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CURRENT ECONOMIC TRENDS IN THE SOUTH PACIFIC

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(**Editors' Note:** This article was written before the sharp declines in stock market prices in the latter part of October. Some possible implications of these events are considered in the article on the international commodities market in this issue.)

Regional developments

Politics rather than economics has dominated 1987 in the South Pacific. Events in Fiji have provided the most dramatic headlines, but unrest and uncertainty in New Caledonia, persistent fears of a 'Libyan connection' with Vanuatu, and even the lengthy process of forming a stable government after elections in Papua New Guinea, have all called into question long-held assumptions of a stable and genuinely 'Pacific' region. Events in Fiji have a particular irony in that during 1986 and early 1987 Fiji's economic performance was the best in the region. While other countries struggled to adjust to low commodity prices, sugar and tourism in Fiji produced both rapid growth and a buoyant balance of payments.

Despite the ostensible domination by political events, economic implications have not been far below the surface of political developments. The coups in Fiji cannot be properly understood without appreciation of fears about the land tenure system. Virtually throughout the South Pacific, the land tenure system is in urgent need of reform, if the countries of the region are to develop a diversified agriculture, forestry, and mining. But the traditional tenure system, with its pattern of communal responsibilities and duties, goes to the heart of the social structure of the indigenous peoples of both Melanesia and Polynesia. Not least of the lessons from Fiji is that governments in the region may decide that the existing tenure system is best left alone.

The question of land tenure is especially important because it is symptomatic of the structural issues that need to be tackled. During 1987 the countries of the region have largely continued with the policies already put in place to cope with the reality of reduced export incomes. Now that they have weathered the three-year decline in commodity prices, the time is ripe to tackle the economic fundamentals. The July 1986 issue of this *Bulletin* drew attention to the heavy regulation and lack of supply flexibility that characterize most South Pacific countries. Without reform of these issues, it is doubtful if the region will be able to reverse its dismal record of low economic growth. A crucial issue for the coming years will be whether the countries can now build upon the monetary and fiscal adjustments that have been made, or whether the sacrifices of the mid-1980s will be dissipated in a failure to undertake fundamental structural reform.

Fiji

During 1986 Fiji turned in the best economic performance of any country in the South Pacific. The two major sectors, sugar and tourism, recovered strongly from the depressed levels of 1985. Real GDP (at constant 1980 prices) increased by 9.1 per cent. The inflation rate fell to less than 2 per cent. The external payments position improved markedly, with a surplus on both current and capital accounts. Real interest rates were high, but the Reserve Bank eased monetary conditions later in the year in response to the falling rate of inflation and the comfortable external reserve position.

In the immediate aftermath of the coup, the feeling of the economic authorities was that the economic fundamentals remained in place, and everything hinged on a return to political stability. It was thought that if finances could be kept tight in the short run, and a political solution found quickly, the economy could equally quickly return to the buoyant *status quo ante*. Accordingly, the authorities responded to the coup with a classic package of measures to protect external financial stability. The Fiji dollar was devalued by 17.75 per cent; exchange control regulations were tightened; emigrant transfers were rationed; overseas portfolio investment suspended; and monetary policy was tightened through the usual Minimum Lending Rate and Statutory Deposit instruments. The tourist industry ran a successful campaign of heavily discounted prices. This was acknowledged to have attracted a lower-spending market category from Australia, but it served its purpose as a holding operation by (in the jargon of the industry) putting bums on aircraft seats.

It is doubtful if the underlying optimism was justified, even if the premise of a speedy political solution had not been destroyed by the second coup and subsequent political events. The key problem was that the sugar industry faced problems whose major impact would not be felt until well into 1988 and beyond. Initial fears that Fiji would not be able to honour its 1987 export contracts because of delays in harvesting and crushing turned out to be misplaced, and exports recovered well. However, this was due in part to drawing on the large sugar inventory that had been established from the record crop of 502,000 tonnes in 1986. The real problem lay not in the short run but subsequently. Even before the second coup, cane planting for the 1988 crop was 80 per cent behind schedule, a delay caused not just by the politics of Indian canefarmers but by severe drought in the western sugar region. With inventories already depleted, 1988 rather than 1987 seemed set to be the difficult year. Given the dominant role of sugar in the Fijian economy, this alone would have ensured the perpetuation of very tight conditions well into 1988 and beyond. Because of differences in import leakage, sugar receipts have a much bigger multiplier effect on the domestic economy than tourist income.

