011, reflecting lower international commodity prices. Papua New Guinea (PNG)'s exports to Australia dropped by 10.0% due to the declines in export earnings from PNG's main products (gold, mineral fuels, petroleum, and petroleum products). PNG accounted for 90.8% of Pacific exports to Australia in the first quarter of 2012.
- In contrast, the value of exports to New Zealand in the first quarter of 2012 rose by 22.2% compared with the same period in 2011, consistent with the country's economic recovery from the Christchurch earthquakes of 2011. Sharp upturns in exports from Nauru (phosphate) and PNG (coffee and food products) helped offset the 6.8% decrease in Fiji's exports (mainly garments) to New Zealand. However, Fiji remained the leading Pacific exporter to New Zealand, accounting for 50.6% of the region's total exports during the period.
- On the imports side, the volume of fuel imports from Singapore in January–May 2012 increased by 6.0% versus the same period in 2011, with a 59.6% increase in the importation of gasoline. Diesel imports declined slightly (by 0.3%), but still accounted for 84.2% of total fuel imports from Singapore. Over the same period, nonfuel merchandise imports from Australia increased by 21.4%, while those from New Zealand fell by 22.1%.

Modest growth in tourism to the Pacific

- After reaching record highs in several Pacific countries in 2011, tourist arrivals in the Pacific have maintained modest growth during the first 5 months of 2012. Departures from Australia to major South Pacific destinations increased by 1.4% compared with the same period last year. The reintroduction of a regular Sydney–Rarotonga flight resulted in a significant surge in Australian tourist numbers (up by 27%) to the Cook Islands. Tonga also recorded a sharp rise (over 40%) in tourist arrivals, which appears at least partly due to its intensified marketing efforts. Fiji saw a 1.1% decline, largely due to the heavy floods experienced in January and late March.
- New Zealand tourism to the Pacific grew by 2.0% in the first 5 months of 2012 (y-o-y). The growth in tourist numbers was mostly directed toward Samoa (up by 8.7%), Vanuatu (7.0%), and Fiji (2.0%). However, this growth appeared to come at the expense of the other Pacific destinations. Departures from New Zealand to the Cook Islands was roughly flat (falling by 0.1%), while those to Tonga declined by 9.6%.

International and regional developments

Challenging environments for private sector growth remain a concern in the Pacific

- Pacific economies generally rank poorly in international comparisons of business environments. PNG, the Pacific region's largest economy, ranks 101st out of 183 in the World Bank's Doing Business 2012 survey. The nine other Pacific economies covered rank no higher than 58th and the average ranking for Pacific countries was about 92.

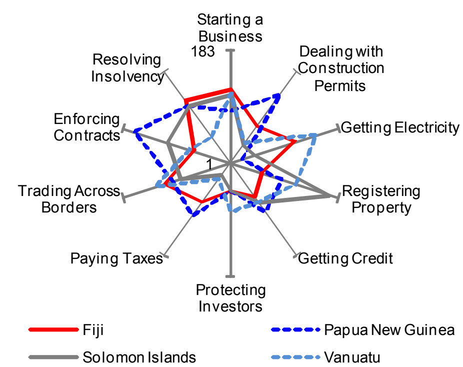
- The smaller, more remote economies making up the Micronesia subregion typically received the lowest Doing Business rankings among Pacific countries, with difficulty obtaining credit cited as the most common problem. Melanesian economies rank higher, as their larger economic bases can serve as adequate platforms for business activity in sectors such as agriculture and mineral production. However, costs of starting a business remain high in Fiji, and contract enforcement issues persist in PNG. ADB-supported reforms (e.g., the Companies Act, online business registry) helped improve the Solomon Islands' ranking. Although Polynesian economies face a mix of the challenges seen in Micronesia (small domestic markets) and in Melanesia (land issues), the Doing Business 2012 survey gave Samoa and Tonga the highest rankings in the Pacific. This highlights the importance of reforms in stimulating private sector development, such as Samoa's reform program (trade and financial sector liberalization, state-owned enterprise reform).

- Given limited domestic demand, competitiveness in external markets is particularly important for businesses in Pacific economies to be viable. While the region's remoteness is a challenge, reforms to reduce external trade costs (i.e., freight costs, tariffs, fees, and procedures) have proven to be effective in enhancing the business environment. Initial ADB analysis of New Zealand trade data with the Pacific shows that trade costs—measured by the divergence between the c.i.f. (cost, insurance, and freight) and f.o.b. (free on board) values of imports, have generally been declining in Samoa, Solomon Islands, and more recently, Vanuatu. These economies also received three of the four highest Doing Business ratings in the Pacific. In addition to lower trading costs, market-determined exchange rates and freely convertible currencies are also essential in facilitating external trade and boosting overall business activity.

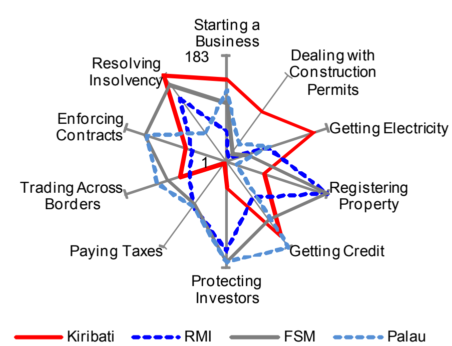
- Pacific economies seeking to improve their business environments may find a model in Mauritius, an Indian Ocean island economy comprising four islands with a population of 1.3 million, about 2,000 kilometers off the coast of the African continent. Mauritius achieved the highest Doing Business 2012 ranking among small island states (23rd out of 183). The government has embarked on an economic reform program aimed at moving Mauritius from dependence on trade preferences to global competitiveness. This has made it easier to start and operate businesses. The foremost of these reforms was the Business Facilitation Act (2006), which removed labor and investment restrictions and lowered costs for export and import businesses. More recently, Mauritius has commenced a comprehensive tax reform program, aimed at unifying and simplifying the Mauritian tax regime and will see removal of investment incentives and export processing zone incentives.

Doing Business 2012 rankings (1=best, 183=worst)

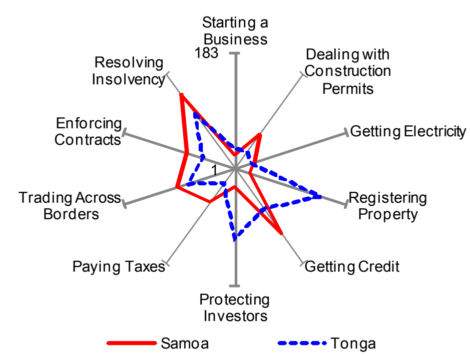
Melanesia



Micronesia



Polynesia



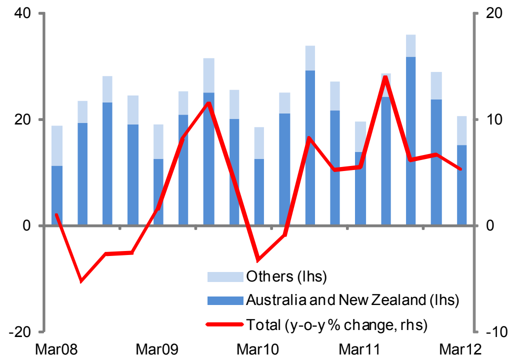
RMI=Republic of Marshall Islands, FSM=Federated States of Micronesia
Sources: World Bank Doing Business database.

Methodological note: World Bank's Doing Business 2012 survey ranks economies from 1 to 183 (1 being the highest). Overall rankings are calculated as the simple average of economies' percentile rankings on each of the 10 categories included in the survey: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency.

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

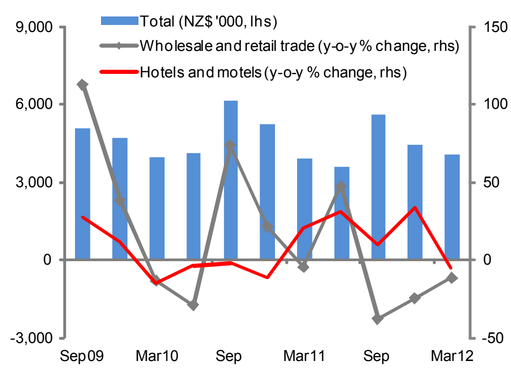
Cook Islands

Visitor arrivals ('000, quarterly)



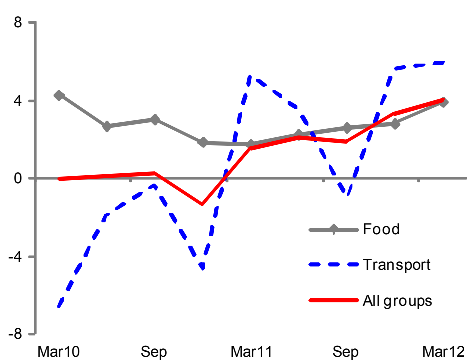
lhs=left-hand scale, rhs=right-hand scale
Source: Cook Islands Statistics Office.

Net value-added tax revenue (quarterly)



lhs=left-hand scale, rhs=right-hand scale
Source: Cook Islands Statistics Office.

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



Source: Cook Islands Statistics Office.

Lead author: Malie Lototele.

Recent developments

- Economic growth in FY2012 (ended 30 June) is now estimated at 3.4%. ADB's downward revision largely reflects lower than projected public capital expenditures, and lower value-added tax (VAT) and income tax collections attributed to lower tourism spending. Nevertheless, the revised growth figure is nearly a percentage point higher than the growth in FY2011.
- Tourist arrivals increased by 6.2% during the first 10 months of FY2012, compared with the same period in FY2011. In addition to strong arrivals from New Zealand, an increased number of Sydney–Rarotonga flights, supported by public subsidies, aided tourist arrivals from Australia.
- Net VAT collections through the third quarter of FY2012 were 7.7% lower than in the same period of FY2011. The bulk of the decline was due to a 26.0% fall in collections from wholesale and retail trade. Collections from hotels and motels grew by 11.7%, suggesting limited pass-through of tourism spending into the broader economy.
- Inflation is a rising concern, with the rate of inflation increasing to 4.0% in the third quarter of FY2012 compared with the same quarter of FY2011. Price increases have been predominantly driven by lagged effects of higher fuel prices late last year.
- Exports contracted by 40.9% in the first half of FY2012 (y-o-y) mainly due to a 34.6% fall in fresh fish exports. Imports fell more slowly (11.4%). The net change in trade flows reduced the trade deficit to $37.8 million (13% of GDP) in the first half of FY2012, compared with $47.2 million in the first half of FY2011.

Outlook

- Growth is expected to slow to 2.0% in FY2013 (a downward revision from the initial projection of 3.4%), reflecting slower growth in tourist receipts. Tourism accounts for about 65.0% of the economy. Inflation for FY2013 is projected at 4.2%.

Key issues

- Public sector salaries took up 43.2% of total government revenue in FY2012 and the FY2013 budget continues to breach the target. Meeting this government target of 40% will require continued implementation of reforms recommended in the 2011 review report of the Public Finance Management and Public Sector Performance technical assistance project.
- A supplemental budget allocation of $3.6 million brought the total subsidy for Air New Zealand's Los Angeles and Sydney flights to $9.9 million in FY2012. This subsidy is projected to increase to $10.7 million in FY2013, or about 9.0% of total government revenues, and reduce resources available for essential government services.
- Private sector activity remains subdued as bank lending continues to be constrained. Net domestic credit was 13.9% lower in the first half of FY2012 (y-o-y), and the total value of loans to businesses and personal services has declined during the past 7 quarters. Business lending has been concentrated on personal services and hotels and motels, which may reflect limited investment opportunities in other sectors.

Fiji

Recent developments

- The Government of Fiji has revised its growth estimate for 2012 upwards to 2.7% (from the 2.3% growth announced in the 2012 national budget). Although floods in early 2012 had a severe impact, particularly on the agricultural sector, the government considers that this will be more than offset by growth in other sectors. In particular, developments in the manufacturing, forestry, and resource extraction sectors (e.g., the commencement of bauxite mining in Nawailevu) are expected to spur growth this year. Tourist arrivals are also expected to record growth of 3.5% this year. Reconstruction and government rehabilitation activities following the floods should also contribute to growth.

- Investment Fiji (a government agency formed in 1980 to promote investment in the country) received a total of 51 investment proposals with a total value equivalent to $121 million in the first 4 months of 2012. This compares with 42 proposals received over the same period in 2011. The government is predicting an increase of 7.5% (or 206 projects valued at $400 million) in the number of projects under implementation in 2012 compared with 2011. The upturn in investment is attributed to a range of government actions, including the development of tax-free regions; incentives offered in the hotel, audiovisual, agriculture, manufacturing, and information and communications technology industries; and a cut in the corporate tax rate from 28% to 20%.

- Banks remain cautious about lending despite excess liquidity. The entry of Bred Bank (Fiji) Limited, a subsidiary of one of the largest banking groups in France, brings the number of commercial banks licensed to operate in Fiji to five and bodes well for greater competition. Bred Bank received its banking license in May and expects to start operations in September.

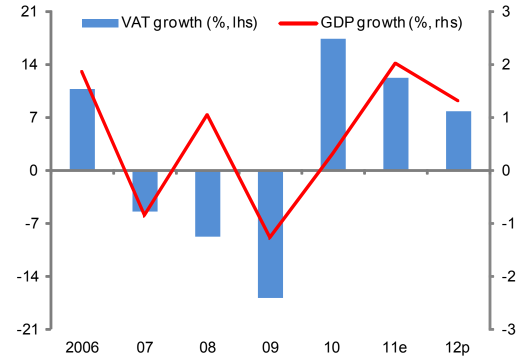
- Inflation fell to 4.5% in June 2012, down from 5.6% in March. Higher food prices (particularly locally produced fruits and vegetables) followed the floods in January and late March. With declining commodity prices and tightly controlled public wages, prices are expected to moderate further over the remainder of the year with the Reserve Bank of Fiji forecasting that inflation will fall to 3.5% by December 2012.

- The new Fiji National Provident Fund (FNPF) Act took effect in March. The act introduced reforms to encourage the long-term sustainability of the national pension fund. A new age-based pension rate was implemented in March 2012, and the Reserve Bank of Fiji recently approved the fund's investment in offshore assets, which will allow the fund to diversify its portfolio.

Outlook

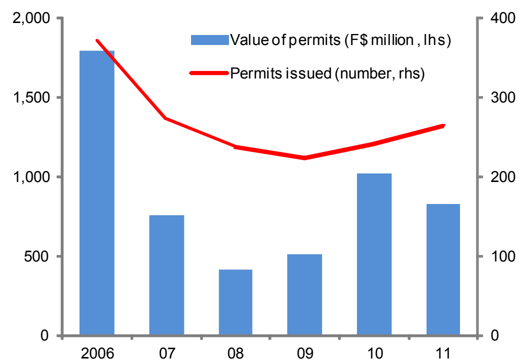
- ADB expects the Fiji economy to grow more modestly than the government forecast, with a growth rate of 1.3% for 2012, rising to 1.7% for 2013 (based on growth in the mining sector and development partner-funded projects). The factors that underpin ADB's less optimistic forecast include the continuing volatility in the Eurozone combined with slower growth in the PRC, both of which could impact on Fiji's major trading

VAT revenue and GDP growth (%, annual)



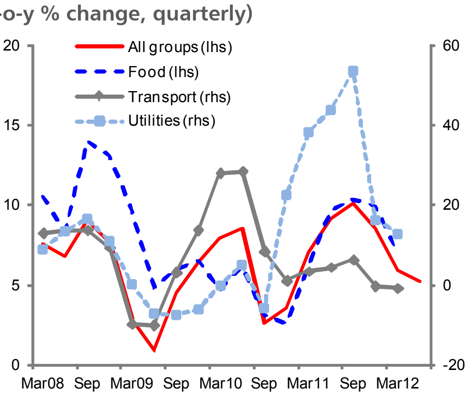
e=estimate, lhs=left-hand scale, GDP=gross domestic product, p=projection, rhs=right-hand scale, VAT=value added tax
Note: VAT revenues are expressed in 2005 prices.
Sources: Reserve Bank of Fiji, Ministry of Finance, and ADB estimates.

