

*Common to all economies covered in this report is that they are, in some form or another, undertaking economic reform. The Pacific region is confronting a difficult economic transition as world trade continues to liberalize. In this more open trade regime, new opportunities exist for Pacific Island economies, although the region faces a number of challenges.**

The Pacific region is uniquely diverse, and the different ethnic/cultural compositions in Micronesian, Polynesian, and Melanesian countries is matched by the regions' geographical terrain, which varies from atoll countries such as Kiribati, to volcanic ones such as Vanuatu. Despite vast differences, the region shares many challenges in common and policy makers throughout the region are attempting to:

- Redefine the role of the public sector and improve efficiency
- Achieve macroeconomic stability
- Encourage and facilitate growth in the private sector
- Improve service delivery, especially to rural areas

Restoring fiscal discipline has received the highest priority in much of the Pacific region. Many economies had been faced with fiscal crises in the 1990s and undertook structural reforms. Samoa, Fiji, Tonga, Vanuatu, Cook Islands, PNG, and American Samoa have all made progress in adopting measures to reduce their reliance on the public sector and promote private sector-led growth.

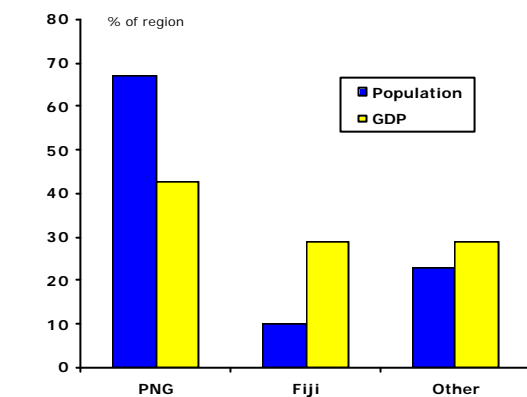
Economic Trends

Economic growth in the Pacific Islands over the last two decades has been low and GDP per capita growth has been lower than in other island economies in the Caribbean and Indian Oceans. During the 1980s and early 1990s, a large number of Pacific Island economies struggled to contain public spending. These economies relied heavily on public sector-led

growth, based upon high levels of public investment, largely financed with aid flows. This type of economic development proved unsustainable, resulting in high levels of public debt.

In terms of economic activity, Fiji and PNG are the largest nations in the region. The two countries make up the bulk of the population in the region and are more diversified in terms of manufacturing and service sector activities. The size of PNG's population and resource endowment, together with Fiji's relatively high income per capita and good infrastructure means that these two economies generate the majority of economic activity in the region.

Percentage distribution of population and GDP (2002)



Source: World Bank

In concert with the International Monetary Fund and the Asian Development Bank (ADB), Pacific Island economies have undertaken a number of macroeconomic reforms over the last 10 years.

* This report was prepared by Woodrow Inman, who undertook a research project on the Pacific Island economies for the Economics Department of ANZ Bank during July -November 2003. The project was undertaken as part of La Trobe University's Work Placement Programme, and is credited towards the Bachelor of International Relations degree.

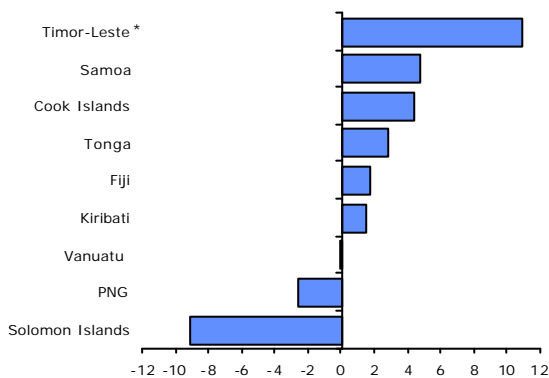
The report focuses on the Pacific Island economies where ANZ Bank is represented. Woodrow received advice and assistance from Barry Coulthurst, Jasmine Robinson, and Bernie Shuttleworth of Economics@ANZ.

Economic data and information on most of the Pacific Island economies is very limited. This has hampered the detail and timeliness of some of the analysis in the report.

