Australian Government

New Zealand Government

Surviving the global recession: strengthening economic growth and resilience in the Pacific

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Contents

Executive summary

This joint report has been commissioned by the Prime Ministers of Australia and New Zealand to inform discussions at the 2009 Pacific Islands Forum Meeting. The report assesses the impact of the global recession on the Pacific and sets out critical policy components for an effective regional response.

Impact of the global recession

All FICs are experiencing lower economic growth, a worsening macroeconomic outlook, falling government revenues and increased poverty.

In common with countries throughout the world, all Forum Island Countries (FICs)[1] are being hurt by the current global recession as demand, output and employment have fallen internationally. The World Bank expects the world economy to contract by 2.9 per cent in 2009, the first time this has happened in six decades. Japan, the United States of America, Australia and New Zealand—major markets for the Pacific region—are all experiencing or expected to experience negative growth in 2009.

Ministers at the 2008 Forum Economic Ministers Meeting (FEMM) alerted the region to the emerging impacts of the global recession. Ministers warned that key points of pressure were from:

> lower prices and reduced demand for commodity exports

> pressure on tourism

> falls in remittance flows

> significant falls in the value of offshore national trust funds and for some

> a deterioration in access to finance.

All FICs are experiencing lower economic growth, a worsening macroeconomic outlook, falling government revenues and increased poverty. Lower cash incomes for families means less money for food, for school fees and for essential health services, worsening health outcomes and children being withdrawn from school. Reduced government support for infrastructure is likely to constrain economic growth and employment and slow recovery. Women and children are particularly vulnerable as poverty increases.

The global recession is exposing underlying structural weaknesses in many FICs, exacerbating the impacts of the economic downturn. In particular, a number of countries were already experiencing stresses as a result of the 2008 international oil price and food price shocks, with high inflation, falling foreign reserves and unsustainable budget deficits. As a result, many FICs' ability to respond to the impacts of the recession is constrained.

1 Refers to developing country members of the Pacific Islands Forum.

Responding to the global recession

The immediate priority for countries is to safeguard macroeconomic stability, and protect core services ... alongside providing targeted support for the most vulnerable.

Responding to the global recession requires coordinated action. Internationally, the G20 is already working to return the world to a path of sustained growth. In the Pacific action will need to be well-coordinated between FICs and core development partners.

Within the context of the global response, each FIC's national policy response must reflect its own circumstances. The main challenge for FICs is to:

> Adjust to reduced revenues and offshore income in a way that both safeguards macroeconomic stability and protects funding for core services, particularly those program that support the poor and vulnerable

> At the same time, commit to continuing fiscal and other reforms designed to improve competitiveness and provide a platform for stronger and more resilient economic growth.

Strengthening budgetary management and prioritising expenditure

Macroeconomic stability is an essential pre-condition for growth and development. Prior to 2009, FICs were already experiencing a range of stresses, with some countries running unsustainable budget deficits even before the current economic downturn. More FICs will face potentially destabilising budget deficits without action to manage expenditure in a manner consistent with a sustainable medium-term fiscal position.

Given the need to maintain fiscal discipline in an environment of declining revenues, it will be important for FICs to take action to strengthen budgetary management and to protect and prioritise expenditure on core development priorities, especially basic health, education and infrastructure. Assistance from development partners may help FICs experiencing fiscal pressures to implement critical budgetary reforms and maintain core services.

The long-term affordability of any significant fiscal stimulus package will need careful assessment, even for FICs with comparatively strong underlying macroeconomic positions. Such packages need to be targeted at increasing local economic activity and employment.

Improving competitiveness for resilient growth

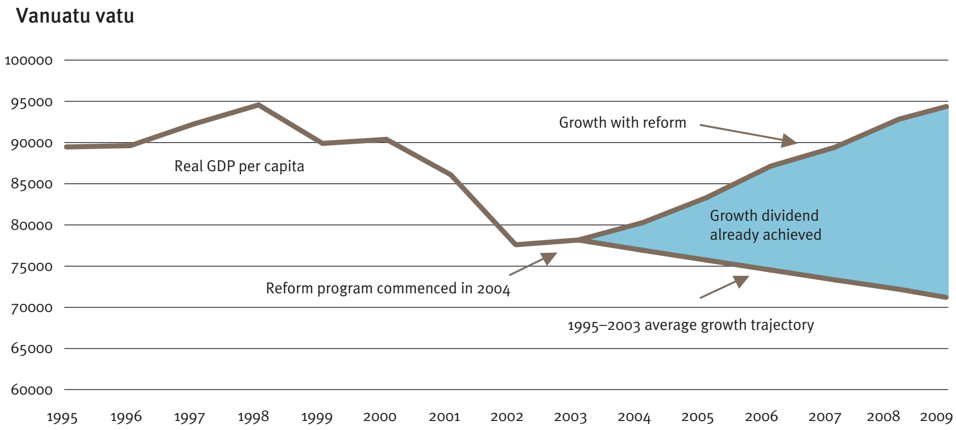
Even before the onset of the global recession, economic growth in the region had been mixed. Those FICs that have implemented and sustained key reforms were already shifting onto a significantly higher growth path. Other countries continue to experience volatile, flat or declining growth in per person terms.

Those countries which have undertaken reform and improved their competitiveness have achieved stronger economic growth in recent years.

Those countries which have undertaken reform and improved their competitiveness have achieved stronger economic growth in recent years. They have more economic capacity and resilience to respond to the recession.

With reform, Vanuatu has achieved average annual Gross Domestic Product (GDP) growth of over six per cent since 2004, more than twice its average growth over the previous decade. Vanuatu's GDP per person is now more than 20 per cent higher than it would have been had it maintained pre-reform growth rates.

Vanuatu GDP growth 1995–2009



Source: World Bank, World Development Indicators, 2009; ADB, Pacific Economic Monitor, May 2009; ADB, Asian Development Outlook, 2009.

By implementing those reforms already highlighted by the Forum Economic Ministers and in the *Pacific Plan*, countries can achieve levels of growth well in excess of those achieved over the last decade. 'This growth dividend' will make a dramatic difference to the achievement of the Millennium Development Goals (MDGs).

Priorities for reform action include:

> improving the accountability and operations of inefficient state-owned enterprises

> introducing competition and appropriate regulation to areas of monopoly service provision

> strengthening the role of private sector and non-government actors in delivering services in partnership with government

> reducing the costs of doing business and improving the legal and regulatory environment for private sector operations.

The evidence is overwhelming that the private sector will thrive where government provides the platform for private sector-led growth including political stability, an effective legal system, a predictable regulatory environment, reliable and appropriately costed infrastructure and an educated, healthy workforce.

The global recession is a challenging environment in which to implement reform programs, but it also increases the urgency for reform. Slowing or stopping the implementation of essential reforms will mean that countries will become less competitive internationally, and slower to benefit from a return to global growth.

The global recession is a challenging environment in which to implement reform programs, but it also increases the urgency for reform.

Development coordination

Support from development partners will be most effective if well-coordinated under integrated FIC national response frameworks. Such frameworks will support the effective and accountable use of all resources—from FIC governments and development partners—for recovery and faster progress towards the MDGs and other priority development outcomes.

Support from development partners will be most effective if well-coordinated under integrated FIC national response frameworks.

Development partner support may include technical assistance and financing for improved budgetary management and structural reform, assistance with the maintenance of core services and targeted programs to protect the most vulnerable. Development partners and

Core service delivery in education should remain a priority.

