The Far East
and Australasia
2007

38th Edition
ECONOMIC TRENDS IN THE PACIFIC ISLANDS
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INTRODUCTION

The years leading to 2006 were characterized by unprecedented political uncertainties in the Pacific Islands. These doubts adversely affected the islands' investment prospects, not only with regard to the domestic private sectors but also in relation to regional development and growth. However, there were some encouraging signs, including the appointment in Tonga of the first-ever woman to the position of Prime Minister in 2005, following a prolonged mass movement for gender equality. In addition to this, there was a departure from the traditional practice of nobles holding the office of Prime Minister in the only kingdom in the Pacific region, in the first half of 2006 there were peaceful conclusions to legislative elections in the three other major island states, namely Fiji, Samoa and Solomon Islands.

Although the restoration of political order and the continuation of the 'Westminster system' of parliamentary democracy (modelled on that used in the United Kingdom) were welcome signs, the issue of poor governance in Solomon Islands arose once again in late April 2006, soon after the conclusion of orderly elections and the appointment of Snyder Kini as Prime Minister. Kini was obliged to resign after only eight days in office, following riots and arson attacks in the Chiruwa area of the country's capital, Honiara. Two members of the National Parliament, who had been arrested and held in custody without bail before being placed on trial for their alleged involvement in the riot, were appointed by the new Prime Minister, Manasseh Sogavare, to positions within his Cabinet. It was apparent that Sogavare's action was deemed to have shown support for the two imprisoned ministers, who had been involved in Kini's removal from office. These developments were a major setback to what were generally considered successful efforts undertaken since 2003 by the two metropolitan powers, Australia and New Zealand, to improve governance. Under the widely acclaimed Regional Assistance Mission to Solomon Islands (RAMSI), troops assembled from the region and led by Australia had been maintaining law and order in the country, which from the late 1990s had been ravaged by political and ethnic rivalries. Furthermore, Australian and New Zealand experts had been engaged to provide technical assistance in many key areas, in the hope of promoting economic growth. Solomon Islands was one of the five states, along with Kiribati, Samoa, Tuvalu and Vanuatu, to have been accorded the status of least developed country (LDC) on account of their vulnerability to natural disasters, level of per capita income and quality of life, this last criterion based on human development indicators, including life expectancy at birth and child mortality rates.

In Fiji, at the legislative election of May 2006, Prime Minister Laisenia Qarase was returned to office for a further five-year term, thus bringing certain outstanding issues to a focus. These included the possibility of granting pardon and amnesty to those involved in the coup of 2000, which had resulted in the overthrow of an elected Government, and the likely release of those who had been convicted and sentenced to life imprisonment. The Commander of the Armed Forces publicly expressed his opposition to these expected actions, eliciting considerable criticism from the international observers of the country's elections. The decision by Prime Minister Qarase to invite the Indian-dominated Fiji Labour Party (FLP), the country's second largest party, to join a multi-party government under the unique provision of the country's Constitution was greeted as a positive step towards greater cooperation, moving away from the confrontational approaches of previous years.

Two other Melanesian countries experienced similar difficulties. Vanuatu was likewise afflicted by problems familiar to countries administered by coalition governments, where ambitious politicians were constantly maneuvering to bring about changes from the ruling coalitions and were introducing frequent parliamentary motions of 'no confidence'. With elections in Papua New Guinea due in 2007, this uncertainty looked set to continue. Once again, international donor attention was focused on the 'arc of instability' in the South-West Pacific region.

Since 2005 the political developments in the Melanesian countries, as well as the implementation of inappropriate policies and the wastage of resources, both domestic and foreign, have resulted in the stagnation of per capita income in many of the Pacific Islands. These were certainly not positive signs, especially in the context of the Millennium Development Goals (MDGs) contained within the Millennium Declaration adopted by the member states of the UN in September 2000. Five of the eight MDGs related to human development, i.e. foremost among them being the reduction of poverty by 50% by 2015. Although benchmark details of poverty based on income and expenditure surveys were available for only two countries in the region, namely Fiji and Papua New Guinea, the imposition of 'subsistence influence', a highly romanticized theme in the literature on the Pacific Islands, was no longer valid.

Increasing migration to towns in search of jobs, following the steady decline in rural populations, the concomitant expansion of squatter settlements, rising crime in urban areas and growing youth unemployment were visible evidence of the poverty experienced by all the Pacific Islands. Furthermore, there were increases in the number of reported cases of HIV/AIDS. A study commissioned by the Commonwealth Secretariat in 2005 indicated that the realization of the MDGs in the eradication of poverty, the reduction of child mortality and the control of the spread of HIV/AIDS and malaria, as well as the achievement of universal education, was proving difficult. This was confirmed by a further study released by the Australian Agency for International Development (AusAID), observing that the Pacific Islands were unlikely to meet the MDGs, as during the 10-year period 1995-2004 they had failed to register an annual per capita income growth rate in excess of 2%, the level indicated by the World Bank as that required for reducing poverty.

