

## TUVALU: LDC status

Graduation of Tuvalu from the Least Developed Country category  
 Department of Economic and Social Affairs  
 Secretariat for the Committee for Development Policy  
 9 March 2009

## TUVALU: ECONOMIC OVERVIEW AND MAJOR CHALLENGES

## BACKGROUND

1. The Tuvalu Government submitted to the UN Committee for Development Policy (hereafter the "Committee") substantial documentation that supports the Government's contention that Tuvalu should not graduate from LDC status. This note summarizes the major arguments why Tuvalu should maintain its LDC status. It re-emphasizes the fragility and vulnerability of Tuvalu's economy, and outlines the key challenges that Tuvalu presently confronts to maintain economic and social progress.

2. The Committee found that Tuvalu met two of three UN criteria for graduation off the LDC list. These are: gross national income (GNI) per capita, and the human asset index (HAI: nutrition, child health, school enrolment, adult literacy).

3. In contrast:

- Of the 68 countries surveyed at the 2006 CDP Triennial Review, Tuvalu had the worst economic vulnerability index (EVI): external shocks, structural exposure to shocks, structural handicaps.
- Tuvalu has the highest exposure index and shock index.
- Tuvalu has the highest agricultural instability index, and second highest export instability index.<sup>1</sup>
- Tuvalu's EVI (79.7/100) is 41 points above the graduation threshold of 38.
- Tuvalu ranks as the most economically vulnerable country in the world.

4. Under the above criteria, Tuvalu received graduation marks in two of three criteria, but this methodology severely under-weighted the importance of EVI in Tuvalu's uniquely fragile development and economic context. Giving equal weight to such broad indicators will naturally under-estimate Tuvalu's severe economic (and environmental) vulnerability.

5. Past economic progress in Tuvalu, by any number of measurements, has been respectable for a resource poor nation of 10,000 people. Tuvalu's long-held emphasis on investment in education and training is reflected in the good results seen in the HAI. The growth of its GNI per capita has grown steadily, but it is built on a fragile base that relies on the health of global financial markets; continuous (and sizeable) flows of development aid, and prudent fiscal management.

6. Although Tuvalu's relatively high GNI and HAI suggest LDC graduation, the progress these criteria measure could easily, rapidly unravel due to Tuvalu's inherent economic vulnerability.

7. We counter that Tuvalu should not graduate from LDC status, unless Tuvalu also meets the EVI graduation criteria. Despite high GNI and HAI measures, Tuvalu has such weak EVI measures that graduation from LDC status at this stage of Tuvalu's development is premature, unnecessarily exposes Tuvalu to greater risk, and increases the country's economic vulnerability – not lessen it.

## ECONOMIC OVERVIEW

8. At independence in 1978 Tuvalu faced a bleak economic future. There were widespread fears that Tuvalu was not a viable nation. Since then support for Tuvalu from aid donors has been steady and substantial. This support has played a central role in Tuvalu's development, as measured across a range of economic and social indicators. Loss of LDC status will eventually undercut aid assistance, which will jeopardize the economy, and put a drag on future development.

<sup>1</sup> Tuvalu's export vulnerability index is further exaggerated because Tuvalu is a non-trading nation in merchandise exports, and has a structural/inherent inability to develop a manufacturing sector in which to produce merchandise exports that earn foreign exchange. This is yet another example of Tuvalu's economic vulnerability and the fragile nature of its economy.

9. Often repeated are Tuvalu's many well-known economic constraints:

- Isolation, especially from major markets;
- Limited natural resources (with the possible exception of marine resources);
- A small, geographically dispersed population; and
- Limited access to human and financial capital, to name but a few.

10. It is arguable that Tuvalu is the world's most remote country, as measured by access to it, distance, transport costs, and other factors. Tuvalu is among the smallest countries by land area and population.

11. Apparent progress under the GNI and HAI criteria are only broad interpretations of Tuvalu's economic and social progress. Economic performance remains fragile and challenged by many external factors that are well beyond domestic influence or control. GNI per capita can be a misleading indicator of economic health. Tuvalu has a high cost of living, and is heavily dependent on imported food and wholly dependent on imported fuel. Its GNI per capita at purchasing power parity (PPP) is among the lowest in the world. Of 192 countries recently surveyed, Tuvalu ranks 18<sup>th</sup> from the bottom (176), below all other SIDS and only a few other LDCs.<sup>2</sup>

12. In spite of these constraints Tuvalu has a record of economic progress, though its vulnerability has made Tuvalu's progress fragile and at continuous risk of reversal. Tuvalu has a well-deserved, and hard-earned reputation for getting favorable returns from its meager resource base — natural, financial and human. Tuvalu, however, is and remains extremely exposed to global economic forces that are entirely outside the country's control.

