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Living with uncertainty in Pacific island countries: Where to turn?

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POLICY BRIEF

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Introduction

A phrase that captures the reality of daily life in Pacific Island countries (PICs) is "living with uncertainty", with regular political upheaval, periodic civil unrest, and the human and physical cost of natural disasters as major contributors to that uncertainty. In the closing weeks of 2024 alone, a severe earthquake struck Port Vila in Vanuatu, only days after the prime minister dissolved parliament and called for a snap election in January 2025. The prime minister of Tonga resigned in the face of a no-confidence vote. Earlier in the year, a state of emergency was declared in New Caledonia in the face of damaging pro-independence rioting, and hundreds of lives were lost in a catastrophic landslide in the Papua New Guinea highlands in May 2024. Regular motions of no confidence in the prime minister defined the political year in Papua New Guinea; a similar threat hung over the Solomon Islands' government[1] and the Fijian Government grappled with tensions between the three coalition partners, internal dissent, and divided public opinion on the need for a proposed constitutional review.

International megatrends add another layer of uncertainty. The UN Economic and Social Commission for Asia and the Pacific (ESCAP) identifies three megatrends[2]—climate change, demographic shifts, and digitalisation—that will impact living standards, and threaten to increase poverty in the absence of active public policy to address those threats.[3] PICs would add a fourth megatrend to this list—geopolitical rivalries—as great powers and their allies seek to both protect their interests and gain influence in the region,[4] alongside uncertainties surrounding the impact of a Trump presidency of the US on international affairs and a growing membership and strategic influence of BRICS countries.

Responding to these uncertainties is challenging, but the challenges are magnified by the contested terrain of national life in PICs. PIC policymakers have to navigate contests on multiple fronts: between national sovereignty and the international legal order; between regionalism, minilateralism, and multilateralism; and even between Pacific Island Forum (PIF) members. There are also associated contests of policy prescription and the intellectual ideas that inform policy—contests within PICs, between PICs and PIF, and between PICs and international financial organisations and other multilateral and bilateral development partners. These contests are, invariably, played out in the fields of economics and finance, but public debate on how the rules of mainstream economics and finance can be adapted to respond to the uncertainties of daily life and PIC national life is minimal.

This policy brief aims to elevate the importance of that debate and encourage an intellectual contest on economic and financial approaches that are PIC-centric. Such a contest will confront tensions between domestic economic policy and rights-based or development-based approaches; between individualist, market-based approaches or communitarian approaches trying to preserve PIC values and culture;

between state and private provision of goods and services, finance and investment; and between the merits of foreign aid and foreign borrowing and building local financing capabilities.

Any PIC policy discussion also needs to disentangle the interests being served through any policy advice, including external advice. The position adopted in this chapter is an acceptance of the importance of deepening Pacific agency over issues that directly impact their daily lives while acknowledging that the scale of uncertainty limits that agency and also limits the agency of PICs as a collective. But there is no point advocating for Pacific agency in the absence of a Pacific-centric approach to economics and finance. The task for policymakers is to align the tools of economics and finance with PIC policy imperatives.

The advocacy of PIC-centric economics and finance is central to the work being undertaken by GAI's Pacific Islands Centre for Policy and Development (PICDPR), but the prompts for this chapter were more specific. One prompt was ESCAP's concern with the threat of increased poverty associated with megatrends and the consequent need to strengthen social protection mechanisms; these will need to be financed. Other prompts included the specific inclusion of an article related to banking in the recently agreed *Nauru-Australia Treaty*, and the recent decision of the Marshall Islands Government to establish a monetary authority in the Marshall Islands, even though the US dollar is the sole legal tender [pending legislation in February 2025; Bill introduced to parliament].

The body of the chapter explores the intersection of the megatrends with the prevailing uncertainties and the implications for economic and financial policies. The final section summarises the discussion, provides some broad recommendations to deepen the policy agency of individual and collective PICs, and identifies selected financial interventions that PIC development partners could make to support this objective. For PIC policymakers to be in a better position to deal with the uncertainties of PIC life, they need to be able to turn to the academic world to adapt mainstream theories to the reality of PIC life and to develop partners to bear more of the financial risks affecting those lives.

Image credit: Saeed Khan/ AFP

Megatrends impacting Pacific island countries

Strengthening social protection frameworks to respond to the megatrends was the unifying theme in ESCAP's 2024 Social Outlook. This chapter takes a more fundamental approach in focusing attention on the financing of social protection frameworks and locating social protection financing within a wider discussion of the financial architecture in PICs. Working with the language of finance directs discussion to the nature of the risks, the instruments available for managing those risks, and which actors are relatively better placed to bear those risks.

The broad policy approach could be described as one of coping with uncertainty,[5] as opposed to eliminating uncertainty and making sure that PICs are not left behind.[6] Much of this uncertainty is radical;[7] that is, these types of risk cannot be quantified and described through some form of probability distribution in the way that risks covered by insurance products can be quantified. This distinction is important to understanding the potential impact of the key megatrends on life in PICs, the type of policy response that is needed, and the implications for the way external actors engage with PICs.

