



Post-Crisis Macroeconomic Policy Challenges in Pacific Island Countries

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July 21, 2011, Apia

Plan of the presentation

External Environment

- Multi-speed global growth has continued, but downside risks have increased.
- Growth prospects are favorable in Australia and New Zealand, supported by strong Asian outlook.

PICs: State of Recovery

- Economic recovery remains weak in most PICs.
- Inflationary pressure has risen
- External position has improved
- Banks are highly liquid but credit demand is weak
- Fiscal position has weakened but consolidating

Policy Challenges and Response

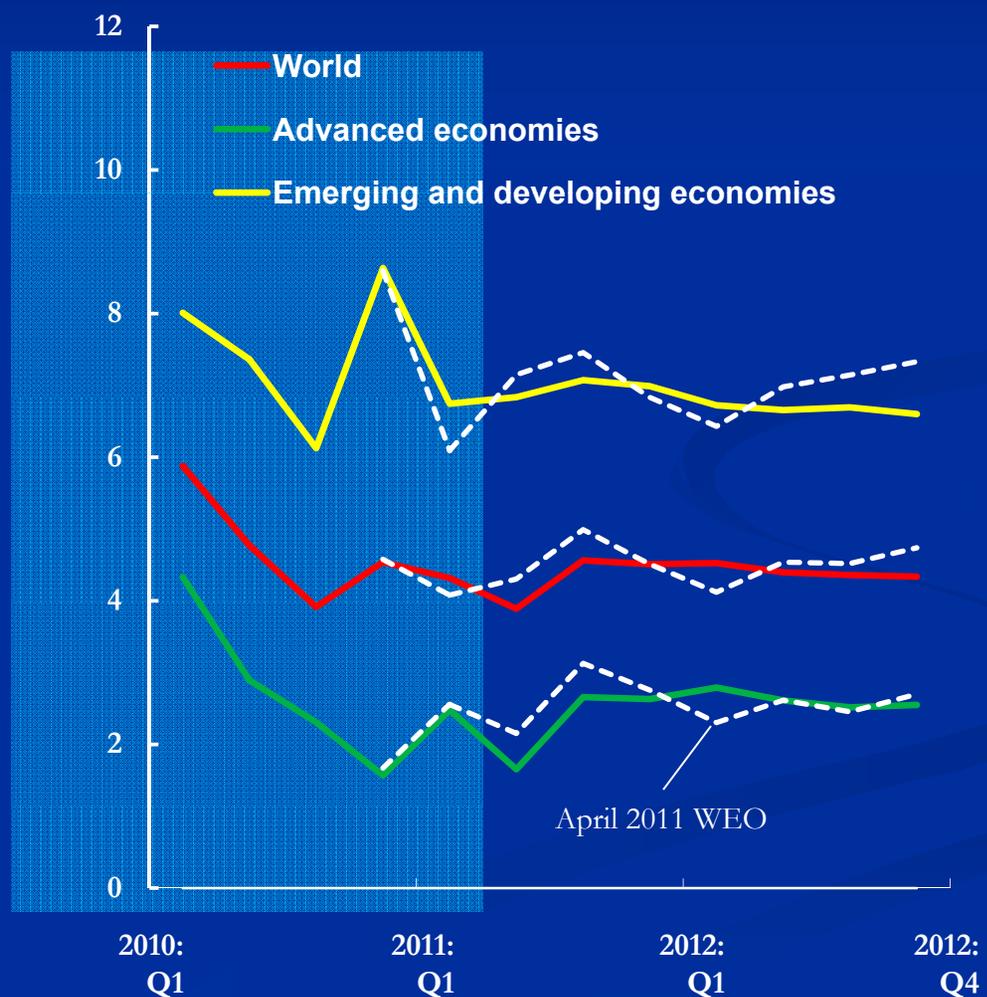
- Strengthen foreign reserves position
- Monetary policy ineffective against imported inflation
- Cautious use of exchange rate to curb inflation
- Strengthen fiscal position and management
- Accelerate structural reforms and strengthen capacity.

External Environment

The global economy has continued to expand despite some negative surprises. Growth will slow temporarily and then reaccelerate in the second half of the year.

GDP Growth

(percent; quarter over quarter, annualized)



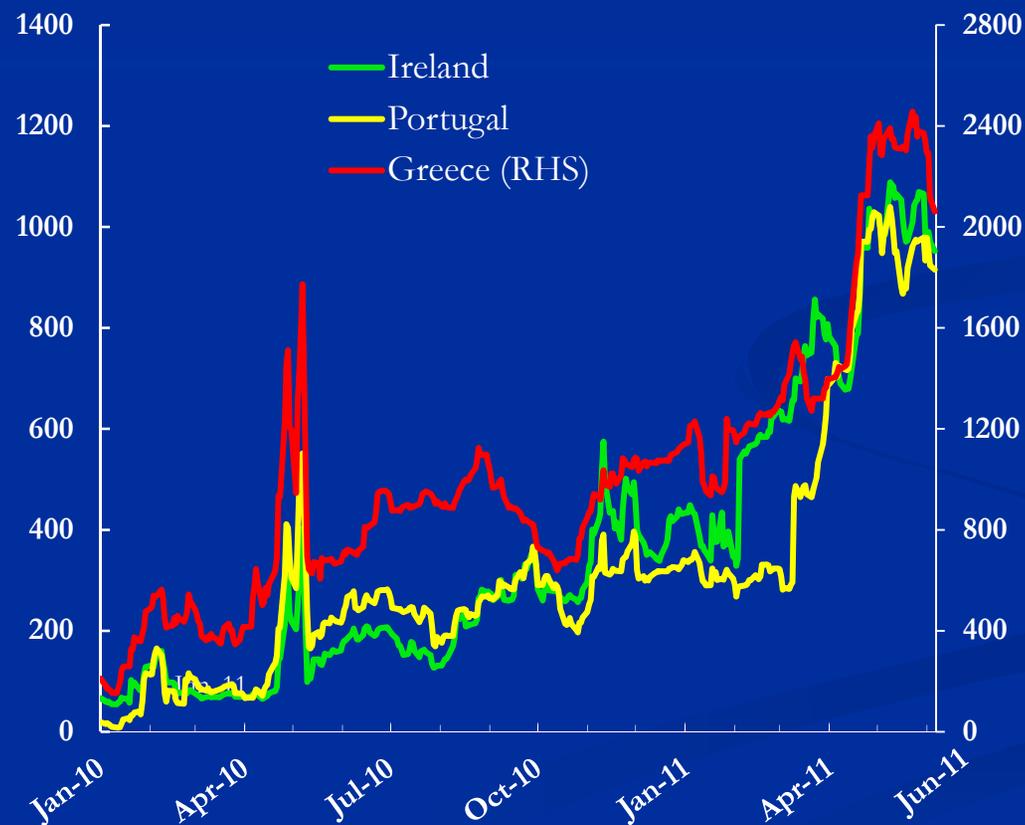
Australia and New Zealand: Australia to grow strongly; NZ to slow temporarily due to Christchurch earthquakes *(Year-on-year percentage change)*



Financial stress has risen, reflecting concerns about sovereign risks in euro area, but also about potential setbacks to U.S. recovery.