Although substantial efforts have been made, region-wide gains from these reforms are yet to materialize. Nevertheless, many economies in the region are heading in the right direction and their public finances are in far better shape than they once were.

The Cook Islands is an excellent example of this process of public sector reform. The accumulation of huge public debt through expansionary government policies over the years prompted a restructuring program that focused on reform of the public service, the sale of state assets, the stimulation of private sector-led growth and the strengthening of financial and economic management. In Vanuatu, progress is being made in financial management, despite sluggish growth and a difficult political environment. As well as these examples, legislation across the region has been enacted to improve the standards of public sector operations.

**Average GDP Growth per annum
(2000-2002)**



* After contracting by 35.4% in 1999, growth rates in Timor-Leste in 2000 & 2001 were high, stimulated by the presence of UN peacekeepers. The UN presence is gradually being scaled down.

Source: Asian Development Bank

Samoa has turned around its economic performance over the last 10 years. It has one of the most impressive records of economic reforms in the region, leading to healthy economic growth over the last 5 years with an average of around 4% per annum. Samoa's structural adjustment measures have also led to low inflation, a stable public sector, and a good external position. Despite the slow-down in GDP growth in 2002, Samoa's economic prospects look promising, largely due to the reform agenda started in the 1990s.

Economic restructuring in Kiribati is developing at a slower pace. There appears to be less enthusiasm for foreign investment without the involvement of the public sector and the fiscal position has deteriorated in recent years. Economic growth has averaged only 1.5% per annum over the last 3 years.

Timor-Leste, the world's newest nation, witnessed a rapid decline in GDP in its first year

of independence. The country is faced with deep-seated economic problems, most notably a very low GDP per capita, damaged infrastructure and poor literacy rates. Nevertheless, the new nation has the support of the international community and is receiving external assistance from bilateral and multilateral channels in its attempts to develop functioning democratic institutions.

The diversity amongst Pacific states inevitably means that the region will not implement economic reforms at the same pace. Varying economic and political climates have a significant bearing on determining the pace of economic reform.

All face similar development constraints

Despite positive developments in many areas of Pacific Island economies, much of the region suffers from similar constraints on development. The Pacific region is comprised of small states, sometimes microstates, which tend to be faced with development challenges that include:

- Vulnerability to external disasters, most notably, natural disasters and environmental change
- High degree of openness to the rest of the world. It is true that this can often bring substantial benefits, however, the states of the Pacific are too small to exercise influence over global markets
- Small domestic markets and limited diversification in production and exports
- Limited capacity in both the public and private sectors

Political Climate

It is hoped that economic reforms can also bring political reform and stability across the region through the strengthening of institutions. Political uncertainty in one Pacific Island nation can have major implications for others in the region, and potential investors and tourists may shy away. For instance, in 2000 the political upheaval in the Solomon Islands and Fiji undermined the Pacific region at large. The coup in Fiji and the uncertain political environment had severe consequences for some of the smaller island economies that rely on Fiji as a transport hub.

Of course, the majority of Pacific states are stable and peaceful. Countless visitors are attracted to the region's tranquil environment and friendliness of its people. However, some states have been wracked by political and economic crises in recent years. Demonstrated most recently in the Solomon Islands, parts of

the region have become politically unstable as a result of weak institutional governance and deteriorating levels of law and order. In recent years, these problems have been most noticeable in the Melanesian countries of Papua New Guinea, Fiji, the Solomon Islands and Vanuatu. There was, however, a major improvement in the law and order situation in the Solomon Islands in 2003 as a result of the support provided by the Australian police and army.

In 2000, the members of the Pacific Islands Forum (PIF)¹ signalled their desire to work closer in resolving instability in the region by signing the Biketawa Declaration. The Declaration provides for members to take joint action if a member state requests assistance in addressing a crisis, such as a fundamental breakdown in governance. The declaration was a significant breakthrough in emphasizing the importance of political cooperation in the region. Before the Biketawa Declaration, Forum members followed a non-interference approach to the internal affairs of other members. The landmark agreement recognizes that the ethnic tension, land disputes, and socio-cultural issues that hamper development in some parts of the region need to be addressed collectively.