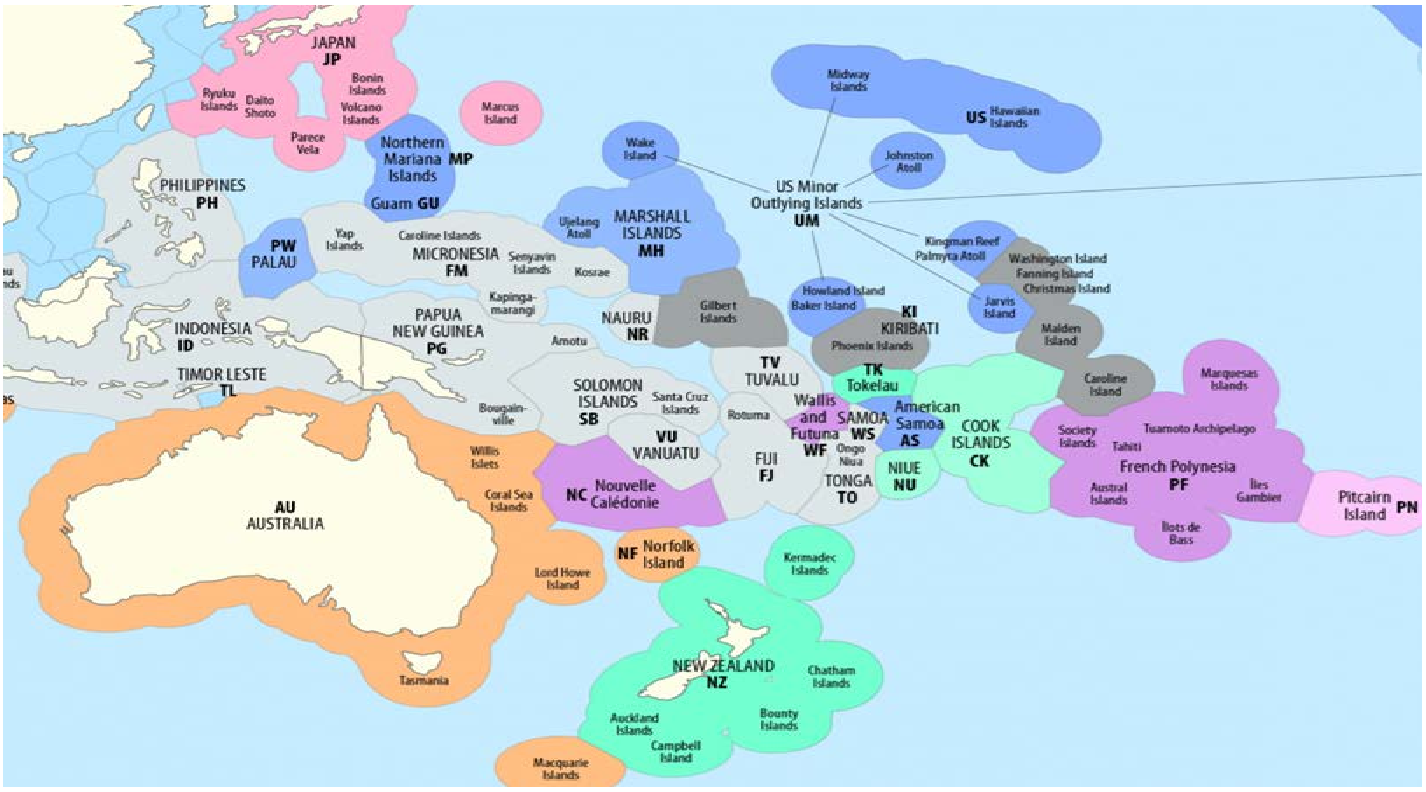
King and Kay note that the world of economics, business, and finance is not stationary: it is not governed by unchanging scientific laws. Individuals do not, and cannot, optimise in the changing world; rather they find ways to cope and adapt. Improving the management of risk is an important part of any adaptation to uncertainty, and as North notes, institutional innovations that brought about a transformation into the risk management sphere have, historically, been critical to capital mobility.[8]

Any acknowledgement of the importance of capital mobility calls into question the level of financial sector development in PICs and the role of development finance institutions (DFIs). Distinguished development economist, Paul Collier, advocates for DFIs to provide more risk financing (and to be prepared to carry any losses that may occur) to accelerate the growth of local firms. Collier argues that DFIs, and development partners generally, need to see themselves as supporters of host countries, rather than saviours carrying their own agendas and value systems.[9]

Geopolitical rivalries

As foreshadowed in GAI's *2024 Strategic Outlook*, maintaining Pacific agency and regional resolve was tested through 2024.[10] PIF has expressed concern about the Blue Pacific Continent being a stage for geopolitical rivalry, but the battle for influence over PICs continues. As long as PIF cannot underwrite the security of individual PICs through any regional initiative, there is a strategic opportunity for the major actors in this rivalry to fill this void and win minds, witness the defence diplomacy initiatives of Australia, China, and the US,[11] and Australia's sport diplomacy initiatives.

Figure 1: The Pacific region



Source: *Western World Daily*.

