



# The Pacific

Fiji Islands  
Papua New Guinea  
Democratic Republic of Timor-Leste

Cook Islands  
Kiribati  
Republic of the Marshall Islands  
Federated States of Micronesia  
Nauru  
Republic of Palau  
Samoa  
Solomon Islands  
Tonga  
Tuvalu  
Vanuatu

# Fiji Islands

Modest growth in 2008 was achieved in the face of rising inflation and continued political uncertainty, which eroded business confidence and aid from donors. The economy is expected to contract in 2009, owing to severe flood damage early this year and the impact on tourism and remittances of the global downturn. A significant improvement in prospects depends on a return to elected government and on reforms to encourage investment.

## Economic performance

Rebounding from a 6.6% contraction in 2007, the economy grew by 1.2% in 2008 (Figure 3.32.1). An 8.7% increase in visitor arrivals in the 12 months to November contributed to the turnaround, although price discounting to attract tourists suppressed income (Figure 3.32.2). Wholesale and retail trade grew by an estimated 3.0% in 2008, hotels and restaurants by 6.0%, and transport and communications by 3.2%.

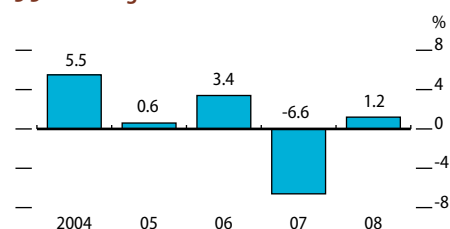
Gold (rebuilding from almost no output in 2007) and mineral-water production also rose last year. However, bad weather reduced sugar output by 7.0%, to the lowest level since 1962. Manufacturing recorded growth of just 0.9%, weighed down by the contraction in recent years of the clothing and footwear industry, which has faced an erosion of its concessional access to the Australian, New Zealand, and United States (US) markets.

This low rate of economic growth partly reflects the impact of the December 2006 military coup, which installed an interim government. In particular, lack of progress toward elections has led to a reduction in assistance from traditional donors and multilateral agencies. The European Union, for example, has approved the disbursement of only €4 million of €64 million it planned to provide as assistance for the sugar industry in 2006-2010. Moreover, business confidence slumped after the coup. Low economic growth also reflects structural problems that have constrained economic performance for two decades, hampering investment, exports, and employment creation.

The interim Government acted to moderate the inflation impact on end-users of higher world oil prices by reducing duties on fuel. Nevertheless, inflation accelerated to a 20-year high of 9.8% in September 2008 year on year, driven by rising food and fuel prices coupled with second-round effects of higher oil prices, such as on transport. Inflation decelerated to 6.6% by year-end as global oil and commodity prices declined (Figure 3.32.3), averaging 7.7% for the year.

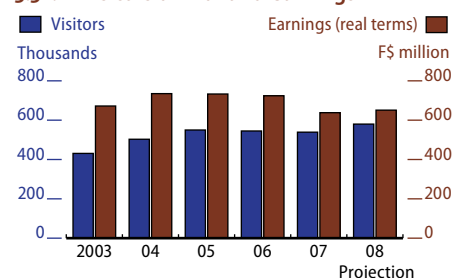
The Reserve Bank of Fiji maintained a generally firm monetary policy stance since late 2006 to protect shrinking foreign reserves and to curb inflation. Some credit restrictions were eased in 2007 and 2008. Growth of private sector credit picked up, but remained low at 4.8%.

3.32.1 GDP growth



Sources: Fiji Islands Bureau of Statistics, available: [http://www.spc.int/prism/country/fj/stats/Economic/gdp\\_summary.htm](http://www.spc.int/prism/country/fj/stats/Economic/gdp_summary.htm), downloaded 4 February 2009; Ministry of Finance and Planning, *Economic and Fiscal Update: Supplement to the 2009 Budget Address*, November 2008.

3.32.2 Visitors arrival and earnings



Source: Ministry of Finance and Planning, *Economic and Fiscal Update: Supplement to the 2009 Budget Address*, November 2008.

Global economic conditions—primarily high oil prices—added to balance-of-payments pressure in 2008 (oil accounts for about one third of the import bill). Imports rose by 26.2%, outpacing export growth of 23.1% and pushing the trade deficit out to an estimated F\$2.1 billion. The current account deficit widened to about 21.0% of GDP, from 17.3% in 2007. Official reserves fell to the equivalent of 2.7 months of imports by end-February 2009 (Figure 3.32.4).

Remittances from Fijians abroad, the biggest source of foreign exchange after tourism, fell to 3.3% of GDP in 2008 (Figure 3.32.5), continuing a downtrend from a peak in 2005. A slackening in offshore employment opportunities owing to the global economic slowdown and an appreciation of the local currency against the Australian and New Zealand dollars contributed to the decline in remittances.

An expanded capital investment program that the interim Government had planned for 2008 faced delays, reflecting a lack of project implementation capacity in some ministries. Government staffing costs, which constitute nearly half all public operating expenditure, rose by 0.9% in 2008, when pay cuts made in 2007 were partly restored. Receipts from direct taxes rose by 0.9% and from indirect taxes by 1.7%. The overall fiscal deficit for 2008 is estimated at 1.5% of GDP. General government debt as a ratio to GDP was 48% at year-end, down from 50.3% in 2007. About 85% of it is domestic debt.

The real effective exchange rate index appreciated by 1.8%, indicating a worsening in international competitiveness against major trading partners.

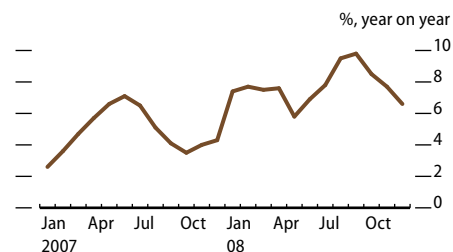
## Economic prospects

The economic slowdown in the country's main trading partners, especially Australia, Japan, New Zealand, and the United States, will put downward pressure on tourism earnings and remittances this year. Additionally, severe flooding in January this year caused about US\$60 million of damage (equivalent to 2.2% of GDP) to sugar, other crops, and livestock as well as to physical infrastructure such as roads and electricity facilities, according to preliminary official figures. Private sector losses in Nadi were estimated at over US\$160 million. Tourism facilities were generally spared, but overseas reports about the floods will have some negative impact on tourism in the early part of this year.

While reconstruction efforts will generate activity and jobs in flood-affected areas, to some extent this will be at the expense of activity elsewhere. The outcome is expected to be a GDP contraction of 0.5% this year.

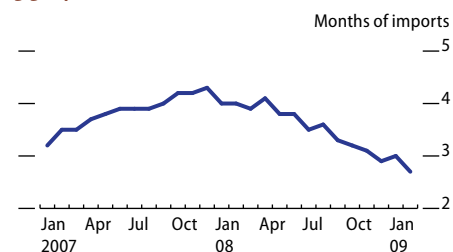
A potential positive element for the economy is an expansionary 2009 budget designed to favor growth and the poor. Planned extra spending is expected to contribute to a widening of the budget deficit to 3.0% of GDP, despite some offsetting revenue-raising measures. The focus is on development of agriculture and rural infrastructure. Government debt is projected to stay at the 2008 level, 48% of GDP. The expanded capital investment program pursued in 2008 has continued into 2009, though implementation hurdles make it unlikely that all capital spending targets will be met.

### 3.32.3 Inflation



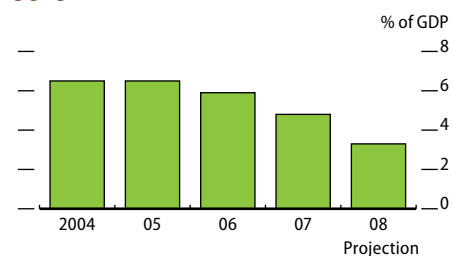
Source: Fiji Islands Bureau of Statistics, available: <http://www.spc.int/prism/country/fj/stats/>, downloaded 4 February 2009.

### 3.32.4 Reserves



Source: Reserve Bank of Fiji, *Monthly Economic Review*, various issues.

### 3.32.5 Remittances



Note: The 2008 projection is based on data to July.

Sources: Reserve Bank of Fiji, *Monthly Economic Review*, various issues; staff estimates.

Indeed, investment overall is expected to remain slack, reflecting weak business confidence, reduced access to funding from abroad, and the chronic problem of high levels of government operating expenditures (mainly the result of a large public payroll) that compress capital expenditures. Investment as a ratio to GDP has been relatively low at about 15%, and is expected to decline this year.

The trade gap is expected to widen as external demand weakens. This will exert further pressure on foreign reserves, which are already low. The current account deficit is projected at about 25% of GDP in 2009 and 2010, reflecting the deterioration in merchandise trade and reduced transfer payments. Inflation is forecast to fall to 4.5% in 2009, given weaker global prices of oil and other commodities.

GDP growth is expected to resume at a low level of 0.2% in 2010, if trading-partner economies start to recover as assumed. The economic outlook also heavily depends on the interim administration holding national elections. Not only does this have a bearing on business confidence, it is integral to accessing European Union funds for much-needed sugar reforms, as well as grant funds from Australia and New Zealand. In late 2008, the interim prime minister stated that there would be no elections in 2009. Responding to this, leaders of Pacific Islands Forum member countries meeting in late January this year announced that Fiji Islands' representatives would be excluded from Forum activities, and that other sanctions might be imposed unless a 2009 election date were announced by 1 May.