Against this background, an Australian non-governmental policy institution, the Centre for Independent Studies (CIS), issued three reviews on the issue of aid to the Pacific Islands during 2005-06, one of which carried the provocative title 'Aid has Failed the Pacific'. The criticism was based on the theory that poor growth performance was due to the ineffective use of aid, which had totalled US $590,000m. during the previous 30 years, and that most of this aid had been spent on consumption by bureaucracies and government elites, being diverted from the intended purposes, as aid was often considered fungible. The smaller island states such as Tuvalu and Kiribati have performed better in their management of aid funds than the governments of countries with larger aid resources in trust funds established under parliamentary statutes. The respective acts of parliament stipulated that trust funds should be maintained and invested by internationally reputable investment institutions, thereby limiting the government's recurrent budget that could be financed by revenue earned from the returns on investments; and restricted the use of trust fund money to investment purposes only, with the condition that funds be drawn from the trust fund over a given period and that they be maintained in real terms. These trust funds now serve as models for the northern Pacific Islands, namely the Marshall Islands, the Federated States of Micronesia and Palau, which were formerly part of the US Trust Territory of the Pacific Islands. All three countries had been receiving annual grants from the USA under their respective Compacts of Free Association, each Compact remaining in force for a 15-year period. The Marshall Islands and the Federated States of Micronesia established trust funds to manage the annual aid inflow that were anticipated under the second Compacts. In 1994, only one year after gaining independence, Palau created a trust fund under its first Compact with the USA.

As the major provider of aid to the Pacific Islands and seemingly provoked by criticism of its approach, in 2005...
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Australia reviewed its overseas aid policy and delivery mechanisms. In April 2006 the Australian Government issued an update of its White Paper on the country’s aid programme. Upon the release of this policy document, the Australian Minister for Foreign Affairs highlighted the need to focus on the alleviation of poverty and the promotion of sustainable development, with a full suite of tools for the private sector, through policies aimed at creating an environment conducive to the generation of increased income and the provision of wider opportunities for gainful employment. A major departure from the norm, highlighted in the White Paper, was regard to aid delivery. Instead of linking aid to specific projects, as had been the case hitherto, Australian aid would henceforth be channelled into different sectors, such as primary education, water supply and sanitation. This was different from the approaches of other donors, including the European Union (EU) and the US Millennium Challenge Corporation, which in February 2006 announced a grant of almost US $65.7m, to Vanuatu for the purpose of identified infrastructure projects. The People’s Republic of China and Taiwan are providing significant amounts of aid to the region, in their respective attempts to win the support of Pacific governments. While the major states, including Fiji and Papua New Guinea, are known to be steadfast in their adherence to the ‘one China’ policy, recognizing only the People’s Republic, the smaller states have become more vocal in their support for the island nation. The visit in April 2006 of Solomon Islands, which led to the swift downfall of newly elected Prime Minister Simeoni, originated in rumours that the rise in Simeoni’s popularity had been due to the growing influence of Taiwan in local politics. Aware of the importance of aid diplomacy, Japan, which was already a leading donor to the region, at a meeting of Pacific nations in May 2006 announced a programme of aid relief and rehabilitation of the Solomon Islands. Japan’s diplomats privately considered this to be an attempt to counter the increasing influence of the People’s Republic of China and Taiwan. Other observers, however, believed that pro- and anti-whaling lobbyists were trying to garner support from the Pacific Islands prior to a meeting of the International Whaling Commission, held in June 2006. At a meeting held in June 2006, contrary to the expectations of Australia and New Zealand, which continued to campaign for whale conservation, Solomon Islands had voted with Japan in favour of the resumption of commercial whaling. Australia was particularly disappointed by the stance taken by Solomon Islands; this had been largely funded by Australia, a recovery in the island’s economy and an improvement in bilateral relations. This unexpected development also coincided with the country’s conferment of its highest honour—the Star of the Solomon Islands—on the Prime Minister of Australia and New Zealand. By contrast Kiribati, also much to the dismay of Australia and New Zealand, abstained from voting.

RECENT DEVELOPMENTS

The Pacific Islands’ growth performance in the first five years of the new millennium remained modest, amid continuing structural constraints and low productivity of the region, which comprises widely dispersed multi-island micro-states, combined with the distances from major markets, have resulted in high international and domestic transport costs. Controlled by the low volume of cargo, the development of even a small domestic market has been constrained by the distances between settlements and the infrequency of internal transport services. The Pacific Islands’ susceptibility to natural disasters and adverse climatic conditions has typically had a negative impact upon crop yields, thus affecting the entire region’s economy. The relatively small populations of the islands reduce their institutional capacity, which in turn depresses demand for goods and services and restrains the potential for private-sector growth and investment. Scope for diversification has been constrained by the narrow resource base and the limitations of the domestic markets, resulting in the concentration of production and exports and in weak private-sector activity. Heavily dependent upon strategic imports, including fuel and food items such as rice and wheat flour, and reliant upon foreign investment to overcome the inherent limitations of small size and resources, the Pacific Islands remained vulnerable to external economic and environmental factors. With favourable world prices for most of the Pacific Islands’ traditional exports such as copra, together with the increase in tourist arrivals and the rise in inward remittances to the Polynesian islands (and also, within Melanesia, to Fiji), in 2006 the rate of economic growth remained reasonable, although the average rate was less than 3%.

