Australian Government
The Treasury

MAJOR ECONOMIC SHOCKS AND PACIFIC ISLAND COUNTRIES

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Context

- There is great diversity among PICs:
  - Resource bases, income and population levels, economic growth rates, export capacity, dependence on imports, importance of aid and remittances, levels of debt, external balance, exchange rate systems
  - It is therefore important to avoid generalisations about the effects and implications of economic shocks and possible solutions

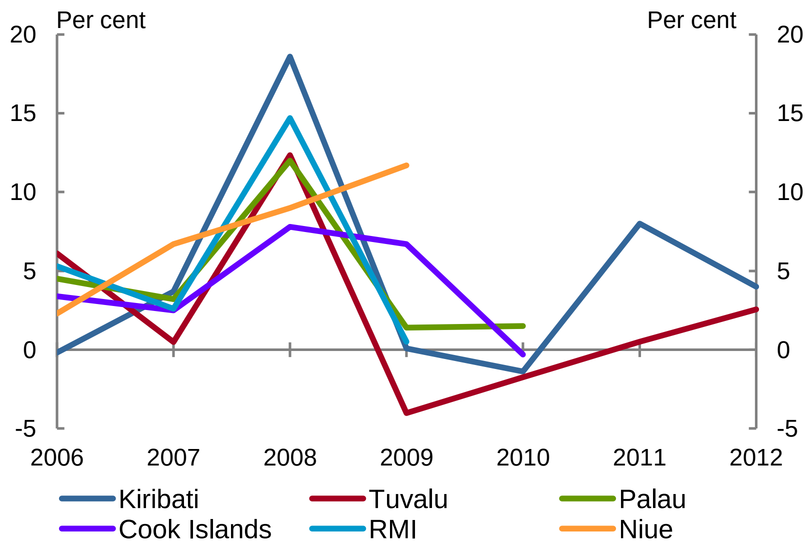
Vulnerability to Shocks

- PICs can be highly vulnerable to economic shocks, particularly the microstates
- Factors which increase vulnerability include high dependence on imports, limited production and export diversification, remoteness from global markets, limited export supply responsiveness, macroeconomic imbalances

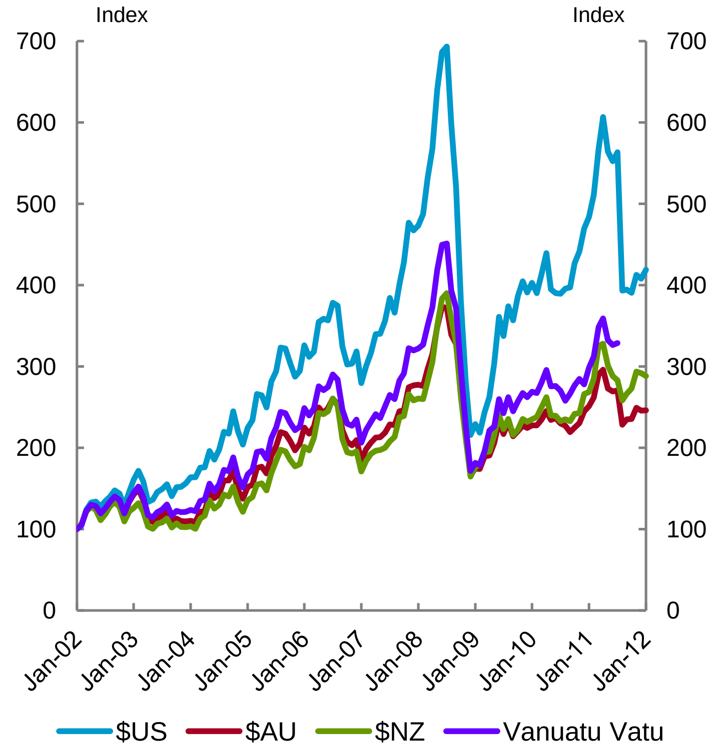
Food and Fuel Shocks

- The food and fuel price shocks raised inflation
  - Although the impacts varied…
  - Countries with appreciating currencies were less severely affected
  - Microstates experienced relatively high inflation rates

Microstates: Annual Inflation Rates



Oil price in $US terms for RMI, FSM and Palau; in the local currencies of Vanuatu; in $A terms for Kiribati, Nauru, Tuvalu; and in $NZ terms for Cook Islands, and Niue

