



Current economic trends in the South Pacific

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Papua New Guinea

During the past six months, Papua New Guinea has suffered a macroeconomic crisis which led to the suspension of conversion of the kina on 4 October. The crisis, occurring shortly after a minerals boom, underlines the need for the Papua New Guinea government to introduce fundamental reforms to its economic management, notably in containing the budget deficits which have been high (and largely unplanned) for the past five years. The United Nations Development Programme (UNDP) *Human Development Report*'s rating of Papua New Guinea as low in human development, despite very high rates of economic growth, suggests that microeconomic management also requires attention to improve resource allocation and the delivery of basic services to the bulk of its population. Over the medium term, the Papua New Guinea government, like its Melanesian neighbours, needs to employ its considerable financial and natural resources much more effectively to lay the foundations for broad-based development for its growing population.

Macroeconomic developments

Real GDP in Papua New Guinea is projected to contract slightly in 1994, reflecting slowing production from major mining and petroleum projects. This follows four years of very high real GDP growth, averaging around 10 per cent per annum. Growth has been driven almost solely by the mining and petroleum sector and is thus deceptive: the sector accounts for only around 3 per cent of formal employment and has limited direct linkages with the rest of the economy. Growth in the non-mining sectors has been slow, although significant increases in international prices for logs at the end of 1992 and for coffee and cocoa in 1994 led to increased rural incomes.

The balance of payments for the first six months of 1994 recorded a deficit of 34 million kina, compared to a deficit of 94 million kina in the corresponding period in 1993. The lower deficit was the result of: higher merchandise exports; a decline in service payments and a net inflow in the non-official monetary sector which more than offset a higher level of general imports; an increase in net outward

transfers; and higher official and private capital outflows. The level of general (non-mining) imports in the first half of 1994 recorded a 17 per cent increase over the corresponding period in 1993, and was primarily attributable to high levels of Government expenditure. The increase in net inflows in the non-official monetary account was associated with an increase in foreign liabilities of the commercial banks following currency swap transactions with the Bank of Papua New Guinea. Gross official external reserves recorded 102.6 million kina at the end of June, sufficient for 1.2 months of non-mining import cover.

In September, the steady decline in foreign reserve holdings led the Government to devalue the kina by 12 per cent against its trade-weighted basket of currencies. The devaluation proved insufficient to prevent the outflow of foreign exchange, however, and on 4 October the Government announced the suspension of conversion of the kina, pending a float of the currency on 10 October. Since then, the kina has been traded twice a day, and has fluctuated in value in the range US\$0.87–US\$0.89. The pre-float value, after devaluation, was US\$0.93. The 'float' has been strictly regulated by the Bank of Papua New Guinea, ostensibly to prevent speculation on the currency: trading is in effect restricted to importers and exporters. Meanwhile, the Government has announced its intention to negotiate another adjustment program with the International Monetary Fund (IMF) and the World Bank, the second since 1990 after the closure of the Bougainville mine. The Bank of Papua New Guinea has also obtained a bridging loan from the Reserve Bank of Australia of US\$35 million to bolster foreign reserves until an IMF/World Bank package is finalised.

Movements in domestic credit reflect the problems experienced in the macroeconomy. Excluding lending to the Government and advances under the

Government's tree crops price support policy, domestic credit fell by 2.1 per cent over the six months to June 1994, reflecting a lack of viable investment projects. Increases in the money supply since 1993 are largely attributable to injections from the Government to finance its fiscal deficits. This has led to very high levels of liquidity in the domestic banking system. At the end of June, commercial banks' holdings of liquid assets (including cash, deposits with the Bank of Papua New Guinea and Government securities) were 39.5 per cent of deposits, compared with a required ratio of 11 per cent. The required liquid assets ratio was raised to 29 per cent when conversion of the kina was suspended in October. Interest rates in Papua New Guinea are not high by regional standards, but have a large spread, with a weighted average lending rate of 9 per cent and a weighted average deposit rate of 3.3 per cent.

Political developments

In August, the Papua New Guinea Supreme Court ruled that the then Prime Minister Wingti's resignation and re-election by Parliament in September 1993 had been contrary to the Constitution, and ordered Parliament to elect a new Prime Minister. The September 1993 resignation and re-election had been designed to take advantage of a Constitutional provision which precludes votes of no-confidence during the first eighteen months after assuming office. As a result of the Supreme Court ruling, Parliament elected Sir Julius Chan as Prime Minister on 30 August after he crossed the floor to join the Opposition. Prime Minister Chan and his Deputy and Minister for Finance and Planning, Chris Haiveta, announced that their first priorities in government would be to restore economic management, to resolve the Bougainville crisis, and to expedite agreement on the Lihir gold mine.

In September, the Government accelerated efforts to reach a negotiated

settlement with the Bougainville Revolutionary Army. In October, a South Pacific Peace-keeping Force, comprising troops from Fiji, Vanuatu and Tonga, with logistical and financial support from Australia and New Zealand, was established to secure a pan-Bougainvillean peace conference. Conference participants agreed that all desired peace, but the absence of key Bougainville Revolutionary Army leaders reduced the capacity of the conference to conclude a peaceful settlement. Security force operations on Bougainville, combined with restoration efforts and funding for care centres, have been a significant drain on the national budget since 1990, and the province is likely to continue to absorb national resources for some time to come. Although Bougainville was previously a major net contributor to the Papua New Guinea economy and national budget, the costs of continuing security force operations and of the restoration work necessary once a solution is found are likely in the short term to outweigh any income generated from revived cocoa and copra production.

Government policies

The steady decline in external reserves over the past two years, despite increased revenue from minerals exports, reflects five years of high budget deficits and declining levels of direct investment. The 1993 and 1994 Budgets entrenched the high deficits of the previous three years, reduced the already narrow tax base and shifted expenditure from investment to consumption and transfers.

The 1993 Budget also saw a reversal of government policy against overseas commercial borrowing, and a 90 million kina commercial loan with a consortium led by Union Bank of Switzerland was concluded in June 1994. The loan conditions included first call on mining and petroleum revenues. In order to meet this condition without breaching prior obligations to the World Bank and IMF, the Government had

to establish a Trust company offshore to which it directed mining and petroleum companies to pay their Papua New Guinea taxes. The move attracted much criticism from investors and Papua New Guinea business interests and was seen as an indication that the Government was not only failing to save its mining and petroleum revenues, but was in fact spending them before receiving them.