Fiji (2006: population: 841,000; GDP per capita: US$3,125; aid per capita: US$716) recovered from the aftermath of the 2000 coup with remarkable speed as a result of aggressive counter-cyclical measures. The country subsequently achieved annual economic growth rates well in excess of 3%. Fiji recorded growth of 4.3% in 2000, 5.0% in 2001 and 4.1% in 2004, but in the third quarter of 2005 GDP per capita was at its lowest level since 1998. Fiji’s overall growth rate in 2005, however, was much lower, at 1.7%, although consumer prices and construction increased strongly, steepening the economy. The main reasons for the weaker growth rate in 2005 were the expiry of the World Trade Organization’s (WTO’s) Agreement on Textiles and Clothing on January 1st of that year, the abrupt discontinuation of the US quota for apparel and the decrease in earnings from sugar exports. The immediate prospects of any revival of the declining sugar exports before the phased withdrawal by 2006 of the preferential trade arrangements with the EU under the Sugar Protocol are also poor. Fiji has therefore become heavily dependent on new export products, such as bottled mineral water, to offset falling trade deficits.

Papua New Guinea (2006: population: 5,779,000; GDP per capita: US$777; aid per capita: US$49) by contrast benefited from the favourable external conditions that prevailed in 2005. The oil and gas sector registered growth of 11.0%, as supply responded to rising international prices. In addition, agricultural sector performed well, showing increases in output of several exportable products, including coffee, copra, coconut oil and rubber, all of which benefited from higher world prices. Furthermore, the construction sector recorded strong growth in response to low interest rates and higher demand for office space and private housing. Low interest rates were primarily due to a commendable fiscal performance, with a budget deficit equivalent to 0.8% of GDP being recorded.

Solomon Islands (2006: population: 465,000; GDP per capita: US$554; aid per capita: US$962) continued its economic recovery in 2005 after the contraction experienced during 2004-05. The following the restoration of law and order, economic growth during 2005 reached 4.4%, most of the improvement being due to strong performance in the areas of agriculture, construction, trade (both in the wholesale and retail sectors). Exports of logs rose, thus raising export earnings, although decreases in the tuna catch and in copra production were recorded.

In 2005 Vanuatu (2004: population: 207,000; GDP per capita: US$1,526; aid per capita: US$1,902) recorded a growth rate of 3.1%, slightly lower than the 4.0% rate of the 2004 due to a downturn in the growth rate was attributed to a decline of 0.8% in the agricultural sector. However, owing to strong growth in the tourism sector, facilitated by the introduction of additional flights to Vanuatu by Pacific Blue, a newly launched airline, and the recovery in construction activity, the country was able to maintain a modest growth rate, in contrast to the contractionary conditions that had prevailed during 2001-03.

Of all the Pacific Islands, the Polynesian nation of Samoa (2006: population: 194,000; GDP per capita: US$2,842; aid per capita: US$1,977) registered the highest growth rate of 6.5%, in 2005, thereby improving on its performance in 2004 when growth of 3.7% was achieved. Strong expansion in the agriculture sector and fishery sectors resulted in increases in the export volumes of nona (or nonu) juice and fish. This expansion, combined with the rise in hotel construction activities, which were encouraged by the Tourism and Hotel Development Incentive Act of 2001, was the main reason for this strong economic growth.

However, Tonga, another Polynesian country (2004: population: 103,000; GDP per capita: US$2,806; aid per capita: 877)
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US $189), endured difficult times during 2005 with mass movements for greater democracy and strike action by civil servants and police for more than a month. Although the strike was settled with an agreement upon a 60%-80% increase in salaries, the economy remained under pressure. Growth during the fiscal year ending June 2005 reached approximately 2.5%, compared with 2.8% in 2001, mainly owing to the good performance in agriculture, which helped to improve exports of squash (zucchini), vanilla, root crops and noni juice. Furthermore, inward remittances rose to $200m. prayag, thus accounting for 50% of the country's GDP.

Economic growth in the Cook Islands (2005: population: 18,400; GDP per caput: US $7,232; aid per caput: US $1,550) slowed down during the year ending June 2005, with a growth rate of 3.0%, compared with 4.2% in the previous fiscal year. This deceleration was due to the severe damage inflicted upon the rural economy by five cyclones in 2005. However, a small increase in tourist arrivals and in retail and wholesale trade enabled the economy to maintain modest growth in that year.