The second coup in September removed any remaining illusion that the task of economic management was simply to keep things tight in the short run pending a return to business as usual. Tourism collapsed in the wake of the second coup, bans by Australian and New Zealand unions reduced export receipts, and capital had continued to flow out since the May coup. Foreign reserves fell below F$100 million, or two months import cover. A second devaluation in October reduced the value of the Fiji dollar by 15.25 per cent against the five currencies - yen, sterling, and Australian, American and New Zealand dollars - used by the Bank in setting exchange rates. Foreign exchange was further restricted to F$1000 per traveller, and the trading banks were advised, in a blunt form of moral suasion, that a tight monetary policy and credit restrictions were required. The influx of sugar receipts in the last quarter of the year should improve the reserve position.

Industries such as sugar, timber, gold, canned tuna and coconut oil will clearly benefit from two large devaluations and, subject to the rise in input costs, so too will Fiji's small manufacturing industry. With depressed local conditions, industries such as garments manufacture, which have hitherto been basically import-substituting, will have to develop an export orientation or else go to the wall. Given the important role of Indian management and ownership in these businesses, it remains to be seen whether the confidence exists to take advantage of the new price competitiveness.

The Reserve Bank has made clear its intention to protect the basic financial stability of Fiji, and is well aware of the potential for social unrest from the tightened domestic economy. But without those stringent policies foreign reserves would have vanished, and social disruption would have emerged anyway. The only way out of this conundrum is for a resolution of the political uncertainty. Without that resolution, the economic fundamentals of confidence, skills and modern institutions will continue to crumble away.

Papua New Guinea

Throughout 1987 economic conditions in Papua New Guinea have been dominated, as elsewhere in the region, by weak prices for agricultural exports. The average f.o.b. prices of copra, copra oil and palm oil all improved in the March quarter 1987, but in real terms prices remained well below the average for 1981-82 when they were at almost record levels. The high 1986 price of coffee has not been maintained into 1987. Even if coffee prices strengthen in the wake of the International Coffee Organisation agreement to reintroduce export quotas, the outbreak of coffee rust means that the future of PNG production remains uncertain.

The 1987 central government deficit is expected to be close to that forecast in the budget. The 1988 budget (presented in November) looks to a slightly more than 10 per cent increase in total expenditure, that is, a little more than the likely rate of inflation. The increase in available revenues is expected to be less than the increase in expenditures, with increases in receipts from customs duties and income taxes being partly offset by a decline in the drawdown from the Mineral Resources Stabilization Fund. The decline in Australian aid and a lesser increase in aid from other sources will increase the financing problem. It is expected that a loan under the European Community Stabex program, to compensate for low 1986/87 commodity prices, will contribute markedly to financing the deficit.

With a worse-than-expected balance of payments outlook for 1987 and stagnant deposit growth, together with capital flight arising from fears of an exchange rate devaluation, liquidity conditions tightened during the first half of the year, causing upward pressure on interest rates. In August, the Bank of Papua New Guinea introduced a variety of adjustments to improve the liquid assets position of commercial banks. These involved reduction of the Bank's lending rate and the imposition of ceilings on bank lending rates. To offset the credit effects of these changes, limits were placed on the amounts that the banks could advance for other than priority purposes. The objective was to ease pressure on interest rates, a sensitive matter when many businesses in Papua New Guinea are highly geared, without encouraging further lending growth which would spill over into imports. However, they marked a retreat from the government's avowed intention of liberalizing the financial system.

