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North Pacific economies

Weak GDP performance prevailed across the North Pacific, including contraction in Palau. However, growth is seen recovering in the near term as delayed infrastructure projects resume in the Marshall Islands and tourism recovers in Palau, though slow growth will likely persist in the Federated States of Micronesia. Along with current fiscal adjustments, stimulating the private sector through improved trade will be crucial over the longer term.

Economic performance

Growth in the North Pacific was subdued in FY2013 (ended 30 September 2013 in all three economies). The economy of the Republic of the Marshall Islands (RMI) grew by only 0.8%, slowing from 3.2% in FY2012 (Figure 3.36.1). The slowdown stems from the postponement of construction projects funded by development partners. Also, a severe drought hit the northern RMI midyear, sharply reducing harvests of food crops and copra. However, fisheries continued to perform well, with higher license fees raising revenues.

The Federated States of Micronesia (FSM) remained on a low-growth path, with growth of 0.6% in FY2013 only slightly improving on the 0.4% recorded in FY2012 (Figure 3.36.2). Growth was largely driven by fisheries, construction, and their associated activities. However, the lack of private investment, subdued business activity, and a slowdown in major public infrastructure projects continue to weigh on the FSM economy.

Palau's economy is estimated to have contracted by 1.0% in FY2013, a sharp reversal from 4.8% growth the year before (Figure 3.36.3). In FY2012, Palau posted a record 116,856 visitor arrivals, but arrivals declined by 7.1% to 108,522 in FY2013, falling steeply in the second half. This was partly because Palau Airways suspended operations to Taipei,China (the largest source market in FY2012) from late April 2013 amid issues affecting the airline's aircraft leases. Limited accommodation capacity and base effects stemming from 3 consecutive years of rapid growth appear to have contributed to the poorer tourism performance. Aside from the sharp fall in tourist arrivals from Taipei,China, Palau recorded fewer visitors from Japan and the Republic of Korea, both important markets. Despite the sharp decline, FY2013 ranks second after FY2012 in the number of tourist arrivals.

Inflation in the North Pacific declined during the year, tracking international food and fuel price movements. Inflation decelerated to 1.6% from 4.3% in the RMI, 2.2% from 5.8% in the FSM, and 3.0% from 5.4% in Palau. In addition to global price falls, the appreciation of the US dollar helped ease inflation in these economies by reducing

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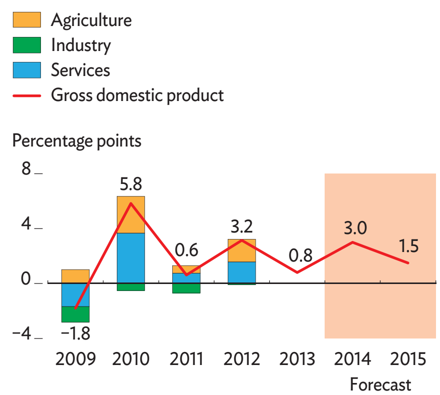
3.36.1 Supply-side contributions to growth in the Marshall Islands



Note: Years are fiscal years, ending on 30 September of the same calendar year.

Source: ADB estimates using data from Republic of the Marshall Islands FY2012 Economic Review.

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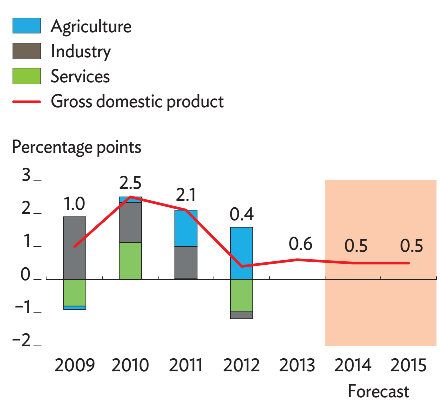
3.36.2 Supply-side contributions to growth in the FSM



FSM = Federated States of Micronesia.

Note: Years are fiscal years, ending on 30 September of the same calendar year.

Source: ADB estimates using data from Federated States of Micronesia FY2012 Economic Review.

