Focus

Achieving growth in the Pacific islands: an introduction

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The Small Island Developing States (SIDS)[1] in the Pacific, spread out over an area of 30 million square kilometres of ocean, and home to over 9 million people, face a complex and unique set of development challenges. As small, highly open economies they are particularly susceptible to external shocks, including fluctuations in import prices and export earnings in particular. Remoteness from major ports and export markets, low levels of connectivity with the outside world and susceptibility to natural hazards further complicate matters and have resulted in the Pacific islands being amongst the most vulnerable economies in the world. In spite of their increasing integration into global markets, most face further challenges owing to very limited absorptive capacities, limited resources, inadequate technology, lack of infrastructure and poor economic management and institutional capabilities. As a consequence, economic growth and related outcomes in most remain heavily reliant on external resources, typically including at least one of aid, migrant remittances, and foreign direct investment (FDI) (AusAID 2008 and McGillivray et al. 2008).

The particular constraints and growth challenges of Pacific SIDS are too often overlooked in the development research literature. Moreover, the policy debate on how to promote and achieve growth in the Pacific islands can benefit from a deeper understanding of the nature and consequences of these often unique, combination of constraints. This *Focus* is devoted to development challenges facing these islands, specifically relating to the achievement of economic growth, and draws on five papers that were presented or tabled at the World Institute for Development Economics Research (WIDER) 'Fragility and Development' research project meeting held in Fiji in December 2006.

Overview

The first two papers in this collection deal with the macroeconomic aspects of economic growth in the Pacific island countries, and the final three focus specifically on aid and growth or variables closely related to growth. As is made clear in the first two papers, and was also emphasised more broadly in the further work emanating from the UNU-WIDER project on 'Fragility and Development', the relationship between aid and development is crucial in many SIDS, including those in the Pacific. Fragile states, and countries vulnerable to external shocks, need to build capacity and raise their resilience, but often lack the ability to absorb and utilise aid effectively.

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The first paper, by B. Bhaskara Rao, K.L. Sharma, Rup Singh and Nalini Lata, 'A survey of growth and development issues in the Pacific islands', provides an appropriately broad view of the key growth and development issues affecting Fiji, Papua New Guinea, Solomon Islands, Samoa, Tonga, and Vanuatu. They analyse the fundamental indicators affecting these countries' output and growth performance, including aid, foreign direct investment, trade, migration, remittances and external debt. The authors report results obtained from a growth accounting exercise, which shows that factor accumulation is the most relevant growth determinant, and that the contribution of total factor productivity is negligible in the countries studied. The study also infers that increasing migration outflows are partly due to political instability, as well as higher earning opportunities and better standards of living and education prospects in the destination countries. On one hand, these findings suggest that migration benefits the local economies through remittances and absorption of excess labour. On the other hand, they imply that migration tends to harm especially the smaller countries where it is difficult to replace human capital, and seem to create inefficiencies, a dependence culture and disincentive to work, lowering overall productivity in the Pacific islands countries. The study points to a rather gloomy conclusion regarding the relationship between aid and growth, doubting whether it has contributed to higher growth in the Pacific countries it examines. This conclusion is however rather contentious as it is not entirely consistent with other findings from the UNU-WIDER study, reported both in this *Focus* and other publications emanating from the study. This does not provide a case for rejecting the paper's conclusions on aid and growth, although it does suggest that it should be treated with great caution as well as pointing to the difficulties in seeking to assess links between aid and various development-related outcomes empirically.

The second paper 'Macroeconomic policies for growth in small Pacific island economies' by Anis Chowdhury and Yogi Vidyattama investigates the macroeconomic performance and policies for growth in small Pacific island countries. The study stresses the impact of various supply shocks and the serious obstacles to development arising from their geography and demography. Specific *foci* of the Chowdhury and Vidyattama analysis are the relationships between economic growth, inflation and the balance of payments, and the expected contributions of fiscal, monetary and exchange rate policies. The authors contend that growth performance among Pacific island countries during the last two decades has been held back by inadequate or conservative macroeconomic policies. They endorse a leading role of the government, given the weak private sector, poor infrastructure and low-level human capital, as well as emphasise that the success of a state-led development strategy will depend on the quality of governance and the government's administrative capacity. Chowdhury and Vidyattama conclude by identifying that under these conditions, donors could play an important role in improving governance by balancing traditional development assistance and technical facilitation.

The previous conclusions reflect the enormous potential impact and policy relevance of aid on SIDS in the Pacific. Large aid inflows (mostly in the form of grants), although variable, have been an important source of government finance. Aid to Pacific island countries such as Kiribati, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu is significantly higher than in other low income countries, both

as a proportion of national income and in per capita terms. Yet these economies have failed to grow at a reasonable rate, and improve economic, social and political conditions. The lack of economic progress in the presence of large aid flows to the Pacific has been a matter of concern in the donors' community, particularly in those donors such as Australia that have provided large shares of aid to Pacific island countries.

