

# ECONOMIC TRENDS IN THE PACIFIC ISLANDS

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## INTRODUCTION

Political uncertainties have continued to affect the economies of the Pacific Islands. In December 2006 the elected Government of Fiji was ousted in a coup, the country's fourth in 20 years. Despite the much-heralded commitment to a return to democracy, by the latter part of 2008 the interim administration of Cdre Frank (Voreqe) Bainimarama appeared unlikely to fulfil its promise to conduct elections in March 2009. Australia and New Zealand, which remained the major aid providers and trading partners of Fiji, along with the USA, were insisting on the holding of elections in early 2009. However, in contrast to the uncompromising approach of regional metropolitan powers, in June 2008 the European Union (EU) dispatched a delegation to hold discussions with the Fiji Government. Fiji's response to the EU was possibly more conciliatory, as the latter was threatening to withhold some €160m. in aid, intended for the restructuring of Fiji's declining sugar industry and to be disbursed over a period of six years.

Following the conclusion of elections in April 2008, when pro-democracy candidates won the majority of seats, Tonga witnessed the coronation of King Tupou V in August. In September 2008 Ham Lini, the longest-serving Prime Minister of Vanuatu in recent times, was replaced by Edward Natapei after the country's legislative election. In 2008 Papua New Guinea's Prime Minister, Sir Michael Somare, indicated that he might relinquish his post, but the veteran politician would leave a lasting legacy and a flourishing economy, in part resulting from the recent global commodity boom, combined with an improvement in terms of trade and the emergence of a stronger national currency. A change in the leadership of Solomon Islands in December 2007, when Derek Sikua replaced Manasseh Sogavare as Prime Minister, marked the beginning of a new period of better relations with Australia, which had been supporting the country since 2003 through the Regional Assistance Mission to Solomon Islands (RAMSI).

The defeat of Australian Prime Minister John Howard at the parliamentary election of November 2007 and his replacement by Kevin Rudd also heralded a new phase in relations between Australia and the Pacific Islands. In March 2008, after discussions with Papua New Guinea leaders, Rudd announced a new policy framework, known as Pacific Partnerships for Development. Dubbed the Port Moresby Declaration, the new policy stated that Australia would work closely with island governments to help them meet the UN's Millennium Development Goals (MDGs—adopted by the member states of the UN in September 2000). In particular, aid programmes would specifically aim at improving economic development and enhancing local employment opportunities through infrastructure projects and broadly based growth. Australia's aid to Pacific Islands was increased in 2008. Total aid over the subsequent four years, for the improvement of services such as transport, sanitation, waste management, energy and communications, was projected at \$A127m. About \$A5.5m. was allocated for 2008–09. In addition, under a separate Public Sector Capacity Project, \$A107m. was to be spent during the next four years, with \$A6m. in 2008–09 being allocated to the strengthening of public administration, including management and policy reform.

While Australian aid to Fiji was maintained at the 2007 level of \$A26.9m., without any increase in 2008–09 on the grounds that a return to democracy would be a pre-condition for any rise in the following three years, aid levels for good performers, including Samoa, Solomon Islands, Tonga and Vanuatu, were revised upwards. Following its strong economic performance during 2006 and an expansion of exports in 2007, Vanuatu (which benefited from a grant of US \$66m, awarded under the US Millennium Foundation Programme) was to receive \$A51.8m. from Australia in 2007–11. Australian aid to Samoa was to be increased to \$A28.3m., reflecting the country's strong management and ongoing reform efforts.

New Zealand, where a parliamentary election was scheduled for late 2008, announced a new Pacific development strategy with regard to bilateral aid. This more focused approach to regional programmes envisaged expenditure in excess of \$NZ2,000m. over an eight-year period. New Zealand's official development assistance to the Pacific Islands would amount to 70% of its total bilateral aid. The aid allocations were expected to make a substantial impact on the improvement of health and education in the Pacific; to address infrastructure shortcomings and to promote economic growth; and to improve governance and leadership.

Meanwhile, international donors' attention focused on the 'arc of instability' in the South-West Pacific region, the most disturbing aspect being the stalemate in Fiji and the possible addition of Fiji to the list of 'failed states'. It remained to be seen whether Fiji, which was not only a major Pacific Island country with far more skilled human resources and greater manufacturing capacity than others, but was also the location of the secretariat of the 16-member Pacific Islands Forum, would continue to be in a position to play a leading role in promoting the regional integration of island states. Fiji had been active in ongoing efforts towards the establishment of a Pacific Island free trade area by 2010. It also seemed uncertain whether Fiji would be a credible partner in the implementation of the much-heralded Pacific Plan approved by the Forum in 2005, let alone in leading negotiations with Australia and New Zealand aimed at the creation of a larger free trade area by 2015, to comprise the 14 Pacific Island members and the two metropolitan powers.

Since 2000 political uncertainties, 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 UN's MDGs. 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 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.

In the context of 'significant concerns of security and stability, especially in Melanesia', in early 2007 the Australian Minister for Foreign Affairs announced changes in aid policy, conceding that some of the formulas of the past had not been as 'good and as successful as hoped'. Noting that recent average population growth rates in Papua New Guinea, Solomon Islands and Vanuatu had been 2.5% per year or higher, that more than 40% of the population of Solomon Islands was under 15 years of age and that the incidence of HIV/AIDS in Papua New Guinea was increasing, with the percentage of the population affected projected to rise from 2% to 10% by 2025, Australia was considering ways of refocusing its aid to

the Pacific Islands. Accordingly, this change in emphasis was reflected in regional aid flows, with more Australian assistance allocated to South-East Asia in the 2007/08 budget than to Papua New Guinea and the other Pacific Islands. The total figure for the Pacific Islands was \$A872m., compared with \$A970m. for South-East Asia, with Indonesia overtaking Papua New Guinea as Australia's largest aid recipient.

