Small island economies

Economic performance in the three small island economies diverged, with growth accelerating in Tuvalu and stable in Kiribati as GDP contracted in Nauru. Infrastructure projects will play a dominant role in economic activity in Nauru and continued growth in Kiribati and Tuvalu. Inflation is expected to be fairly stable while current accounts weaken, with Tuvalu going into deficit. Improving public service delivery while stemming fiscal drain is necessary as reform to state-owned enterprises continues.

Economic performance

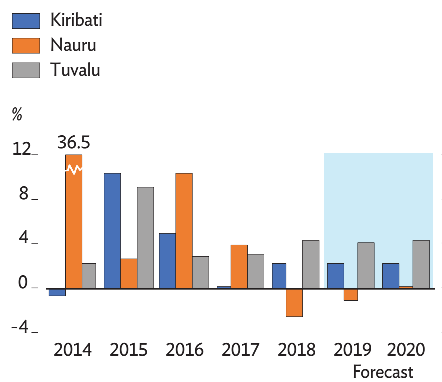
The economy of Kiribati grew by 2.3% in 2018 but at a bit less than half the average growth rate of 5.2% from 2015 to 2017 (Figure 3.39.1). Public spending and projects financed by development partners continue to be the main drivers of economic growth. And, while growth in fishing revenue slowed from 10.0% in 2017 to 0.7% in 2018, fisheries remain an important source of national revenue, providing 71.7% of total revenue in 2018.

In Nauru, the economy is estimated to have contracted as the Regional Processing Centre (RPC), an Australian-funded facility for asylum seekers, scaled down and an overseas refugee resettlement program commenced. Meanwhile, phosphate exports remained weak. The RPC scale-down was, however, slower than initially expected. The facility has been the principal source of economic activity in recent years, driving revenue growth, including from visa fees and income taxes paid by expatriate workers, and from consequent demand for local services, as well as infrastructure investment.

Growth in Tuvalu accelerated to 4.3% in 2018, driven by higher government spending on large infrastructure projects and new housing in preparation for hosting the Polynesian Leaders Group Summit, which was held in June 2018, and the upcoming Pacific Islands Forum, to be held in September 2019. Increased spending was supported by recovery in fishing license revenue, which posted an 84.8% jump in 2018 with the receipt of a one-off payment from a subregional pooling scheme last year.

Inflation rose in Kiribati in 2018 on a pickup in economic activity brought about by sustained public spending and higher wages. However, muted global food prices have kept price

3.39.1 GDP growth



Note: Years are fiscal years ending on 30 June of that year in Nauru and coinciding with the calendar year in Kiribati and Tuvalu.

Sources: Kiribati budget documents; Nauru budget documents; Tuvalu budget documents; *Asian Development Outlook* database; ADB estimates.

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growth in check. Meanwhile, inflation in Nauru continued to slow under economic contraction. Inflation in Tuvalu also decelerated to 1.8% in line with global food price movements.

The current account surplus in Kiribati narrowed further as imports rose and fishing revenue moderated. The current account balance of Tuvalu also remained in surplus in 2018. Higher inflows of fishing license fees offset increased imports of goods to supply government infrastructure investments (Figure 3.39.2).

The fiscal balance in Kiribati posted a deficit in 2018 equal to 20.1% of GDP (Figure 3.39.3). Increased spending on wages by 33.9% and the acquisition of aircraft for Air Kiribati more than offset higher revenue from fishing licenses and 4.2% higher revenue from taxes, which showed up as a surplus in the recurrent budget.

In Nauru, total revenues collected in fiscal year 2018 (FY2018, ended 30 June 2018) were 1.2% higher than in the previous year, mainly reflecting higher tax and nontax revenue collected from operations associated with the RPC. This contrasted with earlier government projections of lower revenue based on the assumed faster scaling-down of RPC operations. This income supported higher expenditure, including capital spending, as well as contributions to the Nauru Intergenerational Trust Fund. The fiscal surplus nevertheless shrank by half from the equivalent of 19.3% of GDP in FY2017 to 8.8%, including trust fund contributions. By year-end, the government's cash buffer was above the International Monetary Fund recommendation of cover for 2 months of spending not associated with the RPC.

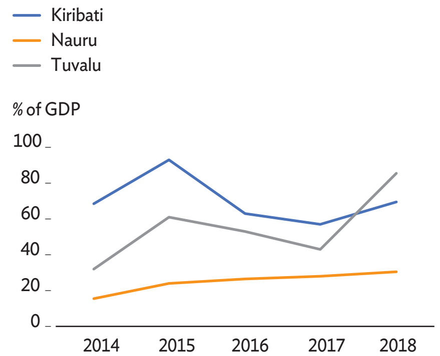
Tuvalu saw tax revenue decline by 20.5% from 2017 but still had a fiscal surplus equal to 33.9% of GDP in 2018 thanks to strong recovery in fishing license revenue and lower operating expenditure.