Debate about economic policy in Papua New Guinea increasingly focuses on the prospect of a mineral-led boom. The gold and copper mine at Bougainville is expected to continue up to at least the turn of the century, and was in healthy profit in 1986. Ok Tedi mine has had a chequered history, but gold mining started in 1984, and the processing of copper ore followed in 1986. Three new gold deposits are likely to be developed in the near future, on Misima Island (despite disagreement on the nature of Misima's development leading to a delay in the approval for its commencement), Lihir Island, and at the Porgera deposit in Enga Province. Oil exploration is also underway in various parts of the country, and there are prospects of large reserves. (See Warwick Davis, 'Background to Gold Exploration' in this issue.)

If the mineral boom does materialize, the task will be to ensure that the revenues are channelled into structural reform and self-sustaining growth, rather than being frittered away (see editors' note, 'Mineral Resources Stabilization Fund', in this issue). Since Independence, Papua New Guinea's growth record has been very poor. With population growing at around 2.5 per cent per year, per capita income growth has almost certainly been negative. Several key issues need to be tackled if this dismal picture is to be reversed.

First, the regulated wage-fixing system needs drastic reform. Wage-setting in Papua New Guinea is one of the strongest Australian colonial legacies (in parenthesis, it is worth recalling the key role played by Mr R.J. Hawke in PNG wage cases during the mid-1960s). Basic wages are far out of line with productivity and with the number seeking work, yet the 1986 budget document is reminiscent of comparably tendentious Australian documents in its claim that 'the wage-setting arrangements during this period partially protected employees from the effects of inflation and therefore preserved orderly industrial relations in the formal sector'.

Second, investments and reform in the educational system are urgently needed to remedy the very low skill levels of the PNG workforce. Educational standards at all levels are low, and insufficient progress is being made towards universal literacy. The tertiary sector is highly fragmented, costly by international standards, and of dubious quality.

Third, the law and order issue needs to be confronted. There is understandable resentment in Papua New Guinea that Western media focus upon a few well-publicized assaults on white women. There seems little realization of the economic cost of poor law and order: increased insurance premiums and security provisions raise the costs of doing business, not to mention the investment-deterrent effect. Moreover, law and order is no longer a problem confined to individual life and property in Port Moresby and Lae, but has become a serious issue in the economic functioning of the Highlands plantations.

Last, but by no means least, any bonanza from the 'Pacific Gold Rush' will raise in acute form the question of the exchange rate for the kina. Papua New Guinea succeeded in introducing its own currency at Independence, and it maintained a hard currency policy which helped to ensure that the kina remained (more or less) convertible, kept the inflation rate low, and had its counterpart in a conservative fiscal policy dominated by the need for expenditure restraint to maintain external balance. Despite moving away from the hard kina policy in the early 1980s, the tradition of a 'strong kina' remains part of the folklore of macroeconomic policy. In the light of Papua New Guinea's high labour costs, it is not at all clear that the kina exchange rate should be supported at its present level if the country wishes to promote new exports. It hardly needs to be said that a mineral boom could exacerbate the problem of an appropriate exchange rate. A PNG version of 'Dutch disease', in which the export success of the mineral sector drives up the exchange rate, will make it even harder to establish competitiveness in other sectors of the economy.

Solomon Islands

Since 1985 the Solomon Islands economy has been grappling with a steep decline in the world market prices of its exports, together with structural deficits in the government budget. By the end of 1985, the deficit on current account of the balance of payments had reached 18 per cent of GDP, and the financing of the government deficit absorbs all the domestic financial savings accumulated by the banking system. The need for readjustment to these realities would alone have ensured some difficult years ahead: Cyclone Namu in May 1986 made a difficult task even tougher by inflicting damage estimated at 10 per cent of GDP. The heaviest damage was sustained by the oil palms of the Solomon Islands Plantation Ltd, and a full recovery of production is not expected before 1990, but copra production was also reduced, and much infrastructure such as roads and bridges were also destroyed.

For both 1986 and 1987 the central problem of economic policy has been to correct the adverse underlying trends in both the government's domestic deficit and the external account, while also assisting growth-producing investment in a country where real income per head has fallen substantially in the decade since Independence.