This apparent change in aid policy was not unexpected. Only very recently an Australian non-governmental policy institution, the Centre for Independent Studies (CIS), had 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 empirical findings 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.

Against this background of declining aid and the inability of the smaller Pacific Islands, including Kiribati and Tuvalu, to take advantage of the greater access to overseas markets offered by trade agreements with other Pacific Islands and the EU, owing to their negligible manufacturing capacity and limited natural resources, emerging trends in remittance inflows led the World Bank to examine the export to Australia and New Zealand of unskilled Pacific islanders as seasonal agricultural labourers on temporary work permits. A World Bank report entitled *At Home and Away: Expanding Job Opportunities for Pacific Islanders Through Labour Mobility*, published in 2006, recommended the introduction of pilot schemes on a trial basis, observing that labour mobility 'could make a significant contribution towards enhancing economic and social stability in the region'. A survey report of households in Fiji and Tonga found that (i) 90% of households surveyed in Tonga received remittances in comparison with 43% of households in Fiji; (ii) Tongan households received an average of US \$3,067 compared with US \$1,328 in Fiji; (iii) remittances per caput amounted to US \$371 in Fiji and US \$753 in Tonga; and (iv) remittances approximated to \$F300m., equivalent to 6.2% of gross domestic product (GDP) and 8.3% of exports, in Fiji, while the corresponding figures for Tonga were 42% of GDP and 152% of exports. Citing the successful experiences of a similar scheme in Canada, recruiting seasonal agricultural workers from the Caribbean and Mexico, the World Bank report observed: 'A scenario of both skilled and unskilled moving in a circular fashion, generating financial flows as well as serving as conduits of social change, is likely to be the most development friendly (model) for the Pacific.'

The Australian reaction was, as expected, not very enthusiastic. The country's views did not differ from those already expressed in a 2005 White Paper entitled 'Australian Aid: Promoting Growth and Stability'. The White Paper made it clear that immigration policies would not be changed to accommodate the Pacific Islands' requests for greater mobility

of unskilled labour. A 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 was further pursued in 2006–07 with investment in the selected Pacific Islands, including Fiji. 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.

The CIS was critical of the proposed guest worker scheme. A study released soon after the World Bank report, while observing that Pacific islanders should continue to be welcomed as long-term immigrants to Australia and New Zealand, pointed to past experiences demonstrating that integration becomes more problematic as selectivity is diluted. The CIS study expressed the view that a guest worker scheme should not move away from proven immigration models, noting that Pacific Island migrants in New Zealand were generally less well integrated into the economy and society than those in Australia (which employed selection criteria for immigrants), with most remaining 'geographically segregated into the second and third generations', living in 'highly concentrated communities in Auckland', and some also 'highly concentrated in a few low skilled occupations'. It was suggested that easier access to welfare in New Zealand and the generally higher level of skills possessed by migrants in Australia were 'key factors in the difference between the behavioural characteristics' of Pacific islanders in both countries.

Directly referring to the World Bank report, the CIS study asserted that the World Bank's 'pressure on developed countries to accept more immigrants, regardless of costs and benefits, follows its abandonment of the key role of growth in development in favour of welfare, including the international redistribution of income through aid'. The CIS study's authors, Professor Helen Hughes and Gaurav Sodhi, believed that Australia's agricultural industry should look first to unemployed rural aboriginal communities as potential workforce and that the recruitment of 'those unemployed and those not in the labour force but able to work' would remove the requirement for guest workers in New Zealand.

However, New Zealand's official reaction to the World Bank's proposals was positive and favourable. Under intense pressure from the farming interests in the country to meet shortages in seasonal labour availability for fruit picking and packaging, the Government ventured to launch pilot schemes, in consultation with Pacific Island countries, with a view to recruiting around 3,000 unskilled farm labourers over a period of three years. Owing to its political situation, Fiji was excluded. Vanuatu was the first beneficiary. Officially designated as the Recognized Seasonal Employer scheme (RSE), the programme was initiated by the Prime Minister of Vanuatu in April 2007, when 104 workers left for New Zealand.

According to the Vanuatu Government, the New Zealand Government granted entry to the total of 300 workers permitted under the RSE scheme during 2007, and it was likely that as many as 1,600 Vanuatu citizens would be allowed to enter as seasonal workers in 2008. It was expected that foreign-exchange earnings from the RSE scheme would be second in importance only to tourism receipts. The operators of New Zealand's vineyards and orchards welcomed the scheme as a great success. Similarly, Australian farmers renewed requests to their Government for the introduction of a comparable scheme to meet their shortage of seasonal farm labour. The Government of Kevin Rudd, which took office in late 2007, announced that it would give favourable consideration to a scheme providing for guest workers from the Pacific Islands to work on farms after assessing the first year of New Zealand's experience in this regard.

