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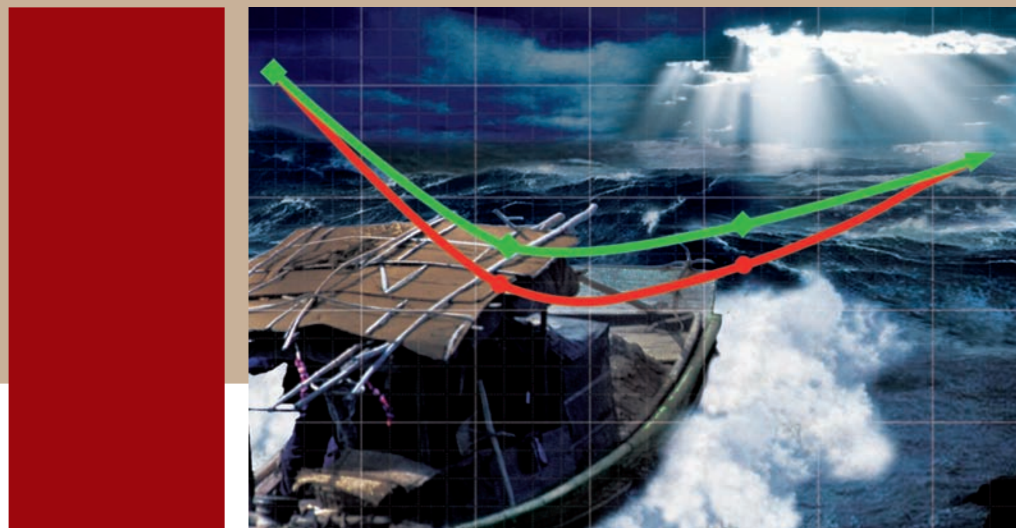

Taking the Helm

A POLICY BRIEF ON A RESPONSE TO THE GLOBAL ECONOMIC CRISIS

Asian Development Bank

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6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel: +63 2 632 4444
Fax: + 63 2 636 2444
www.adb.org

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ABBREVIATIONS

ADB	-	Asian Development Bank
DMC	-	Developing member country
FSM	-	Federated States of Micronesia
GDP	-	gross domestic product
G-20	-	Group of 20 industrialized and emerging countries
IMF	-	International Monetary Fund
MDG	-	Millenium Development Goal
PNG	-	Papua New Guinea
PRC	-	People’s Republic of China
RMI	-	Republic of the Marshall Islands
UK	-	United Kingdom
US	-	United States

Note:
In this publication, “$” refers to US dollars.

FOREWORD

The global financial crisis quickly evolved into a full blown economic crisis that has hit the Pacific. The looming impacts look to be larger than expected 6 months ago, and are unfolding rapidly.

These impacts are likely to be felt over 2009 and into 2010. Even if the global economy picks up in the second half of 2010, as the most recent forecasts suggest, it may take until 2011 for the Pacific economies to fully recover.

This policy brief looks at the challenges created by the global economic crisis and discusses policy options to mitigate its impacts. Should monetary policy be relaxed? Is a fiscal stimulus appropriate? What would a fiscal stimulus look like, and how long should one last? What can be learnt from the actions of neighboring economies?

These are the sort of pragmatic considerations that the region's economic decision makers are facing. This policy brief tries to help decision makers 'take the helm' in finding a way through these difficult economic times. It looks for the key questions that need to be asked, and seeks to provide guidance on practical answers.

Country-specific actions plans are needed for a response to the global crisis. The policy brief is intended to help the region's fiscal and monetary authorities prepare action plans, help businesses and the public work with governments on a response, and help development partners better understand the needs of the region.

The Asian Development Bank will, in close cooperation with other development partners, continue to support efforts by Pacific developing member countries to assess and formulate country-specific responses to the global economic crisis. This policy brief is offered as one element of that support.

Sultan Hafeez Rahman
Director General
Pacific Department

SUMMARY

The global economic crisis has hit the Pacific. Lower commodity prices will see export incomes decline, and tourism income and remittances are expected to fall as source economies experience economic recession. Most of the region's public offshore investment funds have declined in value, and some large private sector operations dependent on offshore demand and funding are at risk.

The growth forecasts for most Pacific countries have been progressively downgraded as the depth of the global economic crisis has become more apparent. The economies of the Fiji Islands, Federated States of Micronesia, Palau, Samoa, and Tonga are now projected to contract in 2009. Economic growth is likely to be low elsewhere, the only exceptions being Papua New Guinea, Timor-Leste, and possibly, Vanuatu. Even if the global economy turns around in the second half of 2010, lags mean that conditions will probably be tough in most Pacific economies into 2011.

Governments need to decide if the global economic crisis is a priority for economic management. If so, a proactive, targeted, and coherent policy response would be best. This should be tailored to the individual circumstances of each Pacific economy.

While the full extent of needs will only become clear as impacts unfold, monetary, fiscal, structural, and livelihood issues are likely to be prominent.

A first step in responding to the global economic crisis would be to better track and understand its impact. Reliable and frequent economic and financial monitoring is needed. This is largely in place in some Pacific economies, but in others, monitoring has a narrow coverage and suffers long lags. Economic monitoring is generally backward-looking, a limitation that will hinder early warning of approaching impacts. Effective monitoring is important to both the formulation of a policy response and reducing uncertainty facing businesses and households.

For those countries that operate an independent monetary policy, a cautious monetary expansion would be a sensible second step, where conditions allow it. The level of official foreign exchange reserves is a good indicator of whether there is room to lower interest rates and/or expand liquidity. There is probably room when reserves are above a target 3 to 4 months of imports and reserves are stable. Inflation is also a good indicator of whether a monetary expansion should be considered—the monetary stance should only be relaxed if inflation is under control.

If reserves are below the target and/or falling rapidly, it can be a sign that the exchange rate is out of line with the economic fundamentals. During the 1997 Asian financial crisis, the Fiji Islands and Solomon Islands were able to use exchange rate management to shield themselves from the full impact of the crisis. It is clear that maintenance of a competitive exchange rate will be important to lessening the impact of this crisis. Authorities need to act decisively when there is a substantial misalignment of their exchange rate. The Fiji Islands has already done so through a 20% devaluation in April 2009.

The global economic crisis will add to fiscal pressure. Most 2009 budgets were formulated before the full extent of the global crisis was known, and it is very likely that their revenue forecasts will prove to be overestimates. The best course is to manage pro-actively the fiscal shock.

Governments may want to do more than just manage the fiscal shock. Most of the larger industrialized and emerging countries are implementing fiscal stimulus packages that are increasing government expenditure and/or reducing taxes. A short-lived fiscal stimulus may also make sense in the Pacific as a way of countering the economic slowdown. Here, a fiscal stimulus can be thought of as a deliberate change on either the expenditure or revenue side of the government budget that raises aggregate demand above what it otherwise would be. The primary role of a fiscal stimulus would be to lift internal demand to try and offset the decline in external demand. A secondary role would be to protect the vulnerable that are made worse off, even with the efforts to lift aggregate demand.

It may be possible to cope with the fiscal shock, and where sensible fund a short-lived fiscal stimulus, by trimming low priority expenditure and increasing the revenue effort. This suggests an immediate need to review the composition of public expenditure and to reprioritize less productive or wasteful expenditures—especially on the recurrent side—so they are reined in or eliminated.

The ability to quickly trim low priority expenditure and increase the revenue effort is however likely to fall short of fully meeting the fiscal need. Extra resources are likely to be required. Options include external grants, where made available, and borrowing, where it is affordable.

The composition of public spending would be a crucial element of fiscal management. Investment spending to rehabilitate and upgrade infrastructure, the protection of spending on social sectors—health and education—and support for the vulnerable warrant top priority. Such expenditure needs to be preserved even if revenue envelopes contract, and warrant targeting by any fiscal stimulus that is adopted. Any tax cuts provided as a fiscal stimulus also need to be carefully designed so they offer maximum support to economies and the poor and vulnerable.

These observations highlight that fiscal management needs to be highly prioritized and targeted. It needs to be consistent with overall fiscal prudence and avoid excessive build-up in public debt and pressure on the balance of payments. In some cases, a fiscal stimulus is already in place, not deliberately as a response to the global crisis but because budgets had already allowed for increases in budget deficits. In other cases, the fiscal expansion appears to be too rapid and extra care is needed to ensure it provides value-for-money.

Structural initiatives that enhance the region's competitiveness—such as reforming state-owned enterprises, removing distortions in the tax and duty systems and mobilizing customary land—can also support the region's economies. But many such initiatives carry long lead times, in some cases, decades may be needed to achieve substantive change. Any quick-win initiatives that are available could however be pursed as a means of lessening the economic downturn and helping economies prepare to recover.

Efforts to provide targeted help to the vulnerable, such as establishing social safety nets, have merit. But, like structural initiatives, they face the difficulty of long lead times. The best immediate option for helping the vulnerable is likely to be to limit the decline in economic growth, complemented, where affordable, by a short-lived fiscal stimulus that pays special attention to the needs of the vulnerable.

Development partners have been an important source of support to the region in times of crisis. They can also help the Pacific economies through this global economic crisis. Development partners can support monitoring and policy dialogue, they can fast-track the activities they are involved in, help governments fast-track others, and if

necessary offer prudent budgetary support so as to minimize pressure on the balance of payments.

Budget support is normally provided with conditions. In this instance, an appropriate focus may be to minimize the risk that budget support would work against long-term growth prospects by easing the incentive for governments to improve their performance. Conditions attached to such support could be preventive (as opposed to curative), by for example requiring protection of core social expenditures or preservation of maintenance of physical infrastructure (perhaps on a multi-year basis). Any budget support provided could also appropriately include sunset clauses, so that from the outset it is regarded as a temporary, specific response to the global economic crisis.

THE GLOBAL STORM HAS HIT

The overall impact

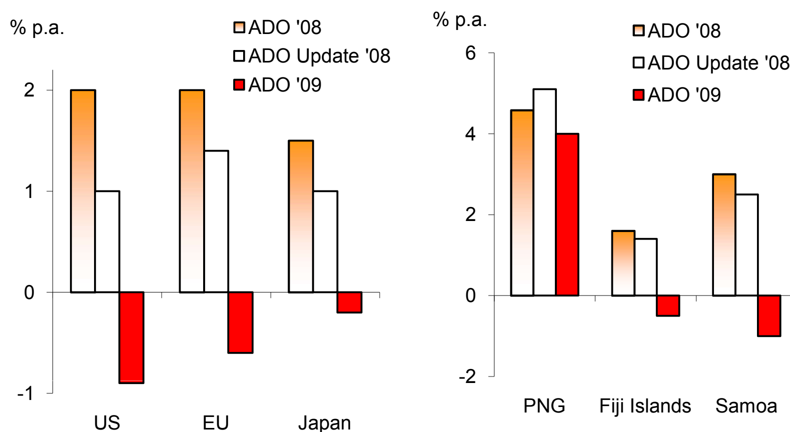
Navigating a Global Storm, released by the Asian Development Bank (ADB) in October 2008, provided an early view of the potential impact of the global economic crisis on the Pacific (ADB, 2008). These impacts are now beginning to show in the economic data. The overall trends are clearly negative, and they are more severe than initially expected.

Some Pacific economies are partially offsetting the impacts of the crisis, such as Papua New Guinea (PNG) and Timor-Leste—they are financing economic activity from the revenue bonanza of the commodity price boom that preceded the global economic crisis. Even so, it is apparent that the Pacific will be heavily affected overall by the global crisis. The sizeable downgrades in economic growth forecasts seen in the world's major economies are now occurring in the region (Figure 1). While country-specific factors are certainly contributing to lower growth forecasts in the Pacific, the global economic crisis is central to a pessimistic outlook now held for 2009 and 2010.

The decline in economic growth in the world's major economies is widely expected to be temporary (Figure 2). The world's major economies are expected to begin

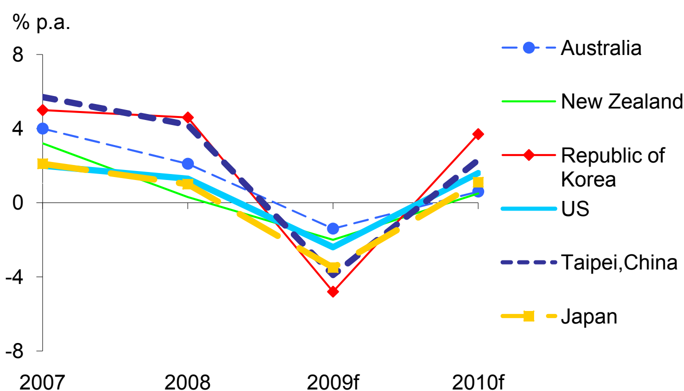
to recover during the second half of 2010. This would begin to reverse the decline in external demand now impinging on the Pacific. This turnaround does, however, hinge on the success of the large fiscal stimulus packages being implemented in the world's major economies. It also depends on how quickly they stabilize and restore confidence in their financial system and get credit flowing again (IMF, 2009a). If the international recovery is delayed, the decline in external demand facing the Pacific will last longer.

Figure 1. Changing forecasts of economic growth for 2009



ADO=Asian Development Outlook, EU=European Union, PNG=Papua New Guinea, US=United States
Note: ADO 2008 was released in April 2008, the ADO Update 2008 was released in September 2008 and ADO 2009 was released in March 2009.
Sources: ADB. Asian Development Outlook. Manila (various editions).

Figure 2. Growth in nearby economies



f = forecast
Sources: ADB (2009); IMF (2009d).

