INTERNATIONAL MONETARY FUND

Staff Country Reports

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Statement by the IMF Staff Representative
June 17, 2005

1. **This statement describes the 2005/06 budget which was presented to Parliament on May 31, 2005 after the staff report was circulated to the Executive Board on May 16, 2005.** The proposed deficit target (4 percent of GDP) for 2005/06 turned out to be much larger than the staff's recommendation (0.9 percent of GDP), which reinforces the concerns expressed in the staff appraisal.

2. **The higher deficit target reflects the large costs of restructuring the loss-making Polynesian Airlines and the public sector wage increase approved by the government, and to a lesser extent the increase in pension benefits.**

- Of the 2½ percent of GDP that has been allocated for the restructuring costs of Polynesian Airlines, about ½ percent of GDP is for the capital costs of the new joint venture with Virgin Blue to be paid upfront, and 2 percent of GDP is for the penalties to be imposed for the early return of the airline's jet to the leasing company. The budget assumes that the authorities will make the full bullet payment for these penalties in 2005 instead of spreading out the costs over time. The inaugural flight of the airline for the new joint venture is expected to take place around September 2005.

- The government has approved an average wage increase of about 35 percent for public servants to be phased in over a period of three years (this compares to the increase of about 40 percent recommended by the Remuneration Tribunal for 2005/06). The wage increase will cost the 2005/06 budget about 1¼ percent of GDP and about 1 percent of GDP each for the 2006/07 and 2007/08 budgets.
- The government has also approved an increase of monthly pensions for senior citizens from 100 tala to 125 tala to take effect July 1, 2005 which is expected to cost the 2005/06 budget about ¼ percent of GDP.

3. **The budget contained some offsetting measures:**

- The government will enforce the 50 percent dividend policy for all state-owned enterprises in 2005/06 which is expected to yield revenues of about ¼ percent of GDP. There were no other new revenue measures announced in the budget.

- A number of cost-cutting measures were announced in the budget mainly targeted at reducing operational costs of government departments, including the removal of all vacancies and new positions except where appointments are pending, reduction of travel costs for public servants, enforcement of the policy on the use of government vehicles, and standardization of allowances for board members in public bodies. These measures could yield savings of about ¼ percent of GDP.

4. **Although the impact of the 2005/06 budget on reserves and interest rates is likely to be manageable, the expanded deficit should have a non-negligible macroeconomic impact on the economy, especially on the balance of payments.**

- If the full payments for the restructuring of Polynesian Airlines are made in 2005, this will lower gross reserves from the current level of 4 months of imports to about 3½ months of imports. Thus, the reserve level at end-2005 would stay broadly unchanged from the end-2004 level. While a higher reserve coverage ratio is desirable, the payments do not significantly undermine Samoa's reserve position.

- The budget also announced that about 2½ percent of GDP of the deficit target would be financed domestically (through issuance of treasury bonds of 5, 10 and 15 year maturities). However, given the level of excess liquidity in the banking system as discussed in the staff report (paragraph 8), which currently stands at about 4 percent of GDP, the impact of this on interest rates is likely to be minimal.

- Excluding the reform costs for the restructuring of Polynesian Airlines, the 2005/06 budget deficit target becomes 1½ percent of GDP. This compares with about ¼ percent of GDP recommended by the staff (excluding restructuring costs for the airline the staff tentatively included in its recommendation). The inflation and growth impact of the higher deficit (about 1 percent of GDP) is likely to be small, especially if a significant part of the wage increase leaks into imports. However, this implies that there would be a non-negligible impact on the balance of payments, reinforcing the staff's concerns and strengthening the case for monetary tightening as recommended in the staff appraisal (paragraph 40).