Economic prospects

The pace of growth in Kiribati is expected to be sustained in the next 2 years as continued infrastructure spending offsets the slowdown in fishing revenue. In October 2018, Kiribati secured a grant from development partners that will provide to South Tarawa, the capital, a seawater desalination plant and a solar photovoltaic plant, as well as rehabilitate and expand the water supply network.

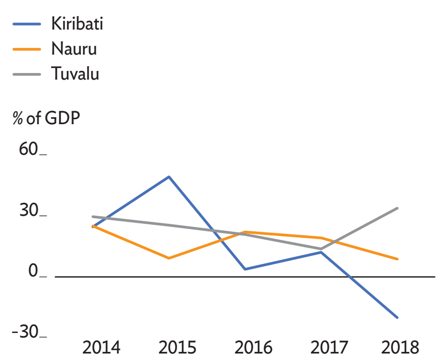
Nauru is expected to experience less severe economic contraction in FY2019 than in FY2018, with the Nauru Port project having commenced construction in January 2019 and able to cushion the slowdown caused by the continued scaling down of the RPC and resettlement of refugees. Growth will remain stagnant in FY2020. The government has approved three supplementary budgets so far in FY2019 because higher

3.39.2 Fishing license revenue



Sources: Kiribati budget documents; Nauru budget documents; Tuvalu budget documents; *Asian Development Outlook* database

3.39.3 Fiscal balance



Note: Years are fiscal years ending on 30 June of that year in Nauru and coinciding with the calendar year in Kiribati and Tuvalu.

Sources: Kiribati budget documents; Nauru budget documents; Tuvalu budget documents; *Asian Development Outlook* database.

revenue, including windfall fishing license revenue from pooled days in prior years, allowed for increases in expenditure alongside the building up of cash buffers. Fiscal discipline will be critical in FY2020 as RPC-derived revenue is uncertain and revenue from fishing license fees is projected to drop from the exceptionally elevated receipts in FY2019.

Tuvalu's economy is projected to accelerate in the next 2 years with the implementation of infrastructure projects supported by development partners. In September 2018, it received additional grant for an ongoing project to climate-proof a harbor in Niutao, a reef island in the north.

Inflation is forecast to accelerate in Kiribati in 2019 and 2020 with expected increases in food prices (Figure 3.39.4). It is likewise projected higher in Tuvalu over the next 2 years, pushed up by increased public sector wages and by ongoing and future infrastructure projects. In Nauru, inflation is expected to continue easing as the economy contracts and global commodity prices, especially for oil, remain low.

The fiscal deficit in Kiribati is expected to persist, equal to 23.2% of GDP in 2019 and 20.8% in 2020, as recent unexpected bounty from fishing revenue is expected to revert to slower growth or decline under less favorable weather. Further, the government's commitment to support Air Kiribati as it establishes its own international operations will incur substantial fiscal costs. Tuvalu will fall into a fiscal deficit equal to 1.1% of GDP in 2019 as spending continues on infrastructure for the regional summit and as fishing revenue declines significantly, as projected. However, higher tax revenue and lower spending in 2020 are expected to restore government finances to a surplus equal to 1.4% of GDP.

The volatility in fishing license revenues will be significant for the current account balance of Kiribati, with the surplus shrinking further in 2019 and 2020 (Figure 3.39.5). Similarly in Tuvalu, weaker fishing revenue inflows in the next 2 years and sustained growth in imports of goods will push the current account into deficit in 2019 and widen the deficit in 2020.

Risks to the outlook include delays in implementing infrastructure projects. For Nauru, any change in expected arrangements for the RPC could significantly affect economic activity in either direction. Fiscal sustainability remains a challenge as the main sources of revenues remain narrow and are highly volatile.

Policy challenge—pursuing reform to state enterprises

State-owned enterprises (SOEs) provide essential services such as water supply and energy utilities, especially in remote areas. However, the high operating costs of SOEs typical

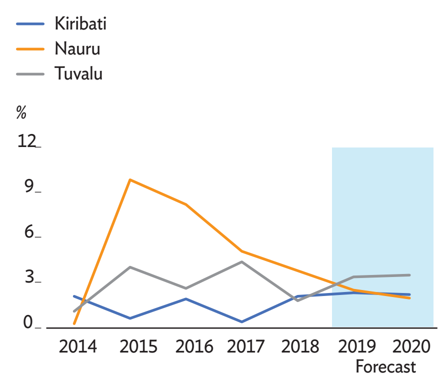
3.39.1 Selected economic indicators (%)

Kiribati	2019	2020
GDP growth	2.3	2.3
Inflation	2.3	2.2
Current account balance (share of GDP)	7.6	4.0
Nauru		
GDP growth	–1.0	0.1
Inflation	2.5	2.0
Current account balance (share of GDP)	...	...
Tuvalu		
GDP growth	4.1	4.4
Inflation	3.4	3.5
Current account balance (share of GDP)	–0.9	–11.0

Note: Years are fiscal years ending on 30 June of that year in Nauru, and coinciding with the calendar year in Kiribati and Tuvalu.