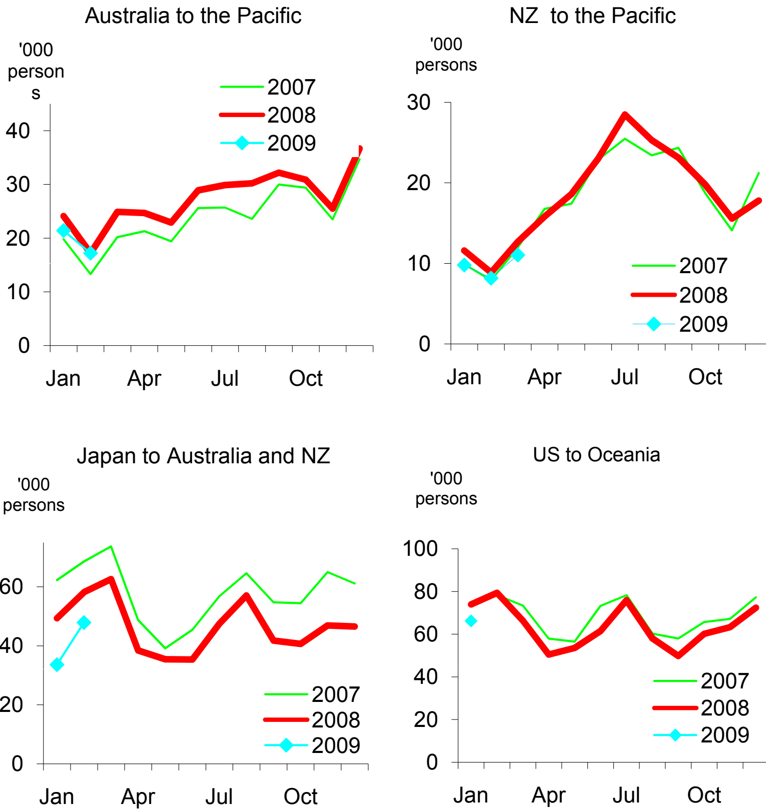
More on the impacts

The main immediate impact of the global economic crisis on the Pacific has been felt via the sharp drop in international commodity prices triggered by the collapse in world demand. Only gold, logs, and phosphate avoided a sharp drop in prices as global economies slowed. Economies that are net importers of the now lower priced commodity prices will benefit. But the net exporters will lose export income (albeit from a boom level). The commodity exporters PNG and Solomon Islands are the most exposed to lower commodity prices. Volumes of commodity exports may also fall in 2009 as external demand slows and as lower prices curb the incentive to produce. Smallholder production of agricultural commodities such as copra, cocoa, and coffee, in particular, tends to fall off quickly when international prices fall.

Tourism arrivals did hold up in most Pacific destinations over 2008. The exception was Palau, which depends heavily on tourism from Asia. Palau saw tourism arrivals decline by about 10% over the year despite a concerted marketing effort in Japan. The observations that tourism numbers held up in most destinations, however, obscures the underlying weakening in the tourism market. Tourism departures from Asia and the United States (US) were weakening even before the global economic crisis (Figure 3). In most Pacific destinations, this was offset by continued growth in tourist departures for the Pacific from Australia and New Zealand and overall numbers stayed up. But the rate of growth in tourism from Australia and New Zealand slowed markedly over the year. Departures from Australia and New Zealand to the main Pacific tourist destinations in the March quarter of 2008 were 24.7% and 11.2% above the March quarter 2007 levels respectively. However, departures for the Pacific from New Zealand in the March quarter of 2009 were 12.5% below the March quarter 2008 level, while departures from Australia over January and February were down 6.5%.

The weakening in tourism arrivals is expected to deepen in 2009 as major source economies weaken and as exchange rate appreciation in the region has adverse effects. Tourist arrivals in the Cook Islands, Samoa, and Tonga are at risk of falling in 2009, given New Zealand's importance to these countries (although special sporting events may help Cook Islands avoid an overall decline). The Fiji Islands and Vanuatu may also record a decline in tourist arrivals from Australia as households reduce their discretionary expenditure. A key consideration will be the consequences of political developments in the Fiji Islands and whether there will be spillovers for other Pacific destinations (e.g., Vanuatu appears to receive more tourists when there are problems in the Fiji Islands).

Figure 3. Departures to the Pacific and Oceania

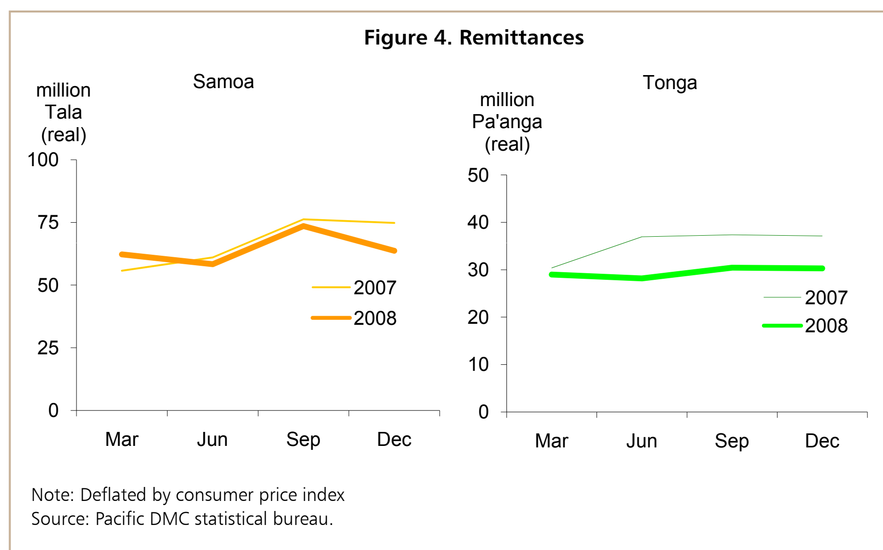


y-on-y=year on year.
Notes: NZ = New Zealand; US = United States; Pacific destinations are Cook Islands, Fiji Islands, Samoa, Tonga, and Vanuatu.
Sources: Australia Bureau of Statistics, www.abs.gov.au, downloaded 10 March 2009; New Zealand Ministry of Tourism, www.tourismresearch.govt.nz, downloaded 10 March 2009; United States Office of Travel and Tourism Industries.

Remittances from Pacific Island families and workers abroad declined noticeably over 2008 in real terms. Exchange rate movements and high inflation were important factors, in addition to developments in overseas labor markets. In Samoa, the decline in the real value of remittances was only noticeable in the final quarter, while in Tonga, the decline was evident from the June quarter (Figure 4). In the Fiji Islands, remittances declined from about 5% of gross domestic project (GDP) in 2007 to an estimated 3.3% of GDP in 2008. The labor markets of New Zealand and US, two of the three key sources of remittances for Pacific countries, progressively weakened over 2008 as they moved to

economic recession. The labor market in another major source of remittances, Australia, followed later as it also moved toward economic recession. Conditions for maritime workers and other overseas workers are also reported to have softened as global trade slows. The weakening in overseas labor markets means the decline in the real value of remittances may become more pronounced in 2009. Samoa and Tonga are the most exposed to this offshore deterioration, with the Federated States of Micronesia (FSM), the Fiji Islands, Kiribati, and Tuvalu also exposed.

Figure 4. Remittances



Note: Deflated by consumer price index
Source: Pacific DMC statistical bureau.

Five economies—Kiribati, Republic of the Marshall Islands (RMI), FSM, Palau, and Tuvalu—have substantial public savings invested in offshore equity markets. As world stock markets plunged, so did the value of the stocks in the trust funds. For FSM and RMI, their trust funds are only to be used over the long term. Their market value is likely to largely recover, if not completely, by the time they are needed. The situation is, however, different elsewhere.

Tuvalu’s financial buffer, the Consolidated Investment Fund, is normally topped up by either external grants or by distributions from the Tuvalu Trust Fund. The Tuvalu Trust Fund is heavily invested in offshore equities, and can only fund new distributions when its market value is above a target minimum. Distributions may be many years away, and there is a need to react now to conserve the funds currently held in the Consolidated Investment Fund. Kiribati is already using its investment Fund, the Revenue Equalization Reserve Fund, and, to a lesser extent Palau, its Compact of Free Association Trust Fund, to help fund government expenditure.

It appears that Kiribati, Palau, and Tuvalu are yet to reduce their public spending to compensate for the decline in the market value and expected income from their trust funds. While the absence of adjustment has the positive effect of helping support demand in these economies for now, it will come at a price. Without corrective action, their funds will be drawn down at an excessive rate. This may even see national assets, accumulated with much effort to secure economic sustainability, set on a long-term path toward depletion.

Implications for the Pacific

The transmission mechanisms that will see these adverse developments disperse through the Pacific economies include:

(i) Declining prices of agricultural commodities will quickly lower incomes for smallholders and plantations, and as logging prices fall, so will logging incomes. Rural areas dependent on tourism will experience a decline in incomes as fewer tourists arrive, or spend less;

(ii) Household spending will decline as rural incomes weaken, and as the flow of remittances declines;

(iii) The demand for transport and other goods and services used in rural production will weaken, affecting a range of rural businesses in formal and informal sectors;

(iv) Urban economies will weaken as demand from rural areas slows, as remittances to urban households decline, and as demand weakens for the tourism and other services based in the main centers, such as international shipping;

(v) Private investment will slow as economies slow and as lower commodity prices, weaker external demand, and potential difficulties in accessing investment funding affect project viability. Projects that are either export oriented or otherwise reliant on overseas demand are most at risk;

(vi) Government revenues will decline as private expenditure and incomes decline. Mining and oil projects, facing lower international prices, will also pay less government revenue. If governments are to avoid deterioration in their fiscal position, they will need to contract or slow growth in government expenditure. Labor and business engaged in the provision of public services will be affected; and

(vii) Living standards will begin to deteriorate. For example, poverty is likely to rise as incomes decline, children may be withdrawn from school because fees can no longer be afforded, and mobile health services may become more infrequent.

Updated economic growth forecasts for the Pacific economies are presented in Figure 5. Almost all growth forecasts have been downgraded because of the global economic crisis.

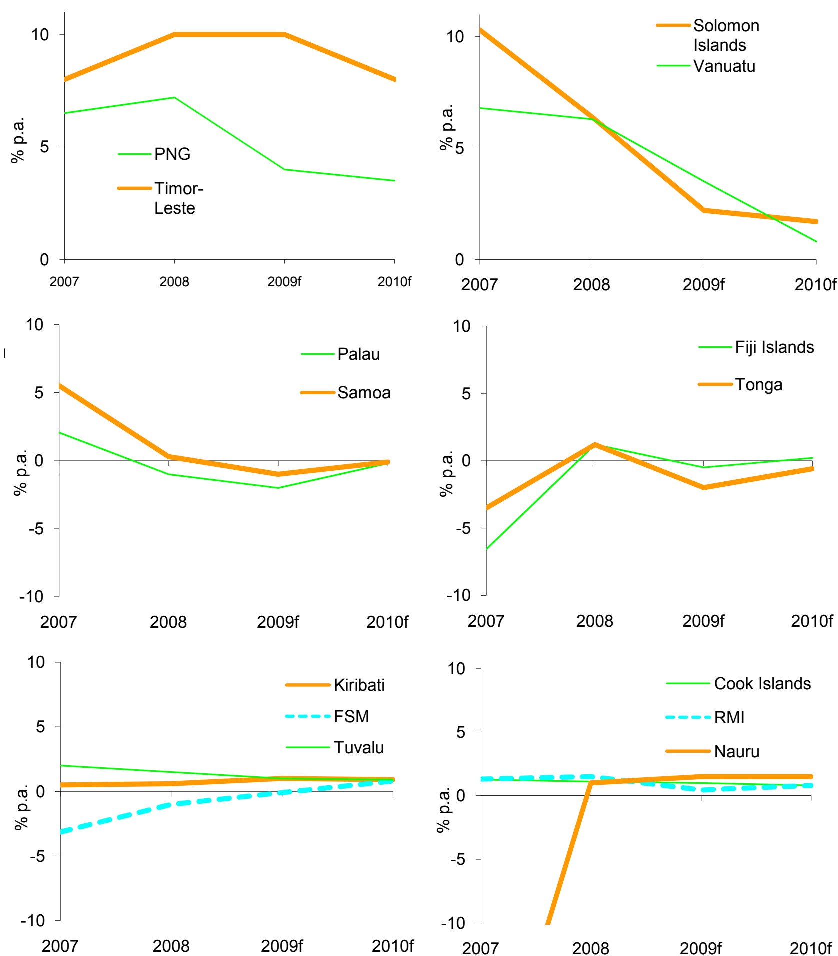
Lower oil prices will provide inflationary relief and also ease pressures in some countries on the balance of payments in the first half of 2009. But any relief will be temporary and it is important to avoid the emergence of a false sense of security. Economic growth is expected to be down overall in 2009. Overall, the Pacific economies grew at an estimated 5.1% in 2008. In 2009, overall growth is expected at only 3.0%. An economic contraction (i.e., negative growth) is projected in the Fiji Islands, FSM, Palau, Samoa, and Tonga, and economic growth is expected to be low in most other Pacific economies. Even if the global economy turns around in 2010, lags mean that economic conditions will be tough in the Pacific in 2010 and problems may continue into 2011.