In July, the Government was faced with a rising fiscal deficit and a deteriorating balance of payments. The budget deficit at the end of June was 278 million kina, compared with an original full year forecast of 243 million kina and a March mini-Budget forecast of 191 million kina. In response to this, the then Minister for Finance and Planning introduced strict expenditure controls whereby government agencies had to seek approval from the finance department and the central bank before they could gain access to funds. Salaries and existing commitments were exempted from the controls, but new commitments were not permitted. Since the controls were introduced in July, government services in many areas, including extension, health and education, and police services have been reduced to a bare minimum and in some instances have ceased. Meanwhile, the fiscal deficit was reduced from 278 million kina at the end of June to under 200 million kina by the middle of September.

The September devaluation of the kina was accompanied by a package of supporting policy reforms. The package included a freeze on public sector wages and recruitment until the end of 1995, in order to reduce the inflationary effects of devaluation, a continuation of the July expenditure controls, and a commitment to a zero budget deficit for 1995. The Government delayed its 1995 Budget from mid-November to March 1995 in order to assess the impact of the expenditure controls and of the currency float. A Supply Bill was introduced on 15 November to meet government requirements for the first

three months of 1995. The Bill re-introduced fringe benefits taxes, removed the duty free privileges of government agencies and targetted a deficit of 55 million kina, or 1 per cent of GDP for 1995. A full expenditure budget is to be brought down in February 1995.

Investment

Investment in Papua New Guinea is dominated by the mining and petroleum sector. Growth in non-mining private investment has been slow over the past few years, reflecting low international prices for Papua New Guinea's four major export tree crops (coffee, cocoa, copra and palm oil) and a lack of competitiveness in manufacturing, which continues to suffer from high wages, low labour productivity, high service and utilities costs and costly access to international markets. Mining and petroleum exploration has declined significantly since 1993, reflecting both a worldwide decline in exploration activity, and investor concerns over sovereign and political risk in Papua New Guinea following the closure of the Bougainville and Mt Kare mines by landowners and the renegotiation of State equity in Porgera mine. Law and order problems in the urban centres continue to impose significant costs on existing investment and to deter new investment.

Agriculture and forestry

Agriculture in Papua New Guinea supports over 80 per cent of the population. Subsistence is still the mainstay of the rural sector, although most households also grow either tree crops or food for cash. Dramatic fluctuations in price for the four major export tree crops have led successive governments to examine alternative export options. There has been some success in growing spices for export, although the small size of the international spice markets leads to easy saturation. Development prospects in the agriculture sector will be improved if the

Government directs resources to support research and extension efforts for minor crops in preference to supporting the domestic price for tree crops. Growers also face significant difficulties in marketing and access, and these are areas which may warrant government attention.

The forestry sector in Papua New Guinea, as in other Melanesian countries, has been the focus of international attention in recent years. The government agreed at the 1994 South Pacific Forum to cooperate with other Forum countries in developing a regional code of conduct on forestry. Since the Forestry Act came into force in 1992, the Papua New Guinea government has been active in forestry reform. It has replaced the former Department of Forests with a National Forests Authority, governed by a Board that includes representation from national government, provincial government, industry and non-government organisations, and has engaged a commercial surveillance company to undertake monitoring of log exports and training of Papua New Guinea staff. The Papua New Guinea government has also established a National Sustainable Development Commission and is in the process of developing a National Biodiversity Strategy. The forests sector features heavily in both of these exercises, as Papua New Guinea's extensive forests are the repository of much of its rich biological diversity. The forestry sector, if sustainably managed, has the potential to generate considerable income for rural communities and for the country as a whole over the long term.

Solomon Islands

Solomon Islands is rated by the World Bank as a lower middle income country in terms of its per capita income but, like its Melanesian neighbours, the country has social indicators more akin to the poorest developing countries. Persistently high

budget deficits and a lack of control in the exploitation of its natural resources have taken their toll on the Solomon Islands economy. Gross foreign reserve holdings have been sufficient to cover less than 3 months of imports for several years, underlining the urgent need to restore macroeconomic stability. To this end, the government under Prime Minister Hilly commenced negotiation of a structural adjustment package with the IMF and World Bank. The new government under Prime Minister Mamaloni has listed structural adjustment as part of its development strategy.

Macroeconomic developments

Although there is a lack of accurate data, GDP estimates for Solomon Islands suggest real growth in the economy, largely driven by the forestry sector. Continued real growth over the medium term, however, is threatened by persistently high budget deficits and an increasing reliance by both government revenue and export receipts on a forestry industry which is internationally regarded as unsustainable.

Forestry exports grew in the first half of 1994, with logging continuing to account for over half of total export receipts. Agricultural commodity exports, other than copra, have shown substantial improvement over 1994, reflecting higher prices and volumes. The strong export performance more than offset a rise in imports and led to a trade surplus of SI\$21 million in the second quarter of 1994. The trade surplus was partially offset by a widening deficit in the services account and a lower surplus on transfers, resulting in a current account surplus of SI\$3 million for the June quarter. In the capital account, substantial private sector loan repayments were partly offset by inflows in the form of loans, and there was a substantial capital outflow (SI\$10 million) associated with the re-purchase of Government House from a Japanese businessman. The previous government had sold it for SI\$6.7 million.

Gross foreign reserve holdings at the end of June were down to an estimated SI\$70 million, sufficient to cover 1.3 months of imports.

Inflation continues to be relatively high, with an average annual increase of 12 per cent in June 1994 in the Honiara Retail Price Index. The inflation rate has recorded over 10 per cent on an annual basis for each of the first six months of 1994.

Monetary policy in the Solomon Islands has been largely driven by the need to contain the adverse macroeconomic effects of high fiscal deficits. In an effort to mop up excess liquidity in the system, the Central Bank of Solomon Islands began issuing its own securities, the Bokolo Bills, in December 1992. Slow domestic investment over the past two years has led the commercial banks to invest in public debt and, despite high levels of government domestic borrowing, crowding-out does not appear to be a significant risk at present.

