



# Asia & Pacific SMALL STATES MONITOR

October 2014

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## In this issue of the *Asia & Pacific Small States Monitor*...

... we highlight the latest economic developments and prospects for small states of the Asia and Pacific region and give an update on the IMF's engagement with these states. At the UN Conference on Small Island Developing States in Samoa last month, the IMF hosted a discussion on building macro-fiscal resilience to cope with natural disasters, one of the main challenges faced by many small states. The IMF also co-hosted a working breakfast with the Prime Minister of Samoa, the Honorable Tuilaepa Sailele Malielegaoi, for small island states' delegation heads. In an op-ed featured in this issue, IMF Deputy Managing Director Min Zhu reaffirms the IMF's commitment to continued engagement with small states to foster higher and more inclusive growth.

In light of the IMF's ongoing efforts to better understand the challenges faced by small states, we feature the latest research of IMF staff on spillovers from global commodity prices to inflation and trade integration in the Pacific island countries. We also include a country note from the most recent Article IV staff report on Tuvalu and an interview with Professor Lino Briguglio, Director of the Islands and Small States Institute at the University of Malta.

Patrizia Tumbarello, Chief of the Pacific Islands Unit, Asia and Pacific Department

***"Growth is critical for overall resilience and it should also be inclusive to be sustainable. The IMF stands ready to work with small states and all partners to help them overcome their development challenges and build a prosperous future."***

IMF Deputy Managing Director Min Zhu

Source: Press release <https://www.imf.org/external/np/sec/pr/2014/pr14412.htm>,

UN Conference on Small Island Developing States, September 3, 2014, Samoa

Apia, Samoa (Source: VisitCapitalCity)



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Prepared by: Shari Boyce (Project Coordinator), Sergei Dodzin, Ezequiel Cabezon, Fazurin Jamaludin, and Yiqun Wu (all Pacific Islands Unit), and Rosanne Heller (Editorial Officer)

The analysis and policy considerations expressed in this publication are those of the IMF staff and do not represent official IMF policy or the views of IMF Executive Directors or their national authorities.

Please send questions and comments to  
[APDsmallstates@imf.org](mailto:APDsmallstates@imf.org) and  
[ptumbarello@imf.org](mailto:ptumbarello@imf.org).

## Economic Developments

- Growth in the first half of 2014 was higher than previously expected in the APD small states. On September 17, Fiji held its first democratic election since 2007. Its return to democratically elected government has helped increase confidence in the economy ([Figure 1](#)). GDP growth in Fiji is now projected at 3.8 percent in 2014, well above average growth over the past decade—and above the average of other small Pacific islands and small states in the region. In other APD small states (Timor-Leste and Tonga), high-frequency data also indicate a pickup in domestic demand in the first half of 2014. Although Solomon Islands suffered a severe flood last April, as well as a disruption of gold production, the economy is showing signs of a slow recovery. The IMF Extended Credit Facility program with Solomon Islands is on track, owing to the authorities' strong commitment in implementing the structural reform agenda. Most notable are public financial management (PFM) reforms, including the recent publication of the PFM road map and midyear budget outlook.
- In most tourism-oriented economies in the region, tourist arrivals grew strongly—owing either to such domestic developments as the resumption of direct flights to Palau from emerging Asia, or such external variables as robust growth in Australia and New Zealand. In Samoa, infrastructure investment associated with preparations for the September 2014 UN conference on Small Island Developing States (SIDS) supported domestic activity.
- Inflation has eased in most Pacific island countries (PICs) in recent months, in line with weak international food commodity prices ([see Special Topic](#)). And external buffers are at comfortable levels in most APD small states, also reflecting the narrowing of current account deficits. Fiscal revenue has been buoyant as a result of higher economic growth relative to last year.

## Outlook

- In 2014, growth in APD small states is expected to pick up to 2.4 percent from 1.3 percent in 2013 and to 2.7 percent in 2015.
- But near-term risks are on the downside. The global recovery remains fragile and country-specific developments (e.g., upcoming legislative elections in Tonga and Solomon Islands) introduce more uncertainty to the outlook. Investment in PICs' domestic infrastructure—together with steady growth in emerging Asia, Australia, and New Zealand—will underpin the short and medium-term performance of APD small states. To lift potential growth, APD small states urgently need structural reforms to bridge infrastructure gaps and boost competitiveness.

