Pacific island economies

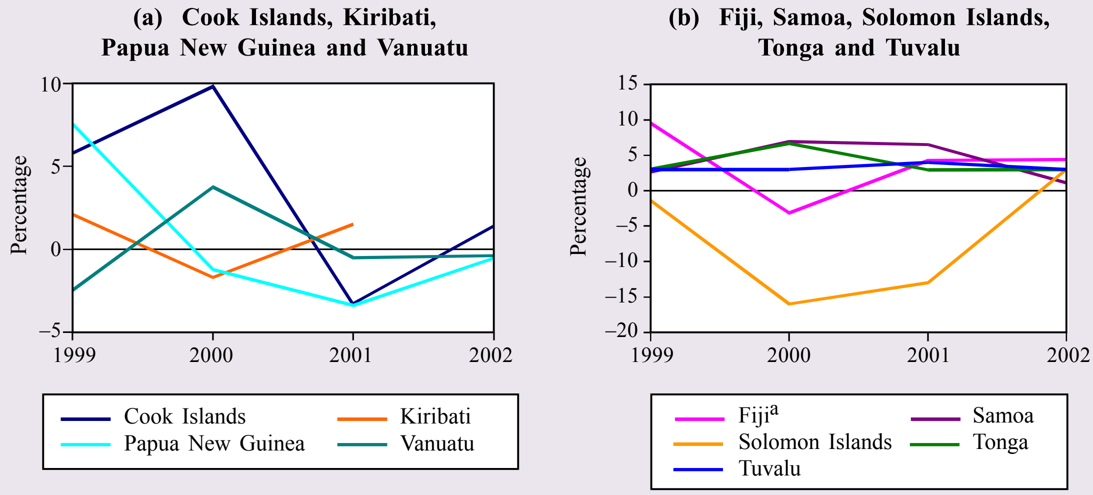
Subregional overview and prospects

Economic performance remained lacklustre in 2002

The economic performance of the Pacific island economies remained generally lacklustre in 2002, with GDP growth in the range of –0.5 to 4.4 percentage points (figure II.11). In particular, the Solomon Islands economy grew by 3 per cent compared with an absolute contraction, caused by internal strife, averaging 14.5 per cent a year in 2000-2001. Meanwhile, the sharp expansion in Samoa's economy, averaging 6.7 per cent a year in 2000-2001, lost steam in 2002; GDP went up marginally by just over 1 per cent owing to irregular weather conditions and the completion of major construction activities. By contrast, Papua New Guinea and Vanuatu recorded a contraction in total output for the year. In Papua New Guinea, this was mainly due to the falling production of mineral commodities, and in Vanuatu, declines in agricultural and service sector outputs.

The subdued economic performance contributed to problems in macroeconomic management, including persistent budget deficits, in a number of countries. Papua New Guinea, Solomon Islands and Vanuatu all had some difficulty in funding such services as primary education,

Figure II.11. Rates of GDP growth in selected Pacific island economies, 1999-2002



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); and national sources.

Note: Data for 2002 are estimates.

[a] Real GDP at factor cost.

basic health care and the maintenance of security for persons and property. Solomon Islands is recovering slowly from the coup in 2000 with the Peace Agreement signed at Townsville, Australia, later in that year. There are reports of a rise in poverty levels in some Pacific island countries, including Fiji, Papua New Guinea and Solomon Islands. Population growth, at the rate of approximately 3 per cent a year in Papua New Guinea, Solomon Islands and Vanuatu, is high by developing country standards and this demographic trend is putting increasing demands on the delivery of basic services as well as pressure on the available services.

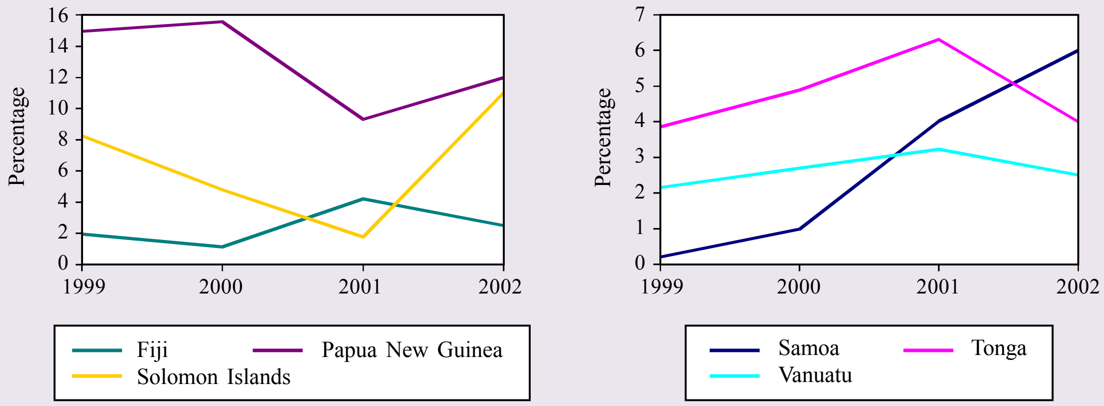
Consumer prices varied in several countries

Consumer prices varied in Pacific island countries in 2002 (figure II.12); this outcome was mainly due to declining world commodity prices and stable exchange rates. The double-digit inflation in Papua New Guinea and Solomon Islands was caused by currency depreciation, while the continued weakness in local food supplies lifted prices in Samoa. Inflation in Pacific island countries is highly dependent on movements in exchange rates and, to a lesser extent, the price of fuel. The latter has inched upwards as a result of tension in the Middle East, and any persistent price hike would not augur well for price stability in the subregion in 2003.

Figure II.12. Inflation in selected Pacific island economies, 1999-2002[a]

(a) Fiji, Papua New Guinea and Solomon Islands

(b) Samoa, Tonga and Vanuatu



Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); and national sources.

Note: Data for 2002 are estimates.

[a] Changes in the consumer price index.

Most countries recorded increases in exports and imports in 2002

There were positive developments on the trade front, and Fiji, Solomon Islands, Tonga and Vanuatu were expected to record some increases in their merchandise export earnings in 2002. However, Papua New Guinea and Samoa registered an unfavourable trade performance, with the former experiencing an export contraction for the second year in a row. Import spending went up in most parts of the subregion, except notably in Solomon Islands and Vanuatu. This upward trend reflected, among other things, the pickup in oil prices and a recovery of demand after some import compression in the previous two years.

Mixed performance in the tourism sector

The coup in Fiji in 2000 served to push intending visitors to Vanuatu, but this was a temporary diversion; the tourist flows returned as political problems ebbed in Fiji, and Vanuatu began to have its own problems. The impact of the October 2002 terrorist attack in Bali remains uncertain, but there is some possibility of a positive ripple effect on tourism in the Pacific island subregion. Again, such a diversion may be only a short-term gain until Bali, as an important tourist destination, makes a comeback. Terrorist activities and the fear of air travel may pose some risks to long-term investment and growth in the tourism industry for the subregion as a whole. An option is for the tourism-dependent economies to revamp and strengthen their security precautions as a competitive factor in inward tourism services.

GDP performance

Several economies managed modest economic expansion in 2002

The pattern of low and uneven GDP growth characteristic of the Pacific island subregion in recent years continued into 2002 with a GDP contraction of about 0.5 per cent in Papua New Guinea and, at the other end of the spectrum, an expansion of 4.4 per cent in Fiji (table II.14). In particular, both Papua New Guinea and Vanuatu experienced output contraction for two years in a row but Cook Islands and Solomon Islands recovered positively in 2002 after experiencing a decline in total production a year earlier. However, Solomon Islands had suffered from a significant fall in GDP, averaging some 14.5 per cent annually in 2000-2001; thus, the economic expansion of 3 per cent in 2002 was a useful achievement although the restoration of the pre-1999 standard of living remains a long-haul process.

Fiji's economy grew by over 4 per cent in 2001 and 2002

After output contraction of 3.2 per cent in 2000 following the political coup of that year, Fiji's economy rebounded, showing a GDP growth of over 4 per cent a year in 2001 and 2002. Growth prospects in excess of 5 per cent for 2003 are perceived as good by the Reserve Bank of Fiji. However, the emigration of skilled and professional workers continues and this may impose some constraints on the upward growth

Table II.14. Selected Pacific island economies: growth rates, 1999-2002

(Percentage)

		Rates of growth			
		Gross domestic product	Agriculture	Industry	Services
Cook Islands	1999	5.8	−27.5	7.0	13.5
	2000	9.8	32.4	6.8	6.5
	2001	−3.3	..	..	..
	2002	1.4	..	..	..
Fiji[a]	1999	9.5	16.0	9.8	7.7
	2000	−3.2	−0.9	−7.4	−1.8
	2001	4.3	1.7	7.4	3.6
	2002	4.4	1.1	..	..
Kiribati	1999	2.1	8.8	38.0	3.4
	2000	−1.7	7.9	−32.4	2.1
	2001	1.5	..	..	..
Papua New Guinea	1999	7.6	4.3	5.7	12.4
	2000	−1.2	9.1	−4.8	−7.0
	2001	−3.4	−5.4	−3.3	1.9
	2002	−0.5	3.6	−5.5	1.3
Samoa	1999	2.6	−3.5	1.4	5.5
	2000	6.9	0.3	11.3	7.5
	2001	6.5	−4.6	11.1	8.4
	2002	1.1	0.5	−3.0	3.0
Solomon Islands	1999	−1.4	−7.2	41.8	−3.6
	2000	−16.0	−20.0	−18.0	−8.0
	2001	−13.0	−15.0	−20.0	−8.0
	2002	3.0	6.0	3.0	0.5
Tonga	1999	3.1	−3.1	12.4	4.2
	2000	6.7	10.8	3.0	5.6
	2001	3.0	1.3	5.4	3.2
	2002	3.0	2.0	4.0	2.5
Tuvalu	1999	3.0	..	..	..
	2000	3.0	..	..	..
	2001	4.0	..	..	..
	2002	3.0	..	..	..
Vanuatu	1999	−2.5	−9.3	5.2	−1.7
	2000	3.7	2.5	8.4	3.3
	2001	−0.5	−14.9	−1.1	3.3
	2002	−0.4	−0.5	0.4	−0.5

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002), *Asian Development Outlook 2002* (Oxford University Press, 2002) and *Asian Development Outlook 2002 Update* (ADB, 2002); and national sources.

