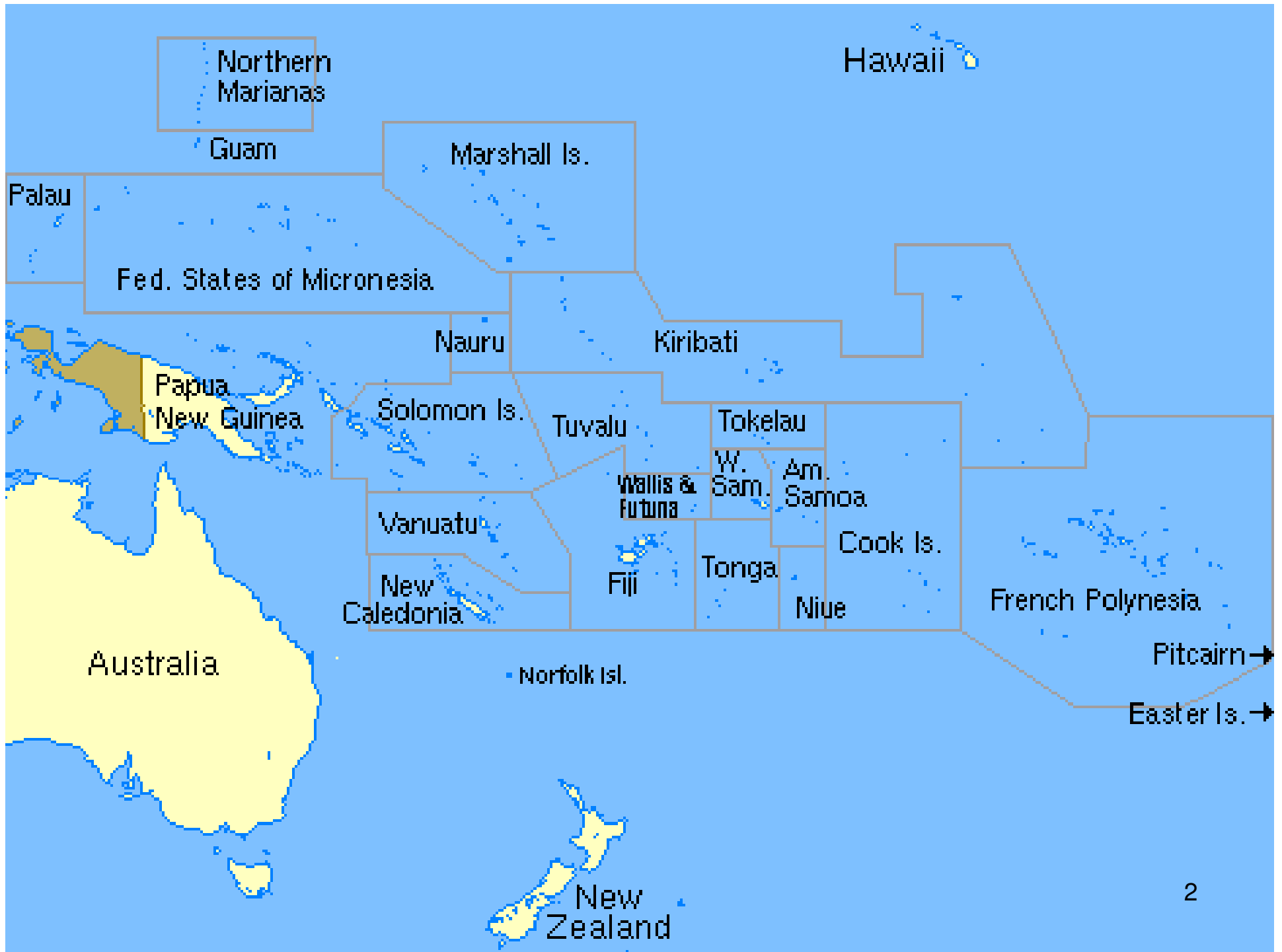


**MONETARY POLICY
RESPONSES IN PACIFIC ISLAND
COUNTRIES
TO GLOBAL ECONOMIC
DOWNTURN**

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GLOBAL ECONOMIC DOWNTURN AND PICS

- Current crisis : Product of three crises (UN ESCAP 2009)
- Volatility in and surging food and fuel prices in early 2008
- Financial crisis in the advanced countries and
- Climate change calamities

IMPACT: FIRST ROUND

- First one: Rapid depletion of foreign exchange reserves
- Dependency on imports of food and fuel
- Limited export earning capacity, except PNG
- Fall in economic activities in advanced countries
- Fall in commodity prices
- Climate change calamities of early 2008
- Severe damages to infra.& destruction of farm lands
- Steep decline in production for subsistence living

