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CURRENT ECONOMIC TRENDS IN SELECTED SOUTH PACIFIC COUNTRIES

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Caution

A caveat must precede any analysis of economic developments in the Pacific islands. The statistical basis for such analyses is most inadequate. Part of the explanation for this deficiency is to be found in the processes by which the statistics have been developed. The colonial powers left behind a well-developed system of record keeping designed to meet the requirements of auditors, but not economists. A competent body of clerks, but not of statisticians, was one of the inheritances of newly independent nations. The international agencies, particularly the international financial institutions, adopted a role of improving statistical standards. However, with few exceptions, such as the IMF program for training balance of payments statisticians (and balance of payments data are now among the most reliable and current in many developing countries), these bodies engaged in remarkably little statistical training. Many courses and programs were established, but only rarely was statistics included in the agenda. The few statistical training programs such as that of the US Department of Commerce and the limited activities of the International Association for Research in Income and Wealth hardly touched the Pacific. Rather, the agencies associated with the United Nations and many national aid administrations sent statistical advisers and officers to lead developing country statisticians along paths outlined in manuals designed for developed country needs. All too often these 'experts' were officers that national statistical agencies or international institutions wished to discard. It was considered better to send these 'experts' far away where they could live in comfort than to spend the same amount of money bringing intelligent statisticians to places where they would be a bother just by being around.

As a result, except in Fiji, the data necessary for economic analyses are either not available (basic national accounts for Western Samoa and Tonga), unreliable (evidenced by the need for the recent major revisions of GDP estimates for Papua New Guinea), so far in arrears to be of minimal use for current policy making (many statistics for Papua New Guinea), or the product of political whim rather than statistical investigation. Even those that are available are often partly derived with political objectives in sight. They often tend to provide an unduly optimistic view of developments. They are often produced by public servants associated with planning

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ministries or similar bodies that are in constant conflict with parsimonious ministries of finance. In the view of public administrators, their major use is often considered to be the provision of support for applications to international and private financial institutions. Therefore, again, they tend to provide favourable interpretations of developments and any projections tend to be based on the most favourable rather than the most realistic assumptions. The negotiators from the institutions often encourage these biases. They are essentially loan officers wishing to persuade investment committees and similar groups to approve lending proposals. Optimistic statistics are valuable instruments in this process.

It is long past the time when the inadequacy of Pacific island statistics was recognized and the governments of these countries insisted that more of the available aid be devoted to changing the situation in a realistic way. It is also long past the time when donor nations recognized the value of reliable and recent statistics for their own uses, acknowledged the weakness of previous efforts in this field, and took appropriate action.

The disappointing record

The year 1988 was a relatively prosperous one for the Pacific islands, other than Fiji, largely because international demand remained strong and because there were certain favourable domestic developments (for example, increasing mineral production in Papua New Guinea). Political developments, again excepting Fiji, contributed to an atmosphere conducive to growth. There were remarkably smooth changes of government in Papua New Guinea and Western Samoa. The ideological shift in the pattern of government expenditure in Papua New Guinea may lead to some uncertainty regarding the long-term future trend. The impact of the earlier disturbances in Vanuatu was exaggerated by the media. In brief, 1988 was largely a year of economic consolidation after the gyration of Pacific export markets in 1986 and early 1987.

Yet, the growth of income in the Pacific developing countries has continued to lag behind that of other countries at comparable levels of development.[1] This slow growth cannot be attributed to unfavourable international conditions. The Pacific countries, along with other developing countries, have experienced relatively favourable international demand and supply conditions over the post-war period.[2] In addition, they have been the largest recipients of international aid on a per capita basis.[3] The reasons for their slow growth must be found in domestic policies.

Cole and Hughes, describing Fiji,[4] stated that macroeconomic policies encouraged development and microeconomic policies discouraged it; the same can be said for Papua New Guinea, and with greater or less strength for the other Pacific nations. There are certain obvious reasons for the differences in economic policies. Macro-policy formulation appears to be a relatively dull activity. Fiscal policy in the form of budget compilations often appears to be a boring book-keeping operation. Monetary policy determination is usually shielded from public gaze and criticism, and is a non-glamorous activity. Exchange rate policy is an esoteric exercise that attracts remarkably little public attention. On the other hand, involvement in preparing national plans is a glamorous experience. Hence, voluminous and ridiculously detailed plans proliferate, often appearing well after the start of the period for which they prescribe policies, leaving the planners little time to examine the implementation of their recommendations before work must commence on the next voluminous edition of their plans. Tariffs to encourage import substitution arouse xenophobic support. Nationally owned enterprises become national monuments. Indigenization of industry and

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[1] For data on developments in similar countries see World Bank, *World Development Report, 1988*, Oxford University Press, 1988, p.211 ff.

[2] Graeme S. Dorrance, *Primary Product Prices and Terms of Trade of Developing Countries with Reference to the South Pacific*, Islands/Australia Working Papers, National Centre for Development Studies, Canberra, forthcoming.

[3] R.V.Cole and T.G. Parry, 'Key issues in Pacific island development' in Cole and Parry (eds.), *Selected Issues in Pacific Island Development*, Pacific Policy Papers No.2, National Centre for Development Studies, Canberra, 1986, p.19.

[4] R.Cole and H. Hughes, *The Fiji Economy, May 1987: Problems and Prospects*, Pacific Policy Papers No.4, National Centre for Development Studies, Canberra, 1988.

commerce proclaims national independence. Processing of domestic raw materials imparts a vision of national sophistication even when it involves a reduction in real national product. The establishment of marketing boards is regarded as protecting farmers, who are seen in all countries as being exploited by commodity traders who are, in the Pacific, assumed to be foreigners. In caricature, macro-policy formulation tends to attract the competent policy makers who are more interested in results than appearances, while micro-policy formulation tends to attract the flamboyant operators who look for dramatic and patriotic effects; in particular, they attract romantic expatriate advisers. For these reasons alone, the appropriateness of micro-policies calls for serious unemotional examination.