Only Timor-Leste, PNG and possibly Vanuatu are expected to continue to grow at adequate rates over 2009. Governments in PNG and Timor-Leste are now spending revenue saved during the boom period of high commodity prices. This is helping support their economies during 2009 and into 2010. In these two economies, the income growth needed to help lift living standards and reduce poverty will continue for now, albeit at a slower rate in PNG. Real estate development and tourism remain firm in Vanuatu, partly because tourists appear to be diverting from the Fiji Islands, and this is expected to result in moderate growth in Vanuatu.

The key concern is that slow economic growth or an economic contraction will lead to a reversal of hard-won gains in living standards.

The Pacific economies expected to contract in 2009 are the Fiji Islands, Palau, Samoa, and Tonga. In the Fiji Islands, where poverty was probably on the rise even before the global crisis, the weak outlook for tourism and remittances will add to the negative effects of political developments and structural problems in the sugar and garment industries. In Palau, the contraction is due to the expected weakening in tourism from Asia, the flow-through to new tourism-based investment and uncertainty arising from the end of existing financial support arrangements from the US. In Samoa, weaker remittances and tourism combined with cutbacks at the major manufacturing operation are expected to see the economy contract. Declines in remittances and tourism are also expected to slow the economy of Tonga, adding to the weakness in agriculture (ADB, 2009).

Figure 5. Economic growth forecasts for the Pacific



f = forecast, FSM=Federated States of Micronesia, PNG=Papua New Guinea, RMI=Republic of the Marshall Islands

Note: GDP growth for Nauru in 2007 was -27.3%; growth in non-oil, non-United Nations GDP is shown for Timor-Leste.

Source: ADB (2009).

Solomon Islands did not generate the savings during the recent commodity boom of the other commodity-intensive economies. It now faces a rapid decline in economic growth as log harvesting slows. Major new developments may be deferred because of the external deterioration.

Economic growth is expected to be low or negative elsewhere. Preparations for special sporting events and rising government expenditure are projected to see positive but low growth in the Cook Islands. A reliance on stable external grants and drawdowns from public savings, which have reached unsustainable levels in some cases, is expected to support low growth in Kiribati, RMI, and Tuvalu.

The lagged impact of external developments and the prospect that the flow through to the Pacific may be even more severe than originally anticipated, mean that these forecasts may well prove conservative. It is possible that the full impact of the global economic crisis may be even larger in 2010 than in 2009. Importantly, more Pacific economies may contract than forecast.

SETTING A COURSE

The intensification of the global economic crisis since September 2008 has surprised most observers. Economists' consensus forecasts of global growth have proved to be overoptimistic as more bad financial and economic news has broken. Considerable uncertainty remains as to the ultimate depth of the economic downturn and its duration. The Pacific economies will have to manage their economies over 2009, 2010, and into 2011 in rough conditions and atypically high uncertainty.

Meeting this economic policy challenge will require urgent but careful assessments of the need and capacity to undertake remedial, prioritized policy actions. These actions are best planned and implemented as a single, coherent response to the domestic impacts of the global economic crisis. A proactive response is called for. Fragmented, ad-hoc, and reactive responses are best avoided.

The prime economic problem imposed on the Pacific by the global crisis is an externally induced, demand-side driven, short-run slowdown in growth. While the severity of the problem varies between Pacific economies, the nature of the problem is shared.

The key policy issues then are whether there is room and capacity for effective counter-cyclical policies, and whether responding to the global crisis is a policy priority.

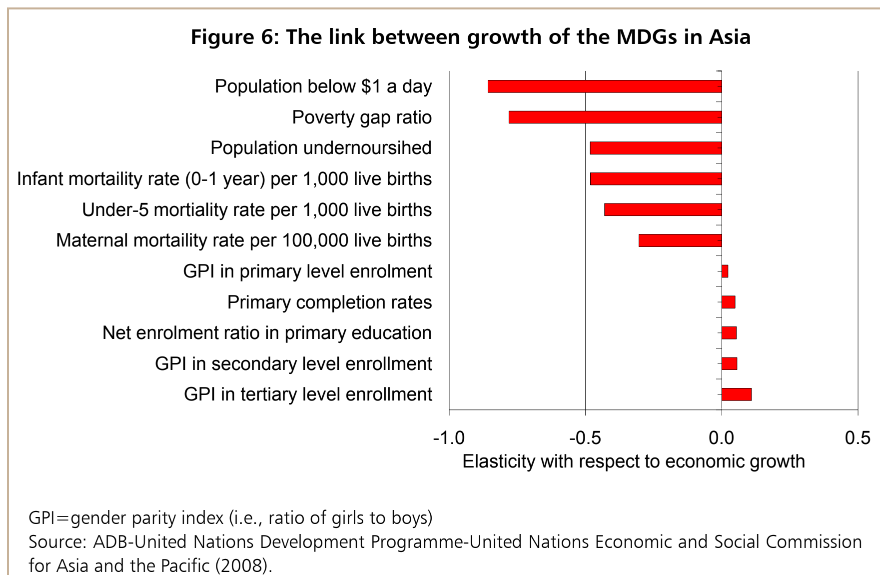
In economic terms, there are both equity and efficiency reasons for minimizing cyclical downturns. A slowdown in economic growth will slow progress in reducing hardship and make some people worse off. Analysis by the United Nations Development Programme of the region's household income and expenditure surveys suggest that a 1% decline in real incomes can increase the number of people living below the poverty line by 0.5 percentage points on average. So, if, for example, 30% of the population were living below the poverty line and the global economic crisis then reduced real incomes by 5%, the share of the population below the poverty line could rise to 32.5%. In the worst case, the drop in incomes could force some into poverty traps that turn a short-term shock into a long-term problem. The adverse impacts are likely to fall more heavily on some community groups than others. In particular, the work of the United Nations Development Programme has highlighted the extra vulnerability of households headed by women and the elderly.

More broadly, the global economic crisis has the potential to either slow progress in achieving the Millennium Development Goals (MDGs), or to add to their underachievement. This is because the global crisis will reduce (below what they would otherwise be) household incomes and the revenue available to government to provide public services. The potential loss of public services means that even those that are living subsistence or near subsistence lifestyles and are remote from the cash economy, and are therefore not directly affected by the economic slowdown, may be indirectly affected. Numbers living a subsistence lifestyle may even rise as the informal and formal sectors weaken. While the subsistence sector would provide a good safety net for those with enough land and marine resources and readily available food, the move back into subsistence would represent a loss in welfare for most. If the global crisis is severe enough, earlier progress towards the MDGs may even be reversed. For most of those living in neighboring high-income countries, the global crisis may mean the loss of an overseas holiday or the latest electronic item, or a two-car family becoming a one-car family, or some other cut-back in non-essential expenditure. In contrast, the impacts are potentially grave in low income countries. A growth slowdown can turn a three-meal a day family into a two-meal a day family, or make attending school or travel to basic medical care unaffordable.

The sensitivity of the MDGs to a slowdown in economic growth is also evident from empirical work from Asia. Elasticities have been calculated that show the percentage change in key indicators for 1% of economic growth (Figure 6). So, for example, in Asia, economic growth of 1% is estimated to reduce the share of people living below the poverty line by almost 0.9%. The opposite would approximately apply. For example,

in Asia, an economic contraction of 1% could increase by almost 0.9% the percentage of people living below the poverty line. While these elasticities would not apply exactly to the Pacific, they are suggestive of likely orders of magnitude.

Figure 6: The link between growth of the MDGs in Asia



GPI=gender parity index (i.e., ratio of girls to boys)
Source: ADB-United Nations Development Programme-United Nations Economic and Social Commission for Asia and the Pacific (2008).

On the efficiency front, an economic slowdown will impose adjustment costs on an economy and there is some potential, if the slowdown is deep enough, for it to push an economy onto a low growth path. For example, releasing workers now can lead to extra costs in retraining staff as economies recover, or of re-establishing marketing and distribution networks that were lost during the economic downturn. Idle equipment imposes costs that can be difficult to recover. Investment plans for new or expanded private sector projects can be disrupted, and the costs incurred in preparing proposals can be lost. The investment in human capital can slow, placing extra limits on the ability of an economy to recover when external demand improves. Those in the informal sector may consume the assets they rely on (e.g., by selling or consuming livestock or selling production, processing, or transport equipment) and face high barriers to reacquiring these assets later (e.g., because of the time taken to produce new livestock or because microfinance agencies closed down during the slowdown or don't exist).

It is significant that the stress from the global crisis will follow that caused by the recent surges in commodity prices. Households that were sellers of what became higher price agricultural commodities were probably better off after the surge in prices, substantially so in some cases. But many, if not most households would have had their real incomes eroded by the very high inflation rates of 2008 that resulted from high

commodity prices (and in particular high prices of fuel and food). While the negative repercussions of the high prices are yet to be fully understood, it is a reasonable expectation that in 2009 there is a heightened vulnerability to the adverse effect of an economic slowdown.

Economies that contract (i.e., experience negative growth) over 2009 and 2010 are likely to be the most exposed, namely the Fiji Islands, Palau, Samoa, and Tonga. While this will hopefully be a short-lived economic contraction, many community members in these countries are likely to face a decline in living standards, which may result in a rise in poverty. In contrast, economies that will continue to grow are better placed to continue to make progress, albeit at a lower rate, in lifting living standards and reducing poverty—the situation facing PNG, Timor-Leste and Vanuatu is therefore less intense than elsewhere in the region.

The primary need across the region is to minimize any economic contraction or reduction in the rate of economic growth. Economies should be able to live with less for a while, so policy probably does not have to respond to a slight economic slowdown. But a sizeable economic slowdown should trigger a policy response. As represented at Figure 7, the challenge is to adopt a quick impact response that reduces the negative effect on economic growth of the global crisis. This would normally be undertaken by counter-cyclical demand management that helps lift aggregate demand in the economy. While not captured in the figure, there is also a need to pay special attention to the needs of the vulnerable, particularly if their relative position is made even worse by the economic slowdown. There is also a need to avoid the short-term response creating problems for the long-term growth outlook.

This situation facing economies now can be contrasted with an economy that has a poor outlook because of deep structural weaknesses. This is the situation normally of most concern in the Pacific. Such structural weaknesses could include inefficient or too little infrastructure, the absence of an enabling environment for the private sector or high waste in government spending. Figure 8 shows an economy where adverse structural factors dominate cyclical factors. For this case, structural initiatives need to be pursued to overcome poor growth outcomes. This is despite the pursuit of structural initiatives often carrying a growth trade off. The trade off arises as structural initiatives normally take some time to generate benefits while often imposing net costs in the short term because of adjustment costs incurred in implementation. For such a situation, the policy priority would be structural reform rather than counter-cyclical policies.

The looming downturn now faced across the Pacific is caused by weakening aggregate demand. This potentially brings economic management into the realm of counter-cyclical demand management. Figure 9 presents a stylized representation of the situation. It shows the potential gains from counter-cyclical policy, i.e., the economic

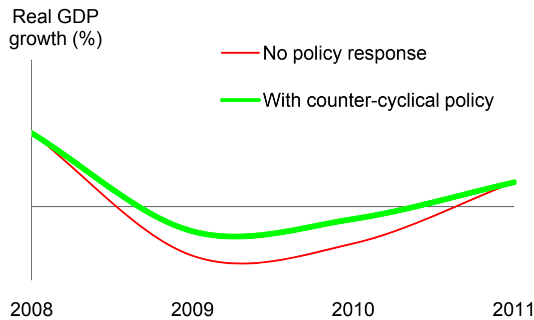
downturn is reduced. It also shows a growth outcome when structural initiatives take some time to generate benefits while incurring short term adjustment costs. The "gain from the pain" of the pursuit of such longer term structural initiatives may only be evident after the worst of the global crisis impacts has been felt. In the figure, structural initiatives that have a longer term horizon only improve the growth outcome in 2011, after the economy has rebounded from the global economic crisis. In contrast, counter-cyclical or any structural initiatives that were able to offer a quick win–i.e., an immediate boost to economic growth with little or no downside—would address the immediate economic needs as they could improve on the growth outcome over 2009 and 2010.

There may even be a case for pausing on any longer term structural initiatives if they will add to economic stress over 2009 and 2010. Economic management could instead refocus attention on counter-cyclical demand management and any quick-win structural initiatives. The case for pausing on longer term structural initiatives is strongest for those economies facing a short-term economic contraction.

This observation gives rise to the important issue of policy prioritization. Responding to the global economic crisis is only one of many policy issues facing the Pacific economies. The resources available to formulate and then implement improved public policy are limited—including the human and political capital and financial resources—and therefore should not be dissipated on low priority issues. Trying to do too much on the public policy front is like building two houses when there is only enough building materials for one—in the end there will be no house no matter how noble the intention.

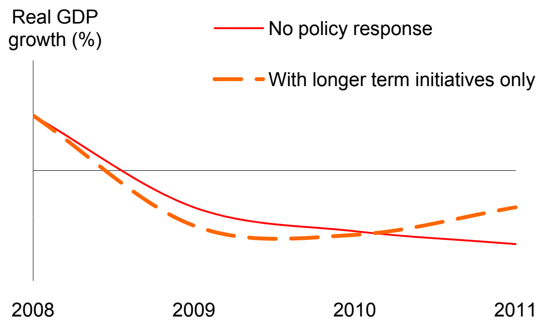
Before setting course on a response to the global economic crisis, it is important to clarify where the issue sits among the range of public policy issues needing attention. For example, for some Pacific economies, the long-term challenges of climate change may be uppermost and the cost of deferring action so as to respond to the global crisis may be too high to contemplate. In some economies, structural issues may be so debilitating that they overwhelm the needs arising from the global economic crisis. In which case, there may be no room to accommodate a counter-cyclical response to the global economic crisis. In some, the global crisis may be serious enough to justify a reorientation of economic initiatives toward the challenges it imposes, but without foregoing any existing initiatives. And yet elsewhere, the need to prepare a targeted response to the global economic crisis may be so strong that the pursuit of other initiatives should be put on hold. The choice of the right course will depend on individual country circumstances and a country's own value judgments on its development priorities.

