ADB Pacific Economic Monitor

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

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Highlights

- Recent developments. Most economies in the Pacific region have experienced significant increases in food and fuel prices since these commodities began their recoveries from Global Economic Crisis (GEC) lows in early 2009. Latest data show particularly sharp price increases in Fiji, Papua New Guinea (PNG), Timor-Leste, and Tonga during this period. Continued price volatility is expected, particularly for petroleum, during the remainder of the year.
- The post-GEC price recovery has benefited resource-rich countries through higher export revenues. Combined with increased government spending and investment, this has allowed PNG and Timor-Leste to register robust growth. However, inflation appears to be mounting in these economies, with PNG showing signs of possible overheating in some sectors.
- Outlook. GDP growth in the Pacific region is now projected to reach 6.4% in 2011, before moderating to 5.5% in 2012. The outlook for the larger petroleum-exporting economies of PNG and Timor-Leste is more favorable due to the prices of their chief exports and ongoing construction activity in resource extraction projects. The other Pacific islands are expected to post much lower GDP growth of around 2.0% for both 2011 and 2012.
- Inflation forecasts for 2011 are revised upward in some Pacific economies, due to international commodity price rises early in the year and broad depreciation of the US dollar against most currencies. Inflation is expected to be high in heavily import-dependent island economies. For the region as a whole, the outlook is for inflation to rise to 8.4% in 2011, and then ease to 5.9% in 2012 as petroleum and commodity prices stabilize.
- Economic policy and management. Recent trends in international prices of petroleum and other commodities are causing at least short-term declines in terms of trade and trade balances for most Pacific economies. The analysis finds clear negative impacts on most Pacific economies, but cautions against crafting policies based on the assumption that price shifts will persist. Past experience has demonstrated the price stabilizing effects of adjustments of both commodity producers and consumers in the long term. Policy recommendations for managing price volatility are considered.
- Simulations of long-term growth prospects indicate that selected Pacific economies will achieve yearly growth of 1%–3% in per capita incomes over the next 2 decades assuming modest improvements in the efficiency of their resource use. Simulations use a growth accounting framework assuming historical rates of factor accumulation and reasonable improvements in technical efficiency. Results show economic growth rates in the Pacific will continue to fall below those achieved in other developing countries in Asia over the past 2 decades. If these simulations hold true, there will be a widening gap between the two regions.
- Lastly, this issue analyzes fiscal adjustment issues in Samoa and Tonga, as case studies of effectively working with Pacific governments in responding to the GEC. Post-crisis fiscal consolidation is underway in both countries led by improved fiscal management, structural reform, and business deregulation. Assistance of ADB and other development partners through budget support grants has been integral to these achievements. Building on these gains will be important in raising economies' resilience to future economic volatility.

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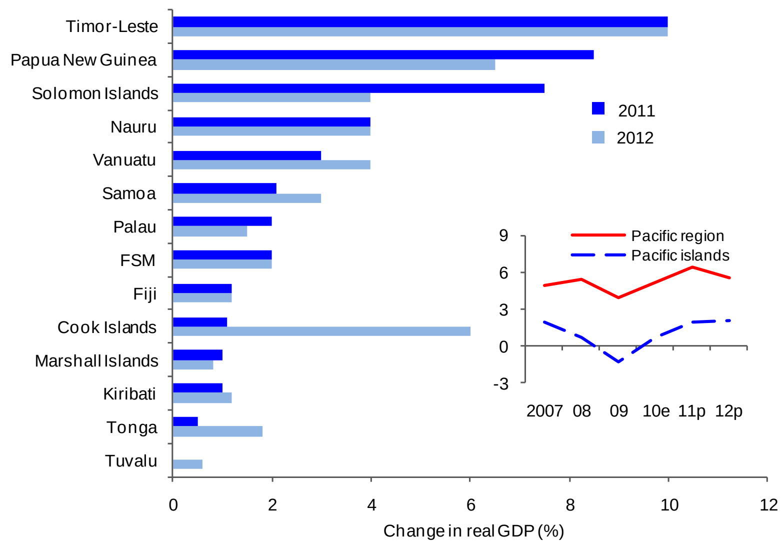
Abbreviations

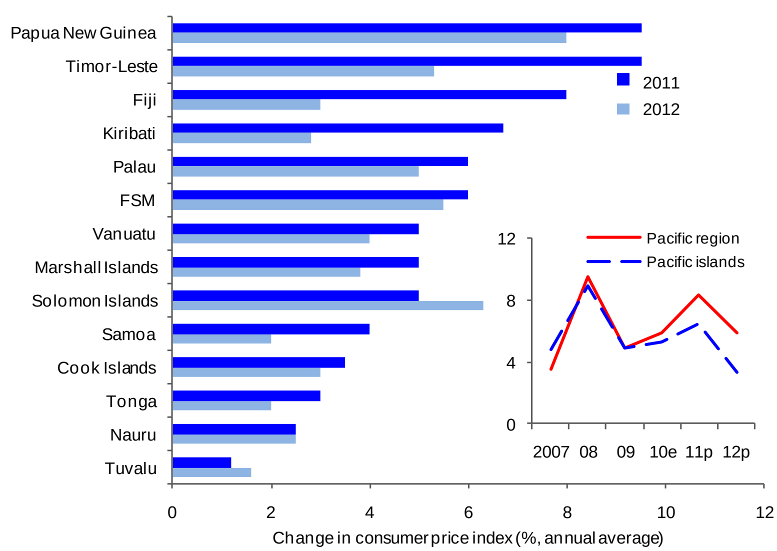
$	US dollars, unless otherwise stated
ABS	Australian Bureau of Statistics
ADB	Asian Development Bank
AUS	Australia
A$	Australian dollar
DMC	developing member country
e	estimate
f	forecast
fas	free along side
fob	free on board
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
lhs	left hand scale
LNG	liquefied natural gas
m.a.	moving average
NZL	New Zealand
NZ$	New Zealand dollar
PNG	Papua New Guinea
rhs	right hand scale
RMI	Republic of the Marshall Islands
SI$	Solomon Islands dollar
SOE	state-owned enterprise
TFP	total factor productivity
US	United States
VAT	value-added tax
y-o-y	year-on-year

Latest Asian Development Bank projections

GDP growth



Inflation



Note: Projections are as of July 2011 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 percentage changes to reduce the impact of seasonality, and 3-month moving averages 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, and Palau; and 31 December elsewhere.

International developments

Natural disasters dampen world economic recovery

- The global economy is expected to continue growing, albeit at a more moderate pace than in 2010, according to the International Monetary Fund (IMF). Coming from 5.1% growth in 2010, world GDP is forecast to grow by 4.3% in 2011 and 4.5% 2012. Emerging and developing economies are expected to remain the main drivers of growth. World merchandise trade is projected to grow by 8.2% in 2011 and 6.7% in 2012.

- ADB's *Asian Development Outlook* 2011 projects growth of close to 8.0% for Developing Asia in the next 2 years, supported by strong domestic demand and robust growth in merchandise exports.

- US economic growth slowed in the first quarter of 2011 compared with 2010 due to reduced government spending, weaker private consumption, and rising import costs, particularly for energy. Euro area GDP, on the other hand, grew faster, led by Germany and France. In March, the devastating earthquake, tsunami, and nuclear crisis significantly disrupted the Japanese economy, causing further contraction of output in the first quarter. The ill effects may persist into 2012.

- The severe flooding and aftermath of Cyclone Yasi have affected Australia's agriculture, mining, and tourism sectors and led to a 1.2% (quarter-on-quarter) contraction in the first quarter of 2011. However, the economy is expected to recover quickly. The New Zealand economy is expected to contract during the first quarter of 2011 following the earthquake in February. The cost of the earthquake is estimated at 8% of GDP. The Reserve Bank of New Zealand cut its policy interest rates by 50 basis points in March to spur investment and shore up confidence in the economy.

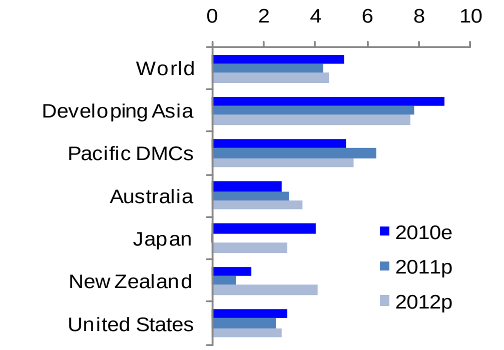
High and volatile commodity prices fuel inflation

- Commodity prices continue to rise, with crude oil being 43% more expensive in May 2011 compared with the same period a year ago. The IMF's food price index peaked in February 2011, 5.4% higher than its June 2008 peak. Prices of key Pacific exports such as logs and coconut oil remain high.

- Driven by rising commodity prices, inflation has become a concern to advanced economies as well as developing ones. Monetary authorities are moving toward more constrained stances as countercyclical measures are wound down and policies tightened in response to early signs of inflation. The US Federal Reserve indicated that its asset purchases program would be completed in June. For the first time in almost 3 years, the European Central Bank raised its policy interest rate (now at 1.5%) with rate hikes in April and July.

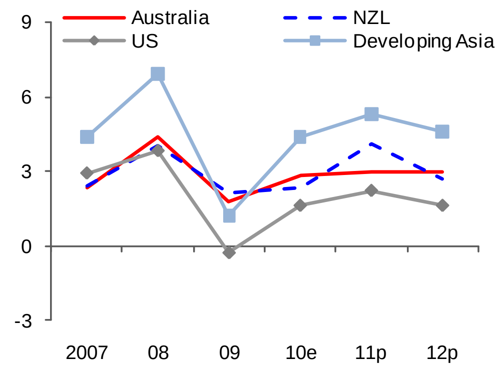
- Downside risks to continued growth persist. Sovereign debt crises in several European Union (EU) countries linger, with Portugal being the latest to request a bail-out. Persistent volatility in food and fuel prices will likely dampen global economic growth and increase hardship, particularly among the vulnerable.

GDP growth
(%, annual)



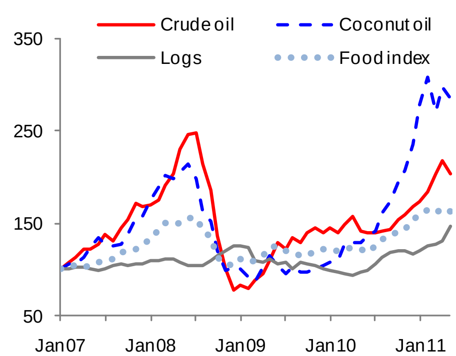
DMC=developing member country, e=estimate, p=projection
Sources: IMF. 2011. *World Economic Outlook* (April and June). ADB. 2011. *Asian Development Outlook 2011.*

Inflation
(%, annual)



e=estimate, p=projection
Sources: IMF *World Economic Outlook* (April 2011). ADB *Asian Development Outlook* 2011.

Key commodity prices
(Index: Jan 2007=100)

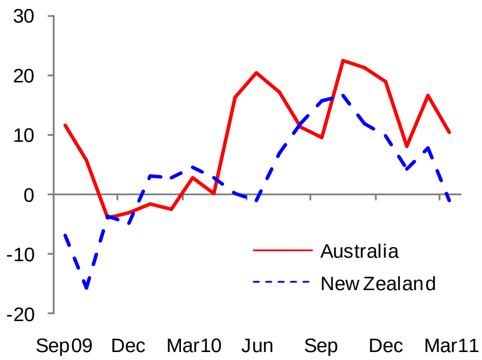


Source: IMF International Financial Statistics.

This section draws on ADB. *Asian Development Outlook* 2011; and IMF. *World Economic Outlook Update.* Washington D.C. (April and June 2011).

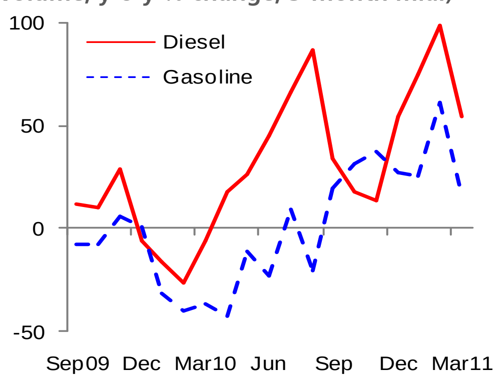
Key trends in the Pacific

Nonfuel exports to the Pacific
(value; y-o-y % change, 3-month m.a.)



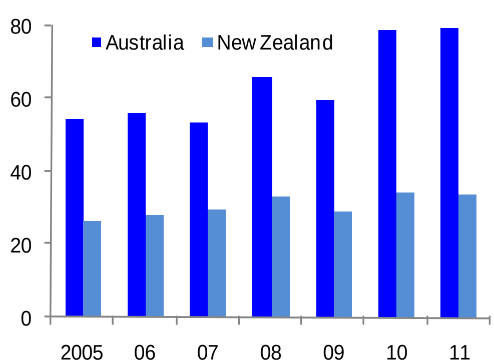
Sources: ABS and Statistics New Zealand.

Singapore fuel exports to the Pacific
(volume; y-o-y % change, 3-month m.a.)



Sources: International Enterprise Singapore.

Tourism departures to Pacific countries
('000; January–March totals)



Sources: ABS and Tourism Strategy Group, New Zealand Ministry of Economic Development.

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

Imports continue to grow amid rising prices

- The value of Pacific nonfuel imports from Australia and New Zealand continued to grow in the first quarter of 2011, but the rate of growth moderated compared with the previous quarter. Imports from Australia grew at an average of 11.7% (y-o-y) in the first quarter, peaking in February and then decelerating. Imports from New Zealand exhibited similar behavior in the same period, with growth also peaking (7.7%) in February before turning negative in March.
- The growth in volume of fuel imports to the Pacific from Singapore slowed in the first quarter of 2011, continuing the volatility from 2010. Importation of diesel slowed down only slightly in Fiji, while sharper declines were observed in PNG, Samoa, and Solomon Islands. Gasoline imports spiked upward in PNG and Solomon Islands in late 2010, and subsequently increased more slowly.
- Import growth remains high in the Pacific. Economies with large natural resource based exports have been more able to support this as rising world commodity prices boosted trade earnings. Pressures on balance of trade, current account, and foreign reserves may emerge elsewhere.

Tourism to the Pacific leveling off

- Tourist departures to major Pacific destinations from primary source markets slowed over the first quarter of 2011 after posting solid growth in 2010. Australian tourism to the region has been on a downward trend. The number of visitors from New Zealand, which posted modest gains in the previous year, also fell in the first quarter of 2011.
- After 20 consecutive months of expansion, Australian tourism to the Pacific fell by 9.1% in March 2011 compared with departures the previous year. Growth in visitor numbers slowed in January and February 2011 before declining in March. Only Fiji and Samoa posted increases in Australian tourist arrivals during the first quarter of 2011, relative to the first quarter of 2010. Elsewhere in the Pacific, the Cook Islands suffered a contraction of 33.3%; Vanuatu saw a modest 4.4% decline; and arrivals to Tonga were unchanged. Overall, Australian departures to major South Pacific destinations were nearly flat, increasing by only 0.5% (y-o-y) during the first quarter of 2011.
- Departures from New Zealand to the Pacific were lower by 1.5% in the first 3 months of 2011 compared with the same period in the previous year. Tonga and Vanuatu experienced large declines, and there were lower New Zealand tourist numbers recorded in Fiji and Samoa. However, New Zealand tourism to the Cook Islands remains strong, expanding by 14.7% (y-o-y) in the first quarter of the year.
- In the coming months, tourism is likely to continue to weaken due to rising fuel prices and transport costs, along with the potential negative impacts of calamities in Australia, Japan, and New Zealand earlier in the year. The recent earthquake in Japan can be expected to have a particularly adverse impact on arrivals in northern Pacific destinations such as Palau.

Cook Islands

Recent developments

- The Cook Islands' economy is recovering after contracting by 3.5% in FY2009 and 0.1% in FY2010. Recovery is underpinned by increases in tourist arrivals and infrastructure construction.
- Inflation is not yet a significant issue. Higher world fuel and food prices in early 2011 increased inflation from –1.4% in the last quarter of 2010 to 1.5% in the first quarter this year.
- Tourism continues to show improvement, but growth relies primarily on New Zealand visitors, which expanded by 15% (y-o-y) in the first quarter of 2011. Australia tourism contracted by 33% during the same period while tourist numbers from the European and US markets continue to trend downward.
- Total exports increased by more than 62% in 2010, with fish exports growing 58%. Exports of fish and pearls are expected to grow moderately over the remainder of the financial year, while exports of noni juice will decline significantly following the Japanese disaster. The balance of trade recorded a deficit of NZ$105.6 million in the September 2010 quarter, which increased by NZ$10.5 million from the June 2010 quarter (or NZ$30.9 million more than the same quarter in 2009).
- Government revenue from imports reached NZ$8.5 million in the September 2010 quarter, NZ$0.2 million more than the previous quarter and NZ$1.0 million more than the same quarter in 2009. Total value-added tax (VAT) on sales and income was NZ$14.5 million for the December 2010 quarter, mostly from wholesale and retail trade (41.1%) and hotels and motels (17.1%).
- Private sector activity remains subdued, with limited commercial bank lending to businesses. Net domestic credit decreased by 1.1% during the September 2010 quarter. Total lending decreased by 0.3% in the December 2010 quarter. Thus, the benefits of economic recovery are still being felt unevenly.

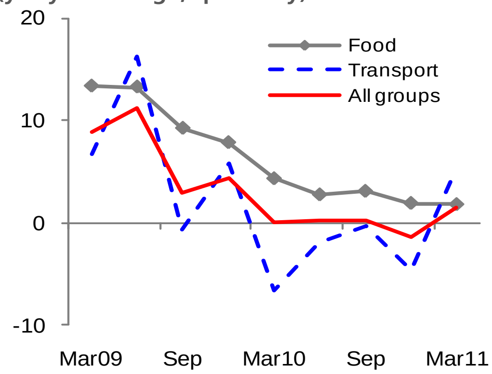
Outlook

- The economy is projected to grow by 1.1% in FY2011 and 6.5% in FY2012 on the back of an intensive 3-year program to rapidly expand air services and increase tourism promotion activities. Inflation is forecast at 3.5% in FY2011 and 3.0% in FY2012 due to the expected upward movement of international oil prices.