Although growth has slowed down from levels attained through 2000/01, economic activity has started to pick up. Real GDP growth increased to 3½ percent in 2003/04 from about 1¾ percent in 2002/03. The slowdown in the manufacturing sector, poor performance of the fishing sector and cyclone Heta's damages in January 2004 (which hit hard the agriculture sector), was more than offset by the robust growth in the services and construction sectors. Growth is projected to be 3 percent for 2004/05. Inflation (year-on-year) rose to double digits in 2004 following cyclone Heta's impact on food prices, but has declined in recent months and is expected to turn negative by the end of 2004/05. Inflation (12 months average) is projected to be about 7½ percent in 2004/05. The trade deficit widened in both 2003/04 and 2004/05 reflecting sluggish export growth, and high import growth which was driven by the boom in the construction sector. Structural weaknesses rather than exchange rate competitiveness, have led to the weak export performance.

Real GDP growth is projected at 3 percent in 2005/06 underpinned by robust growth in the services and construction sectors. Agriculture is expected to recover slowly, while improvements in the fishing sector remain uncertain. Headline inflation (12 months average) is projected to decline to 3 percent in 2005/06. The current account deficit (excluding official transfers) is projected at about 13 percent of GDP in 2005/06 due to continued weak export growth and the increase in construction-related imports.

The fiscal deficit outturn of 0.9 percent of GDP for 2003/04 was lower than budget (1½ percent of GDP). Although revenues were slightly below budget in 2003/04, this was more than offset by continued expenditure restraint. The 2004/05 budget targets a deficit of 0.9 percent of GDP. At end December 2004, the government's fiscal position recorded a deficit of about ½ percent of GDP based on preliminary 2004/05 mid-year figures. The forthcoming 2005/06 budget is likely to face a number of domestic pressures most notably the strong calls for a large wage increase in the public sector. The costs of restructuring Polynesian Airlines are also likely to impose a significant burden on the forthcoming 2005/06 budget. The staff proposes that the fiscal deficit be contained at 0.9 percent of GDP for the forthcoming 2005/06 budget given the need to gradually reduce the debt level. Prudent wage policy is crucial to achieving this deficit target.

Executive Board Assessment

Executive Directors commended the authorities for good macroeconomic management and for continued efforts to undertake structural reforms. They welcomed the recent pickup in growth and the decline in inflation following a significant increase in 2004 that largely reflected the impact of cyclone Heta on food prices. Directors considered that over the medium term, Samoa's economic prospects remain favorable, provided that macroeconomic stability is maintained and structural reforms are deepened to facilitate private sector development.

Directors emphasized that maintaining fiscal discipline will be essential to further reducing public indebtedness and enhancing Samoa's flexibility to respond to external shocks. In this regard, Directors expressed concern about the increased deficit target in the 2005/06 budget to about 4 percent of GDP from about 0.9 percent of GDP in 2004/05. The increase reflects to a large extent the costs allocated for the restructuring of Polynesian Airlines, but also a large public sector wage increase. Directors welcomed the progress made toward the restructuring of Polynesian Airlines, and stressed that further progress needs to be made toward its comprehensive restructuring. With regard to the wage increase, they noted risks for both macroeconomic stability and the government's economic reform program, and urged the authorities to follow a prudent wage policy in future budgets. They welcomed the planned phase in of the wage increase over three years, and the authorities' consideration of a performance-based system in lieu of automatic wage increases in the future. Directors emphasized that expenditure restraint would allow the public debt to GDP ratio—which remains high by regional standards—to decline gradually over the medium term.

Directors encouraged the authorities to continue their efforts toward strengthening tax administration, and in particular to establish a Large Taxpayer Unit and to modernize the 1974 income tax legislation. Directors also noted that a better rationalization of expenditures would enable a reorientation of spending toward the education, health, and infrastructure sectors, which are crucial for medium-term growth. Directors welcomed the authorities' plans to include a medium-term budget framework in the 2006/07 budget.

Directors considered that Samoa's adjustable peg exchange rate regime has served well as a nominal anchor. They agreed that the policy of periodically making small adjustments in the value of the tala has struck an appropriate balance between maintaining competitiveness and preserving the exchange rate peg's role as an anchor for inflation. Directors also welcomed the authorities' intention to tighten monetary policy in view of the potential balance of payments pressures that could arise from the large budget deficit in 2005/06.