Notes: Data for 2002 are estimates. Industry comprises mining and quarrying; manufacturing; electricity, gas and power; and construction.

[a] Real GDP at factor cost.

path. The savings rate recovered from 18 per cent of GDP in 1998 to around 20 per cent in 2000 in the wake of the rebound in agricultural sector income after the prolonged drought of 1997 and 1998. The prognosis for investment and growth for 2002 onwards was dependent on a return of investor confidence in the economy and stability on the political front.

The struggling sugar industry has severe implications for future growth

The sugar industry has historically accounted for approximately four fifths of the value added of Fiji's marketable agricultural commodities. However, its relative importance declined considerably from around 11 per cent of GDP in the mid-1990s to just over 6 per cent in 2002. Expiring leases for land on which sugar cane is grown, combined with poor performance in sugar-milling, will cause production to fall in 2002. Meanwhile, Fiji Sugar Corporation Ltd., has been operating at a substantial loss since 1999, although its financial collapse, which would have had severe, economy-wide ramifications, was headed off by budgetary support in the form of soft loans and government guarantees. All in all, agricultural sector growth of around 1 per cent is expected in 2002, compared with 1.7 per cent in 2001.

Tourism is by far the largest industry in Fiji, with relative shares of 10 per cent of GDP, 30 per cent of formal sector employment and 30 per cent of gross foreign exchange earnings. Its outlook is generally favourable provided that security is maintained and access to land for tourist developments is securely available. In this context, large investments in new hotels and the related infrastructure are needed; only a few projects have materialized, although a number of others are in the pipeline. Tourist arrivals in 2002, at 409,000 persons, are nearly the same as those recorded prior to the coup of 2000. Much of the observed recovery in tourism is due to successful marketing campaigns and heavy price discounting by service providers to reduce excess capacity. Tourism growth accounted for the sectoral expansion in services, which went up by 3.6 per cent in 2001 and by an estimated 3 per cent in 2002.

Fiji's large and rapidly growing garment industry, which had been severely affected by international union boycotts in 2000, has been on the rebound following the lifting of restrictions and revival of orders. However, a deteriorating law and order situation is constraining growth in the industry, given its large female workforce. Reductions in tariff preferences as a result of trade liberalization in such export markets as Australia and New Zealand are eroding the profitability of Fijian suppliers and have made it necessary for them to search for alternative and additional markets, among other things. Meanwhile, several large publicly funded projects, plus the building of a large hotel complex, will provide a much-needed injection into construction activity, which had been subdued since 2000. However, the prospects for the continued growth of this industry and of manufacturing activities in general are closely linked with the resolution of political uncertainties and access to land. By and large, the industrial sector is expected to grow by 4 per cent in 2002, a considerable deceleration from the level of 7.4 per cent reached in 2001.

Papua New Guinea's economy is on a declining path

Economic activities have been generally subdued in Papua New Guinea since the mid-1990s. After a brief recovery, with GDP growth reaching 7.6 per cent in 1999, the economy contracted three years in a row by a total of around 5 percentage points. This represented a large setback in living standards, given the relatively high population growth rate of 2.7 per cent. After many years of delay, a $3.5 billion gas pipeline is to be built from the Southern Highlands of Papua New Guinea to Northern Australia in 2003. The associated economic stimulus is expected to lift GDP growth to over 2 per cent in 2003 and 2-3 per cent in the following years. Elsewhere in the economy, however, the business and investment environment is relatively poor because a number of important issues, such as the deteriorating law and order situation, still have to be addressed and a number of mineral operations are due to be closed in the second half of the decade.

Agricultural output picked-up in 2002

After a big upsurge in 2000, growth in agricultural production in Papua New Guinea became marginal the following year owing to a combination of adverse factors. Deteriorating infrastructure and continuing law and order problems have reduced farmers' access to markets. Poor prices for several export commodities, coffee in particular, reduced earnings and the incentive to produce. Agricultural output is expected to grow by 3.6 per cent in 2002 owing to a stronger growth in palm oil, cocoa and log production with modest improvements in copra, copra oil, coffee and rubber.

The industrial sector in Papua New Guinea contracted by a total of over 13 per cent during the period 2000-2002. Among the main contributing factors were shrinking oil reserves and hence production, and a rapid fall of over 9 per cent annually in the construction industry in 2000-2001. These declining trends in turn reflected the poor business and investment climate as well as the lack of new mineral developments. At the same time, mining output also fell in 2002 owing to the drought-induced difficulties experienced in the two largest mines: low river-water levels prevented the transport of ore. The value added in Papua New Guinea's service sector increased by almost 2 per cent in 2001 and is expected to further increase by 1.3 per cent in 2002, principally because of a rapid expansion in government expenditure in the first half of the year.

Stalled economic activities in Samoa in 2002

After sustained strong growth averaging over 6 per cent a year in 2000-2001, the Samoan economy stalled in 2002, with total output edging up by just over 1 per cent. However, the outlook is for a sharp economic rebound of around 6 per cent in 2003 and a growth path of around 5 per cent in future years. The main contributors and stimuli are expected to be manufacturing, construction and tourism. However, Samoa's subsistence agriculture has continued to decline, with virtually no growth forecast for the primary sector over the coming years. Indeed, negative outcomes in agriculture are possible in view of Samoa's vulnerability to natural disasters. Wet weather conditions early in 2002 hindered agriculture, with adverse effects on most fruit and vegetable crops. An offsetting stimulus came from the expanded fishery output; the export-oriented fishing industry constituted almost half of the value added in primary production. Overall, the marginally positive production in the primary sector expected for 2002 was a turnaround from a sharp drop of 4.6 per cent in 2001 owing mainly to crop disease and a slump in the exports of coconut products and kava, the latter being due in part to problems in the receiving countries.

Samoa's industrial sector experienced particularly strong growth of over 11 per cent a year in 2000 and 2001 as a result of the construction boom, which, in turn, was supported by a strong public investment programme. In 2002, however, a decline of about 3 per cent was expected in industrial output because a number of investment projects were wound up or delayed in order to cool what the Government regarded as an overheating economy. This contributed to a slump in the construction industry and served to weaken the manufacturing sector, owing to its close linkages to construction activities, and domestic demand. A strong rebound in the construction and manufacturing sectors could follow the renewed impetus in public investment in 2003. The service sector, accounting for nearly three fifths of GDP, had experienced strong growth of almost 8 per cent annually in 2000-2001. The momentum could not be sustained, however, because of a tapering off in private sector demand and a tightening of the Government's fiscal position. Growth fell to about 3 per cent in 2002, although a renewed expansion in inward tourism and a more expansive fiscal policy stance could drive service sector growth to 7 per cent in 2003.

The Solomon Islands economy was on the rebound in 2002

In Solomon Islands, the civil unrest that had erupted in 1999 became extensive through 2000, causing severe economic devastation and social dislocation. GDP, for example, fell by an average of 14.5 per cent a year in 2000-2001; per capita income was reduced to around $490 in 2001, compared with a peak of $1,120 in 1997. Among other things, palm oil production ceased in June 1999 and some 2,000 workers lost their jobs at the processing mill. Much of the idle equipment has sustained extensive damage from the weather and militia activities and would thus require heavy new investment before operations could resume.

The Gold Ridge Mine Tailings Storage Facitity, the only mining company, ceased production in June 2000 because of law and order problems, resulting in a loss of 300 jobs and the discontinuation of ancillary services, including those from a health clinic and a primary school. This mine is not expected to reopen in the near future.

Copra and coconut oil production was also in a decline owing to poor commodity prices and the financial problems suffered by the Commodities Export Marketing Authority. Logging has moved out of Guadalcanal to regions less affected by violence, thus further lowering income and reducing access to the ancillary social services that were once provided by the companies. Fish production is also quite subdued, the catch in 2001 being some 15 per cent lower than that of the previous year. Driven by a resurgence in fishery production, GDP growth is expected to reach 3 per cent in 2002. This may mark the start of an economic rebound for Solomon Islands, although heavy reinvestment and new investment are needed to sustain the momentum and reduce the sharp decline in living standards, an outcome compounded by the country's relatively rapid rate of population growth.