Secondary school students, Kiribati.
Photo: Lorrie Graham

FIC governments should continue with work to strengthen the capacity and efficiency of local systems of financial and budgetary management, accountability, monitoring and reporting. In individual FICs, expanding or adjusting existing support programs may be the best option for a rapid response. In those countries facing more substantive adjustment challenges, balance of payments support and temporary budget support may be an important part of well-coordinated assistance programs from development partners.

For FIC governments facing deeper adjustment challenges, it will be important that an effective, country-led dialogue with development partners commences as soon as possible on policy measures needed to support macroeconomic stability and faster broad-based growth. The longer the delays in commencing necessary reforms, the more difficult the adjustment is likely to be.

The four pillars of Forum Island Country policy response to the global recession

To support an effective response to the global recession and promote economic recovery, the policy response of Forum Island Countries could include:

> **First**, safeguarding macroeconomic stability, principally through fiscal adjustment.

> **Second**, strengthening budgetary management, protecting core services (particularly health, education and infrastructure) and targeted programs to assist the most vulnerable.

> **Third**, continuing support for reforms to improve competitiveness and create a stronger platform for resilient private sector-led growth and broad-based economic development.

> **Fourth**, using country-level policy responses as the framework for coordinated development assistance from development partners. Development partners are encouraged to prioritise and reposition their support in response to these country requirements.

The Cairns meeting of the Forum provides an opportunity for Leaders to identify clearly the principles and policies they propose to follow in responding to the global recession ...

An agenda for action

The Cairns Pacific Islands Forum meeting provides an opportunity for Leaders to identify the principles and policies they propose to follow in responding to the global recession, and to lay a firmer foundation for future broad-based growth as envisaged in the *Pacific Plan*. A clear statement by Leaders could provide guidance for domestic policy-making and the negotiation of coordinated external assistance.

Australia and New Zealand will work with other development partners to establish coordinated financing and technical assistance mechanisms targeting economic management, social vulnerability, core services and support for ongoing reform efforts.

Leaders could direct their Economic Ministers to present country policy responses to the global recession at the forthcoming FEMM and to engage with development partners on coordinated support. The 2010 Forum Leaders Meeting and Post Forum Dialogue could review actions taken and results achieved.

A well-coordinated FIC—development partner response to the impacts of the global recession in the Pacific would constitute a critical first step under a new development framework for the Pacific.

Origins and extent of the global recession

Context

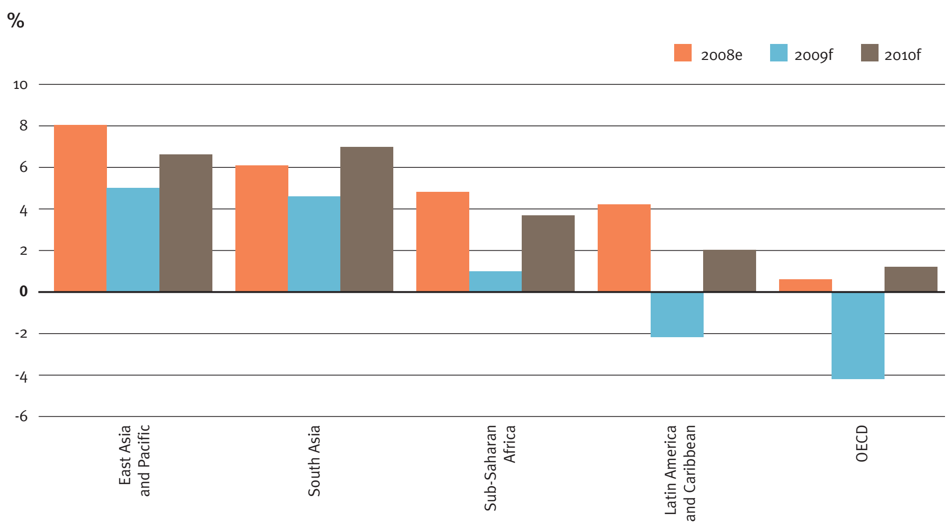
Forum Leaders are meeting at a time when the global economy is facing the worst economic slowdown in more than 75 years. What began as a financial crisis in the United States has turned into global recession. This has resulted in a sharp slowdown in trade and investment, falling commodity prices, declining demand for services and manufactured goods and increasing unemployment and poverty.

The impact of the global recession on regions and individual countries across the world has varied markedly. These differences are a result of individual countries' economic structure and the extent of their global integration. While some countries and regions are facing recession in 2009, other regions are facing slower, but still positive growth.

The impact of the global recession on regions and individual countries has varied markedly.

The World Bank expects the world economy to contract by 2.9 per cent in 2009, the first decline in world output in six decades. It also estimates that Organisation for Economic Cooperation and Development (OECD) countries are likely to see their economies contract by 4.2 per cent. Real GDP growth for the East Asia and Pacific region is expected to slow from eight per cent in 2008 to five per cent in 2009 (Chart 1).[2]

Chart 1: The global recession has had varied impacts on regions—GDP growth projections



Notes: e = estimate and f = forecast
Data for East Asia and Pacific includes China.

Source: World Bank, Prospects for the Global Economy 2009, Forecast Update, June 2009.

2 *Prospects for the Global Economy 2009*, Forecast Update, World Bank, June 2009.

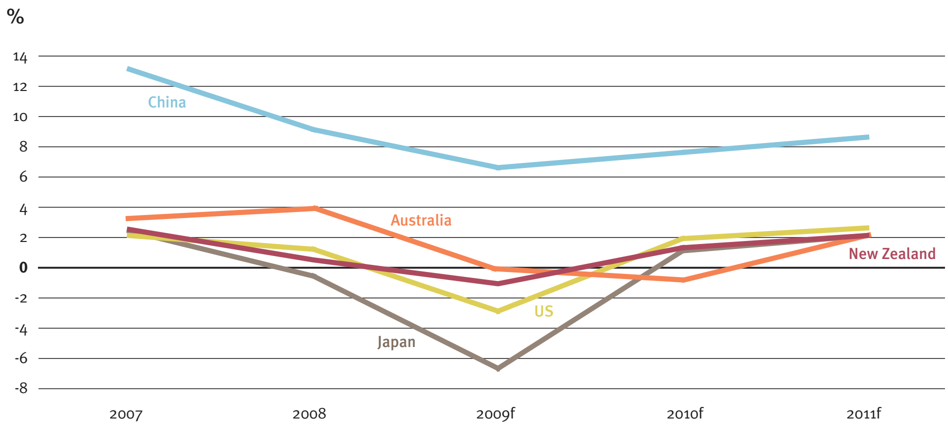
The global recession is having a substantial impact on the Australian and New Zealand economies. In Australia, real economic growth is forecast to be zero in 2008-09 and to fall by 0.5 per cent in 2009-10, reflecting falls in business investment and exports. In New Zealand, real economic growth is forecast to be –1.9 per cent in 2008-09 and –0.8 per cent in 2009-10. The global downturn comes at a particularly difficult time for New Zealand, as the economy had already gone into recession due to other factors. By the middle of 2010, the unemployment rate in Australia is expected to be 8.5 per cent and 7.9 per cent in New Zealand.

The global recession is having a substantial impact on the Australian and New Zealand economies.

Australia and New Zealand have taken decisive and swift action in response to the global recession, to maintain the stability of their financial systems, including through carefully selected spending to support economic activity and employment, and substantial investments in infrastructure to increase productivity. These measures were complemented by a rapid easing of monetary policy by both central banks. Like other FICs, both countries have had to make difficult decisions between competing priorities for public expenditure.