**RECENT DEVELOPMENTS**

The modest performance of many of the Pacific Islands in the early years of the new millennium was a cause for concern. Fiscal excesses and governance problems compounded constraints on growth. The remoteness and insularity of the region, which comprises widely dispersed multi-island micro-states, combined with the distance from major markets, resulted in high international and domestic transport costs. In addition to the problem of low volume of cargo, the development of even a small domestic market was constrained by the distances between settlements and the infrequency of internal transport services. The Pacific Islands' susceptibility to natural disasters and adverse climatic conditions typically had a negative impact upon crop yields, thus affecting the entire region's economy. The relatively small populations of the islands reduced their institutional capacity, which in turn increased the unit costs of services and restricted the potential for private sector growth and investment. Scope for diversification was 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 developments and to environmental factors.

High volatility in petroleum prices in 2006–07 adversely affected the public finances and foreign-exchange reserves of the Pacific Islands. Fuel prices rose significantly from late 2007, while trade deficits continued to expand. The world-wide phenomenon of rising petroleum prices resulted in higher import bills, with corresponding increases in business costs and household expenses. The high rate of inflation was unprecedented in many of the islands, thus reducing the purchasing power of households. Furthermore, air travel became increasingly expensive; this had an adverse impact on tourism, upon which many of the Pacific Islands are highly dependent. On the other hand, Papua New Guinea, which is both a producer and refiner, benefited from the rise in world petroleum prices in 2008. The country was also able to take advantage of increasing prices for other minerals, including copper and gold.

While most Pacific Islands, including Samoa and Tonga, had to draw down their international reserves in order to pay for the higher import bills, Solomon Islands and Vanuatu managed their reserves better because of larger aid inflows. Samoa, Tonga and Fiji had to resort to tighter monetary policies to reduce consumption with a view to conserving their reserves. The disadvantage of such policies was the negative effect on domestic investment, which was discouraged by higher interest rates. The adverse impact of higher petroleum prices once again highlighted the need for the Pacific Islands to introduce alternative sources of energy, including solar and wind power and biofuels. A coconut oil-diesel fuel blend was being promoted as a biofuel substitute for electricity generation in Vanuatu and Samoa.

With favourable world prices for its commodities, Papua New Guinea's economy thus continued to perform well. Among other Melanesian economies, Vanuatu surprised observers, registering robust growth rates in 2005–07.

Fiji recovered from the aftermath of the 2000 coup with remarkable speed. The economy recorded steady growth, but in the process incurred substantial fiscal deficits. Despite the political uncertainties that preceded the coup of December 2006, Fiji's economy was reported to have recorded GDP growth of 3.4% in that year; however, GDP was estimated to have contracted sharply, by 6.6%, in 2007. Exports have declined in recent years and imports, especially of fuel, have increased, resulting in large trade deficits. Although remittances (estimated at about US \$300m. annually) helped to sustain the economy, reported efforts by New Zealand to stop Fiji's armed forces being used as UN peace-keepers in the Middle East and elsewhere did not augur well. A contraction in sugar production, the closure of the country's gold mine and a reduction in garment exports, following the abrupt discontinuation of the US quota for Fijian garments, compounded the problem of rising current account deficits from 2004. The

immediate prospects of any revival of the declining sugar exports before the phased withdrawal by 2010 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, by contrast, benefited from the favourable external conditions that prevailed from 2005. The oil and gas sector registered growth of 11.0% in 2005, as supply responded to rising international prices. Two new gold mines were opened in 2006. In addition, the agricultural sector performed well, achieving increases in output of several exportable products, including coffee, which benefited from higher world prices. Low interest rates were primarily due to a commendable fiscal performance, with a budget surplus equivalent to 2.5% of GDP recorded in 2007. The world-wide commodity boom in 2007 contributed in a substantial measure to the country's good performance. Its GDP growth rate in 2007 was among the region's highest, at 6.2%, compared with 2.6% in 2006. Increased global prices and high demand for commodities was likely further to raise Papua New Guinea's growth in 2008, when the rate was forecast to exceed 7%. The challenge for the authorities was how to utilize the increased export earnings in improving roads and communications, educational opportunities for children and health facilities.

Solomon Islands maintained its economic recovery. GDP continued its steady expansion, with the growth rate reaching 6.1% in 2006 and 10.3% in 2007; this was a remarkable performance in comparison with the contraction experienced during 2000–02. Most of the expansion was due to strong performance in the areas of agriculture, construction and trade (both in the wholesale and retail sectors). Exports of logs rose to a new high point of some 1.1m. cu m in 2006, considered to be an unsustainable figure. Log exports accounted for about 66% of total commodity exports in that year, contributing 10% of GDP and 14% of tax revenue. The budget deficits remained low, equivalent to 1.1% of GDP in 2007. With appropriate policies in place and support from Australia under RAMSI, the economy grew strongly in 2007, at a rate of 5.4%. The country was also approached by Taiwan (much to the dismay of China), following the appointment of the new Prime Minister, Derek Sikua. Taiwan offered to complete the multi-million dollar parliament building in Honiara, initially funded by the USA, on condition that the country hosted the Taiwan-Pacific Allies Summit meeting in 2009.

Vanuatu recorded GDP growth rates of 5.0% in 2005, 7.2% in 2006 and 6.6% in 2007. Furthermore, revised national accounts data had indicated that growth in past years had been much higher than previously reported. These favourable developments, a sharp contrast to the contractionary conditions that had prevailed during 2001–02, were a result of strong growth in the tourism sector, facilitated by the introduction of additional flights to Vanuatu by Pacific Blue, a newly launched airline, and a recovery in construction activity. Vanuatu's steady performance was expected to continue in 2008.