Key issues

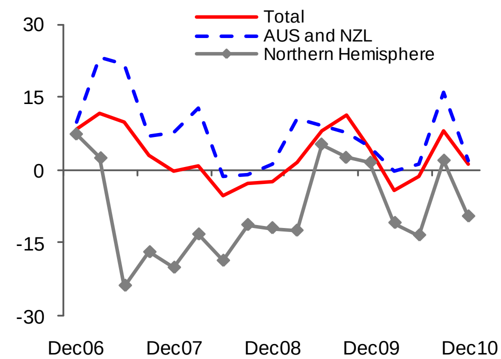
- The share of government personnel expenses to total revenue has surpassed the targeted ceiling of 40%. Implementing the recommendations arising from the ongoing functional review will be essential to ensure the quality of this expenditure.
- Raising private sector capital investment levels is also essential to promote growth, but care must be taken to ensure this is done in a sustainable manner.

Inflation, by commodity group
(y-o-y % change, quarterly)



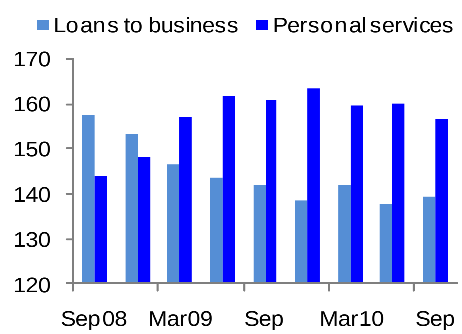
Sources: Cook Islands Statistics Office.

Tourist arrivals
(y-o-y % change, quarterly)



AUS=Australia, NZL=New Zealand
Source: Cook Islands Statistics Office.

Bank lending
(NZ$ million, quarterly)

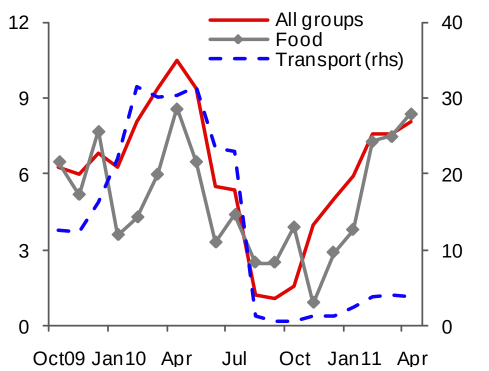


NZ$=New Zealand dollar
Source: Cook Islands Statistics Office.

Lead author: Malie Lototele.

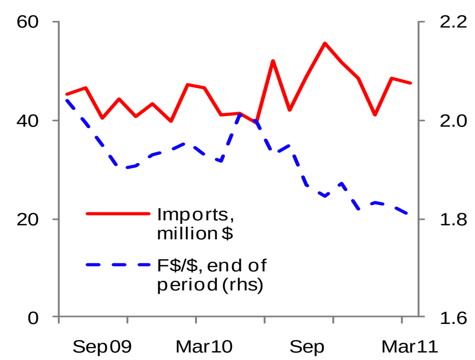
Fiji

Inflation, by commodity group (y-o-y % change, monthly)



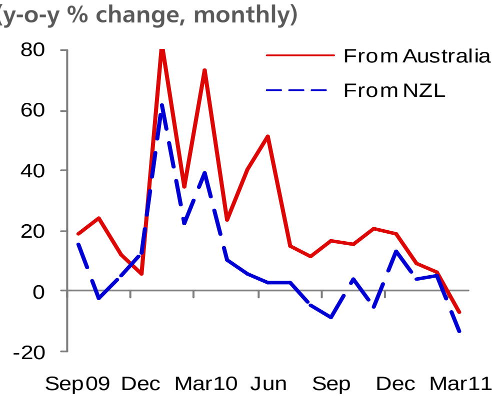
rhs=right hand scale
Source: Fiji Islands Bureau of Statistics.

Imports from Australia, NZL, and US (monthly)



$ = US dollar, F$ = Fijian dollar, rhs=right hand scale
Source: ABS, Statistics New Zealand, US Census Bureau, and Reserve Bank of Fiji.

Departures for Fiji (y-o-y % change, monthly)



Source: ABS and New Zealand Ministry of Economic Development.

Lead author: Emma Veve.

Recent developments

- The official 2011 year-end inflation estimate was revised from 6.0% to 7.0% due to expectations regarding food and oil prices, inflation in trading partner economies, and the improved outlook for domestic growth. The month–on-comparable-month inflation rate stands at 8.1% in April 2011, driven by higher food prices. Once the Prices and Incomes Board allows high international fuel prices to be reflected in local pump prices, this will add to inflation.

- Growth for 2010 was upgraded from 0.1% to 0.6%. This weak outcome was despite reported growth in exports (21%) and tourist arrivals (17%). This performance was not enough to offset weak performances in sugar and other agriculture.

- A weak domestic economy undermines the growth impetus from the global economy. Imports grew just 3.2% in 2010. An assessment of first quarter 2011 performance of major source markets points to only marginally higher import levels. Liquidity remains high, but domestic credit contracted for the sixth straight month in March 2011. The labor market is stagnant, with the Reserve Bank's Job Advertisement Survey finding a 0.5% annual increase in job advertisements in April 2011.

Outlook

- The official inflation forecast of 7.0% may prove to be conservative; ADB projects 8.0% annual inflation, driven by global fuel and food prices. High inflation will further dampen domestic economic activity and drive more people into poverty.

- ADB has raised the growth forecast for 2011 to 1.2%, in the expectation of building on the 0.6% growth of 2010. Indicators show slow tourism growth—Q1 2011 departures from Australia and New Zealand were up 3.6% on the same period in 2010. Cane and sugar production projections are flat. Mining sector growth, while impressive, contributes just 0.4% of GDP.

Key issues

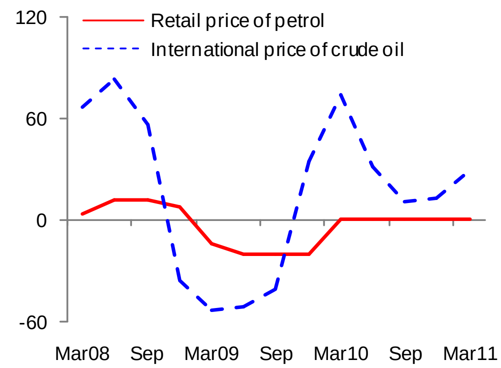
- Only private sector investment will improve Fiji's growth performance. Public investment is constrained by existing debt levels and limited capacity for project implementation. Raising private investment from 3.5% of GDP in 2010 requires improvements to the investment environment, including increased transparency in government decision making.

- Preparations for the 2012 budget have commenced, with Cabinet approval of the Budget Strategy covering 2012 through 2014. Following through on plans to address impediments and bottlenecks to investment—including providing adequate resources to: law enforcement, investment approval agencies, and education and training—will be essential to achieving sustained growth.

Kiribati

- After 2 years of contraction, the economy recovered in the second half of 2010 and realized 0.5% growth for the year. Growth is expected to strengthen to 2.0% in 2011, as public infrastructure projects funded by major development partners—road rehabilitation, and airport and port upgrades—get underway.
- Reform of public enterprises is showing positive outcomes. Kiribati Supply Company was sold to a local business in early 2011. Another five public enterprises are targeted by the government for reform.
- Kiribati experienced deflation in 2010 due to the appreciation of the Australian dollar and fall in the price of rice, which makes up 20% of the consumer price index food basket. Inflation is projected to average 6.7% in 2011 due to higher world food prices.
- Fuel prices are a more important inflationary component in such a remote economy, but retail prices of petrol in Kiribati remained unchanged in the first quarter of 2011 due to price controls. The risk is that inflationary pressures will build behind these controlled prices, and the effects will be felt more strongly when local prices are adjusted.

Petrol prices
(y-o-y % change, quarterly)



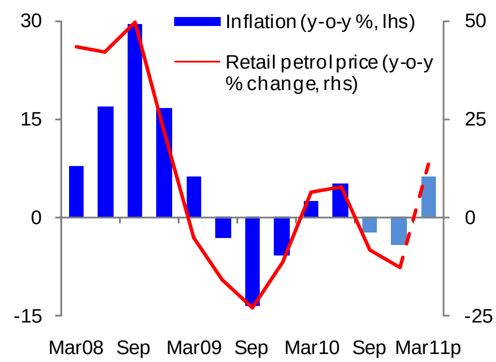
Sources: Kiribati National Statistics Office and IMF International Financial Statistics online database.

Lead author: Malie Lototele.

Marshall Islands

- Despite a steady increase in the international price of crude oil over the second half of 2010, retail petrol prices in the Republic of the Marshall Islands (RMI) fell from $5.38 per gallon in the June quarter to $4.49 in the December quarter. Even with such price cuts, pump prices are still higher in the RMI compared with other northern Pacific DMCs, reflecting its relative remoteness. A subsequent upturn in pump prices also appears likely due to the continued rise in the cost of crude oil, particularly in early 2011. However, recent trends remain broadly consistent with the original inflation outlook, where prices are projected to increase by 5.0% in FY2011 (ending 30 September 2011) and by 3.8% in FY2012.
- A major upgrade of the Amata Kabua International Airport runway in Majuro, a designated emergency landing site for trans-Pacific flights, commenced recently. The $16 million project, aimed at achieving international safety standards, is among the largest construction projects ever in the RMI. This should provide a welcome boost to economic activity, and support the projected moderate acceleration in GDP growth over the near term.
- Recent data on imports from the US also point to some pickup in domestic activity, with large purchases of machinery and transport equipment in January–February 2011. Food imports also increased by 0.6% in value terms in the March quarter of 2011 after previous months of decline, indicating a possible recovery in consumer spending.

Inflation and petrol prices
(quarterly)

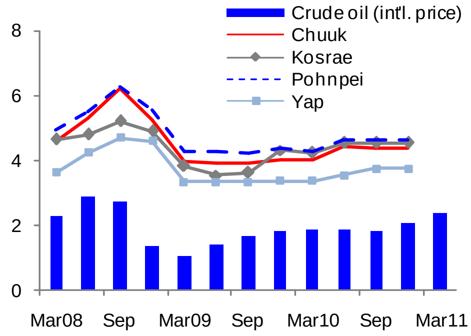


p=projection, lhs=left hand scale, rhs=right hand scale
Sources: RMI Economic Policy, Planning, and Statistics Office and ADB estimates.

Lead author: Rommel Rabanal.

Micronesia, Federated States of

Retail price of petrol, by state
($ per gallon, quarterly)



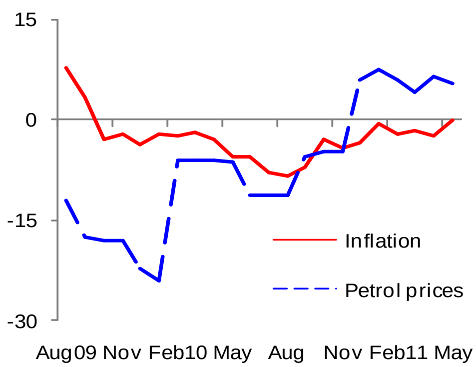
Sources: FSM Division of Statistics and IMF International Financial Statistics online database.

Lead author: Rommel Rabanal.

- Inflationary pressures are again building with the continuing uncertainty in international commodity markets. Retail prices of petrol were fairly stable over the last 3 quarters of 2010, but the sharp increase of almost 30% (y-o-y) in the international price of crude oil in the March quarter of 2011 may eventually drive an upward adjustment of pump prices. On average, retail petrol prices in the FSM are highest in the capital state of Pohnpei, at about $4.63 per gallon as of the December quarter of 2010. Petrol costs about 10 cents less in Kosrae and 27 cents less in Chuuk, while prices are lower by almost $1 per gallon in Yap.
- The recent uptrend and prevailing risks in international food and fuel prices have resulted in an upward revision in the inflation outlook for the FSM. Consumer prices are now projected to increase by about 6.0% in FY2011 (ending 30 September 2011) before moderating slightly to 5.5% in FY2012 as commodity prices stabilize.
- Liquidity in the banking system contributes little to economic growth, as only a small portion of deposits are lent to the private sector. Plans for the FSM Development Bank to engage in retail lending may be reconsidered, to avoid direct competition with private commercial banks. This will facilitate further development of the financial sector and promote more productive lending and increased private investment.

Nauru

Inflation and retail petrol price
(y-o-y % change, monthly)



Sources: Nauru Bureau of Statistics.

Lead author: Milovan Lucich.

- Consumer prices continued to fall in the first 2 months of 2011, marking 17 consecutive months of decline. However, retail petrol prices started to rise in December 2010 and will likely lead to higher inflation in 2011.
- A positive recent development has been the agreement between the government and Digicel, the mobile telephony provider, to begin providing financial services such as retail payments and the payment of government salaries through mobile phones starting in Q2 2011. Financial services have been almost nonexistent on the island since the collapse of the Bank of Nauru several years ago.
- Infrastructure issues continue to constrain Nauru's phosphate exports. Although some repairs have been made to the mooring buoys, a lack of reliable power has hampered the shipment of phosphate ores overseas. Only A$1 million in phosphate exports to Australia was recorded in the first trimester of 2011 after recording A$5 million of exports in the last 4 months of 2010. This is despite recent high phosphate prices, which rose by more than 50% in early 2011 compared with the same period a year earlier.

Palau

Recent developments

- The rising international price of crude oil has translated into higher pump prices in Palau, which in turn threatens to push inflation above recent rates. In the March quarter of 2011, retail petrol prices averaged $4.23 per gallon—the highest level since the September quarter of 2008. This corresponds to an increase of more than 16% compared with the same quarter last year. Based on recent trends, inflation has likely reached the 6% mark over the past 3 quarters, due primarily to the increasing price of petroleum products.
- Visitor arrivals remain strong, as the number of tourists in the first 4 months of 2011 is still up by almost 20% (y-o-y). This rate of growth has been sustained since the first quarter of the current fiscal year (October–December 2010) and bodes well for Palau's tourism-driven economy. Arrivals from Japan, the largest and highest spending market, increased by about a third of its previous level in the period from October 2010 to April 2011. The number of tourists from Taipei,China, also increased by more than 15% in the same period.
- However, imports from Palau's primary trading partner, the US, is still subdued, indicative of possible lingering weaknesses in other sectors of the economy. The recent uptick in the value of food imports may also be driven more by high international commodity prices rather than by firmer domestic demand.

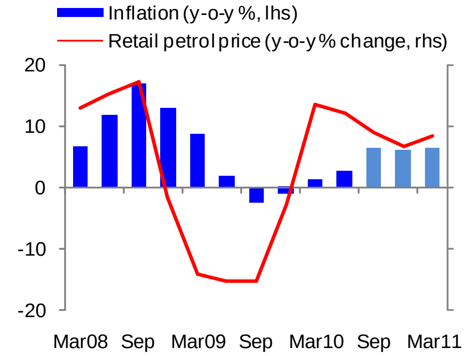
Outlook

- While tourist numbers have yet to be affected by the adverse impacts of the earthquake and tsunami in Japan last March, some slowdown in tourism activity is expected over the second half of FY2011 (ending 30 September 2011). However, the addition of Delta Airlines as a scheduled carrier to Palau expands the existing market access and may compensate for any adverse impacts.
- Sharper-than-expected increases in international commodity prices in early 2011, along with the continuing risk of political upheaval in the Middle East and northern Africa, are projected to drive higher global inflation in the immediate term. Therefore, inflation projections for Palau have been adjusted upward to 6.0% in FY2011 and 5.0% in FY2012.

Key issues

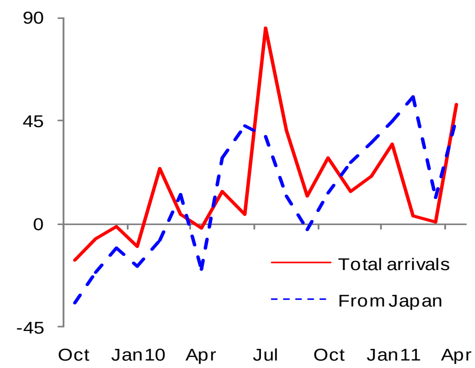
- In November 2010, ADB approved the $16 million Water Sector Improvement Program, its first loan provided to Palau. The program addresses the cost-effectiveness and sustainability of utilities by rationalizing water and sewage charges to reflect the actual cost of service, thereby eliminating the need for perennial subsidies from the government.
- Stimulating increased private sector activity will be essential in the medium term against the backdrop of fiscal consolidation. Simplified licensing procedures, improved access to labor (particularly for foreign firms), and financial sector reforms to facilitate a greater availability of credit are all required to support the growth of foreign direct investment and the private sector in general.

Inflation and petrol prices (quarterly)



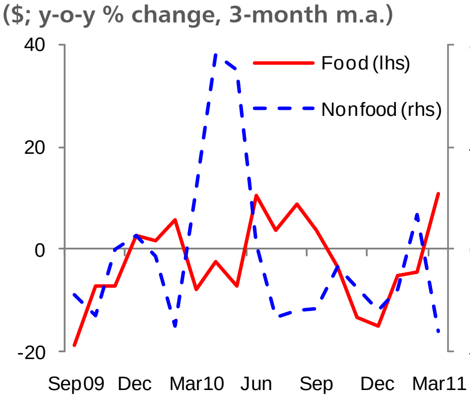
lhs=left hand scale, rhs=right hand scale
Sources: Palau Office of Planning and Statistics and ADB estimates.

Visitor arrivals (y-o-y % change, monthly)



Source: Palau Visitors Authority.

Imports from the US ($; y-o-y % change, 3-month m.a.)

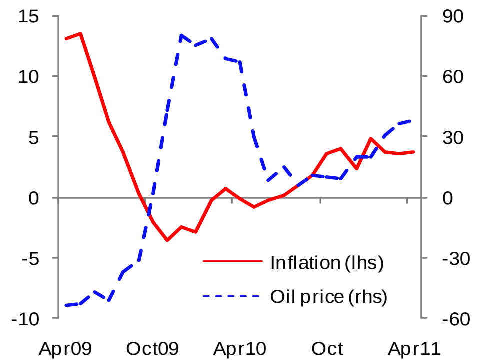


lhs=left hand scale, rhs=right hand scale
Sources: US Census Bureau.

Lead author: Rommel Rabanal.

