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. Global financial instability increased sharply over 2011 following economic setbacks in Europe and the United States (US), most notably driven by sovereign debt problems in the Eurozone. This is contributing to heightened global economic uncertainty, and growth forecasts have been downgraded in a number of leading economies. Growth prospects in developing Asia, however, remain relatively solid.
- The Eurozone crisis is expected to have only limited impacts on the Pacific because the region's growth prospects are more closely tied to the economies of Australia and New Zealand, which remain relatively buoyant due to strong demand from Asian markets for their commodity exports. Main impacts will be indirect, through trade and investment linkages between the EU and the Pacific's economic partners, declining values of Pacific trust funds, and declines in tourism, particularly from US and Japan, if these economies weaken.
- Fiscal Conditions. Better than expected revenue performance in 2011 contributed to improvements in the fiscal balances of many Pacific economies. For 2012, a number of Pacific economies (e.g., Fiji, Samoa, and Tonga) are targeting smaller fiscal deficits, stepping back from recent high deficits incurred to support stimulus or recovery efforts following the global financial and economic crisis (GFEC) and recent natural disasters. In contrast, the two resource rich economies of the Pacific region–Papua New Guinea (PNG) and Timor-Leste–are utilizing the fiscal space afforded by mineral wealth to continue expansionary policies. Large investments in infrastructure are aimed at maintaining high economic growth.
- Fiscal challenges persist in the region. Political instability in Kiribati, Solomon Islands, and Vanuatu is delaying finalization of 2012 budgets and raising uncertainty about medium term fiscal plans. Achieving longer-term fiscal self-sufficiency in the Northern Pacific countries remains challenging given their limited resources. These countries are pursuing fiscal reform to accumulate public savings in the future.
- Progress in fiscal management in the region is welcome and should be sustained to build fiscal space for responding to economic shocks. This will be particularly relevant if the impacts of the ongoing Eurozone crisis persist and spread to the Pacific.
- Economic policy and management. This issue includes four articles discussing financial market issues affecting the Pacific. An analysis of sovereign investment funds in the Pacific shows that the current period of volatility to date has resulted in small valuation losses (relative to 2008-09), but, looking forward, considerable downside risks remain. Issues relating to the development of a domestic bond market in PNG, which can improve the availability of finance and reduce the economy's vulnerability to financial shocks, are also examined.
- The Pacific Financial Technical Assistance Centre outlines arguments against taking short-term measures to control interest rates or regulate bank profits in the region. Finally, an article by Standard & Poor's provides an update on the sovereign credit ratings of selected Pacific economies, given the prospect of weaker global growth and ongoing financial market volatility.
- A note discussing recent inflation in Timor-Leste concludes this issue.

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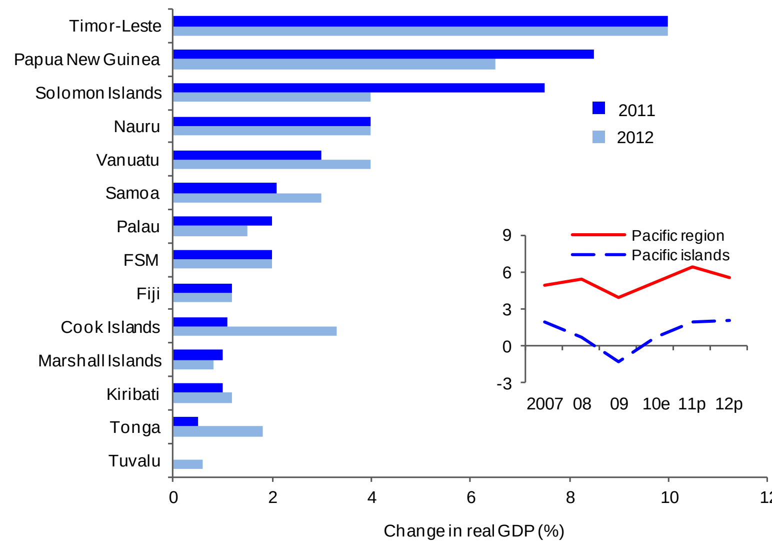
Abbreviations

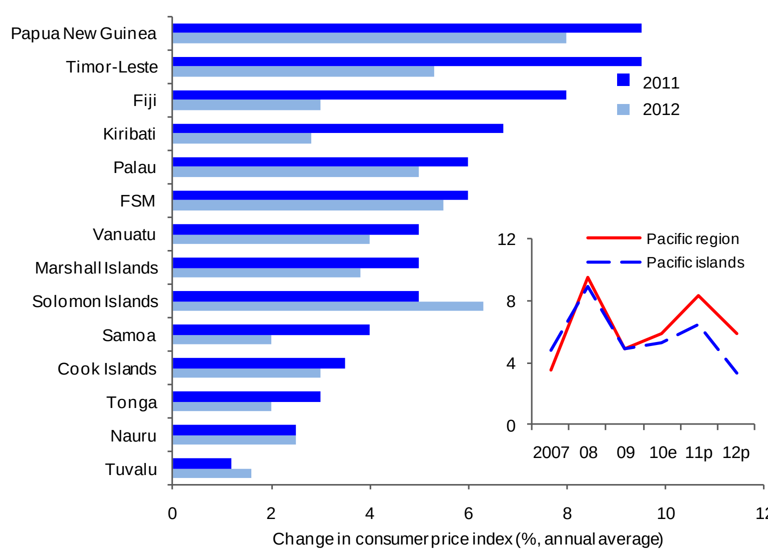
$	US dollar, unless otherwise stated
ADB	Asian Development Bank
ASEAN	Association of South East Asian Nations
A$	Australian dollar
e	estimate
f	forecast
fas	free along side
fob	free on board
FNPF	Fiji National Provident Fund
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
K	kina
lhs	left hand scale
LNG	liquefied natural gas
m.a.	moving average
MISSA	Marshall Islands Social Security Administration
NZ$	New Zealand dollar
PCSPP	Palau Civil Service Pension Plan
PNG	Papua New Guinea
POMSoX	Port Moresby Stock Exchange
rhs	right hand scale
RMI	Republic of the Marshall Islands
SI$	Solomon Islands dollar
TFP	total factor productivity
US	United States
y-o-y	year-on-year

Asian Development Bank Projections

GDP growth



Inflation



Note: Projections are as of July 2011 and refer to fiscal years. Regional averages of 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 (FSM), and Palau; and 31 December elsewhere.

International and regional developments

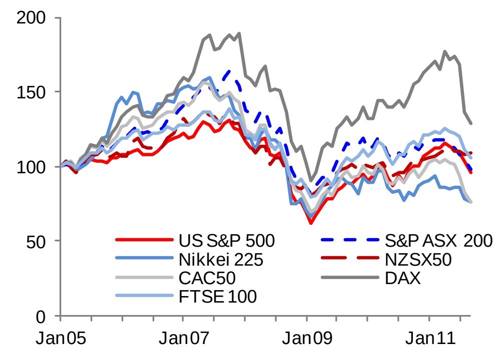
Rise in financial market volatility

- Major stock market indexes have undergone significant swings in recent months. Global financial instability has increased following economic setbacks in Europe and the US. Protracted US debt negotiations, downgrading of the US credit rating by Standard & Poor's, and the more recent failure of the budget Supercommittee have all contributed to rising global economic uncertainty.
- European sovereign debt problems have reached a critical stage (evidenced by sharp rises in interest rates demanded by investors on some country's bonds) and are affecting larger Eurozone economies and broader global markets. Lingering issues, including Greek debt, capitalization of European banks, and credit rating downgrades of sovereign bonds and banks, seem likely to continue to dent market sentiment and raise financial and economic risks into 2012.

Global economic growth prospects weakening

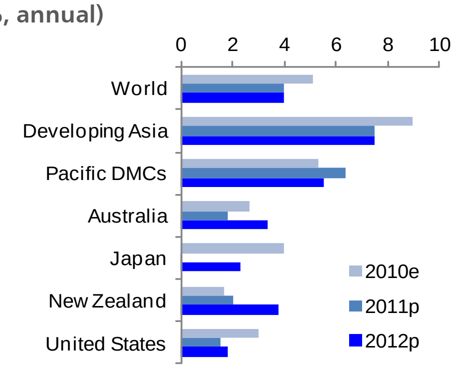
- Global growth slowed in 2011 as major advanced economies suffered fallout from the European debt crisis, fiscal tightening in a few Organization of Economic Cooperation and Development economies, and the after effects of the earthquake and tsunami in Japan. The International Monetary Fund's (IMF) September World Economic Outlook projected growth of about 4.0% in both 2011 and in 2012 for the world economy, down from an earlier forecast of 4.5% in April 2011. The volume of world trade is now expected to grow at only 6.7% compared to 12.8% in 2010.
- Revisions to US GDP estimates indicate that the economic contraction in 2008 and 2009 was deeper, and the recovery since mid-2010 was weaker, than previously measured. The IMF has revised its US growth forecast downward to an average of 1.7% in 2011 to 2012 (from its earlier forecast of 2.8%). The US Federal Reserve Board has signaled its intent to keep interest rates low, at least through mid-2013, to support the fragile recovery in the US. However, the impacts of monetary stimulus are being counteracted by strong measures toward fiscal tightening intended to bring down the country's budget deficit and level of debt. The US Federal Reserve Board has also indicated that it aims to push longer-term interest rates down by selling short-term Treasuries and using the proceeds to buy longer-term Treasuries.
- The IMF revised Australia's 2011 GDP growth forecast from 3.0% to 1.8% due to the muted recovery in coal exports following flooding in Queensland and lower-than-expected private consumption. The Reserve Bank of Australia reduced its cash rate by 50 basis points to 4.25% in the last 2 months of the year in response to moderation in the pace of global growth and rising financial risks. Inflation increased in the first half of the year, but the continued strength of the Australian dollar and subdued demand conditions have contained it, and inflation is now expected to be slightly above its target level (2%–3%) by year's end. The Parliament recently approved a carbon tax, which is expected to lower emissions as it is phased in and to reduce profits of around 500 large emitters.

Stock market indexes
(end of month values, Jan 2005=100)



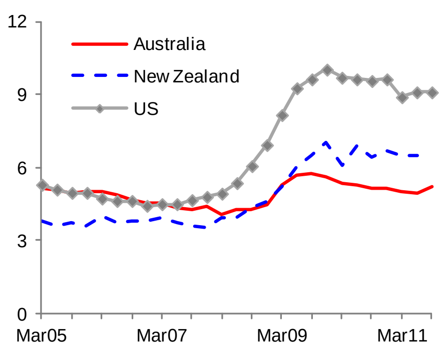
Source: CEIC database.

GDP growth
(%, annual)



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

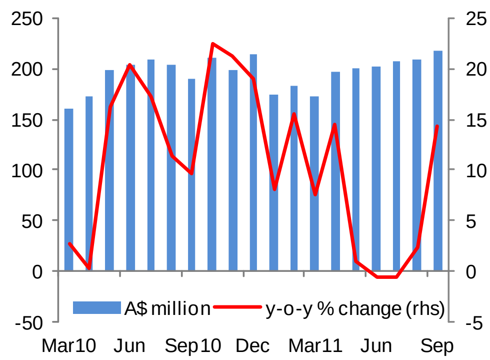
Unemployment in key economies
(% of labor force)



Sources: Australian Bureau of Statistics (ABS), Statistics New Zealand, and US Bureau of Labor Statistics.

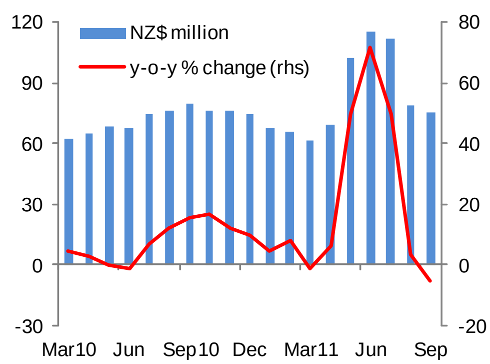
International and regional developments

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



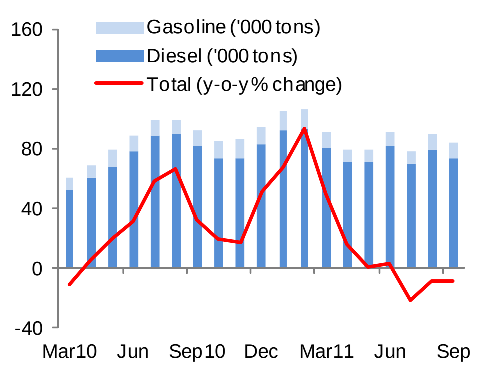
Source: ABS.

Nonfuel exports from New Zealand to the Pacific (3-month m.a.)



Source: Statistics New Zealand.

Singapore fuel exports to the Pacific (3-month m.a.)



Source: International Enterprise Singapore.

- New Zealand's estimated growth in 2011 has been upgraded by the IMF from 0.9% to 2.0%, but the country's credit rating was downgraded by two major credit rating agencies following deterioration in the country's current account balance, an increase in net foreign liabilities, and worsening fiscal position following the earthquakes. Prolonged global financial uncertainty is expected to increase the cost of domestic bank funding (which relies on offshore borrowing) and dampen export demand, which has been supporting growth.

- Unemployment in key economies is stubbornly high and will likely remain so as economic growth stalls and uncertainty increases. The US unemployment rate has averaged above 9% while New Zealand's unemployment rate has hovered around 6% since mid-2009.

- The bright spot in the global economy is found in developing Asia, which is expected to grow by 7.5% in both 2011 and 2012. According to ADB's Asian Development Outlook 2011 Update, growth is being driven by strong domestic private demand, favorable export prices, and enhanced intraregional trade. Inflation in the region is a continuing concern but inflationary pressures are expected to abate with the moderating trend in international commodity prices and weakness in the economies of major industrial countries.

- Pacific economies are expected to experience only limited direct impact from the Eurozone crisis. The region's growth prospects are more closely linked to the performance of the Australian and New Zealand economies, which has remained relatively robust due to strong demand for commodities from Asian markets. The impacts will be felt indirectly through trade and investment linkages between the EU and the Pacific's economic partners, declining values of Pacific trust funds, and a possible fall in tourism, particularly from US and Japan.

Pacific import growth slowing

- Weaker demand for merchandise imports in the Pacific is at least partly due to the volatility in global markets and international commodity prices. However, it also reflects underlying stagnation in some Pacific islands, particularly in the smaller, more remote, and less resource-intensive economies in the region.

- Growth in the value of nonfuel imports from Australia averaged around 10% over the first quarter of 2011, but has since slowed to about 5% over the second and third quarters. This weakening of import demand was reflected in Australian exports to Fiji, which declined by more than 10% in April–July, and Papua New Guinea (PNG), which slowed to just over 2% in May–August compared with 13% in the first quarter.

International and regional developments

- New Zealand's nonfuel exports to the Pacific, which were weak over the first quarter of 2011, showed unusually high growth in the second quarter. This was due to large one-off purchases of transport equipment by the Marshall Islands and Samoa. Nonfuel exports from New Zealand to the Cook Islands and Tonga declined in value over the third quarter of 2011.

- The Pacific's fuel imports are also trending downward after strong growth early in the year. The volume of diesel imports fell by an average of almost 15% in the third quarter of 2011 primarily due to declines in shipments to Fiji and Samoa. Lower fuel imports by Fiji in part reflect reduced re-exports to smaller and more remote islands. The volume of gasoline imports declined by an average of more than 8% over the second quarter of 2011, and showed little growth in the third quarter.

Pacific export performance mixed

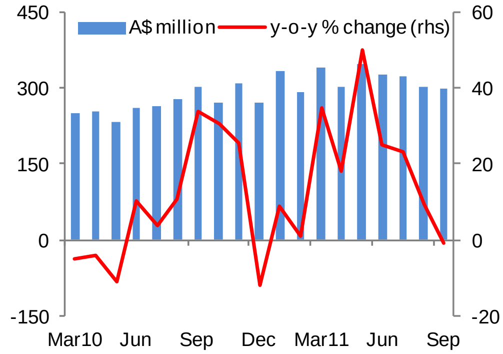
- Growth of Pacific exports to Australia was strong from March to July 2011 but slowed in August–September. Both the growth and slowing were largely driven by exports of mineral resources from PNG. Growth of the Pacific's exports to New Zealand (much smaller than exports to Australia) recovered in the third quarter of 2011 after some weakness in the second quarter. Fiji is the strongest exporter to New Zealand, along with some large seasonal exports of minerals from Nauru and PNG.

Tourism in the Pacific rebounded in mid-2011

- Departures from Australia and New Zealand to major Pacific tourist destinations have increased substantially since the easing felt in the first quarter of the year. The number of Australian tourists rose by about 11% and New Zealand tourists by 6% from April to September 2011. This growth in the middle of the year has boosted totals for the first three quarters of 2011, with tourist numbers now up by more than 7% for Australia and around 3% for New Zealand, relative to the already high levels achieved over the same period last year.

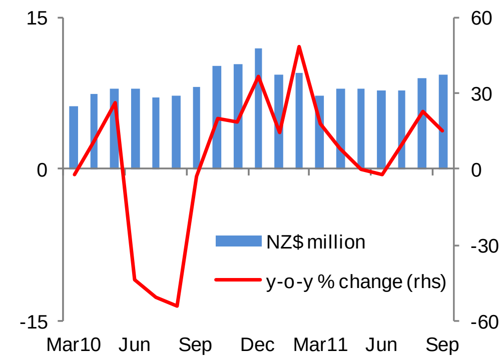
- The number of Australian tourists increased for most Pacific destinations, except for Vanuatu, and was strongest in Samoa (24%) and Fiji (13%). There are clear signs of strong competition among Pacific destinations. The decline in Australian departures to Vanuatu appears attributable to Fiji's regaining its previous tourist market share. The number of New Zealand tourists to Samoa and Vanuatu declined over the same period, but this was more than offset by higher departures to the Cook Islands, Fiji, and Tonga. However, risks to sustaining the robust tourism performance for the rest of the year remain, with the lingering uncertainty in global markets and in particular the latest reduction in growth forecasts for Australia and New Zealand.

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



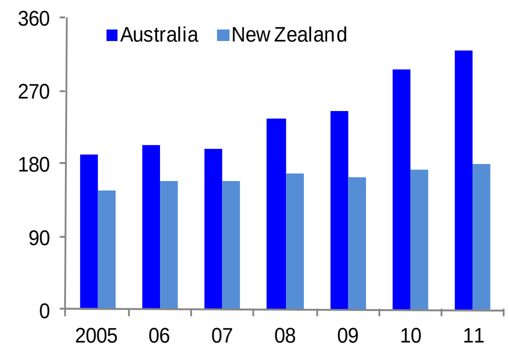
Source: ABS.

Pacific exports to New Zealand (3-month m.a.)



Source: Statistics New Zealand.

Tourist departures to Pacific countries ('000; January–September totals)

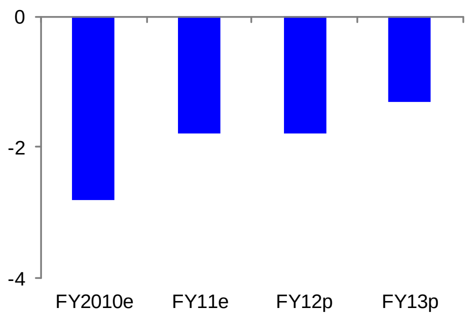


Sources: ABS and Statistics New Zealand.

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

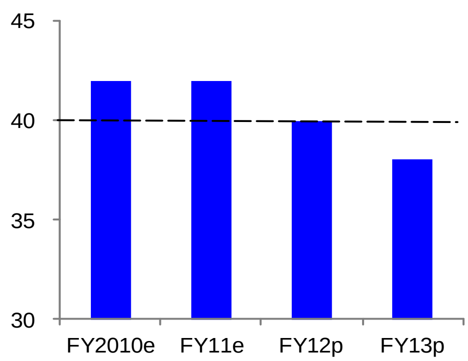
Cook Islands

Budget position (% of GDP, annual)



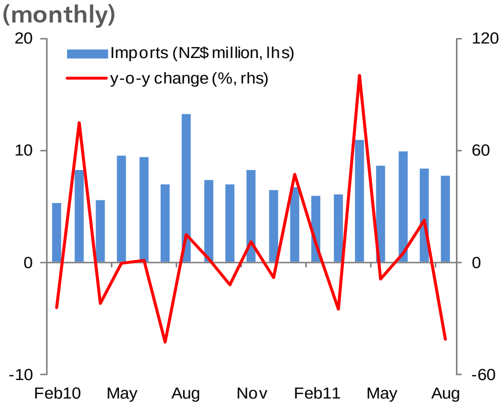
e=estimate, p=projection
Source: Cook Islands Ministry of Finance and Economic Management, Budget Policy Statement 2011/2012.

Government personnel expenses (% of total revenue, annual)



e=estimate, p=projection
Source: Cook Islands Ministry of Finance and Economic Management, Budget Policy Statement 2011/2012.

Imports from New Zealand (monthly)



NZ$ = New Zealand dollar
Source: Statistics New Zealand.

Lead author: Malie Lototele.

Budget performance FY2011

- Revenue performance in FY2011 (ended 30 June 2011) exceeded budget projections by 1.4%, (or about NZ$1.4 million above the budgeted NZ$102 million). The higher revenues came mostly from higher-than-expected earnings from nontax instruments. This contributed to achieving a fiscal deficit (equivalent to about 1.8% of GDP) below the government's target.

Budget FY2012

- Government revenue in July–September 2011 was about 7% higher than projected in the budget, but was around 1% lower than actual collections over the same period in the previous fiscal year. Higher tax revenues partly offset the large decline in government income from fishing licenses. The FY2012 budget projects another small fiscal deficit of about 1.8% of GDP with government expenditure increasing by 5.3%, outpacing revenues, which are forecast to rise by 4.7%. Tax revenues are expected to rise by 6.3%, driven by an expectation of a 5% increase in tourist arrivals.

