North Pacific economies

Growth last year weakened in the storm-hit Federated States of Micronesia and in the Marshall Islands as construction slowed, but Palau achieved modest recovery on higher public and private investment. Reconstruction of damaged infrastructure is expected to boost growth this year in the Federated States of Micronesia, as is recovering tourism in Palau, but capacity constraints will continue to slow expansion in the Marshall Islands. Trust funds can provide necessary fiscal buffers, smooth government expenditure, and minimize growth volatility.

Economic performance

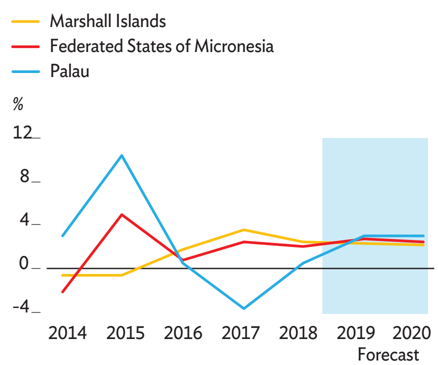
Although GDP growth trajectories diverged, fiscal year 2018 (FY2018, ended 30 September 2018) generally saw weak expansion across the North Pacific (Figure 3.37.1). The Federated States of Micronesia (FSM) weathered a disaster that temporarily slowed growth, which is resuming under subsequent reconstruction and recovery. The Marshall Islands grew more slowly as capacity constraints impeded infrastructure construction. In Palau, public and private investments drove recovery from steep contraction in FY2017.

In March 2018, Tropical Depression Jelawat brought flooding and landslides to Pohnpei State in the FSM, damaging roads and other critical infrastructure. A state of emergency was declared, and following a joint damage assessment, the US approved in July disaster funding under its Compact of Free Association with the FSM.

Stimulus from reconstruction partly offset the adverse economic impact of the disaster, keeping FY2018 growth fairly solid at 2.0%, albeit down from 2.4% in FY2017. Administrative support from the US helped to overcome some constraints on implementation capacity. This assistance supplements transitional arrangements that have been in place since July 2017, with the US Army Corps of Engineers supporting compact-funded projects and helping to resolve project implementation issues.

In the Marshall Islands, growth slowed from 3.6% in FY2017 to 2.5%, and the economy remains dependent on infrastructure investment projects funded by development partners and US compact grants. Continuing capacity constraints in the Marshall Islands have stifled project implementation. As projects nevertheless reach completion, economic stimulus diminishes.

3.37.1 GDP growth in the North Pacific economies



Note: Years are fiscal years ending on 30 September of that year.

Sources: ADB estimates using data from the Republic of the Marshall Islands, Federated States of Micronesia, and Republic of Palau FY2017 *Economic Briefs*.

This chapter was written by Rommel Rabanal and Cara Tinio of the Pacific Department, ADB, Manila.

Palau's economy recovered to 0.5% growth FY2018, reversing 3.7% contraction in FY2017. Growth would have been stronger if a nascent rebound in tourism had not been cut short when two flight services were discontinued. Visitor arrivals grew by a solid 6.6% in the first half of FY2018 following a cumulative 29.9% drop in tourist numbers over the previous 2 years. However, the termination of Delta Airlines flights from Tokyo in May and the indefinite suspension of Palau Pacific Airways charter flights from Hong Kong, China in July drove visitor arrivals sharply down in the second half. For the whole year, tourist arrivals from Palau's two main sources dropped, from Japan by 5.4% and from the People's Republic of China (PRC) by 9.5% after it restricted tour groups transiting to Palau through Hong Kong, China. Consequently, total visitor arrivals fell by 5.0% in FY2018, the third consecutive year of decline (Figure 3.37.2).

Robust construction nevertheless supported economic growth. Public infrastructure projects funded by development partners proceeded in earnest, and some private hotel projects were completed.