Building and construction (annual)



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

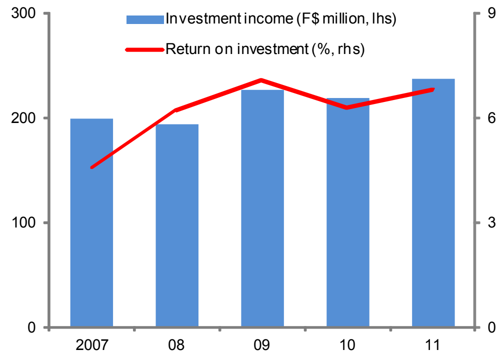
Consumer price index, by commodity group (y-o-y % change, quarterly)



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

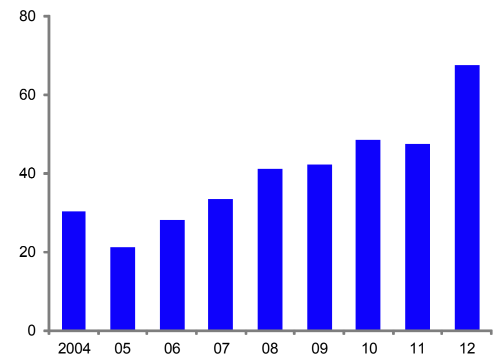
Fiji

Fiji National Provident Fund financial indicators (annual)



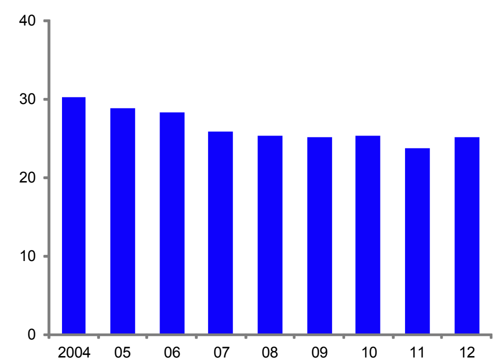
F$=Fiji dollar, lhs=left-hand scale, rhs=right-hand scale
Source: Fiji National Provident Fund.

Coverage of credit information (% of adults, annual)



Note: This measures the number of individuals and firms listed with the largest private credit bureau in Fiji.
Source: World Bank Doing Business database.

Cost of starting a business (% of income per capita, annual)



Source: World Bank Doing Business database.

Lead author: Caroline Currie.

partners; the current extent of government debt, which could constrain development expenditure; and business confidence, which is unlikely to be significantly restored until progress is made on political reform. The drafting of a new constitution this year and the holding of national elections in 2014 will be crucial in terms of improving the current economic situation.

- The government forecasts a fiscal deficit of 1.9% of GDP in 2012, down from 3.5% in 2011. The improved budget estimates are based on relatively optimistic expectations of increased revenue arising from higher VAT receipts (as the reduction in pay-as-you-earn feeds through to consumption) and forecasts of higher economic growth. Nevertheless, Fiji faces considerable short- to medium-term challenges to fiscal sustainability, particularly in light of accumulating government debt, which in 2012 is estimated to be the equivalent of 52% of GDP. Reducing debt levels will be challenging. It will leave little room to deal with future external shocks.
- There are indications that the government is progressing toward restoring democracy. Budget allocations have been made to prepare for the 2014 election through financing electoral boundary reform and an electronic voter registration system. The 2012 budget includes provisions to finance public consultations on a new constitution.

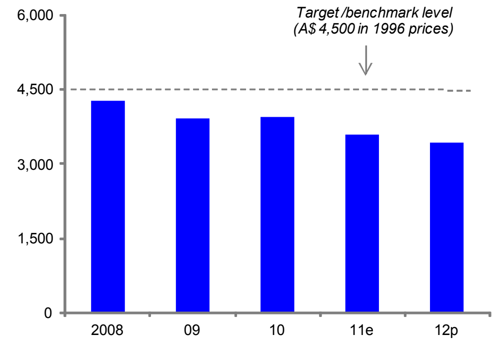
Key issues

- Private sector growth in general, and foreign investment into the Fiji economy in particular, has lagged in recent years due to challenging business and political environments.
- The World Bank's Doing Business survey shows that in 2012, Fiji ranked 77th out of 183 economies, down from 72nd in 2011, and suggests that its business environment has deteriorated. Fiji ranks particularly low in measures related to starting a business, paying taxes, dealing with construction, and trading across borders. Although once ranked as having the best business environment in the South Pacific, Fiji has now moved to behind Tonga and is at about the same level as Samoa. A combination of high entry and operating costs discourages new business start-ups and raises the costs of existing businesses. The country has made progress in improving the business environment through more efficient customs operations and reduced corporate income tax. However, new procedures in setting up a business and in getting construction permits made it less business-friendly.

Kiribati

- Kiribati is expected to grow by 3.5% in 2012, compared with 3.0% in 2011, due to partner-financed projects including major airport and seaport reconstruction and road works. Growth is projected to slow to 3.0% in 2013 as construction activity eases.
- A fiscal deficit of 18.1% of GDP is projected for 2012 due to greater infrastructure spending. To finance the deficit, the budget provides for a A$22.5 million drawdown from the Revenue Equalization Reserve Fund (RERF), higher than the government ceiling of A$15 million a year from 2013–2015. The inflation-adjusted value of the RERF is seen to fall to A$3,500 per capita, below the A$4,500 benchmark. To meet this benchmark, the deficit must be reduced to 3%–5% of GDP beyond 2015.
- The sale of Kiribati Supply Company Limited, a state-owned enterprise (SOE), to a local firm in 2011 demonstrates the benefit of private sector activity. The company has expanded the range of goods offered, thereby increasing competition and lowering prices. Work to privatize two additional SOEs has commenced.
- Nonetheless, the environment in which private businesses operate in Kiribati continues to be challenging. In the World Bank's 2012 Doing Business survey, Kiribati ranked poorly in terms of getting electricity and credit (both 159th out of 183 countries) and starting a business (141st). These low rankings reflect infrastructure, banking, and regulatory inefficiencies.

Revenue Equalization Reserve Fund closing balance (real A$ per capita, annual)



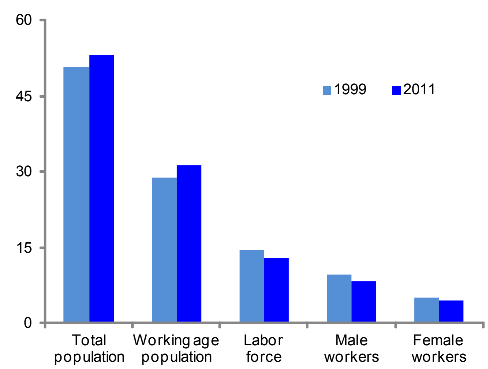
A$=Australian dollar, e=estimate, p=projection
Source: ADB estimates using data from Kiribati 2012 national budget.

Lead author: Malie Lototele.

Marshall Islands

- Growth in the Republic of the Marshall Islands (RMI) is still estimated at 5.4% in FY2012 (ends 30 September). This reflects continued construction activity related to the Amata Kabua International Airport upgrade. In FY2013, growth is expected to slow to 2.6% as the airport upgrade is completed. Inflation was 9.5% in FY2011, but is expected to moderate to 2.5% and 3.0% in FY2012 and FY2013, respectively, due to falling global food and fuel prices.
- Imports from the US declined by $54.6 million (64.9%), in the first seven months of FY2012 compared to the same period in FY2011—imports in FY2011 were inflated due to sizable one-time purchases of machinery, transport equipment, and other inputs to the fisheries sector and the ongoing airport upgrade.
- The Summary Report of the RMI 2011 Census of Population and Housing, released in February 2012, shows that population has grown by only 0.4% a year since 1999. Out-migration caused a significant slowdown from the 3.8% annual growth recorded in 1958–1988. The working-age population grew slightly faster, at 0.7% a year in 1999–2011, but the actual labor force shrank due to retirement, disability, and focus on housekeeping activities, among others. Further, the proportion of Marshallese youth (ages 15-24) enrolled in school fell by 12.4% compared with 1999.
- These developments pose a challenge to promote private sector activity and generate domestic economic opportunities. Corresponding efforts must be made to develop workers and entrepreneurs' ability to capitalize on such opportunities, and make sustainable contributions to the economy.

Labor force participation, 1999 and 2011 (thousands of people)

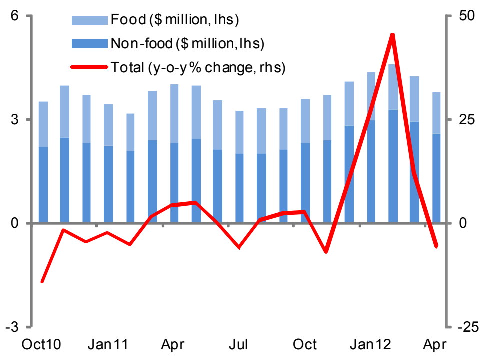


Note: Working age is defined as 15 years and older.
Source: RMI 2011 Census of Population and Housing summary report.

Lead author: Cara Tinio.

Micronesia, Federated States of

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



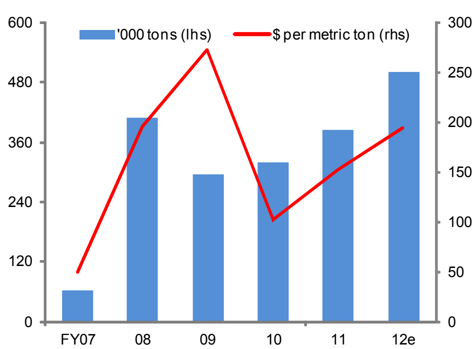
lhs=left-hand scale, rhs=right-hand scale
Source: US Census Bureau.

Lead author: Rommel Rabanal.

- Growth is expected to decline from 1.4% in FY2011 (ends 30 September) to 1.0% in FY2012 and 0.5% for FY2013 as major construction projects are completed. Inflation was 7.5% in FY2011, but is expected to moderate to 3.5% in FY2012 and 4.0% in FY2013 due to falling global food and fuel prices.
- Following 2 years of contraction, the value of the FSM's imports from the US, its primary trading partner (accounting for about 40% of total imports), were about 7% higher in the first 7 months of FY2012 (y-o-y). Purchases of machinery, transport equipment, and manufactured goods associated with ongoing public construction projects drove the recent surge in imports.
- The International Monetary Fund (IMF) estimates that the private sector's share of GDP has remained at 25% over the past 2 decades. The outlook for economic growth therefore remains heavily dependent on public sector construction activities.
- Deficits in infrastructure and skilled labor, along with restrictive investment regulations, are binding constraints to private sector development. Even with sufficient bank liquidity, credit flows are narrow (i.e., loan-deposit ratio of 36% as of FY2010), partly because productive private investment opportunities are limited. The cost of starting a business in the FSM remains high at over 140% of average income per person, compared with Kiribati (22%) and the RMI (18%), according to the World Bank's Doing Business 2012 survey. Reducing business registration, licensing, and other fees will help expand private sector opportunities.

Nauru

Price and volume of phosphate exports (annual)



$=US dollar, lhs=left-hand scale, rhs=right-hand scale
Sources: Republic of Nauru Phosphate Company, Nauru Bureau of Statistics, and World Bank Commodity Price Data (Pink Sheets).

Lead author: Milovan Lucich.

- Phosphate exports grew strongly in FY2012 (ended 30 June) and are expected to have exceeded 500,000 tons for the first time since Nauru recommenced significant phosphate production in FY2007. Maintaining effective management of the phosphate export and mining SOEs, namely RONPHOS and the Nauru Rehabilitation Corporation, will be the key to continuing this strong performance.
- In late 2011, inflation began to pick up following a long period of deflation in the country, and between December 2010 and December 2011, the consumer price index increased by 0.9%.
- On 11 June 2012, Nauru's executive government was changed for the fourth time in the past year, when the President dismissed the previous Cabinet and replaced it with members of the then-opposition. Political instability represents a major issue for maintaining reforms and fostering good governance in a microstate such as Nauru. Frequent changes may lead to key personnel leaving and delays in delivering government services.
- The government is seeking to reduce political instability and improve governance in the country. Parliament recently debated constitutional reforms including an increase in the number of members of Parliament (MPs) from 18 to 19, selection of the speaker from outside Parliament, introduction of a code of ethics for Parliament members, establishment of an ombudsman commission, and strengthening of the Audit Department.

Palau

Recent developments

- The tourism sector maintained its strong performance, with visitor arrivals increasing by 22.6% over the first 7 months of FY2012 (ends 30 September) compared with the same period in FY2011. This is about the same rate of growth recorded during the previous fiscal year, when arrivals reached a record high. Growth continues to be driven by arrivals from Japan and Taipei,China and a recent resurgence of tourists from the Republic of Korea. Strong growth in arrivals is expected to translate into improved prospects for the rest of the economy.
- A sharp rise of over 37% in the value of imports from the US was also recorded in the first 7 months of FY2012 (y-o-y). Such an increase is attributable to increased domestic demand, boosted by tourist spending.
- Prices in Palau have been increasing at a faster pace than earlier estimated. In the first quarter of FY2012, inflation reached 8.7% (y-o-y), a sharp spike from the 2.6% average rate experienced in FY2011. Inflation moderated to 7.9% in the second quarter, but food and transportation costs are still increasing at around double-digit rates. Domestic inflation is at about the same rate as imported inflation, indicative of local price pressures from rising demand and possible supply bottlenecks, particularly in tourism-related sectors.

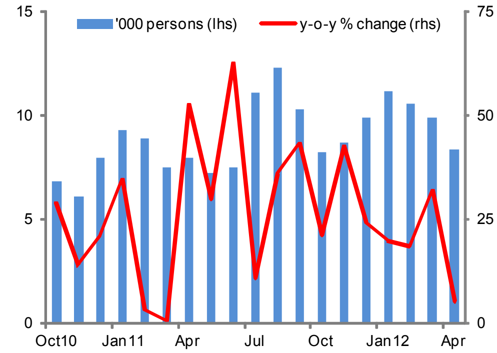
Outlook

- Given the performance of tourism and its relative importance in the economy, ADB now projects GDP growth of 4.0% for FY2012. The introduction of a regular Taipei,China–Palau airline route in May 2012 further enhances tourism prospects, although the global economic uncertainty could potentially dampen growth in tourism. GDP growth is projected to moderate to 3.0% in FY2013 (revised upward from the previous projection of 2.0%), with capacity constraints in tourism facilities and infrastructure seen to limit growth in tourist arrivals.
- Projected inflation for FY2012 is now estimated at 6.0%. Inflation in the second half is expected to be lower than in the first half. Inflation is then seen to rise to 6.5% in FY2013 with a projected increase in international food prices.

Key issues

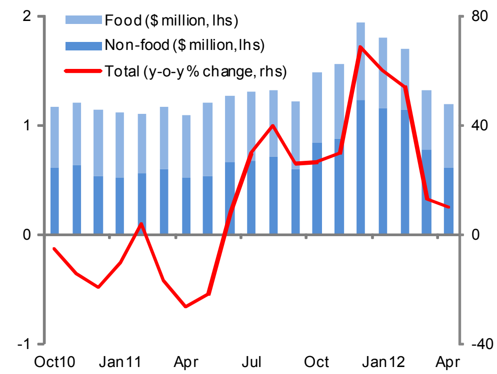
- Sustaining the tourism sector's recent momentum will require a concerted effort from both the public and private sectors. Public investment in infrastructure and services delivery, including sanitation sector improvements, is necessary to help create a more conducive business climate. Facilitating planning approvals for appropriate tourism sector investment is needed to minimize the inherent delays between the existing capacity constraints and the time taken to develop new tourism infrastructure.
- In May 2012, Palau introduced the Secured Transactions Act, a new law aimed at improving access to credit, particularly for businesses. The act specifies clear rules for lending; allows the use of movable assets such as vehicles and farm equipment as collateral; and effectively reduces the transaction costs of borrowing. This will help mitigate high credit risks, which have caused banks to invest most of their assets overseas instead of lending funds to the private sector.

Visitor arrivals ('000, monthly)



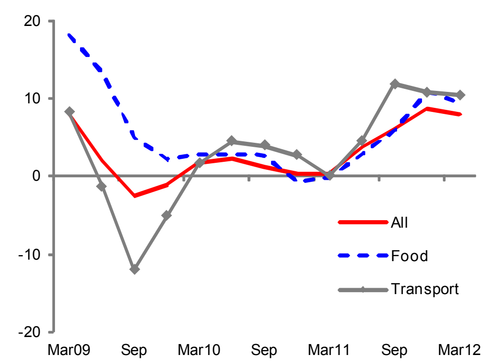
lhs=left-hand scale, rhs=right-hand scale
Source: Palau Visitors Authority.