The economy of the Polynesian country of Samoa, which achieved growth of 4.1% in 2005, decelerated in 2006 when GDP growth was estimated at 1.9%, increasing by 6.1% in 2007. Expansion in the agriculture and fisheries sectors along with hotel construction activities, which were encouraged by the Tourism and Hotel Development Incentive Act of 2003, contributed to steady growth. However, the subsequent scaling down of production activities by Yasaki Samoa (a Japanese firm that since 1992 had been manufacturing automotive harness products in its Apia plant, taking advantage of Samoa's cheap labour), as well as a decrease in agricultural output, were the main reasons for the decline in the rate of growth. Nevertheless, the construction and activities related to the staging of the 13th South Pacific Games in September 2007 helped to halt the decline. Samoans resident overseas continued to send remittances, which can form as much as 25% of the country's GDP.

Tonga, another Polynesian country, endured turbulent times from 2005, when mass movements for greater democracy developed; strike action by civil servants lasted for more than a month. GDP contracted by 3.3% in 2005, but expanded by 4.4%

in the following year, before contracting again, by 0.3%, in 2007. In late 2006 the capital of Nuku'alofa was severely damaged during rioting. The lacklustre performance of 2007 was also attributable to a decrease in export prices for pumpkins and a decline in Tonga's tuna catch. Despite a rise in inward remittances, which accounted for about one-half of the country's GDP, the current account deficit widened, reaching 9.1% of GDP in 2007, which contributed to a decline in official reserves. The fiscal position also deteriorated, as a result of an agreement with the civil service union to raise salaries by 60%–80% in 2005. The rioting of 2006 resulted in the destruction of many businesses in Nuku'alofa. A decrease in tourism and in commercial activities followed in 2007. However, a large inflow of remittances from Tongans working in New Zealand and in the US state of California helped to sustain the economy; such remittances formed about 45% of GDP.

Elsewhere in Polynesia, economic growth in the Cook Islands in 2007 was far better than in the previous year, when GDP had increased by just 0.7%. The growth of 1.3% in 2007 was sustained by the tourism sector. The improvement in tourism receipts was reflected in a rise in bank lending to the trading and retail sectors.

The economy of Kiribati was reported to have contracted by 5.2% in 2006. GDP expanded by just 0.5% in 2007, with a similar rate of growth being anticipated for 2008. Kiribati experienced a steady 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. Kiribati depends heavily upon its fisheries resources and seafarers' inward remittances for sustaining levels of national income. Remittances, tuna fishing licence fees, and earnings from the Revenue Equalization Reserve Fund (RERF—an offshore investment fund established with royalties from discontinued phosphate-mining operations) formed 45% of GDP.

The Marshall Islands attained a growth rate of 1.3% in 2006, compared with 1.7% in 2005. GDP was reported to have expanded by 2.0% in 2007. Under the new financial agreement (2004–29) 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 country was also seeking speedy compensation from the USA for the displacement of local citizens by a missile test. The compensation, worth some US \$475m., included the sharing of power, water and sewer lines on Kwajalein Atoll.

The GDP of the Federated States of Micronesia continued to decrease in 2007, when it contracted by 3.2%, following declines of 2.3% in 2006 and of 0.6% in 2005. The country receives aid from the USA, under the second Compact of Free Association, amounting to US \$92m. annually, with the requirement that initially a total of \$16m. be saved in a trust fund. US grants constitute about 40% of GDP. Contraction in public sector activities was responsible for the decline in growth, as the new requirement of mandatory savings in the second Compact forced the Government to reduce spending.

Nauru has experienced increasing economic difficulties, particularly since the decline of the island's phosphate resources in the late 1990s. With Australia's closure in 2008 of the offshore processing centre for asylum-seekers, which had provided some income to offset the loss of earnings from phosphate-mining activities, the country's future appeared 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. Efforts towards reviving phosphate-mining activities by repairing mine infrastructure were under way. An Australian company had been successful in its investment, resulting in the revival of phosphate exports. However, in mid-2007 phosphate exports were suspended for several months following storm damage to port infrastructure. Consequently, according to the Asian Development Bank (ADB), GDP contracted by 26.8% in that year, in comparison with growth of 5.5% in 2006. It was apparent that

Nauru could no longer rely on phosphate mining alone, as primary phosphate reserves were not expected to last beyond 2010. In the absence of any new productive activity, GDP growth was forecast to decline by 2.4% in 2008.

In 1994 Palau 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 5.9%, 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. Palau continued its progress in 2006, with another solid growth rate of 4.8%, owing to a further increase in tourist arrivals, resulting from improvements in air services, as well as from the construction of new hotels. Owing to the weakening of the US dollar, tourism arrivals from Europe and South Korea rose in 2007 by 13% and 21%, respectively. Hotel and retail sector activities showed strong growth; with the construction of two resorts and a hotel, Palau has now emerged as an attractive tourist destination in the north Pacific. GDP increased by 2.1% in 2007.

