SMALL PACIFIC ISLANDS

The small, remote economies of Vanuatu, Samoa, Tonga, Kiribati and Tuvalu (the "Pacific Islands") are highly vulnerable to external shocks. Most are still in the process of recovering from the combined effects of the global economic crisis and the natural disasters affecting the region in the last two years. If food prices continue to rise in 2011, this will pose a particular challenge for the Pacific Islands, which are heavily dependent on imported food. If oil prices also continue to rise, the effect will be compounded, not only through direct energy costs but also by exacerbating the already high transport costs faced by these remote economies. During the earlier global food and fuel crisis, inflation peaked at just below 20 percent in Samoa and Kiribati.

Among the Pacific Islands, Vanuatu's economy continues to be the strongest performer, with GDP growth estimated to have been 3 percent in 2010. While this represents a downward revision to earlier forecasts, due to the lower-than-expected growth of all major sectors, it remains a solid result in the context of a difficult external environment. The tourism sector, a key driver of the Vanuatu economy, did not continue the growth exhibited in 2009, but more-or-less maintained the gains made in that peak year. Tourism earnings during the peak September quarter were estimated to be higher than during the same period in 2009, largely due to the depreciation of the vatu against the Australian dollar—by far Vanuatu's biggest tourist market. The government is estimated to have posted a modest deficit in 2010, with tax revenue in the first three quarters of 2010 keeping pace with that received in the same period of 2009, but expenditure—mainly development expenditure—higher than the previous year. The fiscal deficit in 2009 stood at just under 1 percent of GDP.

A rebound in tourist arrivals is expected to underpin higher overall economic growth in 2011, with the government forecasting growth of 4.2 percent. The agricultural sector is also projected by the government to grow strongly, boosted by continued high commodity prices for Vanuatu's key exports. Major projects in the construction sector should also support growth, but Vanuatu still faces the challenge of replacing the stimulus to the economy that has been provided by Millennium Challenge Account-funded infrastructure projects over the last half decade. Private sector credit growth continues to be strong—at just under 12 percent in the year to October 2010—with asset quality continuing to improve over the same period. In recent months, however, loans to individuals and households have driven private sector credit growth, with loans to businesses contracting. At this stage, inflationary pressures remain weak, with headline inflation of 2.3 percent and underlying inflation of –1.6 percent in the September quarter, relative to the same period in 2009.

Samoa's economy is now beginning to recover from the combined effects of the earlier global food and fuel crisis, the global economic crisis, and the devastating tsunami of late 2009. After contracting by nearly 5 percent in the 2008/09 fiscal year, the economy is estimated to have grown by 0.6 percent in 2009/10. The tourism sector—whose infrastructure was severely damaged by the tsunami—contracted in 2009/10, but the major reconstruction program instituted in the wake of the tsunami provided a stimulus to the economy and the economy was also boosted by the expansion of a major manufacturing plant. Primarily as a result of the reconstruction program, but also in consequence of falling tax revenues, Samoa's budget is estimated to have recorded a deficit of 8.1 percent of GDP in 2009/10. Samoa's monetary policy stance has remained accommodative.

In 2010/11, the government projects that Samoa's economy will grow by 2.6 percent. Continued implementation of the reconstruction program is expected to play an important role in supporting this growth. To fund this reconstruction program, the government has budgeted for a deficit equivalent to 9 percent of GDP in 2010/11, to be financed mainly through concessional loans. Available indicators suggest that the tourism sector remains subdued. In the first four months of the 2010/11 fiscal year, tourist arrivals were 4 percent below the same period in 2009/10, with tourism earnings 2 percent lower. Remittances, which are critical to the Samoan economy (typically equal to about 30 percent of GDP), are also somewhat subdued—but this may simply be reflecting the extraordinary response of remittances to the tsunami of September 2009. In the first four months of the 2010/11 fiscal year remittances were 4 percent below the same period in 2009/10 (when the tsunami occurred), in local currency terms. After a period of contraction in 2009, private sector credit has begun to expand, and in the year to October 2010 grew by 4 percent. Although inflation remains moderate, it is beginning to pick up, with headline inflation reaching 4.1 percent in October 2010 compared to the same period in 2009, and underlying inflation reaching 3.4 percent.

Tonga's recovery from the combined effects of the earlier global food and fuel crisis, the global economic crisis, and a series of natural disasters that affected the country in 2009 and 2010, is yet to gain traction. After contracting by 0.4 percent in the 2008/09 fiscal year, the economy is estimated to have contracted by a further 1.2 percent in 2009/10. The key reason for the weak performance of the domestic economy has been the sharp decline in remittances that Tonga has experienced during the global economic crisis. In pa'anga terms, remittances fell by 13.6 percent in FY2008/09, and a further 10.2 percent in FY2009/10. Thus far in FY2010/11, remittance receipts have remained flat. Remittances were the equivalent of only 22 percent of GDP in 2009/10, down from 31 percent of GDP in 2007/08. As a result of falling tax revenues and increased construction expenditure financed by two loans from China's EXIM Bank, Tonga's budget deficit was 4.8 percent of GDP in 2009/10. Without budget support grants from donors, the deficit would have been 6.1 percent of GDP. Tonga's monetary policy stance has remained accommodative.

