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Pacific Studies Series

Navigating the Global Storm

A POLICY BRIEF ON THE GLOBAL FINANCIAL CRISIS

Asian Development Bank

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FOREWORD

The crisis in financial markets emerged at an alarming rate. The collapse of the US sub-prime mortgage market and its repercussions sent shockwaves through global financial markets that have challenged governments and monetary authorities, and will continue to do so over coming months. Against a volatile and uncertain background, this policy brief provides early advice on what the global financial crisis could mean for the Pacific Island economies.

The key message is that the Pacific Island economies are largely shielded from the most immediate effects of the crisis. The region's banking system is reasonably well placed to weather the crisis, mainly because it raises most of its own funds from within the region. The generally sound health of the banking system provides further reassurance.

The global financial crisis, which has made a prolonged and painful recession in the United States and Europe almost unavoidable, will depress demand in several Asia Pacific countries and lower commodity prices. While the latter will provide some relief for the Pacific countries, particularly the most vulnerable nations, it has occurred because of a fall in world demand. The fall in world demand brings new concerns for the region.

Lower commodity prices will see the Pacific's export income decline, remittances are likely to ease as source economies face challenging times, and tourism receipts will be adversely affected. The sharp decline in bourses means a number of the Pacific's Trust Funds and superannuation schemes have already fallen in value and face a period of low income.

The impact of the global financial crisis on the Pacific may be lessened through sound economic management. The key response should be to reinvigorate structural reform, which is crucial to achieving sustained economic growth. Closer engagement with financial institutions and new strategic approaches to managing the region's offshore investments also need serious consideration. It is too early to consider relaxing fiscal policy. Monetary policy could, however, be relaxed as inflation eases.

The Asian Development Bank remains firmly committed to help the region mitigate risks and alleviate adverse impacts of the crisis in close cooperation with other development partners.

S. Hafeez Rahman
Director General
Pacific Department

SUMMARY

Triggered by the collapse of the US subprime mortgage market, the global financial crisis has led to an international crisis of confidence. Despite extensive support from governments and monetary authorities, there has been a squeeze on the availability of credit, international stock markets have fallen dramatically and a major downturn is now expected in the world economy. Commodity prices have eased from recent highs and large exchange rate realignments have taken place.

Problems in the US led to an international crisis of confidence

The crisis has already affected the Pacific by reducing the market value of the offshore investments held by the region's Trust Funds and superannuation funds. Commodity export income will soon begin to decline. In PNG, the price boom that triggered a turnaround in economic growth in recent years is now over. Remittances and tourism activity are also likely to ease as economic growth slows in key source economies, and investment may slow as some major projects may find it harder to secure offshore funds at a reasonable cost.

The Pacific economies are likely to slow

The Pacific's banking system does, however, appear to be well shielded from the most immediate effects of the crisis. The Pacific banking system raises and invests most of its funds within the region, and this has provided a barrier against the effects

But the banking system is well placed to weather the crisis

of the international credit crunch. Local supervision and monitoring of the region's banking sector has improved considerably over time, and it is backed up by the offshore supervision of the overseas banks operating in the region. The generally sound health of the Pacific's banking system provides reassurance that it is well placed to cope with the immediate effects of the global financial crisis.

The global crisis nevertheless calls for a renewed look at financial sector surveillance. Once the immediate crisis subsides, there are likely to be international moves toward more integrated and standardized approaches to sector surveillance. The Pacific would benefit from ensuring it incorporates the lessons that will be learned from crisis. There are likely to be opportunities to participate in some of the global regulatory and prudential reforms, and the Pacific could begin now to prepare for engagement.

Financial sector surveillance could be refreshed

There are also opportunities for the region's finance sector to revisit approaches to managing offshore investments. These are mainly held in government trust funds and in national superannuation funds. As of October 2008, the Federated States of Micronesia, Kiribati, Palau, Marshall Islands and Tuvalu were facing a 20% to 30% fall in the local currency value of their trust funds. Some of the smaller superannuation funds could face a similar large reduction in their market value (most of the region's larger superannuation funds carry little offshore exposure).

The management of offshore funds could be revisited

Nevertheless prudent offshore investments remain sensible. Regional approaches may provide one new way of ensuring the best strategic decisions on asset management while minimizing the downside made so apparent by recent events.

Structural reform needs to be reinvigorated

The key response should be to reinvigorate structural reform, which is crucial to achieving sustained economic growth. Recent events reinforce the importance of structural reform, as it provides a means of lessening the downside of the global downturn. The priority continues to the removal of constraints to private sector–led economic growth.

Efforts to improve rural productivity are key to improved livelihoods for the bulk of the population of the agricultural-based economies. Structural reform can include actions to improve transport and communication and basic public services. For the economies growing through tourism, structural reform can be used to open transport and communication markets to new entrants and to achieve the enabling environment required by business. The region's experience has shown that internal reforms can more than offset the effect on tourism of adverse world events, and renewed reform efforts remain an essential step to tourism-led growth.

THE GLOBAL FINANCIAL CRISIS

The Emergence of the Global Financial Crisis[1]

The triggers of the global credit crisis were in the United States (US) subprime mortgage market. Expansionary monetary policy had kept US interest rates low for some years and encouraged borrowing for real estate. Poor lending practices led financial institutions to provide loans to people who were unable to service the loan and should not have received loans in the first place—the subprime borrowers. Those loans were bundled up and turned into investments through a process known as securitization. These mortgage securities were also combined with other securities to try and reduce the risk—as collateralized debt obligations or CDOs—and used to entice more investors to invest. Financial institutions also entered into intricate financial contracts known as credit derivatives or credit default swaps (CDS), which insure debt holders against default.

Low interest rates and poor lending practices in the US were unsustainable

1 Detailed discussion of the global financial crisis is available from the International Monetary Fund (www.imf.org/) and the Board of Governors of the US Federal Reserve (www.federalreserve.gov/).

An oversupply of homes and rising interest rates (particularly for subprime borrowers) contributed to a decline in housing prices and home loans in the US. Rising defaults, together with the decline in house prices and lending, hurt the companies that held and sold mortgage-backed securities and credit derivatives.

Companies involved in home construction and lending were the first affected

Initially the companies affected were those directly involved in home construction and mortgage lending. Financial institutions that had engaged in the securitization of mortgages then showed their stress. On 11 July 2008, one of the largest mortgage lenders in the US collapsed. Fannie Mae and Freddie Mac, two government-sponsored enterprises engaged in mortgage-backed securities, were placed into federal conservatorship on 7 September 2008.

The crisis then began to affect the general availability of credit to nonhousing-related businesses and to larger financial institutions not directly connected with mortgage lending. Many of these institutions held investments whose assets had been derived from bundled home mortgages. Exposure to these mortgage-backed securities, or to the credit derivatives, affected an increasing number of US firms such as Lehman Brothers, American International Group (AIG), and Merrill Lynch. Other firms that came under pressure included Washington Mutual, the largest savings and loan association in the US, and the large investment firms, Morgan Stanley and Goldman Sachs. Cumulative credit losses have been huge.

But the problems spread quickly through the financial sector

Interbank lending rates, being the interest rate at which banks lend to each other, rose to reflect the increased risk in the financial sector. But still financial institutions were wary about conducting their normal business. They become increasingly worried about lending to one another, and this caused credit markets to fail. This applied to both interbank lending and the general market for corporate bonds.

Overseas financial institutions linked to these markets, such as the Iceland banking system that was closely linked to international financial markets (via asset holdings and the products they offered to customers), were also brought into the turmoil of financial markets in the US, UK, and Europe.

An international crisis of confidence had set in

The failure of banks in the US eroded confidence. The subsequent need for US, UK, and European authorities to bail out banks and other institutions has offered market support but at the same time signaled the severity of the crisis. A crisis of confidence had set in. Concerned investors have withdrawn from stock markets, leading to large falls in world stock markets. These falls were seen in both high-income and emerging markets given the links between these markets provided by asset holdings and trade.

Figure 1 provides an overview of key developments in financial markets.

