The Far East and Australasia 2007

38th Edition

Routledge
Taylor & Francis Group
LONDON AND NEW YORK

ECONOMIC TRENDS IN THE PACIFIC ISLANDS

T. K. JAYARAMAN

INTRODUCTION

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

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

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

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

Since 2000 these political developments in the Melanesian countries, as well as the implementation of inappropriate fiscal policies and the wastage of resources, both domestic and foreign, have resulted in the stagnation of per caput income in many of the Pacific Islands. These were certainly not positive signs, especially in the context of the Millennium Development Goals (MDGs) contained within the Millennium Declaration adopted by the member states of the UN in September 2000. Five of the eight MDGs related to human development, the foremost among them being the reduction of poverty by 50% by 2015. Although benchmark details of poverty based on income and expenditure surveys were available for only two countries in the region, namely Fiji and Papua New Guinea, the impression of 'subsistence affluence', a highly romanticized theme in the literature on the Pacific Islands, was no longer valid. Increasing migration to towns in search of jobs, following the steady decline in rural incomes over the years, the consequent expansion of squatter settlements, rising crime in urban areas and growing youth unemployment were visible evidence of the poverty experienced in all the Pacific Islands. Furthermore, there were increases in the numbers of reported cases of HIV/AIDS. A study commissioned by the Commonwealth Secretariat in 2005 indicated that the realization of the MDGs of the eradication of poverty, the reduction of child mortality and the control of the spread of HIV/AIDS and malaria, as well as the achievement of universal education, was proving difficult. This was confirmed by a further study released by the Australian Agency for International Development (AusAID), observing that the Pacific Islands were unlikely to meet the MDGs, as during the 10-year period 1995–2004 they had failed to register an annual per caput income growth rate in excess of 2%, the level indicated by the World Bank as that required for reducing poverty.

Against this background, an Australian non-governmental policy institution, the Centre for Independent Studies (CIS), issued three reviews on the issue of aid to the Pacific Islands during 2003–06, one of which carried the provocative title 'Aid has Failed the Pacific'. The criticism was based on the theory that poor growth performance was due to the ineffective use of aid, which had totalled US $50,000m. during the previous 30 years, and that most of this aid had been spent on consumption by bureaucracies and government élites, being diverted from the intended purposes, as aid was often considered fungible. The smaller island states such as Tuvalu and Kiribati have performed better in their management of aid by putting the resources in trust funds established under parliamentary statutes. The respective acts of parliament stipulated that trust funds should be maintained and invested by internationally reputable financial investment houses; limited the government's recurrent budget that could be financed by revenue earned from the returns on investments; and restricted the use of trust fund money to investment purposes only, with the condition that funds so drawn from the trusts be returned over a given period and that they be maintained in real terms. These two trust funds now serve as models for the northern Pacific Islands, namely the Marshall Islands, the Federated States of Micronesia and Palau, which were formerly part of the US Trust Territory of the Pacific Islands. All three countries had been receiving annual grants from the USA under their respective Compacts of Free Association, each Compact remaining in force for a 15-year period. The Marshall Islands and the Federated States of Micronesia established trust funds to manage the annual aid inflows that were anticipated under the second Compacts. In 1994, only one year after gaining its independence, Palau created a trust fund under its first Compact with the USA.

As the major provider of aid to the Pacific Islands and seemingly provoked by criticism of its approach, in 2005

Australia reviewed its overseas aid policy and delivery mechanisms. In April 2006 the Australian Government issued an official White Paper on the country's aid programme. Upon the release of this policy document, the Australian Minister for Foreign Affairs highlighted the need to focus on the alleviation of poverty and the promotion of sustainable development, with a greater role for the private sector, through policies aimed at creating an environment conducive to the generation of increased income and the provision of wider opportunities for gainful employment. A major departure from the norm, indicated by the White Paper, was with regard to aid delivery. Instead of linking aid to specific projects, as had been the case hitherto, Australian aid would henceforth be channelled into different sectors, such as primary education, water supply and nutrition. This was different from the approaches of other donors, including the European Union (EU) and the US Millennium Challenge Corporation, which in February 2006 announced a grant of almost US $65.7m. to Vanuatu for the purposes of identified infrastructure projects.

The People's Republic of China and Taiwan are providing significant amounts of aid to the region, in their respective attempts to win the support of Pacific governments. While the major states, including Fiji and Papua New Guinea, are known to be steadfast in their adherence to the 'one China' policy, by recognizing only the People's Republic, the smaller states have become vulnerable to what has become known as the 'aid game'. The violence in April 2006 in Solomon Islands, which led to the swift downfall of newly elected Prime Minister Snyder Rini, originated in rumours that the rise in Rini's popularity had been due to the growing influence of Taiwan in local politics. Aware of the importance of aid diplomacy, Japan, which was already a leading donor to the region, at a meeting of Pacific nations in May 2006 announced a programme of fresh aid totalling more than US $400m. Some diplomats privately considered this to be an attempt to counter the increasing influence of the People's Republic of China and Taiwan. Other observers, however, believed that pro- and anti-whaling lobbyists were trying to garner late support from the Pacific Islands prior to a meeting of the International Whaling Commission, held in June 2006. At a meeting held in June 2005, contrary to the expectations of Australia and New Zealand, which continued to campaign for whale conservation, Solomon Islands had voted with Japan in favour of the resumption of commercial whaling. Australia was particularly disappointed by the stance taken by Solomon Islands; this followed the restoration of order by RAMSI, which had been largely funded by Australia, a recovery in the islands' economy and an improvement in bilateral relations. This unexpected development also coincided with the country's conferral of its highest honour—the Star of the Solomon Islands—on the Prime Ministers of Australia and New Zealand. By contrast Kiribati, also much to the dismay of Australia and New Zealand, abstained from voting.