Australia, New Zealand, the United States, Japan, China and several other Asian countries are major markets for FIC exports and tourism services. Australia, New Zealand and the United States are also important sources of remittances. A return to growth in the main trading partners, including Australia and New Zealand will be important drivers for regional recovery (Chart 2).

Chart 2: GDP growth has been affected in FIC key trading partner countries



Notes: f = forecast

Source: World Bank, Prospects for the Global Economy 2009, Forecast Update, June 2009; Australian Budget 2009-10, numbers in June fiscal years.

International action to respond to the global recession

Coordinated action is being taken at the international level to support economic recovery and address the root causes of the global recession. At the London Summit on 2 April 2009, G20 Leaders committed to take all action necessary to restore growth and reduce the likelihood of future economic crises.

Coordinated action is being taken at the international level to support economic recovery and address the root causes of the global recession.

G20 leaders acknowledged that the global recession will impact disproportionately on the vulnerable in the poorest countries and that there is a collective responsibility to mitigate its impact. Leaders recognised that problems in accessing capital could further weaken economic activity in emerging markets and so agreed to commit US$1.1 trillion—mainly to the International Financial Institutions—to help restore credit, growth and jobs. There has also been agreement to a 200 per cent general capital increase for the Asian Development

Bank (ADB) to significantly expand its capacity to lend funds to developing member countries in the region.

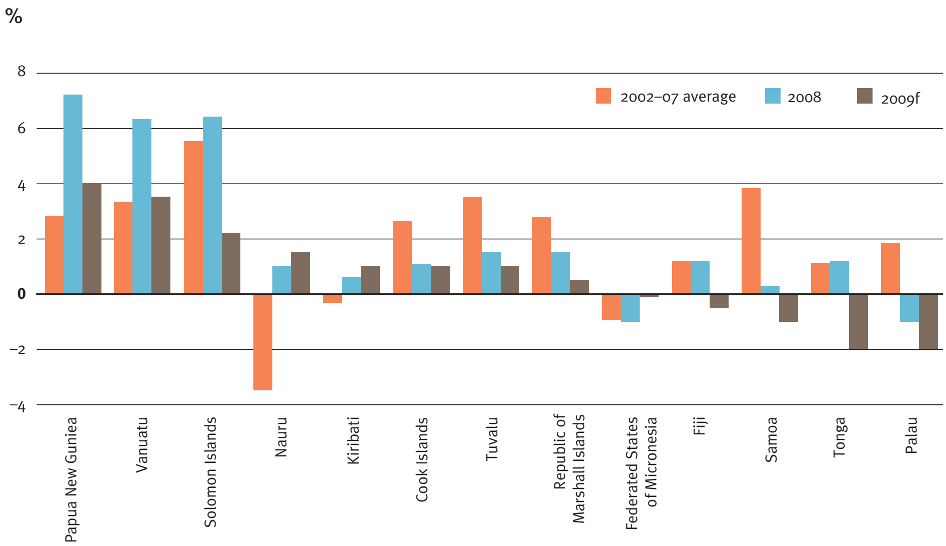
In the Pacific, Australia and New Zealand will work closely with other development partners—in particular the World Bank, the International Monetary Fund (IMF), the ADB, the European Union, Japan, United Nations (UN) agencies and other international organisations—to monitor and analyse the regional impacts of the global recession and develop appropriate responses in partnership with FICs.

Australia and New Zealand will work closely with other development partners to monitor and analyse the regional impacts of the global recession and develop appropriate responses in partnership with FICs.

Impacts on Forum Island Countries

The impact of the global recession on the Pacific has been significant, with all FICs experiencing downward revisions to their growth outlook. While a number of countries are projected to maintain positive but slowing economic growth in 2009, others are facing an economic contraction (Chart 3).

Chart 3: FICs are experiencing lower economic growth in 2009 (real GDP)



Notes: f = forecast
Data for Niue unavailable. The forecast for Tonga in 2009 is expected to be revised upward.

Source: World Bank, World Development Indicators, 2009; ADB, Pacific Economic Monitor, May 2009; and the Asian Development Outlook, ADB, 2009.

The extent and the nature of the impact on individual countries depends on the structure of their economies and the extent of their economic integration within the global economy.

Transmission mechanisms

As noted by Ministers at the 2008 FEMM, the main impacts of the global recession on FICs are being felt to varying degrees through:

> lower commodity prices and reduced demand for commodity exports
> downward pressure on tourism
> pressure on remittance flows with falling offshore demand for FIC labour
> a decline in the value of offshore national trust funds
> a deterioration in private sector access to finance.

FICs have been adversely affected by falling prices for commodity exports and benefited from lower international energy prices.

Some FICs are reliant on commodity exports and all are heavily dependent on commodity imports.

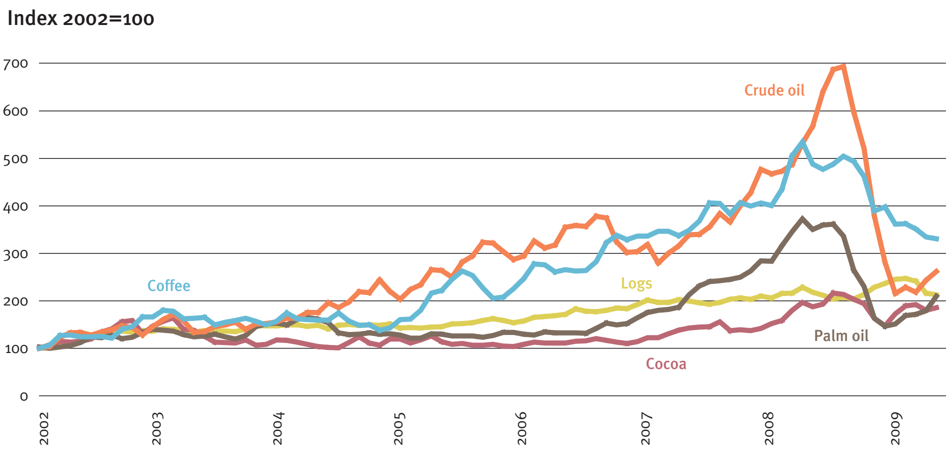
> FICs have been adversely affected by falling commodity prices for exports, particularly Papua New Guinea, Solomon Islands and Nauru.

> All FICs (apart from Papua New Guinea, which is a net oil exporter) have benefited from lower international energy prices.

> Some commodity prices have fallen sharply since the highs of 2008, but the prices for a range of important agricultural exports are showing considerable resilience (Chart 4). The price for many commodities has nearly doubled, and the price for coffee has more than tripled since 2002.

> Falling revenues from commodity exports will result in lower government revenues and lower levels of foreign reserves. The impact on foreign reserves will be offset to some extent by the lower costs of oil imports.

Chart 4: Global recession impacts on commodity prices have varied



Source: World Bank, Commodity Price Data.

Tourism numbers appear to be holding up in many but not all FICs.