### APD Small States: Real GDP

(Year-on-year change; in percent)

	2010-12	2013	2014	2015
		Est.	Proj.	Proj.
Bhutan	8.6	5.0	6.4	7.6
Fiji	2.5	4.6	3.8	2.5
Kiribati	1.7	2.9	3.0	2.7
Maldives	4.8	3.7	4.5	4.3
Marshall Islands	3.2	0.8	3.2	1.7
Micronesia	1.7	0.6	0.6	0.6
Palau	4.7	-0.2	1.8	2.2
Samoa	1.6	-1.1	2.0	2.2
Solomon Islands	7.5	3.0	0.1	3.5
Timor-Leste <sup>1</sup>	10.6	5.4	6.6	6.8
Tonga	1.8	0.8	2.4	3.0
Tuvalu	2.0	1.3	2.2	2.5
Vanuatu	1.5	2.3	3.5	4.0
APD small states <sup>2</sup>	2.0	1.3	2.4	2.7
Small Pacific island countries <sup>2,3</sup>	1.9	1.1	2.3	2.5
Small states (excl. APD) <sup>2</sup>	1.1	2.5	2.2	2.8

1/ Non-oil GDP.

2/ Median.

3/ Includes Fiji, Kiribati, the Marshall Islands, Micronesia, Palau, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.

Sources: IMF, World Economic Outlook database; IMF staff reports; and IMF, staff estimates and projections. Data for Bhutan, the Marshall Islands, Micronesia, Palau, and Samoa are reported on a fiscal year basis.



# Upcoming and Recent Events on Small States

## Upcoming Events

### 2014 Small States Forum

October 11, 2014, World Bank Group Headquarters  
<http://www.worldbank.org/en/events/2014/10/08/small-states-forum-2014>

### 2014 High-Level Caribbean Forum

October 23-24, 2014 in Montego Bay, Jamaica

### Semiannual Development Partners' Forum, Government of Tonga

October 29-31, 2014, in Nuku'alofa, Tonga

### South-Pacific Governors' Meeting

December 4-6, 2014 in Nadi, Fiji

## Recent Events

### UN Conference on Small Island Developing States

September 1-4, 2014 in Apia, Samoa  
<http://www.sids2014.org/>

### Second Finance Ministers & Governors of Central Banks Meeting, Melanesian Spearhead Group

August 27, 2014 in Noumea, New Caledonia

### Training for Pacific Island Journalists

August 24-26, in Nadi, Fiji, organized by the IMF Communications Department

## Photos from the Recent UN Conference on Small Island Developing States in Samoa



Hon. Tuilaepa Sailele Malielegaoi, Prime Minister and Minister of Finance of Samoa and Min Zhu, IMF Deputy Managing Director (DMD)



Dezhi Ma, Tarhan Feyzioglu, Lamin Leigh, Patrizia Tumbarello, DMD Min Zhu, Nritya Subramaniam, Daniel Kanda, Xavier Maret, and Yongzheng Yang



Rachel Kyte, World Bank Group Vice President, DMD Min Zhu, and Stephen Groff, Asian Development Bank Vice President



DMD Min Zhu and Prime Minister of Samoa



DMD Min Zhu, Hon. Winston Dookeran, Minister of Foreign Affairs of Trinidad and Tobago, and Gilbert Hounbo, International Labour Organization Deputy Director-General



Hon. Henry Puna, Prime Minister of the Cook Islands and Patrizia Tumbarello



IMF press conference in Samoa



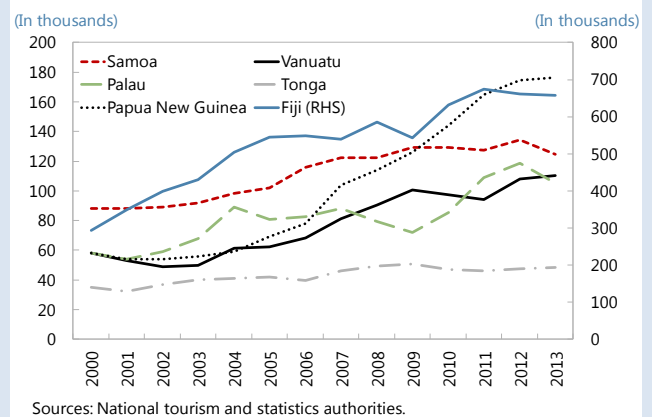
**International trade is widely seen as essential for creating economic prosperity globally, and in Pacific island countries (PICs).** But domestic markets in PICs are too small to allow them to exploit economies of scale, a disadvantage that is exacerbated by PICs' geographic remoteness from major global economic centers. Small size and remoteness mean high costs of production and trading of PIC exports and, hence, lower price competitiveness. Trade integration would allow producers in PICs to enlarge their markets and reduce production and trading costs. Historically, a number of relatively small developing economies—such as Hong Kong SAR, Mauritius, and Singapore—developed manufacturing industry that spearheaded their industrialization and enabled them to become relatively wealthy.

