GLOBAL FINANCIAL CRISIS AND ECONOMIC DOWNTURN: CHALLENGES AND OPPORTUNITIES FOR THE SMALL ISLAND COUNTRIES IN THE PACIFIC

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Abstract. The American financial crisis, which began in late 2007 and spread to the rest of the world, did not spare the remote, small islands in the Pacific. With the decline in economic activities in the advanced countries, the American financial crisis soon became a global economic crisis, triggering a world-wide recession since then. Following the onset of global recession, Pacific island counties have been experiencing the impact in varying degrees. The global crisis has posed challenges with both short- and long-term implications. While the short-term challenges are thought to be dealt with by fiscal and monetary policies, which have only a limited scope, the long-run challenges can be looked upon as opportunities for renewing efforts towards sustained growth as well as minimizing the impacts of similar future uncertainties. This paper, which deals with six major countries in the South Pacific region, namely Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu, seeks to examine policy options, including regional economic integration.

Introduction

The ongoing global economic crisis, which had its origins in the American banking and financial sector disaster in mid-2007 spread to the industrialized countries across the Atlantic as a consequence of their exposure to US mortgaged debts.

The global financial crisis, which eventually became a global recession began to affect the small Pacific island countries (PICs)[1], even though they

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[1] The 14 independent Pacific island countries (PICs), which are the members of the formal inter-governmental organization, known as Pacific Islands Forum are: Cook Islands, Fiji,

did not have any such exposure. All of them are now experiencing the impact of the on-going "great recession"[2] (Heyzer 2009).

This paper analyses the challenges thrown up by the global crisis and the PICs' responses. However, policy options open to the 14 PICs vary. Eight of them are dollarized economies,[3] having adopted the currencies of three major economies in the region as legal tender ever since their political independence. Thus, their hands are tied, as they do not have the option of pursuing monetary or exchange rate policies. The remaining six of them have independent currencies. Except Papua New Guinea, which switched on to a flexible exchange regime in 1994, the other five PICs namely, Fiji, Samoa, Solomon Islands, Tonga and Vanuatu, have fixed exchange rate regimes. These six PICs, being relatively larger economies, have maintained consistent databases. Hence, the paper focuses only on these six PICs utilizing their data series on national income and other critical variables.

The paper is organized into four sections: the second section presents an economic background of PICs; the third section deals with policy options and actual responses; the fourth and last section presents a summary and lists some policy conclusions.

Kiribati, Federated States of Micronesia, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu and Vanuatu.

[2] The term was coined by the United Nations and used by Under Secretary-General Heyzer (2009) in her Preface to the Economic and Social Survey of Asia and the Pacific (UNESCAP, 2009) to distinguish the current recession from the Great Depression of the last century. Heyzer (2009) describes it as the product of three crises. These three crises are: (i) volatility in and surging food and fuel prices in early 2008; (ii) the financial crisis in the advanced countries; and (iii) climate change calamities. The first one precipitated rapid depletion of foreign exchange reserves of PICs. Although the financial sector institutions in PICs were not exposed to the sub-prime mortgage securities, climate change calamities, which adversely affected agricultural lands and hurt their narrow range of export products, which include fruits and vegetables and sugar.

[3] The legal tender of Cook Islands and Niue is the New Zealand dollar; of Kiribati, Nauru and Tuvalu, the Australian dollar; and of Palau, Federated States of Micronesia and Marshall Islands, the United States dollar.

Background

The PICs are grouped into three: Melanesian, Polynesian and Micronesian countries. They display a wide variety of characteristics (Table 1), with population levels ranging from less than 2,000 in Niue to nearly six million in PNG. The Melanesian group (Fiji, Papua New Guinea, Solomon Islands and Vanuatu) with their large volcanic islands have arable land and a good supply of water, making them suitable for agriculture.

The Polynesian countries (Tonga, Samoa and Cook Islands) have small populations, with little potential for large scale agriculture and manufacturing and hence have to depend more on tourism and to a smaller extent, fisheries.