Recent developments

- Projections for growth in visitor arrivals have been revised downward from 13% to 5% as a result of the government's decision not to pursue the Nadi–Rarotonga direct flight in 2011–2012. This is expected to reduce tax revenue growth to about 6.3% instead of the 10% estimated for FY2012.
- The number of New Zealand visitors to the Cook Islands is projected to increase by 3% in FY2012, while visitors from Australia are projected to increase by 44% due to the reintroduction of a Sydney–Rarotonga direct flight in July 2011. The Cook Islands government facilitated the added flights by guaranteeing Air New Zealand subsidies if the number of passengers falls below a defined minimum. Growth in visitor arrivals from the northern hemisphere remains sluggish in spite of the Cook Islands Tourism Corporation's greater promotional focus on the North American markets.
- Fish exports continue to grow. Year-to-date data to March 2011 showed the value of exports has grown by 61% over the same period last year. Exports of pearls, on the other hand, continue to decline. Programs are in place to revive the industry (focused on Manihiki) and double production over the next 3 years.
- The country's trade deficit is estimated to have widened to NZ$355.9 million in FY2011 (15.3% of GDP), which is 3.4% larger than in FY2010.

Key issues

- Total government debt is projected to increase from NZ$94.7 million to NZ$107.6 million (around 28.5% of GDP). This reflects a proposed loan currently under negotiation with ADB. Borrowing will be used primarily to finance infrastructure expenditure and support economic growth. Debt levels remain well within the current ceiling of 35% of GDP.

Fiji

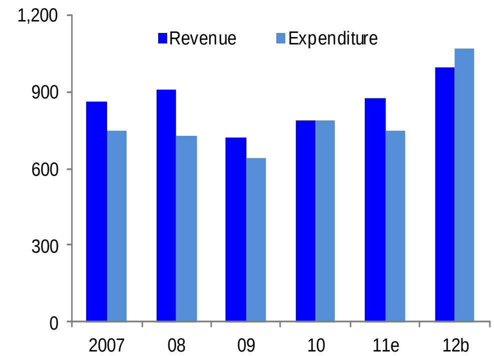
Budget performance 2011

- The budget deficit target of 3.5% of GDP is likely to be achieved despite the expectation in September of a narrower deficit outturn.
- Lower revenue collections (due to the delay in sale of government assets), along with expenditure tracking close to budget, has offset strong growth in collections of value added, hotel turnover (room tax), and water resource (high use surcharge) taxes.

2012 budget

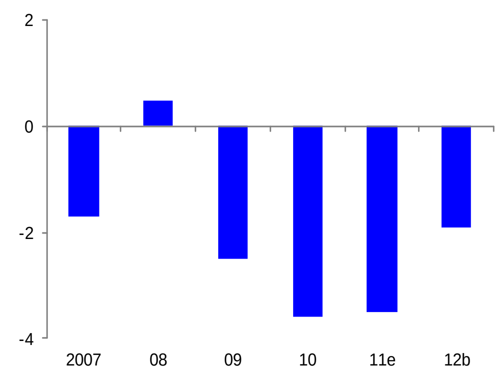
- The budget deficit for 2012 is projected to be 1.9% of GDP, representing a higher level of fiscal consolidation than was contained in the government's 2011 Fiscal Framework. This projection relies on optimistic revenue growth assumptions. In the past, the government has achieved deficit targets by underspending on planned capital expenditures.
- Revenue is forecast at $1.1 billion, up by 12.7% from 2011, based on expectations of strong growth (2.3%) in the Fijian economy driven by corporate and personal income tax cuts intended to boost spending and investment. The forgone revenues from the tax cuts will be more than offset by the conversion of the 5.0% hotel turnover tax to a service turnover tax applying to most tourism-related services. This is expected to generate $32.6 million in revenue. Other revenue enhancement measures include increases in the departure tax, excise taxes on alcohol and cigarettes, and new levies (e.g., voice call charges, credit card fees, and third party insurance).
- The expenditure forecast is $1.2 billion, up by 5.9% from 2011. Operating expenditure (around $840 million) makes up 70% of total expenditure and increased by 5.0% over 2011 levels. Capital expenditure (around $320 million) makes up the balance and rose by 7.1% over 2011 levels. Key features of the 2012 expenditure program include a 3.0% pay restoration for civil servants and an increase of $36.6 million (or 7.0%) in the infrastructure development budget allocation largely financed by the Export-Import Bank of China and the Export-Import Bank of Malaysia. Tourism, agriculture, and infrastructure development remain expenditure priorities, and import substitution and export promotion appear central to the government's development strategy.
- The 2011 fiscal framework shows government debt increasing in 2011–2013 to reach 59.2% of GDP. Interest payments, which are equivalent to around half the government's wage bill, are projected to decrease in 2012 (following a sharp rise of around 26.4% in 2011). The post-2012 fiscal path sees a more rapid reduction in the debt-to-GDP ratio—from 52% in 2012 to around 50% by 2014. This will reverse the trend of increasing debt that began in 2006 and provides stronger impetus towards achievement of the Government's own target of 40%.
- Contingent liabilities (estimated at roughly $1.1 billion or 28% of GDP) pose a threat to the government's fiscal position. These represent ongoing guarantees of state-owned enterprise borrowing, and as such increase the likelihood and extent of debt distress if projected levels of growth are not achieved.

Central government budget position ($ billion, annual)



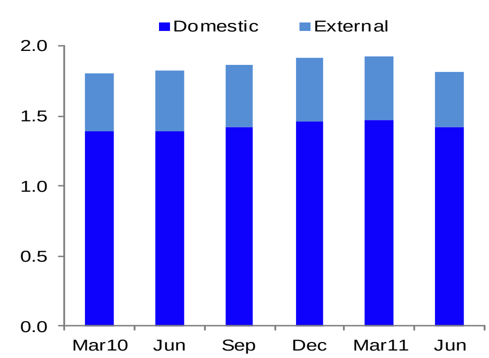
e=estimate, b=budget
Sources: Fiji Bureau of Statistics, Fiji Ministry of Finance. Economic and Fiscal Update: Supplement to the 2012 Budget Address, Asian Development Outlook database, and ADB estimates.

Net budget position (% of GDP, annual)



Sources: Fiji Ministry of Finance. 2011 National Budget and Economic and Fiscal Update: Supplement to the 2012 Budget Address.

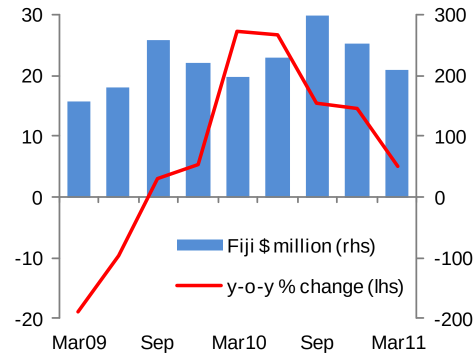
Government debt ($ billion, quarterly)



Sources: Reserve Bank of Fiji and Asian Development Outlook database.

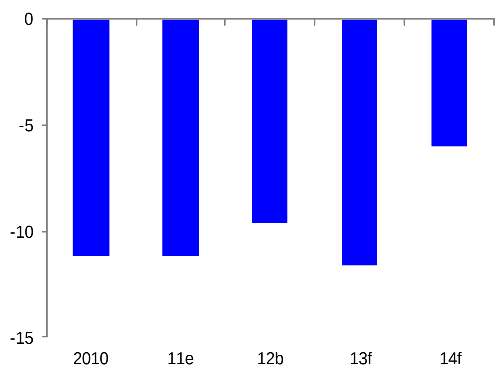
Fiji

Tourism earnings (quarterly)



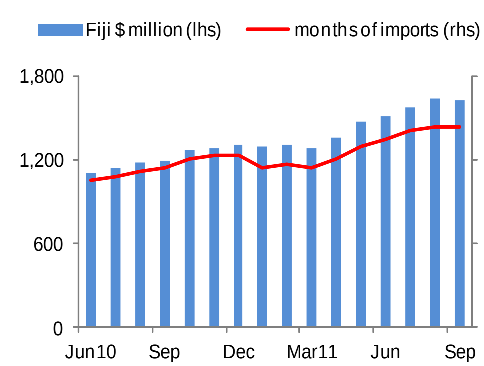
lhs=left hand scale, rhs=right hand scale
Source: Fiji Bureau of Statistics.

Current account balance (% of GDP, annual)



Source: Fiji Ministry of Finance. Economic and Fiscal Update: Supplement to the 2012 Budget Address.

Foreign exchange reserves (quarterly)



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

Lead author: Laisiasa Tora.

Recent developments

- The Government revised its 2011 growth forecast from 2.7% in April to 2.1% in November. This was higher than the 2011 budget forecast of 1.3% and ADB's estimate of 1.5%. The recovery in 2011, which followed 2 years of contraction, was driven largely by a post-cyclone rebound in agriculture (mainly taro, pawpaw, and sugarcane production), manufacturing, and increased tourism.
- The medium-term outlook is less encouraging. Slower growth in major economic partners is expected to affect exports and tourism, exacerbating structural weaknesses in the domestic economy. ADB's growth projection for 2012 is 0.7%, which is closer to the average growth rate over the past 6 years. New construction activity and capital purchases linked to mining investments could boost growth. For example, investment to date for the Namosi Copper Mine has been equal to about 2.2% of GDP, or $86.2 million of a planned total of $1.1 billion. However, this has largely been spent on exploration and feasibility studies, and much of the capital is expected to be imported, so it is unclear how much impact the investment will have on growth in Fiji.
- The current account deficit is expected to remain at around 10% of GDP in 2011, driven by the country's persistent trade deficit. This is forecast to moderate slightly in 2012 although a rise in consumer spending could lead to more imports and worsen the trade balance. Foreign reserves remain at comfortable levels in 2011, at around $880 million and are sufficient to cover about 5.1 months of imports.

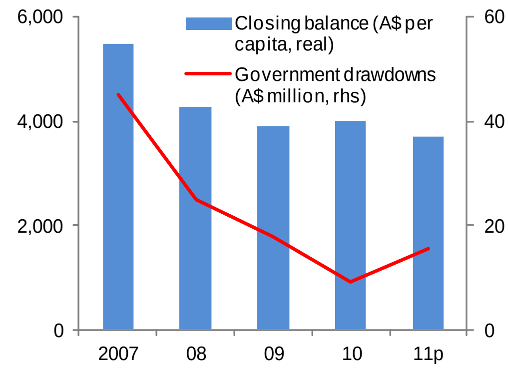
Key issues

- The Fiji government's stronger fiscal consolidation bodes well for debt reduction, but achieving long-term reductions in the country's debt burden rests upon the achievement of revenue and growth targets.
- In 2011, the government increased the balance of its offshore sinking fund by 9.0% (to $37.2 million) in order to ensure it is well placed to repay the international bond issue of $250 million maturing in March 2016. However, there is a risk that these funds may be used to finance current expenditure, particularly if revenue targets are not achieved.
- The 2012 Budget aims to stimulate economic activity through tax cuts to boost spending, but this objective will not be met if consumer and business confidence does not improve due to lingering political and policy uncertainties.
- Structural reforms are critical to improve growth prospects. A recent ADB assessment of private sector development in Fiji identified the following strategies for improvement: creating a stable policy environment, minimizing the role of the state in the economy, and streamlining business regulatory processes.

Kiribati

- Total revenues for 2011 are projected to be A$69.2 million, 11.2% less than the A$77.9 million realized in 2010. A 25% decrease in fishing license revenues, and cuts in corporate and personal income taxes, account for the bulk of the reduction in revenues. Total expenditures are expected to be A$94.6 million, an increase of 9.3% from 2010, which combined with the lower revenues will result in a budget deficit of A$25.4 million (15% of GDP) by year end.
- The government plans to finance the deficit by drawing on its Revenue Equalization Reserve Fund, which has raised concerns about the fund's long term sustainability following its losses during the global financial and economic crisis.
- A second round of parliamentary elections was recently completed, and the presidential election is scheduled for 30 December. Key political issues in Kiribati include diplomatic relations, future aid flows, pensions, and agricultural policy.
- The election schedule has delayed the enactment of the 2012 budget, which is not likely to be tabled until early next year. However, the IMF is projecting a substantially larger fiscal deficit for 2012. This is due to another scheduled sharp increase in infrastructure spending to be financed through new external grants and loans.

Revenue Equalization Reserve Fund (annual)



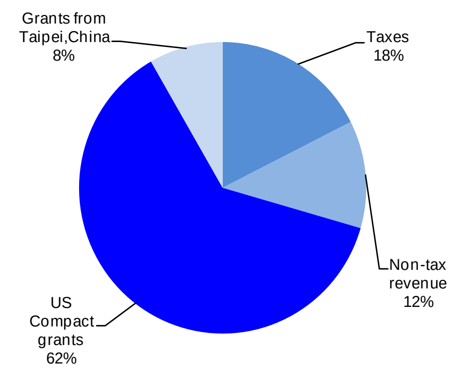
A$=Australian dollars, p=projection, rhs=right hand scale
Note: Per capita balance deflated by consumer price index
Source: ADB estimates based on International Monetary Fund's *Kiribati 2011 Article IV Staff Report*.

Lead author: Malie Lototele.

Marshall Islands

- In FY2011, government revenue from domestic sources grew modestly from the previous fiscal year, but there was some reduction in grants, particularly US compact funds, which resulted in an overall increase in government revenues of about 1.2%. Total expenditure grew by 6.1%, which reflected a 6.4% increase in current expenditure (particularly on public enterprise subsidies) and a 4.6% rise in capital expenditures. This yielded a fiscal surplus equivalent to about 1.4% of GDP, which was substantially smaller than the surplus of 4.6% of GDP in FY2010.
- Parliament passed a $132 million budget for FY2012 in late September. About 70% of funding is sourced from grants from the US (88.6% of total grants) and Taipei,China (11.4%), with the balance coming from domestic taxes (60% of domestic revenue) and non-tax revenue (e.g., fishing licenses and vessel registrations, 40%). As in recent years, half of the total budget is allocated for education and health. Deteriorating infrastructure and poorly performing public enterprises continue to put pressure on the budget.
- The value of the Republic of the Marshall Islands Compact Trust Fund must be built up to compensate for annual US financial assistance which will end in FY2023. This will require targeted expenditure cuts, particularly to the public sector wage bill; reforms to broaden the tax base and improve revenue collection; reforms to state-owned enterprises; and enhancements to public financial management to increase the efficiency of public spending.

Financing the FY2012 budget (% share, by source)

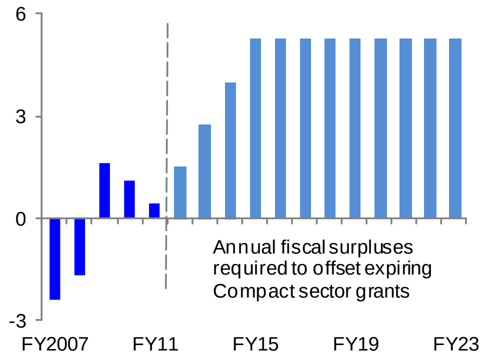


Sources: ADB estimates based on the Republic of the Marshall Islands FY2011-2012 Budget.

Lead author: Rommel Rabanal.

Micronesia, Federated States of

FSM fiscal adjustment
(fiscal balance, % of GDP)



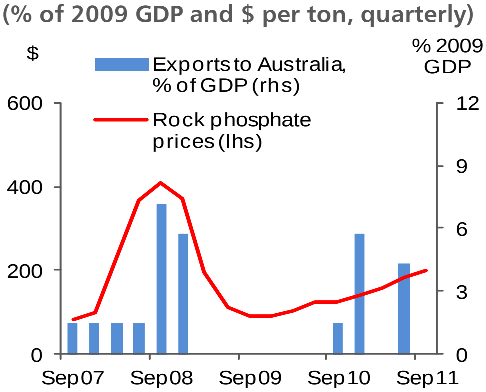
Sources: International Monetary Fund. Federated States of Micronesia–2011 Staff Visit Preliminary Conclusions.

Lead author: Rommel Rabanal.

- The consolidated government fiscal account posted a small surplus equivalent to about 0.4% of GDP in FY2011. This represents the third consecutive year of surplus following chronic budget deficits in the past. Higher tax collections compensated for a slight increase in current expenditures during the year.
- For FY2012, the IMF is projecting another small surplus equal to about 0.5% of GDP. Total domestic revenue is expected to remain at about 20.0% of GDP over the medium term under prevailing conditions. Rising capital expenditure on infrastructure and public works projects will be financed primarily through an increase in grants from the US.
- According to the IMF, the level of annual fiscal surpluses needed for deposit into the Federated States of Micronesia Compact Trust Fund (CTF) must be increased until they are equivalent to 5.3% of GDP by FY2015. Deposits at this level must be maintained for the value of the CTF to have sufficient resources to finance government expenditure after CTF's expiration in FY2023. Recent levels of fiscal balance have fallen considerably short of target levels.
- Fiscal adjustment requires commitment to specific targets for reducing public wages on the part of both the national and state governments. While the recently enacted Unified Revenue Authority Law is expected to facilitate the implementation of a much-needed revenue reform, expanding the revenue base also requires parallel improvements in tax administration to be effective.

Nauru

Exports to Australia
(% of 2009 GDP and $ per ton, quarterly)



Note: No exports from Nauru to Australia were recorded from the March 2009 quarter to the June 2010 quarter.
Sources: Australian Bureau of Statistics and World Bank Commodity Price Data (Pink Sheet).

Lead author: Milovan Lucich.

- The FY2012 budget continues the recent trend of nearly balanced budgets. FY2012 budget estimates project total revenues of A$31.6 million (including general budget support) and total expenditures of A$32.5 million. This results in a small projected deficit of A$0.9 million (1.3% of GDP). However, cash reserves of A$1.0 million will be rolled over from FY2011 resulting in an overall surplus of A$0.1 million.
- A key budget item is the earmarking of A$0.2 million for an initial contribution to the new Nauru Intergenerational Trust Fund, which is designed to provide an ongoing source of revenue when phosphate reserves are exhausted. This will be supplemented by the anticipated $4 million ADB grant currently in preparation.
- Phosphate exports have picked up over the past year despite ongoing infrastructure constraints. The outlook for phosphate exports is positive, supported by strong world demand at relatively high prices.
- Following the former President's resignation after allegations of improprieties in phosphate negotiations, a new President was sworn in on 10 November. At the next meeting of Parliament on 15 November, there was a successful motion of no confidence against the new government. A new President was elected by a margin of 9–8. The ongoing political stability has cast doubt on the economic reform and development plans in the country.

Palau

Budget performance FY2011

- Following a spending cut of almost 7% in the previous year, fiscal consolidation progressed further in FY2011 as total public expenditure was reduced by an additional 4% from FY2010 levels. Expenditures were reduced primarily on publicly provided goods and services. Such cuts may be unsustainable over the longer term given pressing infrastructure maintenance and government service delivery needs.
- Following recent trends, domestic revenue remained stagnant in FY2011. The government is planning to increase revenue by increasing tax rates on high-income earners and increases in hotel room taxes.

Budget FY2012

- The national government budget for FY2012 was delayed. In the version passed by the Senate in early November, the proposed budget amounts to $58 million. Revenue from domestic sources is projected at $40 million, with the balance covered by US compact grants. The national budget excludes expenditure financed through capital grants and non-compact US financial assistance.

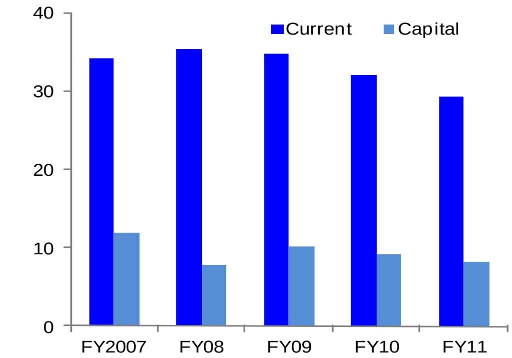
Recent developments

- Tourism is the largest sector in Palau's economy. In FY2011, visitor arrivals increased by 25%. This builds on the recovery achieved in FY2010, from the large cumulative decline in FY2008 and FY2009. The number of tourists increased sharply from Palau's two largest source markets, Japan (36%) and Taipei,China (46%).
- Consumption spending is also picking up, which is indicative of improvements in overall economic activity. The value of imports from the US, Palau's primary trading partner, from June to September 2011 has increased relative to the same period last year.

Key issues

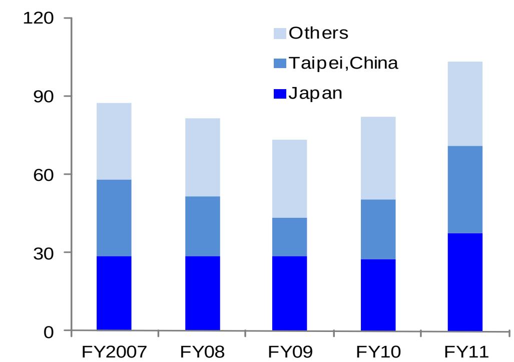
- Longer-term fiscal sustainability requires broader tax reform, particularly introduction of a value-added tax, to broaden the tax base and boost Palau's ratio of tax revenues to GDP (which is low compared with other small Pacific island economies).
- Over the medium term, fiscal sustainability also depends on the success of efforts to reduce Palau's large public sector wage bill. Public sector wages currently account for about 33% of total government expenditure. A comprehensive civil service reform program, which eliminates redundant positions while providing adequate resources for key government functions is planned to ensure that the public wage bill is brought down to a more efficient level.
- Palau's Water Sector Improvement Program, in which ADB is a partner, aims to enhance the sustainability and cost-effectiveness of water and sanitation services. The program works toward full cost recovery in the provision of water and sanitation services in the long run and hopes to enable elimination of water and sanitation subsidies, which put a strain on scarce public finances.

Government expenditure (% of GDP, annual)



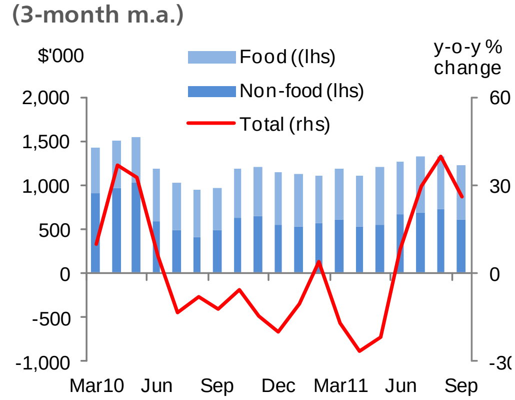
Source: IMF. 2011 Staff Visit to Republic of Palau–Concluding Statement of the IMF Mission. March.