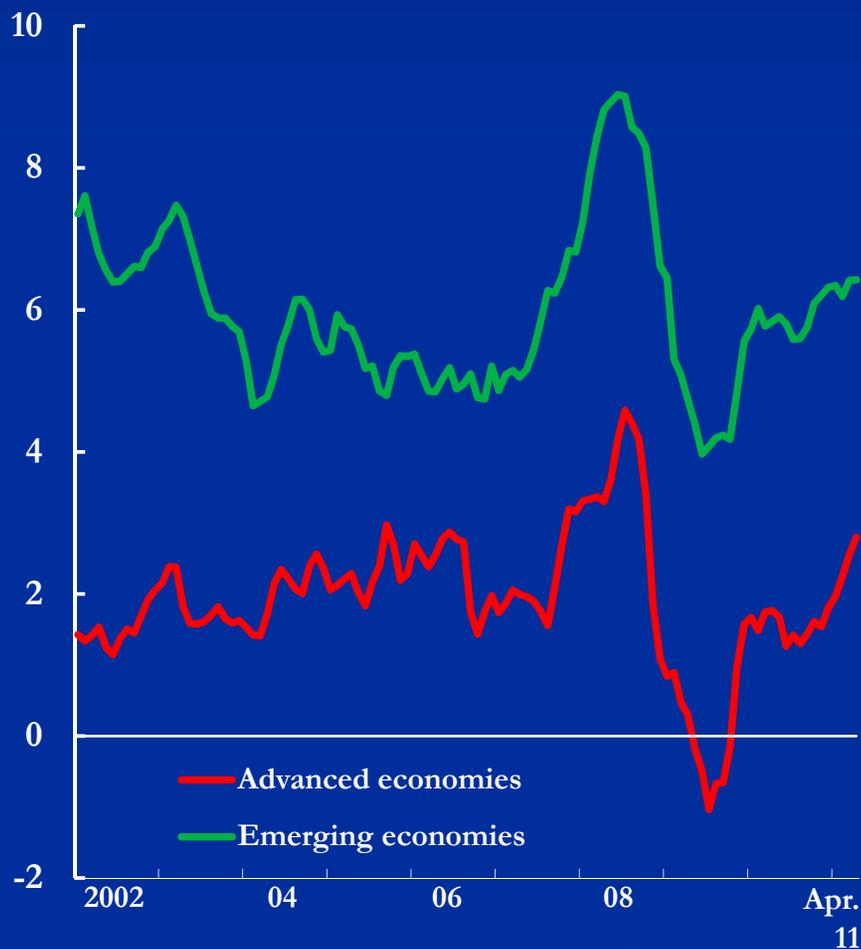
Government Bond Spreads

(two-year yield spreads over German bunds; basis points)

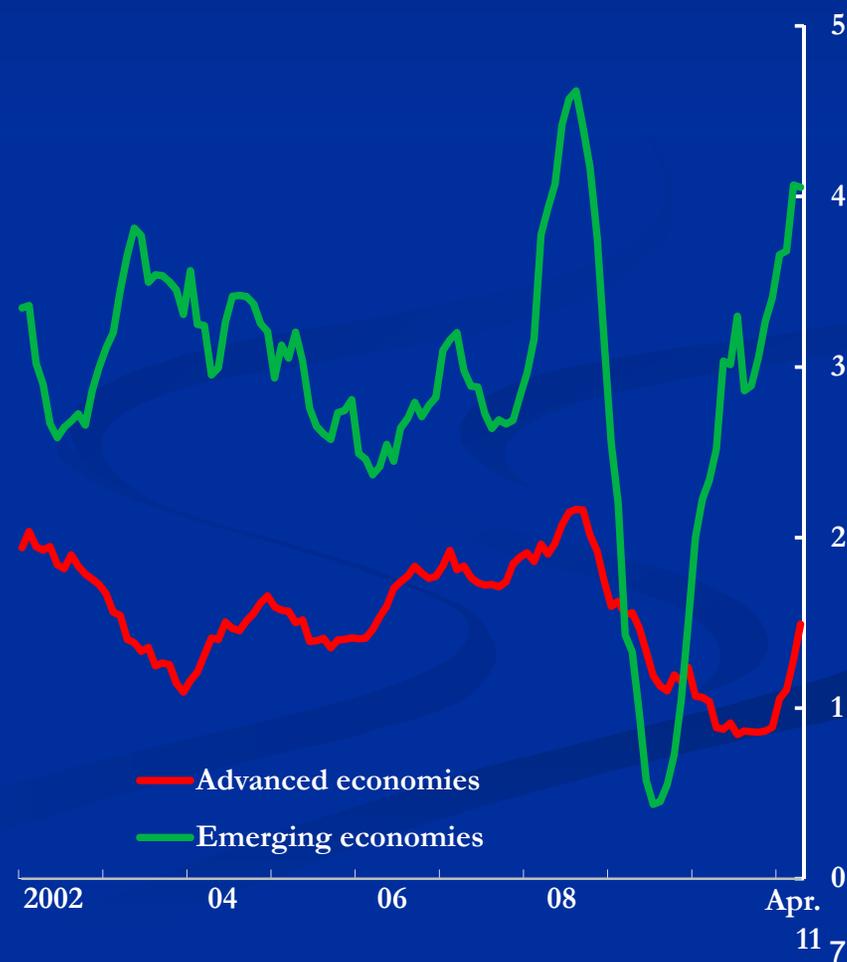


Inflation has picked up. In advanced economies mostly due to commodities. Emerging economies are experiencing broader inflation pressures amid strong activity.

Headline Inflation
(Twelve-month change)



Core Inflation
(Twelve-month change)



Commodity prices have receded somewhat, but remain high.