## Development challenges

There are indications that the incidence of poverty is rising, a result of long-term declines in the sugar and clothing industries, the impact of several coups, and, more recently, external shocks that raised food and fuel prices and further undermined growth. Over 25% of the population have incomes below a basic needs poverty line. Pockets of deep poverty are found in town squatter settlements and more widespread poverty is apparent in rural areas. Much of the poverty reflects poor housing and lack of access to health and education services. The country has, in fact, a very low incidence of hunger and malnutrition.

Economic performance has been lackluster for some time: GDP growth averaged 1.7% in the 10 years to 2007 (1.2% on a per capita basis). Investment is discouraged by political instability (with four coups since May 1987), a cumbersome regulatory and tax environment, and weaknesses in property rights.

Sustainable growth is likely to require a better climate for private-sector development so as to generate jobs and exports. The interim Government is offering tax incentives in an effort to attract investment in export industries. But this move does not address the fundamental constraints and it risks weakening the fiscal position, particularly if it leads to demands for tax breaks by other industries, and if other countries undercut the incentives by offering similar or more generous concessions.

### 3.32.1 Selected economic indicators (%)

	2009	2010
GDP growth	-0.5	0.2
Inflation	4.5	4.5
Current account balance (share of GDP)	-25.0	-25.0

Source: Staff estimates.

# Papua New Guinea

Booming commodity prices underpinned growth in the economy and in government revenue in recent years. GDP growth accelerated a little in 2008, and inflation shot up. The plunge in global commodity prices is expected to pull down growth this year, and inflation is likely to moderate. The Government can draw on savings made in the boom years to support its spending, but also needs to put a higher priority on infrastructure investment and extending basic services.

## Economic performance

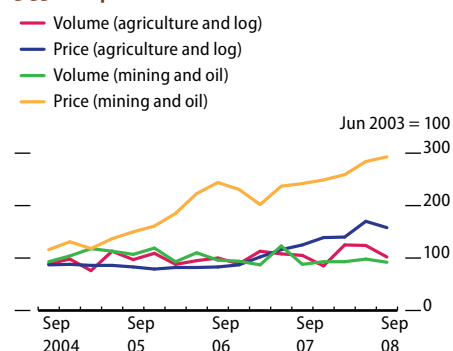
A country with crude oil, metals, and agricultural commodities, Papua New Guinea continued the trend of earlier years to perform strongly in the first half of 2008 on the back of high world commodity prices. GDP growth for the year accelerated to an estimated 7.2%, the highest for over a decade. It was fairly broad-based: services grew by an estimated 9.2%, industry by 7.8%, and agriculture by about 5.0%. This outturn was achieved despite a slowdown in crude oil production, which reflected the gradual depletion of established oil fields.

Strong gains in government revenue during the global commodities boom allowed for a 3% increase in real public expenditure in 2008. Private spending also continued to rise as incomes moved higher, along with commodity prices. Improved business confidence, supported by political and fiscal stability, helped sustain private investment. Expansion of mobile communications (after deregulation of the industry), of construction, and of new mining projects all made solid contributions to GDP growth.

Merchandise exports in nominal US dollar terms rose by 22.9% in 2008, largely driven by higher prices for export commodities (Figure 3.33.1). Mining (mainly copper and gold) and crude oil exports together rose by an estimated 21% in United States (US) dollars (Figure 3.33.2), despite a contraction of about 4% in volumes. The value of oil exports jumped by about 26%, with price increases outweighing a 20% volume contraction. Agricultural exports climbed by almost 30% in 2008. Strong performances were recorded in shipments of palm oil (44%), coffee (37%), cocoa (139%) and copra oil (98%). Export growth is estimated to have more than offset a 13.7% rise in imports, and the trade surplus increased to \$2.8 billion. The current account recorded a surplus of about \$700 million, equivalent to 8.7% of GDP.

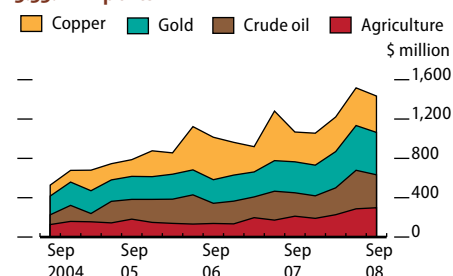
Employment in the private formal sector increased by around 10% in the 12 months to June 2008. However, this accounts for only a small share of the labor force. The cash economy employs only around one fifth of the population. Many people are farmers who produce mainly for their own

3.33.1 Export indexes



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, various issues.

3.33.2 Exports



Source: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, various issues.

consumption, with some cash-crop production of products such as cocoa, copra, and coffee.

Since 2005, the Government has set aside some of its windfall revenue generated during the commodity price boom in “additional investment/priority expenditure” trust funds. The aim is to avoid unsustainable and inflationary increases in recurrent spending and to smooth outlays on social and infrastructure projects during the commodity cycle. By end-2008, trust fund accounts were valued at the equivalent of about 22% of GDP. Contrary to international standards, which treat such new deposits as saving, the budget records them as off budget items, an approach that led to a budget that was roughly in balance last year. Using international norms would have resulted in a budget surplus of almost 12% of GDP (Figures 3.33.3 and 3.33.4). The Government has raised repayments on its debt, lowering gross government debt to an estimated 29% of GDP by end-2008, or less than half the 2002 ratio. The ratio of external public debt to GDP declined to 13.0% in 2008.

Inflation accelerated last year to peak at 13.5% in the third quarter (year on year). The causes were strong growth in money supply and credit; higher costs of fuel, transport, and food staples; increased government spending; and shortages of rental properties and skilled labor. Average inflation was 10.8%, compared with just 0.9% in 2007.

The Bank of Papua New Guinea raised its monetary policy indicator rate in response to rising inflation. Still, lending to the private sector in 2008 rose by an estimated 40% and the money supply by 11.2%. The annual average kina exchange rate appreciated by 10.0% against the US dollar and by 11.4% against the Australian dollar.

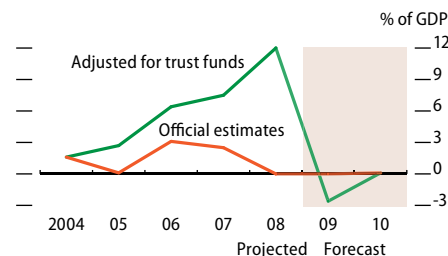
The global slump deepened in the fourth quarter and checked the growth of both export income and government revenue, though to what extent is not yet clear. Gross foreign exchange reserves fell from a historical high of about \$2.7 billion in August 2008 to just over \$2.0 billion by year-end (equal to about 11 months of imports of goods and services) as foreign exchange inflows from exports declined.

## Economic prospects

GDP growth is expected to moderate to about 4.0% in 2009 and 3.5% in 2010 (Figure 3.33.5), as the global economic downturn erodes exports and government revenue, leading to reductions in commodity production, weaker growth in incomes, and generally softer domestic demand. Crude oil production is seen declining further, but mining output should be supported by the Hidden Valley gold mine, which is scheduled to start production in the middle of this year, and the Ramu nickel mine, which is expected to reach full capacity next year.

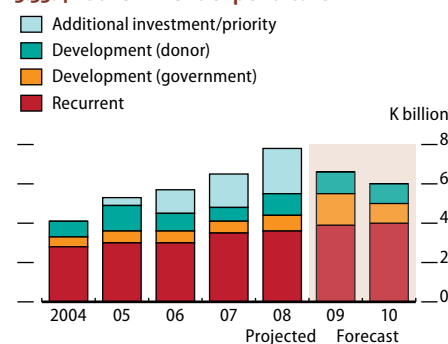
A large liquefied natural gas export project to cost about \$12 billion is in the engineering and design stage. If the Government and energy companies involved make final decisions to proceed with the project, it could start production in 2013, and increase GDP by about 20% over its lifetime. Business confidence is likely to be underpinned by expectations that the project will go ahead. Nevertheless, construction activity overall is expected to slow this year and next, in part because many construction firms are operating at near full capacity.

### 3.33.3 Budget balance



Sources: Department of Treasury, 2009 Budget, Volume 1; staff estimates.

### 3.33.4 Government expenditure



Note: Data refer to 2004 prices.

Source: Department of Treasury, 2009 Budget, Volume 1.

### 3.33.1 Selected economic indicators (%)

	2009	2010
GDP growth	4.0	3.5
Inflation	7.0	6.0
Current account balance (share of GDP)	-7.0	-6.0

Source: Staff estimates.

The plunge in international prices of copper, crude oil, and many agricultural commodities, and the expected reduction in their production, will cause the value of exports to fall from 2008. Furthermore, severe flooding in the Highlands region in February and March 2009 will damage coffee and tea production, which usually peaks between March and June.

Merchandise imports will also decline as domestic demand softens. The trade surplus is expected to decline and the current account to tip into deficit, equivalent to 7.0% of GDP this year and 6.0% in 2010 (Figure 3.33.6).

Commodity prices for most of PNG's main exports have fallen further since the Government approved its 2009 budget in November 2008, further suppressing revenues. At the same time, expenditures are to remain elevated, with support from withdrawals from trust funds. The budget deficit is expected to be at least 3% of GDP this year.

Bank lending to the private sector ramped up during the commodity boom (Figure 3.33.7), and the quality of these loans could deteriorate as the economy slows. With this in mind, the banks will likely take a more cautious stance on lending, tightening credit and making it more expensive. Given the drop in mining and energy profitability, major projects that depend on foreign investment also face higher borrowing costs in global markets, as well as a more difficult environment for equity investment.