By contrast, in 2005 the economy of Kiribati (2004: population: 98,000; GDP per caput: US $635; aid per caput: US $171) suffered from the continued decline in revenue from fishing license fees, which decreased by $4.6m. in 2004 to $4.5m. in 2005. In 2003, the country's growth rate declined from 3.2% in 2004 to 0.3% in 2005. Kiribati depends heavily upon its fisheries resources and seafarers inward remittances for sustaining levels of national income. The Marshall Islands (2004: population: 61,000; GDP per caput: US $3,020; aid per caput: US $628) recorded a growth rate of 2.8% during 2005, a significant rise from 0.4% in 2004. In addition to increased agricultural production, greater external assistance was also provided. Under the new financial agreement with the USA, as part of the Compact of Free Association, the Marshall Islands received fresh inflows of aid. The resultant fiscal expansion facilitated GDP growth. Government expenditure, mainly on wages and salaries, was supported by Compact funds and constituted approximately 80% of GDP. As in the case of the Marshall Islands, to fresh inflows of aid money from the USA under the second Compact of Free Association. Following the expiry of the first Compact in 2001, US Grant Funds were increased by 25% annually, with the requirement that a total of US $1m. be saved in a trust fund. US grants constituted 40% of GDP. Greater focus on public works programmes and an increase in tourism both contributed to the country's modest recovery in 2005. Marshall Islands (2004: population: 10,700; GDP per caput: US $3,456; aid per caput: US $1,000; aid per caput: US $1,000) has faced increasing economic difficulties, particularly since the decline of the island's phosphate resources in the late 1990s. The available figures for the country's recent national accounts are not available. With the substantial reduction in the operations of the Australian Offshore Processing Center for asylum seekers, which provided some income when net earnings from depots were mining activities became negative in 2004, the country's future looks increasingly uncertain. Although the international donor meeting held in November 2005 promised development assistance to revive the economy, pledges need to be followed by direct and immediate assistance.

In 1994 Palau (2004: population: 20,000; GDP per caput: US $8,350; aid per caput: US $878) became the third US-administered Trust Territory to gain independence, following the examples of the Marshall Islands and the Federated States of Micronesia. A trust fund was established into which US aid funds were deposited in order to provide budgetary support which was substantially managed to achieve a budget surplus, estimated at the equivalent of 18% of GDP, by 2004. Improved tax collection and effective budgetary control measures largely contributed to

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2005 Palau was able to maintain a high rate of economic growth, which reached 5.5%, compared with 4.9% in 2004, mainly owing to increased tourist arrivals during the year due to new construction activities. The 3% increase in government revenue, which was almost the same as the 3% increase in tourist arrivals, combined with a steady reduction in government office costs, resulted in a $2m. increase in the government's overall budget surplus, bringing the total surplus for the year to $6.2m. This was the highest surplus since 1997.

The Tuvalu Trust Fund (TTF), which is declared to be an example for small island states, followed, had a total endowment value of US $89.4m. The average return in real terms from the Trust Fund's investments remained at the same level, which was higher than 6% since 1978, and the total yield amounted to $45.6m., thus providing an annual average of $45.1m. to support the government's recurrent budget.

MACROECONOMIC CONDITIONS IN THE PACIFIC ISLANDS

While political stability has been acknowledged as a critical requirement for steady progress towards achieving the MDGs, the continued vulnerability of the Pacific Islands to the adverse effects of recurrent cyclones, "king tides" and other natural disasters has made sustainable development more difficult. Most of these phenomena have been attributed to global warming. In addition to these natural disasters, the Pacific Islands have also had to face other unexpected challenges, including a reduction in world commodity prices and the consequent reduction in export earnings, along with an increase in the cost of strategic imports, such as petroleum and its products, machinery and transportation equipment and other capital goods. As a result, annual trade deficits thus began to widen and with their limited range of export items, the Pacific Islands found it difficult to finance these deficits.

The Pacific Islands have been unable to influence world markets significantly, given their relatively small contribution to global comlunity trade, and external economic conditions remained beyond their control. As a result, emphasis has increasingly been placed on strengthening the region's economic resilience, focusing on its ability to withstand and promptly recover from the impact of "shocks". Attempts to realize this included deliberate measures to move to promote and sustain a higher degree of self-sufficiency through the diversification of activities and the adoption of prudent policies. More specifically, there were two main elements, one of which focused on diversifying the range of globally competitive products, while the other focused on strengthening existing infrastructure and to construct new facilities in order to increase the region's ability to respond to natural disasters.

The development of resilience can be successfully accomplished through macroeconomic policies. Diversification of activities to reduce dependence on one or two exportable crops only cannot be undertaken in isolation. Furthermore, if the Pacific Islands are to benefit from reduced global interest rates, reforms are required in other areas, not merely in the financial sector. More importantly, reforms in micro-economic policies and public financial management are lagging. Macro-economic stability is determined by the current account balance of payments.