Tuvalu experienced a deceleration in economic growth during 2001–05, the highest annual growth rate, of 13.4%, having been recorded in 2000. 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 estimated at 1.0% in 2006 and 2.0% in 2007. 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. Meanwhile, there was a rise in public expenditure to fund, for example, the construction of the Funafuti power station and the upgrading of the Tuvalu Maritime Training Institute. Remittances from Tuvalu's seamen working on foreign vessels on long contracts have been rising in recent years, providing much-needed foreign exchange to the country, which has no commodity exports of any kind. New construction activities, including a parliament complex, a new police station and prison, as well as refurbishment of the existing port in Funafuti, were expected to stimulate growth in 2008.

#### 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, including earthquakes and tsunamis, 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 address 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 are unable to influence world markets significantly, given their relatively small contribution to global commodity trade, and external economic conditions remain 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 reduced its overall fiscal deficits over the three-year period 2001–03 and achieved budget surpluses in 2004–06. Improved tax collection and effective budgetary control measures largely contributed to fiscal discipline. In this disciplined environment, interest rates decreased. At 0.9%, inflation also remained low in 2007, before rising sharply in 2008, when it was expected to exceed 9%. Prudent fiscal management and significant increases in commodity prices in 2007 and 2008 helped to improve the public debt position. Public debt declined from 80% of GDP in 2002 to 40% in 2006 and 35% in 2007, and was expected to decrease further in 2008–10. Favourable commodity prices also resulted in an improvement in export earnings, thereby enabling Papua New Guinea to continue recording current account surpluses in 2005, 2006 and 2007. The national currency is based on a floating exchange rate regime, and the kina has remained strong, appreciating against major currencies. Increases in international reserves and the strength of the currency provided an environment conducive to investment. Meanwhile, a US \$10,000m. liquefied natural gas (LNG) project, undertaken by a consortium led by ExxonMobil, was expected to provide further stimulus to the economy. The international rating of government bonds also improved as a result of the major investment, Papua New Guinea's large natural base, low external debt and improving public finances. Analysts reiterated that the increased revenues earned from commodities in 2007 and 2008 should be appropriately invested in physical, health, education, and urban policing infrastructures.

Fiji, which implemented aggressive counter-cyclical measures to address the decline in private investment that followed the 2000 coup, experienced fiscal deficits throughout the period 2001–06, equivalent to 4.0% of GDP in the latter year. Borrowing from the public and from institutions, including the Fiji National Provident Fund, financed these deficits. Public debt rose from \$F2,487m. in 2005, constituting 54.0% of GDP, to \$F2,979m. in 2006, or 58.5% of GDP. The prevailing excess liquidity in the banking system during 2000–05 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 (before reaching 4.8% in 2007 and rising significantly in 2008) 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 as a result of poor export performance, compounded by the decline in garment exports that followed the ending of the US quotas for Fiji's garments under the Multi-fibre Arrangement. In 2005 the current account deficit reached the equivalent of 17.1% of GDP, despite an exceptional performance by the tourism sector and the rise in inward remit-

tances 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 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%. Following a further rise by one percentage point in June 2006, the rate stood at 4.25%. The discount rate, also known as the minimum lending rate, was raised to 5.25%. In addition, 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. In the context of dwindling foreign reserves (from the equivalent of 5.6 months of import cover in 2004 to 4.0 months in 2005 and 3.7 months in 2006) and the 'drying up' of excess liquidity in the domestic banking system reflected in the rise in domestic interest rates, in September 2006 Fiji successfully carried out its first-ever international bond issue in Singapore for US \$150m. As a result, international reserves increased immediately. However, with imports surging, the pressures on foreign reserve levels continued to mount. After the military coup in December 2006, the macroeconomic situation deteriorated further. In mid-2007 Fiji was in dire straits. Rumours of a devaluation were circulating, as Fiji's international reserves continued to decline and the trade deficit widened with a contraction in export activities.

Nevertheless, the interim Government managed its finances relatively well in 2007. The wage bill and public spending were both reduced, by 9.7% and 28.2%, respectively. So too were transfer payments, by 16%, and capital expenditure, by 45%. Even though revenues declined as the economy contracted, owing to poor investment conditions, reductions in spending produced a budget surplus of around 0.4% of GDP. Total public debt stood at 50.3% of GDP, well above the targeted level of 45% of GDP. Domestic debt reached about 86% of total debt, while external debt was 14%. External debt service expenditures as a ratio of total exports was 3%. A stringent monetary stance adopted by Reserve Bank of Fiji, along with credit 'ceilings' and imposition of exchange controls since early 2007, contributed to exchange rate stability. In late 2007 there were enough foreign-exchange reserves to cover more than four months of imports. Improvements in foreign reserves were mainly due to better-than-expected performance in the tourism sector, despite adverse publicity following the coup and foreign government advisories against travel to the islands. Tourist arrivals reached 539,255 in 2007, compared with 545,168 in 2006, according to provisional estimates. Remittances in 2007 remained at the same level as those in 2006 (F \$247m.). Fiji thus remained one of the 10 leading recipients of remittances in the Asia-Pacific region. Despite these favourable trends, the Corruption Perception Index, released by Transparency International after a survey conducted in late 2005, ranked Fiji 55 out of 165 countries studied. The ratings of Standard and Poor's, a leading credit assessment agency, continued to reflect Fiji's continuing political uncertainty and weak economy.