In this regard, the final three papers of this *Focus* deal with the issue of foreign aid to the Pacific island countries. Chakriya Bowman and Satish Chand assess the impact of aid on institutions in the Pacific islands, in their paper 'Size matters: the impact of aid on institutions'. They suggest that the level of development, the size of an economy, and the level of aid receipts matter for institutional performance as quantified by measures of economic freedom. Cross-country evidence reveals that the impact of aid in countries with small populations is small in comparison with large countries, and that, while aid increases economic freedom as a whole, the impact of aid on economic freedom is harmful for economies with a population of less than 1.4 million. This is significant for small Pacific island countries, where increasing amounts of overseas development assistance fund governance programs. Case studies of Fijian economic governance initiatives are used to illustrate the difficulties encountered when donors fund institutional reform programs in Pacific island countries. Overall, this paper presents a strong case for the need for institutional strengthening programs in these countries.

Simon Feeny and Mark McGillivray ask in their paper the question 'Do Pacific countries receive too much foreign aid?'. They begin by observing that Pacific countries receive some of the highest ratios of aid to GDP in the world (though not all) and that indications are that these levels are set to increase further. These stylised facts motivate the Feeny and McGillivray paper, which examines the levels of aid that Pacific countries can effectively absorb. The paper cites a large number of previous studies, including a number of Pacific countries that show that while growth in recipient countries would be lower in the absence of aid, the link between aid and growth is subject to diminishing marginal returns. Using findings from a number of the recent aid-growth studies, Feeny and McGillivray derive an estimate of the level of aid that maximises its incremental impact on per capita income growth. They establish that a number of Pacific countries receive aid amounts well in excess of this level. While there may be important non-growth objectives which justify the high levels of aid to these countries, the authors note that donors should be cautious of unintended opportunity costs associated with large amounts of foreign aid.

In the final paper, entitled 'Aid allocation and volatility to small island states', Matthew Clarke, Tim Fry and Sandra Mihajilo investigate the volatility of aid to SIDS, including the Pacific island states. Aid volatility occurs when a recipient country receives differing levels of aid from year to year and is widely thought to lessen the positive development impact of these inflows. In their paper, Clarke, Fry and Mihajilo decompose the volatility of aid into that due to bilateral aid (disaggregated into sector and program aid) and to multilateral assistance. The authors focus on 44 SIDS from the Asia Pacific, Africa, and the Caribbean regions, over the period 1973 to 2004. Also, annual changes in aid allocation are considered for both changes in aid provisions from major donors to the Pacific as a whole, as well as for changes in aid receipts in 16 individual Pacific island countries. The authors find that past aid flows are correlated with present aid flows, and that

volatility of both sector and program aid in the Americas and Asia Pacific region are characterised by a higher degree of volatility than in the African region. An important finding is that shocks to bilateral aid result in the persistence of volatility for a number of years before stabilising. Their findings also show that, on average, multilateral aid is not only considerably more volatile than bilateral aid, but it is also more unpredictable. In conclusion the authors point out that making aid less volatile will require a better knowledge of aid allocation decision variables used by donors.

Concluding remarks

SIDs in the Pacific are confronted by a complex set of development challenges. Many of these islands are vulnerable to economic and environmental shocks, and consequently many are characterised as fragile states. A message that is consistent with the findings of each of the papers in this *Focus* is that the role of the international community is crucial in the futures of Pacific island countries. Yet many crucial but unresolved issues remain. Uncertainties relating to global climate change, rising oil and food prices, and changing patterns of south-south trade are of increasing concern to these countries.

Finally, despite facing a common set of complex development challenges as was emphasised here, it needs to be emphasised that the countries in the Pacific have many differences. This is obviously well-known in the Pacific but often given insufficient recognition elsewhere. Pacific countries have different historical and institutional development paths, with differing levels of development, state formation and effectiveness, and different external relations. While there are many common solutions, eventually all solutions will have to implemented and adopted to the individual circumstances facing each country in this region. Much further research is required to understand better these individual country requirements to achieve growth in the Pacific.

Note

[1] Almost a half of all the countries classified by the United Nations as Small Island Developing States (SIDS) are located in the Pacific. These include the Cook Islands, Fiji, Kiribati, the Federated States of Micronesia, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor Leste, Tokelau, Tongo, Tuvalu and Vanuatu, as well as the two territories of New Caledonia and French Polynesia. Australia and New Zealand are also part of the group of Pacific island countries, but are excluded for present purposes.

References

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Website: http://www.wider.unu.edu/research/projects-by-theme/development-and-finance/en_GB/fragility-and-development