# 3

# Macroeconomic Performance in Six Pacific Island Countries

*TK Jayaraman*

## 3.1 Introduction

The six Pacific island countries (PICs) under study are members of the Pacific Community, which comprises 22 political entities. Eight of these are territories of and administered by major powers, including United Kingdom. There are 14 independent states and eight territories. The territories are administered by major powers. The 14 independent states are the members of the intergovernmental organisation known as the Pacific Islands Forum.

The Pacific Community straddles both the International Date Line and the equator, ranging from the Republic of Marshall Islands in the north to Tonga in the south, and from Papua New Guinea (PNG) in the south-western Pacific to Cook Islands in the south-eastern Pacific. They have a combined total land area of 0.53 million square kilometres (sq. km), most of which is accounted for by PNG (0.46 million sq.km). The smallest territory is Tokelau (12 sq.km). PNG has the largest population in the region with close to 6 million people and the territory of Pitcairn has the lowest population of 60.

Private sector development in all PICs has been seriously hampered by the communal land tenure system, unique to all Pacific islands in terms of the communally held land which cannot be freely bought by or sold to any private individual for land-based activities. The commercial banks find it difficult to lend to any land-based activities, including hotel and resorts, in the absence of land as collateral. Among the 14 members of Pacific Island Forum, six of them have independent currencies and are the focus of this book. While PNG switched from a two-decade-old fixed exchange rate regime to a floating exchange rate in 1994, the other five – Fiji, Samoa, Solomon Islands, Tonga, and Vanuatu – continued with their fixed exchange rate regimes, with periodical adjustments in nominal exchange rates, adopted soon after their independence in the 1970s.

The six Pacific island countries display a high degree of diversity in terms of land area, natural and human resource endowments, manufacturing base and export capacity. Among the six PICs, PNG has mineral resources of substantial range and nature, including petroleum and gas, which none of the other five can boast of. Vanuatu is the tax haven in the region, with flourishing offshore financial institutions. Fiji and PNG are the only two

**Table 3.1** Pacific island countries: macroeconomic statistics, 1996–2008

| | *1995* | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* | *2002* | *2003* | *2004* | *2005* | *2006* | *2007* | *2008* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Real GDP growth rate** (%) | | | | | | | | | | | | | | |
| Fiji | 2.1 | 4.8 | -2.2 | 1.3 | 8.8 | -1.6 | 1.9 | 3.2 | 0.9 | 5.5 | 0.6 | 3.4 | -6.6 | -1.2 |
| Papua New Guinea | -3.3 | 6.6 | -6.3 | 4.7 | 1.9 | -2.5 | -0.1 | -0.2 | 2.2 | 2.7 | 3.7 | 2.6 | 6.7 | 7.3 |
| Samoa | 6.6 | 7.3 | 0.8 | 2.4 | 3.1 | 7.1 | 8.1 | 1.8 | 3.1 | 3.4 | 5.2 | 2.6 | 6.1 | 3.3 |
| Solomon Islands | 5.4 | 1.9 | -1.7 | 3.2 | -1.6 | -14.2 | -8.2 | -2.8 | 6.5 | 8.0 | 5.0 | 6.1 | 10.3 | 7.0 |
| Tonga | 2.9 | -0.5 | -3.2 | 3.5 | 2.3 | 5.4 | 7.2 | 1.4 | 3.4 | 1.1 | -3.3 | 4.4 | -0.3 | 1.0 |
| Vanuatu | 4.7 | 7.2 | 8.6 | 4.3 | -3.2 | 2.7 | -2.6 | -7.4 | 3.2 | 5.5 | 6.5 | 7.2 | 6.6 | 5.7 |
| **Inflation** (%) | | | | | | | | | | | | | | |
| Fiji | 0.3 | 4.9 | 3.4 | 5.7 | 2.0 | 1.1 | 4.3 | 0.8 | 4.2 | 2.8 | 2.4 | 2.5 | 4.3 | 7.5 |
| Papua New Guinea | 17.3 | 11.6 | 4.0 | 13.6 | 14.9 | 15.6 | 9.3 | 11.8 | 14.7 | 2.2 | 1.8 | 2.4 | 0.9 | 10.6 |
| Samoa | -2.9 | 5.4 | 6.9 | 2.2 | 0.3 | 1.0 | 3.8 | 8.0 | 0.1 | 16.3 | 1.8 | 3.7 | 5.6 | 6.5 |
| Solomon Islands | 9.8 | 11.8 | 8.1 | 12.3 | 8.0 | 7.1 | 7.7 | 9.4 | 10.0 | 7.1 | 7.3 | 11.2 | 7.7 | 15.1 |
| Tonga | -0.5 | 2.7 | 2.0 | 3.0 | 3.9 | 5.3 | 6.9 | 10.4 | 11.1 | 11.7 | 9.9 | 7.3 | 5.1 | 10.0 |
| Vanuatu | 2.2 | 0.9 | 2.8 | 3.3 | 2.0 | 2.5 | 3.7 | 2.0 | 3.0 | 1.4 | 1.2 | 2.0 | 3.9 | 4.5 |
| **Budget balance** (% of GDP) | | | | | | | | | | | | | | |
| Fiji | -0.2 | -4.7 | -6.5 | 5.0 | -0.3 | -3.2 | -6.5 | -5.7 | -5.8 | -3.1 | -3.4 | -2.9 | -1.3 | -1.5 |
| Papua New Guinea | -0.5 | 0.5 | 0.2 | -1.8 | -2.4 | -1.8 | -3.0 | -3.3 | -1.0 | 1.6 | 0.0 | 3.1 | 2.5 | 1.0 |
| Samoa | -7 | 1.4 | 2.2 | 2.0 | 0.3 | -0.7 | -2.2 | -2.0 | -1.3 | -0.8 | 0.3 | 1.1 | -0.3 | |
| Solomon Islands | -4.6 | -4.3 | -4.2 | -1.6 | -3.7 | -7.5 | -12.3 | -10.3 | 0.2 | 5.1 | 2.5 | 1.5 | -1.1 | NA |
| Tonga | 1.2 | 0.9 | -4.8 | -2.4 | -0.2 | -0.4 | -1.8 | -1.4 | -3.1 | 0.9 | 2.4 | 1.5 | 1.5 | -1.0 |
| Vanuatu | -2.7 | -1.7 | -0.5 | -9.4 | -1.5 | -7.0 | -3.7 | -2.2 | -1.8 | 1.2 | 2.1 | 1.2 | -0.3 | NA |
| **Current A/C balance** (% of GDP) | | | | | | | | | | | | | | |
| Fiji | -0.9 | 3.1 | 4.3 | 4.8 | 2.2 | -6.9 | -7.0 | -1.2 | -6.1 | -13.6 | -14.0 | -22.6 | -15.5 | -21.3 |
| Papua New Guinea | 18.3 | 5.6 | -5.4 | 0.9 | 2.8 | 8.5 | 6.5 | -1.0 | 4.5 | 2.2 | 4.2 | 2.9 | 4.3 | 3.3 |
| Samoa | NA | NA | 7.2 | 6.6 | 2.3 | 4.4 | -2.7 | 1.9 | -0.5 | -7.1 | -6.6 | -10.8 | -4.6 | -7.8 |
| Solomon Islands | 3.7 | 3.1 | -5.3 | -1.7 | 6.9 | -10.1 | -9.4 | -6.5 | -9.1 | -23.5 | -9.8 | 5.6 | -2.8 | -6.8 |
| Tonga | -11.3 | -6.1 | -0.9 | -10.9 | -0.6 | -6.2 | -9.5 | 5.1 | -3.1 | 4.2 | -2.6 | -9.7 | -10.4 | -10.4 |
| Vanuatu | -2.2 | -2.3 | -1.0 | 2.5 | -4.9 | 2.0 | 2.0 | -5.4 | -6.6 | -5.0 | -7.4 | -5.7 | -9.9 | -11.4 |
| **Change in money supply** (%) | | | | | | | | | | | | | | |
| Fiji | 4.5 | 0.9 | -8.7 | -0.5 | 13.6 | -1.5 | -3.1 | 7.8 | 25.0 | 10.5 | 15.1 | 20.2 | 10.3 | 4.9 |
| Papua New Guinea | 13.7 | 30.7 | 7.7 | 2.5 | 9.2 | 5.0 | 6.2 | 7.3 | -4.4 | 14.8 | 29.5 | 38.9 | 27.8 | 21.6 |
| Samoa | 24.4 | 6.3 | 15.2 | 2.5 | 15.7 | 16.3 | 6.1 | 10.2 | 14.0 | 8.3 | 15.6 | 13.7 | 11.0 | 6.9 |
| Solomon Islands | 9.2 | 15.3 | 6.7 | 2.5 | 7.0 | 0.6 | -13.6 | 6.0 | 25.4 | 17.5 | 38.0 | 26.0 | 23.6 | 9.7 |
| Tonga | 0.7 | 5.3 | 6.6 | 14.8 | 12.0 | 18.7 | 14.3 | 8.3 | 14.5 | 13.9 | 22.1 | 5.4 | 13.5 | 10.1 |
| Vanuatu | 13.3 | 10.1 | -0.3 | 12.6 | -9.2 | 5.5 | 5.5 | -1.6 | -0.9 | 9.9 | 11.8 | 7.0 | 16.0 | 12.8 |