The Flow Through to World Growth[2]

The financial crisis has come at a time when economies were already slowing while world oil and other commodity prices remained at high levels. The fall in confidence and asset prices and the contraction in bank credit have led to a process known as deleveraging, whereby firms and consumers attempt to reduce their debt exposure. This is in contrast to the past decade where consumers and firms in many countries dramatically increased their debt. Deleveraging could take a number of years to play out and will be an ongoing drag on growth.

The International Monetary Fund (IMF) forecasts global growth in 2009 of 3%, the slowest pace since 2002, and the outlook is subject to considerable downside risks. The major developed economies are already in or close to recession and, although a recovery is projected to take hold progressively in 2009, the pickup is likely to be unusually slow, held back by continued financial market deleveraging and the erosion of confidence.

Growth in the US economy appears to have slowed sharply in recent months. Gross domestic product (GDP) grew at a 2.8% annualized rate between April and June as a result of strong exports and a fiscal stimulus. As the stimulus wore off, however, the job market worsened, credit contracted and growth in consumer spending fell.

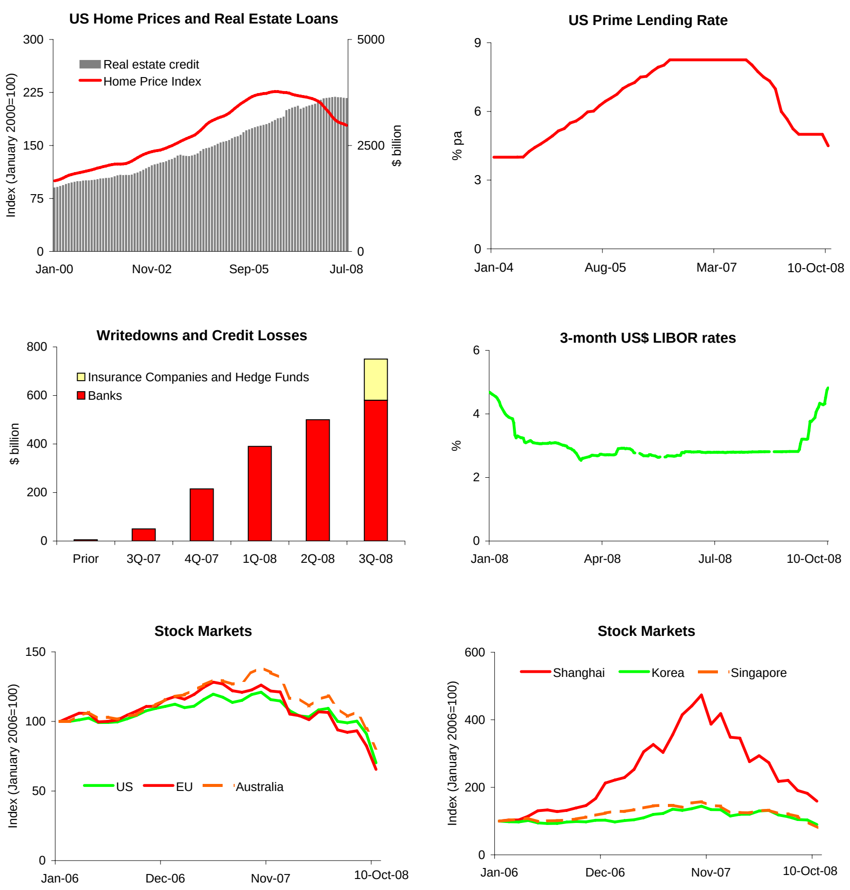
The IMF projects that economic growth in the US will be close to zero in 2009, following a rise of 1.6% in 2008 (Figure 2). Some commentators are projecting negative economic growth for the US in 2009.

While growth prospects in the advanced economies had declined over the past year, until recently continued strong growth in the People's Republic of China (PRC) and other large developing countries were expected to support global growth and commodity prices. Over the last few months, however, growth in the PRC has also slowed. PRC's GDP growth slowed to an annual rate of a 10.1% in the second quarter of this year, from 12.6% a year earlier; growth is now expected to fall below 10% in 2008 and 2009, the first time this has happened since 2002.

PRC's growth is also projected to slow

2 Data for this section are drawn from IMF. 2008. *World Economic Outlook (WEO): Financial Stress, Downturns, and Recoveries*. October. Available: www.imf.org/external/pubs/ft/weo/2008/02/index.htm.

Figure 1: Key developments in world financial markets

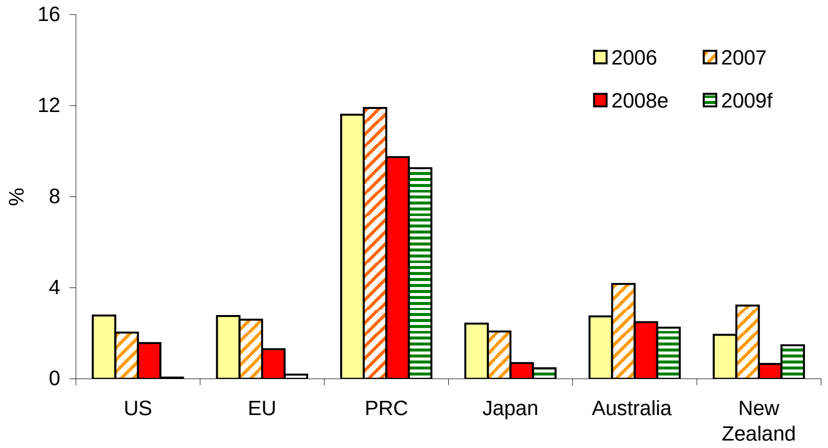


%=percent, $=United States dollar, pa=per annum; EU=European Union, LIBOR=London Interbank Offered Rate

Note: Stock market indices used are: US= Standard and Poor's 500; EU=Dow Jones Euro Stoxx; Australia=Australian Securities Exchange (ASX) all ordinaries; Shanghai=composite index; Korea=Korea Composite Stock Price Index (KOSPI) 200; and Singapore=Singapore Exchange (SGX) Strait Times.

Source: CEIC Database, Standard and Poor's website; British Bankers' Association website, "Shockwaves from the North: Latin America and the External Deterioration", presentation for the Annual Meetings of IMF and World Bank, Washington DC, October 2008.

Figure 2: Growth in key economies



%=percent, e=estimate, f=forecast, EU=European Union, PRC=People's Republic of China, US=United States
Source: International Monetary Fund, World Economic Outlook Database, October 2008.

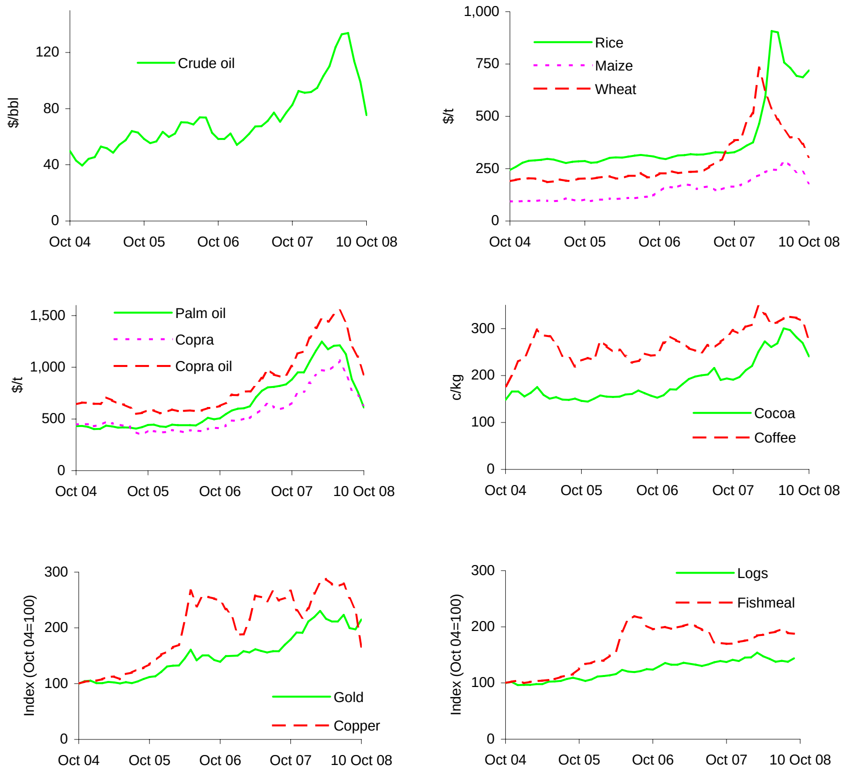
Australia and New Zealand are also affected

Closer to the Pacific, Australia and New Zealand are slowing down noticeably after prolonged periods of economic growth driven by commodity and housing booms. These expansions stretched productive capacity, and pushed inflation above targets. The expected slowdown in Asia will now have a major impact on the Australian economy (East Asia, PRC and Japan now account for around 60% of Australia's merchandise exports, with only 15% flowing to the US and European Union). The latest data show that New Zealand is in recession.