The Micronesian countries are mostly coral atolls countries with a much less resource base, being dependent on remittances, trust funds and fisheries exports for their income.[4]

Growth Performance

Table 2 presents the annual real GDP growth rates for the six PICs. While PNG, Samoa, Solomon Islands and Vanuatu recorded positive annual growth rates, Fiji and Tonga performed rather poorly. The main reason behind Fiji's and Tonga's poor growth is political instability following the military coup in 2006 in Fiji, and pro-democracy riots in 2005 in Tonga. Amongst the better performers, the success of PNG and Solomon Islands is mainly due to growth in exports: of mineral and non-minerals and tree-crops in the case of PNG; and exports of logs of timber in the case of Solomon Islands.

In the absence of any spectacular growth in exports, prudent fiscal and monetary policies supported by remittances in the case of Samoa and surge in tourism receipts in the case of Vanuatu helped to maintain growth (UN ESCAP 2010).

[4] For a fuller treatment of on main determinants of growth in the six PICs and their major economic sectors, including tourism, fisheries and their contribution to GDP in recent years, especially before the crisis, see Browne (2006a) and Jayaraman (2008).

Table 1
PICs: General Indicators (2008)

Country	Pop. ('000) (2008)	Pop. Growth (1991-2000)	Population Density	Urban Population (%)	GDP per Capita (US$)
			Melanesia		
Fiji	853	1.0	47	51	3,306
PNG	5,995	2.5	13	14	943
Solomon Is.	489	2.8	17	17	684
Vanuatu	215	2.7	18	24	1,799
			Polynesia		
Cook Is.	22	0.6	91	70	7,549
Niue	1.8	-2.2	6.9	33	4,364
Samoa	186	0.8	66	23	2,277
Tonga	102	0.4	142	24	2,176
Tuvalu	10	1.6	381	48	1,346
			Micronesia		
FSM	111	2.0	159	22	2,205
Kiribati	101	2.2	138	48	703
Marshall Is.	65	1.9	636	67	2,363
Nauru	10	0.6	482	100	3,500
Palau	20	2.0	85	12	671
			Comparators		
Low-Income Countries	-	2.0	85	12	671
Middle-Income Countries	-	1.1	45	53	6,564

Source: Prasad (2009) supplemented by AusAID and the World Bank.

Table 2
PICs: Growth Performance: 1995-2009
Real GDP Growth Rate (%)

Year	Fiji	PNG	Samoa	Solomon Islands	Tonga	Vanuatu
1995	2.1	-3.3	6.6	5.4	2.9	4.7
1996	4.8	6.6	7.3	1.9	-0.5	7.2
1997	-2.2	-6.3	0.8	-1.7	-3.2	8.6
1998	1.3	4.7	2.4	3.2	3.5	4.3
1999	8.8	1.9	3.1	-1.6	2.3	-3.2
2000	-1.6	-2.5	7.1	-14.2	5.4	2.7
2001	1.9	-0.1	8.1	-8.2	7.2	-2.6
2002	3.2	-0.2	1.8	-2.8	1.4	-7.4
2003	0.9	2.2	3.1	6.5	3.4	3.2
2004	5.5	2.7	3.4	8.0	1.1	5.5
2005	0.6	3.7	5.2	5.0	-3.3	6.5
2006	3.4	2.6	2.6	6.1	4.4	7.2
2007	-6.6	6.7	6.1	10.3	-0.3	6.6
2008	-1.2	7.3	3.3	7.0	1.0	5.7
2009	-2.5	5.5	-0.8	0.4	0.4	3.4

Source: *ADB (2010b), UNESCAP (2009)*

Trade Relations

For their foreign exchange earnings the PICs depend upon a narrow range of exports, the exception being PNG, which is indeed an outlier in this regard. Their exports are mostly fish, fruits and vegetables. Thus they compete with each other.[5] Their exports except in the case of PNG (minerals) and Fiji (sugar) are similar and they seek the same markets. There is little inter-regional trade amounting to only 15% of total exports (Prasad 2009, Jayaraman 2007a, Browne 2006a). As the word economy was booming in the early years of this century and just before the full brunt of global recession came to be felt, PICs experienced fairly reasonable growth, average rate being 5.1%, thanks to growth performance of two commodity-exporting economies of PNG (minerals and non minerals) and Solomon Islands (logs of timber).