Visitor arrivals ('000, annual by source)



e=estimate
Source: Palau Visitors Authority.

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

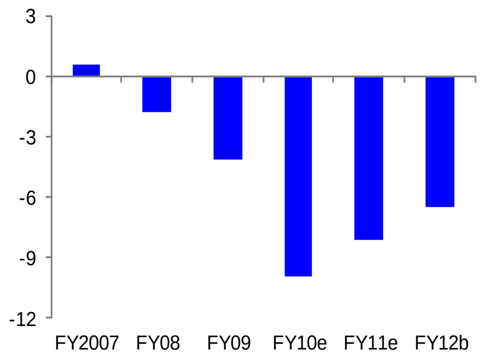


lhs=left hand scale, rhs=right hand scale
Source: US Census Bureau.

Lead author: Rommel Rabanal.

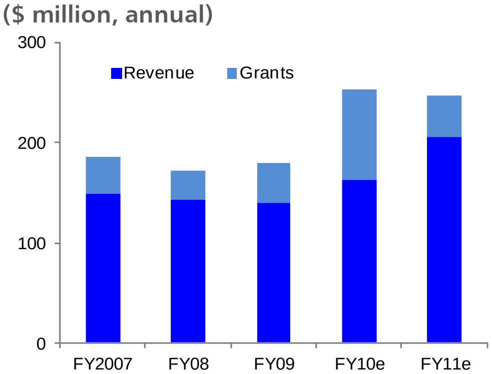
Samoa

Budget position
(% of GDP, annual)



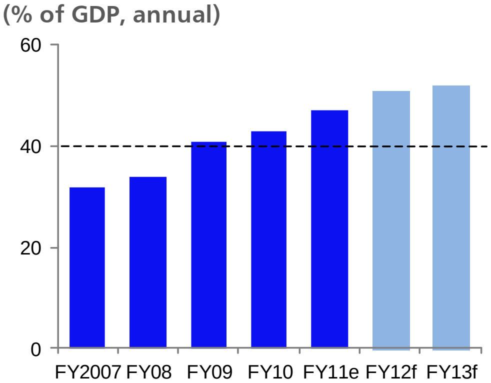
e=estimate, b=budget
Source: Samoa Ministry of Finance *Quarterly Economic Review* (August 2011).

Sources of fiscal inflows
($ million, annual)



Source: Samoa Ministry of Finance. *Quarterly Economic Review* (August 2011).

Outstanding total debt
(% of GDP, annual)



Source: Samoa Ministry of Finance *Fiscal Strategy Statement – Budget 2011/12*.

Budget performance FY2011

- In FY2011, government revenues and expenditures were generally in line with budget targets. The only major exception was development expenditure which was under spent by 18.9%.
- The fiscal deficit for FY2011 was 8.1% of GDP (or $49.6 million), which was lower than the budget estimate of 9.6% of GDP. Budget deficits for the last two fiscal years have been above the government's long term target of 3.0% due to post-tsunami rehabilitation needs, and in order to provide stimulus following the global financial and economic crisis.

Budget FY2012

- The FY2012 budget projects a further narrowing of the fiscal deficit to 6.5% of GDP through reductions in both recurrent (from 27.2% to 25.6% of GDP) and development costs (from 14.7% to 11.7% of GDP), and higher revenues. The government has raised excise taxes on tobacco and alcohol and increased government fees and charges (e.g., motor vehicle registration).
- Revenues and expenditures in the first quarter were below expectations. Recurrent revenue, however, is expected to pick up in the second quarter (coinciding with the festive season) and spending is expected to track more closely to budget in the second half of FY2012.
- In 2011, the IMF recommended that the Government of Samoa reduce its fiscal deficit to 5%-6% of GDP in FY2012 and move toward a medium-term target of no more than 3% of GDP by FY2013. The IMF also advised that with post-tsunami reconstruction nearing completion, fiscal consolidation could start sooner than previously planned. The reduction in Samoa's fiscal deficit in FY2011 shows that this consolidation has commenced.

Recent developments

- The economy grew 2.1% in FY2011 compared with 0.2% in FY2010. This reflected strong growth in construction, due to implementation of ongoing and new infrastructure projects and increased consumer spending based on higher remittances. Tourism related industries (e.g., hotel and restaurants and transport and communications) posted modest growth despite sluggish growth in tourist arrivals. Manufacturing output contracted in the second half of FY2011 as the demand for car parts produced at the Yazaki plant was adversely affected by the natural disasters in Japan.

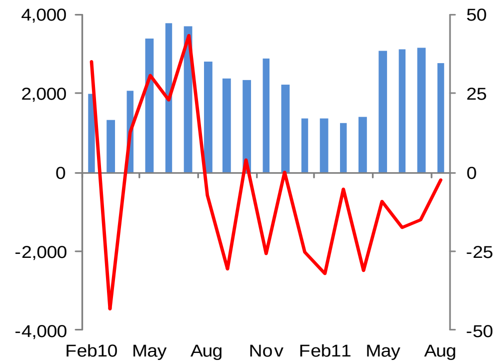
Samoa

- It is expected that GDP will grow by 2.5% in FY2012. Although there will be some slowdown in post-tsunami reconstruction, tourism, remittances, and manufacturing are expected to increase. However, these estimates will be sensitive to global uncertainties.
- The Central Bank of Samoa has maintained an expansionary monetary policy to support economic activity. It has reduced the policy rate and lowered on lending rates to the Development Bank of Samoa and the Samoa Housing Corporation, which are required to lend at concessional rates to agriculture, tourism, fishing, and manufacturing.

Key issues

- Prospects for medium-term growth are generally positive but the 2008 Household Income and Expenditure Survey shows that poverty and income disparities have been increasing.
- Continued efforts to advance fiscal consolidation and wind back debt are essential to create the fiscal space necessary for the government to be able to respond to any external shocks–be this in the form of continued global weakness or weather-related events.

Growth of merchandise exports (monthly)



Source: Samoa Bureau of Statistics.

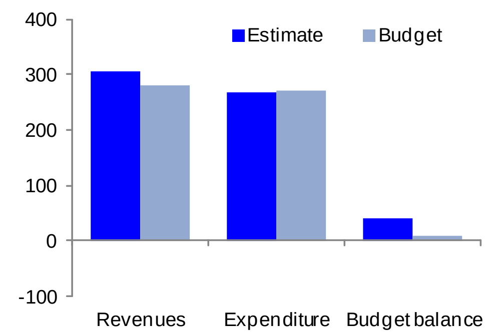
Lead author: Laisiasa Tora

Solomon Islands

Budget performance FY2011

- Strong production of timber and favorable prices in 2011 resulted in 28.5% increase in customs duties compared with 2010. Inland revenues (i.e., goods and sales taxes, personal and corporate income taxes) rose by 22.2% during the comparable period brought about by strong economic activity and high fuel prices. Total revenue in 2011 is almost a quarter higher compared with the previous year.
- Government-funded capital expenditure in 2011 was 10.2% below budget estimates for the year. Under existing budget procedures, implementing agencies are informed of activities to be funded on short notice. This, coupled with delays in budget enactment, results in high levels of development budget underspend. Conversely, spending on payroll and other recurrent expenditures in 2011 was slightly above budget estimates as is generally the case.
- A budget surplus equivalent to 2.1% of GDP was recorded in 2011. Public debt declined from 24.0% of GDP to 21.6% in late 2011 due to debt repayments and the write-down of all external debt arrears.
- The 2011 budget will meet the targets agreed upon with the IMF under the Standby Credit Facility. During the IMF Review Mission in October, Solomon Islands authorities requested a precautionary standby credit facility once the current arrangement expires in December 2011. The IMF Board agreed to this follow up program in November.

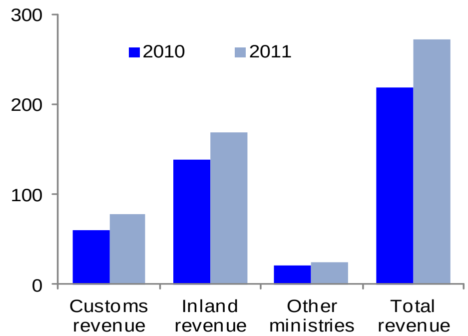
Budget outcomes ($ million, 2011)



Source: Ministry of Finance and Treasury.

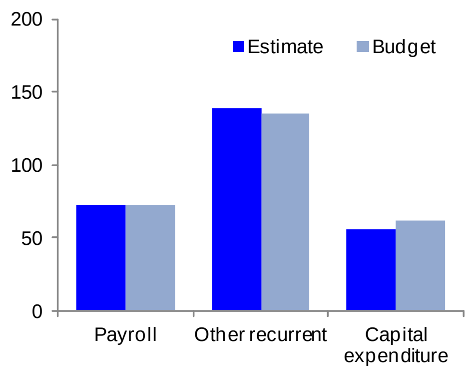
Solomon Islands

Revenue outcomes
($ million, 2011)



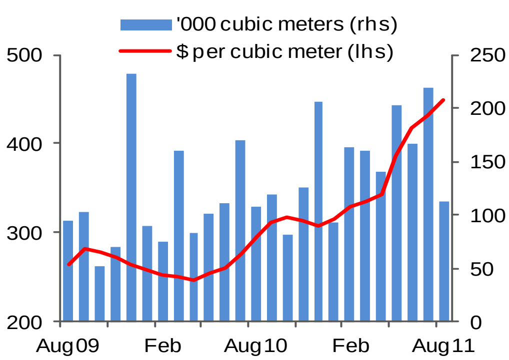
Source: Ministry of Finance and Treasury.

Expenditure outcomes
($ million, 2011)



Source: Ministry of Finance and Treasury.

Price and volume of log exports
(monthly)



lhs=left hand scale, rhs=right hand scale
Sources: Central Bank of Solomon Islands and IMF International Financial Statistics.

Lead author: Milovan Lucich.

Budget FY2012

- Despite the recent change in Prime Minister and Finance Minister, the government is moving forward with its plans to pass the 2012 Budget by the end of this year. The draft budget forecasts a small surplus of about $270,000. Revenue is projected to increase by 22.4% in 2012, which, along with draw downs from the National Transport Fund and pre-disbursed RAMSI grants, is expected to cover a 47% rise in total expenditure. To help preserve the fiscal position if revenue performance weakens, the increase in spending will be concentrated on one-off items, e.g., hosting of the Pacific Arts Festival, or items which can be scaled back including a planned doubling of debt repayments in late 2012.

Recent developments

- In the first nine months of 2011, log production has surpassed total output in 2010 and whole year production is likely to exceed 2008's historical peak of over 1.5 million cubic meters. However, estimates of available timber resources suggest that these levels of production are not sustainable. Log prices in the international market were 48% higher in September than at the end of 2010.

- The Gold Ridge mine recommenced operations in April 2011. Between April and September, the mine exported 26,668 ounces of gold and 12,204 ounces of silver. Favorable mineral prices are expected to encourage mining activity and broaden the country's export base.

- Following the resignation of the previous Prime Minister amid allegations of misuse of aid funds, a new Prime Minister was elected by a vote of 29–21. The Opposition subsequently filed a vote of no confidence motion, but withdrew it before it went to the full Parliament. The new government, which retains most of the members of the previous government, has reaffirmed its commitment to the National Development Strategy 2011-2020 and the reform process coordinated through the Core Economic Working Group.

Key issues

- The National Development Strategy, formulated through an extensive consultation process and approved by Cabinet in June 2011, is an important component of a comprehensive poverty reduction and growth strategy. Its effectiveness will depend on establishing linkages to the budget, and sector and provincial plans.

- The government plans to develop a 4-year rolling medium-term expenditure framework, which is designed to link planning with the annual budget. As a consequence, budgetary expenditures are linked more systematically with target outcomes (e.g., increased economic growth, increased employment, gender balance, slower population growth, higher literacy rates, and lower infant mortality rates). The framework's principal focus is on getting the government to allocate budgetary resources to programs, activities, and projects that promote the country's strategic priorities.

Tonga

Budget performance FY2011

- Revenue performance was relatively strong in FY2011, as actual collections were around 14.6% higher than the budget target and 5.8% more than the FY2010 outcome. However, FY2011 revenue performance is still below FY2009 levels, which could be attributed to subdued domestic economic activity.
- In FY2011, capital expenditure almost tripled to more than $29.2 million compared with FY2010. This was mainly attributable to the inclusion in the budget of the loan from the Export-Import (EXIM) Bank of China for the first time.
- The FY2011 fiscal deficit (including budget support grants) is estimated at 7.5% of GDP, financed mainly by loans from the EXIM Bank of China and draw downs on domestic cash balances. Without the budget support grants, the deficit would have been 10.5% of GDP.

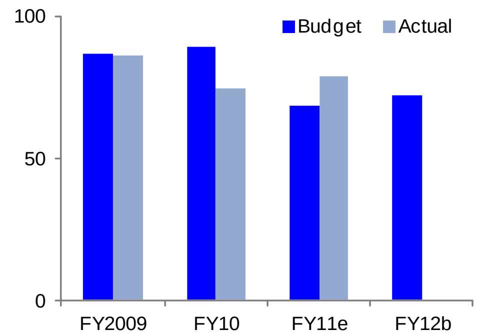
Budget FY2012

- A fiscal deficit of 3.1% of GDP is being targeted based on increased budget support grants and continued expenditure restraint particularly on salaries and wages, which remain flat in nominal terms compared to FY2011.
- At the end of August 2011, total revenue and grants were above budget following receipt of budget support grants of $7.5 million from the European Union, and high revenue collections. The latter is expected to perform above budget by 1.5% (or $84.5 million) at the end of FY2012 led by higher collections of consumption and excise taxes, and customs duty.
- Total expenditure in the first two months of FY2012 was 2.5% higher compared with the same period of last year. Actual expenditure for the whole fiscal year is expected to be close to the target set in the budget.
- A total of $14 million in budget support grants is expected in the current fiscal year, which, together with an anticipated domestic bond rollover of $1.7 million, will result in a cash surplus of $1.9 million.

Recent developments

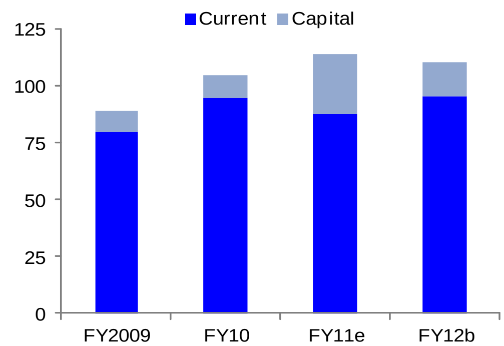
- The economy is expected to grow by 1.2% in FY2012 mainly due to tourism and donor-financed construction.
- Private sector credit continues to decline, with lending to businesses falling by 11.1% (y-o-y) in September 2011. Private remittances also decreased by 7.0% in FY2011 (y-o-y). The level of private remittances in FY2011 was also about $31.4 million less than in FY2008. This represents a large fall in incomes for households since the onset of the global economic downturn.

Revenue performance ($ million, annual)



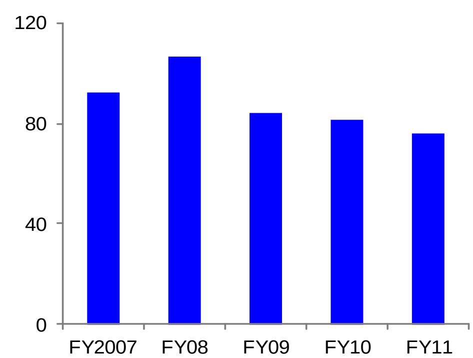
e=estimate, b=budget
Sources: Tonga Ministry of Finance and National Planning and Asian Development Outlook database.

Government expenditure ($ million, annual)



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

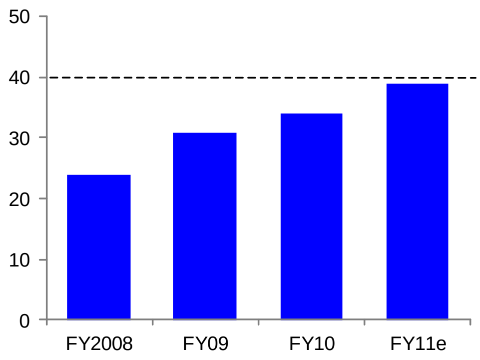
Private remittances ($ million, annual)



Sources: National Reserve Bank of Tonga, Tonga Ministry of Finance and National Planning, and Asian Development Outlook database.

Tonga

External debt
(% of GDP, annual)



e=estimate
Source: Tonga Ministry of Finance and National Planning.

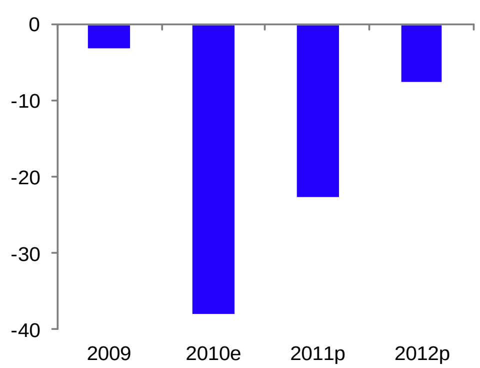
Lead author: Laisiasa Tora.

Key issues

- Improved prospects for the Tongan economy depend upon the government implementing necessary fiscal adjustment, continuing with structural reforms, and developing infrastructure. These measures are important given the deterioration in global economic activity and its likely impact on remittances, tourism, and export demand.
- Tonga is at a high risk of debt distress. Total public debt is projected to reach 56.1% of GDP in FY2012, well above the government's threshold of 40%. External debt makes up 50.1% of GDP, and domestic debt the balance.
- It is critical that year-end cash surpluses be used to build up Tonga's cash reserves rather than to fund additional spending. Tonga's debt payments are expected to increase by 70% in FY2014 at the start of repayments on a large loan from the EXIM Bank of China, which will have significant implications for Tonga's balance of payments.

Tuvalu

Budget position
(% of GDP, annual)



e=estimate, p=projection
Source: International Monetary Fund Article IV Consultation Closing Statement.

Lead author: Malie Lototele.

- Total revenues and grants for 2011 are estimated at A$25.9 million, which is 6% below budget, mainly due to the appreciation of the Australian dollar. Government expenditure is estimated at A$33.6 million, leading to a deficit of A$7.7 million (36% above budget).
- In the 2012 budget, total revenue is projected at A$24.1 million, a reduction of 7% from 2011. Government expenditure is projected at A$29.2 million, or 13% below the 2011 level. These would result in a A$5.1 million budget deficit, equivalent to 14% of GDP.
- Given the performance of global markets, there is likely to be limited scope for drawing on the Consolidated Investment Fund to finance budget deficits. The Fund's balance of A$3.1 million is expected to be depleted in 2012.
- Parliament approved the "decorporatization" of the Tuvalu Electricity Corporation. The corporation will now become a department within the Ministry of Public Utilities, with government assuming its liabilities.

Vanuatu

Budget performance 2011

- Tax revenues increased by 9.3% in the first half of the year mainly due to higher value added tax collection, but this was not sufficient to offset the 44.1% fall in external grants during the same period. Overall, total government revenues declined by 10.0% from January to June 2011 compared with the previous year.
- Current expenditure grew by 8.9% in the first half of 2011, but this was more than offset by a 60.3% drop in capital spending due to delayed implementation of major infrastructure projects. Overall, the fiscal position went from a surplus (0.1% of GDP in the first half of 2010) to a deficit (–0.1% of GDP) in the same period of 2011.
- The government approved a supplementary budget equivalent to 6.1% of the original budget in September. This was not enough to offset the decline in donor-funded spending in the first 8 months of the year.

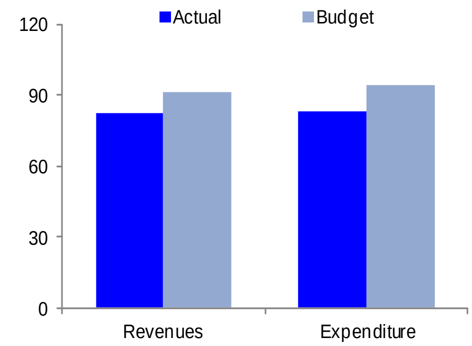
Recent developments

- Several indicators suggest a slight increase in growth in the first half of 2011. Value-added tax collections have improved over their 2010 levels, and non-resident visitor arrivals rose by 19% in the first 7 months of 2011 (cruise ship visitors increased by 35% and air visitors declined by 5%). Construction has also grown modestly in 2011, but approval and implementation of a number of government projects have been deferred to 2012 and 2013.
- Vanuatu's political situation has been marked by frequent changes of government. Between September 2008 and July 2010, the Vanu'aku Party coalition survived numerous no confidence motions. In early December 2010, the coalition lost a vote of no confidence, and a new Prime Minister from the People's Progress Party was appointed. After a number of successive motions of no confidence, the Union of Moderate Parties had its leader elected new Prime Minister. Appointments of three short-lived prime ministers followed as successive constitutional court cases proceded through the judicial system. Amid this political instability, the 2012 Budget is due to be introduced to Parliament in early December with passage expected by the end of 2011.

Key issues

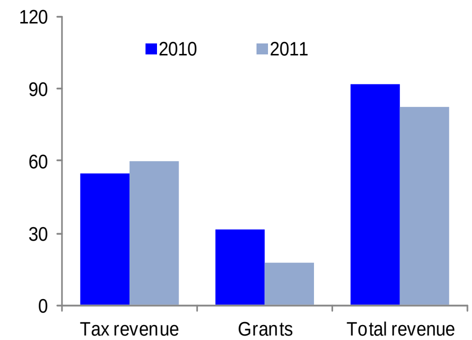
- Construction is key to Vanuatu's growth prospects in the short and medium term. To make the best use of concessional funding from development partners, it is important that Vanuatu prioritize infrastructure spending and improve its capacity to manage infrastructure funds.
- A key impediment to private sector development in Vanuatu is the outdated company law. This bill and the Companies Insolvency and Receiverships Bill have been awaiting introduction to Parliament for over 2 years. The new laws will improve compliance and disclosure, reduce the time needed to incorporate companies and reduce costs of maintaining companies. This will improve the business environment and facilitate transactions with government.

