Pacific Economic Monitor

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The *Pacific Economic Monitor* provides an update of developments and policy issues in the Pacific economies.

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Highlights

A view from neighboring economies

- The world economy is showing some signs of stabilizing, with the rate of economic contraction slowing. However, major neighboring economies—Australia, New Zealand, and the United States—are still projected to contract in 2009. Unemployment remains high in neighboring economies.
- Higher international prices of some key commodities are helping lift export earnings above expectations in the Pacific. Crude oil prices in particular are benefiting Papua New Guinea (PNG) and Timor-Leste. Falling log prices are, however, dampening the outlook for Solomon Islands.
- The drop in departures from Australia to the Pacific halted in April and May 2009. Tourism from Japan, New Zealand, and the US to the region remains in decline.

The state of the Pacific

- Regional economic growth is expected to slow further in 2009 than originally forecast, but remains positive at 2.8%. An overall contraction of 0.4% is expected in 2009 in the Pacific Island economies (i.e., the region excluding PNG and Timor-Leste).
- Five Pacific economies—the Cook Islands, the Fiji Islands, Palau, Samoa, and Tonga—are each projected to contract over 2009. No growth is expected in Solomon Islands.
- Inflation is easing across the Pacific, with the exception of the Fiji Islands (because of devaluation). The recent rise in crude oil prices will see somewhat higher inflation than originally expected.

Risks and scenarios

- The Fiji Islands is beginning to recover its Australian tourists. This will now slow tourism growth in the Cook Islands, Samoa, Tonga, and Vanuatu. Moderate growth is expected in all major destinations in 2010, with the Fiji Islands expected to achieve the highest growth.
- Weakening government revenue outcomes are being addressed by cuts in recurrent expenditure that will put pressure on basic service delivery. Capital spending is rising in some economies as part of the response to the global crisis.

Economic management issues

- The economic and fiscal impacts of the global economic crisis appear to be larger than expected by some economies. There is as strong case for concerted action to stabilize some of the region's faltering economies. The quality of the fiscal response will be central to the achievement of a sustainable recovery.

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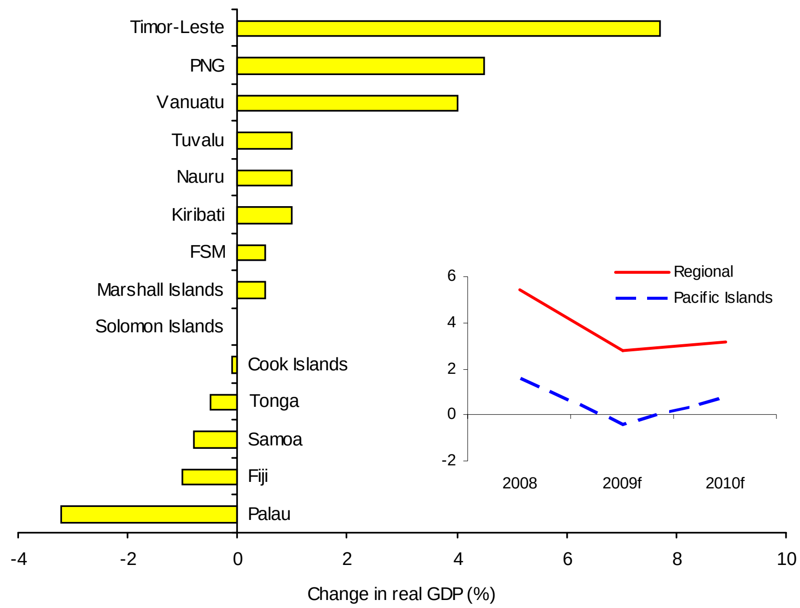
Abbreviations

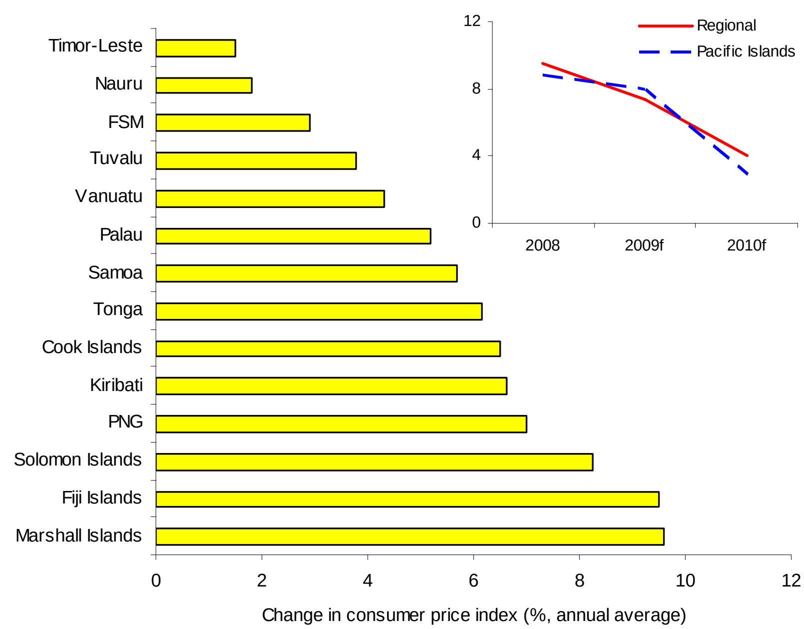
$	US dollars, unless otherwise noted
ABS	Australian Bureau of Statistics
ADB	Asian Development Bank
ADO	Asian Development Outlook
A$	Australian dollar
CPI	consumer price index
f	forecast
fas	free along side
fob	free on board
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
m.a.	moving average
NZ	New Zealand
PNG	Papua New Guinea
rhs	right hand scale
US	United States
y-o-y	year-on-year

Latest Asian Development Bank forecasts for 2009

Real GDP growth



Inflation

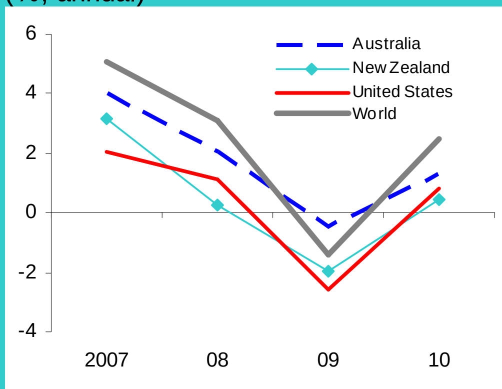


Note: Forecasts for the Cook Islands, FSM, Marshall Islands, Nauru, Palau, Samoa, and Tonga are for their fiscal years (year ended Jun or Sep 2009). Regional averages of GDP growth and inflation are computed using weights derived from levels of gross national income in current US dollar following the World Bank Atlas method. Averages for Pacific Islands exclude Timor-Leste and PNG.
Source: ADB staff estimates.

A note on methodology:
This *Pacific Economic Monitor* uses year-on-year percentage changes and 3-month moving averages. The use of year-on-year percentage changes is to account for the high seasonality in the data. The use of 3-month moving averages is to account for the volatility in monthly data.

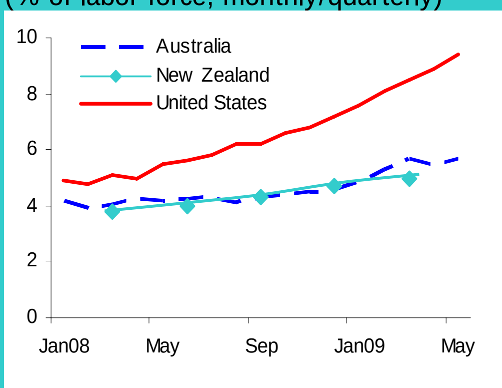
Developments overseas

GDP growth
(%, annual)



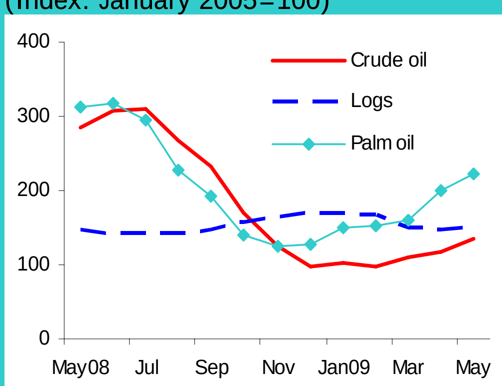
Source: International Monetary Fund. 2009. *World Economic Outlook*, July.

Unemployment in key economies
(% of labor force, monthly/quarterly)



Sources: Australian Bureau of Statistics (ABS), Reserve Bank of New Zealand, and US Bureau of Labor Statistics.

Commodity prices
(Index: January 2005=100)



Source: IMF International Financial Statistics online database.

Signs of stabilization

- The world economy is showing some signs of stabilizing. Financial stress and the pace of economic decline are slowing. The provision of extensive financial and fiscal policy has been central to this outcome. But despite these early positive indications, the global economy is expected to contract in 2009 for the first time since 1950. The International Monetary Fund (IMF) revised forecast for global output is a decline by 1.4% for 2009.
- Both the US and New Zealand economies are still in recession, and are forecast to remain flat until the December quarter before a sluggish climb. Australia is faring better than forecast, avoiding recession with a 0.4% expansion in the March quarter, but nonetheless is still expected by the IMF to contract in 2009.
- The Asian Development Bank's *Asia Economic Monitor* projects that emerging East Asia has entered the transition from recession to a possible V-shaped recovery, with growth dropping sharply this year before returning to 2008 levels next year.

Unemployment remains high

- Labor market conditions are still dire in spite of a slower rate of job losses. The US unemployment rate in June rose to a 26-year high at 9.5%. Australia's unemployment in the same month was also at a high 5.8%, while New Zealand's unemployment rate was 5.0% in the March quarter.

Some commodity prices rising again

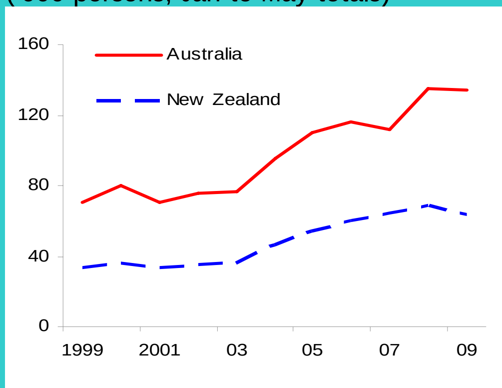
- Commodity prices of some key exports from the Pacific have started to trend up. Crude oil prices have increased by 32% from January to May 2009, while prices of palm oil, coconut oil, and copra have also risen. Log prices are an exception, falling by 11% from January to May. Most commodity prices are expected to settle on a slow uptrend, reflecting a somewhat improved market sentiment.

Stock markets also up

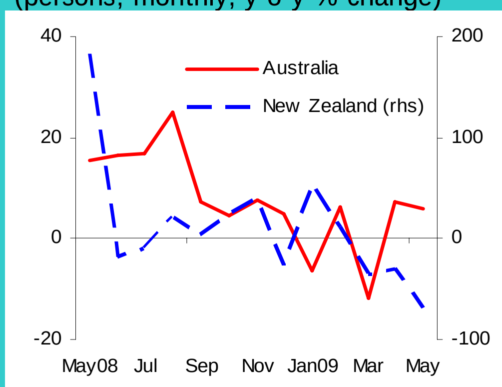
- Major world stock markets posted moderate gains in recent months; the main Australian index rose by 4% while the main New Zealand index is up by 1% year-to-date. The US Dow Jones is down by 10% year-to-date, reflecting continuing uncertainty about the health of the US economy.

Tourism and trade

Departures for the Pacific
('000 persons, Jan to May totals)

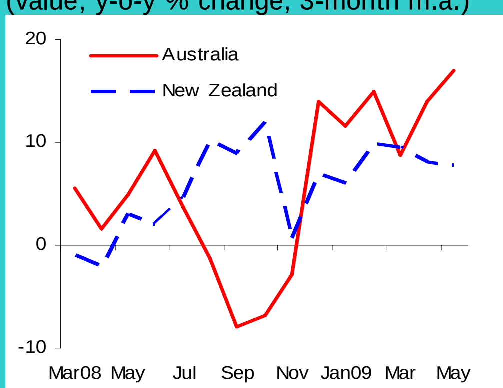


(persons; monthly, y-o-y % change)



Sources: ABS and New Zealand Ministry of Tourism.

Non-fuel exports to the Pacific
(value; y-o-y % change, 3-month m.a.)



Sources: ABS and Statistics New Zealand.

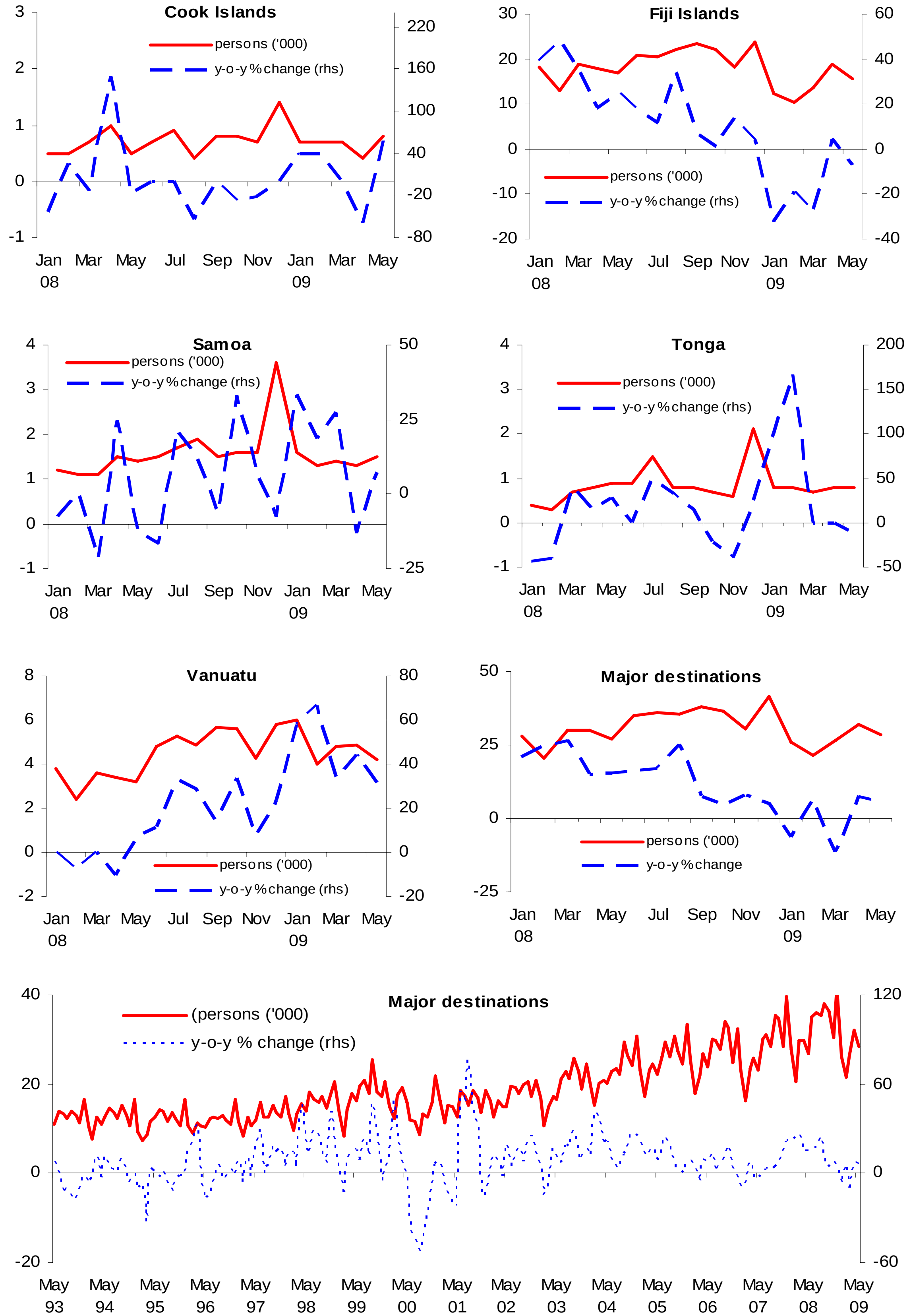
Tourist departures remain weak

- Following a 5% contraction in the March quarter 2009 compared with the March quarter of 2008, tourism from Australia was up in April and May. The durability of this improvement is a key issue for the regional outlook for 2009, but remains highly uncertain at this stage. The latest forecast by Tourism Australia is a 2.9% decline in Australian tourist departures in 2009. Overall, actual Australian tourist departures for the Pacific were flat for the first 5 months of the year.
- Australian tourism has been skewed toward Vanuatu, which has attracted 46% more Australian tourists from January to May of 2009 compared to same period in 2008. Australian departures for the Fiji Islands from June 2008 to May 2009 are still well down, although the large declines seen in early 2009 have now ended.
- New Zealand tourism to the Pacific continues to decline. However, the rate of decline is slowing.
- Tourist departures from the US to Oceania remain low. The volume of Japanese tourists bound for Australia and New Zealand is also weak, and a similar situation is expected in the major Pacific destinations