*Source:* UNESCAP (2009, 2008)

PICs which have some significant manufacturing activities. Tourism has been the major foreign exchange earner for Fiji and Vanuatu, while remittance inflows (from citizens who are employed overseas) are the dominant contributor to gross domestic output (GDP) of Tonga and Samoa. All PICs depend on annual official development assistance. In recent years, in terms of percentage of GDP, Solomon Islands has been the highest recipient of foreign aid.

Growth in PICs has been historically low at about 2 to 3 per cent per year in past decades. During the last eight years, improved performance was recorded by most of them (table 3.1). While world commodity boom until mid-2008 mostly benefited PNG, implementation of reforms in various sectors helped all PICs record better macroeconomic performance. However, lack of diversification in export sector with high commodity concentration on one or two items such as sugar and fish, and discontinuance of preferential treatment for traditional exports such as sugar and withdrawal of quota arrangement for garments, have had adverse effects on balance of payments in most of the PICs. Inflation has been kept low, mainly because their imports are sourced from Australia and New Zealand, whose monetary policies have been targeting inflation. Official development assistance and private remittance inflows provided considerable support to their balance of payments. Macroeconomic performance of each of the six PICs is reviewed in the next section.

## 3.2 Fiji

Fiji (population 853,000), whose key indicators are given in table 3.2, is the leading economy in the South Pacific region. It shares many commonalities with the rest of the PICs including communal land tenure, under which land is not an economic good as it cannot be freely sold and bought, and proneness to natural disasters, including droughts, cyclones and floods affecting one part or another of the country every year (Jayaraman and Choong, 2006a). Fiji's leading position among all PICs is due to its significant manufacturing base, a relatively large endowment of skilled labour and trained professionals and a thriving services sector, encompassing tourism and commercial activities, both retail and wholesale. Manufacturing activities include production of sugar, traditionally meant for exports under preferential trading arrangements with European Union, and consumer goods such as biscuits, detergents and cooking oil for domestic consumption as well as export to other island countries. Being centrally located in the regional map with better airline connections, Fiji has had a clear head start in South Pacific tourism, right from the early days of air travel, attracting far greater foreign direct investment in hotel and resort activities than other island countries in the region.

