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North Pacific economies

Slower growth has been set largely by infrastructure projects. In the Republic of the Marshall Islands, delays affecting a major airport upgrade held performance below expectations. Growth slowed in the Federated States of Micronesia as airport improvement reached completion, and in Palau as market saturation and infrastructure capacity constraints at peak periods moderated growth in visitor arrivals. Economic prospects depend on infrastructure projects in the near term, but longer-term growth could hinge on economic links with Asia.

Economic performance

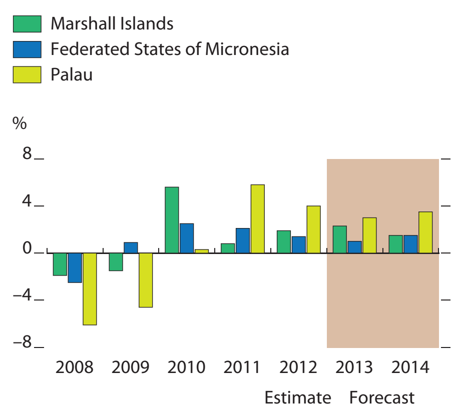
North Pacific economies continued to expand in FY2012 (ended 30 September 2012 for all), but growth was generally more moderate than in previous years (Figure 3.36.1). In the Republic of the Marshall Islands (RMI) and the Federated States of Micronesia (FSM), growth was determined largely by movements in government spending, particularly on infrastructure projects. Economic growth in the FSM declined to 1.4% from 2.1% in FY2011 as infrastructure projects neared completion. In the RMI, a delay in the ongoing airport upgrade had held growth in FY2011 at only 0.8%, lower than expected, but resumed activity helped restore growth to 1.9% the following year. Another important contributor to growth in these economies has been earnings from fisheries. These rose as El Niño drove fish into colder, deeper waters such as those found in the exclusive economic zones of the RMI and the FSM.

Government spending, including outlays related to elections, contributed to Palau's 4.0% GDP growth in FY2012, but tourism was the main driver. Visitor arrivals increased by 13.4%, building on the 25.8% growth achieved in FY2011 and marking the third consecutive year of such double-digit growth following 2 years of declining tourist arrivals (Figure 3.36.2).

Inflation in all three North Pacific economies accelerated in FY2012, largely because of sharp increases in fuel prices in the last quarter of calendar year 2011. Inflation in the RMI increased slightly to 5.7% from 5.4% in FY2011, while inflation in the FSM rose to 5.6% from 4.7% in the same period, spurred by the higher availability of consumer loans. Prices in Palau similarly experienced additional upward pressure, in this case from robust tourism-related demand and possible capacity constraints in peak periods, as inflation soared to 6.0% from 2.6% in FY2011 (Figure 3.36.3).

The North Pacific states are consolidating expenditure to achieve long-term fiscal sustainability. This is especially important in light of the key role that public infrastructure projects play in driving economic

3.36.1 GDP growth



Sources: International Monetary Fund. 2012. Republic of the Marshall Islands, *Preliminary Conclusions of the 2012 IMF Staff Visit.* November; 2012. *2012 Staff Report with the Federated States of Micronesia, Concluding Statement of the IMF Mission.* November; 2012. Republic of Palau, *Country Report* No. 12/54. March; ADB estimates.
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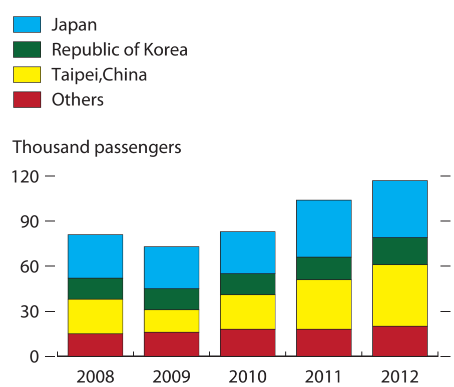
3.36.2 Visitor arrivals to Palau



Source: Palau Visitors Authority. http://www.visit-palau.com
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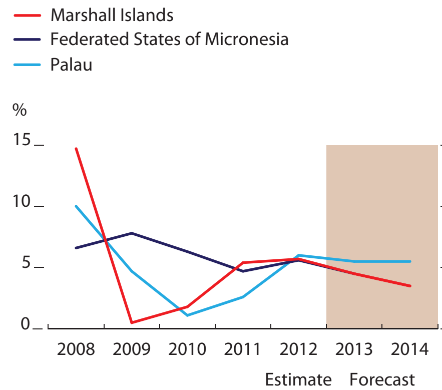
growth, and because grants under their compacts of free association with the US are ebbing annually and less available to fuel government spending. The RMI and the FSM compacts are set to expire in about a decade.