In the post-war pre-independence period, the colonial powers feared that there would be a recurrence of the depressed conditions of the 1930s that were also marked by chaotic commodity price movements. To prevent a recurrence of the 1930s experience, almost all of them engaged in large-scale nationalization of industry and commerce so that microeconomic policies could prevent a recurrence of the immediately pre-war macroeconomic chaos, and they established marketing arrangements to bring order to commodity markets. It was considered essential to prevent the pre-war deflationary pressures from re-emerging. It took a long time to realize that the fundamental post-war problem was inflation rather than deflation. Colonial administrators followed these precepts by creating state-owned enterprises and marketing boards in the colonies. These moves were supported by United Nations and similar agencies that worked to persuade the newly independent nations that private enterprise would never correct the former colonial exploitation, and to establish import substituting industry, and foster indigenization of domestic industry and commerce. (If the newly independent countries followed international agency advice they would also provide comfortable jobs for non-indigenous advisers.)

The international bureaucracy also persuaded the authorities of most developing countries that the terms of trade must inevitably move against them and that measures must be taken, such as the establishment of marketing boards, to alleviate this chronic disaster that, in fact, never emerged.[5]

Recently, in the former colonial powers and elsewhere, the pendulum has swung the other way and privatization and the encouragement of free market forces are the catch words of the day. Even the socialist governments in Scandinavia, Australia and New Zealand are privatizers and market deregulators. Undoubtedly this pendulum, as all moving pendulums, has overshot, or is overshooting, its equilibrium point. Yet the degree of government intervention that is appropriate for optimal development in the Pacific countries deserves serious consideration. Many government enterprises and marketing agencies perform useful roles; some marketing boards have brought information to small domestic producers. Some government agencies have been able to attract expatriate advice that has helped to overcome the recognized absence of indigenous skills that was a legacy of colonial paternalism, although this could often have been achieved by more active encouragement of private direct foreign investment. Most of them have failed to generate internally the funds required for their operation and have become a drain on domestic budgets. Many reflect the auditor-satisfying caution that is designed to prevent corruption, but also prevents rapid action being taken to grasp marketing opportunities. Some of them have followed income policies that tend to reduce producer incomes in most years (for example, the Western Samoan Coconut Marketing Board). Many have assumed that achieving price stability is synonomous with achieving income stability. This is not necessarily true.[6]

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[5]For an examination of the logic behind the terms of trade pessimism and of the actual developments, see Dorrance, op. cit.

[6]See R.C. Falvey, 'Trade problems and policies in the Pacific island economies', in Cole and Parry (eds), *Selected Issues in Pacific Island Development*, Pacific Policy Papers No. 2, National Centre for Development Studies, Canberra, 1986, p.122.

As yet, there has been relatively little discussion of the role of government enterprises and agencies in the Pacific countries. Some consideration has been given to the improvement of their operations (as in the cases of the National Investment Development Authority and the Cocoa Marketing Board in Papua New Guinea, or the coconut and cocoa marketing boards in Western Samoa). Fiji is also considering rationalizing the structure and operation of state-owned enterprises. The possibilities of privatization or abolition are only whispered. In fact, the recently announced Nine Point Plan to enhance Fijian participation in commerce and industry[7] involves an extension of government financing and intervention in the economy. The time is long past for a consideration of the role of government enterprises in Pacific economic activities.

Regional developments

Regional. In 1988 industrial production continued to rise in the developed countries, thereby providing demand for the commodities produced in the developing countries. However, the steady progress of industrial output with practically no increase in its rate of growth did not provide any acceleration effect on the demand for industrial inputs. Apparently, expectations regarding the rate of inflation moderated.[8] Hence, there were few pressures for shifts towards increased inventories, but there is no evidence of a move towards inventory liquidation. Hence, primary product prices have been tending to rise since late 1986.[9] This upward trend continued through mid-1988 when the general rise abated, but prices did not tend to decline thereafter (Chart 1 and 2).[10] Individual commodity prices are subject to unique influences arising from changes in supply. However, the general background provided an atmosphere of support for primary product prices that is likely to persist in the near future, while not leading to expectations of further marked rises for some time. On balance, it appears most likely that average commodity prices will remain close to their present levels, with little prospect for further increases and only a possibility of any widespread marked declines.

The South Pacific tuna treaty was ratified by the United States in June. Fifteen South Pacific countries have signed the treaty under which US fishermen will gain access to one of the world's richest fishing grounds. In return, US industry and government will pay a total of US$60 million to the South Pacific countries over five years. This will be divided according to where the fish are taken. The treaty also provides for technical cooperation with US industry aimed at strengthening and expanding the South Pacific countries' commercial fisheries. In addition the US government has major responsibilities under the treaty to control and monitor the activities of its previously undisciplined purse-seine fleet.

The level of distant water fishing effort in the region remains high. Nevertheless, the region's fisheries are on the whole under-exploited and further fisheries development is primarily constrained by limited market demand. However, grave concerns have recently arisen about the growing number of gill net vessels (from Taiwan, Japan and Korea) entering the southern albacore tuna fishery. This fishery is bordered by American Samoa, Cook Islands, Fiji, French Polynesia, New Zealand, Tonga, Vanuatu and New Caledonia. The albacore longline fishery is already at maximum estimated sustainable levels. Furthermore, gill nets are believed to be wasteful (killing or damaging large numbers of fish that are lost when the net is brought on board); result in navigational and safety hazards; endanger marine mammal populations; and, when lost, continue to trap fish non-selectively. Clearly, as was the case with the US treaty, regional cooperation will again be necessary

[7]Fiji, Ministry of Information Statement, 20 November 1988.

[8]See accompanying note at the end of the Appendix for a description of the inflation expectation index.

[9]See Appendix for a discussion of individual price movements.

[10]All price indexes referred to here are expressed in SDR terms. See note in *PEB*, 1 (2), December 1986, p.2 for the reasons for adopting the SDR denomination.