Tonga's economy showed relatively strong sustained growth

Aggregate production went up by about 3 per cent in Tonga in 2001-2002, a positive outcome in terms of per capita income as the population is estimated to be increasing by 0.5 per cent per annum. In fact, a devastating cyclone at the beginning of 2002 prevented even faster growth, while inward tourism is expected to lift GDP growth by another percentage point in 2003, with relatively healthy economic expansion in the vicinity of 3 per cent annually in the medium term. Tonga is another island economy greatly vulnerable to natural disasters, the damage from which is borne largely by the agricultural sector. This sector, however, has performed reasonably well in recent years, reflecting concerted government efforts to open up new niche markets overseas. There is considerable potential for expanding the export of off-season agricultural products to Japan and other countries, particularly from organic cultivation. Against a declining rural population and tempered by a damaging cyclone early in 2002, the agricultural sector, which includes fishing, nevertheless managed to expand by about 2 per cent during the year. Growth in the agricultural sector in future years is forecast to be in the range of 2-2.5 per cent, assuming no major natural disasters.

A surge in construction, supported mostly by aid funding, had pushed up Tonga's industrial sector output by 5.4 per cent in 2001, but with weaker growth in construction activities the industrial sector is expected to have expanded at a slower pace of about 4.0 per cent in 2002. Current initiatives taken to broaden the scope of food processing will increase manufacturing activities in future years, and the industrial sector as a whole could grow at an annual rate of 2-3 per cent beyond 2002. The service sector, which comprises 45 per cent of the economy, has long benefited from a substantial, and generally higher, flow of remittances from Tongans working abroad as well as significant earnings from inward tourism. The events in Bali in October 2002 are expected to help to strengthen tourism in Tonga in 2003. Tourism receipts amounted to $6.5 million in 2001.

Domestic output contracted again in Vanuatu in 2002

Economic production in Vanuatu was marginally lower (by 0.5 per cent) in 2001 and is expected to show another marginal fall (about 0.4 per cent) in 2002. The average medium-term expansion in GDP was therefore just over 1 per cent a year in the five years to 2002, compared with 2.6 per cent annually for population growth. In addition to the implied decline in per capita income, pressures on government resources (from subdued economic activities) were compounded by natural disasters; in particular, the capital, Port Vila, was struck by an earthquake measuring 7.6 points on the Richter scale early in 2002.

Agriculture accounts for just over one fifth of GDP but supports around four fifths of the population. Commercial farming is dominated by copra, beef and kava production. Copra (and coconut oil) output is set to rise in the wake of a price increase from VT 10,000 to VT 25,000 per ton made possible by a government subsidy. This could be a short-term respite, because of budgetary implications, but it has provided some impetus to the agricultural sector. That sector had performed poorly, with output declining by a total of about 22 per cent during the period 1999-2002. The sharp fall of almost 15 per cent in 2001 was largely due to two devastating cyclones which hit Vanuatu early in 2001. Kava production recovered strongly from the damage but its further growth may be affected by the global slump in demand. Several European countries have banned the sale of kava-based medicinal products, while the United States and the United Kingdom have asked for a voluntary withdrawal of kava products by their suppliers. Even though Fiji and New Caledonia are the destination of about two thirds of Vanuatu's kava exports, a fall in demand for kava in the industrial countries will have an adverse impact on prices and therefore on the growth of the domestic industry. Cocoa production declined with the suspension of the activities of a large plantation estate that traditionally accounted for some two fifths of total output. Organic beef-raising has good prospects for niche marketing; success on this front has been mixed, in part for lack of the organic certification that is necessary to earn the price premium and in part for lack of economies of scale in packaging and transport.

Vanuatu's industrial output varied marginally in 2001-2002. Recent investment in the industrial sector is dominated by the development by the private sector of a mini oil refinery with inputs of crude oil to be imported at international prices from Papua New Guinea and Australia. The objective is to provide domestic fuels at a discount on the prices currently prevailing in the market. The service sector is underpinned by tourism and financial services. Vanuatu is host to around 50,000 tourists each year in addition to 50,000 people who visit for one or two days ashore as cruise ship passengers. Around three quarters of the visitors come from Australia and there was a surge in tourists from New Zealand recently after the opening of a flight to Auckland. The tourism sector was buoyant in 2001, with relatively high hotel occupancy rates; it is also the dominant recipient of private sector lending in Vanuatu. Other things being equal, inward tourism was expected to improve the current account balance in 2002.

Inflation

Inflation remained relatively high in Papua New Guinea and Solomon Islands

The picture as regards consumer prices was mixed in the Pacific island subregion in 2002 (table II.15). There was, in particular, lower inflation in Fiji, Tonga and Vanuatu and, except for Papua New Guinea and Solomon Islands, which showed double-digit increases in consumer prices, inflation remained largely muted at less than 6 per cent in that year. In Fiji, the drought is expected to generate some pressure on prices

Table II.15. Selected Pacific island economies: inflation and money supply growth (M2), 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Inflation[a]				
Fiji	2.0	1.1	4.2	2.5
Papua New Guinea	14.9	15.6	9.3	12.0
Samoa	0.2	1.0	4.0	6.0
Solomon Islands	8.3	4.8	1.8	11.0
Tonga	3.9	4.9	6.3	4.0
Vanuatu	2.2	2.7	3.2	2.5
Money supply growth (M2)				
Fiji	14.2	−2.1	−3.1	4.9[b]
Papua New Guinea	9.2	5.0	1.6	6.7[b]
Samoa	15.7	16.3	6.1	3.6[c]
Solomon Islands	7.0	−0.7[d]	..	..
Tonga	11.9	18.8	14.9	0.7[e]
Vanuatu	−9.2	5.5	5.7	−3.4[e]

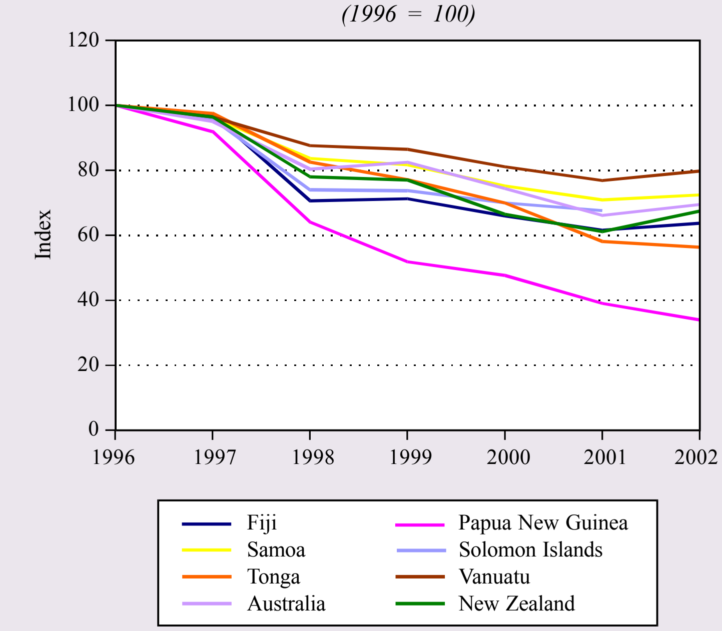
Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); and national sources.

Note: Data for 2002 are estimates.

[a] Changes in the consumer price index.
[b] January-July.
[c] January-June.
[d] January-September.
[e] January-August.

Figure II.13. Index of exchange rates against the United States dollar of selected Pacific island economies and Australia and New Zealand, 1996-2002

(1996 = 100)



Sources: IMF, *International Financial Statistics,* vol. LV, No. 12 (December 2002); and *Far Eastern Economic Review,* various issues.

Note: Data for 2002 are estimates except for Fiji, Samoa, Tonga and Vanuatu, in which case they refer to January-October.

in 2003 but stability in the exchange rate will exert a stabilizing influence, with the result that inflation was expected to be at the rate of 3 per cent in 2003, compared with 2.5 per cent in 2002.

Despite a prolonged recession, inflation in Papua New Guinea is both relatively high and volatile; it also stands out as having been among the highest in the subregion for several years. The exchange rate was floated in 1995 and the currency has depreciated significantly against those of the main import suppliers (figure II.13). Inflation dropped to 9.3 per cent in 2001, from almost 16 per cent a year earlier, largely owing to greater stability in the exchange rate in the second half of 2000 and the first half of 2001. Consumer prices are expected to have risen by around 12 per cent in 2002 and, following a sharp depreciation of the kina in the second half of 2002, inflation is likely to be much higher in 2003.

The Central Bank of Samoa targets an inflation rate consistent with that of its main trading partners; the import content has a relative weight of about half of the typical consumption basket. However, prices in Samoa are also vulnerable to the state of domestic agriculture and the cost of overseas fuels; many sectors of the domestic economy depend heavily on imported energy products. In particular, a surge in the prices of domestic agricultural products in the second half of 2001 contributed to a hike in the inflation rate to 4 per cent from just 1 per cent in the previous year. The continued weakness in fruit and vegetable supplies caused a further sharp rise in food prices and inflation is expected to have risen to 6 per cent in 2002. Consumer prices could rise more modestly in the following year, perhaps by 3 per cent, as a result of the improved supply of local food produce, although this was offset in part by the flow-on impact of higher oil prices in the second half of 2002.