Political cooperation is put to the test by the crisis in the Solomon Islands

Foreign Ministers of Forum members met in Sydney on 30 June 2003 to discuss a regional response to the breakdown in law and order in the Solomon Islands. Responding to the formal request for assistance by the Solomon Islands government, Australian and Pacific Islands police and troops arrived in the strife-torn country on 24 July 2003.

The Regional Assistance Mission to Solomon Islands (RAMSI) has been relatively successful in gradually restoring law and order to the country. On 13 August, Guadalcanal rebel leader, Harold Keke, surrendered to Australian forces and significant amounts of weapons and ammunition has been handed in. Although Australia led the intervention, the principles of the Biketawa Declaration were utilized.

Greater regional cooperation is expected

With these new proposals and its involvement in the Solomon Islands, Australia is seeking a more hands-on role in the region. Australia lobbied vigorously for Greg Urwin to take over the secretary-general position from PNG's Noel Levi. Prior to Mr. Urwin's appointment, a Pacific

islander has always filled the position of secretary-general. At the annual Pacific Islands Forum summit in 2003, measures were drawn up to establish a regional police training centre in Fiji. The initiative plans to enhance policing skills and standards throughout the region.

In the face of both this political instability and political cooperation, a report from the Australian Senate Foreign Affairs Committee in August 2003 proposed a European Union-style Pacific Community. The report proposed a model for political and economic governance in the Pacific with the Australian dollar as a common currency², as well as common labour market and fiscal standards. Across the region, leaders have received the idea with mixed responses. It is not surprising that a proposal supporting the pooling of regional governance should have triggered strong opposition in some quarters.

Despite the Biketawa Declaration and the successful intervention in the Solomon Islands, the political nature of currency union, a single monetary policy and coordinated fiscal policies, probably means that such objectives will not be realized in the near future. Nevertheless, the issue is likely to remain a talking point within the Pacific Islands Forum and there is a feeling throughout the region that greater regional cooperation and integration can bring substantial benefits.

Until recently, political unity among the Pacific Island countries had been largely absent. The recent establishment of the Pacific Island Countries Trade Agreement (PICTA) and the Pacific Agreement on Closer Economic Relationship (PACER), therefore, assumes considerable significance. The agreements set out to generate greater volumes of trade amongst Pacific states.

Trade agreements signal the region's commitment to trade liberalization

PICTA came into force on 13 April 2003, establishing a free trade area that will be introduced over a period of ten years. PICTA required six ratifications, with the sixth country – Nauru – joining the Cook Islands, Fiji, Niue, Samoa and Tonga. Kiribati and Solomon Islands have subsequently signed up.

As far back as 1971 and the establishment of the Pacific Islands Forum, a free trade area was on the agenda. Although a long time in coming,

¹ The PIF comprises Australia, Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Nauru, New Zealand, Niue, Palau, Papua New Guinea, Republic of the Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu and Vanuatu.

² Currently, the exchange rate arrangements of PIF members vary. The Cook Islands uses the New Zealand dollar, Kiribati the Australian dollar, East Timor and American Samoa the US dollar. Samoa, Fiji, Solomon Islands, Vanuatu and Tonga have their own currencies that are pegged to baskets of currencies whose composition and weights are generally kept confidential. Only PNG has a freely floating exchange rate regime.

PICTA fulfils an ambition held by many Pacific leaders.

PICTA status for countries covered

	Date Signed	Date Ratified
Cook Islands	18 August 2001	28 August 2001
Fiji	18 August 2001	16 October 2001
Kiribati	18 August 2001	June 2003
Nauru	18 August 2001	14 March 2003
Niue	18 August 2001	26 February 2003
PNG	5 March 2002	10 August 2003
Samoa	18 August 2001	10 October 2001
Solomon Islands	6 August 2002	June 2003
Tonga	18 August 2001	27 December 2001
Tuvalu	18 August	
Vanuatu	18 August 2001	

PICTA is expected to lead to more jobs and lower import prices in the long term, as well as encouraging greater trade and investment and overall economic development. Other advantages expected to result from the free trade area are specialization and greater efficiency in Pacific economies.