Papua New Guinea, which was the only country that achieved a reduction in the three-year period 2001-03 but also successfully managed to achieve a budget surplus, estimated at the equivalent of 1.8% of GDP, by 2004. Improved tax collection and effective budgetary control measures largely contributed to
In 2005 the budget deficit was estimated at 2.5% of GDP, compared with a projected deficit of 1.4%; government expenditure included equity contributions to Papua New Guinea's joint gas project with Australia. In this discipliined environment, in 2005 interest rates were reduced, and inflation also remained subdued. The prudent financial management improved the public debt position. Public debt declined from 8% of GDP in 2002 to 4.5% in 2005. Favourable commodity prices also resulted in an improvement in export earnings, thereby enabling Papua New Guinea to continue recording current-account surpluses in both 2004 and 2005. The kina, the national currency, which is based on a floating exchange rate regime, appreciated by 2% against the US dollar and by 4% against the Australian dollar during 2005. Increases in international reserves and a stronger currency provided an environment conducive to investment, which was further facilitated by appropriate infrastructure investments.

Fiji, which implemented large scale adjustment measures in the decline in private investment that followed the 2000 coup, experienced fiscal deficits throughout the five-year period 2001-06. Borrowing from the public and from institutions, including the Fiji National Provident Fund, was increased. Public debt rose to F$24.8bn. in 2005, constituting 64% of GDP, with external debt amounting to 7% of GDP. The prevailing excess liquidity in the banking system facilitated borrowing from the public and did not deliver a falsified inflation. Import prices remained low until mid-October 2005, when domestic credit expanded to record annual growth of 27%, the highest since 1990. However, the country's rate of inflation remained low because most of the consumption sourced from Australia and New Zealand, where the respective central banks had been successfully maintaining low rates through inflation-targeting monetary policies. Fiji experienced the adverse effects of a rapid rise in demand, mainly within the housing market, as the demand for construction materials expanded to cater to overseas. The country's trade deficit widened in the mid-point of poor export performance, compounded by the decline in garment exports that followed the ending of the US quotas for Fiji's garments, footwear and fish. In 2005 the current-account deficits reached the equivalent of 13% of GDP, despite an exceptional performance by the tourism sector and the rise in export remittances from Fijian rugby players, teachers and nurses working overseas. In the same year inflows of such remittances totalled $750m., having risen from $115m. in 2000 and $830m. in 2004. These remittances exceeded receipts from sugar exports, which amounted to approximately $150m. in 2005. The country's monetary authority, the Reserve Bank of Fiji (RBF), reduced interest rates in October 2005, by 50 basis points from 1.75%, and again in February 2006, this time by one percentage point to 3.25%.

The discount rate, also known as the minimum lending rate, was raised to 4.25%. In addition, in May 2005 the RBF raised the statutory reserve deposit ratio for the commercial banks from 5% to 7%. These actions signified a major departure from the easy monetary policy for restraining aggregate demand, an approach that had prevailed for a decade. Until 2005 demand had been driven mainly by consumption. As a result of these increases in interest rates, demand was reduced, and this was reflected in the decline in loan approvals by lending institutions.

The Cook Islands were able to record a fiscal surplus of 4.1% of GDP in the financial year ending in June 2005, after two years of deficits. This was due to improvements in revenue collection and to the general buoyancy of the economy. The Islands had experienced a revival of the tourism industry. In 2005 tourist arrivals and revenue increased by 9% and 11% respectively. Much of this was attributed to the introduction of low-cost flights, operated by Pacific Blue from Christchurch, New Zealand, that dropped the return rose in the same year after recovering from the adverse effects of an outbreak of dengue in 2004. Inflation in 2004/05 remained low, at 1.5%, despite an increase in world petroleum prices. The majority of exports were purchased from New Zealand, which had been experiencing a low level of inflation. The Cook Islands were bound by the Manih Agreements of 1968 not to undertake any further borrowing for a period of seven years following the restructuring of external debt. As a result, the Islands' debt amounted to 54% of GDP in 2005. Kiribati's fiscal position was a continuing cause of concern. The country's fiscal deficit reached its highest level in 2005, when it stood at 28.5% of GDP. Further declines in fishery licences fees, limited tourism earnings and increasing recurrent and capital expenditure resulted in budgetary deficits, which were to be serviced by drawsdowns from the country's trust fund, known as the Revenue Equilization Reserve Fund (KERF). If the value of the trust fund was to be maintained, these drawdowns would need to be returned. Since Kiribati uses the Australian dollar as legal tender, and a major proportion of imports are purchased from Australia, the rate of inflation has remained low.