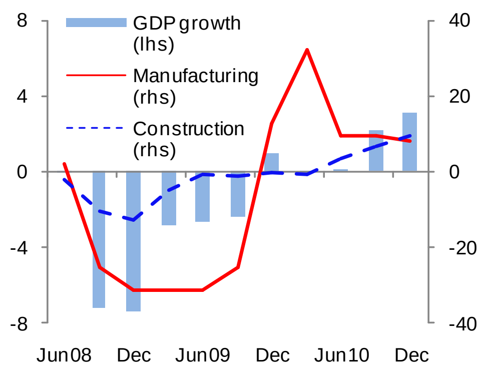
Samoa

Inflation vs. changes in world oil prices
(y-o-y % change, monthly)



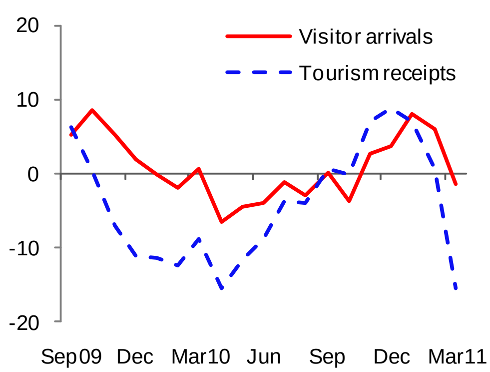
lhs=left hand scale, rhs=right hand scale
Source: Central Bank of Samoa, *Quarterly Bulletin*; IMF International Financial Statistics.

GDP growth, by industry
(y-o-y % change, quarterly)



lhs=left hand scale, rhs=right hand scale
Source: Samoa Bureau of Statistics.

Visitor arrivals and tourism receipts
(y-o-y % change, monthly)



Source: Central Bank of Samoa.

Recent developments

- A combination of fiscal and monetary easing, significant reconstruction expenditure, and improving global demand held the economy's contraction in FY2010 to a relatively low level (–0.2%).
- Inflation has been rising in recent months, largely as a result of increases in world food and fuel prices, and poor domestic agricultural production following excessive rainfall. These factors have placed upward pressure on the prices of locally produced goods and services. Overall prices are expected to have increased by about 4.0% in June 2011 (y-o-y).
- Tourism performance in the third quarter of FY2011 was flat. Total arrivals increased slightly (by 1.0% or 937 visitors) compared with the same period in FY2010, but tourism earnings remained largely unchanged.
- Remittances improved slightly in the third quarter of FY2011, picking up by 2.0%. However, remittances are still well below 2008 levels, reflecting slow improvement in the labor market in major source countries such as New Zealand and the US.
- Lending to the private sector is slowly improving despite tight credit conditions in the banking sector. Annual average credit growth increased from 4.1% in June 2010 to 5.2% in May 2011, largely due to the central bank's efforts to drive interest rates down. On-lending to the Development Bank of Samoa, for example, is expected to push credit growth in agriculture, tourism, and manufacturing.
- Exports declined by 10% in the third quarter of FY2011, while imports increased by 5%. The widening trade deficit contributed to a worsening balance of payments position.
- Foreign reserves declined in the third quarter of FY2011, to about \$162 million (6.7 months of import cover), following rising food and fuel prices, and strengthening currencies of trading partners (particularly Australia and New Zealand).
- A lower budget deficit in FY2011 (equivalent to 9.3% of GDP) was largely achieved on the back of current expenditure restraint, including lower spending on the wage bill, and on goods and services.
- Revenue performance was mixed. Tax revenue underperformed due to lower goods and services tax and import duty receipts, while receipts increased from non-tax revenues such as licenses and fees.
- Capital expenditure tracked close to budget (\$103 million), reflecting the implementation of several major public sector projects, including sanitation and drainage, tsunami reconstruction, and widening of roads under Phase II of the Samoa Infrastructure Asset Management project.

Samoa

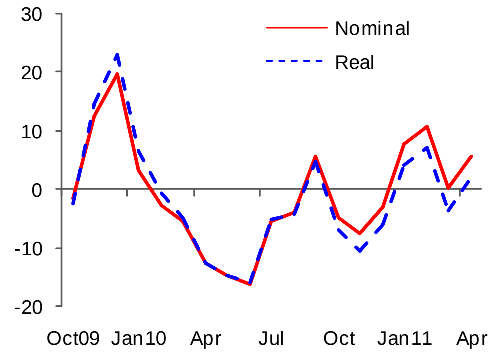
Outlook

- ADB estimates that the Samoan economy will grow by 2.1% in FY2011, due mainly to post-tsunami reconstruction, and a related upswing in manufacturing, construction, transport and communication, and public services.
- The weak points remain exports and flat commercial lending. Exports of fresh fish, beer, noni fruit, and virgin oil all declined in the first quarter of FY2011 compared with the same period in FY2010, reflecting weaker demand in key export markets such as Japan and New Zealand.
- ADB expects inflation to subside to 2.0% in FY2012, driven by recovery in domestic food production. However, continuing global oil and food price rises (largely supply-side driven) pose a significant risk to this outlook.
- It is expected that GDP will grow by 3.0% in FY2012 as a result of the projected recovery in tourism, remittances, and manufacturing. The manufacturing sector, in particular, holds the strongest prospects given the uptick in production at the Yazaki plant.
- Continued reduction in current expenditure, coupled with the completion of tsunami-related reconstruction, provides the government the opportunity to commence fiscal consolidation earlier, and to a greater extent, than previously expected.

Key issues

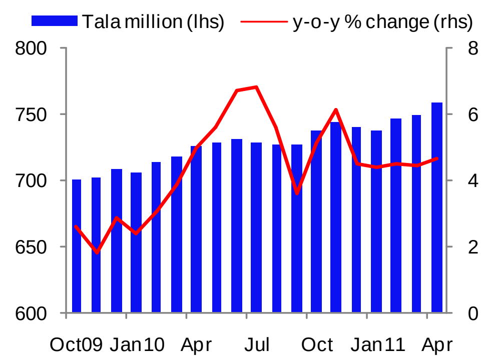
- Despite the more positive economic and fiscal outlook, significant challenges remain: domestically, in terms of rising incidences of poverty, and externally, given high food and oil process and continuing uncertainty in international financial markets, which will likely impact global demand.
- The FY2012 budget projects a fiscal deficit of 6.5% of GDP through a targeted program of reductions in current expenditure (from 27.2% to 25.6% of GDP) and reductions in capital expenditure.
- This bodes well for efforts to stabilize debt levels to the government's medium-term target of 40% of GDP in order to rebuild fiscal space to counter future shocks.
- Stepped-up efforts to reform state-owned enterprises and improve public financial management will also help strengthen this resilience.
- The sale of SamoaTel in early 2011 and the earmarked sale of the Agriculture Stores Corporation provide good demonstrations of Samoa's commitment to returning to a path of higher and more sustainable growth.

Private remittances (tala; y-o-y % change, 3-month m.a.)



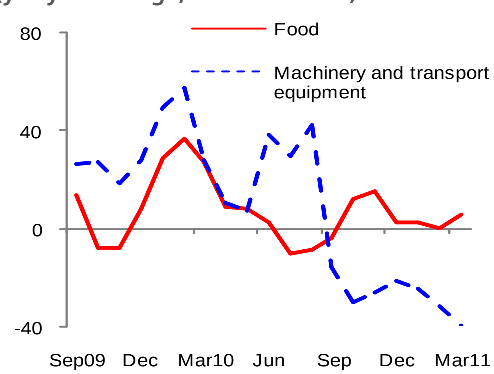
Note: Real values are deflated using the consumer price index.
Source: Central Bank of Samoa.

Credit to the private sector (monthly)



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

Key imports from New Zealand and US (y-o-y % change, 3-month m.a.)

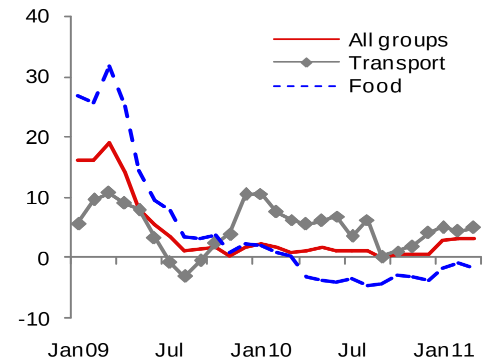


Sources: Statistics New Zealand; US Census Bureau; IMF International Financial Statistics and Central Bank of Samoa.

Lead author: Laisiasa Tora.

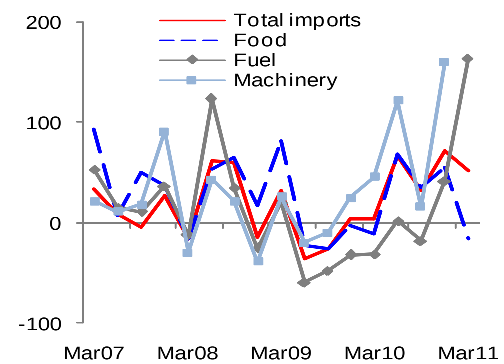
Solomon Islands

Inflation
(y-o-y % change, monthly)



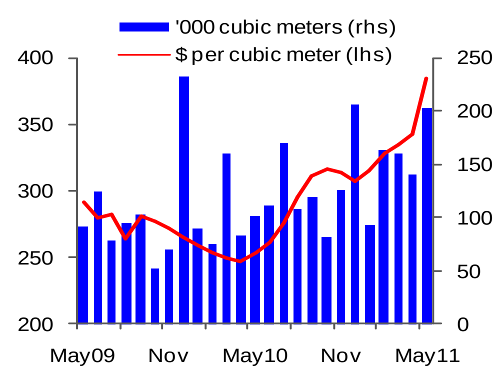
Sources: Central Bank of Solomon Islands.

Imports
(value; y-o-y % change, quarterly)



Source: Central Bank of Solomon Islands.

Log exports
(monthly)



Source: Central Bank of Solomon Islands and IMF International Financial Statistics.

Recent developments

- Stronger-than-expected economic activity in the second half of 2010 led to an upward revision of GDP to 7.2% for the full year. The forestry sector expanded by 32.2% in 2010 following a contraction of 28.0% in 2009. Production of other key exports such as copra, palm oil, cocoa, and fish also increased. Nonmineral sectors such as transport and communications and manufacturing grew 27.5% and 11.3%, respectively.
- Strong revenue collections and a one-off grant from the EU resulted in a fiscal surplus equivalent to 7.1% of GDP in 2010. Revenue rose by a third in 2010 and government spending was below budget due to non-implementation of several projects and a cap on spending earlier in the year. However, payroll spending rose by about 20% compared with 2009 despite a recruitment freeze.
- Inflation remained low in 2010 as a result of greater completion in food importing and retailing and averaged 1% for the year. It started to pick up in the December 2010 quarter due to rising transport prices and accelerated to 4% (y-o-y) in April. The 2011 inflation forecast was revised to 5%.
- Imports surged in the March 2011 quarter due to increased purchases of fuel, and machinery and transport equipment. High global commodity prices, generally strong economic activity, increased foreign direct investment in the forestry sector and increased construction-related demand from the Gold Ridge mining project added to the larger import bill.
- Buoyed by a 35% (y-o-y) increase in log prices, the volume of log exports grew by 49.4% in the first 5 months of 2011 compared with the same period a year ago, to 758,800 cubic meters. If this rate of harvesting is maintained, 2011 will mark the all-time highest level of logging output. The jump in logging output reflects the entry of new logging companies who have imported large amounts of new capital equipment into the country. While these developments will increase GDP growth in the short term, this rate of harvesting is several times the sustainable level and will bring forward the expected depletion of the native forest. Logging stocks are expected to be exhausted later in this decade.
- Other commodities have also seen increases in prices and production over 2011. Cocoa exports increased by 29.2% in May compared with the same period a year ago. Compared to the production levels in the corresponding month a year ago, crude palm oil production was 15% higher and palm kernel oil production was also 15% higher. Gold production has begun to ramp up following the re-opening of the Gold Ridge mine, albeit slightly more slowly than the mine owners anticipated, and was 2,025 ounces in May, an increase from the 525 ounces recorded in the previous month.

Solomon Islands

Outlook

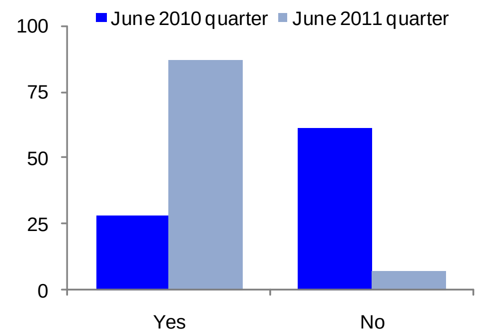
- ADB Business Expectations Survey data show that business conditions continued to improve in the June quarter of 2011. A higher proportion of respondents (87%) reported that sales in the June quarter 2011 were higher than in the same period in 2010. This compared with a figure of 28% in the June 2010 survey. This improvement is consistent with the strength in other high-frequency data.
- Respondents were also more upbeat about the outlook for the following quarter than in previous surveys. About 80% of respondents in the June 2011 survey said they expected business conditions to improve over the next 3 months compared with 56% in the June 2010 survey.
- A larger number of respondents in the June 2011 survey expect business to be better this year compared with the last. Overall, 67% of respondents in the June 2011 survey said they expected business to be better in 2011 than in 2010. In the June 2010 survey, 61% of respondents said yes to the same question for 2010 compared with 2009. ADB forecasts growth of 7.5% in 2011, driven by the resumption of gold mining and continued strength in soft commodities output.

Key issues

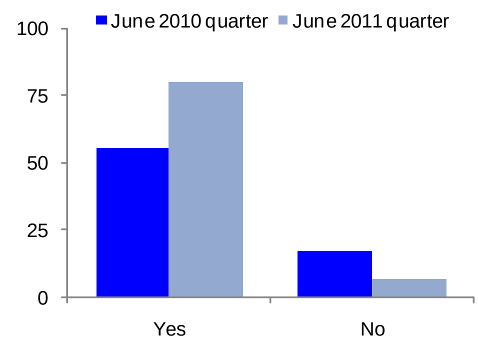
- With recent strong growth and the outlook for more of the same as mining output ramps up, inflation has emerged as a key short-term risk. The Central Bank of Solomon Islands (CBSI) has taken pre-emptive action by appreciating the currency by 5% in June. This will help keep inflation lower than it would be otherwise. Authorities should continue to monitor developments closely and be prepared to take further action, particularly if credit growth begins to rise again.
- Monetary conditions have been highly accommodative but there have been no signs of a pickup in credit growth. In view of the high level of bank's excess reserves, it would be prudent for the CBSI to start mopping up some of the excess liquidity. The CBSI should also closely monitor credit developments and stand ready to raise the cash reserve requirement if banks begin to expand credit aggressively.
- While the economy has recovered from the global economic crisis and is now growing strongly, a key challenge is to ensure that this growth translates into improved living standards for Solomon Islanders. This will require the government to receive a fair return from the benefits of resource projects and to be able to use that revenue to improve service delivery. Key measures to achieve this include legislative reforms to implement a resource-based tax regime, the adoption of fiscal responsibility provisions, and the development of a transparent and predictable mining regime.

ADB Solomon Islands Business Expectations Survey

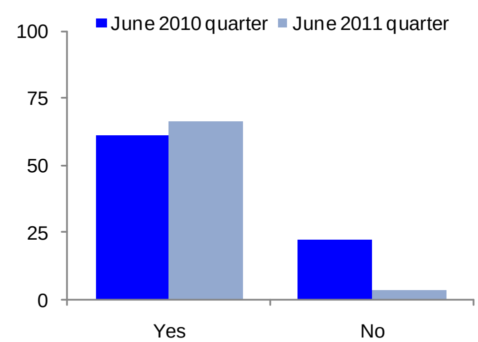
Were sales over the last 3 months up on the same period last year?
(share of responses)



Do you expect sales to improve over the next 3 months?
(share of responses)



Do you expect your business in 2011 to be better than 2010?
(share of responses)

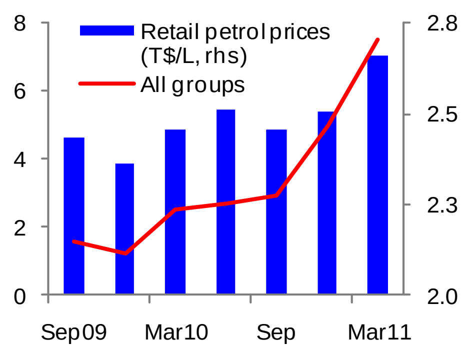


Sources: ADB Business Expectations Survey (June 2010 and June 2011).

Lead author: Milovan Lucich.

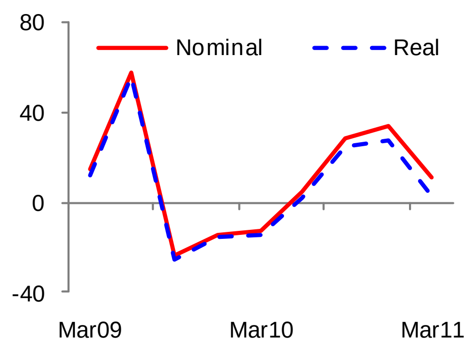
Tonga

Inflation vs. retail petrol prices (y-o-y % change, quarterly)



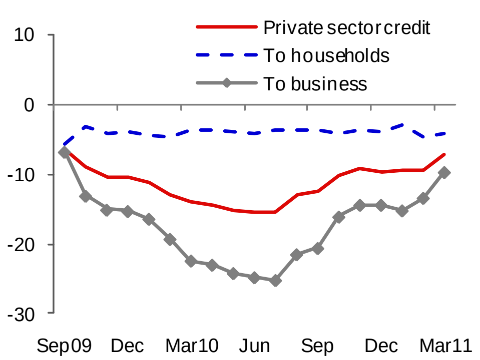
T$/L=Pa'anga per liter, rhs=right hand scale
Sources: Tonga Statistics Department; National Reserve Bank of Tonga, *Quarterly Bulletin*.

Tourism receipts (y-o-y % change, quarterly)



Sources: National Reserve Bank of Tonga, *Quarterly Bulletin*.

Private sector credit (y-o-y % change, monthly)



Source: National Reserve Bank of Tonga.

Lead author: Laisiasa Tora.