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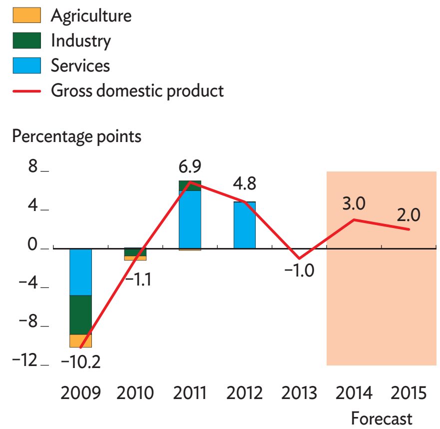
the cost of imports not denominated in that currency. All three North Pacific economies use the US dollar as their official currency and none has a central bank. This largely precludes the conduct of independent monetary policy.

The RMI is estimated to have incurred a fiscal deficit equivalent to 0.7% of GDP, unchanged from FY2012, with increased transfers to state-owned enterprises offsetting increased revenues from fishing licenses. Palau's fiscal position similarly remained negative, its deficit growing from the equivalent of 0.2% of GDP in FY2012 to 1.2% as increased tax collections were insufficient to offset higher recurrent spending. The FSM was the only North Pacific economy to achieve a fiscal surplus, having significantly cut recurrent expenditure to realize a surplus equivalent to 2.4% of GDP in FY2013. This marked the FSM's second consecutive year of surplus and its fourth in the past 5 years.

In the North Pacific, large merchandise trade deficits drive current account imbalances that are reduced by official transfers coming primarily from the US. The FSM saw its current account deficit narrow to the equivalent of 9.8% of GDP from 12.0% in FY2012, or to 41.5% from 44.2% excluding official transfers. Palau's current account deficit widened to 12.4% from 7.7%, or to 27.6% from 23.3% excluding official transfers. The RMI's current account deficit expanded to 8.8% from 7.6% but improved to 35.1% from 37.3% excluding official transfers, on a narrower trade deficit and a wider income surplus.

3.36.3 Supply side contributions to growth in Palau



Note: Years are fiscal years, ending on 30 September of the same calendar year.
Source: ADB estimates using data from Republic of Palau FY2012 Economic Review.
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Economic prospects

Progress in infrastructure construction is expected to drive growth in the near term. Growth in the RMI is projected to accelerate to 3.0% in FY2014 as work proceeds in earnest on delayed projects, such as the airport runway extension, funded by development partners. Recovery in agricultural production in areas affected by bad weather last year is, along with continued strong fisheries performance, expected to support growth. Growth is projected to moderate to 1.5% in FY2015 as annual decrements continue in sector grants from the US under the Compact of Free Association, and as stimulus from public infrastructure construction wanes.

Similarly, Palau's economy is seen to rebound from contraction. New tourism facilities, which could increase accommodation capacity by about 6%, are seen to drive GDP growth at 3.0% in FY2014. Reconstruction to repair damage from Cyclone Haiyan in November 2013 will likely contribute to output. Growth is expected to fall back to 2.0% in FY2015 as the effects of the capacity upgrade dissipate, but this will be somewhat offset by fiscal stimulus tied to the start of at least one large infrastructure project funded by development partners.

The low growth experienced by the FSM is seen to persist for lack of significant new investment or business formation, combined with a paucity of large infrastructure projects. GDP growth is projected to remain at 0.5% in FY2014 and FY2015, supported mostly by a steady fisheries performance.

The North Pacific's high dependence on imports combines with expectations of falling international food and fuel prices in the near

3.36.1 Selected economic indicators (%)

Marshall Islands	2014	2015
GDP growth	3.0	1.5
Inflation	1.5	1.5
Current account balance (share of GDP)	−20.6	−10.9
Federated States of Micronesia		
GDP growth	0.5	0.5
Inflation	2.0	1.5
Current account balance (share of GDP)	−9.6	−9.3
Palau		
GDP growth	3.0	2.0
Inflation	2.5	2.0
Current account balance (share of GDP)	−9.3	−7.4

Source: ADB estimates.

term to suggest that low inflation will persist. Inflation is projected to slow only marginally to 1.5% in FY2014 and FY2015 in the RMI but more steeply in the FSM, to 2.0% in FY2014 and then to 1.5%, and in Palau, to 2.5% in FY2014 and then to 2.0% (Figure 3.36.4).