Growth in domestic lending in 1994 has been largely driven by public sector credit, which accounted for SI\$19.8 million of a SI\$28.4 million increase in domestic credit in the June quarter, including the financing of the re-purchase of Government House. Growth in domestic private credit was principally in housing and personal loans, fisheries, manufacturing and distribution.

Interest rates in Solomon Islands remain relatively high, with the weighted average deposit rates at 7.7 per cent and weighted average lending rates at 15.8 per cent in June 1994.

Government policies

Government policies were thrown into disarray when the Governor-General dismissed the Prime Minister on 13 October on the grounds that he no longer enjoyed the support of the majority of Parliament and called for the election by Parliament of a new Prime Minister. After two weeks of court challenges and public

debate, the Court of Appeal ruled that the Governor-General was within his rights to order Parliament to elect a new Prime Minister, but did not rule on who was to be caretaker Prime Minister in the interim. The matter was resolved on 31 October when Prime Minister Hilly resigned, and on 7 November Solomon Mamaloni was elected Prime Minister.

Given the small size of the Solomon Islands economy and the dominance of the public sector, government actions have a strong determining effect on macro-economic developments. The chronic problem of budget deficit financing in particular has reduced the independence of monetary policy. The forecast deficit for the 1994 Budget was SI\$25 million, but the actual deficit is likely to be significantly higher: the Government had already exceeded its 1994 forecast deficit by April. Government revenue suffered an additional setback in August and September 1994, following the announcement of an increase in export duty on round logs to 65 per cent for logs receiving more than SI\$250 per cubic metre. The forestry industry contested the increased tax and the Government took several weeks to come to a final decision over whether to impose it. As a result of this uncertainty, combined with heavy rains and rough seas during those months, no logs were exported, with consequent adverse effects on both Government revenue and the balance of payments.

In April 1993, the Government introduced an 8 per cent goods tax and extended the scope of the sales tax on services to include airline tickets, telecommunications and legal services. The previous government was examining options to combine the two taxes into a general goods and services tax, without overburdening the limited administrative capacity of the taxation office. As part of the structural adjustment program, the Hilly government also considered rationalising import and export duties, with the objective of creating only three

bands of tariff with a maximum rate of 35 per cent. At present, duty on some goods is as high as 250 per cent.

Like many other Pacific island countries, Government expenditure in Solomon Islands is divided into a recurrent and a development budget. The development budget is largely funded through foreign aid. Solomon Islands is eligible for concessional lending from the World Bank and Asian Development Bank, but poor implementation capacity and the requirement for the Government to fund projects up front and seek reimbursement—a process which can take several months—has led to disappointing draw-downs. The Hilly government's Budget Management Council, which was given the task of containing public expenditure, is to be replaced by a Public Expenditure Committee. The previous government also froze public service recruitment and vacant posts, hoping that this measure would save up to SI\$9 million in 1994.

The Government's commitment (and ability) to pursue expenditure restraint came under question when it agreed to a 5 per cent rise in public service wages in September 1994, after increases of 60 per cent in 1993, 5 per cent in 1992 and 16.5 per

The Hilly government put in place a privatisation program with the government printery and supplies and the water authority being corporatised in 1994. The marine fleet was also earmarked for privatisation in 1994 (it received its budget allocation only for the first half of the year). While divestiture was the ultimate goal of the privatisation program, the Government took a cautious approach and began with commercialisation and corporatisation.

Investment

Investment in Solomon Islands over the past two years has been dominated by the forestry sector, although fisheries, manufacturing and distribution all showed improvements during the second quarter of 1994. The Ministry of Commerce has been

trying to encourage processing industries through the development of industrial estates. The Ranadi Industrial Centre, just outside Honiara, is now fully occupied. Major activities in the centre include timber processing, automobile mechanics, Solbrew and soft drink manufacture. The Centre offers security of land and utilities.

As in other parts of the Pacific, access to land requires complex and often lengthy negotiations between customary landowners and investors. Around 80 per cent of land in Solomon Islands is held under custom land tenure, with the rest held by the government, by pre-Independence plantations and by the churches. Parliament passed a Customary Lands Registration Act in February 1994, enabling the registration of custom lands. Over the longer term, the Act may facilitate the settlement of land disputes and access to custom land by external developers. There has so far been no progress on the implementation of the Act.

Forestry

The forestry sector has been the subject of considerable controversy over the past two years, and the Hilly government established a Timber Control Unit, funded by Australian aid. Following the example of Papua New Guinea, an external surveillance company has been engaged to monitor log exports. A review of forestry legislation, funded by Australian aid, has been delayed by the change of Prime Minister, but it is hoped that changes to legislation will be adopted by February 1995. Solomon Islands is involved in regional initiatives on forestry following from the 1994 South Pacific Forum, including the drafting of a regional Code of Conduct for Logging.

Vanuatu

Vanuatu has enjoyed macroeconomic stability since independence in 1980, with stable external and government recurrent accounts. Investment has been dominated by public infrastructure funded by foreign grants and concessional loans. Despite this, Vanuatu's social indicators (life expectancy, infant and maternal mortality and literacy) are comparable to those of countries with far lower per capita incomes.

Macroeconomic developments

Difficulties in obtaining national accounts and balance of payments data have led to long lags in the publication of statistics. According to preliminary estimates, real GDP grew by 4.2 per cent in 1993, driven by the services sector. Provisional balance of payments data for the March quarter 1994 suggest an overall deficit of 993 million vatu, although a lack of accurate import data makes it difficult to confirm this figure.

Vanuatu operates a passive monetary policy, allowing relatively free capital flows. With an increase in investment during the second half of 1994, there has been little net movement of capital. Vanuatu's monetary structure reflects its liberal exchange regime: around two thirds of liquidity is held in foreign currency.

Domestic interest rates are relatively high, with high spreads. Weighted average deposit rates in March 1994 were 5.1 per cent, and weighted average lending rates were 13.7 per cent. Domestic credit at the end of March 1994 was 2 per cent higher than in March 1993. Growth in domestic private lending was concentrated in the agriculture sector and in consumption and durables. Credit for housing is largely supplied by the Provident Fund.