[5] For a fuller discussion on trade relations, see Prasad (2009), Browne (2006a) and Jayaraman (2007a. 2007b).

The bulk of exports and imports of the PICs are from four sources—Australia (wheat and rice, milk, meat and manufactured and primary processed goods), New Zealand (milk, meat and processed goods), USA (manufactured goods, machinery and transport), Singapore (petroleum products) and Japan (machinery and transport) (Prasad 2009). Economic conditions in these sources have major impacts on PICs

The trade share of GDP for the PICs varies as shown in Table 3. For some of the remittance-dependent economies including Tuvalu, Kiribati, Samoa and Tonga (Browne 2006b), the decline in imports caused by lower remittances can have implications for overall trade volumes. For most of them, a decline in trade volumes will have direct implications for the GDP, which means lower growth rates in the future (Prasad 2009).

Table 3
Trade Share of GDP

Country	Trade Share of GDP (2009)
Cook Islands	74.0
Fiji	82.9
Kiribati	92.3
Marshal Is	59.2
Fed States of Micronesia	56.9
Nauru	166.9
Palau	115.7
PNG	79.9
Samoa	44.9
Solomon Islands	55.1
Tonga	53.7
Tuvalu	42.1

Source: ADB (2010)

Twin Deficits

Declining aid for budgetary support and rising domestic public sector expenditure since the 1990s and stagnant tax revenues led to widening budget deficits (Table 4). With continuing dependency on imports of all food items including rice and wheat, besides fuel and manufactured goods, led to further widening trade deficits (Table 5). However, remittances continued to provide valuable support to the traditionally remittances dependent economies of Samoa and Tonga and resurgence of tourism in Vanuatu at the cost of Fiji, which had experienced political instability following the military coup in December 2006.

Table 4
Fiscal Balance as % of GDP

	1991-2000	2001-2005	2006	2007	2008	2009
Fiji	-3.4	-5.1	-3.4	-2.1	0.5	-3.0
PNG	-2.2	-1.3	3.2	2.6	-2.2	-0.1
Samoa	-5.3	-1.1	-0.5	0.6	-1.9	-4.1
Solomon Is.	-2.8	-5.9	-3.9	-0.7	-3.7	0.1
Tonga	-0.7	2.3	-0.7	3.8	3.6	1.3
Vanuatu	-3.3	-0.9	0.9	-0.3	2.1	0.9

Source : ADB (2010) , World Bank (2010)

Table 5
Trade Balance as % of GDP

	1991-2000	2001-2005	2006	2007	2008	2009
Fiji	-12.7	-19.6	-31.2	-26.8	-33.2	-27.0
PNG	19.2	27.4	40.1	33.5	33.2	19.1
Samoa	-60.1	-82.3	-46.1	-38.6	-44.0	-37.2
Solomon Is.	0.2	-0.6	-17.4	-17.6	-15.4	-13.4
Tonga	-26.7	-28.9	-36.1	-31.2	-36.2	-40.0
Vanuatu	-22.3	-21.8	-25.3	-29.6	-33.7	-35.3

Source : ADB (2010)

Impact on PICs

It was feared that decline in economic activities and fall in disposable incomes in advanced countries, especially in Australia and New Zealand, would lead to decrease in PICS' exports, decline in tourist arrivals and fall in remittances.

Fiji suffered a greater setback in tourism, than initially expected, despite the April 2009 devaluation of its currency by 20%. One clear reason was that political developments in April 2009, which included sacking of judges, abrogation of the Constitution and a clampdown on the Press and other restrictions on individual freedoms, were serious impediments to growth in tourism. Nearly 30% decline in tourism was forecast for Fiji (Asian Development Bank, 2009).

Soon after the December 2006 coup, Vanuatu benefited from the diversion of tourist traffic away from Fiji in 2007, 2008 and 2009. However, in 2010, due to heavy discounting by Fiji's national airline, the Air Pacific and hotel industry as well as economic recovery in Australia in particular, tourist arrivals in Fiji improved and the arrival numbers hit a record at 600,000.