The inflation situation in Solomon Islands was improving as a result of fiscal tightening, given severe budgetary problems, the reluctance of the Central Bank to fund further deficits and a relatively more stable exchange rate. Consumer prices, for example, were on a downward trend, rising by less than 5 per cent in 2000 (compared with over 8 per cent during the previous year) and by less then 2 per cent in 2001, the lowest level for two decades. However, the inflation outlook worsened in 2002, with consumer prices forecast to rise by 11 per cent, largely because of the sharp mid-year depreciation of the local currency against all major trading currencies. For example, the local currency depreciated against the Australian and New Zealand dollars by 17.6 and about 22 per cent respectively.

Inflation in Tonga in 2001 bucked the moderate trend of earlier years, and reached 6.3 per cent, the highest level in the decade. The main cause of this uplift in consumer prices was a sharp depreciation of the exchange rate from late 2000 into parts of 2001. However, a more stable exchange rate in 2002 served to temper inflation, which was expected to return to the normal trend of around 4 per cent during the year.

Vanuatu has characteristically maintained a remarkable record of price stability throughout the 1990s and into the new millennium as well; annual increases in consumer prices were, by and large, limited to within a low band of 2 to 3 per cent. Inflation moderated from 3.2 per cent, which was approaching the threshold for the Reserve Bank of Vanuatu to tighten monetary policy, to 2.5 per cent in 2001-2002. A comfortable level of foreign exchange reserves should ensure continued stability in the exchange rate and hence in consumer prices, barring unexpected natural disasters. The Reserve Bank has limited discretion in shifting the composition of and weights within the basket which serves as the peg for the vatu exchange rate; changes in the weights were made only twice, once in 1998 and again in 2001, to induce a de facto depreciation of the currency against the United States dollar.

Foreign trade and other external transactions

External trade

Several Pacific island countries recorded increases in export earnings in 2002

The available data up to the first half of 2002 indicate an improved trade performance in most parts of the subregion during the year; the exceptions to this pattern were Papua New Guinea and Samoa (tables II.16 and II.17). This represented a reversal in the trend for Fiji, Solomon Islands and Vanuatu, which experienced some decline in export earnings in 2001. However, Papua New Guinea's export earnings fell sharply by almost one quarter in 2002 (figure II.14). The 24 per cent decline in Papua New Guinea was mainly owing to the depletion of mineral oil reserves.

Table II.16. Selected Pacific island economies: merchandise exports and their rates of growth, 1999-2002

	Value (millions of US dollars)	Exports (f.o.b.) Annual rate of growth (percentage)			
	2001	*1999*	*2000*	*2001*	*2002 (two quarters)*
Fiji	530	19.4	−6.8	−6.8	2.0
Papua New Guinea[a]	1 817	9.1	7.3	−13.7	−23.7
Samoa[a]	14	−2.3	−25.6	3.3	−10.3
Solomon Islands	47	3.8	−53.2	−31.9	6.5
Tonga[b]	12	1.6	−9.5	9.5	76.9
Vanuatu	20	−24.3	6.0	−27.0	5.6

Sources: Central Bank of Samoa, *Bulletin* (Apia, 2002), various issues; National Reserve Bank of Tonga, *Quarterly Bulletin* (Nuku'alofa, 2001-2002), various issues; Central Bank of Solomon Islands, *Quarterly Review* (Honiara, 2002), various issues; Reserve Bank of Vanuatu, *Quarterly Economic Review* (Port Vila, 2002), various issues; Reserve Bank of Fiji, *Quarterly Review* (Suva, 2002), various issues; and Bank of Papua New Guinea, *Quarterly Economic Bulletin* (Port Moresby), various issues.

[a] Data for 2002 are estimates for the whole year.
[b] Fiscal year.

Table II.17. Selected Pacific island economies: merchandise imports and their rates of growth, 1999-2002

	Value (millions of US dollars)	Imports (c.i.f.) Annual rate of growth (percentage)			
	2001	*1999*	*2000*	*2001*	*2002 (two quarters)*
Fiji	783	25.3	−11.2	−2.6	7.1
Papua New Guinea[a]	942	−0.1	−7.0	−6.4	2.1
Samoa[a]	119	20.8	−8.5	12.7	9.2
Solomon Islands	81	−15.5	−14.8	−11.5	−15.3
Tonga[b,c]	62	−28.9	12.8	−1.6	18.6
Vanuatu[c]	78	9.3	−7.3	0.5	−0.7

Sources: Central Bank of Samoa, *Bulletin* (Apia, 2002), various issues; National Reserve Bank of Tonga, *Quarterly Bulletin* (Nuku'alofa, 2001-2002), various issues; Central Bank of Solomon Islands, *Quarterly Review* (Honiara, 2002), various issues; Reserve Bank of Vanuatu, *Quarterly Economic Review* (Port Vila, 2002), various issues; Reserve Bank of Fiji, *Quarterly Review* (Suva, 2002), various issues; and Bank of Papua New Guinea, *Quarterly Economic Bulletin* (Port Moresby), various issues.

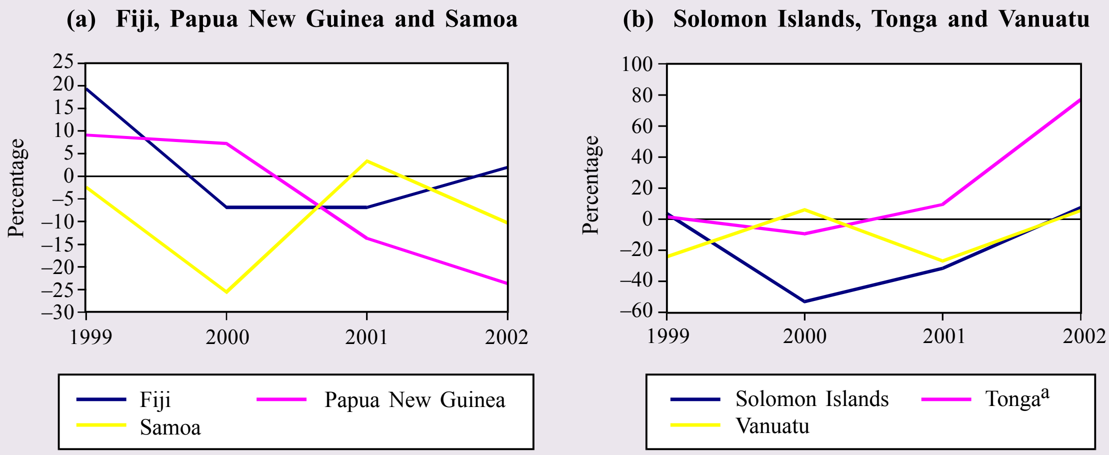
[a] Data for 2002 are estimates for the whole year.
[b] Fiscal year.
[c] Import value f.o.b.

Except for Solomon Islands and Vanuatu, spending on imports in other Pacific island countries are expected to increase in 2002 (figure II.15). The continued contraction of imports in Solomon Islands reflects the poor state of the country's economy during the year.

Fiji's trade deficit widened in 2002 owing to strong demand for intermediate goods

Fiji's merchandise export earnings fell by almost 7 per cent in 2001, to $530 million, largely as a result of a 14 per cent drop in sugar exports and a reduction of 16 per cent in garment export value; the healthy growth of gold and fish exports prevented a sharper fall in total exports. Sugar exports had gone down by 16 per cent in 2000 and the performance of this once-dominant industry is expected to be weak in future years owing to continued uncertainty over the land tenure of sugar farmers. Merchandise imports fell by 2.6 per cent in 2001 to $783 million but there was a 3 per cent contraction in the merchandise trade deficit compared with the previous year's level. The merchandise trade deficit is expected to widen in 2002 as a result of strong demand for intermediate and consumer goods that more than offset the small decline in payments for imported machinery and equipment, mineral fuels and raw materials, and a marginal increase in exports. The prognosis for merchandise trade

Figure II.14. Growth rates in merchandise export earnings of selected Pacific island economies, 1999-2002



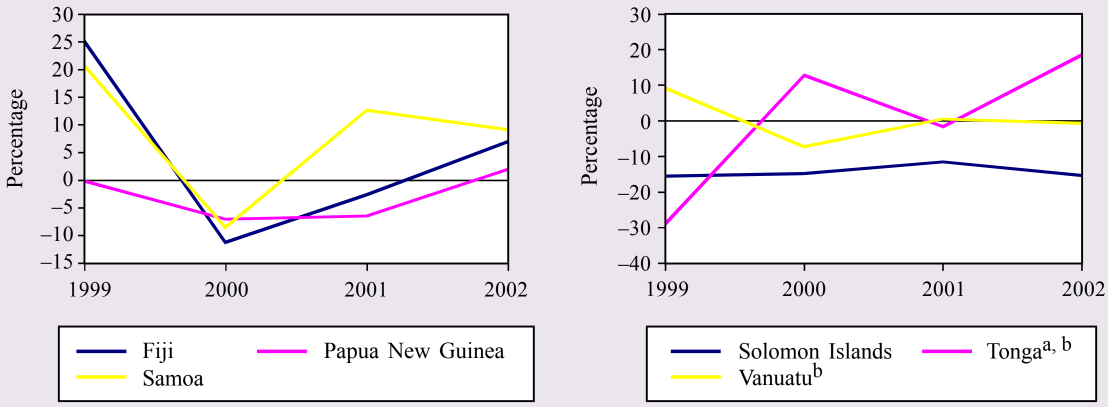
Sources: Central Bank of Samoa, *Bulletin* (Apia, 2002), various issues; National Reserve Bank of Tonga, *Quarterly Bulletin* (Nuku'alofa, 2001-2002), various issues; Central Bank of Solomon Islands, *Quarterly Review* (Honiara, 2002), various issues; Reserve Bank of Vanuatu, *Quarterly Economic Review* (Port Vila, 2002), various issues; Reserve Bank of Fiji, *Quarterly Review* (Suva, 2002), various issues; and Bank of Papua New Guinea, *Quarterly Economic Bulletin* (Port Moresby), various issues.