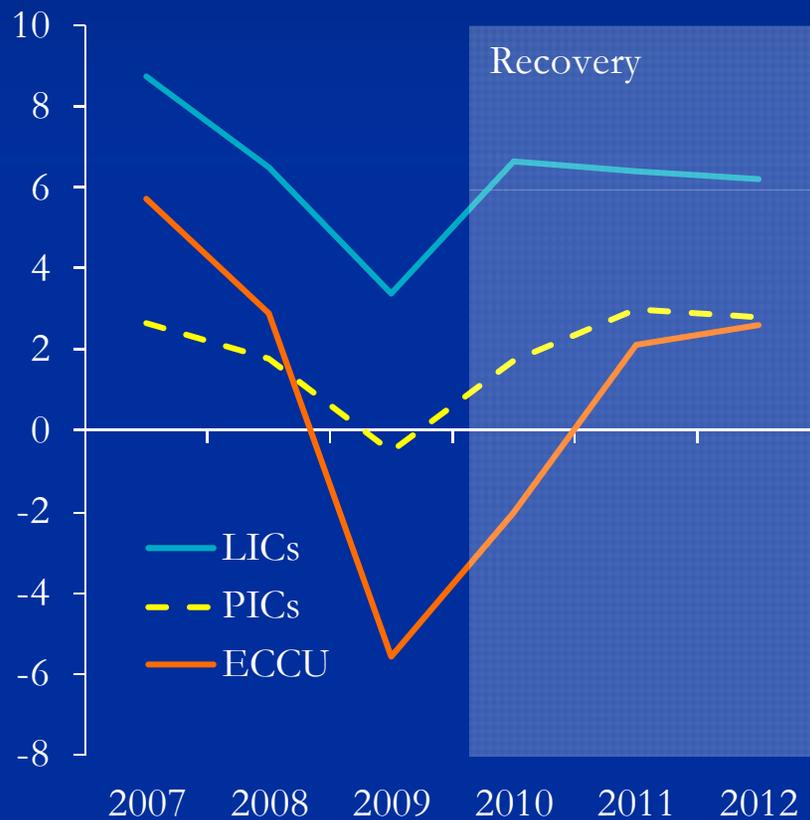
Commodity Price Indices
(Jan. 1, 2010 = 100)



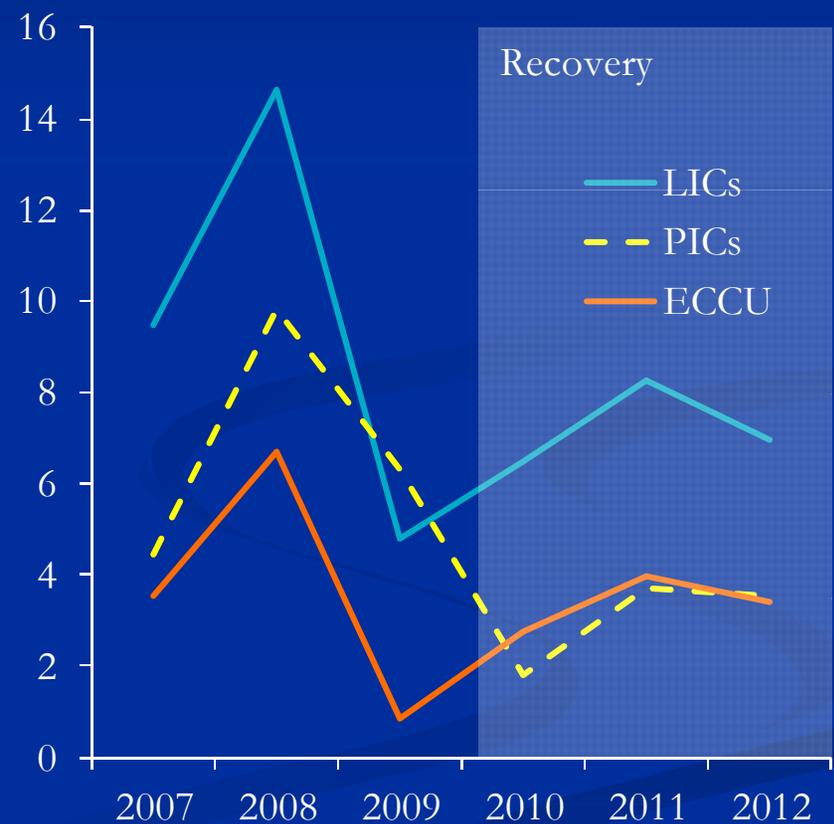
PICs: State of Recovery

PICs are recovering well relative to ECCU

Real GDP Growth



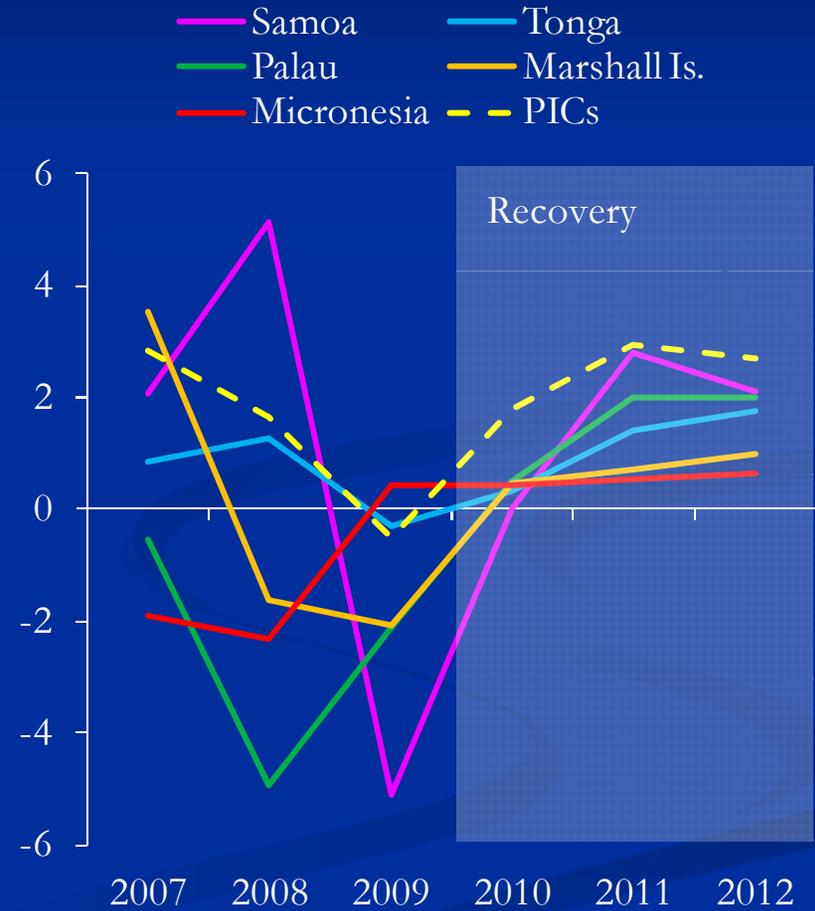
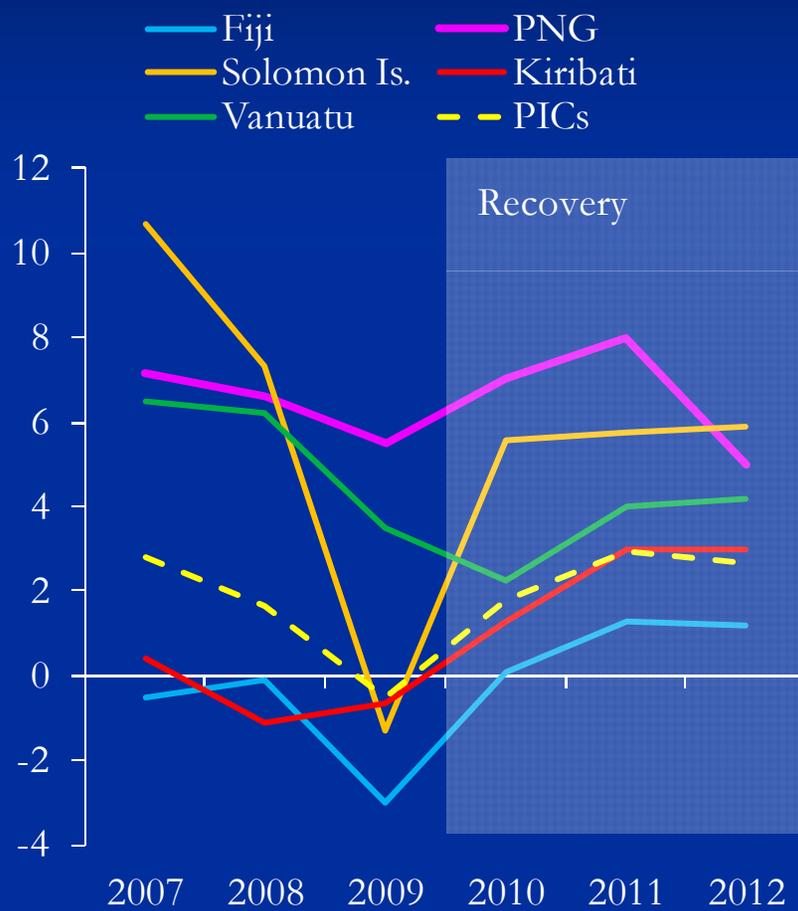
Inflation



