

## **The impact of the global financial crisis on the Pacific Islands**

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### **Introduction**

The global financial crisis has spread from the United States to the rest of the world through two main channels: a “direct” channel (through financial-market linkages), and an “indirect” channel (through trade and investments links operating primarily through global recession).

A common view is that low-income countries, because of their limited integration into global financial markets, have largely escaped the shocks transmitted through the first channel, but are being hit hard by the shocks transmitted through the second channel, in particular through slower export growth, reduced remittances, and lower export commodity prices.

There is also an emerging consensus that initial conditions in developing countries have played a role in influencing the severity of the impact of global financial crisis. Conventional indicators of vulnerability to external shocks (current account balance, fiscal balance, foreign reserves, etc), for example, were weaker in Latin America and Central and Eastern Europe than they were in East Asia.

The special characteristics of small states make a review of how the current crisis has specifically affected them warranted. Some small states have well-developed financial systems, and some operate offshore financial centers. Some may therefore have been affected by the financial crisis through the direct financial channel. Small states also tend to be more open than others to trade and to have less diversified exports. For example, their exports may be dominated by tourism or one or two commodities, sold mainly to a small number of trading partners, such as the former colonial power. They also tend to have a large population living overseas and remittances account for large proportion of national income. They may therefore have been more severely affected by the global financial crisis through the indirect channel.

This paper examines how the global financial crisis has affected six small states in the Pacific: Fiji, Kiribati, Samoa, Solomon Islands, Tonga, and Vanuatu (hereafter the “Pacific states”). In particular, it studies the spread of the crisis to these states through the direct and indirect channels. It also looks briefly at the initial conditions of the Pacific states as they entered the crisis, and compares them against those of other developing economies.

The paper finds evidence of some direct effects. For example, banks in Pacific states have faced higher borrowing costs and some national funds have lost money in foreign stock markets. But, consistent with the common view mentioned above, the direct effects do not seem to have been large. One reason is that most banks in Pacific states are owned by Australian parents that have been relatively little affected by the crisis.

Although the experiences of the six states vary, and up-to-date data is not always available, the indirect effects do not seem to have been severe so far, either. Remittances, which are very important for many Pacific states, have declined, but not drastically. Tourist arrivals have remained strong. The decline in global commodity food prices has also helped the Pacific States. But significant problems may eventually be caused by continuing economic problems in Australia, New Zealand, and other trading partners. Some of initial conditions of the Pacific states, including high current account deficits, suggest that they are vulnerable to those economic problems.

### A. The direct channel—How the crisis has spread to the financial systems of the Pacific

Most of the Pacific Islands have a small number of commercial banks, a state-owned development bank, and a national provident fund (a kind of state-owned pension fund). Total financial system assets are usually large relative to GDP. By the levels of financial intermediation, the banking systems of the Pacific states are relatively shallow, especially by the standard of small economies (Tables 1–3). Fiji’s financial sector is the largest, with six commercial banks and a stock market. Samoa and Vanuatu each have four commercial banks and an offshore financial center. Kiribati’s financial system is the smallest of the six, with only a commercial bank (and no central bank). The commercial bank in Kiribati is supervised by its parent in Australia and the country uses the Australian dollar as the domestic currency.

**Table 1 Size of the banking sector in 2007**  
(Percent of GDP)

Pacific Islands small states	Central Bank Assets	Deposit Money Bank Assets	Other Financial Institutions Assets	Total Financial System Assets
Fiji	3.4	73.9	100.2	177.5
Kiribati	..	..	..	157.0
Samoa	0.2	69.8	53.0	123.0
Solomon Islands	5.1	50.6	27.1	82.8
Tonga	3.5	45.5	14.5	63.5
Vanuatu	3.5	132.6	9.3	145.4
<b>Average</b>	<b>3.1</b>	<b>74.5</b>	<b>40.8</b>	<b>124.9</b>
<b>Memorandum items:</b>				
Caribbean	4.9	77.6	3.6	73.0
Indian Ocean	12.3	89.5	5.8	104.8
Higher MIC	2.9	65.1	39.3	107.3
Lower MIC	3.4	55.9	5.8	65.2
LIC	4.8	72.4	7.3	84.6

Source: World Bank and National Sources.

Note: Figures for Kiribati corresponds to IMF’s estimate for 2001.

**Table 2 Composition of Non-Bank Financial Institutions**  
(Percent of GDP)

	Other Financial Institutions Assets	Of which Development Banks	Of which Provident Fund
Fiji	100.2	13.8	64.2
Kiribati	..	..	..
Samoa	53.0	12.1	32.2
Solomon Islands	27.1	0.3	25.5
Tonga	14.5	13.9	0.6
Vanuatu	9.3	0.0	9.3
<b>Average</b>	<b>40.8</b>	<b>8.0</b>	<b>26.4</b>

Source: National Sources.

**Table 3 Indicators of financial depth in 2007**  
(Percent of GDP)

	Liquid Liabilities (M2)	Private Credit by Deposit Money Banks	Private Credit by Deposit Money Banks and Other Financial Institutions
Fiji	56.8	44.1	48.3
Kiribati	0.0	0.0	0.0
Samoa	46.5	44.1	44.1
Solomon Islands	43.8	28.5	33.0
Tonga	58.5	65.8	65.8
Vanuatu	107.5	47.2	47.2
<b>Average</b>	<b>52.2</b>	<b>38.3</b>	<b>39.7</b>
<b>Memorandum items:</b>			
Caribbean	74.2	59.1	60.0
Indian Ocean	96.6	50.8	53.7
Higher MIC	73.9	54.3	58.8
Lower MIC	56.3	44.9	46.1
LIC	38.9	22.8	23.7

Source: World Bank.

The banks in the Pacific states are mostly foreign owned (Table 4), which brings both benefits and risks. The benefits include introduction of advanced technology, better risk management tools, more competition in the domestic banking systems, and better access to international capital markets. The risks include increased exposure to financial contagion from the foreign parents, increased foreign currency borrowing by residents, and an increased risk of a sudden flood and then sudden stop of cross-border banking flows.

The parent banks of those operating in the Pacific states are mostly Australian (Table 5). As the Australian parents had little or no exposure to toxic US assets and maintained AA credit ratings, there has been little negative spillovers from the parents.

**Table 4 Foreign ownership of banks (a)**

Country	Number of banks (foreign-owned)	Assets of foreign-owned banks (%)	Assets of state-owned banks (%)
Fiji	6 (6)	100.0	0.0
Kiribati	1 (1)	100.0	0.0
Samoa	4 (3)	85.7	14.3
Solomon	3 (3)	100.0	0.0
Tonga	3 (3)	100.0	0.0
Vanuatu	4 (3)	88.0	12.0

Sources: IMF Article IV, various issues.