As regards inward remittances, the prospects for Samoa and Tonga, which contribute about 25% of their GDP, were initially considered not bright due to deterioration in job markets in US, Australia and New Zealand. With rise in joblessness, the overseas Samoan and Tongan residents were expected to be less likely to keep up the past tempo in remitting funds back home in months to come.[6]

The global economic downturn with declining demand for mineral and non-mineral products ended the commodity boom enjoyed by resource rich PICs. Two PICs, PNG with mineral resources and Solomon Islands with log exports immensely benefited from the high prices in the commodity market. It aided spectacular growth in GDP in PNG in 2007 (6.7 percent) and in 2008 (7.3 percent); and in Solomon Islands in 2007 (10.3 percent) and in 2008 (7.0 percent). While PNG's exports are more diversified with petroleum and gas and other mineral products along with agricultural exports including coffee, cocoa and tea (about 95% of export earnings), Solomon Islands' exports were more in terms of timber (70% of export earnings) and palm oil. With fall in demand for both mineral and non-mineral agricultural exports combined with drop in prices, both PNG and Solomon Islands were not able to maintain the same past level of export earnings and growth rates in 2008 and 2009, as experienced in earlier years. In PNG, the kina export price index declined by 32% in the final quarter of 2008. There was a fall in log export price in Solomon Islands, as signs of contraction in log importing advanced counties were

[6] However, subsequent developments showed that remittances were resilient. Remittances continued to be almost at the same level in Fiji and in Samoa they declined in 2009 but recovered in late 2010.

clear. While PNG's growth rate declined to 5.5% in 2009, Solomon Islands growth deteriorated considerably. It was a negative 2.2%

With recovery in Australia beginning in late 2009, commodity prices quickly recovered in PNG and economic growth picked up by around 7% in 2010 compared to 5.5% in 2009. Growth rates became positive reaching 4% in 2010. Table 6 presents the estimated growth rates and forecasts of all six PICs for 2010 and 2011.

To sum up, it was initially held that since the financial sectors of PICs were insulated as they were not exposed to subprime mortgage loans, these countries could possibly escape the impact of crisis. The second and third round effects of the financial crisis leading to fall in aggregate demand and in incomes in the originating economies, came to be felt in all PICs. The transmission mechanisms have been broadly along the following lines: decline in demand for primary products and resultant lower commodity prices; fall in employment and incomes in source countries and decrease in tourist arrivals; decline in inward remittances; adverse impact on assets held overseas and erosion of offshore trust funds; and poor domestic private investor confidence.

Response to the Crisis

Response to the crisis in terms of countercyclical action depends upon whether the country concerned has scope for expansionary fiscal or monetary policies. Further, a greater challenge is to ensure that spending on social protection is not compromised. While developed countries can consider and strengthen their social safety-nets, which include both unconditional and conditional cash transfers to poor households, and public works programmes (Ravallion, 2008), there is limited scope in developing countries, since they have little fiscal or current account leeway (Hostland, 2008).

Further, in developing countries, as international reserves were dwindling in the face of widening trade deficits and rise in current account deficits, there will be mounting pressures on exchange rates (Naude, 2009). In fact, Fiji had to devalue its currency by 20% in 2009 when there were rumours about the weak currency. In April 2009, its international reserves were low, which were just enough to cover a month's imports) and the speculators were attacking the currency under the expectations that currency would be devalued.

There are limitations to fiscal expansion, which stem forth from the already entrenched constraints to macroeconomic management in PICs (Jayaraman 2008). Except PNG, Tonga and Vanuatu, all PICs have been running budget deficits in recent years (Table 6). Any attempt to raise domestic aggregate demand by running fiscal deficits with a view to offsetting declines in external demand would have disastrous effects and can only be inflationary, unless there is effective trimming of their budgets.