In the Marshall Islands, the fiscal position remained precarious. The fiscal deficit in the financial year ending September 2005 was estimated to be equivalent to 3.4% of GDP. Revenues were lower than expected, and capital expenditures increased. In the same year external debt reached approximately 75% of GDP, most of which had been borrowed on concessional terms. With grace periods on loans from the Asian Development Bank (ADB) ending in 2006, interest payments were therefore falling due. Debt-service expenditure was expected to be equivalent to 24% of export revenue. With the closure of the country's tuna-processing plant in 2000, exports declined. However, the remittances of individuals, both local and overseas, were an important aspect of the balance of payments. Since the US dollar is legal tender in the Marshall Islands and most of the country's imports are purchased from the USA, in 2005 inflation remained low, at 2.4%.

In the Federated States of Micronesia, another former US territory, experienced a similar situation. Having failed to manage efficiently the aid inflows from the USA under the first Compact, which expired in 2001, the country established a trust fund under the second Compact, which took effect in 2004, to secure overseas borrowing proved difficult. Fiscal deficits stood at 9.5% of GDP in 2004 and 6.1% in 2005. Inflation was low at 2.5% in 2005, as in 2004.

Nauru's macroeconomic prospects remained poor. Phosphate mining, upon which the economy had previously been dependent, was already declining as resources became depleted. It was reported that phosphate export receipts in 2004 did not cover the cost of mining operations. There was no other income-generating activity in the country, other than subsistence fisheries, and little tourism potential on the island. At the first international donor meeting held in November 2005, several alternatives were proposed, including the development of commercial fisheries, in the hope of creating jobs and export potential. Expectations were raised when a fertilizer company from Australia indicated that it might purchase Nauru's phosphate mining operations for an estimated cost of $65m.

Palau's macroeconomic stability depended on whether its trust fund, established under the first Compact (1984-2006) with the USA with a view to developing financial support for annual budgets, would function successfully. From 2001 the annual fiscal deficit remained in double digits, reaching the equivalent of 12% of GDP in 2004. Remittances from tourism are seen as a potential source of financial support, which inflows have covered 50% of the country's imports. Palau's current-account deficit was estimated at around 15% of GDP in 2004/05. Since Palau uses the US dollar as legal tender and its imports are mostly sourced from the USA, annual inflation has remained low.

From the mid-1990s Samoan's successful record of reform implementation served the country the epithet of the "darling of donors". Prudent policies contributed to strong performance, facilitated by the fiscal surpluses, maintained during 1996-99; these were followed by modest deficits during 2000-04. In 2005 the fiscal deficit reached 0.9% of GDP, despite an increase in local expenditure programmes for staging the South Pacific Games, scheduled for 2007. However, the current account, which recorded surpluses in 2002 and 2003, showed a deficit of 7.3% of GDP in 2005, with inflation reaching approximately 7.8%. From 2004 focus turned to the country's tourism poten-
tial, with substantial investment being made in hotel and resort construction, as well as with the introduction of flights to Samoa in 2008, following the launching of a joint venture, namely Polynesian Blue, between national carrier Polynesian Airlines and Virgin Blue of Australia.

Similarly, Tonga experienced a relatively modest but remarkable recovery from the aftermath of civil unrest and near-collapse of the economy during 1999-2003. Substantial aid inflows and technical assistance to the Ministry of Finance and key industries under the ongoing RAS1I substantially enabled the restoration of fiscal stability. Donors funded approximately 56% of the recurrent budget and nearly 100% of capital budgets in 2004 and 2005. In 2005 the budget was in surplus at 8.3% of GDP, subsequently moving into deficit at 0.2% of GDP in 2006. The current-account balance, which includes official transfers, was in surplus in 2003 and 2004, at 1.4% and 1.1% of GDP respectively. In 2005 a deficit of 2.9% of GDP was expected. With persistent shortages continuing and subsistence agriculture making a slow recovery, inflation remained high, reaching 10% in 2002 and standing at around 7.0% in 2006-08. International credit approvals agreed a memorandum on the country's external debt servicing obligations, with the expectation that the rehabilitation of the once-thriving company, Gudalcanal Palm Oil, and other enterprises such as Gold Ridge Mining, would begin contributing to growth in the coming years. The implementation of prudent fiscal policies and the maintenance of low inflation and order would be crucial.

Tonga faced severe fiscal difficulties during the early 2000s. Strike action by public service workers resulted in salary increases of 60%-80%, as agreed in the terms of the settlement reached in September 2006. These increases were expected to cost the equivalent of 1% of GDP. Consequently, fiscal deficits are expected to rise to 6% of GDP unless additional non-concessional revenue-raising efforts were continued. A new 15% consumption tax was imposed on 1 April 2005, to replace the 26% ports services tax and 5% sales tax, with a view to avoiding discrimination between imports and local goods and services. However, the existing inefficiencies in tax collection were reported to have resulted in the annual loss of an estimated T$20m. pruning. In addition, unprofitable state enterprises were being given financial support by the Government, and the resultant budget deficits (2.6% of GDP in 2005), led to monetary expansion. The annual rate of inflation remained high, rising to 10% in 2006. Furthermore, the country's international reserves were placed under increased strain, despite substantial annual inward remittances. Fiscal pressures such as those arising from the strike action by public servants, along with the protests by pro-democracy supporters, diverted the country's attention away from the implementation of the public-sector reforms initiated in 2002 and were likely to cause further set-backs to Tonga's economic progress.