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



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

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

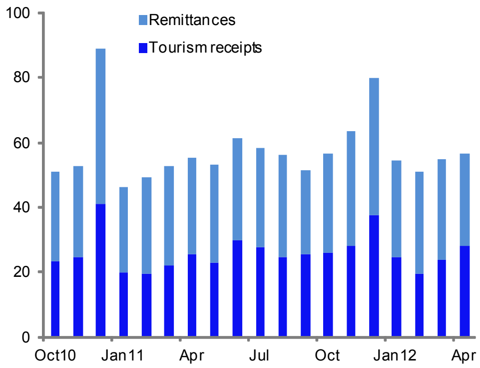


Source: Palau Office of Planning and Statistics.

Lead author: Rommel Rabanal.

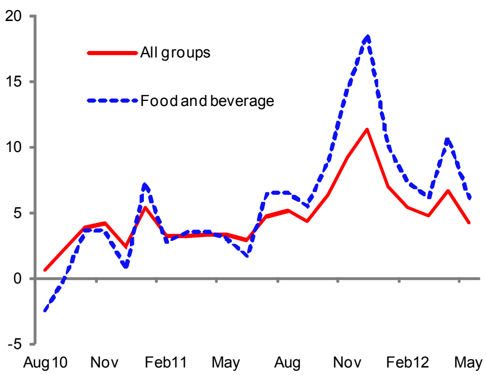
Samoa

Key sources of income
(tala million, monthly)



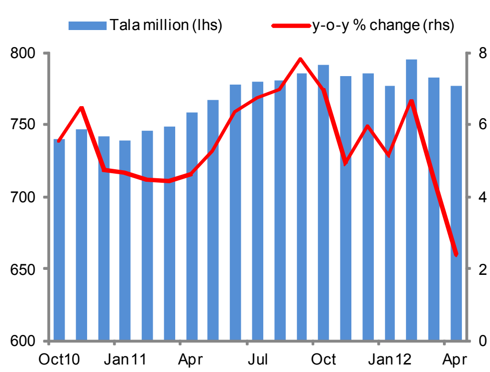
Source: Central Bank of Samoa.

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



Source: Samoa Bureau of Statistics.

Credit to the private sector
(monthly)



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

Lead author: Caroline Currie.

Recent developments

- Samoa's growth through the third quarter of FY2012 (ended 30 June) has been flat and the economy has shown signs of slowing after expanding by 2.1% in FY2011. Factors contributing to this include declining revenues from agriculture and fisheries exports and softening of tourism growth—reflecting lackluster global growth and financial volatility. Some economic stimulus is expected from the 50th anniversary celebrations of Samoa's independence in June 2012, but this is likely to be short lived.
- Tourism accounts for roughly 25% of the economy. In the first 8 months of FY2012, visitor arrivals declined by 2.4%, largely due to weak arrivals from New Zealand, which accounts for 44.0% of total arrivals. A March 2012 rebound saw tourist arrivals increase by 3% (y-o-y), due to a decline in the cost of accommodation in Samoa as owners cut room rates.
- In contrast to global trends toward lower remittances, Samoa recorded 10% growth in remittances in the first 8 months of FY2012 (y-o-y). This is attributed to increased inflows from New Zealand, the US, Australia, and American Samoa. Samoans working overseas tend to be first-generation migrants and remit at higher levels. Remittances comprise approximately 25% of GDP. However, the weak economic growth forecast in New Zealand (the main host country for overseas Samoan workers) will likely stall the growth in remittances by year's end.
- With continuing decline in global food and fuel prices, and a glut of domestically produced fruit and vegetables, inflation has been falling in the last 2 quarters of FY2012 and is expected to average 6% for the year.

Outlook

- Growth is projected to moderate to 1.4% in FY2012 as post-tsunami construction activity winds down. Over the medium term, the economy is projected to grow by 2.5% with development partner support for strengthened public financial management to encourage investment. The outlook is subject to significant risks, particularly weakening global demand affecting major trading partners, which could spill over to Samoa through lower remittances and tourism and export receipts. With little underlying pressure on prices, inflation is projected to ease to 3.3% in FY2013.

Key issues

- Samoa faces considerable challenges in reducing its fiscal deficit (48% of GDP in FY2011) and debt burden while maintaining economic growth. The government is working with ADB and other development partners to speed up fiscal consolidation and debt reduction. New Zealand's economic performance will be important, since it is Samoa's largest trading partner and main source of tourists and remittances.
- After 13 years of negotiations, Samoa officially joined the World Trade Organization (WTO) in May 2012. Samoa is expected to benefit from increased access to WTO member markets and is already developing new export markets, including taro to the US and bottled nonu juice to the PRC. As a WTO member, Samoa should benefit from clearer global trading rules and increased integration with the world economy, under a more transparent and predictable environment for trade and foreign investment.

Solomon Islands

Recent developments

- Driven by strong external demand, log production has continued to increase in the first 5 months of 2012 (against the government's previous expectation of no growth). Log production grew by 12.5% (y-o-y) during this period. Gold production is also ramping up, with 43,400 ounces exported in the first 5 months of 2012—equivalent to last year's total production. The performance of other commodity exports has been mixed. Fish catch rose by 18% in the first 5 months of 2012 compared with the same period last year; however, copra production declined by 7% (y-o-y) and cocoa by 16%. The IMF projects that mineral exports' contribution to total output will jump from around 10% of GDP in 2011 to 20% over the next few years.
- A trade surplus equivalent to $22.4 million in the first quarter of 2012 was achieved as a result of log and gold export earnings outpacing payments for imported food, fuel, and machinery. However, the appreciation of the Solomon Islands dollar against the US dollar could reduce commodity exports and raise import demand, turning the trade surpluses recorded since mid-2011 into deficits. The country's gross foreign reserves were equivalent to 9.7 months worth of imports as of May 2012. Higher commodity production and prices also resulted in a 6% budget surplus in 2011 (against a balanced budget target).
- The economy grew at 10.7% in 2011, stronger than the earlier estimate of 9.3%. Forestry and mining contributed 4.5% and 1.7%, respectively, to total growth. Economic sectors related to forestry and mining, such as construction, transport, and communication also posted robust growth. Favorable weather and high commodity prices prompted higher agricultural and fishery production.
- With higher growth, employment opportunities have improved. The number of job vacancy advertisements grew by 36% and active contributors to the country's pension system by 5%.
- Inflation eased to 7.9% (y-o-y) in April 2012 from a 30-month peak of 10.8% (y-o-y) in November 2011. The revaluation of the Solomon Islands dollar (from SI$8.02:$1 to SI$7.36:$1) and a decline in the price of rice (a major component of consumer expenditure) have helped contain inflation.

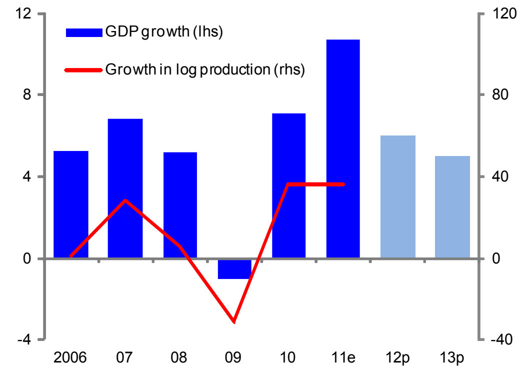
Outlook

- Given the strong growth in forestry and mining in the first half of 2012, ADB maintains its growth forecast of 6.0% in 2012, which is slightly higher than the Central Bank of Solomon Islands (CBSI) 5.5% forecast.
- ADB now projects 2012 inflation to run at 6%—in line with the CBSI forecast. Inflationary pressures may come from wage increases and a higher tax-free income threshold, which was raised from $1,060 to $2,050 per year.

Key issues

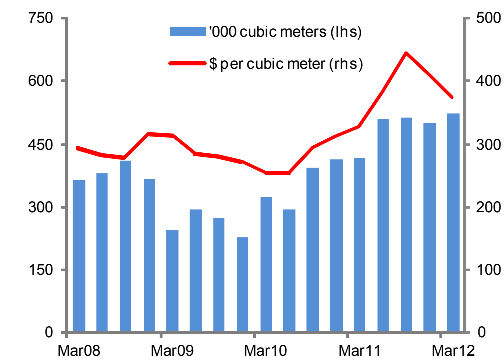
- The strong economic recovery and fiscal performance of the last two years have helped cut the country's public debt from 28% of GDP in 2009 to 19% in 2011. The debt-to-GDP ratio is

GDP and log production growth (%, annual)



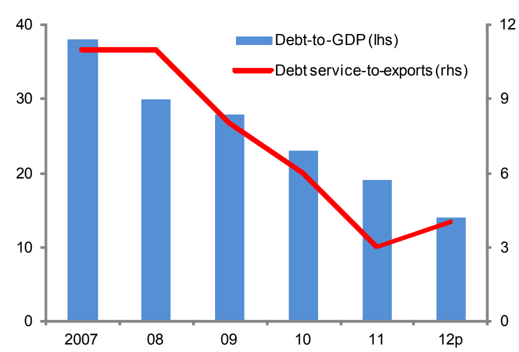
e=estimate, lhs=left-hand scale, p=projection, rhs=right-hand scale
Sources: Solomon Islands National Statistics Office, Central Bank of Solomon Islands, and ADB estimates.

Price and volume of log exports (quarterly)



$=US dollar, lhs=left-hand scale, rhs=right-hand scale
Sources: Central Bank of Solomon Islands and World Bank Commodity Price Data (Pink Sheets).

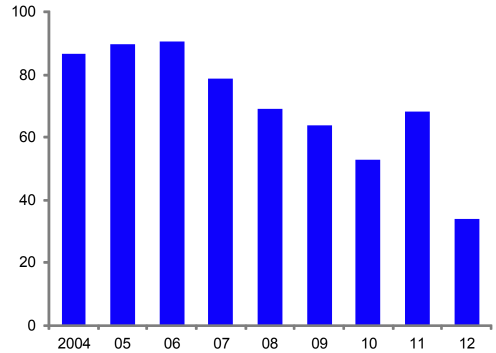
Debt sustainability indicators (annual)



Source: Solomon Islands Ministry of Finance and Treasury.

Solomon Islands

Cost of starting a business
(% of income per capita, annual)



Source: World Bank Doing Business database.

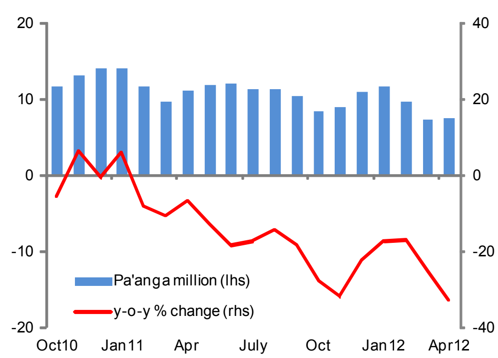
Lead author: Milovan Lucich.

expected to fall further, to about 15.0% by 2012. This includes the Government's plan to borrow $10.5 million for the Submarine Cable Project. Debt servicing has also declined from 8% of export revenues in 2010 to 3% in 2011.

- The government prepared a 5-year Public Debt Management Strategy for the country's return to concessional borrowing (all borrowing was suspended under the Honiara Club Agreement of 2005). The strategy aims to (i) ensure the timely and cost-efficient payment of obligations and fulfillment of financing requirements while exercising prudent risk management and (ii) support the development of a domestic securities market.
- Although the Solomon Islands' business environment remains challenging, there is evidence of improvement. The country's ranking in the World Bank's Doing Business 2012 survey improved markedly to 74th out of 183 countries (compared with 81st in 2011). The government has reduced the time and cost of starting a business through the introduction of an online registration process. However, construction companies now report paying three times more for construction permits compared with 7 years ago.

Tonga

Private remittances
(3-month m.a.)



lhs=left-hand scale, rhs=right-hand scale
Sources: National Reserve Bank of Tonga and Tonga Ministry of Finance and Planning.

Recent developments

- The economy is estimated to have grown by 1.3% in FY2012 (ended 30 June), down from 4.7% in FY2011 mainly due to winding down of development partner-financed infrastructures. Estimated growth for the past few years has been revised upward following a recent revision of the national accounts to include donor-funded in-kind capital projects and public and private transport enterprises. Growth in FY2012 was driven by grants and development partner funding for infrastructure, mostly financed through loans from the EXIM Bank of China.
- Remittances, which account for 20% of GDP, have yet to recover from the global financial and economic crisis. Over the first 10 months of FY2012, remittances were down by 23% (26% when adjusted for inflation) year-on-year. Eighty percent of remittances come from the US, of which 40% are from California, a state that continues to have high unemployment.
- Tourism receipts fell by 7.9% (11.6% if adjusted for inflation) through the first 3 quarters of FY2012 However, for the same period, tourist departures to Tonga from Australia increased by 9.8% and from New Zealand by 1.0%. These contradictory trends could be due to shorter stays and price discounting by tourism operators.
- Private sector credit growth has been declining (on an annualized basis) since May 2009. Despite evidence of ample liquidity in the financial system and low interest rates, loans to households were down by 5.6% (y-o-y) in April 2012 and to businesses by 24.7%. This suggests commercial banks continue to be cautious in lending in light of high levels of nonperforming loans (15.2% of total loans in FY2011).

Tonga

- Inflation decelerated from 6.1% in FY2011 to 1.8% in March 2012 (y-o-y) in line with falling international food and fuel prices, and the appreciation of the pa'anga against the currencies of Tonga's main trading partners.

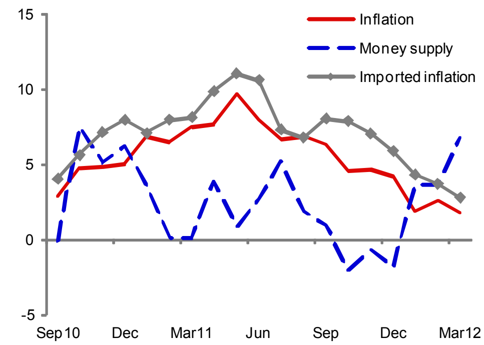
Outlook

- Growth is projected to slow to 1.0% in FY2013 from 1.3% in FY2012 as the effects of the infrastructure projects financed by EXIM Bank of China fades and private sector growth remains weak. Growth could be even lower given the tight fiscal situation and the likely adverse impact of weak global demand on remittances, tourism, and exports.
- Given the decline in international fuel and food prices, ADB revises its inflation forecasts down from 6.0% to 4.6% for FY2012 and from 7.5% to 4.5% for FY2013.

Key issues

- Household consumption remains weak due to lower remittances. The economic outlook remains clouded as credit continues to be constrained by banks' efforts to repair their balance sheets.
- Continued implementation of SOE reforms is important for reducing the costs of doing business and supporting private sector-led growth. Planned privatization of SOEs should improve efficiency and productivity and attract private investment.

Monetary indicators
(y-o-y % change, monthly)



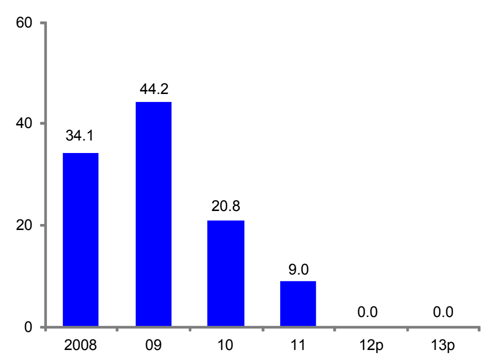
Source: National Reserve Bank of Tonga.

Lead author: Laisiasa Tora.

Tuvalu

- The economy is projected to grow by 1.2% in 2012 (revised from 1.4%) and by 1.3% in 2013. Expansion in private retail and education services and the development partner-funded upgrade of the Tuvalu airport in the last quarter of 2012 will drive growth, offsetting continuing declines in seafarers' remittances (affected by weak global trade). Inflation is projected to rise to 2.6% in 2012 and to 2.7% in 2013.
- The medium-term fiscal framework outlined in the 2012 national budget underscores the severity of the government's financing challenges. The budget deficit is projected to increase from 3.0% of GDP in 2012 to 7.5% of GDP in 2013 if corrective policy measures are not implemented. A one-off grant from Australia in May 2012 relieved immediate fiscal pressure, but the medium-term fiscal outlook for Tuvalu remains highly uncertain due to its heavy reliance on external sources of revenue.
- The government is progressing with SOE reform. Results are already apparent; for example, the Electricity Corporation recorded profits for the first time in 2010 partly through improved collection of arrears (from around 60%–70% previously to 90% in 2010). To support the continuing implementation of SOE reforms, the government recently approved measures to contract out the management of the government-owned hotel and merge the philatelic bureau, the post office, and the travel office. Reforms scheduled to be completed in mid-2013 should improve the operational efficiency of these entities and creating opportunities for increased private sector growth.