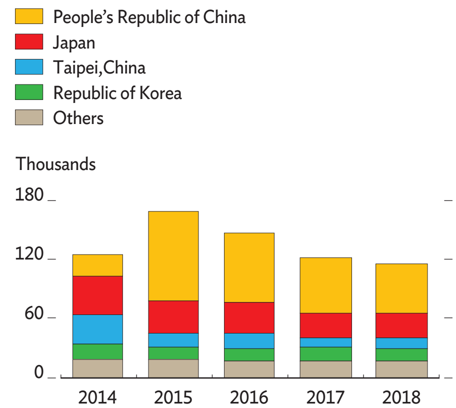
Fiscal positions continued to weaken across the North Pacific in FY2018. Preliminary estimates show that the FSM consolidated fiscal surplus eroded from the equivalent of 15% of GDP in FY2017 to 10%. Revenue from fishing license fees fell from their historic high but still equaled 17% of GDP (Figure 3.37.3). However, public wages continued to expand along with government expenditure on services it contracts to implement projects funded by development partners. Capital expenditure built on increases recorded in FY2017, when several project management bottlenecks were cleared.

Likewise, the Marshall Islands is estimated to have realized a smaller fiscal surplus, equal to 3.0% of GDP. The 4.5% surplus in FY2017 reflected record fishing license fee revenues worth 19.4% of GDP that came, not from significantly higher collections in the period, but mostly from a large, one-time appropriation of receipts previously undisbursed by the agency responsible for collecting them. In FY2018, fishing license revenues plunged by 37.7%, reverting to the norm before FY2017 and driving total revenue down by 16.5%.

Palau also saw its fiscal surplus narrow, from 4.8% of GDP in FY2017 to 4.3%, as expenditure increased to fund transfers, including to the civil service pension fund. Steady deterioration in the government's fiscal position also reflected continuing delays in implementing much-needed tax reform that would facilitate higher domestic revenue mobilization.

Inflation in the North Pacific is driven largely by import costs. Higher international prices for food and fuel, and their spillover on prices for other consumer goods, stirred inflation in two of the three economies but were countered by subdued economic activity. Inflation therefore remained very low in

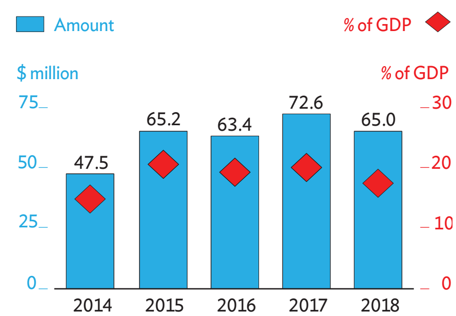
3.37.2 Visitor arrivals in Palau by source



Note: Years are fiscal years ending on 30 September of that year.

Source: Palau Bureau of Labor and Immigration.

3.37.3 Fishing license revenue in the Federated States of Micronesia



Note: Years are fiscal years ending on 30 September of that year.

Sources: Federated States of Micronesia Department of Finance and Administration and Division of National Statistics.

FY2018, rising from 0.1% to 1.0% in the FSM, from 0.0% to 0.7% in the Marshall Islands, and from 0.9% to 1.1% in Palau.

Higher import bills and lower fishing license revenue in the primary income account further narrowed the FSM current account surplus from the equivalent of 7.5% of GDP in FY2017 to 2.0%. Palau's large current account deficit narrowed only slightly, from 17.9% of GDP to 17.5%, as a larger surplus in the transfers account offset lower tourism receipts. The Marshall Islands current account surplus widened from 3.7% of GDP to 7.0% as, despite higher international commodity prices, imports slowed in line with project implementation delays.

Economic prospects

The outlook for the North Pacific economies is mostly positive. In the FSM, growth is projected to rise to 2.7% in FY2019 as recent steady progress in ramping up capital spending is seen to continue in the near term. Current arrangements for managing and implementing compact-funded projects appear to address capacity constraints. The capital spending program will proceed in accordance with the Infrastructure Development Plan, FY2016–FY2025, which prioritizes energy, water supply and sanitation services, and broader climate change adaptation. More growth promises to stem from potentially greater consumption stirred by expectations of lower fuel prices and stable prices for imported food. Growth is projected to taper slightly to 2.5% in FY2020 as some capital projects near completion.