Chart 1
International indexes
(1985 SDR values = 100)

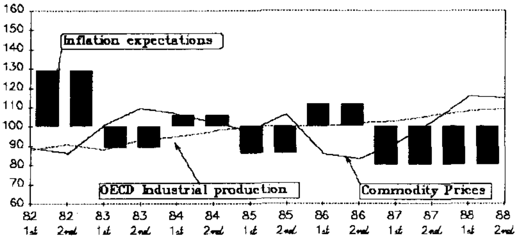
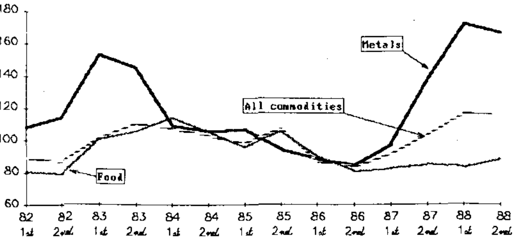


Chart 2
International trade price indexes
(1985 SDR values = 100)



to preserve this important regional resource.[11]

Fiji. Fiji continues to be the big question mark pending a resolution of the recent political moves. Domestic demand remains seriously depressed; standards of living have fallen markedly and continue to decline. GDP is estimated to have fallen by 7.8 per cent in 1987 and by a further 2 per cent in 1988; investor confidence and hence levels of investment remain low; both inflation and unemployment are high and rising; and flight of skilled manpower especially at management and skilled levels continues at dangerous levels.

Several analysts[12] have argued that the political upheavals in Fiji provide an opportunity to open its over-regulated economy and promote export-led growth. However, Fiji has not as yet embarked strongly on that course. For example, the adoption of the Nine Point Plan requiring Fijian (that is Melanesian) control of selected, but yet unspecified, industries, and providing funds for loans to Fijians only, will probably serve to discourage non-Fijian (both domestic and foreign) investors. It may also prove to be a move towards a more inward oriented highly protected economy that will in fact strengthen the underlying tendencies towards high cost production that have hampered Fiji's growth.

The other initiative in the area of industry policy has been the establishment of Tax Free Zones and the granting of a 13-year income tax holiday to new enterprises. It is claimed that a total of seventy-six companies have been approved for tax free status. Of these, twenty-seven are existing local companies and forty-nine are reported to be new companies from overseas, only eleven of which have yet set up operations. International experience indicates that tax free zones generally have not been successful in promoting long-term investment and growth, and that there are costs to the government finances that are already under severe strain in Fiji. Garment manufacturers paying lower wages than the minimum required in other industries are currently the most numerous participants in the scheme. The additional employment generated is stated to have reached approximately 2400 in the ten months up to October 1988. The tax free scheme would therefore appear to account for more than the small increase (of 1100) in total employment in the first half of 1988. There has already been some criticism that these incentives also discriminate against and discourage other domestic enterprises.

Employment outside the Tax Free Zones would appear to have further declined in the first six months of 1988. With post-coup unemployment levels close to 20 per cent, and some 14,000 new entrants joining the workforce each year, the Tax Free Zone policy by itself will not bring about a major turnaround in the economy.

The 1987 budget deficit rose from the original estimate of F$86 million to F$101 million, equivalent to 7.9 per cent of GDP. This reflected a steep decline in revenue collection, particularly customs revenue, in the second half of 1987. The deficit budgeted for in 1988 was F$119 million, but the actual deficit may be considerably

[11]See G.L.Preston,'The role of management in developing Pacific island inshore fishery resources', *PEB*, 3(1), June 1988, pp.34-8.

[12]For example, Cole and Hughes, op. cit.; and W.Kasper, J.Bennett and R. Blandy, *Fiji, Opportunity from Adversity*, Centre for Independent Studies, Sydney, 1988.

higher. Government revenue in the first quarter of 1988 was 27 per cent lower than the corresponding quarter of 1987. This compares unfavourably with the latter half of 1987 when government revenue was down by only 10 per cent on its level for the corresponding period in 1986.

A fiscal review committee has been established to examine levels of government expenditure and the scope for rationalizing state-owned enterprises. The results of the committee's work will not become apparent until the 1989 budget is announced, but it is expected that there will be a strong emphasis in the budget on fiscal restraint and reducing the budget deficit, and that there may be some move away from non-tariff import restrictions in favour of a wider use of tariffs. Tariffs are generally considered to be the lesser evil of these forms of protection because they allow the price mechanism to function: foreign price signals feed through more readily to the domestic economy. The Posts and Telecommunications Department, currently under review by the committee, may also be rationalized.

Following the successful implementation of fiscal (for example, reductions in the government's salary bill) and monetary policies after the coup, the country's external position remains sound. The overall balance of payments for the first eight months of 1988 showed a surplus of F$34 million compared to a deficit of F$124 million in the corresponding period of 1987. The balance of trade deficit is expected to narrow from F$57 million in 1987 to F$36 million in 1988. Exports are expected to increase by 31 per cent to F$437 million, mainly reflecting higher sugar prices and expanded gold production. Non-traditional exports (fish, timber and garments) are also expected to grow. Imports are expected to increase by 18 per cent to F$550 million.

Tourism has recently shown signs of some recovery. Tourist arrivals totalled 55,300 over the period June to August 1988, an increase of 35 per cent over the corresponding period in 1987. However, total arrivals in 1988 are expected to be about the same as in 1987, some 26 per cent below 1986 levels. There has also been a reduction in income per tourist because of discounting.

The government is forecasting small positive real growth in GDP in 1989 but these prospects remain largely dependent on political developments. It seems to be clear that major economic reform, if it is desired by the government, must await wide popular acceptance of a new constitution and the formation of a new government. The recent suspension of the Internal Security Decree that was a major impediment to progress is a welcome development.

Papua New Guinea. Papua New Guinea is one of the countries where economic growth in recent years has been low despite the consistent application of relatively sound macroeconomic policies. These include a lowering of fiscal deficits, a decline in public consumption as a proportion of GDP, a steady increase in fiscal self-reliance, and restoration of discipline over external borrowing.