Inflation is projected to slow to around 7.0% in the forecast period (Figure 3.33.8). Falls in import prices of fuel, flour, and other commodities will trim inflation, but this will be somewhat offset by upward pressures generated by continued high levels of public spending, capacity constraints in construction, and short supply of rental housing. The central bank is unlikely to ease its monetary stance until it is sure inflation is coming down.

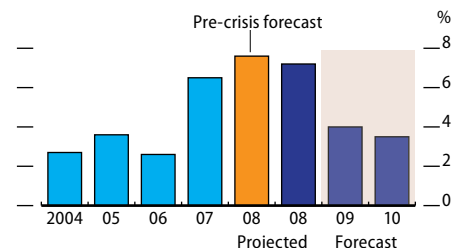
Foreign exchange reserves are expected to decline but are sufficient to enable the central bank to smooth any excess volatility in the exchange rates.

## Development challenges

Public infrastructure continues to deteriorate in many parts of the country. The Government faces a critical need to manage fiscal savings from recent years and to use them to improve infrastructure and basic service delivery, as outlined in its medium-term development strategy. A related challenge for the Government is to manage public expectations that overall public expenditure can continue to rise quickly. Public financial management systems will be severely tested during the adjustment to more austere fiscal conditions.

Efforts to increase the level of real development expenditure have been hampered by a lack of skilled staff to plan and implement projects, especially at local level. The Government has sharply raised its grants for development spending to K14 million (\$4.8 million) for each of the country's 89 districts. The capacity of local government to administer and effectively implement projects will need to be significantly enhanced if increased expenditure is to be translated to improved public service

### 3.33.5 Real GDP growth



Note: The fiscal position excludes the Fund for Reconstruction and Development.

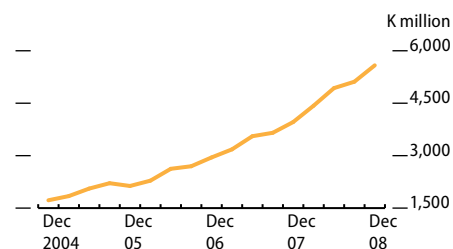
Sources: Department of Treasury, 2009 Budget, Volume 1; staff estimates.

### 3.33.6 Current account balance



Source: Department of Treasury, 2009 Budget, Volume 1.

### 3.33.7 Lending to the private sector



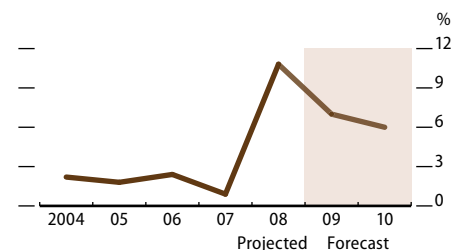
Source: Bank of Papua New Guinea, Quarterly Economic Bulletin, various issues.

delivery. More broadly, increased investment in human and physical capital is needed to equip people with skills, provide basic services, and reduce the very high poverty incidence.

It will be important for the Government to pursue reforms to state-owned enterprises by increasing accountability, strengthening governance, and opening to competition those facilities dominated by the public sector, such as air and sea ports and electricity. Potential gains have been highlighted by the opening of the formerly government-owned mobile telephone sector. This resulted in notable improvements in phone services in rural areas. There are also promising signs in aviation, where consumers now benefit from lower international airfares offered on some routes by a competitor to the national carrier.

The Government last November approved a policy framework that paves the way for increased private sector participation in the economy through a greater role in public service delivery, such as physical infrastructure and health services. It will now draft laws and regulations and prepare a list of projects for public-private partnerships. Placing greater reliance on private sector development will require complementary efforts to improve the business environment. The World Bank's *Doing Business 2009* report ranks Papua New Guinea 95 overall in a list of 181 countries, but much lower on issues including enforcement of contracts and access to credit.

### 3.33.8 Inflation



Sources: Bank of Papua New Guinea, *Quarterly Economic Bulletin*, various issues; staff estimates.

# Democratic Republic of Timor-Leste

A large expansion in government expenditure and increased agriculture production lifted economic growth to an estimated 10% in 2008. Public spending, funded by revenue from offshore petroleum production, will continue to rise this year and keep economic growth high. Inflation is expected to ease. However, a rise in poverty points to the need for better targeted government spending to address a lack of basic services and rural underdevelopment.

## Economic performance

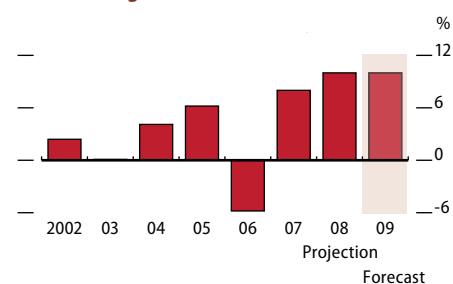
Expansion of public spending programs funded by revenue from offshore petroleum production spurred the economy in 2008. Actual government expenditure more than doubled from 2007 to reach an estimated \$450 million. This lifted the ratio of government expenditure to GDP to the order of 100%, excluding petroleum and the United Nations (UN) contribution to government operations.

About 2,000 international security and police personnel are still in Timor-Leste, under the auspices of the UN, to support law and order following outbreaks of civil unrest, including extensive unrest in 2006 and attacks on the president and prime minister in early 2008. These international forces, combined with civilian support and a large donor presence, provide an important source of demand in the economy. Economic activity was also supported over the year by an improved political and security situation, one that, though generally calm, remains fragile.

Agriculture, which accounts for about 85% of employment, recovered after being hit in 2007 by bad weather. An increase in the harvested area saw rice production rise by 21% such that it met about 40% of annual requirements (100,000 metric tons). The public sector accounts for around half the employment outside agriculture. Wholesale and retail trading and other private services (petroleum operations are entirely offshore), engage much of the rest of the working population. Non-petroleum, non-UN GDP grew by an estimated 10% in 2008 (Figure 3.34.1).

From 8.9% in 2007, inflation eased to average 7.6% last year, when domestic food shortages caused by the bad weather pushed food prices higher. The surge in international commodity prices in 2008 propelled inflation to as high as 10.6% in June, year on year (Figure 3.34.2). Inflation then eased as the international price of crude oil and other commodities declined. The Government increased subsidies for imported rice in 2008, and this suppressed the impact of higher international food prices (Figure 3.34.3). Nevertheless, around half inflation last year was attributable to higher food prices (food accounts for 58% of the consumer

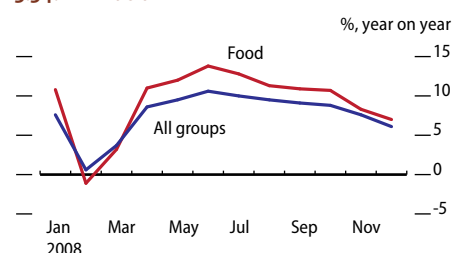
3.34.1 GDP growth



Note: Non-petroleum, non-UN GDP.

Sources: Government of Timor-Leste, *General Budget of State 2006–07 and 2008*.

3.34.2 Inflation



Source: Timor-Leste National Directorate of Statistics, *Consumer Price Index December Quarter 2008*.

price index). Most of the increase in food prices was in turn a result of higher prices of rice, corn, and other cereals, as well as cassava and other root crops.

Strong growth in domestic demand was evident in a large rise in imports. Merchandise imports rose from \$68.6 million in the first half of 2007 to \$89.9 million in the first half of 2008. Excluding the offshore petroleum operations, merchandise exports (mainly coffee) are a small fraction of imports. Even after a bumper coffee harvest last year, merchandise exports totaled just \$11.6 million in 2008.

Loans and advances by commercial banks leveled off in 2008, suggesting slower growth in private business activity (Figure 3.34.4). Broad money supply rose by 33.1% as the international forces increased deposits with the banking system. The shortage of lending opportunities saw the commercial banks' liquid asset ratio rise to 79.4% by end-2008 from 71.3% a year earlier. Nonperforming loans remain a problem for the banks, even though their ratio to total loans eased to 28.2% by end-2008 from 30.2% at end-2007.

Access to microfinance remained low, and was largely limited to loans secured by public sector salaries. This gap hampers development of agribusiness, in particular, because loans are not generally available for the purchase of rural products. The poor pay very high rates of interest to money lenders, estimated at up to 25% a month.

The Government made transfer payments totaling around \$100 million in 2008. These included subsidies for the aged and the vulnerable, pensions for former public office holders, and pensions for ex-combatants. It also paid people to return to their villages from temporary camps (more than 10% of the population was displaced by the 2006 violence). These payments supported consumption and helped achieve civil stability. However, outbreaks of civil strife remain a risk, as highlighted by heightened tension following the serious wounding of the president in a February 2008 attack.

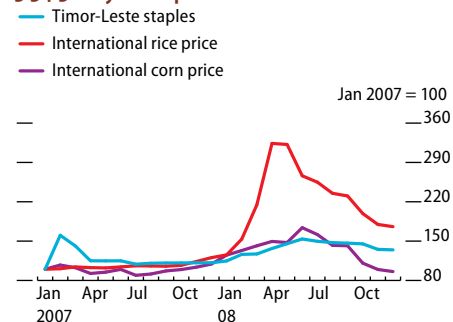
## Economic prospects

The economy will remain dominated by government activities over the medium term. Almost all the Government's own revenue is drawn from the Petroleum Fund, which receives income from the nation's offshore petroleum production. The Petroleum Fund more than doubled in value to an estimated \$4.2 billion by end-2008, almost all invested in United States (US) government securities. The use of the US dollar as the national currency protected Timor-Leste from adverse exchange rate effects.