In 2010/11, the government projects that Tonga's economy will grow by 1.4 percent, but achieving this expansion will be difficult if remittances and private sector credit remain subdued. By the beginning of the 2010/11 fiscal year, the earlier decline in remittances appeared to have bottomed-out, and remittances began to rise again. Remittances are still lower than the previous year, however, with remittances in October 2010 some 3.7 percent below the same period in 2009. Private sector credit continues to contract, and in October 2010 was 10.3 percent below the same period in 2009. Although inflation remains moderate, it is beginning to pick up with headline inflation reaching 4.8 percent in October 2010 compared to the same period in 2009. As a result of continued weak tax revenues and a further increase in construction expenditure, Tonga's budget deficit is expected to be around 4.8 percent of GDP (or 9.2 percent of GDP in the absence of anticipated donor budget support grants). The loans contracted to finance the increased construction expenditure are causing a sharp increase in Tonga's level of indebtedness, with public debt projected to reach 58.5 percent of GDP in the next fiscal year.

The economies of Kiribati and Tuvalu are both estimated to have begun to recover in 2010, after experiencing modest contractions in 2009. Government expenditure in both countries depends, to a significant extent, on revenues from trust funds—the asset bases and returns from which were severely affected by the global financial crisis. Seafarers' remittances, an important source of income for households in both countries, were also negatively affected by the global downturn. The contraction in global trade reduced demand for seafarers from Kiribati and Tuvalu and consequently their remittance receipts. Kiribati is estimated to have grown by around 1 percent in 2010, with a smaller—perhaps marginal—rate of growth in Tuvalu. Both face significant challenges ahead to sustain economic growth, not least due to shortfalls in financing critical government expenditure and in adapting to the impacts of climate change (see the Box on climate change adaptation in Kiribati).

Financing critical government expenditure is an immediate challenge for Tuvalu in 2011, because the reserve funds available to the government to finance deficits are likely to be insufficient to enable the government to maintain recent levels of expenditure this year. Government expenditure has risen steadily over the last half decade, with the primary cause of the

The challenge of climate change adaptation in Kiribati

Kiribati is one of the most vulnerable countries in the world to the effects of climate change and sea level rise. With a population of just over 98,000, it consists of 33 low-lying atoll islands spread over a vast area of 3.5 million square kilometers of ocean. Nearly half of the population lives in South Tarawa, a highly dense area with a population growth of 3 percent per year. At current rates, the national population will increase by 55 percent by 2025, placing even greater challenges on a fragile environment.

Most of the land in Kiribati is less than 3 metres above sea level and on average only a few hundred metres wide, rendering retreat options untenable. The islands are exposed to periodic storm surges and to droughts, and are becoming increasingly vulnerable due to high population concentration, accelerated coastal development, and environmental degradation. Estimates suggest that by 2050, some 25–54 percent of areas in Bikenibeu, South Tarawa, and 55–80 percent of Buariki, North Tarawa, could become inundated.

Climate change and sea level rise could also severely affect the main Tarawa groundwater lens, increase the epidemic potential for dengue fever, decrease agricultural productivity, and divert critical tuna resources from Kiribati waters. Moreover, climate change is threatening the marine ecosystems around Kiribati, in particular through impacts on the coral reefs surrounding the islands, with implications for subsistence and small-scale commercial near shore fisheries, failure of the reef to act as an effective buffer of wave energy, and increased island instability as sediment resources decline.

Overall, in the absence of adaptation, Kiribati could face economic damages due to climate change and sea level rise by 2050 equivalent to 17–34 percent of its 1998 GDP. Recognising the seriousness of the challenge, the government initiated the Kiribati Adaptation Program (KAP), aimed at reducing Kiribati's vulnerability to climate change, climate variability and sea level rise. The KAP involves mainstreaming climate change adaptation into national economic planning and the operational plans of all government ministries, diagnosing climate-related problems, designing cost-effective adaptation measures, and implementing these across vulnerable areas of Kiribati. At present, Kiribati is piloting investments for the protection of key coastal assets in South Tarawa (the road, airport and hospital) and the protection of freshwater supplies—Kiribati's two areas of greatest vulnerability. Community consultation and participation is a cornerstone of the KAP, particularly given that some of the components of adaptation rely on community awareness, behavioural change and private investments.

increase being subsidies and transfers—particularly transfers for health treatment abroad. Although revenues had also been expanding, resulting in a reduction in the deficit, this trend reversed shared in 2010. To address the current shortfall, expenditure rationalisation and increased donor support may both be required in 2011. A reduction in government expenditure is, however, likely to have a negative effect on Tuvalu's economic growth in 2011.