RECENT DEVELOPMENTS

The Pacific Islands' growth performance in the first five years of the new millennium remained modest, amid continuing constraints. The remoteness and insularity of the region, which comprises widely dispersed multi-island micro-states, combined with the distance from major markets, have resulted in high international and domestic transport costs. Compounded by the low volume of cargo, the development of even a small domestic market has been constrained by the distances between settlements and the infrequency of internal transport services. The Pacific Islands' susceptibility to natural disasters and adverse climatic conditions has typically had a negative impact upon crop yields, thus affecting the entire region's economy. The relatively small populations of the islands reduces their institutional capacity, which in turn increases the unit costs of services and restricts the potential for private-sector growth and investment. Scope for diversification has been constrained by the narrow resource base and by the limitations of the domestic markets, resulting in the continuation of unvaried production and exports and in a weak private sector. Heavily dependent upon strategic imports, including fuel and food items such as rice and wheat flour, and reliant upon foreign investment to overcome the inherent limitations of scale and resources, the Pacific Islands remained vulnerable to external economic and environmental factors.

With favourable world prices for most of the Pacific Islands' traditional exports such as copra, together with the increase in tourist arrivals and the rise in inward remittances to the Polynesian islands (and also, within Melanesia, to Fiji), in 2005 the rate of economic growth remained reasonable, although the average rate was less than 3%.

Fiji (*2004:* population: 841,000; gross domestic product—GDP—per caput: US $3,125; aid per caput: US $76) recovered from the aftermath of the 2000 coup with remarkable speed as a result of aggressive counter-cyclical measures. The country subsequently achieved annual economic growth rates well in excess of 3%. Fiji recorded growth of 4.3% in 2002, 3.0% in 2003 and 4.1% in 2004, but in the process incurred sizeable fiscal deficits, equivalent to 5.6% of GDP in 2002, 6.0% in 2003, 3.3% in 2004 and 4.3% in 2005. Fiji's overall growth rate in 2005, however, was much lower, at 1.7%, although private consumption and construction increased strongly, thus sustaining the economy. The main reasons for the weaker growth rate in 2005 were the expiry of the World Trade Organization's (WTO's) Agreement on Textiles and Clothing on 1 January of that year, the abrupt discontinuation of the US quota for Fijian garments and the decrease in earnings from sugar exports. The immediate prospects of any revival of the declining sugar exports before the phased withdrawal by 2008 of the preferential trade arrangements with the EU under the Sugar Protocol were also poor. Fiji has therefore been obliged to identify and promote new export products, such as bottled mineral water, to offset growing trade deficits.

Papua New Guinea (*2004:* population: 5,772,000; GDP per caput: US $677; aid per caput: US $46) by contrast benefited from the favourable external conditions that prevailed in 2005. The oil and gas sector registered growth of 11.0%, as supply responded to rising international prices. In addition, the agricultural sector performed well, achieving increases in output of several exportable products, including coffee, copra, coconut oil and rubber, all of which benefited from higher world prices. Furthermore, the construction sector recorded strong growth in response to low interest rates and to higher demand for office space and private housing. Low interest rates were primarily due to a commendable fiscal performance, with a budget deficit equivalent to 0.6% of GDP being recorded.

Solomon Islands (*2004:* population: 466,000; GDP per caput: US $554; aid per caput: US $262) continued its economic recovery in 2005 after the contraction experienced during 2000–02. Following the restoration of law and order, economic growth during 2005 reached 4.4%, most of the expansion being due to strong performance in the areas of agriculture, construction and trade (both in the wholesale and retail sectors). Exports of logs rose, thus raising export earnings, although decreases in the tuna catch and in copra production were recorded.

In 2005 Vanuatu (*2004:* population: 207,000; GDP per caput: US $1,526; aid per caput: US $182) recorded a growth rate of 3.1%, slightly lower than the 2004 level of 3.5%. The decrease in the growth rate was attributed to a decline of 0.8% in the agricultural sector. However, owing to strong growth in the tourism sector, facilitated by the introduction of additional flights to Vanuatu by Pacific Blue, a newly launched airline, and the recovery in construction activity, the country was able to maintain a modest growth rate, in contrast to the contractionary conditions that had prevailed during 2001–03.

Of all the Pacific Islands, the Polynesian country of Samoa (*2004:* population: 184,000; GDP per caput: US $2,042; aid per caput: US $167) registered the highest growth rate, of 5.5%, in 2005, thereby improving on its performance in 2004 when growth of 3.7% was achieved. Strong expansion in the agriculture and fisheries sectors resulted in increases in the export volumes of nonu (or noni) juice and fish. This expansion, combined with the rise in hotel construction activities, which were encouraged by the Tourism and Hotel Development Incentive Act of 2003, was the main reason for this strong economic growth.