The Compact of Free Association agreements that the US renegotiated with the Federated States of Micronesia, the Marshall Islands, and Palau in 2024, and Australia's bilateral agreements with Tuvalu and Nauru in 2024, also highlight the limitations of regionalism in safeguarding the security of individual PICs. The Compact agreements are hybrid defence-economic security agreements, with the US Government guaranteeing to provide whatever defence capability is needed.[12] Similarly, the Australian agreements with Tuvalu and Nauru attempt to integrate economic, social, and defence considerations. The Australia-Tuvalu Falepili Union[13] was signed in August 2024, and the *Nauru-Australia Treaty* was signed in December 2024. While both agreements are overtly in Australia's interest and have been criticised for increasing Australia's hegemony in the region,[14] they are, at least, an attempt to integrate economic, social, and defence considerations important to Tuvalu and Nauru.[15] The agreements attempt to both protect—against climate change and military threats—and underpin the provision of essential services—education, health and other social services. A feature of the *Nauru-Australia Treaty* is the recognition of the importance of continued banking services to Nauru and (and implicitly to all PICs) through a specific article on banking.[16]

Despite the attempts of the US and Australia to recognise local concerns, there is a major power imbalance, if only due to the US and Australia financially underwriting the agreements and the administrative demands placed on the beneficiary countries. More generally, as Keen and Sora note, geopolitical rivalries have been accompanied by increases in aid and wider interest in the region, but there has not been a corresponding increase in local capability to deal with this interest.[17] "Increasing external engagement has intensified resource competition among government agencies, tiers of government, and between government and civil society" (p.6).[18] This competition may seem to bring opportunities to domestic actors, but that competition could be described as development arbitrage, with the result that aid is not being directed to where it is most needed, blunting the development impact, and weakening governance. There is a real risk that external support in the name of development, and badged as building resilience, may have the opposite effect and ultimately weaken states.

Geopolitical rivalries also limit the value of regional solutions: it is difficult to craft regional solutions that involve geopolitical rivals, and where any solution privileges one of these rivals it increases the likelihood of a bilateral response from the other. The implementation of the Pacific Policing Initiative (PPI) in 2024 highlights this dynamic. The initiative builds on earlier efforts in policing cooperation undertaken through the Pacific Islands Chiefs of Police (PICP) since 1970,[19] but it extends this cooperation to establish a capability to deploy at short notice at the request of any participating government,[20] including four countries that are not full members—American Samoa, the Commonwealth of the Northern Marianas, Guam, and Tokelau.

PIF leaders collectively endorsed the PPI at the August 2024 Leaders Forum,[21] noting that the mechanism provided a regional capability while respecting national sovereignty by giving members "discretion to choose how they would contribute to and benefit from the three pillars identified in respect of national sovereignty and in line with national priorities".[22] While PPI "is a demonstration of the practical implementation of regionalism [through] the pooling of resources and expertise to enhance the region's overall capabilities",[23] it is not clear how much can be read into it as "an indication of the strength of Pacific regionalism".[24] Regional policing cooperation is not new, the initiative risks being branded as an Australian initiative that promotes Australia's interests under the guise of regional cooperation, and despite PIF leaders collectively endorsing PPI there were strongly worded reservations from several individual leaders concerned about an escalation of tensions between the US and China,[25] and warning against using PPI as a geopolitical response.[26]

The timing of PPI's establishment and Australia's involvement is a response to China's support for Solomon Islands police during and after the civil unrest in 2021,[27] but it remains to be seen whether PPI will blunt China's direct support for Pacific policing. PPI is not an exclusive arrangement, and individual countries can continue to access Chinese policing support, as several PICs including Fiji, Kiribati, Samoa, Tonga, and Vanuatu are doing. A Chinese cloud lingered above the PPI launch: the Vanuatu prime minister announced continued Chinese support for police and security forces in Vanuatu on the same day as the Australian prime minister announced the establishment of the PPI centres of excellence. One of those centres will be located at the Samoa Police Academy, which was built by a Chinese contractor with Chinese government funding.[28]

Unresolved is how PIF countries will achieve the maritime capability needed to secure a Blue Pacific, without fragmenting the region. PPI provides a precedent for an equivalent military capability and there the Eastern Caribbean's Regional Security System (RSS) offers a working model for pooling defence personnel and assets but under the direction of the government that has called on that military support.[29] PIF leaders are unlikely to support such a force but that sentiment could change, including amongst the Melanesian Spearhead Group as Kanak demands for independence fuel continuing unrest in New Caledonia.[30]

The choices made will reflect financing constraints, even for larger PIF members. Australia has shown its hand through more aggressively moving to protect its defence interests, but it does expect support, particularly from New Zealand.[31] New Zealand's defence policy has shifted under the current government, with an increased emphasis on interoperability with the Australian military and a willingness to explore benefits from participating in AUKUS Pillar 2. Participation would potentially bring the benefit of access to advanced military technologies, without compromising New Zealand's anti-nuclear position.[32] The associated question concerns New Zealand's financial capability to be involved, given persistent fiscal constraints, consistently lower economic growth than Australia, and reliance on trade with China.

Those considerations could well tilt the balance to protecting trade access rather than building regional defence capability.[33] How New Zealand resolves this dilemma will be watched closely by other PIF members, especially other signatories to the *South Pacific Nuclear Free Zone Treaty* (Rarotonga Treaty).

Climate change

PICs "are at the frontline of the adverse impacts of climate change":[34] their oceanic territories cover around 20 per cent of the earth's surface. PIF leaders have long regarded climate change as the "single greatest threat to the livelihoods, security and wellbeing of the peoples of the Pacific",[35] and are unified in their efforts to protect their peoples against any adverse impacts and to have the developed world take greater responsibility for reducing and addressing the damage caused through greenhouse gas emissions, including through "timely access to scaled-up, effective and sustainable finance".[36] To get the developed world to accept this responsibility, PIF is relying on UN mechanisms to be effective.