The adverse effect of Cyclone Namu on export earnings of palm oil and of higher food imports was more than offset in the 1986 balance of payments by inflows of aid and insurance payments (together with Stabex payments from the European Development Fund), so that even though the current account deficit widened to 34 per cent of GDP, there was a small surplus in the overall balance of payments. With the realization that the exceptional Namu-related payments would recede, the initial outlook for 1987 and 1988 was very gloomy. It was expected that the underlying deficit on current account would continue to widen until 1988. The deficit remains unsustainably large, but the effect of export prices of timber, vegetable oils and fish, and the changed relative prices of exports and imports from the steady depreciation of the Solomon Islands dollar, mean that the out-turn for 1987 is likely to be markedly better than was first feared. Since mid-1987 the authorities have reduced the pace of depreciation of the Solomon Islands dollar, preferring to emphasize the potential for cost reduction in some export industries rather than risking a feedback into prices and wages of continued adjustment in the exchange rate. However, the achievement of a sustainable set of balance of payments relationships remains a major policy goal, and exchange rate policy is likely to remain flexible.

The substantial increase in the government budget deficit in 1985-86 and the prospects for continued large deficits have made fiscal adjustment the second key policy issue. Rising demand for government services from a rapidly growing population, rising aspirations, a decline in revenue from export duties, a costly devolution of power to provincial governments, inefficiencies in planning and executing the development budget, and a public service whose salaries account for two-thirds of the government's domestic expenditure constitute a formidable structural problem, which was capped in 1986 by the repair bill for Cyclone Namu.

The need to accommodate government borrowing from the banking system while restraining domestic credit for balance of payments reasons has crowded out private sector credit. While the Central Bank hopes to bring about a marginal reduction in interest rates, no substantial easing of monetary conditions will be possible until the government deficit is tackled - and this requires direct attention to fiscal policy. The 1987 budget speech clearly expressed government anxiety to reduce the budget deficit, and the government is now considering a reform of the tax system, to increase the efficiency of the system and broaden the tax base. It is expected that the first elements of this reform will be announced in the 1988 budget.

Fiscal adjustment also requires substantial discipline on the expenditure side. There is much interest, but as yet no concrete proposals, to relinquish to the private sector some of the services currently provided by government. A review of public service establishment is now taking place, but no firm proposals have yet emerged for fundamental reform of the present administrative system and the costs it engenders. Public sector wages will also have to be tackled firmly. The budget speech of December 1986 explicitly noted that there was no provision for increases in public service pay scales, but early in 1987 public servants were awarded an 8 per cent rise. The impact of such wage rises on government expenditure needs no elaboration. What is suprising is that the equity implications have sparked no comment. Those already fortunate enough to have wage jobs in Honiara have received wage rises roughly in line with prices. Given the overall fall in income per head, this suggests that those in rural areas have borne the brunt of the fall in export prices and the costs of Cyclone Namu.

While concern with the fiscal and external imbalances has dominated recent economic policy, the longer term policy agenda must also address some fundamental structural problems if the people of the Solomon Islands are to enjoy real and sustained economic growth. Foremost among these is the land tenure system. Without a clear system of property rights, reforestation for the important timber industry and exploration for gold will both be hindered. Skill levels, both technical and managerial, are very low. Attitudes to foreign investment have not always been benign, and the procedures of the Foreign Investment Act are cumbersome and complex. There are plans to introduce a 'one-stop' approval process. Development planning and project implementation are an acknowledged weakness, and agricultural growth suffers from poor transportation and marketing services.

Western Samoa

Considerable progress has been made in achieving financial stability over the last two to three years, but the economy remains structurally weak. The crucial policy issue is whether government will use this window of opportunity to tackle the economic fundamentals, or whether the hard-won gains of the last two years will be dissipated.

Samoa has, in the past, not been able to combine sustained growth with financial stability. Low real growth during the 1970s gave way at the end of the decade to a short-lived boom from a burst of development expenditure that was financed by very substantial domestic borrowing. With few constraints on credit expansion, and the credit going largely to purchases of imports, the consequence was a rapid depletion of Western Samoa's foreign exchange reserves. By 1982 Western Samoa had neither financial stability nor growth. The following year, the IMF helped launch a stabilization program with the orthodox ingredients of reduced government expenditure, credit control, and devaluation of the tala.