Consolidated Investment Fund balance
(% of GDP, annual)

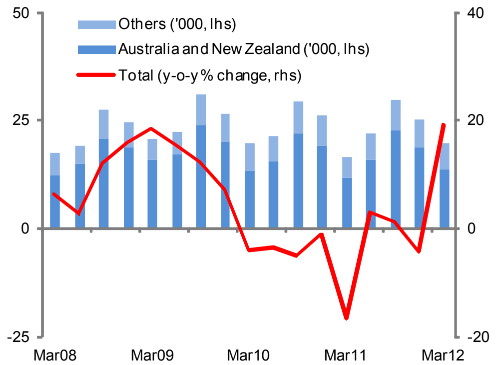


p=projection
Source: International Monetary Fund. 2012. *Tuvalu—Concluding Statement of the IMF Mission*.

Lead author: Laisiasa Tora.

Vanuatu

Visitor arrivals by source country (quarterly)



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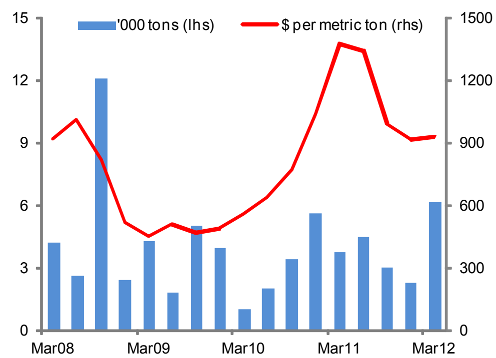
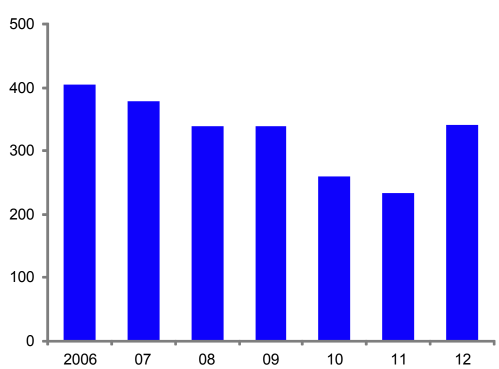
Source: Vanuatu National Statistics Office.

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).

Cost of securing construction permits (% of income per capita, annual)



Source: World Bank Doing Business database.

Lead author: Milovan Lucich.

Recent developments

- Growth in the last 2 years now appears to have been weaker than previously estimated due to lower-than-expected construction activity, tourism, and grant inflows. 2010 growth is now estimated at 1.5% (from a previous estimate of 2.2%), and for 2011, 2.5% (from 4.3%).
- In the second half of 2011, the economy slowed as major public works projects were put on hold and prices of copra and coconut (the country's key exports) declined. Domestic copra prices fell by a third in 2011 and led to decreased output and introduction of price-support subsidies.
- Foreign grants declined by 45.7% in 2011, resulting in a comparable drop in development expenditures. Lower grants also generated a budget deficit equivalent to 2.2% of GDP, above the 0.7% 2011 budget target, which was financed by domestic borrowing. Total outstanding government bonds increased by $10 million in 2011.
- Following a 7% decline in 2011, tourist arrivals increased by 15.2% during the first 4 months of 2012 (y-o-y). Over the same period, arrivals from Australia increased by 11.7% and from New Zealand by 25.8%. Cruise ship arrivals, mainly from Australia, also grew by 169% in the first quarter of 2012.

Outlook

- ADB's 2012 growth forecast is revised downward from 4.5% to 3.0% in light of continued weakness in the international prices of key exports and the postponement of major public works projects. Growth is expected to accelerate to 4.5% in 2013, when construction projects restart.
- The inflation projection is maintained at 3.0% for 2012, as increased credit to businesses and election-related spending place upward pressure on prices.
- To finance the general election and hosting of the African, Caribbean, Pacific-European Union Conference, the 2012 budget incorporates a slightly higher deficit (around 2.6% of GDP). The conference is expected to boost tourist arrivals for the year.

Key issues

- Higher growth in construction spending is key to growth prospects. Vanuatu's development partners provide access to a range of concessional financing options. To make the best use of funds and implement projects in a timely and efficient manner, it is important to prioritize infrastructure spending and invest more in government's capacity to manage funds.
- Vanuatu ranks among the highest (76th out of 183) Pacific economies in the World Bank's Doing Business 2012 survey, but is below Tonga, Samoa, and Solomon Islands. The number of days to start a business has been reduced by simplifying business registration and issuing provisional licenses. In December 2011, Parliament passed the Business License (Amendment) Act, which will further expedite the process of starting a business by requiring that business licenses be issued within 5 days upon payment of licensing fees. The number of days needed to acquire a construction permit has also fallen over the years. However, the cost and the number of procedures to acquire a construction permit have increased.

Papua New Guinea

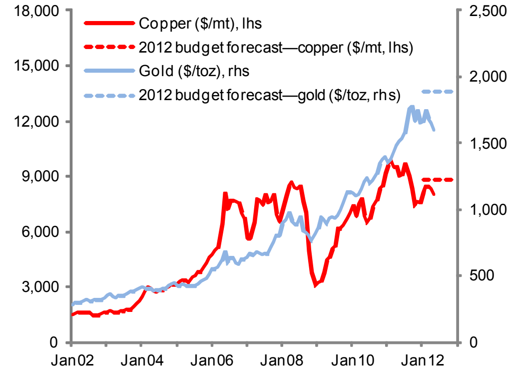
Recent developments

- Global prices of PNG's two largest export and government revenue earners, gold and copper, fell below 2012 budget projections during the first half of the year. In May, the treasurer announced that if this trend continues, the government expects a $235 million budget deficit in 2012 (1.5% of GDP), instead of a balanced budget as initially targeted.
- PNG's public debt is less than 25% of GDP and a budget deficit of this magnitude poses little risk to macroeconomic stability. In June 2012, the IMF lowered PNG's risk of public debt distress from moderate to low due in part to ongoing improvements in debt management and repayment.
- The international prices of agriculture products, such as logs, cocoa, coffee, palm oil, and copra, which comprise 20% of PNG's exports, also fell during the first half of 2012 from their peak levels last year. Lower prices for these commodities have only a minor impact on government revenue, but will result in falling real incomes for PNG's largely rural population.
- The continued appreciation of the kina has also contributed to reducing rural incomes. Most export contracts for agricultural goods are denominated in either Australian or US dollars. Since the beginning of 2011, the value of the kina has risen by 31% against the Australian dollar and 27% against the US dollar.

Outlook

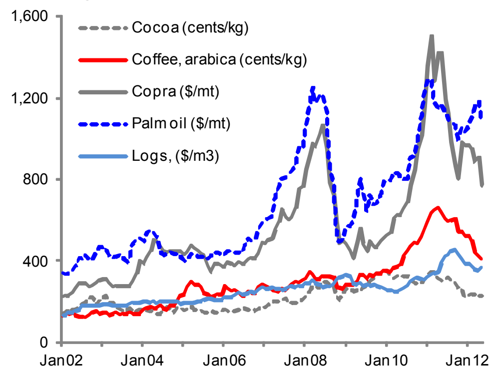
- Economic growth for 2012 is still expected to reach 7.5%. This will be supported by construction of a $16 billion liquefied natural gas (LNG) facility, which is now entering its peak development phase. Growth will be further supported by high government spending and commodity prices, which remain high by historical standards despite recent declines.
- A survey of PNG's top 100 chief executive officers (CEOs) found that 90% expect company profits to be higher in 2012 than in 2011, with none expecting a decline. Two-thirds of the group said that their 2011 profits had exceeded expectations. The survey also, however, highlighted major constraints on expanding domestic investment. The five most critical issues were shortage of skilled labor, poor law and order, lack of technical expertise, unreliable utilities provided by state-owned enterprises, and the poor state of transport infrastructure.
- Rising firm profitability, combined with constraints on local investment, have led to a dramatic increase in offshore investment since PNG's commodity boom began in 2002. Outward investment from PNG to Australia reached $1.2 billion (equal to 12.8% of GDP) in 2010, 350% higher than investments by Australian companies in PNG.
- Inflation is expected to decline to 6.5% in 2012 as the stronger kina translates into lower prices for imported goods. Also contributing to this outcome has been a further tightening of monetary policy, with the issuance of central bank bills worth $44 million in the first quarter of 2012 (building on a net issuance of $517 million in 2011) and raising of the commercial banks' cash reserve requirement from 6% to 7% in March 2012.

International gold and copper prices (monthly)



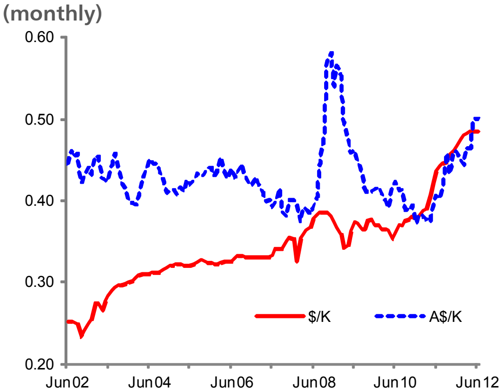
$=US dollar, lhs=left-hand scale, mt=metric ton, rhs=right-hand scale, toz=troy ounce
Source: World Bank Commodity Price Data (Pink Sheets).

International agriculture and log prices (monthly)



$=US dollar, kg=kilogram, m^3=cubic meter, mt=metric ton
Source: World Bank Commodity Price Data (Pink Sheets).

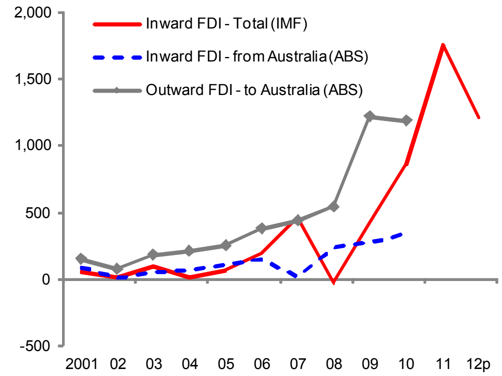
Kina exchange rate (monthly)



A$=Australian dollar, K=kina
Source: Bank of Papua New Guinea.

Papua New Guinea

Foreign investment flows
($ million, annual)



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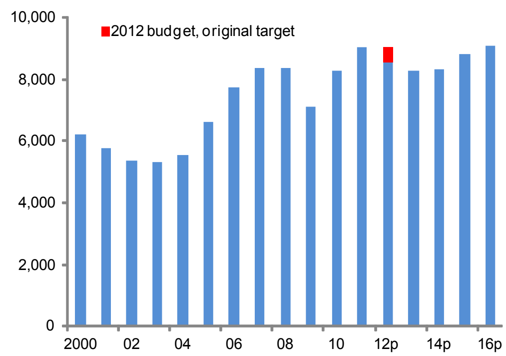
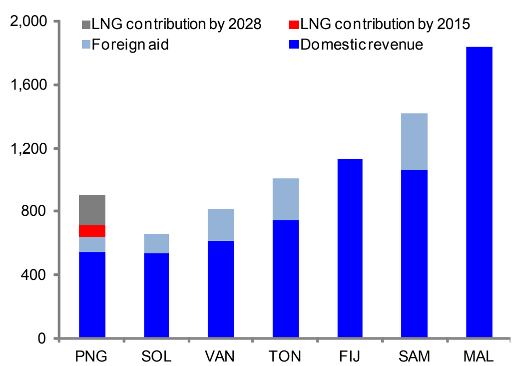
Sources: Australian Bureau of Statistics and International Monetary Fund.

Government revenue and grants
(kina, constant 2000 prices, annual)



p=projection
Sources: PNG Department of Treasury and ADB estimates.

Government revenue and grants, 2011
($ per capita)



FIJ=Fiji, LNG=liquefied natural gas, MAL=Malaysia, PNG=Papua New Guinea, SAM=Samoa, SOL=Solomon Islands, TON=Tonga, VAN=Vanuatu
Note: Data for all countries is from 2011, except for Solomon Islands (2010).
Sources: Country budget documents and ADB estimates.

Lead author: Aaron Batten.

Key issues

- Maturing mining and oil operations and the scaling down of LNG construction will contribute to slower economic growth of 4.5% in 2013. A key issue for government will be managing the 8,000 local workers who will be retrenched from the LNG project beginning late this year. Landowner companies have highlighted the potential for social unrest in the absence of alternative work arrangements for their workers.

- Later this year, the PNG government will finalize its third Medium Term Fiscal Strategy (MTFS). The MTFS 2013–2017 will play an important role in establishing the fiscal rules required to balance PNG's large social and physical infrastructure investment needs with maintaining the macroeconomic stability that has underpinned the last decade of economic growth.

- A significant challenge for the next MTFS is the likelihood of much slower growth in government revenue. Declining output from maturing mining and oil operations are currently expected to contribute to an 8% decline in domestic government revenue (adjusted for inflation) between now and 2014. The onset of LNG revenues will offset some of this decline from 2015 onwards; however, overall revenue growth will remain slow, with the government projecting that there will be no net savings within the newly created Sovereign Wealth Fund during the period covered by the next MTFS.

- Declining revenue growth will further suppress the already low level of revenue per capita generated by the government, currently among the lowest in the South Pacific. To illustrate, if revenues expected at the peak of LNG production in 2028 were added to the 2011 national budget, government revenue per capita would still be well below that of Fiji, Samoa, and Tonga.

- Three main factors contribute to PNG's low government revenue per capita. First is a small income tax base. ADB estimates that less than 5% of the population (or 10% of the working age population) is currently employed in the formal private sector. Second, as a result of tax concessions and the removal of the additional profits tax in 2003, the average effective tax on PNG's mining, oil, and gas companies is now on the low side of fiscal regimes across the world. For example, the recently opened Ramu nickel and cobalt mine has a 10-year tax holiday. Similarly, the PNG LNG project is not expected to make a large contribution to government revenue until after 2020, due in part to accelerated depreciation allowances. The third factor is poor tax compliance and enforcement. The PNG tax office lacks the human resources to effectively pursue individuals, firms, and industries suspected of not paying their full tax obligations.

- The next few years are likely to be an austere period for PNG. This highlights the need to focus medium-term expenditures on rehabilitating existing service delivery infrastructure, rather than on creating new assets that may further undermine the state's ability to fund recurrent maintenance. Strengthening revenue compliance and reviewing resource sector taxation arrangements would help alleviate fiscal pressures over the medium term. More broadly, addressing the business constraints identified by the country's CEOs will be crucial in diversifying the PNG economy, increasing private sector employment, and expanding the revenue base with which to finance future public investments.