Part of the impression of low growth may be a statistical exaggeration. The National Statistical Office estimates that real GDP grew by 7.3 per cent in 1986 and 5.8 per cent in 1987 (compared with previous estimates of 3.3 per cent and 2.9 per cent respectively). There is almost universal sceptism (including in government circles) regarding the accuracy of these estimates. Nevertheless, there is general acceptance of an underlying real GDP growth rate of approximately 5 per cent in both 1986 and 1987. Even so, with population growth slightly higher than official estimates, the revised per capita growth rates are low by present international standards. The need to conduct analysis on such uncertain foundations is an example of the caveat introduced at the beginning of this review.

A recent World Bank report, prepared for the first Papua New Guinea Consultative Group Meeting of aid donors in May, recognized a number of serious constraints to development in Papua New Guinea. These include a complex system of customary land ownership, low levels of adult literacy, social and administrative fragmentation resulting from extraordinary cultural and ethnic diversity, a severe lack of unifying infrastructure, rugged mountainous terrain and a wide geographic dispersion of a small population, institutional weaknesses, and a shortage of skilled domestic manpower. The Bank recommended a six-point strategy for medium-term development comprising support for agriculture, a major program of rural infrastructure, investment in human resource development, increased investment, promotion of the private sector, and institutional reform and staff development in the public sector. This is a rather broad agenda that could impose severe strains on Papua New Guinea's resources, even after increased foreign financing.

The Papua New Guinea government has accepted many initiatives and promulgated many proposals since independence. However, it has carried very few through to completion. For example, the 1988 Budget proposed a major reallocation of government expenditure that was only partly implemented. The proportion of government expenditure devoted to economic development (largely on agriculture) was budgeted to increase markedly, but it declined. Hence, the adoption of the World Bank's program and the reallocation of expenditure in the 1989 Budget must be accepted with reservations. Good intentions are not enough: implementation is required.

Even so, the Bank projects that constant-price GDP could grow at an average rate of 3.5 per cent during 1988-95; this should probably be raised close to 5 per cent in the light of recent statistical revisions (still not rapid progress in per capita terms). This advance would be led initially by strong growth (13 per cent per annum during 1988-90) in the mining sector, assuming that existing mines continue to operate and presently planned mines are completed. The non-mining economy is projected to grow at a disappointing rate of 2.7 per cent per annum over the planning period. Government projections in the recent budget are broadly in line with the Bank's forecasts. Real GDP growth rates between 3 and 4 per cent are expected to be sustained until 1993, when production from the Porgera gold mine should raise economic growth.

There has been a marked change of sectoral emphasis in the 1989 Budget. The policy of the previous government was to redirect expenditures to the economic and infrastructure sectors. This corresponded with a drive to decrease recurrent expenditures and increase productive investment. An undesirable side effect of this strategy was the decline in importance allocated to education, law and order, and health. These restrictions threatened to constrain long-term economic growth. The 1989 Budget restores the balance between economic and social sector spending with expenditure on social services and law and order being raised by 21 per cent and 17 per cent respectively. The government's budget statements give strong recognition to the continued importance of reducing public consumption. Most observers consider that much could be done to improve the effectiveness of public expenditure, in particular by introducing efficiency measures in recurrent operations and by improving the quality of public investment. It is to be hoped that this objective will be achieved.

The increased drawings on the Mineral Resources Stabilization Resources Fund[13] included in the Budget is a cause for concern. If Papua New Guinea is to avoid the 'Dutch Disease' that is prevalent in many countries 'enjoying' a mineral resources boom, it must not anticipate the revenues that it is hoped will be associated with mineral development over the next few years. Rather, in the immediate future, revenue should be accumulated to finance investment as it becomes absorbable by the economy. To that end, for a short time, the balances in the MRSF should be allowed to increase rather than being depleted.

The balance of trade is expected to deteriorate over the next few years, as the growth in capital goods imports for minerals development and for consumption by those employed in mining activity is anticipated to exceed mineral export growth as new mines are developed. However, foreign transfers associated with mineral exploration and development are likely to be greater than the

[13] See 'The Papua New Guinea Mineral Resources Stabilization Fund', *PEB*, 2(2), December 1987, pp.19-21.

additional expenditure on imports. Hence, there should be little, if any, pressure on the overall balance of payments and levels of reserves.

In the first six months of 1988, mineral exports increased by 40 per cent over the corresponding period in 1987 because of increased production from the Ok Tedi mine and relatively high copper and gold prices. Over the same period, most agricultural export volumes remained stable, with cocoa and coconut products declining. Large dividend payments by Bougainville Copper Limited and substantial repayment of government offshore commercial debt tended to offset the large trade balance. Overall, the balance of payments deficit for the six months to June 1988 was K17 million and is projected to be in the range of K20-30 million for the full year. Reserves at the end of June 1988 stood at 5.2 months' imports.

The government considers that depreciation of the kina is inappropriate at this time. It argues that exchange rate policy has been an important instrument in the maintenance of price stability in recent times and that this policy emphasis needs to continue. With inflation expected to accelerate to 7 per cent in 1989 (some observers consider 8-9 per cent a more realistic estimate), largely because of indirect tax increases, there is some force in this argument. In addition, the government argues that there is limited short-term capacity in the economy to allow for increased import substitution or export expansion simply as a result of changed external price signals. Most economists tend to underestimate the elasticities of demand and supply despite evidence to the contrary. It is argued that structural constraints to improved production responses need to be addressed by a broad range of medium-term development policies. Critics continue to argue, however, that coordinated exchange rate and wages policies are necessary to improve Papua New Guinea's international competitiveness. The government is expected to argue for partial rather than full indexation at the next Minimum Wages Board hearing in the new year in an attempt to achieve a real decrease in Papua New Guinea's relatively high wage levels. Some devaluation of the kina would also contribute to international competitiveness.