Fiji has a fixed exchange rate regime, which has served the country well. Since most of the imports have been sourced from Australia and New Zealand, domestic inflation has remained low. With no mineral resources, Fiji is heavily dependent on imports ranging from wheat flour, rice and other items of food and beverages, to fuel and capital and transportation machinery and equipment. Fiji's exports have been sugar, garments, *kava*, a non-narcotic beverage root crop, spices and gold. Export earnings have been far less than imports with the result that trade balance always remained negative. However, tourism earnings and

**Table 3.2** Selected key indicators in Fiji

| | |
|---|---|
| Land area (sq.km.'000) | 18.3 |
| Population (2006: '000) | 853 |
| Per capita GDP (US$) current prices: 2006 | 3,306 |
| Aid per capita in US$ (2006) | 65 |
| Aid as % of GDP (2006) | 1.8 |
| Human development ranking (2006) | 106 |
| Annual growth rate in % (2001–07) | 1.3 |
| Annual growth rate inflation in % (2001–07) | 3.0 |
| Overall budget balance as % of GDP (2001–07) | -4.1 |
| Current account balance as % of GDP (2001–07) | -11.4 |

*Source:* ADB (2008), UNESCAP (2008, 2009)

in recent years, remittances have provided substantial support to country's current account balance, minimising pressures on the fixed exchange rate regime.

Fiji's economic growth since its political independence in 1970 until 1986 was steady despite the adverse effects of annual natural disasters. In the first decade of its independence (1970–79), the annual average growth rate was a close 6 per cent. Following the two military coups in 1987, economic growth was on the decline, as tourism was adversely affected while the country remained isolated by the world community and the investment environment became unattractive to overseas investors. In order to prevent capital outflows following the deterioration in political climate, the interim government imposed severe exchange controls on various transactions. The government took another major step: it devalued the Fiji dollar in two steps, totalling about 33 per cent. Further, there was a shift in emphasis on economic strategy. It deregulated the economy to bring domestic prices in line with world prices by abolishing subsidies with a view to encouraging Fiji's external competitiveness.

Although democracy returned with elections in 1990, the atmosphere was one of uncertainties all around until 1997 when a new constitution was adopted, paving the way for recovery. However, much damage had been done by then, as out-migration of skilled workers had reduced Fiji's human capital (D'Hoore, 2006). The continued state of weak investment climate and political sanctions against Fiji affected capital inflows. Consequently, current account in the balance of payments suffered serious deficits. In 1998, in the wake of the Asian financial crisis, the authorities resorted to devaluation of the currency by about 10 per cent, adversely affecting export earnings.

Following the adoption a new constitution in 1997, fresh elections were held in 1999. Before the newly elected government could settle down, investor confidence was given yet another jolt in 2000, this time by a civilian coup. Once again, the international community applied sanctions against Fiji, which included suspension by the Commonwealth. As a result, tourism earnings decreased and FDI inflows became scarce. Economic growth declined by 3 per cent in 2000. The central bank, Reserve Bank of Fiji (RBF), imposed credit ceilings

on bank lending, raised its lending rate and clamped exchange controls with a view to conserving foreign reserves, as the exchange rate came under pressure.

Order was restored when fresh elections were held in 2001. With the guidance of a coalition government, the next five years witnessed steady recovery. Economic sanctions were lifted and the country was readmitted to the Commonwealth. Tourism boomed again and the newly emerged garment industry flourished as exports to USA and EU under quota arrangements grew. However, the sugar industry lagged behind, as leases had expired without renewal. Poor management of sugar mills also contributed to fall in exports. Despite the decline in the pre-eminence of sugar as a major export earner, the economy grew thanks to expansionary fiscal policies. The latter gave rise to annual budget deficits during each of the five years until 2006. The fiscal deficit was 6.5 per cent of GDP in 2001, 5.7 per cent in 2002 and 5.3 per cent in 2003 and continued to be around 3 per cent in each of the next three years.

Private sector confidence also returned, accompanied by an unprecedented credit boom (Jayaraman and Choong, 2007a). As fiscal deficits and growth in bank credit stepped up aggregate demand, which spilled over into demand for imports, annual current account deficits began to widen each year (Jayaraman and Choong, 2007b) during this period rising from 1.2 per cent of GDP in 2002 to 22.6 per cent of GDP in 2006 (UNESCAP, 2008). The sugar industry was already on the decline. With the expiry of garment export quota arrangements with USA effective January 1, 1995, and as there were no new sources of exports, pressures were soon felt on exchange rate (Jayaraman and Choong, 2008). The RBF applied the brakes, raising the statutory reserve deposit ratio to 7 per cent from 5 per cent and imposed credit ceilings in regard to credit for certain sectors.

Fiscal deficits were financed by public borrowing (Jayaraman and Choong, 2006b), most of which was done by selling bonds to a captive institution, the Fiji National Provident Fund. As government felt that domestic borrowing sources were drying up and that it would be preferable to take advantage of good credit standing, it floated in July 2006 the very first international bond for a total of US$150 million. Overseas private borrowing helped the country's international reserve position by adding equivalent foreign exchange, further reinforcing exchange rate stability. As it helped to add to the real resources of the country, inflation was kept low as well.

An uninterrupted growth for a five-year period, which no doubt resulted in the overheating of the economy by fiscal deficits and private sector credit boom, was halted by a military coup in December 2006 before the completion of the full five-year term of the elected government. Since January 2007, the economy has been in a downward spiral. Tourism was the major victim, though it made a slight recovery in later months. The economy, which grew at annual rate of 3.4 per cent in 2006, plunged in 2007 to a record negative growth rate (-6.6 per cent). The estimated growth rate in 2008 was 1.2 per cent (RBF, 2008).

The interim government since 2007 followed a sensible fiscal policy by reducing the deficit to 1.5 per cent of GDP. However, as world economic conditions deteriorated in mid-2008, Fiji's economy came under fresh stress, this time induced by factors beyond its control. With exports declining and tourism sector stagnating, the predominant concern has been with protecting foreign reserves, which were at F$832 million in December 2008,

adequate to cover just about three months' imports. As the global oil price plummeted from the peak of US$145 per barrel to below US$50 per barrel, there was some relief on the inflation front. Domestic inflation fell from 20-year high at 20 per cent in September 2008 to 7.5 per cent in December 2008.

The monetary policy statement of December 2008 notes that, 'the primary focus of the monetary policy in the medium term will continue to be on protecting our foreign reserves position. The credit ceiling remains the key instrument in alleviating the pressures on foreign reserves by dampening credit to non-priority sectors, particularly for consumption activities' (RBF, 2008).