Trade amongst the Pacific Islands economies is currently very low, but opportunities to expand this trade are expected to result from PICTA. The region struggles to attract foreign investment, which is largely the result of their small domestic markets. However, with the eventual creation of a regional market of around 6 million people and a potential tariff rate of zero, investment opportunities can be enhanced. By further exposure to international competition, businesses will be forced to become more efficient. Additionally, governments will have to implement reforms needed in an environment of increased competition.

As well as the PICTA, the Pacific Agreement on Closer Economic Relations (PACER) has also come into force. The agreement required the ratification by seven Forum members and this was achieved when Niue joined Australia, Cook Islands, Fiji, New Zealand, Samoa and Tonga. Subsequent ratifications have come from Kiribati, Nauru, PNG and Solomon Islands.

Consistent with the "stepping stone" approach historically favoured by Forum members, the PACER provides for free trade to be established gradually among members. This is essentially the result of the different development status of the members. The PACER is not a Free Trade Agreement (FTA) notifiable to the WTO and does not legally compel members to reduce tariffs. However, Pacific economies will be required at a yet-to-be determined date to enter into negotiations for free trade arrangements with Australia and New Zealand. There will be an FTA only if these negotiations are successful.

PACER Status

	Date Signed	Date Ratified
Australia	18 August 2001	3 July 2002
New Zealand	18 August 2001	27 November 2001
Cook Islands	18 August 2001	28 August 2001
Fiji	18 August 2001	15 October 2001
Kiribati	18 August 2001	June 2003
Nauru	18 August 2001	14 March 2003
Niue	18 August 2001	26 February 2003
PNG	5 March 2002	10 August 2003
Samoa	18 August 2001	10 October 2001
Solomon Islands	6 August 2002	June 2003
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Tuvalu	18 August 2001	
Vanuatu	18 August 2001	

For the Pacific economies, the principal benefits of the PACER are expected to be derived from improved financial and technical assistance, as well as trade facilitation. For the developed economies of Australia and New Zealand, PACER grants an assurance that they will not be disadvantaged in Pacific Island markets if trade arrangements between the Pacific economies and other developed nations take place. For instance, if a Pacific Island country begins negotiating free trade arrangements with another developed country, for example Japan, PACER would require automatic consultations with Australia and New Zealand, resulting in negotiations for an FTA between those Pacific Island nations and Australia and New Zealand.

Impact of global trade liberalization

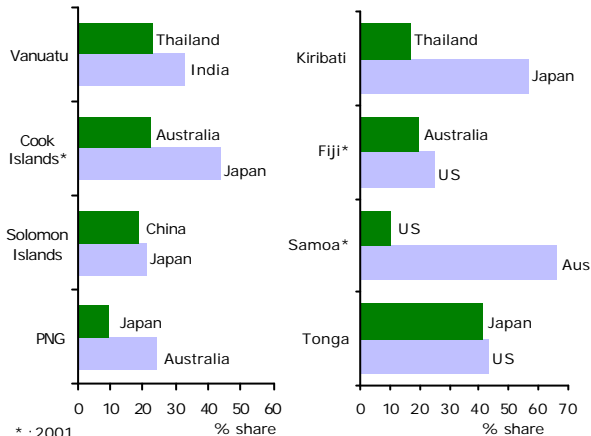
Throughout the region, numerous industries are dependant on access to the markets of foreign industrialized countries. Many Pacific economies, most notably Fiji, whose sugar industry receives privileged access to the European Union, are mindful of the worldwide drive towards cutbacks in such preferences as part of liberalization of international trade.

As well as the sugar industry, labour-intensive manufacturing in Fiji, in particular clothing, is set to lose its preferences in industrialized markets. Other Pacific economies are faced with a similar situation. For instance, wire harnesses in Samoa, and tuna canning in American Samoa, are heavily dependent on preferential trading arrangements that are to be phased out over time.

Additionally, many Pacific nations acquire sizeable chunks of revenue from taxing imports heavily. The introduction of a free trade area and the reduction in tariffs would, in the short term, place additional strain on government revenues.

It is hoped that the progressive liberalization of trade in the region will bring economic gains to all members. However, it is likely that PNG and Fiji, with their population size and diverse economies, will have the greater potential to expand economic activity as trade barriers are reduced.