Directors commended the Central Bank of Samoa for the recent measures taken to strengthen the supervision framework. They noted that the approval of the international banking bill, which requires all offshore banks to establish a physical presence in Samoa, will enhance the development of the financial sector. Directors welcomed the progress made in strengthening Samoa's framework for Anti-Money Laundering and Combating the Financing of Terrorism. Directors commended the authorities' interest in improving the investment guidelines of the National Provident Fund (NPF). They noted that given its high level of nonperforming loans, which reflects increasing activity in non-core functions, there is a need to strengthen the NPF's supervisory framework. Directors noted that a financially-sound pension fund will be needed to deal with the fiscal pressures that can arise when the population ages.

Directors acknowledged the progress made in a number of key areas of structural reform, such as civil service reform, telecommunications sector liberalization, and WTO accession talks. They welcomed the authorities' commitment to implement the reforms outlined in the Strategy for the Development of Samoa. They emphasized that it is important for Samoa to continue to move forward its public sector reform agenda and tackle impediments to private sector development. In particular, they noted that deeper reforms of state-owned enterprises and land reform are important to enhance private sector development. This will require enacting and implementing the Companies Act and its supporting legislation, and engaging in consultations with the public to build an institutional framework for an efficient lease market for communal

Statement by Jong Nam Oh, Executive Director for Samoa
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June 17, 2005

Key Points

- Owing to the comprehensive reform program launched in the 1990s, Samoa's economic development compares very favorably with its peer Pacific island countries.
- Macroeconomic performance remains sound and the medium-term outlook favorable.
- The macroeconomic risks to the medium-term outlook, including the 2005 budget, are manageable. The DSA shows that absent a combination of extreme shocks, the debt outlook is sustainable. The authorities recognize, however, that vulnerabilities associated with being a small island economy requires a safer debt position.
- The one-off cost to the 2005 budget of restructuring Polynesian Airlines will end annual budgetary subsidies and transfers to the airline (averaging 1 percent of GDP over the last few years). More significantly, it represents an important structural reform achievement that could serve as an example for the region.
- Their intention to tighten monetary policy to contain the balance of payments pressures associated with this higher budget deficit is also in line with staff's advice.
- The authorities are committed to implementing their ambitious structural reform agenda spelled out in the Strategy for the Development of Samoa (SDS), which addresses key outstanding structural reform measures identified by staff.
- Samoa's financial system is sound and well-supervised. Consistent with staff's recommendations, the authorities are interested in strengthening the investment guidelines of the National Provident Fund to enhance its financial soundness.
- The authorities value the objective and quality assessment of their policies provided in the context of the Fund's Article IV consultations process. They expressed strong interest in a staff interim visit.

1. Samoa suffers from physical and economic characteristics that restrict economic development. These include smallness in size and population, geographic remoteness and isolation, narrow productive sectors, vulnerability to terms of trade fluctuations, and susceptibility to natural disasters. Nevertheless, implementation of structural reforms and a history of prudent economic and financial management since the 1990's have enabled economic development in Samoa, which compares very favorably with its peer Pacific island countries. More importantly, the authorities remain committed to maintaining their track record of prudent economic policies to ensure macroeconomic stability and growth. Furthermore they intend to build on the achievements to date on the structural reform front by addressing key outstanding issues.

2. GDP growth increased to 3½ percent in 2004 from 1¾ percent in 2003. Inflation also stabilized in recent months, after having picked up in early 2004 - reflecting increased import and food prices following cyclone Heta. The current account balance is estimated to have deteriorated by end-December 2004, reflecting strong imports for the construction sector and continued weak export growth. Staff and authorities agree on a favorable outlook of 3 percent growth in 2005/06.

Commitment to macroeconomic stability

3. Noting the risks to this favorable outlook, the authorities remain committed to the continued implementation of sound economic management to ensure macroeconomic stability and growth.

4. Reflecting fiscal restraint and continued strong revenue performance, fiscal performance up to 2004 has been encouraging as the overall deficit declined to less than 1 percent of GDP since 2002/03. Public debt also declined from 60 percent of GDP in 2001 to 48.5 percent in 2004/05. The administration's budget submitted to the parliament, while representing an increase in the target fiscal deficit, is in our authorities' view manageable. The wage increase and the cost of restructuring Polynesian Airlines will result in a slightly higher debt-to-GDP ratio, but will not lead to an unsustainable debt outlook. However, the authorities are also aware that the vulnerabilities of a small island economy requires a safer debt outlook.