Prior to 2008, drawdowns from the Petroleum Fund were limited to its "sustainable income," so that the Fund's capital would be sustained indefinitely. The Government budgeted to draw down more than the sustainable income in 2008, a decision that led to intense political debate. While the actual drawdown did ultimately match the end-year estimate of sustainable income, budgeted drawdowns for 2009 and 2010 are well above the sustainable income.

The 2009 budget increases government expenditure to \$902 million, almost double the 2008 estimate of non-petroleum, non-UN GDP. Much of the additional expenditure is for imported goods (including

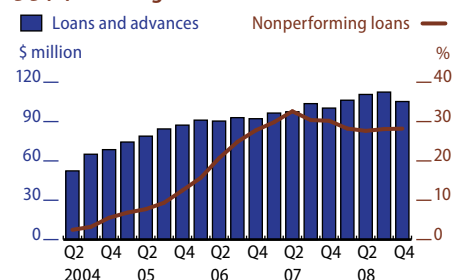
### 3.34.3 Key food prices



Note: Timor-Leste price index for cereals, roots, and their products; Bangkok rice price; and US (gulf ports) corn price shown.

Sources: Timor-Leste National Directorate of Statistics, *Consumer Price Index December 2008*; International Monetary Fund, *International Financial Statistics* online database, downloaded 4 February 2009.

### 3.34.4 Lending indicators



Source: Banking and Payments Authority.

#### 3.34.1 Selected economic indicators (%)

	2009	2010
GDP growth	10.0	8.0
Inflation	7.1	6.5
Current account balance (share of GDP)	-	-

Source: Staff estimates.

capital goods) and services, and so there will only be a muted effect on GDP growth. The most direct impact on the economy will be from a further increase in public sector wages and salaries, which have almost tripled over 3 years. The Government also plans substantial spending on electrification (Box 3.34.1).

Non-petroleum, non-UN GDP is expected to grow by a further 10% in 2009, supported by a February 2009 decision of the UN Security Council to extend for at least 12 more months to February 2010 the UN Mission and international security presence. Nevertheless, civil unrest remains a downside risk for growth over the medium term. GDP growth is expected to ease in 2010 as budgeted declines in government expenditure feed through the economy (Figure 3.34.5). The actual outcome will rest on budget disbursement rates, which have been low (but increasing) in recent years because of difficulties in project planning and delays in procurement. Inflation is expected to ease in the forecast period to about 7.1% in 2009 and 6.5% 2010, as global food price inflation slows from 2008 levels.

## Development challenges

The positive outlook for key economic aggregates masks deep poverty. The share of the population living below the poverty line increased from about 36% in 2001 to about 50% in 2007, according to the nation's second poverty study. Poverty is largely a rural problem (three quarters of the poor live in rural areas), although its incidence also is rising in towns. The Food and Agriculture Organization and World Food Programme have estimated that 30% of the population, for at least 2 months each year, lives on a diet that is insufficient to meet basic human needs. Food shortages arise from low agricultural output, high post-harvest cereal losses (up to 90% in upland corn), distortionary food subsidies, limited market access, and the very few alternative means of earning incomes in rural areas.

Low rural incomes, high population growth rates, rapid urbanization, and the after-effects of civil unrest are major challenges. The quality of government expenditure will be central to responding to them and to setting Timor-Leste's development path. The expansion in expenditure now under way has the potential to share the rapidly accumulating financial wealth with the population. Well-managed spending can generate additional wealth by converting low-return savings in financial instruments into high-return investments in human and physical capital.

More could be done to raise development returns from public expenditure. For example, the subsidization of imported rice shielded many people from rising international prices, but it also suppressed prices received by domestic growers. This damped a much-needed supply response from farmers, and consequently held down growth in their incomes.

Furthermore, the subsidies benefit the better-off more than the poor, as the better-off consume more rice and the poor rely more on corn and cassava. A government decision to hold 2 years of rice imports in storage as a buffer against price hikes will have similar side-effects, suppressing farm production and rural incomes. One alternative would be cash transfers to the poor. This approach would enable them to buy rice when the price rises and to pass on to farmers the benefit of the higher prices.

### 3.34.1 Electrification

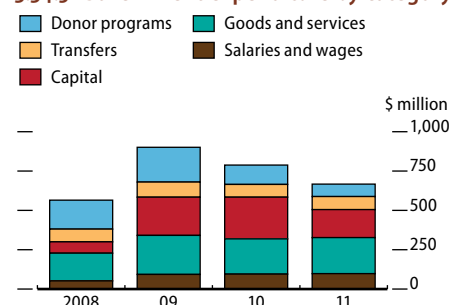
More than half the \$616 million capital expenditure budgeted in 2009–2012 is to be spent on building power stations fueled by imported oil to electrify urban (and later rural) areas. The Government has contracted to install 180 megawatts (MW) in generating capacity by end-2010, with supporting transmission and distribution lines. This represents a very large increase on current capacity of 40 MW.

This electrification program was announced in mid-2008 and the contracts were signed by year-end. A longer preparation phase would have been helpful to allow a fuller consideration of development issues involved.

A key issue is whether the supply expansion will outstrip demand—a 2004 power sector study found the country needed 50–100 MW of additional capacity by 2025 to lift the electrification rate to 80% from 20%. Another issue is whether electrification should be such a high budget priority.

Electricity is a service that can be at least partly self-funded from user charges. But because services such as law and order, road maintenance, and education and health services for the poor generally cannot be self-funded, they are the priority for budget resources.

### 3.34.5 Government expenditure by category



Sources: Government of Timor-Leste, *General Budget of State 2006-07 and 2008*; Directorate of Treasury, Ministry of Planning and Finance, *Democratic Republic of Timor-Leste Annual Financial Report and Accounts 2005-06 and 2006-07*; staff estimates.

## Small Pacific countries

Global influences are buffeting these 11 small Pacific economies. Rising prices for imported food and fuel in the first half of 2008 suppressed consumption spending and pushed up inflation in many of them. The global economic slowdown started to curtail tourism and remittance inflows, and erode prices of export commodities, while the global financial crisis is slashing the value of investments held in trust funds by some of the countries. Growth slowed, or output contracted, in about half the economies last year. The rest grew a little faster than in the previous year. In 2009, most are forecast to record slower growth, or a contraction in GDP. Inflation accelerated in all the countries in 2008, and to double-digit rates in five of them, but is expected to ease this year.

Box 3.35.1 discusses the impact of the global financial crisis and the economic downturn on the Pacific economies.

### Cook Islands

Hurt by a 3.0% decline in visitor arrivals, the economy grew by an estimated 1.1% in 2008 (Figure 3.35.1). Tourism is the main industry—annual visitor arrivals of around 100,000 compare to a resident population of around 15,000 persons. The decline in tourist arrivals was concentrated in visitors from Canada, Europe, and the United States (US), the high-spending segments of the market. Arrivals from New Zealand, the main source of tourists, rose by 3.3%.

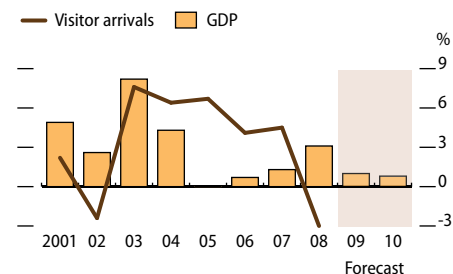
Investment in tourism has driven the economy since the mid-1990s, but it tapered off last year. The number of available room nights flattened out, after recording growth of 4.6% in 2006 and 9.2% in 2007. A government policy allowing 100% tax deductibility for capital expenditure ended in 2008, and that appears to partly account for the slowdown in such investment.

Merchandise exports, mainly fresh fish and pearls, continued to weaken and are now less than 5% of the estimated value of tourism expenditure. The loss of one of only two shipping services to the country also contributed to the weak economic performance by suppressing consumer expenditure.

Inflation peaked at 11.8% year on year in the third quarter of 2008 and eased to 9.2% in the fourth. The annual average inflation rate of 7.8% was well above the 2.5% recorded in 2007, and was driven by higher prices for food, fuel, electricity, and greater household rents and mortgage costs.

The fiscal balance deteriorated in FY2008 (ended 30 June 2008) as the operating surplus declined (Figure 3.35.2). This was largely a result of a further increase in the Government's wage and salary bill, following cost-of-living adjustments and an expansion in public employment. The

3.35.1 Growth in GDP and visitor arrivals, Cook Islands



Sources: Cook Islands Statistics Office: *Annual Statistical Bulletin 2008* and online database, downloaded 12 February 2009; staff estimates.

### 3.35.1 The impact of the global slowdown on the Pacific

The global economic slowdown and financial crisis have hurt Pacific economies in several ways. Commodity exporters have suffered a drop in export income and government revenue because of lower world commodity prices. Countries with trust funds invested in international financial markets have seen the value of their funds drop, which will likely reduce income streams to national budgets. Some economies rely heavily on income from tourism or remittances, sometimes both, and they are expected to weaken as many of the source countries—generally the wealthy Pacific Rim nations—are in recession. International funding for new projects, particularly those involving commodities and energy, will be more expensive or even unobtainable.

Export prices for producers of agricultural and mining commodities and energy (notably Papua New Guinea, Solomon Islands, and Timor-Leste) have dropped, and export volumes of some commodities are likely to fall in 2009. Governments in Papua New Guinea and Timor-Leste saved some of their surging revenue flows during the commodity boom, which will help to support public spending and their economies through this period of lower commodity prices. But Solomon Islands lacks this cushion, and faces a rapid decline in output of logs, its major export.