**Key questions facing PIC policymakers are what industries can facilitate their trade integration with the rest of the world and how to advance this process.** Some PICs—specifically Fiji and Samoa—have tried to use manufacturing as a platform for trade integration, but the initial expansion enabled by preferential trade arrangements could not be sustained as preference margins eroded over time. PICs have generally been struggling to find a viable trade strategy to support growth, which slowed significantly over the past decade. While smallness and remoteness will continue to hamper PICs' trade growth, these countries need to continue searching for a more effective trade strategy that is sensitive to the evolving external environment.

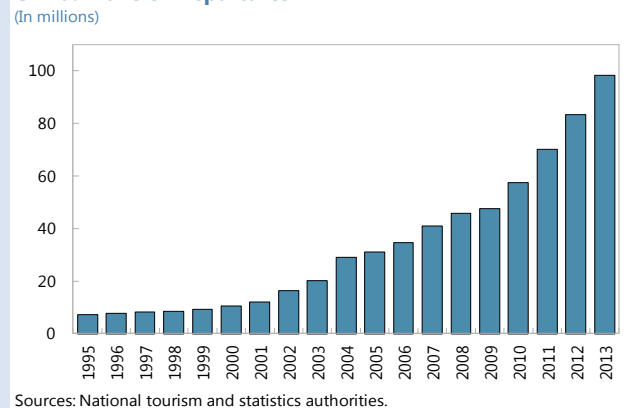
**Recent IMF analysis suggests that the emergence of Asia as a global economic center presents a number of PICs with an unprecedented opportunity to develop tourism as a locomotive for trade integration and inclusive economic growth, since tourism is a labor-intensive industry.** In order to further develop the tourism sector, alleviating pressing infrastructure bottlenecks is key. This requires improving the composition of public spending as well as ensuring a high rate of return on public investment. The analysis also notes that PICs' traditional markets will remain important for a long time to come and should be further developed for deeper integration beyond trade in goods and nonfactor services. For example, the seasonal employment scheme, opened to PICs and Timor-Leste, first introduced by New Zealand in 2006 and followed more recently by Australia, is a successful case of enhanced integration with neighboring countries that has generated income opportunities and enhanced skills of Pacific island workers in countries with a shortage of labor.

**Moreover, if the PICs can strongly link tourism with agriculture, they stand a better chance of improving broad-based growth.** By supplying the domestic tourism industry, agricultural producers would avoid the disadvantages arising from distance and certain import restrictions. In fact, if domestic producers are located close to tourism centers, they would also be able to save a sizable portion of domestic transportation costs. Despite weak performance over the past decade, agriculture is still, by far, the largest sector for most PIC economies, and it provides employment and income for more households than any other sector. Thus, linking agriculture to tourism can help revive agriculture and broaden the base for economic growth.

**Pacific Island Countries: Annual Visitor Arrivals**



**China: Traveler Departures**



1/ Prepared by Yiqun Wu, based on the recent Working Paper, "Pacific Island Countries: In Search of a Trade Strategy", by Hong Chen, Lanieta Rauqueqe, Shiu Raj Singh, Yiqun Wu, and Yongzheng Yang, IMF Working Paper 14/158.

**Pacific island countries (PICs) are highly exposed to international commodity price shocks and exchange rate volatility.<sup>2</sup>** This is due to the structure of these economies—narrow production and export bases and, hence, for most, heavy reliance on imported food and fuel. Moreover, frequent natural disasters also increase inflationary pressure by disrupting the supply side of the economy. The result is volatile inflation, which poses a challenge for monetary policy. During 2000-12, average CPI inflation in these countries was higher and more volatile relative to other developing Asian economies. To enhance the effectiveness of monetary policy, it is necessary to fully understand the extent to which inflation dynamics are attributable to domestic factors (e.g., changes in credit) or exogenous factors (e.g., changes in international commodity prices and exchange rate volatility).