Budget outcomes ($ million, January–June)



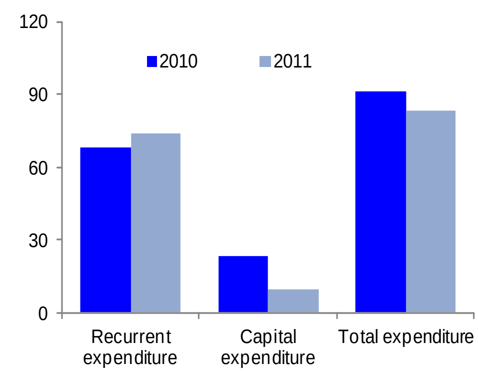
Source: Vanuatu Department of Finance.

Revenue outcomes ($ million, January–June)



Source: Vanuatu Department of Finance.

Expenditure outcomes ($ million, January–June)

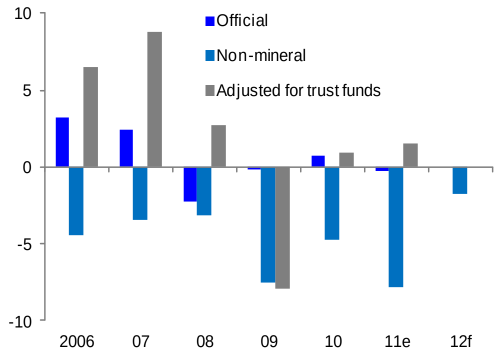


Source: Vanuatu Department of Finance.

Lead author: Milovan Lucich.

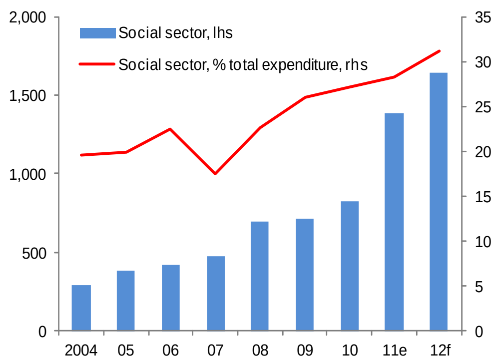
Papua New Guinea

Budget balance
(% of GDP, annual)



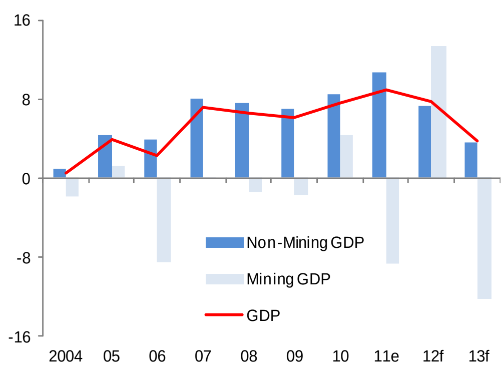
e=estimate, f=forecast
Sources: PNG Department of Treasury and ADB estimates.

Expenditure priorities
($ million, current)



e=estimate, f=forecast, lhs=left hand scale; rhs=right hand scale
Note: Social sector expenditure includes recurrent and development allocations to Law and Order, Infrastructure, and Health and Education.
Sources: PNG Department of Treasury and ADB estimates.

Real GDP growth
(%, annual)



e=estimate, f=forecast
Source: PNG budget documents.

Budget 2011

- The 2011 budget recorded a preliminary deficit of $40.5 million (0.3% of GDP) against an original balanced budget target. Domestic revenue collection was 6.6% above projections as a result of higher than expected economic growth of 8.9% (against an original forecast of 8.0%) and high prices for all major exports including gold, copper, oil, palm oil, coffee, logs, coffee, cocoa, and copra. A mid-year Supplementary Budget allocated an additional $359.6 million in expenditures to infrastructure, health centers, and pre-funding for a new commitment to achieve universal primary and secondary education (free up to year 10, and with a 75% subsidy thereafter).
- The majority of supplementary budget expenditures remained undisbursed in 2011 adding to net trust fund deposits. Adjusted for these trust funds, the 2011 budget outcome records a 1.6% GDP surplus.
- High levels of government expenditure, combined with rising international food prices and a range of resource project investments, spurred higher than expected inflation in 2011. The Consumer Price Index (CPI) has increased by 8.2% this year.

Budget 2012

- Total revenue and grants are expected to grow by 7.3% in 2012, with a 19% increase in domestic taxation receipts from the non-mineral sector offsetting a 13% drop in mining and oil revenues and a 9% decline in donor grants.
- With $4.8 billion in expenditure and net lending, the 2012 budget plans for a balanced fiscal outcome. This budget aims to further increase the share of government expenditure directed towards key development sectors. Expenditures on health, education, infrastructure, and law and order, are slated for substantial increases. The share of total expenditures going to these sectors is projected to rise from 28% in 2011 to 31% in 2012.
- Underpinning budget revenue growth projections is an assumption of continued strong economic growth of 7.8% in 2012. Economic growth is expected to be supported by liquefied natural gas (LNG) project construction which reaches its peak in 2012, along the commencement of operations at the Ramu Nickel and Cobalt mine. High levels of domestic consumption and rising formal sector employment are expected to support the wholesale and retail trade sectors, and the budget forecasts these sectors will grow by 19% in 2012.
- The 2012 budget details the final design of the government's new Sovereign Wealth Fund (SWF). Two key elements are a commitment to invest assets offshore and to maintain sustainable rates of expenditure. The SWF aims to capture all government revenues from mining, oil, and gas concessions. The government's returns from its equity stake in the LNG project are earmarked to provide guaranteed minimum funding for specific investment priorities such as capital investment in state-owned enterprises and national infrastructure. Funding for these priorities will be channeled through investment accounts under the authority of an overarching Development Fund and will be implemented through a newly created Infrastructure Authority.

Papua New Guinea

Recent developments

- Due to rising imports tied to new resource projects, PNG's current account deficit widened to 37.2% of GDP in 2011 and is expected to be 33.6% of GDP in 2012. New resource projects are financed mainly through foreign direct investment flows, so there is little implication for external stability. High levels of foreign exchange reserves held by the Central Bank, which totaled 18 months of non-mineral import cover as of October 2011, will also support external stability.

- Strengthening of the kina, which appreciated by 21% against the US dollar and 18% against the Australian dollar in 2011 should led to downward pressure on inflation during the second half of 2011. The Central Bank has acted to stem monetary growth during 2011. By the end of September, it had issued net Central Bank Bills totaling $0.6 billion, raised the policy interest rate (kina facility rate) by 75 basis points to 7.75%, and lifted the capital adequacy requirement for banks from 4% to 6%. These measures tightened liquidity conditions and contributed to a slowdown in private sector lending during 2011.

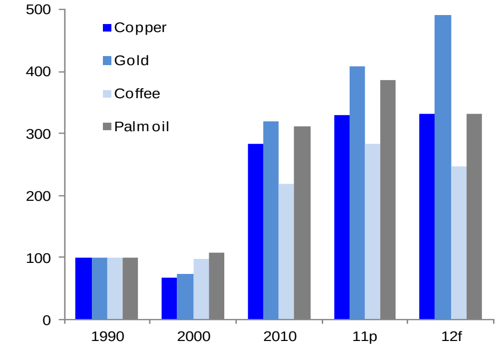
- Countering these downward pressures on price growth are high levels of public and private investment. Many sectors of the economy, including construction, shipping, and port facilities, are operating at close to full capacity. A return to high international food prices has added further to inflationary pressures, and in the first half of 2011 food price increases have accounted for up to 40% of the increase in the CPI. Central Bank efforts to control monetary growth are also being hampered by high Government deposits in commercial bank trust fund accounts, which reached $1.2 billion (18% of total commercial deposits) in 2011.

Key issues

- A leading issue for authorities is meeting public expectations for an improved standard of service delivery financed by future LNG revenues. Achieving the objectives of flagship policies such as Free Primary Education and the National Health Plan will require significant improvements in public sector financial management, which continue to constrain the effective implementation of expenditure plans. This issue has been amplified by the continued allocation of surplus mineral revenues through mid-year supplementary budgets. Since mid-year expenditure plans have not been developed through the full budgetary process, government agencies are not well prepared to implement plans effectively.

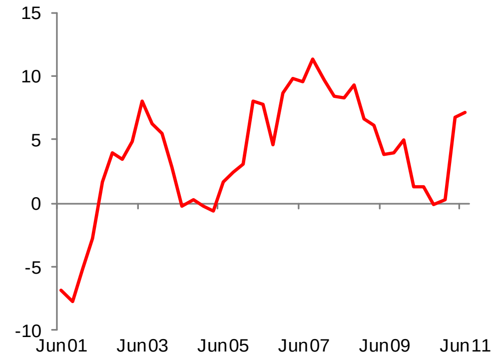
- Expected revenue increases in 2012 are underpinned by strong economic growth and a continuation of high commodity prices for many of PNG's key exports. In particular, gold prices are forecast to be 20% higher than the record levels in 2011. Any adverse economic shocks during 2012 that impact on the economy either through slowing domestic investment or lower global commodity prices will make it difficult for government to meet its growing expenditure commitments without compromising fiscal balance. Any significant deviation from

Commodity prices (Index: 1990=100)



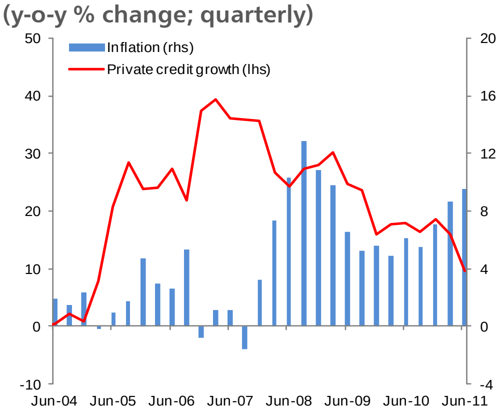
f=forecast, p=provisional
Sources: World Bank Pink Sheet and PNG budget documents.

Private sector employment (% change, quarterly)



Source: Bank of PNG.

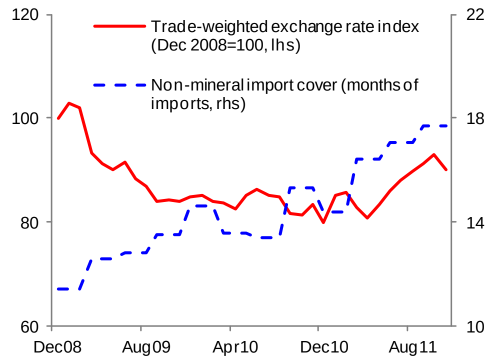
Headline consumer price index and private sector credit growth (y-o-y % change; quarterly)



lhs=left hand scale; rhs=right hand scale
Sources: Bank of PNG Quarterly Economic Bulletin and ADB estimates.

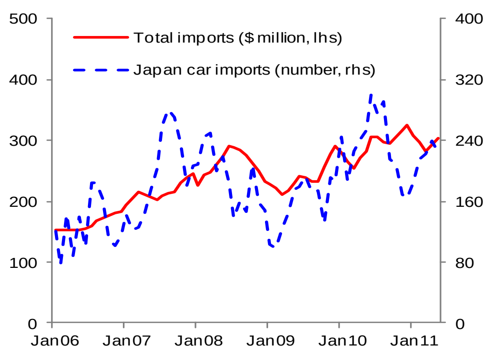
Papua New Guinea

Exchange rate and international reserves (Index and months of imports)



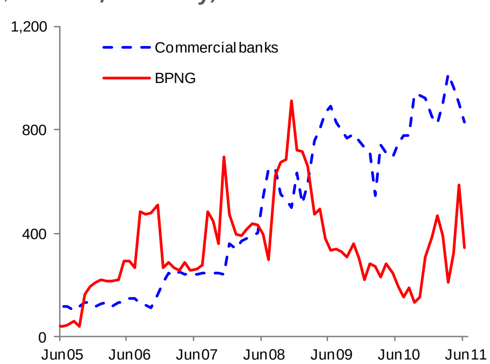
lhs=left hand scale; rhs=right hand scale
Source: Bank of PNG.

Imports ($ million and number of cars, 3-month m.a.)



lhs=left hand scale; rhs=right hand scale
Sources: Japan e-stats website, http://www.e-stat.go.jp; and Bank of PNG *Quarterly Economic Bulletin*.

Central government bank deposits ($ million, monthly)



Sources: Bank of PNG *Quarterly Economic Bulletin* and ADB estimates.

Lead author: Aaron Batten.

fiscal discipline would undermine investor confidence, add to inflationary pressures, and disrupt the macroeconomic stability that has underpinned the last nine years of economic growth.

- The change of government in August 2011 ended an historic nine year period of political continuity and will test fiscal discipline. National elections scheduled for mid-2012 have created concerns that authorities may return to prior patterns of unsustainable expenditure increases during election periods.

- Winding down of the LNG project construction phase during 2013 and 2014 may also increase macroeconomic uncertainty. While real GDP is expected to expand by 21.1% in 2015 as LNG exports begin, only a limited amount of initial LNG production value will flow through the domestic economy, as the project is not expected to deliver large revenue flows until after 2020. A significant drop in domestic demand is likely to take place across a range of sectors that had previously been heavily engaged in LNG construction activities including transport, construction, and aviation. This effect is likely to also spill over into the wholesale and retail sectors.

- Policy options to manage these risks include focusing near term capital expenditures on renovating existing infrastructure, and delaying the introduction of non-priority investment projects until LNG construction activities near completion. In the short run, this will help to prevent further capacity distortions in the local economy. In the medium term, this will help to smooth aggregate demand and promote an orderly transition of the skilled workforce between projects. Authorities may also consider the phased introduction of any new large-scale oil and gas construction projects to stem inflationary pressures.

- The government's proposed Stabilization Fund lays a solid foundation for managing volatile resource revenues into the future. However, the creation of new agencies and funding mechanisms within the overarching Development Fund have the potential to duplicate existing budget processes, thereby reducing fiscal accountability and weakening expenditure quality. Clarifying the role of the Development Fund accounts and establishing strong oversight institutions that are integrated with budgetary and public financial management systems will be key to the success of the SWF.

Timor-Leste

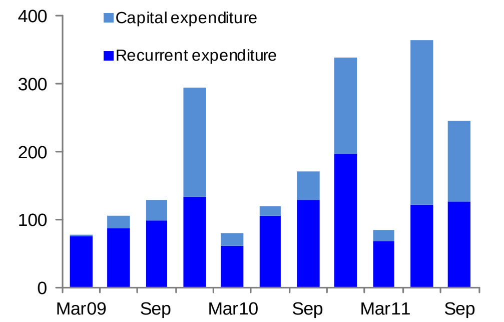
Budget performance in 2011

- The large 2011 budget is continuing to drive the economy. Although the full budget allocation is unlikely to be spent, government expenditure including development partner-funded activities is on-track to exceed $1.4 billion over 2011. This will be an increase of around 40% over the 2010 level, and will see the ratio of government expenditure to GDP excluding the petroleum sector and the UN (the preferred measure of GDP) reach close to 200% in 2011 (government expenditure can exceed GDP because of a high import content). The overall budget execution rate is expected to stay high in 2011 at around 90%, matching the performance of the previous two years.
- The national electrification program has accounted for much of the increase in government expenditure in 2011. Around half of the total project cost of $0.9 billion will be spent over the year. The program will provide two new power stations, a new transmission system and greatly extend the distribution system. The first major milestone was met in late November, when the first power station entered operation.
- In addition to a near doubling in capital expenditure over 2011, expenditure on wages and salaries, goods and services, and transfers, are all expected to rise. Wages and salaries are projected to rise by around 15% in 2011, primarily because a large number of temporary civil service positions have been converted to permanent positions during the year (shifting expenditure out of goods and services).
- The high world oil price will boost petroleum revenue to almost $3 billion in 2011. High petroleum revenue is underpinning a budget surplus, and $2 billion was saved in the Petroleum Fund over the first three quarters of the year. The Fund's balance had reached $8.9 billion by the end of September 2011, around 12 times the annual non-petroleum, non-UN GDP.

Budget 2012

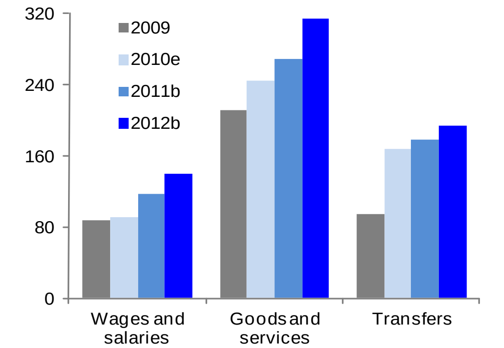
- The budget for 2012 provides for a further large increase in government expenditure. Expenditure is to rise by around 20% to $1.75 billion, $1.55 billion of which is to be funded from the Petroleum Fund and domestic revenue. This would keep the ratio of expenditure to non-petroleum, non-UN GDP close to 200%.
- Big-ticket capital expenditure items are again prominent. Capital expenditure is budgeted to rise to 100% of non-petroleum, non-UN GDP. Expenditure on the national electrification program is tapering off, but will remain high at $280 million. A large allocation is to be made for the infrastructure required to trigger industrial development on the south coast—the Tasi Mane program—and $170 million is allocated to road projects. A proposal to inject $200 million in the recently established Timor-Leste Investment Corporation was withdrawn from the final budget. Modeled on Singapore's Temasek, the corporation is envisioned to pursue strategic investments in infrastructure and commercial developments.
- It is proposed that road investments will be partly funded by the country's first public loans. A total of $120 million in loans from

Government expenditure
($ million, quarterly)



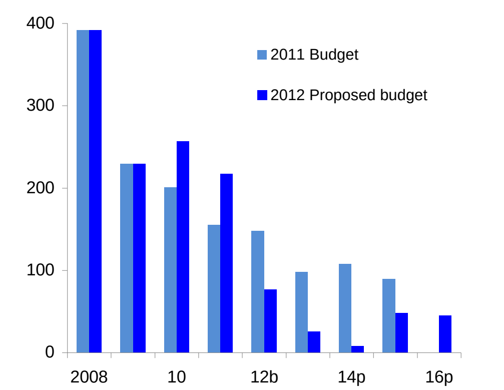
Note: Excludes expenditure funded by development partners.

Main recurrent expenditure items
(million $, annual)



b=budget, p=projection
Note: Excludes expenditure funded by development partners.

Budget balance
(% of non-petroleum, non-UN, GDP, annual)

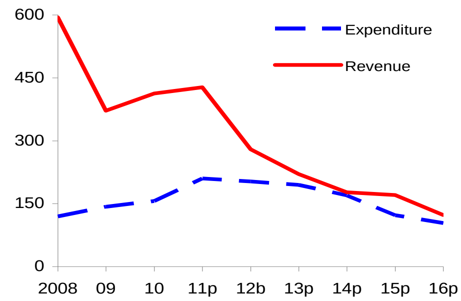


b=budget, p=projection
Sources: ADB estimates based on Timor-Leste National Statistics Directorate, Government of Timor-Leste Transparency Portal (available at http://www.transparency.gov.tl/public/, Government of Timor-Leste. Budget books 1 and 6. Dili (November), various years.

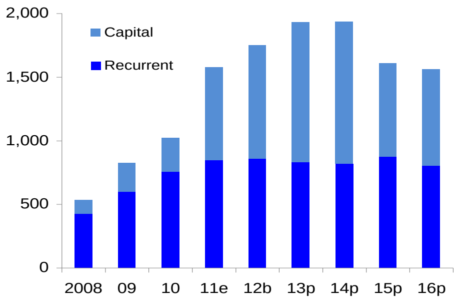
Timor-Leste

2012 Budget

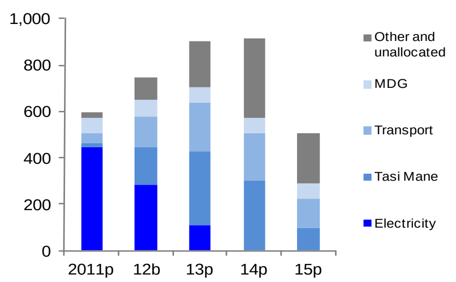
Expenditure and revenue (% of non-petroleum, non-UN, GDP, annual)



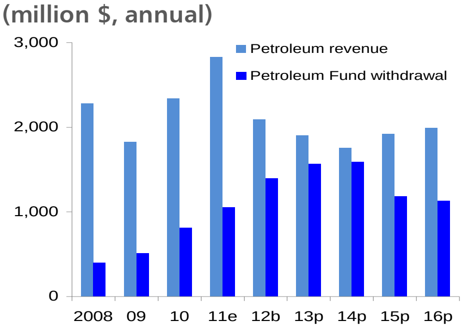
Recurrent and capital expenditure (million $, annual)



Infrastructure Fund expenditure (million $, annual)



Petroleum accounts (million $, annual)



b=budget, e=estimate, GDP=gross domestic product, MDG=Millennium Development Goals, p=projection, UN=United Nations.

Sources: ADB estimates based on Government of Timor-Leste. 2012 Proposed Budget. Budget books 1 and 6. Dili (November) and Government of Timor-Leste. 2012 Budget. Budget books 1 and 6. Dili.

ADB, the World Bank, and potentially other development partners, are proposed to support a multi-year project to upgrade major roads on the north coast and a north–south link.

- The most striking feature of the budget proposed for 2012 is the trend in the fiscal stance. The cushion that Timor-Leste has enjoyed between revenue and expenditure has almost gone. Official projections are for the budget to move from the present surplus to near balance by 2014. This is due to both a large increase in expenditure and a downgrade of projected petroleum revenue. Output projections for Timor-Leste's main producing field, Bayu-Undan, have been downgraded, and cost projections have been revised upwards. Projected profits are thus down, which will reduce the tax paid to Timor-Leste.