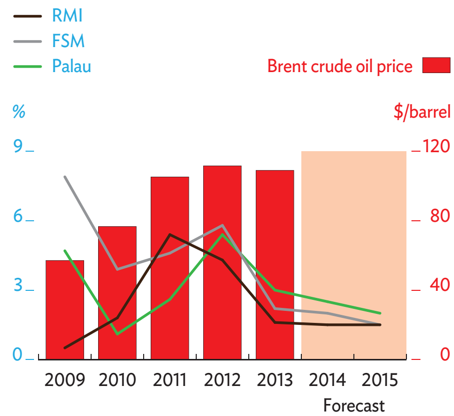
Declining international prices are expected to lower food and fuel import bills, and contribute to improving current account positions in the FSM and Palau (Figure 3.36.5). With income flows from fishing licenses expected to remain robust, the FSM's current account deficit is projected to narrow slightly to the equivalent of 9.6% of GDP in FY2014 and 9.3% in FY2015. A rebound in tourism arrivals and receipts as hotel capacity expands is seen to significantly narrow Palau's current account deficit to the equivalent of 9.3% of GDP in FY2014. This deficit is projected to shrink further, to 7.4% of GDP, in FY2015 with continuing modest growth in tourist arrivals and receipts.

The RMI will likely widen its current account deficit as falling prices for food and fuel imports are more than offset by increased imports of capital inputs for the resumption of work on delayed infrastructure projects. In particular, two ships imported by development partners for interisland transport are expected to raise the RMI's current account deficit to the equivalent of 20.6% of GDP in FY2014. The deficit is expected to revert to 10.9% of GDP in FY2015 as capital imports return to normal and revenues from fish exports and fishing license fees continue to grow. Annual budget support and capital grants from the US play an important role in enabling North Pacific economies to finance their current account deficits.

The governments of the RMI and the FSM are proceeding with fiscal adjustments to prepare for the scheduled expiration in 2023 of each respective Compact of Free Association with the US. They are seeking to build up trust funds able to generate investment returns sufficient to fund government expenditures and replace annual compact grants. While the FSM has generated modest fiscal surpluses in 4 of the past 5 years, the latest estimates suggest that current rates of saving are inadequate. Tougher fiscal consolidation will likely be required to mobilize revenue through reform to taxes and tax administration, and to make public expenditure more efficient, if the FSM is to avoid graver fiscal adjustments and public service cuts after 2023. Compared with the FSM, the RMI is closer to achieving its Compact Trust Fund target value by FY2023, though further reform is required to generate fiscal buffers to safeguard against possible shocks and variability in investment returns.

The renewal of the economic provisions of Palau's Compact of Free Association has awaited approval from the US Congress for more than 3 years. In the meantime, Palau receives financial assistance in the form of discretionary funding under a continuing US Congress resolution. As with the current RMI and FSM compacts, the proposed renewal for Palau includes provisions that would offset declines in annual grants by increased funding for trust fund contributions and infrastructure projects. Resources arising from a renewed compact will need to be properly managed to avoid sharp fiscal adjustments in the future. In all three North Pacific economies, structural reform to develop the private sector is key to maintaining growth while ensuring fiscal sustainability.

3.36.4 Inflation



FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands.

Note: Years are fiscal years, ending on 30 September of the same calendar year.

Sources: Federated States of Micronesia FY2012 Economic Review; International Monetary Fund. Republic of the Marshall Islands, *Staff Report for the 2013 Article IV Consultation*; Republic of Palau, *FY2012 Economic Review*; ADB estimates.