However, Tonga, another Polynesian country (*2004:* population: 102,000; GDP per caput: US $2,084; aid per caput:

US $189), endured difficult times during 2005 with mass movements for greater democracy and strike action by civil servants lasting for more than a month. Although the strike was settled with an agreement upon a 60%–80% increase in salaries, the economy remained under pressure. Growth during the fiscal year ending June 2005 reached approximately 2.5%, primarily owing to the good performance in agriculture, which helped to improve exports of squash (pumpkin), vanilla, root crops and nonu juice. Furthermore, inward remittances rose to 200m. pa'anga, thus accounting for 56% of the country's GDP.

Economic growth in the Cook Islands (*2003:* population: 18,400; GDP per caput: US $7,332; aid per caput: n.a.) slowed down during the year ending June 2005, when a growth rate of 3.0% was recorded, compared with 4.2% in the previous fiscal year. This deceleration was due to the severe damage inflicted upon the rural economy by five cyclones in 2005. However, a small increase in tourist arrivals and in retail and wholesale trade enabled the economy to maintain modest growth in that year.

By contrast, in 2005 the economy of Kiribati (*2004:* population: 98,000; GDP per caput: US $633; aid per caput: US $171) suffered from the continued decline in revenue from fishing licence fees, which decreased from $A46.6m. in 2001 to $A24.5m. in 2004 and to $A18.0m. in 2005. As a result, the country's growth rate declined from 3.3% in 2004 to 0.3% in 2005. Kiribati depends heavily upon its fisheries resources and seafarers' inward remittances for sustaining levels of national income.

The Marshall Islands (*2004:* population: 61,000; GDP per caput: US $1,767; aid per caput: US $835) registered a growth rate of 3.5% during 2005, a significant rise from 0.4% in 2004. In addition to increased agricultural production, greater external assistance was also provided. Under the new financial agreement with the USA as part of the Compact of Free Association, the Marshall Islands received fresh inflows of aid. The resultant fiscal expansion facilitated GDP growth. Government expenditure, mainly on wages and salaries, was supported by Compact funds and constituted approximately 80% of GDP. The US Ronald Reagan Ballistic Missile Defense Test Site, located on Kwajalein Atoll, also continued to contribute to the expenditure component of GDP.

The Federated States of Micronesia (*2004:* population: 110,000; GDP per caput: US $2,064; aid per caput: US $787) recorded improved economic growth during 2005. Following a contraction of 3.8% in 2004, the economy recovered to reach a modest growth rate of 1%. This was primarily due, as in the case of the Marshall Islands, to fresh inflows of aid money from the USA under the second Compact of Free Association. Following the expiry of the first Compact in 2001, US Grant Funds were increased to US $92m. annually, with the requirement that initially a total of US $16m. be saved in a trust fund. US grants constituted 40% of GDP. Greater focus on public works programmes and an increase in tourism both contributed to the country's economic recovery in 2005.

Nauru (*2003:* population: 10,100; GDP per caput: US $3,465; aid per caput: n.a.) has faced increasing economic difficulties, particularly since the decline of the island's phosphate resources in the late 1990s. Reliable figures for the country's recent national accounts are not available. With the substantial reduction in the operations of the Australian Offshore Processing Center for asylum seekers, which provided some income when net earnings from depleting phosphate mining activities became negative in 2004, the country's future looked increasingly uncertain. Although the international donor meeting held in November 2005 promised development assistance to revive the economy, pledges would need to be followed by direct action and financial assistance.

In 1994 Palau (*2004:* population: 20,000; GDP per caput: US $6,350; aid per caput: US $978) became the third US-administered Trust Territory to gain independence, following the examples of the Marshall Islands and the Federated States of Micronesia. A trust fund was established into which US aid funds were deposited in order to provide budgetary support from 2009, when the Compact of Free Association (1994–2009) was due to expire. Approximately US $410m. was to be provided in total over the 15-year period of the Compact. In 2005 Palau was able to maintain a high rate of economic growth, which reached 5.5%, compared with 4.9% in 2004, mainly owing to increased tourist arrivals during the year and to new construction activities. The latter included the building of an 85-km highway and the establishment of a new national capital on the island of Babeldaob.

Tuvalu (*2003:* population: 9,880; GDP per caput: US $2,285; aid per caput: n.a.) experienced a deceleration in economic growth during 2001–06. The highest annual growth rate, of 13.2%, was recorded in 2001. Thereafter, the rate of GDP growth began to decrease as the result of a decline in construction activities following the completion of a hospital and a government office block, combined with a steady reduction in revenue from fishing licences, telecommunications licences and the '.tv' internet domain name. Growth rates were 5.5% in 2002, declining to 4.0% in both 2003 and 2004. In 2005 GDP growth decreased to 2.0%. The Tuvalu Trust Fund (TTF), which is declared to be an example for small island states to follow, had a total endowment value of US $99.4m. The average return in real terms from investments made with TTF resources has remained higher than 6% since 1978, and the total yield amounted to $A58.9m., thus providing an annual average of $A3.1m. to support the government's recurrent budget.

MACROECONOMIC CONDITIONS IN THE PACIFIC ISLANDS

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

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

The development of resilience can be successfully accomplished only in a sound macroeconomic environment. Diversification of activities to reduce dependence on one or two exportable crops only cannot be undertaken in isolation. Furthermore, if the Pacific Islands are to benefit from financial globalization, reforms are required in other areas, not merely in the financial sector. More importantly, reforms in macroeconomic policies and public financial management are long overdue. Macroeconomic stability is determined by the annual fiscal position, which in turn affects price levels, interest rates and exchange rates, along with the current account of the balance of payments.