Government policies

Government revenue in Vanuatu is heavily dependent on taxes on international trade,

notably import duties. This dependence on a narrow base restricts the Government's capacity to increase revenue and will be unsustainable over the medium term, particularly given existing and future expenditure needs in infrastructure, health and education. In recognition of this, the Government commissioned a taxation consultant early in 1994 to examine options for a sustainable taxation system but one which protected the tax haven status of the Offshore Finance Centre. This followed on from an IMF review of the Vanuatu revenue system in 1993. The Warren report, funded under the Australian aid program, was presented in August 1994, and a submission based on the report's recommendations is currently with the Council of Ministers.

The Warren Report recommends some fundamental changes to the revenue system, including the introduction of a 3 per cent personal income tax, a 4 per cent turnover tax and a 3 per cent tax on business profits for resident companies. The tax haven status of the Offshore Finance Centre would be protected as offshore companies would remain exempt. The report also suggests the Government consider contracting at least part of its revenue collection functions out to a private company, similar to the arrangement it has for its open ship registry. The report further recommends earmarking specific revenue items to specific expenditure. The earlier IMF report recommended that, over the longer term, the Government also review the expenditure side of its budget, and in particular consider integrating the recurrent and development budgets.

There has been much debate about the Warren Report's recommendations, in particular the recommendation to introduce direct income taxes. The report was subject to extensive consultation between the Government and private sector, in particular the Finance Centre Association. While some maintain it is necessary for the sustainability of the

taxation system, and that it will not jeopardise Vanuatu's tax haven status, others argue that it would be a regressive step, and deter potential investors in the Offshore Finance Centre. Some have also argued that the Government should first reverse existing exemptions, such as the (private) electricity company's exemption from import duty on fuel. These measures were also recommended in the Warren Report.

In pursuit of its decentralisation objectives, the Government passed a Decentralisation Act in 1994, creating six regional authorities to replace several smaller local councils. The regional authorities will be elected under a system whereby the party that wins the largest share of the vote automatically obtains half of the seats in the regional assembly, with the other half of the seats distributed equally between all parties. The regional authorities will have powers to raise taxes on property, and will be responsible for administering education (up to secondary level), health services and water supply. The purpose of the Act is to improve implementation of projects and delivery of services at a village level, and thus reduce rural-urban migration. It is worth noting that the Papua New Guinea government is now considering the abolition (or at least the substantial restructuring) of provincial governments with precisely the same aims.

One of the Government's major tasks over the medium term will be to improve its human resource capacity through better and more accessible education and health services. Vanuatu inherited two systems of education and health at independence, arising from the joint French and British administrations. The present government abolished primary school fees in 1992 and introduced substantial subsidies for secondary schooling with the intention of increasing participation by lower income groups, particularly in rural areas. There is no evidence that school fees were a major barrier to participation in education, however, other factors such as a lack of

school facilities, poorly maintained infrastructure, and a lack of teachers and materials could be more significant deterrents to parents sending their children to school. There is evidence that parents value education and are willing to pay the 10,000–15,000 vatu charged for government schools to educate their children. There is also some indication that people in rural areas engage in cash-generating activities in order to meet school fee obligations.

Investment

The investment climate in Vanuatu improved significantly in the second half of 1994, although the public service remained debilitated in the aftermath of the strikes and dismissals at the beginning of the year. The constitutional appeal to clarify the granting and withdrawal of business licences and visas in 1993 also seems to have helped to improve investor confidence.

The Government is working on an Investment Code, with assistance from the United Nations Development Programme, to be completed early in 1995. The Investment Code is intended to present a clear government policy on foreign investment with appropriate institutional arrangements and a simplification of the investment process. The Government is considering proposals to establish a Business Services Commission, drawing on other regional experience, notably the Fiji Trade and Investment Board and the Papua New Guinea Investment Promotion Authority, as possible models. The Commission should facilitate the long and often frustrating process of obtaining business licences and work permits and visas for expatriate employees that has deterred investors in the past. Proposals include the creation of a statutory authority governed by a Board comprising political secretaries from relevant Ministries and private sector representation. There are suggestions that the Board should be

answerable to at least two Ministers, for example the Minister for Finance and the Minister for Economic Development, in order to minimise the risk of political interference in licence approvals.

There are also proposals to establish a National Chamber of Commerce to facilitate consultation between government and business. The proposals have not been accorded a high priority, although they may be revived. Some officials consider that such an entity should be left to the private sector to organise, and that in fact the Financial Centre Association already performs many of the functions envisaged for a National Chamber of Commerce, although the latter would presumably have a much broader membership base.

As with other Pacific island countries, access to land continues to pose difficulties for investors, particularly for foreigners. All land in Vanuatu other than in the two urban centres of Port Vila and Luganville is held under customary ownership. Land in the two urban centres is governed by the Urban Lands Act which regulates the process by which the Government can acquire land from customary landowners. The Constitution does not allow land to be transferred as freehold, and external parties (including the Government) can only hold land under lease. The Government is seeking a change in the Constitution to allow freehold title in the urban areas, but as much of Port Vila is still subject to land disputes, it is unlikely to achieve this objective in the short term.

Financial sector

In December 1993, a Financial Services Commission was established to oversee the operations of the Offshore Finance Centre and act as a coordination point and Vanuatu's international representative on financial services matters. The International Companies Act was amended in April 1994 to nominate the Financial Services Commission as the principal regulator for

the Offshore Finance Centre. Further amendments to the Banking Act, the Insurance Act, the Companies Act and the Trust Companies Act are awaiting approval. These amendments will give the Commission specific powers to supervise offshore banks and finance centre companies. Under the proposed legislative amendments, the Reserve Bank of Vanuatu will retain its supervisory role over the domestic commercial banks, while the Financial Services Commission will take responsibility for offshore banks. The Governor of the Reserve Bank is a member of the Commission's Board of Directors.

Agriculture

Agriculture continues to support the bulk of the population through subsistence activities supplemented by cash cropping. The sector has expanded little over the past few years, reflecting low international prices for copra and cocoa, the major agricultural export crops. Growers receive price support for these crops at a level higher than the international price. Under this system, farmers are not prone to search for alternative products.

Diversification in agriculture received a boost in 1993 when Vanuatu commenced exports of squash to Japan. Squash exports totalled 2,000 tonnes in 1993 and are expected to reach 3,000 tonnes in 1994. Agricultural extension officers are now including squash husbandry in their programs on Efate island. As shown in Tonga, squash is a good smallholder crop which is relatively easy to plant and easier to maintain than other high-value niche market crops such as vanilla.