Commodity prices have retreated from their peaks

As prospects for global growth have declined and weakened commodity demand, oil and other commodity prices have fallen. They do, however, remain at historically high levels (Figure 3).

Figure 3: World commodity prices



$=United States dollar, bbl=barrel, t=metric ton, c=cents, kg=kilogram.
Note: Prices shown are crude oil Brent spot price, Thai rice (5%), US maize (no. 2 yellow), Canadian wheat, Malaysian palm oil, Philippine/Indonesian copra and copra oil, International Cocoa Organization price of cocoa, International Coffee Organization price of Arabica coffee, United Kingdom gold, Copper London Metal Exchange (grade A), logs from Malaysia and fishmeal (any origin).
Source: World Bank Commodity Price Data (Pink Sheet), various months, Thompson Datastream, *Wall Street Journal*, and *Financial Times*.

IS THE PACIFIC AT IMMEDIATE RISK?

The Pacific's banking system

The Pacific's banks are well positioned to weather the crisis

The Pacific's banking system is well placed to weather the most immediate effects of the global financial crisis, as it is somewhat separated from international financial markets. For example, the Bank of South Pacific and the National Bank of Vanuatu have very little exposure outside the region. This is mainly because the level of local deposits typically exceeds or closely matches the level of local loans, meaning there is little or no dependence among the commercial banks on offshore sources of funds (Figure 4).[3, 4] The generally sound health of the banking system and the absence of sophisticated financial products provides further reassurance.

In most Pacific developing member countries (DMCs), the largest share of the banking market is held by branches or subsidiaries of large international banks, such as ANZ, Westpac, and (in Palau) the Bank of Hawaii. While the parent companies of these banks have not been immune from the financial crisis, these banks are among

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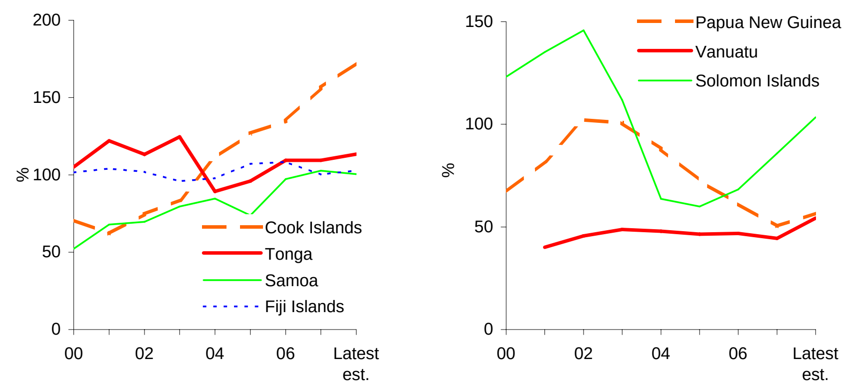
3 The Cook Islands is an exception. Strong growth in lending to the private sector saw net domestic credit exceed liquid liabilities in 2002-03, and the banking system now requires funds from offshore (New Zealand being the key source).

4 Similarly, PDMC governments only occasionally raise funds on the commercial, international financial markets. Offshore funds are typically raised through one of the international financial institutions or on a concessional basis from donor countries.

Figure 4: Net domestic credit to deposits



%=percent, est.=estimate

Note: Data for Cook Islands and Tonga are for the year ended June.

Source: Bank of Papua New Guinea Quarterly Economic Bulletin, Central Bank of Solomon Islands Quarterly Review and Monthly Economic Bulletin; Reserve Bank of Fiji Quarterly Review; National Reserve Bank of Tonga Quarterly Bulletin; Reserve Bank of Vanuatu.

the best regulated and managed, and hence thus far have been relatively unaffected by the global credit crunch.

Prudent regulation and sound management underpin a generally healthy banking system

ANZ and Westpac are two of only 20 banks in the world with an AA credit rating or better and the Australian banking system was recently ranked the fourth soundest in the world in a World Economic Forum survey.[5] The Australian Government has also guaranteed temporarily all Australian deposits and foreign borrowing by Australian banks. BRED Banque Populaire and Bank of Hawaii both have Aa3 ratings, with the Bank of Hawaii cited in a recent MS Money article as one of the five most stable US financial institutions.[6]

The credit ratings of the major banks in the Pacific are summarized in Table 1. It should be noted that some overseas institutions that have been adversely affected by the global financial crisis also had high credit ratings.

5 http://gcr.weforum.org/gcr/

6 http://articles.moneycentral.msn.com/Investing/SuperModels/5BanksSafeFromTheStorm.aspx?page=1

Table 1: Credit ratings of major banks in the Pacific

Bank	Credit Rating
Westpac	AA (S&P)
ANZ	AA (S&P)
Bank of South Pacific	B+ (S&P)
Bank of Hawaii	Aa3 (Moody's)
BRED Banque Populaire	Aa3 (Moody's)

S&P=Standard and Poors
Source: Credit ratings agencies.

Banks will be indirectly affected by the crisis

Although relatively well insulated from the most immediate effects of the world financial crisis, Pacific financial institutions may be affected indirectly. Slowdowns in tourism activity, in real estate demand, and in commodity-based lending can be expected to slow regional economies and dampen the demand for loans. The recent boom in some countries such as Papua New Guinea (PNG) led to an expansion in loans, some of which may deteriorate in quality as economic growth slows. Financial institutions will need to more closely monitor credit quality.

Careful supervision is needed

Governments, regulators, and financial supervisors, backed up by offshore supervision of the overseas banks, hence need to maintain very close contact with the region's financial institutions.

The Pacific's offshore trusts

Most of the region's offshore investments will fall in value

One pronounced immediate impact of the financial crisis will be a fall in the value of the region's offshore investments. These are mainly held in government trust funds and the offshore investments of the superannuation/retirement funds. The extent of the fall will depend on the asset mix of the offshore investment, with the fall in the stock component likely to follow the overall fall in world stock markets.

For example, Timor-Leste's Petroleum Fund is invested in US government bonds and hence is largely immune to the decline in world stock markets (fortunately for Timor-Leste in this instance, recent moves to try and raise the fund's returns by shifting from bonds to stocks were not followed through).

Some trusts may have fallen by 20% to 30%

In contrast, the trust funds of Federated States of Micronesia (FSM), Kiribati, Palau, Marshall Islands and Tuvalu face a large fall in value because they are weighted toward stocks (Table 2). The fall in the total local currency value of these funds is likely to range from 20% to 30%. Incomes are also likely to be low for some time.

Kiribati, Palau and Tuvalu have invested a large share of their trust funds in stocks for some time. This means they have benefited from the growth in major stock markets seen until 2007, and the recent drop in value needs to be seen in this context. In the case of the Tuvalu Trust Fund for example, its local currency value is likely to have returned close to the levels seen in 2002 and 2003.

While the market or book values of the region's trust funds have fallen, a loss is only incurred if the stocks are sold at a low price. Many offshore investments will increase in value again once world stock markets strengthen.