Papua New Guinea not only reduced its overall fiscal deficits over the three-year period 2001–03 but also successfully managed to achieve a budget surplus, estimated at the equivalent of 1.8% of GDP, by 2004. Improved tax collection and effective budgetary control measures largely contributed to fiscal discipline. In 2005 the budget deficit was estimated at 0.6% of GDP, compared with a projected deficit of 1.0%; government expenditures included equity contributions to Papua New Guinea's joint gas project with Australia. In this disciplined environment, in 2005 interest rates were reduced, and inflation also remained low. Prudent fiscal management improved the public debt position. Public debt declined from 80% of GDP in 2002 to 49% in 2005. Favourable commodity prices also resulted in an improvement in export earnings, thereby enabling Papua New Guinea to continue recording current-account surpluses in both 2004 and 2005. The kina, the national currency, which is based on a floating exchange rate regime, appreciated by 2% against the US dollar and by 4% against the Australian dollar during 2005. Increases in international reserves and a stronger currency provided an environment conducive to investment, which was further facilitated by appropriate infrastructure investments.

Fiji, which implemented aggressive counter-cyclical measures to address the decline in private investment that followed the 2000 coup, experienced fiscal deficits throughout the five-year period 2001–05. Borrowing from the public and from institutions, including the Fiji National Provident Fund, financed these deficits. Public debt rose to $F2,487m. in 2005, constituting 54% of GDP, with external debt amounting to 7% of GDP. The prevailing excess liquidity in the banking system facilitated borrowing from the public and did not deter further private investment. Interest rates remained low until mid-October 2005, when domestic credit expanded to record annual growth of 27%, the highest rate since 1990. However, the country's rate of inflation remained low because most consumer imports were sourced from Australia and New Zealand, where the respective central banks had been successfully maintaining low rates through inflation-targeting monetary policies. Fiji experienced the adverse effects of a rapid rise in domestic credit, mainly within the housing market, as the demand for construction materials began to extend overseas. The country's trade deficit widened in the midst of poor export performance, compounded by the decline in garment exports that followed the ending of the US quotas for Fiji's garments, footwear and fish. In 2005 the current-account deficit reached the equivalent of 13% of GDP, despite an exceptional performance by the tourism sector and the rise in inward remittances from Fijian rugby players, teachers and nurses working overseas. In the same year inflows of such remittances totalled $F500m., having risen from $F50m. in 2000 and $F300m. in 2004. These remittances exceeded receipts from sugar exports, which amounted to approximately $F200m., thus accounting for 8% of foreign-exchange earnings. Moreover, tourist arrivals reached 500,000 in 2004 and rose further to approximately 530,000 in 2005. The country's monetary authority, the Reserve Bank of Fiji (RBF), raised the policy indicator interest rate in October 2005, by 50 basis points from 1.75%, and again in February 2006, this time by one percentage point to 3.25%. The discount rate, also known as the minimum lending rate, was raised to 4.25%. In addition, on May 2006 the RBF raised the statutory reserve deposit ratio for the commercial banks from 5% to 7%. These actions signified a major departure from the easy monetary policy for restraining aggregate demand, an approach that had prevailed for a decade. Until 2005 demand had been driven mainly by consumption. As a result of these increases in interest rates, demand was reduced, and this was reflected in the decline in loan approvals by lending institutions.

The Cook Islands were able to record a fiscal surplus of 3.1% of GDP in the financial year ending in June 2005, after two years of deficits. This was due to improvements in revenue collection and to the general buoyancy of the economy. The islands had also witnessed a revival of the tourism industry. In 2005 tourist arrivals and revenue increased by 9% and 11% respectively. Much of this was attributed to the introduction of new flights, operated by Pacific Blue from Christchurch, New Zealand. Pearl exports rose in the same year after recovering from the adverse effects of an outbreak of algae in 2001. Inflation in 2004/05 remained low, at 1.7%, despite an increase in petroleum prices. The majority of imports (amounting to 50% of GDP) were purchased from New Zealand, which had also been experiencing a low level of inflation. The Cook Islands were bound by the Manila Agreement of 1998 not to undertake any further borrowing for a period of seven years following the restructuring of external debt. As a result, the islands' debt amounted to 34% of GDP in 2005.

Kiribati's fiscal position was a continuing cause for concern. The country's fiscal deficit reached its highest level in 2003, when it stood at 28.5% of GDP. Further declines in fishing licence fees, limited tourism earnings and increasing recurrent and development expenditure resulted in budgetary deficits, which were to be serviced by drawdowns from the country's trust fund, known as the Revenue Equalization Reserve Fund (RERF). If the value of the trust fund was to be maintained, these drawdowns would need to be returned. As Kiribati uses the Australian dollar as legal tender, and a major proportion of imports are purchased from Australia, the rate of inflation has remained low.

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

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

Nauru's macroeconomic prospects remained poor. Phosphate mining, upon which the economy had previously been dependent, was already declining as resources became depleted. It was reported that phosphate export receipts in 2004 did not cover the cost of mining operations. There was no other income-generating activity in the country, other than subsistence fisheries, and little tourism potential on the island. At the first international donor meeting held in November 2005 several alternatives were proposed, including the development of commercial fisheries, in the hope of creating jobs and export potential. Expectations were raised when a fertilizer company from Australia indicated that it might provide assistance for phosphate-mining operations, at an estimated cost of $A6m.