TRANSMISSION MECHANISM OF GLOBAL DOWNTURN

- Lower commodity prices & reduced demand for commodity exports
- Decrease in tourism
- Declining remittances with falling demand for PIC workers
- Falling values of offshore trust funds
- Deterioration in private sector access to credit

GROWTH FORECASTS & TOURISM IMPACT

IMF World Economic Outlook (April 2009):

Global contraction by 1.3%

- USA: 2.8%,
- Australia: 1.4%
- NZ: 2.0%
- Decline in economic activities: negative flow-on-effects to Pacific region
- Decline in tourist arrivals in 2009 by 5.5 % for all PICs
- Actual year-to- year: arrivals from Aus & NZ decreased by 13% by March 2009
- About 29.8% decline in tourism is forecast for Fiji

Growth Forecasts for Major Pacific Island Countries

Table 1; PICs: Forecast for 2009					
Country	Growth Rate % Forecasts	Trade Balance % of GDP 2008	Import cover months 2009-Qr1	Budget Balance (% of GDP) 2009	Budget Balance (% of GDP) 2009
Fiji	-0.5	-35.8	2.7	-3.0	-5.0
PNG	4.0	32.5	10.9	-2.9	-5.0
Samoa	-1.0	-43.1	4.8	-5.5	NA
Sol.Is	2.2	-20.5	2.5	-3.7	NA
Tonga	-2.0	-52.3	4.7	1.0	NA
Vanuatu	3.5	-43.3	5.4	0.9	NA

Source : ADB (2009)

IMPACT ON PICs

- Dec. 2006 coup in Fiji: Benefited Vanuatu
- Diversion of tourist traffic away from Fiji
- Short-run outlook for VAN: Not encouraging.
- Contraction in AUS & NZ
- Tourist arrivals expected to decline. (RBV 2009)
- Inward remittances in SAM & TON: 25% of GDP
- Fall: due to deterioration in overseas job markets

DECREASING EXPORTS & FALLING COMMODITY PRICES

- Economic downturn: Declining demand for mineral & non-mineral products
- End of commodity boom.
- Two PICs: benefited by commodity boom
- Growth: PNG: 2007: 6.7% & 2008: 7.3%
- Solomon Islands: 2007: 10.3% & 2008: 7.0%
- PNG's exports: diversified with petroleum, gas & mineral products along with agricultural exports including coffee, cocoa and tea (about 95 percent of export earnings)

DECREASING EXPORTS & FALLING COMMODITY PRICES (Cont'd)

- SI's exports: timber (70% of export earnings) & palm oil.
- With fall in demand & drop in prices: PNG and SI would not be able to maintain the same past level of export earnings and growth rates.
- PNG: the kina export price index declined by 32% in Dec 2008
- Fall in log export price in SI likely due to contraction in log importing advanced countries

RESPONSE TO THE CRISIS

- Countercyclical: expansionary policies, fiscal or monetary
- Challenge: How to ensure spending on social protection is not compromised.
- Developed countries: Strengthening social safety-nets, including unconditional and conditional cash transfers to poor households & public works
- Limited scope in PICs: Little fiscal or current account leeway
- PICs face higher inflation: surge in food & fuel prices; pressure on exchange rates to depreciate; and an outflow of international capital
- Challenge: Trying to balance stimulation of growth under inflation threat

FEAR OF TWIN DEFICITS

- Except PNG & VAN, all PICs : Running budget deficits: last 5 years
- Raising domestic demand & fiscal deficits for offsetting declines in external demand: Fear of widening trade deficits
- Fear of resulting drain on limited international reserves level
- Increase pressures on exchange rate
- Disastrous effects: inflation, unless effective trimming of their 2009 budgets

MACROECONOMIC STABILITY

Identified: First Pillar by UN ESCAP: *Surviving the Global Recession: Strengthening Economic Growth and Resilience in the Pacific* : Aug 2009 Forum Leaders Summit in Cairns

- A sustainable fiscal policy & public debt position
- A sustainable BOP position and comfortable level of reserves
- Low inflation
- For budgetary support sustainable drawdown by PICs dependent on overseas held offshore trust accounts

SUPPORTIVE MEASURES FOR FISCAL STIMULUS

- Needed Supportive Measures:
 - (i) More vigorous revenue collection efforts;
 - (ii) Changes in expenditure composition: cutting wasteful expenditures & ambitious projects; and
 - (iii) Diverting the saved resources towards labour intensive & quick yielding projects including rehabilitation & upgrading infrastructure.
- While effecting these critical changes: keep in mind the interests of the already affected vulnerable sections of the society.