Import story remains mixed

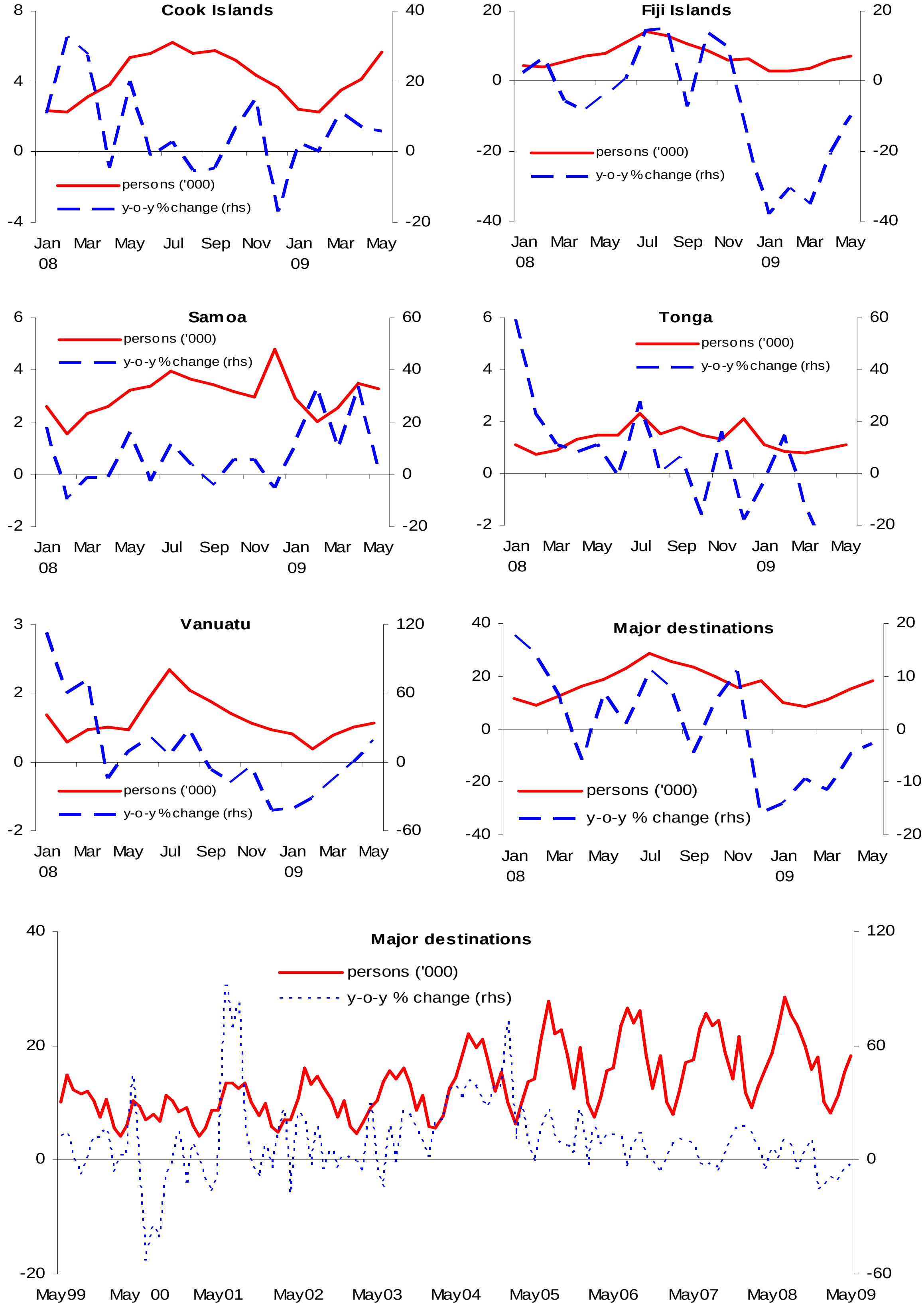
- Growth in the overall value of imports (exclusive of fuel) by the Pacific has so far held steady.
- Growth in the nominal value of non-fuel Australian exports to the Pacific has increased, mainly because of rising imports by PNG. Imports by the Fiji Islands from Australia are down for the first 5 months of the year.
- The nominal value of non-fuel imports from New Zealand has leveled off in total. Imports by the Cook Islands and Samoa are up over the first 5 months of the year. There is, however, a marked slowdown in the level of imports by Tonga.
- Motor vehicle imports from Japan remain in negative territory for most Pacific economies. The general weakness in domestic demand appears to also be constraining consumption of nonessential items. Vehicle imports by the Fiji Islands are slowing and showing signs of stabilizing after sharp increases in early 2009.

Departures from Australia to the Pacific
(monthly)



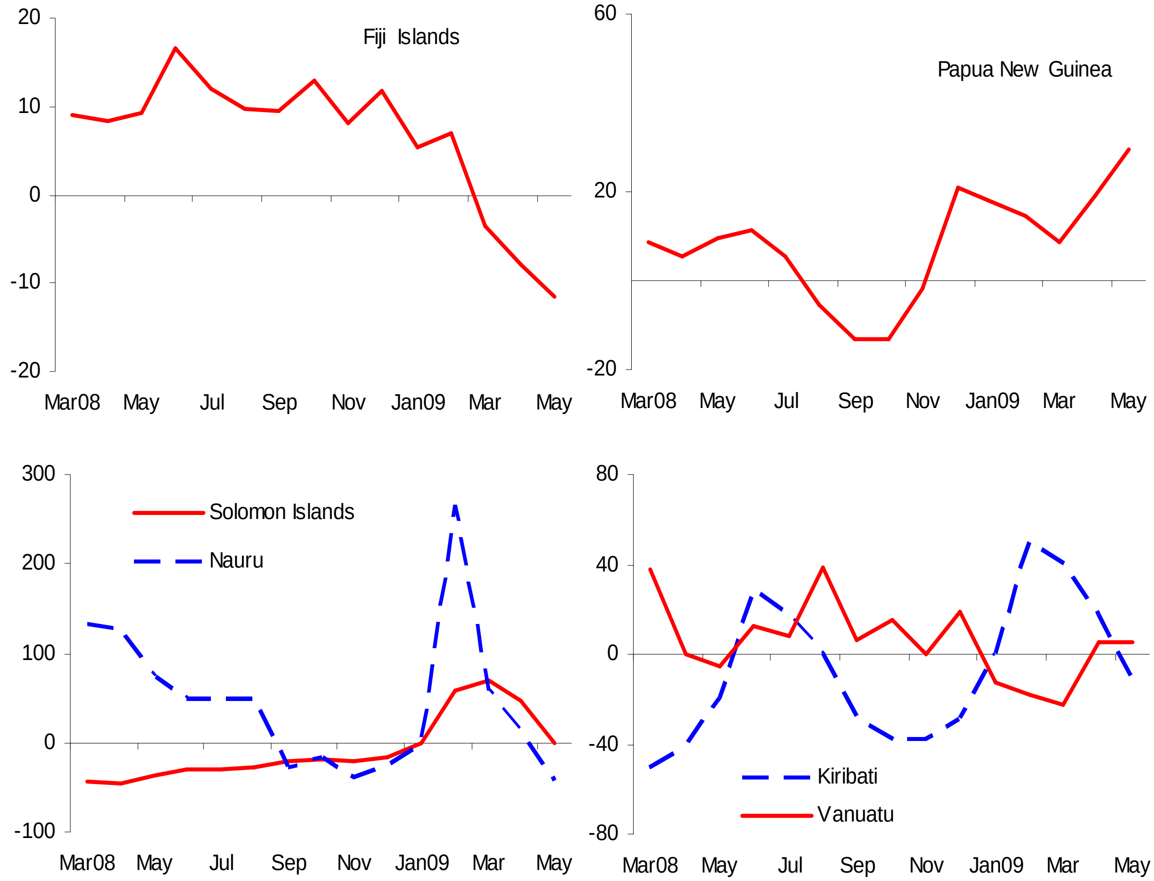
Source: ABS.

Departures from New Zealand to the Pacific
(monthly)



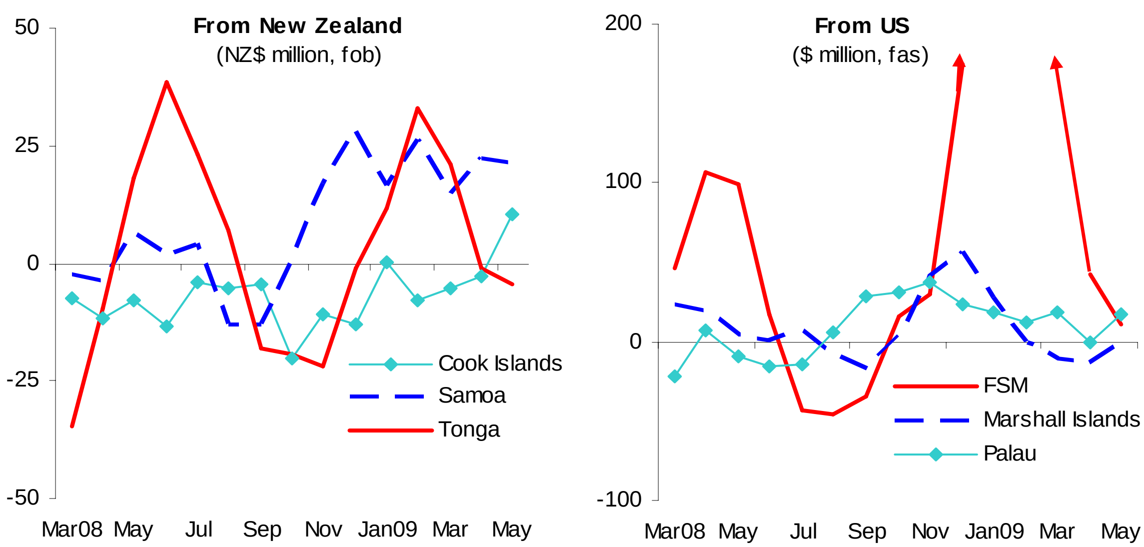
Source: New Zealand Ministry of Tourism.

Non-fuel merchandise exports from Australia
(A$; y-o-y % change, 3-month m.a.)



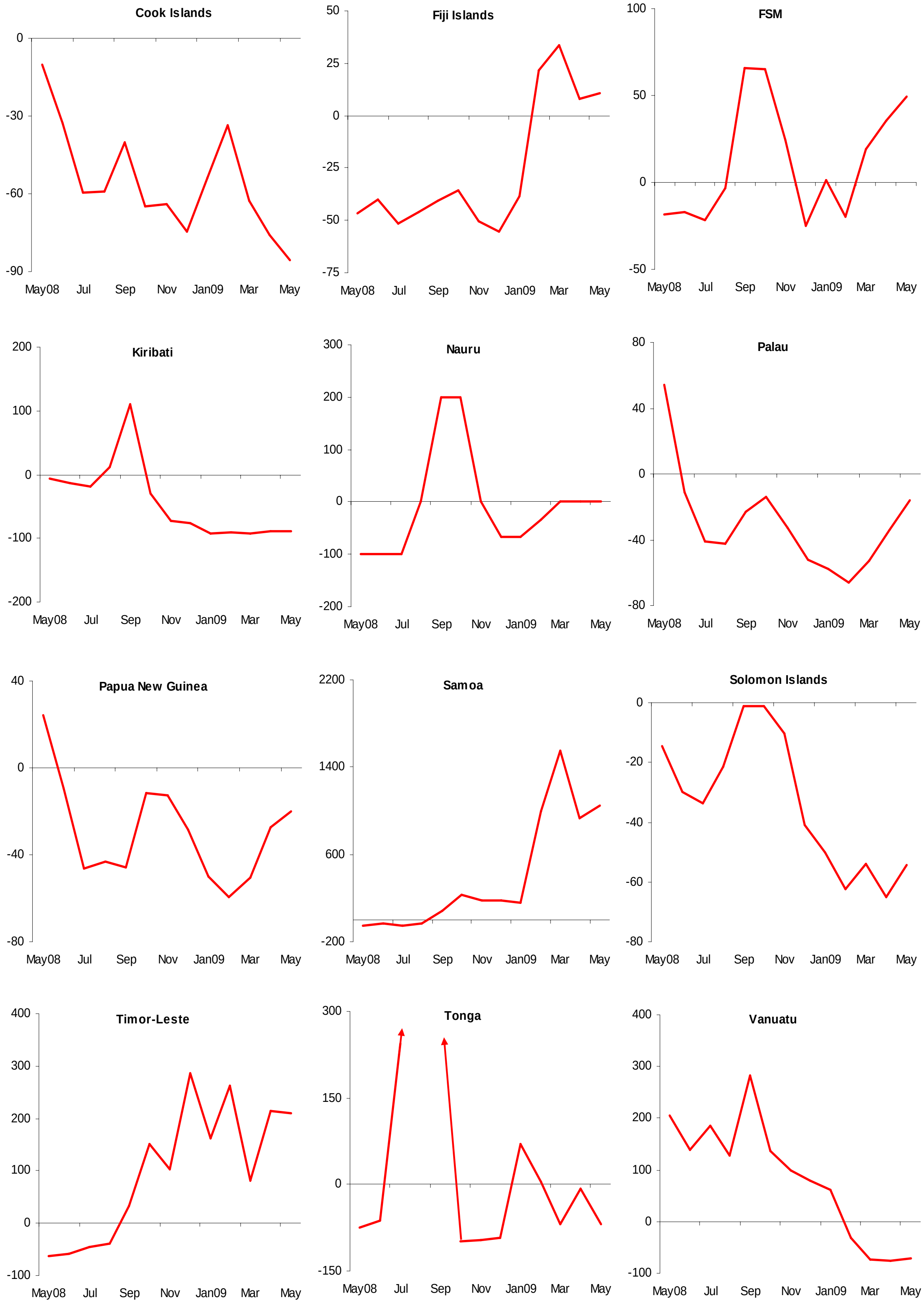
Source: ABS.

