Asia & Pacific SMALL STATES MONITOR

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

…we review the devastating effects of Cyclone Pam on Vanuatu, as well as its impact on neighboring Pacific small states. We also highlight the plunge in oil prices and its likely effect on Asia and Pacific Developing (APD) small states. We then cite the challenges faced by small states in managing revenue volatility and improving the spending mix, and report on our recent work on the high spreads between lending and deposit interest rates in the Pacific islands.

This issue presents a piece drafted by the Solomon Islands authorities describing their debt management framework, and its role in guiding borrowing decisions. With public investment becoming a more important source of growth, debt management increases in importance. We look forward to contributions from other members in the future. We have also introduced in this Monitor the IMF Resident Representative's corner based in Fiji; reports from Suva will be a regular feature of future issues.

Patrizia Tumbarello, Chief of the Small States Unit, Asia and Pacific Department, IMF

"It's a setback for the government and for the people of Vanuatu. After all the development that has taken place, all this development has been wiped out."

President Baldwin Lonsdale, Vanuatu
Copyright © Associated Press; Source: Washington Post, March 16, 2015

Vanuatu – Post-Cyclone Pam (Source: www.imagicity.com)

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Economic Developments

- In 2014, GDP growth varied greatly across small states (Figure 1, page 13). Palau registered record growth owing to the resumption of direct flights from Asia and a large increase in travelers from China. In *Maldives* growth was strong at 5 percent buoyed by tourism activity with a pickup in arrivals from new markets in Asia. *Fiji*'s growth at over 4 percent was broad based as confidence strengthened in the run-up to the elections and persisted thereafter, while in *Kiribati* growth was supported by strong fishing license fees and donor support. In *Tonga* growth was moderate at 2.3 percent in 2013/14, owing to reconstruction in the aftermath of Cyclone Ian. *Samoa*'s growth was 2 percent because of spending to prepare for the UN Small Island Developing States Conference and continued reconstruction following Cyclone Evan. In *Solomon Islands*, the closure of the Gold Ridge mine and April floods weakened economic activity. In the *Marshall Islands* and the *Federated States of Micronesia* activity was subdued reflecting a slowdown in infrastructure projects.

- In March 2015, two natural disasters affected several small states of the Pacific. Cyclone Pam, a devastating storm, hit *Vanuatu* and several other neighboring countries, especially *Tuvalu* (see Special Topic 1) and Typhoon Maysak hit the *Federated States of Micronesia* leaving considerable destruction.

- In 2014, inflation eased in most of Pacific Island countries, the result of falling international oil prices. With oil imports representing up to one quarter of GDP, current account balances improved, adding to the comfortable external buffers in most APD small states.

Outlook

- GDP growth is projected at 2.8 percent in 2015, and 2.7 percent in 2016. Owing to the pass-through of lower oil prices, inflation is projected for the APD small states to fall by 1½ percentage points in 2015 (see Special Topic 2) relative to past projections.

- The natural disaster in *Vanuatu* is expected to dampen economic activity in the short term, with exports of goods and services dropping sharply. Reconstruction activity, including restoring or rebuilding almost the entire housing stock, will provide a partial offset. Economic expansion in *Solomon Islands* is forecast to rise to 3.3 percent this year, led by agriculture, tuna processing, and construction, but uncertainty persists regarding sustainable sources of growth. *Tonga* is expected to revert to a moderate growth path in light of preparations for the South Pacific Games. For *Maldives*, growth is expected to slow a little in 2016 following a leveling off after the recent rapid expansion of tourism and as fiscal consolidation begins to have an effect.

- External risks are to the downside, including negative spillovers from slower growth in Asian emerging markets. Infrastructure projects will help sustain APD small states' short- and medium-term performance. The key challenge in the Pacific region remains lifting potential growth and building resilience to natural disasters.

APD Small States: Real GDP
(Year-on-year change; in percent)

	2010-13	2014 Est.	2015 Proj.	2016 Proj.
Bhutan	7.7	6.4	7.6	8.2
Fiji	3.0	4.1	3.3	3.0
Kiribati	1.1	3.8	2.9	1.5
Maldives	4.9	5.0	5.0	3.9
Marshall Islands	3.5	0.5	1.7	2.2
Micronesia	0.3	0.1	0.3	1.0
Palau	3.4	8.0	2.2	2.7
Samoa	1.0	1.9	2.8	1.4
Solomon Islands	6.9	1.5	3.3	3.0
Timor-Leste[1]	9.3	6.6	6.8	6.9
Tonga	0.7	2.3	2.7	2.4
Tuvalu	1.8	2.2	2.5	2.5
Vanuatu	1.6	2.9	-4.0	5.0
APD small states[2]	3.0	2.6	2.8	2.7
Small Pacific island countries[2, 3]	1.7	2.3	2.6	2.4
Small states (excl. APD)[2]	1.6	2.6	2.0	2.5

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

High-Level Dialogue on Natural Disasters and Workshop on "Strengthening Fiscal Frameworks in the Pacific Islands"
co-hosted by the government of Fiji, Australian government, and the IMF
June 22-25, 2015, Nadi, Fiji

The 46th Pacific Islands Forum Leaders' Meeting
September 7-11, 2015, Port Moresby, Papua New Guinea

Forum Economic Ministers' Meeting (FEMM)
October 27-31, 2015, Rarotonga, Cook Islands

South Pacific Central Bank Governors' Meeting
December 2015, New Zealand

Recent Events

PFTAC Steering Committee Meeting
March 12-13, 2015, Rarotonga, Cook Islands

South Pacific Central Bank Governors' Meeting
December 2-5, 2014, Suva, Fiji

2014 High-Level Caribbean Forum
October 23-24, 2014, Montego Bay, Jamaica

2014 Small States Forum
October 11, 2014, World Bank Group Headquarters

Photos from Recent Events and IMF Missions

IMF Deputy Managing Director Min Zhu speaking at the Pacific Islands Working Luncheon in Washington DC

Samoa team with Prime Minister Tuilaepa Sailele Malielegaoi

Caroline Waqabaca (advisor to the IMF Executive Director), Permanent Secretary of Finance Filimone Waqabaca, Fiji, and Patrizia Tumbarello

Breakout sessions at the PFTAC Steering Committee Meeting, Rarotonga, Cook Islands

Tongan Prime Minister 'Akilisi Pohiva and Yasuhisa Ojima (IMF Mission Chief for Tonga)

Country Work and Missions

In December 2014, Tubagus Feridhanusetyawan (IMF Resident Representative for the Pacific Islands)visited *Nauru* to assess Nauru's progress in preparing for IMF membership. He also participated in the February 2015 Article IV consultation *Tonga*, and the Article IV consultation in *Samoa* in March. Upcoming missions include the Article IV consultation in *Kiribati*, scheduled for late April 2015, and the membership mission to *Nauru* scheduled for May.

Tubagus Feridhanusetyawan during the South Pacific Central Bank Governors Meeting

Outreach and Presentations

The *South Pacific Central Bank Governors' Meeting* was held in Suva during December 2-5, 2014. Tubagus Feridhanusetyawan made a presentation on the *Prospects and Challenges in the Asia and Pacific Small States*, highlighting that despite uneven global recovery, growth prospects for the Pacific islands remain broadly favorable with low inflation. But fiscal policy space is limited in some, and the effectiveness of monetary operations is hampered by large excess liquidity in the banking system. Therefore, policies should aim at enhancing resilience by building fiscal buffers and implementing structural reforms to lift potential growth.