Recent developments

- Tonga's economy, still weak as a result of falling remittances and subdued business activity, is being hit hard by inflation. For FY2011, it is now estimated that growth was 0.5%.
- Inflation is expected to rise to 3.0% in FY2011, reflecting rising global food and oil prices, higher excises on tobacco and alcohol, and a modest depreciation of the pa'anga against the New Zealand dollar.
- A fiscal deficit of 7.5% of GDP was achieved in FY2011, largely through budget support from Tonga's development partners. The deficit funded a 13.9% increase in overall government spending over FY2010 levels, particularly in capital expenditures.
- Recurrent government spending declined by 15.7%; however, this was mainly the result of reduced spending on goods and services, and operations and maintenance. The public sector wage bill increased by 2.7%.
- Private sector credit growth continued to contract in the third quarter of 2011, declining by 9.4% compared with the same period a year ago. This is due to ongoing consolidation in the banking sector, which involves the write-off of bad debts, and uncertainty about Tonga's economic prospects.

Outlook

- ADB projects growth of 1.8% for FY2012, driven mainly by development partner-funded construction and infrastructure activities, and stronger tourism earnings and remittances.
- Inflation is expected to ease to 2.0% in FY2012. The appreciation of the Tongan pa'anga against the US dollar will dampen the inflationary impact of rising oil prices, and is projected to offset the upward pressure from an anticipated uptick in domestic demand arising from increased construction and infrastructure activities.
- The budget deficit (including budget support) for FY2012 is projected at 3.1% of GDP, which represents a substantial narrowing from the previous year. The deficit will be financed by budget support and the further drawdown of loans from the Export-Import Bank of China. Without budget support, the forecast for the deficit would be around 6.6% of GDP.

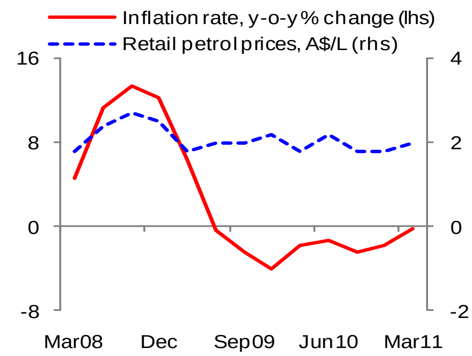
Key issues

- Tonga's economy remains vulnerable to shocks. It is therefore critical that the government gives priority to mitigating the risks to Tonga's fiscal position and to creating room to respond to future shocks.
- Achieving this will require avoiding new borrowing, even on concessional terms. This should be complemented by measures to reduce recurrent spending, particularly controlling the wage bill, and to improve tax administration and collection to maximize the economy's revenue potential.

Tuvalu

- Tuvalu experienced negative inflation (deflation) of –0.1% in 2009 and –1.9% in 2010 due to lower global food prices and the strong Australian dollar. However, rising global food and fuel prices are expected to revive inflation to an estimated average rate of 1.2% in 2011 and 1.6% in 2012.
- In line with the steady increase in the international price of crude oil over the second half of 2010, retail petrol prices in Tuvalu increased from $1.78 per liter in the last quarter of 2010 to $2.00 in the first quarter of 2011. Fuel prices are expected to continue to rise in 2011.
- The economy is projected to remain flat in 2011 as spending cuts are made to ensure longer-term fiscal sustainability. However, for 2012, the economy is forecast to grow by 0.6% as development partner-financed public works commence and employ locals.
- For the first time, an allocation of A$277,200 has been made in the 2011 budget for the payment of community service obligations to public enterprises. Continued implementation of the Public Enterprise Act 2009 will support the move toward operating public enterprises as commercial entities, providing an impetus to growth.

Inflation and retail petrol prices (quarterly)



A$/L=Australian dollars per liter, lhs=left hand scale, rhs=right hand scale
Source: Tuvalu Ministry of Finance and Economic Planning - Central Statistics Division.

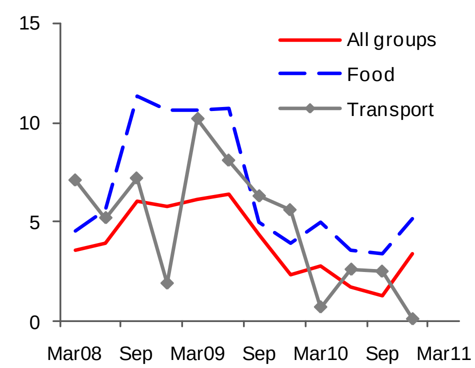
Lead author: Malie Lototele.

Vanuatu

Recent developments

- Growth in 2010 has been downgraded to 2.2% due to a sharp decline in construction activity and weakness in the tourism sector. These declines offset strong growth in some agricultural commodities. Higher prices and increased capacities in production facilities led to a huge annual growth in exports of coconut oil (94.3%) and beef (24.2%) in 2010.
- Visitor arrivals, one of the main drivers of the economy, fell by 20% (y-o-y) in the March 2011 quarter, the fifth consecutive quarter of decline. Low forward bookings for the first half of the year and the cancellation of Pacific Blue's flight from Port Vila to Sydney in May indicate continued weakness of the tourism sector going forward.
- A number of indicators such as import values, VAT collections, and private credit growth also point toward a slowdown in economic activity in the last quarter of 2010 versus a year earlier. Credit growth continued to slow over the first quarter of 2011.

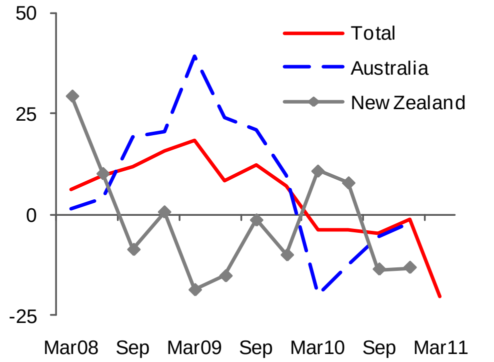
Inflation (y-o-y % change, quarterly)



Source: Reserve Bank of Vanuatu.

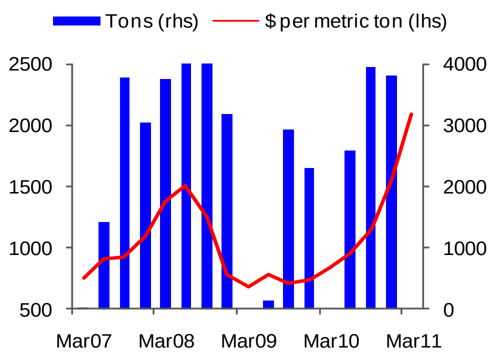
Vanuatu

Visitor arrivals (y-o-y % change, 3-month m.a.)



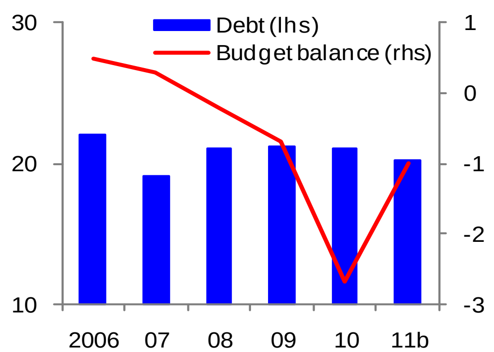
Source: Vanuatu National Statistics Office.

Coconut oil exports (quarterly)



lhs=left hand scale, rhs=right hand scale
Sources: Reserve Bank of Vanuatu and IMF International Financial Statistics.

Budget balance vs. public debt (% of GDP)



lhs=left hand scale, rhs=right hand scale, b=budget
Source: IMF. Vanuatu: 2011 Article IV Consultation-Staff Report.

Lead author: Milovan Lucich.

- Inflation started to accelerate in the December 2010 quarter, driven by high food prices and the effects of increased excise taxes on some commodities. The price of diesel imported from Singapore jumped by 28.5% from November 2010 to March 2011 and will likely to be passed onto consumers through higher retail petrol and electricity prices. The Reserve Bank expects year-end inflation to be around 4%.
- The fiscal deficit expanded to 2.7% of GDP in 2010 from 0.7% in 2009 as a result of revenue shortfalls. A small fiscal deficit of around 1% of GDP is forecast for 2011. Despite small deficits in recent years, public debt has been stable relative to GDP and is now around 20% of GDP. The stabilization in public debt as a percentage of GDP has been due to fiscal consolidation over the 2000s and nearly a decade of positive economic growth.

Outlook

- Whether major public construction projects scheduled in 2011 will be pushed through remains uncertain. After close to a decade of relative stability, political instability returned to Vanuatu in 2010. There have been four changes of Prime Minister since December 2010. Further court challenges and intense lobbying of individual members is likely to continue in the lead up to national elections in 2012. This adds to the risk of continued political instability over the next 12 months.
- Given this uncertainty and the poor performance of tourism in the first quarter, growth forecasts for 2011 have been downgraded to 3.0% from 4.2%, with further downgrades likely if tourism growth does not recover.

Key issues

- Vanuatu relies heavily on infrastructure to achieve its development goals for its geographically dispersed population. Income-generating opportunities are scarce in rural areas, where most of the population lives; the rural economy is based on agriculture and fishing and, increasingly in some areas, tourism. Mobility between islands is essential for rural development and poverty reduction, but transport infrastructure and services are inadequate.
- The main form of travel is by sea. To improve shipping services, there is a need for improved ports, wharves and jetties, and other transportation infrastructure in the rural areas and outer islands. The introduction of a franchise shipping scheme is also required to improve the reliability and affordability of shipping services to the outer islands.
- The road network is also inadequate, consisting of 1,800 km of roads, of which less than 100 km are paved and less than 400 km have gravel services.

Papua New Guinea

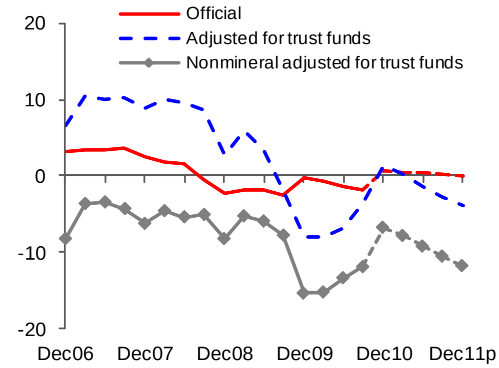
Recent developments

- The Bank of PNG revised its GDP growth estimate for 2010 upward to 8.0%, a 0.5% increase over its prior estimate. The stronger growth is being driven by high export commodity prices, increased government spending, rising investments in the construction of new resource extraction facilities, and spillover effects associated with these activities.
- Inflation rose to 9.0% in the March 2011 quarter. Some sectors (e.g., construction, transport) appear close to operating at full capacity and are showing signs of possible overheating. Increased inflation under such conditions can be expected.
- The main components of the overall inflation measure showed increases of 11.1% for fuel, housing, and electricity; 7.2% for food; and 5.7% for transport and communications. The inflation rate exceeded the Bank of PNG's target of 8.5% and prompted an increase in the Kina facility rate by 25 basis points in June. The rate increase was the first interest rate hike in 18 months. The Bank of PNG's more recent statements have indicated its willingness to accept single digit inflation in light of the high growth in the country and what it views as the seasonal and external factors pushing inflation higher.
- Private investment has been strong through the first half of 2011 as businesses continue gearing up to take advantage of the spillover opportunities anticipated from the liquefied natural gas (LNG) project. Private consumption improved as the recovery in agricultural commodity prices benefited the segment of the population engaged in commercial farming.
- The 2011 national budget provides for expenditures and net lending equivalent to $4.06 billion, which represents more than a 13% increase over 2010 even before expenditures from a supplementary budget are considered. This budget, the largest in the country's history, begins the government's plans to increase expenditures sharply over the next few years. Revenue increases are keeping up with the increasing expenditures, so the government expects to generate sufficient revenues to ensure a balanced budget (excluding trust fund drawdowns).

Outlook

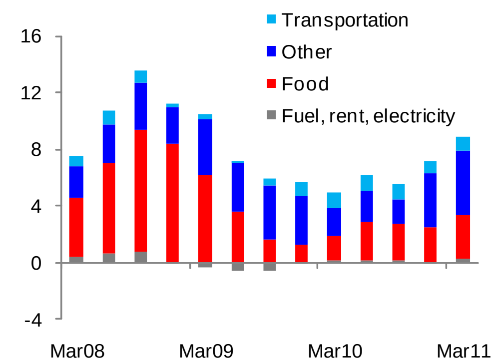
- In the near term, favorable commodity prices and strong investor confidence will boost economic growth. ADB now projects that GDP growth will be 8.5% in 2011 and 6.5% in 2012. Net foreign assets continue previous trends in expanding their influence on domestic money growth and fuel inflation in 2011. The Bank of PNG appears to be taking positive steps to balance the need to accumulate additional foreign exchange reserve against the cost of sterilizing the liquidity this accumulation creates. However, the bank's

Fiscal balance
(% of GDP, quarterly)



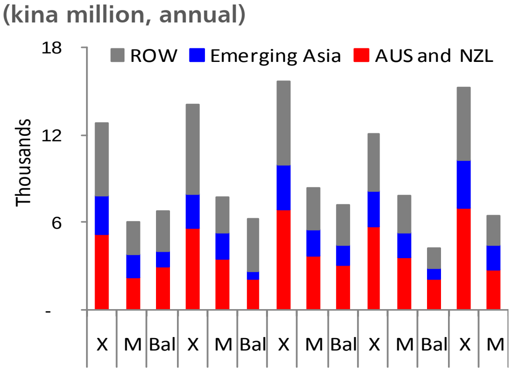
p=projection
Note: Superannuation payments made prior to 2009 are adjusted for as a provision against a future public liability.
Sources: PNG Department of Treasury and ADB estimates.

Contribution to inflation
(% points, quarterly)



Source: PNG National Statistical Office.

Trade balance and trade shares with principal markets
(kina million, annual)



Bal=trade balance M=imports, ROW=rest of the world, X=exports
Note: 2010 exports are through September only, hence no calculated trade balance.

Papua New Guinea

ability to control inflation through standard monetary measures will likely be limited due to the external factors driving the expansion of the money supply.

- ADB expects headline inflation to increase to 9.5% in 2011 and 8.0% in 2012. Supply-side constraints in some sectors (such as the housing market in Port Moresby and Lae, skilled labor, construction, and transportation) are creating inflationary pressures, so inflation is expected to persist. Rising food prices and the depreciation of the kina against the Australian dollar (although the kina appreciated against the US dollar) will further fuel inflation.

- Growth in the PNG economy could accelerate faster than anticipated due to factors including further rises in export commodity prices, increased mining activity, greater trust fund expenditures combined with lagged impacts of 2009 withdrawals, and election related spending. Conversely, growth prospects could be adversely affected by falling export commodity prices, potential civil unrest related to ongoing construction of resource extraction facilities or the forthcoming election, exchange rate appreciation, and continued acceleration of inflation.

- The increase in imports related to resource projects appears likely to widen the current account deficit over the next few years. However, these projects will be financed mainly through foreign direct investment flows, so there is little implication for external stability. During the first half of 2011, available indicators suggest PNG's current account deficit will continue to widen, even beyond the 30% of GDP estimate offered in the prior issue of the *Pacific Economic Monitor*.

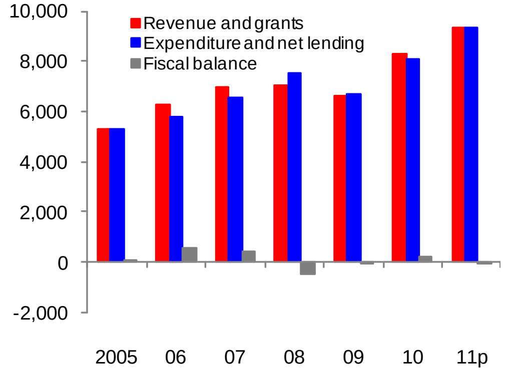
- The volatility in the prices of PNG's main export commodities has increased sharply in recent years. This appears likely to continue in light of the uneven recovery from the GEC and pending debt crises in selected countries, greater integration in global commodity markets, and foreseeable supply and demand shifts in response to price rises in 2011.

Key issues

- Prime Minister Somare's departure from the country and the subsequent announcement that he would not be returning to PNG in late June, as well as the approaching national elections in 2012, are raising the level of political and policy uncertainty in PNG.

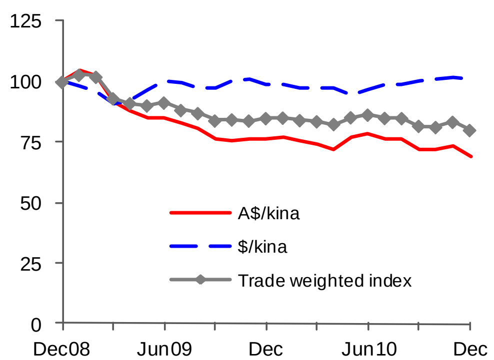
- Elevated public expectations regarding improvements in living standards raise additional uncertainties about future developments in PNG. Given the law and order situation and the long history of civil unrest and conflict, there is a clear need for the government to maintain stability and improve basic service delivery.

Government fiscal position (kina million, annual)



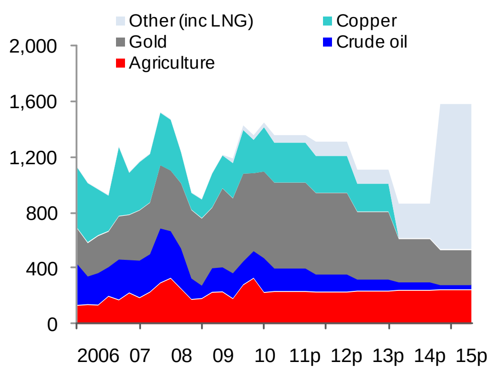
p=projection
Sources: PNG Department of Treasury.

Exchange rates (Index: December 2008=100, monthly)



A$=Australian dollar
Source: Bank of PNG.

Agricultural and mineral exports ($ million; quarterly)



LNG=liquefied natural gas, p=projection
Sources: Bank of PNG and the 2011 National Budget.

Papua New Guinea

- The PNG government's plans to create a new sovereign wealth fund to hold revenues from the LNG project are proceeding in a promising direction. The fund will be administered by the Bank of PNG and held offshore, and should improve the accountability and transparency of resource revenue flows. Expenditures from the fund will be part of the annual budget. Leading up to the creation of the fund, detailed plans for the fund's structure are being developed. Existing trust funds are gradually being brought under Bank of PNG oversight.