The FSM has in the past 4 years realized surpluses in its consolidated budget, which combines the accounts of the federal government and all four state governments. This trend continued with a consolidated surplus equal to 1.2% of GDP in FY2012, reflecting better revenue administration at the state level, economic growth, and more stable public wages. In contrast, the RMI realized a fiscal deficit estimated at 1.1% of GDP in the same period, reversing the 3.7% surplus recorded in FY2011. Unstable domestic tax collection and diminished foreign grants reduced government revenue and exacerbated the impact of off-budget expenditures arising from ad hoc directives. Palau recorded a fiscal deficit equal to 3.2% of GDP in FY2012, but this was a slight improvement from the FY2011 deficit of 3.5%, stemming mainly from higher revenue collection related to the strong economic performance driven by tourism.

Increased tourism also drove a current account surplus in Palau, which was equal to 6.0% of GDP in FY2012. Meanwhile, the RMI and the FSM continued to run current account deficits, equal to 6.3% of GDP for the RMI and 15.0% for the FSM. However, these deficits were narrower than in previous year, as the winding down of infrastructure projects, or delays in implementing them, cut imports of machinery and capital inputs.

3.36.3 Inflation



Sources: International Monetary Fund. 2012. Republic of the Marshall Islands, *Preliminary Conclusions of the 2012 IMF Staff Visit*. November; 2012. *2012 Staff Report with the Federated States of Micronesia, Concluding Statement of the IMF Mission*. November; 2012. Republic of Palau, *Country Report* No. 12/54. March; ADB estimates.
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Economic prospects

Infrastructure development will remain a key driver of economic growth in the North Pacific, with construction providing short-term stimulus and the resulting capacity upgrades boosting longer-term prospects. Growth in the FSM is expected to moderate to 1.0% in FY2013 as most airport improvement projects are completed. In contrast, GDP growth in the RMI is projected to accelerate to 2.3% in the same period on the back of its recommenced airport rehabilitation project and spending related to the country's hosting of the Pacific Islands Forum. Because the growth outlook in Palau depends heavily on sustaining tourism's robust performance, it may slow as the limited capacity of tourism-related facilities and infrastructure imposes constraints during peak periods, and as recent high rates of growth translate into market saturation. Given these constraints, GDP growth in Palau is expected to moderate to 3.0% in FY2013.

Growth in the RMI is projected to moderate again to 1.5% in FY2014 as airport rehabilitation winds down. Conversely, the start in FY2014 of ADB-supported projects to upgrade ports in the FSM, and to improve water and sanitation in Palau, is expected to accelerate growth in the FSM to 1.5% and in Palau to 3.5%. Longer-term growth prospects are weighed down by outmigration, the lack of growth drivers from the private sector, and annual decrements in compact grants, particularly in the RMI and the FSM, where scheduled decrements are already taking place.

With international prices of food and fuel projected to decline over the next couple of years, inflation in the North Pacific is expected to

3.36.1 Selected economic indicators (%)

Marshall Islands	2013	2014
GDP growth	2.3	1.5
Inflation	4.5	3.5
Current account balance (share of GDP)	–2.5	–2.5
Federated States of Micronesia		
GDP growth	1.0	1.5
Inflation	4.5	3.5
Current account balance (share of GDP)	–14.3	–14.0
Palau		
GDP growth	3.0	3.5
Inflation	5.5	5.5
Current account balance (share of GDP)	7.5	7.5

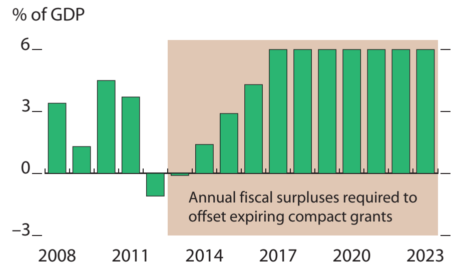
Source: ADB estimates.

trend downward in the near term. In the RMI and the FSM, inflation is projected to moderate to 4.5% in FY2013 and 3.5% in FY2014. It is expected to remain higher in Palau because domestic activity is more robust and tourism facilities remain close to capacity. That said, a projected moderation in tourism-led growth is expected to push inflation slightly lower in FY2013 to 5.5%, a rate likely to be sustained in FY2014 by demand arising from the implementation of the large water and sanitation project.

The lower cost of food and fuel imports is also expected to affect current account balances across the North Pacific. The resulting savings, together with a sharp increase in grants, are seen to narrow the RMI's current account deficit from 6.3% of GDP to 2.5% in FY2013. The FSM's current account deficit is expected to improve to 14.3% of GDP from 15.0% in FY2012, in part because of lower imports of machinery and capital inputs as infrastructure projects are already completed. Current account deficits in the RMI and the FSM are generally financed through capital grants. High tourism receipts have supported current account surpluses over the past 3 years in Palau, and a lower merchandise import bill is projected to boost surpluses to 7.5% of GDP in both FY2013 and FY2014.