Main Export Markets in 2002



Source: Department of Foreign Affairs & Trade, Australia

Tourism

Tourism is a critical income earner for the Pacific. The region's islands³ are as diverse geographically as they are culturally. Large numbers of tourists flock to the Pacific region for its array of rugged coastline, white coral beaches, black volcanic sand beaches, bare lava plains, coloured lakes, coral atolls and volcanic mountains.

Tourism has grown considerably in the Pacific Islands in the last 25 years and is now the dominant sector in the region and is a key source of foreign exchange earnings. While tourism is a crucial driver of economic growth for Pacific Island economies, it is a complicated industry that indirectly affects many other sectors of the economy. The World Travel and Tourism Council estimates that, including indirect effects, tourism contributes 13% to the GDP of the Oceania region⁴.

Significant flow-on effects can be derived from a vibrant tourism sector. Increased tourist numbers can provide:

- A larger domestic market for local agriculture
- More opportunities for selling other products, such as marine resource products

- Increased growth of local industry and services

While there is the potential for the expansion of the tourism industry in the Pacific Islands, the sector also faces constraints, such as:

- Poor utilities infrastructure (electricity, water supply, liquid and solid waste disposal)
- Environmental sustainability issues
- Possible adverse reactions to rising tourist arrivals

Many countries, such as Samoa, Tonga, Vanuatu, Fiji, American Samoa and the Cook Islands, have focused on establishing better infrastructure and have invested in hotel developments to meet the increased demand. Additionally, many countries in the region have undertaken increased external marketing campaigns to further stimulate the industry.

After an initial global decline due to the conflict in Iraq and the outbreak of SARS, tourism has rebounded in the second half of 2003 and has been vital to economic growth in the region. Furthermore, according to the Asian Development Bank, the sector is likely to continue expanding in 2004.

The entry of a new airline, Pacific Blue (a subsidiary of Virgin Blue), will affect the Pacific Islands tourism market. While Virgin Blue claims that it will inject considerably more tourists to the region, its lower airfares create a significant challenge to the already vulnerable economic position of the nationally owned carriers in the region, such as Air Vanuatu, Samoa's Polynesian Airlines and Royal Tongan Airlines. However, Virgin Blue has expressed interest in undertaking partnership deals with some of these nationally owned airlines.

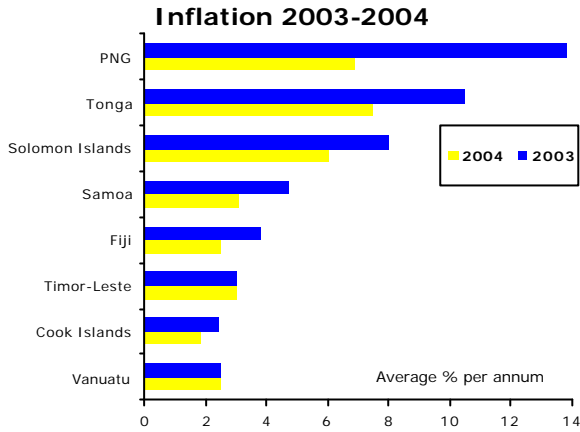
Modest economic recovery anticipated

Strengthening commodity prices for agriculture, mining, and marine based-based primary commodities has boosted the region's economies in 2003, and is expected to continue in 2004. Tourism looks set to rebound further after the war in Iraq and the SARS outbreak hampered the industry in early-2003. The region is expected to achieve a modest economic recovery in the medium term. The ADB anticipates growth of between 2-3%.

Increased macroeconomic stability in PNG and declining oil prices in 2004 is expected to push down inflation to moderate levels region-wide.

³ Approximately thirty thousand islands dot the Pacific Basin

⁴ World Travel and Tourism Council, Oceania: Travel and Tourism, a World of Opportunity, 2003. Available on website www.wttc.org/measure/PDF/Oceania.pdf



Excluding Kiribati & American Samoa

Source: Asian Development Bank

The strain on the current account witnessed in 2002 is expected to lessen in 2003, largely due to improved performance in exports in the larger countries in the region and the improving outlook for the global economy, regional trade, and tourism.