Timor-Leste

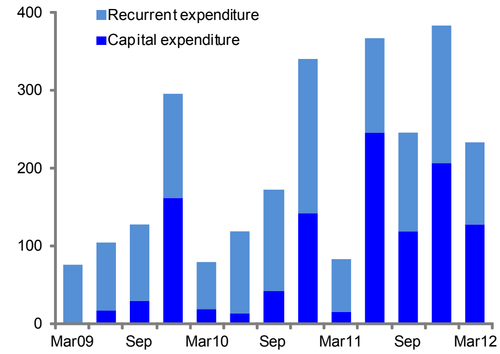
Recent developments

- The build-up in government expenditure continues to underpin economic growth. Expenditure in the first 6 months of 2012 rose to $620 million, 18.0% above the level of the same period in 2011 and the equivalent of about 60% of annual nonpetroleum GDP.
- Most of the increase in expenditure was accounted for by a very large increase in cash transfers, which are mainly received by veterans of the struggle for independence, the elderly, and single mothers. At $110 million over the first 6 months of 2012, total transfers were more than twice the level of the same period of last year. This represents a large injection of purchasing power, predominantly into the rural economy, and can be expected to stimulate consumption.
- Capital expenditure remains high as the national electrification program continues and road works gather momentum. Civil works on Timor-Leste's first major road upgrades commenced in the first half of 2012. With ADB support, the government is widening roads from Dili to the border with Indonesia, from the current 4.5 meters to 6.0 meters plus shoulders. Preparations to extend this upgrading throughout the country continued over the first 6 months of 2012, with a view to completing most of the upgrades within 5 years.
- After rising by 18.5% over 2011—a historical high—private sector credit growth is now easing. Total loans rose by only 1.5% over the first quarter of 2012. A new civil code that came into effect in March unexpectedly tightened requirements on loan agreements and associated legal documents. A key requirement is for public notarization for loans of more than $10,000. These are likely to delay the finalization of new loans and prolong the recent slowdown in lending activity.
- Petroleum revenue remains high, with around $900 million earned over the first quarter. This is well above official expectations, as the 2012 budget projected petroleum revenue for the entire year of $2.1 billion. The large inflow lifted the Petroleum Fund balance past $10 billion, which is equivalent to about 10 times the value of annual nonpetroleum GDP. The Petroleum Fund Law was recently changed to allow for increased investment in equities, with the goal of increasing the fund's longrun rate of return. This rebalancing is now gaining momentum, with the share of the fund invested in equities rising from 4% to 14% over the first quarter of 2012. The high petroleum revenue is expected to lead to large budget and current account surpluses continuing through the end of 2012.
- Inflation in Dili rose to 17.4% in December 2011 (y-o-y)—the highest in the Asia and Pacific region. Inflation has been driven by a shortage of key consumer goods and cost pressures from overseas suppliers. An easing in price pressures has seen inflation in Dili quickly ease from these peaks, but it remains high at 11.2% (y-o-y) as of May 2012.

Outlook

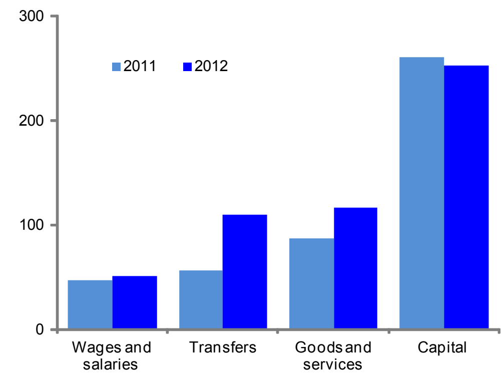
- The current coalition government's 5-year term ends in the middle of 2012. The July parliamentary elections are important both in setting policy directions for the next 5 years and in determining the future of the United Nations (UN) peace keeping mission.

Government expenditure ($ million, quarterly)



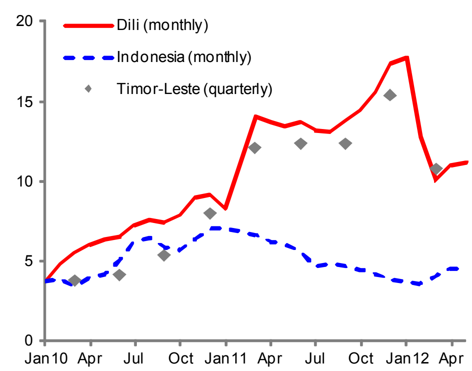
Note: Own-funded expenditure shown.
Source: Timor-Leste National Statistics Directorate.

Key expenditure aggregates ($ million, January-June totals)



Note: Own-funded expenditure shown.
Sources: Timor-Leste National Statistics Directorate and Timor-Leste Transparency Portal.

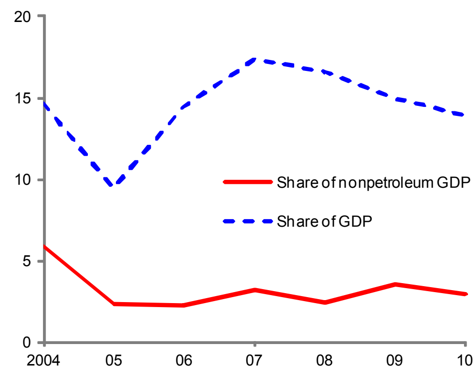
Consumer price index (y-o-y % change)



Source: Timor-Leste National Statistics Directorate.

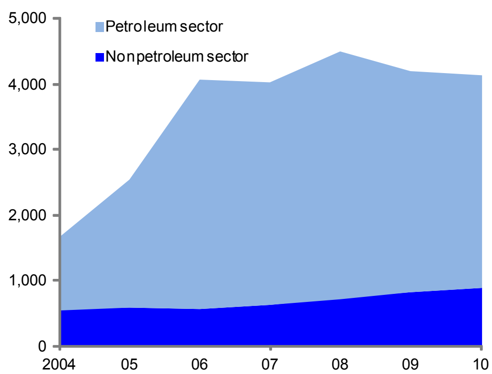
Timor-Leste

Development partner and international security forces share of GDP (%, annual)



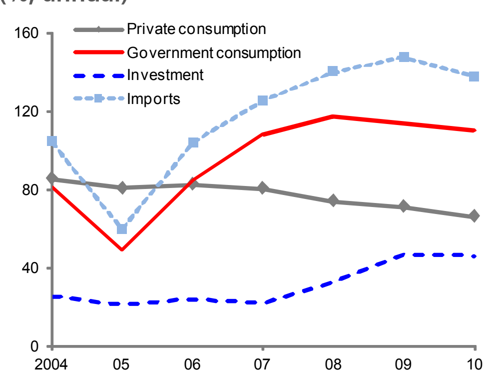
GDP=gross domestic product
Source: National Statistics Directorate. 2012. *Timor-Leste National Accounts 2004–2010*. Dili (April).

GDP by sector ($ million at constant 2010 prices, annual)



GDP=gross domestic product
Source: National Statistics Directorate. 2012. *Timor-Leste National Accounts 2004–2010*. Dili (April).

Key ratios to nonpetroleum GDP (%, annual)



GDP=gross domestic product
Source: National Statistics Directorate. 2012. *Timor-Leste National Accounts 2004–2010*. Dili (April).

Lead author: Craig Sugden.

- The government and the UN plan to complete the peacekeeping mission by the end of 2012 if the elections to be conducted over the year are orderly and peaceful. The peace keeping mission would then probably be replaced by a much smaller UN mission focused on the development of the political system.
- The presidential elections held over March and April were smooth, the campaign leading up to the July parliamentary elections was orderly, and the vote itself on July 7 was conducted in a peaceful and orderly manner. So long as the process of establishing a new government is also smooth, the withdrawal of the peace keeping mission can be expected to proceed as scheduled. Additional security forces provided by an International Stabilization Force already started to phase out in early 2012. The future of these forces will be set by the new government.
- Departure of the security forces provided by the UN and the International Stabilization Force (ISF) would immediately reduce formal sector employment—the peace keeping mission alone employs around 1,000 Timorese—and cut back the demand arising from operations and the local expenditure of staff.
- Recently released national accounts show that development partners, the UN mission, and the ISF together contributed 13.9% of nonpetroleum GDP in 2010. Taking into account recent economic growth, and the relative size of the security forces, their departure will have a direct effect of cutting nonpetroleum GDP back by about 5.0%. Most of this will be felt in 2013, with the effect concentrated in the capital, Dili.
- The outlook remains for 10% growth in the nonpetroleum economy in 2012, fuelled by high government expenditure. Growth will remain high in 2013 because of the stimulus provided by high government expenditure, but is likely to ease to 8% because of the departure of the UN mission and tightening supply bottlenecks in the economy. Inflation is projected to average 10.2% in 2012 before easing to 7.4% in 2013.

Key issues

- The recently released national accounts have provided the first detailed estimates of GDP. They highlight that the petroleum sector has dominated GDP since operations began at the Bayu-Undan offshore field. The nonpetroleum sector, i.e., nonpetroleum GDP, has averaged double digit growth since 2006, but still accounted for only one-fifth of total GDP in 2010.
- The national accounts also highlight the nonpetroleum economy's dependence on government consumption (i.e., government spending on wages and salaries, and goods and services) and the recent rise in investment, most of which has been funded by the government. Because the nonpetroleum economy is so shallow, imports account for a large share of government spending, private consumption, and investment. This gives rise to an unusually high import ratio in Timor-Leste, of more than 100% of nonpetroleum GDP.
- Spurring private sector development by creating a business-friendly environment remains a priority to deepen the economy and address an over-reliance on petroleum-funded government expenditure. A vibrant private sector would enhance prospects for sustaining the country's high growth over the long term.

Reforming state-owned enterprises in Kiribati

Introduction

Across the globe, there is ample evidence that poorly performing state-owned enterprises (SOEs) can have adverse impacts on economic growth. They hinder growth by earning low, often negative, returns on the resources invested in them. Continued investment in inefficient SOEs siphons off scarce public funds that could otherwise be invested in other sectors, such as health and education. Moreover, the low productivity of inefficient SOEs in delivering public services that they are often entrusted to provide (e.g., transport and utilities) affects the competitiveness of the private sector.

SOEs may also damage growth prospects indirectly. Inefficient SOEs, which produce goods and services used as inputs by private businesses (e.g., electricity) at very high costs, can cause a vicious cycle of high-cost production. This leaves output below its potential level, wages lower than they might otherwise have been, and exporters struggling to make headway in competitive overseas markets.

Why have SOEs generally performed poorly? In most cases, this is due to their conflicting mandates, weak governance arrangements, and lack of accountability. SOEs do not operate with the same efficiency incentives as private sector firms: there are few consequences for poor financial performance and few rewards for profitability. SOEs often face a multiplicity of objectives and expectations. This is most evident where SOEs are expected to perform both economic and social functions. The frequently-encountered need to provide or maintain jobs in excess of requirements is particularly damaging.

Where SOE boards are composed of directors who are appointed for political reasons rather than according to the skills needed by the SOE boards, and not subsequently held accountable for results, the performance of the SOE invariably suffers. Lack of disclosure of SOE accounts in many countries allows this situation to persist without inviting public concern. Finally, the continued financing of poorly performing SOEs often acts as a disincentive for efficiency, as poor performance attracts additional capital.

Broadly-based re-evaluation of the rationale for SOEs began in the 1980s, largely as a response to a difficult economic environment. The most ambitious SOE reform programs, undertaken in New Zealand, the United Kingdom, and Latin America, included a number of divestitures, the introduction of hard budget constraints, and modernized legislation to establish effective monitoring, reporting, and accountability frameworks. As a result of these reforms, SOE performance improved dramatically. In New Zealand, for example, the productivity of Telecom New Zealand increased by 85% during this period, New Zealand Post turned a NZ$40 million net loss into a NZ$48 million net profit without increasing the nominal postage rates, and Coal Corporation increased productivity by 60%.

SOEs play a significant role in the economies of the Pacific. Most SOEs were established to respond to a perceived market failure. They have been mandated to deliver goods or services that the private sector was either unable or unwilling to provide (e.g., cases of natural monopoly, or goods with large associated externalities). In the Pacific, as elsewhere around the world, SOEs have also been charged with the provision of core infrastructure services, e.g., power, telecommunications, transport, and water.

The small size and distribution of Pacific populations, with typically limited purchasing power and long distances from markets, were seen as impediments to the private sector's ability to operate successfully. However, it was believed, despite the limited nature of the resources available to Pacific governments, that these weaknesses could be overcome with government financial support. Thus, SOEs were used, in "key sectors," to provide strategic support for start-up enterprises in line with government economic policy. For instance, nascent tourism sectors were developed in many Pacific economies through SOEs providing accommodation services. Fish canneries have likewise been supported in the hope of increasing value added in fisheries. Over time, many SOEs have moved beyond their core function and diversified into purely commercial activities, directly competing with and further inhibiting the development of the private sector.

However, SOEs in the Pacific are rarely, if ever, operated according to commercial principles. Most receive a range of subsidies and other preferential treatment from governments, lowering their operating costs and making it very difficult for effective competition to emerge. This contradicts the stated rationale of using SOEs as a vehicle for development and is a key reason that they have come to be viewed as a problem, rather than as a solution to market failure.

The benefits of SOE reform in the Pacific are most clearly evident in the telecommunications sector. Across the Pacific, SOEs have been the sole providers of telecommunications services, with governments arguing that having a public monopoly was a better outcome than having a private one. The absence of competition was the result of strong barriers to entry rather than a lack of willing competitors. However, SOEs failed to adopt new technology, and often maintained high service charges. Opening up of the sector has led to the successful establishment of competing private industry; to the customer, the change has meant a wider range of services available at lower cost.

Reforming state-owned enterprises in Kiribati

The SOE reform process in Kiribati

The reform environment in Kiribati is particularly challenging. Institutional weaknesses, and the economic and social vulnerabilities, combine to create an additional layer of complexity to the development challenge of SOE reforms that all Pacific countries face. State involvement in running enterprises is extensive: the government is responsible for the operation of 22 SOEs in areas as diverse as hotels, energy and water utilities, and even retail. Some SOEs perform dual functions, being both commercial enterprises and, in effect, providing community services and helping to implement government policies. For example, public utility SOEs have been asked to extend services to remote, sparsely populated outlying islands where costs of providing the service are much higher than potential revenues.

Until recently, Kiribati had a very limited formal governance framework for SOEs. In general, SOE governance was the responsibility of "parent" ministries with no overarching policy requiring planning and budgeting. Up-to-date financial statements and annual reports were rare, so there was little transparency and public accountability. Also, few SOE financial reports included performance measures, or any formal reporting requirements against targets. Boards of directors often included senior civil servants, potentially leading to conflicts of interest between their duties as directors and their positions as policy advisers to ministers. Boards typically lacked commercial acumen and directors received little training to assist them with their role.

The lack of management and financial capacity, and of transparency and accountability, has meant that the majority of SOEs have struggled to be financially viable or maintain consistent levels of service to their customers. The incidence of SOEs needing financial bailouts has been high, and government has too frequently been called upon to honor guarantees of SOE debts, provide new infusions of working capital, and fund redundancies. Bailouts over the past three years have totaled $12 million and a further $10 million is likely over 2012.

The global financial crisis adversely affected the Kiribati economy, putting more pressure on limited government resources. The Revenue Equalization Reserve Fund (the sovereign wealth fund) lost nearly 10% of its value, remittances contracted, and the value of the Kiribati Provident Fund (a pension fund) declined. These setbacks hastened the government's commitment to SOE reform. The results of the government's efforts in enabling SOE reform are discussed below with reference to the experience and lessons learned from the privatization of the Kiribati Supply Company Limited (KSCL).

The Case of Kiribati Supply Company Limited

KSCL was established as a limited company in the late 1980s to supply construction material, electrical fittings, plumbing fittings, stationery, and general hardware from three locations in South Tarawa—Betio, Bairiki and Bikenibeu, including a branch in Kiritimati Island. At the peak of its operations, KSCL employed over 80 employees, with extensive services at its branches. However, over time, it lost market share in the face of increased competition from a growing number of private sector suppliers. With available government support, including guaranteed procurement for government projects, KSCL had little incentive to cut overhead costs and its debts mounted as sales fell. This left the government with the choice of whether to retain or sell its hardware business in an increasingly competitive market.

A particular challenge in implementing SOE reforms was the absence of a clear policy upon which to base government's decision to sell or retain SOEs. To address this issue, the government, in conjunction with ADB, developed a policy framework that was subsequently adopted by the Cabinet as the basis for ownership decisions and SOE reform. A key component of the policy framework was a decision tree designed to help government reach a decision as to whether to retain or sell its shares in individual SOEs.