**Table 5 Foreign ownership of banks (b)**

Country	No. of banks (foreign-owned)	Foreign banks	Domestic banks
Fiji	6 (6)	ANZ, Westpac, Bank of Baroda, Habib Bank, Bank of Hawaii (US), NBF Asset management Bank	
Kiribati	1 (1)	ANZ	
Samoa	4 (3)	ANZ, Westpac, Samoa Commercial Bank	National Bank of Samoa (S)
Solomon Is.	3 (3)	ANZ, Westpac, Bank of South Pacific (PNG)	
Tonga	3 (3)	ANZ, Westpac Malaysian Banking Finance	
Vanuatu	4 (3)	ANZ, Westpac, Credit Corporation (PNG)	National Bank of Vanuatu(S)

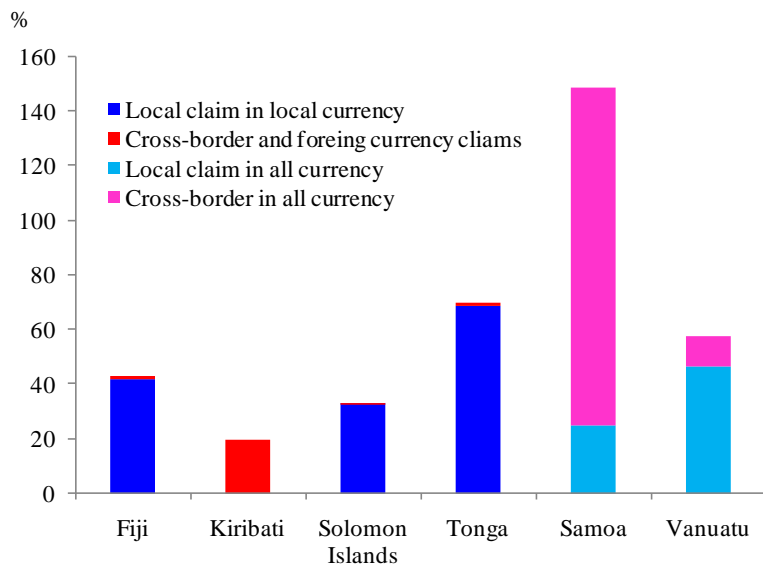
Sources: IMF Article IV, various issues.

Foreign ownership of banks could also encourage residents to borrow in foreign currency. But the existence of capital controls in the Pacific states except Kiribati and Vanuatu has helped to moderate the risk. Data from the Bank of International Settlements (BIS) suggests that almost all foreign bank flows to Fiji, Kiribati, Solomon Islands, and Tonga are local-currency lending intermediated by the “domestic banks” (that is, local subsidiaries of the foreign banks) (Figure 1).<sup>1</sup> This appears to be the case in Vanuatu as well, although we

<sup>1</sup> Figures for Fiji, Kiribati, Solomon Islands, and Tonga are based on the BIS data on the “immediate borrower” basis. The data on the immediate borrower basis classifies “local claims” (lending through domestic subsidiaries of foreign owned banks) in foreign currencies as “cross-border” claims (direct lending without using local subsidiaries). In Kiribati, the country’s use of the Australian dollar as a domestic currency probably explains why all bank lending appears as “cross-border” and/or foreign currency lending.

cannot tell the currency mix of the local lending.<sup>2</sup> In Samoa, however, we find a large cross-border banking flows that are not intermediated by the “local banks”.<sup>3</sup>

**Figure 1 Size and composition of foreign bank lending**  
(Percent of GDP)



Source: The BIS International Banking Statistics.

Note: “Local” claim refers to the BIS reporting banks’ lending to a country through their local subsidiaries or branches. “Cross-border” claim refers to the BIS reporting banks’ lending to a country without using local subsidiaries or branches. Figures for Fiji, Kiribati, Solomon Islands, and Tonga are based on the BIS data reported on the “immediate borrower” basis. Figures for Samoa and Vanuatu are based on the BIS data reported on the “ultimate-risk” basis. See additional information under footnotes 2 and 3.

However, the banking sectors in the Pacific Islands have been affected by the crisis through the direct (financial) channel in several ways.

### *Costs of financing and availability of credit*

The disruption of global financial markets has reduced liquidity in the domestic banking systems, increasing the costs of borrowing and reducing the availability of credit. Several Pacific states reported a marked decline in liquidity in their domestic banking sector in the fourth quarter of 2008, requiring the authorities to inject more liquidity (for example, by reversing open-market operations and relaxing liquidity ratios for banks). Retail deposit rates have been raised as banks have sought to attract deposits to replace other sources of funding, although rates have subsequently come down somewhat (for example in Samoa and

<sup>2</sup> Because Samoa and Vanuatu are offshore financial centers, their exposures to foreign bank lending to the residents are analyzed using the BIS data reported on the “ultimate risk” basis. The data on the “ultimate risk” basis captures only the portion of foreign bank claims for which the resident of the country is ultimately responsible for servicing in case of default by the “immediate borrower”. Under the ultimate risks basis, local lending includes both domestic and foreign currency lending.

<sup>3</sup> The cross-border flows in Samoa appear very large. Some may be remittances. Recorded remittances to Samoa have recently collapsed, but many believe that Samoa is still one of the largest recipients of remittance in the region. The World Bank recently reported that reporting by banks or money-transfer companies often lacks the details required to distinguish remittances from other transfers ([http://devdata.worldbank.org/wdi2005/Section6\\_1.htm](http://devdata.worldbank.org/wdi2005/Section6_1.htm)).

Vanuatu).<sup>4</sup> Lending rates have not been raised across the board, but credit cycles are turning in a number of the states. More generally, the crisis has raised the costs of capital of the banks. Although the banks in the Pacific are relatively liquid and not very reliant on foreign funding, “excess” liquidity (measured by the gap between domestic credit and M2, both relative to GDP) has diminished in recent years and in some cases the loan-to-deposit ratio exceeds 100 percent (Appendix Table T1 and Table 16).