Growth in Palau is similarly projected to increase with expectations of some recovery in tourism and further increases in capital expenditure thanks to greater financial assistance from the US. Visitor arrivals last year were already below the number recorded in FY2012—before the influx of tourists from the PRC gathered momentum—so no further sharp reductions are likely. Skymark, a low-cost airline in Tokyo, plans to commence regular flights to Palau by mid-2019, which should stem recent declines in arrivals from Japan, Palau's highest-spending tourist market. A recent rebound in tourist numbers from Taipei,China—the fourth-largest tourist market—also bodes well for a recovery in tourism.

In September 2018, Palau and the US agreed to amend their Compact of Free Association. The agreement offers Palau more than $120 million in financial assistance to FY2024. Although most funds are allocated to Palau's Compact Trust Fund, $20 million will be available to finance agreed infrastructure projects that could boost annual capital spending by a quarter—plus $2 million annually for infrastructure maintenance. A further $22 million in direct economic assistance promises further economic stimulus. Growth is thus seen to accelerate to 3.0% in FY2019 and FY2020.

3.37.1 Selected economic indicators (%)

Federated States of Micronesia	2019	2020
GDP growth	2.7	2.5
Inflation	0.7	1.5
Current account balance (share of GDP)	1.0	1.5
Marshall Islands		
GDP growth	2.3	2.2
Inflation	0.5	1.0
Current account balance (share of GDP)	8.0	7.5
Palau		
GDP growth	3.0	3.0
Inflation	0.5	1.5
Current account balance (share of GDP)	–16.3	–16.0

Source: ADB estimates.

Growth in the Marshall Islands, by contrast, is projected to continue slowing to 2.3% in FY2019 and 2.2% in FY2020 as project completion and persistent implementation constraints spell less stimulus from infrastructure investment. The outcome of national elections at the end of 2019 will better shape economic projections for FY2020 and beyond.

The Government of the Marshall Islands plans to issue a cryptocurrency called the sovereign in mid-2019, posing potentially significant downside risks to growth: inflationary pressures if the sovereign causes excessive growth in the money supply, observed volatility in cryptocurrency values, and the threat of quarantine from the international financial system.

Inflation in all three economies is projected to ease slightly in FY2019 before reaccelerating in FY2020 in line with international food and fuel price trends (Figure 3.37.4). Commodity prices are likewise expected to be reflected in import bills, but other factors are seen to drive divergent trends in current account positions in the North Pacific. The FSM current account surplus will likely narrow further to the equivalent of 1.0% of GDP in FY2019 and recover somewhat to 1.5% in FY2020, reflecting the effect of El Niño on tuna migration and thus on fishing license revenue. By contrast, the Marshall Islands current account surplus is expected to widen to 8.0% of GDP in FY2019 as capital equipment imports decline with project completion, and then narrow by half a percentage point in FY2020 with rising commodity import prices. In Palau, the current account deficit is projected to narrow to 16.3% of GDP in FY2019 and 16.0% in FY2020 as tourism receipts recover from the recent slump.

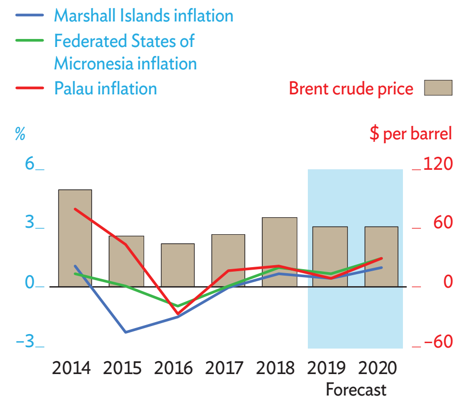
With fishing license revenue in the FSM at risk of falling, the fiscal surplus is forecast to narrow to the equivalent of 7.0% of GDP in FY2019 before bouncing back to 10.0% in FY2020.

In the Marshall Islands, fiscal surpluses are forecast to narrow further to the equivalent of 2% of GDP in FY2019 and then edge back to 3% in FY2020. High recurrent spending, including subsidies to state-owned enterprises and continued social security transfers, will remain unchecked if necessary reform is not implemented (Figure 3.37.5). Tax reform languished, stifling domestic revenue collection.