Figure 7: Stylized growth paths—the global crisis



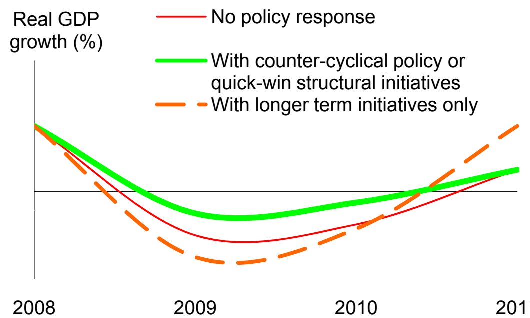
Note: The horizontal axis can be viewed in different ways. It can be viewed as showing zero growth, the growth rate expected in the absence of the global crisis, or the long-run potential or actual growth rate.
Source: ADB.

Figure 8: Stylized growth paths—when structural factors dominate



Note: The horizontal axis can be viewed in different ways. It can be viewed as showing zero growth, the growth rate expected in the absence of the global crisis, or the long-run potential or actual growth rate.
Source: ADB.

Figure 9: Stylized growth paths—the global crisis again



Note: The horizontal axis can be viewed in different ways. It can be viewed as showing zero growth, the growth rate expected in the absence of the global crisis, or the long-run potential or actual growth rate.
Source: ADB.

AT THE WHEEL

Once a broad course of action has been set, detailed policy initiatives need to be formulated. This section looks at those initiatives that would reduce the impact of the global economic crisis. The initiatives are ordered sequentially. That is, it discusses first the initiatives that make sense to pursue first, either because they are easy to implement and have a relatively quick impact or lay the foundation for further action. The initiatives that are probably the most difficult or time consuming to undertake or are likely to take longer to show benefits are discussed last. Not all policy initiatives suit every Pacific economy and this is brought out in country-specific discussion. Each economy should tailor any action plan for responding to the global crisis to its own circumstances.

The discussion of policy initiatives draws on the international response to the global economic crisis, that are discussed at Annex 1. The Annex also looks back to the lessons in the Pacific from the 1997 Asian financial crisis, a period that has many parallels to the current crisis.

Policy Formulation

Share information and encourage open dialogue. One of a government's key roles as economic manager is to collect and share economic information. Governments and monetary authorities gain credibility by clearly articulating their policy objectives and how well they use their policy instruments to achieve these objectives. Doing so reduces uncertainty on the direction on the economy and on government actions. This would help the public in forming their expectations on macroeconomic variables (e.g., economic growth, inflation, and exchange rate) as well as financial and credit conditions.

In this case, a lack of reliable information on the impact of the global economic crisis will add to uncertainty in the minds of business people, households, and suppliers or labor. Such uncertainty would present an impediment to economic activity. Businesses can become even more reluctant to expand their operations and to employ people. Informal business activities, even smallholders engaged in cash cropping, can slow down because of uncertainty, just like formal businesses. Decisions to cultivate a new plot of land or go to the nearby town to purchase stock for the family kiosk or shop may be impaired by uncertainty in future conditions. Households may defer major decisions and trim items from their budgets, such as school fees or house improvements.

For some Pacific economies, this is an opportune time to enhance the collection of robust and timely economic data. Such enhancements will help monitor the impacts of the crisis and can be used to help design a policy response. The crisis means it is also important to encourage open dialogue between the government and the public. Finance ministries and central banks can use their existing networks of engagement with the business sector and the broader community to do so. This will deepen engagement with the public and help strengthen both the demand and supply of essential policy and institutional reforms.

The simplest policy initiative to take in response to the global crisis is thus to widely share information on the state of the economy and the formulation of economic policy. In some Pacific economies, frequent economic monitoring is largely in place. For example, there are fortnightly, monthly, and/or quarterly public releases of economic information, from sales and prices in the central produce market to detailed information on monetary conditions. In other Pacific economies, the information is too aggregated, too infrequent, or in some cases absent. In all cases, economic and financial monitoring is generally backward-looking, a limitation that will hinder early warning of approaching impacts. More can be done on regional monitoring, to better understand the broader trends that drive country-level impacts. Use of out-of-country data from statistical bureaus of neighboring economies offers a way to quickly obtain reliable, high frequency data of both key external developments and conditions within the Pacific (Pacific Department, 2009).

Openness in policy dialogue can be provided in a variety of ways. The public release of policy papers, news releases, and presentations to workshops and conferences are commonly used options. Regular presentations to the media and business organizations, even informally, can also help generate the dialogue needed to reduce uncertainty. Samoa for example held a Government Stimulus Forum on 27 March 2009 to prepare, with private sector and community support, recommendations to Cabinet on a response to the global economic crisis. Such dialogue can also be helpful in providing insights on economic developments that can improve economic management.

Monetary policy

Adopt a careful monetary policy stance. Expansionary monetary policy provides one of the quickest ways to provide some support to aggregate demand. Within the Pacific economies, changes in monetary policy are normally implemented through changes to benchmark interest rates (only the Fiji Islands, PNG, Samoa, Solomon Islands, Tonga and Vanuatu operate an independent monetary policy). Interest rates can be relaxed to lower business operating costs and make business investment more affordable. Lower interest rates may also help households spend more. Central banks normally reduce interest rates by lowering official rates, lowering discount rate, and increasing liquidity in the banking system, for example by easing reserve requirements or buying back official securities. If conditions are right, a careful easing in monetary policy may be manageable to partially offset the decline in external demand caused by the global economic crisis.

There have already been adjustments to the monetary setting in response to the new economic conditions. The Central Bank of Samoa cut its lending rate to commercial banks from 7.8% to 5.0% in February 2009. The Reserve Bank of Fiji also acted to ease liquidity constraints by reducing the statutory reserve deposit ratio from 6% to 5% effective from 7 April 2009. And the Reserve Bank of Vanuatu reduced the statutory reserve deposit ratio in November 2008, and then in January 2009 relaxed the liquid asset ratio and introduced a secured advance facility for banks.

Monetary policy can only be safely eased when demand can be increased without placing excessive pressure on import demand and hence the balance of payments, and when inflation is not a threat. An overly expansionary monetary policy will force adjustments elsewhere, potentially even exchange rate devaluation. The reserve, inflation and current account position of the Pacific economies is summarized at Table 1. While expectations of a decline in inflation over 2009 and into 2010 give some comfort that a careful monetary expansion can be undertaken, this need to be seen in the broader context of rising pressure on the balance of payments in most economies. In some economies, notably Samoa, Tonga and Vanuatu, there has recently been considerable

growth in private sector credit and there may be little if any capacity to cope with further credit growth.

Table 1: Key economic indicators

	Official foreign reserves (months of imports)		Inflation (annual average, %)		Current account balance (% of GDP)	
	End-2007	End-2008	2008	2009p	2007	2008
Cook Islands			7.8	5.1	6.2	4.5
Fiji Islands	4.4	2.9	7.7	4.5	-17.3	-21.0
FSM			5.0	2.9	-12.8	-20.4
Kiribati			11.0	6.5	-75.4	-72.6
Nauru			4.5	3.3	-9.8	
Palau			12.0	6.4	4.6	
PNG[a]	13.0	10.9	10.8	7.0	2.0	8.7
RMI			17.5	9.2	-27.7	-26.0
Samoa	4.7	4.4	11.5	7.0	-4.3	-10.2
Solomon Islands	3.7	2.5	16.5	8.6	-2.6	-4.9
Timor-Leste			7.6	7.1	348.3	
Tonga	4.4	4.8	9.9	6.2	-10.1	-10.8
Tuvalu			5.3	3.7		
Vanuatu	7.0	5.8	5.8	3.9	-9.9	-11.4

f=forecast, FSM=Federated States of Micronesia, GDP=gross domestic product, PNG=Papua New Guinea, RMI=Republic of the Marshall Islands, blank=not applicable/available.
a Months of non-mining and oil imports.
Source: ADB (2009), Reserve Bank of Vanuatu and staff estimates.

The situation is clearly already extremely tight in the Fiji Islands and Solomon Islands. Their official foreign reserves are below target levels (a typical target level of reserves is 3 to 4 months worth of imports). Additional pressure can be expected from declining merchandise exports and, for the Fiji Islands, from declining tourism receipts and remittances. The Solomon Islands probably lacks the room for even a mild monetary expansion given low reserves and very weak export outlook.

Any monetary expansion needs to be undertaken against a backdrop of sound prudential regulation of the banking sector. Pacific banking and financial systems have been funded largely domestically and regionally, and to date have been shielded from a direct credit crunch. There is no need in the Pacific to bail out the region's banks or for governments to take a larger stake in the banking sector. However, the ongoing global liquidity shortage and increased risk aversion may have an indirect impact on the branch operations of foreign banks via their effects on balance sheets if the economic slowdown increases domestic loan default rates. Sound prudential supervision by the monetary authorities of bank and nonbank financial institutions is important as a means of providing early warnings of any developing financial distress. The need extends to the national provident funds that are increasingly engaging directly in major private developments and lending to business and households.

While monetary policy is a potentially useful tool for macroeconomic management in the Pacific (where an independent monetary policy can be operated), it does not have the influence it does in many other regions. In the Pacific, demand is not as sensitive to interest rate changes as elsewhere, the financial sector is not as extensive or as well developed and some of the central banks are yet to receive the operational autonomy needed to maximize their effectiveness. Monetary policy can help, but other policy initiatives will probably also be required to achieve a countercyclical response to the global economic crisis.

Exchange rate management

Maintain a competitive exchange rate. A competitive exchange rate is an essential requirement in times of macroeconomic stress. The Fiji Islands and Solomon Islands successfully reduced the impact of the 1997 Asian financial crisis by devaluing their exchange rates (Annex 1). While the circumstances of 1997 are different and an exchange rate adjustment may not have the same quick, positive effects as before, the exchange rate remains a critical tool of macroeconomic management (for Pacific economies that use their own currency under a fixed exchange rate regime, and even potentially in PNG given its managed float).

This time, countries have had to contend with large changes in cross-rates in key currencies (e.g., the Australian dollar depreciated by more than 30% against the US dollar) and have tended to maintain stable, nominal, weighted average exchange rates. Pacific economies that either use the US dollar or have a heavy weight in their exchange rate baskets for the US dollar, have tended to appreciate against the Australian dollar and New Zealand dollar. The high inflation rates in 2008 in most Pacific economies added to the appreciation in the real exchange rate. This has resulted in a loss in competitiveness against some important economies. This will be a potentially important issue for those that are reliant on tourism from Australia and New Zealand. In April 2009, the Reserve Bank of Fiji devalued the Fijian dollar by 20%, in part to offset the appreciation against the Australian dollar and New Zealand dollars.

A trend decline in foreign reserves is a simple, but normally meaningful indicator of whether an exchange rate is competitive. When reserves fall substantially below target levels, or are expected to do so soon, the case for exchange rate adjustment becomes more pressing. Use of official foreign exchange reserves level as an indicator of whether the exchange rate setting is appropriate ought to be augmented by other indicators on the financing side. Additional indicators include the openness of financial accounts, the stock of liquid short-term liabilities, access to short-term borrowing facilities overseas, and seasonal trends of exports and imports.

Maintenance of a competitive exchange rate requires coordinated actions on several fronts. Perhaps most importantly, exchange rate management needs to be coordinated with fiscal and monetary management so the overall macroeconomic stance is consistent and sustainable. For example, if monetary policy becomes too expansionary or domestically financed fiscal expansions are too large, they will probably need to be accompanied by a devaluation of the exchange rate. In the worse case, a spiral of devaluation may be forced on an economy if the exchange rate is required to undertake the work of other policy instruments. Structural policy also needs to be supportive of the exchange rate setting, and in particular, to support the emergence of the supply response needed to realize the full benefits of a competitive exchange rate. A firm stance is needed on excessive increases in wages and salaries (i.e., increases in excess of productivity growth). They need to be resisted as they lead to an appreciation of the real exchange rate and a loss of international competitiveness.

Fiscal policy

Pro-actively manage the fiscal shock. The global economic crisis will add to fiscal pressure. Most 2009 budgets were formulated before the full extent of the global crisis was known, and it is very likely that their revenue forecasts will prove to be overestimates. In some cases, the Solomon Islands being an example, the revenue forecasts had already proven over-optimistic by early-2009. Fiscal space is likely to shrink as the global crisis results in revenue collections falling below forecasts. Financial stress may also lead to the realization of governments' contingent liabilities (such as loan guarantees for state-owned enterprises or subsidies for airlines), further shrinking the fiscal space if it leads to immediate financial costs. Budgets may move from surplus to deficit or projected deficits may widen because of the fiscal shock (in the absence of corrective action).

Governments may have to work hard to manage the fiscal shock. A key risk is that expenditure cuts made to fit a smaller revenue envelope may fall too heavily on key activities, such as maintenance or delivery of essential services.

There are a number of ways a fiscal shock could be managed. Governments could trim low priority expenditure and raise the revenue effort. This suggests an immediate need to review the composition of public expenditure and to reprioritize less productive or wasteful expenditures—especially on the recurrent side—so they are reined in or eliminated. On the revenue-raising side, more vigorous efforts could be made to improve tax administration, including the prosecution of tax evasion. And the drain on the budget from inefficient state-owned enterprises could potentially be diminished through acceleration of reform programs.