Source: ADB estimates.

3.39.4 Inflation



Note: Years are fiscal years ending on 30 June of that year in Nauru, and coinciding with the calendar year in Kiribati and Tuvalu.

Sources: Kiribati budget documents; Nauru budget documents; Tuvalu budget documents; *Asian Development Outlook* database; ADB estimates.

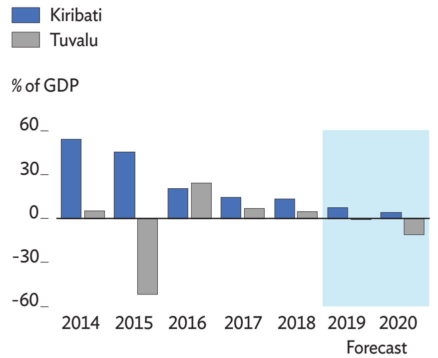
in small island economies pose serious concerns for their fiscal sustainability, especially as some SOEs rely heavily on continuous subsidies and repeated capital infusions from the national government. SOE reform to promote fiscal sustainability and responsiveness must ensure the continued provision of essential services while minimizing the fiscal burden on the government.

Maintaining fiscal sustainability is a longstanding challenge for Kiribati. Part of the recent increase in recurrent government expenditure has been to fund higher subsidies for SOEs. The government has made strides in consolidating and downsizing SOEs involved in copra production and trade, and it managed to sell its telecom SOE, but there is a need to continue pursuing improvement in the quality and relevance of SOE financial reports. Further, the government should lay out a plan to enhance the sustainability of its SOEs by improving SOE governance and also, for example, recalibrating tariffs for water supply and sanitation services. Finally, SOEs should not be exempted from the value-added tax to better level the playing field for the private sector and encourage its growth.

In Nauru, SOEs play important roles in the economy and are significant employers. However, weak SOE governance puts at risk the sustainability of the large portion of public assets and infrastructure that SOEs manage. Poorly performing SOEs can absorb large amounts of scarce capital and divert government resources away from critical social investments into health care and education. The government has started to tackle these challenges. Reform to the state-owned power utility has reduced fiscal costs and made electricity supply more reliable. The cabinet approved an SOE policy in 2018 that establishes a framework for SOE reporting, provides guidelines on director appointments and community service obligations, and calls for the establishment of a central monitoring unit to oversee SOE performance. Comprehensive SOE legislation is planned.

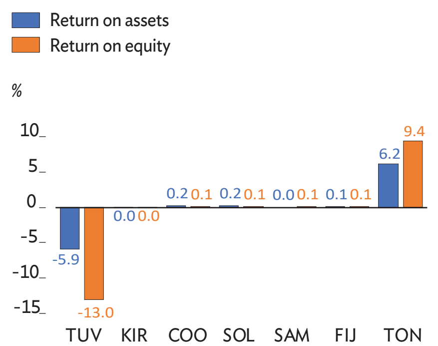
Although Tuvalu's outlook remains generally optimistic, the weak balance sheets of its SOEs pose risks to the fiscal balance because SOEs rely heavily on government subsidies (Figure 3.39.6). The latest forecast from the International Monetary Fund indicates that fiscal support to SOEs will increase to equal about 4% of GDP in the medium term. This makes it imperative that SOEs strengthen their financial performance and so mitigate their drag on the national budget. Specific reforms would require the government to pay its outstanding obligations to SOEs; introduce differential electricity tariffs for public and commercial entities to increase the revenue of Tuvalu Electricity Corporation, an SOE; adopt a more transparent approach to annual fiscal transfers to SOEs; and closely monitor any joint ventures that SOEs join.

3.39.5 Current account balance



Sources: *Asian Development Outlook* database; ADB estimates.

3.39.6 Returns on state-owned electricity enterprises, 2015



COO = Cook Islands Te Aponga Uira O Tumu-Te Varovaro (power authority), FIJ = Fiji Electricity Authority, KIR = Kiribati Public Utilities Board, SAM = Samoa Electric Power Corporation, SOL = Solomon Power, TON = Tonga Power Limited, TUV = Tuvalu Electricity Corporation.

Note: The figures for Solomon Islands and Tonga are 2016 data.

Source: Pacific Power Association. 2015 and 2016. Pacific Power Utilities: Power Benchmarking 2015 and 2016 Fiscal Years.