Several Pacific economies—Kiribati, Marshall Islands, Federated States of Micronesia, Palau, Timor-Leste, and Tuvalu—have substantial public savings invested in offshore financial markets. The value of most of these funds has plunged, in tandem with the markets.

(Timor-Leste's fund is invested mainly in US Government securities, so it weathered the global financial crisis.) So far, governments do not appear to have reduced public spending to compensate. Kiribati and Tuvalu in particular need to trim government spending quickly so as to match the decline in the value of their offshore investments. The longer this adjustment is deferred, the greater the overall impact of the global slump is likely to be.

Economies that rely on tourism or on remittances from workers abroad, or both, are likely to see little growth or declines in earnings from these sources. Tourist departures to the north Pacific from Asia and the United States have already fallen by about 10% in 2008. Palau, which relies on tourists from Japan and Taipei, China (both in recession), has experienced a decline in tourism, despite a heavy marketing effort in Japan. Tourist numbers to Cook Islands, Samoa, and Tonga are likely to fall in 2009, given recession in New Zealand (an important source for their tourist businesses), while Fiji Islands and Vanuatu come up against expected subdued growth, at best, in tourist arrivals from Australia.

As for remittances, the United States and New Zealand labor markets, two of the three key sources for Pacific countries, weakened early in 2008 and Australia, the third, has since followed. The deterioration in these three sources suggests that the decline in the real value of remittances to the Pacific seen in 2008 will become more pronounced in 2009. Samoa and Tonga are the most exposed, followed by Fiji Islands and Federated States of Micronesia.

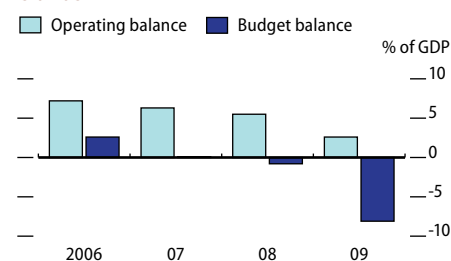
Government, recognizing that this bill is approaching unsustainable levels, has frozen public service employment.

A large fiscal deficit is budgeted for FY2009; capital expenditure has expanded while collections of value-added and income taxes have declined. The Government has secured a loan equivalent to about 4% of GDP from the People's Republic of China (PRC) to build a new headquarters for the Ministry of Education and a new sports stadium. Avatiu harbor and Rarotonga airport will be upgraded and the Government is considering buying fuel tank farms in an effort to create a public monopoly, which it hopes will lower the price of fuel.

Recurrent costs are also rising. The Government has budgeted for an NZ\$3 million economic stimulus package to provide subsidized loans to businesses, and will continue to subsidize a direct air route to the United States, with the budget provision equivalent to 1.5% of GDP this fiscal year, twice that of last year.

Growth is expected to remain low. Tourism to the Pacific from New Zealand showed signs of slowing late in 2008 as that economy contracted. A number of special events scheduled for 2009 (a mini-South Pacific Games and a world youth netball championship), as well as the proposed

3.35.2 Government fiscal position, Cook Islands



Sources: Government of Cook Islands, *Appropriation Bills*, various issues; staff estimates.

public construction projects, are expected to support GDP growth of 1.0% in 2009.

As the Cook Islands uses the New Zealand dollar as its domestic currency, inflation is expected to ease this year to 5.1% as recession pulls down inflation in New Zealand.

An increase in productivity, which was achieved after reforms in the mid-1990s, appears to have dissipated, and follow-on reforms have not been pursued. Moreover, capital accumulation has slowed because of tighter restrictions on foreign investment. New efforts are required if economic growth is to return to moderate levels. The initial priorities are to follow through on plans to contract out the operation of the fuel tank farms that the Government plans to buy and to ensure that government contracts that involve subsidies are open to competitive bidding. Over time, it will be important to reduce the size of the public service and the overall cost of government, to privatize state enterprises, and to improve tourism infrastructure on Rarotonga and Aitutaki.

## Kiribati

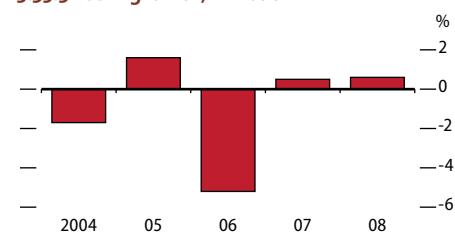
This economy is dominated by a large public sector that provides two thirds of all paid employment and close to half the GDP. Almost half of national income comes from external sources, predominantly fishing license fees, seafarers' remittances, development assistance, and revenue from the country's Revenue Equalisation Reserve Fund (RERF), an offshore investment fund. GDP grew by an estimated 0.6% in 2008 (Figure 3.35.3), supported by high levels of government expenditure.

Reflecting higher global oil prices, the fuel import bill climbed to an estimated A\$27 million, representing an increase over 4 years of the equivalent of 15% of GDP; during the same period the cost of imported food grew by the equivalent of around 5% of GDP. Not all the rises in fuel costs were passed on to consumers, and instead were partly covered through higher subsidies, borrowing by state enterprises, and a grant of fuel from Japan. A government restriction on the profit margin allowed on rice sales; and a grant of rice from Taipei, China helped limit the rise in rice prices. Still, inflation was about 20% at year-end.

The market value of the RERF, the key source of government income, fell by an estimated 20% last year, along with the slump in global financial markets. Drawdowns from the RERF to fund the budget deficit (about A\$40 million was taken out in 2008) are unsustainably high and spending cuts are required to reduce the drain on the fund. In addition, revenue from fishing licenses dropped by 22% in 2005–2007 compared with 2002–2004. The outlook is poor for these fees owing to governance shortcomings that put the commercial viability of fish stocks at risk. Further, the year-on-year variation in license earnings is unpredictable, because of the migratory nature of the fish stock and the influence of climate on fish migration.

Remittances, though, have been fairly stable at around US\$8 million a year, though their local-currency value fluctuates. The weak global economic outlook suggests that employment for seafarers will be curtailed in 2009–2010, but this could be offset by new opportunities for seasonal work in Australia under that country's new temporary labor arrangement.

3.35.3 GDP growth, Kiribati



Sources: Kiribati National Statistics Office; staff estimates.

Economic growth is forecast at around 1.0% in 2009. Inflation is seen slowing to 6.5% because of lower average prices of imported food and fuel.

Longer term, if the economy is to sustain growth, the Government needs to find new revenue sources and improve the management of its revenue and expenditure. Reform of the civil service and public enterprises could provide significant budget saving.

As a low-lying atoll nation, Kiribati is vulnerable to the effects of global climate change, but it has barely started to put in place adaptive measures such as water-storage systems and drought-resistant crops. Moreover, rapid population growth is retarding social and economic progress. Expanded technical training is needed to assist workers in competing for better-paying jobs abroad.

## Republic of the Marshall Islands

GDP grew by an estimated 1.5% in FY2008 (ended 30 September 2008), mainly on the back of a grant-financed increase in public expenditure. Copra production rose in response to high international prices, and production exceeded 7,000 tons for only the third time in 50 years.

High prices for imported fuel, coupled with price increases for electricity, transportation, and rice, propelled inflation to 29.4% year on year in the third quarter of 2008 (Figure 3.35.4). This was the highest inflation rate in the Pacific, an outcome that reflected the economy's remoteness and very high import dependency.

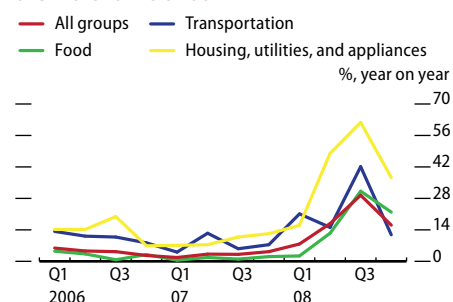
Efforts were made last year to reduce electricity usage as fuel costs rose. That culminated in the signing on 30 January 2009 of the Majuro Energy Declaration, an agreement between civil society, the private sector, and the Government that maps a path toward greater energy efficiency and security. Nevertheless, fuel imports claimed almost 20% of the national budget in FY2008. Funds for capital projects (specifically a grant from Taipei, China) were redirected to finance the fuel imports. Tax collections declined to an estimated 16.0% of GDP in FY2008 from 17% in FY2007. Government revenue was eroded by layoffs at the US military base on the island of Kwajalein.

In the FY2009 budget, the Government has reduced discretionary expenditure (such as travel) in an attempt to increase capital spending and repair its fiscal position. Japan contributed significant grant funding, but the budget continues to depend heavily on funds from the US under the amended Compact of Free Association. US grants account for 63.8% of projected revenue and grants.

The slump in global financial markets cut the value of the Compact Trust Fund from US\$93.1 million in January 2008 to US\$72.1 million in November. While this does not have an immediate effect on the fiscal position, because the Fund was set up for long-term saving, extra efforts are required to curb expenditure and raise revenue so as to generate more saving to rebuild the Fund. Public debt remains very high (Figure 3.35.5) and arrears on that debt are a continuing problem.

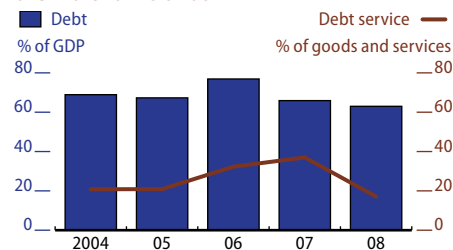
Economic growth is expected to remain low, at only 0.5%, in FY2009. Inflation will ease to about 9%, mainly because of the decline in oil prices, although damage to crops caused by high waves in January 2009 delayed an expected reduction in food prices. In a helpful development, the US

3.35.4 Inflation by major group, Republic of the Marshall Islands



Source: Economic Policy Planning and Policy Office, Republic of Marshall Islands Consumer Price Index, various issues.