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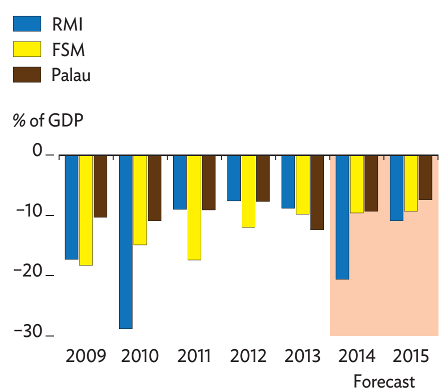
3.36.5 Current account balance



FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands.

Note: Years are fiscal years, ending on 30 September of the same calendar year.

Sources: Federated States of Micronesia, *FY2012 Economic Review*; International Monetary Fund. Republic of the Marshall Islands: *Staff report for the 2013 Article IV Consultation*; Republic of Palau, *FY2012 Economic Review*; ADB estimates.

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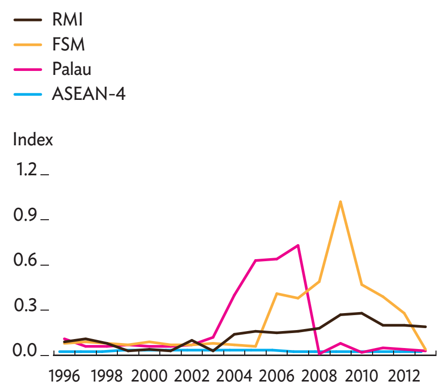
Policy challenge—improving trade performance

Because their domestic markets are small, North Pacific economies must rely on external demand to absorb expanded output from productive sectors and thereby sustain growth. However, their remoteness poses persistent challenges to merchandise trade. Recent cross-country comparisons show North Pacific economies falling further behind in terms of integrating with global markets and easing structural impediments to trade. The United Nations Conference on Trade and Development uses its Liner Shipping Connectivity Index to measure an economy's integration into global shipping networks by the number and size of ships and shipping services visiting its ports. Results show the three North Pacific economies ranked in 2013 among the bottom 10 of 164 countries. Similarly, the World Bank's *Doing Business* survey shows all three economies' rankings in cross-border trade deteriorating in 2014. Among 189 countries covered, the RMI fell from 57th to 62nd, the FSM from 101st to 103rd, and Palau from 95th to 96th.

A measure of trade costs that considers insurance and freight costs as a proportion of free-on-board value found that trade costs increased in the three North Pacific economies in the latter half of the 2000s (Figure 3.36.6). From 1996 to 2003, all three exhibited relatively low trade cost indexes (TCIs) linked to the predominant goods being exported to the US in those years (e.g., coconut oil from the RMI, and garments from the FSM and Palau). Garment exports from Palau to the US ceased in 2004 following the expiration of the World Trade Organization's Agreement on Textiles and Clothing. From 2005 to 2007, Palau's TCI climbed as fish became its primary export to the US. Similar upward trends in the TCIs of the RMI since 2002 and of the FSM in particular from 2008 to 2010 also reflect greater fish exports. The shift in export composition from coconut oil and garments, which are easy to package, store, and transport, to highly perishable fish, which require refrigerated storage and expedited delivery, appears to have raised the average costs to these economies of exporting goods. The low TCIs exhibited by the FSM and Palau in recent years again coincide with much lower fish exports to the US than previously.

The North Pacific economies' poor rankings in international comparisons of trade performance appear to reflect high transport and logistics costs. Trade costs can be reduced by improving port facilities and customs efficiencies toward enhancing capacity for higher-volume shipments. Export diversifications toward niche products can help these economies absorb high transport costs, and hence overcome challenges arising from remoteness. Palau's declaration of its entire exclusive economic zones as a marine sanctuary creates a potential niche market for services trade. With parallel upgrades in basic services, Palau can develop as a high-end ecotourism destination and generate greater tourism revenues.

3.36.6 Trade cost index for North Pacific economies



ASEAN-4 = Indonesia, Malaysia, the Philippines, and Thailand, FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands.

Note: Trade cost is defined as the cost of insurance plus freight as a proportion of free-on-board value.

Source: ADB estimates using data from the US Census Bureau.

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