Governor Rarawa, Solomon Islands, Mrs. Rarawa, Tubagus Feridhanusetyawan, and Governor De Vasconcelos, Timor-Leste, during the South Pacific Central Bank Governors' Meeting

The *2015 Pacific Financial Technical Assistance Centre (PFTAC) Steering Committee Meeting* was held on March 12-13, 2015, in the Cook Islands, attended by the authorities of all PFTAC members, donors, and development partners. Tubagus Feridhanusetyawan made a presentation entitled *Pacific Island Countries: Key Macroeconomic Challenges and Links to the Technical Assistance Program*. He highlighted that growth in the Pacific islands is projected to moderate, while inflation will remain low, owing to lower global food and fuel prices. However, Pacific island countries are facing structural challenges, including volatile revenue, A large share of recurrent spending, and infrastructure bottlenecks. Therefore, building buffers against shocks, particularly natural disasters, remains a key policy strategy in addition to implementing public financial management (PFM) reforms to improve the quality of spending and the expenditure mix to close infrastructure gaps. Technical assistance (TA) priorities should thus focus on PFM, revenue administration, macroeconomic analysis, banking supervision, and macroeconomic statistics.

Donor Coordination: The Resident Representative's Office and PFTAC jointly hosted a quarterly donor briefing and coordination meeting in February 2015, in which development partners provided updates of their work program in the Pacific islands.

Minister of Finance of Nauru, David Adeang and Tubagus Feridhanusetyawan

Progress on Nauru's IMF Membership Application

The Republic of Nauru submitted a membership application to the IMF and the World Bank Group (WBG) in April 2014. The Nauru authorities attended the IMF/WBG Annual Meetings in October 2014 as an observer and were briefed by staff on the membership process. Several PFTAC/STA TA missions have been conducted over the past six months, helping the authorities prepare macroeconomic data for quota estimation. The joint IMF-World Bank Group membership mission is now scheduled for early May 2015. Nauru has been a member of the Asian Development Bank since 1991, of PFTAC since 1993, and of the United Nations since 1999.

SPECIAL TOPIC 1

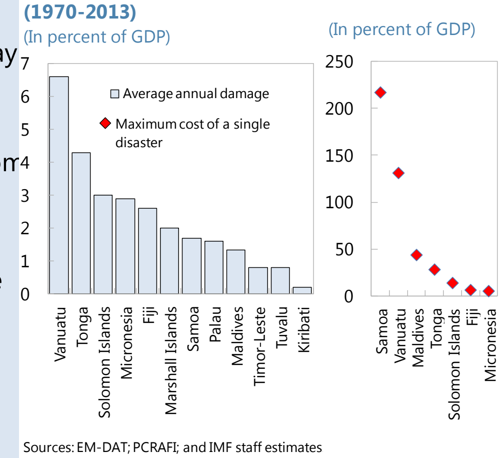
Cyclone Pam and Natural Disasters in the Asia and Pacific Small States[1]

The devastating cyclone Pam struck Vanuatu on March 13, leaving in its wake considerable destruction—one of the strongest ever storms in the Pacific region. The storm crippled the country's infrastructure; disrupted communication and the water and power supply; damaged a large share of residential buildings and tourist facilities; and destroyed crops and livestock. Eleven people were reported to have died, and thousands remain in evacuation shelters. Cyclone Pam also affected other Pacific island countries, including Tuvalu and, to a lesser extent, Kiribati and Solomon Islands. The impact of cyclone Pam on Tuvalu was also very destructive with half of the population affected on average and 90 percent of the population affected in the outer islands.

The international humanitarian response was rapid. Numerous aid workers have been deployed, and critical supplies were airlifted at first, followed by cargo ships. Assistance pledges from bilateral and multilateral development partners topped US$20 million in the first week after the disaster. In addition, the cyclone triggered a payout from the Pacific Catastrophe Risk Insurance Pilot of US$1.9 million which was disbursed two weeks after the event and has provided immediate liquidity to the government. A Post Disaster Needs Assessment is currently being conducted (April 6-23) by the World Bank Group. Possible IDA support, including from the Crisis Response Window, will be discussed based on the results of the assessment. An IMF mission is currently in Vanuatu (April 15-30) to assess the macroeconomic impact of the disaster and determine financial needs.[2]

On March 29, Typhoon Maysak hit the Federated States of Micronesia (FSM), in particular the Chuuk and Yap states. While assessments of the damages and losses are still on-going, the impact seems to be substantial. In light of disaster assistance agreements between the FSM and the United States under the Compact of Free Association, the U.S. Agency for International Development has started to provide humanitarian assistance to Micronesia. Other countries, including Marshall Islands, Australia, and Japan, and the United Nations are also providing emergency assistance.

APD small island states are highly vulnerable to natural disasters. The combination of location and small size heightens their susceptibility to earthquakes, tsunamis, and other weather-related extreme events. Climate change is increasing these vulnerabilities. Tropical cyclones, for instance, are expected to increase in intensity over the coming decades. Extreme events such as floods and droughts will add pressure to fragile island systems and may threaten the entire existence of low-lying island nations. Natural disasters in small states affect a large part of the population, especially the poor.



Damage of Natural Disasters (1970-2013)

Natural disasters pose severe macro-critical challenges for small states. Apart from their devastating humanitarian cost, such disasters destroy or damage infrastructure and other capital and create considerable macroeconomic volatility. IMF staff analysis of small Pacific states for the period 1970-2013 suggests that natural disasters reduce medium-term potential growth and worsen countries' underlying fiscal positions.[3] After a shock, growth declines by an average of 0.7 percentage point in the first year. Although output begins to recover in the following year, the response implies a permanent loss in income level. In addition, the fiscal balance deteriorates by a 0.5 percentage point of GDP in the first two years after the shock.

Policy responses to the threat of natural disasters need to be multidimensional. Natural disaster risks should be integrated into macroeconomic frameworks to ensure the availability of adequate fiscal buffers (or self-insurance) and to properly assess debt sustainability. To the extent possible, disaster-preparedness measures should be taken and investment in resilience should be scaled up, which requires making room for them in the budget. While self-insurance should continue to play a crucial role in risk management by allowing sufficient policy space (international official reserves and low debt), continuing participation in sovereign insurance mechanism would also help mitigate immediate balance of payments shortfalls. Still, the economic effects of natural disasters are difficult for small states to internalize and manage on their own. Therefore, external assistance is expected to continue to play a vital role. The IMF's engagement on helping countries to cope with natural disasters includes macroeconomic surveillance, lending under IMF-supported programs, and capacity development (see Issue 02/2014 of this Monitor).

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[1] Prepared by Nasha Ananchotikul, Vladimir Klyuev, and Yiqun Wu.

[2] See 2012, Handbook of IMF Facilities for Low-Income Countries, including for natural disasters.