Palau's macroeconomic stability depended on whether its trust fund, established under the first Compact (1994–2009) with the USA with a view to developing perennial support for annual budgets, would function successfully. From 2001 the annual fiscal deficit remained in double digits, reaching the equivalent of 12% of GDP in 2004. Remittances from tourism are seen as a potential source of financial support upon the expiry in 2009 of the Compact, under which inflows have covered 50% of the country's imports. Palau's current-account deficit was estimated at around 15% of GDP in 2004/05. Since Palau uses the US dollar as legal tender and its imports are mostly sourced from the USA, annual inflation has remained low.

From the mid-1990s Samoa's successful record of reform implementation earned the country the epithet of 'the darling of donors'. Prudent policies contributed to strong performance, facilitated by the fiscal surpluses, maintained during 1996–99; these were followed by modest deficits during 2000–04. In 2005 the fiscal deficit reached 0.9% of GDP, despite the large public expenditure programme for staging the South Pacific Games, scheduled for 2007. However, the current account, which recorded surpluses in 2003 and 2004, showed a deficit of 7.9% of GDP in 2005, with inflation reaching approximately 7.8%. From 2004 focus turned to the country's tourism potential, with substantial investment being made in hotel and resort construction, as well as with the introduction of new flights to Samoa in 2005, following the launching of a joint venture, namely Polynesian Blue, between national carrier Polynesian Airlines and Virgin Blue of Australia.

Solomon Islands experienced a slow but remarkable recovery from the aftermath of civil unrest and near-collapse of the economy during 1999–2003. Substantial aid inflows and technical assistance to the Ministry of Finance and key industries under the ongoing RAMSI subsequently enabled the restoration of fiscal stability. Donors funded approximately 55% of the recurrent budget and nearly 100% of capital budgets in 2004 and 2005. In 2003 the budget was in surplus at 8.3% of GDP, subsequently moving into deficit at 0.5% of GDP in 2005. The current-account balance, which includes official transfers, was in surplus in 2003 and 2004, at 1.4% and 1.1% of GDP respectively. In 2005 a deficit of 7.9% of GDP was expected. With persistent shortages continuing and subsistence agriculture making a slow recovery, inflation remained high, reaching 10% in 2002 and standing at around 7.0% in 2003–05. International creditors agreed a moratorium on the country's external debt-servicing obligations, with the expectation that the rehabilitation of the once-thriving company, Guadalcanal Plains Palm Oil, and other enterprises such as Gold Ridge Mining, would begin contributing to growth in the coming years. The implementation of prudent fiscal policies and the maintenance of law and order would be crucial.

Tonga faced severe fiscal difficulties during the early 2000s. Strike action by public-service workers resulted in salary increases of 60%–80%, as agreed in the terms of the settlement reached in September 2005. These increases were expected to cost the equivalent of 11% of GDP. Consequently, fiscal deficits appeared likely to rise in the coming years unless additional revenue-raising efforts were continued. A new 15% consumption tax was imposed on 1 April 2005, to replace the 20% ports services tax and 5% sales tax, with a view to avoiding discrimination between imports and local goods and services. However, the existing inefficiencies in tax collection were reported to have resulted in the annual loss of an estimated 20m. pa'anga. In addition, unprofitable state enterprises were being given financial support by the Government, and the resultant budget deficits (2.8% of GDP in 2005), led to monetary expansion. The annual rate of inflation remained high, rising to 10% in 2005. Furthermore, the country's international reserves were placed under increased strain, despite substantial annual inward remittances. Fiscal pressures such as those arising from the strike action by public servants, along with the protests by pro-democracy supporters, diverted the country's attention away from the implementation of the public-sector reforms initiated in 2002 and were likely to cause further set-backs to Tonga's economic progress.

Tuvalu, which demonstrated improved financial management in the early 2000s as a result of good administration of the islands' trust fund, nevertheless faced revenue losses as a result of declining sales of fishing licences and telecommunication licences and the reduction in income from the '.tv' domain name. The budget deficit in 2005 reached approximately 4% of GDP. The country's debt, all of which was derived from international funding agencies and was hence obtained on concessional terms, stood at 80% of GDP. Tuvalu, which uses the Australian dollar as its currency and which obtains most of its imports from Australia, recorded annual inflation rates of less than 3%. With an extremely limited range of exports, confined to copra and fish, an increase in the inflow of remittances would be needed to sustain the economy.

Vanuatu's fiscal position was strained from the late 1990s until 2003. Prudent fiscal policies and monetary management, however, enabled the country to restore budgetary discipline. The budget was in surplus in 2004 for the first time, although this was followed by a small deficit, equivalent to 0.3% of GDP, in 2005. The much-heralded Comprehensive Reform Programme, funded by the ADB and implemented over a period of several years beginning in 1998, proved unsuccessful, demonstrating that the country needed an incremental approach, rather than the sudden implementation of radical policies. Addressing the issues of poor governance and of the neglect of the rural sector, by means of income-enhancing infrastructure investment projects, might have been more beneficial. In August 2005 Fiji imposed restrictions on imports of kava from Vanuatu in retaliation for Vanuatu's ban on imports of biscuits from Fiji, thus breaching the provisions of the free-trade agreement signed by members of the Melanesian Spearhead Group (namely Fiji, Papua New Guinea, Solomon Islands and Vanuatu) and resulting in a decline in exports. Annual current-account deficits, meanwhile, had been rising since 2002. The current-account deficit in 2005 was equivalent to 6.1% of GDP. Political stability was required to guarantee the island's prospects for future growth, which were improved with major investment in infrastructure projects assisted by the US $65.6m. grant from the US Millennium Challenge Corporation.