FISCAL RESTRAINT

- PNG's bitter lessons from the past boom-bust cycle episode of the 1990s
- PNG's recent windfall gains from commodity boom invested in trust accounts
- VAN: Prudent fiscal Budget surpluses: 2004-2008
- Fiscal stimulus: Fears of wastage: Govts. with an eye on next elections
- Temptations: pursuing expansionary policies of doubtful quality

BORROWING OPTIONS

- Domestic Borrowing: Limited by Highly Prevailing Debt levels in PICs.
- Clear Recognition by March 2009 Monetary Policy Statement (MPS) by Central Bank of Solomon Islands

BORROWING OPTIONS (Cont'd)

- “It would not however be appropriate for Solomon Islands to implement such a program at this juncture as the cost would be prohibitive, it would encumber the nation with further debts and provide very little boost to the economy given the supply constraints of the economy and the dependence on foreign demand” (CBSI 2009).
- Absence of well established capital markets: Unsold Govt bonds are picked up by central banks: Monetisation of fiscal deficits

EXTERNAL BORROWING

- PICs' Investment projects: Funded by bilateral grants or multilateral grants & loans on concessional terms from ADB & WB .
- Bilateral aid inflows: Resource constraint in advanced economies
- Lukewarm response to WB President's plea to advanced countries to earmark 0.7% of their fiscal stimulus packages to developing countries
- External borrowing: an option open to PICs

EXTERNAL BORROWING (Cont'd)

- ADB: A US\$3 billion Countercyclical Support Facility (CSF): short term loans supporting its member countries' fiscal spending to counter the crisis.
- US \$400 million under ADF: Concessional loans to poorer countries: crucial budget support for the most fiscally constrained countries in responding to the crisis
- 2006: With good rating, Fiji was successful in its first ever overseas bond for US\$150 million
- 2009: A repeat is not likely to be successful

WHO CAN AFFORD A FISCAL STIMULUS EFFORT?

- PNG & Vanuatu: High level of international reserves
- PNG's: import cover: 10.9 months
- VAN: import cover: 5.4 months
- Stimulus: temporary measures to meet temporary decline in aggregate demand
- Increases in salaries, a permanent burden on exchequer
- Recalling the 1990s, Deputy Governor BPNG's warned :
"We have to avoid this. We may be going through this cycle again" (Bakani 2009)
- Rise in wage bill: Spillover to demand for foreign goods & assets

MONETARY POLICY

- Options for an easy money policy, on their own or in combination with an expansionary fiscal policy: Ruled out in all PICs.
- Fall in food and fuel prices in late 2008 provided relief
- Volatility in prices is likely
- All PICs, including PNG (managed float) target international reserves.
- Monetary policies of 5 PICs, other than PNG, target nominal ER as anchor
- Expansionary monetary policy: Inflationary

MONETARY POLICY (Cont'd)

- Rise in private sector credit in Fiji, SI & PNG overheated the economy
- Although PNG has a flexible exchange rate regime, it does not rely on exchange rate as an adjustment mechanism
- PNG: Depreciation Worry: Rising import prices
- PNG: preference for stable or appreciation of exchange rate as a buffer against overseas inflation.
- Samoa allowed appreciation of ER (CBS 2009)

SECONDARY ROLE

- Monetary policy: At best only a secondary role in PICs.
- PICs have to be watchful of their reserves.
- Easing of monetary conditions: would fan growth in credit & result in higher imports, leading to widening trade deficits.
- Reserves of 4 PICs as of Dec 2008/latest month of May 2009: below targeted levels of import cover:
- Fiji: 2.7 months of import cover against 4 months
- SI: 2.1 months of import cover as against 3 months
- Tonga: 4.7 months of import cover as against 5 months.
- Samoa: 4.3 months of import cover as against 5 months

INFLATION: STILL A THREAT TO PICS

- Inflation is another guiding indicator.
- Only if inflation is below the normally targeted level of 3% to 4% could any monetary expansion be thought of.
- As of May 2009, inflation is high in all countries:
- Fiji: 5.5% for food items; Forecast for year-end inflation: 9.5 percent
- PNG: 10.2%
- Samoa: 12.4%
- SI: 17.8%
- VAN: 5.8%