#### *Buildup of debt among households and firms*

Several Pacific states experienced rapid growth in credit to the private sector, driven mainly by commercial banks (Table 6). Except in Fiji, the expansion in private credit had a strong “household bias” (Table 7). The strong credit growth could reflect better economic conditions and rising household incomes, but abundant liquidity in the global financial markets may have encouraged the strong credit flows into these countries. Banks in the Pacific get their financing mainly from retail deposits. They are not dependent on wholesale or parent funding. But growth in credit to the private sector has slowed markedly. Non-performing loans in the Pacific have also risen (Table 8). If the credit boom in the past several years was unsustainable—based on optimism about the resilience of these economies during economic downturn—loan performance will further deteriorate as the economy slows, raising the risk of second-round effects on the domestic banking systems.

**Table 6 Real credit growth, 2003–2007**

Country Name	2003	2004	2005	2006	2007	Av 0307	Av 0507
Fiji	36.0	21.2	33.2	40.1	8.4	27.8	27.2
Kiribati	..	..	..	..	..	..	..
Samoa	17.6	11.7	36.2	33.1	10.1	21.8	26.5
Solomon Islands	28.6	15.5	64.8	50.2	54.9	42.8	56.6
Tonga	20.4	-2.2	58.0	6.1	28.9	22.3	31.0
Vanuatu	-0.3	13.0	17.9	9.6	18.5	11.7	15.3

Source: WDI.

Note: Claims on private sector, annual percentage change adjusted for inflation.

**Table 7 Allocation and growth of commercial bank loans (% of total)**

	Households		Businesses		Agriculture	
	2003	2008	2003	2008	2003	2008
	Fiji	33.5	29.4	56.1	61.7	2.2
Kiribati	..	..	..	..	..	..
Samoa	7.8	13.5	90.0	84.7	2.2	1.8
Solomon Islands	16.2	20.6	64.0	62.2	19.7	16.9
Tonga	26.1	32.6	45.0	47.0	4.7	4.3
Vanuatu	39.0	50.9	60.6	48.5	..	..

Sources: National Sources.

<sup>4</sup> According to central bank monthly or quarterly reviews

**Table 8 Non-Performing Loans in the banking sectors**  
(Percent of Total Loans)

	2003	2004	2005	2006	2007	2008
Fiji	2.2	1.7	1.5	0.5	1.1	2.4
Kiribati	..	..	..	..	..	..
Samoa	5.3	5.2	4.4	4.0	7.1	7.8
Solomon Islands	..	..	..	..	..	..
Tonga	..	..	..	..	..	..
Vanuatu	7.4	14.6	15.7	16.9	14.4	12.0

Sources: National Sources.

Note: Figures for 2008 refer to different months or quarters across reporting countries.

### *Offshore financial centers*

The offshore financial centers in Samoa and Vanuatu have been directly affected by the global financial crisis. In Vanuatu, for example, the central bank reports that offshore financial firms have made losses since the first quarter of 2008. (Similar information for Samoa was not readily available.) But the implications for the domestic economies are likely to be limited.

In Samoa according to the IMF, offshore entities are not permitted to conduct business with the residents. Domestic commercial banks are permitted to conduct offshore business but none has pursued that line of business aggressively.<sup>5</sup>

Potential impact of problems in the offshore centers on the domestic sector can be gauged from the size of centers. In Vanuatu, in 1997, the sector contributed about 2.5 percent of the country's GDP, 4.0 percent of government revenue, and around 400 jobs (about 0.5 percent of the country's labor force) (ADB, 1998). In 2008, according the central bank's quarterly review, the contribution to employment rose to 755 jobs (0.7 percent of the labor force). In Samoa, according to the IMF (2007), the offshore center contributed about 1.1 percent of GDP and about 3.9 percent of government revenue in 2005/06. The number of people directly employed in the offshore sector was 36 at the end of February 2007 (about 0.06 percent of the labor force).

### *National funds*

All the Pacific states except Tonga have a national provident fund, which is a compulsory retirement savings scheme for public and private sector employees funded by member contributions (5–10 percent of wages and salaries) matched by employers' contributions. The funds were set up in the 1950s and some now have a large share of financial-system assets (Tables 1–2). In Fiji, Samoa, and the Solomon Islands, for example, they hold 25–60 percent of financial-sector assets. Kiribati has a Revenue Equalisation Reserve Fund (RERF), which was set up with revenues from the sale of phosphates.

Because most Pacific Islands have capital account restrictions that limit the ability of national provident funds to invest overseas, the recent collapse of stock asset prices overseas has had

<sup>5</sup> IMF 2007 Samoa Article IV.

only a small impact on most of the funds.<sup>6</sup> But in Kiribati, the RERF is entirely invested overseas (in foreign currencies, equities, and bonds). The earnings of the RERF fell sharply along with global financial markets. Because revenues from this fund contribute 15–20 percent of the government’s revenues, the decline in earnings will require the government to reduce deficit financing from the fund.

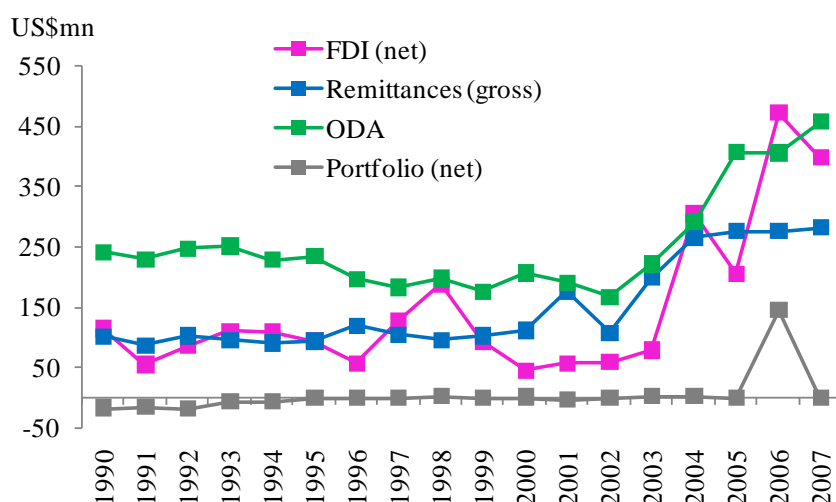
## B. Indirect channel—How the global slowdown has affected the Pacific

The global recession is expected to affect the Pacific states in two main ways: a decline in private capital flows (foreign direct investment, portfolio flows, and remittances) to the states and a decline in demand for exports from the states.

### *Private capital flows*

A decline in private capital flows could have major impact on the Pacific states. Although the states are famous for being the world’s highest recipients of aid per capita, private flows now exceed official flows (Figure 2). Over the last five years, private capital flows—foreign direct investment, remittances, and, to a lesser degree, portfolio flows—increased dramatically: they have doubled in the Solomon Islands and Vanuatu, increased six-fold in Fiji, and increased 20-fold in Samoa and Tonga, reaching 15–20 percent of GDP in Fiji and 40 percent of GDP in Tonga (Appendix Figure A1).