- The deterioration in the fiscal stance will slow the build-up in the Petroleum Fund. The 2012 budget projections are for the value of the Petroleum Fund to reach only $11.5 billion in 2016.

- The tightening in the fiscal position is probably overstated in the official projections, because of a conservative approach to projecting petroleum revenue. The government uses price projections from the International Energy Agency, adopting the mid-point of their low and reference case. The International Energy Agency's reference case estimate is for a higher world oil price in 2012 than in 2011, and a pronounced upward trend thereafter. The projection used by the government is for a fall in the world oil price in 2012, almost no change over 2013, and only a very slight upward trend thereafter. The official long-term projections also exclude the prospect of revenue from new petroleum developments. As pointed out by the IMF and World Bank in their 2010 Debt Sustainability Analysis, this practice puts some strain on the credibility of revenue projections.

- Even though actual revenue is likely to exceed the budget projections, the latest fiscal projections have serious implications. They call for extra attention to the quality of revenue and expenditure management.

Revenue management

- Domestic taxes contribute around 5% of total revenue, and are equivalent to around 10% of non-petroleum and non-UN GDP. This is a low contribution from domestic taxation, with an internationally typical tax to GDP ratio of 20% to 30%. High levels of petroleum revenue have so far dulled the imperative to increase domestic taxes. The situation is changing, and it is now becoming important to collect more taxes domestically.

- To maintain the investor-friendly tax environment put in place in 2008, additional tax revenue would need to be collected from consumers. This can be done by adopting a value-added tax, which almost all countries now have. The 2011 budget raised the prospect of exploring this tax. Timor-Leste's application to join the Association of Southeast Asian Nations (ASEAN) adds to the imperative to do so. Membership would require Timor-Leste to join the ASEAN Economic Community planned for 2015. Customs duties are to be eliminated within the community. As most of Timor-Leste's imports are from ASEAN members, almost all customs revenue would be forgone.

Timor-Leste

- A value–added tax is a good option for replacing what is currently the main source of domestic tax revenue, and to subsequently raise more domestic revenue as required.

- Raising more revenue from user charges would also be important to strengthening the fiscal position. User charges for services such as electricity and water are important to providing service providers the funds needed for operations and maintenance. User charges are also important for moderating demand and preventing over use of services. While the budget will probably need to shoulder most of the recurrent cost of the new infrastructure services, it is desirable that users pay a reasonable share.

- The priority is to raise more revenue from electricity users. Once the electrification program is complete, the fuel bill alone could easily rise from the 2011 cost of $60 million to more than $100 million p.a.. Operating and maintaining the new power plants will also be a sizeable cost. A good next step is to understand the capacity of users to pay, and to explore the changes needed by service providers to collect and use revenue efficiently.

Expenditure management

- Timor-Leste’s development rests on the quality of the large public investment program now underway. There will be three key drivers of success in investment:
  (i) Good project selection and design. Public investment projects should aim for an economic rate of return that is higher than the cost of the funds used, e.g., investment that draws on the Petroleum Fund should earn an economic rate of return above the return from the Fund. Otherwise it will be better to leave the money in the Petroleum Fund;
  (ii) Competitive tendering, to ensure the best supplier undertakes the work at the minimum cost; and
  (iii) Supervision of works, to ensure quality.

- Many of the actions required to harness these drivers of success are already in place in the Ministry of Finance, the National Development Agency, and line ministries. Follow through will be essential.

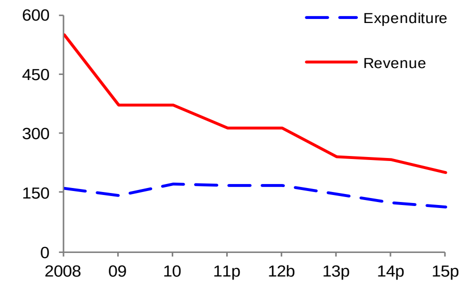
Outlook

- The outlook remains for an internationally high rate of economic growth over 2011 and 2012, driven by high government expenditure. Private sector activity is expected to continue to strengthen.

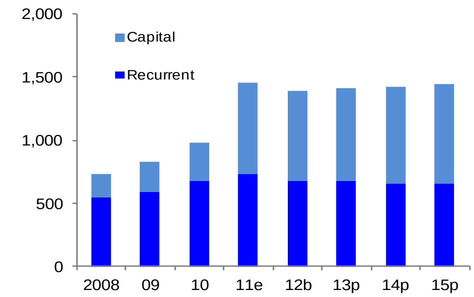
- Inflation is projected to remain over the remainder of the year, and average around 10% for the year-as-a-whole. An easing in inflation is likely in 2012. While the high inflation rate is helping some people in rural areas, because they are receiving better prices for their agricultural products, the high inflation is a serious concern. This is because of the social problems caused by a higher cost of living and the economic damage of inflation.

2011 Budget

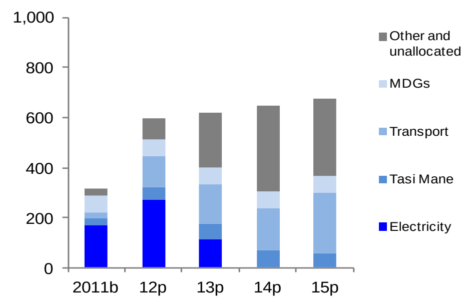
Expenditure and revenue (% of non-petroleum, non-UN GDP, annual)



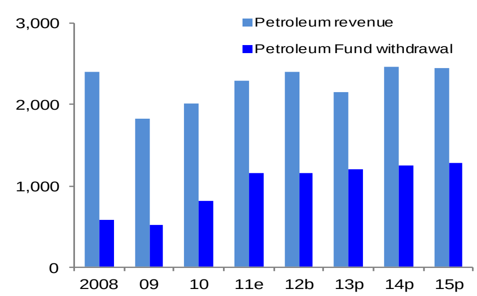
Recurrent and capital expenditure (million $, annual)



Infrastructure Fund expenditure (million $, annual)



Petroleum accounts (million $, annual)



b=budget, e=estimate, GDP=gross domestic product, MDG=Millennium Development Goals, p=projection, UN=United Nations.

Sources: ADB estimates based on Government of Timor-Leste. 2012 Proposed Budget. Budget books 1 and 6. Dili (November) and Government of Timor-Leste. 2012 Budget. Budget books 1 and 6. Dili.

Lead author: Craig Sugden.

Sovereign investment funds in the Pacific: impact of recent global economic developments

Recognizing the need to stabilize long-term economic prospects in response to limited opportunities and high vulnerability to shocks, Pacific developing member countries have created investment funds through natural resource revenues, public savings or donor assistance. These funds serve various purposes, including ensuring transfer of income over time, providing for old age income of retirees, minimizing adverse economic effects of "booms," and promoting long-term budgetary self-reliance. This article seeks to examine the effects of the 2008-2009 global financial and economic crisis (GFEC) and the impact of recent financial market volatility on asset values and allocation of selected Pacific investment funds.

The Global financial and economic crisis

The subprime mortgage crisis that started in 2007 negatively affected the United States economy. From a peak of 1,377 in October 2007, the S&P 500 index plunged by almost 50% to 735 in February 2009. Offshore investments in US mortgage-backed securities quickly spread the contagion to the world's major stock markets, including in Australia where some Pacific countries invested their funds.

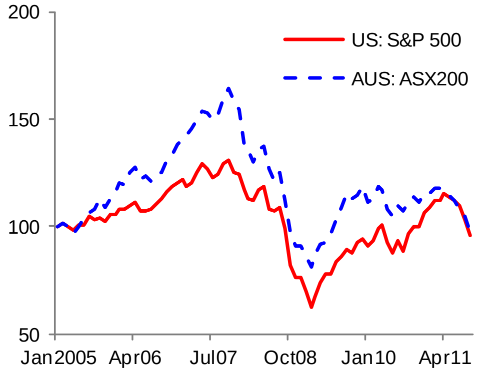
Selected Sovereign Investment Funds in the Pacific

Name	Country	Date created	Estimated value ($ million) FY2007	Estimated value ($ million) FY2010	Objective
Trust Fund for the People of the Federated States of Micronesia (FSM Compact Fund)	FSM	2004	122.8	177.2	Contribute to economic development and long-term budgetary self-reliance of FSM by providing annual source of revenue through FY2023.
Trust Fund for the People of the Republic of the Marshall Islands (RMI Compact Fund)	RMI	2004	83.8	112.8	Contribute to economic development and long-term budgetary self-reliance of RMI by providing annual source of revenue through FY2024.
Tuvalu Trust Fund (TTF)	TUV	1987	90.6		Assist the government in achieving greater financial authority in management of its recurrent budget; enable it to maintain and improve existing levels of social infrastructure and services; enhance its capacity to receive and effectively utilize external capital development and technical assistance; enable it to meet long-term maintenance and operating costs of socioeconomic infrastructure and services; and assist the government in its economic development efforts.
Petroleum Fund of Timor-Leste (Petroleum Fund)	TIM	2005	2,086.2	8,903.1	Contribute to wise management of petroleum resources for the benefit of current and future generations; to be a tool that contributes to sound fiscal policy where appropriate consideration and weight are given to the long-term interests of Timor-Leste's citizens.
Fiji National Provident Fund (FNPF)	FIJ	1966	2,197.1	2,165.9	Deliver services and ensure sustainable returns to citizens.
Nambawan Super (Nambawan)	PNG	1961	765.0	1,139.9	Protect and maximize the superannuation benefits of members through prudent investment management.
Marshall Islands Social Security Trust Fund (MISSA)	RMI	1990	69.0	64.9	Establish a financially sound social security system with pension benefits and early retirement, whereby workers would be ensured a measure of security in their old age and during disability, and whereby surviving spouses and surviving children of deceased workers would be ensured support after the loss of the family's income.
Civil Service Pension Plan (CSPP)	PAL	1987	48.4	40.7	Attain 8.7% annual rate of return or a rate of return at least 4% over the inflation rate, whichever is greater; control costs of administering the fund and managing the investments.

FSM=Federated States of Micronesia
Note: FY2010 is 2011 figures for FNPF and Petroleum Fund. FY2010 is 2009 figure for MISSA. Estimated values are as of year-end.
Sources: Annual Reports and authors' estimates.

Sovereign investment funds in the Pacific

Stock market indices
(Index: Jan 2005=100, monthly)



AUS = Australia
Source: Standard & Poor's.

Impact of the GFEC on fund values

The performance of the Pacific investment funds was partly due to the allocation of different kinds of domestic and offshore assets: equities (listed in global stock exchanges and/or local bourses, and unlisted equities); bonds (government or investment grade corporate bonds); cash and term deposits; loans; and property (through direct holdings or real estate investment trusts).

On average, net assets held by most of the Pacific investment funds reviewed fell by 10% in FY2008. Without new contributions or infusions, the average negative impact on net assets would have been only slightly higher at 10.4%.

Some Pacific investment funds (the Petroleum Fund, Nambawan, and the FNPF) weathered the negative effects of the GFEC. These funds' strong performance was the result of the nature and location of the funds' assets, which partly insulated them from the developments in the global financial market.

Return on Investments
(%)

	FY2006	FY07	FY08	FY09	FY10
FSM Compact Fund	7.7	17.9	(20.1)	(0.2)	11.3
RMI Compact Fund	12.0	14.9	(21.8)	1.3	8.8
TTF	10.4	9.7	(8.6)	(1.7)	1.8
Petroleum Fund	4.3	7.5	7.1	0.7	3.6
FNPF	6.2	5.5	4.9	4.8	5.5
Nambawan	10.9	27.0	7.4	8.7	10.4
MISSA	9.1	11.6	(9.9)	5.1	
CSPP	5.7	14.3	(13.5)	7.1	5.7

CSPP= Civil Service Pension Plan, FNPF=Fiji National Provident Fund, FSM=Federated States of Micronesia, MISSA=Marshall Islands Social Security Administration, TTF=Tuvalu Trust Fund
Sources: Annual Reports.

The Petroleum Fund invested heavily in US Treasuries that are less risky than equities and thus was able to withstand the negative impact of the GFEC. Although concentrated on equities, Nambawan investments were on domestic assets whose value benefited from the 6.6% growth of the PNG economy in 2008. Conversely, the FNPF's investments are concentrated in Fiji government bonds, which account for 76% of the fund's total investments.

In contrast, double digit dips in net asset value were recorded by the CSPP (–15.7%) and the TTF (–12.7%). It was noted that a chunk of the CSPP investments was concentrated in US equities, whose values were adversely affected by the GFEC. The TTF, whose investments were concentrated on Australian equities, was also hit hard as a result of the contagious nature of the crisis. Other investment funds that had a decline in their net asset values during the GFEC include MISSA and the FSM Compact Fund.

The Pacific investment funds under review, again with the exception of the FNPF, Nambawan, and Petroleum Fund, also realized negative returns on investment in FY2008 that ranged from –8.6% (TTF) to –21.8% (RMI Compact Fund).

(It is noted that the poorest performances were reported by funds with an October-September fiscal year; the end of this reporting period coincided with onset of the GFEC in late 2008, which meant that there was no time for the managers of these funds to recoup their losses.)

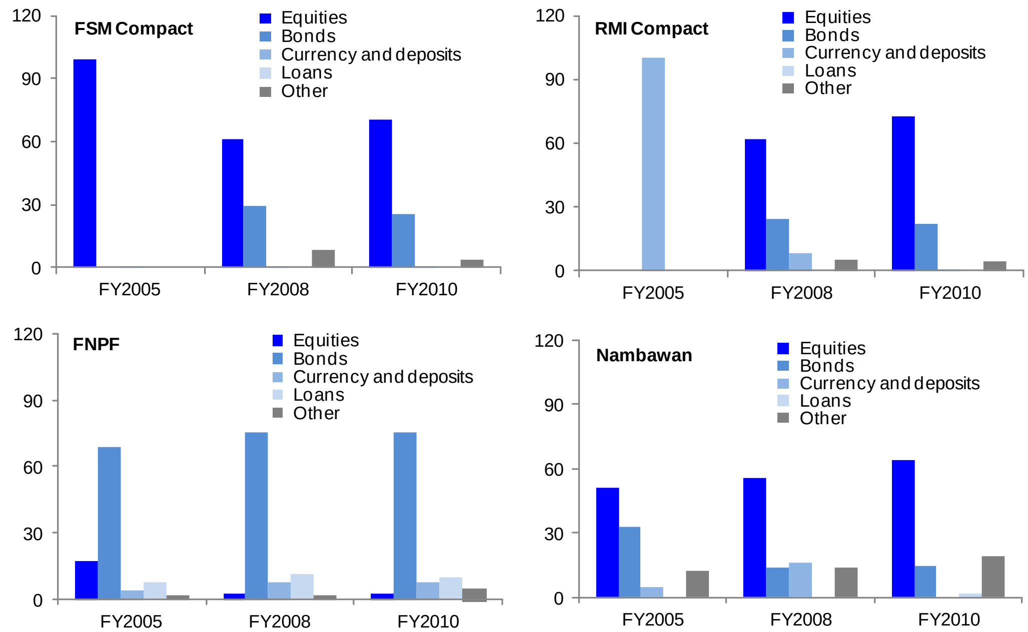
In FY2009, all of the funds reviewed except for the FSM Compact Fund and the TTF had recovered to realize positive net investment incomes; however, as of FY2010, only the FNPF and the Petroleum Fund recorded net investment incomes above pre-crisis levels.

In general, equities accounted for 50–70% of the reviewed investment funds' pre-crisis assets, followed by bonds (15–30%), and other assets such as cash and real estate. Global financial developments would therefore have implications on the viability of these investment funds, and their ability to support development in the Pacific region. The onset of the GFEC saw a shift in investments from equities towards relatively less risky assets such as US Treasuries.

However, Nambawan investments in equities rose while those in bonds fell by half during the crisis. The increase in equities reflects the fact that the fund invested substantially in unlisted equities (around 16.5% in 2009, across a whole range of industries in PNG), which provided good returns in an economy that grew by

Sovereign investment funds in the Pacific

Allocation of investments (%)



FNPF=Fiji National Provident Fund, RMI=Republic of the Marshall Islands, FSM=Federated States of Micronesia
Source: Authors' estimates.

6.6% in 2008. The falling share of bonds reflects a decreasing appetite for assets with low real returns. PNG inflation rose from 0.9% to 10.8% in 2007–2008 due to high global food and fuel prices, local infrastructure bottlenecks, and fast-paced domestic growth. By 2010, the share of equities rose to 64.0% of the fund's total portfolio. Property holdings increased to 19.0% as investments in PNG real estate offer good returns due to constraints on land development particularly in urban areas.

Three investment funds—the FNPF, Nambawan, and Petroleum Fund—continued to post positive growth after the crisis. The Petroleum Fund saw its net assets increase from a pre-crisis value of US$2.1 billion to US$6.9 billion in 2010. Nambawan recorded a 36.8% gain in its net assets value while the FNPF rose by 4.2% over the three-year period.

Policy-driven diversification

Further, although the FNPF and the Petroleum Fund changed the mix of assets in their portfolios, these moves were policy-driven rather than a reaction to the GFEC. In the case of Fiji, the Reserve Bank of Fiji (RBF) instructed that international investments be repatriated. The repatriation, which started in mid-2005, concentrated the FNPF's investments in Fiji government bonds and other domestic assets. As of mid-2011, 75% of the FNPF portfolio is held in government bonds.

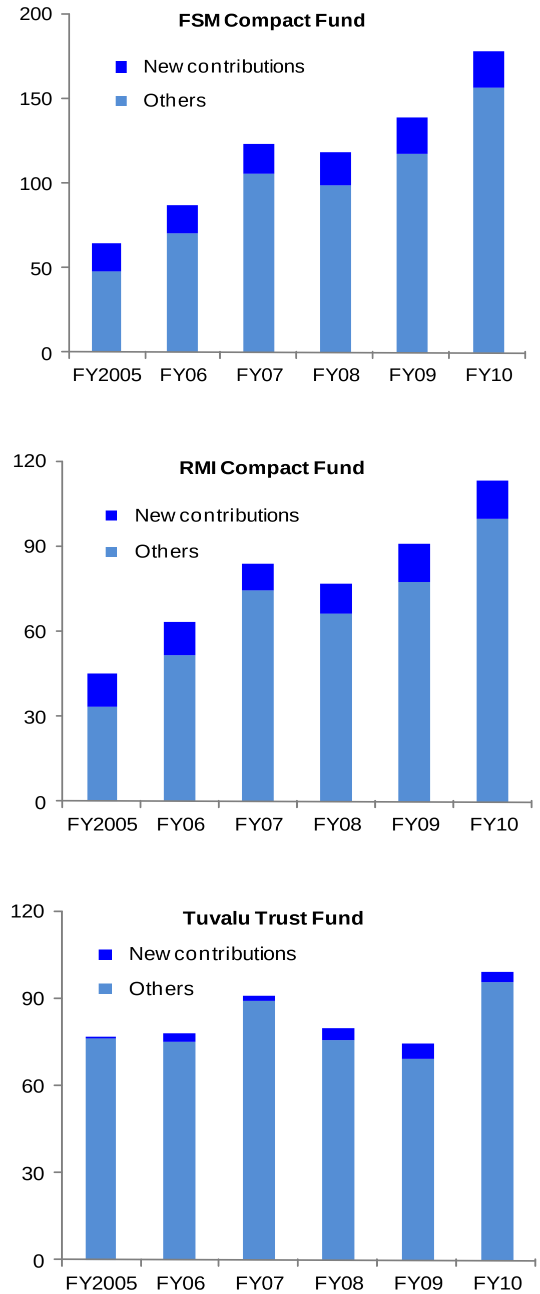
The repatriation limited FNPF's investment options, which resulted in a decline in the share of equities in FNPF's portfolio from 17.0% in 2005 to 2.3% in 2010. The repatriation also reduced investment returns, realized exchange rate losses, and caused excess liquidity in the domestic financial system, depressing the yields on government bonds where the assets are now concentrated. In 2011, RBF relaxed foreign exchange restrictions, which resulted in an increase in offshore investments.

The Petroleum Fund, on the other hand, is driven by a desire to diversify. When the fund started in 2005, it was managed by Timor-Leste's Banking and Payments Authority and had more than 99% of its assets invested in US Treasuries (with maturities of less than 5 years). The Petroleum Fund's investments in non-US assets have increased from 7.6% of its total portfolio in FY2008 to 11.6% in FY2010, but as of mid-2011, this has decreased to around 8.0% of the total portfolio. The fund subsequently decided to engage external managers and invest in sovereign bonds and equities of other developed economies. By mid-2011, only 4.1% of its assets were invested in equities, but the Timor-Leste government recently passed legislation allowing the fund to invest up to 50% of its assets in equities.

Investments in non-US offshore assets have been increasing. This is particularly true for funds in those countries with strong economic and political ties to the

Sovereign investment funds in the Pacific

Net assets
($ million)



FSM=Federated States of Micronesia, RMI=Republic of the Marshall Islands
Sources: Annual reports.

US, such as the CSPP, the FSM Compact Fund, and the RMI Compact Fund. Based on available data, the share of non-US assets in their portfolios increased by an average of 33.0% between FY2008 and FY2010. The FSM and RMI Compact Funds quickly recovered from the negative impact of the GFEC. The FSM Compact Fund's non-US equity, private equity, fixed income, and emerging market debt investments are made through global trust funds.

In the RMI Compact Fund, non-US investments are made through exchange-traded funds, fixed income, international equity, and real estate investment trusts. In contrast, the CSPP, MISSA, and TTF still have to recover losses resulting from the GFEC. By 2010, the share of equities in the CSPP and MISSA portfolios returned to pre-crisis levels.