[3] Cabezon, Hunter, Tumbarello, and Wu, "Strengthening Macro-Fiscal Resilience to Natural Disasters and Climate Change in the Small States of the Pacific," forthcoming IMF Working Paper.

SPECIAL TOPIC 2 Small States of the Pacific—Impact of Lower Oil Prices[1]

Most APD small states are oil importers and stand to gain from the large oil price declines since June 2014. We use changes in the IMF World Economic Outlook (WEO) projections between Fall 2014 and Spring 2015 to assess how lower oil prices have affected the outlook for key macroeconomic variables in APD small states.[2]

Growth. The decline in oil prices will support growth in most cases. Among oil importers, growth in APD small states has been revised upward by an average 0.5 percentage point in 2015, relative to the WEO Fall 2014 projections. Private disposable income and private sector profitability are expected to rise, thanks to lower prices of gasoline and inputs.

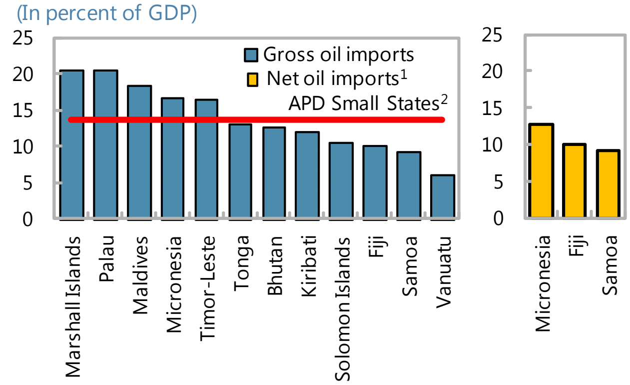
Inflation. Owing to the pass-through of lower oil prices, inflation is expected to ease by an average of 1.5 percentage points in 2015. This is due to lower transportation costs, given the large weight of such costs in the CPI basket, and lower electricity prices.

Transportation's Weight in the CPI Basket (2014)
(In percent)

Bhutan	11.0
Fiji	16.2
Kiribati	8.1
Maldives	5.4
Marshall Islands	13.7
Micronesia	9.3
Palau	16.8
Samoa	9.3
Solomon Islands	9.9
Timor-Leste	6.4
Tonga	11.9
Tuvalu	8.8
Vanuatu	11.8

Sources: Country authorities; and IMF staff estimates.

APD Small States: Oil Imports, 2013-14
(In percent of GDP)

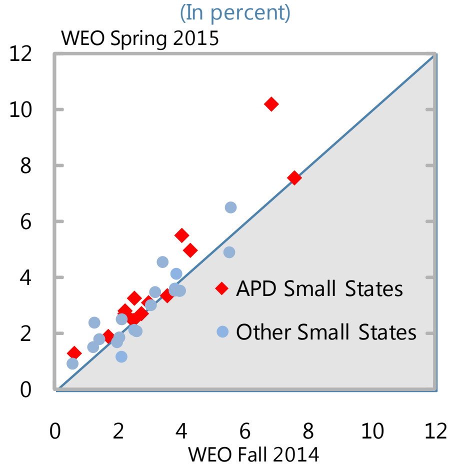


1/ Average.
2/ Net oil imports shown where data exist, except for Timor-Leste where net oil exports are 35 percent of GDP.
Sources: Country authorities; IMF, WEO; and IMF staff estimates.

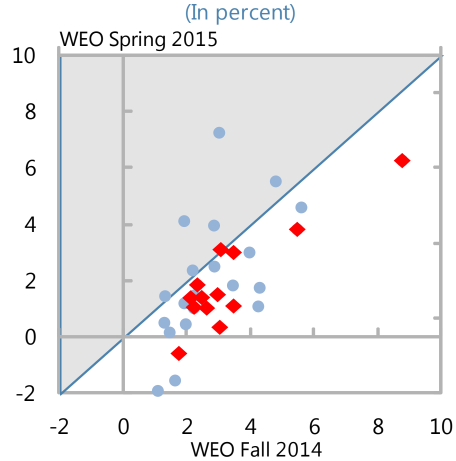
Current account balance. With oil imports representing up to 25 percent of GDP, the average current account balance is projected to improve by 1.5 percentage points of GDP in 2015. This reflects the expectation that the effects of lower world oil prices will outweigh any effects of higher domestic demand (i.e., from increased disposable income) on the value of imports.

Fiscal balance. For oil-importing countries, lower oil prices will have a small positive impact on the fiscal balance in the short term. While input costs will be lower, oil importers will face a revenue loss from lower oil-related import duties.

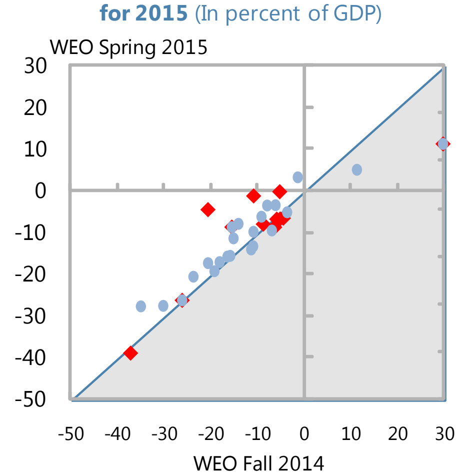
Real GDP Projections for 2015
(In percent)



Inflation Projections for 2015
(In percent)



Current Account Balance Projections for 2015 (In percent of GDP)



Source: IMF, *World Economic Outlook*, October 2014 and Spring 2015.

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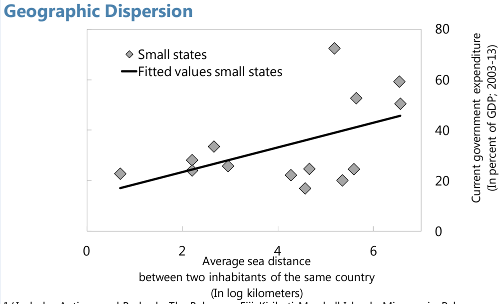
[1] Prepared by Kazuaki Washimi (Small States Unit, Asia and Pacific Department).

[2] Differences between the Fall 2014 and Spring 2015 projections are used given that oil price declines were the dominant source of difference in these two sets of projections. However the projections were also affected by other factors.

SPECIAL TOPIC 3 Strengthening the Fiscal Framework and Improving the Spending Mix in Small States[1]

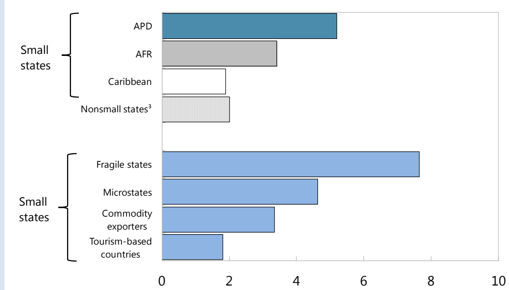
The unique characteristics of small states make fiscal management more challenging than elsewhere. Most importantly, the diseconomies of scale in providing public goods and services, driven by the small size and geographical dispersion, and the public sector being the main employer introduce rigidities into the budget, tilting the composition of spending toward recurrent outlays. With limited fiscal resources, high recurrent spending can crowd out capital spending, leading to under-investment in infrastructure and other growth-enhancing areas. At the same time, small states generally face greater revenue volatility than other country groups owing to their exposure to exogenous shocks and narrow production bases. This is particularly true for fragile states and commodity exporters. Small states often lack the capacity to weather revenue volatility for two reasons: they cannot finance temporary fiscal shocks because domestic banking systems are shallow, and they have limited access to international capital markets.