**Figure 2 Aggregate capital flows to the Pacific states**



Source: WDI, UNCTAD, and ADB.

*Foreign direct investment.* Private capital flows to the Pacific are mainly remittances and foreign direct investment (FDI). Information on FDI in 2008 is not yet available, but there is anecdotal evidence that it has declined. Globally, manufacturing FDI has been severely affected by the current crisis, especially in the car industries. In Samoa, Yazaki, a Japanese auto-parts assembly plant and the biggest private-sector employer in the country, slashed production and reduced its workforce by more than a third in 2008. A further job cut is

<sup>6</sup> Some countries have raised the limits on the funds’ ability to invest overseas, which may have increased the impact on the funds of the crisis. For example, the IMF’s Fiji 2002 Article IV reported that the country has allowed foreign investments of the Funds up to 15 percent.

expected as demand from Australia, its main customer, remains weak.<sup>7</sup> Commodity FDI, which is important for the Solomon Islands, also slowed in 2008. In the Solomon Islands, the planned reopening of the Gold Ridge gold mine is now in doubt.<sup>8</sup> Foreign investment in tourism and property development, which is important in Fiji, Tonga, and Vanuatu, might suffer a similar decline as the financing available to foreign investors in these areas has diminished.

*Portfolio flows.* Portfolio flows are trivial except for Fiji, the only one of the six Pacific states with a stock market. The market capitalization of the Fijian stock market is about US\$500 million (around 15 percent of GDP).<sup>9</sup> Like other stock markets, the Fijian stock market has fallen sharply since the onset of the crisis, but Fiji's losses are also the result of an ongoing political crisis. There was a military coup in December 2006, which was followed by financial repression, censorship, and a 20 percent devaluation of the Fijian dollar.

*Remittances.* On average, remittances account for 10 percent of GDP in the Pacific states, but their importance varies among countries (Appendix Figure A1). In Tonga, remittances remain the most important component of private capital flows (30 percent of GDP). In Fiji, Kiribati, and the Solomon Islands, remittances are less than 10 percent of GDP. Remittances appear least important in Samoa (less than 0.2 percent of GDP) and in Vanuatu (less than 3 percent of GDP), but remittances to these countries—especially Samoa—may be underestimated (Table 9; see also footnote 3). In Fiji and Tonga, remittances are reported to account for 50–60 percent of household income.<sup>10</sup> They are typically used for packaged food, education, clothing, and health care. They are also used for investments, such as land purchases and housing improvements.<sup>11</sup>

**Table 9 Estimated migrant population overseas in 2005**  
(Numbers unless otherwise stated)

	Total	Population	% of population
Fiji	148,355	854,000	17.4
Kiribati	4,837	94,000	5.1
Samoa	100,982	183,000	55.2
Solomon Islands	4,324	481,000	0.9
Tonga	51,570	102,000	50.6
Vanuatu	3,092	217,000	1.4

Source: University of Sussex and World Bank.

<sup>7</sup> ADB (2008, p.254, ADB 2009, p.285)

<sup>8</sup> ADB (2009, p.286).

<sup>9</sup> See <http://www.spse.com.fj/publish/home.shtml>.

<sup>10</sup> According to Luthria, et al (2006), remittances in Tonga accounted for around 62 percent of household income, and in Fiji around 20 percent of household income; but according to an AusAID report ([http://www.ausaid.gov.au/publications/pdf/fiji\\_study.pdf](http://www.ausaid.gov.au/publications/pdf/fiji_study.pdf)), the share in Fiji is about two-thirds of household income among low-income remittance-receiving households, and around 55 percent among high-income remittance-receiving households. The AusAID is reporting from a much smaller survey focusing on rural households; the sampling frame is not nationally representative and, in particular, under samples Indo-Fijian and urban households, which comprise 45 and 56 percent of the national population, respectively (p.144).

<sup>11</sup> AusAID (op cit, p48).

**Table 10 Estimated migrant population overseas in 2005, by host country**  
(Percent of total migrant population)

	Australia & NZ	US	Europe	Pacific Islands	Japan and Asia	Others
Fiji	45.9	23.5	3.0	2.3	0.1	25.1
Kiribati	18.1	23.1	26.8	22.3	0.2	9.4
Samoa	56.1	19.2	0.5	15.5	0.1	8.6
Solomon Is.	41.6	4.0	9.7	35.0	0.3	9.4
Tonga	47.2	38.7	1.1	3.3	0.2	9.5
Vanuatu	37.4	3.4	31.2	18.6	0.1	9.3
<b>All</b>	<b>48.9</b>	<b>24.1</b>	<b>2.6</b>	<b>7.7</b>	<b>0.1</b>	<b>16.6</b>

Source: University of Sussex and World Bank.

Source: University of Sussex, World Bank, and IMF WEO.

Remittances appear already to have fallen in Fiji, Samoa, and Tonga. According to ADB (2009), the fall in Fiji was from 4.3 percent of GDP in 2007 to 3.3 percent of GDP in 2008; in Samoa, it was -4.6 percent in real terms over the same period; in Tonga, remittances fell “slightly”.

A decline in remittances—combined with the buildup of domestic indebtedness among households and firms—raises a concern about the second-round effect on the domestic banking system. A decline in remittances may cause households to cut back on consumption and reduce spending on health and education. The more indebted the households are, the more sensitive their expenditures would be to the income shock, so the build up of household debt in several Pacific Islands before the crisis has likely raised the sensitivity of domestic demand to external shocks. A large decline in remittances may also cause debt-repayment difficulties and increase banks’ non-performing loans. The prospect of a sharp decline in remittances, therefore, adds to the risk of a damaging second-round effect on the domestic banking systems.

However, remittances may not fall sharply. First, remittances are said to be more resilient than other components of private capital flows (IMF 2009, World Bank 2009). Second, the remittances come from a variety of countries (Table 10). For example, the ADB (2009) reported that in Samoa remittances from the US fell in 2008 while those from Australia and New Zealand rose slightly, softening the overall decline. Third, Australia has recently expanded its temporary guest-worker policies to include Kiribati, Tonga, and Vanuatu. The recent World Bank report found that documented migrants and those who receive social security in their host countries are more likely to send remittances to their families than undocumented or unprotected migrants.