3.35.5 External debt indicators, Republic of the Marshall Islands



Sources: Economic Policy Planning and Policy Office, FY2007 Economic Statistical Tables, September 2008; International Monetary Fund, Country Report, June 2008.

accreditation agency removed, in February 2009, its sanctions on the College of the Marshall Islands. It had previously identified shortcomings in training. (Given a shortage of job opportunities at home, the US is an important employment outlet for young Marshallese.)

The private sector could make a greater contribution to growth and employment creation in this economy, which is dominated by the public sector (the general government wage and salary bill is almost 22% of GDP). Development of private activity requires improved access to finance and land, reforms to ineffective laws and regulations, better infrastructure, and more efficient state enterprises.

## Federated States of Micronesia

Continuing the poor performance of recent years, GDP contracted by an estimated 1.0% in FY2008 (ended 30 September 2008) (Figure 3.35.6). The lackluster outturn reflects delays in disbursement for public works under financial assistance arrangements with the US. Economic performance is largely driven by US grants under the Compact of Free Association, of about 25% of GDP. Growth was also hampered by the erosion of household spending power by a doubling of inflation to 5%. Exports remained weak at around 10% of GDP in FY2008, or less than 15% of imports.

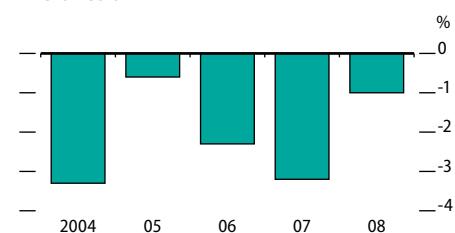
The Government reined in the overall fiscal deficit to about 3.0% of GDP in FY2008 from over 6% in FY2006 (Figure 3.35.7). This followed the receipt of additional grants from the PRC and cuts in public sector spending in the states of Chuuk and Kosrae, in response to severe financial stress. Despite the efforts by these two states, the US suspended the provision of certain of their Compact grants in August 2008, pending the restoration of sound financial management. Fuel subsidies were raised as global oil prices surged, aggravating a shortage of public funds for essential services. Tax collections were stagnant over the year and remained low at around 12% of GDP.

The plunge in global financial markets lowered the value of the economy's Compact Trust Fund by around 20%. The Fund was established to provide the Government with revenue after ending of current financial arrangements with the US in FY2024. More immediately, the global slowdown will damp tourism in FY2009, which relies heavily on the US, Japan, and other Asian economies that are either in or close to recession. Remittances will likely take a hit because many of the overseas workers are in the US and in lower-paid jobs that are highly exposed to the downturn there. About 1,000 people are on active duty in the US Armed Forces (which compares with around 15,000 formal sector workers at home), and their steady incomes will provide a buffer against the economic downturn.

Substantial grants available from the US have the potential to provide an economic stimulus that would offset these negative external factors; at least \$100 million, the equivalent of 40% of GDP, in grants allocated during FY2004–2008 remain undisbursed. However, disbursement delays are expected to persist and a further small economic contraction (0.1%) is projected for FY2009.

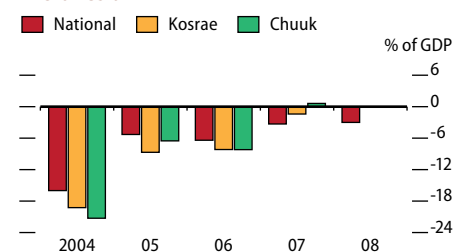
Correcting the poor growth performance will require strong effort

3.35.6 GDP growth, Federated States of Micronesia



Sources: Government of Federated States of Micronesia, FY2007 Statistical Tables, June 2008; International Monetary Fund, Country Report No. 09/81, March 2009.

3.35.7 Fiscal balance, Federated States of Micronesia



Note: Figures for FY2008 for Chuuk and Kosrae states are not yet available.

Sources: Government of Federated States of Micronesia, FY2007 Statistical Tables, June 2008; International Monetary Fund, Country Report No. 09/81, March 2009.

to improve budget management. The immediate priority is to accelerate public works, and this will require timely review of bidding proposals, execution of contracts, and allocation of cofinancing needs.

## Nauru

The economy expanded by an estimated 1.0% in FY2008 (ended 30 June 2008), driven by exports of phosphate. Both export volumes and prices of phosphate rose, as illustrated by a large increase in the value of Australia's imports from Nauru, which are almost entirely phosphate (Figure 3.35.8). Subtracting from growth, the Australian Government closed a refugee processing center on Nauru, which had been an important source of employment.

New phosphate contracts came into force in early 2008, locking in prices at a much higher level than previously and providing prospects of continued growth in exports. This will support modest economic growth of about 1.5% in FY2009 and FY2010.

The use of the Australian dollar as legal tender and the sourcing of about 60% of imports from Australia mean that Nauru's inflation usually tracks Australia's. In line with the Australian trend, inflation in Nauru is forecast to ease, from 4.5% in FY2008 to 3.3% in FY2009 and 2.0% in FY2010.

Primary phosphate reserves are expected to last about 5 more years, and mining has started of deeper, secondary reserves that could provide 20 years of exports worth as much as A\$1 billion. The long-term economic future will depend on measures to convert this mineral wealth into alternative sources of income. The immediate challenges are to promote a performance-oriented public service, resolve a high level of public debt, and achieve good governance that can underpin sound public and private investment. The budget is expected to show a small surplus in FY2009, though in the longer term fiscal resources will be strained by a need to start repaying the large public debt.

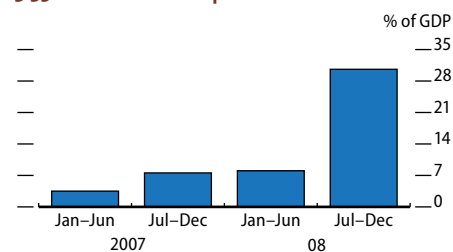
## Republic of Palau

A 10.1% fall in tourist arrivals contributed to an economic contraction of about 1.0% in 2008. Monthly arrivals fell below prior-year levels during the first half of 2008 (Figure 3.35.9). One reason was the closure of a charter-flight operator from Taipei, China, the second-biggest source of visitors. An aggressive midyear marketing campaign boosted arrivals from Japan, the main source, but this only partly offset fewer arrivals from elsewhere.

Higher international commodity prices fueled inflation, which accelerated to a peak of 16.8% in the third quarter on a year-on-year basis, and averaged 12.0% over the full year (Figure 3.35.10). The cost of food rose particularly fast as global prices of rice and other grains shot up. Rising fuel costs fed into increased transport costs.

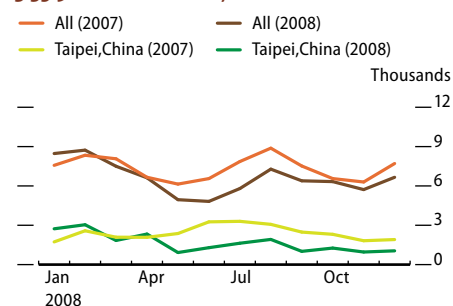
Tourism, the main driver of the economy, will likely be affected again this year because of recessions in Japan; Taipei, China; and some other economies. The Government has begun talks with the US to renew financial assistance arrangements that end this year. (US grants account

3.35.8 Australian imports from Nauru



Source: Australian Bureau of Statistics, available: <http://www.abs.gov.au>, downloaded 16 February 2009.

3.35.9 Visitor arrivals, Palau



Sources: Palau Visitors Authority.

for about 20% of GDP.) Until the outcome of these talks is known, uncertainty is likely to undermine business and consumer confidence. Infrastructure spending, boosted in recent years by some large road projects, is scheduled to decline from those levels, and planned private investment in tourism facilities is likely to be delayed until tourism picks up again.

On these developments, the economy is expected to contract by about 2.0% in 2009 and by about 0.2% in 2010. Inflation is forecast to ease to 6.4% and 0.8% in these years, primarily because of lower fuel and other commodity prices.

A trust fund established with the help of the US to provide a sustainable source of funding for the Government's budget fell in value by about 28% in 2008 as global financial markets slumped. This loss in value adds to pressures to improve fiscal sustainability, by measures such as developing local revenue sources and rendering public spending more efficient. The environment for the private sector also requires attention, with the reform of state enterprises and outdated tax and foreign investment regulations a high priority.

## Samoa

Coming off a period of fairly strong expansion in 2007, the economy grew by just 0.3% in 2008 (Figure 3.35.11). Job cutbacks at Yazaki, which assembles automotive parts for export and is the biggest private-sector employer, contributed to the slowdown. The company reduced its workforce by more than a third in 2008 and cut the working week of the remaining employees. In the 12 months to September 2008, value added in manufacturing contracted by 5.7% and in construction by 7.3%. About 3% of formal jobs were lost in the first 9 months of 2008, many from construction and manufacturing (Figure 3.35.12).

A decline in remittances from Samoans in the US outweighed a gain in remittances from Australia and New Zealand, leaving total remittances in real terms down by 4.6% in 2008 (Figure 3.35.13). Tourism receipts fell by an estimated 7.6% in real terms.