PICs:

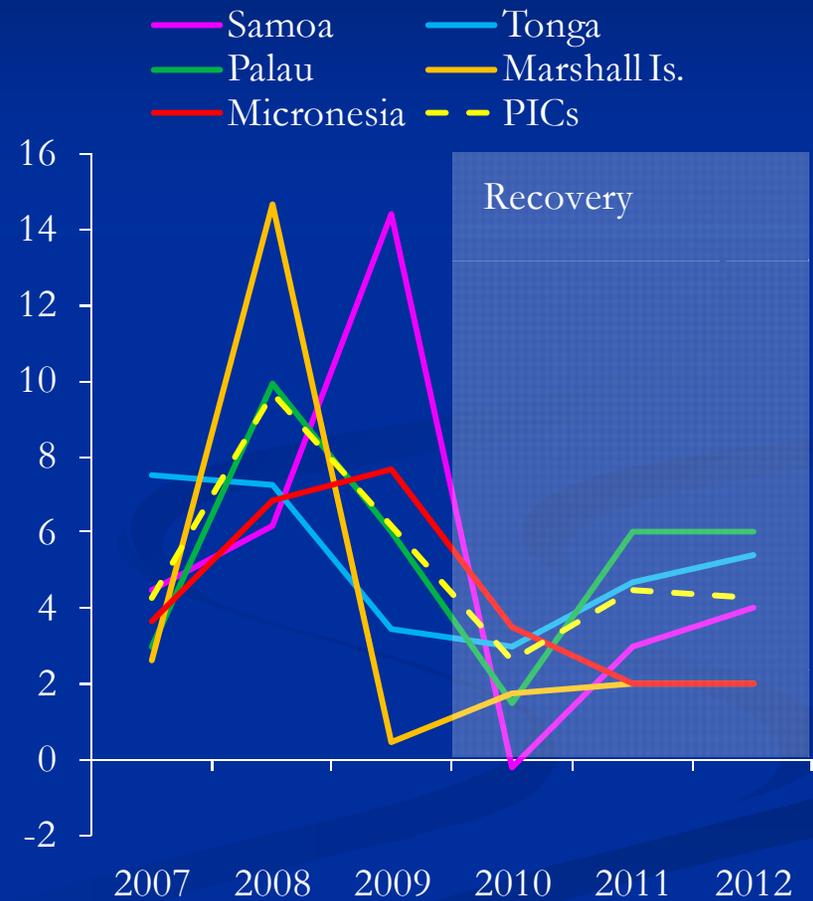
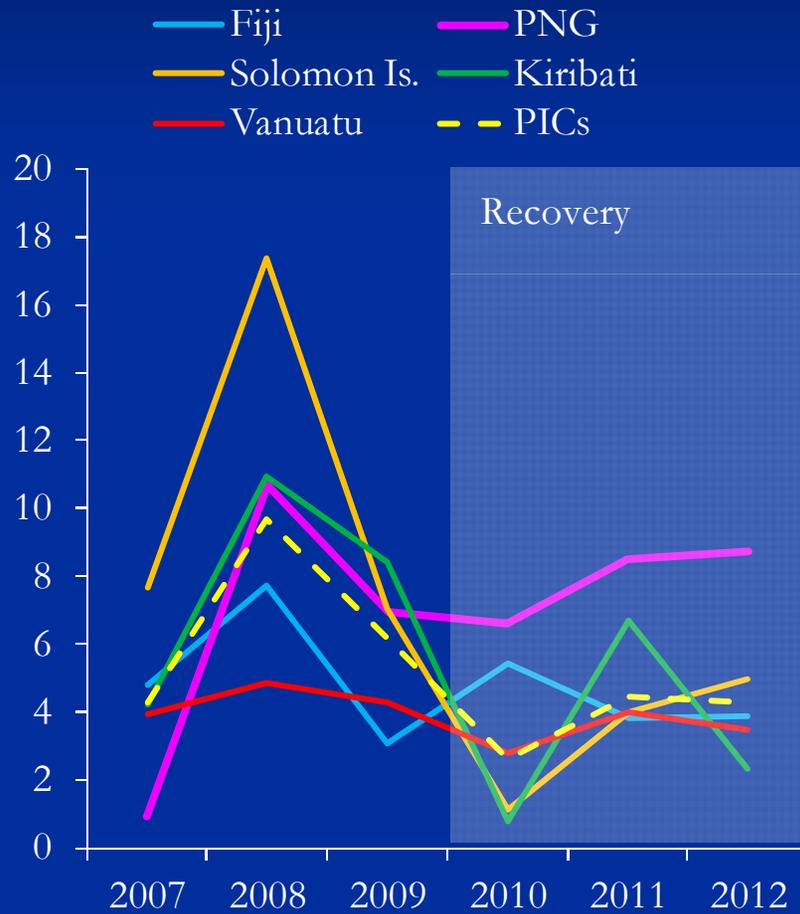
Recovery continues, but remains slow and uneven

(GDP year-on-year percentage change)



Inflation has picked up in PICs despite slow growth.