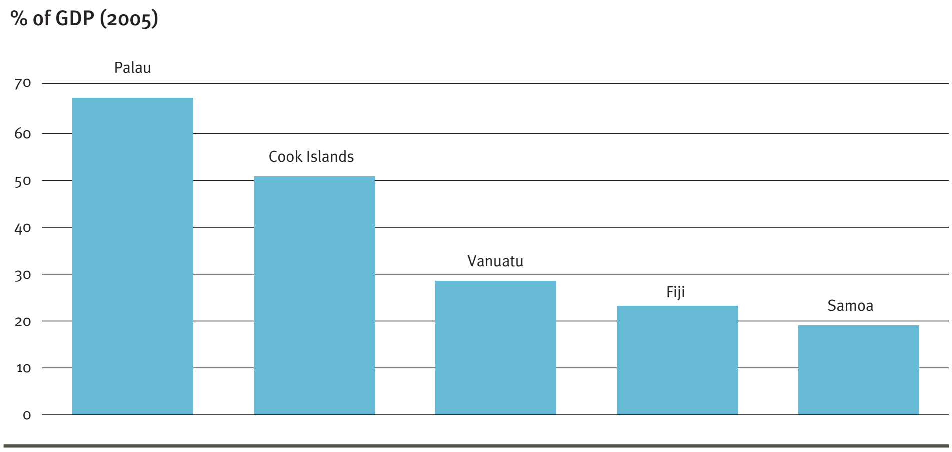
Tourism is a critical source of income and foreign exchange in a number of FICs (Chart 5). So far, tourism numbers appear to be holding up in many countries.

> Fiji in particular is experiencing lower tourism numbers and lower returns (due to the global recession and other factors).

> Tourism numbers appear to be remaining strong in the Cook Islands, Vanuatu and Samoa, which may be gaining from declining tourism in Fiji. Both Vanuatu and Samoa are benefiting from the recent aviation and communication reforms which have improved their international competitiveness.

> Tourism in the northern Pacific countries is more heavily affected with tourist numbers down from Japan, Taiwan and the United States.

Chart 5: Tourism: an important sector for some FICs



Source: Derived from World Bank statistics, World Bank WDI 2009.

Tourism is a critical source of income and foreign exchange in a number of FICs.

Above: Frangipanis, Kiribati. Photo: Jodi Gatfield, AusAID;

Left: Tourist Information Centre, Tonga. Photo: Cathy Reid, AusAID

Offshore demand for FIC workers has been adversely affected by the global recession.

Remittances are a very important source of income and foreign exchange for a number of FICs (Chart 6).

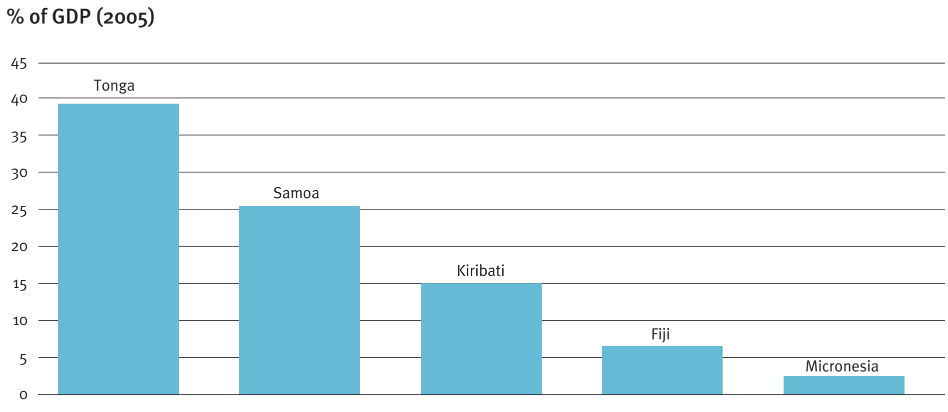
> The ADB reports that remittances to FICs have progressively declined in real terms in 2008[3].

> Offshore demand for FIC workers has been adversely affected by the global recession, as economic growth in destination economies (United States, Australia and New Zealand) has declined.

> Demand by shipping companies for seafarers from Kiribati and Tuvalu has also fallen.

> The impact on remittances and demand for FIC labour can be expected to decline further. Tonga and Samoa are particularly exposed to falling remittances.

Chart 6: Remittances are a major source of income for some FICs



Source: IMF Working Paper—Remittances in the Pacific Region, 2007

The values of national trust funds invested in overseas markets have dropped sharply.

FICs with **national trust funds** invested in overseas share markets have seen the values of the funds drop sharply. National trust funds are most important for the smallest FICs which use the income stream to supplement government revenues.

> During 2008, the Republic of Marshall Islands, Palau, Federated States of Micronesia, Kiribati and Tuvalu all experienced a fall in value of their trust funds of between 20 and 30 per cent.

> However, the value of these funds has grown considerably over the years and it is expected they will recover over time.

FICs raised concerns regarding the impact of the global recession on the cost and availability of finance for the private sector at the FEMM in 2008. The World Bank has noted that financing conditions faced by developing countries deteriorated sharply in 2008, directly as a result of the global recession[4].

3 *Taking the Helm: A policy brief on a response to the global economic crisis* Pacific Studies Series, Asian Development Bank 2009.

4 *Global Development Finance – Charting a Global Recovery*, World Bank, 2009.

Impact on government revenues and services

All FICs are facing falling government revenues as a result of the global recession. Many governments are now assessing options for cutting expenditure or finding additional financing for 2009 budgets, including from development partners.

If governments were to cut expenditure on core services such as health, education and basic infrastructure, families already facing falling incomes may be further affected through reduced access to these services. Reducing access to core services may have long-term impacts, such as:

> children taken out of school may never attain appropriate education standards

> falling education enrolment, retention rates and education standards would constrain future national development

> a reduction in health services such as immunisation will result in worsening health outcomes, such as increasing under five mortality rates

> any deterioration in infrastructure services is likely to further constrain economic growth and slow eventual recovery processes.

Reducing expenditure on core services will reduce access and may have long-term adverse impacts.

The global recession is highlighting existing structural weaknesses

The global recession has exposed a range of underlying structural weaknesses in many FICs which have exacerbated the impact of the recession and constrained countries' ability to respond. A number of countries were already stressed as a result of the 2008 international oil price shock with high inflation, falling foreign reserves and unsustainable budget deficits. As a result, their ability to respond to the global recession is constrained.

The global recession has exposed a range of underlying structural weaknesses in many FICs.

The Government of Solomon Islands, for instance, has identified that the reduction in forestry sector activity is having major effects on the rural economy, government revenue and foreign reserves. The long-anticipated decline in the forestry sector has been brought forward by the global recession. A return to global growth will not address this structural change. With no immediate alternative source of growth, the Solomon Islands Government is now developing its policy response to the decline in forestry, a structural change that goes well beyond the global recession.

Other countries are also recognising the need to bring forward domestic reform efforts. For example, Kiribati is seeking to progress reform of its state-owned enterprises (SOEs) because of the negative impact of SOE losses on budget management. Vanuatu has identified the reform of its ports sector as an important step in improving competitiveness and reducing the costs for the private sector. Tuvalu is strengthening its budgetary management. The Republic of Marshall Islands is taking forward fiscal reforms and the Federated States of Micronesia will continue public sector investment in education, finalise proposed tax reforms and improve foreign investment regulations.

Pacific growth, the MDGs and the global recession

> Leaders believe that the Pacific region can, should and will be a region of peace, harmony, security and economic prosperity, so that all of its people can lead free and worthwhile lives.
>
> *Auckland Declaration of Pacific Islands Forum leaders, 6 April 2004*

The global recession and service delivery

The global recession is affecting every FIC through slower economic growth, increased economic uncertainty and worsening vulnerability of households. Families most at risk are likely to live in urban areas where people have less recourse to traditional food gardens and social support mechanisms. At the family level, lower incomes can translate into less money for food, children being withdrawn from school and reduced access to health services with consequences for long-term human and development prospects. Women and children are particularly vulnerable when poverty is increasing.

Those families most at risk are likely to be in the urban areas where people have less recourse to traditional food gardens and social support mechanisms.