Trade Balance (% of GDP) in Selected PICs

Trade Balance (% of GDP)				
	2005	2006	2007	2008
Fiji	-25.5	-29.3	-30.4	-33.8
PNG	36.6	39.5	32.4	34.8
Samoa	-41.1	-45.8	-39.8	-44.6
Solomon Is.	-4.2	-12.3	-9.4	NA
Tonga	-40.5	-44.6	-38.3	-43.9
Vanuatu	-22.5	-26.9	-31.7	-34.4

Source : ADB (2009)

Budget Balance: Selected PICs : 2005-2008

Budget Balance				
	2005	2006	2007	2008
	% of GDP	% of GDP	% of GDP	% of GDP
Fiji	-10.3	-2.9	-1.8	-1.5
Kiribati	-2.8	-5.7	-3.4	-13
PNG	0.1	3.1	2.5	0
Samoa	0.3	-0.4	1.1	-3.2
Solomon Is.	0.6	0.7	-0.3	-5.6
Tonga	0.7	-4.3	1.4	2
Tuvalu	-7.4	18.7	-14.3	-5.4
Vanuatu	2.1	0.9	0.1	6.3

Source: ADB (2009)

Current Account Balance (% of GDP) in Selected PICs

Current Account Balance (% of GDP)						
	2005	2006	2007	2008	2009 (est)	2010 (est)
Fiji	-14.0	-22.5	-17.3	-21.3	-25.0	-25.0
PNG	12.4	7.3	2.0	8.7	-7.0	-6.0
Samoa	-4.7	-9.9	-4.3	-10.2	NA	NA
Solomon Is.	0.5	-4.1	-2.6	-4.9	-10.1	-12.1
Tonga	-2.7	-9.6	-10.1	-10.8	NA	NA
Vanuatu	-6.1	-7.5	-9.9	-11.4	-13.2	-13.0

Source : UN ESCAP (2009), ADB (2009)

CAUTIOUS MONETARY POLICY STANCE

- Central banks of 3 PICs (PNG, Solomon Islands, and Tonga): No change in their cautious monetary stance of not relaxing the tightening conditions they adopted in 2008
- PNG's central bank noted clear signs of risks (MPS of March 2009)
- A larger than expected depreciation of the kina exchange rate
- Delays in the pass through of low import costs to domestic prices by businesses

CAUTIOUS MONETARY POLICY STANCE (Cont'd)

- A rebound in international food and fuel prices;
- Excessive Govt spending;
- Fast drawdown of trust account funds
- Rise in consumer demand in the event of fresh wage increases
- Despite lower inflation overseas, uncertain full impact of downturn
- Expected fall in export receipts
- Effect of potential depreciation of the kina combined with continued very strong domestic demand: inflationary pressures in 2009.

TIGHT MONETARY POLICY IN PICS

- BANK OF PNG (BPNG): Tight monetary policy stance in the first half of 2009
- BPNG suggested a similar tight fiscal policy
- BPNG: concerned with impact of rise in fiscal spending on liquidity
- BPNG advice to government: Reduce liquidity in the banking system by transferring trust account funds from the commercial banks to BPNG.

TIGHT MONETARY POLICY IN PICS (Cont'd)

- CBSI: Concerned with current level of reserves was below the Bank's desired level sufficient to cover the predicted next three months of imports.
- CBSI : May 2009 MPS: To continue its past tight monetary policy, as it "would prevent a hemorrhaging of reserves" (CBSI 2009).
- Tonga: NRBT in its May 2009 MPS recognized :
- Vulnerability of the economy to external shocks such as oil price increases
- Adverse weather conditions
- High dependence on imports & remittances
- Importance of exchange rate & price stability

TIGHT MONETARY POLICY IN PICS (Cont'd)

- Lower prices of imports facilitated by the weakening of NZ
- NRBT (2009) MPS: Any relaxation of monetary stance would only lead to “a re-acceleration of credit growth which would put pressure on domestic resources, potentially leading to more inflation, higher imports and lower foreign reserves.”
- MPS noted: increased incidence of loan defaults & wanted to maintain the financial health of the banking system.
- NRBT to maintain tightened conditions by “closely monitoring growth in lending and foreign payments obligations” & continuing the issue of NRBT notes when necessary to ensure financial stability.”

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PROACTIVE POLICIES

- Vanuatu: In 2008: tightened monetary conditions in the face of inflation
- RBV raised rediscount rate by 25 basis points in September 2008 to 6.25 percent.
- In the second half of 2008:RBV relaxed policy stance
- Emergence of tight liquidity situation: bank excess reserves falling to low levels
- Dec 2008: RBV reduced rediscount rate to 6%
- Further steps to alleviate the tight liquidity conditions.