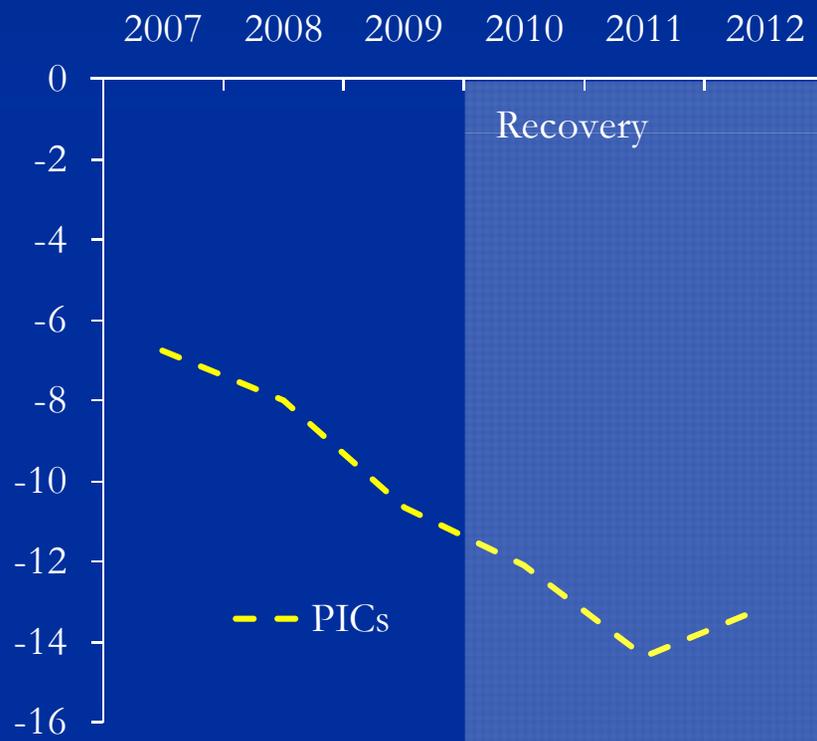
(Year-on-year percentage change)



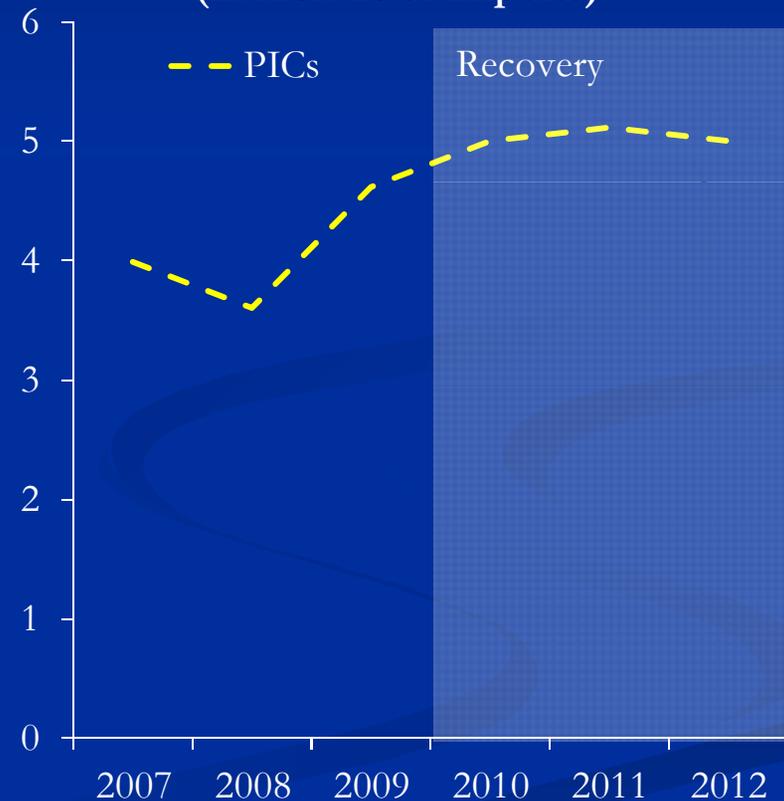
External Position:

Has improved but needs further strengthening.

Current Account (In percent of GDP)

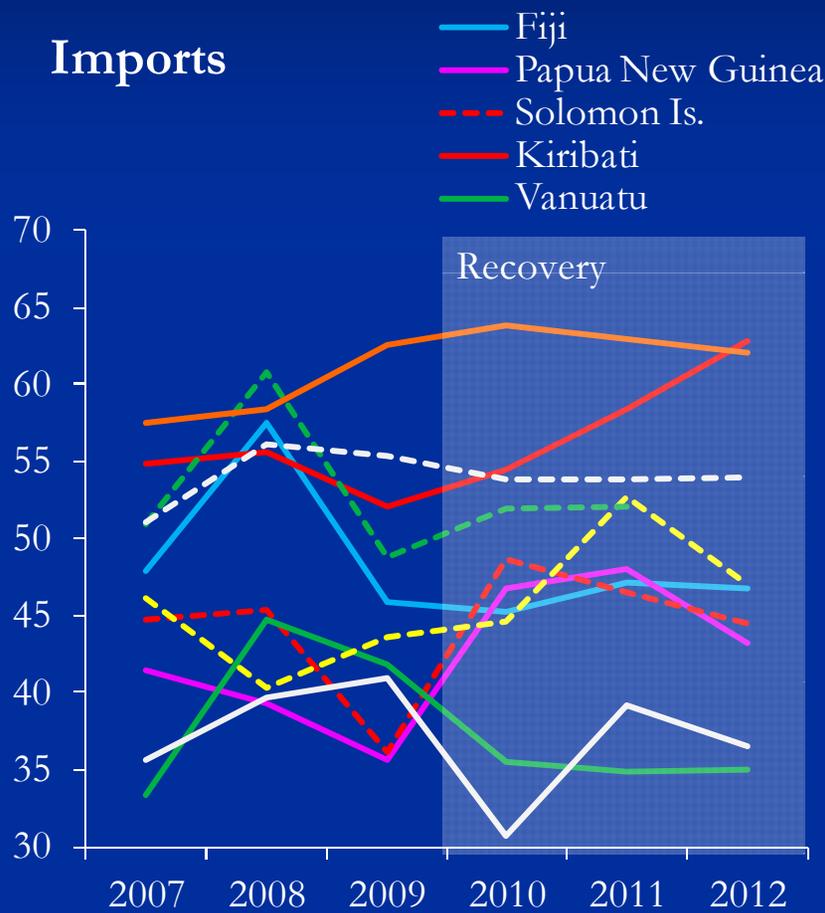


Net International Reserves (In months of imports)