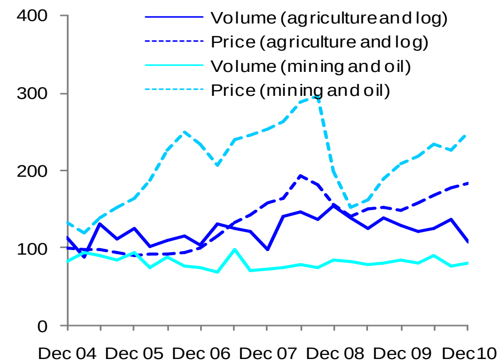
- Plans for the fund currently call for the creation of three resource pools. One pool will be used to sterilize export earnings and reduce impacts of rising revenues on the exchange rate and inflation. A second pool will save resources for future use. The third pool will be used to finance increased infrastructure investment by the government. Moving forward, the challenge will be to ensure that drawdowns are coordinated and expended within the absorptive capacity of the economy.

- Real interest rates on government securities and deposits are negative. Given signs of emergent inflation in the near-term, a tighter monetary policy warrants consideration. The Bank of PNG needs to focus its efforts on countering the self-reinforcing inflation expectations among businesses raising their prices. Measures to encourage competition and expand the supply of goods and services with the largest price increases are recommended.

- Stemming rising inflation will require strategic investments to address emerging bottlenecks in the economy. Investing in transport infrastructure and increasing the provision of vocational training should be prioritized.

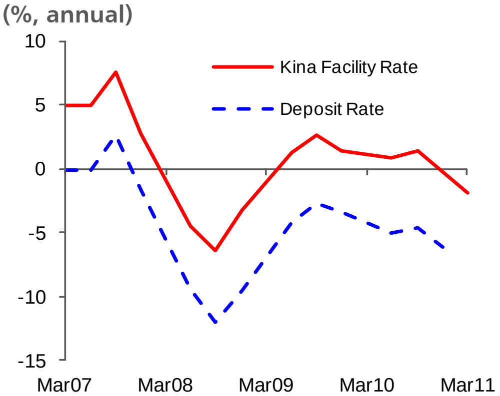
- Price inflation in rental housing is acute and is adversely affecting the standard of living of even highly skilled formal sector workers employed in PNG's cities. Growth of squatter settlements in the main cities is a side effect of these rising costs. Barriers to the development of more rental housing, such as problems securing land for development due to uncertainties within PNG's traditional land tenure arrangements need to be addressed urgently.

Exports
(Index: Dec 2003=100, quarterly)



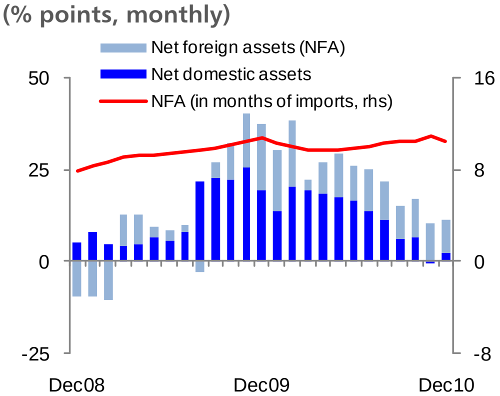
Sources: Bank of PNG.

Real interest rates
(%, annual)



Note: Kina Facility Rate is the average of repurchase and reverse repurchase rate and deposit rate is the weighted average deposit. Both Kina Facility Rate and the deposit rate are adjusted for inflation.
Source: Bank of PNG.

Contributions to money supply
(% points, monthly)

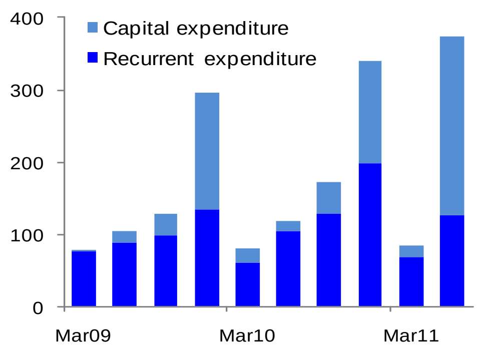


lhs=left hand scale, rhs=right hand scale
Source: Bank of PNG.

Lead author: Christopher Edmonds.

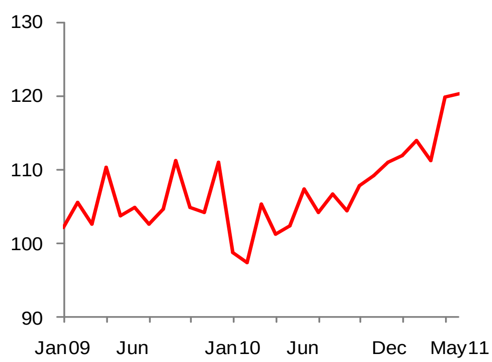
Timor-Leste

Government expenditure
($ million, quarterly)



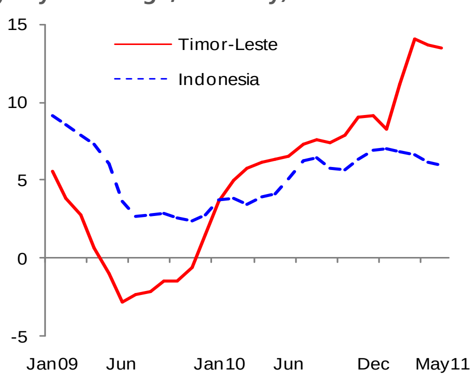
Source: Timor-Leste National Statistics Directorate and Government of Timor-Leste Transparency Portal (available at http://www.transparency.gov.tl/public/)

Loans to the private sector
($ million, monthly)



Source: Timor-Leste Banking and Payments Authority.

Consumer price index, Dili
(y-o-y % change, monthly)



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

Recent developments

- The economy remains buoyant, boosted by continuing high levels of public expenditure. In 2009 and 2010, close to 90% of the National Budgets were actually spent and flowed into the domestic economy. Expenditures from domestic revenues (own-funded) rose by 25% to reach $758 million. The 2011 budget allowed for a further large increase in own-funded expenditure. Of a budget for 2011 of $1,265 million, $458 million was spent over the first six months.

- Slightly more than half of total own-funded expenditure and 93% of capital expenditure have been spent on the national electrification project. A new power plant, transmission network, and distribution systems will enter operation in late 2011. The project will lower the unit cost of electricity and greatly expand the coverage; the 2010 population and housing census reported that only 19% of households in rural areas used electricity as their main source of lighting (the figure is 88% in urban areas and 37% overall).

- Private investment levels are measured inaccurately, but there is anecdotal evidence that private investment associated with the economic boom has increased, which is reinforced by the emergence of an upward trend in commercial bank lending to the private sector. After five years of almost no change, lending levels rose by 8.4% over the first five months of 2011. Lending is projected to continue to rise, helped by a shift towards more risk sharing at one of the larger commercial banks. The Commercial Bank of Timor-Leste was established in July as the first locally owned commercial bank.

- Broad money expanded by 7.6% in the 12 months to May, marking a significant slowdown compared to growth of 28.2% in 2010. Deposits with the banking system, most of which are accounted for by government deposits, fell by 9.3% during the first five months of 2011. The non-performing loan to liquid asset ratio remains high and increased slightly, from 17.2% to 17.9% between March 2010 and 2011. Provisioning for non-performing loans nonetheless remains adequate.

- Inflation rose to 13.5% in May on a year-on-year basis, which marked the fourth consecutive month of double-digit inflation—largely tracking movements in international commodity prices. The depreciation in the dollar against most currencies further fueled inflation. Prices of meat products, and fats and oils, were about 20% higher in May 2011 compared to May 2010, while the average price of vegetables increased by a third and cereal prices increased by about 2% (reflecting rice subsidies) over the same period.

Outlook

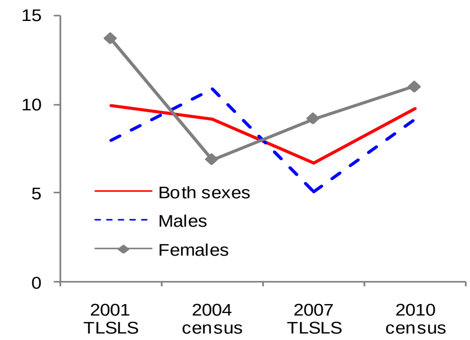
- The outlook remains for high rates of economic growth over 2011 and 2012 on the back of high government expenditure. Inflation is projected to stay high in 2011 at 9.5% on an annual average basis, and then ease in 2012 as world commodity price inflation slows.

Timor-Leste

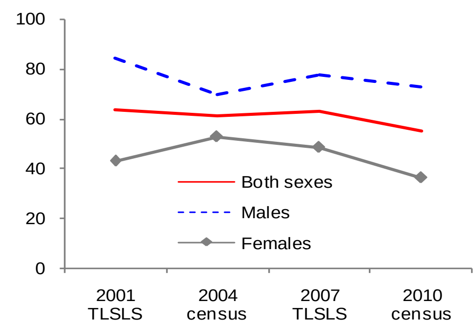
Key issues

- The Strategic Development Plan (SDP) 2011-2030 was submitted to the National Parliament on 7 July. It presents a vision to create a peaceful and prosperous nation, and to eradicate extreme poverty by 2030. The plan sets out the actions to be undertaken by 2015, 2020, and 2030 in three key development areas—social capital, infrastructure, and the economy. The Plan recognized the need for strengthened institutional framework to achieve its objectives.
- Continued high economic growth is central to the achievement of the SDP goals. The non-petroleum economy is projected to grow at an average rate of 11.3% per annum from 2011 to 2020 and between 8.3% and 11.2% per annum from 2020 to 2030. These projections are in line with those prepared by the ADB (see February 2011 edition of the Monitor). Achieving a high level of private investment and increased productivity, particularly in agriculture, underpins high economic growth under the SDP. The SDP envisions the coming decade as being public sector led, before the private sector becomes the primary driver of economic growth. The private sector is seen to have a role in developing and operating infrastructures needed for a diversified economy.
- The balance in the Petroleum Fund is projected to rise from the current level of $7.7 billion to $18.3 billion in 2020, and then to $22.9 billion by 2030, even while substantial withdrawals are made to finance public investment in human and physical capital.
- An Economic Policy and Investment Agency will be created by 2015. The Agency will be responsible for national economic planning and the oversight, implementation, and monitoring of government programs and projects.
- The Population and Housing Census 2010 shows there was a substantial rise in the unemployment rate from 2007 to 2010. Unemployment was 9.8% in 2010, with rates of 16.7% in urban areas and 6.9% in rural areas. The rise in unemployment seems to reflect a typical pattern of rural-to-urban migration with rural workers seeking higher wages in urban areas. Agriculture's share of employment declined from around 80% to 65% between 2001 and 2010. The share of the population living in urban areas increased from 25% to 30% between 2004 and 2010.
- The United Nations Development Programme's Human Development Report for Timor-Leste (2011) now classifies the country to be in the 'medium human development' category. It ranks 120th out of 169 countries, based on 2010 data. This current ranking is higher than comparable countries in the Pacific and Southeast Asia. Progress in human development was most dramatic in per capita gross national incomes which increased by over 200% from 2005 to 2010. Life expectancy at birth also increased by more than 2 years over this period, while years of schooling remained basically unchanged.

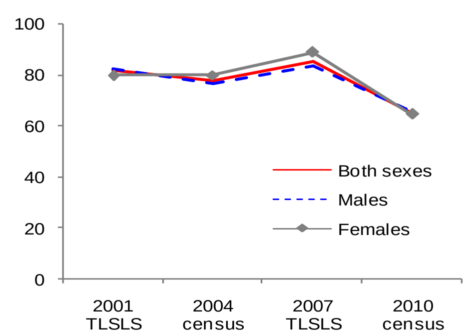
Unemployment rate (% of labor force)



Labor force participation rate (% of population aged 15 to 64 years)



Agricultural employment (% of total employment)



TLSLS=Timor-Leste survey of living standards
Sources: National Statistics Directorate and United Nations Population Fund. 2011. Population and Housing Census 2010. Suco Report. Volume 4. Dili (July); National Statistics Directorate. 2008. *Timor-Leste Survey of Living Standards 2007: Final Statistical Abstract*. Dili (July), National Statistics Directorate. 2006. Timor-Leste Census of Population and Housing 2004 Atlas, National Statistics Directorate, and ADB staff estimates.

Lead author: Craig Sugden.

Managing price volatility

Continued high volatility in international commodity prices should be expected as the world economy continues its gradual recovery from the GEC. This comes on top of persistent debt distress concerns in a few economies and fluctuating exchange rates. There is a long-term trend toward rising crude oil prices as available sources of oil are depleted, and volatility is likely to persist due to unrest in major oil-producing regions, and supply and demand responses to high prices. Some observers also see prices of agricultural staples (e.g., rice, maize, and wheat) increasing in relative terms in the long run. Growth in large emerging economies, and rising meat consumption, which increases demand for staples as animal feed, are expected to spur demand. Loss of agricultural land to urban expansion and environmental degradation, and land diversion to produce biofuels are also seen to constrain supply.

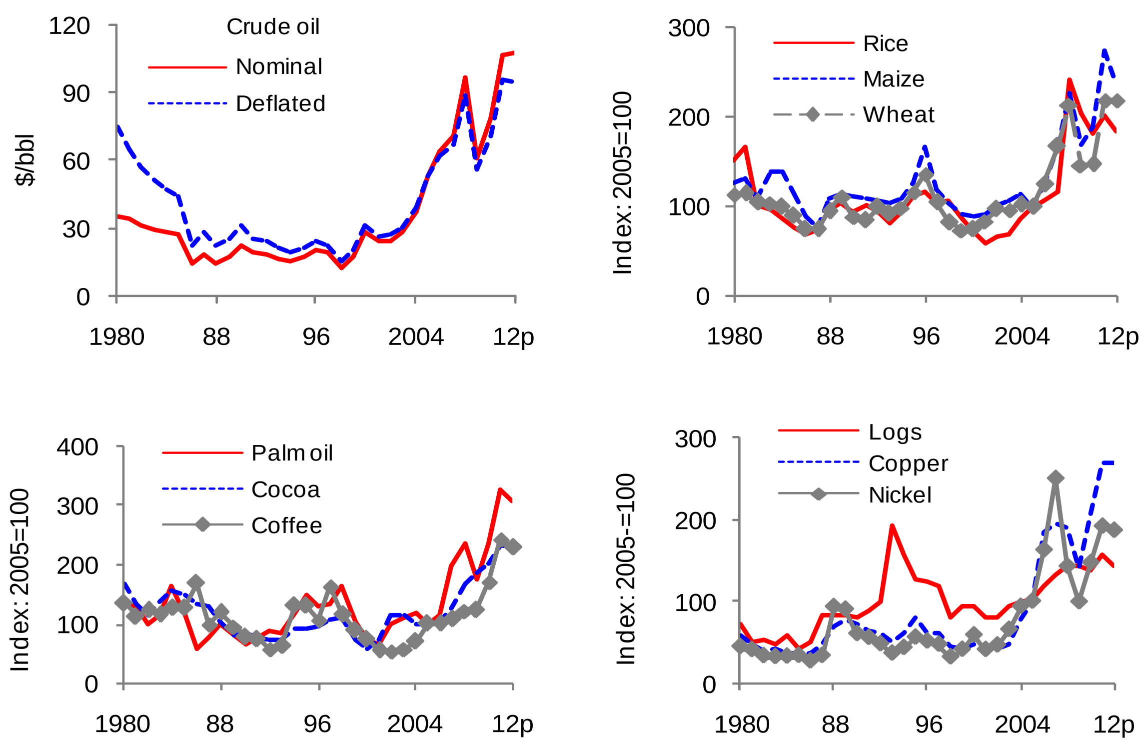
In the near term, global markets have seen the prices of some cereals driven up by recent supply disruptions in commodity-producing areas due to natural disasters. Although there are convincing arguments for why trends toward higher commodity prices are likely, suppliers and consumers' responses to such increases in the long term will also have an impact on price movements and should be given due consideration in policymaking.

This article estimates the impact of price volatility if crude oil and food prices rise in 2011 as forecast by the International Monetary Fund (IMF, *World Economic Outlook 2011*). In the near term, trade deficits are seen to widen by 4-8%, with larger losses for import-dependent Pacific economies with limited commodity exports. There will be positive gains for those exporting commodities, particularly petroleum. Policies for managing volatile commodity prices, which are likely to persist given longer-term adjustments in both demand and supply, are outlined in the conclusion.

Commodities trade in the Pacific

Pacific economies fall into two groups with respect to their commodity trade. The first group, which includes most Pacific island economies, is heavily dependent on imports to meet their food and fuel needs. Food imports constitute a large share of total imports for economies that have small agricultural bases or are

World prices of key commodities
(1980–2012)



bbl=barrel, p=projection
Notes: Prices for 2011 and 2012 are projected. Deflated series for crude oil derived using the US GDP deflator.
Source: International Monetary Fund. World Economic Outlook 2011 (April) database.

Managing price volatility

dependent on tourism activities. Transport costs tend to represent a larger part of the final price of food in these econo Pacific, and link food and fuel prices. This group finances the cost of imports from limited exports of cash crops (such as palm oil, cocoa, and coffee) and a few mineral commodities (copper, nickel, phosphates, etc.), tourism revenues, remittances, and donor assistance. The second group includes larger natural resource exporting economies in the Pacific, i.e., Papua New Guinea (PNG), Solomon Islands, and Timor-Leste, also depend on imports to meet their food needs, but export revenues from fuel, mineral, and forestry commodities can cover the cost of food imports. They stand to profit as their products fetch higher prices in the global market.

The impact of volatile prices depends on local market conditions (e.g., domestic production, competition, availability of food substitutes), and government policies and economic interventions. Exchange rate instability, particularly the appreciation of the US dollar in its role as the currency for most international transactions, adds to price volatility. High inflation spurred by commodity price volatility can adversely affect households across the region, and hamper government efforts in reducing poverty and securing human development gains.

Making waves

IMF's projected price increases for 2011 are similar to the magnitudes experienced in 2007–2008, except notably for rice due to good harvest and higher stock inventory.