Fiji, too, demonstrated improved fiscal management in the early 2000s in comparison with the islands' trust fund, nevertheless faced revenue losses as a result of declining rates of fishing licences and telecommunication licences, and the reduction in income from the 'ivory ban' domain. The budget deficit in 2005 was reduced to 4.7% of GDP. The country's debt, all of which was derived from international funding agencies and was hence obtained on concessional terms, stood at 68% of GDP. Fijian, which uses the Australian dollar as its currency and which obtains most of its imports from Australia, recorded annual inflation rates of less than 5%. With an extremely limited range of exports, confined to copra and fish, an increase in the inflow of remittances would be needed to sustain the economy.

Vanuatu's fiscal position was strained from the late 1990s until 2003. Prudent fiscal policies and monetary management, however, enabled the country to restore budgetary and fiscal discipline. The budget was in surplus in 2004 for the first time in 10 years; this was followed by a small deficit, equivalent to 0.3% of GDP, in 2005. The much-hailed Comprehensive Reform Program (Capon), funded by the ADF and implemented over a period of several years beginning in 1998, proved success in demonstrating that the country needed an incremental approach, rather than the sudden implementation of radical policies, to address the issues of poor governance and of the neglect of the rural sector, by means of income-enhancing infrastructure investment projects, might have been more beneficial. In addition to the introduction of the Tsukiji, the introduction of the kimono and the establishment of the island's prospects for future growth, which were improved with major investment in infrastructure projects assisted by the US $65.6m. grant from the US Millennium Challenge Corporation.

Macroeconomic stability in the French and US territories has remained the responsibility of the respective sovereign nations. Two long-established tuna canneries continue to operate in American Samoa, a US-administered territory, which retains close trade relations with the USA. In 2006 the canneries employed 4,738 workers (36.6% of those engaged in the formal sector), paying an average hourly rate of US $36.00, and accounting for 24.5% of the territory's total wage costs. The American Samoan Government employed about 5,100 workers at an average hourly rate of US $7.94, this represented 18.4% of the territory's total expenditure on wages in 2006. The third largest employer in American Samoa, the trade and services sector, accounted for only 8.3% of the total wage bill while employing 10.3% of all surveyed workers. The majority of American Samoan's exports of processed tuna are destined for the USA. The cost of processed tuna imports far exceed the value of its exports, and the trade balance has been financed by the inflow of remittances from the USA mainland and from Hawaii. Annual fixed transfers from the US federal government support the territory's budget. American Samoa's natural constraints, namely its remote location, limited transport facilities and susceptibility to cyclones have hindered the island's development. The mobility of labour within the USA has been significant in assisting American Samoa to overcome the disadvantages of a small economy. The relative prosperity of the territory, compared with its western neighbour, Samoa, was reflected in the per capita GDP of US $9,000 in 2005. However, with the advent of free-trade arrangements, it was feared that American Samoa's canned tuna exports would no longer be competitive and that the two canneries might be closed down and their operations transferred to Asia, where labour costs are lower but from where access to the US market would remain favourable.

Guam, another US-administered Territory, has remained dependent mainly on US military activities on the island. In recent years tourism has emerged as a major contributor to the economy, with substantial investments in hotel construction and renovation activities. According to the Guam Department of Revenue and Taxation, 1.2m. tourists, an increase of 5.8% compared with the previous year, and the sector was expected to benefit from the anticipated recovery in the Japanese economy; a record 1.2m. Japanese tourists visited Guam in 2006. In October 2005 it was announced that 7,900 US marines, along with their dependents, were to be relocated from the Japanese base of Okinawa to Guam over a six-year period. This would increase the number of military personnel stationed on Guam to more than 10,000 and would bring greater military spending to the island. Large-scale infrastructure programmes, including water supply and waste management projects, were initiated and facilitated such construction activities, as well as US Federal government wage payments and procurements, amounted to US $1.3bn in 2004. With the expansion in military and tourism activities, Guam's economy was the highest in the islands in the region, at US $23,000m.

The Commonwealth of the Northern Mariana Islands was granted special status under the Covenant Agreement signed with the USA, which incorporated it into US law as a territory sector, with visitors coming mainly from the USA and Japan. It employs more than 50% of the labour force and contributes about 25% of GDP. The garments industry is the territory's thriving sector. Two trade agreements, one with the USA and the other with Japan, were negotiated to stimulate growth. 889

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In September 2001, however, the Cook Islands, Nauru, Niue, Samoa and Vanuatu came under increasing scrutiny, owing to suspicions of money-laundering and other criminal activities, as well as suspicions linked to terrorism organizations. Aware of the unsolicited adverse publicity, those Pacific Islands with OFCs made efforts to improve their image by conforming to the standards prescribed by the Asia-Pacific Group on Money Laundering (APGML) and the Financial Action Task Force (FATF). The Organisation for Economic Co-operation and Development (OECD) and the IMF. In October 2003, Nauru became the last of the Pacific Islands to be removed from the FATF list of non-co-operative countries and territories.