A number of steps were announced in the budget to improve the level of domestic savings and investment. These include improving the availability of services to facilitate rural savings and rural credit; encouraging and improving the availability of services for household saving to facilitate housing and equity investment; liberalizing the Housing Guarantee and Interest Subsidy Schemes to improve access to housing finance; liberalizing Credit Guarantee and other business development schemes to improve access to business finance; rationalizing the activities of the Agriculture Bank and Papua New Guinea Banking Corporation to improve efficiency and the delivery of services; and establishing a stock exchange, including related improvements to the capital market. In addition the Bank of Papua New Guinea has recently issued strong directives to savings and loan societies, a large number of which had been incurring administrative expenses consistently in excess of income. Many studies indicate that institutional reforms have little effect on the total volume of saving, as distinct from its distribution between forms. This volume is largely contingent on general economic conditions and expectations regarding future incomes and inflation rates. The relevance of a stock exchange is particularly doubtful.[14]

Solomon Islands. At present, the Solomons Islands, like many other countries, is facing a balance of payments deficit that is, very largely, a product of the domestic fiscal deficit. Recurrent government expenditure grew at an average annual rate of 19 per cent between 1985 and 1987, while revenue increased by an average of 13 per cent. Government capital expenditure has grown even faster, increasing by 78 per cent in 1986 and 60 per cent in 1987. The overall budget deficit, including the capital budget, has therefore widened since 1985. It almost doubled in 1985 and 1986 and tripled between 1985 and 1987 to SI$64 million or 22 per cent of GDP.

[14]See Book Review in *PEB*, 2(1), June 1987, pp.39-40.

This rapid growth in the budget deficit can be attributed to a number of factors. First, much of the trouble stems from the separate and different treatment of the recurrent and capital budgets. Because the capital budget is largely aid-funded, and aid is in relatively plentiful supply, it is not subject to the stringencies that apply to the recurrent budget. Insufficient attention is given to the demands imposed on the recurrent budget, such as maintenance costs, by rapidly increasing capital expenditures. Second, weaknesses in expenditure and staffing control systems have hampered attempts to reduce the size and the cost of the public sector. Third, there have been major increases in government subsidies to state-owned enterprises and joint ventures. Fourth, the system of provincial governments (deriving three-quarters of their revenue from national government grants) has proved costly. While some provinces are reasonably well run, provincial governments are generally considered to be inefficient and even unnecessary. Fifth, on the revenue side, there is evidence of considerable undercollection of tax. It has been suggested that only 10,000 out of 28,000 eligible taxpayers file returns.[15]

While the problem of fiscal imbalance is clearly serious, there is little evidence of real progress towards rectifying the situation. The underlying trend in the budget deficit in 1989 is not clear from the Solomon Islands' budget presentation. However, the shortfall between total revenue and total expenditure (that includes public debt service) is budgeted at SI$10.6 million, the same level as was originally budgeted for in 1988. The deficit increased greatly in 1988 because of wage increases and an expansion of the civil service. A review of the civil service has been completed but no decisions have been announced. A draft report of a review of provincial government has been completed but has been enveloped in political controversy.

This expansionary fiscal policy has resulted in considerable pressure on the external account. The balance of trade deficit widened from SI$18.6 million in 1985 to SI$37.4 million in 1987. After an alarming first quarter result (an estimated deficit of SI$23.8 million) the trade balance improved markedly in the second quarter (an estimated deficit of SI$1.1 million) because of the commencement of the fishing season and a recovery in log exports after a poor first quarter. The underlying trend in the current account is masked by substantial STABEX receipts. If these payments are ignored, the current account deficit has widened from SI$27.9 million in 1985 to SI$33.9 million in 1987, and approximately SI$36 million in the first half of 1988. STABEX receipts, which with other aid flows have been largely responsible for maintaining a minimum level of foreign reserves, are expected to end by 1990.

Continuing large fiscal imbalances have thrown an extra burden on monetary and exchange rate policy in an attempt to contain the damage to the external account. The Solomon Islands dollar was devalued by 21 per cent in 1985, 24 per cent in 1986, and 11 per cent in 1987, in nominal effective terms. This trend continued in the first six months of 1988 with a further 7 per cent devaluation. As a large part of the government's deficit is financed domestically, its effect is to increase privately held deposits, raise imports, and erode external reserves. Enlarged deposits in turn provide the base for increased bank lending to the private sector, further adding to the pressure on external reserves and domestic prices. After averaging 10.3 per cent between 1983 and 1987, inflation was running at an annual rate of between 18 and 20 per cent between April and July this year. Monetary policy has been progressively tightened to counter these effects. Interest rates on bank lending increased from 15 per cent in 1984 to 17 to 18 per cent over 1985-87. An 18 per cent interest rate ceiling on lending currently applies but the 12 per cent ceiling on deposit rates has been lifted recently. A statutory reserve deposit requirement of 5 per cent of deposits with the banks was also reintroduced in October. Exchange rate and monetary policies have

[15] See A.V.Hughes, *Climbing the Down Escalator: The Economic Conditions and Prospects of Solomon Islands*, Islands/Australia Working Paper No. 88/2, National Centre for Development Studies, Canberra, 1988.

been unable to turn around the deterioration in the balance of payments arising from fiscal deficits.

In short, it appears that time is running out for the Solomon Islands economy. STABEX receipts, which have financed the large underlying balance of payments deficit in recent years, are expected to cease in 1990. It is unlikely that other aid flows will increase sharply enough to make up that external financing gap. Much depends on the success of an impressive array of recent large investment projects. These include construction of a new tuna cannery, acquisition of three purse-seine fishing vessels, continued coconut and cocoa plantings, rehabilitation of the largest sawmill on North Guadalcanal, a joint venture in fast-growing hardwood timber plantations on Kolombangara, a mining feasibility study of the Gold Ridge gold deposit, completion of a SI$5 million investment in wheat and rice milling, and a joint venture to undertake a SI$10 million extension of satellite telecommunications to provincial centres which involves the privatization of the domestic telephone system. Unless the problem of the government's budget deficit is tackled resolutely, the Solomon Islands' economic future will remain precarious.