Taking advantage of the strained political relations between Fiji and the two metropolitan neighbours, China announced rises in aid to Fiji for 2007 and 2008. In 2005 China's aid to Fiji was only US \$1m., but by 2007 grants and loans had increased substantially, to reach US \$167m. This represented more than one-half of China's total annual aid to the entire Pacific region and was much higher than the total of Australian aid pledged to Fiji in 2007–08. Chinese aid to Fiji includes low interest loans of US \$150m. for the purposes of infrastructure and squatter-resettlement programmes. China's assistance to Fiji, as well as assistance to other countries in the region (such as the rebuilding of Nuku'alofa following the rioting in Tonga), has caused concern among US authorities, owing to the fact



that Chinese aid is without preconditions relating to issues such as improvements in human rights and governance.

In the Cook Islands a fiscal surplus, equivalent to 2.1% of GDP, was achieved in 2006. This surplus rose to 3.6% in 2007, owing to improvements in revenue collection and to the general buoyancy of the economy. 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. In June 2006 the Government settled an external debt incurred in the 1990s to fund a hotel project as part of efforts towards reducing the country's debt level by 50%. The islands also witnessed a revival of the tourism industry, with tourist arrivals rising by 5.7% in 2006. Much of this was attributed to the introduction of new flights, operated by Pacific Blue from Christchurch, New Zealand. Pearl exports decreased in 2006. Inflation remained relatively low, at 2.4% in 2007, since the majority of imports were purchased from New Zealand, which had also been experiencing a low level of inflation. However, inflation increased in 2008. Furthermore, the fiscal position of the Government was at risk, as revenues declined owing to a reduction in import duties, while cyclone rehabilitation expenditures raised public expenditure. The cost of living adjustments during 2008 and the extent of a subsidy provided to Air New Zealand for bringing passengers to Rarotonga from Los Angeles were expected to determine the budget position in 2008.

Kiribati's fiscal position was a continuing cause for concern. The country's fiscal deficit reached its highest level for several years in 2006, when it stood at 26.0% 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. If the value of the RERF 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 traditionally remained low. However, inflation reached 3.8% in 2007 and was expected to exceed 5% in 2008.

In the Marshall Islands, the fiscal position remained precarious, with little growth in revenues. The budget deficit in 2007 was 0.7% of GDP. Inability to meet debt obligations has created greater difficulties. In 2007, the net present value of debt-to-GDP ratio was estimated at 75% and the debt-service ratio as a share of exports at 32%. With the closure of the country's tuna-processing plant in 2000, exports were on the decline. 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, inflation remained low, before reportedly rising sharply in 2008.

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. The fiscal deficit stood at 16.0% of GDP in 2004, but decreased to 5.3% in 2005, largely as a result of Chinese bilateral grants, and reached 5.5% in 2006. The federal budget deficit decreased further in 2007. Inflation also decreased from 4.7% in 2006 to 3.2% in 2007, but was expected to rise in 2008.

Nauru's macroeconomic prospects remained weak. Phosphate mining, upon which the economy had previously been dependent, was declining as resources became depleted. It was reported that phosphate export receipts in 2004 did not even 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. Public sector reforms were needed to rationalize public finances. Furthermore, there was a strong requirement for improving the country's domestic financial system to gain credibility for its business environment. The international debt position of Nauru has been a major concern, as it is

estimated to be around 30 times GDP. Any effort to service debt would place severe strain on the budget.

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. In 1999–2002 the annual fiscal deficit remained in double digits, reaching the equivalent of 29.3% of GDP in 2002. The budget deficit was reduced in the following year as domestic revenue collection increased. By 2007, however, the budget deficit had risen to 7.5% of GDP. Remittances and earnings from tourism are seen as potential sources of financial support upon the expiry in 2009 of the Compact, under which inflows have covered 50% of the country's imports. According to UN data, of all the countries in the region in percentage terms the tourism sector of Palau makes the largest contribution to GDP. In 2005 tourism contributed 67% of Palau's GDP. Palau hoped to negotiate another Compact with the USA beyond 2009 for continued aid inflows. In 2006 the current account of its balance of payments deteriorated, owing to imports of capital equipment to address the frequent power failures and of construction goods. Since Palau uses the US dollar as legal tender and its imports are mostly sourced from the USA, annual inflation remained comparatively low in 2007, at 3.2%, but increased in 2008.

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. With revenue collection improving, in 2005–07 fiscal surpluses were maintained; the surplus was equivalent to 1.1% of GDP in 2007, in spite of the large public expenditure programme for the staging of the South Pacific Games, which were held in Samoa in 2007. However, the current account recorded deficits equivalent to 10.8% and 4.6% of GDP in 2006 and 2007 respectively. The rate of inflation rose from 3.8% in 2006 to 5.5% in 2007, increasing further during 2008. Meanwhile, the ratio of external debt to GDP had declined from 54.3% in 2002 to 35.9% in 2006. However, the current account deteriorated in 2006, with the trade deficit widening as a result of higher prices for petroleum imports as well as a fall in export earnings. In addition, the settlement of an external debt for national carrier Polynesian Airlines in 2006 reduced Samoa's foreign-exchange reserves to the equivalent of 3.9 months of import cover compared with 5.4 months in 2005. Samoa has increased its tourism potential in recent years, with substantial investment being made in hotel and resort construction and the introduction of new flights to Samoa in 2005, following the launching of a joint venture, namely Polynesian Blue, between Polynesian Airlines and Virgin Blue of Australia. It was hoped that an increase in tourism earnings would ease the current account situation, as earnings from traditional exports of coconut-based products were likely to diminish.