Lower levels of economic growth are likely to slow country progress against the MDGs and lead to an increasing incidence of poverty. The recent ADB report *Taking the Helm*[5] discusses the link between slower growth and poverty. Most Pacific countries, but especially those facing an economic contraction, such as Palau, Samoa, Tonga, Fiji and the Federated States of Micronesia, can expect significant worsening of poverty and other social outcomes.

Maintaining core services and providing targeted assistance to the most vulnerable will be a particular challenge for governments. Governments can work with their development partners to prioritise and protect basic services in education, health and infrastructure. Countries that protect and improve services and support the most vulnerable will achieve better progress against the MDGs.

Translating growth into progress against the MDGs

Progress against the MDGs in the Pacific has been mixed. Some countries have made considerable progress in areas such as universal primary education whilst others are off-track in meeting specific targets particularly for reducing poverty and child mortality and improving maternal health[6].

The experience in the Pacific also demonstrates that while economic growth is fundamental to achieving the MDGs, governments must ensure that the benefits of growth are widespread, environmentally sustainable and underpin improved service delivery. While inter-country comparisons carry risks because of differences in circumstances and

Those countries that protect and improve services and support the most vulnerable will achieve more progress against the MDGs.

5 *Taking the Helm: A Policy Brief on a Response to the Global Economic Crisis*; Pacific Studies Series, ADB 2009.

6 *Tracking Development and Governance in the Pacific*, AusAID, 2008 and 2009.

differences in data quality, some FICs are making stronger progress than others with similar income levels against the MDG targets.

While economic growth is fundamental to the achievement of the MDGs, governments must ensure that the benefits of growth are widespread, environmentally sustainable and that growth underpins improved service delivery.

Countries with higher economic growth per person have, on the whole, been able to achieve stronger development outcomes. But the translation of strong growth to broad-based development outcomes such as those measured by the MDGs is not automatic. Most progress is made where governments have taken appropriate policy actions to nurture broad-based economic growth and social development.

Trends in per person growth in the Pacific

Slow economic growth per person over recent times in the Pacific has constrained development progress in many countries. Over the period 1998–2008, many of the countries in the region had low or negative economic growth in per person terms (Table 1).[7] If economic progress in FICs had been consistently higher than population growth rates over the last decade, the outlook for the region would have been markedly different. Wealth would have been substantially higher and progress against the MDGs significantly stronger. While the global recession has made economic growth in 2009 more difficult, with a few exceptions, growth and development outcomes across the Pacific in the last decade have been disappointing.

Table 1: Slow GDP per person growth—constraining development

	GDP per person ($US) in 1998 (constant 2000 prices)	GDP per person ($US) in 2008 (constant 2000 prices)
Melanesia		
Fiji	2 000	2 215
Papua New Guinea	695	690
Solomon Islands	892	794
Vanuatu	1 349	1 324
Polynesia		
Samoa	1 237	1 703
Tonga	1 464	1 678
Cook Islands	7 088	8 935
Tuvalu	1 973	2 735
Micronesia		
Kiribati	533	482
Marshall Islands	2 081	2 276
FSM	1 970	1 824
Nauru	2 497	2 225
Palau	6 831	6 608

Note: Data for Niue is not available.

Source: Derived using data from the World Bank (World Development Indicators database 2009); ADB, Asian Development Outlook 2009; United Nations database on population – World Population prospects: The 2008 Revision.

7 *Pacific 2020: Challenges and Opportunities for Growth*: AusAID, May 2006.

Surviving the global recession: stabilisation, recovery and resilient growth

"… we now face a financial storm of unparalleled magnitude. It is therefore imperative that we examine and improve upon all existing opportunities, both internal and external, as envisioned under our strategic development plan, to enable us to respond to this crisis today and in the future.

… Our strategy is, and shall continue to be, broad-based and focused on measures that have an immediate impact on our economy and that lay a strong foundation for long-term sustainable economic growth and development."

President Mori's State of the Nation Address, Government of the Federated States of Micronesia, Palikir, May 14, 2009

Context

In 2009, FICs face the challenge of responding to the global recession, alongside the ongoing need to achieve sustained improvements in broad-based growth. For some FICs, a return to higher international energy and food prices will further add to economic management difficulties.

Appropriate policy responses to the global recession will depend on specific country circumstances and are likely to include a range of critical components. In broad terms, the challenge is to:

> adjust to lower export receipts and offshore income in a way that both safeguards macroeconomic stability and protects funding for core services particularly those programs supporting the poor and vulnerable

> renew commitments to continue implementing fiscal and other reforms designed to improve competitiveness, and provide a platform for stronger and more resilient economic growth into the future.

This section discusses the importance of the first three pillars of a response to the global recession. These are:

> **Pillar 1** safeguarding macroeconomic stability

> **Pillar 2** strengthening budgetary management, protecting core services and assisting the vulnerable

> **Pillar 3** undertaking reforms to improve competitiveness and private sector-led growth.

Pillar 1: Safeguarding macroeconomic stability

Macroeconomic stability underpins business confidence and the planning and investments needed for sustainable economic growth.

Macroeconomic stability is an essential pre-condition for ongoing growth and development. It underpins business confidence and the investment plans that are needed for sustainable economic growth. It allows households and businesses to save and plan for the future. Macroeconomic stability is also essential for governments to plan, finance and implement programs that deliver core services. Box 1 sets out some of the actions required for supporting macroeconomic stability.

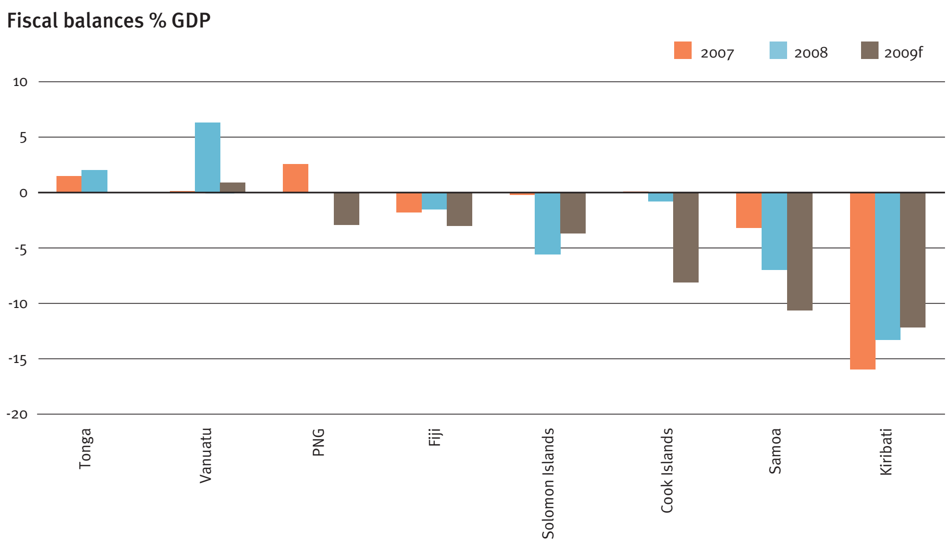
Box 1: Pillar 1 – Actions to safeguard macroeconomic stability

- A sustainable fiscal policy and public sector debt position.
- A sustainable balance of payments position and comfortable level of external reserves.
- A competitive exchange rate.
- Low inflation.
- Sustainable draw downs for PICs dependent on offshore trust accounts for budgetary revenues.

Many FICs are facing potentially destabilising budget deficits.