**A recent APD analysis suggests that inflation in PICs depends mostly on external factors.** As expected, rising headline inflation is positively associated with exchange rate depreciation against the Australian dollar, an increase in international food and oil price inflation, and an increase in credit growth, while the output gap does not have an impact on inflation. In particular, a 1 percentage point depreciation of the national currency against the Australian dollar is associated with an increase in inflation of about 0.2 percentage point. These results reflect the importance of Australia as the main country of origin for PICs' imports as well as PICs' heavy reliance on food and fuel imports.

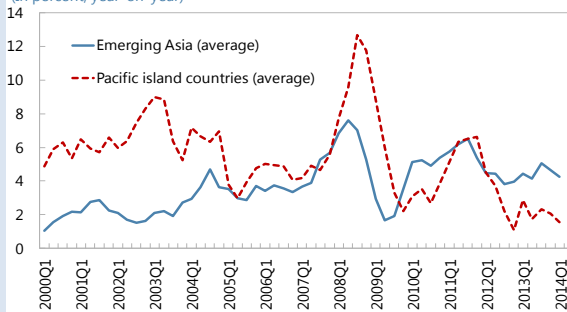
**The analysis suggests that given the importance of the exchange rate as a channel of inflation, the exchange rate could be managed flexibly to provide a buffer against external shocks.** It would offer greater independence for monetary policy.

<sup>1</sup> Prepared by Yiqun Wu, based on "The Drivers of Inflation in the Pacific Island Countries," by Xuefei Bai, Patrizia Tumbarello, and Yiqun Wu.

<sup>2</sup> The analysis covers the Pacific island countries with central banks: Fiji; Papua New Guinea; Solomon Islands; Samoa; Tonga; and Vanuatu.

**Headline Inflation**

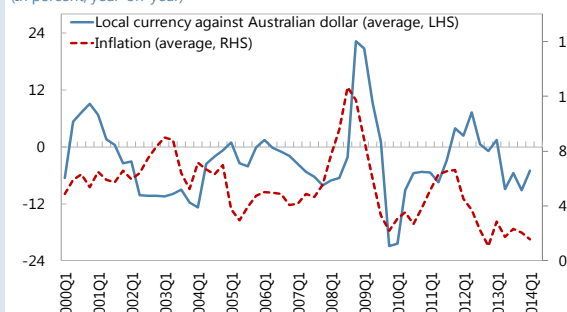
(In percent; year-on-year)



Sources: Country authorities; and IMF, International Financial Statistics Database.

**Pacific Island Countries: Inflation and Exchange Rate**

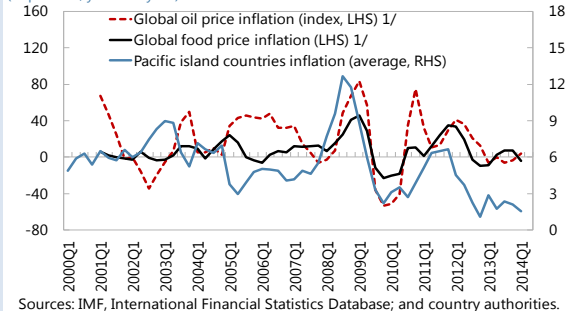
(In percent; year-on-year)



Source: IMF staff estimates.

**Pacific Island Countries: Inflation and Global Commodity Price Inflation**

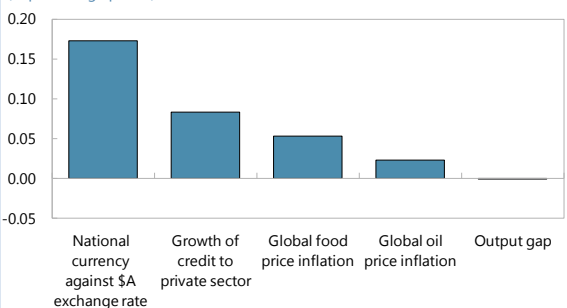
(In percent; year-on-year)



Sources: IMF, International Financial Statistics Database; and country authorities. 1/ Three-quarter lag.

**Pacific Island Countries: Inflation Pass-through<sup>1/</sup>**

(In percentage points)



Source: IMF staff estimates. 1/ Impact of a 1 percentage point increase.

## Enhancing the IMF's Engagement with Small Developing States

By IMF Deputy Managing Director Min Zhu



The third United Nations Conference on Small Island Developing States (SIDS) held in Apia, Samoa, on September 1-4, 2014, provided an important opportunity to address the common challenges shared by a group of nations spread across the globe. Some of these challenges are long standing; others reflect the unique problems posed by climate change and a rapidly evolving global economy. Regardless, the small states require the focus and support of the international community if they are to address these challenges successfully.