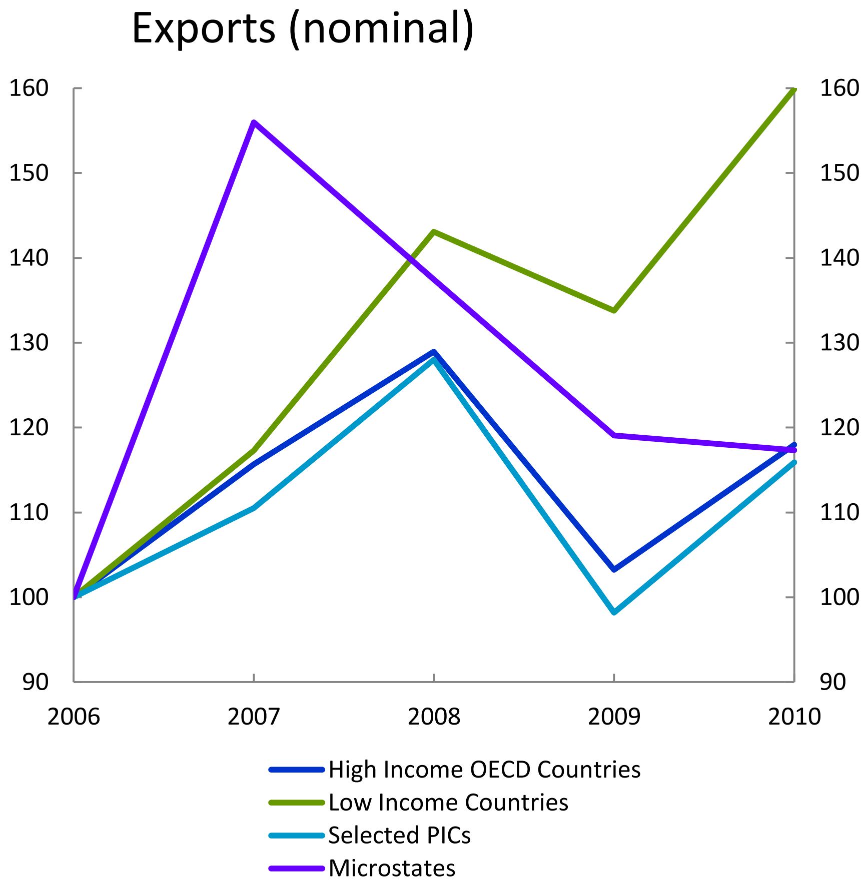


Microstates: Percentage change in real GDP

	Between 2007 and 2009	
Cook Islands	-7.0	
RMI	-3.2	
Kiribati	-1.8	
Palau*	-10.4	
Tuvalu	-2.2	(2009 to 2010)
Nauru	-18.1	(2008 to 2009)
‘Other PICs’	+4.8	

Global Recession

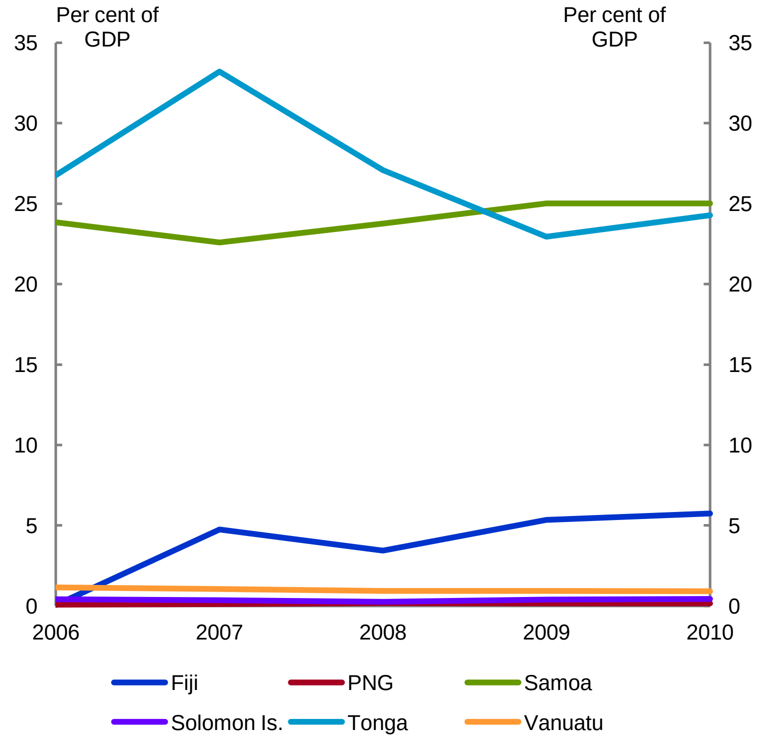
- Exports from selected PICs fell widely, in line with contractions in industrialised countries
- Exports from microstates fell more steeply