### *Exports*

International trade accounts for 100–120 percent of GDP in the Pacific states, which makes them more vulnerable to transmission of the financial crisis through trade than many other developing countries are (Tables 11–14). Tourism is the biggest exports for most Pacific states. In Vanuatu, tourism is more important than remittances as a source of foreign exchange. In Fiji, Tonga, and Samoa, tourism is second only to remittances. Tourism is not important for Kiribati or the Solomon Islands. Unlike the other Pacific Islands, the Solomon Islands is a significant commodity exporter, exporting timber, palm oil, copra, and cocoa.

**Table 11 Trade openness, 2000-2007**  
(Exports and imports as percent of GDP)

Country Name	2000	2001	2002	2003	2004	2005	2006	2007
Fiji	135.4	129.4	125.4	128.1	124.2	129.1	117.2	113.4
Kiribati	92.0	100.6	110.4	93.2	96.0	131.9	113.0	..
Samoa	91.0	113.7	109.2	75.2	80.6	86.8	93.3	82.9
Solomon Islands	95.7	94.2	74.3	108.2	106.5	132.8	147.6	..
Tonga	66.8	62.6	81.1	81.3	80.3	85.3	77.0	87.5
Vanuatu	96.9	96.4	106.0	103.6	105.0	105.7	101.9	104.3

Source: WDI and ADB.

**Table 12 Main destinations of exports, 2007**  
(Percent of total exports)

	Australia & NZ	Japan and Other Asia	US	Europe	Pacific Islands	Others
Fiji	15.0	4.7	16.8	12.9	16.8	33.8
Kiribati	7.5	21.7	22.8	27.7	..	20.3
Samoa	47.5	0.6	3.4	0.7	30.8	17.1
Solomon Is.	1.6	78.9	..	3.7	3.1	12.7
Tonga	11.3	37.1	31.5	0.5	11.3	8.5
Vanuatu	0.6	71.9	..	0.7	0.0	26.8
<b>All</b>	<b>13.4</b>	<b>27.8</b>	<b>10.3</b>	<b>8.3</b>	<b>13.0</b>	<b>27.2</b>

**Table 13 Main origins of imports, 2007**  
(Percent of Total Imports)

	Australia and NZ	Japan and Other Asia	US	Europe	Pacific Islands	Others
Fiji	38.7	43.9	2.1	..	..	15.3
Kiribati	39.8	22.6	3.1	0.5	27.1	7.0
Samoa	30.1	36.5	5.2	..	16.2	12.0
Solomon Is.	31.1	41.8	1.9	..	7.9	17.4
Tonga	36.3	11.9	9.4	2.1	32.3	8.0
Vanuatu	32.2	21.4	8.5	8.7	4.5	24.6
<b>All</b>	<b>36.0</b>	<b>37.9</b>	<b>3.6</b>	<b>1.1</b>	<b>6.0</b>	<b>15.5</b>

**Table 14 Tourist arrivals by country of origin in 2007**  
(Percent of total arrivals)

	Australia & NZ	Japan and Other Asia	US	Europe	Pacific Islands	Others
Fiji	56.8	8.7	12.0	11.3	6.3	4.8
Kiribati	25.7	4.2	2.0	9.2	40.1	18.9
Samoa	59.2	2.4	6.6	3.6	27.6	0.6
Solomon Is.	48.9	12.4	7.5	5.6	23.7	1.9
Tonga	70.0	n.a.	13.0	n.a.	6.1	10.9
Vanuatu	75.1	0.9	3.2	4.7	3.6	2.2
<b>All</b>	<b>59.6</b>	<b>6.4</b>	<b>10.2</b>	<b>8.8</b>	<b>10.6</b>	<b>4.3</b>

Sources: ADB, WDI, National sources.

Note: Kiribati's figures are based on data in 2003.

**Table 15 Tourist arrivals, 2000-2008**  
(Thousands)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Fiji	294	348	398	431	504	550	545	540	582
Kiribati	5	5	5	5	4	3	4	5	..
Samoa	88	88	89	92	98	102	116	122	122
Solomon Islands	5	6	..	7	11	9	11	14	..
Tonga	35	32	37	40	41	42	39	46	49
Vanuatu	58	53	49	50	61	62	68	81	91

Source: WDI and national sources.

Note: Solomon Islands' 1999, 2004, and 2004 figures are estimates only.

Tourist arrivals grew in 2008, offsetting the slowdown in remittances (Table 15). Even in Fiji, with its ongoing political strife, visitor arrivals have held up, because of active marketing and heavy discounting. The latest available data (end of 2008 or first few months of 2009) show that arrivals are still increasing in most Pacific Islands, although per capita spending by tourists has fallen in some states. The importance of tourists from Australia and New Zealand helped the Pacific states in 2008; countries that are more reliant on tourists from China, Japan, and United States have suffered more.<sup>12</sup> Tourist arrivals are likely to fall in 2009 as the recession is expected to deepen everywhere, including Australia and New Zealand (Appendix Figure A2).

The deepening recession in Australia and New Zealand creates an additional concern. Some of the Pacific states are heavily reliant on Australia- and New Zealand-based carriers for air connectivity, including Air New Zealand and Pacific Blue, an Australian subsidiary of the UK-based Virgin group. Air New Zealand has said it will reduce flights to Samoa and Tonga, unless those countries agree to subsidize the flights. Withdrawal of these flights would obviously have an adverse impact on these countries' tourism and export revenues (Tables 12–14).<sup>13</sup>

### C. Initial conditions

The IMF finds that developing countries' initial conditions affect how vulnerable they are to contagion from the current crisis.<sup>14</sup> For example, *World Economic Outlook* (April 2009) compares standard indicators of vulnerability (current account balance, fiscal balance, and foreign exchange reserves) across emerging regions and finds that initial conditions were weaker in emerging European and Latin American countries than in emerging Asian countries. The *Global Financial Stability Report* (April 2009) considers a broader range of indicators, including exposures to foreign bank lending and growth of private sector credit before the crisis, and draws a similar conclusion. Figure 3 and Table 16 present these indicators for the Pacific states.

<sup>12</sup> ADB (2009).

<sup>13</sup> EIU (Samoa and Tonga, 2009).

<sup>14</sup> For example, IMF's GFSR (April 2009), WEO (April 2009), and IMF (2009) *The Implications of the Global Financial crisis for Low-Income Countries*. The reports were, however, careful to point out also that, unlike during other crises, domestic imbalances were not the cause of contagion and that even countries that maintained external and internal surpluses did not escape contagion from the current crisis.