Small States[1]: Current Government Expenditure and Geographic Dispersion



1/ Includes Antigua and Barbuda, The Bahamas, Fiji, Kiribati, Marshall Islands, Micronesia, Palau, Samoa, Solomon Islands, St. Kitts and Nevis, Tonga, Trinidad and Tobago, Tuvalu, and Vanuatu.
Source: IMF staff estimates.

Volatility of Revenue
(Standard deviation of detrended revenue-to-GDP ratio; 1990-2013)



Source: IMF staff calculations.

Despite the lumpiness (relative to their small GDP) of capital projects, fiscal frameworks are not typically designed with a multi-year perspective to allow smoothing of expenditures over the business cycle. Although foreign assistance has provided some countercyclical support during downturns to aid-dependent small states, the volatility of revenue has generally resulted in volatile spending patterns and procyclical fiscal policy. Reflecting the rigidities in recurrent spending cited above, budget pressures typically affect primarily capital spending. This means that already strained capital budgets face further cuts in the event of external shocks, which further undermines longer-term growth prospects.

Assessing the fiscal stance in small states is complicated. Because of revenue volatility, especially in the Pacific, headline fiscal balances do not always accurately reflect the underlying fiscal position. However, data deficiencies, capacity constraints, and structural changes in the economy make it difficult to estimate meaningful cyclically-adjusted or structural balances based on output gaps. The existence of several extra budgetary funds that are not integrated in the budget presentation and the difficulties in measuring capital spending, when projects are implemented outside the central government or controlled by planning ministries using charts of accounts differing from that used by finance ministries, add additional challenges in evaluating the fiscal position.

Strengthening fiscal frameworks by isolating the budget from revenue volatility and shielding public spending (especially capital) could help increase small states' resilience to shocks and boost their potential growth. This means using fiscal anchors to smooth the volatility of revenue and capital expenditure over the business cycle and creating policy space for spending on infrastructure, health, and education. It also means strengthening the medium-term orientation of fiscal policy as fiscal policy should not be formulated on a year-by-year basis only. And improving the quality of public spending through public financial management reforms is key to supporting growth.

However, policies need to be tailored to the special challenges of small states. The design of fiscal anchors should be country-specific and kept simple. Medium-term fiscal estimates could focus only on main aggregates to facilitate the adoption of a multi-year budget framework. Using such a framework could also help—from a political economy point of view—contain spending pressure, particularly acute in small states given their development needs by better sequencing the implementation of capital projects.

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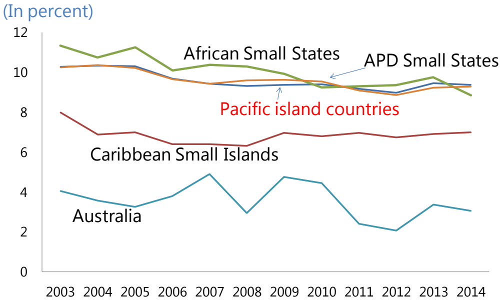
[1] Based on "Strengthening Fiscal Frameworks and Improving the Spending Mix in Small States," by Cabezon, Kanyabutembo, Tumbarello, and Wu, forthcoming paper.

SPECIAL TOPIC 4

Why Are Interest Rate Spreads So Large in the Pacific Islands?[1]

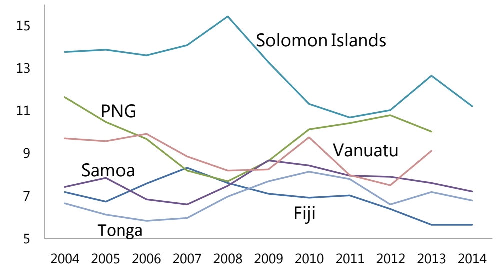
Spreads between lending and deposit rates in Pacific Island countries is approaching 10 percent on average—higher than in most comparators. While the small scale, geographic dispersion, and vulnerability to shocks are common factors that increase the cost and risk of credit in the Pacific islands, there is considerable variability in interest rate spreads both across countries and over time, which facilitates the analysis of their determinants.

Average Interest Rate Spreads
(In percent)



Sources: IMF, *International Financial Statistics;* and IMF staff calculations.

Pacific Island Countries: Interest Rate Spreads
(In percent)



Sources: IMF, *International Financial Statistics;* and IMF staff calculations.

The following factors are robust, statistically significant determinants of interest rate spreads:

- *Economic size* (the country's GDP), suggesting that the higher level of sophistication, greater opportunities for diversification, and economies of scale available in larger, higher-income countries reduce spreads;
- *Inflation*, which erodes the real value of interest margins, prompting the banks to raise the spreads. Higher inflation is also often an indicator of broader economic uncertainty, for which the banks seek compensation. While the quantitative impact of inflation on spreads is found to be small, the notable decline in inflation in the region in the last few years may explain the broad reduction in spreads observed during that period;
- *Quality of bank balance sheets*, as indicated by loan loss provisions or non-performing loans, with lower spreads in stronger banking systems; and
- *Banking sector concentration*, with greater competition reducing spreads.

The last result on banking sector concentration suggests that, while the elevated spreads in the Pacific island countries partly reflect the cost and risk of doing business in these countries, the oligopolistic nature of the banking systems also plays a role.[2] This point is also supported by high bank profitability in the region. The effect is nonlinear, with an entry of a new bank (and corresponding redistribution of market shares) having a major effect on spreads in countries hosting very few banks, but only a marginal impact where competition is already strong.

Data also indicate that the quality of public institutions (in particular, the strength of contract enforcement) also affects spreads. In that regard, while quantitative evidence is not readily available because of measurement issues, communal ownership of land and frequent government changes are also likely to contribute to the high spreads. The prevalent land tenure pattern limits collateral availability, while high government turnover increases political and economic uncertainty.

These results of the quantitative analysis are in line with economic theory. They suggest that the following measures could help reduce interest rate spreads:

- Strengthening bank balance sheets via more aggressive debt collection, writing off nonperforming assets, elimination of connected and directed lending, and better regulation and supervision;
- Increasing competition in the banking system by leveling the playing field and eliminating barriers to entry where they exist; and
- Improving economic institutions, particularly ensuring clear property rights (including land tenure), appropriate collateral regimes, compilation of credit history, and strong contract enforcement.

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[1] Based on "What Drives Interest Rate Spreads in Pacific Island Countries?," by Jamaludin, Klyuev, and Serechetapongse (forthcoming IMF Working Paper). Because of data availability, the analysis covers the six countries with their own currencies.

[2] There are natural limits to the number of banks that a small economy can sustain. The results suggests, however, that at the current levels of concentration, the degree of competition could be increased, and a relatively small dilution of market power (via the entry of an additional bank or a more uniform distribution of market shares among existing banks) would have a noticeable impact on spreads.