Table 6
Pacific Island Countries: Updated Key Indicators

Countries	Fiji	PNG	SAM	SOL	TON	VAN
Growth 2010[e] (%)	0.1	7.0	0.0	4.0	-1.2	3.0
Growth 2011[f] (%)	0.5	8.5	2.1	7.5	0.5	4.2
Fiscal Bal 2010[e] (% GDP)	-3.5	-4.0	-7.8	-5.5	-0.6	0.0
Inflation (%) 2010[e]	5.0	7.2	2.8	0.7	5.1	1.3
Trade Bal (% of GDP) 2010[e]	-32.8	22.8	-44.1	-15.7	-30.3	-31.6
Reserves Import cover in months (2010)[e]	3.8	10.5	7.2	8.7	7.5	6.0

Notes: e= estimate; f= forecast

Any fiscal stimulus effort is a risky venture unless there are supportive measures in place. These are: (i) undertaking more vigorous revenue collection efforts; (ii) effecting changes in the current expenditure composition by cutting wasteful expenditures and ambitious projects; and (iii) diverting the saved resources towards labour intensive and quick yielding projects including rehabilitation and upgrading infrastructure (Jayaraman, 2008). In the absence of fiscal deficits being financed by domestic tax revenue efforts, such deficits eventually lead to monetization of deficits.

On the other hand, expansionary monetary policy to boost domestic demand to compensate for falling external demand for limited range of exports and demand for tourism services would be disastrous. Since the financial sectors in the six PICs under study are at nascent stages, empirical studies have shown that the transmission mechanisms of monetary policy decisions are weak (Jayaraman, 2010a, 2009c, 2008d) and monetary policy is generally ineffective in impacting growth (Jayaraman, 2011). Further, excess demand created by rise in loose monetary policy will spill over into external sector as increase in demand for imports. Given the current low level of export earnings, expansionary monetary policy or fiscal policy or a combination of both policies for boosting domestic demand will only widen trade deficits. Twin deficits have occurred time and again in PICs.[7] Trade deficits, if not controlled by reducing budget deficits, lead to worsening of the current account imbalances, which would lead to pressures on exchange rate under fixed exchange rate regime, fanning speculation rumours relating to eventual devaluation.[8]

One tool in the hands of PICs which have independent currencies, namely Fiji, PNG[9], Samoa, Solomon Islands and Tonga is devaluation of the currency to improve external demand for domestic goods and tourism services.[10] The efficacy of this tool depends primarily on the well-known conditions, given other factors, that domestic demand for imports and overseas demand for exports should be greater than unity.[11]

The 2009 devaluation of Fiji's currency has revealed the inadequacies of devaluation as an option to meet the impact of global economic downturn. While demand for imports for fuel and food have remained constant, only imports of capital and intermediate goods have been falling, reflecting the sluggishness of domestic demand due to poor investment climate.[12] Besides these developments, the exchange rate pass-through effect on inflation has been quite high. The already disadvantaged sections of the community now have to bear greater impact of rise in price level of all essential items.

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7 For empirical studies on twin deficit hypotheses in Fiji and Vanuatu, see Jayaraman and Choong (2007; 2008) and for a panel study, see Jayaraman, Choong and Law (2010).

8 For an empirical study on pressures on exchange rate of Fiji, see Jayaraman and Choong (2008).

9 Although PNG has a floating exchange rate, it prefers to intervene and sells kina for avoiding appreciation of its currency.

10 This remedy is not available to dollarized economies.

11 This is known as Marshall-Lerner theorem.

12 This is more due to impact of political instability introduced by military coup and continuing uncertainties associated with current isolation of Fiji by Australia and New Zealand with sanctions of all kinds as well as suspension of Fiji from the Commonwealth.

The prospects of greater aid inflows[13] appear dim, as the traditional donors to PICs are now pre-occupied with their domestic economies and their priorities have now changed (UNESCAP 2009). Supplementing domestic resources with external borrowing is certainly an option open to all PICs[14], whose external debt levels are relatively low. Further, all PICs except Fiji are eligible to borrow on concessional terms from international lending institutions including Asian Development Bank (ADB). The ADB announced a scheme of financial assistance by way of short-term loans to its member countries[15], known as Countercyclical Support Facility (CSF). However, no PIC utilized the facility so far.