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 strategic 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 2006 the fiscal deficit reached 4.0% of GDP; this was estimated to have decreased to 1.1% of GDP in 2007. Public debt was relatively high, standing at 55% of GDP, most of which was external. The current account, which includes official transfers, remained in deficit in 2007, when the shortfall was equivalent to 10.8% of GDP. However, in 2006 the current account balance turned to deficit, which represented 37% of GDP, mainly as a result of fuel and imports related to gold mining. With persistent shortages continuing and subsistence agriculture making a slow recovery, the rate of inflation remained high, reaching 8.4% in 2006 and 7.6% in 2007. The ADB expected the rate of inflation to reach 15% in 2008. International creditors agreed on a moratorium on the country's external debt-servicing obligations, with the expectation that the rehabilitation of the once-thriving Guadalcanal Plains Palm Oil company 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. The challenges lay in the improvement of domestic infrastructure and services in remote islands. Furthermore, the country had to raise the business skills of its citizens and improve their access to credit to establish small and medium-sized enterprises.

Tonga has experienced severe fiscal difficulties in recent years. Strike action by civil servants 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 could be raised. 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 given financial support by the Government, and there was an expansion in the money supply. Owing to retrenchment in the civil service and to reduced spending, the Government recorded a budget surplus, equivalent to 1.5% of GDP, in 2007. Annual rates of inflation remained high, at 10.0% in 2005 and 7.2% in 2006. Following a decline to 5.1% in 2007, a substantial rise was expected in 2008. 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 setbacks to Tonga's economic progress. Tonga's public debt in 2007 was estimated at 55% of GDP, of which about 86% was external. The Government's decision to borrow US \$50m. from China for urban infrastructure raised concerns about the sustainability of the country's debt in terms of future debt servicing capability. Tourism receipts fell in recent years, while more importantly, exports of squash, the country's major commodity (with significant foreign-exchange earning potential) were also declining.

Tuvalu, which demonstrated improved financial management in the early 2000s as a result of good administration of the islands' trust fund, nevertheless confronted revenue losses as a result of declining sales of fishing licences and telecommunication licences and the reduction in income from the 'tv' domain name. Following a surplus in 2006, the budget deficit in 2007 reportedly reached the equivalent of 14.3% 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 in the range of 3%–4% in 2005–07. Inflation was expected to exceed 5% in 2008. 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 entered into surplus in 2004 for the first time. A surplus equivalent to 1.2% of GDP was recorded in 2006. The budget was expected to balance in 2007, despite an increase in civil service wages, as revenue collection showed significant improvement. Inflation was low in 2006, at 2.0%, but reached 3.8% in 2007 and was expected to increase further in 2008. International reserves remained at a high level, equivalent to 7.5 months of import cover. Annual current account deficits, meanwhile, had been rising since 2002. The current account deficit in 2006 was equivalent to 11.3% of GDP, rising to 12.4% of GDP in 2007. The country will need to pay greater attention to improving its export earning possibilities, by providing greater access to agricultural produce in remote rural areas in outer islands through the provision of farm roads and links to markets and the construction of new jetties and ports. Major investment in infrastructure projects assisted by the

US \$65.6m. grant from the US Millennium Challenge Corporation (MCC) was expected to alleviate the long-standing deficiencies. However, in late 2008 the Government decided to defer 11 MCC projects, as the cost estimates for procurement by tendering companies had exceeded the originally approved estimates by the MCC. The cost overrun was mainly due to the weakening of the US currency. Since the US Government insisted that all additional expenditures be borne by Vanuatu, the Government has been seeking help from other donors, including Australia and New Zealand. Vanuatu was one of the few island countries designated by Turkey for assistance. In the first Turkey-Pacific Islands Foreign Ministers Meeting held in Istanbul in April 2008, Turkey announced that it would give US \$37m. towards small and medium-sized projects in the region.

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, in particular its remote location, limited transport facilities and susceptibility to cyclones, have hindered the islands' 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. 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, have been initiated. It was estimated that nearly US \$10,270m. was likely to be invested by the US Defense Department to attract construction labour from other former Trust Territories. 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. Guam now attracts tourists from China and has asked the US Federal Government to relax visa requirements for Chinese visitors, in order to increase the number of tourist arrivals.

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. The entry of China into the World Trade Organization (WTO) had a major impact on the islands' clothing industry, as Chinese garments were cheaper than those of local manufacturers. 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. Being closer to Australia and New Zealand than other Pacific Islands, New Caledonia launched a tourist promotion programme in these countries. Meanwhile, the opening in New Caledonia of the first Pacific office of the European Investment Bank was likely to give a much-needed stimulus to construction activities for office accommodation and housing.

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 one-half, the Government is still the island's largest employer. 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 was struck by a severe cyclone, the effects of which continued throughout 2005. The process of rebuilding remained in progress in 2006. In November 2007 the Government's efforts to raise revenues by proposing a consumption tax of 12.5% on alcohol and tobacco and a reduction in income tax rates were halted by the opposition, which claimed that the Government was nearly bankrupt and that the reduction in income tax rates was designed to benefit legislators and civil servants. Niue hosted the Pacific Islands Forum Leaders' Summit in August 2008. Topics of discussion included food and fuel security. Plans for infrastructural investments made during the meeting were expected to be funded by China, which was also considering assisting with the upgrading of Niue's telephone system.

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.