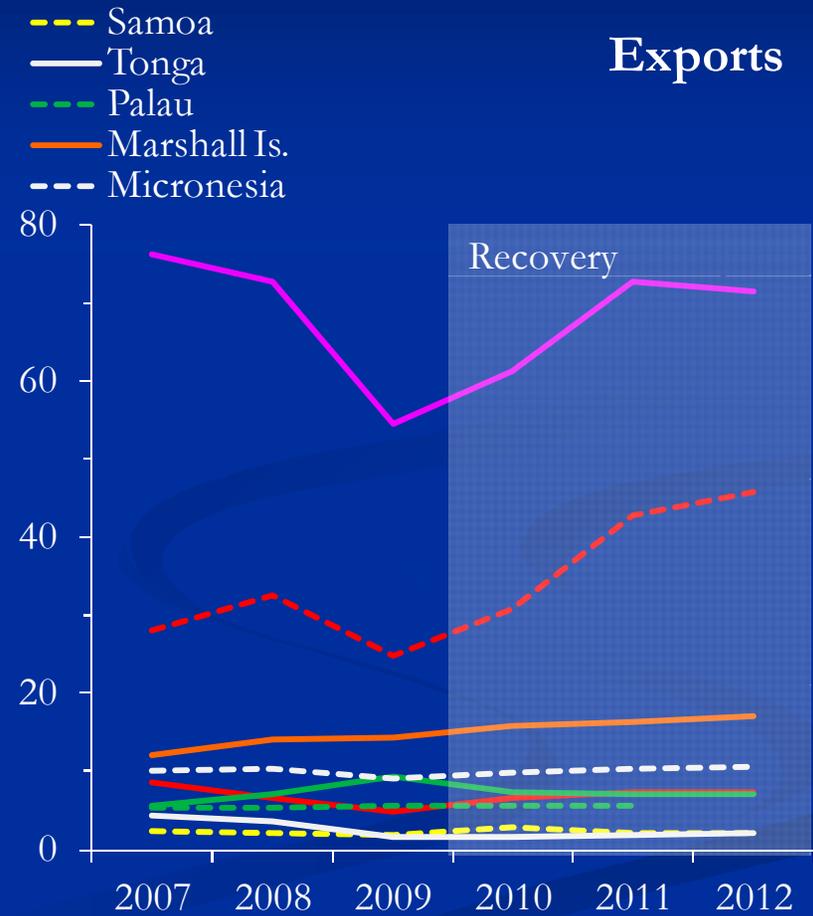


Imports and Exports (In percentage of GDP)

Imports



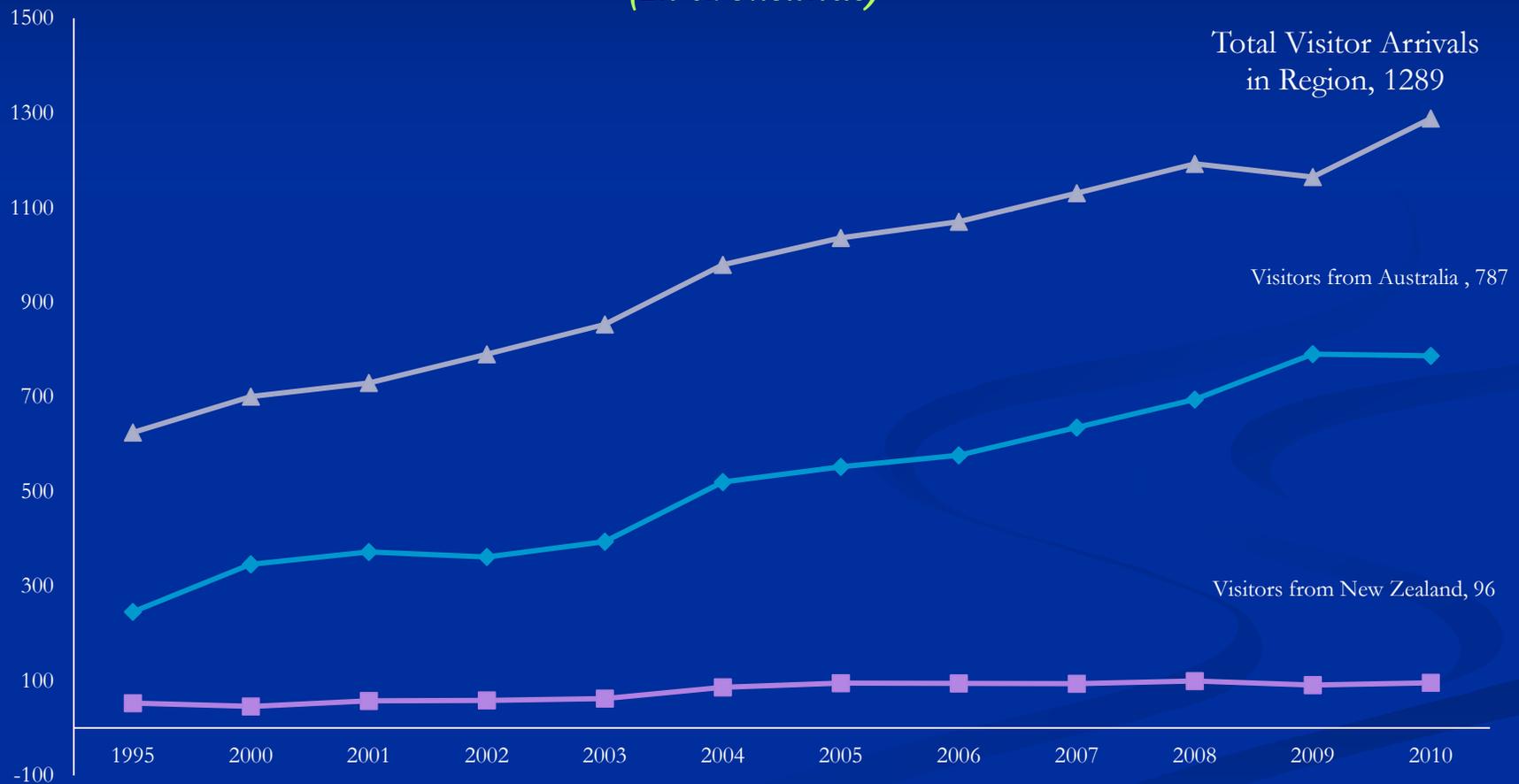
Exports



Tourism:

Likely to continue to recover but natural disasters in Australia and NZ could slow growth.