A sustainable fiscal policy setting is essential to ensure macroeconomic stability, especially for FIC economies that are open and highly dependent on imports. With the global recession reducing taxes and other revenue, many FIC governments are facing potentially destabilising budget deficits unless they take steps to manage expenditure in a manner consistent with a sustainable medium-term fiscal position (Chart 7).

Chart 7: Fiscal balance in selected FICs



Notes: f = forecast
Sources: ADB, Asian Development Outlook, 2009; ADB, Pacific Economic Monitor, May 2009; Samoa Bureau of Statistics and Ministry of Finance: 2007=2007-08, 2008=2008-09, 2009=2009-10; Kiribati 2009 IMF Article IV Consulation report.

In adjusting to the global recession, and for FICs with an independent currency, fiscal policy will need to be supported by sound monetary and exchange rate policy. These latter policy levers however, are constrained by weak links to growth—monetary policy in particular needs to consider potential impacts on the current account and international reserves. Fiscal policy will therefore be a key macroeconomic policy tool for the small open economies of the Pacific. Monetary policy should focus on maintaining control of inflation and, in concert with flexibility in exchange rate policy, protecting international reserves which may be coming under pressure from a loss of export markets and/or a fall in the terms of trade.

Maintaining a well-functioning financial system will be important to enable countries to emerge healthily from the global recession. Although they were not heavily exposed to the global recession, banks could be placed under stress if borrowers become unable to service their debts as Pacific economies slow and remittances decline. Banking supervision should be stepped up so that any build up of bad loans is quickly identified and acted upon.

Pillar 2: Strengthening budgetary management, protecting core services and assisting the vulnerable

Given the importance of maintaining fiscal discipline in an environment of declining revenues, many FIC governments may wish to consider ways to protect and prioritise expenditure for their core development priorities. Through better public expenditure management, including expenditure reprioritisation, most FICs can generate the 'fiscal space' needed for fiscal stability (Box 2).

Prioritising expenditure to support core services including on basic health, education and infrastructure and other services is crucial for protecting the vulnerable, meeting development objectives and supporting recovery and for long-term growth. Budget prioritisation can help identify areas of lower priority with savings redirected to higher priority areas.

Prioritising expenditure to support core services including on basic health, education and infrastructure and other services is crucial for protecting the vulnerable, meeting development objectives and supporting recovery and for long-term growth.

Box 2: Pillar 2 – Actions to strengthen budgetary management, protect core services and assist the vulnerable

> Reprioritise budgeted expenditure and reduce expenditure on lower priority items, to reduce or redirect expenditure in line with a sustainable fiscal position.
> Protect and strengthen core service delivery, particularly in health, education, and basic economic services.
> Strengthen the effectiveness of revenue collection.
> Strengthen the efficiency and effectiveness of public expenditure.
> Improve financial management and accountability within the budget process.

Many FICs are taking action to improve their public expenditure management:

> Solomon Islands and Nauru have recently taken steps to improve revenue collection, including from fishing licenses, with substantial outcomes.
> Tonga and other countries are improving their procurement and contracting processes to achieve better value-for-money outcomes.
> Many FICs are taking a range of steps to improve financial management and accountability within the budget process to reduce leakage and waste, and better link funding and service outcomes.
> Better audit services, for instance, can be valuable in improving the effectiveness, transparency and accountability of national financial management systems and improve fiscal capacity. The Pacific Regional Audit Initiative (PRAI), endorsed by Forum Leaders in 2008, is an example of a program supporting better financial management in the region.

Investing in infrastructure should remain a key priority.

Power and utility worker, Nauru.
Photo: Lorrie Graham

For the FICs hard hit by the global recession, and those that were already experiencing underlying fiscal pressures, improved public expenditure management may be insufficient in the short-term to provide the space for the required fiscal adjustment. In these cases, development partners can support credible fiscal management programs by increasing financing for services and resources to fill financing gaps, particularly where country efforts are at the same time, strengthening the quality and efficiency of service delivery.

Possible role of fiscal stimulus packages in FICs

Fiscal stimulus packages targeted at improving road maintenance and the rehabilitation of schools and health centres can support better services and at the same time, increase local employment.

A number of FICs are considering whether a fiscal stimulus might be an appropriate part of their policy response to the global recession. As part of its global fiscal stimulus strategy, the IMF has recognised that for many countries facing financing constraints, an expansionary fiscal policy would not be sustainable or appropriate. Even for FICs with a comparatively strong underlying macroeconomic position, the long-term affordability of significant fiscal stimulus package would need careful assessment.

Their open economies and high dependence of many FICs on imported good and services means that fiscal stimulus measures—such as untargeted interventions including cash transfers, salary increases and tax cuts—could lead to increased imports and a worsening of their current account deficit, while having a limited impact on local job creation.

The principles of sound economic management suggest that any fiscal stimulus package should be treated with caution, be carefully targeted, appropriately financed and focused on the core development priorities. Macroeconomic trends should be monitored closely. FICs may also be aware of the risks involved in over-reaching particularly given that the global recession may be prolonged, and increases in international energy prices could place further stresses on non-oil exporting countries.

With these issues in mind, any stimulus package might be targeted and designed to support core service delivery and/or temporary programs to protect the vulnerable. Such packages can be scaled up progressively. Efficient and effective expenditure on road maintenance and the rehabilitation of schools and health centres are examples of how governments can support better services in a way that will also increase local economic activity and employment.

Pillar 3: Improving competitiveness for broad-based growth and resilience

While maintaining macroeconomic stability is a necessary condition for economic development, it is not sufficient to guarantee sustained and broad-based growth and development. While some countries have better growth prospects than others, experience has shown that many current constraints to growth can be overcome, given effective economic management and sound policies.

Reforms to improve country competitiveness and services are needed to underpin stronger growth, and these reforms need to be persevered with and go beyond stabilisation to address deeper structural and institutional weaknesses.

The economic growth rates of FICs are highly variable. FICs have shown distinctly different growth trajectories over the last five years. Some are continuing with low average growth rates (two per cent or lower) and some with medium growth (two–four per cent). Only a few countries are achieving the higher growth rates (above four per cent) needed to support substantive improvements in income per person.

The *Pacific 2020 Report*[8] emphasised that reforms to improve country competitiveness and services are needed to underpin stronger growth, and that these reforms need to be persevered with and go beyond stabilisation to address deeper structural and institutional weaknesses. A two-pronged approach to reform has previously been suggested:

8 ibid

(i) structural policy reforms and sensible public investment where a relatively quick growth impact can be expected (for example in infrastructure) combined with

(ii)greater attention to the more difficult, long-term growth constraints (such as governance and land tenure).

Additional attention must also be paid to recognising and helping strengthen the important role women must have in more inclusive efforts to promote resilient and sustainable economic growth.

Reforms can address regulatory and infrastructure bottlenecks in the economy as well as investments in human capital through improved health and education services. The countries that have performed best have implemented both. Slowing or stopping reform because of the global recession will mean that countries will be less competitive and slower to benefit from the return to global growth.

Reform has improved services, reduced costs and added to economic growth and resilience in a number of countries. Box 3 sets out the key components of reform programs which have been set out in a range of Forum documents including the FEMM and in the *Pacific Plan*.

Reform has improved services, reduced costs and added to economic growth and resilience in a number of countries.

Box 3: Pillar 3 – Actions to improve competitiveness, growth and resilience

> Reform the operation of inefficient and loss making state-owned enterprises and improving their accountability within budget processes.

> Introduce competition and appropriate regulation in sectors where monopoly service provision is not delivering service outcomes required.