In December 2024, the international climate change spotlight was on oral submissions to the advisory proceedings of the International Court of Justice (ICJ). The ICJ process started in April 2023, when the UN General Assembly requested an advisory opinion on the obligations of states under international law in respect of climate change.[37] The Court has also been asked to consider the legal consequences under these obligations where significant harm has been caused, particularly for small island developing states.[38]

As important as the Court proceedings are, they are unlikely to bring the near-term change PICs are seeking, for two reasons. First, any advisory opinion of the Court will be issued against a backdrop of continued erosion of a rules-based international order; and second, ICJ advisory opinions are not binding, unless "certain instruments or regulations provide that an advisory opinion by the Court does have binding force". Some subsequent action would be required of the UN to compel members to act. Pending that action, PICs would be relying on "the authority and prestige" of the Court and offending parties to act as if an advisory opinion had the sanction of international law.[39] Some countries argued that greater compliance with existing international agreements—the United Nations Framework Convention on Climate Change (UNFCCC), the 1997 Kyoto Protocol, and the 2015 Paris Agreement[40]—offered a greater chance of reducing greenhouse emissions. Australia favoured that approach in its written submission, pointing out that resorting to litigation would involve complex legal issues, such as demonstrating that states knowingly caused harm, factual proof of damage, and how compensation would be calculated.[41]

A month earlier, the spotlight was on the UN Climate Change Conference in Baku, Azerbaijan (COP 29). That meeting, which had been labelled "The Finance Cop", was successful in securing increased commitments from developed countries for climate change-related financing in developing countries;[42] the establishment of a UN carbon market; and the finalisation of the establishment of a Loss and Damage

Facility.[43] Taking the gloss off those headlines are concerns over the US notification of withdrawal from the Paris Agreement and the cessation of financial commitments under UNFCCC,[44] unease surrounding the effectiveness of the COP process, in general,[45] and continued reliance on public finance to meet the financing goals. For PICs, the reliance on public financing is even more pronounced. It remains to be seen whether governments in developed countries will have fiscal capacity to meet their climate financing commitments, alongside other demands on government revenues.

Image credit: Shutterstock

The establishment of the Pacific Resilience Facility (PRF), originally championed by Dame Meg Taylor, "a custodian of regionalism",[46] during her term as Secretary General of PIFS (December 2014–May 2021) edged closer to a reality in 2024. Forum leaders reaffirmed their support for the Facility,[47] which will be Pacific-led and managed, and domiciled in Tonga. An establishment agreement will be discussed at the Special Economic Ministers Meeting in March 2025 and PIFS is aiming to have a PRF treaty ratified by September 2025.[48]

PRF will focus on building resilience through grant funding of community projects underserved by large global climate funds and multilateral organisations. The Facility will not be reliant on debt financing as PIF members strive to avoid further increasing debt burdens and to shift the costs of climate change adaptation to the developed world. Proposals for initial community projects will be called in 2026.[49] PIF leaders have targeted an initial capital of USD 500 million by January 2026, with a longer-term goal of USD 1.5 billion. Commitments to date are less than USD 200 million, with the largest commitments from Australia (AUD 100 million) and Saudi Arabia (USD 50 million).[50] Those targets are ambitious on their own, and even more ambitious when positioned alongside pledges to fund competing global climate change finance initiatives.

The Pacific Catastrophe Risk Insurance Company (PCRIC) stands in contrast by being operational and offering a parametric insurance product. PCRIC is a successor to the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI), which was modelled on the Caribbean Catastrophe Risk Insurance Facility (CCRIF). The facility pools member country risk, diversifying risk to insurers and lowering operating costs. A parametric trigger allows for quick payouts in the event of a disaster. Through offering protection against lower frequency-high impact/high-cost events, and rapid settlement, this type of mechanism can supplement other post-disaster financing mechanisms.

While PCRIC attempts to address weaknesses in the design of the earlier PCRAFI, as with the proposed PRF, it is reliant on donor support to capitalise the entity and build balance sheet strength to absorb the insured risks. Currently that donor group is small—Canada, Germany, Japan, the UK, and the US—as is the member pool—Fiji, Marshall Islands, Tonga, Samoa, and Vanuatu—both constraining the growth of the facility.[51] Those constraints will have to be overcome for PCRIC to a wider range and larger monetary scale of catastrophes. Solomon Islands' withdrawal from PCRAFI in 2007 when its claim to assist flood victims was not accepted still weighs on Solomon Islands and other non-members of PCRIC.