Note: Data for 2002 are for two quarters only, except for Papua New Guinea and Samoa, in which case they are estimates for the whole year.

[a] Fiscal year.

Figure II.15. Growth rates in merchandise import spending of selected Pacific island economies, 1999-2002

(a) Fiji, Papua New Guinea and Samoa **(b) Solomon Islands, Tonga and Vanuatu**



Sources: Central Bank of Samoa, *Bulletin* (Apia, 2002), various issues; National Reserve Bank of Tonga, *Quarterly Bulletin* (Nuku'alofa, 2001-2002), various issues; Central Bank of Solomon Islands, *Quarterly Review* (Honiara, 2002), various issues; Reserve Bank of Vanuatu, *Quarterly Economic Review* (Port Vila, 2002), various issues; Reserve Bank of Fiji, *Quarterly Review* (Suva, 2002), various issues; and Bank of Papua New Guinea, *Quarterly Economic Bulletin* (Port Moresby), various issues.

Note: Data for 2002 are for two quarters only, except for Papua New Guinea and Samoa, in which case they are estimates for the whole year.

[a] Fiscal year.
[b] Value f.o.b.

is improving given a recovery in garment exports to Australia and New Zealand following the lifting of trade bans imposed by trade unions in those countries.

The coup-induced slump in tourism drove down service exports by over 7 per cent in 2001, after an earlier fall of 9.5 per cent in 2000. Tourism is by far Fiji's most important source of foreign exchange earnings and, all in all, service exports amounted to 29 per cent of GDP in 1999. The strong recovery in tourism accounted for the expansion of over 11 per cent in service exports in 2002. The overall current account deficit rose marginally in 2001 to 3.6 per cent of GDP. In 2002, the improvement in the service balance more than compensated for a higher trade deficit, thus contributing to a slightly lower current account deficit of 3.1 per cent of GDP.

A sharp decline in Papua New Guinea's merchandise exports in 2002

Papua New Guinea's merchandise exports went down by almost 14 per cent in 2001, to $1.82 billion, and declined further, by almost 24 per cent, during the first half of 2002. All major export sectors performed poorly. Agricultural export earnings fell by 25 per cent in 2000 and by another 30 per cent in 2001; they were expected to decrease by a further 28 per cent in 2002. The main source of this persistent slump is coffee, which registered sharp falls in both export volumes and export prices. As a result, earnings on this commodity in 2001 were just one third of the level received in 1999; more seriously, it was expected that such earnings would be halved again in 2002. Palm oil exports have been steady and have now become the country's most important agricultural export.

Mineral oil exports are also on a declining trend owing to the depletion of reserves. Despite favourable external prices, gold and copper exports were expected to be lower in 2002 as a result of supply disruptions at the two largest mines caused by drought conditions. Forestry exports went down in 2001 and 2002 owing to a restrictive export tax regime. Merchandise imports, which had fallen by 6.4 per cent in 2001, to $942 million, recovered to grow by around 2 per cent during the first half of 2002. The share of merchandise imports as a percentage of GDP remained relatively steady at 31.4 per cent, compared with that of merchandise exports, which reached 60 per cent of GDP in 2001.

The merchandise trade surplus, at almost 29 per cent of GDP in 2001, was relatively steady when compared with the previous year but, because of the contraction in GDP, it was $164 million lower in absolute terms. Because of the poor export performance, the trade surplus was estimated to have shrunk further, by some $329 million, to less than one fifth of an already falling GDP. The deficit on external services and incomes fell steadily, from $713 million in 2000 to $608 million in 2001, and was expected to fall to around $527 million in 2002. This trend was due to lower outflows on services and other incomes earned because of the recessional conditions of the domestic economy, including the export sector. The overall current account surplus was over 9 per cent of GDP in both 2000 and 2001, but with the sharp shrinkage of the trade surplus the out-turn for 2002 was expected to be just about 1 per cent of GDP.

Samoa's merchandise exports recovered strongly to grow by 3.3 per cent, or $14 million in 2001, after the steep decline by over a quarter suffered in 2000. The turnaround was, by and large, due to increased fish exports, which accounted for some two thirds of the merchandise export value. Also in 2001, garment exports took over from coconut products to become the country's second most important earner of foreign exchange. This fledgling industry first commenced exports in 2000 and there is considerable scope for greater earnings in this sector. Receipts from the traditional mainstay of the export sector, coconut products, in 2001 were half their 1999 level because of a temporary closure of the coconut oil mill. Operations were scheduled to resume late in 2002, and this would provide a welcome boost to exports in the years to follow. In addition, kava exports nearly disappeared owing to the cessation of orders from the German and American pharmaceutical markets. Taro exports were on the rise after the recovery of the crop from a devastating blight in 1993.

All in all, merchandise exports were expected to be down by 10 per cent in 2002, with the value of fish, garments and coconuts changing little from their 2001 export levels.

Samoa's merchandise trade deficit expected to have worsened in 2002

Merchandise imports in Samoa rose strongly in 2001 to $119 million, or 53 per cent of GDP, owing to higher oil prices and buoyant local demand. The merchandise trade deficit of $105 million, or over 46 per cent of GDP, is expected to have worsened further to 49 per cent of GDP, or about $130 million, in 2002. These massive trade deficits were offset by equally substantial surpluses in the service account balance and inflows of private remittances. The value of exported services dropped slightly in 2001 to $63.6 million, but was expected to expand by over 11 per cent in 2002. The uplift was largely due to tourism, which accounted for three fifths of service exports; indeed, it was likely that revenues from inward tourism would be nearly three times greater than the total earnings on merchandise exports in 2002.

In 2001, the overall surplus on the service account was almost $41 million, or just under 17 per cent of GDP. Net private remittances were relatively stable, adding another $44.3 million in 2001, although this figure was marginally lower, by 2 per cent, than the previous year's level. The strengthening of the currencies of New Zealand and Australia, which are the main sources of private remittances for Samoa, was expected to boost inward remittances by almost one fifth in 2002. The overall current account deficit is also generally stable. It deteriorated in 2001 to an amount equal to 11.2 per cent of GDP, from 5 per cent in the previous year. A further marginal shortfall equivalent to 12.3 per cent of GDP was forecast for 2002.

Solomon Islands' export sector expected to have rebounded in 2002

The export sector was the most severely hit by the civil unrest in Solomon Islands. Merchandise exports fell by 53 per cent in 2000 and by another 32 per cent in the following year, to $47 million, but rebounded with positive growth of over 6 per cent during the first half of 2002. Copra, palm oil and gold exports had disappeared completely and fish exports were at a fraction of their previous level. Log exports were the only commodity to have held up and constituted four fifths of earnings on merchandise exports. The stability of log exports will provide a foundation for trade earnings, which, other things being equal, would recover in the renewal and rehabilitation process.

Balance on the merchandise trade account revealed the severe deterioration in the external trade sector in Solomon Islands. The country had enjoyed a merchandise trade surplus of 14 per cent of GDP in 1999. This became a deficit equivalent to 9.4 per cent of GDP in 2000 and worsened to equal 16.7 per cent during the following year. An improved outcome was expected in 2002 as merchandise exports picked up and imports continued to fall. The external current account also swung sharply from surplus to deficit and amounted to just over 18 per cent of

GDP in 2000. However, a sharp turnaround in inward transfers from abroad more than compensated for the deterioration in the merchandise and service accounts in 2001 and, as a result, shortfalls in the external current account were lowered to 13.3 per cent of GDP; it was expected that the deficit for 2002 would be less than 7 per cent of GDP.

Tonga's efforts in finding new niche markets have yielded dividends in recent years

In Tonga, concerted efforts made by the Government to widen the export base, including the provision of better conditions for the fishing industry and the exploration of new niche markets in agriculture, have yielded dividends in recent years. Merchandise exports went up by 9.5 per cent in 2001, following a decline of almost the same magnitude in the previous year; an even larger upswing of almost 77 per cent was achieved for the first half of 2002. Fish and squash continued to be the principal foreign exchange earners, accounting for 65 per cent of the total export earnings in 2000.