Non-fuel merchandise exports from New Zealand and the United States
(y-o-y % change, 3-month m.a.)



FSM=Federated States of Micronesia
Sources: Statistics New Zealand and US Census Bureau.

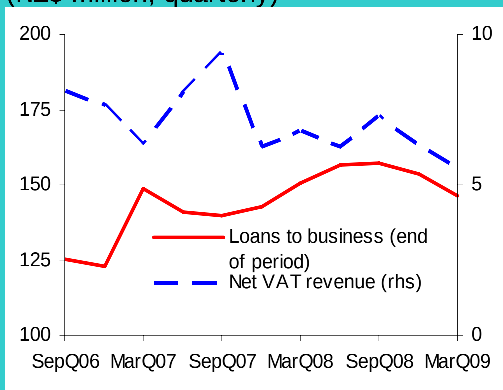
Motor vehicle imports from Japan
(number; y-o-y % change, 3-month m.a.)



Source: Japan e-Stats website.

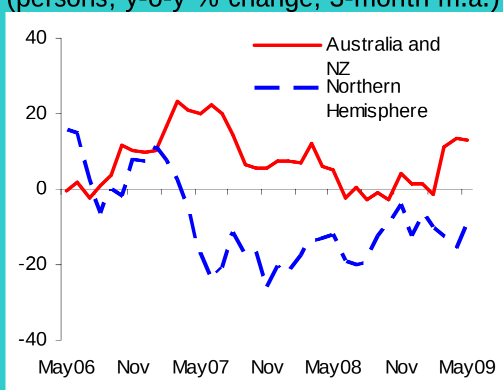
Cook Islands

Key indicators
(NZ$ million, quarterly)



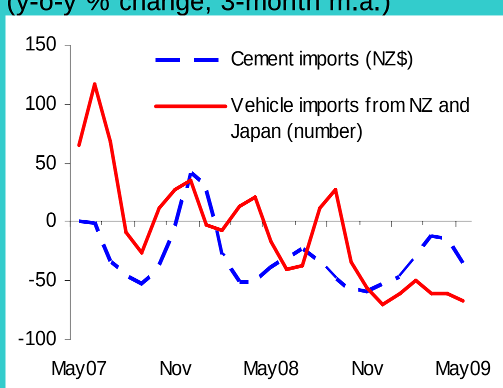
Source: Cook Islands Statistics Office.

Visitor arrivals
(persons; y-o-y % change, 3-month m.a.)



Source: Cook Islands Statistics Office.

Key imports
(y-o-y % change, 3-month m.a.)



Sources: Japan e-Stats website and Statistics New Zealand.

Key developments

- The latest data point to a continuation of weak economic conditions. Compared with the same quarter in 2008, in the March quarter of 2009 lending to business was down 2.8%; the volume of air cargo imports was down 41.8%; and car and truck registrations were both down more than 40%. The volume of air cargo exports (mainly fish) is now around 10% of 2005 levels. April and May data on key imports point to continuing weak demand. Underlying tax revenue collections were down about 3.5% in 2008/09 (they normally rise every year).
- The overall weakening is despite a moderate improvement in residential construction and a small recent increase in visitor arrivals. Total visitor arrivals from June 2008 to May 2009 were 0.8% below arrivals during the same period in 2007–2008. However, arrivals in March to May of 2009 were 7.0% above the same period in 2008. Arrivals from Australia and New Zealand have picked up, more than offsetting a continuing decline in arrivals from the Northern Hemisphere.
- The rise in arrivals from Australia and NZ appears to be a result of intensive marketing and a substitution away from the Fiji Islands. With the Fiji Islands now recovering its tourists, an easing in underlying tourism demand from "standard tourism" appears imminent.
- Total visitor arrivals and the economy will receive a boost in the second half of 2009 from a different kind of tourism, via the South Pacific Mini Games and other sporting events and conferences. However, these are short-lived one-time events, and are unlikely to reverse the underlying weakness in the economy.
- High inflation is adding to economic stress by eroding purchasing power; inflation remains high at 11.2% on a year-on-year basis as of June 2009. The contraction in the real economy could have been as much as 3.0% in 2008, and a further contraction is possible for 2009.

Key issues

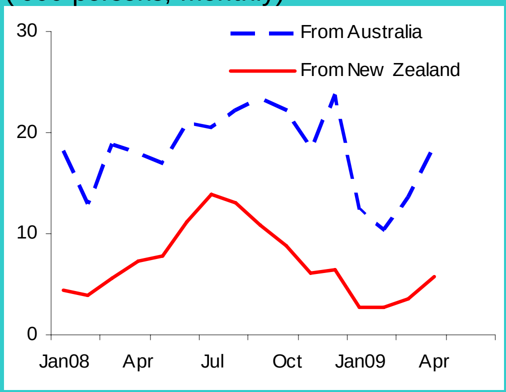
- The 2009/10 Budget provides a much-needed lift in capital expenditure that is to continue over the medium term. Such a public investment program has the potential to help turn the economy around.
- Much more could be done to raise the economy's productivity and help it return to its long term annual growth of around 3.5%. The Cook Islands needs to catch up with efforts made by regional competitors (e.g., in telecommunications and in improving the enabling environment for investors) to raise its international competitiveness.

Fiji Islands

GDP growth
(%, annual)

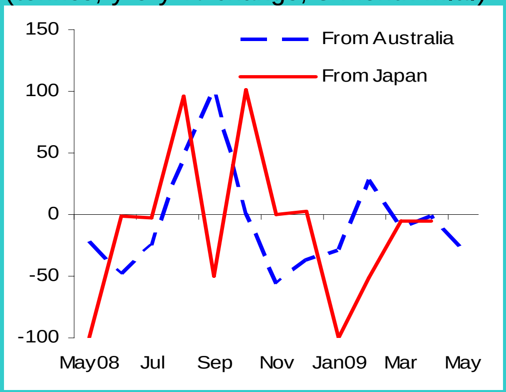
Sources: Reserve Bank of Fiji and ADB staff estimates.

Departures to the Fiji Islands
('000 persons, monthly)



Sources: ABS and New Zealand Ministry of Tourism.

Cement imports
(tonnes; y-o-y % change, 3-month m.a.)



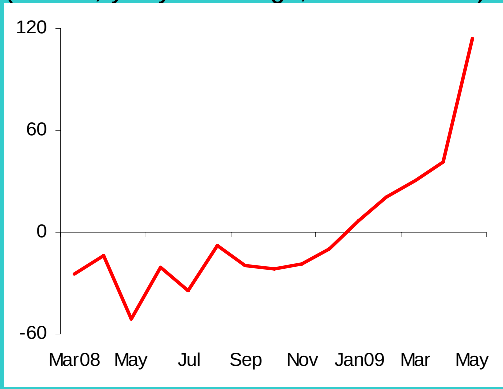
Sources: ABS and Japan e-Stats website.

Key developments

- In April, the Reserve Bank of Fiji revised its growth forecast. The revised projection is for a contraction of 0.3% in 2009. There are significant downside risks to this forecast: the weak economies of major trading partners; rising fuel prices; the significant contraction in tourism earnings; underlying structural constraints that continue to restrict export growth, particularly for sugar and garments; and slow implementation of major public works. ADB forecasts have been downgraded to reflect these downside risks—the economy is now forecast to contract by 1.0% in 2009, before a slight recovery of 0.5% in 2010 helped by an expected turnaround in tourism.
- Economic data presents a mixed picture for the first half of 2009. Compared with the same period in 2008, resident departures from Australia showed signs of leveling off while departures from New Zealand dropped by about 20%. Total new car sales fell by 16% in May. Imports of frozen chicken from New Zealand in April 2009 were 35% lower than the same period in 2008, indicative of rising stress on many households.
- Tax revenue collections fell below budget estimates in the June quarter of 2009 due to decreased economic activity, a situation likely to prevail throughout 2009. Total spending over the same period was around $92 million below budgeted levels, resulting in a modest fiscal surplus of around 0.7% of GDP. There is a risk that capital spending will be deferred given the weakness in revenue. While this can control the aggregate fiscal position, it will be at the expense of much-needed capital. External debt servicing costs will increase significantly as a result of the devaluation of the Fiji dollar.
- Major monetary policy changes were made in the March quarter of 2009 to maintain financial and external stability. The impact of these policy changes, which include the 20% currency devaluation and reduction of lending rates to commercial banks, has improved the situation slightly in the short term.
- As expected, inflation is rising because of the devaluation. The year-on-year inflation rate stood at 5.0% as of June 2009 and is projected to reach 9.5% at the end of 2009 (compared with 6.6% at the end of 2008), and 13.5% in mid-2010 before moderating. The depreciation, the recent surge in oil prices (rising by around 32% from January to May 2009), and the June minimum wage increase are key factors behind this projection. Rising inflation could also make the export sector

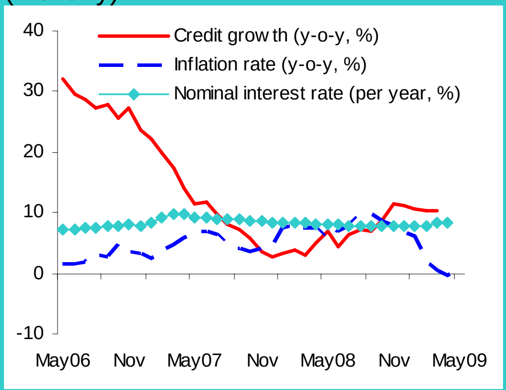
Fiji Islands

Petroleum imports from Singapore
(tonnes; y-o-y % change, 3-month m.a.)



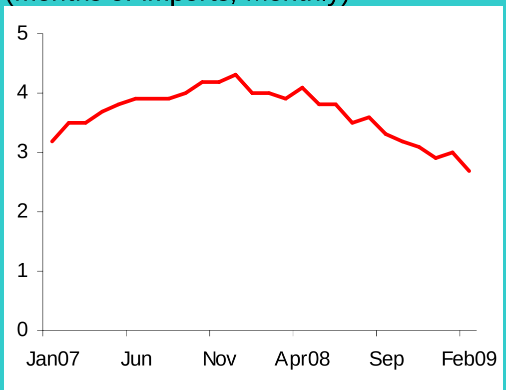
Source: International Enterprise Singapore.

Monetary indicators
(monthly)



Source: Reserve Bank of Fiji.

Foreign exchange reserves
(months of imports, monthly)



Source: Reserve Bank of Fiji.

uncompetitive and undermine the initial gains from devaluation.

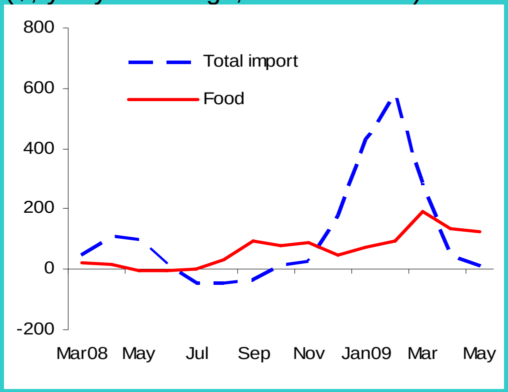
- External accounts remain under pressure as import payments are outstripping export revenues, widening the trade deficit by 4.3%. Cumulative to April 2009, imports fell by 6.8%, led by a decline in imports of intermediate goods. But exports fell by 21.0%, compared with a 41.0% growth rate in the same period in 2008. Lower receipts were recorded for sugar, mineral water, garments, and fish.
- Foreign reserves increased to $315 million, although troublingly this remains significantly below the target of 4–5 months of import cover. Liquidity in the banking system also improved from $51 million in early 2009 to $73 million, and bank private credit growth has increased.

Key issues

- Weak external demand will, despite the benefits from the devaluation, continue to put pressure on the balance of payments and foreign reserves. It is critical that aggregate demand is moderated so that import levels are reduced, given the prevailing low demand for exports.
- There is a risk that without essential structural changes to the key export sectors, the devaluation benefits may be muted. Foreign reserves will remain a key concern in the absence of an export upturn.
- Fiscal discipline is necessary to tightly control nonessential expenditures and to reduce operational costs so capital works can expand. The implementation performance of capital projects must be drastically improved to stimulate economic activity and to support private sector growth.
- The net deficit will need to be sharply reduced over the medium term to return to a sustainable debt level of below 40% of GDP. High interest rates—around 8% for 5-year bonds and 10% for 10-year bonds—and the devaluation have increased the government's debt servicing costs. This will have the adverse effect of constraining critical development expenditures, at least until the benefits for the economy and government revenue from the devaluation flow through.

Federated States of Micronesia

Imports from the US
($; y-o-y % change, 3-month m.a.)

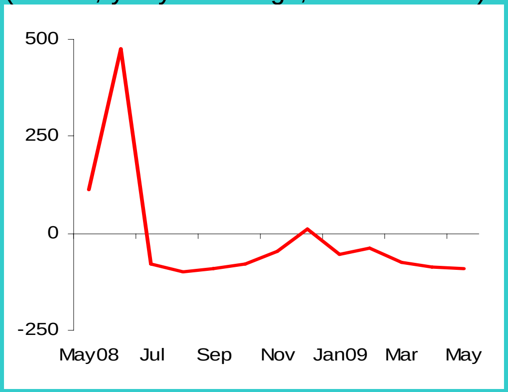


Source: US Census Bureau.

- Import demand was buoyant in early 2009, as imports of machinery and transport equipment surged. Food imports, likewise, continue to grow. Large externally funded infrastructure projects appear to be behind these developments, by providing a fiscal stimulus that supports employment generation and economic activity.
- The disbursement of grants provided under the Compact of Free Association agreement is likely to remain the key short-run positive factor for growth. A slowdown in commercial and consumer lending is expected to continue through the rest of 2009. Tourism revenues and remittances are expected to be sluggish at best because of the economic slowdown in the US and Asia. Taking these positive and negative factors into account, only very slight economic growth is projected for 2009.

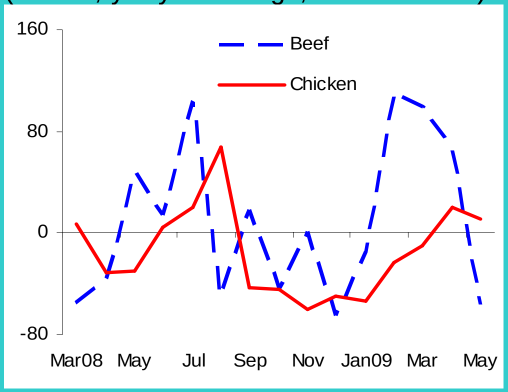
Kiribati

Cement imports from Australia
(tonnes; y-o-y % change, 3-month m.a.)



Source: ABS.

Meat imports from Australia
(tonnes; y-o-y % change, 3-month m.a.)



Source: ABS.