The small states are an important component of the 188 member countries that make up the International Monetary Fund, and the Fund believes it is important to signal its commitment to work in partnership with the governments of these nations. By working alongside other international financial institutions and development partners, we can better serve the small states. The SIDS conference provides an opportunity to listen to perspectives on these challenges, share ideas on how best to address them, and to learn from one another.

There are several issues facing small states as they strive to boost economic growth after lagging behind the rest of the world since the late 1990s. Because of their size, they face higher fixed costs in providing public goods such as infrastructure or social services. In the private sector, higher costs have led to concentrated markets with reduced competition. A very high dependence on imports and exports exposes many countries to external shocks from global markets such as swings in commodity prices. Small size also prevents these countries from diversifying into a wider range of economic activities, and that only increases their vulnerability to shocks.

In addition, small states' domestic financial markets tend to be shallow, and international investors see them as riskier. So they have less favorable—that is, more expensive—access to global capital. That limits their options when they seek to borrow.

Then there are the unique problems that many small states face because of natural disasters. This risk has grown in recent years, and many attribute this trend to the effects of climate change. This risk was clearly demonstrated in the Pacific Ocean by the recent cyclones in Tonga and Vanuatu, and the severe floods in Solomon Islands. Natural disasters not only take a toll on island economies and their populations in the short term, but they also lower growth prospects into the future and burden countries with higher levels of debt.

Economic policies play a vital role in dealing with all of these vulnerabilities, and this is where the IMF can help. As the international financial institution charged with assisting countries to develop and implement policies to achieve strong, stable, and inclusive growth, the Fund has intensified its engagement with small states in recent years.

In addressing the problem of vulnerability to all sorts of external shocks, policymakers in the small states need to think about how to build and maintain appropriate levels of budget balances, public debt, and foreign reserves. IMF experts work closely with governments to help achieve these goals.

Of course, the IMF is prepared to provide financial assistance to small states when needed, and 20 small states are eligible for concessional lending—with loans currently facing no interest rate charge as part of programs aimed at putting in place policies to address immediate and longer-term economic issues.

The IMF is also assisting the small states by providing technical assistance and training that strengthen the ability of government officials to devise and implement economic policies. This “capacity development” is intended to align with the Fund's policy advice and financial support, and this integrated approach is included in a set of guidelines on how the IMF can better serve and engage with small states in all key areas of its operations.

The Fund is not alone in scaling up its efforts in small states. We have worked together in the past years with other development partners and international financial institutions in identifying key areas of needed reforms and capacity building for policymakers. During the recent SIDS conference, for example, the IMF joined with the World Bank and other development partners to host an event on building economic resilience to natural disasters. We discussed how a more systematic approach can be developed and implemented to help countries deal with the increasing frequency and magnitude of these events.

The problems are big, but they are not insurmountable. Through policy advice, technical assistance, and lending programs, the IMF will continue to stand ready to work with small states to help them overcome their development challenges and build a prosperous future.

## Tuvalu

**Context:** Tuvalu is one of the smallest and most isolated countries in the world. With a population of some 11,000 living on 26 square kilometers, Tuvalu is more than 3,000 kilometers away from its nearest major external market (New Zealand). The country faces tremendous challenges stemming from its remoteness, lack of economies of scale, weak institutional capacity, and, above all, climate change and rising sea levels, which threaten the country's very existence.

**Outlook and Risks:** Growth prospects, however, are generally positive owing to several large infrastructure projects financed by development partners that are planned to be implemented over the medium term. Inflation is expected to rise moderately, reflecting rapidly growing government expenditure and substantial public sector wage increases. Near-term risks mainly stem from elevated banking sector vulnerabilities, while over the medium to long run, growth prospects may be hampered by the dominance of inefficient public enterprises in the economy, volatility of fishing license fees, and weak competitiveness.

**Policy Issues:** The authorities are cognizant of the challenges and a policy reform matrix, formulated in consultation with development partners, has been fleshed out in an effort to enhance governance and social development, facilitate private sector growth, and safeguard macroeconomic stability. In the near term, fiscal consolidation is needed, along with a fiscal framework that targets a structural fiscal surplus in the medium term. Establishing a regulatory framework and conducting a complete diagnosis of the banking system as soon as feasible will also be important. In addition, the authorities need to develop a reform plan for public enterprises to enhance transparency and improve efficiency, and continue to implement reforms toward inclusive growth, including through an improved business environment, enhanced vocational training, and greater efforts to explore job opportunities at home and abroad.