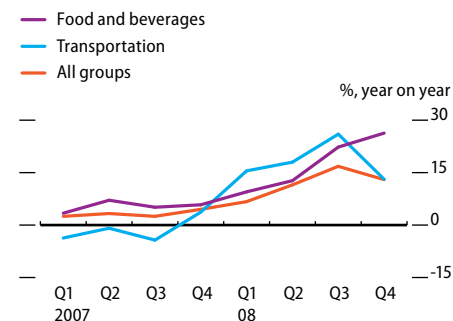
Merchandise exports dropped by 28.7% in nominal terms last year and remained a small fraction of merchandise imports, which were boosted by higher prices for imported petroleum products. The merchandise trade deficit widened from 40.5% of GDP in 2007 to about 45% in 2008. Official reserves declined to the equivalent of 4.4 months of imports at end-2008, still above the central bank's target of 4 months of imports.

Inflation accelerated to a peak of 18.7% in November 2008, year on year, driven by rising prices of food and fuel. Food was propelled by the rise in global prices, higher costs of agricultural inputs including fuel, and reduced supplies of some locally grown food. Year-average inflation at 11.5% was more than double the 2007 outcome.

The softening in the Australian and New Zealand labor markets indicates further declines in remittances. Tourism earnings, too, are expected to weaken. Further labor cutbacks at the Yazaki plant are possible if the automotive market in Australia, the main customer, remains weak.

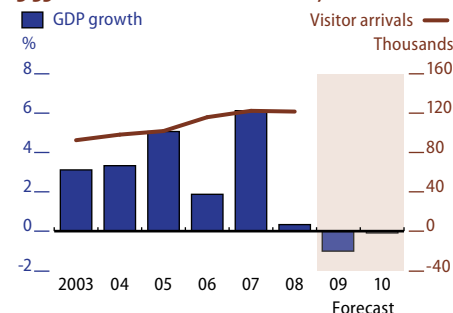
Aggregate demand will be supported by a planned increase in public

### 3.35.10 Inflation, Palau



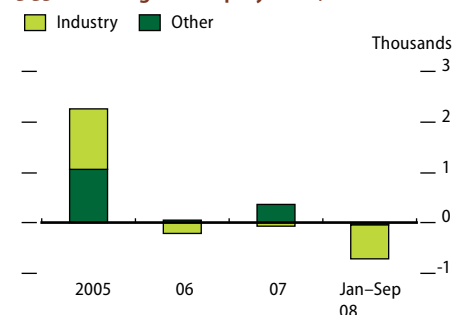
Source: Palau Office of Planning and Statistics, available: <http://www.palau.gov.net/stats>, downloaded 11 February 2009.

### 3.35.11 GDP and visitor arrivals, Samoa



Sources: Samoa Bureau of Statistics; Central Bank of Samoa, *Selected Economic Indicators*, various issues.

### 3.35.12 Change in employment, Samoa



Source: Samoa Ministry of Finance, *Quarterly Economic Review*, various issues.

development expenditure: the overall budget deficit is expected to widen from 3.2% of GDP in FY2008 (ended 30 June 2008) to 5.5% of GDP in FY2009. Still, the economy is forecast to contract by about 1.0% this year. Inflation will ease to about 7.0%, mainly the result of lower global fuel prices, which will also bring down the import bill. Official reserves should remain above the target of 4 months of imports. For the longer term, improvements in infrastructure, reform of state-owned enterprises, and facilitation of access to customary land for commercial use would help promote growth.

## Solomon Islands

Economic growth remained relatively high at 6.4% in 2008, supported by the momentum generated when prices for export commodities were rising and by an expansionary fiscal policy (Figure 3.35.14). Growth was below the 10.3% seen in 2007, when high rates of logging (and 29.6% growth) accounted for an estimated one quarter of economic growth, 66% of export earnings, and 16% of government revenue from internal sources. In 2008, exports of copra, cocoa, and fish grew, but log exports declined by 5.1% in US dollar terms. The US dollar value of total merchandise exports increased by 2.8% in 2008 (Figure 3.35.15).

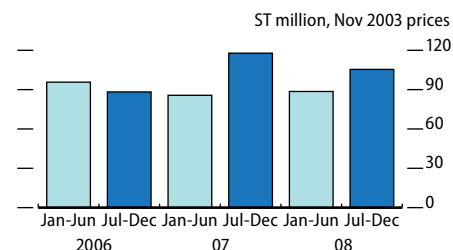
Commercial bank credit to the private sector, including that to individuals, grew by 34.3% in 2008, after growth of 50.4% in 2007. Reflecting the expansion in aggregate demand, as well as rising prices of fuel and other imported items, inflation accelerated to average 16.5%, double the rate of 2007. On a year-on-year basis, inflation peaked at 23.5% in September and ended the year at 19.3%.

Strong demand and rising costs of imports contributed to a decline in official reserves, to below the central bank's target of 3 months of import cover by year-end. The real effective exchange rate of the Solomon Islands dollar remained relatively stable.

A substantial rise in development spending and, to a lesser extent, a further increase in the Government's wage bill resulted in a budget deficit for 2008, equivalent to 5.6% of GDP (Figure 3.35.16). (The wage bill has moved up from the equivalent of 6.2% of GDP in 2004 to a budgeted 10.0% in 2009.) In 2009, the projected budget deficit of 3.6% will likely exceed funding available from cash reserves. Government borrowing to bridge the gap is ruled out under the 2005 Honiara Club agreement between the country and its official creditors. Consequently, the Government may well have to curtail public expenditure unless it can secure additional donor funding.

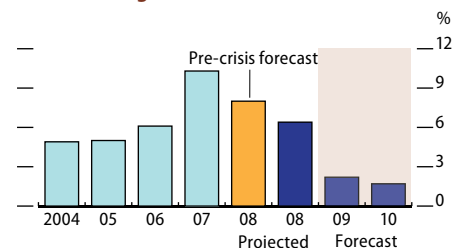
Logging rates have been above sustainable levels since 1992, reaching five times the sustainable rate in 2007. The commercially exploitable natural forest is expected to be fully depleted in another 4 years or so. Expected softer demand for logs from the PRC this year will translate into a reduction in logging rates. That may help the environment, but also trim economic growth. Furthermore, the planned reopening of the Gold Ridge gold mine is looking uncertain as a result of difficulties in obtaining finance. There are indications that businesses and consumers expect an economic slowdown, with the value of building works approved

3.35.13 Remittances, Samoa



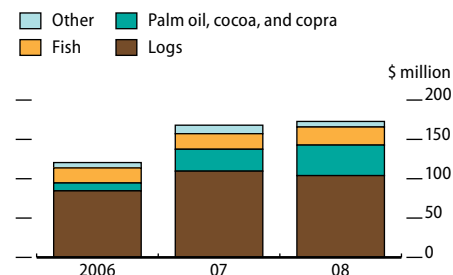
Source: Central Bank of Samoa, *Selected Economic Indicators*, various issues.

3.35.14 GDP growth, Solomon Islands



Source: Central Bank of Solomon Islands, *Quarterly Review*, September 2008.

3.35.15 Merchandise exports, Solomon Islands



Sources: Central Bank of Solomon Islands, *Quarterly Review*, September 2008 and *Monthly Economic Bulletin*, various issues.

in the 12 months to September 2008 at a little under half the value for the year-earlier period.

GDP growth is forecast to ease to 2.2% in 2009 and 1.7% in 2010 as logging exports decline. A larger than expected fall in logging rates could entail no GDP growth, and a huge widening of the current account deficit. Inflation is expected to trend down below 10% in 2009.

The central bank needs to show strong action if it is to slow the depletion in foreign reserves and maintain macroeconomic stability. The Government could assist by reducing its recurrent expenditure, particularly on wages. Additional efforts are also called for to address the structural weaknesses that threaten the sustainability of growth. Developing alternatives to logging heavily depends on improving governance, economic management, infrastructure, and the business climate.

## Tonga

After an economic contraction in FY2007 (ended 30 June 2007), this economy grew by an estimated 1.2% in FY2008 (Figure 3.35.17). Reconstruction of areas damaged during civil unrest in late 2006, coupled with the building of new tourism projects, underpinned a 6.9% expansion in construction in FY2008. The transport and communications subsector grew by 5.6%, assisted by increased competition in telecommunications. Finance and real estate recorded 5.0% growth, in part reflecting higher bank lending. The expansion in these subsectors offset a 3.2% contraction in agriculture, forestry, and fishing, which was partly attributable to low prices for squash and vanilla exports, and to poor fishing conditions.

Visitor arrivals rose by 17% to 41,600, and the real value of visitor spending rose by more than 50% in FY2008. However, remittances declined slightly in real terms.

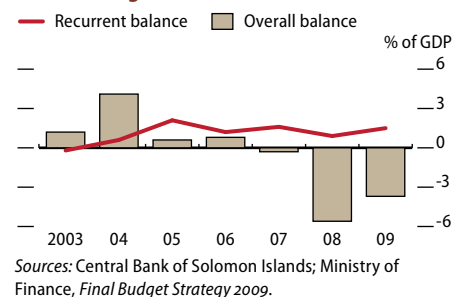
Reflecting the slight improvement in economic activity, the real value of internally raised government revenue rose by 1.8%. In contrast, the real value of expenditure and net lending fell by 7.3%. The budget surplus rose to about 2.0% of GDP.

Inflation peaked at 12.6% year on year in May 2008, before easing to 6.4% by December (Figure 3.35.18). The average inflation rate of 9.9% for FY2008 was double that of the previous year, driven by higher prices for food, fuel, transport, and electricity.