Debt Management Framework in Solomon Islands

Solomon Islands experienced a period of instability caused by ethnic tensions, during 1999-2003. In 2013 debt[1] peaked at 67 percent of GDP and annual revenue at 303 percent,[2] such a debt level was unsustainable. If all debts and debt arrears were fully serviced in 2003, about 20 percent of domestically sourced revenue would have been required–an untenable level for a nation in which public service provision had been sharply reduced during the period of instability.

Debt is now about 11 percent of GDP, and annual debt servicing as a proportion of domestically sourced revenue is about 3 percent. Owing to the policies implemented by successive governments, with both advisory and financial support from the Regional Assistance Mission to Solomon Islands (RAMSI), Solomon Islands debt is now at a sustainable level.

Key to repairing the debt situation was the Honiara Club Agreement signed in 2005. This Agreement was developed and ratified at a meeting of Solomon Islands external creditors. The Solomon Islands Government initiated the meeting to obtain agreement on acceptable measures to alleviate unaffordable debt-servicing pressures on the budget. As part of the Agreement, about 10 percent of the stock of external debt was restructured and the creditors of the remaining stock agreed to a debt-servicing moratorium until the fiscal situation improved. In return, Solomon Islands agreed to implement an economic reform program and to not borrow until certain debt benchmarks were met. The Honiara Club Agreement was seen as a proxy debt management framework within which successive governments could exercise debt and fiscal discipline.

In 2010/11, Solomon Islands' debt metrics had improved so much that there was a good case to resume prudent borrowing, to fund desperately needed development. To facilitate the resumption of new borrowing, the Government cited the need for a broad strategy to govern and guide future borrowing decisions. In 2012 the Solomon Islands Cabinet endorsed a Debt Management Strategy (DMS) that became the first piece of the Debt Management Framework (DMF).

The DMS sets policy limits on debt indicators to ensure that the level of debt remains sustainable (i.e., face value of debt/GDP and annual forecast debt servicing/domestically sourced revenue). The DMS requires that the debt management unit undertakes a Debt Sustainability Analysis annually to monitor these indicators. The DMF was further strengthened in 2013 with the enactment of the new Public Financial Management Act, which gives legal effect to key provisions of the DMS. Key provisions include:

- Properly defining "Government borrowing":
  - a broad definition has been included in the PFMA to capture all obligations that could result in a direct, or indirect (i.e., contingent liability) obligation on government.
  - the broad definition captures:
    - direct Government borrowing,
    - state-owned enterprise borrowing, and
    - Government guarantees.
  - a broad definition is intentionally included to bring into the debt evaluation process proposals that could create a central Government contingent liability.

- Establishing an appropriate authority to enter into government borrowing:
  - only the finance minister can authorize government borrowing.
  - having a single authority to enter into government borrowing promotes:
    - accountability in decision making,
    - transparency in decision making, and
    - assessment of competing borrowing proposals on a comparative basis.

- Requiring a Debt Management Advisory Committee to be established:
  - the Finance Minister is required to consult the advisory committee on all proposed government borrowing.
  - the advisory committee is required to assess Government borrowing proposals against the DMS.

[1] On a face value basis.

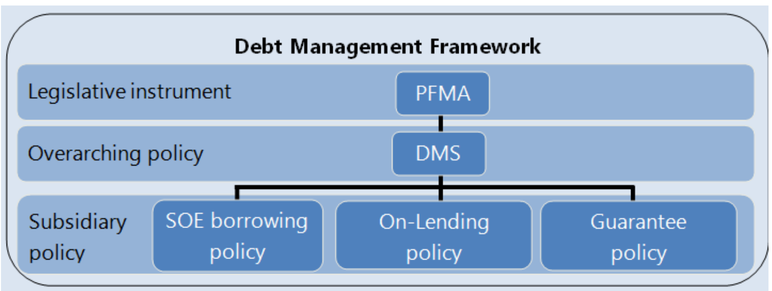
[2] These debt indicators do not include contingent liabilities.

Authorities' Feature — Debt Management Framework in Solomon Islands (concluded)

- Requiring an Annual Borrowing Limit to be set as part of the budget process:
  - the annual borrowing limit is included in the annual Appropriation Bill, and is thus a legally enforced limit;
  - the annual borrowing limit imposes borrowing discipline and an efficient allocation of scarce borrowed funds; and
  - setting a limit on the *flow of debt*, as opposed to the *stock of debt*, ensures that Solomon Islands can adapt to changing economic conditions while incurring debt to fund much needed development.

The DMF was finalized in 2013 with the endorsement by the Cabinet of a State-Owned Enterprise Borrowing Policy, an On-Lending Policy, and a Guarantee Policy – each of which is subsidiary to the overarching DMS policy document (Diagram 1). The subsidiary policies outline eligibility requirements by both entity and project, and the process that proponents of the respective Government borrowing need to follow to have their proposals assessed by the DMAC. Subnational borrowing can only occur with authorization of the finance minister. This enables the Government to properly manage and account for contingent liabilities. The DMF promotes borrowing to fund properly identified development, while keeping debt at a sustainable and affordable level.

Diagram 1 – Solomon Islands Debt Management Framework



Prepared by Nick Yiannakopoulos
nyiannakopoulos@mof.gov.sb
For further information refer to
http://www.mof.gov.sb/GovernmentFinances/DebtManagement.aspx,

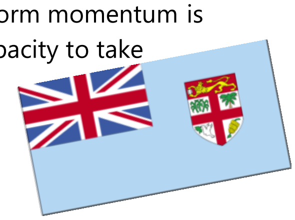
Fiji — Country Note

Context: With successful landmark elections in September 2014, Fiji took a decisive stride toward returning to democratic government for the first time since 2006. The successful elections are expected to solidify the recent improvements in relationships with traditional development partners, improve access to concessional development finance, and boost confidence in the economy. In terms of economic policy, the comfortable parliamentary majority for the former interim Prime Minister's party (FijiFirst) is expected to support continued economic reform momentum.

Outlook and Risks: Progress toward elections had led to increased confidence in the economy. The latest available consumption and investment indicators suggest continued strength in economic activity in 2014. Downside domestic risks are focused on a slowing of the reform momentum and that the planned large-scale privatizations may not materialize, potentially jeopardizing the authorities' medium-term debt and deficit targets. On the upside, a smooth transition to reform-oriented democratic government could result in stronger confidence in the economy, overheating, and upward pressure on inflation. On the external risks, Australia and New Zealand, the two most important tourism markets for Fiji, could be adversely affected by lower commodity demand from China and elsewhere.

Policy Issues: With the economy now growing above potential, near-term macroeconomic management needs to be carefully calibrated. The accommodative monetary policy in place since 2011 has stimulated economic activity. The Reserve Bank of Fiji should now tighten policy in order to moderate credit growth and curb excess liquidity. Fiscal policy has been prudent and well focused in recent years, but the expansionary 2014 budget was a major departure from these welcome trends. Reversion to the prudent trend is strongly encouraged. The authorities have accelerated economic reforms in recent years, for example in the sugar sector and pension schemes, but the key policy challenges remain to raise potential growth, reduce unemployment, improve financial inclusion, and increase resilience to shocks. Following the elections, continued structural reform momentum is needed to improve the business environment, address the infrastructure backlog, and raise the absorptive capacity to take full advantage of a potential increase in investments.