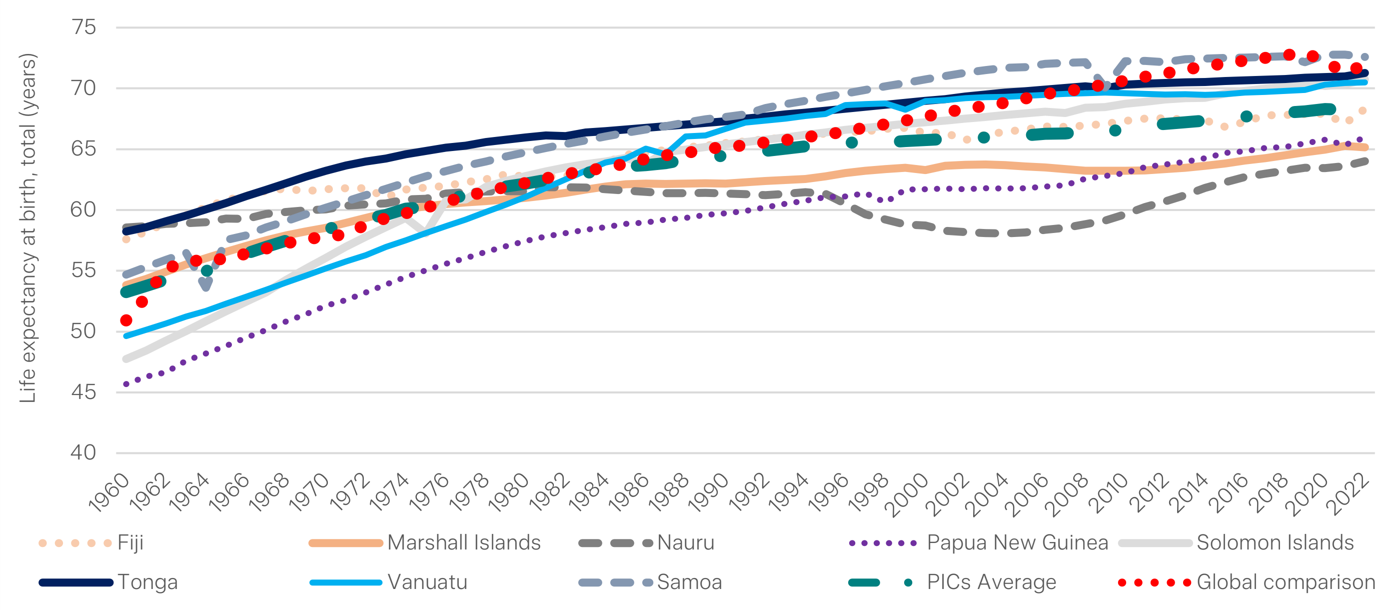
If PICs are to be less reliant on partner governments capitalising Pacific climate finance institutions, then the strategic implication is to develop domestic financial systems to access private pools of savings, both international and domestic. PCRIC could potentially be used to further this objective. Private sector parties have flagged their interest in adapting PCRIC (and its predecessor PCRAFI) country-specific models to build private insurance capability in PICs.[52] PCRIC modelling could also provide a foundation for developing a Pacific catastrophe bond market. Catastrophe bonds are now an accepted disaster risk financing instrument in capital markets and could supplement other risk financing instruments. From an investor perspective, the instrument adds diversification to an international portfolio, and market participants have an incentive to build more detailed datasets and models, thereby reducing radical uncertainty to a more tractable problem that can be described through probability distributions.

Recourse to international fora and commitments moves the climate change financing discussion outside the boundaries of geopolitical rivalries. But the possibility remains that it could be part of those rivalries because of the potential leverage major actors would gain from shouldering the burden of meeting that financing need. Developing private financing solutions will reduce that likelihood.

Demographic change

The demographic profile of PICs is changing, as it is in the rest of the world. Life expectancy at birth has increased from 67 years in 2000 to 71 years in 2022,[53] and the proportion of the population in retirement is increasing. By 2050, 8 in 10 of the world's retirees will be living in developing regions, including the Pacific region,[54] and retirement funds will be called on to play an increasingly important role in providing social protection to people in the retirement phase of their lives.

Figure 2: Life expectancy in the PICs



Source: World Bank.

At first glance PICs are well served, with some form of retirement scheme to be found in almost all PICs—either some form of the provident fund model or a social security administration scheme, as is the case in the north Pacific. The former are private schemes in that they are not part of the consolidated public balance sheet, while the latter are. In either case, the fund or scheme has to have the financial capability to meet continuing retirement payment obligations: both need to be underpinned by increased participation and increasing investment returns. But the ability of all funds to do so is currently compromised. The social security administration schemes of the north are defined benefit schemes with significant unfunded liabilities; and the private funds, which are typically defined contribution, are expected to compensate for underdeveloped social protection frameworks and underdeveloped financial systems. The problem manifests itself in three ways.

First, although existing PIC retirement funds are well-established, they are not part of a comprehensive retirement incomes policy. Retirement income frameworks in developed countries typically have three tiers—the first tier aims to provide basic financial support to protect against poverty; the second tier to increase the adequacy of retirement income; and the third tier aims to raise the income replacement rate.[55] Most PIC funds can be described as tier two schemes—they are mandatory save as you go schemes, owned by their contributors. But in the absence of an effective tier one mechanism, they are providing a basic level of protection as well. Second, in some cases, retirement funds have been asked to cover the absence of adequate disaster risk financing mechanisms. Governments have directed funds to provide emergency financing through allowing early withdrawal of contributions, as happened in Fiji in the aftermath of Tropical Cyclone Winston in 2016 and Tropical Cyclone Yasa in 2020. Governments tend to regard the funds as a public entity, despite not being government-owned and hence not part of the consolidated public balance sheet. Both factors compromise the adequacy of retirement income and the severity of the impact depending on the age of the contributor and what proportion of accumulated contributions was withdrawn.[56]

The third manifestation concerns the impact on investment returns. The financial management of these funds is affected whenever there are early returns, as funds need to have more liquid assets than otherwise would be the case with a consequent impact on investment returns. Some funds are also drawn towards providing other social services that PIC governments have underprovided—housing, health and education, for example—or to compensate for a general lack of credit from credit providers. Two contributing factors are the shortage of domestic investment opportunities and funds wanting to protect the current living standards of contributors. But there is a tension between owning finance providers that finance social finance and investing in a finance provider to boost long-term investment returns which build the wealth of contributors.