The Future

Attracting private investment is vital to future economic expansion in the region. From the public sector-dominated economies of the past, the region is now in the process of economic restructuring. Throughout the region, it is now accepted that, to benefit from the globalisation of international trade, states need to promote private sector-led growth. The new global trade regime poses further challenges to the political and economic climate in the region. While there has been mixed success throughout the region in addressing these challenges, Pacific Island leaders are taking steps toward achieving macroeconomic stability and sound governance.

The Region in Profile 2002

	American Samoa	Cook Islands	Fiji	Kiribati	PNG
Population (000s)	57	17	823	94	5,400
GDP per capita (US\$)	N/A	N/A	2160	810	530
GDP growth 1997-2002 annual averages	N/A	1.5	2.6	3.6	-0.9
Government Budget Balance (% of GDP)	N/A	0.3	-7.0	-5.9	-3.8
Inflation: 1997-2002 Ann avg, CPI	N/A	2.7	2.9	3.2	11.5
Current a/c balance % of GDP	N/A	6.3	-5.0	-6.5	-1.1
International Reserves US\$ mn	N/A	N/A	264.0	N/A	321.5
Main exports	Canned fish, taro, pineapples	Pearls, fresh fruit	Garments, sugar, fish, gold, timber.	Copra, live fish, fishing licences	Gold, crude oil, copper, palm oil
Main markets	US	Japan, Australia, US, NZ	US, Australia, UK, Japan	Japan, Thailand, Korea, US	Australia, Japan, China