Source: Fiji-IMF Staff Report for the 2014 Article IV Consultation



Images borrowed from CIA World Factbook and the Fijian Government website.

Micronesia

Country Note

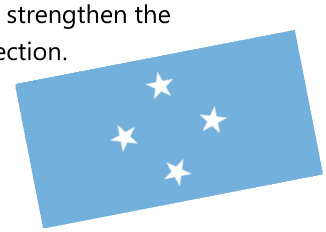
Context: The economy of the Federated States of Micronesia (FSM) stagnated in FY2014 (ending September) with real growth estimated at 0.1 percent, reflecting a slowdown in infrastructure projects. Inflation is expected to drop to 0.7 percent in FY2014 owing to falling oil prices. The current account strengthened due to a one-off increase in corporate tax revenues and an increase in fishing license fees.

Outlook and Risks: Growth is expected to improve slightly to 0.3 percent for FY2015. The economy is projected to grow at 0.6 percent over the medium term. However, risks to the outlook are tilted to the downside. While the authorities have recently produced the "2023 Action Plan" to better prepare for the expiration in 2023 of grants provided under the Compact of Free Association with the United States, its implementation hinges on achieving a national consensus and enacting the required legislative measures. On the upside, implementation of policy reforms included in the 2023 Action Plan could boost the economy while strengthening medium-term fiscal sustainability.

Policy Issues: Raising growth and ensuring long-term fiscal sustainability remain the two critical issues that the FSM needs to address. While the Unified Revenue Authority has been established and the states have started fiscal consolidation efforts under the Long-Term Fiscal Frameworks, more needs to be done to achieve fiscal sustainability in the post-2023 period. The implementation of the long-debated tax reform package, in particular, the adoption of a VAT in lieu of state sales taxes, and the introduction of a net income tax on corporations instead of the Gross Revenue Tax, remains critically important. Fiscal consolidation should be extended to the national government and accompanied by improvement in the quality of public spending, so as to safeguard priority in the social services and infrastructure investment with high development impact. Improving the investment climate is key to promoting private sector-led growth in the FSM. Land surveys and registration should be expedited to address land tenure issues. Efforts to strengthen the regulatory framework of credit unions, including by enacting a new Credit Union Act, are steps in the right direction.

Source: [IMF Staff Completes 2015 Article IV Mission to the Federated States of Micronesia, Press Release No. 15/127]

Images borrowed from CIA World Factbook and the website for the Government of the Federated States of Micronesia.



Samoa

Country Note

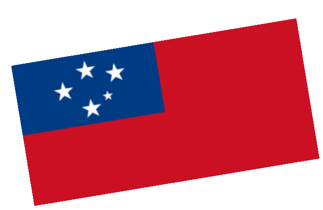
Context: The government has managed to maintain macroeconomic stability and restore growth during a difficult period following the two natural disasters and the global financial crisis, helped in part by IMF emergency assistance disbursed under the Rapid Credit Facility (RCF) in 2013. Real GDP grew by around 2 percent in fiscal year 2013/14, led by reconstruction activities, a recovery in agriculture, and preparations for the United Nations Small Island Developing States conference in September 2014. Inflation has risen recently on the back of a recovery in food prices, but underlying inflation (excluding food, transportation, and communication) remains subdued.

Outlook and Risks: Over the medium term, growth is expected to be around 2 percent on average supported by the expansion of agriculture and tourism. However, this outlook is subject to downside risks related to natural disasters, a growth slowdown in major trading partners, and a delay in fiscal consolidation or structural reforms.

Policy Issues: The government has reacted appropriately to recent shocks by increasing expenditure for recovery and reconstruction. However, public debt has risen rapidly to 55 percent of GDP, leaving little fiscal space to address future shocks. In addition, financial fragility in some public financial institutions could add significantly to the public debt in the case of another natural disaster. Therefore, a gradual fiscal consolidation that safeguards social spending and economic growth is critical for fiscal and debt sustainability. The authorities' goal is to reduce the fiscal deficit to bring debt to 50 percent of GDP by 2020. A range of measures to contain the risks to public finances from public financial institutions, including redesigning their role to support private financial markets and enhancing the soundness and resilience of the financial system, is needed. Enhanced financial supervision by the Central Bank of Samoa, including on-site supervision covering all financial institutions, will be important to clearly identify and minimize risk in the financial system. Establishing a credit bureau, a collateral registry, and a framework for the use of customary land as collateral will also help facilitate credit for growth.

Source: [Statement at the End of the IMF 2015 Article IV Consultation Mission to Samoa, Press Release No. 15/138]

Images borrowed from CIA World Factbook and the website for the Government of Samoa.



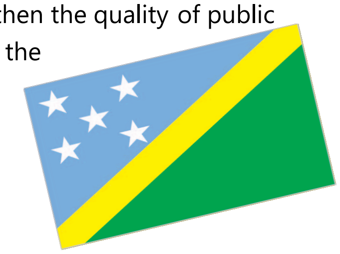
Solomon Islands

Country Note

Context: Solomon Islands held its parliamentary elections on November 19, 2014. The new government led by Prime Minister Sogavare announced an ambitious policy agenda aimed at boosting GDP growth by fighting corruption and enhancing business confidence to attract FDI, supported by large public investment over the medium term. In 2014, the closure of the Gold Ridge mine and April floods weakened economic activity but nonmineral production and exports have surprised on the upside thanks to reentry logging and a rebound in agriculture and fisheries. Performance under the IMF-supported Extended Credit Facility arrangement has been broadly satisfactory.

Outlook and Risks: The economic activity is expected to increase by 3.3 percent in 2015, led by agriculture, tuna processing, and construction, but uncertainty regarding sustainable sources of growth in the medium term remains and risks to the outlook are to the downside. The chances of the country's only gold mine re-opening are limited given current gold prices. At the same time, the logging industry is being adversely affected by the depletion of forestry resources. The timing of major infrastructure projects—including the Tina River Hydro and the submarine cable projects—which were earlier expected to support growth in 2014–15 has been shifted to late 2015 and beyond. The aid envelope may also decline more than previously envisaged. On the upside, consumers' and producers' windfall from sustained low oil prices could raise growth more than anticipated, given the country's dependence on oil imports. Additional upside risks include better prospects for exploiting nickel deposits (starting in late 2015) and a nascent bauxite industry.

Policy Issues: In the medium term, the authorities will need to recalibrate ambitious spending plans in line with implementation capacity, revenue envelope, financing availability, and the need to preserve fiscal buffers for resilience against shocks given the serious setback in mining prospects linked to the closure of the country's only gold mine. Efforts to strengthen the quality of public spending and fiscal management by advancing public financial management reforms, including improving the transparency and accountability in the use of constituency development funds, will be key. The current monetary stance is appropriate but the central bank should stand ready to tighten policy if inflationary pressures surge.



Source: [Solomon Islands—Staff Report for the Fourth Review Under the Extended Credit Facility Arrangement]

Images borrowed from CIA World Factbook and the website for the Office of the Prime Minister and Cabinet of Solomon Islands.