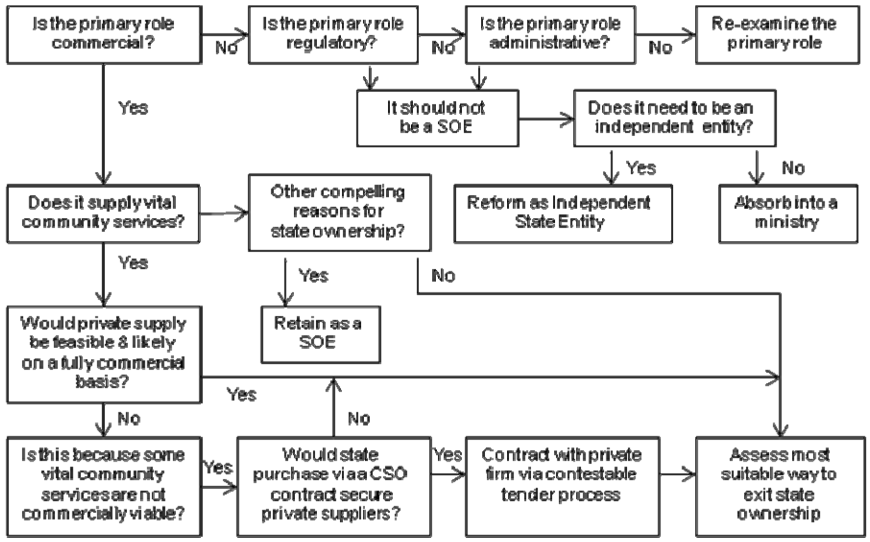
A SOE Reform Steering Committee, chaired by the secretary to Cabinet, was set up to drive the reform process. Committee members include the secretary of finance, the attorney general, and the heads of the two ministries responsible for most SOEs. The secretary of lands has also been included—acknowledging the importance of land leases for SOEs. Its membership pools the expertise of experienced senior civil servants, and its group decision-making processes have reduced political pressure on the permanent secretary–an important factor in overcoming vested interests opposed to reform in small close-knit communities.

Using the decision tree, government decided to sell 100% of its share in KSCL. The successful bidder (out of four bids) was a local company. The sale was finalized in October 2011, about a year after being offered for bidding. KSCL is now a fully privatized business.

The KSCL case provides an example that a loss making SOE can be privatized and turned into a revenue neutral one (with the potential to generate revenues from higher sales tax over time). Lessons learned from the preparation for sale of KSCL, which could serve to guide the eventual sale of other SOEs and potentially turning them into profitable privately owned enterprises, include the following:

Reforming state-owned enterprises in Kiribati

Decision tree for SOE ownership



- Clear identification of SOE assets and liabilities is a prerequisite for a successful sale.
- Though a company is technically insolvent, it may have significant market value through its long term leases of scarce land in prime sites.
- Debt forgiveness by the government, and agreement by the government to take responsibility for paying creditors, reduces uncertainty for the purchaser, increases the SOE's value, and facilitates full sale of the SOE.
- The social impact of staff redundancies resulting from the privatization must be addressed; in the case of KSCL, the government agreed to pay laid off workers a minimum of 6 months' salary.

The sale of KSCL has inspired the government to continue with SOE reform. Based on the criteria in the decision tree, enterprises, other than those with compelling reasons for state ownership (for example, providing a vital community service that cannot be provided by a private operator), will now be candidates for privatization.

Conclusion

The example provided by Kiribati under circumstances where SOE losses were threatening to undermine the overall government budget is one that could be emulated in other Pacific countries, and provides some common lessons for SOE reform:

- A starting point is to gain agreement from the government on a policy framework for SOEs, including criteria of retaining SOEs in government ownership and how community service obligations should be handled.
- A strong and active reform steering committee is a key success factor since they act as the bridge between specialist reform advisors and Cabinet.
- Business improvement is essential for SOEs that are to be retained in government ownership.
- Formal plans for business improvement need to be realistic and close monitoring by both the board and external monitors is important.
- Improving accounting systems and financial reporting are essential prerequisites. Without up-to-date financial data, managers and boards are flying "blind" and cannot develop realistic and practical strategic plans.
- Where a decision is taken to sell a SOE, the realized value from the sale can be improved by careful identification of assets and liabilities, especially land leases since these may have scarcity value on crowded atolls. Again, good accounting records and financial reports are keys to improving sale results as they reduce uncertainty for the purchasers.
- If reducing staffing levels is necessary, it is important to have policies that provide adequate compensation to staff as well as support to ease the transition.

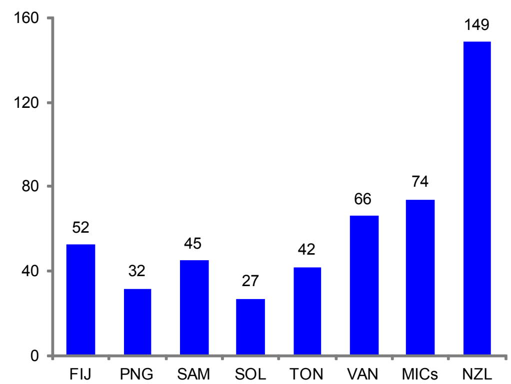
Lead author: Caroline Currie.

Improving access to finance in the Pacific through secured transactions reform

A crucial issue in promoting sustainable growth is the extent to which businesses can access finance in order to fund working capital and investment. This is particularly important for smaller businesses with potential to grow but have difficulty obtaining financing. One of the most important reasons for limited credit to businesses is that financial institutions in general are reluctant to lend to borrowers who do not have collateral to secure loans. Real estate, which is a typical source of collateral for entrepreneurs in many countries, is often unavailable in the Pacific because a large proportion of land is communally held. As a result, many businesses are starved of financing.

The most widely used indicator of access to finance, the ratio of credit to the private sector to GDP, supports these conclusions (Figure 1). The ratio for most Pacific developing member countries (DMCs) is lower than the average for middle-income countries, the group to which the majority of countries in the region belong. For middle-income countries, bank financing is by far the most important source of funding for businesses (Holden and Prokopenko 2001).

Figure 1: Ratio of private sector credit to GDP (%)



FIJ=Fiji, GDP=gross domestic product, MICs=middle income countries, NZL=New Zealand PNG=Papua New Guinea, SAM=Samoa, SOL=Solomon Islands, TON=Tonga, VAN=Vanuatu
Source: World Bank. World Development Indicators.

Reasons access to finance is limited in the Pacific

A 2007 ADB study (*Diagnostic Studies for Secured Transactions Reform in the Pacific Region: Improving Access to Affordable Credit*) identified 7 factors why access to finance in Pacific DMCs is limited:

- **Inability to pledge collateral.** The ability to pledge movable property (chattels) as collateral is limited. Communal and traditional land holdings make it difficult or impossible to pledge land as collateral.
- **Weak and outdated legal systems.** Many laws governing financial transactions and lending are antiquated, sometimes dating from the 19th century. Bankruptcy laws are often inadequate or even nonexistent, and legal procedures for repossessing pledged collateral tend to be lengthy and costly.
- **Poor enforcement mechanisms**. Court systems in the region are underfunded. As a result, enforcing judgments is difficult and in some countries it can take months or even years to execute on awards, making some movable property essentially worthless (see Holden 2007).
- **Government-directed credit.** Development banks generally lend to favored sectors of the economy, politically connected borrowers, or frequently to the government itself at an artificially low interest rate.
- **Financial regulation**. In some countries in the region, bank regulation is weak and some banks are undercapitalized. In others, the international banks are subject to the prudential norms of head offices, which are located in advanced countries. Lending criteria are therefore very stringent.
- **Lack of credit information.** There is very little credit information available on potential borrowers. Credit bureaus could particularly help the poor build credit histories.
- **Limited access to financial services**. In most parts of the Pacific region, access to financial services was found to be limited, partly due to geographic dispersion. Other contributing factors include inadequate infrastructure, poor telecommunications, and lack of competition in the financial sectors.

Making lending more secure

The uppermost question in the minds of lenders faced with loan applications is whether they are likely to be repaid. The answer involves a number of factors. First, borrowers' cash flows, from which payments of principal and interest must come, must support the size of the loan. A further critical question that must be answered is the likelihood of being repaid in the event that the underlying business fails or defaults on the loan.

Improving access to finance

The underdevelopment of the financial sector is closely connected to the lack of an effective secured transactions framework. A secured transactions framework is the legal, regulatory, and technical system sanctioned by law to use movable property as collateral for loans. A well-functioning secured transactions system generates economic and social gains for creditors and debtors as it reduces transaction costs and thereby increases the availability of credit. It also benefits small businesses by making it easier to purchase equipment such as boats, outboard motors, rotor tillers, and trucks because equipment dealers and finance companies can easily secure these assets as collateral.

The widespread occurrence of lending secured by movable property in developed countries contrasts with the situation in nearly all countries in the Pacific (and developing countries in general), where it is difficult or impossible to secure lending using this type of collateral.

Secured transaction reforms in the Pacific

In 2006, no Pacific DMC had a well-functioning system for securing loans with movable property. Since then, there has been a program of reform, which has resulted in the introduction of secured transactions laws (also known in the region as personal property securities acts or PPSAs) in the Republic of the Marshall Islands, the Federated States of Micronesia, Palau, Papua New Guinea (PNG), Solomon Islands, Tonga, and Vanuatu.

In 2012, Samoa is expected to pass its PPSA and Timor-Leste to commence with secured transactions reform. Work is ongoing to ensure that the electronic registries keep pace with the needs of lenders and borrowers. Registry upgrades will be implemented in all countries by the end of 2012.

How secured transactions reform contrasts with the previous systems for pledging collateral

Prior to the reforms, a variety of laws governed the pledging of collateral as security for loans. Since Pacific DMCs have common law legal systems, they bore strong resemblance to those that existed in Australia (before 2012) and New Zealand (before 2004). For example, companies generally pledged assets under provisions of the companies acts and leased equipment under bills of sale acts or hire purchase acts. Generally, individuals could only purchase equipment under either of the latter two types of acts. Many forms of collateral could only be used with great difficulty; for example, pledging future income was virtually impossible.

The costs of borrowing were high because virtually every loan necessitated the use of a lawyer to draw up loan agreements. It was difficult for lenders to determine if the assets being pledged had already been used as collateral with another lender, because searches required an in-person visit by a lawyer to the companies office or the bills of sale registry, where record keeping was frequently chaotic. Once legal costs and other transaction costs of obtaining a loan were factored into effective interest rates, borrowing became extremely expensive.

Repossession in the event of default in most cases required a court order and could only be undertaken by the sheriff of the court, who was often unavailable. In short, the system was costly for borrowers and risky for lenders.

Following the reforms, lenders register all pledges of collateral in an electronic registry, which is easily searchable to ensure that the borrower has not pledged the same assets to other lenders. Standardized loan documents are used, reducing the transaction costs of borrowing. The time to process a loan has declined from weeks to no more than a few days.

A wider range of assets can be pledged, including future income. In the majority of cases, in the event of default lenders do not need to obtain court orders and can repossess the assets themselves, which reduces lending risk. In most countries, stamp duties have been eliminated and the costs of registering a security interest have been fixed, as opposed to a percentage of the loan under the unreformed system. As a result, effective interest rates have fallen.

Impact and lessons learned

In the countries where the reforms have occurred, access to credit has improved markedly. The reforms have been especially effective in Solomon Islands, where they have enhanced the impact of the new Companies Act. Follow-up analysis has found that small businesses have received loans that have enhanced their productivity and ability to supply customers (Box 1).

Figure 2 shows cumulative net security interests registered (i.e., new security interests registered less security interests terminated) and the number of searches of the registries. It is important to remember that it is the lenders that register security interests; they are notifying other potential lenders that they have a security interest in the collateral described in the registry and that they have priority over other lenders with effect from the date of registration.

As a minimum, security interests registered correspond to the number of loans that have been made; a security interest could correspond to more than one loan. During the first year of the operation of the registry, security interests registered under the prior system are included in the registrations. As a result, not all of the security interests registered can be ascribed to the secured transactions reform.

Improving access to finance

Box 1: Nonbank Financial Intermediary Benefits from Secured Transactions Reform

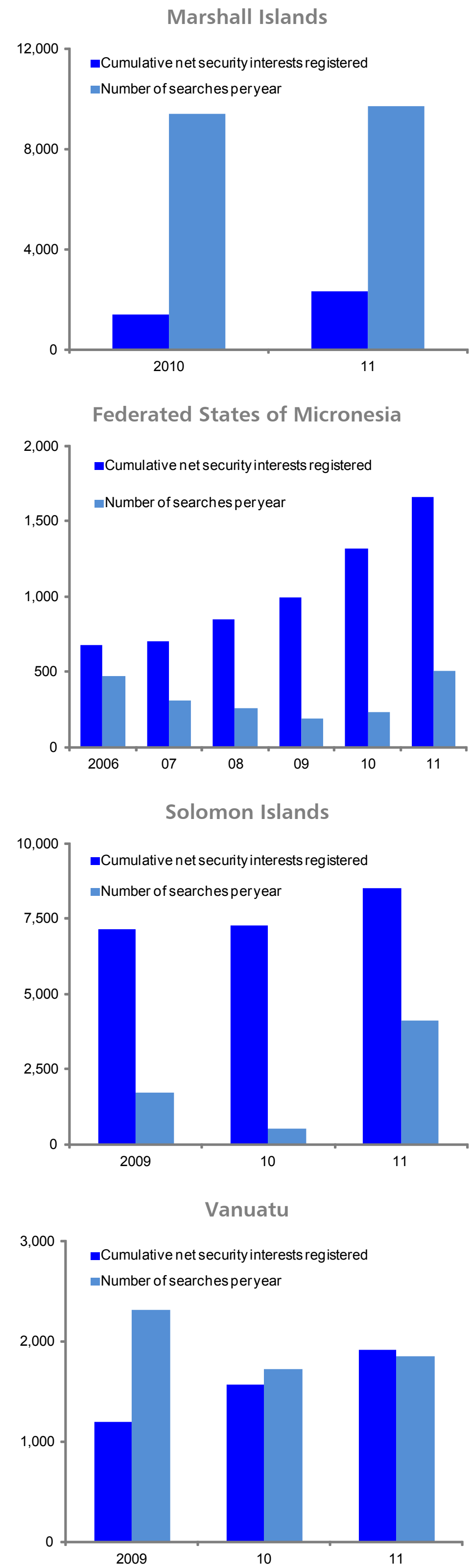
Credit Corporation, the leading nonbank financial institution in Solomon Islands, has reported that the amount of time spent approving a loan has been reduced from 30 days to 1 day through simplified agreements and elimination of the need for government approvals. It also found that simplified enforcement mechanism has made a significant difference, rendering repossession cheaper and faster. Credit Corporation has recently grown their lending books, particularly with loans made to businesses in the provinces and from previously marginalized groups, such as women entrepreneurs. A corporate restructuring is expected to lead to further rapid growth in lending, with the possibility of more creative uses of collateral under the Secured Transactions Act.

The number of searches of the registry reflects at least partly loan applications and demonstrates that the system is being used actively in all countries in which reforms have occurred. Results for PNG, Palau, and Tonga are not included since procurement for a registry in PNG and Palau has not yet commenced and the electronic registry in Tonga was only installed in the middle of 2011.

Secured transactions reforms have also reduced borrowing costs. Since lenders' risks are reduced, the risk component of lending rates has declined. The payment of stamp duty on some loans, a remnant of the United Kingdom laws, has been abolished. The reforms have yielded the following benefits:

- Lending rates have decreased two percentage points on secured loans in RMI, implemented by the Bank of the Marshall Islands due to the lower risk resulting from the passage of the secured transactions law.
- In Vanuatu, the Secured Transactions Act led to the elimination of stamp duty, which has resulted in a decline in the cost of borrowing. While this does not necessarily translate into an equivalent decline in interest rates, the term of most loans in the region has been short, less than 12 months in many cases, so translating the elimination of stamp duty into an annual decline in the total borrowing cost is a good approximation of changes in interest rates.
- Processing time has been greatly reduced and legal fees have dropped sharply because lawyers are no longer required to prepare lengthy legal documents.
- Repossession has been made easier in the event of default. Although only a relatively small number of these have occurred, lenders report that the process is far easier than it was in the past.

Figure 2: Registry activity indicators, annual



Sources: Country electronic registries.

Improving access to finance

It should be noted that simply passing a law will not bring about the desired results. Intensive implementation is also needed. Capacity building is necessary for the operators of the electronic registry. Lenders and the legal profession require instruction in the implications of the new law. Nonbank financial intermediaries must become aware that they can secure loans far more effectively than in the past. The courts must be apprised of the new procedures.

In the longer term, once the framework has been operating effectively for some time within a country, there is the potential for offshore lenders to enter the local financial market through the registration of security interests. This is an ongoing process that ADB's Private Sector Development Initiative project will continue to implement.

Conclusions

Secured transactions reforms have a positive effect on other parts of the financial sector in addition to commercial banks. They provide opportunities for nonbank financial institutions to increase liquidity by using accounts receivable as security to obtain loans from commercial banks. For example, microfinance institutions, which generally have low loan–loss ratios, could use their loan portfolios to increase their lending potential. Finance companies can likewise do the same. This has not occurred because of the newness of the reformed systems and because financial institutions (and donors) have yet to appreciate the potential to increase financial intermediation that the new framework offers.