Western Samoa. Following the change of government in February 1988, developments in the area of state-owned enterprises have been mixed. The coconut and cocoa marketing boards have been restructured and, in so doing, some elements of the latter have been privatized. For some time, these agencies have been criticized for inappropriate pricing and marketing policies. On the other hand, the Special Projects Development Corporation, which was privatized by the former government last year, has been resurrected; plans to sell off some assets of the Western Samoan Trusts Estates Corporation have been scrapped; and proposals to privatize the fish market and close the government-owned bond store and allow private operators to service the market are now not to proceed. The government has decided to take up the major stake in the Royal Samoan Hotel project while postponing the Nauru Hotel development that was to be wholly financed by the Nauru government. There are doubts about the financial viability of any large-scale luxury hotel development in Western Samoa. Other established hotels are expanding their capacity and the spinoffs to Western Samoan tourism from political instability in Fiji may fade over time. By and large, these actions do not appear to reflect a conscious economic policy but rather a dismantling of the previous government's decisions and associations.

In addition to rationalizing the coconut and cocoa marketing boards, other steps have been taken to boost coconut and cocoa production. Cocoa in particular has been in serious decline, its share of total export value falling from 14 per cent in 1986 to 2 per cent in the first half of 1988. An extremely generous bonus scheme has been introduced for new coconut and cocoa plantings and fertilizer is to be provided to growers free of charge. The extent of these subsidies is a cause for concern, particularly as copra producers are currently being paid approximately 17 per cent more than the world market price. If copra prices recover further, as they may, an easing of these subsidy levels would be desirable.

Remittances continue to underpin the economy by balancing the external account. Emigration levels remain high at more than 3000 per annum and remittances continued to grow strongly in 1987, increasing by 22 per cent to T77.2 million. However, in the first half of 1988, remittances were down by T5 million or 14 per cent on the corresponding period for 1987, when they were particularly high as emigrants sent funds to their families to meet some of the cost of the drought. A number of other reasons have been suggested for this, including the influx of returnees (bringing remittances with them) for the independence celebrations. The effect on Samoan migrants of the downturn in the New Zealand economy was perhaps the most important factor.

In 1987 the Central Bank introduced policies to stimulate the deposit of remittances in savings and investment accounts. The steps taken included linking the extension of fresh credit to an increase in longer term savings, keeping real interest rates high to discourage lending for consumption and imports, and encouraging commercial banks to give priority to lending for productive investment. These policies have been moderately successful. Commercial bank lending for purposes other than the finance of trade and personal consumption was increased as a share of total lending from 8.7 per cent in the year to June 1987 to 9.4 per cent in the year to June 1988. The Central Bank may consider additional interventions to improve further the composition of commercial bank lending.

The underlying structural trade deficit worsened in the first half of 1988. Exports grew by 30 per cent, but from a low base, to T13.9 million, because of improved coconut and timber prices, but this was more than offset by a 20 per cent increase in imports to T71.4 million. The balance of trade deficit increased to T57.5 million in the first half of 1988 compared to T48.7 million for the first six months of 1987. Nevertheless the balance of payments is estimated to have remained in overall surplus because of the high level of remittances and increased project aid.

Overall, Western Samoa remains financially strong but economically weak. Real growth in GDP has been low at close to 1 per cent. However, because of emigration, per capita incomes may not have fallen. GDP growth is believed to have improved in 1988 largely because of stronger copra prices. Fiscal and exchange rate policy settings appear sound - the former emphasizing restraint on current expenditure and the latter producing a gradual depreciation that will strengthen the country's competitive position. Monetary policy needs to remain cautious to contain imports and lessen the risk of inflation (currently 8.9 per cent).

Vanuatu. Two of Vanuatu's key activities, tourism and the finance centre, are likely to be heavily influenced by the country's image abroad. The latter, which consists of the banks, trust companies, insurance and legal and accounting firms, has consistently contributed an important share of the nation's output, government revenue (through various fees and charges) and employment of the Ni-Vanuatu labour force. In the second quarter of 1988, the activity of the centre turned downwards. It seems that recent political events combined with competition from similar centres in the Cook Islands and Western Samoa may have adversely affected the growth of the centre.

Tourism, on the other hand, showed a resurgence in the first half of 1988. Total tourist arrivals in the March and June quarters were 52 per cent higher than in the corresponding period of the previous year, but still substantially below 1985 levels.

Vanuatu's status as an income tax free country that provides privileges for depositors with the finance centre seriously limits the government's fiscal policy options. The tax base is very narrow. Customs receipts account for 70 per cent of tax revenue. The major revenue measure in the 1988 budget was a reduction in exemptions from customs duty. The government has foreshadowed the introduction of a turnover or sales tax in 1989-90 but this is intended to replace a number of existing taxes including video, hotel and restaurant taxes and business licence fees.

Clearly fiscal policy is the key issue in economic management. The budget deficit in 1987 was VT508 million or 3.9 per cent of GDP. Attempts to reduce the deficit drastically in 1988 are expected to be only partly successful. Total aid has been declining in real terms: France has ceased budget support, and 1988 will see the last budget support grant from the United Kingdom. A major difficulty is the inability to meet the recurrent costs of a large development budget. This suggests both that high levels of budget support in the past have supported a false level of absorptive capacity, and that the quality of past public investment has been poor.

Government expenditure is high by developing country standards, at 37 per cent of GDP. Recurrent expenditure is equivalent to 23 per cent of GDP. The government's fiscal strategy is to eliminate the gap between its recurrent expenditure and domestic revenue. In particular, borrowing to finance recurrent expenditure is to be avoided wherever possible. The intention is to treat borrowing as a form of capital finance earmarked for specific capital and development projects and only undertaken on concessional terms.

The balance of trade deficit is expected to narrow from VT3900 million in 1987 to VT3100 million in 1988, reflecting an improvement in copra prices, a recovery in agricultural exports from cyclone-affected levels in 1986 and 1987, and a decrease in imports following completion of the post-cyclone reconstruction program. Unfortunately, the value of cocoa exports has declined steeply following a sharp fall in world prices, and coffee output has been adversely affected by volcanic activity on Tanna Island. A more flexible exchange rate policy would assist in addressing Vanuatu's trade imbalance. Since February, the vatu has been tied to a basket of currencies.