Impact of the late-2011 downturn

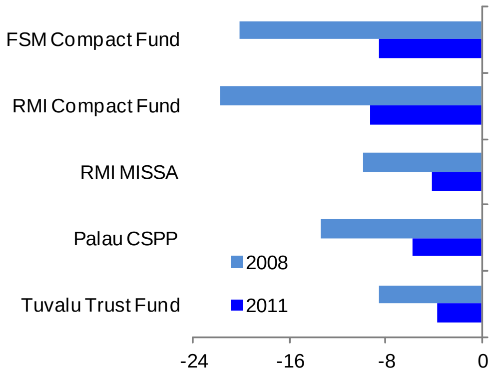
Throughout 2011, uncertainties in Europe and the US have contributed to volatility in stock markets. Based on the observed impacts of the GFEC on the Pacific's investment funds, and taking into account portfolio adjustments made in the interim, the possible effects of the current episode of financial market volatility are examined through simulation analysis. Simulations assume a 10% fall in global stock values over 2011 and derive the likely impacts on Pacific investment funds.

At present, investment portfolios of the Pacific's funds are heavily weighted toward equities in advanced economies. The recovery in global stocks over 2009–2010 raised the return on equities and increased their attractiveness as investments. However, even with greater exposure to the volatile global financial market, simulation results show that potential impacts over 2011 will be smaller than the observed valuation losses during 2008. However, considerable downside risks to the value of Pacific investment funds remain, if the Eurozone crisis worsens.

Simulations of 2011 returns on investments for Pacific funds show declines ranging from 4.0% to 9.0%, less than half of the observed negative impacts in 2008. The largest falls are expected for funds that are most heavily invested in equities, such as the CSPP, and the FSM and RMI Compact Funds; all of which could record investment losses of more than 5%. All three funds have more than 60% of investments in equities, mostly in US markets. The RMI Compact Fund reportedly lost 10% of its value in August 2011 when the S&P 500 fell by almost 18%. Subsequently, there was some recovery but the continued uncertainty, in Europe in particular, makes it difficult to make any firm predictions.

Sovereign investment funds in the Pacific

Estimated returns on investments
(%, 2008 and 2011)



CSPP=Civil Service Pension Plan, FSM=Fed. States of Micronesia, RMI=Republic of the Marshall Islands, MISSA=Marshall Islands Social Security Administration,
Source: Authors' estimates.

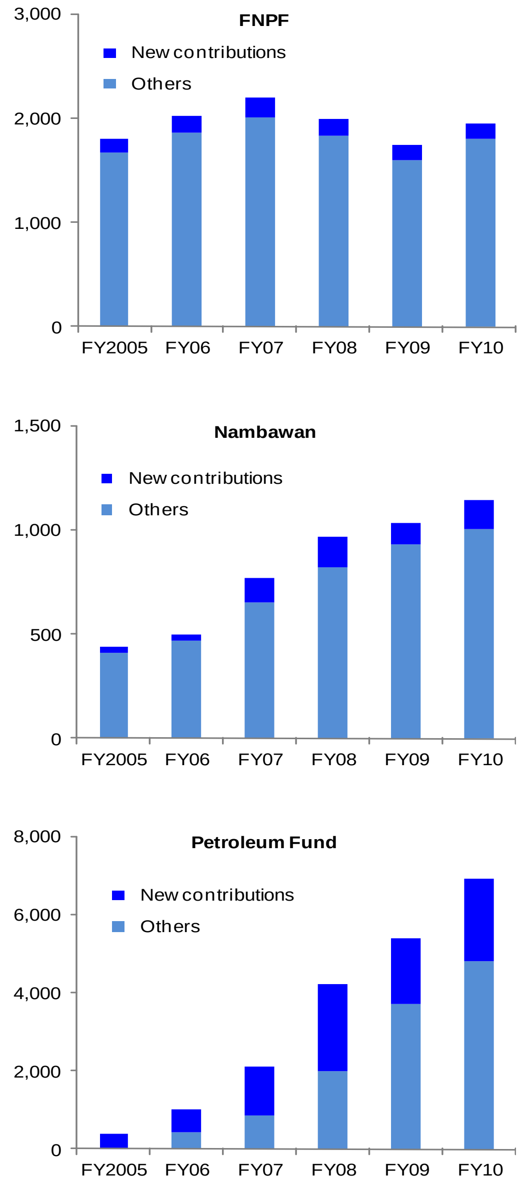
Implications on current drawdowns and savings

The Pacific investment funds face several immediate challenges. First, although stock market indexes have recovered from their record lows in the first quarter of 2009, they remain below pre-crisis levels. Second, low returns on government bonds (reflecting very low key interest rates in advanced economies) and quantitative easing have reduced yields on government bonds. New bonds purchased typically have lower yields than the bonds being retired. Since September 2011, the yield on 5-year US Treasuries has been below 1%. These create problems in many investment funds, particularly for social security funds with unfunded liabilities.

Unfunded liabilities. Unfunded actuarial liability for the CSPP rose from 55.0% in 2007 to 60.9% in 2009. The MISSA's unfunded liability has been on the decline, but remains high (72.0% in 2008, the latest year available). Nambawan's unfunded liability has likewise declined from 51.3% in 2006 to 40.0% in 2010 due to better returns on its assets. The FNPF has no unfunded actuarial liability (i.e., it has excess assets over actuarial present value of accrued benefits); however, its surplus has been on the decline from 13.3% of net assets in 2008 to just 1.6% in 2010.

Trust fund withdrawals. Another challenge is the countries' ability to withdraw from their trust funds. The Tuvalu government has not withdrawn from its trust fund since 2009 because the fund's market value remains below its required maintained value. The Consolidated Investment Fund (CIF), a mechanism for holding distributions from the TTF until they are drawn down in

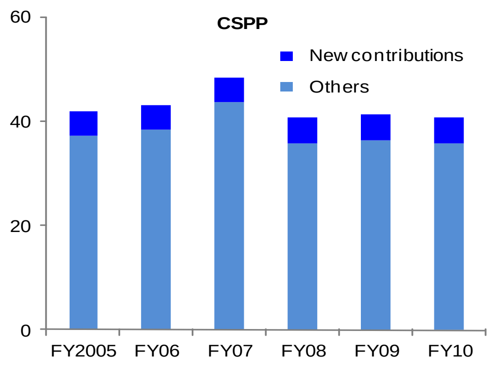
Net assets
($ million)

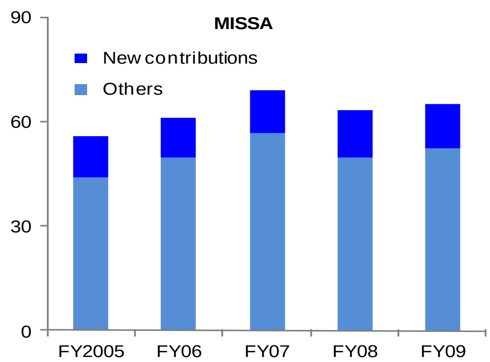


FNPF=Fiji National Provident Fund
Sources: Annual reports.

Sovereign investment funds in the Pacific

Net assets ($ million)





CSPP=Civil Service Pension Plan, MISSA=Marshall Islands Social Security Administration
Sources: Annual reports.

the budget, may be drained during 2011. This will have repercussions on the government's cash flow and funding in the latter part of FY2011 and into FY2012. The CIF's balance as of 31 March 2011 was A$6.5 million.

Compact trust funds. Over the long-term, FSM and RMI must build up the value of their Compact trust funds. The International Monetary Fund estimates that the fall in the global equities market will cause the Compact trust funds to incur an income shortfall of around 6% of GDP for FSM and 8.5% of GDP for RMI when the Compact sector grants expire in FY2023.

In assessing the performance of these sovereign investment funds, it is important to take a long-term view and recognize that falls in asset values due to stock market declines will only be translated into losses if equities are sold at lower prices. However, it is expected that asset values will increase as global markets recover. In addition, the funds are expected to gain dividends from holding these equities, which will positively impact net income. The key issue is the efficient and transparent management of investment portfolios to maximize returns for stakeholders.

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

Interest rates and bank profitability in the Pacific

Interest rate levels have been an issue of increasing political and public attention in the Pacific, particularly as the effects of the global economic crisis pressured incomes and living standards in the vulnerable small open economies of the region. As a result, Pacific central banks have been assessing the cost of financial services to the general public, particularly interest rates being paid on deposits and charged on loans.

This article aims to inform the debate by providing comparative information on interest rate levels and other key profitability indicators. The analysis focuses on the six Pacific countries with central banks—Fiji, Papua New Guinea (PNG), Samoa, Solomon Islands, Tonga, and Vanuatu. Data availability and reliability are major constraints in cross country analysis of this type. To ensure comparability, the analysis largely works from disaggregated prudential data so that ratios can be derived on a similar basis.

Bank profitability and revenue sources

Banks in the Pacific are sound and profitable. From a financial sector stability perspective, this is critically important: it has enabled the Pacific to withstand the global financial crisis without significant shocks to its financial systems or significant government intervention or financial support. The dominance of Australian banks, which withstood the crisis better than most international banks, contributed to this successful outcome. Where banks have incurred losses and capital has fallen below required levels, the strong position of parent institutions has enabled swift and appropriate re-capitalization.

Like elsewhere, interest rates in the Pacific reflect a wide range of factors. Interest rates are the centerpiece of commercial banks' core business of financial intermediation. They are the key price in the financial sector, the main transmission mechanism of monetary policy, the main vehicle for matching supply and demand and, normally, the key determinant of profitability. In addition to market liquidity conditions and overhead costs, risk is a key element affecting interest rate levels.

The Pacific has a number of characteristics that would tend to drive up interest rates. Economic risk is relatively high, particularly due to the region's vulnerability to shocks, and broader country risk is also perceived to be elevated. Creditor risk—the likelihood that banks' credit will not be repaid—is relatively high, particularly as factors that moderate credit risk (e.g., credit reporting bureaus, and bankruptcy laws) are not present. Financial markets are also shallow, with limited opportunities to diversify risk.

Net interest income
(% of total assets, 2008)

Country	%
Solomon Islands	8.6
Samoa	6.1
Vanuatu	3.6
Tonga	5.8
Average Small Island States	**6.0**
Papua New Guinea	3.8
Fiji	5.2
Australia	1.6
New Zealand	1.9
Brazil	4.0
Indonesia	5.4
Kazakhstan	2.8
Malaysia	2.3
Mexico	1.2
Philippines	1.6
Uruguay	0.0

Sources: Central Bank data, International Monetary Fund (IMF) Financial Soundness Indicators database, and IMF estimates.

Headline data suggest that banks' interest operations are broadly in line with comparable regions. Interest rate levels vary widely even within the Pacific. Headline lending rates as reported to the IMF show that Solomon Islands is consistently the highest (around 15%) and Fiji the lowest (around 8%). Lending rates in the Pacific are, on average, below Africa and South Asia, and broadly in line with the Caribbean. Data on interest rate spreads—the difference between lending and deposit rates—show a similar pattern. However, care needs to be taken with these data as they are vulnerable to mistakes in reporting, and reported interest rates are not always directly comparable.

Prudential data provided by Pacific central banks allows a more rigorous comparison of interest rates. They provide a fuller picture of interest and other operations, including actual flows of interest income and expenses, and their disaggregated nature provide more certainty that fully valid comparisons are being made.

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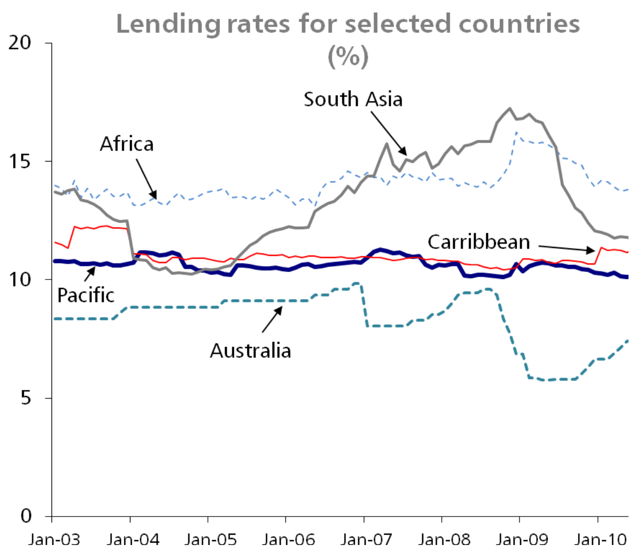
Interest rates and bank profitability in the Pacific

International comparisons are drawn from the IMF's Financial Soundness Indicators database, which has far more restricted coverage than the headline interest rate database but allows comparison on a broader set of analytical ratios derived from commercial banks' balance sheets. The analysis selects emerging markets for comparison purposes, but acknowledges that these countries have very different market conditions and structures from the Pacific. Where possible, indicators from a broader range of countries are also drawn from the IMF's Global Financial Stability Report.

Analysis shows that interest income is broadly in line with expectations. Net interest income—interest income from all sources less all interest expenses expressed as a measure of average bank assets—is the best technical measure of the interest rate spread. In 2009, spreads in the Pacific ranged from 3.5% (PNG and Vanuatu) to 8.5% (Solomon Islands). This was generally higher than spreads in emerging markets, although close to that of Indonesia, and much higher than in Australia. These differentials are broadly in line with what one might expect given the country risks discussed above, and the shallowness and immaturity of the financial markets in these economies.



Source: Pacific Financial Technical Assistance Centre.

As a result of foreign exchange operations, non-interest income is higher than in other regions. Fees, charges, and foreign exchange activities are significant contributors to bank income and profitability. Foreign exchange income is by far the largest contributor, reflecting the highly open nature of the Pacific economies that leads to a large volume of international trade transactions, supplemented by tourism and remittances. Overall, as with interest income, levels of non-interest income in the Pacific are significantly above those in comparable economies.

Non-interest operations
(% of average assets, 2008)

	Non-interest Income	Gross non-interest expense	Net non-interest income
Solomon Islands	8.6	5.9	2.7
Samoa	4.9	4.8	0.2
Vanuatu	2.9	4.0	(1.0)
Tonga	6.3	6.4	(0.1)
Avg. Small Islands	5.7	5.2	0.4
Papua New Guinea	3.0	2.7	0.3
Fiji	2.6	3.4	(0.8)
Australia	1.3	1.7	(0.4)
New Zealand	0.8	1.2	(0.4)
Brazil	5.5	6.7	(1.3)
Indonesia	3.1	4.1	(1.0)
Kazakhstan	1.3	2.6	(1.3)
Malaysia	1.6	1.5	0.1
Mexico	0.6	0.9	(0.3)
Philippines	0.8	1.6	(0.8)
Uruguay	1.7	5.1	(3.4)

Sources: Central bank data, IMF Financial Soundness Indicators database, and IMF estimates.

At first sight, overall bank profitability in the Pacific is very high. Returns on assets in the region ranged from –6.0% to 9.5% in 2009, and averaged close to 5%, which is high by international standards. Returns have remained broadly at these levels over the last decade, but have been declining in most countries.

However, profits from interest operations are broadly in line with international norms. Very high foreign exchange activities contribute significantly to the income and profits of commercial banks, but without them, returns on assets would be more in line with international comparators. However, it is not possible from current data sources to identify whether foreign exchange income is a significant element in profitability in other regions.

Credit risk does not appear to have been excessively high in the Pacific in recent years. Banks' provision expenses—the precautionary expenses banks make against loans that are not performing as expected, or believed to pose more than a normal degree of credit risk—have remained at around 1% of average gross loans. However, the ratio has been much higher in Tonga in recent years, demonstrating the impact of high credit risk manifesting itself in a sharp increase in non-performing loans. Even excepting Tonga's recent experience, Pacific banks' provision expenses are significantly above those in Australia and some selected emerging markets, but lower than in Brazil and Indonesia. A similar conclusion is derived from the proportion of the total loan loss reserve—the amount banks have put aside to cover bad loans—to total loans.

Interest rates and bank profitability in the Pacific

Return on average assets (%, annual)

		2006	2007	2008	2009
South Pacific	avg.	5.2	4.9	4.0	2.8
	high	7.7	8.6	10.5	9.3
	low	3.5	2.9	(2.5)	(5.7)
South Pacific (excluding FX income)	avg.	2.5	2.1	1.0	0.4
	high	3.5	3.1	3.9	3.3
	low	2.0	1.2	(6.6)	(8.2)
Australia		1.5	1.4	0.7	0.9
New Zealand		1.7	1.6	1.3	…
Latin America	avg.	2.2	2.1	1.9	1.9
	high	3.5	3.1	3.5	5.5
	low	1.0	1.2	1.0	0.4
Sub-Sahara Africa	avg.	3.0	2.5	3.3	…
	high	5.8	3.9	4.2	…
	low	1.5	1.6	2.2	…
Mid East & Central Asia	avg.	2.2	2.1	1.4	…
	high	4.0	3.4	3.2	…
	low	0.7	0.9	(2.6)	…
Emerging Europe	avg.	1.6	1.7	1.3	0.3
	high	3.4	3.9	3.5	1.6
	low	0.9	0.7	(0.6)	(3.3)

FX=foreign exchange, …=no data available
Sources: Australian Prudential Regulation Authority, Central bank data, IMF. 2009. Global Financial Stability Report.

Recommendations

Pacific policy makers have been considering whether actions to reduce interest rates and other income streams are required, particularly given the economic pressures arising from the global economic crisis. Some central banks have taken action and others are considering whether existing regulations provide an appropriate framework to allow interventions.

The need for a response depends on the ultimate policy objective. There are a number of possible objectives that policy makers in the Pacific may have, including increased access to affordable credit for domestic businesses, moderating bank profitability, and enhancing consumer protection. These are not exclusive to each other, and many can and should be addressed through institutions other than the central bank.

In terms of central banking, the long-term means to achieve these objectives is clear and is already being pursued by all Pacific countries. It lies in a credible and effective monetary policy framework and well-functioning and competitive financial markets. Reducing country risk, by maintaining stable macroeconomic and political environments and continuing progress on structural reforms to improve the business environment, would also contribute, as would improved consumer protection and financial literacy among economic stakeholders.

Taking additional short-term measures to control interest rates or profitability is risky and requires careful consideration of costs and benefits. There is the potential for them to act against progress on the long term agenda outlined above. For instance, interest rate regulation can influence rates in the short term, but has many challenges and can lead to unintended outcomes, (e.g., contractions in credit) and increased charges in other areas. Short-term regulatory measures that control bank profitability or interest rates can frustrate market development, and the short-term benefits need to be substantial to justify them.

However, a number of additional measures could contribute to finance sector development. These include a continuation of the enhanced dialogue that has already begun with commercial banks at both national and regional levels. There are also bank-level measures to ensure disclosure of effective interest rates, and wider dissemination of industry-level data, such as that contained in this paper. Enhanced supervision and strengthened consumer protection can also contribute. These, and other regional and national measures, should emphasize the importance of transparency and disclosure to enhance accountability and consumer protection.

Building financial competence and inclusion is fundamental to long-term financial sector development. Pacific central bank governors and finance ministries have already recognized this at a regional level through the Coombs Declaration, the endorsement of the MoneyPacific goals, and their active support for Microfinance Pasifika and the Pacific Financial Inclusion Program. These support many national and regional programs implemented by governments, central banks, development partners, and the private sector. Increased investment in physical and technological infrastructure will also be required to bring the unbanked into the financial sector in a cost-effective manner.

Lead authors: Matt Davies (IMF-PFTAC Coordinator) and John Vaught (IMF-PFTAC Financial Sector Supervision Advisor). The full analysis can be found in the paper "Interest Rates and Bank Profitability," which can be accessed at: http://www.pftac.org/publications.html.

Global uncertainties and credit quality in selected Pacific countries

The prospect of weaker global growth and ongoing volatility in financial markets stemming from European debt concerns could undermine the credit quality of emerging Pacific countries such as the Cook Islands, Fiji, and Papua New Guinea (PNG).

These countries benefit from low external funding requirements and insulated financial systems. That said, Standard & Poor's ratings service views a key vulnerability to be their open economies and risks associated with a reliance on income from one key sector to fund growth—namely tourism for the Cook Islands and Fiji, and commodities for PNG. Adding to this are domestic inflationary pressures for all three countries.

These risks cap off a year of diverging credit trends. Standard & Poor's raised the foreign currency rating on Fiji to "B" from "B–" following continued improvements to Fiji's external position and after the implementation of Standard & Poor's revised methodology and assumptions for sovereign ratings, published on 30 June, 2011. Conversely, Standard & Poor's affirmed a "B+" foreign currency rating but lowered the local currency long-term rating on PNG to "B+" from "BB–" based on the new methodology that puts more weight on the development of local currency debt markets, which are shallow in PNG. This factor, in combination with very limited monetary flexibility, required an equalization of the local and foreign currency ratings on PNG.

Pacific sovereign foreign currency ratings (as of 29 October 2011)

Cook Islands	BB/Negative/B
Fiji	B–/Stable/C
Papua New Guinea	B+/Stable/B

The Cook Islands, on the other hand, remains at "BB–" but with a negative outlook, reflecting the risk of a downgrade if its fiscal settings do not improve with greater political stability and fiscal discipline.

Apart from individual credit vulnerabilities, a weaker-than-expected global economic environment is the most likely threat to Pacific sovereigns. The recovery of many developed economies—such as the US and Eurozone members—is stubbornly weak and appearing increasingly fragile. Ongoing financial market volatility stemming from European sovereign debt concerns is further weighing on global growth prospects. While Standard & Poor's recent lowering of the US rating to "AA+" does not in itself directly affect the Pacific sovereign ratings, it partly reflected Standard & Poor's view that the effectiveness, stability, and predictability of policy making and political institutions—another risk factor in the Pacific—are currently uncertain in major developed sovereigns at a time of ongoing fiscal and economic challenges. If growth in the developed economies slows much more than Standard & Poor's currently anticipates, there would be adverse consequences for remittances, tourism, and demand for resources, with possible consequences for the credit quality of the Pacific countries.

Moreover, the rated Pacific countries have weaker balance sheets compared with 2008, which affords them less flexibility to respond to external shocks. In the Cook Islands and Fiji, net general government debt levels have risen significantly in the past few years, partly reflecting a cyclical weakening in revenues and spending on fiscal measures to stimulate growth and fund much-needed infrastructure projects.