Global Recession

- Remittances fell in Tonga and Fiji

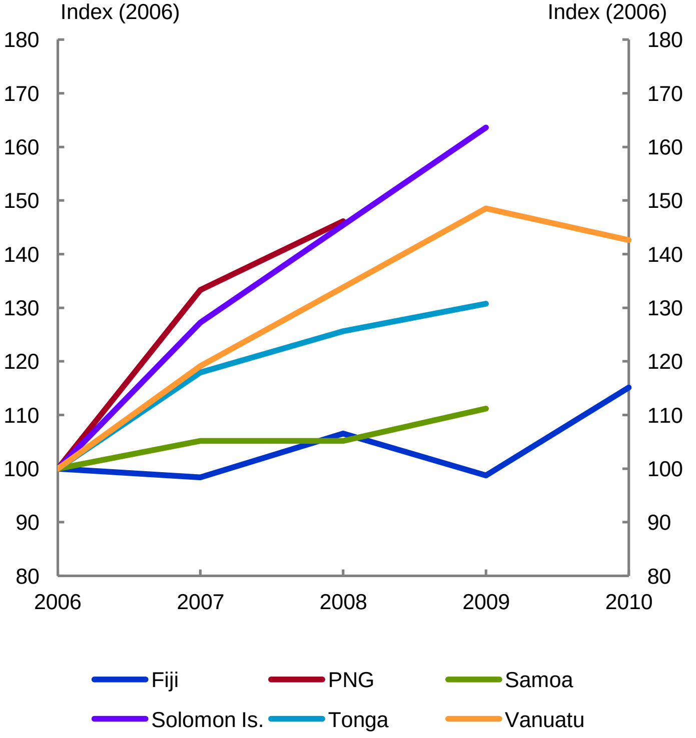
Remittances as a percentage of GDP



Global Recession

- The relative buoyancy of the Australian and Asian economies provided a cushioning effect for some PICs

Tourism and business (visitor arrivals)



Global Recession

- The combined effects of recent shocks and natural disasters led to:
  - Significant reductions in economic growth in middle sized non resource-rich countries.
  - A contraction in output in microstates.
- However, expansion continued in resource/ tourism-rich states

Policy Responses

- Monetary policy had to first address liquidity and inflation concerns
- Fiscal policy was relaxed in a number of countries
- Foreign currency reserves fell initially, deeply in the case of Fiji and Solomon islands, but have since recovered, and are now relatively high

Exchange Rate Policy

- Two shocks in close proximity—food/fuel prices and slump in demand due to global recession — lead to challenges
- Exchange rates tended to become overvalued. This tendency persists today in a number of countries
- Fundamental question: would greater exchange rate flexibility have provided a shock absorber for countries with relatively fixed exchange rates?
- Much would depend on the extent of food and fuel import dependency and export responsiveness to price and exchange rate changes
- Over the longer term increased exchange rate flexibility would likely improve export prospects following the global recession

Future Shocks?

- International crude oil prices have remained high for a year now, and threaten to go higher
- Any recession confined to Europe would be unlikely to have major direct impact on PICs
- Recessions and high public debt in some donor countries could have implications for future aid flows

Macroeconomic Policies

- The scope for additional expansionary fiscal policies in some countries is constrained by high budget deficits and debt
- Low levels of foreign sourced income (exports, remittances and tourism), high current account deficits and high external debt make some countries highly vulnerable to shocks
- Lowering current account and fiscal imbalances can improve the capacity to respond to external shocks

Structural Policy Changes

- Resilience to external shocks can be developed by
  - Resource allocation policies aimed at:
    - Diversifying food production, reducing food and fuel import dependency, export diversification, establishing alternative sources of energy
  - Microeconomic reforms aimed at:
    - Progressively removing remaining trade distorting barriers, facilitating land reform, adopting improved agriculture techniques, encouraging greater competition, increasing productivity and lowering costs

Conclusions

- Australia supports continued strong country surveillance and policy advice to PICs from IMF, World Bank and Asian Development Bank
- Australia also supports efforts being made by these international institutions to beef up resources, and to engage in greater cross regional analysis of policy issues constraining growth possibilities across the Pacific