The ability to trim low priority expenditure and raise the revenue effort may fall short of fully meeting the need, and extra fiscal resources may be needed. Whether this

is the case will very much depend on the speed and intensity of the economic slowdown. If Pacific governments are to avoid being caught on the 'backfoot' in the face of a rapidly unfolding crisis, it is best to at least plan for the possibility that extra resources will be required to manage the fiscal shock.

Options for securing extra resources include accessing external grants, where made available, and borrowing, where affordable. External grants are an important source of funding in the Pacific. They provide the extra goods and services or the foreign exchange that can allow government expenditure to take place with minimal, if any, pressure on the balance of payments. Pacific governments can be confident they can afford to meet the fiscal shock from any external grants made available for this purpose. However, borrowing to fund a wider budget deficit is a different matter. Whether it would be affordable can only be assessed on a case-by-case basis.

External borrowing from reputable agencies provides extra foreign exchange that can minimize any pressure on the balance of payments. The ability to secure concessional financing terms backed up by technical support are further positives. The offering of diaspora bonds to overseas communities at a "patriotic" discount, with coupon payments in local currency (as in Israel, India, and Philippines), might offer a longer-term means by which governments could look beyond existing funding sources. But external borrowing will be unaffordable if public debt levels and debt servicing costs are already too high. What constitutes "too high" varies from country to country. In a normal economic situation, a good guide is that external public debt of more than 30% of GDP in weak policy and institutional settings is too high, while more than 50% of GDP is "too high" in stronger settings. In this situation of a temporary growth slow down, it may even be justifiable to move somewhat beyond these limits over the short term, if borrowing is sound.

Domestic borrowing indirectly places pressure on the balance of payments because it raises domestic demand, and hence import demand, without providing the foreign exchange needed to meet this extra import demand. Pacific economies that already have balance of payments problems need to approach extra domestic borrowing cautiously. As for external borrowings, it would be imprudent to borrow domestically if debt levels were already too high.

Provide a short lived, value-for-money fiscal stimulus. Governments may want to do more than just manage the fiscal shock. Most of the larger industrialized and emerging countries are implementing fiscal stimulus packages that are increasing government expenditure and/or reducing taxes. A fiscal stimulus may also make sense in the Pacific as a way of countering the economic slowdown. Here, a fiscal stimulus can be thought of as a deliberate change on either the expenditure or revenue side of the government budget that raises aggregate demand above what it otherwise would be.

The primary role of a fiscal stimulus would be to lift internal demand to try and offset the decline in external demand (that is primarily impacting on the region via reduced income from exports of goods and services and via reduced remittance flows). A secondary role would be to protect the vulnerable that are made worse off, even with the efforts to lift aggregate demand.

It may be possible to provide a short-lived fiscal stimulus by making better use of existing resources. That is, by reallocating existing resources to uses that will make a larger contribution to the region's economies over the short term. A decision to pursue a fiscal stimulus would add further impetus to efforts to review the composition of public expenditure and to reprioritize less productive or wasteful expenditures. Action to make better use of existing resources would be a sensible precautionary action, but extra funding sources will probably be needed to provide a concerted response to the global crisis. Again, options for securing extra resources include accessing external grants, where made available, and borrowing, where affordable. As discussed above, whether borrowing would be affordable can only be assessed on a case-by-case basis.

The composition of any additional public spending undertaken would be crucial. Investment spending to rehabilitate and upgrade infrastructure and the protection of spending on social sectors—health and education—and support for the vulnerable warrant top priority. Even if the economic downturn is successfully limited, some groups are likely to be more affected than others, and some may require extra support (e.g., a fiscal stimulus that funded road maintenance in rural areas may offer little help to those that lose jobs in urban-based manufacturing). Any tax cuts also need to be carefully designed so they offer the maximum support to economies and the poor and vulnerable.

Any short-lived fiscal stimulus needs to be mindful of the potential to run counter to longer-term needs. So, for example, a fiscal stimulus that creates a new permanent program that is unaffordable over the long term is undesirable. Nor should the global economic crisis be used as an excuse to introduce or reintroduce public expenditure programs that are generally regarded as inappropriate.

Further thoughts on how to prepare a fiscal stimulus are provided at Annex 2. It is clear that case-by-case analysis is required to understand the best way of using a fiscal stimulus in an effort to try and limit the growth slowdown.

Structural Policy

Continue structural initiatives. Recent structural initiatives in aviation and mobile telecommunications in the Pacific have proven that reforms that increase competitive pressures and allow the private sector to take on roles normally reserved for government can quickly boost economic growth. And they can do so with little, if any, direct cost to the budget.

In aviation, the key structural initiatives have been the entry of Virgin Blue-linked operations in Cook Islands, the Fiji Islands, PNG, Samoa, Tonga, and Vanuatu, and the contracting out of international operations of Solomon Airlines. In mobile telecommunications, the entry of Digicel in PNG, Samoa, Tonga, and Vanuatu, has shown there is room for more than one operator. Competition has lowered charges, expanded service coverage, and triggered product innovation.

Much more remains to be done to boost the productivity of Pacific economies and to give the region's tourism and other industries a competitive edge that will help support economic activity. Structural initiatives that improve price signals and promoting the shift of resources into higher rates of return activities will make the economies more flexible and help them respond to shocks. The imperative for such reforms is increased by the global economic crisis, and recognition of this may see a strengthening of the political and broader community commitment for much needed change.

In telecommunications, facilitating more competition among Internet service providers and allowing more competition from alternative telecommunication services (e.g., Internet-based voice services) could lower telecommunication costs even more. More flexible licensing and the relaxation of regulations are needed. In the more remote Pacific economies, new, alternative service providers, such as those based on radio technology, are within reach.

In airlines, there is still room to encourage the entry of more operators to some destinations and to intensify competition among existing operators. Most importantly, there has been very little action taken on domestic airlines, even though they are central to the transport system of most Pacific economies, and tourism especially. Any legislated monopolies for the (often government-owned) domestic carrier are a priority for removal. Such reforms will need to be complemented in some cases by the explicit provision of community service obligations for routes that are not commercially viable, preferably via a competitive bidding process. Frameworks for community service obligations are now reasonably well understood and can be prepared quickly, provided budget funds can be set aside for their implementation.

Coastal shipping would benefit from similar initiatives to bring in new operators, to intensify competition among existing operators and to fund routes that are not commercially viable via community service obligations. This approach is now being applied in Solomon Islands (the Domestic Maritime Support Project is expected to commence by the end of the third quarter 2009), is to be extended to PNG and is suitable for wider application.

Similarly, more can be done on power supply. Internationally, considerable progress has been made to introducing competition in generation; transmission (that takes power to areas of uses) and distribution systems (that actually deliver the power

to users) tend to stay in public ownership. There are some examples in the Pacific of private operation of generation, such as in Papua New Guinea and Vanuatu, but it is yet to be undertaken in a fully competitive environment. Competitive bidding of new power generation options has been shown internationally to be a way of triggering new investment and lowering electricity costs. There is also substantial potential to make savings on the high fuel bills of the energy sector, notably by raising the efficiency of oil usage through supply and demand side management measures.

Structural initiatives that were able to provide a quick positive impact while having low adjustment costs are have obvious pluses. Certain reforms in transport and telecommunications do potentially have these characteristics. For example, airlines tend to employ only a small number of people (they are instead capital intensive), yet reforms can have a very quick impact on airfares. Because some tourists make holiday decisions close to the departure date (helped by the availability of the Internet and the widespread practice of last minute discounts), tourism numbers can respond quickly to a drop in airfares. Hence, opening airlines to competition can fall within the realm of a quick impact response. Also, competition in the provision of transmittal services for remittances flows has been shown to significantly reduce costs, underpinning remittance flows and their contribution to household incomes and poverty reduction.

A key issue faced in pursuing structural initiatives is the time required to formulate and implement actions. For example, the regional process of introducing more competition into the aviation sector and the Pacific Island Air Services Agreement took many years. And the recent reforms in mobile telecommunications in PNG can be traced back to efforts started in 2000 (if not earlier) through an attempted privatization of PNG Telikom and subsequent legislative reform. So, while in theory some structural initiatives may be able to provide a quick impact response, in practice this may not always be achievable. Moreover, structural reform in general is best seen as a long-term task, considering that developing institutional infrastructure—property rights, business laws, promotion of market competition, and regulatory frameworks for imperfectly competitive markets—is at its core. Simplification of bureaucratic procedures and improved efficiency in public administration would facilitate private sector economic activity. However, introducing a customer orientation and greater efficiency in public services cannot be accomplished as quickly as the phrase 'cutting red tape' might suggest.

There are some potential wrong turns on structural policy that are best avoided. Firstly, it is best to avoid offering protection to local business, in an effort to raise the demand for locally produced goods and services. The targeting of selected industries or businesses is also best avoided. Efforts to match a competing country's actions to attract investment can be healthy if they lead to the removal of a damaging imposition on business but it is important to avoid such actions becoming a race to the bottom.

For example, trying to attract investment by competing on import duties on investment goods or on processing times for foreign investment applications would be positive. But offering increasingly generous concessions on fish licenses or tax holidays can impose more costs in terms of revenue forgone than the potential benefits.

Social protection

Protect the poor and vulnerable. The experience with high food and oil prices in 2008 highlighted how little is known about how the vulnerable cope with broad-scale economic shocks in the Pacific, and the absence of mechanisms for helping the vulnerable at such times. The Asian experience sends a cautionary note in this regard. Even in Asia where there is a long history of providing social safety nets and a solid analytical base to work from, achieving effectiveness has been difficult—social safety nets are often poorly targeted and impose high cost. Internationally, the literature on social safety nets highlights the theoretical and practical difficulties of establishing cost-effective support for the vulnerable. For example, information failures can make targeting programs very costly, and targeting can be beyond the administrative capacities of developing countries. In times of stress, generalized interventions may be needed as a stop-gap measure until targeted interventions can be developed (Sugden 2009).

A further important lesson from the recent experience is the potential downside of poorly formulated actions aimed at helping the vulnerable. Most Pacific governments responded to the high prices in 2008 by suppressing the increase in consumer prices. But this would have kept prices for locally grown food below what they would otherwise have been, suppressing a much needed supply response from agriculture. For example, in Timor-Leste the subsidization of imported rice shielded many people from rising international prices, but it also reduced prices received by domestic growers, for both rice and substitute staples. It consequently held down growth in rural areas, where most of Timor-Leste's poor live. Furthermore, the subsidies for imported rice benefited the better-off more than the poor, as the better-off consume more rice and the poor rely more on corn and cassava. A government decision to now hold 2 years of rice imports in storage as a buffer against price hikes will have similar adverse effects, suppressing farm production and rural incomes.

In principle, it is preferable to directly compensate any loss of income borne by the vulnerable during times of economic stress and to avoid interventions that suppress commodity prices. Hence, cash transfers to the vulnerable are preferable to direct interventions in food markets. Cash for works programs are also potentially attractive, as are subsidy schemes that target human capital formation (e.g., school feeding programs and school subsidies that target schools attended by lower income groups can help households cope with lower incomes and encourage participation in school).

Such interventions may however take some time to develop and implement (e.g., 2009 school fees may already be paid by the time a school subsidy program is put in place). Notably, time will be required to prepare the data and analysis required to underpin program design and other implementation issues (e.g., cash for works programs may be contrary to minimum wage legislation). Too much haste may lead to poorly designed programs that may become a drain on fiscal positions.

Given the gaps in knowledge and an ability to help, the best immediate option for protecting the poor and vulnerable is likely to be to limit the decline in economic growth. Efforts to make any fiscal stimulus responsive to the needs of the vulnerable are also sensible. Extra protection for the vulnerable is desirable, to the extent that counter-cyclical policy is unable to offset the contraction in aggregate demand, or if new pockets of hardship emerge. But there would be major practical hurdles in providing an effective response in 2009 or even 2010. The Cook Islands, the Fiji Islands and Timor-Leste are possible exceptions in this regard, as they have rudimentary formal social safety nets that could potentially be ramped up as a response to the global economic crisis.

STAYING ON COURSE

Governments can form a proactive response to offset the short-term impact of the global economic crisis. The faster any response to the external shock is made, the better. Otherwise, the economic adjustment to the shock will need to be made in other ways, such as rising unemployment and declines in real wages and other income sources.

A first step would be to better track and understand the impact of the crisis. Existing economic and financial monitoring is generally backward looking, has a narrow coverage, and suffers long lags. Work to supplement economic, financial, and social monitoring is called for.

A second step would be to prepare a targeted policy response. The best policy responses will be developed on a case-by-case basis so they are tailored to each country's circumstances. To do so, policy dialogue is needed on macroeconomic and microeconomic management and support for the vulnerable. Country-level dialogue is the key to mobilizing an effective response that is tailored to country circumstances. Achieving a high level commitment to a response to the global crisis will also be helped by bring-

ing together the region's key decision makers, so that they may crystallize their own policy position by sharing experiences and debating policy issues, many of which will be common across the region.

At the macroeconomic level, most if not all governments will face the challenge of managing a fiscal shock caused by the global economic crisis. Revenue is likely to fall below projections and see the overall fiscal positions deteriorate, in the absence of corrective action. A fiscal stimulus that increased government expenditure or potentially reduced taxes (e.g., an across-the-board reduction in the value-added tax rate) to boost economies may also be sensible, where affordable and providing good value-for-money.

Beyond a macroeconomic policy response, governments could continue with structural initiatives, and at a faster pace if possible, provided the short-term adjustment costs do not intensify the externally induced economic slowdown.