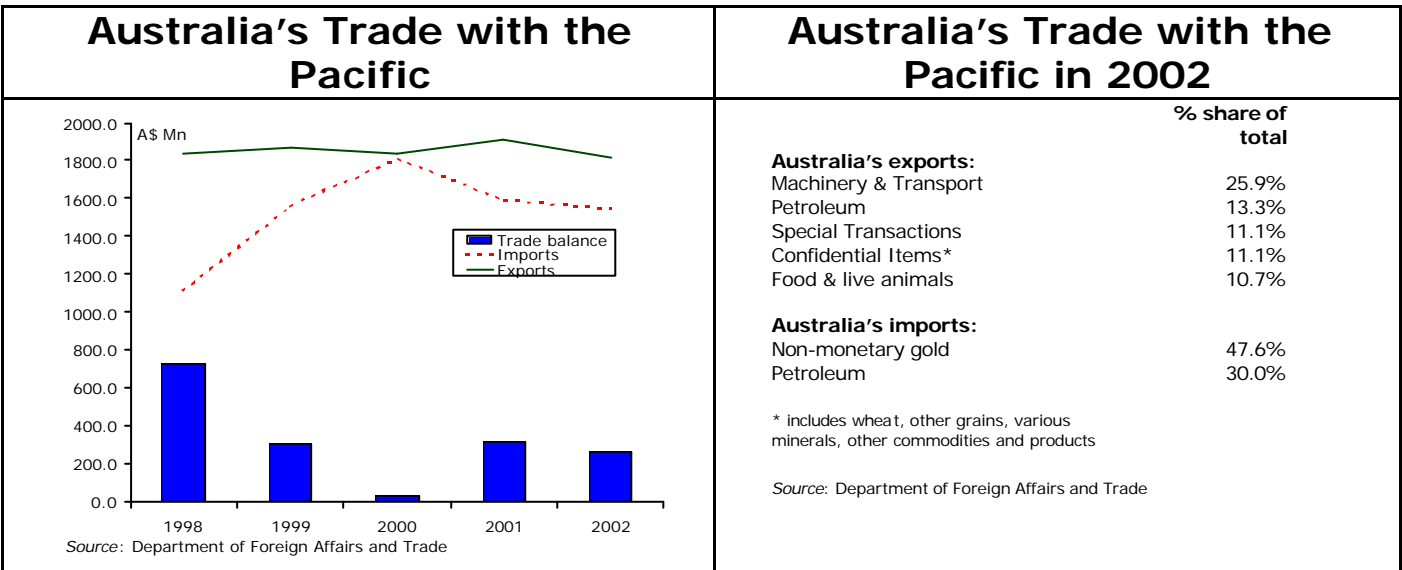
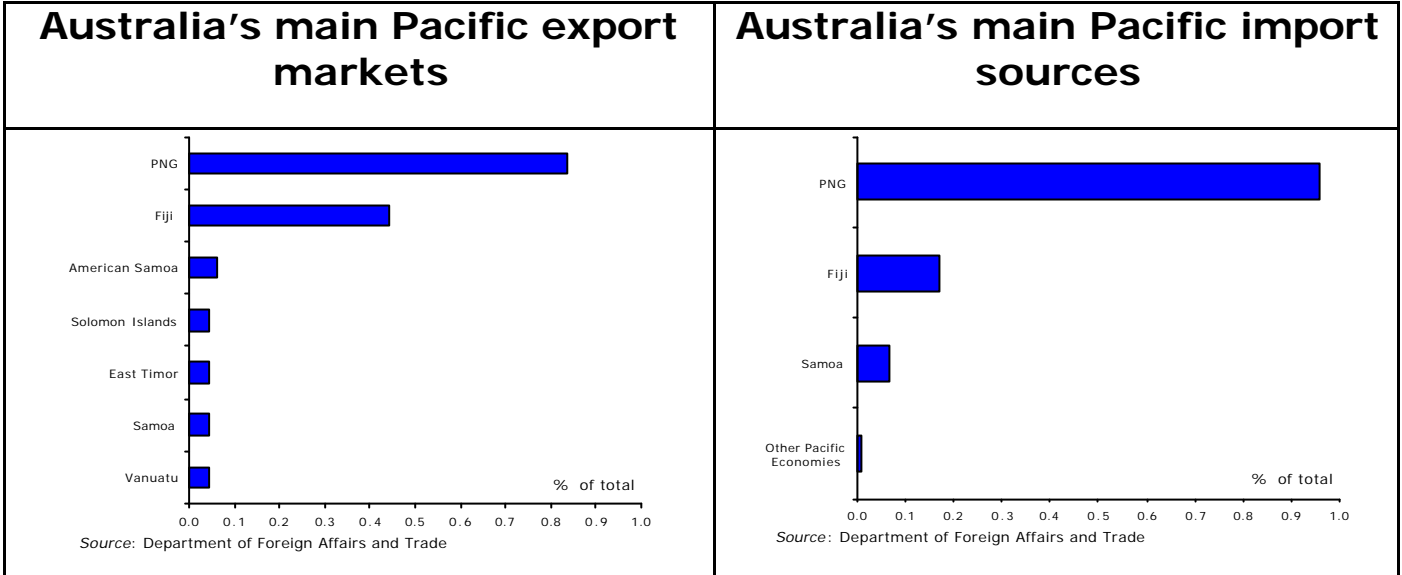
Sources: Asian Development Bank (ADB), Economist Intelligence Unit, IMF, World Bank

The Region in Profile 2002

	Samoa	Solomon Islands	Timor-Leste	Tonga	Vanuatu
Population (000s)	176	443	750	101	205
GDP per capita	1420	570	460	1410	1080
GDP growth 1997-2002 annual averages	3.4	-4.9	0.4	2.4	0.9
Government Budget Balance (% of GDP)	-2.1	-12.2	-8.6	-0.6	-2.1
Inflation: 1997-2002 Ann avg, CPI	3.2	9.0	37.3	5.2	2.5
Current a/c balance % of GDP	-0.7	3.0	-16.0	5.5	-2.0
International Reserves US\$ mn	N/A	18.2	N/A	27.7	36.5
Main exports	Fresh fish, garments	Timber, fish, cocoa	Coffee, oil & gas	Squash pumpkin, vanilla, kava	Timber, copra, beef, cocoa
Main markets	Australia, Indonesia, US	Japan, South Korea, Philippines	N/A	Japan, US, Greece, NZ	India, Indonesia, Thailand, Japan