5. The one-off cost to the 2005 budget of restructuring Polynesian Airlines will end costly budgetary subsidies and transfers to the airline, which have averaged 1 percent of GDP over the last few years.

6. The authorities have requested a wage increase of 35 percent in the 2005/06 budget (instead of 40 percent recommended by the Remuneration Tribunal). Consistent with their discussions with staff, this will be phased in over three years to minimize the impact in one given year. The authorities view the wage increase as long overdue, with public sector wages having remained the same since 2001. Moreover, Samoa's public wage bill as a share of GDP is significantly lower than the regional average. The authorities are considering staff's advice to develop a performance-based system, which would see future wage increases based on productivity.

Monetary policy and financial sector soundness

7. The reserve position is expected to remain at comfortable levels, even taking into account the impact of the higher budgetary deficit for 2005/06. The monetary authorities signaled their intention to tighten monetary policy to contain the budgetary risks to macroeconomic performance.

8. Samoa's financial system is sound and well-supervised. Consistent with staff's recommendations, the authorities are interested in strengthening the investment guidelines of the National Provident Fund. Nevertheless, Samoa is a good illustration of how market size and remoteness make sound policies insufficient for attracting private foreign capital. In such cases, securing sufficient capital for supporting productive activities is a real concern.

Structural reforms to strengthen private sector-led growth

9. The reform program launched in the early 1990's has laid much of the ground work for economic development. The authorities now face the challenge of enhancing the environment for private sector-led growth, as outlined in the SDS 2005-07. In particular, the SDS outlines the need to promote the investment climate, improve the availability of land for private investment, and the deepening reform of state-owned enterprises.

10. Programs are already underway to help improve the investment climate (such as a reform of key utilities and improving the regulatory regime). The establishment of a one-stop shop facility is also viewed as important.

11. The authorities also recognize the importance of land reform aimed at improving the capacity to use land for collateral and investment. The government's recent initiative to facilitate the leasing of unused communal land for productive uses is an important progress in this regard.

12. The government has made significant progress in public enterprise reform in the context of its SOE policy framework. These include the divestment of the government's minority interest in a number of enterprises, and the announcement of the privatization of the Samoa Shipping Services, the Agriculture Store, and the Samoa Broadcasting Corporation. Enterprises of strategic public interest will be subjected to the corporatization program to give them a stronger commercial focus. The authorities will continue with their efforts to further improve the operations of the remaining SOEs, including by contracting private operators for management of the remaining SOEs.

13. Due to the remoteness of Pacific island countries, high transport costs represent one of the most important obstacles to their development. Highly subsidized state-owned airlines are thus very common in the Pacific. For Samoa, subsidies and transfers to Polynesian Airlines averaged 1 percent of GDP over the last few years. The joint venture with Virgin Blue holds promise of improving the operations and finances of Polynesian Airlines. Samoa's success in addressing this problem could serve as an example for parts of the region where transport bottlenecks remain and subsidies to state-owned airlines still burden the budget. The recent push to shift to a more regional approach for coordination in addressing the chronic problems of transport could benefit from this model.

14. The tourism sector is viewed as offering great potential, especially as a means of providing employment. The authorities' efforts to develop the tourism sector are bearing fruit, which is evident in the growth of the sector's share of GDP from 4 percent in 2001 to 17 percent in 2003.

Conclusion

15. Finally, the authorities value the objective and quality assessment of their policies provided in the context of the Fund's Article IV consultations process. They expressed strong interest in a staff interim visit, as the next Article IV is not expected to take place until 2007.

16. On behalf of our Pacific Island authorities, we would like to thank staff for the interesting paper on Pacific Island Regional Issues. The paper covers many important issues. In our view, the paper merits substantive consideration by the Executive Board in the context of efforts to strengthen regional surveillance.