Limiting the decline in growth is probably the best immediate option for helping the vulnerable, complemented by a fiscal stimulus that pays special attention to the vulnerable.

Development partners can play a key role. In addition to supporting monitoring and policy dialogue, they can fast-track the activities they are involved in, help governments fast-track others, and offer prudent budgetary support for a fiscal stimulus that minimizes pressure on the balance of payments.

Budget support is normally provided with conditions–i.e., agreed indicators on what governments will do in return for the support. In this instance, an appropriate focus may be to minimize the risk that budget support would have the unintended effect of working against long-term growth prospects by easing the incentive for governments to improve their performance. Conditions attached to budget support could be preventive (as opposed to curative). Such conditions could look at what is termed the functional allocation of government expenditure, and for example seek to protect expenditure on core social expenditures that support the most vulnerable. Conditions could also look at the economic classification of government expenditure, and for example seek agreement on the wage and salary bill and seek to preserve expenditure on the maintenance of physical infrastructure or essential capital works (perhaps on a multi-year basis). Any budget support provided could also appropriately include sunset clauses, so that from the outset it is regarded as a temporary, specific response to the global crisis.

Coordination of monetary, fiscal and exchange rate policy, is critical to ensuring internally consistent and effective counter-cyclical management. Notably, such consistency is absent from PNG's 2009 fiscal stimulus package, which calls for a contractionary monetary policy to protect the balance of payments. If monetary policy

were instead eased in a coordinated fashion, the fiscal stimulus could be lower and public funds could be conserved for future needs (Government of PNG (2009)).

A broad assessment of key initiatives suitable for each Pacific economy is presented in Table 2. This is only a preliminary assessment and the rapidly evolving impacts of the global economic crisis mean any policy response needs to be frequently revisited to ensure that it best meets community needs.

Looking beyond the immediate issues raised by the global economic crisis, the experience highlights the importance of having a pro-active and forward-looking approach to economic management. This approach is not yet a common practice in all Pacific economies. No matter how small an economy, it is sensible to have some sort of formal economic management plan in place, with clearly stated fiscal and broader economic policies, targets, and indicators established. Having such a plan is even more important during times of economic difficulty, but even during 'normal' times is worth following as standard practice. The response to the global economic crisis is an opportunity to make progress on this front.

Table 2: Key policy initiatives–potential or already in place[a]

Country	Information sharing and open dialogue	Careful, short lived monetary expansion	Maintain a competitive exchange rate	Manage the fiscal shock, and where sensible provide a short lived, value-for money fiscal stimulus, by					Quick-win structural initiatives	Help the vulnerable
				Making better use of existing resources	Using external grants	Drawing down own savings	Borrowing: Domestic	Borrowing: External		
Cook Islands	√			√	√	√	√	√	√	√
Fiji Islands	√	x	√	√	√		possibly	√	√	√
FSM	√			√	√	X	x	x	√	√
Kiribati	√			√	√	X	x	x	√	√
Nauru	√			√	√		x	x	√	√
Palau	√			√	√	X	x	x	√	√
PNG	√	√	√	√	√	√	√	√	√	√
RMI	√			√	√	X	x	x	√	√
Samoa	√	possibly	√	√	√		√	√	√	√
Solomon Islands	√	x	√	√	√		x	x	√	√
Timor-Leste	√			√	√	√	√	√	√	√
Tonga	√	possibly	√	√	√		x	x	√	√
Tuvalu	√			√	√	X	x	x	√	√
Vanuatu	√	possibly	√	√	√		√	√	√	√

FSM=Federated States of Micronesia, PNG=Papua New Guinea, RMI=Republic of the Marshall Islands.
Legend: √ = justified, **x** = unsuitable, blank = not applicable.
a. Some initiatives are already in place. In some cases additional action may not be required, while in others there may be good arguments for winding back some recent actions.
Source: ADB.

ANNEX 1: THE BACKDROP

The Global Economic Crisis

Conditions Elsewhere

Triggered by the United States (US) subprime crisis that began in August 2007, the global financial crisis has spilt over to the real economy, resulting in sharp declines in economic activity and deterioration of labor market conditions. Recently available data paint a dire picture of the world economy:

(i) The US, which officially entered into recession in December 2007, saw its economy contracting at an annual rate of 6.2% in the 4th quarter of 2008. The US unemployment rate in March 2009 soared to a 25-year high at 8.5%, dragging business and consumer confidence down. In Japan, gross domestic product (GDP) fell at an annual pace of 12.1% in the 4th quarter of 2008, with a sharp decline in exports;

(ii) In the 15-member Euro zone area, output growth contracted by 1.5% during the comparable period, with major economies such as France, Germany, and Italy all in the red. The United Kingdom (UK) economy likewise contracted at an annual rate of 1.5% in the 4th quarter of 2008;

(iii) Major economies in Asia and the Pacific either showed a dramatic slowdown,

are on the cusp of recession, or are in economic contraction. The economy of the People's Republic of China expanded at 6.8% in the 4th quarter of 2008 compared to the same period a year ago, way below the double-digit growth rates recorded during the last 5 years. Republic of Korea contracted by 3.4% and Taipei,China by 8.4% during the comparable period;

(iv) The Australian economy contracted in the 4th quarter of 2008; and, in the same quarter, New Zealand recorded its fourth consecutive quarter of contraction.

The International Monetary Fund (IMF) projected that the global economy will contract by as much as 1% in 2009 with recovery in 2010 conditional on policies stabilizing financial system and boosting aggregate demand (IMF, 2009c).

The Response Elsewhere

To offset falls in aggregate demand, major economies around the world have adopted expansionary fiscal policies spreading over several years (Table A1.1). The fiscal stimuli vary across countries but consist largely of infrastructure spending and tax cuts (Table A1.2). Most of the expenditure-related fiscal measures (e.g., infrastructure spending) are temporary in nature while revenue-related measures (e.g., personal and corporate income tax cut) are permanent in nature (IMF, 2009b). The effectiveness of the fiscal stimulus in raising aggregate demand depends on a host of factors: size of the fiscal stimulus, type of instruments used, trade openness, constraints on borrowing, policy response of monetary policy, and long-term sustainability (IMF, 2009a). However, one point is clear: the fiscal positions of these economies are expected to deteriorate over time with consequences on interest rates, exchange rates, and inflation.

In its April 2009 meeting, the Leaders of the Group of Twenty (G-20) industrialized and emerging economies, pledged an additional $1.1 trillion program of support to restore economic growth, to save and create jobs, and to repair the financial system and restore lending. Out of this amount, international financial institutions such as the IMF and the Asian Development Bank (ADB) will get at least $850 billion in additional resources to assist emerging and developing economies weather the global crisis. The G-20 leaders also vowed to resist trade protectionism, refrain from competitive currency devaluation, boost global trade by supporting trade finance, and fulfill their official development assistance pledges. They have also agreed to take actions against tax havens and to regulate and oversight hedge funds (G-20, 2009a).

Table A1.1: Estimated size of discretionary measures

Country	2008	2009	2010
		% of GDP	
Australia	0.7	0.8	0.3
Canada	0.0	1.5	1.3
China	0.4	2.0	2.0
France	0.0	0.7	0.0
Germany	0.0	1.5	2.0
Indonesia	0.0	1.3	1.1
Japan	0.4	1.4	0.4
Korea, Republic of	1.0	1.5	0.3
UK	0.2	1.4	-0.1
US	1.1	1.9	2.9

UK=United Kingdom, US=United States.
Source: IMF (2009a).

Table A1.2: Fiscal initiatives in major economies

Fiscal Measure	Country
(i) Revenue side	
Personal income tax cuts	Canada, Germany, Indonesia, Italy, UK, US
Reduction in corporate income taxes	Canada, France, Germany, Indonesia, Republic of Korea, Russia, Spain, US
(ii) Expenditure side	
Infrastructure spending	Canada, People's Republic of China, France, Germany, Indonesia, Italy, Republic of Korea, Saudi Arabia, US
(iii) Protection of liquidity-constrained or vulnerable groups	
a. Strengthening unemployment benefits	Canada, Russia, UK, US
b. Cash transfers	Canada, Republic of Korea, Japan
c. Support to children	Australia, Germany
d. Pensioners	Australia, Canada
e. Concessional loans to low-income citizens	Saudi Arabia
(iv) Support to small- and medium-sized enterprises and strategic or vulnerable sectors	Republic of Korea, Canada, Germany, Russia
(v) Address long-term policy challenges	
a. Improve the quality of health and education	Australia, People's Republic of China, Saudi Arabia
b. Incentives for development of environmentally-friendly technologies	Canada, People's Republic of China, Germany, UK

UK=United Kingdom, US=United States.
Source: IMF (2009a).

Governments have also taken drastic steps to stabilize the financial system, particularly the banks. Bank rescue initiatives have two key components. Firstly, to ensure that banks have continued access to funding, governments expanded the retail deposit insurance and implemented wholesale funding guarantees. Secondly, to reduce bank leverage and recapitalize the banks, the government infused capital in return for preferred equity stake and bought distressed assets from banks (BIS, 2008). Table A1.3 identifies key elements of the main rescue plans. The US and UK governments have also been aggressive in supporting bank mergers and recapitalization to strengthen banks' balance sheets. Financial institutions (e.g., American Insurance Group, Fannie Mae, and Freddie Mac) posing systemic risks were taken over by the national government.

Central banks have supported these actions by aggressively cutting policy interest rates to boost domestic growth. In the US, the Federal Reserve Bank has even used unconventional policy instruments to help unfreeze the credit markets. It opened up new lending facilities by accepting a wider range of collateral, which includes assets backed by commercial paper, mortgage, consumer, and business loans (e.g., auto loans, credit card loans, and student loans), and US Treasuries. In the UK, the Bank of England has started buying assets backed by commercial paper. The Bank of Japan will provide subordinated loans to banks to shore up their capital bases and will increase their purchase of government bonds. Whether such moves will get credit flowing again to businesses and not just end up as banks' excess reserves remains unclear.

The medium-term agenda has now extended to strengthening financial markets so as reduce the risk of a future global crisis. Actions will include determining the appropriate proper degree of regulation and oversight of financial institutions, markets, and instruments posing systemic risk to avoid excessive risk taking and leveraging; and strengthening macro-prudential oversight and international cooperation (G-20, 2009b).

Back to the Asian Financial Crisis

Impacts on the Pacific

The 1997 Asian financial crisis had a significant adverse impact on a number of neighboring economies, causing a dip in their growth performance (Table A1.5). While this impact was less than what is predicted from the current global economic crisis, the Asian Financial Crisis still serves as guide to how crisis elsewhere can impact on the Pacific economies. Notably, the Asian financial crisis highlights that outcomes are likely to depend on a range of factors: the starting position of the Pacific economies; exchange rate adjustments and policy responses; changes in world commodity prices and concentration of commodity exports to selected markets; and income from remittances, tourism, investment and donor agencies and/or countries (ADB, 1999).

Table A1.3: Elements of banking system rescue plans in developed economies

Country	Expansion of retail deposit insurance	Guarantee of wholesale liabilities		Capital injections	Asset purchases
		New debt	Existing debt		
US	Yes	Yes	No	Yes	Yes
UK	Yes	Yes	No	Yes	No
Germany	Yes	Yes	No	Yes	Yes
France	No	Yes	No	Yes	No
Italy	No	Yes	No	Yes	No
Australia	Yes	Yes	Yes	No	Yes
New Zealand	Yes	No	No	No	No

UK=United Kingdom, US=United States.
Source: Domanski and Ramaswamy (2008).

Table A1.4: Policy interest rates

Economy	Oct 2008 Level	Current Level
US	1.0%	0-0.25% (since Dec 2008)
Japan	0.3%	0.1% (since Dec 2008)
EU	3.75%	1.5% (Mar 2009)
UK	4.5%	0.5% (Mar 2009)
PRC	6.66%	5.31% (since Dec 2008)
Republic of Korea	4.25%	2.0% (Feb 2009)
Australia	6.0%	3.25% (Mar 2009)
New Zealand	6.5%	3.0% (Mar 2009)

EU=European Union, PRC = People's Republic of China, UK=United Kingdom, US=United States.
Sources: www.bloomberg.com.

Table A1.5: Economic growth during the Asian Financial Crisis

Countries	1997	1998	1999
	Change in real GDP (%)		
Australia	4.0	5.1	4.3
New Zealand	2.1	0.0	4.3
PRC	6.6	4.5	5.7
Republic of Korea	4.7	-6.9	9.5
Japan	1.6	-2.0	-0.1
US	4.5	4.2	4.5

GDP= gross domestic product, PRC = people's Republic of Korea, US=United States.
Sources: ADB. *Asian Development Outlook*, various years and World Bank, *World Economic Outlook*, various years.

Among the Pacific economies, Papua New Guinea (PNG) and Solomon Islands were adversely affected by the Asian crisis, largely through falling commodity prices for major exports: logs, copper, and oil for Papua New Guinea and logs for Solomon Islands. In addition, both countries' export markets for logs were concentrated in Japan and then crisis-hit Korea. The negative shocks of the crisis were estimated at about 6% to PNG and 5% to Solomon Islands (ADB 1999). Elsewhere, the Fiji Islands experienced lower tourist arrivals from Japan and Korea; Nauru's phosphate exports to Republic of Korea and Indonesia slumped during the crisis but new export markets opened up; Samoa's export of wiring harness to Australia was affected by rising competitiveness of imports from Indonesia, Republic of Korea, and Thailand due to currency depreciation; and Vanuatu experienced falling exports of beef to PNG and Solomon Islands and timber to Republic of Korea (ADB 1999).