Forestry reform continues to feature on the Government's agenda, particularly following the 1994 South Pacific Forum, when Australia, New Zealand, Papua New Guinea, Fiji, Solomon Islands and Vanuatu agreed to work together to develop and a regional Code of Conduct on logging operations and to cooperate on forest

management issues in the region. Vanuatu has banned log exports, with legislation being passed in December 1994 (and effective immediately) to enforce the ban.

Tourism

Tourism is a major contributor to export earnings in Vanuatu. The Government, with funding from the United Nations Development Programme and the World Tourism Organisation, is in the process of developing a Tourism Master Plan. The Plan will focus on rural areas, and particularly on eco-tourism at a village level. The Government is beginning to target the North and Southeast Asian markets for tourism: tourist arrivals from Japan are increasing and there are prospects for package tours from Korea.

The Government, as part of its decentralisation policy, is keen to promote Santo and the outer islands for tourism development. To this end, it tendered for an international airport, capable of taking Boeing 767 jets, to be built on Santo. The Australian consortium which won the A\$25 million project is currently putting together a financing package.

Fiji

Over the medium term, the Fiji government will need to build on the reforms it has introduced since the 1987 coups to improve competitiveness and to increase labour productivity. Improvements in the competitiveness of the manufacturing and tourism sectors will be critical as trade liberalisation in Fiji's major trading partners erodes Fiji's margins of preference for manufactures. The Uruguay Round outcomes, which will see a significant reduction in Fiji's preferential access to the European sugar market after the expiry of the Lome IV Convention in 2000, reinforce the need for diversification in agriculture and elsewhere.

Macroeconomic developments

Recent growth rates in Fiji have been disappointing after the high growth rates of four years ago when the introduction of tax-free factories saw an expansion of manufacturing. The Fiji government estimates that real GDP grew by only 2.0 per cent in 1993, partly reflecting the devastation of Cyclone Kina in January 1993. Real GDP growth in 1994 is forecast at 3.2 per cent reflecting a revival in tourist arrivals, improved sugar production and renewed building and construction activity.

Inflation has been on a downward trend since mid-1993, and the annual average inflation rate at the end of October 1994 was 1.5 per cent. The downward trend reflects low inflation in its major trading partners and reductions in import duty rates.

Commercial bank credit at the end of July was an estimated 12 per cent higher than in the corresponding period last year, with the increase mostly going into housing loans. There was little growth in agricultural credit. Lending for manufacturing increased, mainly in the food and beverage industry, as did credit for tax-free factories (although there was no new lending). Non-bank credit also rose. Nominal interest rates in Fiji are higher than in its major trading partners—Australia, New Zealand and the United States—but comparable to other Pacific island countries. Weighted average commercial bank lending rates were 11.35 per cent at the end of September 1994, and weighted average term deposit rates were 7.04 per cent. (Average rates on savings deposits were 3.25 per cent over the same period.)

A new Banking Bill is to be introduced in the 1995 Budget session of Parliament. The Act will give the Reserve Bank of Fiji increased powers to monitor domestic banks, and will increase the disclosure requirements of deposit-taking financial institutions, including the non-bank institutions.

The balance of payments is expected to record an overall surplus of F\$12.3 million for 1994, compared with a deficit of F\$66.3 million in 1993. The balance of payments outcomes for 1993 and 1994 are complicated by the import and export of aircraft. A turnaround in the balance of payments is expected in the current account from a deficit to a surplus and a reduced deficit in the capital account. External reserves at the end of 1994 are expected to record F\$427 million, sufficient to cover 5.3 months imports, compared with 4.9 months imports at the end of 1993.

Fiji has operated relatively strict exchange controls since the period of capital flight following the coups of 1987, although these have been progressively relaxed since 1992, and were further relaxed in January 1994. The limits for movement of foreign exchange out of the country were increased to F\$6,000 for travellers, F\$125,000 for emigrants and F\$5,000 per family for overseas investment. There are no restrictions on remittance of profits, and exporters may keep up to 10 per cent of export earnings in foreign currency. In addition, the Fiji National Provident Fund is now able to undertake limited offshore investments. The forward exchange market is still relatively new and dominated by the Reserve Bank. Commercial banks can undertake forward transactions as long as they are able to match import and export receipts. The Fiji dollar remains pegged to a trade-weighted basket of currencies.

The Government has pursued deregulation of the labour market, and wages are now set through direct negotiation between employers and unions, with arbitration available through an independent arbiter. The Government has expressed its intention to link wages more closely with productivity and its own actions with respect to public service wages will provide a strong demonstration effect, not least as a large formal sector employer. In September 1993, the public sector union wage claim of 10 per cent was heard by an

independent arbiter, who granted them a 2.5 per cent increase. The Government had budgetted for an increase of 1 per cent and, in the 1995 Budget address, invoked the Counter Inflation Act which empowers it to set civil service salaries at a level considered appropriate to control inflation with no recourse to arbitration. The public service unions threatened strike action and the matter is yet to be resolved. The practice of retrospective wage claims is an impediment to budgetary planning; a system whereby wage increases are negotiated on a forward basis would remove the uncertainty of retrospective claims by ensuring that increases were appropriated through the normal Budget process.

Government policy

The net budget deficit for 1994 is expected to be around 2.9 per cent of GDP, a significant improvement on the deficit outcome of 4.0 per cent in 1993, reflecting increased outlays for rehabilitation following Cyclone Kina and the 1992/93 public service wage outcome. The Government considers a deficit of around 2.5 per cent of GDP to be sustainable and has targetted this level for 1995. Government external debt remains relatively low, and the Government continues to pursue its quick repayment policy on external debt. All of Fiji's external debt is non-concessional.

The Government is continuing to concentrate on improving compliance with the value added tax (VAT) introduced in 1992. Although the VAT was introduced with an extensive public relations and education campaign, compliance problems remain. These are improving as traders and tax collectors become more familiar with the system. The VAT has succeeded in broadening the tax base, and could provide a model for other Pacific island countries.

The Government continued to pursue its policy of trade liberalisation in 1994 when import licensing of rice, canned fish

and dairy products was replaced with tariffs. Licensing for panel wood products is to be removed during 1995 to comply with GATT rules. The Government reduced the general tariff rate from 25 per cent to 22.5 per cent in the 1995 Budget and removed the duty-free status of government agencies and statutory bodies.