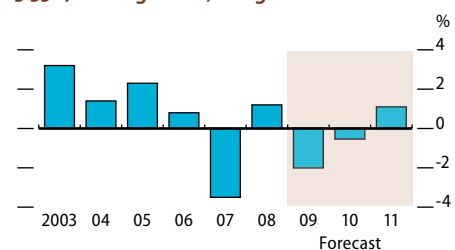
Merchandise imports, underpinned by higher costs of imported commodities, rose by 27.4% in nominal terms in FY2008. Conversely, merchandise exports (less than 10% of merchandise imports) fell by 7.0%. The trade deficit widened and official foreign reserves fell in the second half. Reserves were later bolstered by inflows of funds into the banking sector. The overall balance of payments recorded a small deficit of \$1.3 million. The nominal effective exchange rate depreciated by 2.0% over the fiscal year.

Easier credit from some commercial banks in FY2008 pushed up nonperforming loans, and the banks reacted by tightening lending in the first half of FY2009. Private sector credit growth slowed to 4.3% year on year by December 2008 (Figure 3.35.19). This will put downward pressure on business investment and housing construction. An expected

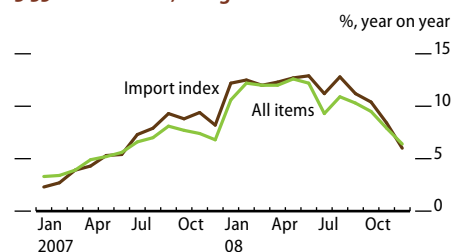
3.35.16 Budget balance, Solomon Islands



3.35.17 GDP growth, Tonga



3.35.18 Inflation, Tonga



fall in remittances due to weaker labor markets in the US, New Zealand, and Australia will also weigh on economic growth. The real value of remittances in the first half of FY2009 fell by 18.4% from a year earlier. These negative factors are expected to see GDP contract by 2.0% in FY2009 and by 0.6% in 2010.

The PRC has offered concessionary loans for reconstruction. However, it is unclear how much of that funding the Government will draw on, given the uncertain economic outlook and conditions that tie some of the funding to purchases of goods and services from the PRC. Public expenditure is another potential source of support for the economy: the Government projects a 36.5% expansion in its spending in FY2009 (Figure 3.35.20). But funding for this expansion depends in large part on securing a 150% hike in donors' grants, a goal that looks too ambitious.

Inflation is expected to ease to 6.2% in FY 2009 as lower global commodity prices feed through into domestic prices. Lower import prices also offer some relief to the external account.

## Tuvalu

Supported by a 9.8% increase in government expenditure in 2008 (Figure 3.35.21), the economy grew by an estimated 1.5%. Outlays rose for public sector staffing, goods and services, and grants and subsidies. However, plans to boost capital spending were not realized, mainly because income from grants fell well short of expectations. The overall fiscal position eroded when a medical treatment plan cost four times the budgeted amount and the subsidy for the electricity utility was nearly double the budget allocation, a result of higher costs of imported fuel. The recurrent fiscal deficit was around 0.4% of GDP.

Tuvalu uses the Australian dollar as its legal tender, and inflation usually tracks that in Australia. Last year, however, inflation peaked at 13.4% in the third quarter, far above the rate in Australia, because of the economy's sensitivity to higher fuel and transportation costs.

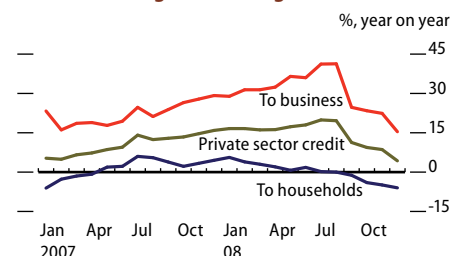
Tuvalu has a narrow economic base and produces almost no merchandise exports. It relies on external earnings to provide revenue for funding government spending. Earnings from fishing licenses increased by 18.7% last year, and remittances grew slightly. But fees from licensing the country's ".tv" Internet domain name were flat. The value of the Tuvalu Trust Fund, which is mainly invested in offshore markets, fell sharply in 2008 as a result of the global financial crisis. No distribution was therefore made from this fund to the Government's accounts.

GDP growth in 2009 and 2010 is projected to ease to about 1.0%, reflecting lower external earnings during the global economic slowdown.

Distributions from the Tuvalu Trust Fund are held in the Government's Consolidated Investment Fund. No such distributions are likely while international financial markets are depressed. This suggests the Consolidated Investment Fund will be depleted within 3 years at current government expenditure levels, even though Australia and New Zealand have committed to provide additional funding. In this context, restraints are needed on expenditure; however, the 2009 budget provides for a further increase in the wages bill and in other operating expenses.

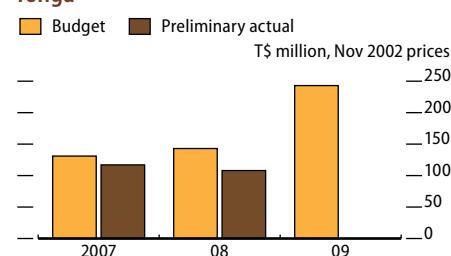
Parliament in November 2008 approved tax and customs reforms, as

3.35-19 Credit growth, Tonga



Sources: National Reserve Bank of Tonga, *Quarterly Bulletin*, September 2008.

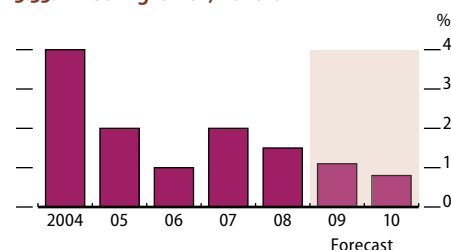
3.35-20 Real government expenditure, Tonga



Note: Fiscal year ending June.

Sources: Ministry of Finance, *Budget Statements: Review of the Tongan Economy and Outlook*, various issues.

3.35-21 GDP growth, Tuvalu



Sources: Central Statistics Division, Government of Tuvalu, available: <http://www.spc.int/prism/country/tv/stats/Index.htm>, downloaded 9 February 2009; staff estimates.

well as a broad-based consumption tax to come into effect on 1 July this year. This new tax is expected both to offset the reductions in import duties required under Tuvalu's ratification of the Pacific Island Country Trade Agreement, and to improve the tax system's efficiency and equity. Longer term, widening income disparities and the vulnerability of the low-lying atoll country to climate change are worrying.

## Vanuatu

Growth in tourism and property development drove GDP growth of 6.3% in 2008, a fourth successive year of above 6% growth. Visitor arrivals grew by 13.3% in the 12 months to September 2008, with arrivals by air up by 8.0% (Figure 3.35.22). Private sector credit increased by 40.1% in the 12 months to November 2008. A 46.8% rise in the value of merchandise exports, led by copra and coconut oil, assisted the economic expansion.

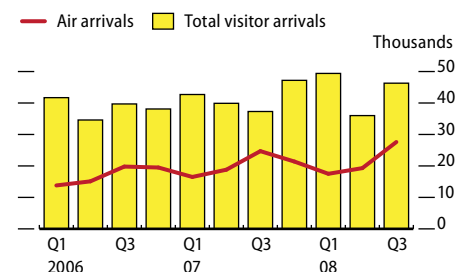
Inflation breached the Reserve Bank of Vanuatu's 0–4% target band when it hit 6.0% in the third quarter, and it averaged 5.8% for the year, according to preliminary figures. The central bank responded by raising its key policy interest rate for the first time in 2 years in September 2008. It changed tack in December 2008 as the global economic slump deepened, and relaxed bank liquid asset and reserve requirements. M2 money supply increased by 14.4% over the 12 months to November.

Merchandise imports rose by 31.0% in 2008 to reach seven times merchandise exports, pushing out the trade deficit. Still, foreign exchange reserves were at a comfortable 7.5 months of imports at year-end.

Australia accounts for more than half the visitor arrivals, so the economic slowdown there will likely crimp income from tourism this year. Also, prices for Vanuatu's agricultural exports are softening. These factors are expected to offset lower costs for imported oil and commodities, leading to a current account deficit of around 13.0% of GDP in 2009 (Figure 3.35.23). Vanuatu has relied on foreign investment inflows to finance its current account deficit, but the global crisis is likely to damp such investment this year. GDP growth is forecast to moderate to around 3.5% in 2009. Inflation is expected to ease to 3.9% because of lower prices for imported commodities, particularly fuel.

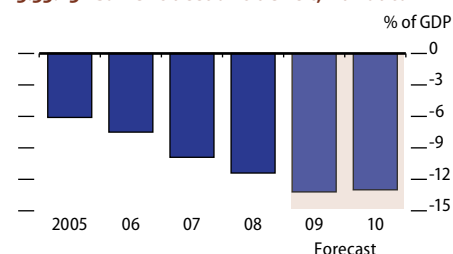
Construction funded by the US Millennium Challenge Corporation has been scaled back due to higher than expected costs, but it will still provide a much-needed boost to the country's infrastructure in the coming years. Australia and New Zealand have included Vanuatu in their programs to import labor for seasonal work. This move should, in time, help lower internal migration, the effects of which are most vividly seen in the form of urban squatter settlements and increasing numbers of urban unemployed.

3.35.22 Visitor arrivals, Vanuatu



Source: Reserve Bank of Vanuatu, *Quarterly Economic Review*, September 2008.

3.35.23 Current account deficit, Vanuatu



Sources: International Monetary Fund, *World Economic Outlook* database; ANZ *Pacific Quarterly*, November 2008; staff estimates.