Tonga continues to carry a sizeable merchandise trade deficit, which was equal to almost 43 per cent of GDP in 2001, compared with a relative share of 14.6 per cent in the case of merchandise exports. However, the value of imported merchandise was just over 57 per cent of GDP, compared with 54 per cent in 2000; the marginal decline of 1.6 per cent in import spending in United States dollar terms was offset by the depreciation of the local currency in 2001. Surpluses in the external service account, which amounted to 7.5 per cent of GDP in 2001, compensated in part for the large trade deficit. However, as in the case of Samoa, by far the most important item in the external current account was private unrequited transfers, which, in 2001, brought in $52 million, or almost 39 per cent of GDP. The level of such transfers was twice as high as that of the mid-1990s, although their expansion was expected to taper off in 2002 mainly owing to the adverse impact of the economic slowdown on Tongan workers in the United States. Tonga has recorded a current account deficit since the early 1990s, and the shortfall amounted to 10.7 per cent of GDP in 2001.

Export earnings expected to improve in Vanuatu in 2002 with the recovery in cocoa and copra output

Vanuatu's merchandise exports slumped by 27 per cent, to $20 million or just one tenth of GDP, in 2001, owing principally to the effects of the two devastating cyclones early in the year on cocoa and copra production. Export earnings increased by 5.6 per cent in the first half of 2002, along with the recovery in cocoa and copra output. As in the case of several other Pacific island economies, spending on imports far exceeded receipts from exports, so that the merchandise trade deficit was equivalent to just over a quarter of GDP in Vanuatu in 2001. However, by far the most important exchange earner is inward tourism, which also brought in an amount equal to a quarter of GDP for the same year. Such earnings were thus the main factor accounting for the surplus of just under 1 per cent of GDP in the external current account for 2001; it was likely that the continuing growth in inward tourism would result in a surplus in the external current account for 2002.

Capital flows

Fiji's capital account surplus shrank in the aftermath of the May 2000 coup but, with restored confidence, external capital was again flowing in. The capital account showed a sizeable surplus of $40 million, or 2.4 per cent of GDP, in 2001. This translated into a lower deficit, equal to 1.8 per cent of GDP, in the overall balance of payments in 2001, compared with a shortfall of 3.1 per cent of GDP in the previous year. The stock of foreign reserves stood at F$770 million as at September 2002; this amount was sufficient to cover 3.7 months of imports. In the aftermath of the coup, the Reserve Bank of Fiji introduced capital transaction control measures to stem capital flight and minimize the likelihood of a foreign exchange crisis. Among the notable measures were a reduction in transaction ceilings on foreign exchange, an increase in interest rates on the use of the Reserve Bank's lending facilities, an increase in the documentary requirements involving foreign exchange and the withdrawal of some delegations given to commercial banks on approving foreign exchange transactions.

Fiji has one of the lightest external debt service burdens in the subregion

Along with the improving domestic environment, control measures were being withdrawn in January 2003 with the aim of bringing the foreign exchange control regime to pre-coup conditions. Meanwhile, Fiji's external debt has been in steady decline for a number of years and was around 8 per cent of GDP in 2000. Much of this debt was concessional in nature and external debt-servicing took up only 1.5 per cent of GDP, making it one of the lightest debt-service burdens in the subregion.

In Papua New Guinea, the external capital account deficit shrank from 5.3 to 2.6 per cent of GDP in 2000-2001 on account of a large official drawdown of funds made available under the Structural Adjustment Programme. Partly as a result, the balance-of-payments surplus expanded to $196 million, or 6.5 per cent of GDP, and led to a build-up of foreign exchange reserves, which, at $458 million, were enough for nearly six months of import cover. The small capital account surplus of $49 million, or 1.8 per cent of GDP, in 2002 was principally due to the reorganization of equity ownership in the mineral sector. Despite the lower trade surplus in 2002, the balance of payments was also expected to remain in surplus, although its magnitude would be lower, equivalent to around 3 per cent of GDP.

External debt on the rise in Papua New Guinea

External debt attributable to mining and oil companies has been on the decline because of little new investment and reductions in outstanding loan positions. However, the external debt of the government sector has been on the rise and this accounted for the considerable increase in the level of Papua New Guinea's foreign public debt in 2001 to almost 49 per cent of GDP, compared with 40 per cent in 2000. The debt-service burden jumped to 10 per cent of GDP in 2001, compared with just over 8 per cent in 2000 and 5.4 per cent in 1999.

External debt service remained manageable in Samoa in 2002

Samoa's capital account surplus rose sharply in 2001 to almost $26 million, or almost 11 per cent of GDP, from $12.5 million in the previous year. The capital account is dominated by official flows and the higher surplus reflected the rise in external concessional loans for public investment programmes. The capital account surplus for 2002 was expected to be marginally lower, at around 10 per cent of GDP. The overall balance of payments continued to be in good shape, with a small surplus of 0.4 per cent of GDP in 2000 and a small deficit of 0.6 per cent of GDP in the following year. However, the overall shortfall for 2002 was likely to have been greater, at around 2.7 per cent of GDP. The level of foreign reserves was, by and large, reasonably reassuring at more than four months of import cover. Samoa's external debt levels stabilized at around $145 million in the period 1997-2000, but continued to fall as a percentage of GDP; the level was 55 per cent in 2002, compared with 59 per cent in 2001. The burden on external debt service remained manageable at 2.5 per cent of GDP in 2002.

External debt-servicing is a major problem in Solomon Islands

Solomon Islands recorded capital account surpluses in 2000 and 2001, owing in large measure to the building-up of payment arrears. The overall balance of payments showed a deficit of $19 million in 2000 but a small surplus of $2 million in the following year. The foreign reserve level, at $24 million as at the end of 2001, was less than one half the 1999 level but was enough for three months of cover for lower import demand. External debt increased sharply, from 57 per cent to an estimated 77 per cent of GDP between 1999 and 2001. The slump in GDP was the reason for the surge in the relative importance of external debt, which remained relatively stable in United States dollar terms. Debt-servicing was contained to 4.8 per cent of GDP in 2001, although the decline in export earnings meant that debt-service payments absorbed 21.3 per cent of merchandise export receipts in 2001, compared with 7.4 per cent in 1999.

The overall balance of payments was kept under control in Tonga, with small surpluses recorded for 2000 and 2001. The higher capital inflows expected in 2002 in support of the Public Sector Reform Programme would lead to a larger surplus of around 4 per cent of GDP. Foreign reserve levels were stable and sufficient for four months of import cover. As a share of GDP, external debt went up to just over 43 per cent of GDP in 2001, compared with 39 per cent in 2000, because of the depreciation of the local currency relative to the United States dollar. Debt-servicing was manageable at 2.4 per cent of GDP.

The balance of payments of Vanuatu has been characterized by extended periods of merchandise trade deficits financed by large surpluses on the external service account and sustained inflows of foreign aid and FDI. Since 1998, funds disbursed from multilateral agencies and bilateral donors under the Comprehensive Reform Programme have been a significant source of capital inflows. Overall, the capital account showed only a small deficit in both 2000 and 2001, and the overall position in external payments came very close to balance, recording a deficit of only 0.2 per cent of GDP in both years. Official reserve levels were healthy at 5.3 months of import cover. In principle, the level of external debt in Vanuatu is protected by a safeguard requirement that the Government maintain a prudent level in its external debt position. External debt was low compared with that of other Pacific countries, at under 30 per cent of GDP, and debt-servicing has been less than 1 per cent of GDP in recent years.

Key policy issues

Governance

Governance issues are compounding socio-economic difficulties in several subregional economies

Several Pacific island economies have faced severe social difficulties in recent years, including civil unrest, law and order problems and political disturbances. In large part such difficulties are the symptoms of an unsatisfactory economic performance, the inadequacy of basic services to meet the growing needs of an expanding population, unrelenting pressure on government resources and persistent and sizeable budget shortfalls (table II.18). The importance of good governance in both the

Table II.18. Selected Pacific island economies: budget and current account balance as a percentage of GDP, 1999-2002

(Percentage)

	1999	*2000*	*2001*	*2002*
Budget balance as a percentage of GDP				
Fiji	–5.4	–6.6	–6.9	–6.9
Papua New Guinea	–2.7	–2.0	–3.6	–3.5
Samoa	0.3	–0.7	–2.3	–2.0
Solomon Islands[a]	–3.7	2.9	–8.0	–3.0
Tonga[a]	–0.3	–0.4	–2.6	–4.0
Vanuatu	–3.1	–7.4	–4.0	–3.0
Current account balance as a percentage of GDP				
Fiji	–4.5	–6.3	–3.6	–3.1
Papua New Guinea	2.7	9.9	9.4	1.1
Samoa	–8.1	–5.0	–11.2	–12.3
Solomon Islands	..	–18.1	–13.3	–6.8
Tonga	–12.8	–10.8	–10.7	–9.7
Vanuatu	–5.4	2.1	0.8	1.7

Sources: ESCAP, based on ADB, *Key Indicators of Developing Asian and Pacific Countries 2002,* vol. XXXIII (ADB, 2002) and *Asian Development Outlook 2002* (Oxford University Press, 2002); IMF, *International Financial Statistics,* vol. LV, No. 11 (November 2002); and national sources.