Key developments

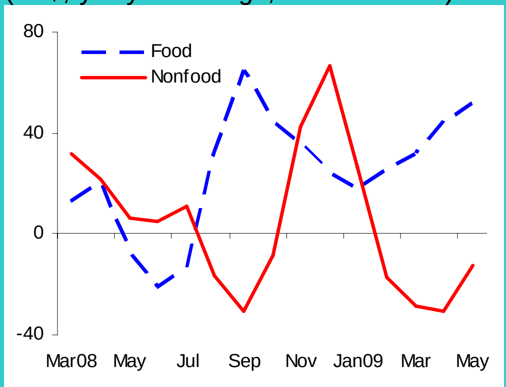
- The decline in world trade volumes will have a negative impact on seafarer remittances and suppress household consumption levels. IMF forecasts (*World Economic Outlook*, July) a contraction in world trade volumes in 2009 (-12.2%) before only a slight rebound in 2010 (1.0%), which points to a sustained problem for Kiribati.
- Cement imports rose in April 2009 but the trend level is still far below a typical level. This reflects the limited scale of ongoing construction. Vehicle imports, which declined significantly in the December quarter of 2008, remain negligible. Meat imports continue to decline, suggesting substitution of cheaper alternatives—a sign of stress at the household level.

Key issues

- Increased spending on public infrastructure has been discussed as a possible economic stimulus. However, implementation of any package remains some way off.
- The rally seen in world stock markets will lift the market value of the Revenue Equalization Reserve Fund. But if the target per capita value is to be achieved, drawdowns must be minimized to allow the rebuilding of capital. By March 2009, the yearly drawdown has reached A$10 million. A reduction in nonproductive public spending is essential.

Marshall Islands

Imports from the US
(US$; y-o-y % change, 3-month m.a.)

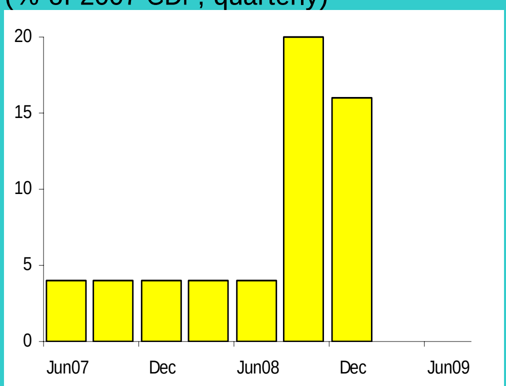


Source: US Census Bureau.

- 2008's fiscal constraints spilled into 2009. Overall spending is flat, and cuts in discretionary spending were needed to allow for a small rise in capital expenditures. A rise in food imports from the US suggests some improvement in domestic demand. Subdued economic growth of 0.5% is forecast for 2009.
- Attaining fiscal sustainability is central to the medium-term outlook. Weaknesses in the fiscal position include stagnant domestic revenue collections, declining grants, rising operational expenditures, and large transfers to unprofitable public enterprises.
- Budget cuts made to low-priority expenditures are a step in the right direction. These positive actions can now be usefully extended to a well thought-out program of fiscal and economic reforms.

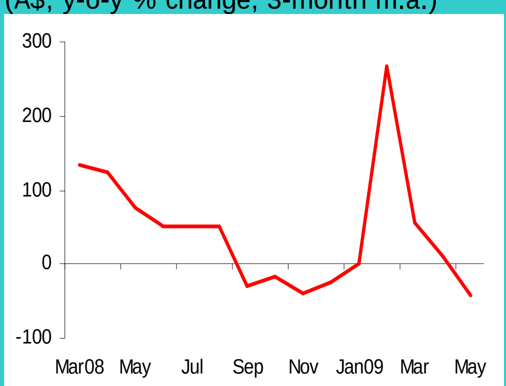
Nauru

Australian imports from Nauru
(% of 2007 GDP, quarterly)



Note: Mostly consists of phosphate.
Source: ABS.

Australian exports to Nauru
(A$; y-o-y % change, 3-month m.a.)



Source: ABS.

Key developments

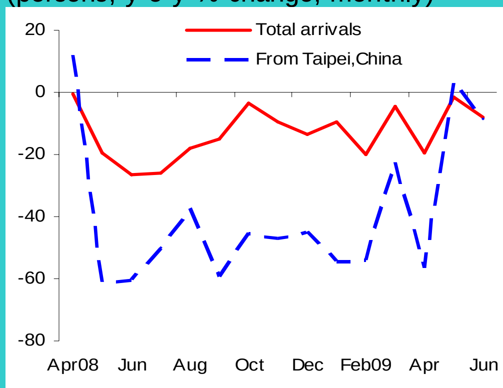
- After recording sharp increases in the second half of 2008, receipts from phosphate exports are down in the first half of 2009. Australia, Nauru's main buyer, recorded no imports of phosphate during this period. Port damage also restricted exports of small shipments to Asian countries such as the Republic of Korea. Lower world demand is now suppressing phosphate prices.
- Australian exports to Nauru have trended up in recent years. A key factor was the resumption of phosphate mining, which stimulated aggregate demand and returned the economy to positive growth. Nauru's import demand, however, has shown signs of slowing in recent months, consistent with a weakening domestic economy. Reflecting this slowdown and the weak outlook for phosphate, growth forecasts have been downgraded to 1% for 2008/09 and 0% for 2009/10.
- In the 2009/10 Budget, Nauru continued the recent pattern of near-balanced budgets. Higher donor funding is expected, which will help offset an expected 10% contraction in domestic revenue.

Key issues

- Nauru’s long-term economic future remains dependent on making good use of phosphate income, reducing indebtedness, and developing any viable alternative sources of income.

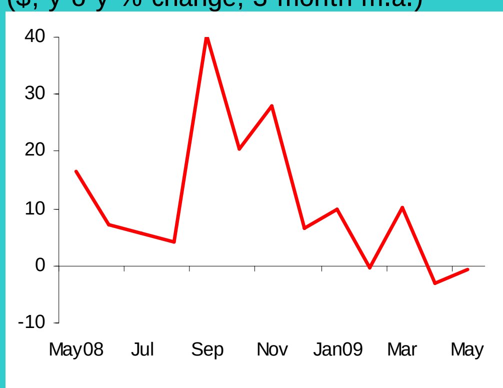
Palau

Visitor arrivals
(persons; y-o-y % change, monthly)



Source: Palau Visitors Authority.

Food imports from the US
($; y-o-y % change, 3-month m.a.)



Source: US Census Bureau.

Key developments

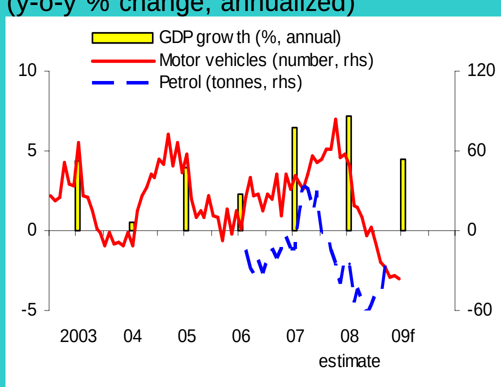
- The slowdown in neighboring economies led to a substantial decline in tourism activity. Total visitor arrivals for January to June 2009 were 11.4% below the same period in 2008. Tourist numbers from Taipei,China in particular were down, although there has been an improvement since May.
- Domestic demand has been weak as reflected in flat growth of US food imports over the first 5 months of 2009. Inflation in the March quarter was down to 8.6% after peaking at 16.8% in 2008.
- A weaker turnout in the tourism industry, lower infrastructure spending (from recent highs), and delays in planned private investment in tourism facilities are expected to result in economic contraction in 2009 and 2010. The outlook for 2009 would, however, improve much if the recent pickup in tourism continues.

Key issues

- The extension to September 2010 of US financial assistance through the Compact of Free Association will provide temporary budget relief. Nevertheless, the need remains to reduce low-priority public spending to stabilize the fiscal position and lessen drawdowns on the diminished trust fund assets.
- Investor confidence is likely to remain undermined by uncertainty about the new financial arrangements with the US, on top of the impact of the global crisis. This suggests the investment outlook will remain subdued.

Papua New Guinea

Key imports
(y-o-y % change, annualized)



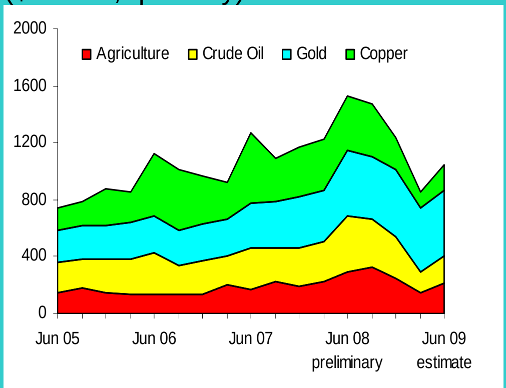
Note: Motor vehicles from Japan; petroleum from Australia.
Sources: ABS; Japan e-Stats website; PNG Department of Treasury; and ADB staff estimates.

Key developments

- The growth outlook has improved slightly as export earnings benefit from a recovery in international commodity prices. The kina price of PNG exports rose by 20.0% during the June quarter of 2009. Growth for 2009 has been revised upward from 4.0% to 4.5%, and the 2010 forecast from 3.5% to 3.9%.
- However, there remains much uncertainty in the outlook for PNG. This is mainly because of global uncertainty and the prospect of commodity prices remaining volatile.
- Despite the recovery in commodity prices, year-to-date export earnings through the end of June 2009 are estimated to be around 33% lower than in the corresponding period of 2008. Lower export income

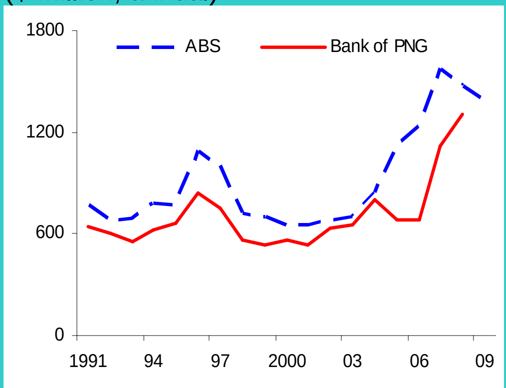
Papua New Guinea

Agricultural and mineral exports
($ million, quarterly)



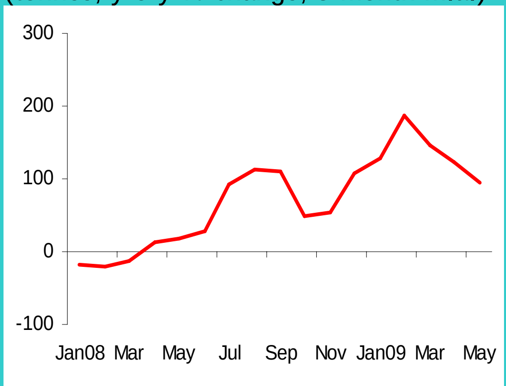
Sources: Bank of PNG and ADB staff estimates.

Imports from Australia
($ million, annual)



Sources: ABS and Bank of PNG.

Chicken imports from Australia
(tonnes; y-o-y % change, 3-month m.a.)



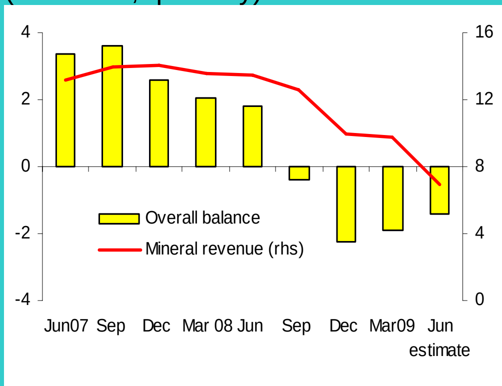
Source: ABS.

will continue to reduce government revenues and slow private consumption.

- The purchase of imported motor vehicles has been a good indicator of economic growth in PNG. As a luxury good, demand for Japanese vehicles picked up substantially during the recent commodity boom period. However, vehicle imports continue to drop dramatically. The quantities of imported diesel and petroleum, another useful indicator of economic activity, have also trended down since the second half of 2008. The demand for staple goods such as poultry and flour is slowing but remains strong.
- Year-to-date total kina imports from Australia, PNG's largest trade partner, declined by 9% through the end of May 2009 compared with the corresponding period in 2008. Official trade data, as reported by the Bank of PNG, shows continued strong growth in import demand through the end of March 2009. There is generally a strong correlation between the alternative trade data sources, so the recent decline in Australian exports to PNG may be an early indication of dampening import demand.
- The Government ran a deficit of 351.3 million kina in the 12 months ending June 2009, estimated to be about 1.4% of GDP compared with a surplus of 1.8% in the 12 months ending 30 June 2008.
- The non-mineral deficit also appears to be widening as the ratio of mineral revenues to GDP declined to an estimated 6.9% from June 2008 through May 2009, compared with 13.5% in the 12 months ending 30 June 2008. From April 2008 to March 2009, real tax revenues declined by 8.1% but real expenditures and net lending increased by 6.5%.
- For 2009 as a whole, the government has increased the targeted deficit from 2.6% to 3.3%, with revenue supported through drawdowns from trust fund savings generated during the recent commodity boom period. The budget shows a deficit of 1.2% of GDP for 2009 as trust fund drawdowns are included as an above-the-line revenue item.
- Inflation continued to slow in the June quarter of 2009, dropping to 6.7% from 10.2% in the previous quarter.
- Monetary conditions remain fairly accommodating, as reflected by negative real commercial bank lending rates in recent months. Monetary and credit aggregate growth rates remain high but are no longer accelerating. Annual private sector growth in June 2009 was about 25% compared with 40% in the corresponding period in 2008.
- The Bank of PNG has maintained its policy stance in recent months, keeping the policy rate unchanged at 8% between December 2008 and June 2009.

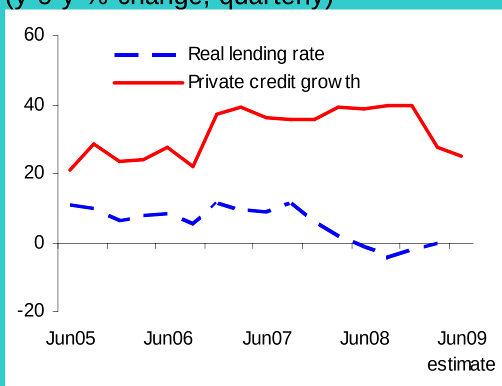
Papua New Guinea

Central Government balances
(% of GDP, quarterly)



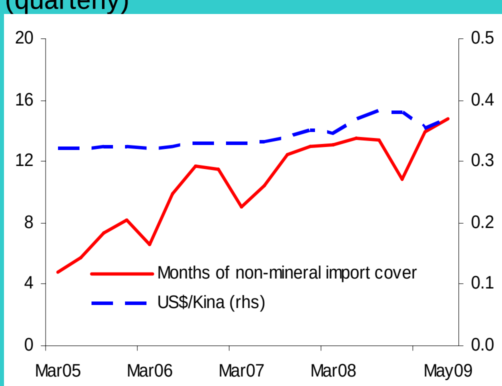
Sources: PNG Ministry of Treasury and ADB estimates.

Monetary indicators
(y-o-y % change, quarterly)



Sources: Bank of PNG and ADB staff estimates.

Exchange rate and reserves
(quarterly)



Source: Bank of PNG.