In order to improve competitiveness over the medium term, the Government will need to renew its efforts in public sector reform, and particularly in rationalisation and privatisation of public enterprises. The high cost of public enterprise is reflected in the economy's cost structure and impedes improvements in its international competitiveness. The Public Enterprise Unit, charged with the implementation of the privatisation program, was recently transferred from the Ministry for Finance to the Ministry for Commerce and Industry, and several public enterprises have been corporatised as a preliminary step to divestiture. A Public Enterprise Bill, to re-organise government commercial activity and to clarify the relationship between government and public enterprises, has been drafted. While a phased approach to privatisation has been adopted by many countries, there remains a risk that changing the legal structure of a public entity (say, through corporatisation) may not affect its efficiency nor the competitiveness of the environment in which it operates.

The Government's strategy to promote Fijian participation in business, seen as inconsistent with its push for deregulation, has shifted in focus from restricting activities and use of import licences to improving educational opportunities for Fijians. Fijians still have access to concessional credit from the Fiji Development Bank as well as preferential access to scholarships and public service employment. The major party in the government coalition proposed in October to give Fijians preferential access to shares in privatised state enterprises.

The review of the Agricultural Landlord and Tenants Act is expected to be complete in 1997, when the first significant group of 30-year leases comes up for renewal. ALTA only applies to land held under customary land tenure. The Native Lands Trust Board is continuing to grant new leases under the existing legislation. Where leases are not renewed, the Board will pay compensation to the outgoing tenant for improvements to the land—in some cases it will recoup this from the incoming tenant. The Board does not favour substantial change to the existing Act, despite recommendations from observers, including the World Bank, to deregulate rents (currently set at no more than 6 per cent of the unimproved value of the land), widely perceived to be below market rates and therefore a disincentive for land improvement. The Board is running extensive educational campaigns and consultations with landowning groups on the nature of the Act. The Lands Department is also examining options, for example sharefarming, where the landowner and tenant work together and share profits from a given piece of land. Sharefarming and sub-letting of native land is currently illegal under the Act although informal arrangements exist.

Investment

Investment has recorded slow growth over the past couple of years, reflecting changing markets for manufacturing and uncertainty created by the Constitutional Review, due in 1997, and the review of the Agricultural Landlord and Tenants Act. The most substantial recent foreign investment was the takeover of Carpenters in Fiji by a Malaysian company MBf in July 1994. Applications under the Tax Free Factory scheme increased in 1994, after significant setbacks in 1992 when New Zealand garment manufacturers withdrew. In September, however, Fiji's largest garment factory burnt down, leaving an uncertain future for its more than 1,000

employees. The increase in new applications in 1994 was primarily for garment exports to the United States. Manufacturing in Fiji continues to face high wages and high-cost utilities and services, and will need to become more competitive as preferential access to key markets is inevitably eroded.

The Fiji Trade and Investment Board is undergoing review with the assistance of the World Bank's Financial and Investment Advisory Service. The Board is preparing a new Investment Act and an investment strategy to emphasise its promotional rather than regulatory functions and to rationalise investment incentives to remove distortions. A committee has been established comprising the Board, customs, inland revenue, immigration and environment officials to consider project proposals. The committee, which meets fortnightly, is empowered to consider all aspects of an investment proposal, including requirements for work permits, visas and environmental impact assessments. The purpose of the committee is to reduce the need for investors to seek separate approval from several different authorities, providing a 'one-stop shop'. The Board is working with other Ministries to develop guidelines for the appraisal of projects, for instance in timber milling and fisheries.

The largest investment on the horizon is Placer Pacific's proposal to develop the Namosi copper mine. Negotiations continue between the mining company and the Government over taxation, land access, environmental impact and the distribution of revenue between provinces. There is still some uncertainty over the profitability of the mine. If the mine goes ahead, it will involve a F\$1.5 billion investment, and could generate substantial revenues.

The agriculture sector, which continues to support over half of the population, has limited prospects unless alternative export opportunities are identified and exploited.

Sugar is likely to decline after Fiji's preferential access to the European market—to which it currently exports at over double the international price—closes at the end of the decade.

Tourism prospects are being set for medium term development, with tourist arrivals increasing and the expected increase in visitors to the region for the Sydney Olympics in 2000. In September, *Air Pacific* commenced direct flights to the United States (Los Angeles) and introduced a third weekly flight to Japan. Fiji is looking to diversify its tourism markets to Asia, and in particular to Japan and Korea.

Tonga

The Tongan economy has grown in real terms at a moderate rate of slightly less than 2 per cent per annum over the past five years. Population growth is low (around 0.5 per cent) due to high rates of emigration.

Macroeconomic developments

The Reserve Bank of Tonga estimates the economy grew by 4.7 per cent in real terms over the 1993/94 financial year, based on a very good squash harvest, a booming construction sector and a buoyant tourism industry.

The underlying rate of inflation was 3.2 per cent in the June quarter of 1994. The imported component of inflation in the June quarter of 1994 was 1.5 per cent, reflecting low inflation in Tonga's major trading partners. Domestic inflation recorded a 6.6 per cent increase over the June quarter of 1993, indicating a lessening of Tonga's competitiveness.

Interest rates in the Kingdom have shown little change since the March quarter, although they recorded a noticeable change after the opening of two new commercial banks, ANZ and MBf, at

the end of 1993. The average lending rate at the end of June was 10.1 per cent, and the average deposit rate was 3.9 per cent. Interest rate spreads are likely to continue to narrow over the short term as the new banks compete for market share.

Deposits with commercial banks stagnated in the first half of 1993 but recovered during 1994, allowing an increase in private credit which has recorded high growth - albeit from a low base. Public sector savings in the form of a fiscal surplus of T\$4.3 million in the 1993/94 financial year also enabled higher growth in private credit. The increase in private lending has been primarily in housing and construction, although there has been some lending for tourism. Credit growth in Tonga is seasonal, with large increases during the months of July to October, coinciding with squash planting and the need for pre-planting finance. As the crop is harvested towards the end of the year, these advances are repaid to the Tongan Development Bank (the principal lender in the agricultural sector).