In Palau, the fiscal surplus is expected to increase to the equivalent of 8.9% of GDP in FY2019 with a surge in grants and then fall back to 1.9% in FY2020 as grant inflows ease.

The parties to the Nauru Agreement, which together manage fishing rights in most of the Pacific, have announced plans to expand their vessel day scheme to cover other forms of fishing. If successful, this could boost fishing license fee revenue for the Marshall Islands and the FSM.

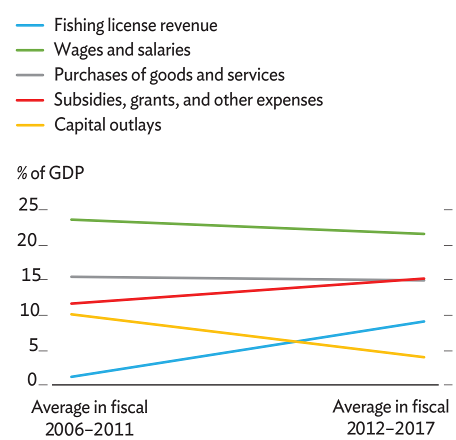
3.37.4 Inflation in the North Pacific economies



Note: Years are fiscal years ending on 30 September of that year.

Sources: ADB estimates using data from the Republic of the Marshall Islands, Federated States of Micronesia, and Republic of Palau FY2017 *Economic Briefs*.

3.37.5 Fishing license revenues and components of public spending in the RMI



Source: ADB estimates using data from the Republic of the Marshall Islands FY2016 *Economic Review*.

Policy challenge—managing volatility

Like most of their island peers, the North Pacific economies are subject to large growth swings year to year stemming from narrow economic bases and vulnerability to external shocks (Figure 3.37.6).

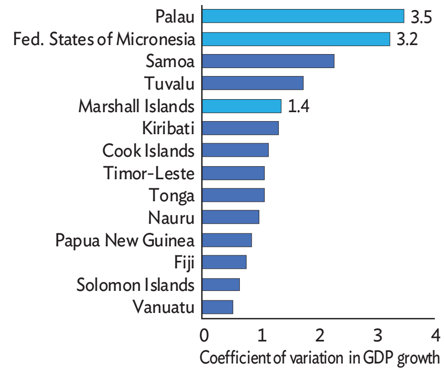
In the FSM, stagnant growth in the private sector has left economic activity determined largely by public infrastructure construction. To illustrate, growth accelerated from FY2009 to FY2011 on a series of airport upgrades, then contracted for 3 consecutive years as public investment stagnated. Economic growth in the Marshall Islands has similarly depended on public investment projects, as well as on grant-supported government operations. Fiscal constraints caused by variation in grant inflows contributed to contractions in FY2008 and FY2009, then the airport upgrade in Majuro drove expansion from FY2010 until its completion in FY2013. Contractions in the next few years reflected delays in implementing new projects, and subsequent recovery accompanied project resumption.

In recent years, fishing license fees have stimulated finances and growth in both the FSM and the Marshall Islands. However, ADB analysis has shown volatility driven by El Niño weather patterns, as detailed in the December 2017 *Pacific Economic Monitor*. In Palau, volatility derives mainly from tourism peaks and troughs that often mirror global financial and economic crises or even more localized events, such as a collapse in arrivals from Taipei,China caused by a downturn there in FY2013, or an influx of tourists from the PRC in FY2015 followed by the recent policy-induced decline.

Trust funds can help minimize economic volatility by smoothing government revenue otherwise subject to large fluctuations. Higher revenues earned during peak periods can be stored in these instruments to build fiscal buffers for use in subsequent downturns. This allows governments to smooth their annual expenditure and, given the public sector's outsize impact on economic activity in the North Pacific, tamp down volatility in GDP growth.

Further, as disasters and extreme weather can exacerbate volatility, disaster risk management and climate change adaptation need to be emphasized. Climate-proofing can be incorporated into comprehensive strategies to strengthen public investment planning and implementation, yielding more sustainable infrastructure development.

3.37.6 Coefficient of variation in GDP growth, 2009–2018



Note: The coefficient of variation is the ratio of the standard deviation to the mean, where values exceeding 1.0 indicate high variance.

Source: *Asian Development Outlook* database.