Although the Bank of PNG will be in a position to loosen monetary policy to support domestic demand as supply-side inflationary pressures ease, there are unlikely to be any major changes. This is mainly because concerns remain over the possible inflationary impact of the government's expansionary fiscal policy.

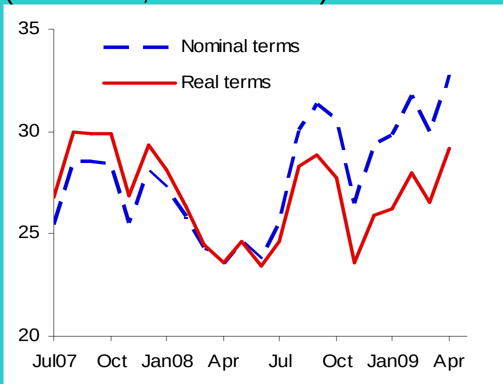
- The current account balance is expected to move into negative territory during 2009 as export earnings decline, while momentum in the construction sector and strong government demand maintain import demand. However, a recent pickup in export volumes has helped the kina to appreciate against all major trading partner currencies. The kina appreciated by 8% against the US dollar between April and June 2009.
- The Bank of PNG intervened in the foreign exchange market by buying foreign currency to prevent the kina from appreciating too rapidly, and in the process has replenished some of the international reserves lost through heavy trading in the second half of 2008. As of 31 May 2009, international reserves were $2.2 billion (or about 14 months of non-mineral import cover).

Key issues

- Despite the recent pickup in commodity prices, there remain downside risks to government revenue forecasts. Fiscal pressures are expected to build as the Government comes under pressure to quickly implement its additional priority spending programs.
- Given public sector capacity constraints, fiscal discipline is important to ensure that trust fund savings are not drawn down too rapidly. Accumulated mineral windfalls are best safeguarded and directed toward a steady upgrading of infrastructure and basic service delivery, as outlined in the Government's medium-term development strategy.

Samoa

Remittances
(tala million, 3-month m.a.)

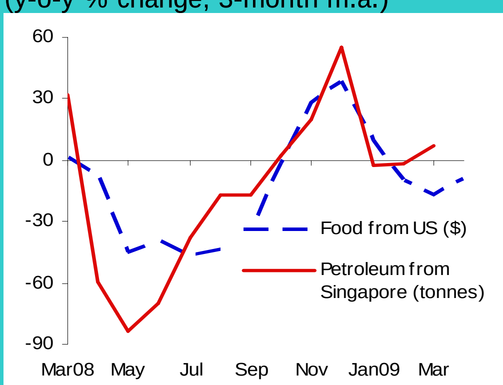


Note: Real values derived using consumer price index.
Source: Central Bank of Samoa.

Tourism
(y-o-y % change, 3-month m.a.)

Note: Real values derived using consumer price index.
Source: Central Bank of Samoa.

Key imports
(y-o-y % change, 3-month m.a.)



Sources: International Enterprise Singapore and US Census Bureau.

Key developments

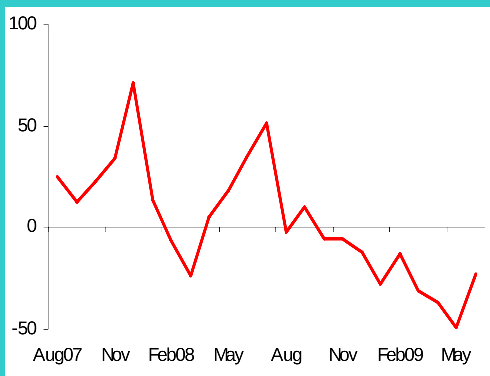
- A weakening in growth was inevitable following the end of the mini-boom in construction, but the economy was unexpectedly pushed into recession by the loss of jobs at Yazaki's large manufacturing operation, a decline in remittances, weakening tourism, and the erosion of purchasing power by high inflation. GDP in the September quarter of 2008 was 8.0% below the same period of the previous year, the December quarter was down 7.3% over the previous year, and the March quarter of 2009 was down 4.3%.
- The real value of remittances has been rising on a year-on-year basis since March. This could be an early sign of an approaching economic turnaround. However, it could instead reflect an increase in payments for new vehicles in preparation for the September switch to driving on the left hand side of the road (vehicle imports are up substantially this year). If so, remittances may decline later in the year.
- Tourism has improved this year. Samoa has benefited from problems in the Fiji Islands and the ongoing stimulus provided by the restructuring of the national airline and development of major hotels. These factors, combined with the filming of the *Survivor* television series now underway, are expected to result in overall growth in tourism in 2009.
- However, the growth in tourism is unlikely to offset negative effects elsewhere. A number of jobs are being lost due to the closure of a major cannery in American Samoa. This is adding to jobs lost in the local economy. The level of commercial bank lending to the private sector has hardly changed since late 2008, indicating a pause in private investment. Data on imports of key commodities are consistent with a leveling off in activity.
- Inflation had eased to 9.2% year-on-year as of June 2009, half of last year's peak. International reserves have risen to 5.1 months of imports, above the official target of 4.0 months.

Key issues

- 2008/09 will record a large economic contraction. This is, however, expected to be the bottom of the downturn, primarily because of a large fiscal expansion provided for in the 2009/10 Budget. Some of the fiscal expansion is for projects that use few local products or services and offer little help to the economy, but others—notably expanded road works—have the potential to boost the economy.

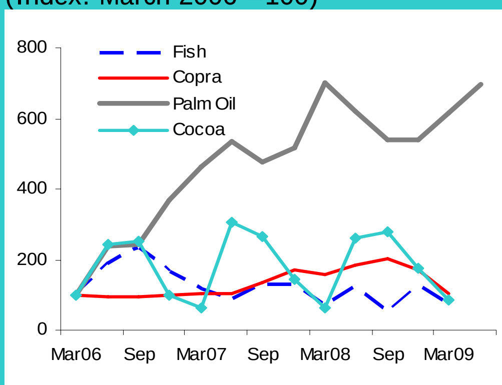
Solomon Islands

Logging volumes
(m^3; y-o-y % change, 3-month m.a.)



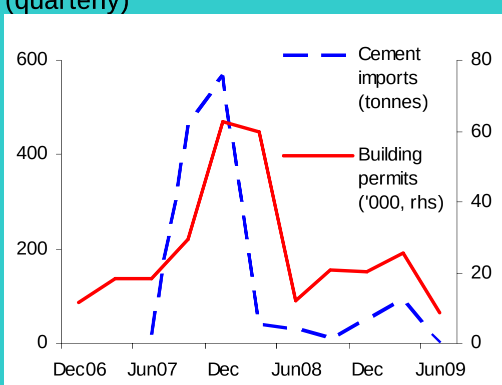
Source: Central Bank of Solomon Islands.

Production of key commodities
(Index: March 2006 =100)



Source: ADB. 2009. Draft *Solomon Islands Economic Report*.

Building activity
(quarterly)



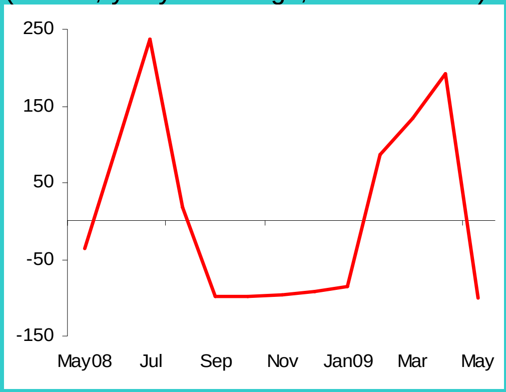
Note: Building permits are lagged by 3 quarters.
Sources: ABS and Honiara City Council.

Key developments

- Solomon Islands is one of the Pacific economies most affected by the global economic crisis. Exports are dominated by logs, fish, palm oil, and copra, and in total declined by 11% in the March quarter of 2009 in value terms compared to the same quarter in 2008. Logging volumes fell by 31% in the March quarter and registered a 22% fall in the June quarter; they are on track to decline from 1.5 million m^3 in 2008 to 1.1 million m^3 in 2009, a fall of almost 30%.
- As a result of the weaker-than-expected export performance, growth forecasts for Solomon Islands have been downgraded to 0% in 2009 and 2.6% in 2010. Growth is expected to remain modest in the out-years as the medium-term decline in logging stocks is increasingly felt.
- Imports of cement, petroleum, and chicken have all started to drop, in line with a slowing economy. The decline in cement imports matches (with a lag) the decline in building permits issued.
- A positive recent development has been the stabilization and improvement in the foreign reserves position. Import cover as of July is in excess of 3.0 months after having fallen to as low as 2.5 months earlier in the year. This has been partly due to some one-off factors such as receipt of substantial aid disbursements. The effects of the increased aid flows will wane as these funds are spent. Foreign reserves may again come under pressure in the second half of the year and into 2010.
- Inflation peaked at 23.5% in September 2008 on a year-on-year basis. After surging once again to 16.5% in the March quarter of 2009 due to flooding in Guadalcanal, inflation had fallen back to 9.3% in June as fuel and food prices eased and demand weakened.
- Inflation forecasts have been revised down to 8.3% for 2009 and 6.9% for 2010 as the economy slows. But inflation remains at risk of reaccelerating, particularly if the Government resorts to central bank financing.
- Growth in domestic credit has fallen sharply over the past year as the central bank has moved to reduce excess liquidity in the banking system.
- The fiscal situation has come under particular pressure. Logging revenues are in sharp decline, and other tax collections, such as consumption taxes, are affected by the slowing economy and lower prices, particularly for oil. Actual revenue for the first quarter of 2009 of around SI$316 million

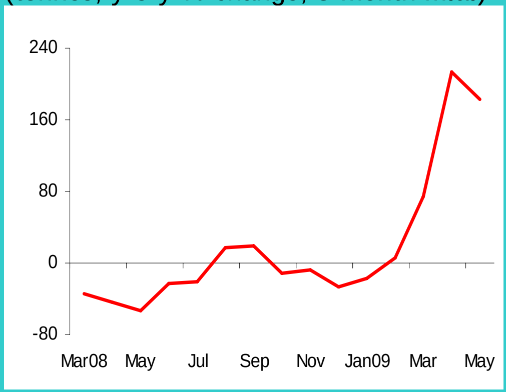
Solomon Islands

Cement imports from Australia
(tonnes; y-o-y % change, 3-month m.a.)



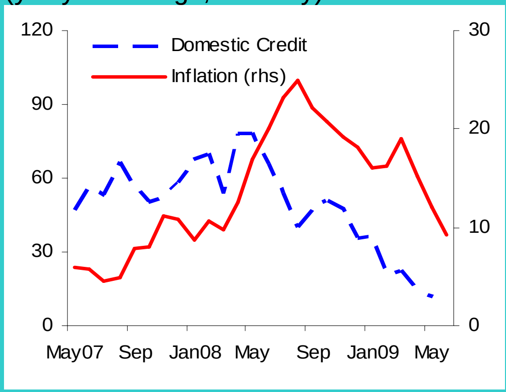
Source: ABS.

Petroleum imports from Singapore
(tonnes; y-o-y % change, 3-month m.a.)



Source: International Enterprise Singapore.

Monetary indicators
(y-o-y % change, monthly)



Source: Central Bank of Solomon Islands.

($39.5 million) was down by about 11% compared to a forecast of SI$357 million ($44.6 million). Due to the decline in revenue and lower-than-expected cash reserves carried forward from previous years, the government had $12.5 million less available to spend in the first 4 months of the year compared with budget forecasts.

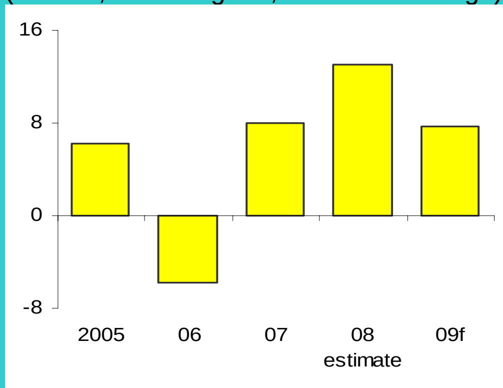
- The Government has taken fiscal measures geared toward maintaining sufficient cash flow to meet the payroll including (i) a 10% cut on recurrent budget appropriations, (ii) a hiring freeze, (iii) a reduction and reprioritization of its development expenditure, and (iv) a further temporary 25% cut in recurrent expenditures (to be reversed in the December quarter if affordable) to assist with cash flow management. The development budget has taken the brunt of the adjustment, with very little of the government-funded development budget executed so far this year.

Key issues

- The global recession's strongest impact in the Solomon Islands is on exports and government finances. The situation has been exacerbated by poor budgetary management in recent years that has led to increases in government expenditures of more than 20% per year.
- With government revenue underperforming, and the government committed to not borrowing, it will be necessary for the government to trim unnecessary expenditures, raise additional revenues, and focus its resources on priority needs. Additional planned spending on members of Parliament, including travel and spouses' allowances, is unaffordable. The government should also consider reallocating resources from the recurrent budget to support key development projects that are needed to offset lower growth and employment due to declining exports.
- As many businesses in Solomon Islands are directly or indirectly dependent upon the government, it is important that the government not fall into arrears with its bills and other obligations. Otherwise, the government's weakened financial position will worsen the economic downturn in the private sector.

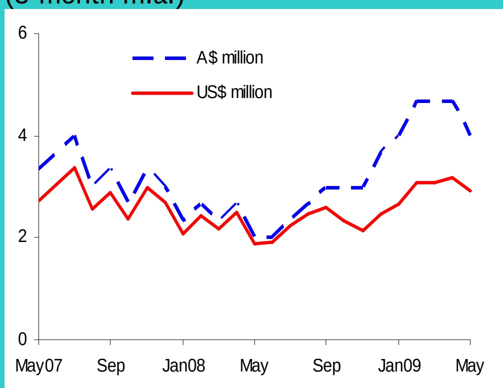
Timor-Leste

Real GDP growth
(Non-oil, excluding UN; % annual change)



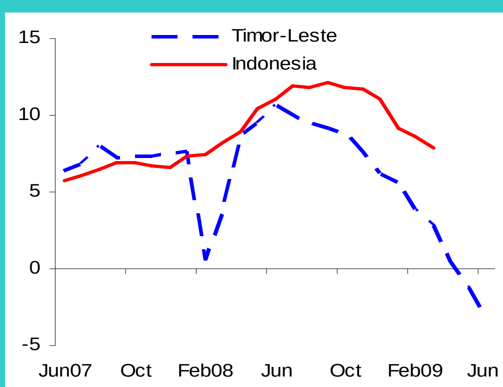
UN = United Nations
Source: Asian Development Outlook database.

Merchandise imports from Australia
(3-month m.a.)



Sources: ABS and Reserve Bank of Australia.

Inflation
(y-o-y % change in CPI, monthly)



CPI = consumer price index
Sources: Timor-Leste National Statistics Directorate and Bank Indonesia.