Macroeconomic stability in the French and US territories has remained the responsibility of the respective sovereign nations. Two long-established tuna canneries continued to operate in American Samoa, a US-administered territory, which retains close trade relations with the USA. In 2004 the canneries employed 4,738 workers (38.6% of those engaged in the formal sector), paying an average hourly rate of US $3.60, and accounting for 24.5% of the territory's total wage costs. The American Samoan Government employed about 5,100 workers at an average hourly rate of US $7.99, and this represented 58.9% of the territory's total expenditure on wages in 2004. The third largest employer in American Samoa, the trade and services sector, accounted for only 8.3% of the total wage bill while employing 10.3% of all surveyed workers. The majority of American Samoa's exports of processed tuna are destined for the USA. The cost of the territory's imports far exceed the value of its exports, and the trade balance has been financed by the inflow of remittances from the US mainland and from Hawaii. Annual fiscal transfers from the US federal government support the territory's budget. American Samoa's natural constraints, namely its remote location, limited transport facilities and susceptibility to cyclones have hindered the island's development. Free mobility of labour within the USA has been significant in assisting American Samoa to overcome the disadvantages of being a small economy. The relative prosperity of the territory, compared with its western neighbour, Samoa, was reflected in its per caput GDP of US $9,000 in 2005. However, with the advent of free-trade arrangements, it was feared that American Samoa's canned tuna exports would no longer be competitive and that the two canneries might be closed down and their operations transferred to Asia, where labour costs are lower but from where access to the US market would remain favourable.

Guam, another US-administered Territory, has remained dependent mainly on US military activities on the island. In recent years tourism has emerged as a major contributor to the economy, with substantial investments in hotel construction and renovation having been made. In 2005 Guam received 1.2m. tourists, an increase of 5.8% compared with the previous year, and the sector was expected to benefit from the anticipated recovery in the Japanese economy; a record 1.8m. Japanese tourists were reportedly planning to travel to the island in 2006. In October 2005 it was announced that 7,000 US marines, along with their dependants, were to be relocated from the Japanese base of Okinawa to Guam over a six-year period. This would increase the number of military personnel stationed on Guam to more than 10,000 and would bring greater military spending to the island. Large-scale infrastructure programmes, including water supply and waste-management projects, were initiated. Total US grants facilitating such construction activities, as well as US federal government wage payments and procurements, amounted to US $1,300m. in 2004. With the expansion in military and tourism activities, Guam's GDP per caput was the highest of the islands in the region, at US $23,000.

The Commonwealth of the Northern Mariana Islands was granted special status under the Covenant Agreement signed with the USA, which entered into force in 1978. The tourism sector, with visitors coming mainly from the USA and Japan, employs more than 50% of the labour force and contributes about 25% of GDP. The garment industry was formerly a thriving sector. Two trade provisions assisted this industry's performance: quotas were imposed on imports of garments from other low-cost producers, and goods manufactured in the Northern Mariana Islands were exported to the USA tax free. Furthermore, with very few military installations and limited military spending, the Northern Mariana Islands benefited from the autonomous power to control immigration and determine minimum wage levels, thus contributing to economic growth. Under a new global trade regime effective from 1 January 2005, however, the USA removed import quotas for textiles and clothing. As the garment industry had already begun the process of consolidation, the sector experienced a decline in both production and exports. Furthermore, the Northern Mariana Islands' tourism industry suffered a serious set-back in October 2005 when Japan Airlines (JAL) discontinued its scheduled flights between Japan and Saipan. Japanese tourists had hitherto constituted almost 75% of total arrivals, with JAL carrying 40% of these travellers. JAL's decision resulted in a decline in the number of tourists by 29% in 2005. In that year the Northern Mariana Islands' per caput GDP was estimated at US $13,350.

The economy of French Polynesia was once dominated by military-related activities. When nuclear-testing facilities were scaled down in 1996, French Polynesia began focusing on tourism, pearl farming and deep-sea commercial fishing as sources of income. In 2005 GDP per caput was estimated at US $17,000, the second highest in the region, supported by official grants and inflows of private investment from France.

New Caledonia, which is another Pays d'outre-mer ('Overseas Country') of France, is believed to hold approximately 25% of the world's known nickel resources. Only a small proportion of land is suitable for cultivation. Therefore, New Caledonia is heavily dependent on imports for supplies of food and all other essential commodities. Financial support from France generally contributes more than 30% to New Caledonia's GDP, and French citizens, retiring to the island and forming a large percentage of the population, also make a significant contribution to consumption, an important component of GDP. In 2005 GDP per caput was estimated at US$ 15,000.

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

Norfolk Island is a territory of Australia. The tourism industry has experienced steady growth over the years to become the primary source of revenue on the island. The agricultural sector has become self-sufficient in the production of beef, poultry, and eggs. The island's exports consisted of postage stamps, seeds of the Norfolk Island pine and of the Kentia palm and also small quantities of avocados.