*Current account.* All the Pacific states run a large deficit on their merchandise trade accounts, and all are net importers of food and fuel (Appendix Table A2). The commodity price shock of 2007–08 widened their current account deficits from an average of 8.6 percent of GDP in 2006 to an average of 10.0 percent of GDP in 2008. Domestic food prices rose sharply, with the increase in the prices of both imported food and agricultural inputs, such as fuel and fertilizer (Appendix Figure A2). Inflation rose sharply, in many countries to double-digit levels by mid 2008.

*Foreign reserves.* With the widening of trade deficits, foreign reserves came under pressure, but were buoyed by tourism revenues, private capital flows, and in some countries, large official inflows. Foreign reserves in most countries have remained above the official target levels of import cover (3 to 4 months) in 2008. An exception was the Solomon Islands, where a decline in export demand for logs from China put additional pressure on reserves.

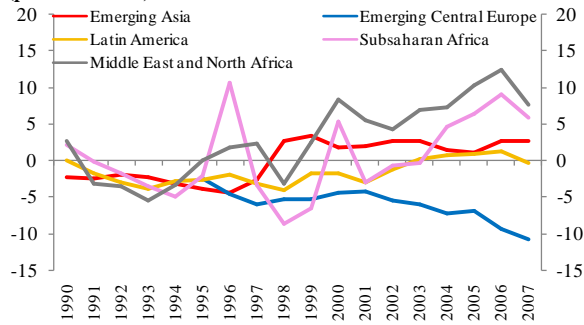
*Fiscal balance.* Fiscal balances were weakened in some countries as a result of the commodity price shocks. Governments used subsidies and tax cuts to mitigate the impact of rising food and fuel costs. But, overall, domestic factors dominated the ongoing weaknesses in their fiscal accounts, including higher development spending, higher public sector wage bills, and higher reconstruction bills after natural disasters or, as in Fiji and Tonga, a military coup and a riot.

*Exposure to foreign bank lending and foreign-currency share of total loans.* As noted earlier, most banks in the Pacific states are foreign owned, and their domestic lending appears in data as foreign bank flows. In the Table 16, therefore, we only consider the “cross-border” portion of the loan not intermediated by the local subsidiaries of the reporting foreign banks. As discussed earlier, most foreign bank flows of the BIS reporting banks are through local bank lending, and those that are not are small in all countries except Samoa, some of which may actually represent remittances (see footnote 3).

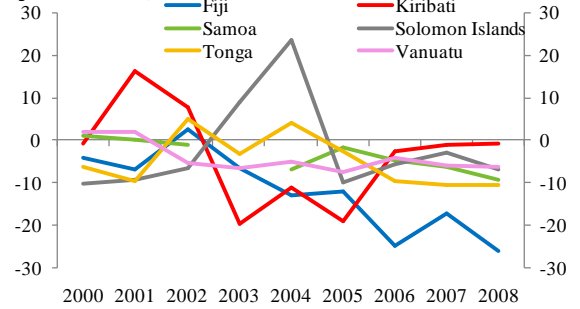
*Credit growth in the private sector and the ration of loans to deposits.* As discussed earlier, credit growth to the private sector expanded rapidly. The expansion was mostly funded by domestic retail deposits, but loan to deposit ratios exceeded 100 percent in some of the countries, which signals growing reliance on outside funding. Indebtedness in the private sector raises the sensitivity of domestic demand to external shocks, and raises the risk of a second-round effect of the economic slowdown on domestic banks.

**Figure 3 Vulnerability Indicators by Regions and Countries**

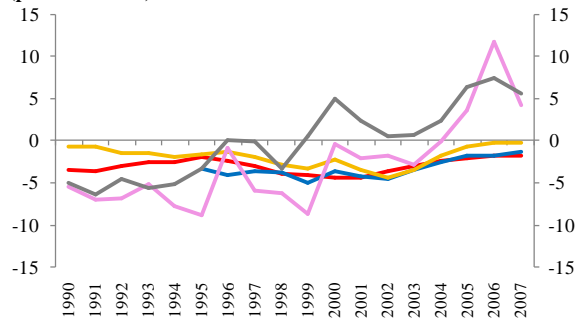
**Current Account Balance (percent of GDP)**



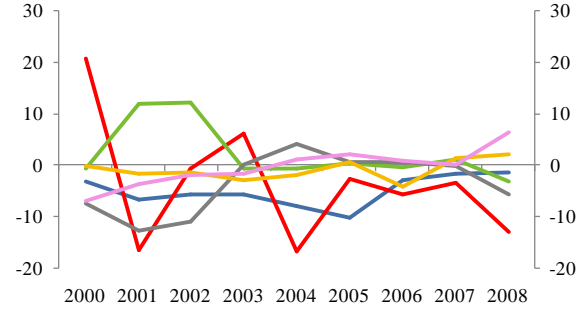
**Current Account Balance (percent of GDP)**



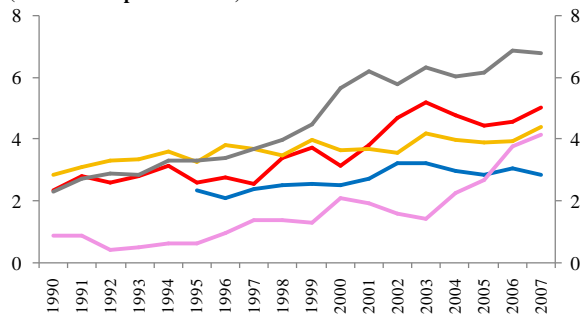
**Fiscal balance (percent of GDP)**



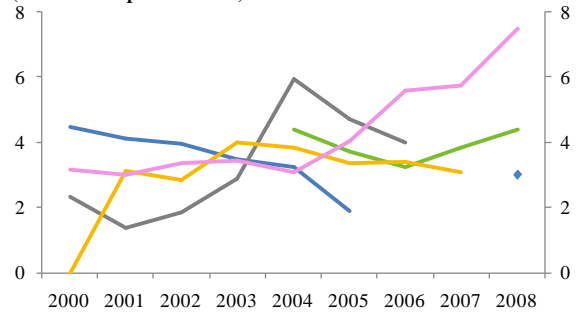
**Fiscal Balance (percent of GDP)**



**Foreign Exchange Reserves (months of imports covered)**



**Foreign Exchange Reserves (months of imports covered)**



Source: ADB, IMF WEO (April 2009), WDI, and author's calculation.