The current account recorded a deficit of T\$2 million in the June quarter, comprising a reduced trade deficit of T\$21 million partially offset by a surplus in the invisibles account of T\$19 million. The surplus in the invisibles account reflected a seasonal increase in remittances associated with two major church conferences during the quarter and an increase in foreign grants from the European Commission for several projects in Vava'u and Australia for the new Tongan Water Board office. External reserve holdings declined from T\$46.0 million at the end of March to T\$43.1 million at the end of June, sufficient for a relatively comfortable cover of 5.9 months of imports.

Government policy

The 1993/94 Budget recorded a surplus of T\$4.3 million. The 1994/95 budget projects a 2 per cent rise in expenditure and new

revenue measures which should generate an additional T\$0.5 million. Given the Reserve Bank of Tonga's estimate of 2.5 per cent growth in real GDP, this should result in another fiscal surplus for 1994/95.

The five year cycle of civil service wage claims, due in 1994, has been delayed. Although statutory authorities are undergoing their own wage reviews, these are not expected to result in significant wage increases. The Government has been relatively successful in containing public sector wages, although the job opportunities afforded by emigration of skilled workers have placed upward pressure on skilled wages.

The Government announced its intention to reform the civil service and to implement a privatisation program, but the civil service review has been deferred, pending Ministerial approval. There is scope for improving the efficiency of the civil service through rationalisation of government departments.

To date, the international services of the telecommunications authority have been contracted out to a British company. In June 1994, management of the International Dateline Hotel was contracted to the Sheraton group, with the Government retaining its 99 per cent share. The Commodities Board (now Tongan Investments Ltd) has also undergone a corporatisation process and many of its holdings are now turning profits and could be privatised. Privatisation of some of the smaller government operations could be financed through domestic equity, although the larger enterprises might require foreign capital.

Investment

Investment in Tonga is dominated by the public sector, largely financed by foreign grants or concessional lending. Two major construction projects are currently underway: the Queen Salote Memorial Hall, funded by a Taiwanese grant and the

Tonga Trust Funds, and the market in Nuku'alofa, funded under an Asian Development Bank project.

The Government is in the process of preparing a Companies Act, based on New Zealand legislation, which is designed to improve the regulatory framework for investment. The Act is still in its drafting stage and will not be ready for presentation to Parliament until at least next year.

The Small Industries Centre has seen a decline in manufacturing for export, reflecting an erosion of preferential access combined with recession in New Zealand and Australia, and management and marketing problems in the industries concerned. Export manufacturing has been replaced by manufacturing for the small domestic market, primarily in confectionery and footwear.

Agriculture and fisheries

Agriculture dominates employment and exports in Tonga. Although around a third of the population lives in Nuku'alofa, most Tongans rely on subsistence farming for some of their food. Exports are dominated by squash and, to a lesser extent, vanilla. Tonga has good soils and climate for agricultural production, and is beginning to explore the export markets for other crops, such as potatoes to Fiji.

Squash is exported under quota to Japan only during November and December. The 1993 squash season was reported to be the best ever in terms of yield, quality and price. The quota for 1994 is set at 15,000 tonnes, with an absolute maximum of 17,000 tonnes allowed. This quota is likely to be exceeded by production, and farmers are contesting it. The quota was initially justified on the grounds of quality control, but this argument would seem to be less compelling now that the crop is well established. Moreover, it is not clear whether higher export volumes would lead to a significant fall in prices. Both the

United States and New Zealand export significantly higher volumes to Japan during their squash seasons. There is an opportunity for Tonga to export squash during May /June and the Tongan industry attempted to enter this market in 1994, with a proposed 2,000 tonnes. In the end, however, poor weather conditions and other problems resulted in a poor quality and undersized crop, most of which was rejected for export. The final export volume was only around 250 tonnes.

Vanilla is becoming increasingly important as an export crop. Tongan vanilla, exported to the United States, has developed a reputation for very high quality. Other export crops include watermelon and papaya, which can now be exported to New Zealand, following a lifting of quarantine restrictions. There is also some interest in exploring prospects for beans and root crops, and for the very high-value product aloe vera.

Fisheries in Tonga are relatively undeveloped, with only eight operators, of whom the largest is the government-owned Sea Star. Tonga's tuna resource is not as extensive as that of the Micronesian countries, but it remains under-exploited and there is potential for further development of tuna exports. There are prospects for deep water species such as snapper for the US market, although over-exploitation is already leading to declines in supply. Tonga is moving towards the development of a commercial longline fishery.

Tourism

The tourism industry in Tonga is still very small, although tourist numbers increased by an estimated 6 per cent during the 1993/94 financial year. Sunday trading restrictions and a lack of international standard hotels continue to constrain growth in the sector. Most tourist facilities are modest and suited to backpacker tourism rather than the higher end of the

market. The airport in Vava'u is being upgraded and there is a possibility of direct flights between Nadi and Vava'u in the future. The National Tourism Plan, to be implemented under an Asian Development Bank program, includes ambitious plans for infrastructure development. A US\$10 million project to upgrade ports, roads and other facilities is due to commence in March 1995.

Access remains a constraint to tourism development. *Royal Tongan Airlines* has joint service arrangements with *Air Pacific* (previously with *Polynesian Airlines*) but still lacks direct services to major tourist sources. International routes remain unprofitable for *Royal Tongan Airlines* (although these are to some extent offset by domestic profits) and the increase in air visitors remains slow.

Western Samoa

The Western Samoan economy is extremely vulnerable to external shocks, as shown after two major cyclones in 1991 and 1992, the latter of which caused damage valued at around 300 per cent of GDP for that year. Western Samoa is heavily dependent on a narrow range of exports, foreign grants and remittances. The establishment of the Yazaki Samoa automotive assembly plant in 1991 demonstrated Western Samoa's potential in export processing and manufacturing: relative to other Pacific island countries, Western Samoa has low wages and a high level of skills in its workforce.

Macroeconomic developments

After two years of negative real growth attributable to Cyclones Ofa and Val, Western Samoa recorded real GDP growth of an estimated 6 per cent in 1993. This performance is unlikely to be repeated in 1994: taro leaf blight has devastated Western Samoa's most important export

crop. Increases in production of other agricultural crops, tourist arrivals and industrial output are not expected to be sufficient to prevent a decline of around 6 per cent in real GDP in 1994.