Kiribati and Tuvalu are the most affected

The fall in the value of offshore investments is of most concern for those that need the income from their investments now. This includes Kiribati and Tuvalu that have become overly dependent on drawdowns from the Revenue Equalization Reserve Fund and Tuvalu Trust Fund, respectively, to fund high levels of government expenditure.[7] Both countries face the need for a substantial reduction in government expenditure to correct for the fall in the value of their funds.[8]

FSM, Palau and Marshall Islands are also affected

In Palau, FSM, and Marshall Islands, their trust funds are designed to provide a long term replacement for US financial assistance.[9] Only Palau is making drawdowns (up $5 million per annum (p.a.) to 2009, then $15 million p.a. thereafter) at this stage, and these are independent of changes in the market value of the fund. Thus, the fall in stock prices need not have an immediate effect on government spending. However, lower drawdowns or a higher rate of savings in the funds may now be required if they are to achieve the long-term target value.[10]

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7 The Pacific's trust funds are discussed in Asian Development Bank. 2005. Trust Funds in the Pacific: Their Role and Future. Manila.

8 Tuvalu has a large buffer held in what is termed its Consolidated Investment Fund (that holds the distributions from the Tuvalu Trust Fund that the government can spend). But this buffer is unlikely to be replenished for some time, and drawdowns from the Consolidated Investment Fund need to be reduced or it will be depleted.

9 These trust funds are reviewed in the latest Article IV Staff Reports of the International Monetary Fund.

10 Even before the world financial crisis, the US Government Accountability Office highlighted the risk that a few consecutive years of poor stock market performance could deplete Palau's Trust Fund well before the target of 2044 (United States Government Accountability Office. 2008. Compact of Free Association: Palau's Use of and Accountability for U.S. Assistance and Prospects for Economic Self-Sufficiency. Report to Congressional Committees. June, 37).

Table 2: Major trust funds in the Pacific

Country	Name	Year of inception	Share held in overseas stocks	Initial source of funds	Market value		
					$ million	% of 07 GDP	As of
Kiribati	Revenue Equalization Reserve Fund	1956	High	Phosphate mining	570	745	Feb 2008
FSM	Compact Trust Fund	2004	High	Government and donors	84	35	Sep 2007 (projected)
Palau	Compact of Free Association Trust Fund	1995	Around 65%	Government and donors	161	95	Mar 2008
Marshall Islands	Compact Trust Fund	2004	Around 80%	Government and donors	97	65	Dec 2007
Timor-Leste*	Petroleum Fund	2005	Nil	Petroleum revenue	3,203	835	Jun 2008
Tuvalu	Tuvalu Trust Fund	1987	High	Government and donors	87	325	Mar 2008

* GDP excluding oil and the activities of the United Nations
FSM=Federated States of Micronesia, GDP=gross domestic product.
Source: Banking & Payments Authority of Timor-Leste. 2008. Petroleum Fund of Timor-Leste Quarterly Report for the Quarter ended 30 June 2008. Presented to the Minister of Finance; United States Government Accountability Office. 2008. Compact of Free Association: Palau's Use of and Accountability for U.S. Assistance and Prospects for Economic Self-Sufficiency. Report to Congressional Committees. GAO-08-732. June; International Monetary Fund. 2008. Republic of the Marshall Islands: Selected Issues and Statistical Appendix. IMF Country Report No. 08/186. June; Tuvalu Trust Fund Advisory Committee Secretariat. 2008. 2008 First Half Year Report. April; United States Government Accountability Office. 2007. Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income. Report to Congressional Committees. GAO-07-513. June; and Kiribati Authorities.

The Pacific's superannuation and retirement schemes[11]

Superannuation funds that are invested locally are isolated from immediate effects

The superannuation funds of most larger Pacific DMCs focus on investments in local activities. For example, the National Provident Fund of the Fiji Islands, with $1,455 million in assets at the end of 2007 did have small offshore investments but these were recently sold. Vanuatu's National Provident Fund ($70 million of assets as of the end of 2006) and Samoa's National Provident fund (assets of the order of $100 million as of June 2006) report no offshore equities among their assets.[12] The Solomon Island National Provident Fund (assets of $100 million as of December 2007) holds up to 30% of its assets offshore, with around half of this held as cash. These funds are largely dependent on domestic economic growth and, hence, are only indirectly exposed to the world financial crisis.

11 Data for this section are from the websites of the region's central banks and superannuation schemes and personal communication.
12 The Vanuatu National Provident Fund recently relaxed constraints on offshore investments but has limited these to US government securities.

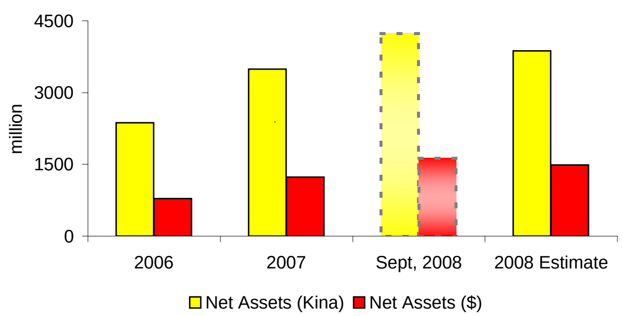
PNG's funds have fallen by around 10% (from their end-September level)

The situation is somewhat different in PNG. Nambawan Super held 17% of its $680 million in assets in offshore equities as of the end of 2007, while around 5% of the $625 million of assets held by PNG's Nasfund were offshore as of the end of 2007. However, a significant share of remaining assets is held in mining and oil and other commodity-based stocks that are dual listed on the Port Moresby and overseas stock exchanges. The value of these stocks has dropped substantially as world stock markets and commodity prices have fallen. Moreover, the apparent ending of the commodity price boom will dampen prospects for properties and other non-commodity–based investments of these superannuation funds. These effects have the potential to reverse some of the growth in value enjoyed by these funds in recent years. Preliminary estimates suggest that the net assets of the two largest superannuation funds have collectively contracted by about 10% since the end of September 2008. These net asset values, however, are still over 60% higher than what they were as at the year-end of 2006. (Figure 5).

In other countries that lack sufficient local investment opportunities, superannuation funds are largely invested offshore (Cook Islands, Kiribati, Nauru, and Tuvalu are examples). They would have substantially decreased in value through the effects of the financial crisis on their overseas stock holdings.

Provided those superannuation funds with an offshore exposure have avoided investments in now-failed entities, the value of their investments should rebuild over time.

Figure 5: PNG's superannuation funds



Note: ADB Staff estimates. Estimates were calculated by disaggregating the fund's offshore equity investment assets (including those dual listed offshore stock exchanges) and moving their value in line with company specific share value information as published in the national newspapers. The estimate for year-end 2008 assumes stock prices remain at their value as of 15 October 2008.
Source: 2007 Annual Reports for the National Superannuation Fund of PNG (NASFUND) and the Nambawan Super, and various market share values of listed companies as published in the Post Courier Newspapers on the 31 December 2007, 30 September 2008 and the 15 October 2008.

WILL THE PACIFIC'S GROWTH SLOW?

Tourism is likely to weaken

A tight global economic situation has always been a threat to the Pacific DMCs that rely on tourism (Figure 6). Tourism demand thrives on robust economic conditions creating new market opportunities, and providing the disposable income needed to grow tourism spending. The global financial crisis and downturn in world growth have the potential to dampen the region's tourism industry. Notably, visitors' arrivals from Asia have shown a sensitivity to conditions in their home economies (Figure 7). And the potential need to offer discounts to keep tourism arrivals up may dampen industry profits (as it did in the Fiji Islands following the December 2006 coup).