The Pacific countries are highly dependent on imported commodities such as oil (for transport and cooking), food,

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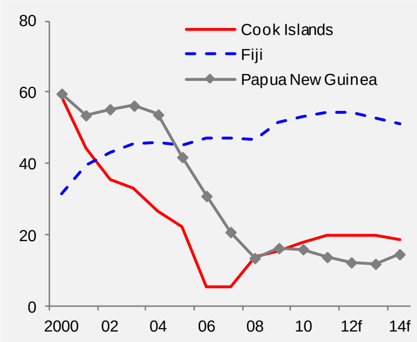
Global uncertainties and credit quality

and clothing. For PNG, in particular, an overheating domestic economy adds to acute inflationary pressures.

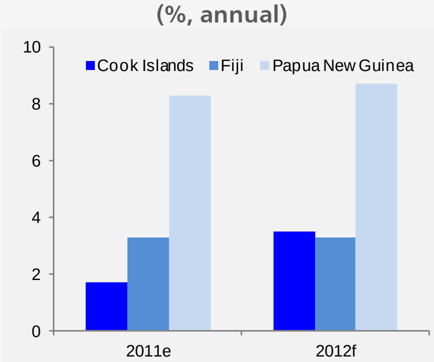
Net general government debt
(% of GDP)



f=forecast
Source: National statistical offices and Standard & Poor's estimates.

Working in the Pacific countries' favor is their comparatively low reliance on external funding. This reflects local banking systems that are predominantly domestically funded, are foreign owned, and have been performing soundly. It also reflects a greater proportion of concessional, rather than commercial, borrowings by regional governments to close their economies' sizable infrastructure gaps.

Consumer price inflation
(%, annual)



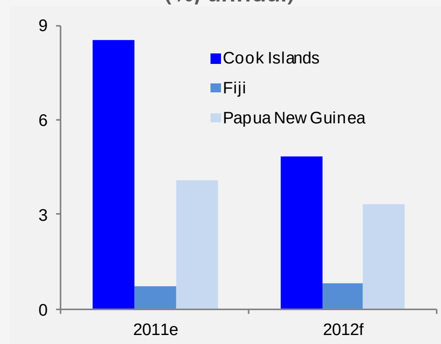
e=estimate, f=forecast
Sources: National statistical offices and Standard & Poor's estimates.

Weakening fiscal settings shape Cook Islands' credit quality

Standard & Poor's lowered the ratings on the Cook Islands in December 2010 due to the weakening fiscal settings and the heightened potential for the previous strong advances in fiscal flexibility to be further unwound through undisciplined spending and debt accumulation. Standard & Poor's believes that the political settings are fragmented and have historically challenged the country's ability to develop and implement policies that would promote development and reform efforts for sustainable economic growth.

Adding to the political uncertainty is the deterioration in the country's growth prospects. GDP contracted by a total of 7.2% in the past 3 years, reflecting weak activity in the retail, transport, and communications sectors. With improving tourist arrivals, Standard & Poor's expects annual per capita GDP growth (affected by a falling population) to average 5.7% over the next 3 years.

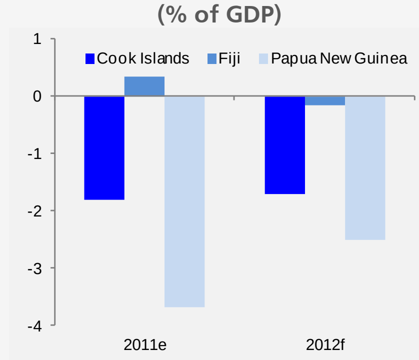
Per capita GDP growth
(%, annual)



e=estimate, f=forecast
Sources: National statistical offices and Standard & Poor's estimates.

At the same time, sharply higher government spending and rising debt and interest burdens signal a significant departure from years of successful fiscal consolidation. While the bulk of spending is earmarked to close significant infrastructure gaps, a sizable component represents spending on less-productive investment. Standard & Poor's expects general government fiscal deficits of 1.8% in 2011 and 2012, with a broadly balanced fiscal position by 2014. Standard & Poor's estimates that general government debt (net of liquid assets) has risen steeply to 19% of GDP in 2011, from a low of 6% in 2007.

General government balance
(% of GDP)



e=estimate, f=forecast
Sources: National statistical offices and Standard & Poor's estimates.

The negative rating outlook reflects the possibility for a downgrade if the Cook Islands' fiscal settings do not improve sustainably. Greater political stability and fiscal

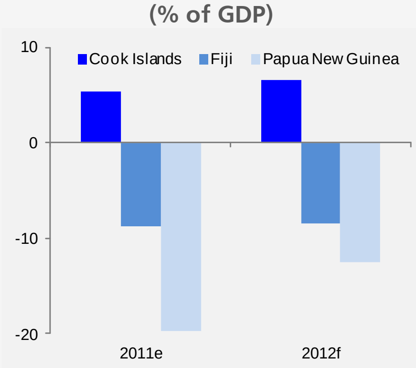
Global uncertainties and credit quality

discipline will be important to such an improvement. Ratings could be lowered if new borrowings or the use of debt-repayment reserves to fund recurrent expenditure and "nation-building" projects, e.g., sporting facilities, adds to a higher debt profile, in addition to loans for infrastructure development.

Improving external position lifts Fiji's credit quality

The raising of the foreign currency rating on Fiji on 5 August 2011 to "B" from "B–" follows continued improvements to the country's external position. Under Standard & Poor's revised sovereign rating methodology, the local currency rating on Fiji is also now equalized with the foreign currency rating, based on Fiji's use of fixed pegging against a basket of currencies and the shallowness of its local currency capital markets. Fiji's sizable current account deficits, reflecting large merchandise trade deficits, have improved in recent years. The ratings on Fiji reflect the country's persistent fiscal and current account deficits, and Fiji's growth prospects, which have been reduced by past political instability, low productivity in the sugar sector, and flood damage to both crops and infrastructure in late 2010. After contracting for 3 of the past 4 years, Fiji's per-capita GDP could rise in 2011, in Standard & Poor's view, as the economy grows by 0.7% in real terms, thanks to a rebounding tourism sector and some fillip from government spending.

Current account balance
(% of GDP)



e=estimate, f=forecast
Source: National statistical offices and Standard & Poor's estimates.

Standard & Poor's expects Fiji's general government debt burden (net of liquid assets) to stabilize in 2011 at 55% of GDP and for the funding mix to shift slightly to favor external commercial debt. Standard & Poor's estimates Fiji's gross external financing needs (current account outflows plus short-term external debt by remaining maturity) to be 105.6% of current account receipts plus usable international reserves in 2011, compared with 283% in 2006. Standard & Poor's forecast of US$349 million for Fiji's 2011 external borrowing needs includes the government's US$250 million bond issued in March 2011 to replace the US$150 million issue that matured on September 13, 2011.

Standard & Poor's ratings also reflect Fiji's challenging political and policy environment, diminished institutional transparency and independence, and decrees that weigh on civilian and media freedoms. Standard & Poor's expects these to weaken prospects for investment and for donor re-engagement, and thus the nation's growth prospects.

High commodity prices to boost PNG's growth, but adding to persistently high inflation

PNG's creditworthiness is likely to continue to benefit from favorable commodity prices, a government commitment to development, and a financial system that has no significant links to global wholesale funding markets. Standard & Poor's expects annual per capita GDP growth of 4.2% in 2011 supported by high gold, copper, and oil prices and the construction of a liquefied natural gas (LNG) plant that is boosting non-mining (such as transport, storage, and communication) activity.

Standard & Poor's expects consumer prices to rise by more than 7% in 2012 and 2013, in part reflecting substantial inflows of capital into the country and emerging capacity constraints in labor and product markets that are associated with the LNG project construction. Key downside risks to PNG's outlook could arise from delays in completing the LNG project, a weakening in prices and demand for resources exports, and sharp falls in house prices in Port Moresby and Lae.

Off-budget borrowing and expenditure undermine PNG's efforts to consolidate its fiscal policy and illustrate ongoing weaknesses in governance and transparency. Standard & Poor's estimates the fiscal accounts will be broadly balanced in 2011. While the government's fiscal strategy targets spending from the trust accounts at less than 4% of GDP, an election due in 2012 raises risks of further unrestrained spending that may add to demand and inflationary pressures.

Political and institutional frameworks remain weak and pose a key challenge as PNG manages the large windfall gains from the LNG project. A new prime minister and ministerial lineup should improve political certainty in the near term—albeit the political settings following general elections due in 2012 remain highly uncertain.

The stable outlook balances PNG's improved economic prospects with the challenges it faces in overcoming weak political and institutional settings, and in closing infrastructure shortcomings to raise the prospects of the largely disenfranchised population through minerals sector revenue.

Lead author: Kyran Curry, Standard & Poor's (kyran_curry@standardandpoors.com).

Bond market development in Papua New Guinea

The Asian financial crisis of 1997 and the global financial and economic crisis of 2008 have highlighted the significant economic risks associated with large holdings of foreign currency-denominated debt. This has contributed to a growing international consensus regarding the important role that local currency bond markets can have on fostering financial stability and sustainable economic growth. Robust domestic bond markets improve the efficiency of local financial intermediation, reduce a country's exposure to both currency and maturity mismatch risk, and promote broader financial sector development, which itself is strongly linked with economic growth and poverty reduction. ADB continues to play a key role in promoting the development of these markets throughout Asia, with local currency bonds on issue in emerging East Asia now exceeding $5 trillion in 2011 from $836 billion in 2000.

This article discusses the implications of these regional trends in local currency-denominated bond markets for a small emerging economy like PNG and what, if anything, the PNG government can do to develop its own domestic bond markets. Looking forward, it also considers the impact that scaling up Liquefied Natural Gas (LNG) production and revenue will have on PNG's domestic bond market and government borrowing more generally.

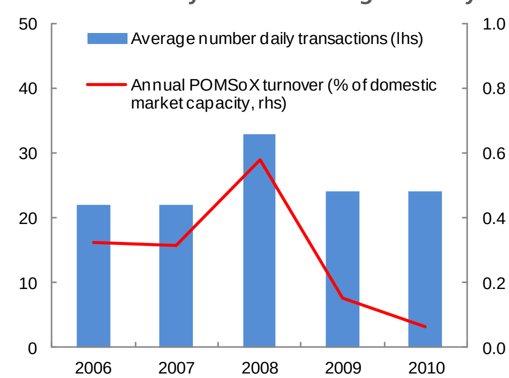
Recent developments

Significant innovations have taken place in PNG's financial sector in recent years. Following a government debt-induced macroeconomic crisis from the late 1990s to the early 2000s, major reforms were undertaken in the financial sector. These included (i) establishing the Bank of PNG (BPNG) as an autonomous entity, allowing it to undertake regulatory and supervisory functions without undue political influence; (ii) restructuring local banks; and (iii) improving the governance arrangements for superannuation (pension) institutions.

Reforms have played a central role in reinvigorating the financial sector and encouraging a more vibrant business environment. The sector is now generating profits, with average return on bank equity reaching approximately 30% by mid-2011. The rate of non-performing loans among commercial banks is below 2%, and superannuation funds have become a major source of domestic investment. Increased availability of domestic credit has also contributed to the expansion of micro savings and loans schemes across the country, benefitting thousands of Papua New Guineans–with Nationwide Microbank signing up its 100,000th customer in May 2011.

However, unlike its emerging Asian neighbors, PNG has made limited progress in developing its domestic bond markets. PNG's bond market is dominated by government securities, including Treasury bills (short-term maturity) and Inscribed Stock (long-term maturity), which are issued to meet the government's deficit financing needs. These two instruments are equivalent to 16% of GDP in 2010, with inscribed stock accounting for 60% of total outstanding domestic debt. Close to two-thirds of these are held by other depository corporations, followed distantly by other financial corporations (15.6%), BPNG (9.5%) and other resident sectors (9.7%). The BPNG also issues short- and long-term central bank bills for liquidity management purposes. Sales of both government and BPNG securities are undertaken through a primary dealer system, which is accessed by a few large institutional investors with varying levels of competition.

Port Moresby Stock Exchange activity



lhs=left hand scale, rhs=right hand scale
Source: POMSoX annual reports (2006–2010)

There is almost no secondary trading market, with most securities being held until maturity and no effective repurchase facilities. Corporate bonds are nonexistent. More broadly, shares on the Port Moresby Stock Exchange (POMSoX) are thinly traded, and many businesses lack access to sophisticated financial products that they can use to expand their operations or reduce financial risks. Despite high levels of domestic bank liquidity, many firms have trouble accessing capital, particularly small and medium enterprises that are unable to access international markets.

Opportunities and challenges

Although PNG's small size limits opportunities, a number of options do exist for strengthening the local currency bond market. One is to list government-issued securities on the POMSoX. This would allow the POMSoX to enter into debt markets and further develop the exchange's market presence in the PNG economy. From the government's perspective, this would also increase the opportunities for retail and other

Bond market development in PNG

institutional investors to invest in government securities, thereby increasing market liquidity and deepening government access to the domestic financial sector. Reducing the cost of bond trades and promoting new market entrants may also help to overcome the one-way "buy and hold" approach to investing in government securities that prevails in PNG, which gives limited options for investors to adjust their portfolios.

Another option to develop domestic bond markets is the issuance of local currency denominated bonds by international financial institutions (IFIs). This would allow both sovereign and non-sovereign lending to be denominated in the local currency rather than the US dollar, and could lower the economy's vulnerability to external shocks.

The issuance of local currency bonds by IFIs could also help to strengthen international best practice standards within the bond issuance market. Further, the high credit rating which would typically accompany such an asset, together with its long maturity period, would allow investors to diversify their holdings across a range of risk classes. Experience in other countries (e.g., People's Republic of China, India, Malaysia, the Philippines, and Thailand) illustrates that these developments can have an important "icebreaker" effect, particularly on international investors, by strengthening investor confidence and appetite for local investments. This would contribute further to the depth and international integration of the local capital market.

Before this type of reform could be considered in PNG however a number of current market constraints would need to be addressed. These include overcoming a number of regulatory overlaps and gaps that exist within PNG's financial market including the BPNG, POMSoX, Securities Commission, and Treasury. Current regulatory arrangements for overseeing the operations of the POMSoX are also inadequate. The Securities Commission has primary responsibility for regulating stock market operations; but it suffers from inadequate funding and technical capacity.

Beyond providing low-cost trading options, the government must also address the underlying determinants of why financial institutions choose to adopt a "buy and hold" approach to investing in government securities. These include high levels of market liquidity; a perceived scarcity of alternative investments resulting from high market risk; and borrowers' inability to use key assets, such as land, as collateral.

Efforts to develop domestic bond markets must also balance a number of fiscal management priorities, including how best to manage LNG revenues, which are expected to be substantial. The 2011 budget estimates the government to begin receiving K1 billion per annum by 2016, and then scaling up to a peak of K6 billion per annum by 2026. Over time, these additional revenues are expected to reduce the government's need for deficit financing and allow further reductions in the net government debt stock, which in 2011 was equal to 24% of GDP. This may erode the size and significance of the existing local currency bond market and limit opportunities for future expansion.

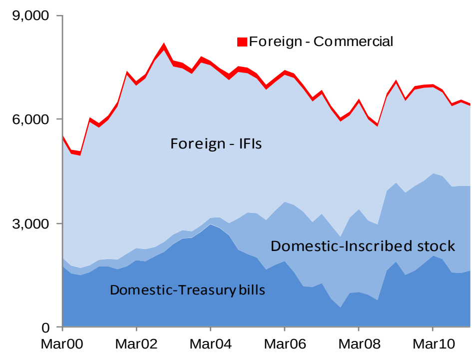
The issuance of government bonds, however, is determined not only by the year-end fiscal position but also by the government's short-term cash flow management needs. In any one week, the government may find it does not have enough revenue to meet weekly expenditure requirements. As such, even in a year when the government records a fiscal surplus, it may still increase or maintain its issuance of domestic bonds. For instance, despite recording a net fiscal surplus of K685 million between 2004 and 2010, the nominal value of the government's domestic debt stock increased from K3.0 billion in January 2004 to K4.2 billion at the end of December 2010.

The government's need to access domestic finance will also be affected by arrangements made for managing surplus LNG revenues. Under current plans, the majority of LNG revenues are to be deposited into an offshore Sovereign Wealth Fund (SWF). To ensure effective fund usage, transparency, and long-term sustainability, restrictions will be put in place to limit the potential rate of drawdown from the SWF and ensure that funds are channeled through proper budgetary processes and support the objectives of the current Medium-Term Fiscal, Debt, and Development Strategies. Under this scenario, the government may determine that using domestic bond markets as a means of short-term cash flow management is a more prudent fiscal management strategy than frequent drawdown from the SWF.

Further, the government will need to consider the implication of LNG revenues on its long-term borrowing strategy more generally. While the government will accrue substantial savings in its SWF over the coming decades, withdrawals from the SWF will not be cost-free as the country loses future investment income when withdrawals are made. As such, continuing to borrow may, in many cases, offer financial benefits for PNG if it can obtain cheaper finance compared with the opportunity costs of funding projects from the SWF. In particular, this is likely to be the case with concessional lending from IFIs, which offers project investment funds

Bond market development in PNG

PNG's Government debt structure (kina, millions)



Source: Bank of PNG, Quarterly Economic Bulletin, March 2011 Update.

at rates likely to be lower than forgone interest from drawing down on SWF investments.

Borrowing from IFIs also allows countries to benefit from additional capacity development and knowledge services, which can supplement government systems in converting resource wealth into service delivery. For these reasons, IFIs continue to play an important role in many countries that maintain net national savings (e.g., People's Republic of China).

Next steps

To promote the development of its domestic bond market and address the challenges raised above, the Government of PNG would need to undertake a number of initial reform efforts. These include designating the Financial Management Division of the Treasury Department as the government's capital market development coordinator and chair of a Capital Market Development Working Group, comprising representatives from all relevant agencies. The mandate of the working group would initially focus on outlining, prioritizing, and advocating market development activities developed within a Capital Market Development Master Plan.

Before the listing of either IFI or government bonds on the POMSoX is considered, a comprehensive review of Securities Legislation is required to clarify the roles of BPNG, the Securities Commission, and the Treasury to prevent regulatory overlaps or gaps. These efforts should include shifting the Securities Commission under a more appropriate organization, such as BPNG, and the provision of additional funding to strengthen the Securities Commission's capacity to regulate the POMSoX. The BPNG's National Payment System Development Program should also be fully implemented to ensure that the POMSoX has an effective and modern payments system that can process listed securities.

To promote secondary trading further in existing bond markets, initial efforts should focus on developing repurchase agreements and international standard documentation and guidelines; and together with other relevant players, promoting development of the interest-rate swap market. In the medium term, BPNG and the Treasury may also allow short-selling of government securities, as this benefits market liquidity and can create efficiencies in the primary market.

Conclusion

PNG's finance sector has undergone considerable changes in recent years. However, it still faces many challenges, and capital markets in particular remain underdeveloped. Further financial reform efforts could be directed towards developing the domestic currency bond market. These efforts can offer a number of benefits, including deepening domestic capital markets and reducing PNG's vulnerability to external shocks. Financial sector development can also improve the availability of financing for small and medium enterprises, which would reduce the cost of financing for government and increase PNG's attractiveness as an investment destination. Ultimately, this would improve the ability of the PNG economy to generate the type of inclusive economic growth required to achieve the development goals espoused by the Government of PNG in Vision 2050.

Lead author: Aaron Batten. This article builds on the findings of the "Domestic Bond Market Development" component of an ADB-funded technical assistance project to support public financial management in Papua New Guinea (PNG). The report on which this article is based was prepared by PDP Australia Pty Limited, the consulting firm engaged for the project, and was finalized in May 2011. The views expressed in the article are those of the author and do not represent those of ADB or PDP Australia Pty Limited.

Timor-Leste's inflation challenge

A key issue now faced by Timor-Leste's policy makers is whether government expenditure should be reduced to slow economic growth to reduce inflationary pressures. In considering this issue, it is important to understand how much of the inflation is due to strong domestic demand rather than the result of international factors beyond Timor-Leste's control.

Comparison of the prices of locally produced versus imported items can shed some light on the importance of domestic and international factors. But such comparisons have a serious limitation. Many locally produced goods compete with imported goods, and their prices tend to follow the price of imports. For example, the price of local rice tends to follow the price of imported rice (after subsidies). Further, substitution effects across commodities also affect prices. For example, if the price of imported meat rises, some consumers will switch from imported meat to local substitutes such as fresh fish, raising the price of fresh fish.

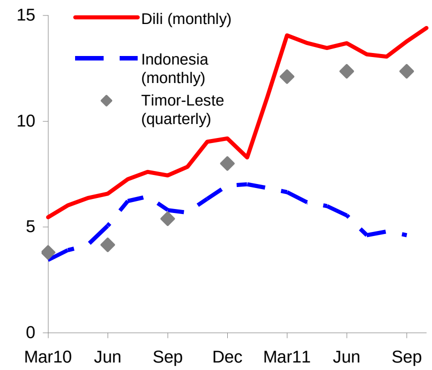
A second limitation is that imports are used to produce many locally produced items. A higher price of locally produced goods can be due to a higher price of imported inputs. The key import is fuel, which is used in the production of nearly every locally produced good. Fishing, for example, is fuel intensive, so when the price of fuel rises, so does the price of fish.

Some reassurance that inflation is largely an imported problem is provided by the recent pattern of inflation. Almost all of the inflation in 2011 has occurred in the first quarter. This can be linked to the flow through of higher world oil and food prices as well as the depreciation of the US dollar. Other contributing factors were the reduction in rice subsidies, rain during the 2010 dry season, and the increase in the electricity price. These local developments are one-offs that increase the price level, but won't cause ongoing inflation. The low additional inflation over the second and third quarters, despite strong domestic demand, gives some confidence that domestic demand is not the main problem.

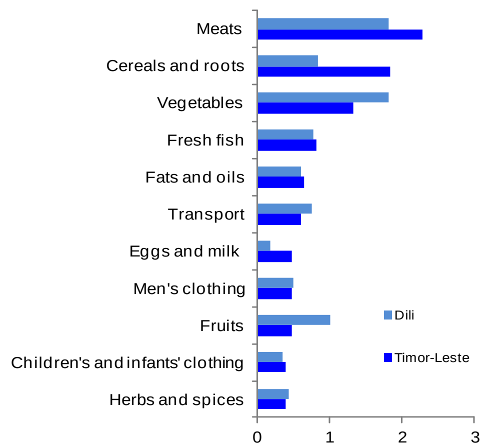
If inflation is largely an imported problem, it should now ease, mainly because world prices have eased. If, for example month-on-month inflation remained at recent levels, the annual inflation rate would be below 10% early in 2012. If inflation is instead largely caused by strong domestic demand, it will be evident in a rebuilding of the month-on-month inflation rate and high inflation across most commodities.