> Reduce government involvement in economic activities and delivery of services better able to be delivered by the private sector.

> Strengthen the role of non-government actors (private sector, churches and community groups) to deliver services effectively in partnership with government.

> Address red tape and reduce the cost of doing business for the private sector.

> Improve the legal and regulatory environment in which the private sector operates.

Reforms in telecommunications in Vanuatu has led to improved services for consumers.

Women at Port Vila Markets, Vanuatu.
Photo: Rob Maccoll

Box 4 (p. 22) sets out the experience of Vanuatu, which now appears to have shifted to a higher growth path through a successful and ongoing reform program. In addition, reforms in telecommunications in Palau, Tonga, Samoa, Fiji Vanuatu and Papua New Guinea, have resulted in improved services, greater coverage and reduced costs for consumers. Countries that have undertaken more substantive reform have benefited most.

But reform has been patchy. Many countries continue to have:

> poorly functioning and loss-making publicly-owned utilities providing expensive and unreliable monopoly services

> government services with limited coverage, or of a quality that makes it difficult to achieve governments' desired service outcomes

> private sectors constrained by red tape, and high costs or weak and inappropriate regulatory and legal frameworks.

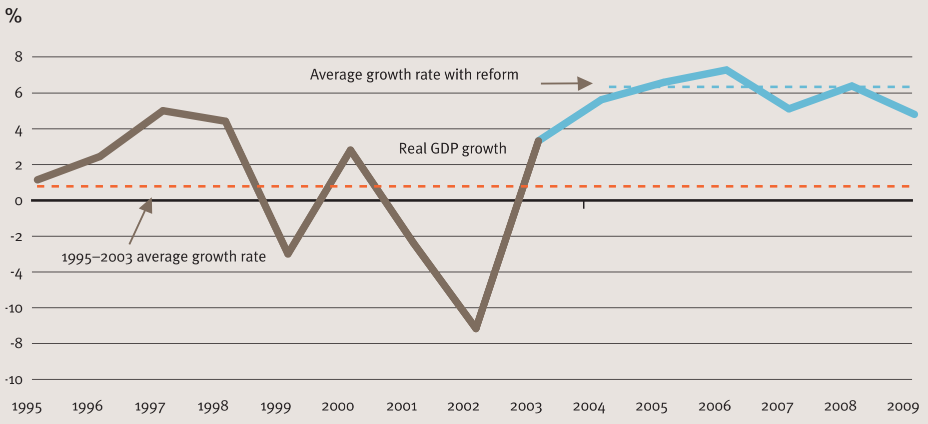
The World Bank 'Costs of Doing Business' indicators show that most FICs can still make further progress in addressing the constraints that can prevent the development of a resilient private sector with the capacity to create wealth and jobs.

Box 4: Vanuatu's reform experience

For more than a decade up to 2003, Vanuatu experienced low and volatile economic growth. As a result of the progressive introduction of reforms, Vanuatu's growth has risen and stabilised. Measures have included reforming aviation services, introducing competition in telecommunications, improving economic governance and continuing with land reform.

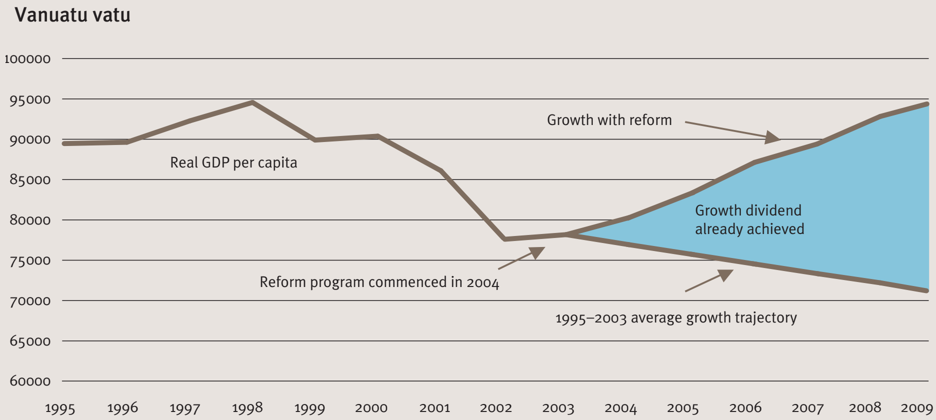
Vanuatu has gained a significant 'growth dividend' from its reform program. On average, it has shifted its growth from a low growth path of less than two per cent between 1990–2003 to a high growth path averaging just under six per cent a year since 2004 (Chart A below). Telecommunications reform and subsequent telecom sector growth is estimated to have contributed around a one percentage point increase to GDP in 2007 alone.[8]

Chart A



The Chart B also shows the changes in per person GDP under the Vanuatu reform program. Without reform, based on earlier growth rates, annual GDP per person would have continued to fall, to around 75,000Vt compared with the current level of over 90,000 Vt—i.e. a 20 per cent increase in just six years.

Chart B



Source: World Bank, World Development Indicators, 2009; ADB, Pacific Economic Monitor, May 2009; ADB, Asian Development Outlook, 2009.

8 *Governance for growth program*, 2008 Annual Report (Jan-Dec), Republic of Vanuatu, January 2009.

An important area for growth for many countries is remittances. But increased remittances will come from migrants who are well educated and healthy and able to take advantage of higher paying skilled employment opportunities. Reform of education and training services in the Pacific will therefore have substantial benefits to local development outcomes and to remittances (Box 5). Remittances are already an important source of income in a number of countries and have the potential to become a major source of wealth for many countries and a very important one for smaller FICs.

Improving education and training will lead to substantial benefits in the Pacific.

Box 5: Strengthening education and training: trade in services

Kiribati and Tuvalu have invested in international standard **technical training** in maritime services. Both countries gain from the remittances of merchant seamen being employed by international shipping fleets. Kiribati and Tuvalu are now looking to improve basic education standards and technical training across a range of sectors so that their people can achieve internationally recognised levels of skills and benefit further from skilled migration.

While the challenge of implementing reforms is significant, the benefits for economic growth and development can be substantial. When reforms are implemented, including those highlighted by the FEMM and in the *Pacific Plan*, countries can expect to achieve levels of growth well in excess of those of the last decade, and to be able to use such growth to make a substantal difference in progress towards the MDGs. Table 2 shows that countries can turn around their current limited progress and achieve substantial improvements in GDP per person with a sustained real growth of around five per cent per annum in a little over a decade.

FICs can achieve substantial improvements in GDP per person with sustained growth of around five per cent per annum.

Table 2: Projected GDP per person in selected FICs in 2020 (constant 2000 prices)

	GDP per person ($US) in 2007	GDP per person ($US) in 2020 assuming recent growth continues	GDP per person ($US) in 2020 assuming high growth is achieved	Projected average population growth 2008–2020
Melanesia				
Fiji	2 202	2 498	3 931	0.4
Papua New Guinea	656	580	991	1.7
Solomon Islands	764	668	1 111	2.0
Vanuatu	1 275	1 318	1 831	2.1
Polynesia				
Samoa	1 713	2 575	2 965	0.7
Tonga	1 666	1 896	2 921	0.6
Cook Islands	8 641	14 665	18 643	–1.0
Tuvalu	2 711	3 348	4 727	0.6
Micronesia				
Kiribati	487	584	759	1.5
Marshall Is, Rep	2 282	2 218	3 454	1.7
FSM	1 851	1 551	3 213	0.6
Nauru	2 209	1 933	3 913	0.5
Palau	6 702	7 027	11 561	0.7

Notes: Recent growth refers to the annual average GDP growth rate over the period 1997–2007; except for Tuvalu, which refers to the period 2004–2007. High growth is assumed to be 5 per cent. Data for Niue is not available. The national population growth rate is a function of both the fertility rate and net migration.