Secured transactions reform strengthens the stability of financial systems in general. Secured loans are far more likely to be repaid than unsecured loans. Bank regulators can determine the extent to which financial institutions' loan portfolios are secured against collateral and adjust their ratings of the soundness of banks accordingly.

It must be remembered, however, that just like other reforms to promote economic development, secured transactions reforms are not a panacea and will take time to transform the lending landscape. Lenders need time to adjust to the new lending framework. These reforms are cutting edge, and have yet to be fully implemented in Australia and PNG, where the head offices of most commercial banks in the region are situated. As a result, senior management is not yet familiar with the new frameworks and may be reluctant to change lending standards that require personal guarantees or pledges of property. Further, the new reforms are only just being tested in the courts of some countries. However, experience in countries with well-functioning secured transactions frameworks in place for extended periods indicates that the reforming Pacific economies will reap substantial benefits in improving access to finance, thereby boosting inclusive growth.

Lead authors: Paul Holden and Terry Reid, ADB Private Sector Development Initiative, Sydney.

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Economic empowerment of women through private sector development in the Pacific

Throughout the developing world, women are especially burdened by underdevelopment. They must simultaneously manage their households and generate income despite the lack of support at family, community, and government levels. Since the United Nations (UN) International Women's Year (1975) and the UN Decade for Women (1976–1985), there have been significant changes in thinking regarding the economic issues facing women in developing economies. Now, in both discourse and practice, women are considered an integral component of development strategies (Fonjon 2001). Women are capable of contributing to building the private sector and achieving long-term poverty reduction for their households and communities. Recent economic analysis of the private sector in Pacific developing member countries over the past 5–10 years has highlighted the crucial role that women can play in business. Yet they remain excessively disadvantaged, because many existing laws and regulations in Pacific island economies are outdated, according men legal primacy in many economic activities and discriminating against women. For example, many business name acts require women to obtain signatures of a spouse or male relative. As a result, most women in Pacific island economies remain locked into the informal sector, where economic returns are much lower than they are for formal business activities.

This paper describes the work being done to improve the overall legal and regulatory environment in the Pacific, which will assist in supporting economic empowerment of women. There have been targeted interventions that assist women's entry into the formal economy. ADB works closely with all member countries in the Pacific and women's groups in reforming existing business laws. These reforms are expected to assist women to become increasingly involved in commercial activity. As integral drivers of the development process, women will ultimately underpin the success of the reforms. This paper outlines the constraints faced by women and how reforming business laws will promote women's participation in the formal sector and create significant economic empowerment.

Women's roles in economic development

The integral role that women play in economic development and poverty reduction is increasingly recognized (International Finance Corporation 2010). The third Millennium Development Goal of the UN recognizes that women can be key drivers of the development agenda. Women entrepreneurs' earnings generally result in greater poverty reduction because women tend to invest profits directly into their families' well-being (Jalbert 2000). Further, higher incomes through female-run enterprises often result in better control and access to household resources, and better child health and nutrition outcomes (Duflo 2005)

Women are significant private sector participants in developing economies, which are primarily agriculture-based with large informal sectors. Informal economic activities usually range from self-employment in trading activities to small enterprise. Women may also engage in wholesaling and export trading, and sometimes build sizable financial operations. However, in many cases, women prefer to operate microenterprises in the informal economy to avoid excessive and often burdensome expenses of regulatory requirements (e.g., business licensing and registration) while still earning an income. The informal economy allows women to establish businesses with comparative ease, providing the convenience of being able to operate from home and giving access to arrangements that provide short-term solutions to address their families' basic needs. In addition, setting up a business in the informal economy is sometimes deemed more convenient for women because they may face less discrimination and harassment in trying to secure financing from representatives of government and formal institutions, which tend to be male-dominated. In addition, women may not have the proper skills and assets to participate in the formal economy.

However, informality is rarely the route to long-term business success because of the significant challenges faced in expanding business activities and raising income through informal sector activity. Successful informal businesses have difficulty accessing finance—they quickly outgrow the capacity of microfinance institutions but are denied access to the formal banking system. They cannot use the legal system to deal with contract disputes. Formalization of women's businesses can help women secure long-term welfare, reduce poverty, and improve household stability. Simple adjustment mechanisms must be made available to encourage women in the informal sector to make the transition to the formal economy.

Responses to business law constraints

In the private sector, women are disproportionately constrained relative to men. This is due both to cultural factors existing in patriarchal societies and discriminatory laws. While social and cultural factors must be considered in attempting to remedy the situation, this paper focuses only on business law reforms. Reducing transaction costs in establishing and

Economic empowerment of women

running businesses can likewise reduce the social constraints of the "double-shift, double-burden" (women working at home and in the business), and ensure that women's already limited time can be used more productively.

The key constraints that women face with regard to business laws include

- unsuitability of present business and company structures, which are not flexible enough to meet the needs of women;
- high transaction costs in setting up a business (which have more impact on women, who do not control the family budget or cash flow);
- lack of knowledge and familiarity with business processes and procedures, and general ignorance of the law; and
- difficulty in accessing financial services and mobilizing collateral (e.g., land is almost always controlled by men, so only movable property is available to women to obtain credit).

The present legal frameworks in most Pacific economies are outdated and unsuited to the local context. More specifically, these legal frameworks weren't drafted with the aim of gender equality.

Besides addressing outdated laws, business law reform in the Pacific implemented by ADB addresses the particular constraints faced by women in business. The main objective is to promote private sector-led, inclusive economic growth in the Pacific. Through its Private Sector Development Initiative, ADB is dealing with business law constraints by addressing the thematic nature of the problems inherent in existing business laws. For instance, new laws would remove almost all discretion from the company registration process in order to reduce discrimination and transaction costs. Moreover, these new laws are tailored specifically to suit the local environment, with key stakeholders consulted during the drafting and implementation phases. The rebuilding, or at least improved support, of institutions with a role in administering the new laws would complement the changes to business processes.

The new laws also engender an automated process that significantly reduces additional layers of unnecessary regulations. This sub-layer of regulation was identified as a major impediment in many Pacific economies and was mostly affecting women (who, for example, are deterred by the requirement to physically attend the registry). Automation of business processes improves the accuracy, certainty, and currency of information. In turn, this will be useful for internal administrative purposes and the evaluation of the outcomes of the policy.

The reform agenda

The new laws have introduced a number of different business structures that support women in managing their businesses independently, without undue influence from men. The laws create alternative ownership options and impose reporting and disclosure requirements that reduce male influence. Under the new laws companies are simple to incorporate and easier to manage on an ongoing basis. Hence, the associated transaction costs are minimal.

The current legal frameworks for creating company structures in several Pacific economies were based on the 1948 United Kingdom Companies Act, and remain outdated and inappropriate for the local context: specifically, they do not actively support the participation of women. For instance, they do not permit alternative company structures, such as the formation of community companies.

In addition, under present trust laws, men are invariably the major trustees and control the trusts. This deprives many women of the ability to control and manage community assets for legitimate business purposes. The laws' lack of compulsory disclosure and communities' reluctance to pursue legal remedies make the present structure problematic for community asset holding. There is a crucial need to modify the present entrenched structures in order to create greater flexibility for women wishing to engage in the private sector.

New companies acts have been introduced in Solomon Islands and Tonga; Vanuatu is in the process of enacting a new act. The new and revised companies acts introduce the following benefits for women:

Simplified and automated business incorporation. This has all but eliminated the need to involve a lawyer, and therefore reduces the time and monetary costs associated with incorporation. Furthermore, automation eliminates discretion through an electronic process that does not directly involve the registrar or other staff. These changes make it easier for women, both practically and financially, to engage in businesses while reducing the chances of discrimination. The new laws also provide for an automated enforcement mechanism that directly identifies reporting and disclosure failures on the part of companies. This reduces chances for any illegal interference with registered companies—specifically women-owned companies. Detailed incorporation documents such as memorandums of association and articles of association requirements have been replaced with simple company rules that will provide guidance for women undertaking business

Economic empowerment of women

activities. This also reduces transaction costs as lawyers do not have to draft incorporation documentation.

Introduction of single shareholder/director and limited liability companies. Single shareholder companies remove the need for a second owner (usually a male), giving women greater control over their businesses. Under previous company structures, women weren't always able to manage the business income and operations adequately because of male interference. Women were often minority shareholders and had no input into decision making. This reform may also involve formalizing the informal sole trader businesses. There are numerous benefits for women in incorporating a business under these more flexible structures, including liability protection through separation of ownership from personal legal identity and greater opportunities to obtain credit and expand business opportunities due to formal recognition under the company law framework.

Introduction of community companies. The establishment of the community company structure under the new Solomon Islands Companies Act 2009 opens up greater opportunities for women to participate in business activities. Previously, women had limited resources, assets, and access to finance. Under the new act, women can now mobilize collectively owned and managed community assets (which could comprise any form of movable property from livestock to crops and general inventory) in order to operate various business activities. The community company entity is more transparent and accountable, providing a generally more attractive alternative to holding and utilizing community assets compared with the present trusts structure.

Flexibility of company meetings and resolutions. Under a more flexible regulatory regime, women can participate in meetings held in more convenient locations and times, and without the need of always physically attending (e.g., attendance by electronic means). This arrangement is more considerate of women's special needs and concerns.

Secured transactions and access to finance. Initially, access to microcredit provides women with opportunities to take out small loans. The availability of credit has enabled many self-employed women and microenterprises to stabilize and modestly increase their incomes. With a succession of loans, some women have been able to expand their businesses and/or move into newer and more profitable lines of work while building up a savings cushion (McKee 1989). Problems arise when business success engenders the need for larger loans. In many Pacific economies, cash or land is the only form of collateral accepted by banks, and women are much less likely than men to have access to land titles. Secured transactions reform provides a path to business growth once the size of microloans can no longer supply sufficient credit. Such reforms would allow women to use movable assets (e.g., equipment, inventory, accounts receivables, crops, livestock, and shares) at their disposal as collateral. This would provide a diverse range of options for women and give banks greater flexibility to support women's businesses.

Women have also benefited from the introduction of secured transactions laws and automated registries in a number of Pacific countries. Recently, new laws have been introduced in the Federated States of Micronesia (2006), Vanuatu (2007), Solomon Islands (2008), Republic of the Marshall Islands (2009), Tonga (2010), PNG (2011), and Palau (2012). These laws will significantly improve the environment for accessing credit by (i) introducing a simple system that provides certainty around loans supported by movable collateral and (ii) significantly reducing associated transaction costs. The system supports lending through an electronic registry that simplifies registration of security interests.

Reform initiatives have not been limited to pursuing the passage of laws, but also include publicity and awareness-raising activities. Besides disseminating information through community education programs, several nationwide radio programs were aired to raise public awareness of the new features of the business laws. Further, beyond simply creating an enabling business environment for women, reforms have also assisted in changing the prevailing attitudes toward women's participation in societal affairs. This was achieved through a project design that included extensive consultations with both women and men, and with organizations that regularly interact with women.

Importance of data collection to gender mainstreaming

It should be noted that there is a paucity of gender data currently available. There has been some recent research completed on gender and economic empowerment, but much of the data is anecdotal.

Business law reforms have facilitated the collection of reliable data that will be crucial for monitoring and evaluation purposes. Other than rudimentary information about sectoral employment figures, most statistical agencies in the Pacific do not aggregate the nature of women's business involvement in a thorough manner. Without data, it is not possible to adequately ascertain the level of women's involvement or the nature of the constraints women face in business. Hence, it is difficult to assess and track the effectiveness of previous policies and to design new policy instruments. For instance, due to the lack of data, it is often assumed that there is equal opportunity for women to join the

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formal economy, and the diversity of experiences and situations faced by women is not fully appreciated. Data collected under the new laws will also be important for ascertaining the problems associated with women's access to finance.

Sex-disaggregated data was initially collected prior to the implementation of the laws. The automated company registry processes will continue to collect post-implementation data. For example, the compulsory re-registration of companies under the new companies acts in Solomon Islands, Tonga, and Vanuatu will provide sex-disaggregated data about existing companies. In Solomon Islands, data shows the number of women directors and shareholders are about a third of their male counterparts (i.e., 800 women directors vs. 2,656 men, 839 women shareholders vs. 2,293 men). Data in other Pacific economies will not be readily available until full implementation of automated company registries following the introduction of new laws.

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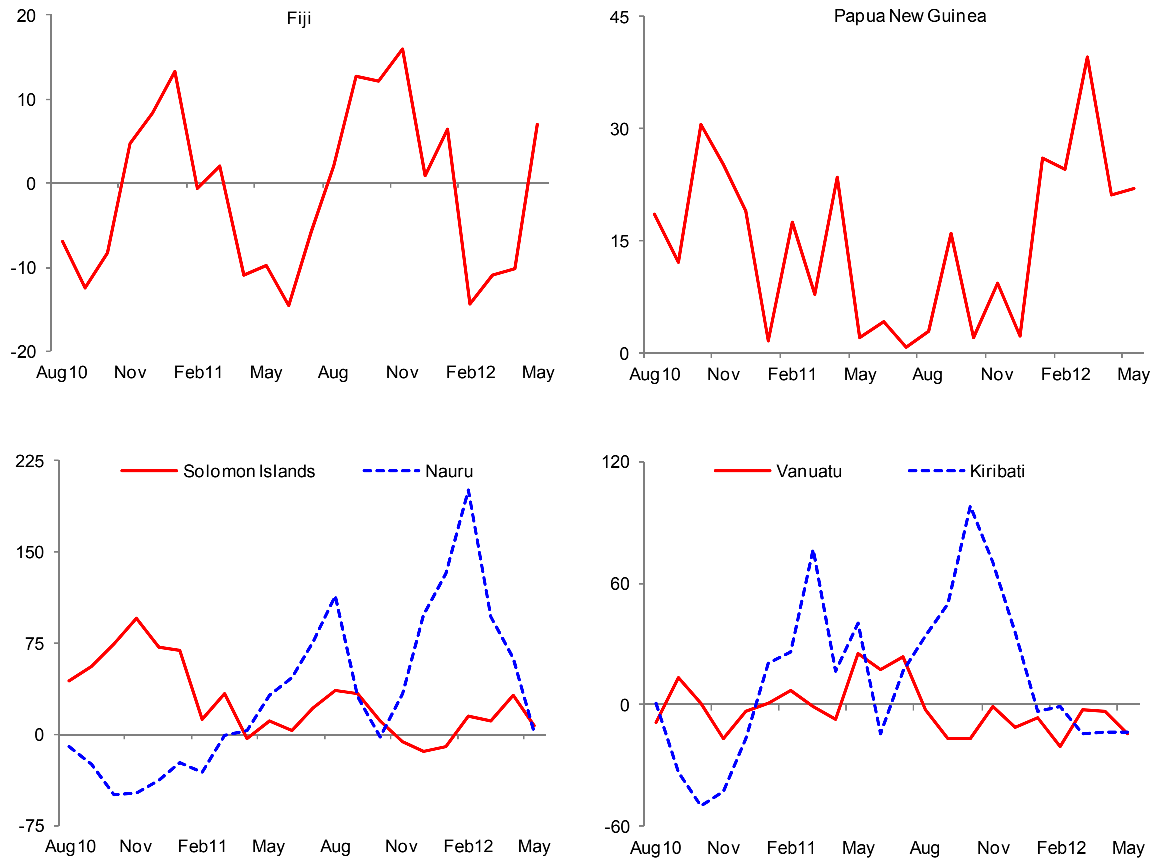
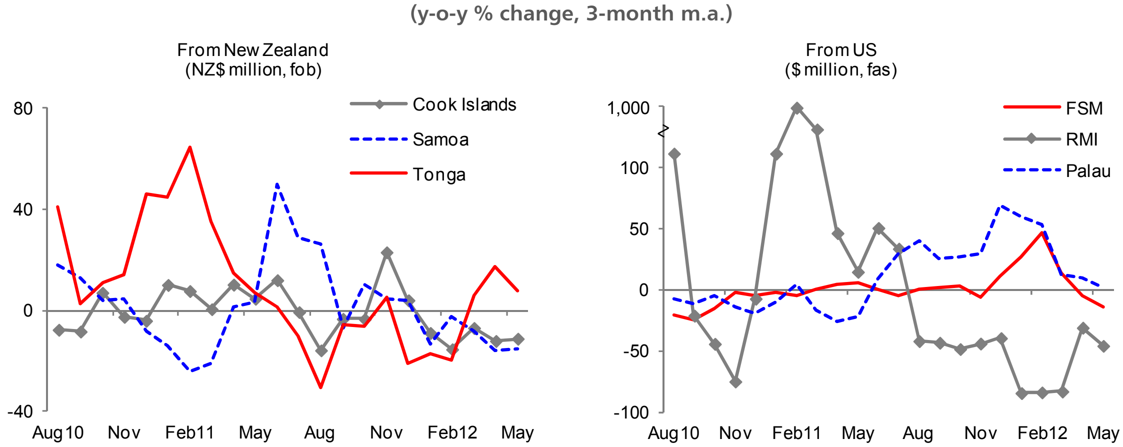
Nonfuel merchandise exports from Australia
(A$; y-o-y % change, 3-month m.a.)