Note: Data for 2002 are estimates.

[a] Excluding grants.

public and the private sectors, as well as a synergistic development partnership between these two sectors, cannot be overemphasized. There is, moreover, a clear need to enhance the role of the private sector in socio-economic activities and services to improve efficiency in resource utilization and, in the process, take some of the load off the public sector. In fact, while extensive structural reforms have been initiated by several Pacific island countries in recent years, the outcome has not always been satisfactory, in part because of inadequate response from the private sector. Consequently, a number of countries have actually abandoned or postponed some scheduled reform measures, such as the privatization of selected public enterprises.

Budget deficits

An external debt burden is not a major problem for most Pacific island countries because the debt stock, relative to, say, GDP, is comparatively modest and a large proportion of external obligations are on highly concessional terms. On the whole, budget deficits as a percentage of GDP have been increasing for some of these countries, including the small, atoll economies (see box II.1), in recent years. However, (non-inflationary) deficit-financing mainly from domestic sources implies the crowding-out of private sector activities.

Fiji's fiscal position deteriorated in 2002

In Fiji, for example, the fiscal position has deteriorated, and the budget deficit was forecast to reach 7 per cent of GDP in 2002 and 4 per cent in 2003. Consequently, debt levels that were on a downward trend prior to the coup in 2000 are on the rise once again, reaching 45 per cent of GDP in 2001. The bulk of this debt is held domestically, and foreign obligations amount to approximately 15 per cent of the total. The medium-term forecasts for the budget and debt levels remain largely sanguine. The actual outcomes, however, will be largely dependent on the success of expenditure reforms and the effectiveness of several newly introduced measures to raise tax compliance while also broadening the tax base. Total expenditure as a proportion of GDP in 2002, for example, stood at 31 per cent, compared with the target of 28 per cent. The priorities for allocations have been changed, with public investment slated to rise from 20 to 30 per cent of the budget. Total government revenue is currently low, standing at just 22.8 per cent of GDP in 2001 and 24.1 per cent in 2002.

Since the tax reforms of 1999 in Papua New Guinea and despite the new revenue measures introduced in 2000, tax revenue has been on a declining trend as a share of GDP. This is due in part to the limited success of VAT, which was introduced as part of the 1999 reforms. Among the causal factors for this lack of success are the inadequate resources committed to enforcing VAT compliance. Further difficulties for

Box II.1. Difficult issues for economic management in small, atoll economies in the Pacific

The available data indicate GDP growth in the range of 0.2-4 per cent in Cook Islands, Kiribati, the Marshall Islands, the Federated States of Micronesia and Tuvalu in 2002. Cook Islands' economy rebounded in that year, after registering a contraction in overall production in 2001, while Kiribati, the Marshall Islands and Tuvalu sustained an average economic expansion of 2.9 per cent a year in 2001-2002. The public sector continues to be a major growth-inducing force in most of these atoll economies. For example, the Marshall Islands economy benefited from the temporary boost in funding and other forms of assistance provided through United States Government programmes under the Compact of Free Association with the United States. Grant funding amounted to about 71 per cent of total government revenue in 2002. The first 15-year phase of the Compact for the Marshall Islands expired in September 2001. Provisions for the next phase, currently under negotiation, are expected to be finalized in 2003; meanwhile, the Compact provides for two years of interim financing.

The Federated States of Micronesia and Palau also benefit from funds received under the Compact of Free Association with the United States. In fact, economic growth in the former economy has been driven largely by the expansionary fiscal policy made possible by the successful adjustment to the reduction in Compact funds that occurred in the mid-1990s. The Federated States of Micronesia and the United States have also been negotiating the nature and extent of continued financial support under the Compact since 1999. The commitments for the first 15 years ended in 2001; on 1 October 2001, additional transitional funds became available for a further two years while negotiations continued. Palau signed its Compact of Free Association with the United States in 1995; it is not due for renegotiation until 2009.

As in the larger Pacific island countries, the small and atoll economies in the subregion face even bigger problems with increasing budget deficits. In the case of the Federated States of Micronesia, the budget surplus in 2002 was a welcome change from the deterioration in consolidated government finances which had been reflected in sizeable budget deficits since 1988; the shortfalls ranged between 4 and 6 per cent of GDP in each year from 1997 to 2001. Local revenue generation is weak in smaller Pacific island economies, a reflection not only of problems with tax collection but also of the low levels of private sector development in those economies. It is therefore welcome news for Cook Islands, the Marshall Islands, the Federated States of Micronesia, Nauru, Niue and Palau that they are to receive a total of 20.9 million euros from the EU during the next five years; the Federated States of Micronesia will be allocated about one third of those funds. All six island economies are new members of the African, Caribbean and Pacific group aid, trade and development partnership with the EU, joining it under the new Cotonou Agreement signed in June 2000. Eight other Pacific island countries have already been included in the Lomé conventions. These funds are to be used by the six countries for developing renewable energy sources, improving health and education services and dealing with drought and cyclone emergencies.

Most Pacific island countries continue to be affected by various natural disasters, including cyclones, drought and earthquakes, which have caused significant damage to property and, in several cases, loss of lives. Several economies, including Fiji, Guam, Solomon Islands, Tonga and Vanuatu, were victims of natural disasters in 2002 alone. In the case of Guam, the overall cost of the damage from Typhoon Pongsona is estimated at $70 million, a substantial sum for a small island economy. This disaster came at a time when the Government of Guam was facing some financial difficulties. It plans to lay off hundreds of workers, increase some taxes and possibly borrow $120 million to balance the budget in 2003.

tax administration were then added by a court ruling late in 2002 that the VAT rate as currently applied was unconstitutional. Meanwhile, VAT revenues in 2001 had reached only one third of the original projections and amounted to less than 9 per cent of the tax revenue for the year, instead of becoming the Government's most important source of revenue, as had been hoped initially.

A mini-budget in Papua New Guinea in 2002 was aimed at reducing the revenue shortfall

Total government revenue fell to 28.4 per cent of GDP in 2001, from over 31 per cent during the previous year. This drop was due to the slump in VAT revenue collections and a fall in realized taxes on log exports and corporate incomes. Total government expenditure amounted to just under one third of GDP in 2001, but one seventh of such spending was absorbed by debt-service payments. The budget deficit exceeded projections and, at 3.6 per cent of GDP in 2001, was the highest shortfall in a decade. It expanded rapidly in 2002, in part because of increased spending relating to the general elections and in part because of the ongoing recession. A mini-budget introduced by the incoming Government for the second half of 2002 aimed at reducing the fiscal deficit to under 3.5 per cent of GDP for 2002, compared with earlier expectations of more than 6 per cent.

Samoa plans to increase the VAT rate by 2.5 per cent to address a persistent fiscal deficit

Samoa continues its prudential fiscal management with the budget deficit for the financial year to June 2002 set at 2 per cent of GDP, down slightly from the previous year's outcome, which was equivalent to 2.3 per cent of GDP. For future years, however, the Government is targeting a balanced budget. Tax revenue in financial year 2001/02 was rising in line with GDP growth and stood at around 21 per cent of GDP. A matter of concern for the Government is the declining trend in non-tax revenue, which fell a further 29 per cent in 2002 to its lowest level since the early 1990s. This persistent fall is due partly to the implementation of the Public Sector Reform Programme and partly to weakened enforcement. Thus, in an effort to maintain a strong revenue base, plans are being made to increase the VAT rate in Samoa from 10 to 12.5 per cent.

External grants to Samoa rose sharply in 2002 to $27.6 million, or almost one third of government revenue, and were the main contributor to the observed rise in total revenue to almost one third of GDP in 2002, from just under 31 per cent in 2001. However, there was a modest rise in public spending, from 33.1 to 34.8 per cent of GDP in 2001-2002, mainly because of advanced allocations on an aid-funded programme plus higher public sector wages and salaries. There was, in fact, an implied tightening of expenditure, especially in the second half of 2002. Loan-funded infrastructure projects were held back to contain expenditure and cool off the economy. Government debt had reached almost 62 per cent of GDP in 2000, but dropped to under 59 per cent in the following year owing to a strong economic performance. The debt-service burden was highly manageable in 2001 at just 2.4 per cent of GDP.

The budgetary position of Solomon Islands remains fragile

By contrast, the budgetary position of Solomon Islands remains precarious. This is the net result of large and persistent past deficits combined with sizeable losses of government revenue caused by declining economic activities and the rise in civil unrest, which had begun in 1999. Expenditure went up considerably to accommodate higher public sector wages and salaries; the estimated deficit for 2001 was 8 per cent of GDP. In addition, large arrears in payments had been building up and some public sector salaries were not being paid. The security situation was improving but the increased efforts to curb law and order problems could be hampered by overdue payments. Domestic debt was approaching one third of GDP in 2001, but the true debt position may be higher when account is taken of accumulated overdue payments.