In 2009, with the officially declared recession in Australia, New Zealand and the USA, prospects of any economic recovery through exports of goods and tourism services were becoming less promising. Added to these worries, the political situation was also getting worse. In April 2009, as a judicial pronouncement turned against the interim government, judges were dismissed and the Constitution was abrogated. One of the first decisions immediately after the abrogation of the Constitution was the devaluation of the Fiji dollar by 20 per cent. The devaluation was defended on the ground that the nominal exchange rate had been out of line for some time in the past, as it was overvalued and it was expected that devaluation would improve the competitiveness of Fiji's exports and export earnings from both goods and services including tourism. One immediate result was the foreign reserves were revalued at the new exchange rate and at the end of April 2009, they rose to F$631 million, as against F$429 million in March 2009 (RBF, 2009).

## 3.3 Papua New Guinea

Papua New Guinea, which attained independence in 1975, is the biggest of all PICs with the largest land area (463,000 sq.km) and highest population (almost 6 million). The country has abundant natural resources, notably mineral resources, including copper, petroleum and gas, which none of the other PICs has. The export base is not only well diversified in terms of mineral exports, including copper in early years and petroleum and natural gas in the late 1990s and early 2000s, but also in terms of tree crop exports such as coffee, cocoa and tea, which makes PNG an outlier for all purposes.

PNG has had a larger share of natural disasters affecting the lives of people in the region, including major volcanic eruption and two cyclones in 1997–98, El Nino drought in 1997–98, besides difficulties arising from human activities including closure of Bougainville copper mine in 1989 and the Asian financial crisis of 1997. PNG's economic growth since independence in 1975 has centred on its mineral exports performance.

About 85 per cent of the population is living in rural areas in 600 islands, predominantly in the mountainous areas. The government has been dependent on mineral exports and related export levies and royalty incomes. Earnings from copper exports in the 1980s and petroleum boom in the 1990s were however frittered away by expansionary fiscal policies, which consisted of wasteful government expenditures, ending in fiscal deterioration and external imbalances. As macroeconomic adjustments were needed, the government approached International Monetary Fund (IMF). Two stand-by arrangements during

1990–92 and a third in 1995 rescued the country from the brink. However, subsequent falls in mineral exploration activities, deterioration in physical infrastructure in rural areas, the 1997 drought and the closure of copper mines, contraction in external demand for exports, and law and order problems put the economy in poor shape. As private capital outflows increased, the domestic currency, kina, depreciated despite central bank intervention (Marciniak, 2006). Inflation soared to 20 per cent in 1998. Yet another, fourth IMF stand-by arrangement in 2000–01, this time with a view to stabilising the economy through fostering private-sector-led growth, was implemented. However, economic recovery failed to follow (Marciniak, 2006).

**Table 3.3** PNG: selected key indicators

| | |
|---|---|
| Land area (sq.km.'000) | 463 |
| Population (2006: '000) | 5,995 |
| Per capita GDP (US$) current prices: 2006 | 943 |
| Aid per capita in US$ (2006) | 47 |
| Aid as percentage of GDP (2006) | 6.7 |
| Human development ranking (2006) | 145 |
| Annual growth rate in per cent (2001–07) | 2.5 |
| Annual growth rate inflation in per cent (2001–07) | 6.2 |
| Overall budget balance as per cent of GDP (2001–07) | -1.7 |
| Current account balance (% of GDP) (2001–07) | 3.4 |

*Source*: ADB (2008), UNESCAP (2008, 2009)

To revive the economy in the second half of 1990s, government adopted expansionary policies. These included tax reductions and provision of agricultural export subsidies and regular transfers to unviable state-owned enterprises. As a result there were massive annual budget deficits. Government debt rose to 60 per cent of GDP in 1996 from 45 per cent in 1990. Balance of payment crises ensued and international reserves dwindled at one point to a half-month of non-mineral imports (Marciniak, 2006). Events forced PNG to resort to a floating exchange rates regime, which brought in a measure of external stability, though only for a short period. A sharp contraction in exports due to drought in 1997 and the Asian financial crisis caused another current account crisis. Budgetary reforms introduced in 1999 restored some stability. However, in the months leading up to the 2002 elections, the familiar fiscal excesses were once again indulged in by the incumbent government to re-capture power, which led to deterioration of both budget and current account balances. Reviewing a 25-year economic growth, IMF noted economic performance since independence in 1970 had fallen short of potential with per capita income in 2004 hardly above its 1975 level. There were three years of negative growth following the election of a new government in 2002 (Marciniak, 2006).

The economy began to pick up in 2005, as growth was aided by sensible fiscal and monetary policies as well as by an export boom. The budgets were brought under control

and monetary tightening followed. Inflation was brought down. Higher mineral revenue and greater aid inflows helped to materialise the turnaround in the economy. Budget savings were used to retire public debt, which was brought down to 50 per cent of GDP. International commodity boom and lower non-mineral imports contributed to a rise in international reserves by 2005. A massive rise in mineral revenue boosted government revenues from 28 per cent of GDP in 2002 to 36 per cent of GDP in 2006 and debt was reduced to 35 per cent of GDP. Inflation fell to 5 per cent.

In 2007, aside from mineral boom, there was strong growth in non-mineral sectors, including construction, telecommunication and agriculture. After decades of stagnation, formal sector employment grew by a quarter in 2005–07. The commodity boom continued and PNG's growth rate rose from 6.7 per cent to 7.3 per cent in 2008. However, declining production was expected to lower the contribution from the petroleum sector in 2010.

The fall in global commodity prices due to the onset of recession in industrialised countries since mid-2008 is expected to affect all the commodity-export-based economies. PNG will be no exception. The resilience of such economies is tested on the basis whether during the prosperity phase, the government invested the boom revenues in physical infrastructure and human capital, or frittered away valuable resources on unproductive and wasteful projects including a huge rise in salaries and wages to civil servants.