Annual % change in commodity prices (2008 vs. 2011)

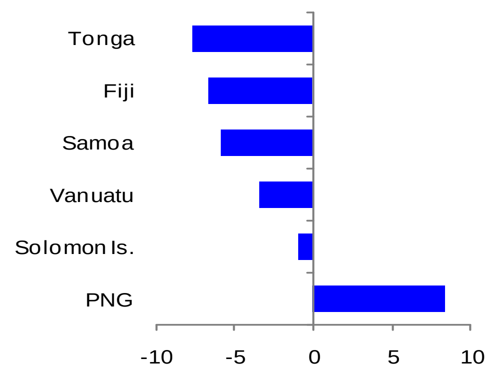
	2008	2011p	2011ytd
Crude oil	36.4	35.6	31.4
Rice	110.7	11.4	(0.6)
Maize	36.7	45.3	56.9
Wheat	27.7	49.4	48.4
Palm oil	20.0	39.0	38.2
Cocoa	31.4	13.7	4.9
Coffee	12.1	42.1	47.7
Logs	8.5	13.0	18.2

p=projection, ytd=year to date
Notes: For crude oil, the changes quoted above are based on the average $/barrel prices. For all other commodities are derived from price indexes (2005=100). 2011ytd figures are as of April. Figures in parentheses denote negative values.
Sources: International Monetary Fund. World Economic Outlook 2011 (April) database and International Financial Statistics online database.

The surge in international petroleum and commodity prices in 2009–2011 has had serious implications for Pacific economies' terms of trade. The extent of the impact will vary across the region, depending on prevailing structures of trade. Smaller island economies that are heavily dependent on imported food and fuel and have very few export commodities of their own will experience larger terms of trade losses, with trade deficits projected to widen by around 4%–8% in 2011.

The impact of projected 2011 price increases may be lessened on the trade balances of economies with established nonfood agricultural and forestry/mineral export bases such as the Solomon Islands, as higher export revenues partially offset inflation of the import bill. Net exporters of petroleum, such as PNG, are projected to post substantial terms of trade gains as high oil prices boost trade surpluses by as much as 8% of GDP.

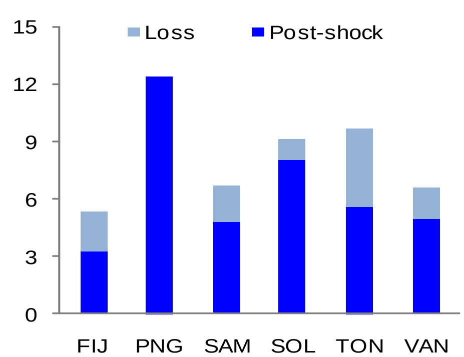
Impact of higher commodity prices on terms of trade (% of GDP)



PNG=Papua New Guinea, Solomon Is.=Solomon Islands.
Source: ADB estimates based on data from Reserve Bank of Fiji; Bank of PNG; Central Bank of Samoa; Central Bank of Solomon Islands; National Reserve Bank of Tonga; and Reserve Bank of Vanuatu.

Given current trends, reserves are expected to decrease by a range of 2 months' worth of imports (for Fiji) to 4 months' worth (for Tonga) if crude oil and food prices rise in 2011 as forecast by the IMF. This projected impact on foreign exchange reserves is comparable to the magnitudes seen in 2007–2008. However, Pacific economies are now more able to withstand such shocks given current comfortable levels of reserves, which were previously boosted by increased special drawing rights allocations from the IMF.

Impact of rising prices on foreign reserves (months of import cover)



FIJ=Fiji, PNG=Papua New Guinea, SAM=Samoa, SOL=Solomon Islands, TON=Tonga, VAN=Vanuatu.
Source: ADB estimates based on data from Reserve Bank of Fiji; Bank of PNG; Central Bank of Samoa; Central Bank of Solomon Islands; National Reserve Bank of Tonga; Reserve Bank of Vanuatu.

Managing price volatility

While all Pacific economies are net importers of agricultural staples, imports generally represent a small share of the total local food supply. This suggests that any international price increases might not have too large an effect on local prices, provided that governments avoid direct market interventions. Several governments in the Pacific are still implementing price controls and this, together with steady international rice prices and shipping delays, has kept local cereal prices stable. Price controls, however, will require alternative procurement arrangements with either the government purchasing directly from international markets or subsidizing domestic suppliers. In both cases, there will be pressure on fiscal accounts when higher-priced stocks arrive.

Retail petrol prices
(in $/liter)

	Mar10	Jun10	Sep10	Dec10	Mar11
Cook Islands	1.73	1.73	1.76	1.86	1.88
Kiribati	1.08	1.05	1.07	1.18	1.19
Marshall Islands	1.41	1.42	1.24	1.19	-
Micronesia, Fed. States of	1.05	1.13	1.14	1.14	-
Nauru	1.39	1.36	1.41	1.58	1.64
Palau	0.96	1.01	1.02	1.02	1.12
PNG	1.15	1.20	1.17	1.22	1.36
Samoa	0.93	1.00	0.99	1.00	1.10
Solomon islands	1.12	1.16	1.12	1.17	1.37
Timor-Leste	1.00	0.98	0.96	0.96	-
Tonga	1.29	1.29	1.27	1.36	1.47
Tuvalu	1.63	1.94	1.62	1.78	2.00
Vanuatu	1.30	1.34	1.31	1.38	-

Note: Local prices were converted to dollars using market exchange rates.
Sources: Cook Islands Statistics Office, Federated States of Micronesia Division of Statistics, Kiribati Ministry of Public Works and Utility, Marshall Islands Economic Planning and Statistics Office, Palau Office of Planning and Statistics, Papua New Guinea Independent Consumer and Competition Commission, Samoa Ministry of Finance, Central Bank of Solomon Islands, Timor-Leste National Statistics Directorate, National Reserve Bank of Tonga, Tuvalu Central Statistics Department, and Reserve Bank of Vanuatu.

Most Pacific economies also have pricing mechanisms that automatically adjust to wholesale and retail fuel prices, often with a lag or a form of smoothing mechanism. However, differing procurement practices, taxes, distribution costs, and access to alternative energy sources give rise to significant price variances across individual countries. Local transportation and retail prices are already showing early signs of an "oil push" as pump prices are generally increasing across the Pacific.

The Way forward

It is impossible to precisely predict future movements in international commodity prices, particularly in the longer term. Caution must be exercised in crafting policy initiatives based on highly uncertain expectations of prices well into the future because volatile prices can have serious macroeconomic implications in the Pacific.

To reduce adverse economic impacts of price volatility, policymakers should seek to generate growth in private incomes and employment. Creating an environment in which efficient use of resources is encouraged, transaction costs are minimized, and investment in appropriate infrastructure is promoted offer promising avenues for broadening the economic base. Minimizing government intervention in various commodity sectors, and avoiding subsidies and price controls will give local markets the flexibility to respond to international price movements, and safeguard fiscal sustainability.

The poor are the most vulnerable to price changes in agricultural staples due to their reliance on these goods for income and food intake. To cushion the impact of price volatility, governments should offer targeted social safety nets that will ensure access to food when prices become unaffordable.

In the agriculture sector, creating an enabling environment for growth through investment in public infrastructure for storage and transportation can increase local production and reduce vulnerabilities to external food supply and price shocks. Diversifying the agricultural base, especially into higher value-added activities, and broadening export markets should increase the range of economic opportunities for would-be entrepreneurs.

Since crude oil prices can affect economic performance in multiple ways, measures to encourage energy conservation, promote the use of energy efficient appliances and capital equipment, and otherwise reduce dependence on petroleum-based fuels should be implemented. More importantly, governments must ensure that retail prices accurately reflect the true costs to the economy in order to avoid distortions and the resulting risks to fiscal balances. Once alternative energy technologies become economically viable in the Pacific context, measures to diversify the energy mix can complement existing efforts to mitigate impacts of fuel price volatility.

Lead authors: Christopher Edmonds, Joel Hernandez, Rommel Rabanal, and Cara Tinio. This article draws on *Pacific Financial Technical Assistance Centre and Asian Development Bank. 2010. Macroeconomic Impacts of Energy Prices in the Pacific.*

Sources of growth in the Pacific

Economic growth in the Pacific region has historically been low overall, but has also experienced high volatility. The remoteness of the Pacific economies and their relatively small markets, limited private sector development, and vulnerability to natural and economic external shocks have all contributed to relatively poor regional performance over the past few decades despite the continued inflows of technical and financial assistance from development partners that are large in terms of per capita GDP.

In 1998, an ADB assessment summarized the Pacific's low growth experience as "the outcome of consistently low productivity increases and capital accumulation combined with high levels of population growth" (ADB. 1998. *Improving growth prospects in the Pacific.* Manila). This conclusion reflects a "growth accounting" perspective, a well-established analytical approach used in economics that generally disaggregates long-run growth into components driven by the accumulation of factor inputs, capital (physical and human) and labor, and productivity improvements.

This article applies a growth accounting framework to analyze historical growth and estimate growth potential in selected Pacific economies over the next 20 years. Simulations assume prevailing trends in factor accumulation and changes in the efficiency of resource use. Economic performance in the Pacific has historically been more dependent on factor accumulation than on increases in productivity. If productivity can be improved, simulations show Pacific economies could realize long-run GDP growth ranging from 1%–6% per annum. These estimates, though modest, are higher than recent historical performance, and emphasize that the efficient use of resources is an integral part of economic growth.

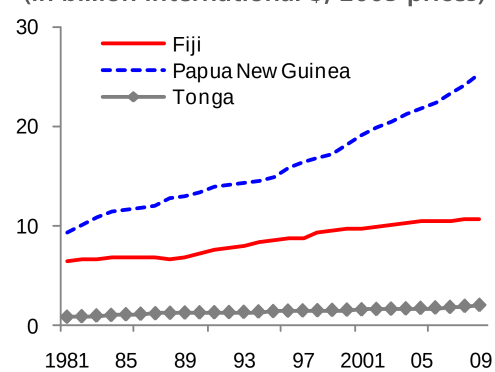
The Polynesian subregion is estimated to grow at a slightly slower pace than the Melanesian subregion in the long run. This can be explained partly by the relative difficulty of raising human capital returns in economies that are relatively more advanced and already have highly educated work forces. Less developed economies, where education standards are low, have much more room to reap the growth benefits of enhanced human capital.

Accounting for past growth

The model used in this analysis is based on an existing growth accounting framework (Lee and Hong. 2010. *Economic growth in Asia: determinants and prospects*. ADB Economics Working Paper Series No. 220. Manila.) and decomposes observed economic growth into four components: (i) the accumulation of physical capital; (ii) the expansion of the labor force; (iii) upgrades in human capital or efficiency of labor (through education and training); and (iv) improvements in the aggregate productivity of all factor inputs combined, or total factor productivity (TFP). This analysis provides insights into the relative importance of factor accumulation and TFP growth in explaining growth in selected Pacific island economies.

Factor endowments are generally low and have grown slowly in the Pacific relative to other regions. The diversity in economic conditions that affect resource flows into Pacific economies, and the resulting accumulation of factor inputs in the region, must be noted. Larger resource-rich Pacific economies such as Papua New Guinea (PNG) are able to attract greater capital investment relative to the smaller island economies, primarily due to high returns to capital offered in its extractive industries. Capital accumulation is also positively influenced by greater endowments of complementary factor inputs such as land and labor in the larger economies.

Capital stock
(in billion international $, 2005 prices)



Source: Heston, Summers and Aten. 2011. Penn World Table Version 7.0. Center for International Comparisons of Production, Income, and Prices at the University of Pennsylvania. May.

The different levels of development play a central role in determining the potential for improvements in human capital and vice versa. For example, education standards in Fiji improved rapidly in the 1980s and 1990s, significantly contributing to economic growth, which in turn enabled further improvements in education. The generally low education standards in the Melanesian subregion contribute to the countries' low economic growth. However, the low level of educational development also means these countries have

Sources of growth in the Pacific

substantial room for catching up, which could boost future economic growth.

Growth accounting also yields estimates of changes in total factor productivity (TFP), which measures the productivity arising from the combination of all factor inputs. This is the component of growth that is not accounted for by factor accumulation. Estimates of historical TFP growth in the Pacific are quite few compared to other regions. However, recent available estimates are consistent in showing that TFP growth has been close to zero, or even negative, in most Pacific economies over the past 20–30 years.

Estimates of TFP growth in the Pacific (annual average % change)

	1972-2004	1985-2007a
Fiji	0.1	1.0
Kiribati	-	1.2
Marshall Islands	-	0.0
Micronesia, Fed. States of	-	0.0
Papua New Guinea	0.0	1.0
Samoa	0.0	2.8
Solomon Islands	0.0	0.4
Tonga	3.5	(0.8)
Vanuatu	(4.2)	0.3

a=approximate values, TFP=total factor productivity
Note: Figures in parentheses denote negative values.
Sources: Estimates for the period 1972-2004 are from Rao, et al. 2007. *A survey of growth and development issues of the Pacific Islands*. United Nations University World Institute for Development Economics Research (UNU-WIDER). Helsinki. For 1985–2007, figures are approximated from ADB. 2011. Asia 2050: Realizing the Asian Century. Manila. (Figure 1, p. 85)

A few Pacific economies have demonstrated an ability to generate improvements in TFP that are modest but have generally been sustained. For example, it is estimated that PNG realized annual TFP growth of 1.0% during the years 1986–2004, despite underlying economic and political instability (Faal. 2006. *Growth and Productivity in Papua New Guinea*. IMF Working Paper 06/113. Washington).

This article next presents the results of an analysis of the contributions of capital, labor, human capital, and TFP, to economic growth in selected Pacific island economies during the years 1980–2010. These are used in the next section to assess future growth prospects.

Computations show that, apart from generally low TFP growth, factor accumulation in Fiji, PNG, and Tonga has likewise been slow. This means that these countries have historically lagged in developing the drivers for growth, and implies that they could have used their existing stocks of capital and labor more efficiently.

Over the past 30 years, labor has been the primary driver of growth in Fiji. Meanwhile, the contribution of education to GDP growth has declined over time, even as average years of schooling have gone up. This likely reflects the impact of significant numbers of highly skilled Fijians migrating overseas. TFP has been a drag on growth in Fiji, although this negative effect has become less severe over time.

PNG's growth has been driven by the accumulation of labor, as well as increasing capital stock. Average TFP growth was negative in the 1980s, due perhaps to political instability and threats of secession the country suffered during the decade, but it has since posted modest increases. The contribution of education to growth has been notably low during the past 30 years. This is not surprising considering that the average Papua New Guinean spends only five years in school.

Finally, the analysis carried out for this article shows that capital accumulation and TFP improvements largely explain GDP growth in Tonga. When the economy slowed down from the 1980s to the 2000s, the contribution of TFP to growth declined, while the contribution of labor accumulation increased. Even though average years of schooling in Tonga stand at a relatively high 10 years, the contribution of education has remained consistently low.

Results of the growth accounting simulations

To gauge future growth prospects, the analysis assumes future factor accumulation will follow average historical rates recorded for each country over the past decade. Of course, it should be noted that actual rates are likely to deviate from past ones, depending on countries' success in improving their business environments (to attract more foreign capital) and education systems (to raise their populations' human capital). The historical rates of capital stock accumulation ranged from 2.2% (Solomon Islands) to 6.1% (Vanuatu), while those for labor stocks ranged from 1.1% (Samoa) to 2.8% (Solomon Islands). Human capital growth was measured based on the growth of average years of schooling, which ranged from 0.6% (Cook Islands, Samoa, and Tonga) to 2.2% (PNG, Solomon Islands, and Vanuatu).

Simulations set long-run TFP growth at historical rates (1985–2007; see ADB. 2011. *Asia 2050: Realizing the Asian Century.* Manila); and at a generally more optimistic rate of 0.6% per annum for the next 20 years. The 0.6% rate is consistent with historical estimates of rates that some Pacific economies were able to sustain in the past and appears to be achievable. It is also

Sources of growth in the Pacific

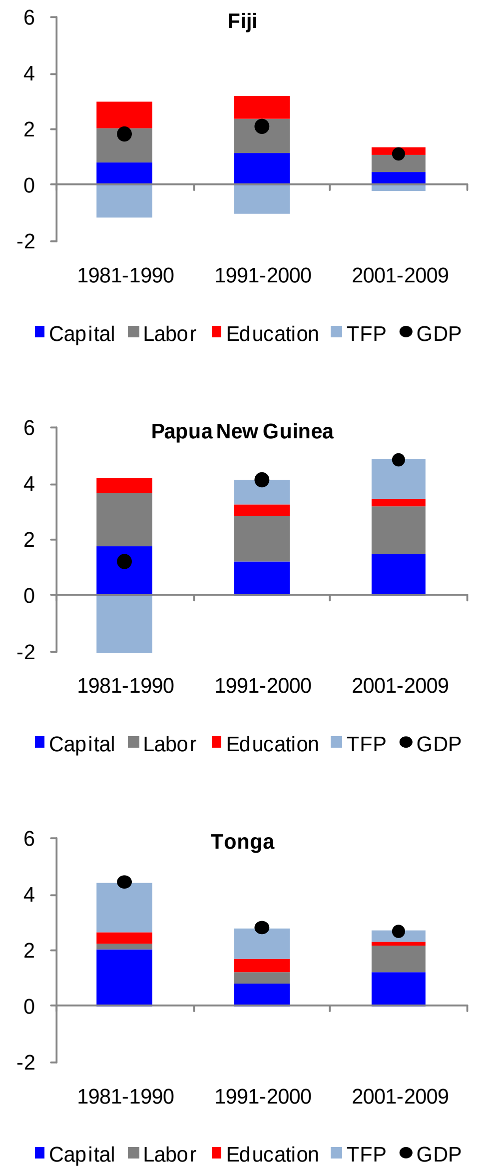
comparable with historical TFP growth achieved in the region's closest Asian comparators, Indonesia and the Philippines, based on the estimates of Lee and Hong (2010). In the Philippines, labor has been a stable and key source of growth for the last 3 decades. Like PNG, the Philippines managed to improve its average TFP growth from negative in the 1980s to being the largest driver of growth in the 2000s. Indonesia posted close to zero TFP growth in the 1980s to the 1990s, but was able to register 2.1% TFP growth in the 2000s. Capital accumulation used to account for more than half of Indonesia's GDP growth, but its relative contribution to growth was overtaken by TFP and labor in the 2000s.

These growth rates for TFP, labor, and capital result in simulated long-run annual GDP growth rates in the range of 1%–6% for Pacific economies. In per capita terms, this translates into growth rates of 0.5%–5% per annum during the next 20 years. The lower figure comes from the simulation based on historical estimates of TFP growth for the subregion, while the higher figure reflects the more optimistic regionwide TFP growth rate of 0.6% per annum. Complete simulation results are summarized on the table on page 29. This article next reviews the growth accounting simulation results for the Melanesian and Polynesian subregions, before considering results for each selected economy.