Inflation in Western Samoa has risen since the beginning of the year due to the decline in taro supplies. At the end of August, the annual average inflation rate was 14 per cent, although this partly reflects the effect of the introduction of the Value Added Goods and Services Tax in January 1994. Low inflation in Western Samoa's major trading partners means that inflation is largely domestically driven, and it has fluctuated significantly over the past few years, reflecting the effects of the two cyclones and more recently taro leaf blight on domestic food production.

Interest rates in Western Samoa continue to be regulated by the Central Bank of Samoa. In June 1994, commercial bank lending rates were 12.0 per cent, while the rate on three month time deposits was set at 5.5 per cent. Negative real interest rates create a disincentive for savings. Given Western Samoa's negative gross domestic savings and consequent dependence on external savings for investment (via remittances and foreign aid), there would seem to be a strong argument for allowing market forces to have a greater role in determining commercial bank rates.

Commercial bank lending to the private sector increased by 3 per cent over the twelve months to June 1994, and was primarily in construction, transport and professional and business services. Meanwhile, lending to agriculture, trade and manufacturing recorded significant declines over the same period. Non-bank lending to the private sector increased by over the second quarter of 1994, and was concentrated mainly in housing and construction. The Central Bank of Samoa is currently proposing new legislation to bring the non-bank financial institutions under its control.

The balance of payments recorded two years of deficits in 1992 and 1993, leading to a 25 per cent decline in external reserves. This situation is unlikely to be reversed for the next two years. Export earnings fell significantly during the first eight months of 1994 (by 57 per cent compared with the corresponding period in 1993), largely due to taro leaf blight which caused taro exports to fall by 99 per cent. Improvements in exports of coconut cream and bananas have not been sufficient to offset this decline. Imports have also fallen, by around 21 per cent, compared with the first eight months of 1993. For the first half of 1994, export earnings were sufficient to finance only 4 per cent of the import bill, and government projections for the end of 1994 indicate that exports will be equivalent to less than 3 per cent of imports for the year. Higher earnings from tourism and export processing will partly offset the deficit in the trade account. (Earnings from the Yazaki factory are recorded as export processing under the services account rather than in the trade account.) The capital account is forecast to record a dramatically lower surplus due to repayments of debt associated with Polynesian Airlines. As a result of these developments, external reserves are likely to fall further by the end of the year. Gross reserves at the end of June 1994 recorded WS\$121 million, sufficient to cover 5 months imports. Western Samoa's extreme vulnerability to external shocks means it requires a relatively large cushion of external reserves, and the Government is focussing on improving the balance of payments for this reason.

Government policies

The deterioration in the external accounts led the Government to review its 1994/95 Budget in October 1994. An additional WS\$17.5 million is to be raised from the sale of government shares in commercial enterprises, and the National Revenue Board is currently examining options to increase taxes on alcohol and tobacco with

a view to raising them from 1 January 1995. The VAGST is expected to return less than originally forecast and the training programs for its implementation are continuing to ensure that the private sector and revenue collectors are able to administer it. The Government is also turning attention to enforcement measures to ensure adequate penalties for deliberate evasion of the tax.

On the expenditure side, the Government has cancelled all vacant positions although public service increments will be retained. Current expenditure is to be cut from WS\$109 the additional costs to the Government of *Polynesian Airlines*. This will involve cuts in domestic financing of a number of projects. Some will be funded by external aid, while other savings will be made through delays in project implementation.

Public enterprises

Polynesian Airlines has suffered serious difficulties over the past few months, through poor management and some bad luck. Its debts currently total around WS\$82 million. *Polynesian's* chronic financial problems led to questions over its viability and a significant restructuring in the second half of the year. Compounding this, the airline temporarily lost its remaining international aircraft to an accident in September.

The Government decided, for reasons of national interest, against liquidating or selling the airline. Instead, the airline underwent an extensive restructuring exercise, involving the replacement of its Board of Directors, the appointment of a new Chief Executive and a significant reduction in its staff numbers. The airline also rationalised its routes, terminating its less profitable international routes and concentrating on its regular routes to New Zealand, Australia and the South Pacific. It returned its remaining Boeing 767 to its lessor and will focus its operations on its Boeing 737 and two light aircraft. Over the

longer term, the Government has raised the possibility of full or partial privatisation of *Polynesian Airlines*, or of entering into a joint venture arrangement with another international commercial airline.

The Government's decision to continue to support *Polynesian Airlines* has led to additional financial commitments, with implications for fiscal policy. These include the payment of WS\$2.5 million for a loan guaranteed by the Government, and an additional WS\$21.2 million in working capital and to repay unavoidable debts. The Treasury has been charged to negotiate the rescheduling of *Polynesian Airlines'* other debts over the next several months. In the 1994/95 Budget, the Government injected WS\$1.5 million into the airline as equity capital, and converted Treasury advances worth WS\$6.7 million into additional equity. With the injection of government funds and its comprehensive restructuring, *Polynesian Airlines* should show improved performance and reduce its reliance on the national budget.

Investment

Investment in Western Samoa is dominated by public infrastructure, largely funded by foreign grants and concessional loans. Given negative gross domestic savings, private investment is largely funded by external savings in the form of remittances. The Government has tried to encourage private investment by passing the Enterprise Incentives and Export Promotion Act, which offers generous tax and duty concessions for new manufacturing ventures, and through the establishment of the Small Industries Centre, which provides serviced land for manufacturers. Major manufacturing industries in Western Samoa include coconut cream production, which accounted for around half of export earnings in the first half of 1994 (reflecting the decline in taro exports as well as an increase in coconut cream production), beer and cigarettes. The Yazaki Samoa

automotive wire harness assembly now dominates the industrial sector. It is the largest single private employer in Western Samoa.

Western Samoa's relatively low wages (compared with other Pacific island countries) and skilled workforce create the potential for manufacturing in high-value niche markets, which will be increasingly important in a more liberal global trading environment. Coconut cream is already under threat from competition from

Malaysia and Thailand, and investment continues to be constrained by a lack of domestic credit, difficulties in obtaining long-term access to land and an incentive structure that discriminates between industries.

Growth in tourism is constrained by a lack of infrastructure and poor access to potential markets in Asia. The Government has approved two major hotel development projects to be commenced over the next year.