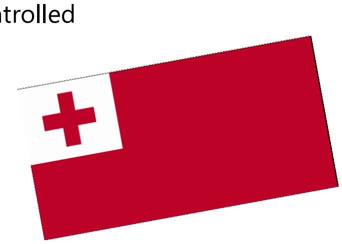
Tonga

Country Note

Context: Tonga's economy grew by around 2 percent in fiscal year (FY) 2013/14 (year ending June), driven by agriculture and construction, following a contraction in 2012/13 mainly caused by the completion of a large capital project. Inflation has remained moderate at around 0-3 percent in recent years, reflecting low global food prices and, more recently, a sharp decline in oil prices. The external position has strengthened owing to grants and remittance inflows, which have bolstered international reserves.

Outlook and Risks: Real GDP growth is expected to average 2-3 percent in FY2014/15 – FY2019/20. Although reconstruction in the aftermath of 2014 Cyclone Ian is slower than expected, preparations for the 2019 South Pacific Games will support economic activity over the next few years. Inflation is projected to remain low, reflecting the weak outlook for global commodity prices. The balance of risks remains tilted toward the downside. Spillovers from a protracted period of slower growth in advanced and emerging economies could weigh on Tonga, mainly due to its economic ties with Australia and New Zealand. On the domestic side, potential cost overruns relating to the Games could make it necessary to mobilize additional fiscal resources.

Policy Issues: Fiscal spending pressures in the near term remain high due to reconstruction work and wage increases for civil servants. Although reconstruction spending would be offset by grant inflows, moderating the share of the wage bill in recurrent spending remains important. The key medium-term fiscal challenge is to build sound fiscal positions to bolster resilience to shocks. Ongoing tax reforms and the adoption of a roadmap for public financial management reform should be complemented by setting clear medium-term fiscal targets. The spending program for the South Pacific Games should be closely controlled to avoid any potential cost overruns. Since inflation has been consistently below the reference range of 6-8 percent, the authorities should moderate the informal inflation range to a lower reference rate in order to better anchor medium-term inflation expectations.



Source: [IMF Staff Concludes 2015 Article IV Mission to the Kingdom of Tonga, Press Release No. 15/73]

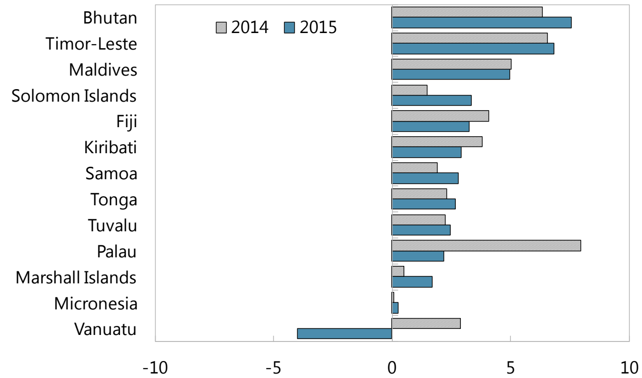
Images borrowed from CIA World Factbook and the Tonga Portal Government website.

Figure 1. APD Small States: Economic Landscape[1]

GDP growth in 2014 varied greatly across small states and we project this to continue in 2015…

APD Small States: Real GDP Growth

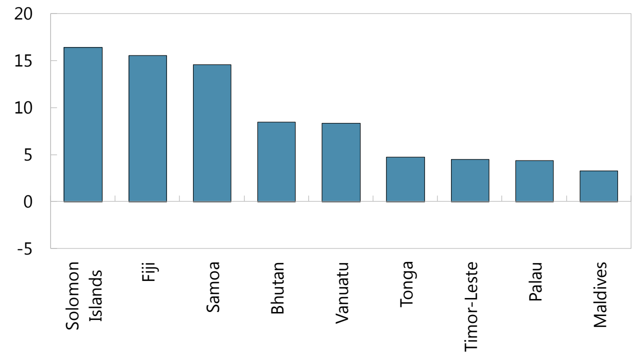
(In percent)



…consistent with varying rates of credit growth…

APD Small States: Growth of Domestic Credit to Private Sector, December 2014

(In percent; year on year)

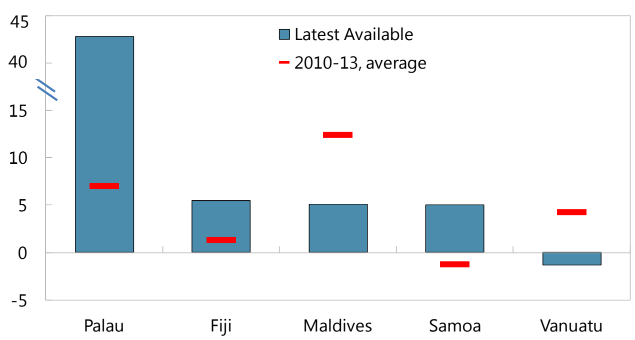


Note: November 2014 for Bhutan and Vanuatu.

…and differences in tourism inflows.

Tourism-intensive APD Small States: Tourist Arrivals

(Year-on-year percent change)

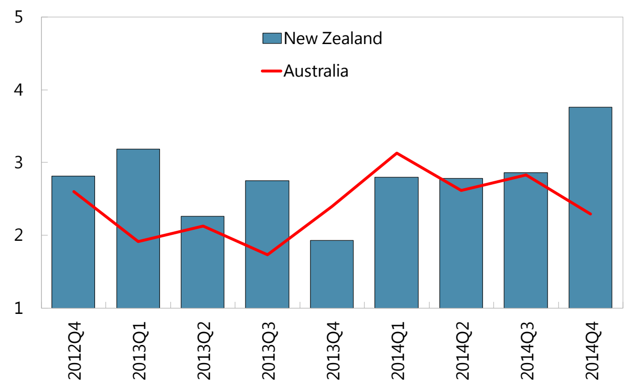


Note: February 2015 for Fiji, Maldives, and Palau; December 2014 for Samoa and Vanuatu.

But all states benefited from robust growth in Australia and New Zealand.

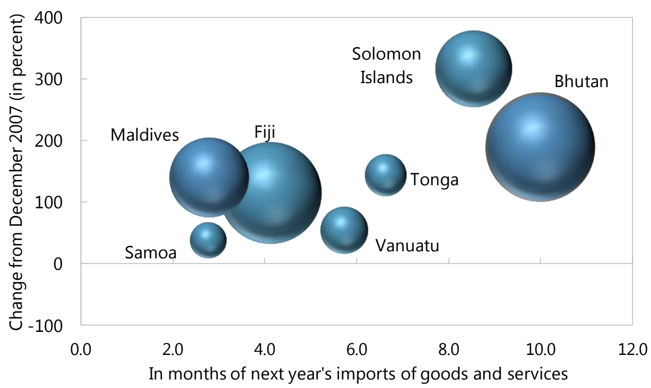
Real GDP Growth

(In percent; year on year)



Reserve buffers remain at comfortable levels in most countries…

APD Small States: International Reserves, January 2015

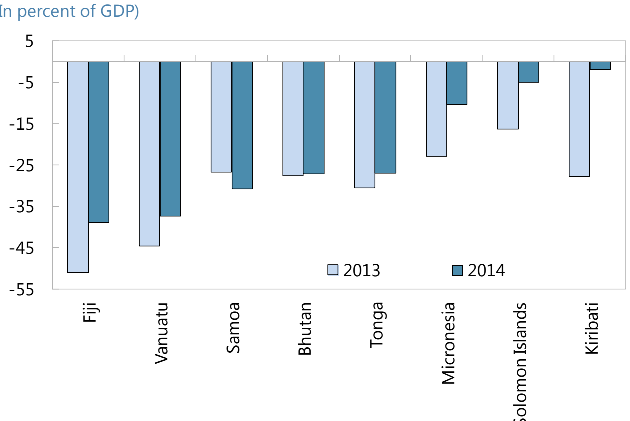


Note: December 2014 for Bhutan; November 2014 for Vanuatu.
The size of bubble represents reserves in billions of U.S. dollars.