Source: [Tuvalu-Staff Report for the 2014 Article IV Consultation](#)

Maps: National Geographic and CIA World Factbook.



**Tuvalu, rising sea levels**

(Source: The Telegraph /ALAMY)

## Interview



### Interview with Professor Lino Briguglio

*Lino Briguglio is Professor of Economics at the University of Malta and Director of the Islands and Small States Institute at the same university. At the recent UN Conference on Small Island Developing States in Apia, Samoa, the APD Small States Monitor asked him about his work and the current challenges facing small states.*

*Would you give us a brief overview of your work on small states?*

I have had the opportunity to work on a range of small state issues, including economic vulnerability and resilience, development strategy, competitiveness, and the effects of climate change, just to name a few. I have also been active in international cooperation and engagement on small state issues, for instance through my involvement with the Small States Network for Economic Development and my work with the Commonwealth Secretariat and the World Bank Group.

*What are you working on at the moment?*

My work on small states started with a systematic and comprehensive investigation into the economic vulnerabilities of small island states and their implication for governance. It is now well known that small states face many common challenges, but as we know, these economies are also highly heterogeneous. Most recently, I have tried to better quantify these differences by building an Economic Vulnerability Index that synthesizes measures of fragility and resilience for all small states. The different levels of vulnerability and the resultant variations in the levels of economic development offer many important lessons for the way we think about policies to promote economic growth in these countries. I also developed an index of resilience which assesses the extent to which policies are geared to cope with natural disasters.

*In your view, what are the main takeaways from the UN Conference on Small Island Developing States?*

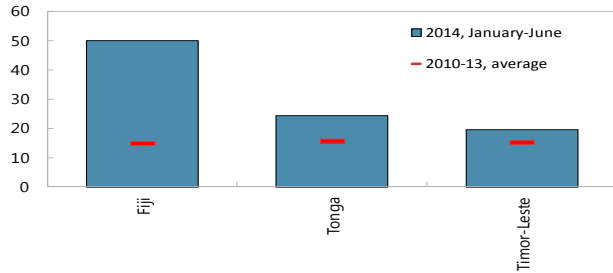
Discussions at the conference showed that, despite the challenges faced by small states, strong and appropriate policies do make a difference—which underlines the importance of sound domestic policies and the role played by international organizations. There is also increasing focus on the impact of natural disasters and climate change on our assessment of the vulnerability of small states, particularly small island economies. We all need to do a better job of incorporating this, or at least of thinking about it, when discussing the risks and vulnerabilities faced by small states.

# Figure 1. APD Small States: Recent Economic Landscape

High-frequency data indicate a pickup in domestic demand in the first half of 2014 in some APD small states...

## Selected APD Small States: Vehicle Registrations, January-June, 2014

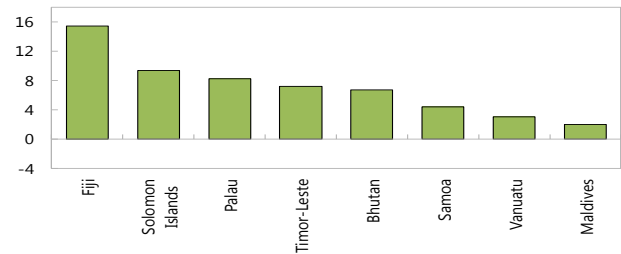
(Year-on-year percent change)



...consistent with developments in private credit growth...

## APD Small States: Growth of Domestic Credit to Private Sector, 2014, Latest Available Data

(In percent; year-on-year)

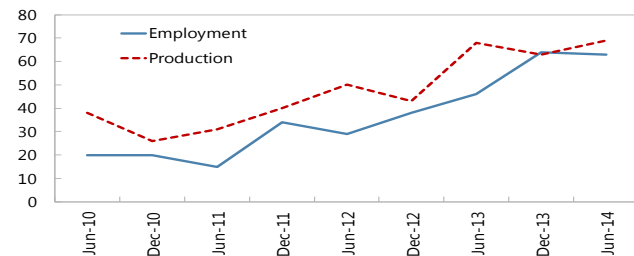


Note: July 2014 for Bhutan, Fiji, Maldives, Samoa, Solomon Islands, Timor-Leste, and Vanuatu; and March 2014 for Palau.

...especially in Fiji where business sentiment ahead of the election was strong.