Close and accurate monitoring of inflation is needed to better understand the problem and formulate the best policy response. If inflation remains high and is found to be driven by strong domestic demand, it is important to explore the alternatives to slowing the economy to reduce inflation. For example, increased and better targeting of transfers on the poor can help alleviate the adverse social effects. Targeted infrastructure investment that alleviates supply bottlenecks or otherwise reduces the cost of local production can also help provide a medium to longer term solution.

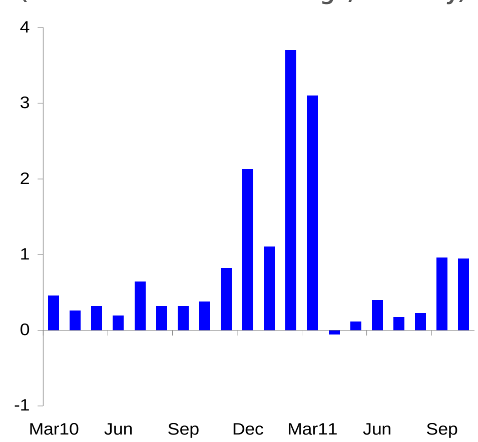
Consumer price index
(y-o-y % change)



Contributors to inflation
(contribution to y-o-y % change, Sep 2011)



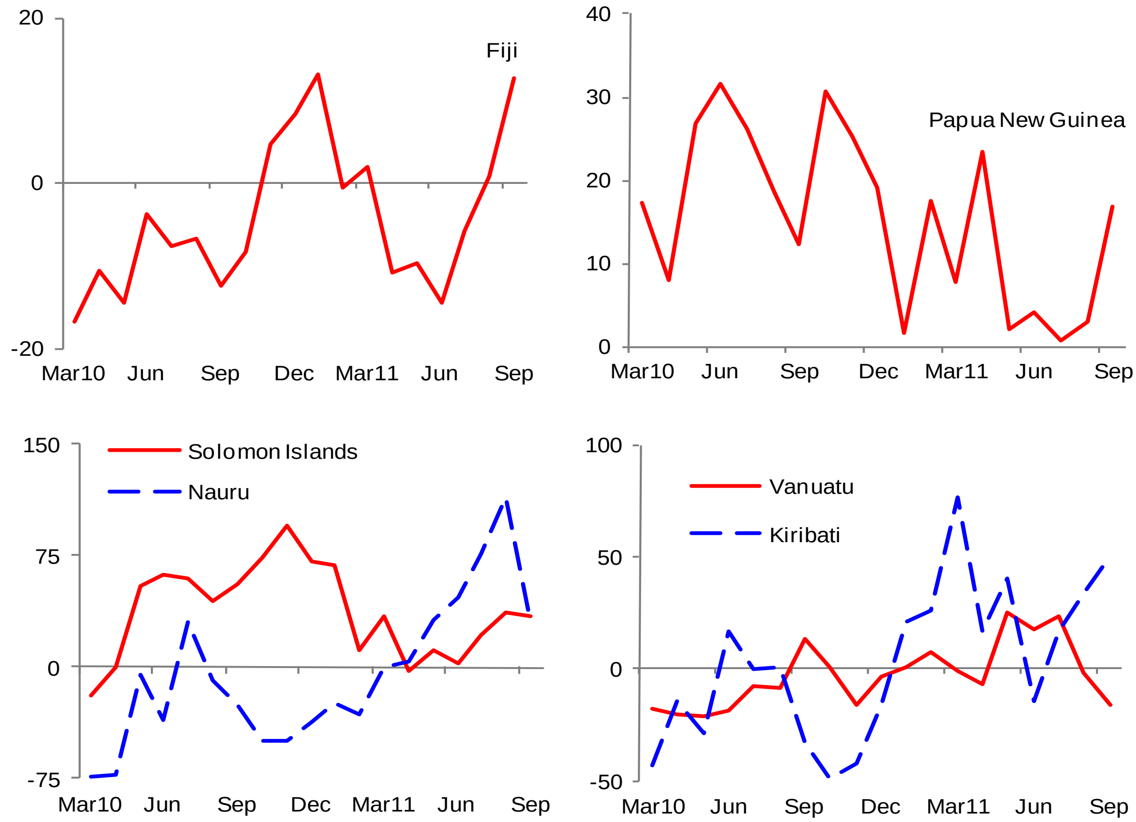
Inflation month-by-month, Dili
(month-on-month % change, monthly)



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

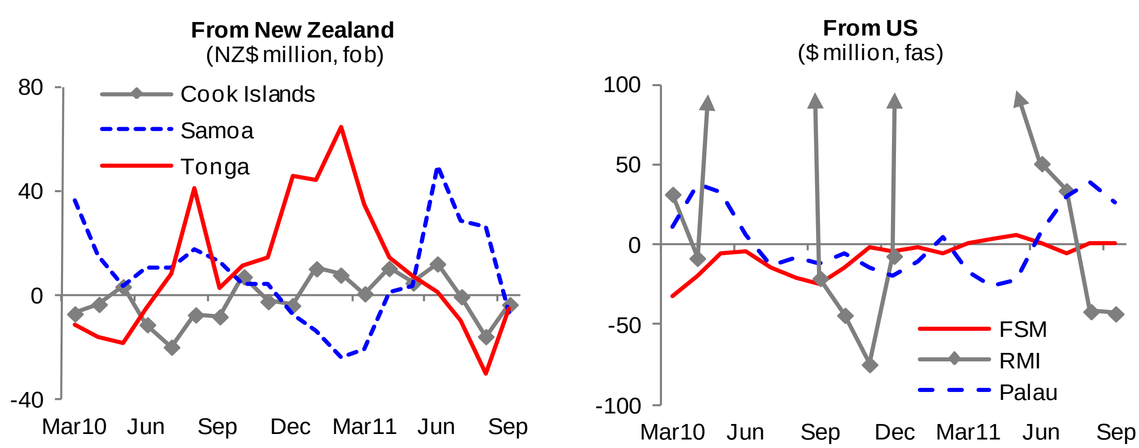
Lead author: Craig Sugden.

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



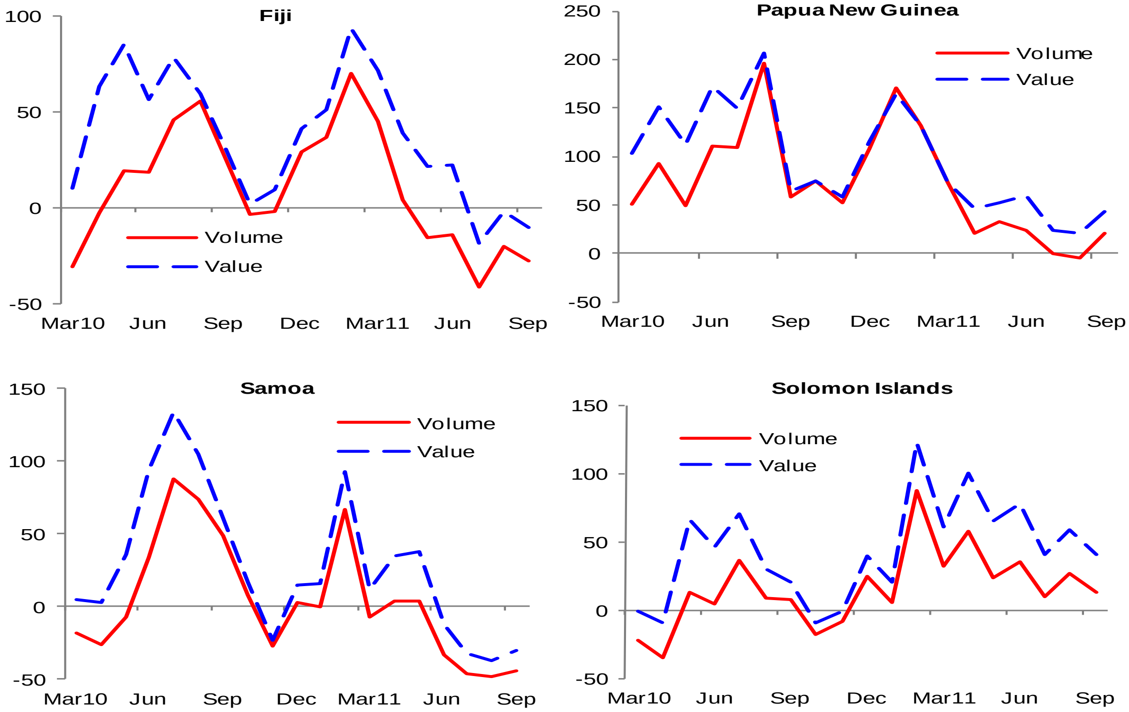
A$ = Australian dollars
Source: Australian Bureau of Statistics.

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

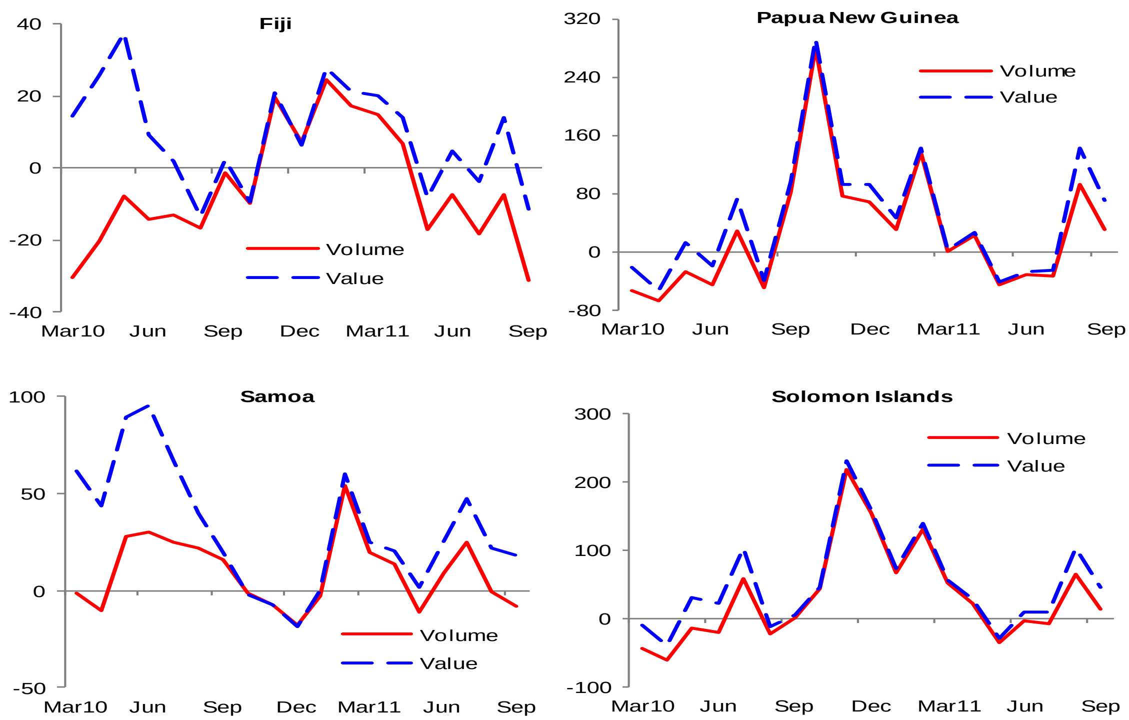


FSM=Federated States of Micronesia, fas=free alongside, fob=free on board, NZ$=New Zealand dollar, RMI=Republic of the Marshall Islands, US=United States
Note: The Cook Islands–Fiji shipping route closed in 2009.
Sources: Statistics New Zealand and US Census Bureau.

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

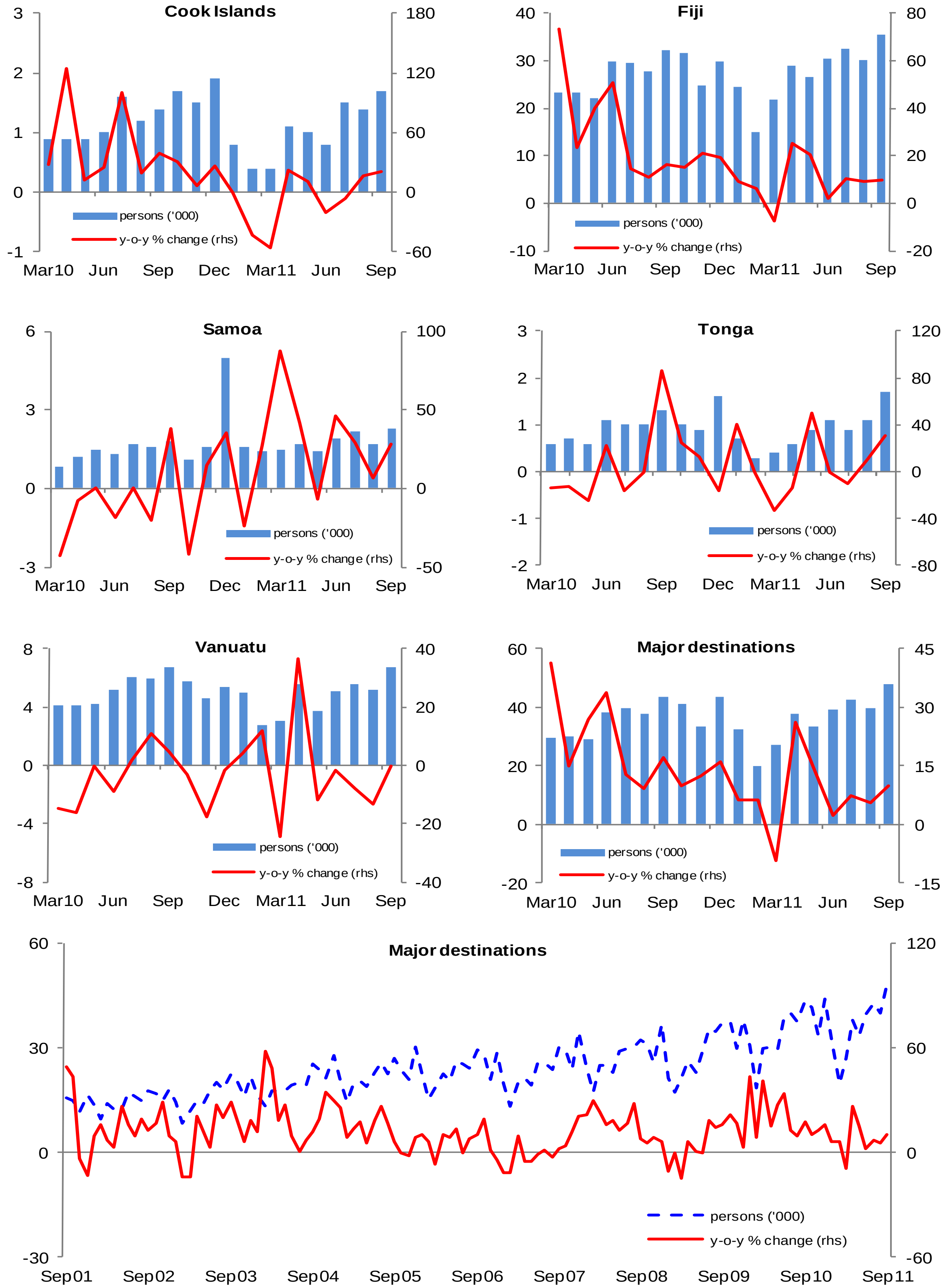


Gasoline imports from Singapore
(y-o-y % change, 3-month m.a.)



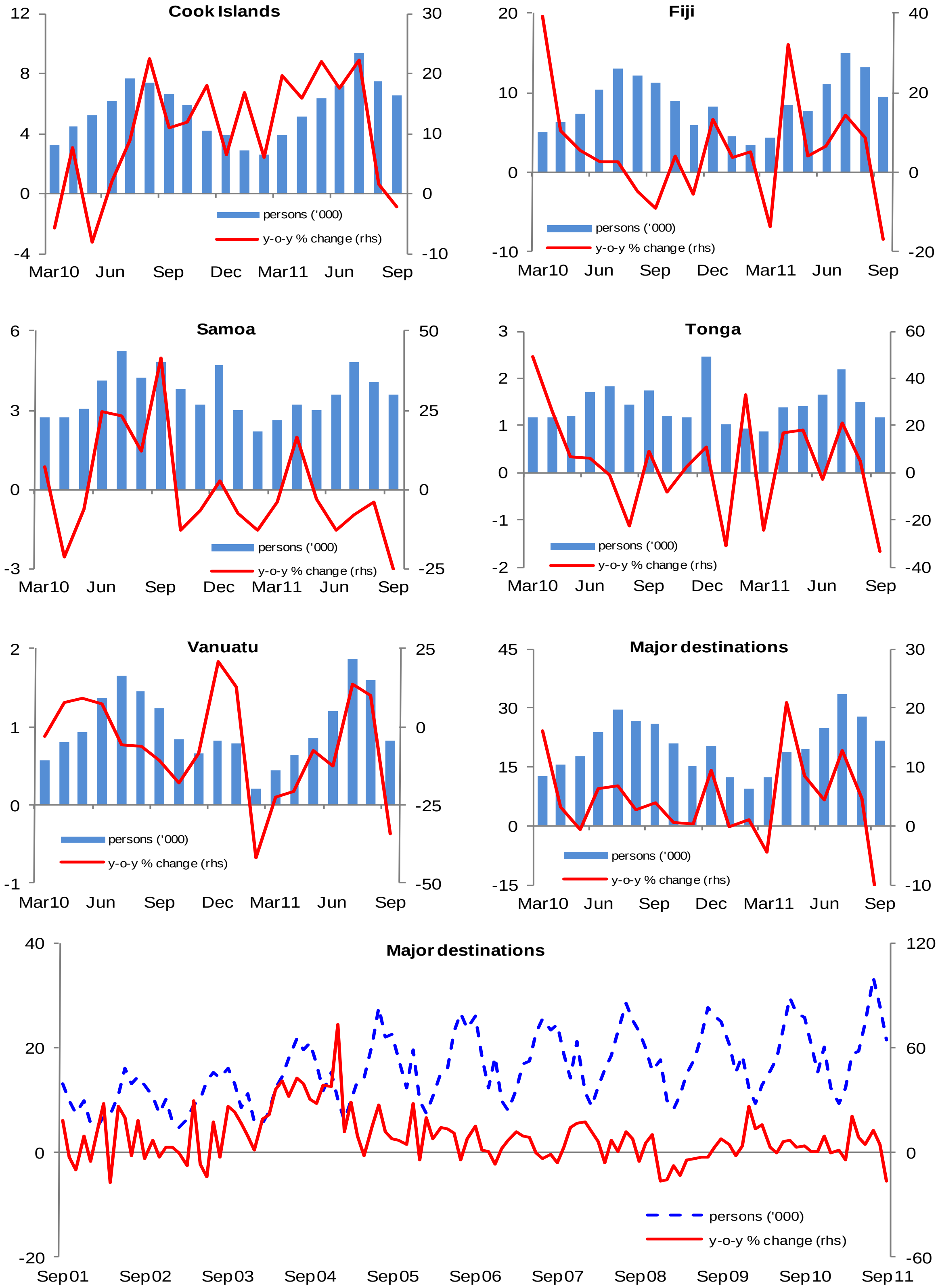
Source: International Enterprise Singapore.

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: Statistics New Zealand.

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	1.9 (Sep-Q 2011)	-4.5 (Jun-Q 2011)	-8.0 (Sep-Q 2010)	---	-1.8 (FY2011e)
Fiji	1.5	9.1 (Oct 2011)	2.4 (Jun 2011)	-26.1 (2011f)	5.1 (Oct 2011)	-3.5 (2011f)
FSM	1.0	4.0 (FY2011f)	12.6 (Dec 2009)	-46.2 (2009e)	2.7 (FY2009)	0.4 (FY2011e)
Kiribati	2.0	5.4 (2010f)	---	-42.8 (2009)	---	-15.0 (2011f)
Marshall Islands	1.0	1.6 (FY2010e)	2.1 (FY2010e)	-57.3 (FY2010e)	---	1.4 (FY2011e)
Nauru[b]	4.0	0.0 (May 2011)	---	---	---	0.6 (FY2011e)
Palau	2.0	2.5 (Jun-Q 2010)	---	-46.3 (FY2010e)	---	-1.6 (FY2011e)
PNG	8.5	9.6 (Jun-Q 2011)	11.7 (Jun 2011)	12.8 (Jan-Jun 2011)	10.5 (Jun 2011)	0.0 (2011f)
Samoa	2.1	5.1 (Aug 2011)	6.9 (Sep 2011)	0.0 (2010e)	6.1 (Aug 2011)	-8.1 (FY2011e)
Solomon Islands	7.5	8.1 (Aug 2011)	-9.2 (Sep 2011)	-1.2 (Jan-Jun 2011)	8.5 (Sep 2011)	2.1 (Jan-Aug 2011)
Timor-Leste[c]	10.0	14.4 (Oct 2011)	17.8 (Apr 2011)	-63.7 (2010e)	---	217.0 (2011f)
Tonga	1.5	6.3 (Sep 2011)	-8.4 (Sep 2011)	-30.9 (FY2011e)	8.2 (Oct 2011)	2.1 (Jul-Aug 2011)
Tuvalu	0.0	-1.0 (Mar 2011)	---	---	---	-14.0 (2011f)
Vanuatu	3.0	0.6 (Jun-Q 2010)	11.6 (Dec-Q 2010)	-31.6 (Sep-Q 2010)	6.5 (Oct 2011)	-0.7 (2011e)

--- = 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 Update*. Manila; and statistical releases of the region's central banks, finance ministries and treasuries, and statistical bureaus.

Key data sources:

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

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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