Key developments

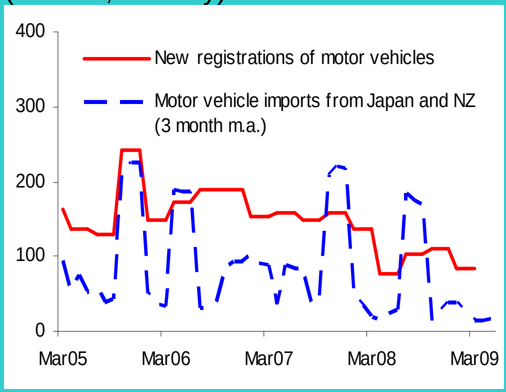
- The IMF has upgraded growth estimates for 2008 from 10% to about 13%. The large rise in government spending, a good year for the agriculture sector, and peace and stability underpinned the economy. Higher government wages and large cash transfers (e.g., to the elderly, veterans, and internally displaced persons) provided important economic stimulus.
- The Petroleum Fund grew by $553.0 million in the March quarter, lifting savings to around $4.8 billion. This is roughly 11 times the non-oil GDP.
- The high growth rate is reflected in rising trends in imports from Australia and vehicles from Japan. Bank lending remains stable, with past over-lending and the associated high rate of non-performing loans continuing to weigh down the financial sector.
- Rising government spending is expected to keep growth high over 2009 and into the medium term. But some easing in growth is expected as the rate of increase in spending is now slowing.
- Inflation has also declined as the retreat in international commodity prices fed through the economy and as the US dollar appreciated. Inflation was –1.3% on a year-on-year basis by the June quarter after averaging 7.6% in 2008. A relatively high inflation rate in the main source of consumer imports (Indonesia), combined with high demand in Timor-Leste, is expected to produce a positive inflation rate of around 1.5% in 2009.

Key issues

- The key challenge for economic policy remains the conversion of the large savings in the Petroleum Fund into broad-based development, while ensuring the fund remains viable for future generations. Recent success in achieving peace and stability needs to extend to high-return capital investments and recurrent programs. Here the priority is to meet the basic needs of the agriculture sector, which most of the population will remain dependent on for some decades.
- Improved agricultural extension services, access to markets, and investment in human capital (via education and health programs) are normally the first steps to agriculture-led development. Some of the shortcuts now being used in the development process, such as government intervention in the buying and selling of produce, are unlikely to match the returns from these solid building blocks of growth.

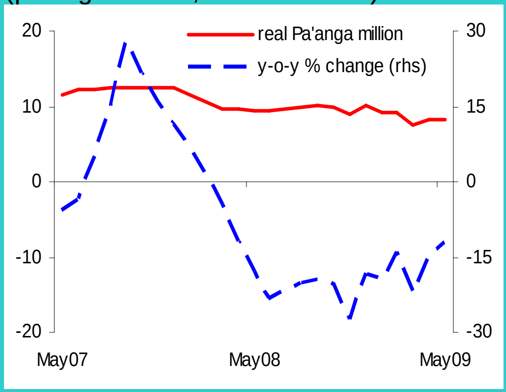
Tonga

Motor vehicles
(number, monthly)



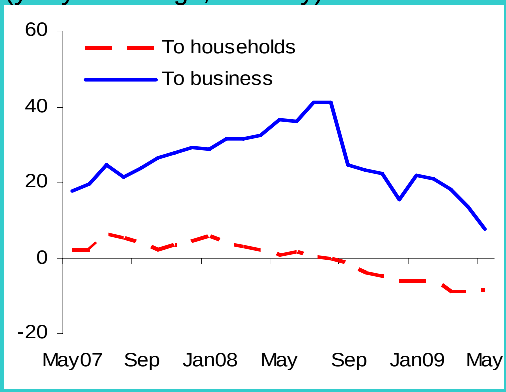
Sources: Japan e-Stats website, National Reserve Bank of Tonga, and Statistics New Zealand.

Private remittances
(pa'anga million; 3-month m.a.)



Sources: National Reserve Bank of Tonga and Tonga Ministry of Finance and National Planning.

Private sector credit
(y-o-y % change, monthly)



Source: National Reserve Bank of Tonga.

Key developments

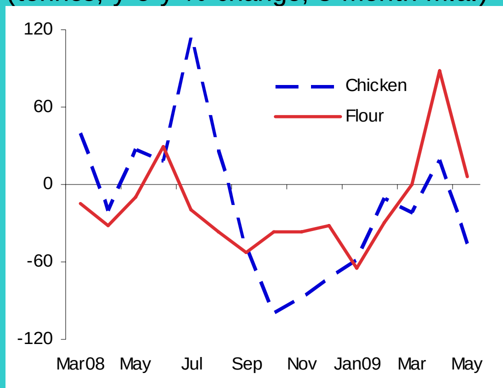
- The Government expects the economy to grow by 1.7% in 2009/10. A key downside risk to this forecast is the potential for delays in implementation of the reconstruction work financed by China Eximbank. A more conservative estimate of domestic content of the work reduces its potential contribution to economic activity, further dampening the growth outlook.
- Remittances, the major source of foreign exchange receipts, are down by about 13% as of May 2009 on a year-on-year basis and continue to trend down. Credit growth has also slowed to almost nil as lending remains constrained, with commercial banks tightening credit policies after a rapid increase in bad loans.
- The recession in New Zealand and the US and softening demand for seasonal workers in Australia (some companies employing such workers have reportedly gone into liquidation) suggest that growth is indeed more likely to be lower than the official projection.
- Inflation rose by 1.9% in May 2009 due to higher food and transport prices, and may peak around 5.0% in early 2010 before abating. If oil prices stay at recent levels, inflation may exceed earlier projections and reach about 3.1% in 2010. The reserves position improved over the first half of 2009 to 4.7 months of import cover, slightly above the 4.0 month target level. However, rapid changes in prices of key imports such as fuel could undermine these recent gains.
- Revenues and grants received at the end of the March quarter were around 20% under budget. Total expenditures are also below budget, resulting in a fiscal surplus of 8.9 million pa'anga at the end of May 2009. The surplus appears to reflect tight spending control, particularly for non-staff expenditures such as operations and maintenance. Cuts to such items, however, have the potential to adversely impact service delivery.

Key issues

- The Government's response to the likely impacts of the global economic crisis has been limited to policies that have not contributed to underlying economic performance (e.g., wage increases and tighter expenditure controls on essential services). The economy remains highly vulnerable to external conditions, notably via remittances. Efforts to diversify the export sector and to implement structural reform remain critical.

Tuvalu

Imports from Australia
(tonnes; y-o-y % change, 3-month m.a.)



Source: ABS.

Key developments

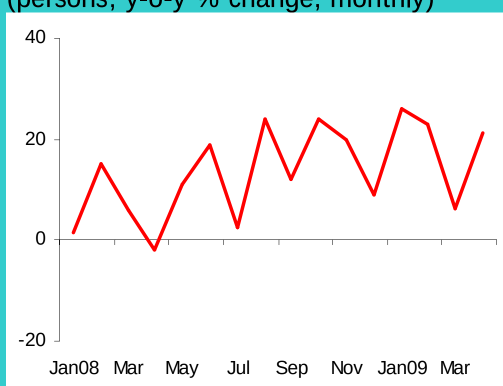
- Expected growth in 2009 and 2010 is subdued at 1%, due to low foreign earnings. Imports from Australia declined in May 2009, suggesting waning demand as real incomes decline. Although food prices have fallen from the peaks seen at the end of 2008, prices of key commodities remained higher than at the end of 2007 (e.g., the price of rice in the March 2009 quarter was two-thirds higher than in the December quarter 2007.

Key issues

- The lower market value of the Tuvalu Trust Fund, lower seafarer remittances, and a drop in domestic employment following completion of the wharf reconstruction will reduce government revenue. There is little potential to quickly correct the fiscal imbalances caused by higher government expenditure. However, addressing inefficient public expenditures, such as medical treatment and scholarships, could free funds for other priority areas.

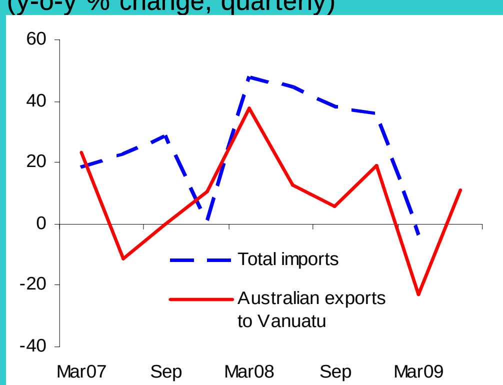
Vanuatu

Visitor arrivals
(persons; y-o-y % change, monthly)



Source: Vanuatu Statistics Office.

Imports
(y-o-y % change, quarterly)



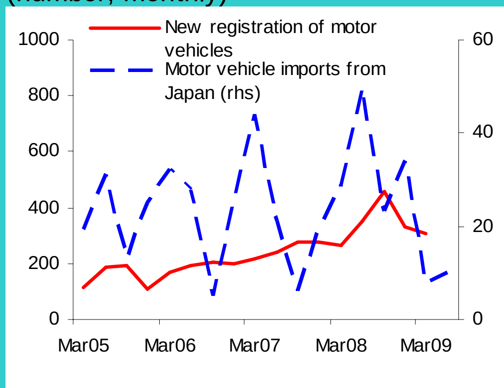
Sources: ABS and Vanuatu Statistics Office.

Key developments

- Growth forecasts for Vanuatu have been revised up to 4.0% for 2009, reflecting strength in tourism and signs of improvement in domestic demand.
- Tourism in Vanuatu has continued its strong growth momentum in the first half of 2009. In the first 5 months of 2009, the number of cruise ship visitors rose by 58% and airline visitors rose 18% (compared with the same period of 2008). Tourism from Australia has been particularly strong, with air departures for Vanuatu increasing by 40% in the same period.
- A key issue for the remainder of 2009 is the potential effect on Vanuatu of a recovery in tourism in the Fiji Islands. Growth in tourist arrivals to Vanuatu is expected to slow in the second half of 2009 followed by a further slowdown in 2010 as the Fiji Islands recovers from the recent floods and wins back tourists.
- The more recent data shows signs of a pickup in import growth in the June quarter, with Australian exports to Vanuatu recovering in this period.
- Similarly, while both motor vehicle registrations and Japanese car exports slowed in late 2008 and early 2009, the more recent Japanese export data shows some increases.
- The pace of credit growth remains a concern, with credit increasing by over three times the forecasted

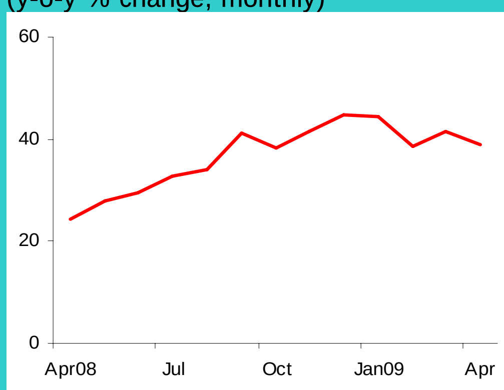
Vanuatu

Motor vehicles
(number, monthly)



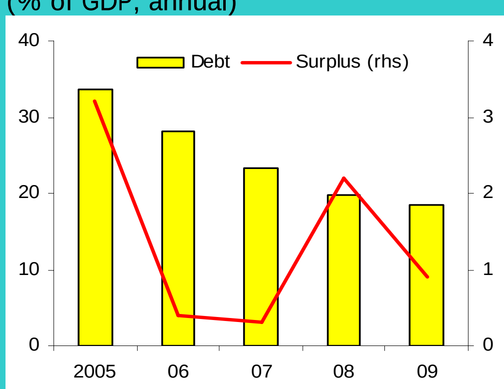
Sources: Japan e-Stats website and Vanuatu National Statistics Office.

Credit to the private sector
(y-o-y % change, monthly)



Source: Reserve Bank of Vanuatu.

Public debt and budget surplus
(% of GDP, annual)



Source: IMF Article IV staff report 2009.

nominal GDP growth rate. Credit to the private sector grew by 35.3% over the year to May 2009, a slight easing from the 44.0% earlier in the year. This level of credit growth, partly driven by new entrants to the banking sector, is unsustainable. It raises the prospect of more non-performing loans as the economy eases from the recent near-boom conditions.

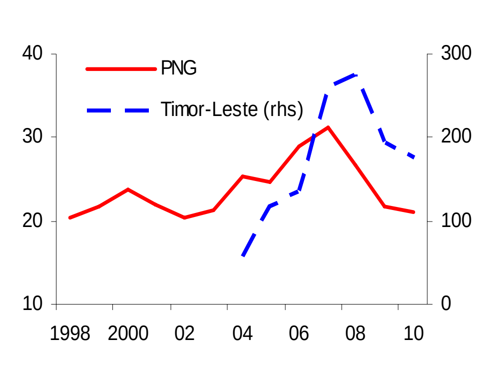
- Despite lower world prices for food and fuel, inflation has only eased slightly. Annual inflation was 6.1% on a year–on-year basis as of the March quarter of 2009. This is only slightly below the 5.8% increase in the December quarter. The inflation forecast for 2009 has been revised up slightly to 4.3%.
- Foreign reserves have continued to decline over 2009. The monthly import cover was equivalent to 5.0 months in June, down from 5.8 months in December 2008. This remains somewhat above the Reserve Bank of Vanuatu's minimum target level of 4.0 months.
- Fiscal surpluses and strong growth in nominal GDP has reduced the ratio of public debt to GDP to 18.4% in 2009. This strong recent fiscal performance gives the government room for a careful countercyclical fiscal response if the economy weakens.

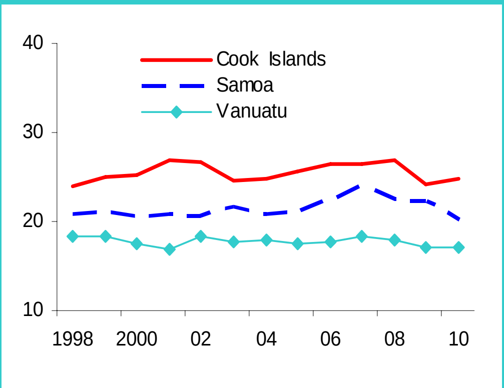
Key issues

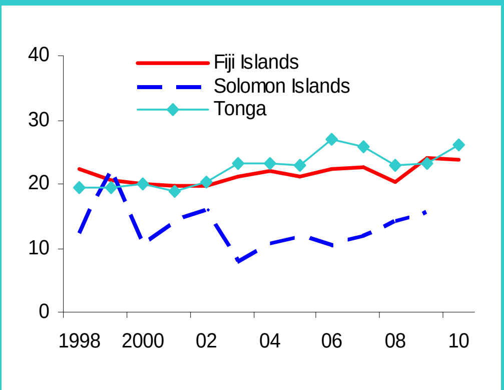
- Despite the good recent fiscal performance, improvements could be made to public expenditure management. More than half of the recurrent budget is spent on the wage bill, crowding out expenditures in areas that would help improve the productive capacity of the economy. Most development expenditures are currently financed by donors. While donor contributions are expected to remain strong over the next few years, the government could further support development spending by reprioritizing its expenditures.

Government budgets

Tax revenues
(% to GDP)







Notes: Tax revenues include direct and indirect taxes. 2009 are best estimates in most cases but use budget projections in some. 2010 data are budget projections. Fiscal years vary among countries.
Sources: Various Pacific countries' statistics offices and budget documents.