The economies in the Polynesian subregion—Cook Islands, Samoa, and Tonga—could be expected to have long run growth of around 3% per year under the growth accounting simulations. Given these economies' levels of development, "conditional convergence" suggests they should indeed grow at lower rates than economies in the Melanesian subregion—Fiji, PNG, Solomon Islands, and Vanuatu—over the long run. On average, the Melanesian economies grow at roughly 4% under the simulations. The slower growth of more advanced economies may be explained by the relative difficulty of raising human capital returns in countries that already have highly educated work forces, whereas economies at lower levels of development, where education standards are low, have much more room to reap the growth benefits of enhanced human capital.

The economy of Cook Islands grows by around 2%–3% per annum in the next 2 decades under the simulations. The upper range assumes reasonable TFP growth over the simulation period, while the lower range assumes no TFP growth, given the lack of historical estimates for Cook Islands.

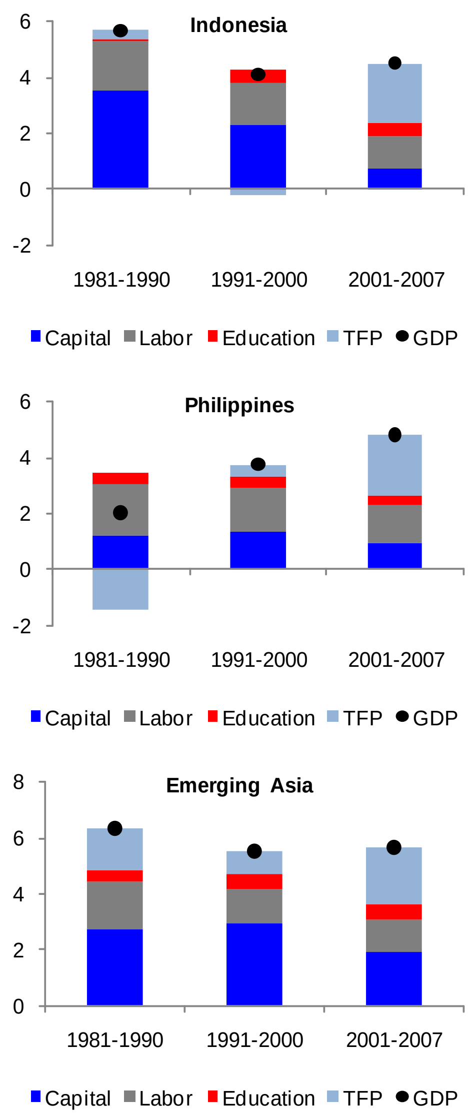
Sources of GDP growth in the Pacific
(percentage points)



GDP=gross domestic product, TFP=total factor productivity
Source: Authors' estimates based on data from Heston, Summers and Aten. 2011. Penn World Table Version 7.0. Center for International Comparisons of Production, Income, and Prices, University of Pennsylvania.

Sources of growth in the Pacific

Sources of GDP growth, Asian comparators (percentage points)



GDP=gross domestic product, TFP=total factor productivity
Source: Lee and Hong. 2010. Economic growth in Asia: determinants and prospects. ADB Economics Working Paper Series No. 220.

Results show that Fiji's GDP could grow by 3.5%–4% per annum in 2011–2030 and suggest that the country's growth will be hampered in the long run by a scarcity of labor. This implies that it will be important to address problems of out-migration of workers who prefer employment abroad to that available in the country, assuming that worker remittances do not play an important role in capital accumulation.

Driven by resource exports, PNG's economy grows by roughly 4% per annum under the two simulation scenarios. The analysis suggests the growth potential may be limited by the historically low levels of capital accumulation. Infusions of adequate physical capital and improvements in education standards would help to boost economic growth and harness the large and rising labor endowments.

The simulation estimates Samoa's long run GDP growth at 3%–6% per annum. The lower range reflects the assumption that TFP will grow by 0.6% per annum. While the upper growth estimates reflects the historical average TFP growth of 2.8% (which appears to reflect productivity gains derived from the introduction of a comprehensive market-based liberalization program and public sector reforms). Such large improvements in TFP may be difficult to sustain in the coming years as past reforms run their course and opportunities for additional efficiency gains from reform diminish.

The economy of the Solomon Islands grows by around 4% per annum under the two simulation scenarios. Possible risks to this outlook include continued low capital accumulation, the narrow base of the economy, and possible depletion of the country's forest resources whose exploitation has played a significant role in spurring growth in the past. Diversifying the economy to promote sectors other than extractive industries and improving education standards appear promising in terms of mitigating these risks.

Tonga's GDP could grow in the range of 1%–3% per annum in 2011-2030 according to simulations. The lower rate reflects continued inefficient use of factors of production, particularly capital, reflected in the country's estimated historical rate of TFP growth. Reversing this trend would help Tonga to realize higher TFP growth and allow its economy to grow at par with its Polynesian neighbors.

Finally, Vanuatu's economy could sustain its recent growth momentum and grow by as much as 5.1% per annum in the next 2 decades, or by as little as 4.7%,

Sources of growth in the Pacific

under the two simulation scenarios. The country's record 8 consecutive years of GDP growth have been driven by sound structural reforms and proceeding with the reform agenda will be crucial for sustaining this in the longer term.

Economic growth rates in the Pacific will continue to fall short of those seen in other developing countries in Asia, even under the more optimistic TFP growth assumptions applied in the growth accounting simulations. Even if Pacific economies grow in line with simulation results, the gap between the two regions will continue to widen.

Policy to support growth

Sustained increases in productivity will be important for Pacific economies to support higher rates of long-term GDP growth. Improved economic management, sound policy, and institutional frameworks that support broad-based growth can help countries reach their growth potential. One issue that is relevant across the region, particularly in Melanesia, relates to land markets and the security and ease of land transactions. Unclear titling and access issues severely limit incentives for private investment in some Pacific economies, so resolving land tenure holds promise of enabling large increases in the productivity of land, and with it the returns to capital and labor.

Growth in the Pacific can also be enhanced by accelerating capital accumulation, which remains low by international standards. To encourage greater investment and faster accumulation of capital, Pacific island economies can improve their business environments, improve provision of public goods such as transport and telecommunications infrastructure that businesses rely on, reduce corruption, and advance the rule of law.

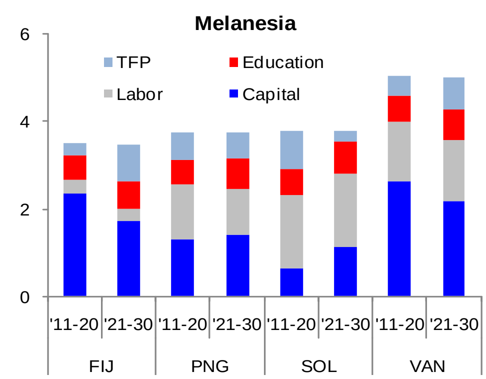
Raising education standards in Melanesia to approach levels already attained in Polynesia would also boost long run economic prospects by speeding accumulation of human capital.

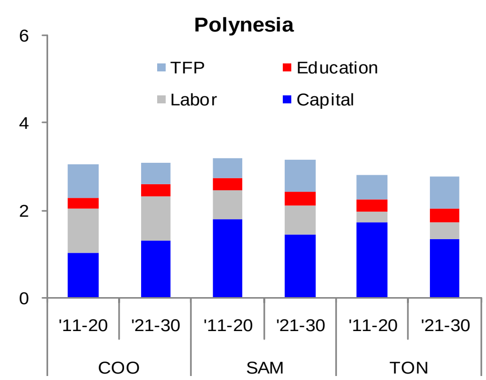
Simulation results, 2011-2030
(GDP growth, % per annum)

	Historical	0.6% TFP growth
Melanesia	**4.2**	**4.1**
Fiji	4.1	3.5
Papua New Guinea	4.3	3.8
Solomon islands	3.6	3.8
Vanuatu	4.7	5.1
Polynesia	**3.1**	**3.0**
Cook Islands	2.3	3.1
Samoa	6.2	3.2
Tonga	0.9	2.8
Pacific region	**3.7**	**3.6**

Source: Authors' estimates.

Contributions to GDP growth
(% points)





COO=Cook Islands, FIJ=Fiji, PNG=Papua New Guinea, SAM=Samoa, SOL=Solomon Islands, TFP=total factor productivity, TON=Tonga, VAN=Vanuatu
Source: Authors' estimates.

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

Building fiscal space in Samoa and Tonga

The medium-term outlook is positive but the domestic environment remains weak

The smaller Pacific islands (excluding Papua New Guinea and Timor-Leste) are showing stronger signs of recovery after experiencing low growth or contraction over the past 2 years. Expectations of a more positive outlook, driven by a recovery in the world economy, have been tempered by the continuing rise in commodity prices; natural disasters in major markets such as Australia, Japan and New Zealand; and the lingering sovereign debt crisis in the European Union (EU).

These international developments pose a significant challenge to Pacific islands, all of which rely heavily on global demand and external sources of income. This challenge is compounded by subdued domestic activity as many businesses, already dealing with weak consumer demand following the global recession, operate within tight credit conditions. Private sector credit, a key indicator of business activity, continued to decline in 2010 in Fiji, Samoa, Solomon Islands, and Tonga. In response, countries have continued with monetary and fiscal easing to stimulate demand and stabilize growth.

Fiscal expansion continues to drive growth

Fiscal expansion has led the growth impetus with large investments in infrastructure and public works. Much of this expansion has been financed by grants and loans from development partners, with the Export-Import Bank of China becoming more prominent in several Pacific island countries. The impact of looser monetary policy has been muted due to weak transmission mechanisms in the region and a cautious approach to lending by commercial banks.

The temptation to continue expansionary policies has been considerable given the weak domestic environment; flat revenue receipts; upward pressure on the public sector wage bill; and large development agendas, particularly in terms of infrastructure needs. However, rising levels of public debt in the face of significant external risks have prompted calls for fiscal consolidation, sooner rather than later, and to a greater extent than earlier anticipated.

An overview of Samoa and Tonga

The Samoan and Tongan economies were particularly affected by the global economic crisis. GDP contracted by 1.7% and 0.4%, respectively, in FY2009; in FY2010, Samoa contracted by 0.2% and the Tongan economy by 1.2%. The real value of remittances (on which both countries are highly dependent) declined by around 20% in FY2009. This led to significantly lower household incomes, business activity, and government revenue.

Both economies were also affected by natural disasters, with the cost of the September 2009 tsunami in Samoa being estimated by the United Nations Development Programme and the World Bank (WB) at around 10% of GDP. GDP was estimated to have grown by 2.1% in Samoa and 0.5% in Tonga in FY2011 due to the maintenance of loose fiscal and monetary stances in both countries.

Sectors driving growth

In Samoa, growth has been supported by post-tsunami reconstruction and increasing tourism, remittances and manufacturing activity as the global economy recovered. Growth in Tonga has been driven by development partner financed construction and stronger tourism. Consequently, the estimated FY2011 outturns for the budget deficit were 9.3% of GDP in Samoa and 7.5% of GDP in Tonga. Contributions from other sectors, e.g., agriculture and fisheries, have been weaker.

A lot depends on global recovery

Medium-term prospects will remain positive if the global recovery continues. In Samoa, GDP growth of 3.0% in FY2012 is forecast, with stronger contributions from tourism, remittances, and manufacturing. The Tongan economy is projected to grow by 1.8% in FY2012, supported by tourism, remittances, and increased public works projects financed by development partners.

However, if global growth falters, remittances and tourism could be hit, weakening economic activity and further threatening macroeconomic stability. In addition, high public debt in both countries—around 53% of GDP in Samoa, and 45% of GDP in Tonga—leaves them more vulnerable to future shocks, and poses a further risk to economic prospects. Samoa and Tonga will have little room to implement countercyclical macroeconomic policies if downside risks materialize.

Fiscal consolidation needs to start now

Mitigating these risks will necessitate fiscal consolidation, improved fiscal management, and structural reforms to raise long-term growth potential with budget support from development partners, such as that requested by Samoa and Tonga from ADB.

Building fiscal space in Samoa and Tonga

The FY2012 national budgets for Samoa and Tonga indicate that plans for fiscal consolidation will proceed, which bodes well for creation of space needed to respond to shocks. Samoa's budget deficit is projected to narrow from 9.3% of GDP in FY2011 to 6.5% in FY 2012, and Tonga's will be reduced from 7.5% of GDP in FY2011 to 3.1% in FY2012, on the back of budget support from development partners and some degree of expenditure reprioritization.

In the case of Tonga, this narrowing represents a faster pace of fiscal consolidation than even that recommended by the International Monetary Fund (IMF). In the case of Samoa, the IMF recommended a reduction to around 5%–6% of GDP in the fiscal deficit.

The path to consolidation…

The medium-term path of consolidation recommended by the IMF for both countries provides a sharper perspective. A medium-term deficit target of no more than 3.0% of GDP by FY2013 is recommended for Samoa to allow public debt to stabilize at its medium-term target of 40.0% of GDP. In Tonga, however, a primary surplus of 1.0% of GDP over the medium term is recommended to bring public debt down to around a sustainable level of 30.0% of GDP by the early 2020s. The pace of consolidation will need to be stepped up in order for these debt targets to be met.

The continued provision of budget support to supplement the government's revenue is central to this effort. Samoa and Tonga recognize that improved fiscal management, with continued implementation of structural reforms, is equally important.

…is helped by budget support…

Budget support for Samoa (approximately $53.4 million, or 8.8% of GDP) and Tonga (approximately $16.0 million, or 4.5% of GDP) is anticipated from the ADB, EU, WB, and bilateral partners such as Australia and New Zealand in FY2012.

However, delays in the receipt of budget support, held back by slower than anticipated progress in achieving qualifying requirements, could pose a significant fiscal risk. Productivity gains that could potentially result from this experience should help ensure timely receipt of these funds in the future.

…improved fiscal management…

The FY2012 fiscal strategies of Samoa and Tonga emphasize avoidance of new borrowing (even at concessional terms), reduction in recurrent spending, careful prioritization of spending to ensure better alignment to core functions and national development plans, and improvement of tax administration.

Control of the wage bill will continue to pose a challenge and could undermine productivity gains in other areas of spending. In Samoa, personnel costs as a percentage of recurrent spending are expected to exceed the target range of between 30%–32% by around 7% in FY2012. In Tonga, these costs are budgeted to remain flat relative to their level in FY2011, but achievement of this is dependent on effective implementation of recruitment controls, and freezing of new recruitments, among other measures.

…and continued structural reforms

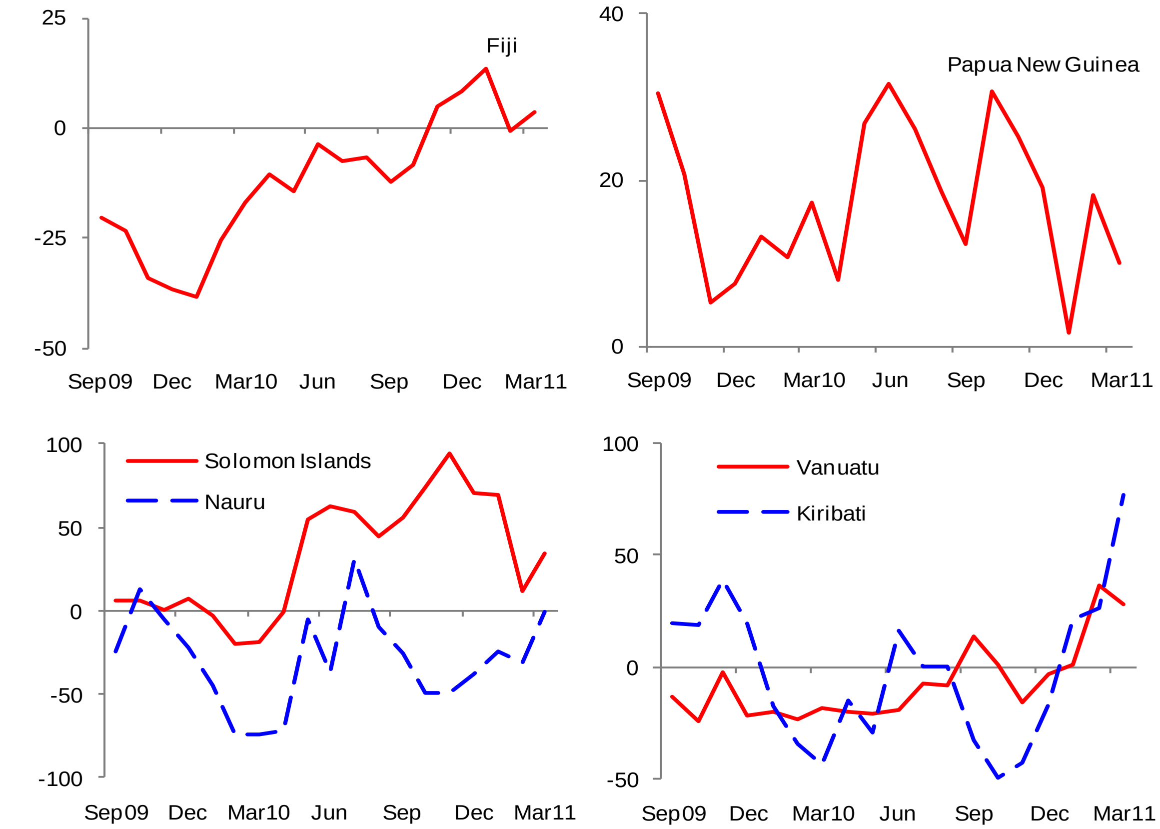
Significant progress is being made in reform of state-owned enterprises, public financial management, and in terms of improving access to credit and the regulatory environment for business. These efforts will help create more opportunities for the private sector to develop and expand, reduce costs of doing business, and help to raise long-term growth prospects for the Samoan and Tongan economies.

Consolidation is the best preparation for the future

Samoa and Tonga are on the initial path to recovery, aided by substantial development partner support. This provides an opportune, albeit limited, window to focus on action to strengthen resilience to shocks and address constraints to growth. Firm commitment from government, demonstrated by achievement of fiscal consolidation targets and on-going progress with structural reforms, will be critical for future macroeconomic stability to be achieved.