## Fiji: Business Expectations

(In percent)<sup>1/</sup>

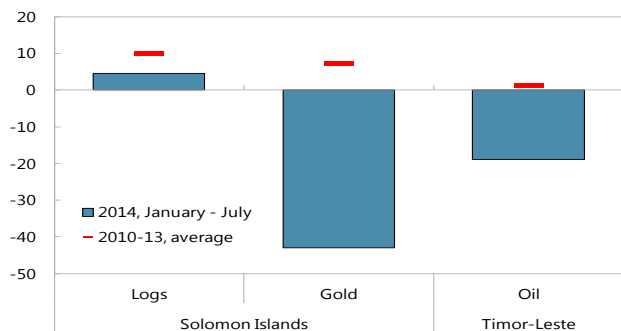


1/ Represents the percentage of firms aiming at increasing production and employment in the next 12 months after deducting the percentage of firms that aim at reducing production and employment.  
Source: Reserve Bank of Fiji.

Output fell in Timor-Leste owing to the ongoing depletion of oil reserves under production and in Solomon Islands because of the floods and disruption of gold production.

## Selected APD Small States: Commodity Production

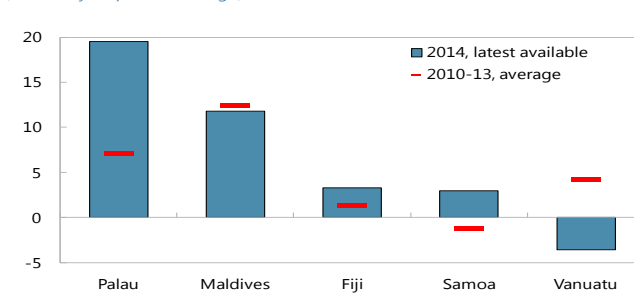
(Year-on-year percent change)



In most tourism-oriented economies, tourist arrivals grew strongly reflecting the resumption of direct flights to Palau, an increase in Asian tourist arrivals in Maldives...

## Tourism-intensive APD Small States: Tourist Arrivals

(Year-on-year percent change)

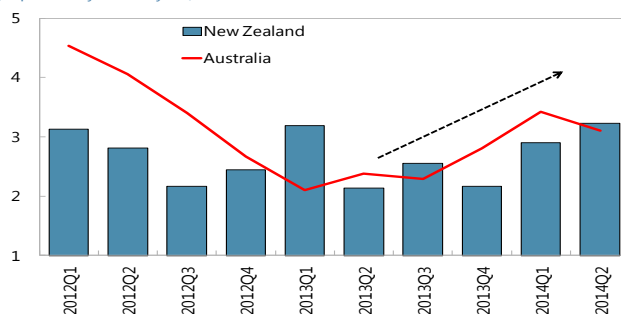


Note: January-July for Fiji, Maldives, Palau, and Samoa; and January-June for Vanuatu. For Vanuatu, data include only air arrivals.

...and solid growth in Australia and New Zealand.

## Real GDP Growth

(In percent; year-on-year)



Note: Asia and Pacific developing (APD) small states include: Bhutan, Fiji, Kiribati, Maldives, the Marshall Islands, Micronesia, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

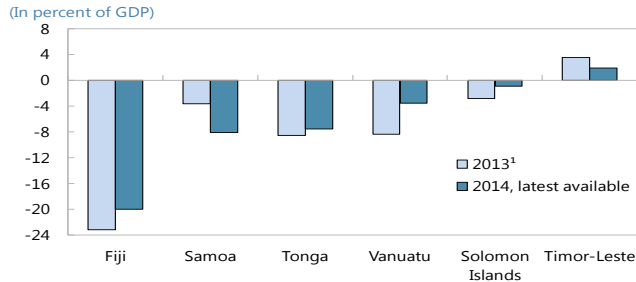
Sources: Country authorities; and IMF staff estimates.



# Figure 1. APD Small States: Recent Economic Landscape (concluded)

External imbalances narrowed (with the exception of Samoa because of construction-related imports associated with the recent UN conference)...