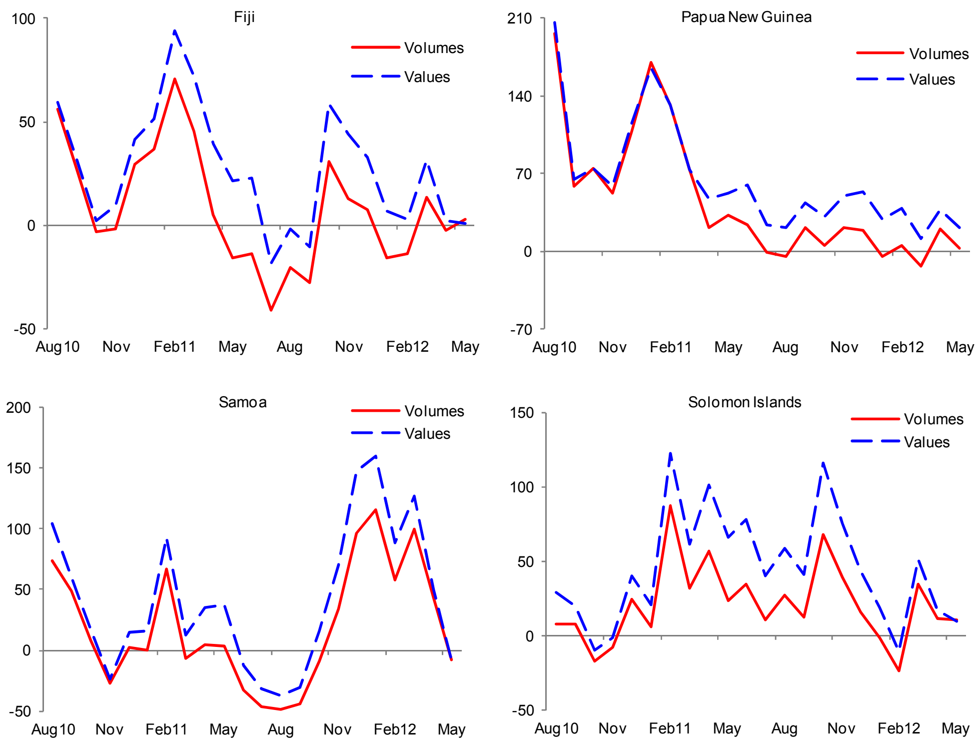
A$=Australian dollars, m.a.=moving average, y-o-y=year on year
Source: Australian Bureau of Statistics.

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

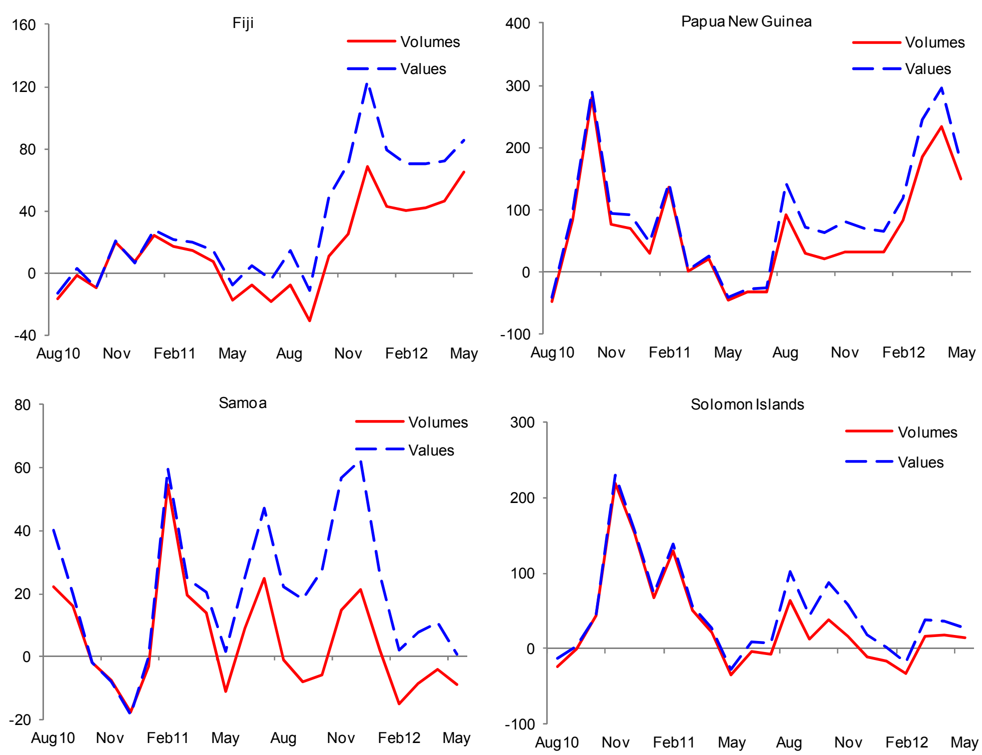


FSM=Federated States of Micronesia, fas=free alongside, fob=free on board, m.a.=moving average, NZ$=New Zealand dollar, RMI=Republic of the Marshall Islands, US=United States, y-o-y=year on year
Note: The Cook Islands–Fiji shipping route closed in 2009.
Sources: Statistics New Zealand and US Census Bureau.

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

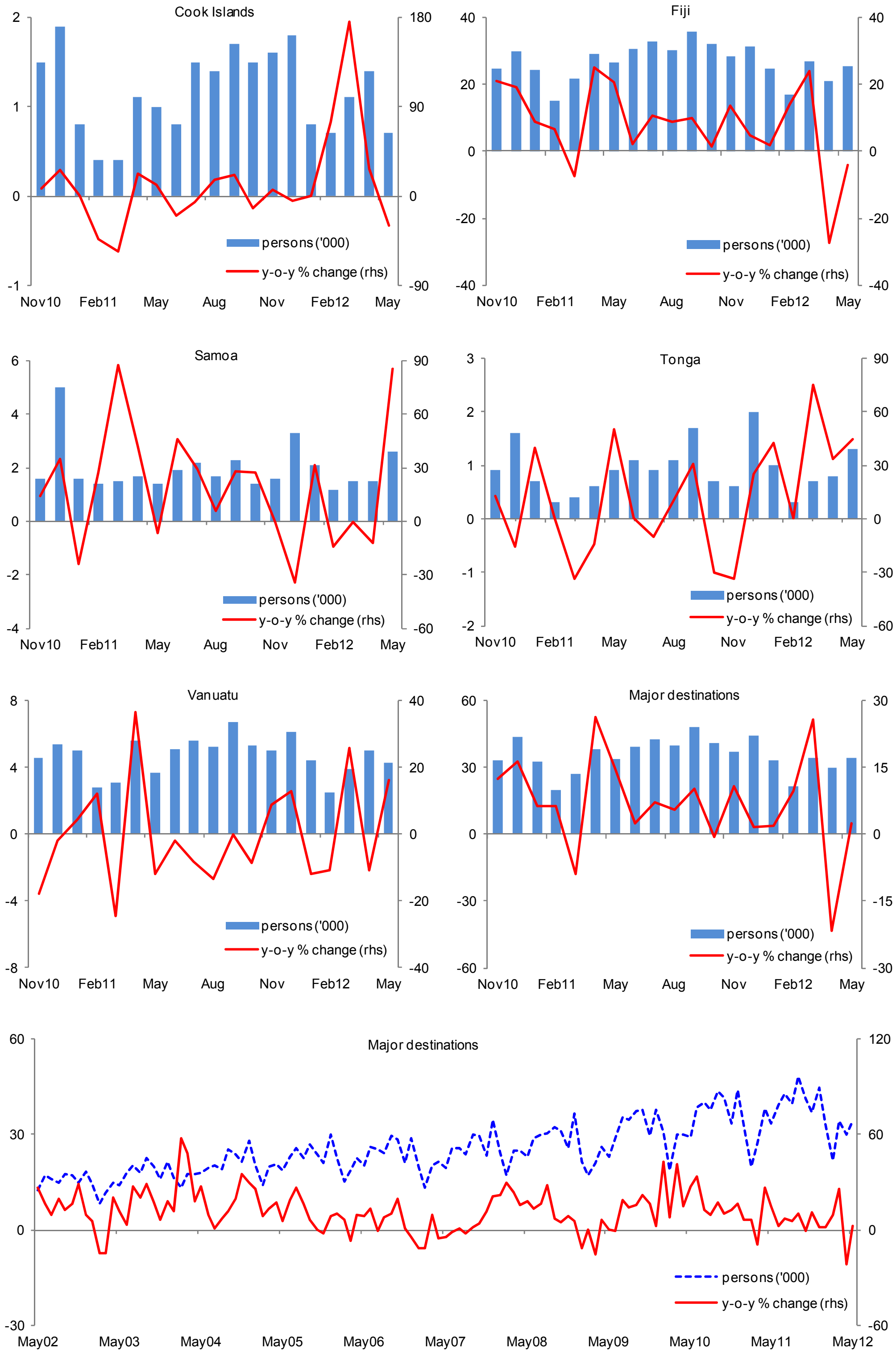


Gasoline exports from Singapore
(y-o-y % change, 3-month m.a.)



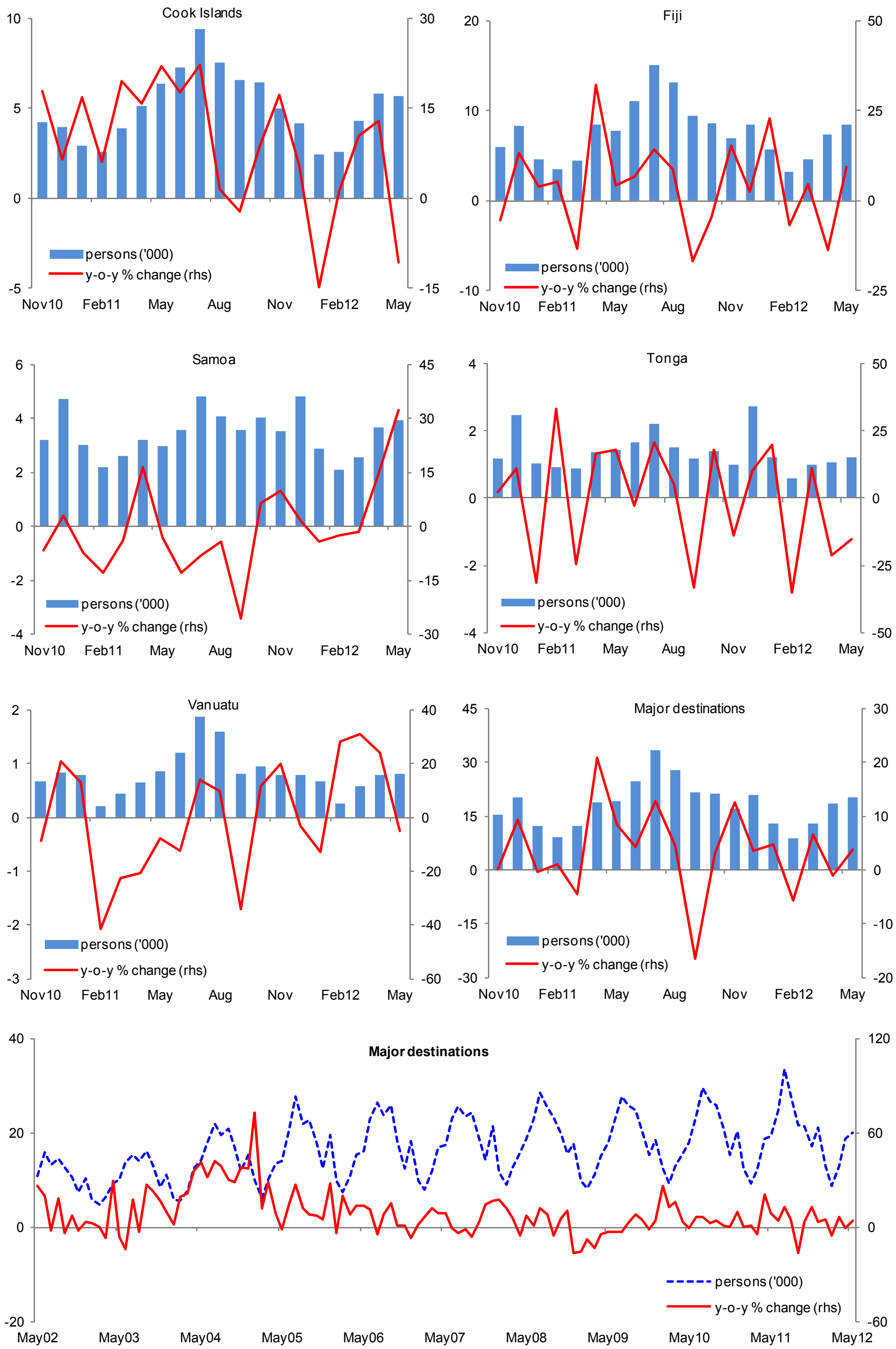
m.a.=moving average, y-o-y=year on year
Source: International Enterprise Singapore.

Departures from Australia to the Pacific
(monthly)



rhs=right hand scale, y-o-y=year on year
Sources: 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)	4.0 (Mar-Q 2012)	–4.0 (Dec-Q 2011)	-31.0 (FY2011)	—	–2.8 (FY2012e)
Fiji	1.3	4.5 (June 2012)	7.3 (Mar 2012)	–26.1 (2011e)	4.7 (June 2012)	–3.5 (2011e)
Kiribati	3.5	5.5	—	–48.0 (2010e)	—	–18.1 (2012p)
Marshall Islands	5.4	2.5	2.1 (FY2010e)	–57.3 (FY2010e)	—	1.4 (FY2011e)
FSM	1.0	3.5	12.6 (Dec 2009)	–46.2 (2009e)	2.7 (FY2009)	0.4 (FY2011e)
Nauru	4.8	0.9 (Dec 2011)	—	—	—	0.6 (FY2011e)
Palau	4.0	7.9 (Mar-Q 2012)	—	–46.3 (FY2010e)	—	–1.6 (FY2011e)
PNG	7.5	4.0 (Mar-Q 2012)	7.2 (Sep 2011)	9.9 (2011e)	10.9 (Mar-Q 2012)	0.3 (Mar-Q 2012)
Samoa	1.0 (FY2012e)	5.5 (June 2012)	2.4 (Apr 2012)	9.6 (2011e)	5.0 (Apr 2012)	-7.3 (FY2012e)
Solomon Islands	6.0	7.9 (Apr 2012)	10.7 (Mar 2012)	2.6 (Mar-Q 2012)	9.6 (May 2012)	6.0 (2011e)
Timor-Leste[b]	10.0	11.2 (May 2012)	1.5 (Mar-Q 2012)	–75.1 (2011e)	—	181.0 (2012p)
Tonga	1.3 (FY2012e)	1.5 (Apr 2012)	-14.8 (Apr 2012)	-37.9 (FY2011)	9.0 (Apr 2012)	–2.0 (FY2011e)
Tuvalu	1.2	2.6	—	-19.5 (2011e)	6.7 (2011e)	-3.0 (2012p)
Vanuatu	3.0	2.1 (Mar-Q 2012)	11.5 (Mar-Q 2012)	-24.2 (2011e)	6.8 (Dec-Q 2011)	-2.6 (2012p)

— =not available, e=estimate, FSM=Federated States of Micronesia, GDP=gross domestic product, 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*. 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.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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