Past experiences in the boom–bust cycle have shown the economy of PNG grew when the commodity boom contributed to prosperity all around: government expenditures increased, including wages and salaries of civil servants and other recurrent expenditures, leaving less for capital expenditures. When the world-wide recessionary conditions led to a large downturn in the prices of exports of PNG's mineral and non-mineral commodities, including coffee, tea and cocoa, government revenues and GDP were affected as government did not have resources to maintain the earlier levels of expenditures. One such boom–bust phase was in the 1990s, which is called 'the lost decade' of PNG. During the boom phase of the 1990s, mineral and non-mineral export receipts grew but government managed its revenues poorly. In the words of the central bank governor Kamit (2009), the nation was deprived of 'an opportunity to set the stage for progress and growth'.

Unlike the record of previous booms, PNG set aside the windfall gains from high commodity prices in 2006–08 in various trust accounts, which would be spent during the bust phase of the business cycle on key priority areas including infrastructure, health and education (Kamit, 2009). Sensible fiscal policies pursued since 2004 have put the government finances in good shape. The government has also succeeded in reducing its debt. The debt ratio, which in 2001 was 71 per cent of GDP, was reduced to 30 per cent in 2008. Debt servicing expenditure has been reduced, leaving greater savings for investment. Using these carefully saved resources, PNG can beat the recessionary conditions by maintaining the boom levels of expenditures. Further, as the kina appreciated against the US dollar as well as the Australian and New Zealand currencies, inflation would also be kept down.

## 3.4 Samoa

Samoa's main activities are subsistence agriculture and fisheries. The commercial banks find it difficult to lend to any land-based activities, including hotel and resorts, in the absence of land as collateral. Although the country has several attractive tourist locations with beaches, the hotel and resort sectors have not progressed well mainly because of customary land tenure system.

The country's exports have been copra and copra products such as coconut milk and coconut cream and fish. Agricultural activities are mainly subsistence oriented and surplus is sold in local markets, which provide incomes to families who own the land communally. Samoa is prone to frequent cyclones. The country depends upon private remittances from its former citizens and residents overseas, and these remittances are estimated to be equivalent to about 25 per cent of GDP. While remittances help families to finance their domestic consumption, generous annual transfers from governments of Australia and New Zealand assist government to bridge its annual budget deficits. Most of the investment projects such as roads, jetties and ports are externally funded.

During a 30-year period (1970–2000), when some of the newly independent Pacific island countries progressed with sound demand management policies, Samoa presented a contrasting picture (Leigh, 2006). Weak fiscal management and poorly performing state-owned enterprises contributed to the decline of the Samoan economy, which was also battered by two cyclones in 1991 and 1992, destroying the country's physical infrastructure.

**Table 3.4** Samoa: selected key indicators

| | |
|---|---|
| Land area (sq.km.'000) | 2.8 |
| Population (2006: '000) | 186 |
| Per capita GDP (US$) current prices (2006) | 2,277 |
| Aid per capita in US$ (2006) | 254 |
| Aid as percentage of GDP (2006) | 11.2 |
| Annual growth rate in % (2001–07) | 3.1 |
| Annual growth rate inflation in % (2001–07) | 5.3 |
| Overall budget balance as % of GDP (2001–07) | -0.7 |
| Current account balance as % of GDP (2001–07) | -4.3 |

*Source:* ADB (2008), UNESCAP (2008, 2009)

Fiscal adjustment measures including downsizing the public sector and closure of non-viable state enterprises and financial sector reforms, which began in the late 1990s, brought about much-needed economic transformation. It enabled Samoa to outperform other Pacific island countries during the next five years (2000–05), with solid economic growth as well as improvements in public finances, fall in inflation and reduction in debt levels (KVAConsult Ltd, 2007; Leigh, 2006). The financial sector reforms which began in late 1990s consisted of dismantling of all quantitative credit controls and removal of ceilings on interest rates charged by commercial banks, and encouragement of competition in the

banking sector by granting licences for new banks to enter. Further, the CBS launched new policy initiatives.

Although growth in 2006 was low (1.8 per cent) due to a fall in exports as well as scaling-down of Yazaki Samoa (which produces automotive harness products for Australian automobile industry) and slowdown in agricultural production, the economy picked up during 2007. The economy was estimated to have grown by 6.1 per cent, led by expansion in agricultural sector and tourism and as well as construction of public sector projects and hotels in preparation for the South Pacific Games held in September 2007. However, with the slowdown in construction activities in 2008, the growth was reduced to 3.3 per cent and, with the global economic recession, tourist arrivals were expected to be lower than forecast and expansion of tourism-based construction activities was expected to be slow.

## 3.5 Solomon Islands

Solomon Islands (population 489,000), whose key indicators are given in table 3.5, share many commonalities with rest of the PICs. The country's manufacturing base is very small, confined to tuna canning, palm oil, coconut oil, soaps and detergents, and biscuits and breads. Solomon Islands is heavily subsistence oriented, providing livelihood to 80 per cent of the population.

**Table 3.5** Solomon Islands: selected key indicators

| | |
|---|---|
| Land area (sq.km.'000) | 28.0 |
| Population (2006: '000) | 489 |
| Per capita GDP (US$) current prices: 2006 | 684 |
| Aid per capita in US$ (2006) | 418 |
| Aid as % of GDP (2006) | 47.8 |
| Annual growth rate in % (2001–07) | 3.6 |
| Annual growth rate inflation in % (2001–07) | 8.6 |
| Overall budget balance as % of GDP (2001–07) | -2.1 |
| Current account balance as % of GDP (2001–07) | -9.5 |

*Source:* ADB (2008), UNESCAP (2008, 2009)

The country's fixed exchange rate regime has served the country well. Small countries' economies, with a high degree of openness in terms of percentage of imports and exports, have benefited from a fixed exchange rate regime. Since most of the imports are sourced from Australia and New Zealand, whose central banks have been targeting inflation, Solomon Islands' inflation has been kept low in recent years despite expanding domestic fiscal deficits. Although much better endowed with large land and marine resources than other PICs, with the exception of Papua New Guinea, Solomon Islands' economic progress has been disrupted several times in the past by frequent government changes as well as volatile political uncertainties.

Economic structure has remained stagnant during the last three decades, characterised by a large public sector and a small private sector with modest activities. The country's exports have been timber, tuna and palm oil. The country is heavily dependent on imports ranging from food and beverages to fuel and capital and transportation machinery and equipment. Steady aid inflows in the past and more in recent years after the Regional Assistance Mission to Solomon Islands (RAMSI), which was mounted in 2003 to restore law and order, have been a great source of support to the country's current account balance, minimising pressures on exchange rate.