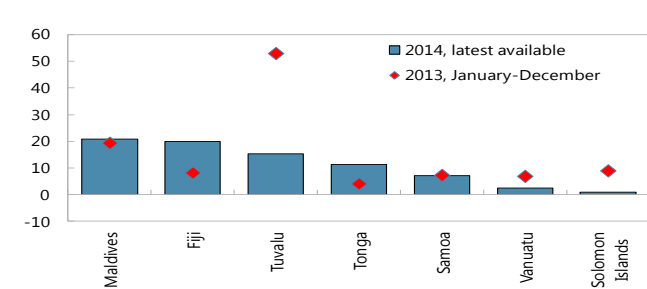
## APD Small States: Current Account Balance, January-June 2014



1/ Indicates the same period as the latest available in 2014.  
Note: January-March for for Fiji.

Fiscal revenue was strong in several countries...

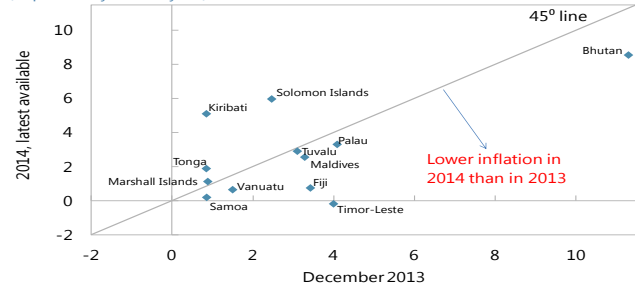
## APD Small States: Fiscal Revenue excl. Grants



Note: January-August for Tuvalu and Vanuatu; January-July for Maldives and Solomon Islands; January-June for Fiji and Samoa; and January-March for Tonga.

Inflation has eased in most countries...

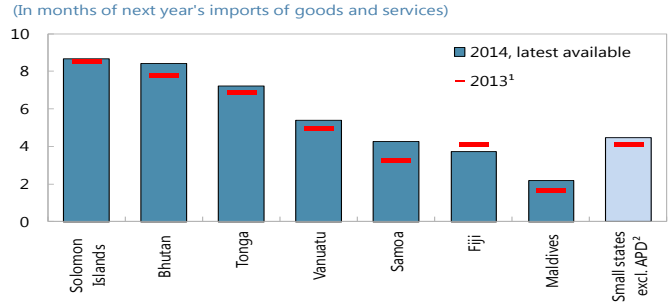
## APD Small States: Inflation



Note: August 2014 for Fiji, Samoa, Timor-Leste, and Tonga; July 2014 for Maldives and Solomon Islands; June 2014 for Bhutan, Kiribati, Palau, and Vanuatu; and March 2014 for the Marshall Islands and Tuvalu.

...keeping external buffers at comfortable levels in most APD small states.

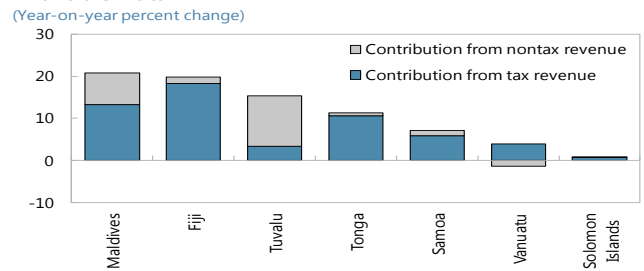
## APD Small States: Reserves, July 2014



1/ Indicates the same month as the latest available month in 2014.  
2/ Latest available data June 2014.

...driven by buoyant tax collections in Fiji, Maldives, and Tonga, high fishing license fees in Tuvalu, and duties and land leases in Maldives.

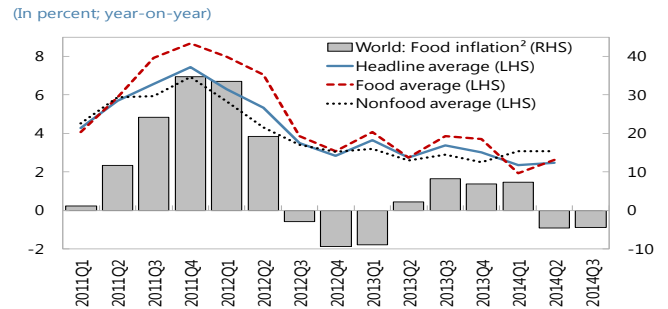
## APD Small States: Fiscal Revenue excl. Grants, 2014, Latest Available Data



Note: January-August for Tuvalu and Vanuatu; January-July for Maldives and Solomon Islands; January-June for Fiji and Samoa; and January-March for Tonga.

...as lower global food price inflation passed through to domestic prices.

## APD Small States: Headline Inflation<sup>1</sup>



1/ Simple average.  
2/ Three-quarter lag.

Sources: Country authorities; and IMF staff estimates.