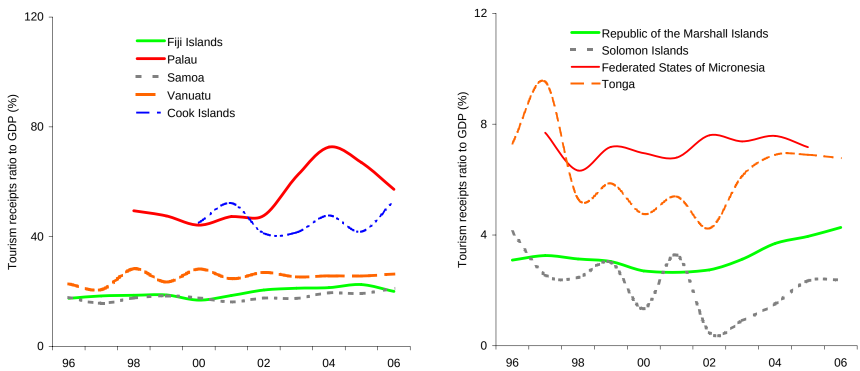
Tourism activity is likely to weaken

In this case, the easing in world oil prices may provide some help by resulting in lower air fare costs to the Pacific. Against this, however, the currencies of a number of Pacific DMCs have appreciated significantly against the Australian and New Zealand dollars. As Australia and New Zealand are the largest source of tourists to the region, this will be to the disadvantage of their tourism industries.

Pacific governments could act to minimize any slowdown

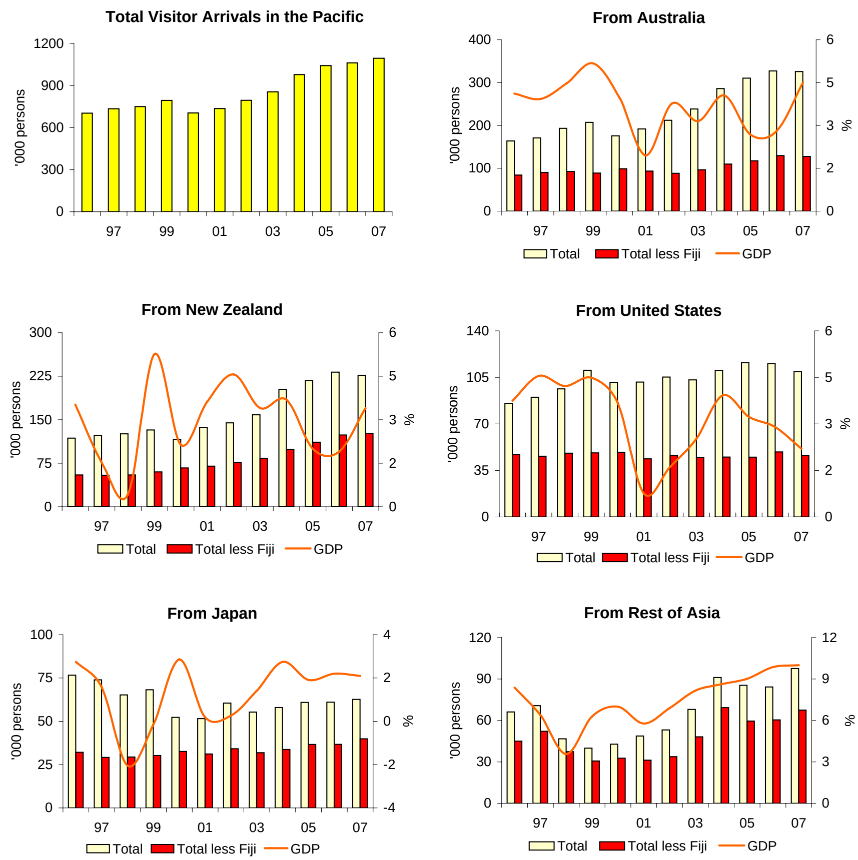
It is however important to note that the Pacific DMC governments have demonstrated they are a key factor in the strength of the region's tourism. Indeed, internal events have probably played a larger role in determining tourism activity than variations in world economic growth. For example, visitor arrivals from Australia and New Zealand have shown a greater sensitivity to events within the Pacific (e.g., coups in the Fiji Islands) than changes in their home economies. And the recent rise in tourism arrivals in a number of Pacific DMCs can be traced back to efforts to open air services to competition and develop hotels and other accommodations through a more investor-friendly business environment.

Figure 6: The economic importance of tourism



%=percent
Source: World Bank's World Development Indicators online database and Cook Islands Half-Year Economic and Fiscal Update, various years.

Figure 7: Visitor arrivals



'000=thousand, %=percent, GDP=gross domestic product

Note: Visitors arrival data for Nauru and Timor-Leste are not available.

Source: Pacific development member countries statistical websites, Reserve Bank of Fiji Quarterly Economic Review (June 2008), Cook Islands Statistics Office Annual Statistical Bulletin (2007), Republic of Palau Economic Report (2000), World Bank's World Development Indicators Online, International Monetary Fund's World Economic Outlook Database.

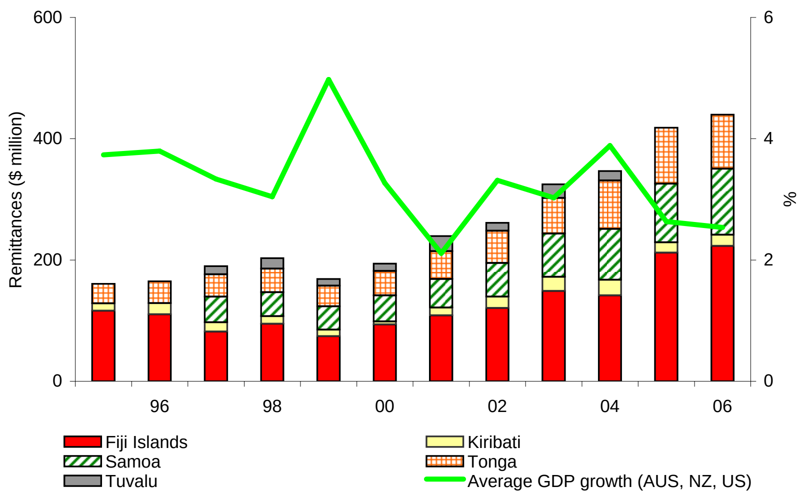
Remittances may also weaken

Remittances may slow as neighboring economies weaken

Migrant workers' remittances have become increasingly important to the region, particularly in Samoa, Tonga and to a lesser extent in the Fiji Islands, Kiribati and Tuvalu.[13] The global financial crisis has the potential to slow these flows as the incomes of Pacific Islanders living overseas decline (e.g., because of unemployment or a fall in the availability of over time work).

However, it is difficult to project the likely extent of any decline. This is in part because the resilience shown by remittances to the Pacific to changes in economic growth in neighboring countries that gives some cause for optimism. For example, remittances grew over 2000 and 2001 despite a slowdown in growth in Australia, New Zealand and the US. The negative relationship was again evident in 2005 and 2006 (Figure 8).[14] Furthermore, the implementation of seasonal worker schemes between Pacific Island nations and Australia and New Zealand is also providing a new source of remittance flows.

Figure 8: Remittances in the Pacific



$=United States dollar, %=percent, AUS=Australia, GDP=gross domestic product, NZ=New Zealand, US=United States

Source: Fiji Islands Bureau of Statistics, Samoa Department of Statistics website, Tuvalu's Ministry of Finance and Economic Planning Central Statistics Division, Kiribati National Statistics Office, National Reserve Bank of Tonga, and World Bank's World Development Indicators online.

13 The ratio of remittances to GDP is of the order of 30% to 35% in Tonga, 20% in Samoa, and 5% in the Fiji Islands, Kiribati and Tuvalu.

14 The growth in remittances may also have been partly due to special factors (e.g., the 2000 coup in the Fiji Islands and a rising number of Pacific Islanders involved in overseas security and military operations).

Access and pricing of international capital

Tighter global credit markets have driven up the cost of international financing and are likely to lead to reduced flows of private investment to developing countries. However the majority of Pacific DMCs have little need for direct access to international credit markets. The Fiji Islands and resource-rich countries such as PNG and the Solomon Islands could however be at some risk of higher borrowing costs, as the financing options available to these countries to raise capital from international markets will have been reduced. This will make it more challenging to secure sufficient project funding for major projects such as in the tourism, mining, and energy sectors, as well as for smaller activities. The fall in world commodity prices will make many commodity-based projects appear less profitable, further compounding difficulties in raising financing.[15]

Foreign direct investment flows into the Pacific DMCs tend to be longer term in nature so the current financial market turmoil is unlikely to have an immediate impact on the Pacific. The full impact will become clearer when investors begin to make longer-term investment decisions depending on how they assess impacts on longer-term prospects for economic growth and commodity prices.