In a referendum held in February 2006 Tokelau, a self-administering territory of New Zealand, rejected proposals to establish a system of self-governance. Tokelau, with a population of just 1,500, relies heavily on aid from New Zealand—approximately $NZ4m annually—to maintain public services. Annual aid is substantially greater than domestic revenue derived from copra, postage stamps, souvenir coins and handicrafts. Inward remittances to families from relatives in New Zealand provide substantial financial support. GDP per caput was estimated at US $1,000 in 2005.

THE CHALLENGES FACING THE PACIFIC ISLANDS

In the latter part of the 20th century some Pacific Islands, particularly countries such as Vanuatu where little or no revenue was derived from direct tax on either personal incomes or company receipts, encouraged the development of offshore financial centres (OFCs). Following the attacks on the USA in September 2001, however, the Cook Islands, Nauru, Niue, Samoa and Vanuatu came under increasing scrutiny, owing to suspicions of money-laundering and other criminal activities, as well as possible links to terrorist organizations. Aware of the unsolicited adverse publicity, those Pacific Islands with OFCs made efforts to improve their image by conforming to the standards prescribed by the Paris-based Financial Action Task Force (FATF), the Organisation for Economic Co-operation and Development (OECD) and the IMF. In October 2005 Nauru became the last of the Pacific Islands to be removed from the FATF list of non-co-operative countries and territories. The region was aware that any islands remaining on the 'blacklist' would have faced sanctions, including the imposition of higher risk premiums on local firms when making transactions with international companies, the termination of correspondence alliances between local banks and banks based in OECD countries and the rejection of letters of credit issued by local banks.

The impact of OFCs on domestic economies, however, has been negligible. The previous labour-intensive methods of managing and transferring financial inflows outside their jurisdictions has become obsolete. With technological advancements, as many as 50 finance companies could be managed from just one office location. As a result, there was little impact on employment, and the main repercussions were limited to the increases in consumption expenditure that arose from imports of items such as air-conditioners, copying machines and computers. These institutions made no substantial domestic investment, as funds received were transferred elsewhere almost immediately. The Pacific Islands have become aware of the need to develop the local financial sector, with a view to encouraging domestic savings and investment, as well as attracting legitimate capital inflows. Furthermore, previously overdependent on OFC activities, Vanuatu needlessly resorted to indirect taxation as the sole means of raising revenue, on the assumption that OFC institutions would succeed only in countries that could provide true tax havens. Vanuatu therefore needs to consider the introduction of direct taxation on personal incomes and company profits, which would give a welcome measure of equity in taxation. Furthermore, revenue from import duties, hitherto the main source of income in the absence of direct taxation, was expected to decline following the implementation of the WTO trade liberalization programme. This, accompanied by the prospect of expanded free-trade provisions under the proposed regional integration process, meant that the Vanuatu Government needs to identify new avenues for mobilizing the country's resources.

Increased globalization and the new environment of freer trade under the auspices of the WTO have provided further challenges. Widening trade deficits in the Pacific Islands have required additional efforts to explore new export items and to develop niche markets for exclusive products such as nonu juice, bottled natural water and off-season fruits and vegetables, for example squash sales to the northern hemisphere. The need for greater promotion of the tourism industry has also been acknowledged. Furthermore, the EU planned to terminate trade agreements for preferential treatment of the products of the Pacific Islands by 2007, and the Sugar Protocol governing Fiji's exports to the EU under the Cotonou Agreement, which was signed in 2000 and ratified in 2003 by 77 African, Caribbean and Pacific (ACP) countries, was also due to expire. As a result, the Pacific Islands needed to restructure their existing export industries, including sugar and tuna processing, in order to compete with the rest of the world for access to EU markets. The Cotonou Agreement was to be replaced by a new agreement, known as the Economic Partnership Agreement (EPA) for the Pacific Islands, on condition that the islands should accelerate and promote regional integration along similar lines to those of the Melanesian Spearhead Group trade agreement. Meanwhile, access to Australian markets under the South Pacific Regional Trade and Economic Co-operation Agreement (SPARTECA) was becoming less significant, as Australian tariffs on imports of products such as copra, coconut milk and cream and other agricultural products from cheaper sources in other regions were also being reduced. Faced with ever-increasing competition from rival economies in Asia, the Pacific Islands needed to respond quickly, restructuring their economies and improving their negotiating position. Having found themselves unable to attract substantial foreign direct investment in the immediate past, they sought to co-operate and offer an assured regional market of 7m. consumers

Following the EU's offer of an EPA for promoting regional integration and improving their production capabilities and marketing skills, in 2003 the islands of the region signed a Pacific Island Countries Trade Agreement (PICTA) to establish a free-trade area among the 14 Pacific Islands by 2010. It was decided that Australia and New Zealand, the two advanced member countries of the Pacific Islands Forum, the regional organization involved, were to be excluded from the free-trade area. The Pacific Islands were clearly concerned about the prospect of the immediate removal of trade barriers and the impact that this would have not only on local consumer goods industries but also on government finances from the resultant loss of tariff revenue. The Pacific Islands believed PICTA to be a move towards a closer relationship with the two advanced members of the Forum, including free trade in goods and services as well as mobility of labour, and Australia and New Zealand tacitly agreed. However, these two countries were successful in persuading the Pacific Islands to sign another agreement known as the Pacific Agreement on Closer Economic Relations (PACER). PACER obliged the Pacific Islands to begin negotiations with Australia and New Zealand by April 2011. If during the negotiations on EPA any Pacific Island were to establish reciprocal trade relations with the EU, tantamount to a free-trade area, PACER would take effect prior to 2011.