The government expects both the balance of trade and GDP growth to improve in coming years. GDP grew by only 0.7 per cent in 1987 and is expected to increase by 3 per cent and 3.5 per cent in 1988 and 1989 respectively. However, economic prospects are largely dependent on the recovery of tourism, the prices of principal exports, and the quality and quantity of investment (both public and private).

Tonga. Tonga was hard hit by drought during 1987-88. Copra production declined by 60 per cent in the first half of the financial year and fell to almost zero during the latter six months. In April, copra was imported to supply the coconut mills. As a result, real GDP is believed to have declined, perhaps by as much as 5 per cent. Inflation was high at close to 15 per cent per year because of local food shortages.

The economic effects of the drought were mitigated by continued steady growth in industrial production (reflecting the presence of a few imaginative entrepreneurs as well as Tonga's open trading policies and an attractive range of business incentives) and the construction sector. GDP is expected to recover strongly in 1988-89 because of better weather conditions and higher copra prices.

The balance of trade deficit widened during 1987-88. The value of exports fell by 54 per cent to P7.1 million while imports increased by 8 per cent to P60.9 million. The level of private remittances also declined by 4 per cent to P36.7 million, probably reflecting the economic downturn in New Zealand. As a result, the overall balance of payments moved from a small surplus (P2.3 million) into deficit (P9.2 million). The level of foreign reserves remains healthy at approximately five months' imports.

It is proposed to establish a Reserve Bank which is expected to be fully operational by mid-1989. It is envisaged that the Bank will introduce greater flexibility than has applied to date in both interest rate policy and, in due course, exchange rate policy. The pa'anga has been tied to the Australian dollar for over a decade and there has been a ceiling of 10 per cent on interest rates since 1921. As a result, real interest rates have often been negative, discouraging savings. The establishment of the Reserve Bank might facilitate economic management and, in particular, promote improved competitiveness, increased savings and investment, and greater price stability.

A push for improved performance of state-owned enterprises is an important facet of fiscal policy. Activities that have been or are being reviewed include the Commodities Board, elements of fisheries operations, the printing office, sawmills, the Dateline Hotel, the government store and the machinery pool. The objective is to improve efficiency and enhance government savings for further investment in the economy.

Kiribati. While Kiribati is still highly dependent on discretionary foreign aid, the Revenue Equalisation Reserve Fund, built up through levies on earlier phosphate mining, has been increased by sound investment policies from A$68 million in 1979 to A$170 million; the income from these investments provides a reliably continuous source of revenue now equal to approximately 15 per cent of GDP. The prospective decline in phosphate mining in Nauru will lead to a decline in remittances by I-Kiribati workers that cover approximately 10 per cent of Kiribati's foreign payments.

Addendum

On 13 December the Fijian Minister of Finance announced the 1989 budget. It provides very large reductions in many customs duties, in some cases up to three-quarters. Vehicles and parts, clothing, goods purchased by hotels, and stores and seeds for farmers, have all been subject to large duty reductions or made duty free. The export tax on logs has been eliminated. The post-*coup* cuts in civil service salaries are to be restored. The expected increase in revenues associated with renewed growth are expected to keep the 1989 total budget deficit close to its 1988 level, with a small surplus on current account providing some finance to reduce the capital account deficit. There are important relaxations of exchange control. Overdraft facilities for non-resident controlled companies are being reintro-duced. It is planned to introduce incentives for domestic industry to compensate for the privileges granted to companies in the tax-free zones. Inflation is forecast to fall from 13 per cent to 8 per cent and growth to change from a rate of minus 8 per cent to one of plus 2.5 per cent.

Appendix
Individual primary commodity prices

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Individual prices

The price of *copper* reached a record peak during the last quarter of 1988 (Charts 2 and 3). Despite some fall back at the end of the quarter it is still at historically high levels. As copper is an input in a wide range of electrical equipment, machinery, and vehicles, the demand for it is greatly dependent on the level of industrial output. The continuing expansion of activity in the developed countries has provided a firm base for relatively high prices. Production difficulties in the United States, Zambia, and Peru have converted the price reflecting basic demands into the record levels consequent on a shortage of supplies. With prospects for continuing, and perhaps, rising demand from industrial users, the price outlook for 1989 appears to be strong. If supply difficulties are overcome (and some of them appear to be of rather medium-term continuance) the price should fall back from its historic levels, but still remain profitable for Papua New Guinea producers.

The international (that is, SDR) price of gold is fundamentally determined by the demand for *gold* as an asset rather than as a consumable commodity, and by the US$/SDR exchange rate, as it is determined in US dollars. The evident weakening of inflation expectations has apparently been reflected in a decline in the demand for gold as a protection against rising prices, with a consequent decline in its dollar price. It is also possible that the US dollar will continue to depreciate, with a consequent fall in the international price. The depressing effect of improved inflation expectations has been partially offset by demand, primarily from Japanese and Taiwanese holders, both official and private, shifting some of their foreign asset holdings from currencies to gold. As a consequence of these countervailing influences, the dollar price of gold has moved in the $380-$425 range and declined from its early 1988 levels even more in terms of SDRs. These prices are still profitable for PNG and Fijian mines. If anything, the prospects are for an end to the price decline and some return to early 1988 levels.

All *sugar* prices increased in 1988 (Chart 4). Demand for sweeteners tended to increase, and the US drought and the spread of a contaminant (aflatoxin) severely reduced the world's available maize crop. This led to a rise in the price of high fructose corn syrup that is now a larger source of sweetness than sugar in the United States. Despite record production in 1987/88, the ratio of sugar stocks to consumption is now close to a ten-year low. Until production responds to the high prices, which it is doing slowly, sugar prices might be expected to rise slightly.

With the passing of fears of frost in Brazil during the southern hemisphere winter, the price of *coffee* receded after August (Chart 5). The failure of the International Coffee Organization to establish a global export quota until October contributed to the price decline. With the establishment of quotas, prices may be expected to strengthen. The decade's trend towards the use of soluble rather than ground coffee appears to have reversed, and, consequently, the price premium of arabica over robusta coffee has widened. This has been favourable to Papua New Guinea which is a robusta exporter.