The overall adverse impact of the Asian crisis was minimal for most Pacific economies. Cook Islands and Tonga were unaffected as tourists to these countries came largely from New Zealand and not from Asia. The aid-dependent economies of the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) were supported by the steady flow of Compact Trust Funds from US (ADB, 1999).

The fall in fuel prices due to global slackness in demand had a beneficial effect on Pacific economies, since imported fuel costs are the equivalent to 5% to 10% of GDP. Kiribati benefited from the Australian dollar depreciation, as its Revenue Equalization Reserve Fund was denominated in US dollars (ADB, 1999).

To put things in perspective, an assessment of the impact of the Asian crisis concluded that "home grown problems or other external factors such as the weather have been far more important in terms of generating adverse pressures than the Asian Financial Crisis" (ADB 1999). Indeed, several Pacific economies were experiencing sluggish growth or economic contraction even before the onset of the Asian financial crisis due to local economic conditions. Tonga was in recession from 1995. FSM experienced weak growth but was well-insulated from the crisis. Drought affected PNG's agriculture and mining sector, as well as agricultural production in the Fiji Islands, RMI, and Tonga. Nauru was in economic crisis in the 1990s primarily due to the collapse of its key export, phosphate, and poor investment decisions. Some Pacific economies, such as Cook Islands and Tuvalu, even recorded decent economic growth during the crisis period (ADB, 1999).

The response in the Pacific

Out of the six Pacific economies with their own national currencies, four underwent significant depreciation largely to ease balance of payments pressure. The PNG kina depreciated the most by 30% from mid-1997 to the end of 1998; followed by Solomon Islands

dollar, 20%; Fijian dollar, 20%; and Tongan pa'anga, 5%. The Samoan tala and Vanautu vatu appreciated against most currencies, but depreciated against the US dollar.

The depreciation of the PNG kina was a response to a deteriorating balance of payments due to an export slump, repayments of official loans, capital repatriation by mining companies, and weak foreign direct investment. The Solomon Islands dollar depreciation was due to worsening trade deficits and adjustments due to real exchange rate appreciation from 1990 to November 1997. The Fijian dollar devalued by 20% in January 1998 as the economy slumped due to drought and a deteriorating current account. The devaluation of the Fijian dollar was accompanied by tariff cuts and moderation of wage increases, resulting in a 14.5% real exchange depreciation by end of 1998. The Tongan pa'anga depreciated to restrain import growth, to arrest dwindling foreign reserves (in terms of import cover) and to adjust to real exchange appreciation since the mid-1990s.

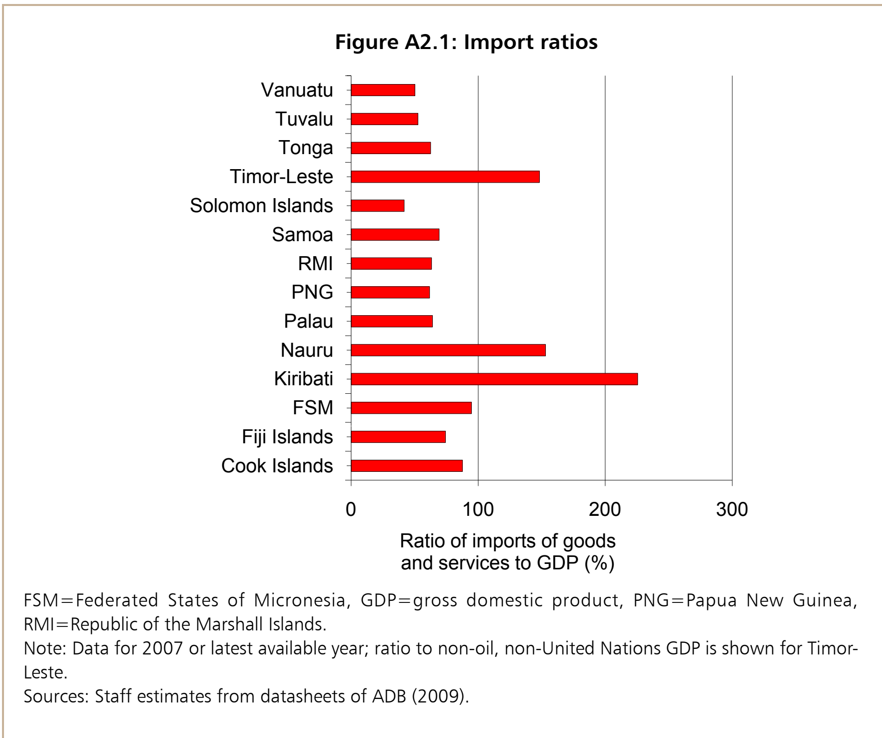
The economic contraction of Solomon Islands became less severe due to an increase in other exports such as fish and palm oil, the opening up of its first gold mine, and receipt of aid funds. The Fiji Islands secured a temporary agreement with Australia, its key export market, to relax local content requirements resulting in a 12.3% increase in clothing and footwear output.

ANNEX 2: THOUGHTS ON A FISCAL STIMULUS

Can a fiscal stimulus benefit the Pacific economies?

The Pacific economies are highly import dependent, with a ratio of imports to GDP of more than 50% in most economies (Figure A2.1). This gives rise to the concern that any boost to expenditure from a fiscal stimulus would have little effect on economies, with the benefits instead flowing overseas via increased imports. This concern can be explored with the help of multipliers derived from an input-output model. Such multipliers show the potential short-run effect of a change in expenditure on an economy.

Figure A2.1: Import ratios



FSM=Federated States of Micronesia, GDP=gross domestic product, PNG=Papua New Guinea, RMI=Republic of the Marshall Islands.
Note: Data for 2007 or latest available year; ratio to non-oil, non-United Nations GDP is shown for Timor-Leste.
Sources: Staff estimates from datasheets of ADB (2009).

Input-output models provide a disaggregated description of an economy identifying important inter-relationships between industries. An input-output model identifies an industry's inputs to production as intermediate materials and services, which are purchased from other industries, and the factor inputs of land, labor and capital. An industry's output is either sold to other industries or the 'final demand' categories of consumption, investment, government and exports. An input-output table also shows the level of imports in an economy and the level of indirect commodity taxes paid. Input-output multipliers measure the impact of a change in sales by an industry on value added (i.e., wages, salaries and supplements and gross operating surplus, that when added together constitute GDP), labor income and the number of persons employed. For example, a value-added multiplier for farming of 0.5 would imply that for every $1 increase in farm sales, total value-added in the economy would increase by $0.5.

Three types of multipliers are normally derived for an input-output model, being:

- an initial multiplier. This looks at the direct effect of a change in industry output, such as a change in income paid to those working in the industry;

- a Type I multiplier. This captures both the direct and indirect, production-induced effect. The latter refers to the industry's purchase of inputs from other businesses, and the further purchase of inputs by those other businesses, etc; and
- a Type II multiplier. This captures the direct and indirect effect of the Type I multiplier, and also captures an indirect consumption effect that flows from the expenditure of the income that is earned.

The initial multiplier captures only the direct effect of an industry's expansion, while the Type I and Type II multipliers capture this direct effect and the flow-on effect as expenditure feeds through the economy. Multipliers will normally be higher for regions with a broader economic base, because more of the flow-on opportunities are captured by the region itself. This is evident in the multipliers derived for regions of the Australian state of Queensland. For example, the multipliers for Queensland's main commercial region of Brisbane-Moreton are higher than those for the less densely populated and less developed Northern, North West and Far Northern regions (Table A2.1).

Table A2.1: Import shares and multipliers

Variable	Final demand category	Fiji Islands	Tonga	Selected Queensland regions			
				Far Northern[a]	Northern[b]	North West[c]	Brisbane-Moreton
Average import share (%)[d]							
	Private final consumption expenditure	35	41	49	52	72	37
	Gross fixed capital formation	37	45	38	46	45	36
	Government final consumption expenditure	11	22	27	29	31	20
	Total final demand	32	37	36	46	42	32
Type I value-added multipliers							
	Private final consumption expenditure[e]	0.74		0.75	0.75	0.69	0.82
	Gross fixed capital formation[f]	0.68		0.64	0.63	0.51	0.74
	Government final consumption expenditure[g]	0.89		0.85	0.81	0.82	0.89

blank=not available
a The region contains Cape York, including the bauxite area of Weipa, and extends south to Cairns.
b The region to the south of Far North, including areas to the west of Townsville and Bowen.
c The region to the west of the Far North region, encompassing Mt Isa.
d Imports not allocated to a final demand category are allocated between final demand categories on a pro-rata basis.
e Found as the weighted average of the multipliers for industry's supplying products purchased by households.
f Found as the weighted average of the multipliers for industry's supplying products used in gross fixed capital formation.
g Found as the simple average of the multiplier for public administration, health and education.
Source: ADB staff estimates based on the input-output tables for the Fiji Islands for 1997 as prepared by the National Statistics Office of the Fiji Islands (and reproduced in Levantis (2000), Tonga Statistics Department (2005a,b) and the input-output tables for regional Queensland as prepared by the Queensland Office of Government Statistician (2002).

Multipliers for even remote regions are more than zero. There can be important spill-over benefits for local economies from increased expenditure, even when the economies are import dependent. For example, an expanding construction industry would require additional building materials. The rise in demand for building materials would result in an expansion in local suppliers; such as the sand and gravel used in concrete, the timber required for formwork and in buildings, and the metal products required for concrete reinforcing through to fencing and roofing. The activities that support these suppliers would in turn grow—from transport to vehicle maintenance, to banking and other business support services. There are also multiplier effects when households spend more. Retail activity would grow, retailers would demand more stock from wholesales and other sources of supply, transport demand would rise, etc. And the workers in the retail industries would then spend their money on a variety of goods and services, creating demand for others, and so on.

Input-output multipliers are available for the Fiji Islands. The multipliers are of the order of 0.7 for private consumption and investment (Table A2.1). That is, a $1.0 increase in private consumption and investment is estimated to increase GDP by the order of $0.7, on average. The multiplier for government consumption is estimated to be somewhat higher. The multipliers are likely to be lower elsewhere in the region as they are smaller and/or less developed economies.

In Tonga for example, imports are estimated to account for approximately 37% of expenditure, compared to approximately 32% in the Fiji Islands (note that a ratio of imports to GDP is not the same as the share of expenditure spent on imports). The high import dependence of Tonga is likely to see lower multipliers in Tonga compared to the Fiji Islands. But judging by the reasonably high multipliers in the remoter Queensland regions compared to the Brisbane-Moreton region (even though the remoter regions are more import dependent), multipliers are likely to be higher than 0.5 in Tonga.

These estimates give confidence that an increase in expenditure provided by a fiscal stimulus would benefit Pacific economies. The 'bang for the buck' would be highest for the more developed Pacific economies, but nonetheless has the potential to be sizeable elsewhere. Certainly a share of any fiscal stimulus would spillover to the Pacific's major sources of imports, notably Australia, New Zealand and Asia. However there are grouds for expecting much if not the bulk of the benefits of a fiscal stimulus to be retained in the Pacific. The deterioration in economic conditions may also have an upside in this respect, as it may make households reluctant to purchase the consumer durables such as cars and electronic equipment, the purchase of which may offer low short-run benefits for the region's economies.

Funding a stimulus by making better use of existing resources

Most Pacific economies can identify expenditures or revenue leakages in their budget that can be trimmed back. Trimming less productive or wasteful expenditure, cutting back on revenue concessions or requiring better returns from government businesses and other investments will allow funds to be reallocated to better uses. This would allow more to be done within existing fiscal envelopes. Such actions would make sense regardless of the adverse impacts of the global economic crisis, but make even more sense now if they provide a quick way of lifting economic activity.

The government wage bill is perhaps the most important area of excess expenditure in many Pacific budgets. High government wage bills have two dimensions: the number of persons employed and pay rates. As documented in Sugden and Taniguchi (2008), these dimensions are negatively related internationally, with relatively high pay rates typically associated with relatively small public services. In the Pacific, this is most noticeable for Papua New Guinea (PNG), where pay rates for public servants are—relative to what the economy can afford—among the highest internationally. The PNG public service, as a share of total employment, is also among the smallest internationally. Relative government pay rates are also very high by international standards in Kiribati, Solomon Islands, Timor-Leste, and to a lesser extent, in Vanuatu, and are relatively high in the Fiji Islands, Federated States of Micronesia (FSM), and Tuvalu. The largest public services in the region, as a share of employment, are in Palau and Republic of the Marshall Islands (RMI), and the public service is also large by international standards in Tuvalu. Relative government pay rates and size are closer to international benchmarks elsewhere in the region.

Government pay rates and employment can be trimmed back where they are relatively high, to generate savings on the wage and salary bill. If this is not possible, wage and salary restraint can be used to try and create more room in the next budget. In this respect, it will be important to avoid pressures for wage and salary adjustments for the high inflation seen over 2008 and into 2009. An increase in the wage and salary bill as a means of providing a fiscal stimulus would be misguided given its adverse longer term consequences.

Other areas of excess in government expenditure include international travel budgets, overseas medical care, international missions, and subsidies for tertiary study (tertiary study is important, but students capture a large share of the benefits of tertiary study and most can afford to pay a higher share of costs). Tax and import duty concessions for favored industries or firms, which are a form of 'negative expenditure', also often impose high fiscal costs without a compensating benefit.

It may even be the case that the severity of the outlook facing the Pacific calls for a re-prioritization of existing useful activities, if a better use of the funds can be found.