Frustration and disappointment with the poor progress made in the implementation of structural reforms led Australia and New Zealand to reconsider their approach. The 2001 terrorist attacks on the USA imposed new responsibilities on Australia to attempt to secure the Pacific region against the newly emerging threats of terrorism, as well as against the existing risks of money laundering and weapons dealing. Moreover, ethnic strife and civil disorder in Solomon Islands from the late 1990s and the overthrow of an elected Government in Fiji in 2000 caused further concern in Australia and New Zealand.

In July 2003 an Australian Senate Committee report on Australia's relations with Pacific Island states recommended the establishment of a Pacific Economic and Political Community along the lines of the EU. The Committee also considered the possibility of adopting a common currency, preferably the Australian dollar, for the purposes of promoting fiscal and monetary discipline in the region. The Prime Minister of Australia proposed the idea of a single regional currency at the Pacific Islands Forum Leaders' Meeting held in Auckland, New Zealand, in August 2003. The subject was not included in the agenda and was therefore not formally discussed, but the indications were clear: in the event of further regional integration in the medium- to long-term future, 'dollarization' would be given due consideration.

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

A more practical solution would be to enter into a free-trade arrangement with Australia and New Zealand immediately. Although there would be a loss of revenue and higher adjustment costs involved, these losses would be significantly lower than if PACER, and the subsequent adjustment required, were postponed until after 2011. However, during the interim period, free-trade arrangements with Australia and New Zealand would discourage trade solely between Pacific Island producers, rendering obsolete the region's capacity to produce goods locally, for example biscuits, beer and cigarettes in Fiji. Some observers have suggested that a compromise should be agreed during the negotiations on free trade permitting skilled workers from the Pacific Islands to seek employment in Australia and New Zealand, and granting a limited number of temporary work permits each year for unskilled workers to be employed in those countries at times of labour shortages.

Partly in response to the problem of the overwhelming complexity of the trade agreements, in 2003 an Eminent Persons Group appointed by the Pacific Islands Forum travelled around the region, meeting numerous leaders from different sectors, and prepared a Pacific Vision report. The Pacific Island leaders met in Auckland in April 2004 to consider the Group's report, on the basis of which they agreed to develop a Pacific Plan. The Pacific Plan Task Force (PPTF) was also established, with specific terms of reference. Consultation procedures began and a time frame for preparing a draft document was agreed. The final document was presented to the Pacific Island Leaders' Meeting in Port Moresby in Papua New Guinea in December 2005.

The Pacific Plan was based upon four objectives: economic growth, sustainable development, good governance and security. Specifically, with regard to economic growth, the Pacific Plan sought to integrate trade in services, including temporary provisions for the movement of labour during the course of PICTA and PACER negotiations, and to develop the capacity for bulk-purchasing of essential items such as fuel and medicines. While the latter had been on the agenda since 197 without any progress, the inclusion of trade in services indicated the willingness of the Pacific Islands to consider deeper integration on the right terms. Consequently, the two advanced Forum member countries were obliged to consider relaxing immigration laws for temporary workers from the Pacific Islands seeking employment in Australia and New Zealand on farms and in other unskilled positions that could not be filled by local workers, a situation that had resulted in shortages of manual labour.

The 2005 White Paper entitled 'Australian Aid: Promoting Growth and Stability' made it clear that immigration policies would not be changed to accommodate the Pacific Islands' requests for greater mobility of unskilled labour. However, the White Paper confirmed the proposal put forward by the Australian Prime Minister at the Annual Pacific Islands Forum Leaders' Meeting held in October 2005 for establishing an Australia-Pacific Technical College. It was envisaged that the college would train Pacific islanders in vocational and technical skills, preparing them to contribute to the economies of the Pacific Islands and thus addressing the current shortages in the region. Furthermore, as they would be trained in accordance with Australian standards, the graduates from the proposed college would become qualified as skilled workers and would then meet the requirements of the international labour market in general and Australia in particular.

Greater involvement by Australia and New Zealand in the region addressed the second, third and fourth objectives of the Pacific Plan. Expert advice on financial management and public-sector reform was provided, in addition to assistance in strengthening legal infrastructure. A prosecution service was inaugurated in Fiji, and those involved in the 2000 coup were brought to trial. RAMSI was established to restore law and order in Solomon Islands (see above).

In June 2005 the ACP-EU Council of Ministers held a summit meeting in Papua New Guinea to discuss the progress on finalizing EPA with each regional group. The meeting adopted a new financial protocol and determined the precise allocation of €23,700m. in development assistance, which was to be provided over the period 2008–13 and represented a 35% increase in funding in comparison with the preceding ninth European Development Fund. The European Commission also proposed that the Pacific Islands should have access to further €500m. (US $650m.) in development assistance funds. Special reference was made to the Cook Islands, Samoa and Tuvalu for successfully implementing their national-regional programmes, resulting in the allocation of additional EU funding following mid-term reviews.

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