Source: Derived using data from the World Bank (World Development Indicators database 2009); ADB, Asian Development Outlook 2009; United Nations database on population – World Population prospects: The 2008 Revision.

Strengthening development coordination and effectiveness

> "Our efforts towards improving aid effectiveness, consistent with the Paris Declaration and Pacific Aid Effectiveness Principles, remain critical if partnerships for development are to increase in relevance and impact."
>
> "Such an approach will allow for national priorities to receive additional resources and also have an accelerated impact for achieving the desired national outcomes. This will help improve ownership of policy implementation by all national stakeholders."
>
> *Secretary General of the Forum Secretariat, Tuiloma Neroni Slade, Pacific Islands Forum Secretariat, Press Statement, May 25, 2009*

Before the global recession, FICs were already facing challenges in achieving their development priorities and meeting the MDGs. The onset of the global recession has further underlined the importance of improving the overall effectiveness of the use of all resources for development.

The global recession further underlines the importance of improving the effective use of all resources for development, strong country leadership and effective country systems.

The *Paris Declaration on Aid Effectiveness* (2005), the *Pacific Aid Effectiveness Principles* (2007) and the *Accra Agenda for Action* (2008) set out key principles and steps for improving development cooperation. In particular, these underline the importance of strong country leadership and effective country systems.

Development partners, including Australia and New Zealand, are already supporting FIC efforts to respond to the global recession and they are ready to do more. They are committed to working with FICs and prioritising and repositioning their support to help meet country requirements.

Each country's global recession response framework, drawing on the actions identified in this report, will provide direction to development partners on national policy directions and requirements for support. Subject to country needs, as set out in the country policy response to the global recession, there are a number of areas where development partner assistance may be appropriate:

- **Strengthened fiscal policy and budgetary management.** This is likely to have a critical role in any response to the global recession. In some instances this may require additional short-term technical assistance, such as that currently provided through the Pacific Financial Technical Assistance Centre (PFTAC)
- **Protecting core services.** Governments that have prioritised their budgets but are still unable to find the resources needed to protect key education, health or other vitally important services could initiate coordinated discussions with development partners already working in these sectors
  - Development partners are likely to be more receptive to requests when governments have already prioritised their own expenditure plans in support of these services and

have established clear service improvement outcomes linked to possible areas of support.

> **Vulnerable groups.** In cases of particular hardship, governments may wish to explore with development partners supporting carefully targeted programs for vulnerable groups.
  – Governments could also strengthen their own support to such high-risk groups, including through strengthening front-line services in health and education and maximising the use of existing traditional, civil society or faith-based support systems.

> **Support for reform.** Many countries are already receiving some support for ongoing reform programs, but more support may be required because of the difficult environment.
  – Better coordinated support from development partners for such country efforts will improve aid effectiveness, particularly when provided as a part of an agreed national response frameworks.
  – Countries can also learn from each other's experiences—Forum processes and development partners can facilitate such exchanges.

Each country's global recession response framework will provide direction to development partners on requirements for support.

Development partners and governments should continue to strengthen the capacity and efficiency of local systems. This could include support to strengthen local financial management and accountability mechanisms, budget processes and audit arrangements, as well as the local monitoring and reporting so that there is a better evidence base for future policy making.

Countries facing deeper adjustment challenges may require a more substantial program of support, possibly including balance of payments and budgetary support alongside support to sector programs and the vulnerable. For these countries it is important that governments and development partners begin a dialogue on policy measures needed to support macroeconomic stability and adjustment. The longer the delay in commencing the necessary reforms, the more difficult the adjustment will likely become.

At the country level, development partners are already adjusting assistance programs to better meet current requirements—however more can be done.

> Because designing and agreeing on new programs is often a lengthy process, fast responses are best achieved by adjusting a current program. An example might be to bring forward a school or health clinic refurbishment program within an existing multi-year program, as this is likely to provide increased opportunities for local employment.

> Another example could be to re-allocate resources from the building of a new facility that is still some way from implementation to more immediate maintenance of existing structures or other recurrent costs.

At the country level, development partners are adjusting existing assistance programs but more can be done.

Box 6: Pillar 4 – Actions to strengthen development coordination and effectiveness

> Ensure responses follow established aid effectiveness principles and practice, as set out in the Paris Declaration, the Pacific Aid Effectiveness Principles and the Accra Agenda for Action.

> Use individual country policy frameworks to engage with development partners (donors and development finance institutions) so development assistance is better coordinated and supports country-led responses to the global recession.

> Development partners to prioritise and reposition their support in response to country requirements.

Role of the Forum in responding to the global recession

FICs have already established an economic reform agenda including through the work of the FEMM and more broadly, as set out in the *Pacific Plan*. The *Pacific Plan's* themes of economic growth, sustainable development, and good governance are directly relevant in responding to the global recession.

The Pacific Island Forum (PIF) can play a valuable regional role in supporting country responses to the global recession and reform in the region, including by supporting analysis and collaborative approaches to common constraints, as well as sharing of experiences and lessons learned.

Leaders could direct their economic ministers to present their respective country policy responses to the global recession ahead of the 2009 FEMM and task them to engage with development partners on coordinated support. The 2010 Forum Leaders' Meeting could then review actions taken and results achieved. This work could also be supported at officials' level such as through FIC Partners and Pacific Plan Action Committee meetings.

A well-coordinated FIC—development partner response to the impacts of the global recession would constitute a practical example of regional action under a new development framework for the Pacific.

Annex 1

Components of a response to the global recession

Pillar 1: Safeguarding macroeconomic stability

> A sustainable fiscal policy and public sector debt position.

> A sustainable balance of payments position and comfortable level of external reserves.

> A competitive exchange rate.

> Low inflation.

> Sustainable draw-downs for Forum Island Countries dependent on offshore trust accounts for budgetary revenues.

Pillar 2: Strengthening budgetary management, protecting core services, and assisting the vulnerable

> Reprioritise budgeted expenditure and reduce expenditure on lower priority items; to reduce or redirect expenditure in line with a sustainable fiscal position.

> Protect and strengthen core service delivery, particularly in health, education, and basic economic services.

> Strengthen the effectiveness of revenue collection.

> Strengthen the efficiency and effectiveness of public expenditure.

> Improve financial management and accountability in the budget process.

Pillar 3: Improving competitiveness and broad-based growth and resilience

> Reform the operation of inefficient and loss-making state-owned enterprises and improve their accountability within budget processes.

> Introduce competition and appropriate regulation in sectors where monopoly service provision is not delivering service outcomes required.

> Reduce government involvement in economic activities and delivery of services better able to be delivered by the private sector.

> Strengthen the role of non-government actors (private sector, churches and community groups) to deliver services effectively in partnership with government.

> Address red tape and reduce the costs of doing business for the private sector.

> Improve the legal and regulatory environment.

Pillar 4: Strengthening development coordination and effectiveness

> Ensure responses follow established aid effectiveness principles and practice, as set out in the Paris Declaration, the Pacific Aid Effectiveness Principles and the Accra Agenda for Action.

> Use individual country policy frameworks to engage with development partners (donors and development finance institutions) so development assistance is better coordinated and supports country-led responses to the global recession.

> Development partners to prioritise and reposition their support in response to country requirements.