Tokelau remains a self-administering territory of New Zealand. In a referendum held in February 2006, and repeated in October 2007, islanders rejected proposals to establish a system of self-governance. With a population of just 1,500, Tokelau 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 FOR 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 risked the imposition of sanctions, including 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.

In February 2007 a legislative measure known as the 'Stop Tax Haven Abuse' bill (also referred to as the Levin-Coleman-Obama bill) was introduced in the US Senate. A companion bill was also introduced in the House of Representatives. It was estimated that tax haven abuses cost the US Treasury US \$100,000m. per year in lost revenue. The Senate bill focused on 34 'offshore' centres, which included the Cook Islands, Nauru, Samoa and Vanuatu, which have secrecy provisions that prevent US agencies from enforcing US laws. Once enacted, the impact of the bill would be severe on the aforementioned four Pacific Islands. Concerned about the implications, the Pacific Islands Forum Secretariat commissioned a study with a view to considering the implementation of further measures by these islands. The study was expected to be completed by the end of 2008.

However, the impact of OFCs on domestic economies has been negligible. The previous labour-intensive methods of managing and transferring financial inflows outside their jurisdictions have 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. 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, may need 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 trade liberalization programme of the WTO. 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 noni (or 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, at least 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. competition from rival economies in Asia continuing to increase, 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), which obliged the Pacific Islands to begin negotiations with Australia and New Zealand by April 2011 with a view to establishing a larger free trade area by 2015. 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.

EPA presented difficulties for the Pacific Islands, which were under pressure from the EU to finalize the Agreement by 31 December 2007. The EU had already announced that it would phase out the preferential price for sugar by 2010 through a 35% reduction over a three-year period. As a result, sugar exports from Fiji would have to compete with the exports from the rest of the world. The Pacific Islands were aware that

they were unlikely to gain much from EPA since trade in goods with the EU represented no more than 10% of their combined total trade. Fiji and Papua New Guinea accounted for some 90% of this trade. Moreover, Fiji and Papua New Guinea already had duty-free access to the EU market. The other Pacific Islands, which were designated as least developed countries, were also eligible for tariff-free access to the EU under its 'everything but arms' policy. Thus, the Pacific Islands were not actively interested in EPA. Most importantly, under the provisions of PACER, the conclusion of EPA with the EU would probably precipitate the beginning of negotiations on free trade with Australia and New Zealand, ahead of the stipulated date of commencement of April 2011. The idea of having free trade between the Pacific Islands under PICTA until 2015, excluding Australia and New Zealand, as a gradual move towards regional integration, would not materialize. In an attempt to avoid these complications, the Pacific Islands proposed the negotiation of individual sub-agreements with the EU in selected areas such as fisheries, services and tourism. This proposal was quickly rejected, however, as the EU pointed out that any arrangement would have to be WTO-compatible, which required a regional agreement.

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 idea of a single regional currency was floated during the Pacific Islands Forum Leaders' Meeting held in Auckland in August 2003. Since the subject was not included in the agenda, it was 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 adjustments 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 1971 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.

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 a 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.

Efforts to forge a collective regional approach in trade negotiations suffered a serious set-back when Fiji and Papua New Guinea broke ranks in November 2007 and signed independent agreements with the EU. The latter insisted on signing an EPA either before the end of 2007 or at interim dates and on an individual basis. Fiji and Papua New Guinea found it necessary to sign interim agreements to protect their trading interests (sugar exports for Fiji and tuna and coffee exports for Papua New Guinea) as they could not persuade other Pacific Islands to come to a common understanding among them with regard to services, investment and intellectual property rights, which were added to the agreement at the insistence of the EU. The anticipated gains from an EPA for smaller PICs are not large, as their trade is minimal. Furthermore, those islands with least developed country status already enjoy free trade access under the 'all but arms' category. An interim trade agreement with EU brought great advantages to Fiji. In May 2008 the Fiji Sugar Corporation (FSC) signed a \$F 2,000m. deal for the supply of raw sugar at preferential prices for the next seven years. The contract for the supply of 300,000 metric tons

of sugar per year was sealed with the traditional EU market buyer Tate & Lyle, which is the largest cane sugar refiner in the EU and which has been trading with the FSC since the inception of the African, Caribbean, Pacific-EU Sugar Protocol in 1975. The EU preferential price is expected to remain attractive despite reductions of 36% by 2009, provided that efforts to achieve greater efficiency in refining and higher productivity are ongoing and successful. It was understood that a comprehensive EPA at the end of 2008 was still possible.

It was apparent that the Pacific nations were not able to reach a consensus. In late 2008 the much-heralded PICTA had yet to become a reality. Furthermore, the free trade envisaged by the countries of the Melanesian Spearhead Group (Fiji, Papua New Guinea, Solomon Islands and Vanuatu), agreement for which was signed long before PICTA, was disrupted in early 2008 when the quarantine authorities of Fiji sent back two containers of kava to Vanuatu on the pretext that greater scrutiny was required at the port of origin. Meanwhile, Australian Prime Minister Kevin Rudd announced his vision for an Asia-Pacific Community on the lines of the EU, which was not very dissimilar from the previous Government's approach. Prime Minister Rudd wanted the Community to encompass the much larger economies of China and India as well.

The Pacific Islands Forum Secretariat decided to undertake a feasibility study on possibility of the establishment of a Pacific Single Market and Economy (PSME); however, analysts remained sceptical about the likelihood of any significant progress being made.

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