For Solomon Islands the 1980s were a difficult period. Falls in trade and withdrawal of annual budgetary support by the United Kingdom, put the country's finances in poor shape. Aside from the decline in international prices of copra, palm oil and timber, which resulted in lower export earnings, cyclone *Namu* in 1986 led to reduction in export volumes as well, as it uprooted the country's copra and oil palm plantations. The adverse impact of the cyclone lingered on export earnings for three years. Solomon Islands had to seek help from the International Monetary Fund (IMF) to tide over the shortage in foreign exchange. Two Stand-by Arrangements, one in 1981 and the second in 1983 came to the country's rescue. However, as the authorities could not fully meet conditionality requirements, the full amount envisaged under the second stand-by arrangement of 1983 could not be disbursed (Ginting and Porter, 2006).

The next decade witnessed a spurt in export earnings, thanks to controversial log export policies, which were questioned by international agencies from environmental protection point of view. As timber exports to Japan, Korea and Malaysia reached new highs, there was a boom during the 1990s. Annual economic growth during the first half of the 1990s was around 8 per cent. However, exports to Asian countries came to a sudden halt in the late 1990s as the Asian financial crisis of 1997–98 abruptly reduced the demand for log exports. Further, in addition to fall in export earnings, the ethnic crisis which exploded in 1999 severely affected the economy, as physical infrastructure and private sector shops in the capital town, Honiara, were destroyed in the riots. The GDP declined throughout the next six-year period. All export-oriented projects were closed and international reserves were at a minimum level until 2003, when RAMSI arrived to restore law and order in the country. In the meanwhile, the Solomon Island dollar was allowed to gradually depreciate by 30 per cent and inflation reached the peak at 16 per cent.

The end of ethnic conflict encouraged private sector activities. Export trade in timber resumed in earnest. Many of the suspended foreign investment projects were revived to put the economy on the path to growth. Annual growth rate during 2003–07 averaged at 7 per cent. Substantial aid inflows averaging around 49 per cent of GDP helped the country to reduce current account deficit, from around 24 per cent of GDP in 2004 to a sustainable level of 3 per cent in 2007. Government's fiscal surpluses during 2003–06 were also due to aid inflows, besides growth in revenues, mainly from export taxes and royalties from log exports.

In 2007, the economy grew at an impressive 10.3 per cent, the highest annual growth in 15 years. The growth was due to expansion in logging activities during the year, as the forestry sector represents 16 per cent of total GDP. Export of round logs rose by 25 per cent.

The expansion of logging on an unsustainable scale brought closer the imminent decline of the forestry sector, now forecast to begin as early as 2010 and exports becoming negligible by 2014.

Further, volatility in fuel and food prices in the early months of 2008 had already exposed government's weaknesses, especially in its fiscal management and its ability to resist demand for rise in public sector wages. In 2008, GDP growth rate fell to 7 per cent, the second highest in the region, next only to Papua New Guinea which was benefiting from the mineral boom. As fiscal expenditure rose and with continued increases in private sector lending, both budget balance and current account balance deteriorated (Central Bank of Solomon Islands (CBSI), 2008).

Annual fiscal deficits have been posing major problems for monetary authorities, as their monetisation in the past led to excess liquidity in the system. Further, inflows of aid money and a credit boom, reflected in the high annual growth rate of 60 per cent during 2005–07 have compounded the problem. The CBSI and finance ministry have to co-ordinate their efforts with a view to reducing inflationary pressures.

## 3.6 Tonga

Tonga (population 102,000), whose selected key indicators are given in table 3.6, shares many commonalities with the rest of the PICs. The country's manufacturing base is small and is confined to processing coconut-oil-based soaps and detergents, biscuits and breads. Tonga's economy is heavily subsistence oriented, providing livelihood to 80 per cent of the population.

Tonga's fixed exchange rate regime has served the country well. Since most of the imports have been sourced from Australia and New Zealand, whose monetary policies have been targeting inflation, inflation has been kept low. Being a small country with no mineral resources and limited commercial agriculture and no manufacturing basis, Tonga is heavily dependent on imports ranging from food and beverages to fuel and capital and transportation machinery

**Table 3.6** Tonga: selected key indicators

| | |
|---|---|
| Land area (sq.km.'000) | 0.7 |
| Population (2006: '000) | 102 |
| Per capita GDP (US$) current prices: 2006 | 2,176 |
| Aid per capita in US$ (2006) | 211 |
| Aid as percentage of GDP (2006) | 8.8 |
| Human development ranking (2006) | 55 |
| Annual growth rate in per cent (2001–07) | 1.9 |
| Annual growth rate inflation in per cent (2001–07) | 8.9 |
| Overall budget balance as per cent of GDP (2001–07) | 0.04 |
| Current account balance as per cent of GDP (2001–07) | -3.7 |

*Source*: ADB (2008), UNESCAP (2008, 2009)

and equipment. Exports have been bananas, squash, copra and fish. Export earnings have been far less than imports with the result that trade balance had always remained negative. However, remittances from Tongans resident in New Zealand, USA and Australia, tourism receipts, and regular aid inflows have been a great source of support to the country's current account balance, minimising pressures on the exchange rate.

While the 1970s were characterised by relatively favourable macroeconomic conditions, economic situation deteriorated in the 1980s and mid–1990s. As Australia and New Zealand liberalised their imports of vegetables from rest of the world, Tonga ceased to enjoy the special treatment accorded to its exports of bananas and copra. However, emergence of squash exports to Japan as an off-season crop brought a sustained level of export earnings in the next few years. In the 1990s, Government announced its strategy of promoting manufacturing through tax holidays and tariff preferences. However, despite an initial rise in domestic production, exports did not take off. The second half of the 1990s and early years of 2000 witnessed a weakened budget discipline and policy slippages and poor governance threatened macroeconomic stability. Losses in the US stock market due to risky management of investments led to depletion of the Tonga Trust Fund, which was built through country's official reserves, amounting at one time to 20 per cent of GDP (Singh, 2006).