This distinction is sometimes blurred, as it was for the tier one and two roles of PIC funds, because financial services are underprovided within existing financial systems: the architecture of these systems is not fit for purpose. Underdeveloped PIC financial systems not only constrain economic development but also exacerbate existing strategic exposures. The task for policymakers is to protect the long-term objective of underpinning retirement incomes while exploiting the long-term financing role these funds can play within the local and regional economies.

PIC retirement funds are an underestimated tool for financing Pacific development. Furthermore, they are a tool that increases Pacific agency. Retirement funds are hybrid social protection-finance mechanisms—their role is to provide a layer of social protection, but they act as financial institutions in discharging this role. Fund balance sheets must be structured accordingly, in terms of asset mix, risk profile, liquidity, and predictability of income flows. They need long-term assets to match long-term liabilities of pensions and other retirement benefits.

Through pooling financial resources, individual funds can access a wider range of long-term investment possibilities within the region. This was the motivation for the establishment of the Pacific Islands Investment Forum (PIIF) in 2018. PIIF comprises 20 superannuation, provident, trust, and sovereign funds in 12 countries, serving 1.6 million members[57] and with combined assets of around AUD 90 billion.[58] Infrastructure is an important asset class for retirement funds in developed countries, but PICs rely on funding from development partners to finance infrastructure investments. The CEO of the PIIF Secretariat captures PIIF's intention: "This is a trend we would like to see changed in the Pacific to enable our Pacific Funds to invest in Pacific Infrastructure.[59]

If this long-term financing objective is to be realised, then policymakers need to address structural problems that are contributing to the underfinancing of PIC economies so that retirement funds can play their natural financing role. PIC development partners can also contribute to this objective through support that bolsters governments' ability to provide basic tier one protection in preference to competing with local financial institutions. Donors have been assisting PIIF develop as an entity and in developing a co-investment platform, and this support needs to continue, even if it means less loan opportunities for development partners. As was the case with climate finance, PICs need infrastructure financing mechanisms that share the risks of financing infrastructure between PICs and their development partners.

Digital transformation

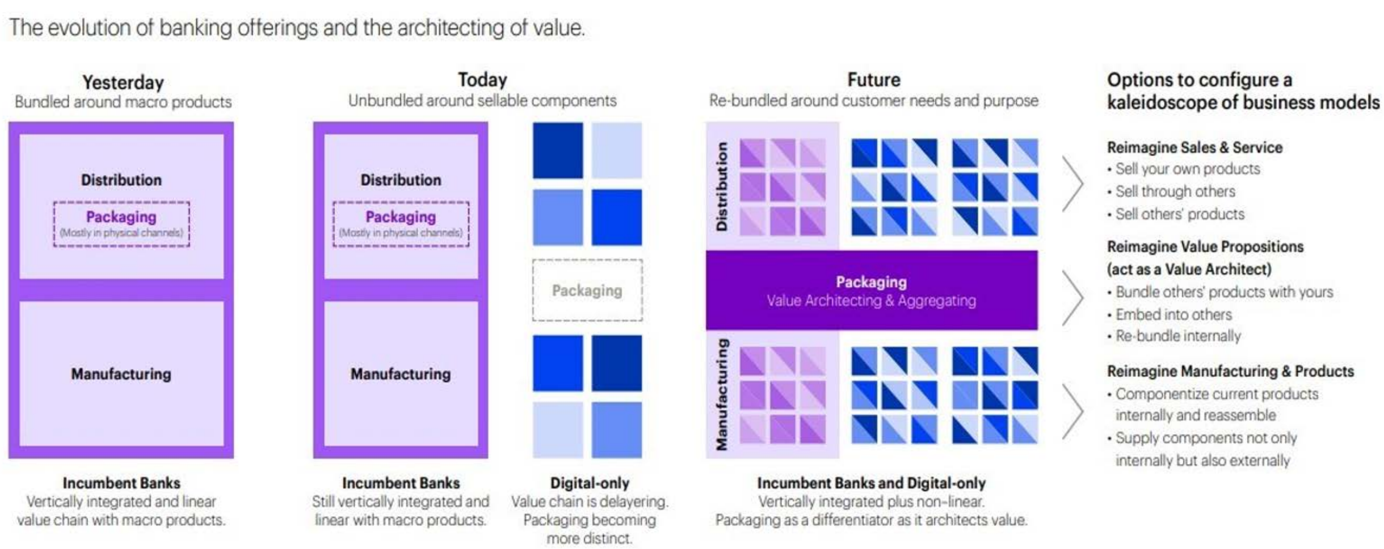
While not downplaying the opportunities offered by digital transformation, ESCAP was more concerned with the pressure that associated social dislocations—fewer employment opportunities for lower-skilled workers, for example—would put on social protection frameworks. This is less of a concern for PICs, given their industrial structure, and the focus is more on the opportunities on offer and how these transformations can improve connectivity and reduce the uncertainties of daily life. Internet availability and reliability have improved significantly, and increasing numbers of Pacific islanders can access Elon Musk's Starlink.[60] Even before factoring in the revolutionary impact of AI, improved connectivity can improve many aspects of island life, including core social services in health and education. To date, the focus in PICs has been on commerce and finance.