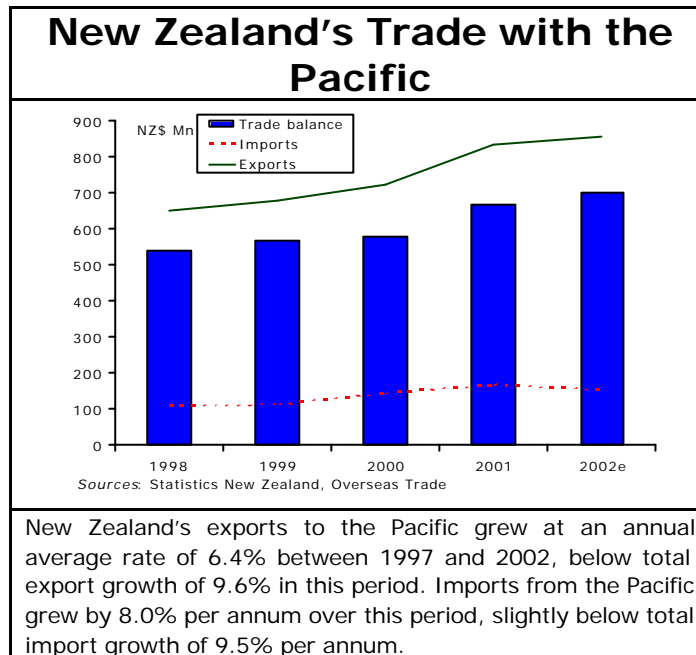
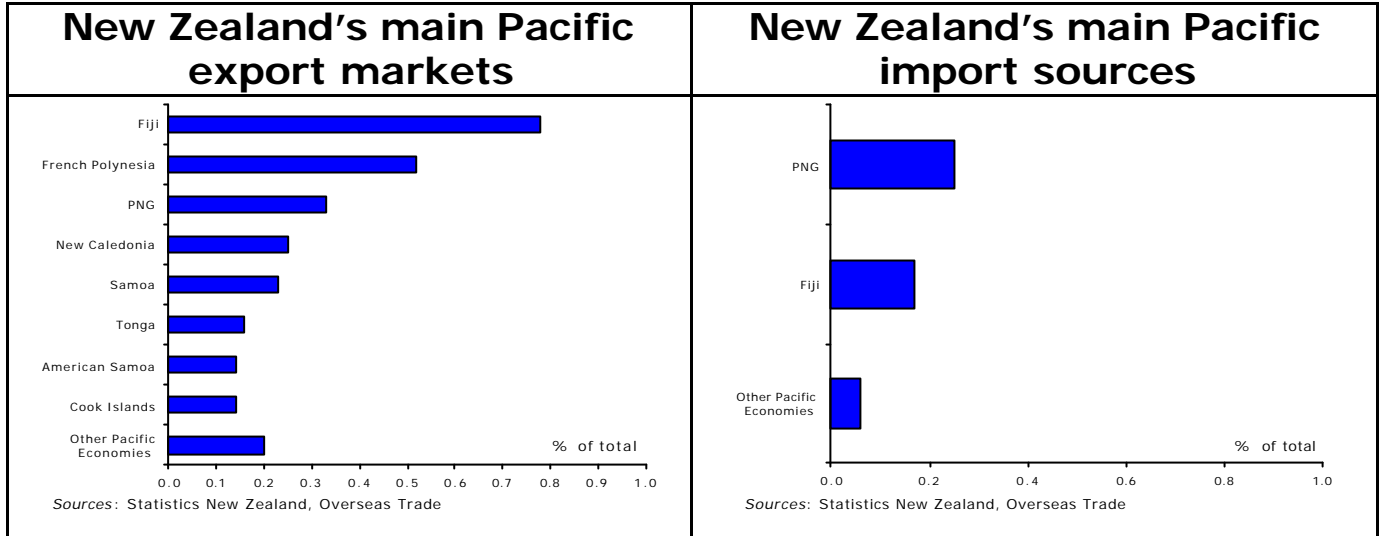
Source: Asian Development Bank (ADB), Economist Intelligence Unit, IMF, World Bank

Australia's Trade With the Pacific



Australia's exports to the Pacific remain at levels similar to those of 1998. During this time, total exports grew by an average 8.7% per annum. Imports from the Pacific grew by 7.8% per annum over this period, below total import growth of 8.5% per annum.

NZ Trade With the Pacific



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