Since then considerable progress has been made in achieving financial stability, despite the collapse in commodity prices. In 1986 the rate of inflation fell below 6 per cent (compared to the 20 per cent characteristic of earlier years); the current account deficit fell to some 5.9 per cent of GDP; foreign reserves were the equivalent of 5 months' imports; and the government budget was in surplus. These trends have broadly continued during 1987. The rate of inflation has further moderated, and in July stood at an annual rate of 3.4 per cent. The balance of payments recorded an overall surplus of WST9.7 million in the first six months of 1987, an increase over the same period for 1986. It is expected that the government budget brought down in late 1987 will be broadly balanced, but it is worth noting that an election is due in February 1988.

An interesting development of 1987 has been the introduction of policies to stimulate the conversion into savings and investment of a major portion of private remittances. The inflow of remittances has been responsible for the strong growth of domestic liquidity during 1986 and 1987. Remittances have in the past been placed in short-term deposits, and the commercial banks have used their liquidity to lend largely for consumption - which spills over directly to increased demand for imports. The Central Bank previously attempted to combat this with a fixed ceiling of permissible credit expansion, but this has been replaced in 1987 by a flexible system which links the extension of fresh credit to an increase in longer-term savings. Real interest rates are being kept high to discourage lending for consumption and imports, and banks are encouraged to give priority in their lending to productive investment.

With financial stability achieved, the key policy problem for 1987 and beyond is that the economy is growing at only a very slow rate and the balance of payments remains structurally weak. Real GDP rose by no more than 1.5 per cent in 1986. Western Samoa has few policies in place to improve the supply response of the economy. Public enterprises need to be rationalized, and in appropriate cases deregulated or even privatized. The skill level of the workforce needs to be improved. Above all, the agricultural sector needs a massive restructuring. The pricing, marketing, and land tenure systems all have to be addressed, so as to reverse what the Asian Development Bank rightly described as 'agricultural stagnation'. If there is to be a change in the economic fundamentals in Western Samoa, now is the time to make it, so that the financial gains of the last few years can be consolidated.

Vanuatu

Developments in Vanuatu during 1987 have an immediate parallel with those in the Solomon Islands. An economic situation already made difficult by continuing depressed world prices for primary commodities was made even worse by natural disaster. In February 1987 Cyclone Uma caused extensive damage in Port Vila and the southern islands - an especially costly blow coming so soon after Cyclones Eric and Nigel had damaged the copra-growing regions in the country's north in 1985. As in the Solomons, the short-run impact has been mitigated by the influx of insurance payments, special grant aid, and local construction activity. By mid-year the extensive damage to tourist facilities had been repaired.

Exchange rate policy remains the thorniest issue of macroeconomic management in Vanuatu. Vanuatu has in the past chosen to maintain a 'strong vatu' policy. The years 1985 and 1986 were characterized by persistent strengthening of the vatu against the currencies relevant for its trade and tourism receipts. This high value could not be sustained at a time when export prices and tourism receipts were dropping sharply, and the vatu was devalued twice during 1986, with realignments continuing to take place during 1987. Precise comparisons depend upon the time frame chosen, but the broad result of the changes during 1987 is that the vatu has depreciated against the countries which supply most of its imports, but appreciated by 6 per cent against the US dollar, in which Vanuatu's copra sent to Europe is invoiced. These divergent trends add to the complexity of exchange rate management. However, to take a longer perspective, in October 1987 the vatu was still 15 per cent higher against the Australian dollar than in 1984, and Australia is the major source of tourists.

An important element in Vanuatu's 'strong vatu' policy of the early 1980s was the avoidance of imported inflation, and the Central Bank continues to voice fears about the lagged domestic price consequences of the 1986 devaluations. The other side of this argument is that, despite the currency realignments, Vanuatu remains a high cost economy. It is not obvious that the current exchange rate is compatible with a strong resumption of tourist arrivals, which in 1986 had fallen to only half those of 1983. Nor is the current exchange rate conducive to the development of products with good export prospects, such as Vanuatu's high quality beef.