PIFS launched the Pacific E-commerce Initiative in 2018, and the *Pacific Regional E-commerce Strategy and Roadmap* was endorsed by Forum trade ministers in 2021, following earlier country assessments.[61] PIC development partners have also provided substantial support towards introducing digital finance innovations, through identifying opportunities and policy considerations, as well as supporting the introduction of new financial products; the UN Capital Development Fund's (UNCDF) Pacific Financial Inclusion Program is a prominent actor in this area.[62]

Two fundamental challenges confront PIC policymakers if the opportunities for digital transformation are to be fully realised. First, the institutional framework, including the regulatory framework, has to support any digital transformation. Policymakers need a good understanding of costs and benefits and where they need to strike a balance between protecting consumers and incentivising providers. That point of balance may be different to that which exists with legacy technologies. The work of Acemoglu, Johnson, and Spence on the importance of institutions underscores this point.[63] The implication is that individual PICs have to have the necessary policymaking capabilities: regional initiatives can guide and support, but national policymaking is a national responsibility.

The second challenge concerns investment in new technologies and the financing of any investment. Digital solutions may overcome geographical constraints, but the scale of any business base will still be a factor in their implementation. The cost of investing in new technologies will be large relative to the business base, potentially constraining that investment, especially by smaller, local providers. The solution could lie in the modularisation of banking services—unbundling the multiple activities historically performed by banks into separate providers—and then rebundling around customer needs and purpose.[64] This would allow financial service providers to build scale through being able to offer specialist financial services across the region.

Figure 3: Modularisation of banking



Source: Accenture. '[The Future of Banking: Time to rethink business models]'

Any lack of scale calls into question the role of government and development partners on ownership of new technologies, in incentivising private sector parties to take on the risk with implementing new technologies, and in financing these risks. PIC governments have a patchy record as owner of government enterprises, but there is a case when government ownership can provide additionality and can take on risk financing that private parties are not in a position to finance.[65] There is a risk that external financing from development partners—both grants and loans—comes at the cost of developing domestic financial systems, working against the PIC agency.

If PICs are to benefit widely from e-commerce initiatives, then these initiatives need a supporting digital finance infrastructure. Payment systems are being modernised to allow for new payments products and providers of payment services, as are clearing and settlement systems; but some smaller PICs are still reliant on checks and manual clearing of these checks. The more pressing issue, and one which affects a larger number of PICs, is the loss of corresponding banking relationships (CBRs). It is futile to talk of improving economic connectivity between PICs and countries outside the region if international payments cannot be made.

If unresolved, this issue threatens the economic viability of the countries affected and opens another front in the regional geo-political contest. The search for a solution became more earnest in 2024 with the initial meeting of the Pacific Banking Forum (PBF), co-hosted by the Australian and US governments in Brisbane in July.[66] Earlier in the year, the World Bank and convened a meeting in Sydney to progress solutions to the region's CBR problem and in September the World Bank announced it would be working with PIFS and seven PICs to provide a clearing mechanism to maintain CBRs, initially through a temporary clearing house which would be succeeded by a permanent, commercially viable entity.[67] The participating countries are Fiji, Kiribati, the Marshall Islands, Samoa, Tonga, Tuvalu, and Vanuatu. PIFS will coordinate the development work and establishment of the clearing house in Suva. The World Bank is funding the project through its International Development Association (IDA) funding window.

Any permanent CBR solution will come with demanding AML/CFT requirements for participating countries; the weakness in those regimes is a major factor behind the loss of CBRs and the need for PICs to strengthen these regimes is a feature of any discussion on Pacific finance, including at the PBF. It was also a feature of the *Nauru-Australia Treaty*, under which Australian support to protect continued banking services in Nauru.[68] PICs already receive considerable technical assistance to strengthen AML/CFT frameworks, but it is not clear that individual PICs can maintain the capability required without ongoing assistance. The proposed CBR solution points to a way forward, with development partners taking on more of the risk of countries not being able to meet international AML/CFT standards.

A permanent CBR solution will also provide a more solid foundation for developing PIC banking systems, but regulatory frameworks need to change to support this objective. Regulators need to encourage new digital banking platforms, and the unbundling of financial services, especially where the sponsors are willing to address business financing needs and to provide banking services outside the main urban areas. The regulatory point of balance needs to be moved towards incentivising providers and away from protecting depositors through less restrictive entry and capital requirements. PIC regulators already have the agency to apply international prudential banking standards in a more proportionate manner, and this application needs to be supported by development partners: PIC regulators should not be applauded for compliance with international standards—standards that were not targeted at small banks in small countries—when their banking systems do not provide the credit needed to finance the domestic economy.