Local sources of credit may ultimately be affected

A prolonged global financial crisis will lower capital inflows to domestic banking systems in Pacific DMCs. This will reduce credit available for business. In general however, any tightening in liquidity conditions may have little impact on private investment as the key constraint is usually the shortage of good investment projects rather than a shortage of funding.

Export income is likely to weaken

Lower commodity prices will lower export income

World commodity prices have already begun to ease, and most Pacific DMC economies will weaken as their export revenue declines. Given the heavy dependence on primary product exports of many of these economies, the decline in commodity prices and the ensuing deterioration in the terms of trade may potentially have a serious impact on growth rates in the region in 2009 and in the medium term. In PNG, for example, recent price falls would see a reduction over 2009 of around 25% in both mining and oil and agricultural export income.[16]

15 On 16 October 2008, Esso Highlands Limited, an Exxon Mobil Corporation subsidiary, announced that the first phase of the Front-End Engineering and Design of the PNG Liquefied Natural Gas Plant had been completed and competition would start on the engineering, procurement, and construction, with construction expected to commence in 2010 (http://asx.com.au/).

16 Based on the assumption, that 2009 export volumes match 2008 volumes, and that PNG exporters receive the world commodity prices as at 10 October 2008 until the end of 2009.

PNG's commodity price boom is over

Despite the recent reversal, commodity prices are coming off historically high levels, so the easing in commodity prices should be placed in context. In PNG, for example, the price boom that has triggered a turnaround in economic growth and government finances in recent years is over. But economic growth is likely to remain at moderate levels as the now stronger non-mining and oil economy will help sustain activity.

The impact of lower demand in the US will mainly trickle through to the Pacific region via the Australian and East Asian economies, especially the People's Republic of China (PRC), which in turn is a key export destination of Australia. Thus, the indirect impact of the global financial crisis on the Pacific will largely depend on the extent to which the crisis spills over to the PRC and hence commodity prices.

The growth in foreign aid may slow

Slower economic growth may affect aid budgets

The world economic downturn may affect the ability of some donor countries to sustain recent levels of foreign aid. Certainly, prospects of further large increases in aid to the Pacific have weakened, and this will reduce the prospects for growth in aggregate demand. The potential boost to productivity from investment and capacity development will also be affected.

In some cases, local currencies appreciated against donor currencies as the financial crisis unfolded (e.g., against the Australian and New Zealand dollars). While this reduces the local currency value of aid, there should be little effect on the real value of aid. This is because imports of the goods and services funded by aid from these donor countries have become cheaper in local currency terms (i.e., more or less the same volume of goods and services can be afforded as before).

An easing in inflation will help

Lower oil prices should reduce inflation

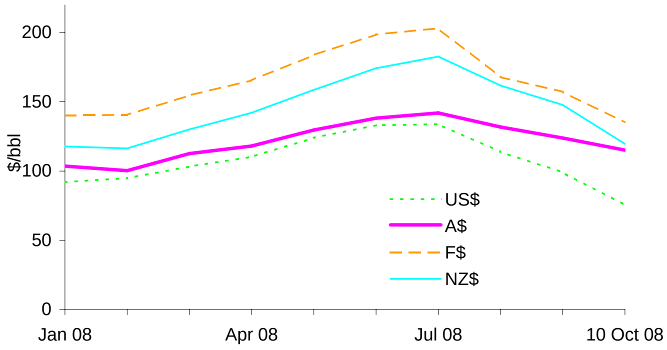
Inflation rates have surged over 2008 as high world oil and food prices have fed through to the Pacific. In the Marshall Islands, for example, inflation reached 22% in the September quarter. With world commodity prices now receding, the recent inflationary pressures will ease. The world oil price in particular, the key source of inflationary pressures in the region, has declined over recent months (whether expressed in US$ or converted to local currencies, see Figure 9).

But the flow through may take some time

The timing of the inflationary relief is also dependent on government attitudes to electricity prices. Many electricity utilities have had their prices held too low (to meet costs), and electricity prices may need to stay up even as lower world oil prices reduce their costs.

Exchange rate movements will also affect how quick inflation will ease. The currencies of a number of Pacific DMCs have depreciated (as the US dollar has strengthened). This will keep prices higher than they otherwise would have been. For example, Kiribati, Nauru and Tuvalu which use the Australian dollar, have borne a depreciation against the US dollar. This will add to the local price of imports from the US (although the prices of imports from Australia, a key source, will be relatively unaffected).

Figure 9: The local currency price of crude oil



Note: A$=Australian dollar, bbl=barrel, F$=Fiji Islands dollar, NZ$=New Zealand dollar, US$=United States dollar
Source: World Bank Commodity Price Data (Pink Sheet), various months and web sites of the region's central banks.

INTERNATIONAL COMPETITIVENESS

The US dollar strengthened during the crisis

The global financial crisis saw the Australian dollar depreciate by more than 25% against the US dollar. This sharp exchange rate movement has been caused by a severe shortage of US dollars because of reduced interbank lending by increasingly risk averse financial institutions, and the sudden decline in commodity prices, which has been the catalyst for weaker commodity currencies such as the Australian dollar and, to a lesser extent, the New Zealand dollar.

Many Pacific currencies have also appreciated

Although Pacific Island trade has gradually shifted toward its Asian neighbors, Australia and New Zealand remain significant trading partners for many Pacific Island economies and key sources of bilateral donor assistance within the region. Since the financial turmoil began, the currencies of many Pacific Island economies have strengthened considerably against these weakened currencies. For example, over October 2008 PNG's kina appreciated by about 20% against the Australian dollar while the Samoan tala gained about 12% on the New Zealand dollar.

The immediate direction and impact of these sharp cross-rate movements on the competitiveness of Pacific DMC economies will depend largely on the foreign exchange policies pursued in these countries. These are quite varied and fall under five broad categories:

(i) Adopted the US dollar—Marshall Islands, FSM, Palau, and Timor-Leste
(ii) Aligned to the US dollar[17]—PNG, Solomon Islands, Vanuatu, and Tonga
(iii) Aligned to a weighted currency basket[18]—Fiji Islands and Samoa
(iv) Adopted the New Zealand dollar—Cook Islands
(v) Adopted the Australian dollar—Nauru, Tuvalu, Kiribati

This can affect international competitiveness

Those countries that align with the US dollar will benefit from cheaper Australian imports but may experience a loss of trade competitiveness, and vice versa. Which countries have adopted the appropriate foreign exchange policy? In considering this question, it is important to take into account a multitude of factors, such as (i) the direction of trade, both origin of imports and the destination of export; (ii) the industry composition of the export sector, i.e., commodity, industry, tourism, etc.; and (iii) origin and destination of capital flows, such as remittances and foreign investments.

The real exchange rate (RER)[19] is a measure of trade competitiveness that accounts for both the relative price between trading partners as well as movements in bilateral exchange rates. Figure 10 shows how the RER has developed for Pacific DMCs with different foreign exchange policies. An RER shows an increase or appreciation as a loss of international competitiveness, and a decrease or depreciation as a gain in international competitiveness.

The majority of Pacific DMCs that have aligned to the US dollar have lost some competitiveness as a result of recent developments. In the case of the Solomon Islands and Timor-Leste, the losses need to been seen in the context of gains over the last 8 years. Those Pacific DMCs that aligned with either the Australian or New Zealand currencies will have recovered some competitiveness.

The RER also has an inflation dimension. Pacific DMCs with an appreciation in the RER will normally find imports cheaper in local currency terms, and this will help reduce inflation or even result in deflation (i.e., falling prices).[20] In contrast, those DMCs with a depreciation in the RER will find imports more costly in local currency terms, and this will tend to add to inflation. Hence, the inflation effect will normally mirror the international competitiveness effect.