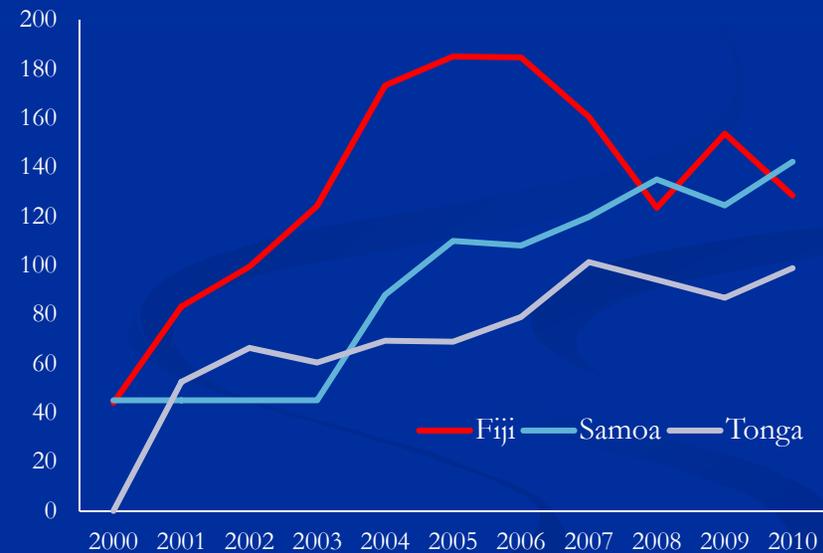
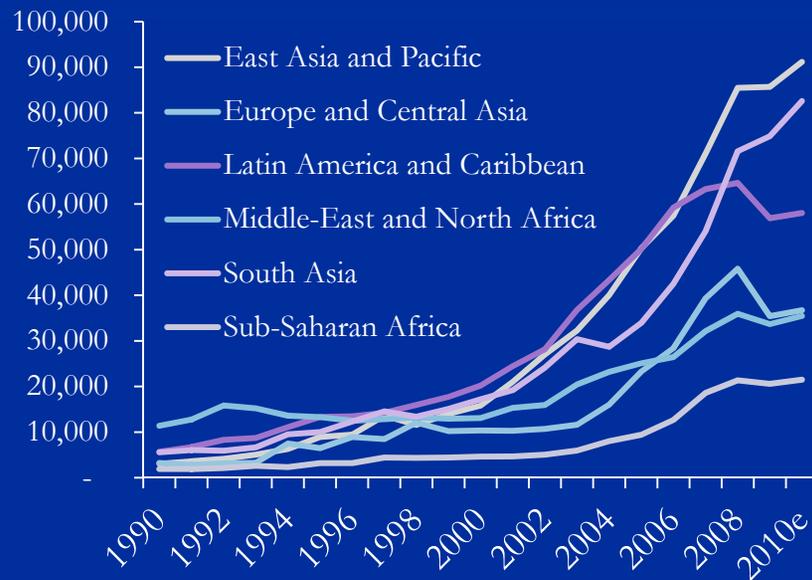
(In thousands)



Remittances: (In millions of US\$)

Strong recovery in Asia and the Pacific

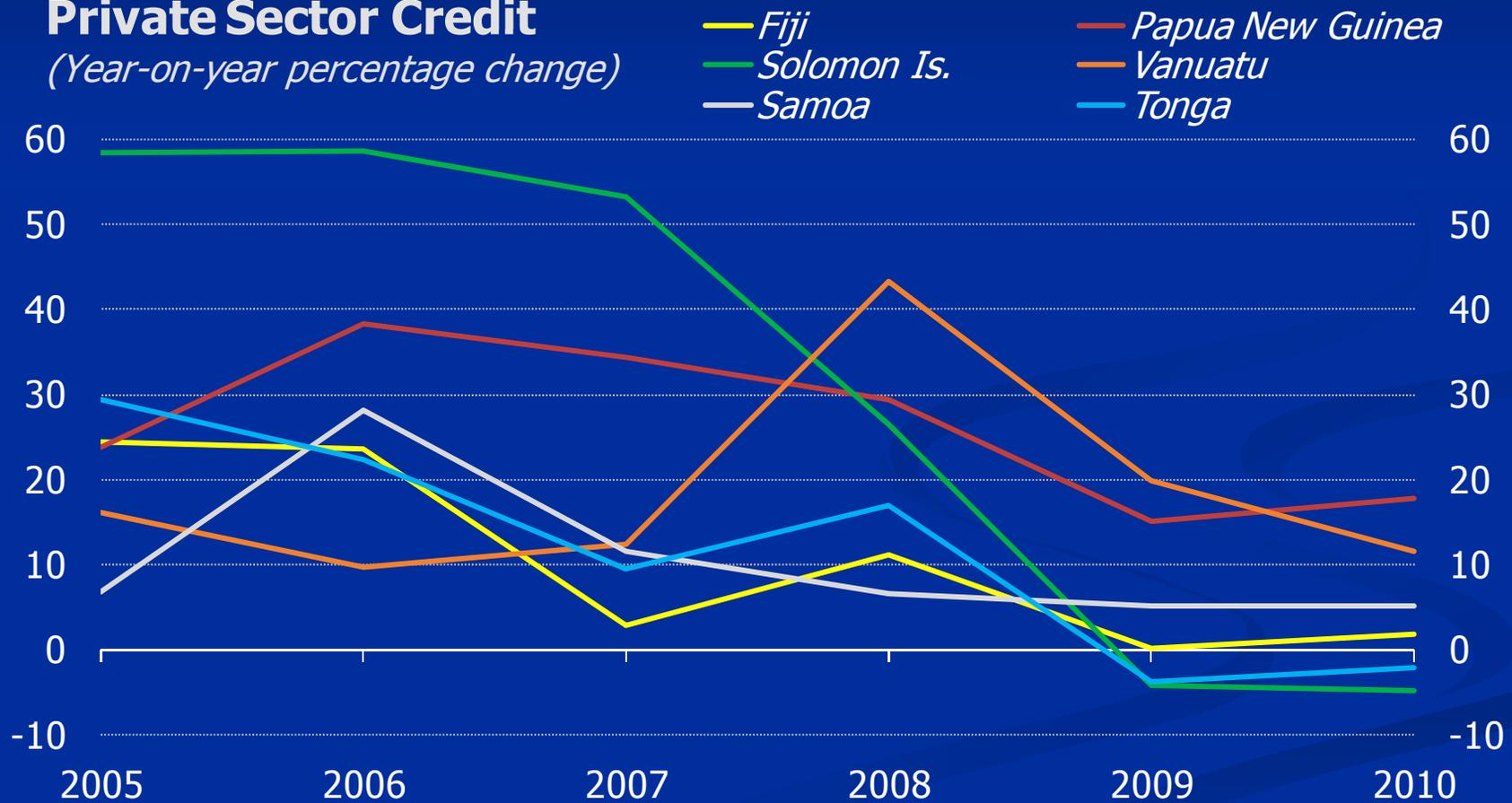
but PICs have yet to see large benefits



Credit growth has been sluggish despite easy monetary condition, reflecting weak economic activity