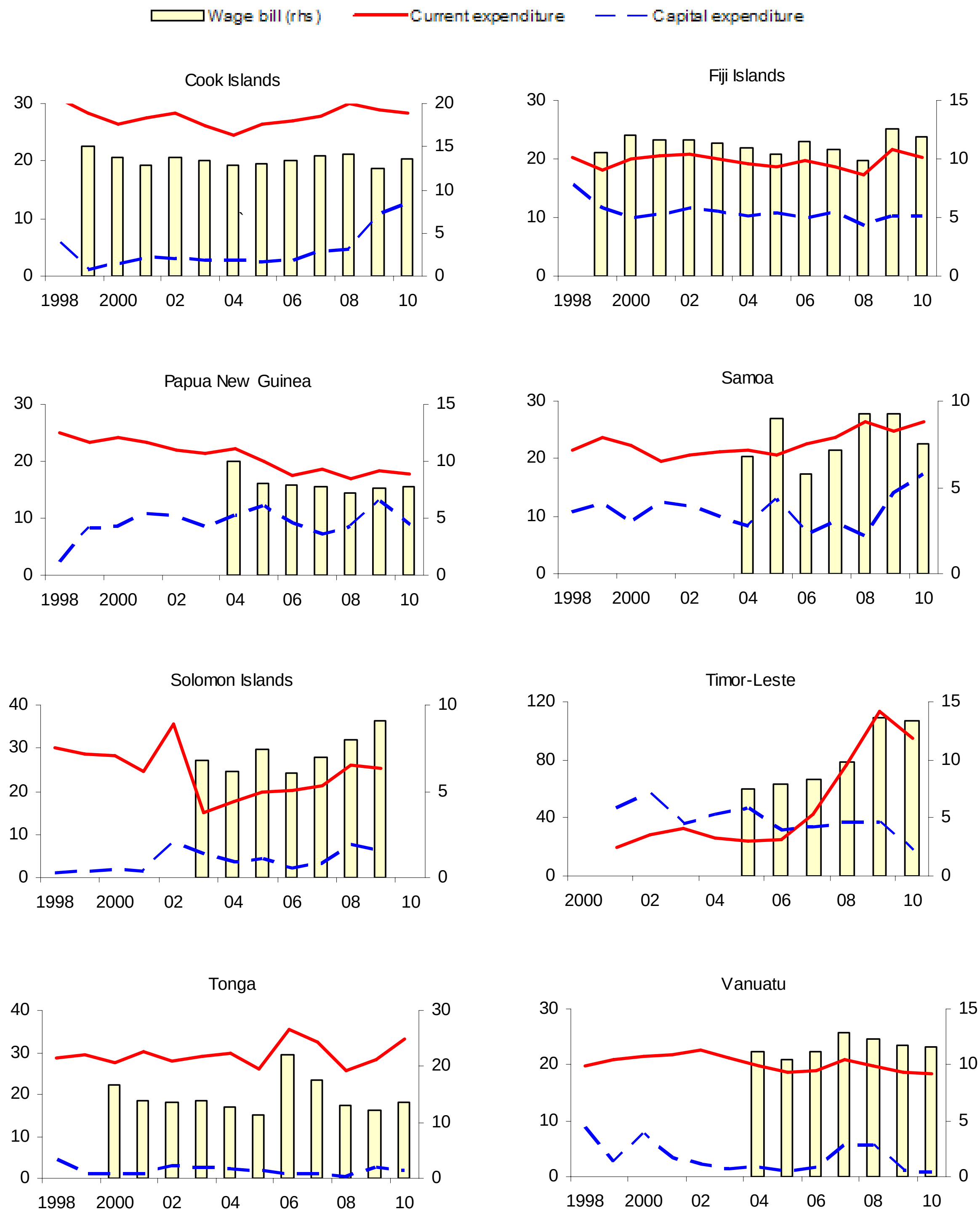
Key risks

- Government revenue is weakening in most Pacific countries as their economies slow and incomes from external investments decline. Some governments have already anticipated lower collections and factored weakening revenue into their latest budgets. For example, PNG has factored in a 20% decline in tax revenues in 2009, primarily from lower mining and oil revenues. Timor-Leste also expects much lower oil revenue. The Cook Islands and Samoa have recognized that their tax revenue is likely to be flat at best because of the global economic crisis. Some others appear to be overly optimistic, with revenue projections assuming a more robust economic performance than the data are pointing to.
- Countries that maintain an optimistic outlook run the risk of high revenue shortfalls. This, in turn, can lead to last minute spending adjustments. In the Pacific (as elsewhere), it is typical for poor revenue outcomes to be met by cuts to capital expenditures and maintenance. Across-the-board spending cuts on goods and services are also often used. Such cuts are normally a crude response that damages basic service delivery, particularly if made at the last minute.
- To date, only the Marshall Islands and Samoa have reported efforts to prioritize expenditures to reduce the impact of spending cuts.
- Some countries (e.g., the Cook Islands, PNG, Samoa, and Timor-Leste) are expanding capital works in order to provide a fiscal stimulus. Increased spending on good capital projects can be sensible provided it is affordable.
- Others are potentially aggravating their fiscal and economic problems by increasing public sector pay rates and allowances (e.g., in Tonga and in Solomon Islands for Parliament members).

Preferred scenario

- A sound response to the economic downturn is to anchor the budget in realistic revenue programs and to prioritize expenditures. This will reduce the risk of disrupting the delivery of basic services by making damaging cuts to essential expenditures.
- It is also important to steer the budget toward good capital projects, particularly those with high local content. Providing a short-term stimulus and building the economy's productive capacity will reduce the risk of prolonged economic downturn.

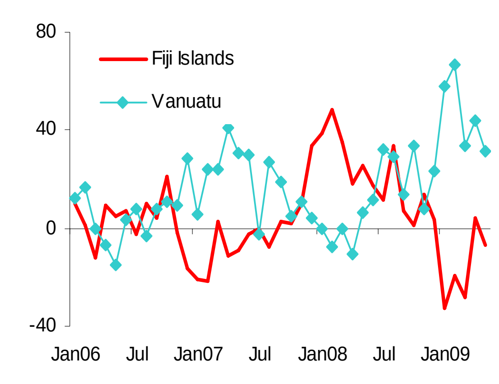
Key government expenditure aggregates
(% of GDP)



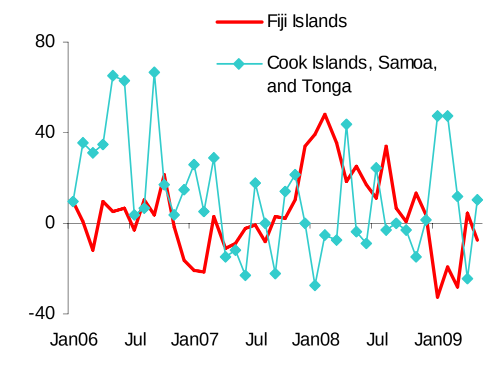
Notes: 2009 are best estimates in most cases but use budget projections in some. 2010 data are budget projections. Fiscal years vary among countries.
Sources: Various Pacific countries' statistics office and budget documents.

Tourism

Australian tourist departures
(persons; y-o-y % change, monthly)

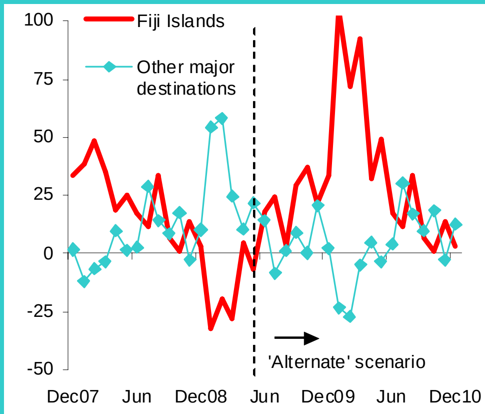


Source: ABS.



Source: ABS.

Forecasts for Australian departures
(persons; y-o-y % change, monthly)



Note: Other major destinations are the Cook Islands, Samoa, Tonga, and Vanuatu. Values to the right of the broken line are projections.
Sources: ABS and ADB staff estimates.

Key risks

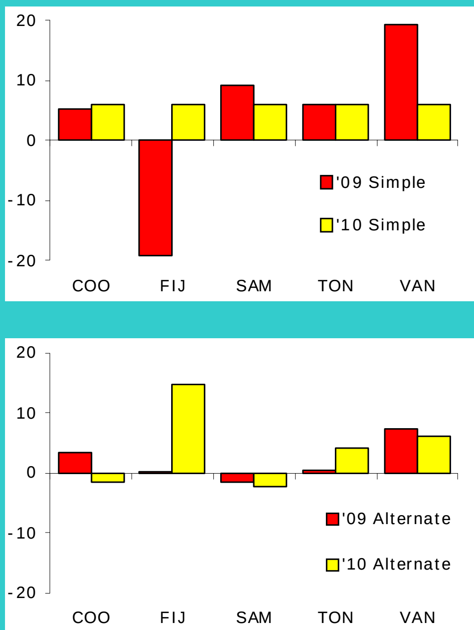
- Tourism activity has been highly variable across the Pacific this year. While the latest data show that tourist arrivals in the Fiji Islands are down by 19% so far this year, they are up by 19% for Vanuatu, 9% for Samoa, 6% for Tonga, and 5% for the Cook Islands.
- There is a substitution effect evident between destinations for Australian tourism. Notably, problems in the Fiji Islands (e.g., floods in January and political uncertainty) spurred an increase in tourist arrivals to other Pacific economies this year.
- A well-established substitution effect is evident between the Fiji Islands and Vanuatu. This reflects their shared market within Australia. For example, Australian departures to the Fiji Islands fell in 2007 because of the December 2006 coup and its aftereffects, while departures to Vanuatu rose rapidly. When the Fiji Islands recovered its tourists in 2008, the growth in Australian departures for Vanuatu slowed and ultimately contracted. The substitution effect between the two destinations has been even more pronounced this year.
- Destination-switching between the Fiji Islands, on one hand, and the Cook Islands, Samoa, and Tonga, on the other, is a more recent development. It has been apparent this year, but the effect was weak in 2007. This appears to represent a structural break from the previous periods. It is likely driven by the introduction of low cost air travel alternatives that have opened up Pacific destinations to a wider market.
- This substitution effect is not evident for New Zealand tourism to the Pacific. Tourist arrivals are all trending down for the first 5 months of the year for the Cook Islands, the Fiji Islands, Samoa, Tonga, and Vanuatu.
- The substitution effect has important implications for the outlook in the tourism-based economies. This is studied by conducting scenario analyses.

Scenarios

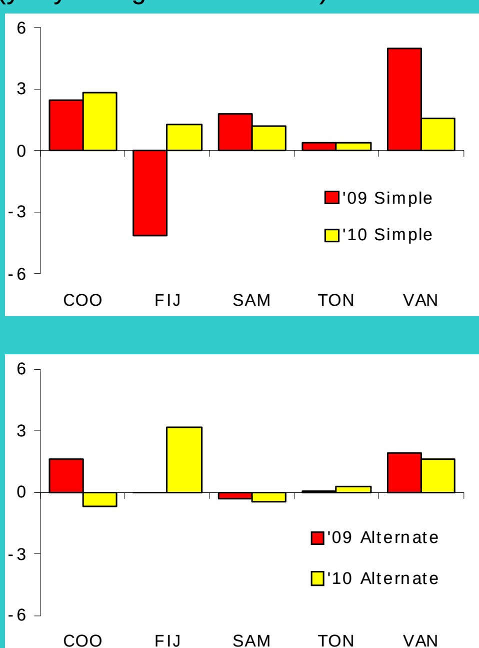
- A "simple" scenario was prepared that uses year-to-date numbers as an estimate of the growth in tourist arrivals for all of 2009. That is, the latest outcome on a year-to-date basis is assumed to apply for the whole year. Tourist arrivals are then assumed to increase in 2010 in all destinations by 6%. The 6% figure is the latest Tourism Australia forecast for Australian outbound tourism.
- An "alternate" scenario assumes that the patterns evident in 2007–2008 will be replicated in 2009–2010. That is, for both Australia and New Zealand

Tourism

Visitor arrivals
(y-o-y % change)



Tourism receipts
(y-o-y change as % of GDP)



COO=Cook Islands, FIJ=Fiji Islands, GDP=gross domestic product, SAM=Samoa, TON=Tonga, VAN=Vanuatu
Note: Scenarios assume a 1% increase in arrivals leads to a 1% increase in receipts and vice versa.
Source: ADB staff estimates.

departures, the monthly pattern for 2009 is assumed to match the monthly pattern in 2007, and the monthly pattern for 2010 is assumed to match the monthly pattern in 2008. In this way, the alternate scenario incorporates the substitution between destinations evident in the behavior of Australian tourists. Projections made under this scenario do follow the actual outcomes so far in 2009.

- A "complicated" scenario was also constructed based on a model that assumes that tourism in a destination expands due to exogenous factors (e.g., growth in international travel, global economic growth) and endogenous factors (e.g., country-specific conditions such as peace and political stability and aggressive marketing campaigns to lure tourists). Both cyclical patterns and structural trends are recognized in the model. The model assumes that tourism arrivals will grow by 6% during 2010 after falling by 2% on an annualized basis over the second half of 2009. These results are similar to the alternate scenario, and for this reason are not reported.
- Using the two scenarios, the change in tourism receipts as a percentage of GDP was also estimated.
- Under the simple scenario, the Fiji Islands bears a major contraction in 2009 while other destinations gain. All are projected to be better off in 2010, benefiting equally from an assumed improvement in international tourism.
- The alternative scenario presents a very different story. Under this scenario, the Fiji Islands does much better in the second half of 2009 than in the first half. In total, there is little change over the year. This relatively better outcome is at the expense of other destinations. The Fiji Islands is projected to be a big winner in 2010 as tourism arrivals fully recover. Again, this is in part at the expense of other destinations.
- The complicated scenario of the model produces a projection (not shown) between the simple and the alternate scenarios. Such a middle view is probably the most realistic.
- One important implication of the scenario analyses is that it is premature to assume an early tourism-led economic recovery in the Cook Islands, Samoa, and Tonga, and a continuation of Vanuatu's recent very high growth rates. The flip side is that there is some prospect of economic support from tourism for the Fiji Islands in the second half of 2009 and during 2010.

40th Pacific Islands Forum

STEERING A NEW COURSE

Remarks by
President Haruhiko Kuroda
Asian Development Bank

At the 40th Pacific Islands Forum
Cairns, Australia
5 August 2009

I. INTRODUCTION

Excellencies, distinguished guests:

It is a great privilege for me to join you here today. I would like to thank Prime Minister Rudd for his warm hospitality and the Pacific Islands Forum for giving me this opportunity to share my perspectives with you.

II. THE GLOBAL STORM

As we meet, the global economy is starting to show some signs of stabilizing. The pace of economic contraction is slowing and the optimist in all of us would like to think that the worst of the economic crisis may be over. We must be cautious, however, since this may not signal the beginning of a sustained recovery. It is important to note that the key drivers of recovery—the US, Japan, and European economies—have yet to bottom out.

The crisis has hit our region quite hard. In Asia, most economies have seen their worst performance since the 1997/1998 Asian financial crisis. An open and outward approach to economic policy underpinned Asia's economic transformation. But this year, it has been the export-intensive economies that have faced the most pressure as external sales tumbled.

The outlook for Asia is now more encouraging. Many indicators show that most economies in Asia have bottomed out. Indeed, it is possible that Asia can lead the recovery of the global economy if this trend continues.