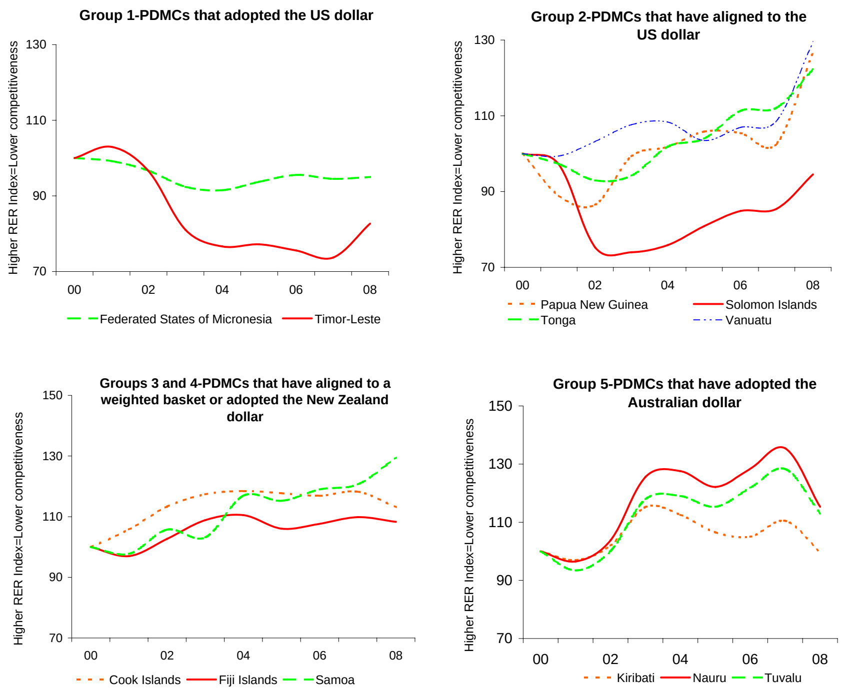
17 This category includes countries that have either pegged against the US dollar, are managing a float that is anchored by the US dollar, or pegged against a basket of currencies that has a very heavy US dollar weighting.

18 The Fijian dollar and the Samoan tala are weighted against both the US dollar and the Australian dollar.

19 The real exchange rate is defined as $RER = e^*(Pf/Pd)$, where Pd is the domestic price level and Pf the foreign price level, both expressed as indices with the same base year.

20 It is the change in the nominal exchange rate that normally drives import prices in local currency terms. However, the nominal exchange rate and RER will normally move together in the Pacific DMCs as most are small open economies with a high import dependency.

Figure 10: Real exchange rates



PDMCs=Pacific developing member countires, RER=real exchange rate, US=United States
Note: Used end of period exchange rates for 2000-07, rate as of 15 October 2008 for 2008. Bilateral exchange rates calculated as geometric means using trade weights of major partners.
Source: Asian Development Outlook, various years, International Monetary Fund's International Financial Statistics online database, Pacific Regional Information System website, and various central bank publications.

There can be a trade-off between inflation and competitiveness

Pacific DMCs have had to confront the multiple challenge of trying to keep inflation down (an RER appreciation is best from this perspective) while achieving international competitiveness (an RER depreciation is best from this perspective). For those that operate their own exchange rate, they can influence the inflation outcome through exchange rate management. That is, allowing a nominal appreciation in the exchange rate of Pacific DMCs may be attractive in terms of achieving inflation targets, but it is likely to adversely affect international competitiveness and hence economic growth. Pacific DMCs that operate their own exchange rate need to weigh up this trade-off.

A POLICY RESPONSE

Consolidate the fiscal balance

Fiscal conservatism is needed

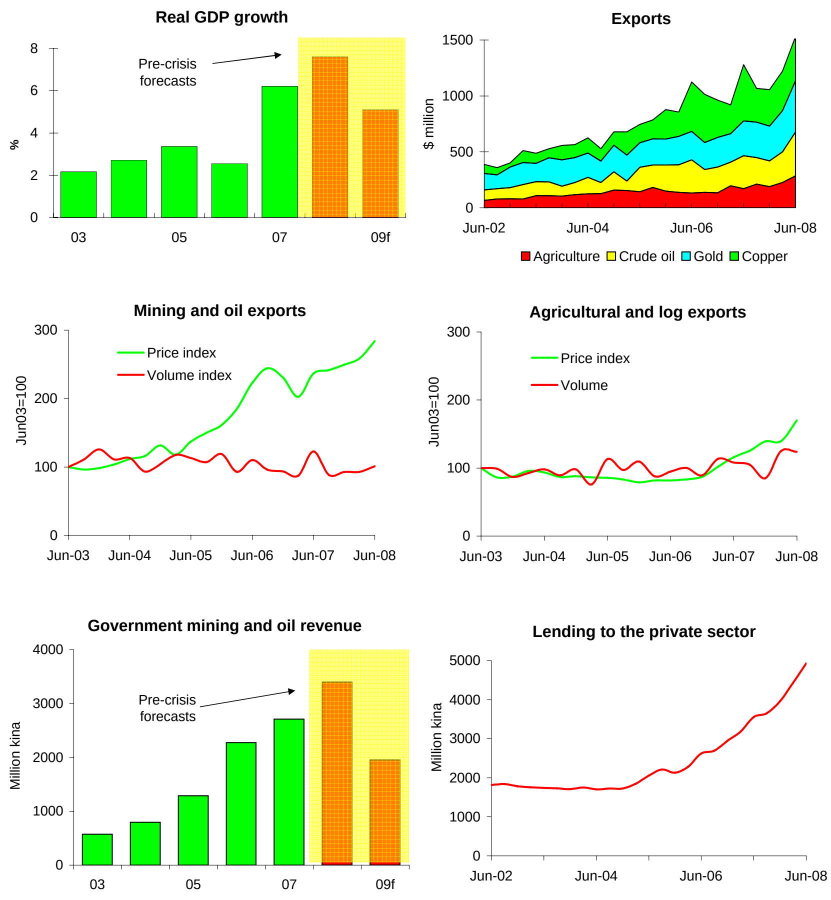
Most of the region's governments have already been put under pressure by high world prices—via calls for subsidies to electricity utilities and relief for the broader community from rising inflation. It is important that Pacific Island governments now exercise fiscal conservatism. This would provide some fiscal space to respond to any downturn in economic growth or external shocks.

While a fiscal stimulus in the form of moderate budget deficits may ultimately be desirable to help manage any downturn in the region's economies, it is too early for such a response—any capacity to relax fiscal policy should be held in reserve at this stage.

The need is particularly strong in PNG

Efforts to trim low priority expenditure and improve revenue collections are a sensible, quick response that will help protect fiscal positions and the ability of governments to respond when needed. In PNG, the end of the commodity price boom calls for an early winding back of expectations for new government initiatives and rising government expenditure (Figure 11).

Figure 11: The Price Driven PNG Economy



%=percent, $=United States dollar, PNG=Papua New Guinea

Source: Bank of Papua New Guinea, various issues of Quarterly Economic Bulletin and July 2008 Monetary Policy Statement, and Department of Treasury, 2008 Budget, Volume 1,and Mid-Year Economic and Fiscal Outlook Report (MYEFO) 2008.

Ease monetary policy

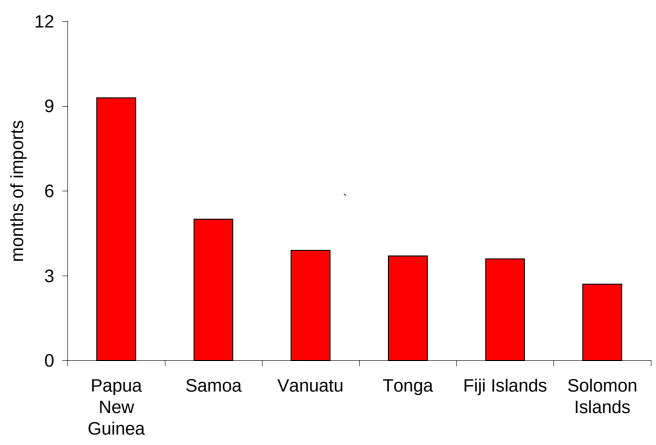
Monetary policy needs to factor in the risk of economic slowdown

Macroeconomic policy priorities vary considerably across Pacific DMCs. In an increasing number of these countries, the downside risk of slowing economic activity is rising as external conditions deteriorate and inflation starts to moderate. This shift may justify a gradual easing of the monetary policy stance, for example, through a reduction in interest rates (note that only those Pacific DMCs with their own currency have a capacity to operate monetary policy).