Conclusion and recommendations

This chapter has highlighted the intrinsic uncertainties that characterise daily life in PICs and the way global megatrends are exacerbating these uncertainties. Policymakers continually grapple with balancing the imperatives of providing for, and protecting, their populations. External support is essential for both, but there are real tensions between the interests being served by that external support and the interests of PICs. The task for all is to more closely align respective interests to reduce intrinsic uncertainties. The onus for achieving a closer alignment falls disproportionately on external partners. It will require an intellectual shift that emphasise external actors' responsibilities and duties to PICs, and a corresponding operational shift to bear the financial costs of discharging those responsibilities: external actors must be prepared to finance a greater share of the risks—the uncertainties—of PIC life.

If strengthening PIC agency is a genuine objective and Pacific islanders are to have greater influence over their domestic and international affairs, then policymakers need a capability that matches that aspiration. That capability is more than the application of some technical apparatus. It is the application of such apparatus to problems that affect a local population that brings its own value set to the trade-offs within any policy decision.

Universities are well-placed to further this objective. But engagements that raise awareness of Pacific life and greater visibility of Pacific academics, including in senior administrative roles are not enough. Curricula need to equip students with skillsets to provide relevant public policy advice. One of the capabilities needed is to be able to critically assess the applicability of mainstream advice in other countries. In addition to deepening public policy skills, university research can contribute to developing theoretical frameworks that have more explanatory power in Pacific islands. The task is to teach an economics that can be used in PICs, as opposed to doing mainstream economics in PICs. Mainstream economics through its emphasis on individualism and markets does not capture the highly communitarian values and behaviours in Pacific islands life, as Ratuva notes in his advocacy for a turn to social economics and social solidarity.[69]

Similarly, the importance of institutions has generally been neglected in the teaching and practice of economics. That is changing, and the importance of institutions to economic development is more widely accepted. The 2024 Nobel Prize in Economic Sciences was awarded to Daron Acemoglu, Simon Johnson, and James A Robinson "for studies of how institutions are formed and affect prosperity".[70] That work demonstrates that:

> *"There are vast differences in prosperity between nations. One important explanation for this is persistent differences in societal institutions. By examining the various political and economic systems introduced by European colonisers, Daron Acemoglu, Simon Johnson and James A. Robinson have been able to demonstrate a relationship between institutions and prosperity. They have also developed theoretical tools that can explain why differences in institutions persist and how institutions can change."*[71]

PIC policymakers cannot ignore the implications of this work, but they need to be equipped with academic training in ways of thinking with economics that are compatible with the values, institutions, and choices that confront Pacific island policymakers.

RECOMMENDATION 1

Universities make a greater contribution to developing theoretical frameworks to strengthen PIC policymaking capability.

1. Assess applicability of mainstream economic thinking to Pacific island contexts and identify alternative ways of thinking with economics that captures the communitarian values and behaviours in Pacific islands life.
2. Critically examine impact of PIC institutions on living standards and economic development to:
   a. Identify where existing institutions constrain economic development and to identify the dynamics of institutional change in PICs; and
   b. Ensure that regulatory frameworks facilitate digital transformations and productivity increases, more generally.

The under-provision of finance is a longstanding problem in PICs, and one which has severely constrained PIC economic development. Again, a Pacific-centric approach is needed. That approach requires a rethink of the institutional approach to finance and an acceptance that a lack of finance is the most important finance sector policy issue confronting PIC policymakers. Addressing this problem requires regulatory frameworks to be reset to tilt more towards incentivising credit providers than protecting depositors and investors, and to encourage the unbundling of financial services. It also requires PIC retirement funds to play a more active role in financing long-term domestic investments, including essential infrastructure, and regional development.

This rebalancing needs to be supported by a proportional application of international standards to PICs and a rethinking of the nature of a financial regulator in PICs. Most PICs will only be able to support a single financial sector regulator, and that regulator needs to be able to provide core central banking services—banker and fiscal agent of government and operator of the payments system—as well as regulating and supervising the entire financial system, not just the banking system.

PICs also need their development partners to re-appraise their financing modalities. External interventions should not compromise local financial sector development. If partners value PIC agency, then the sustainable route to that objective is through ensuring that external financial assistance does not blunt domestic financing opportunities, and governments do not carry heavy debt burdens. PICs need more risk finance to cope with the uncertainties of PIC life and external partners, potentially, can play a substantive role in providing that finance alongside PIC financiers.

RECOMMENDATION 2

Policymakers place increased emphasis on developing domestic financial systems to meet domestic financing needs.

1. Rationalise financing role of development partners to:
   a. Reduce debt financing and increase risk financing, particularly for disaster risk finance; and
   b. Generally, contribute to the development of domestic financial systems.
2. Ensure that the financial sector regulator in small PICs has a legal mandate to provide core central banking services and regulate entire financial system.
3. Continue to build a co-investment platform for PIC retirement funds so they can pool investment funds to finance essential infrastructure.

Crafting and implementing PIC-centric economic and financial policies will require a shift in the way PIC external partners frame their engagements. The application of international standards needs to be more selective with a corresponding emphasis on finding the level of proportionality that fits PIC contexts. Where there is less room to be selective—with AML/CFT standards, for example—then the cost of compliance needs to shift to external partners; it is their interest to do so, and they are, relatively, in a much stronger financial position.

RECOMMENDATION 3

A more selective application of international standards.

1. International standards to be proportionately applied in PICs wherever possible.
2. Where proportionality increases the risks to external partners, then these partners need to finance the costs of PIC compliance.

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