Tonga's overall budget deficit is on an upward trend

In Tonga, tax revenue fell short and expenditure exceeded the budget in 2001, the latter being attributable to a rise in public sector salaries and support for loss-making public trading enterprises. Total government revenue as a share of GDP rose slightly to 28 per cent in 2001, while expenditure expanded sharply from just under 29 per cent to almost 32 per cent of GDP in 2000-2001. Consequently, the overall budget deficit was on an upward trend; it was equivalent to 0.4 per cent of GDP in 2000 but went up to 2.6 per cent in the following year and was expected to reach 4 per cent of GDP in 2002. This has been a matter of significant concern to the Government and responsive measures are being taken to address the problem through the Public Sector Reform Programme introduced in mid-2002. For some time, ways and means have been considered to find alternatives to tariffs as a principal source of revenue. Tax revenue has declined marginally as a share of GDP but this has been offset by the relatively healthy growth of non-tax revenues.

The budget deficit, although relatively high, moderated in Vanuatu in 2002

Vanuatu recorded relatively large fiscal deficits, averaging 5.7 per cent of GDP in 2000-2001. The budget shortfall, although becoming lower at 3 per cent of GDP, in 2002, persisted despite a variety of measures implemented by the Government to rein in expenditure. Optimistic revenue projections for gambling taxes and VAT are primarily responsible for these deficits. But the revenue base is narrow and broadening efforts are called for so that total revenue can reach 27 per cent of GDP, as intended, from the current level of around 24 per cent. However, the recommendations of a committee to review revenue are yet to be accepted or implemented. Total government debt built up to nearly 40 per cent of GDP in 2001, and debt-servicing payments reached 3.5 per cent of GDP and absorbed more than 16 per cent of government revenue.

Money and finance

Demand for credit in Fiji remained subdued, with the Government absorbing the bulk of the available funds

The Reserve Bank of Fiji has maintained an accommodative stance on monetary policy, with the indicator rate on its 91-day bonds at 1.25 per cent as at September 2002. A relatively healthy foreign exchange position has enabled the Reserve Bank to relax controls on cross-border capital flows. Commercial bank interest rates were also on a downward trend as a result of the build-up of excess liquidity in the year. In particular, the weighted average lending rate on outstanding loans and advances had fallen in 2002 to 8 per cent, compared with 8.3 per cent in 2001 and 8.4 per cent in 2000. However, demand for credit remained subdued, with the Government absorbing the bulk of the available funds. One issue is that, despite the excess liquidity in the system, interest rate margins remained large and lending rates high relative to those in the neighbouring industrialized countries, Australia and New Zealand. There were signs of recovery in the demand for credit by the private sector, which could result in interest rates either stabilizing or edging upwards in 2003.

The downward trend in private sector credit in Papua New Guinea was a reflection of the poor business and investment environment

Credit extended to the private sector in Papua New Guinea fell by 1.3 per cent in 2001 in local currency terms. As a share of GDP, it declined from 16.2 per cent in 2000 to 15.3 per cent in 2001 and further to 13 per cent in 2002. This downward trend reflected the poor business and investment environment and persisted despite an easing of interest rates. Lower borrowings from agriculture and commerce were the main factor responsible for the credit slump. However, money supply registered a strong expansion in 2002 owing to rises in government credit. Lending rates eased in 2001 to 14.6 per cent, the lowest levels since 1998, from 15.5 per cent in 2000. However, the interest rate margin expanded, with average deposit rates falling from 6.7 in 2000 to 4.1 per cent in 2001.

Financial sector liberalization in Samoa has contributed to improving private sector access to credit

The programme of financial sector liberalization in Samoa began in 1998 and has proved particularly successful in improving private sector access to credit and, by extension, facilitating greater participation of the private sector in development. Private sector credit has grown rapidly since liberalization. At the same time, government credit demand has been lowered; in fact, the Government continues to be a big net lender in the monetary system. Private sector credit, which had grown by 14.5 per cent to reach 31.3 per cent of GDP in 2001, slowed somewhat and expanded by 5 per cent in the following year. This was a reflection of successful government efforts to cool off the economy, as noted earlier. The building and construction industry continued to be a major borrower, with the agricultural sector absorbing just 4 per cent of private sector credit in 2002. Nominal interest rates have been stable in recent years, with the weighted average lending rate going down marginally from 11 per cent in 2000 to 9.9 per cent in 2001 and to an expected 9.8 per cent in 2002. The deposit rate declined in a similar manner over those years and the interest rate spread remained steady at around 4.4 per cent.

The high lending rates in Solomon Islands reflected higher commercial risks

There are difficult issues to resolve in Solomon Islands' financial system. Its net foreign asset position fell by 60 per cent as at the end of 2001, compared with 1999. Private sector demand for credit fell by 22 per cent in 2001, and this contributed to sharp increases in liquidity. Domestic financial institutions and the Central Bank have declined to purchase any Treasury Bills, thereby imposing severe discipline on the budget. There were signs of revival in credit demand by the private sector towards the end of 2002 along with the improved security situation. Reflecting higher commercial risks, among other things, the (average) lending rate went up to 15.5 per cent in 2000 from 14.5 per cent in 1999; the interest rate margin also increased to more than 13 percentage points in 2000 compared with levels of around 11.6 percentage points in 1999.

There is a comparatively low interest rate spread in Tonga, in part because of the regulation on interest rates. Deposit and lending rates have remained largely unchanged for a number of years so that the interest rate spread remained between 4.8 and 5.2 per cent during the period 1998-2002. In 2001, the private sector accounted for 86 per cent of domestic credit, which expanded by just under 10 per cent compared with almost 18 per cent in 2000. The rapid growth in money supply (M2) in 2000-2001, averaging almost 17 per cent annually, was of some concern. Lower public sector borrowing is expected to contribute to a sharp decline in money supply growth in 2002.

In response to the slowdown in economic activities in the second half of 2001, the Reserve Bank of Vanuatu eased monetary conditions. Private sector credit went down by almost 5 per cent in 2000 but rebounded in 2001 to grow 6.4 per cent. Vanuatu continues to have high lending rates, which increased to 10.2 per cent up to September 2002 from 9.1 per cent in 2001; the interest rate spread has been increasing in recent years and reached over 9 per cent in 2002.

Combating money-laundering issues

Addressing concerns that countries in the subregion may be easy targets for people and organizations involved in money-laundering activities is a major challenge for subregional economies

FDI and other forms of external capital inflows are crucial for economic and social development in the Pacific island economies, especially given the low levels of domestic savings in the subregion. However, concerns that these economies may be an easy target for money-laundering activities have brought a new perspective to the whole issue of capital flows. Money-laundering, defined as the process of disguising proceeds from criminal acts as legitimate income, is posing a new threat to Pacific island countries.[2] Central bankers from Pacific island countries have agreed to be specially vigilant in dealing with capital transfers and related transactions so as to weed out criminal proceeds and funds used to support terrorist activities. Fiji and Vanuatu are in the process of establishing a Financial Intelligence Unit responsible for gathering, storing and disseminating information to relevant authorities on financial transactions associated with criminal activities.

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[2] See *Survey 2001,* box II.2.

Development of statistics

The chronic lack of reliable and up-to-date data on Pacific island economies has been a major problem for policy makers and government planners. At the initiative of the Secretariat of the Pacific Community (SPC), a broad range of statistical indicators, including those for the millennium development goals, will soon be available for the first time in a regional Internet-based information system which the national statistical offices in the Pacific subregion will be able to update. The Pacific Regional Information System (PRISM) is currently been developed by SPC and is expected to go online in May 2003. Although PRISM may not generate fresh data, it is expected to provide a cheaper, wider and easier way to disseminate essential data from the subregion.

The Secretariat of the Pacific Community's new initiative with the Pacific Regional Information System is likely to address data problems in Pacific island countries

PRISM offers new scope for enhancing capacity in the Pacific by providing regional solutions to common problems and disseminating key information on the extent, causes and dynamics of such issues as poverty, healthy lifestyles and the environment to a wide range of users within the Pacific island subregion and beyond. One of the features of this new project is that it contains not only statistical data but also the sources of these data and information on how they were compiled. Another distinguishing feature of PRISM is that the national statistical offices will be the main beneficiaries; the national Internet web sites will be built and maintained by national statistical office staff, with major emphasis on ensuring national ownership of the information to be stored in PRISM. SPC will be developing PRISM in consultation with other subregional organizations, thereby improving the quality, coverage and dissemination of information throughout the subregion.

The primary aim of PRISM is to give national statistical offices the tools and skills needed to develop, publish and maintain their own Internet web sites, containing key statistical indicators, statistical summaries, reports, concepts, definitions and other documentation relating to the statistical indicators. The PRISM web site will act as a portal to the national statistical web sites to be developed and maintained by the national statistical offices in cooperation with SPC. Where countries lack the capacity to host their own web sites locally, these web sites will be hosted at SPC. All the information on the national web sites will be compiled on the SPC PRISM web site, which will also contain a number of additional resources for users. In this way, PRISM will provide the national statistical offices with more cost-effective data dissemination and storage facilities and eliminate much of the costly duplication of effort now faced by Pacific island countries in responding to numerous queries and requests for information and statistics.