**Table 16 Vulnerability indicators of selected countries**

	Current Account Balance <sup>1/</sup> (percent of GDP)	External Debt Refinancing Needs in 2009 <sup>2/</sup> (percent of reserves)	Net External Position vis-à-vis BIS-Reporting Banks <sup>3/</sup> (percent of GDP)	Average real credit growth over the last 5 years <sup>4/</sup> (percent, year-on-year)	Loan/Deposits <sup>5/</sup> (Ratio)	Forex share of Total Loans (percent of loans)
<i>Europe</i>						
Bulgaria	-15.3	106	-36.2	35.9	1.3	66.9
Croatia	-6.9	128	-44.6	13.1	1.1	62.0
Estonia	-5.8	218	-67.4	27.3	2.1	85.3
Hungary	-3.9	103	-50.2	14.3	1.4	65.7
Kazakhstan	-7.4	98	-5.1	50.1	1.7	43.6
Latvia	-6.7	331	-57.6	38.4	2.8	89.3
Lithuania	-3.7	448	-41.5	43.2	2.0	64.0
Poland	-5.0	168	-15.5	14.7	1.1	32.6
Romania	-8.6	127	-31.9	47.1	1.3	55.5
Russia	-0.9	34	3.1	34.5	1.3	15.3
Serbia	-13.2	...	-12.4	26.2	1.2	68.0
Turkey	-1.1	110	-11.8	29.8	0.7	28.9
Ukraine	0.9	206	-17.5	47.5	2.0	59.5
<i>Gulf States</i>						
Kuwait	19.2	109	3.8	19.8	1.1	...
Saudi Arabia	-7.2	...	22.3	22.2	0.9	8.2
UAE	-5.6	...	-12.2	32.5	1.2	18.9
<i>Africa</i>						
Egypt	-2.7	14	8.5	0.9	0.6	28.0
Ghana	-10.9	13	-5.0	26.4	0.8	...
Nigeria	-12.7	...	10.6	34.2	1.1	...
South Africa	-5.5	64	4.4	12.8	1.2	...
Uganda	-6.0	...	...	17.7	0.8	...
<i>Asia</i>						
China	10.3	14	0.7	11.3	0.8	...
India	-2.5	33	-8.9	18.2	0.8	...
Indonesia	-0.4	73	-7.5	15.1	0.8	19.8
Korea	2.3	93	-20.6	6.3	1.2	8.5
Malaysia	12.5	24	-8.2	5.2	0.9	...
Pakistan	-5.9	27	2.4	13.5	0.7	...
Philippines	1.8	43	-2.2	...	...	...
Thailand	0.1	33	1.3	2.6	1.0	...
Vietnam	-5.8	8	-7.4	26.4	1.1	21.2
<i>Latin America</i>						
Argentina	1.6	74	2.5	14.6	0.7	15.8
Brazil	-1.7	36	-7.1	15.9	0.8	...
Chile	-4.7	76	-7.0	11.6	1.4	...
Colombia	-4.1	56	0.5	16.0	2.0	6.3
Mexico	-2.7	60	-2.1	11.7	0.8	11.6
Peru	-3.7	35	-2.2	8.2	0.9	57.5
Venezuela	-2.2	69	19.7	45.8	0.8	<0.5
<i>Pacific Islands</i>						
Fiji	-21.2	..	-0.5	13.7	82.3	..
Kiribati	-3.1	..	..	..	..	..
Samoa	-8.4	..	-120.3	16.8	106.5	..
Solomon Islands	-9.6	..	..	48.9	87.1	..
Tonga	-8.8	..	-1.6	14.0	103.1	..
Vanuatu	-5.3	..	-10.8	18.8	59.2	..

Sources: IMF *GFSR*, April 2009, Table 1.1. Figures for Pacific Islands are added by the author. See related tables in this paper for data sources. Note: The shaded boxes of the table point to areas of potential concern. Cut-off values are as follows: current account balance below -5 percent of GDP; refinancing needs above 100 percent of reserves; net external liabilities to BIS-reporting banks below 10 percent of GDP; average real growth of credit to the private sector greater than 30 percent year-on-year; loans-to-deposit ratio exceeding 1; and foreign-currency denominated loans exceeding 50 percent of total loans. 1/ Projections of the current account balance and GDP for 2009 in dollar terms from the WEO. 2/ Short-term debt at initial maturity at end-2008 plus amortizations on medium- and long-term debt during 2009, estimated by IMF staff. 3/ Data on external positions of reporting banks vis-à-vis individual countries and all sectors from the BIS, as of September 2008. Figures for Pacific Islands related to "cross-border" claims only, as "local claims of foreign affiliates" correspond almost entirely to domestic credit (since almost all banks are foreign-owned). 4/ Average growth of credit to the private sector, adjusted for inflation. 5/ Credit to the private sector relative to demand, time, saving, and foreign currency deposits.

**Appendix Table A1 Measure of excess liquidity**  
(Percentage Points)

	2000	2001	2002	2003	2004	2005	2006	2007
Fiji	10.2	10.4	9.3	10.0	10.5	7.4	6.0	12.0
Kiribati	..	..	..	..	..	..	..	..
Samoa	4.8	3.9	3.3	4.8	4.4	1.0	-1.8	1.3
Solomon Islands	8.2	9.3	6.3	7.0	6.8	10.4	9.5	5.3
Tonga	-8.9	-6.1	-10.1	-10.0	-1.4	-8.5	-7.1	-12.3
Vanuatu	62.5	64.8	68.0	58.6	54.8	53.3	51.0	56.2

Source: WDI.

Note: Excess liquidity is defined as the difference between the ratio of M2 to GDP and the ratio of domestic credit to GDP.

**Appendix Table A2 Merchandise trade balance (%GDP)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Fiji	-14.5	-21.0	-20.9	-23.2	-27.6	-30.6	-35.0	-30.3	..
Kiribati	-78.0	-80.6	-96.1	-83.3	-88.4	-115.1	-92.6	-111.4	..
Samoa	-39.7	-48.0	-46.2	-38.3	-40.3	-41.2	-46.3	-40.3	-45.0
Solomon Islands	-7.7	-15.7	-4.0	-8.7	-9.2	-27.9	-23.5	-18.5	..
Tonga	-39.4	-48.6	-49.9	-44.4	-45.2	-51.4	-45.3	-53.2	-67.6
Vanuatu	-24.9	-29.8	-30.4	-27.9	-27.5	-30.2	-29.8	-40.9	-41.5

Source: WDI.