…reflecting a narrowing of external imbalances in some of them.

APD Small States: Current Account Balance

(In percent of GDP)



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

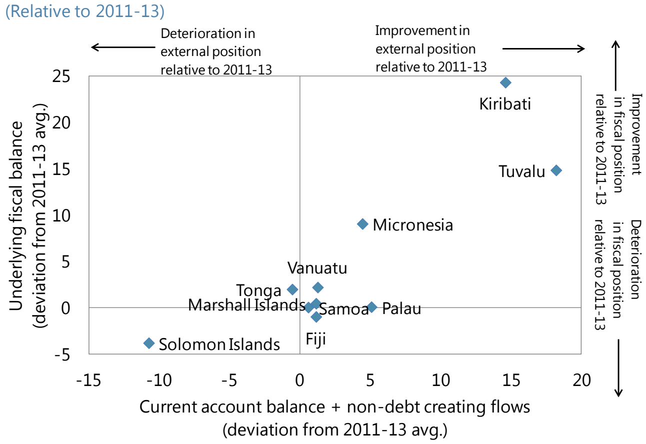
Sources: Country authorities; and IMF staff estimates.

[1] Prepared by Tlek Zeinullayev (Small States Unit, Asia and Pacific Department).

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

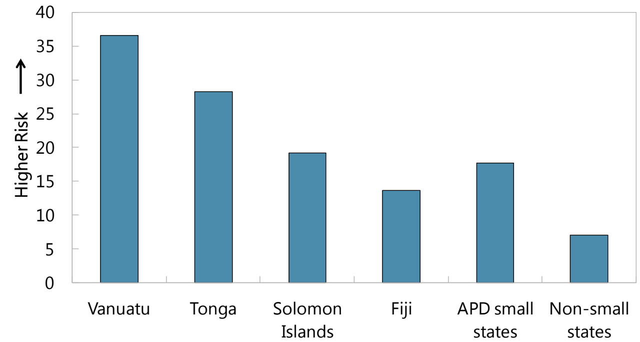
Still, some need to rebuild policy buffers to enhance resilience…

Change in Fiscal and External Positions, 2014
(Relative to 2011-13)



…given their high vulnerability to natural disasters…

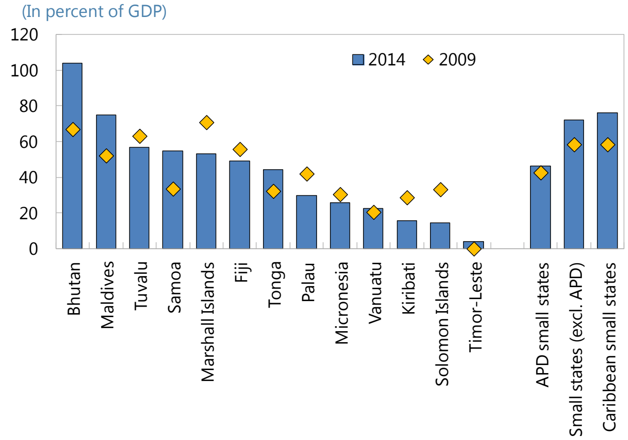
Natural Disaster Risks - World Risk Index, 2014
(In percentage points)



Note: High value indicates high risk.
Source: 2014 *World Risk Report*.

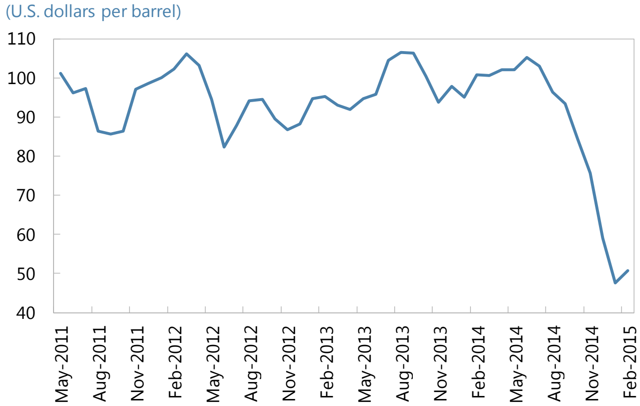
…and lower fiscal space in some Pacific island countries.

Public and Publicly Guaranteed Debt
(In percent of GDP)



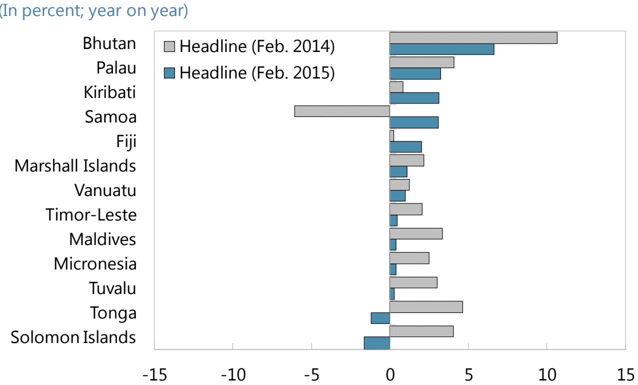
The oil price decline, if sustained, could improve policy tradeoffs…

Global Oil Price
(U.S. dollars per barrel)



…as inflation will continue to ease in most countries…

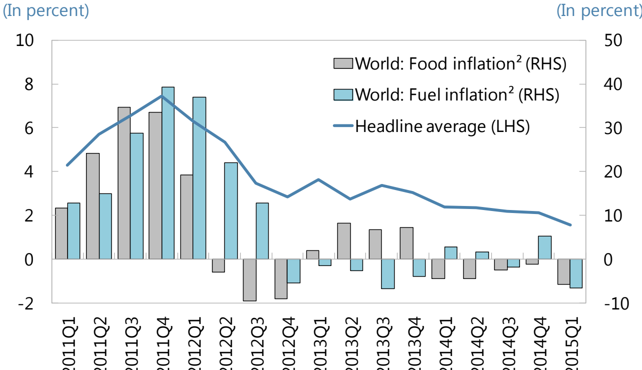
APD Small States: Inflation, 2015, Latest Available
(In percent; year on year)



Note: December 2014 for Bhutan, Kiribati, Palau, Tuvalu, and Vanuatu; and March 2014 for the Marshall Islands.

…owing to the pass-through of lower global food and oil prices.

APD Small States: Headline Inflation[1]
(In percent) (In percent)



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

Sources: Country authorities; 2014 World Risk Report; and IMF staff estimates.