Modern Economy, 2011, 2, 153-162
doi:10.4236/me.2011.22020 Published Online May 2011 (http://www.SciRP.org/journal/me)

Scientific Research

Oil Price and Economic Growth in Small Pacific Island Countries

Tiru K. Jayaraman[1], Evan Lau[2]
[1]*School of Economics, Faculty of Business and Economics, The University of the South Pacific, Suva, Fiji Islands*
[2]*Department of Economics, Faculty of Economics and Business, Universiti Malaysia, Sarawak, Malaysia*
E-mail: jayaraman_tk@usp.ac.fj, lphevan@feb.unimas.my
Received November 22, 2010; *revised February* 11, 2011; *accepted February* 17, 2011

Abstract

Among the 14 Pacific Island countries (PICs), only Papua New Guinea has fossil fuel resources. None of the remaining 13 PICs has any energy sources. Consequently, all the 13 PICs are totally dependent on oil imports for their economic activities. Recent surges and volatility in oil prices have had serious economic repercussions on economic growth. Since PICs have limited foreign exchange earning capacities, as they have very narrow range of exports and are highly dependent on foreign aid, high oil prices in recent months have seriously tested their economic resilience. This paper applies the recently developed panel analysis procedures to five major PICs, namely Fiji, Samoa, Solomon islands, Tonga and Vanuatu with a view to assess the impact of oil price on economic growth. The findings are that oil price, economic growth and international reserve are cointegrated. The study findings are that although in the long run there is no long run causality relationship between these variables, in the short run the causality linkage runs from oil prices and international reserve to economic growth. The paper concludes with a brief discussion on policy options.

Keywords: Oil Price, Economic Sector, Pacific Island Countries (PICs), Panel Analysis

1. Introduction

During an eight-year period (2000-2007), oil prices increased three-fold. From early January 2008, there were further increases in oil price, which reached the record level in mid 2008 at US$145 per barrel. Among the 14 Pacific island countries (PICs), only Papua New Guinea (PNG) is a producer and net exporter of oil and refined fossil fuels. The commodity price boom, since the beginning of the decade with oil price rising along with gold price doubling and copper prices increasing four fold, has been a big boon to PNG, in terms of improvement in terms of trade as well as resultant rise in its export earnings (Australian Agency for International Development, [1]). On the other hand, the smaller PICs with no petroleum resources have been hit hard by surges in worldwide oil prices (United Nations Economic Commission for Asia and Pacific [2], Asian Development Bank [3,4]). Being totally import dependent for all fuel and other energy needs, their trade balances have deteriorated considerably during recent years.

Aside from rise in oil price, increases in the prices of food grains due to higher demand in their use as feedstuff for bio-fuels, have also contributed to inflationary pressures in PICs. The latter are totally dependent on imports of wheat flour and rice as well, since they do not grow any wheat or rice, with the exception of Fiji, where rice production meets around 10% of total consumption.

While PNG, which has been running trade surpluses with substantial build-up in its foreign exchange reserves can thus afford food imports at higher prices to meet rising domestic food needs, the ability of smaller PICs to bear imports at higher costs is increasingly constrained by the availability of international reserves. With decline in foreign exchange earnings from their limited export bases, consisting of traditional commodities, such as sugar in the case of Fiji, logs and oil palm in the case of Solomon Islands, and fruits and vegetables such as squash in the case of Samoa and Tonga, beef and kava in the case of Vanuatu, mounting trade deficits of PICs have to be financed by stagnant foreign exchange reserves. The result has been that despite heavy reliance on tourism and foreign aid inflows, PICs have been struggling with earmarking greater resources for critical growth enhanc-

Copyright © 2011 SciRes.