The other key feature of Vanuatu's economy during 1987 has been the economic ramifications of political developments. Throughout the year, Vanuatu has enjoyed (if that is the correct word) very poor public relations overseas. Tourism and the financial sector are two of the country's three main foreign exchange earners. Both industries have the additional benefits of employment creation and infrastructural development. The financial sector can also be a good mechanism for skills transfer in banking, accounting, computing and modern communications, and purely portfolio investment may lay the groundwork for direct investment by foreign firms.

It is, of course, a matter for the people and government of Vanuatu to weigh the benefits of these industries against the costs, and to decide national policies accordingly. It needs to be recognized, however, that tourism and tax havens are industries crucially dependent upon overseas confidence. This confidence has been lacking during 1987. The $US1.5 million fishing agreement with the Soviet Union, including the right to onshore facilities, and the continued disquiet in the region about diplomatic links with Libya, have had an economic cost for Vanuatu.

Similarly, tourism has been affected not just by the exchange rate and Cyclone Uma, but by the saga of Air Vanuatu and continuing uncertainty about air links with Australia (now partially resolved following the March 1987 agreement with Ansett to operate a weekly service to Port Vila). Vanuatu authorities also complain that the country's image as a tourist destination suffers from confusion with New Caledonia. But this is a straightforward problem of appropriate marketing, just as Fiji's tourist operators moved quickly, with advertising and incentives, to repair the public relations damage from the May coup. All that is required is the appropriate policy decision.

The crucial point is that none of these latter problems has been caused by a harsh world trade environment or natural disaster. They are all matters amenable to direct policy control.

Tonga

Tonga is one of the classic 'aid and remittance' economies of the South Pacific. Earnings from the major exports of coconut oil and dessicated coconut are insufficient to pay for imports of consumer and capital goods, and large trade deficits are funded by inflows of overseas remittances and foreign aid. Remittances are a major source of cash income at the village level, and aid in the form of official grants and concessional loans is also an important source of finance for the balance of payments.

Data for 1987 are not yet available, but, in 1986, export earnings declined by 36 per cent, and imports increased in both volume and value. However, this did not result in any detrimental effect on the current account, partly because of continuing foreign aid flows and partly because the levels of private remittances continued to increase steadily. Indeed, the Tongan pa'anga value of these remittances was boosted by the depreciation of its Australian-pegged currency against the New Zealand and American dollars.

In short, the country lives beyond its means. Private consumption amounts to more than 100 per cent of GDP, and domestic consumption is kept buoyant by foreign aid and private remittances. The 1987-88 budget statement itself drew attention to the 'consistent strong flows of transfer payments from abroad ... and in consequence ... the rapid rise in the number of vehicles, video recorders and television sets, telephones, housing construction and electricity connection'.

The relaxation and then sudden reimposition of New Zealand visa requirements for Pacific islanders in late 1986 emphasized the potential volatility of remittances. The crucial issue for Tonga is whether there are feasible options to strengthen the structure of the economy and ensure stable economic growth in future. Since 1983, the government has followed a policy of freeing up the economy to enable the private sector to develop. Many price controls have been dismantled, some commodity boards and statutory authorities partially deregulated, infrastructural investment increased, company tax and customs duties reformed, and personal income taxes have been reduced, financed by a 5 per cent Goods and Services Tax. Export-oriented manufacturing is being encouraged by a Small Industries Centre which offers the usual range of fiscal incentives, and there are hopes that tourism might benefit as a substitute destination for Fiji.

On balance, problems in Fiji are likely to disadvantage Tongan tourism: Nadi has long been the hub for regional air traffic, and tourists have typically treated Tonga as a complement to, rather than a substitute for, a holiday in Fiji. There is little of tourist interest on the main island of Tongatapu, and the scenically attractive Vava'u group has limited infrastructural development.

Nevertheless, the general thrust of Tongan policy to maintain a competitive exchange rate, improve the flexibility of the economy, and to increase the export orientation of its trade policies marks it out as an exception among the small South Pacific countries.