III. TURBULENCE IN THE PACIFIC

In the Pacific, the global crisis has markedly slowed growth or caused economic contraction. Weaker revenues are constraining the ability of governments to finance much-needed basic services. Declining incomes, falling remittances, and high inflation threaten the quality of life in the Pacific. Low-wage female employees in tourism and the manufacturing sector are at particularly high risk as labor markets worsen.

Much of the burden of a policy response to the global economic crisis will fall on fiscal policy. An increase in government expenditure, where fiscally sustainable, may be needed in the worst-hit economies. However, this must be supported by structural reforms to help economies sustain economic recovery over the medium term, and be combined with policies to protect the most vulnerable.

However, even with the best response now, the lagged effects of that action mean recovery could still be some way off.

IV. PLOTTING A NEW COURSE

I would now like to share some perspectives that I believe are particularly relevant to managing these challenges.

In times of economic stress, it may be tempting to put on hold efforts to correct the structural weaknesses that constrain economies. Yet times like these can instead provide us with our greatest opportunities.

Asia's experience following the 1997/1998 financial crisis provides useful insights. Asia learned important lessons from the crisis, and pursued deep-seated financial reforms to help build the resilience of the financial sector. This resilience has softened the impact of the current global economic crisis.

40th Pacific Islands Forum

And the efforts towards regional cooperation and economic integration were at the heart of the rebuilding of the Asian financial sector following the Asian financial crisis. Efforts to improve regional cooperation and economic integration in other sectors have also helped protect Asia during the global financial crisis this time.

The third point is the importance of quick and decisive action in the face of serious economic stress. The early action taken this year by many countries to safeguard financial systems, to adjust the monetary policy stance, and to pump-prime budgets demonstrate this point. These early actions are helping the global economy stabilize and, for some economies, to begin the transition to recovery.

V. ADB'S RESPONSE TO THE REGION'S CHALLENGES

The recent tripling of ADB's capital base and the replenishment of concessional Asian Development Fund (ADF) last year gave us much-needed resources to support prompt responses to the global financial crisis and address longer term development needs in Asia and the Pacific.

In the Pacific, ADF resources have been increased to $203 million over 2009 and 2010, from $130 million during the 2007–2008 period. Extra resources from ADF and other sources are helping ADB provide quick-disbursing budget support to the economies worst hit by the global economic crisis. Programs will help stabilize economies and facilitate the reforms that will aid recovery. Country-led responses are being supported by strengthened country dialogue and high-level technical assistance underpinned by enhanced monitoring and analytical work.

Extra resources are also helping ADB address other threats to the region. Most notably, we are active in addressing climate change, a threat that is contributing to the Pacific being one of the more economically and environmentally fragile regions of the world.

Earlier this year, ADB prepared the Climate Change Implementation Plan (CCIP) for the Pacific to identify climate change issues and options in the Pacific DMCs. CCIP identified adaptation as a priority area for the Pacific countries. We are already making good progress in helping the DMC countries integrate adaptation measures in the national development plans and climate proofing infrastructure. We are also working with them in further integration with disaster preparedness and response.

As part of our mitigation effort, ADB has set an ambitious target of doubling clean energy investments such as renewable energy and energy efficiency to $2 billion per year starting in 2013. This will be of great relevance to the Pacific DMCs in terms of their contribution to climate change mitigation, but more importantly in addressing their energy security issue as renewable energy and energy efficiency investments would help ease Pacific DMCs' dependence on expensive imported fossil fuel.

I am also pleased to note the progress made by the Pacific DMCs and major development partners to establish in 2008 the Pacific Regional Infrastructure Facility. Last year, ADB conducted high level consultations with all major development partners, and with the Pacific Forum Island Secretariat and the Secretariat of the Pacific Communities. We will continue to work on these regional cooperation efforts to further strengthen coordination with development partners.

In these and other ways we are working closely with our development partners to strengthen our collective ability to assist the Pacific DMCs.

VI. CONCLUSION

This Pacific Leaders Meeting provides a very timely opportunity to discuss these important issues and take early action to hasten the achievement of their development goals. Addressing the complex and, in many respects, unique challenges facing the region will require changes to how governments, the private sector, and communities contribute to development. As you know from your own experience, visionary leadership that shapes practices and cultures to meet the aspirations of communities for a better future, is vital.

And, we, ADB, have been working closely with other development partners to provide harmonized assistance to the Pacific region. We stand ready to redouble our efforts to help address the impact of the global economic crisis, and the broad range of challenges facing the region.

Once again, I thank the Forum for the opportunity to address you today.

Interest rate margins

Interest rate margins

- Interest margins reflect a variety of determinants. Stable growth and low inflation tend to boost credit growth and banking sector profitability and hence interest rate margins (for example, see the 2009 IMF working paper, *The Determinants of Commercial Bank Profitability in Sub-Saharan Africa*). Conversely, economic downturns lead to credit contractions that are likely to exert downward pressure on lending rates. This may in turn narrow interest rate margins (i.e., banks may become less profitable as economies weaken).

- In a competitive banking sector environment, interest rate margins can be expected to adjust to prevailing economic conditions. But this may not be the case if a banking sector is highly concentrated (i.e., a small number of banks have most of the market share) or there are significant barriers to entry (such that the industry is non-contestable). Under these conditions, interest margins may not narrow as credit growth shrinks during economic downturns.

- In such an environment, there is a risk that economic recovery would be made more difficult; interest rates would remain too high and monetary transmissions that aim to stimulate credit growth would be muted.

Margins in the Pacific

- Interest rate margins are generally higher in the Pacific than in other regions. There are many factors that could account for this. For example, it could be a result of above-average country risk (e.g., political or macroeconomic risks) and other sources of high transaction costs. Another possible contributing factor to higher interest margins is the relatively high reserve requirements imposed by regulatory authorities, which compel banks to seek higher returns on non-reserve assets to offset the opportunity cost of holding low or non-interest-bearing reserves.

- High interest rate margins could also be a result of limited competition in the region's banking sector. In the Pacific there are only a small number of commercial banks. There are also few alternative non-bank credit sources, and only two shallow stock markets exist in Suva and Port Moresby, which do not yet allow for secondary trading. Weak competition may allow banks to maintain high margins (see text box).

- Interest margins in the Fiji Islands, Samoa, and Tonga have been steady for some time and are yet to adjust downward despite economic downturn. In contrast, the growing non-bank financial sector in PNG, composed of pension funds and other finance companies, appears to be contributing to a steady decline in interest rate margins there. The new entrants appear to be deepening the financial sector and increasing competition.

- However, before concluding that there must be a problem with a lack of competition in the Pacific's banking sector, it is important to note that interest rate margins are also yet to narrow noticeably in some other nearby and Asian economies. The Pacific is not alone in seeing steady interest rate margins despite the current economic contraction.

- A more effective way to assess if Pacific banks are overly profitable would be to conduct a benchmark test of their rates of return.

Market Power in the Fiji Islands' Finance Industry

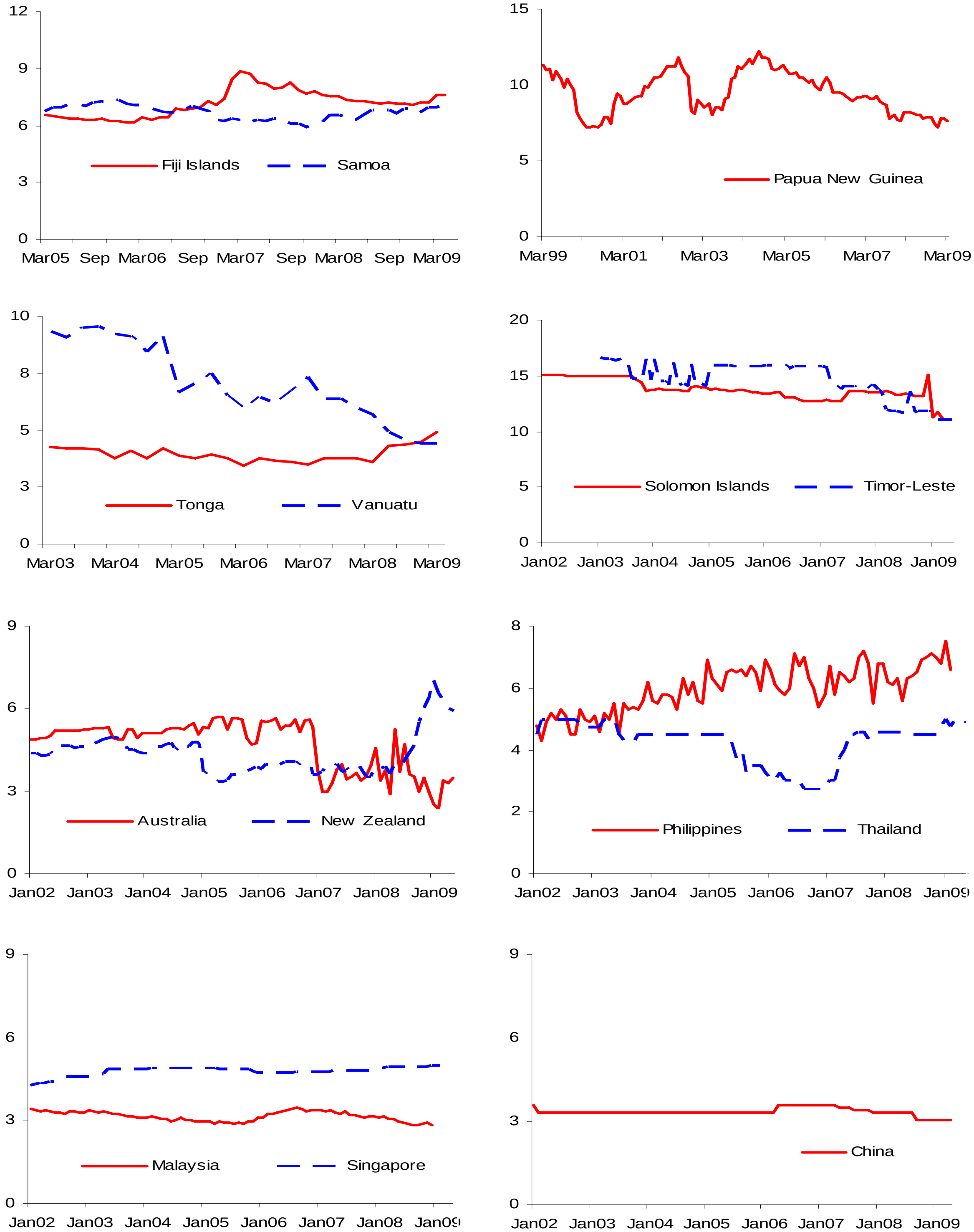
In 1998, in response to public concern about the activities of the Fiji Islands' banking industry, the Minister of Finance established a Committee of Inquiry into Financial Services. The committee found there was insufficient competition in the financial sector: it concluded that the banking industry was an oligopoly (that is, controlled by a small number of players) dominated by two major foreign banks, ANZ and Westpac.

Oligopolies tend to form cartels as a basis for manipulating a market. The committee did not establish the existence of a formal cartel among the banks; it did find evidence of "price leadership" and other behavior patterns whereby the banks tend to replicate each other's practices. There was no evidence that the banks are aggressively competing for the available market, which suggests that they are not functioning as in a competitive market.

The lack of effective competition was found to result in high bank profits, high user charges, excessive interest rate margins, and poor service standards. The four major banks earned a return on equity of 12.6 to 16.0 on their global operations in 1997. But in the Fiji Islands, the return on equity ranged from 26.0 to 28.0 in the same year. Poor service standards were evident in declining rural services, long queues at the major banks, excessive waiting times for services, and the indifferent attitude of staff to customer concerns. The committee concluded that the low level and poor quality of services was becoming the accepted norm in the industry and that there was apparent apathy and complacency by management about the situation.

Source: Fiji Islands Ministry of Finance. 1999. *Report of the Committee of Inquiry into Financial Services.* Parliamentary Paper 19. Suva: Parliament of the Fiji Islands.

Interest rate margins
(Lending rates less deposit rates, monthly, %)



Notes: Interest rate margins are based on weighted average lending and deposit rates, where available. Other margins are based on the following rates: Malaysia (average lending rate and fixed 3-month deposit rates); New Zealand (base lending rate and deposit rate); Singapore (minimum lending rate and 3-month time deposit rate); Timor-Leste (loans + 6-month LIBOR, and savings deposit rate); and Tonga (prime lending rate and savings deposit rate).
Sources: Banking and Payments Authority of Timor-Leste, Bank of Papua New Guinea, Central Bank of Samoa, Central Bank of Solomon Islands, IMF's International Financial Statistics online database, National Reserve Bank of Tonga Reserve Bank of Fiji, and Reserve Bank of Vanuatu.

Latest Pacific Economic Updates

	GDP Growth (%, 2009f)	Inflation (%, y-o-y)	Credit Growth[a] (%)	Trade Balance (% of GDP)	Import Cover (months)	Fiscal Balance (% of GDP)
Cook Islands	–0.1	11.2 (Jun-Q 2009)	5.5 (Mar-Q 2009)	–70.2 (2008)	-	8.1 (FY2009f)
Fiji Islands	–1.0	2.3 (Jun 2009)	10.2 (Apr 2009)	–43.1 (2008)	2.7 (Feb 2009)	–3.0 (2009f)
FSM	0.5	5.0 (2008)	-	-	-	3.0 (FY2009f)
Kiribati	1.0	11.0 (2008)	-	-	-	–13.0 (2008)
Marshall Islands	0.5	5.6 (Mar-Q 2009)	-	–37.9 (2008)	-	-
Nauru[b]	1.0	2.5 (Mar-Q 2009)	-	-	-	0.4 (FY2009f)
Palau	–3.0	8.6 (Mar-Q 2009)	-	-	-	–4.8 (2008)
PNG	4.5	6.7 (Jun-Q 2009)	25.7 (May 2009)	32.5 (2008)	9.7 (Mar 2009)	–3.3 (FY2009f)
Samoa[c]	–0.8	12.9 (May 2009)	6.1 (May 2009)	–39.4 (2008)	5.1 (May 2009)	–5.5 (FY2009f)
Solomon Islands	0.0	19.1 (Mar 2009)	4.0 (May 2009)	–28.1 (2008)	3.2 (May 2009)	–3.7 (2009f)
Timor-Leste[c]	8.0	–3.1 (Jun 2009)	–5.2 (Jun 2009)	-	-	90.1 (2009f)
Tonga	0.4	1.4 (Apr 2009)	2.4 (Apr 2009)	–56.8 (2008)	4.6 (May 2009)	1.0 (FY2009f)
Tuvalu	1.0	5.3 (2008)	-	-	-	–5.4 (2008)
Vanuatu	4.0	5.8 (Dec-Q 2008)	35.3 (May 2009)	–43.3 (2008)	5.2 (Mar 2009)	6.3 (2008)

[a]Credit growth refers to growth in total loans and advances to the private sector.
[b]The Australian CPI is the proxy for measuring Nauru's inflation.
[c]Credit growth includes loans and advances by commercial banks to both public and private sectors.
Notes: Period of latest data shown in brackets; import cover for PNG is months of non-mining and oil imports.
Sources: ADB. 2009. *Asian Development Outlook 2009 Update*. Manila (*For publication*); and statistical releases of the region's central banks, finance ministries and treasuries, and statistical bureaus.

Key data sources:

Data used in the *Pacific Economic Monitor* are available in the ADB PacMonitor database, available in spreadsheet form at www.adb.org/pacmonitor

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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