PROACTIVE POLICIES (Cont'd)

- VAN: Reductions in LAR ratio from 8% to 7% & SRD ratio from 8.5% to 8% in November 2008.
- Jan 2009: Further reduction in SRD ratio to 5%
- Feb 2009: VAN: foreign reserves: 5.4 months of import cover, above the target : 4 months of import cover
- Mar 2009 MPS: downward trend in tourism & export earnings.
- Fear of a widening of current account deficit
- Downward pressure on foreign reserves
- MPS: no further relaxation of monetary policy

PROACTIVE POLICIES (Cont'd)

- Central banks of Fiji & Samoa: Eased monetary conditions in 2009.
- Fiji: in early 2009: Decline in reserves, decrease in liquidity
- April 2009: RBF lowered SRD ratio: 5% from 6%
- April 10: Fiji devalued currency by 20%: Reason: ER was out of alignment with the economic fundamentals.
- Rise in domestic inflation: Rise in prices of all imported items
- Fiji's intl. reserves: Revaluation: Went up to F\$641 million in May 2009 from F\$429 million in March
- Moral suasion: RBF persuaded banks to freeze the lending rate at December 2008 level & keep a spread of not more than 4%

PROACTIVE POLICIES (Cont'd)

- Samoa: Effective Feb 2009: Reduction in lending rate from 7.8% to 5%
- The term for such lending was increased from 7 days to 30 days
- Range of collaterals: extended
- CBS reviewed MP Stance after May 2009 budget
- Budget deficit : 11% of GDP
- CBS has decided not to change the monetary policy stance

DEVALUATION AS A REMEDY?

- Prior to devaluation in PICs: Need for evaluation of pros and cons during the current global crisis
- If the exchange rate is out of line with macroeconomic fundamentals, immediate option: correct the fundamentals
- Corrections: Reduce fiscal deficit by cutting of all non-essentials
- Reduce growth in private sector credit
- Monetary tightening
- Proactive measures: Appropriate production incentives for exports

FISCAL AND MONETARY POLICIES COORDINATION

- BPNG : Central Banking Act 2000: BPNG : greater independence in choice of policy instruments.
- In other PICs: Degree of autonomy varies
- In Samoa: Approval of cabinet is needed for changing SRD ratio.
- Regardless of autonomy, need of the hour is frequent consultation between central banks and the ministries of finance.
- Renewed emphasis on coordination of fiscal and monetary policies

NEED FOR COORDINATION (Cont'd)

- Past experience: central banks were called upon at a later stage
- when the economy used to get overheated with expansionary fiscal policies
- often in ending up with rise in public debt & sometimes in the monetization of deficits
- More of fire fighting exercise to put down inflationary pressures.
- PNG's central bank Governor Kamit put it thus: "Experience of the 1990s show that when there is excessive Government spending there can be downward pressure on the exchange rate and high inflation. And monetary policy is burdened with the task of restoring macroeconomic stability. That is, monetary policy could become preoccupied with the Government's debt management" (Kamit 2009).

CONCLUSIONS

- Monetary policy can play only secondary role
- Monetary policy transmission mechanism is slow & ineffective in PICs
- Sluggish interest rate-supply response
- High inflation potential in the short run
- Challenge is: “How to balance stimulation of economic growth in an environment where inflation is a threat”(CBS Gov Scanlan May 2009)
- Deficit financing & cheap money policy: contribute to boosting demand
- Subsequent efforts to slowdown the economy carry further risks of entrenching inflation and foster an inflationary psychology
- All central banks are watchful of reserves

CONCLUSIONS (Cont'd)

- Cautious monetary policy stance
- Moral suasion by central banks
- RBF Governor's plea to trade unions not to press for wage rise
- PICs: Avenues are open for supplementing domestic resources from ADB assistance under US \$3 billion Countercyclical Support Facility (CSF).
- ADB Assistance: Adds to real resources
- Reduce inflationary pressures
- Increases international reserves

BPNG's MPS (March 2009) reflects concerns of every PIC central bank governor:

- “The objective of economic stability will not be achieved by monetary policy alone. It also requires prudent management of fiscal policy by the Government within the budget framework and its medium term policies. Should export tax receipts be lower than projected, expenditure should be adjusted accordingly to avoid a reckless budget blowout.”

ROLE OF MONETARY POLICY

- Weak links to growth
- Key tool: fiscal policy subject to fiscal space
- Monetary policy focus: control on inflation; protect foreign reserves resulting from loss of export markets; and fall in TOT
- Maintenance of sound financial system
- Banks under stress: borrowers unable to service debt if remittances slow down
- Step up bank supervision: avoid build up of bad loans

THANK YOU