Private Sector Credit

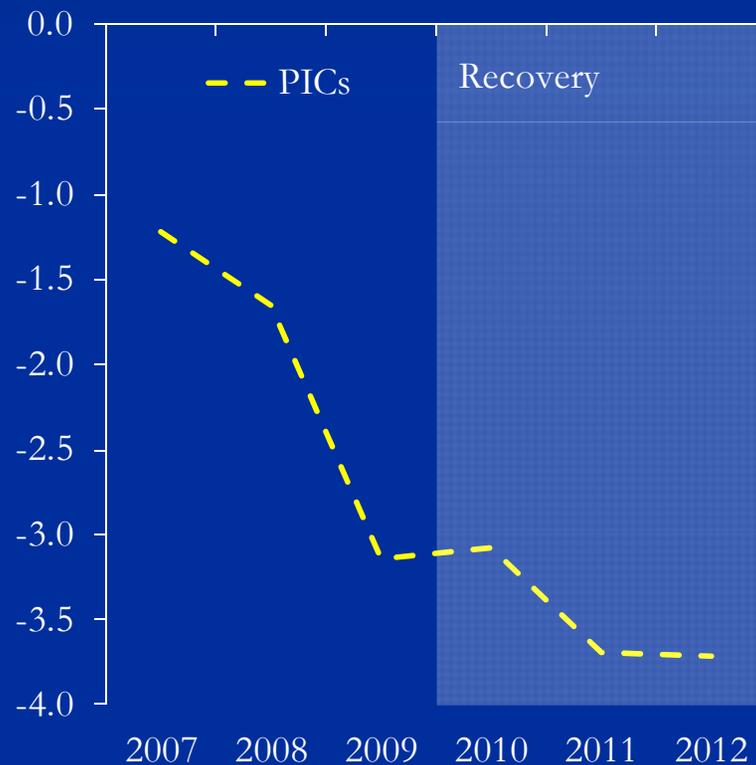
(Year-on-year percentage change)



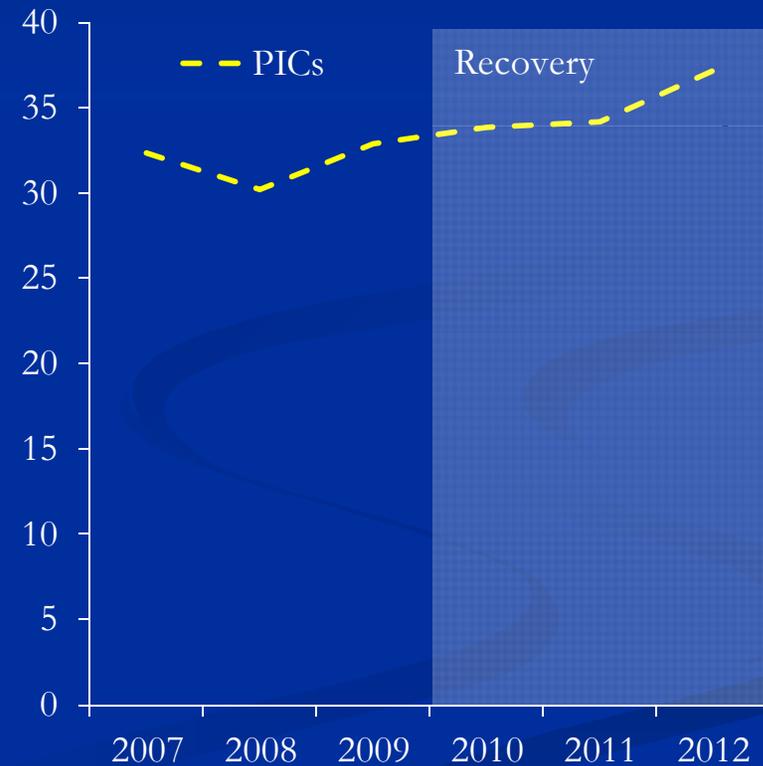
Fiscal space has become more constrained in most countries

(In percent of GDP)

Fiscal Deficit



Public Debt



Policy Challenges and Response

Lessons from the crisis

- Reveals the vulnerability of the PIC economies to external shocks
- Need to strengthen the balance sheets
- Need to build up foreign reserves as buffers against terms of trade and demand shocks
- Need to strengthen fiscal position in order to provide room for some countercyclical response to mitigate the worst impact of the crisis

How does the external environment look?

- Climate change – natural disasters
 - Need for insurance
- External environment is more uncertain
 - Sovereign debt problem in the US and Europe
- Asia is doing relatively well
 - Australia and New Zealand
 - High commodity prices
- High oil and food prices

What are the challenges?

- PIC economies are small, remote and diverse
- Inflation is rising
- Economies have rebounded but growth is generally low
- Banks are flushed with liquidity but credit growth is anaemic
- External positions have improved but are vulnerable to shocks

What should be the macropolicy response?

- Stronger balance sheet
 - Higher level of foreign reserves
 - Stronger capital and liquidity requirements on banks
 - Stronger prudential framework
- Cautious monetary policy
 - Manage bank liquidity to avoid credit boom
- Judicious adjustment of exchange rate
- Consolidate fiscal policy
 - Build up fiscal reserves and buffer

Monetary Policy

- Rising inflation and weak growth
- Monetary conditions are relatively loose. Interest rates are low and banks are flushed with liquidity. However, demand for credit from private sector is weak and further monetary easing is unlikely to stimulate activity.
- Tightening may be needed where inflation is being driven by domestic demand and threatens to exceed the comfort zone.
- Central banks should watch credit growth and may need to mop up liquidity to avoid a credit boom
- Directed lending is unlikely to be effective in stimulating growth and could undermine medium-term banking soundness and lead to inefficient investment.

Exchange Rate Policy

- Exchange rates are mostly pegged to a major currency or basket of currencies and have provided an important nominal anchor for price stability.
- However, given the weakness in monetary transmission mechanism, exchange rate adjustment can be used to dampen imported inflationary pressures, especially in countries where foreign reserves are sufficient.
- While inflation is a concern in the short run, a competitive exchange rate is essential for export growth (including tourism) and maintaining a prudent level of foreign reserves.

Fiscal Policy

- Fiscal position was weakened during the crisis.
- Fiscal consolidation is needed in [most] countries to build up fiscal buffer over the medium term and strengthen fiscal position.
- Important to prioritize expenditure towards infrastructure investment and health and education sectors.
- Strengthen capacity and improve public financial management to increase efficiency and effectiveness—PFTAC can help.
- Reduce debt burden. - seek concessional resources; avoid excessive borrowing, especially commercial loans.

Structural Reforms

- Low growth reflects structural factors – low investment and productivity
- Macro policy should support growth by providing stable macro environment – low inflation and well targeted fiscal spending
- Structural reforms and infrastructure investment are needed to improve the business environment and support private sector investment.
- Key areas include SOEs, PFM, tax regime, land tenure system, business regulatory framework, and financial system.

Conclusions

- External environment for PIC growth remains favorable despite heightened risk in financial markets.
- PICs have generally recovered from effects of the Great Recession but growth been low and uneven.
- However, inflation has risen reflecting rising import prices
- Policy mix should aim at maintaining macro stability and strengthening economic resilience to external shocks
- Macropolicy should focus on maintaining financial and price stability
- Accelerated structural reforms and infrastructure investment are needed to help build capacity and boost private investment



Thank You

IMF Resident Representative

<http://www.imf.org/external/region/pis/rr/index.htm>.

PFTAC:

<http://www.pftac.org/>