With limited monetary policy instruments, Tonga relied primarily on movements in foreign exchange reserves as indicators of the appropriateness of monetary policy. The National Reserve Bank of Tonga (NRBT) resorted to moral suasion and persuaded the commercial banks to restrict lending. However, political developments since early 2000 slowed down economic growth, while adverse terms of trade shocks as well as rises in fuel and food prices contributed to increase in inflation. Pro-democracy riots that led to the burning and looting of the capital in November 2006 were estimated to have resulted in losses of nearly US$60 million or about 30 per cent of GDP. Despite a modest recovery following a rise in tourism and remittances and aid-funded construction activities, the economy shrank in 2007 by 3.5 per cent (AusAID, 2008). Although expansionary measures including fiscal deficits and monetary easing were appropriate to revive the economy in 2007, there were inflationary pressures lurking around the corner.

In mid-2008, worldwide increases in food prices and fuel and subsequent volatility in fuel prices exposed government weaknesses in handling the unforeseen impact on balance of payments. Along with inflation, decline in reserves was causing concerns. Although real exchange appreciated by 13 per cent during 2003–07 due to domestic inflation relative to inflation in trading partners, government was not keen to adjust the nominal exchange rate, as there was no visible advantage in depreciation of the currency. Already exports of squash to the niche market in Japan had weakened and Tonga's exports were just 10 per cent of total imports. Thus, containing inflation was a priority rather than promoting competitiveness of limited exports. Further, depreciation of nominal currency would only raise prices of imports of fertilisers and insecticides and other inputs, which go into the production of vegetables, fruits and squash, aside from increasing landed prices of all critical imports.

The policy actions now require co-ordination between finance ministry and monetary authorities to contain fiscal deficits by resisting any temptation to yield to pressures from

the civil service for wage rise and to minimise deficit financing needs so that the objectives of monetary and exchange rate stability are within reach.

## 3.7 Vanuatu

Vanuatu's economy is heavily subsistence oriented, dominated by root crops and commercial ranch and fishery activities to a small extent, which provide livelihood to 80 per cent of the 215,000 population. The country's manufacturing base is small, which is confined to processing coconut-oil-based soaps and detergents, and biscuits and breads. However, Vanuatu has been historically an open economy with offshore financial institutions (OFC) inherited from the days of the joint Anglo-French condominium rule. The country also provides flag-of-convenience registration of ships. Additionally, absence of all forms of direct taxation, including personal and corporate income taxes, estate taxes, death duties and gift taxes, have made Vanuatu a pure tax free haven in the South Pacific. Thus, the services sector of Vanuatu comprising financial and tourism activities, has been a major support to Vanuatu's economy. Selected key indicators are given in table 3.7.

**Table 3.7** Vanuatu: selected key indicators

| | |
|---|---|
| Land area (sq.km.'000) | 12.2 |
| Population (2006: '000) | 215 |
| Per capita GDP (US$) current prices: 2006 | 1,799 |
| Aid per capita in US$ (2006) | 227 |
| Aid as % of GDP (2006) | 13.4 |
| Human development ranking (2006) | 118 |
| Annual growth rate in % (2001–07) | 2.7 |
| Annual growth rate inflation in % (2001–07) | 2.5 |
| Overall budget balance as % of GDP (2001–07) | -0.5 |
| Current account balance as per cent of GDP(2001–07) | -5.4 |

*Source*: ADB (2008), UNESCAP (2008, 2009)

These developments have indeed given rise to the emergence of a dual economy, with OFC institutions in Port Vila, the country's capital on Efate, the main island, and commercial tourism, confined to Port Vila and the big island of Santo. The rest of the country's scattered numerous islands continue to be characterised by subsistence agriculture.

Vanuatu has a fixed exchange rate regime and this has served the country well. Most imports are sourced from Australia and New Zealand, whose monetary policies have been targeting inflation, so inflation has been kept low. As a small country with no mineral resources and limited commercial agriculture, Vanuatu is heavily dependent on imports ranging from food and beverages, to fuel and capital goods and transportation machinery and equipment. Vanuatu's exports have been beef, copra, cocoa and *kava*, a non-narcotic beverage root crop. Export earnings have been far less than imports with the result that

trade balance always remained negative. However, tourism earnings, steady aid inflows and in recent years, remittances in particular, have provided substantial support to country's current account balance, minimising pressures on the fixed exchange rate regime.

Vanuatu's economic progress during the first ten years of independence has been uneven. Soon after independence in 1980, there were departures of skilled expatriate residents, consequent to a rebellion in the outer islands. After normality returned, three cyclones during 1985–98 inflicted severe damage to standing crops and coconut plantations. In 1986, as a foreign airline discontinued its services to the country, tourist traffic plunged and exchange earnings fell. Domestic inflation rose, closely tracking the exchange rate developments and it averaged 9 per cent.

With bilateral grants falling from 80 per cent of public sector expenditure in 1980 to nearly 50 per cent in 1983 and 21 per cent in 1989, government had to restrict expenditures and increase revenues mainly through indirect taxes, which included fees, charges and import duties. Government gave up its conservative stand and began borrowing from international agencies, including Asian Development Bank (ADB) on concessionary terms, which are available to lower-income countries for development projects. These included international telecommunication network and airport runway extension. These helped to augment tourism receipts by allowing larger aircrafts to land. As the domestic currency, the vatu appreciated, inflation moderated. A comprehensive reform programme was also launched in 1998 with ADB funding for improving economic and financial management.

Although gross domestic product grew annually at 4.25 per cent during the period 1991–95, there were several unanticipated shocks, which resulted in a deterioration of overall macroeconomic performance. In 1998, loss of trust in the state-sponsored Vanuatu National Provident Fund (VNPF) led to a run on the institution and riots in Port Vila, which prompted government to permit unconditional withdrawals of retirement savings of VNPF members. The payouts of funds by VNPF led to a sharp rise in liquidity in the banking system. There were capital outflows as well, as confidence in the domestic currency had already been shaken in the process. There was also an unsuccessful attempt by Reserve Bank of Vanuatu (RBV) to devalue the vatu, which only caused further large capital outflows.[1] Because of the VNPF crisis, the official reserves of the RBV decreased dramatically, from the equivalent of around six months of imports to less than three months of imports. Fresh monetary policy initiatives were undertaken in 1998. They included introduction of open market operation in the central bank's own short-term securities, known as RBV Notes for liquidity management, which helped to stabilise the economy.