The impact of OFCs on domestic economies, however, has been negligible. The previous labour-intensive methods of managing and transferring financial inflows outside their jurisdictions have become obsolete. With technological advances, as many as 50 finance companies could be managed from just one office location. As a result, there was little impact on employment, and the main repercussions were limited to the increases in consumption expenditure that arose from imports of items such as computers and telephones. Subsequent OFCs, contributing more than 20% to Nauru's GDP, and Pacific citizens, relying on the island and forming a large proportion of the population, also make a significant contribution to consumption, an important component of GDP. In 2005, GDP per capita was estimated at US$12,000.

Nauru obtained the status of self-government in 1974 but has remained largely dependent on the New Zealand for the management of its public services. Although efforts have been made to decrease government expenditures by reducing the public service by almost half, the government is still the island's largest employer. The GDP per capita was estimated at US$7,000 in 2005. Nauru depends on the agricultural sector for its exports of processed passion fruit, nectarine, lime oil, honey and coconut cream. The sale of postage stamps to foreign collectors is an important source of revenue. In January 2004, however, Nauru suffered from a severe cyclone, the effects of which continued throughout 2005. The process of rebuilding remained in progress in 2006.

Norfolk Island is a territory of Australia. The tourism industry has experienced steady growth over the years to become the primary source of revenue on the island. The agricultural sector has become self-sufficient in the production of beef, vegetables and fruits. The island exports consisting of copra, postage stamps, souvenirs coins and handicrafts, inward remittances to families from relatives in New Zealand provide substantial financial support. GDP per capita was estimated at US$1,000 in 2006.

THE CHALLENGES FACING THE PACIFIC ISLANDS

In the latter part of the 20th century, some Pacific Islands, particularly countries such as Vanuatu and Tuvalu, were granted autonomous status. A portion of the revenue was derived from direct tax on personal income or company receipts, encouraged the development of offshore financial centres (OFCs). Following the attacks on the USA in
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Although there would be a loss of revenue and higher adjustment costs due to these losses would be significantly less than if PACEER, and the subsequent adjustment required, was postponed until after 2011. However, during the interim period, free-trade arrangements with Australia and New Zealand would discourage trade with other Pacific countries, rendering obsolete the region’s capacity to produce goods locally, for example, biscuits, beer and cigarettes. Some observers have suggested that a compromise could be agreed during the negotiations on the basis of an agreement between workers from the Pacific Islands to seek employment in Australia and New Zealand, and granting a limited number of temporary work permits each year for unskilled workers to be employed in those countries at times of labour shortages.

Partly in response to the problem of the overwhelming complexity of the trade agreements, in 2008 an Australian-Perspectives Group appointed by the Pacific Islands Forum visited around the region, meeting numerous leaders from different sectors, and prepared a Pacific Vision report. The Pacific Island leaders met in Auckland in April 2004 to consider the Group’s report, on the basis of which they agreed to develop a Pacific Plan. The Pacific Plan Task Force (PPTF) was established, with specific terms of reference. Consultative procedures began and a time frame for preparing a draft document was agreed. The final document was presented to the Pacific Islands Forum Meeting in Port Moresby in Papua New Guinea in December 2006.

The Pacific Plan was based upon four objectives: economic growth, sustainable development, good governance, and security. Specifically, with regard to economic growth, the Plan sought to integrate trade in services, including temporary provisions for the movement of labour during the course of the Pacific Islands Forum Leaders Meeting held in Auckland, New Zealand, in August 2005. The subject was not included in the agenda and was therefore not formally discussed, but the indications were clear in the event of further regional integration in the medium to long-term future, ‘delocalisation’ would have to be considered.

Various studies have shown that the implementation of free trade in goods with Australia and New Zealand would involve higher adjustment costs than the PACEER with the EU, given the magnitude of the volume of trade with Australia and New Zealand, which is much greater than that with the EU. The revenue loss from the abolition of tariffs on imports from the two advanced Forum members must be recovered by means of the imposition of other taxes, including value-added tax, and Vanuatu in particular needs to consider the introduction of income tax and other direct taxes to offset this loss of revenue from import duties. The only perceived option is to delay PACEER negotiations, avoiding free trade in goods and services and thereby denying access to the EU until 2011, which is simply not feasible. According to legal experts, once negotiations on concluding EPA with the EU have commenced, PICTA would not have been considered a sufficient commitment to prevent the Pacific Islands from being drawn into PACEER discussions, which would have to begin sooner than anticipated. Yet to withdraw from PACEER would prove extremely detrimental to the prospects of regional integration.

A more practical solution would be to enter into a free-trade arrangement with Australia and New Zealand immediately.
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