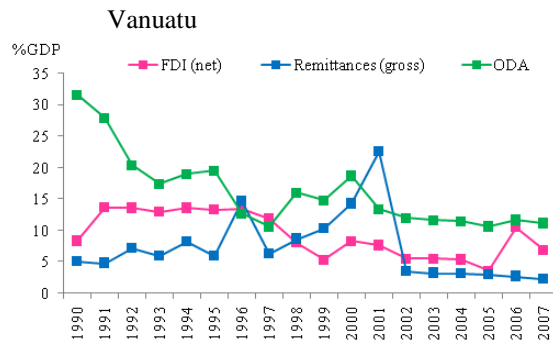
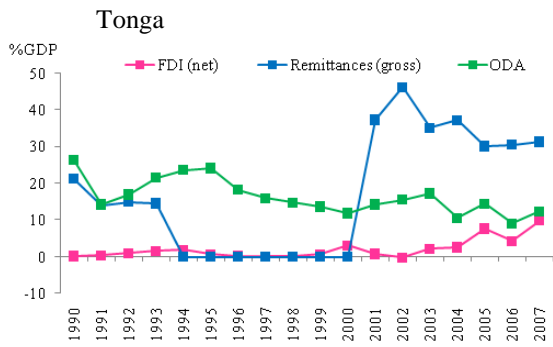
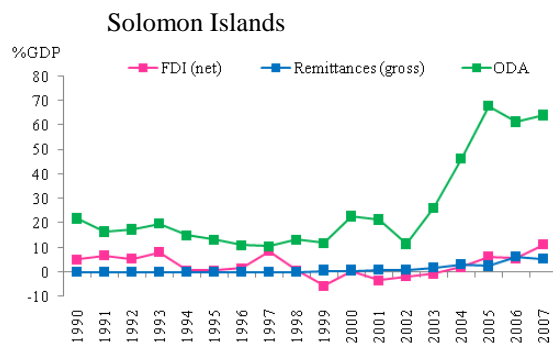
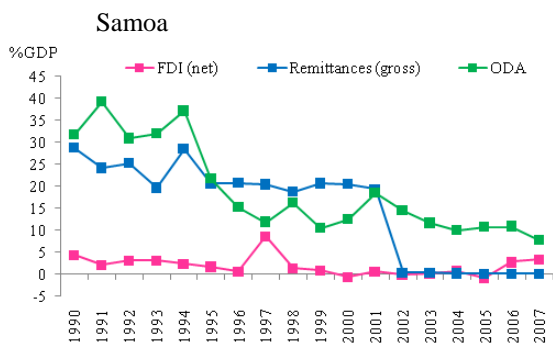
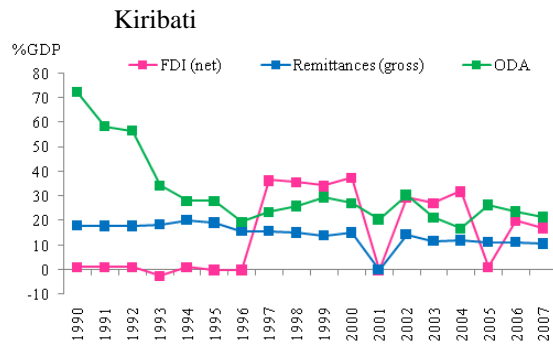
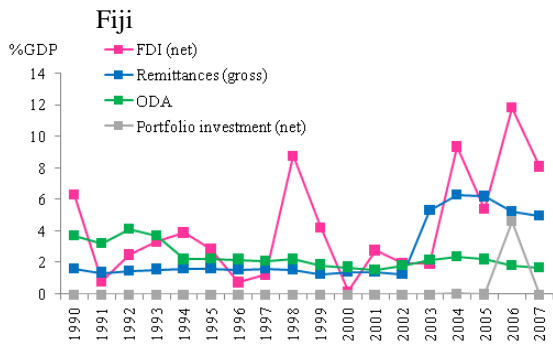
**Appendix Table A3 Current account balance (% GDP)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Fiji	-4.0	-6.7	2.5	-6.6	-12.9	-12.1	-24.7	-17.3	-26.1
Kiribati	-0.8	16.1	7.6	-19.5	-11.1	-19.1	-2.6	-1.0	-0.9
Samoa	1.0	0.1	-1.1	-95.3	-6.8	-1.6	-4.6	-6.1	-9.4
Solomon Islands	-10.1	-9.4	-6.5	9.1	23.5	-9.8	-5.6	-2.8	-6.8
Tonga	-6.2	-9.5	5.1	-3.1	4.2	-2.6	-9.7	-10.4	-10.4
Vanuatu	2.0	2.0	-5.4	-6.6	-5.0	-7.4	-4.1	-5.9	-6.2

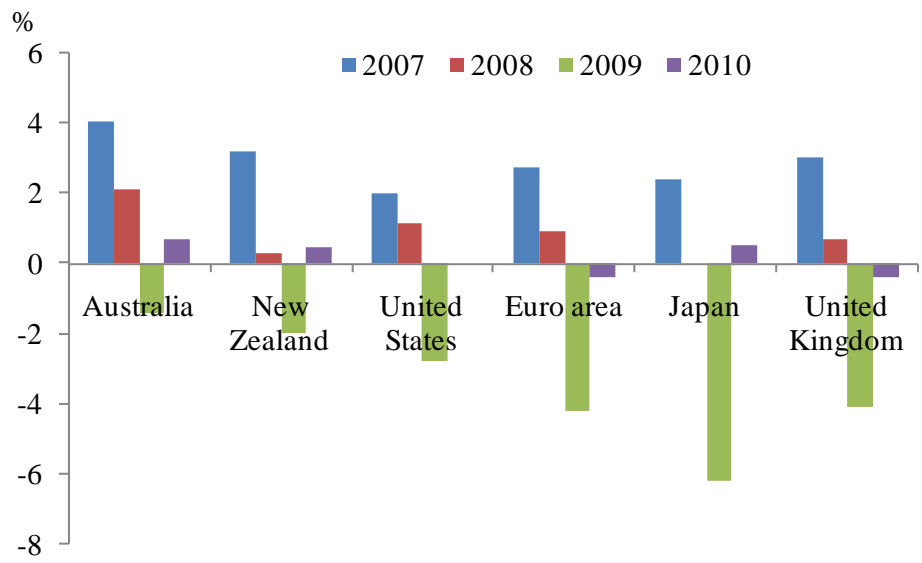
Source: IMF WEO April 2009

Note: Estimates start after 2007, except Samoa and Tonga (after 2006).

## Appendix Figure A1 Capital Flows in the Pacific Islands, 1990-2007



**Appendix Figure A2 Growth forecasts of Trading Partners**  
(Percentage change)



Source: IMF *WEO* April 2009.

**Appendix Figure A3 Commodity prices**  
Index (2000=100)