However, inflationary pressures driven by past increases in world oil and food prices are still a concern. Policy makers need to strike a careful balance when considering the appropriate rate in which to ease monetary policy settings.

Most Pacific DMCs have sufficient levels of international reserves to accommodate a relaxing of monetary policy (Figure 12). Exceptions are the Fiji Islands and Solomon Islands that have little, if any, room for expansionary monetary policy.[21]

Figure 12: International reserves



Note: Latest data for the following countries are as of: June 2008 for Papua New Guinea, July 2008 for Samoa and Vanuatu, and August 2008 for Tonga, Fiji Islands, and Solomon Islands.
Source: Bank of Papua New Guinea website, Central Bank of Samoa's Economic Performance (July 2008), Reserve Bank of Vanuatu's Financial and Economic News (August 2008), National Reserve Bank of Tonga website, Reserve Bank of Fiji Economic Review (September 2008), and Central Bank of Solomon Islands Monthly Economic Bulletin (August 2008).

21 Both the Fiji Islands and Solomon Islands face large risks to their key exports. In addition, by September 2008, Solomon Islands Reserves had fallen below 1 month of imports and in 2011, the Fiji Islands will need to make a bullet repayment of an offshore bond equivalent to around 1 month of imports.

Renew banking surveillance

Banks will probably face more pressure over time

Although relatively well insulated from the direct effects of the banking crisis, Pacific banks may be affected indirectly through possible reductions in liquidity and a deterioration in loan quality as economic growth slows. Local regulators and financial supervisors, backed up by offshore supervision of the overseas banks that have set up operations in the Pacific, should maintain very close contact with the region's financial institutions as the situation develops. Central banks should carefully monitor liquidity conditions and take action to inject further liquidity where necessary.

Once the immediate global financial crisis subsides, there are likely to be international moves toward a macroprudential and regulatory architecture that is more integrated in its approach and uniform in standards, and that involves closer and more effective cross-border coordination and collaboration among supervisors, regulators, and central banks.

The structure of this new financial architecture will evolve over the next few years but may include the following:

(i) Authorities must ensure that the risk measurement systems of firms take a sufficiently long-term perspective and establish standards for risk disclosure that are consistent not only across firms but also across borders;

(ii) Banks and securities firms must improve their liquidity management, while central banks must have in place backstops that can be applied quickly and flexibly in the event of system-wide pressures; and

(iii) Banks with significant activities in other countries must reassess their cross-border lending plans and authorities have to work on cross-border cooperation and contingency planning to ensure that domestic laws do not interfere with international cooperation, when dealing with firms operating in more than one country.

Opportunities will emerge to strengthen supervision

Pacific DMCs would benefit from ensuring that their own regulatory and supervisory arrangements incorporate the lessons that will be learned from the current crisis and be ready and have adequate capacity to participate in some of the global regulatory and prudential reforms that are likely to emerge.

Revisit the management of offshore investments

Prudent offshore investments still make sense

A mix of stocks, bonds, and property investments in a range of international markets (developed and developing) provides a "balanced" portfolio and remains a sensible strategy for a long-term fund, despite the current financial shock. Recent events should not deter Pacific DMCs from carrying the risks inherent in investments in offshore stocks.[22]

Decisions on the right asset mixes are ongoing. For example, FSM, PNG, Marshall Islands, Solomon Islands, and Vanuatu have recently considered or relaxed constraints on overseas investments. While Pacific DMCs should clearly aim to out-source the management of overseas investments to overseas entities (on a competitive basis), it is much harder to outsource the strategic decisions on investment strategies and the selection of fund managers. There may be gains from a regional approach to managing strategic decisions on offshore investments.[23] A regional or subregional approach is likely to make most sense for the smaller Pacific DMCs that would find it harder to build the required skills internally.

A regional approach could offer benefits from extra bargaining power and an associated greater exposure to up-to-date portfolio management techniques and systems. A regional approach would also help ensure that the investment funds are managed by appropriately trained and experienced staff. The result is likely to be improved strategies to achieve the portfolio mix that suits each Pacific DMC, to avoid investments in unnecessarily risky investments, and to time the purchase and sale of assets to maximize fund returns.

Extra support for strategic decisions would help

Reinvigorate structural reform

Structural reform provides the Pacific Island economies with the best path to achieving sustainable economic growth. Recent events reinforce the importance of structural reform, as it provides a means of lessening the downside of the global downturn. The priority is to address constraints to private sector–led economic growth in the region.

Structural reform can sustain economic growth

22 As the US Government Accountability Office explained: "Investment strategies vary in their levels of returns and volatility. A more conservative investment strategy usually carries a lower level of volatility but also brings lower levels of expected returns over time; a more aggressive investment strategy seeks higher returns but is likely to have higher volatility, with returns on the investment varying more widely year to year. By varying the weight of each investment asset, investors can vary their return and risk levels. The annual compounded real returns of large (US) company stocks and international stocks from 1970 to 2005 were around 6%, with standard deviations of approximately three times the return for the large company stocks and more than three times the return for the international stocks. US treasury bills have the least volatility and the lowest returns, around 1%." (US Government Accountability Office. 2007. Compacts of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income. Report to Congressional Committees. GAO-07-513. June, 13–14)

23 This does not mean a common fund or any loss of sovereignty. A country could retain complete control of its funds while benefiting from regional dialogue and advisory services.

There is still a need to adjust to high oil and food prices

It is important to keep in mind that prices of oil and food are projected to remain at historically high levels (even though below recent peaks), and be a source of ongoing pressure on living standards and economic prospects.[24] Structural reform that helps the adjustment to relatively high oil and food prices remains important.

Efforts to improve rural productivity are the key to improved livelihoods for the bulk of the population of the agriculture-based economies. Structural reform can include actions to improve transport and communication and other basic services including agriculture extension in FSM, PNG, Solomon Islands, Timor-Leste, and Vanuatu. Such actions will lower costs and help keep net returns to agriculture and fishing as high as possible even though prices are falling.

Private investors need a supportive environment

For the economies growing through tourism, structural reform can include continued efforts to lower transport and communications costs. It is also important to help build the human skills needed by the industry. In transport and communication, the key is to create a more enabling environment for higher private investment. The benefit of deregulation has already been shown by the growth spurt provided by air transport reform in the Cook Islands, Samoa, and Vanuatu; and by the expansion in mobile telecommunication services and fall in prices that followed the entry of private providers. Structural reforms strengthen the economy's resilience to external events and also remain an important path to tourism-led growth.

Reform options are well mapped out in the Pacific

Many of these initiatives require public sector reform that focus governments on core activities and free up budget resources (e.g., for investment in infrastructure and maintenance). The imperative to pursue efforts to improve the enabling environment for the private sector is also raised by the global financial crisis. Sensible actions in these areas have been mapped out in most Pacific DMCs; implementation has, however, often fallen short of plans. Ways of overcoming the slow rate of change are needed if Pacific DMCs are to minimize the adverse impact of recent events.

24 The pressures arising from high prices are discussed in ADB. 2008. Living with High Prices: A Policy Brief. Pacific Studies Series.

Navigating the Global Storm

The global financial crisis emerged at an alarming rate. A global credit squeeze led to large falls in international stock markets and the world economy is weakening rapidly. The Pacific is largely shielded from the most immediate effects of the crisis, but it is not immune. This Policy Brief provides early advice on what the global financial crisis could mean for the Pacific and what it could do to lessen its adverse impacts. The key response should be to reinvogate structural reform, which is crucial to achieving sustained economic growth.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two thirds of the world's poor. Nearly 1.7 billion people in the region live on $2 or less a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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