13. Rarely has Tuvalu been more vulnerable than it was in 2008. Over the past year the economy reeled under sharp spikes in the cost of imported food and fuel. This put severe strain on the Government and the nation. Below is but one comparative example:

- In mid-2008, gasoline prices in the U.S. were around US\$4/gal.
- In Tuvalu, gas prices reached \$12/gal, or three times the price of fuel paid for in the U.S., a country many orders of magnitude richer.

14. In Tuvalu, spending cuts ensued, national (and unaffordable) subsidies increased, and household budgets got squeezed, badly. While prices for food and fuel have eased somewhat, they still remain at historic highs due to unfavorable exchange rates, import time lags, and high transport costs.

15. Presently, Tuvalu's economy has been hard hit by the flow-on effects of the global financial crisis. Beginning in 2008, the portfolio value of the Tuvalu Trust Fund (TTF) started to collapse. Obviously, it won't recover anytime soon. The TTF is the foundation of much of Tuvalu's macroeconomic stability and financial sustainability, with zero income expected from the TTF for years to come.

17. Other foreign-sourced income also feeds the Tuvalu economy, mostly through the national budget. So far these income sources remain relatively strong, in part because many of them are denominated in US\$. The recent, large depreciation of the Australian dollar (A\$) means that US\$-based assets and the income derived from those assets may increase in 2009. This may sound good, but it is not. It only reinforces the vulnerability of Tuvalu's economy, highlighting those economic factors that are outside Tuvalu's control, which may just as easily move against the Government — and fast.

<sup>2</sup> Sources: IMF - International Monetary Fund, World Economic Outlook Database, April 2005; CIA: The World Factbook (2005, covers countries not mentioned by the IMF, information may refer to 2004 or earlier.) Slightly different figures will be found at Country Economies Classification of The World Bank Group. See: [http://www.nationsonline.org/oneworld/GNI\\_PPP\\_of\\_countries.htm](http://www.nationsonline.org/oneworld/GNI_PPP_of_countries.htm).

18. In mid-2008, when Tuvalu faced historically high food and fuel prices, the A\$ was almost at parity with the US\$. Projections were income from the TTF would drop to zero. They did and are not expected to recover for at least several years. The Government confronted a fiscal crisis.

19. Given the situation the Government maintained fiscal discipline, moved to reduce its debt obligations, and moved to build its cash reserves. Nonetheless, the Government was still unable to balance its 2009 Budget. As a precautionary measure, the Government sought and received one-off grants from Australia and New Zealand to boost its cash reserves that should help Tuvalu navigate through the current global financial crisis and the ancillary impacts that it will impose on Tuvalu.

#### MAJOR CHALLENGES

20. At any time, Tuvalu confronts many challenges to develop its economy. The challenges we now face are more difficult than ever before, and could prove insurmountable if Tuvalu loses its LDC status.

21. In Tuvalu, the public sector dominates the economy. Which means prudent macroeconomic policy is vital to achieve medium-to-long-term economic progress. The foundation of Government macroeconomic policy is a fiscal strategy anchored by the Tuvalu Trust Fund, and annual income earned from the TTF. The TTF has a balanced portfolio, invested around the world in a mix of equities and fixed-interest securities. In good years, decision-makers use real TTF returns to fund the national budget's structural deficit. In bad years, such as now and for the foreseeable future, Tuvalu's inherent economic and financial vulnerability is exposed.

22. Tuvalu has taken steps to reduce the volatility inherent in TTF investments by building a buffer account that grows in good times and can be drawn down when TTF returns are poor or non-existent. But the current global financial crisis could threaten the basis of this policy. If the crisis is protracted, currently the worst seen in 80 years, many of the assumptions upon which the TTF was established will be sorely tested if Tuvalu's cash reserves run out.

23. Another challenge facing Tuvalu is to maintain its other major sources of income: fishing licensing; income from the marketing and licensing of .tv, Tuvalu's country-code internet domain name; foreign aid; and remittances. Each of these sources are dependent upon factors outside the control of Government.

24. Income from fishing licenses, .tv, and foreign aid all flow through the national budget, and are subject to annual spending and distribution priorities. All could be severely affected by the current crisis. The Government's most worrisome scenario is one where all these revenue sources fall at the same time – a real possibility in such uncertain times.

25. Amplifying the current crisis could be a fall in remittance income from workers overseas, most importantly seafarers employed on foreign merchant ships. Though this source of economic support has remained relatively stable over the years accurate figures have been difficult to quantify since remittances are a private income flow. If world trade contracts by double digits, the number of seafarers employed will fall, which would have a sudden and severe impact on household income.

26. Tuvalu's greatest potential challenge, among many: If all these sources of income decline at once, domestic revenue would dry up, GNI would start contracting, and HAI indicators would decline over time. The loss of LDC status at such a critical juncture would severely restrict Tuvalu's ability to sustain current level of development.