Fiji, which is not eligible for loans on concessional terms as it is in the category of lower middle-income countries, floated its first ever international bond in September 2006 for US$150 million at an interest rate of 7%.

It was a successful issue as it was oversubscribed, thanks to a then favourable rating by various agencies. Fiji again floated another international bond in April 2011 for an amount of US$250 million at a rate of 9%, despite a rating of -B for its overseas bonds by Standard and Poor's.

13 For an empirical analysis on foreign aid inflows to PICs and their contribution to growth in PICs, see Jayaraman and Ward (2006).

14 For an empirical panel study on external debt and growth in PICS, see Jayaraman and Lau, (2009).

15 In May 2009, ADB announced the establishment of a US $3 billion Countercyclical Support Facility (CSF) that would provide short term loans faster, and cheaper special programme loan facilities, aiming at supporting its member countries' fiscal spending to counter the crisis, if they lack the financial means to do so amid tight global credit conditions and a sharp increase in funding costs. Additionally, it will also make available a further $400 million under Asian Development Fund (ADF) Facility for providing concessional loans to poorer member countries, which include all PICs except Fiji being a middle income country. The ADF resources are available to eligible countries through loans and grants. The resources will provide crucial budget support and funds to finance key development projects in poorer countries that are among the most fiscally constrained in responding to the crisis. However, Fiji which was in dire need of foreign exchange, as its international reserves were at the lowest level, being sufficient just to cover one month's imports, did not utilize the facility. Instead, it devalued its currency, apparently for the reason that it wanted to avoid any loan from ADB which would carry conditionalities. For similar reason, Fiji gave up its efforts in November 2010 to borrow US$500 million from IM, which were initiated in April 2011.

The purpose was to pay off the 2006 bond obligations, which are due in September 2011. The remaining amount is expected to be spent on capital projects aimed at promoting tourism and other growth enhancing projects.

Since Fiji's external debt level as a percent of GDP is much lower than the levels of external debt in other PICs, the debt burden is expected not to expose the country to high risks. However, it remains to be seen how far the reform process would be carried through in the coming years as there is no external pressure on Fiji in the form of conditionalities which would have been imposed by IMF or ADB, had Fiji borrowed from either of the two multilateral agencies.

Policy Implications

The challenges faced by PICs in the face of the global economic crisis are formidable, but not insurmountable. However, the process of meeting the challenges cannot be through the expansionary policies as adopted by developed countries. There is not much fiscal space in PICs, except PNG and Vanuatu. These two countries through their prudent fiscal policies since the early 2000s had built in budget surpluses and international reserves to meet contingencies during bad times. In all other economies, the position is different.

Further, any loose monetary policy would not work, as financial sectors in PICs with independent currencies are not well developed and monetary policy transmission mechanism is weak. Thus, PICs' central bank responses to global economic downturn have been largely ineffective (Jayarama, 2009b). In these circumstances the age old remedy seems appropriate: the Victorian rectitude.[16] The troubled countries in Europe falling under the label of PIGS (Portugal, Ireland, Greece and Spain) and the United Kingdom have now embarked on austerity programmes: cutting wasteful expenditures and trimming public sector. It is only by these efforts, the current account imbalances can be made sustainable.

16 The term is derived from the budget presented by British Prime Minister Gladstone under Queen Victoria. Gladstone was also the Leader of Liberal Party. Gladstonian Liberalism consisted of "limited government expenditure and low taxation whilst making sure government had balanced budgets".

In the medium term, by these austerity measures, the current imbalances can be offset by inflow of foreign domestic investment and other capital inflows, as FDI and capital inflows can be attracted only by sound policies which will raise credibility and assure the overseas investors of safety of their capital and return.

In the long run, PICs should seek deeper integration of their economies and forge a closer relationship with Australia, since Australia has shown its remarkable resilience by its economic performance during the last three critical years. By integrating the economies with Australia by trade in goods and services and investment, PICs would be in a position to shield themselves from the adverse effects of volatility in business cycles in the rest of the world (Jayaraman, 2007a).

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