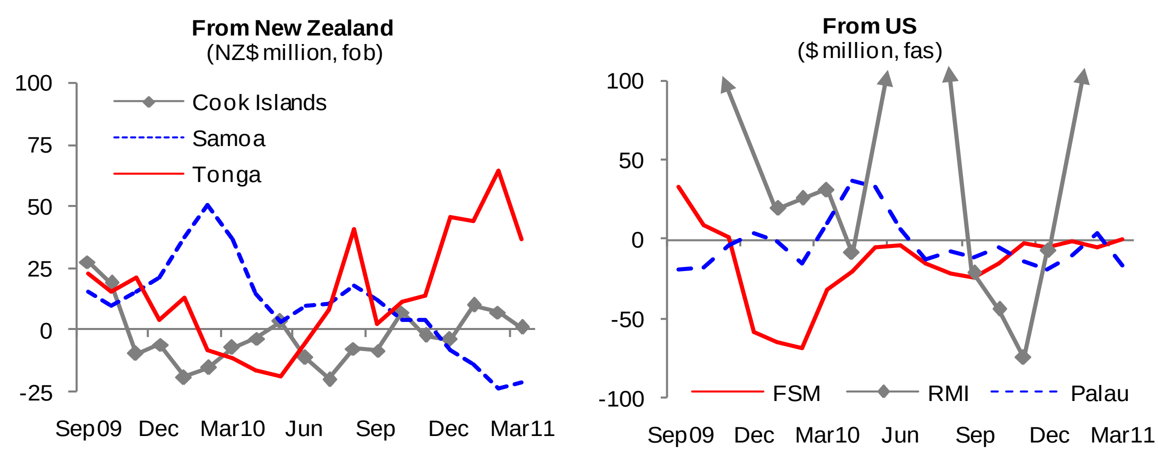
Lead author: Laisiasa Tora.

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



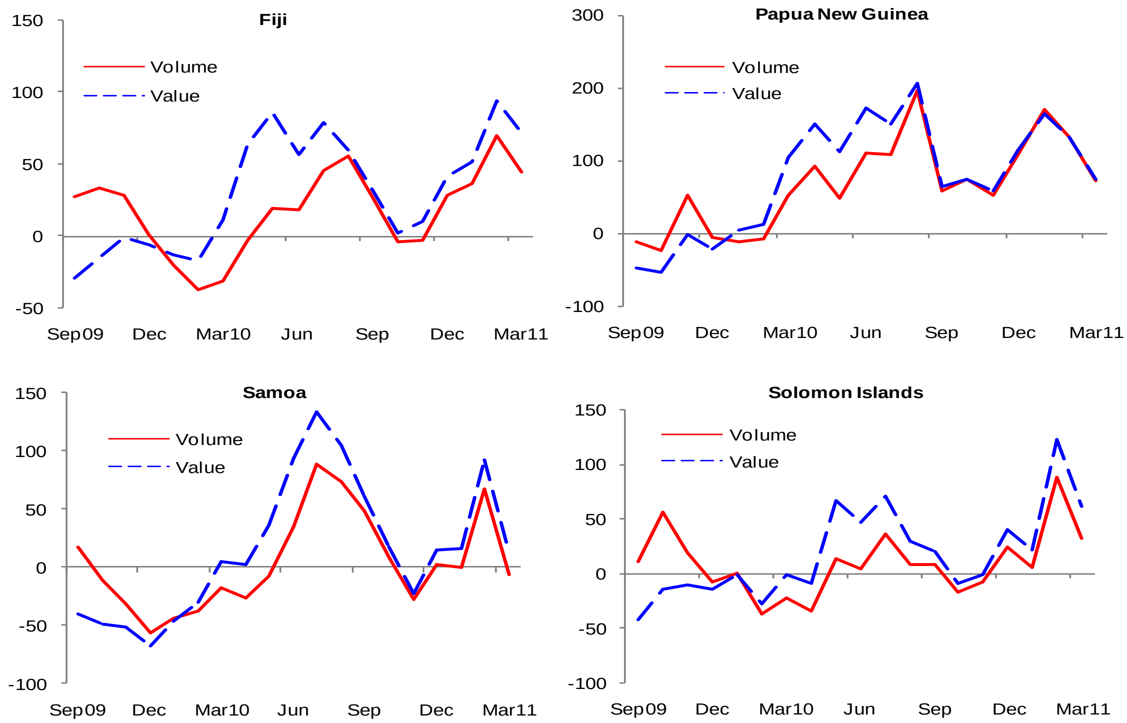
A$ = Australian dollars
Source: Australian Bureau of Statistics.

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

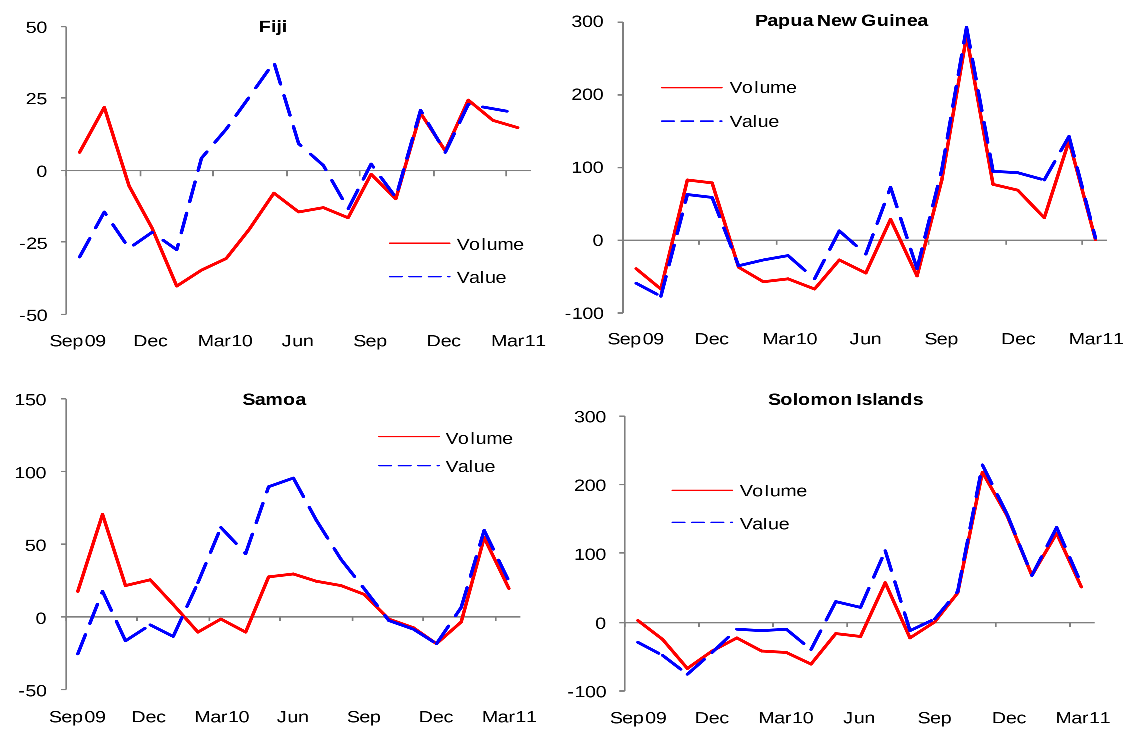


FSM=Federated States of Micronesia, fas=free alongside, fob=free on board, NZ$=New Zealand dollar, RMI=Republic of the Marshall Islands, US=United States
Note: The Cook Islands–Fiji shipping route closed in 2009.
Sources: Statistics New Zealand and US Census Bureau.

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

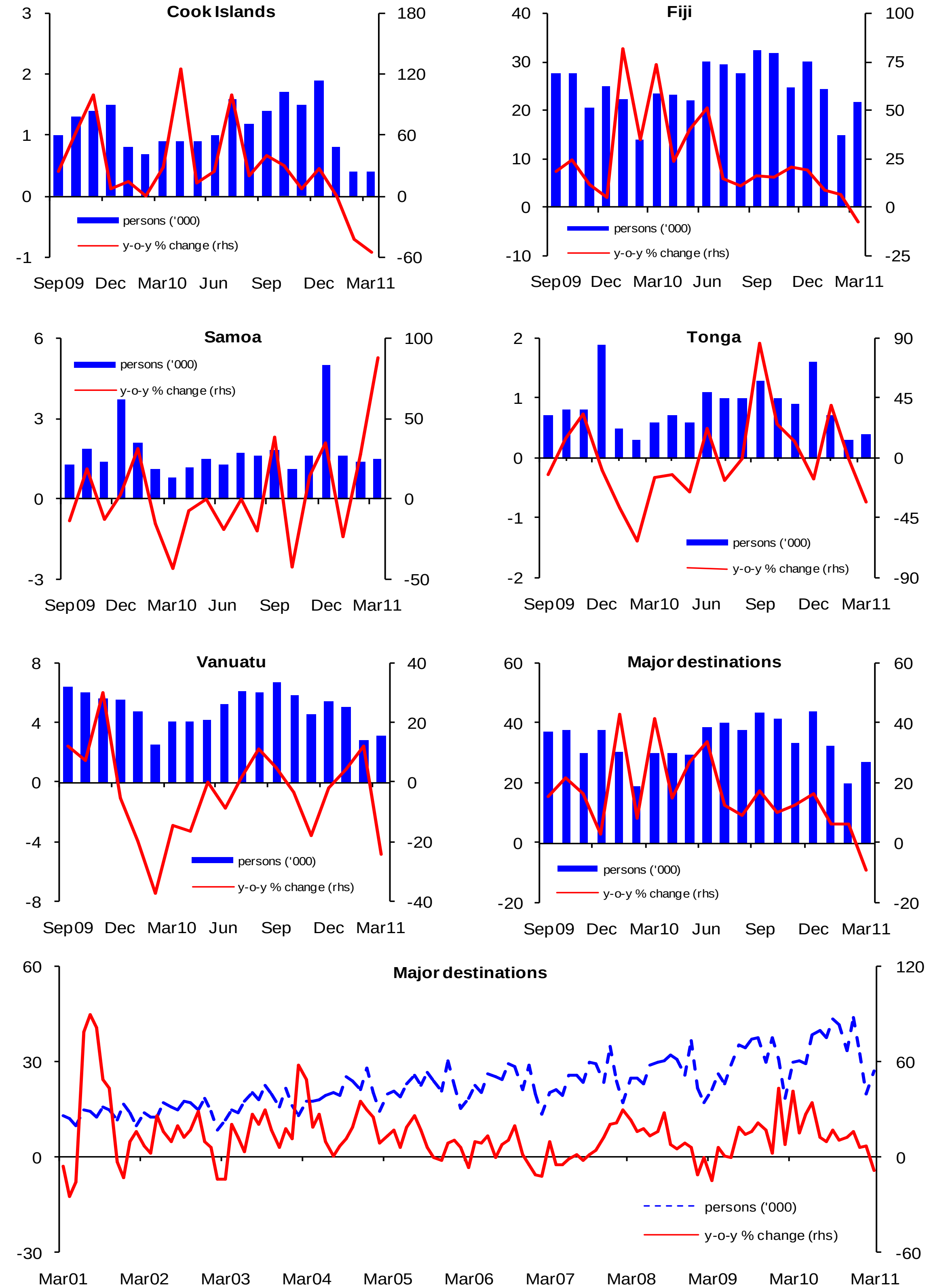


Gasoline imports from Singapore
(y-o-y % change, 3-month m.a.)



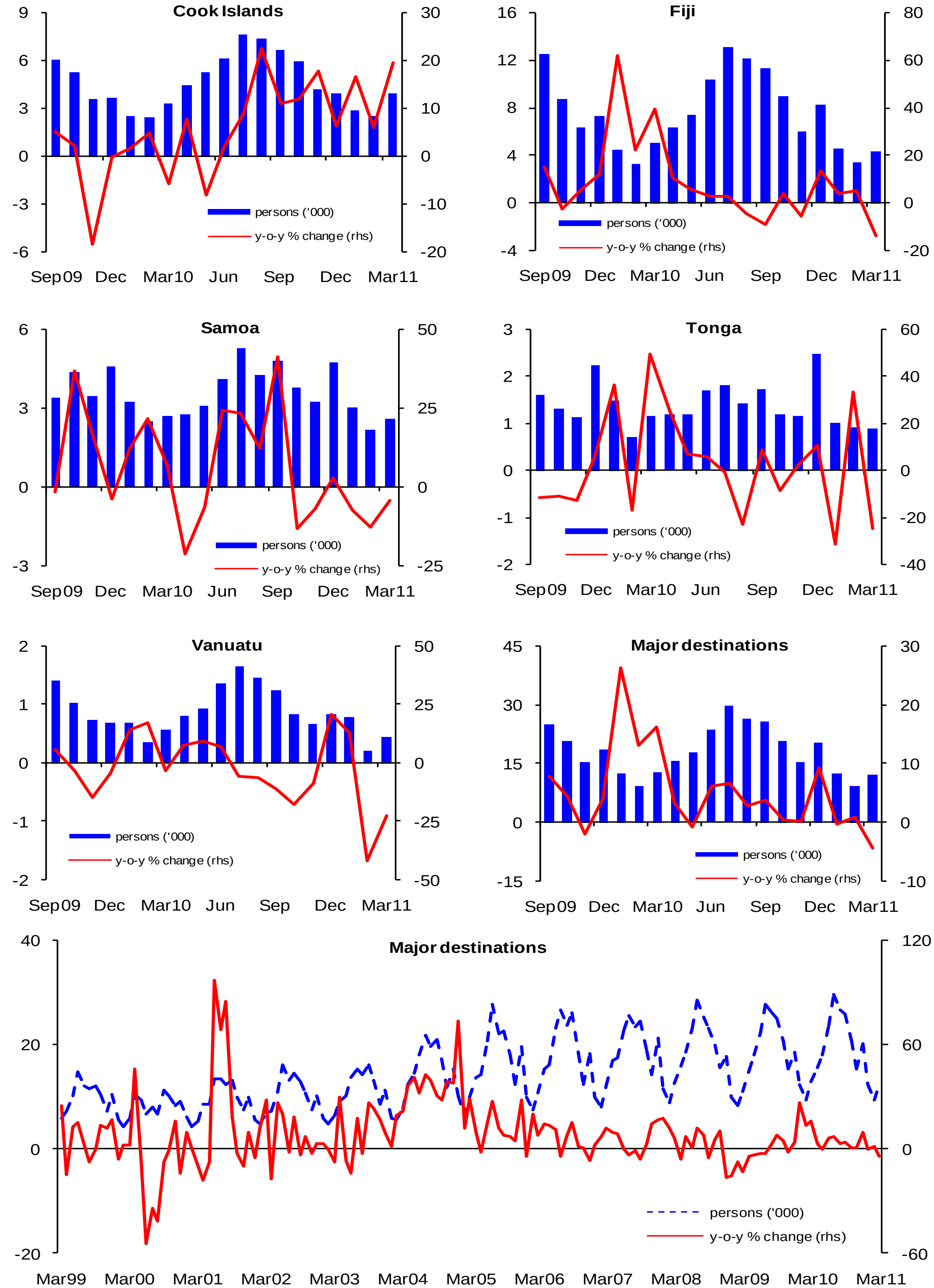
Source: International Enterprise Singapore.

Departures from Australia to the Pacific
(monthly)



Sources: Australian Bureau of Statistics and Tourism Research Australia.

Departures from New Zealand to the Pacific
(monthly)



Source: Tourism Strategy Group, New Zealand Ministry of Economic Development.

Latest Economic Updates

	GDP Growth	Inflation	Credit Growth[a]	Trade Balance	Import Cover	Fiscal Balance
	(%, 2011f)	(%, y-o-y)	(%)	(% of GDP)	(months)	(% of GDP)
Cook Islands	1.1	1.5	–0.4	–8.0	---	–1.8
		(Mar-Q 2011)	(Sep-Q 2010)	(Sep-Q 2010)		(FY2011e)
Fiji	1.2	8.1	1.4	–32.8	4.3	–3.5
		(Apr 2011)	(Jun 2010)	(Jun-Q 2010)	(May 2011)	(2010e)
Kiribati	2.0	6.7	---	–42.8	---	0.6
		(FY2011f)		(2009)		(2010e)
Marshall Islands	1.0	5.0	6.5	–46.5	---	0.3
		(FY2011f)	(FY2009)	(FY2009e)		(FY2010e)
Micronesia, Fed. States of	1.0	6.0	12.6	–46.2	2.7	0.7
		(FY2011f)	(Dec 2009)	(2009e)	(FY2009)	(FY2010e)
Nauru[b]	4.0	0.0	---	---	---	14.2
		(May 2011)				(FY2010e)
Palau	2.0	6.0	---	–46.3	---	–2.4
		(FY2011f)		(FY2010e)		(FY2010e)
PNG	8.5	9.0	18.5	22.8	10.5	0.7
		(Mar-Q 2011)	(Dec 2010)	(Sep 2010)	(Dec 2010)	(2010)
Samoa	2.1	3.8	4.6	–44.1	6.9	–9.3
		(Apr 2011)	(Apr 2011)	(Sep-Q 2010)	(Apr 2011)	(FY2011e)
Solomon Islands	7.5	4.00	–16.3	–15.7	9.0	7.1
		(Apr 2011)	(May 2011)	(Sep-Q 2010)	(Apr 2011)	(2010e)
Timor-Leste	10.0	13.5	17.8	–63.7	---	200.2
		(May 2011)	(Apr 2011)	(2010e)		(2010e)
Tonga	0.5	7.5	–7.1	–30.3	6.0	–4.2
		(Mar 2011)	(Mar 2011)	(2010)	(Apr 2011)	(FY2011e)
Tuvalu	0.0	–1.0	---	---	---	–27.9
		(Mar 2011)				(2010)
Vanuatu	3.0	3.4	11.6	–31.6	5.8	–2.7
		(Dec-Q 2010)	(Dec-Q 2010)	(Sep-Q 2010)	(Dec-Q 2010)	(2010)

--- = not available, e=estimate, f=forecast, FSM=Federated States of Micronesia, GDP=gross domestic product, PNG=Papua New Guinea, p=preliminary, Q=quarter, y-o-y=year on year

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

[b] Inflation for Nauru is on a year-to-date basis.

[c] 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 non-mining and oil imports.

Sources: ADB. 2011. *Asian Development Outlook 2011*. 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 substantially 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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