Political instability has taken its toll on the economy. However, fiscal consolidation since 2001, which was supported by strong recovery in exports and rise in export prices of key crops, including copra and *kava*, expansion in airline capacity and greater number of flights, helped the economy to perform well. The pegged exchange rate regime helped to keep inflation low and the vatu remained stable. Improved economic performance (rate of growth was 6.5 per cent in 2005; 7.2 per cent in 2006; and 6.6 per cent in 2007) and better governance won the grant assistance of US$66 million from the US Millennium Challenge Corporation which would enable the government to improve physical infrastructure including ports, roads and jetties in outer islands for moving agriculture produce

to the urban centres on two major islands and to the largest harbour on Santo, which would promote exports.

The assessment by IMF (2008) shows that with the strong growth in the tourism and construction sectors and increased aid inflows, real GDP grew 6.6 per cent in 2008. Inflation rose from 4.1 per cent in 2007 to 5.8 per cent in 2008, reflecting the effects of higher international prices of food and fuel, higher credit growth, and rise in government spending. Despite higher spending, fiscal surplus increased to 2.3 per cent of GDP due to significant overperformance on revenues, mainly VAT, reflecting buoyant economic activities and improved tax compliance.

The RBV, which relaxed its monetary stance in December 2008 (RBV, 2008), now has to face the impact of global slowdown in Australia and New Zealand, the largest sources of tourism revenues and foreign direct investment (FDI). There are indications that new construction activities funded by large capital inflows from Australia, and to a lesser extent from New Zealand, have begun to slow. Although tourist arrivals continued to remain strong, spending by tourists has been on the decline. A further relaxed monetary policy and an accommodative fiscal stance for 2009 should help to cushion the impact on growth. GDP growth was expected to be in the 3–4 per cent range in 2009 and to recover thereafter. Lower commodity prices would halt rising inflation and rising international reserves supported by aid inflows would be able to finance imports (IMF, 2009).

## Note

1. In the aftermath of the Asian financial crisis in 1998, several countries such as Papua New Guinea, Fiji and Solomon Islands devalued their currencies by 20 per cent. Shortly afterwards, because of the VNPF crisis, the RBV followed suit. However, the government immediately revoked the RBV decision on the grounds that the devaluation could have a potentially high cost if it were to spark an inflation–wage spiral.

## References


Asian Development Bank (ADB) (2008). *Key Indicators of Asia and Pacific Developing Countries*, Manila: Asian Development Bank.

Australian Agency for International Development (AusAID) (2008). *Pacific Economic Survey 2008*, Canberra: The Commonwealth of Australia.

Central Bank of Solomon Islands (2008). *Monetary Policy Statement 2008*, www.cbsi.sb

D'Hoore, A (2006). 'Fiji', in C Browne (ed) *Pacific Island Economies*, Chapter 8, Washington, DC: International Monetary Fund: 69–77.

Ginting, E and N Porter (2006). 'Solomon Islands', Chapter 15, in C Browne (ed), *Pacific Island Economies*, Washington, DC: International Monetary Fund. 143–153.

International Monetary Fund (IMF) (2008). *Vanuatu: Selected Issues and Statistical Appendixes* Washington, DC, December 2008.

IMF (2009). *Statement of an IMF Staff Mission at the Conclusion of the 2009 Article IV Discussions with Vanuatu*, Press Release 09/56, March 4, 2009.

Jayaraman, TK and CK Choong (2006a). 'Growth Constraints and Determinants of a South Pacific Island Economy: The Case of Fiji', *Global Economic Review*, 35 (4): 425–444.

Jayaraman, TK and CK Choong (2006b). 'Public Debt and Growth in the South Pacific Islands: A case Study of Fiji', *Journal of Economic Development*, 31(2): 107–121.

Jayaraman, TK and CK Choong (2007a). 'Financial Sector Development and Growth in Fiji: An Analysis of Credit boom and its Implications', *The Asia Pacific Economic Journal*, 5(1), 1–20.

Jayaraman, TK and CK Choong (2007b). 'Is the Twin Deficits Hypothesis Relevant to Fiji?' *Fijian Studies*, 5(1), 1–25.

Jayaraman, TK and CK Choong (2008). 'Exchange Market Pressure in a Small Pacific Island Country: A Study of Fiji', *International Journal of Social Economics,* 35 (12): 985–1004.

Kamit, LW (2009). *Address to the Lowy Institute for International Policy Conference on Tackling Extreme Poverty in Papua New Guinea, Sydney, May 14, 2009*, www.bpng.pg

KVAConsult Ltd (2007). 'Samoa Economic Update 2007', *Pacific Economic Bulletin*, 22 (3): 1–14.

Leigh, L (2006). 'Samoa', Chapter 14, in C Browne (ed), *Pacific Island Economies,* Washington, DC: International Monetary Fund. 133–142.

Marciniak, P (2006). 'Papua New Guinea', in C Browne (ed), *Pacific Island Economies*, Washington, DC: International Monetary Fund 121–132.

RBF (2008). *Monetary Policy Statement November 2008*. Suva: Reserve Bank of Fiji.

RBF (2009). *Monthly Economic Review: May 2009,* Suva: Reserve Bank of Fiji.

RBV (2008). *Monetary Policy Statement 2008,* Reserve Bank of Vanuatu. www.rbv.vu

Singh, R (2006). 'Tonga', Chapter 16, in C Browne (ed), *Pacific Island Economies,* Washington, DC: International Monetary Fund 154–162.

UNESCAP (2008). *Economic and Social Survey 2008,* Bangkok: United Nations Economic and Social Commission for Asia and the Pacific.

UNESCAP (2009). *Economic and Social Survey 2009*, Bangkok: United Nations Economic and Social Commission for Asia and the Pacific.