Saturday, October 26 2013

Current account deficits in Pacific region

T.K. JAYARAMAN

The latest news from Samoa on its current account balance in external accounts is reflective of the prevailing situation in all Pacific island countries (PICs).

Samoa's current account deficit has been rising since last two fiscal years. Samoa's fiscal year (FY) begins from July and ends in June, whereas for other PICs, the fiscal year is the same as calendar year: January to December. For FY 2013, its current account deficit is reported to be 13.4 percent of GDP as compared to 10 percent of GDP in FY 2012. It is estimated to grow and reach 15.5 percent of GDP in FY 2014.

A country's current account in balance of payments is influenced by three major components: trade in goods, services and transfers. A trade deficit occurs when payments for imports of goods exceed the earnings from exports. The second component consists of services, which in case of PICs are mainly earnings from tourism; and the third one: private and official transfers. Private transfers cover inward remittances from individuals to domestic residents and transfers from private bodies mostly charities to domestic organizations. The last category is transfers from governments in terms of grants, which are known as foreign aid.

Trade deficits

Trade deficits are normal for any developing economy. PICs are no exception. However, they are more dependent on essential imports of staples, rice and wheat flour and fuel. Their total imports including intermediate and capital goods such as machinery and transport always exceed exports. Further, their exports are limited and narrow in range except in the case of Papua New Guinea (PNG). PNG's exports cover a much wider range, consisting of mineral and non-mineral exports.

Trade deficits are not worrisome. If they are offset by tourism earnings, remittances and foreign aid to some extent, current account deficits remain small and sustainable. The sustainability is assured, if capital inflows, which fall under capital account in balance of payments, are sizeable. The healthy capital inflows, as distinguished from the destabilizing, short-term hot money inflows, include foreign direct investment (FDI). If FDI inflows are rising and substantial, foreign exchange reserves of the country go up. Otherwise, reserves decline.

Floating and fixed currencies

If annual current account deficits increase steadily and are not covered by net capital inflows, and if there is a decline in FDI inflows, the country's currency would be under pressure. PICs, except PNG have fixed currencies. The impact of exchange rate pressures are not immediately felt until the pressures build up overtime.

PNG's currency, the kina is a floating one. It is determined daily by interaction of supply and demand for foreign exchange. The kina has considerably depreciated in recent weeks, by about 14 percent to 16 percent against the Australian and American dollars. The result is adverse. All imported items have become more expensive. Monetary authorities are now on a fire-fighting exercise to fight inflation. The position is expected to be reversed, when the nearly completed liquefied natural gas project goes on stream in 2014.

Devaluation as ultimate remedy

Currencies of Samoa and other four PICs (Fiji, Solomon Islands, Tonga and Vanuatu), being fixed currencies can tide over periods of temporary current account deficits by running down foreign exchange reserves. After all, there is a finite limit to the reserves. The better approach is controlling domestic aggregate demand, mostly budgetary expenditures. Often current account deficits are due to non essential expenditure items such as junket travel and high wage bills. They result in budget deficits.

Annually widening deficits would lead to depletion of international reserves. It will eventually lead to seeking the ultimate remedy: currency devaluation as it happened to Fiji's currency in 2009 with disastrous consequences.

The latest projections on current account deficits made by ANZ's Pacific Monthly Report for October reveal that Fiji's current account deficit for 2013 would be 22.5 percent of GDP as against the estimated 6.8 percent for 2012. The corresponding figures for Solomon Island are: 14.5 percent and 6 percent; for Tonga 10.7 percent and 11.7 percent; and for Vanuatu 8.0 percent and 6.3 percent.

The estimated budget deficits for 2013 for PICs, except for Solomon islands and Tonga are higher than those for 2012: Fiji: 2.8 percent of GDP; 7.9 percent for PNG; Samoa: 7.0 percent; and Vanuatu: 2.5 percent.

Challenges before Government

Reasons for Samoa's current account deficits are traced to declines in tourism receipts and increases in imports of materials for post-cyclone reconstruction and government expenditures on Small Island Developing States Global Forum and Commonwealth Youth Games in 2014/15.

Remedial measures are obvious. Two clear ways are promoting exports of agricultural exports, fruits and vegetables to traditional markets, notably New Zealand and tourism. Unfortunately, the growth of Samoa in the just ended fiscal year has been poor, most of which has been attributed to world recession and cyclone impact.

The planned expenditures on cyclone reconstruction and improvement in agriculture would speed up recovery. Unless the recovery is followed by rise in exports, steady tourism earnings and increase in remittances, current account deficits would present challenges to policy makers.