The governments of the RMI and the FSM have made good progress in controlling expenditure and generating more revenue. However, the International Monetary Fund estimates that the RMI must build up fiscal surpluses equivalent to 6.0% of GDP by FY2017, and maintain them at this level until FY2023, to generate sufficient replacement income for expiring compact grants (Figure 3.36.4). The FSM's fiscal adjustment is even more challenging, requiring surpluses equivalent to 6.4% of GDP by FY2016 (Figure 3.36.5). Recent fiscal surpluses are far below these goals. The FSM's consolidated budget surplus is projected to slim to 0.8% of GDP in FY2013, even with planned cuts to current and capital expenditure, because of the continuing decline in compact grants. The RMI's fiscal account is expected to remain in deficit despite anticipated cuts in current expenditure. While similar fiscal contraction is expected in Palau, its realization remains uncertain as the newly elected government, which assumed office in January 2013, has yet to submit a national budget. In the meantime, continuing budget authority legally allows expenditure up to the same amount as in FY2012.

3.36.4 Fiscal adjustment in the Marshall Islands



Source: International Monetary Fund. Republic of the Marshall Islands, *Preliminary Conclusions of the 2012 IMF Staff Visit.* http://www.imf.org

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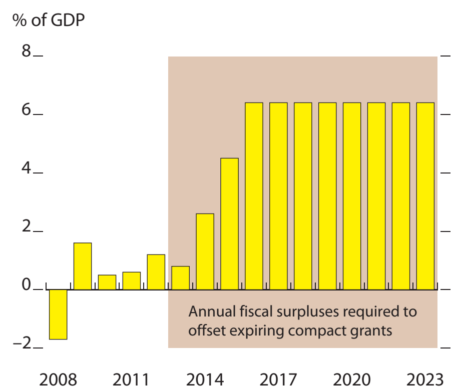
3.36.5 Fiscal adjustment in the Federated States of Micronesia



Source: International Monetary Fund. *2012 Staff Report with the Federated States of Micronesia, Concluding Statement of the IMF Mission.* http://www.imf.org

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Policy challenge—stronger linkages with Asia

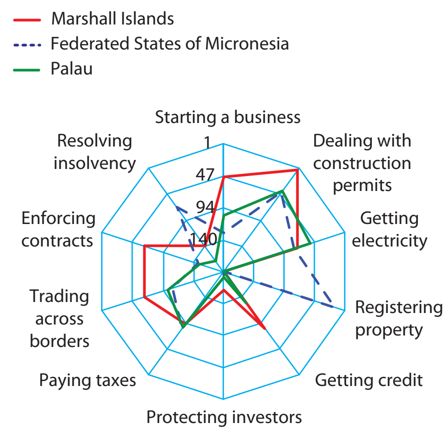
The end of the compact agreements will require comprehensive fiscal reform to ensure long-term fiscal sustainability. Revenue reform may include imposing value-added taxes. Cuts in current expenditure must reduce large public wage bills. Parallel improvements will need to improve tax administration. In addition, the end of payments under the compacts will mean that subsidies to state-owned enterprises and generous social security schemes will no longer be sustainable.

Asia's rising importance in the global economy presents opportunities for North Pacific economies to boost their growth potential by tapping into the region. The North Pacific's economic links with Asia have been gaining importance, and in some cases are already quite significant, as detailed by the article *Changing tides—evolving North Pacific economic linkages?* in the December 2012 edition of ADB's

Pacific Economic Monitor. For instance, Palau's merchandise trade is almost exclusively oriented toward Asia, at 99.8% for exports and 90.5% for imports in 2011, and over 80% of its visitor arrivals are from Japan, the Republic of Korea, and Taipei,China. The RMI's tuna exports reach a wide range of Asian countries such as the People's Republic of China (PRC) and Japan, its two biggest markets as of 2011, as well as the Philippines and Singapore. The FSM already imports key items from Asia, such as cars from Japan, fuel from the Republic of Korea, and household appliances from the PRC. Trade linkages with Asia are likely to continue expanding with cheaper transport costs to and from Asian markets, and lower production costs in the larger economies of developing Asia. Expanding such opportunities in a changing global economic landscape will help balance the group's economic ties, which remain heavily tilted toward the US. Stronger links with Asia are particularly relevant in the medium to long term as annual financial assistance from the US is scheduled to decline and eventually expire.

However, to fully benefit from Asia's rapid growth, the North Pacific should further develop these emerging economic links, particularly those in the areas of trade and investment. This requires substantial improvements to the business environment. In the World Bank's *Doing Business 2013* survey, North Pacific economies fared poorly, with the RMI ranked at 101 of 185, Palau at 111, and the FSM at 150—all weak in terms of protecting investors, enforcing contracts, and registering property, among other shortcomings (Figure 3.36.6). In particular, rigid investment and labor policies must be relaxed. Better business environments should help expand private sector sources of growth in these economies, particularly in sectors that can be viable even in small island economies. For example, a better business environment is likely to unlock the potential of underdeveloped tourism in the RMI, which receives only 3,500 arrivals annually, and in the FSM, with 15,000 arrivals, both dwarfed by the more than 100,000 annual arrivals to Palau.

3.36.6 *Doing Business 2013* rankings



Note: Numbers in parentheses show ranking out of 185 countries worldwide. 1 = best, 185 = worst.

Source: World Bank. Doing Business database. http://www.doingbusiness.org

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