Budget processes are designed to allow for the ongoing scrutiny of government activities, and such processes can be utilized for such a reprioritization. This point applies to activities funded internally as well as those that are externally funded.

Making existing resources available for a fiscal stimulus is only part of the task at hand. A better use of the resources also needs to be found. In this case, a better use would be one that increased aggregate demand so as to provide a counter-cyclical policy response. If the vulnerable will bear a disproportionate share of any adverse impacts from the economic slowdown, a better use of resources would also give more support to the vulnerable.

So for example, retrenching public servants would reduce household expenditure and potentially require cut backs in service delivery. These effects will tend to add to the economic stress facing economies and possibly the vulnerable (who are often on the fringe of government service delivery). Retrenching public servants may however make sense if the savings could be re-spent in a way that more than replaced the lost household expenditure or any cutbacks in service delivery. It is easier to see how other options for making savings, such as reducing international travel budgets, could readily provide a better use of existing resources.

In making better use of existing resources, it is best to have conservative expectations with regard to the potential to resolve what are in many cases long-standing and deep rooted problems in public expenditure management and in state-owned enterprises. Many actions required to make better use of existing resources have been tried before, and the considerable time that may be required to make such actions work is evident from experience. The potential to rely too heavily on making quick progress on such matters is one of the major lessons from the policy advice provided to Indonesia and Thailand during the Asian financial crisis, a lesson that is relevant to the Pacific.

It is also important to remember that the global crisis is not the only risk facing the region—notably there is the ever present risk of natural disasters—and it is prudent to always have some fiscal room to help cope with such risks, should they eventuate. Vigilance in finding the best use of resources helps economies ready themselves to manage adverse shocks.

Is fiscal policy already too expansionary?

In some cases, a fiscal stimulus is already in place. This was not a deliberate response to the global economic crisis, but arose because budgets had already allowed for increases in budget deficits. This is evident in changes in the overall fiscal balance as budgeted for 2009. In the Cook Islands, the Fiji Islands, PNG, Samoa, Timor-Leste and Tonga, the 2009 budgets provided for a more expansionary fiscal stance. In Kiribati, a large fiscal

expansion in 2008 is expected to spillover into 2009 (Figure A2.2). In PNG and Timor-Leste, the fiscal stimulus is being funded from government savings accumulated during the recent boom in commodity prices. Government savings are key sources of financing in the Cook Islands and Kiribati, whereas larger domestic deficits in the Fiji Islands and external deficits in Samoa are being funded by moderate levels of borrowing. While Solomon Islands has projected a reduction in the budget deficit for 2009, the revenue projections underpinning the budget are optimistic and the underlying fiscal position may in truth be expansionary.

In the case of the Cook Islands, Kiribati, PNG, and Timor-Leste, the planned fiscal stimulus is well above the average for the Group of 20 (G-20) industrialized and emerging countries. Using the G-20 countries as a benchmark, which is reasonable given the severity of the crisis they are facing, the fiscal stimulus is too high in the Cook Islands, Kiribati, PNG, and Timor-Leste. Concerns over the quality of some recent, large-scale expenditure initiatives in PNG (including that absorptive capacity is overstretched) add to the argument for a much lower fiscal stimulus in PNG.

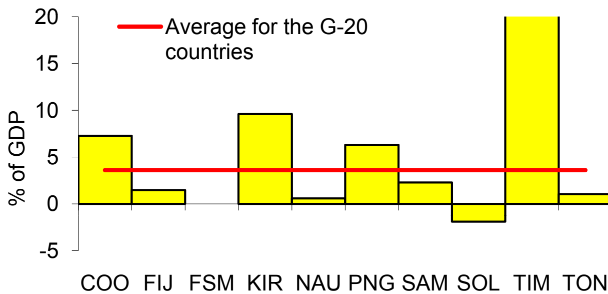
Timor-Leste has an extremely expansionary fiscal stance. In an effort to speed economic development, the 2009 budget provides for a near 60% increase in government expenditure over the year, lifting expenditure to almost double the gross domestic product (exclusive of the activities of the oil sector and the United Nations). Timor-Leste's fiscal stimulus is being funded from savings accumulated during the recent boom in the oil price, and is affordable provided it is short-lived. However, part of the fiscal expansion has been allocated to potentially low priority expenditures. Moreover, long-standing capacity constraints remain and will make it difficult to achieve implementation timetables. These factors suggest that they are likely to exceed the capacity to implement, suggesting that a lower rate of fiscal expansion is called for.

The ability to borrow

Looking beyond the four countries that have already relaxed fiscal policy too much—i.e., Cook Islands, Kiribati, PNG, and Timor-Leste—Samoa and Vanuatu may borrow, either domestically or externally on a concessional basis, to fund a short lived fiscal stimulus. The Fiji Islands could also borrow externally on concessional basis. But the Fiji Islands would need to approach any domestic borrowing with extreme care, as too much domestic borrowing could place excessive pressure on an already strained balance of payments and low level of liquidity in the banking system.

Nauru has extremely high debt levels and should not borrow. Public debt levels in RMI and Solomon Islands, and probably also Tonga, are also already too high for the government to contemplate borrowing for a fiscal stimulus (Table A2.2). While debt levels are not as high in the FSM and Tuvalu, their fiscal stance is unsustainable and additional

Figure A2.2: Loosening of the fiscal policy stance



COO=Cook Islands, FIJ=Fiji Islands, FSM=Federated States of Micronesia, GDP=gross domestic product, KIR=Kiribati, NAU=Nauru, PNG=Papua New Guinea, SAM=Samoa, SOL=Solomon Islands, TIM=Timor-Leste, TON=Tonga.

Notes:

a. The figure shows the projected 2009 budget balance less the estimated 2008 budget balance, as a % of GDP.

b. The data for Kiribati show the difference between the 2008 and 2007 budget deficits. This understates the fiscal expansion in 2008, with higher grants adding to an expansion in budgeted expenditure. The fiscal stimulus is spilling over into 2009, as capacity constraints have slowed the implementation of major projects budgeted for 2008.

c. The increase in Timor-Leste's budget deficit is projected as more than 100% of GDP excluding the contribution from the oil sector and assistance from the United Nations.

Sources: ADB (2009) and IMF (2009c).

fiscal stimulus would be out of place. For FSM, the best response would be to continue to search for ways of overcoming the constraints to utilizing the unused external grants already available (constraints that would probably also impinge on any new borrowing). There is considerable uncertainty as to the soundness of Palau's fiscal stance, given high expenditure levels and the unresolved status of future financial support from the United States. Borrowing for a fiscal stimulus may also be out of place in Palau.

A cautionary note is in order for Kiribati and Palau. Both need to rein in their government expenditure. Nevertheless, this will be difficult to do, and even with quick action, they are likely to continue to make drawdowns from their trust funds over the short run. This will require the sale of equities held by the funds at current low market prices. If Kiribati and Palau were to borrow now, they could reduce the drawdown of their trust funds, and give time for the market value of the equities to rise. Chand (2009) describes a need for a form of 'bridging finance'. There may be a case for moderate borrowing by Kiribati and Palau if there was some way to ensure that doing so helped avoid trust drawdowns and thereby helped preserve the long-term fiscal position. For example, Kiribati's Revenue Equalization Reserve Fund could consider adoption of rules similar to those of the Tuvalu Trust Fund that only allow drawdowns when the fund value is above a target, minimum level.

Table A2.2: Key indicators of fiscal sustainability

Country	Gross public debt (% of GDP, latest estimate)				Budget balance (% of GDP)		
	External debt		Total debt		2007	2008	2009
Cook Islands			15.7	('08)	0.1	-0.8	-8.1
Fiji Islands	15.3	('08)	48.0	('08)	-1.8	-1.5	-3.0
FSM	27.8	('08)			-3.3	-3.0	-3.0
Kiribati	11.5	('08)			-3.4	-13.0	
Nauru	1338.3	('07)			4.8	0.6	0.0
Palau	10.0	('07)			-4.9	-4.8	
PNG[a]	13.3	('08)	29.0	('08)	7.5	3.4	-2.9
RMI	60.1	('08)			-0.6		
Samoa	31.2	('08)			1.1	-3.2	-5.5
Solomon Islands	22.1	('07)	43.1	('08)	-0.3	-5.6	-3.7
Timor-Leste	0	('07)	0	('08)	264.3	251.8	90.1
Tonga	29.3	('08)	33.8	('08)	1.4	2.0	1.0
Tuvalu	34.0	('07)			-14.3	-5.4	
Vanuatu	20.7	('06)	29.4	('05)	0.14	6.30	

FSM=Federated States of Micronesia, PNG=Papua New Guinea, RMI=Republic of Marshall Islands, blank=not applicable/available.
a Official estimates adjusted for trust account deposits/withdrawals as announced in the 2009 Budget.
Source: ADB (2009).

When does a fiscal stimulus offer value-for-money?

There are always costs associated with governments' activities, and governments should only take action when the benefits of their actions exceed the costs. Benefits and costs need to be viewed from a broad sense and include all impacts on community well-being. This includes impacts on cash or subsistence incomes or on the nonmonetary dimensions of living standards, such as equity and access to opportunity, for both the current and future generations. The assessment of benefits and costs needs to be realistic, including factoring in all likely impediments, to actually achieving the benefits that in theory should be available. In economic terms, static and dynamic efficiency effects (that normally materialize as effects on the accumulation of the factors of production and an economy's productivity) and equity effects need to be considered.

A fiscal stimulus will provide value-for-money when the benefits generated exceed the costs, and the fiscal stimulus offers more benefits than alternative government actions of similar (total) cost. An implication is that if the resources to be used in providing a fiscal stimulus could be used elsewhere to generate more benefits for the community, these alternatives should be preferred over the fiscal stimulus.

Options for delivering a fiscal stimulus

Because of the importance of the individual circumstances of each country, whether a fiscal stimulus will offer value-for-money can only be assessed on a case-by-case basis.

There are, however, some important observations that can be made on the key options for delivering a fiscal stimulus, such as:

a) Public works;
b) Tax cuts or cash transfers to households; and
c) Tax cuts for business.

Public works, including maintenance and new investment, are attractive because they raise local demand and also provide longer term benefits via a flow of services. By raising the productivity of the economy, good public works will help the Pacific recover when the global economy turns around. Labor-intensive approaches to public works may also have an added development benefit in the lower income Pacific economies. This is because labor-intensive approaches may offer extra income to poor communities and encourage their "ownership" buy-in to local works (provided this is not at the expense of reduced quality and sustainability, or have higher costs that lead to too little road maintence etc been delivered). In contrast, increased government expenditure on import-intensive activities (e.g., buying vehicles and other imported equipment or employing international consultants) would do little to help lift the region's economies (although they should, nonetheless, continue if offering value for money).

One way to respond quickly is to fast track the existing program of public works, for example by speeding funding or approval processes, facilitating procurement and speeding up disbursement. In doing so, it is important for governments to stay away from doing the actual works. Implementation is best left with the private sector via an open and transparent competitive bidding process. It would be best to avoid the temptation of extending government funding to major private sector developments as an alternative way of stimulating the economy; funding and ownership for private projects should be left to the private sector.

Tax cuts or (where feasible) transfers to households may have a beneficial effect on local demand, but probably lack the other longer term positive effects (unless tax cuts or transfers prevent cutbacks in household education and health expenditure and/or the forced sale of productive assets). However, the demand stimulus is not certain: if tax cuts or transfers are saved or spent on imported goods or services, there can be little, if any, benefit to the local economy. Potentially important considerations in formulating a fiscal stimulus using these mechanisms are the variation across income groups in the propensity to consume (i.e., how much of the additional dollar of income or transfer is spent) and the import composition of consumption. Transfers to the lower income groups may, for example, have a more beneficial effect for the region's economies than transfers of the same amount to high income groups who are likely to save more of the transfer and may also spend more on imported items.

Tax cuts for businesses provided via a reduction of taxes and duties on inputs to production would make sense even in the absence of the global crisis. This is because taxes on business inputs are one of the most damaging ways to raise government revenue. In the current environment, tax cuts for business can help ease cost pressures and minimize the expected loss of employment. They offer both a beneficial effect on aggregate demand and longer term positive effects.

Tax cuts for households are best provided via a general reduction in value-added tax and/or goods and services tax rates, which could be later reversed easily. A cut in value added tax rates is potentially the quickest way to reach the broader population, particularly in largely rural-based economies with relatively small formal sectors (i.e., PNG, Solomon Islands, Vanuatu). And as the conventional view is that a value added tax is a regressive tax (i.e., lower income households pay a higher share of their income as value added tax than higher income households), a reduction in the value added tax rate can be expected to have a distributional benefit in addition to a counter-cyclical macro benefit. Reductions in income tax rates would instead mainly benefit those on higher incomes (and are not used at all in Vanuatu). Reductions in tariff rates and/or custom duties could also be contemplated, especially where they affect the cost of business inputs. Tax cuts could play only a small role in Timor-Leste as tax collections are low.

In contrast to the quick impact offered by tax cuts, support for public works carries long lead times. New public works, unless already very well advanced in planning, can probably be ruled out as a short-lived fiscal stimulus measure, so that the emphasis should be on accelerating existing works programs. Development partners have a role to play by accelerating their assistance and helping governments to hasten their own programs, though even this may prove difficult because of administrative and technical capacity constraints. Direct cash transfers to households, however desirable, are probably impractical in most Pacific economies in the short term, as the distribution mechanisms are not in place and may take some years to develop. The Cook Islands, the Fiji Islands and Timor-Leste are exceptions in this regard.

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