Coconut oil accounts for only a small part of world vegetable oil production. Hence, the prices of *coconut products* are almost completely determined by demand in the rest of the world and supplies of other sources of vegetable oils. Consumption and the demand for these oils remained high. However, the US drought reduced the soybean and (of lesser importance) maize crops. Latin American production of soybeans increased so that the world total of oilseed production in 1988 was almost the same as in 1987. On balance, there was some upward pressure on coconut product prices that remained close to their end-1987 levels, well above their 1986 nadir, but far below the unusually erratic levels of 1984. A return of the US soybean harvest to its pre-1988 level, and a continued expansion of palm oil production (which has increased by over 30 per cent since 1984/85) may lead to some decline in coconut product prices in 1989, but probably not to their 1986 levels.

Fish prices have declined since mid-year after rising steadily since 1985. It is rumoured that some sales are made below the posted Pago Pago prices (used here as typical). Increased sales by Mexico in the important US market may be the major source of this decline. The depreciation of the Mexican currency has resulted in the peso value of a given weight of fish rising despite the decline in the SDR price.

Chart 3
Mineral price indexes
(1985 SDR values = 100)

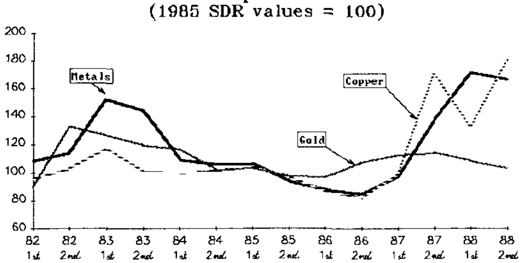


Chart 4
International copra, coffee and fish prices
(1985 SDR values = 100)

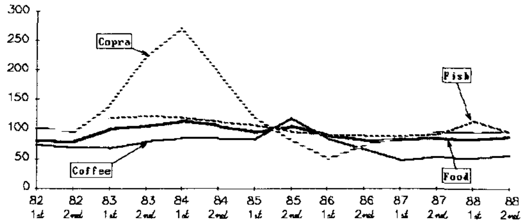
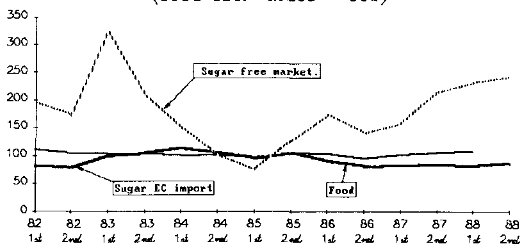


Chart 5
International sugar prices
(1985 SDR values = 100)



Inflation expectations

If purchasers of commodities expect that price increases will accelerate in the near future they may attempt to increase their inventories of commodity inputs and finished products (requiring commodity inputs) so that they may forestall the effects of the expected price increases provided that the interest and other carrying costs of inventories do not exceed the expected inflation. The precautionary demand arising from these expectations will exert upward pressure on the prices of commodities. Conversely, expectations of deceleration in the rate of price increases, or even price declines, will exert downward pressures on commodity prices. That is, price expectations may be more important than prior price increases as determinants of commodity prices. Hence, an index of price expectations is reported in Chart 1.

It is difficult to perceive expectations. Attempts have been made to sample the opinions of decision makers regarding future price movement. These attempts are extreme examples of subjective analyses based on what must be voluntary responses. The expectations index in Chart 1 is based on actual purchases and sales by participants in financial markets who are assumed to be representative of members of the general business community making purchase and sales decisions in many markets. It is a change in the differences in the effective rates of interest on short-term Eurodollar deposits in the London market and the yield on long-term Eurodollar bonds, both as reported in *The Economist.*

It is based on the assumption that dealers in the market believe that if inflation accelerates, interest rates will rise; hence expectations of accelerating inflation lead to expectations of rising interest rates. If interest rates are expected to rise, market participants will postpone purchases of long-term securities until the expected rise occurs. This will exert downward pressure on the prices of outstanding securities, and an upward rise in their yields. In so far as funds are held in liquid form in expectation of rising yields on long-term securities, they may be temporarily held as short-term deposits. This demand for short-term assets will lower their yield. Simultaneously, borrowers anticipating long-term requirements for funds in the near future will accelerate their long-term borrowing and hold any anticipatory funds in short-term deposits, or similar instruments. This will also tend to widen the spread between long-term and short-term rates. In summary, a widening of the spread between long-term and short-term interest rates is assumed to indicate a strengthening of inflationary expectations and a narrowing of the spread to indicate a weakening of these expectations.

The spreads between long-term and short-term rates in national markets are subject to influences in addition to inflation expectations. In particular, they are influenced by issue and redemption (or purchase and sale) activities by the monetary authorities. A comparison of rates on a Eurocurrency market has been chosen as being least subject to national financial policy decisions. The Eurodollar market has been chosen as the largest and most active of the Eurocurrency markets. As this index compares two Eurodollar rates, the effects of speculation regarding the foreign exchange value of any currency should be minimized as this speculation may be expected to influence both rates in the same direction.

This index is primarily directionally rather than quantitatively significant. It measures the interest rate spread in one period as a percentage of the spread in the previous period. That is, if the index is larger than 100, inflation is expected to accelerate. If it is less than 100, inflation is expected to decelerate (or prices to decline). The absolute value of the index may give some indication of the expected rate of acceleration or deceleration, but these values should be regarded as having only very weak significance.

The significance of this index as an indicator of inflation expectations is dependent on the validity of the assumptions on which it is based. Some of the more important of these may be listed in descending order of importance:

1. The disposition of funds between long- and short-term assets by financial market participants is strongly influenced by expectations regarding general price changes expected in the near future.
2. Expectations regarding interest rate movements are strongly influenced by expectations regarding inflation in the near future.

3. The Eurodollar market is the one least influenced by national financial policies.
4. Expectations by financial market participants regarding price movements are closely similar to those held by participants in commodity markets.

