Small island economies

Sustained increases in fishing license revenues have supported GDP growth and solidified fiscal positions in Kiribati, Nauru, and Tuvalu. These and other inflows are expected to boost growth in 2014. Inflation returned after Kiribati and Nauru recorded deflation in 2012, but it is expected to track Australia’s relatively low rate. Windfall gains create opportunities for these economies to rebuild fiscal buffers to fund future service delivery.

Economic performance

Growth in 2013 in the small island economies of the Pacific was close to rates in the previous year and largely in line with forecasts (Figure 3.38.1). Economic expansion reflected sustained revenue increases from fishing license fees and progress in the construction of major public infrastructure projects.

In Kiribati, GDP growth was 2.0%, slightly down from 2.5% in 2012 despite increases in fishing license revenues, because scheduled infrastructure projects—most notably road construction—suffered delays. In contrast, Tuvalu saw progress in upgrading its airport, strong growth in fishing license revenues, and increased retail activity, which lifted growth to 1.1% from 0.2% in 2012. In Nauru, Australian-financed construction related to the expansion of the Regional Processing Centre (RPC) for asylum seekers supported GDP growth at 4.5% in FY2013 (ended 30 June 2013). This was slightly slower than in 2012, mainly because phosphate production and exports declined (Figure 3.38.2).

Revenues from fishing license fees continued their strong performance for a second consecutive year, with 2013 revenues exceeding budget projections by 62% in Kiribati, 37% in Tuvalu, and 4% in Nauru (Figure 3.38.3). As parties to the Nauru Agreement, all three economies have benefitted from rising rates under a vessel day scheme, wherein foreign fishing vessels are charged by the number of days they spend in the parties’ waters.

In addition to the revenue from fishing licenses, higher income from visa fees and customs duty attributable to the RPC has boosted Nauru’s fiscal position, and Tuvalu’s position improved with the collection of tax arrears from state-owned enterprises.

Kiribati recorded another large current account deficit, equivalent to 30.2% of GDP, from substantial imbalances in the merchandise and services accounts. In contrast, Tuvalu had a small current account surplus equal to 3.5% of GDP supported by inflows of fishing license revenue and official development assistance. No estimates of Nauru’s current account balance were available.
All three countries use the Australian dollar as legal tender, and none has a central bank, which precludes their having independent monetary policies or exchange rate flexibility. Since the collapse of the Nauru economy in FY2004, the population has been without domestic access to formal banking services. However, the government developed an information memorandum with international assistance to attract a commercial bank to the island. Prospects are positive for the re-introduction of some banking services this year, as the government is in advanced discussions about this with a preferred bank. A weaker Australian dollar, particularly in the middle of 2013, brought inflation back to Kiribati and Nauru, which experienced deflation in 2012, but inflation remained low at 2.0% in Kiribati and Tuvalu and 1.4% in Nauru (Figure 3.38.4).

**Economic prospects**

Infrastructure upgrades are expected to drive growth over the next 2 years. Kiribati’s economy is projected to grow by 3.0% in 2014 and 2.0% in 2015 as construction picks up on projects funded by development partners: upgrades of the airports at Tarawa and Kiritimati and of the South Tarawa Road, and the extension of Betio Port. In Nauru, growth is projected at 10% in FY2014 and 8% in FY2015. This will reflect the rebuilding and expansion of the RPC and associated resettlement villages, higher government spending, and payments to landowners from the liquidation of the Nauru Phosphates Royalties Trust (NPRT). In Tuvalu, the airport upgrade and increased retail competition are seen to drive economic growth at 2.0% in both 2014 and 2015.

Inflation is generally expected to be similar to that experienced in Australia, which targets inflation within a band of 2%–3%. Over 2014 and 2015, inflation is projected to remain at 2.5% in Kiribati. In Tuvalu, inflation is projected to accelerate to 2.5% as growth picks up in 2014, then moderate to 2.0% in 2015 in line with expected declines in international food and fuel prices. Robust economic activity and the introduction of an A$6,000 business visa fee are fueling price pressures in Nauru, and inflation is projected to accelerate to 5.0% in FY2014 and then to 7.0% in FY2015.

Island governments plan to increase expenditure to support economic growth in the near term. The governments of Kiribati and Tuvalu plan higher recurrent expenditures, to be financed in part by the continuing strength of fishing license revenues and budget support grants, and higher capital spending associated with ongoing infrastructure projects. In Nauru, the FY2014 budget continues recent large increases in spending. Spending will exceed A$96 million, which is more than three times the amount spent 3 years ago. As Nauru is unable to borrow because of its recent history of debt distress, higher spending depends on the government meeting its revenue targets. One additional source that the government is looking toward is a large but controversial increase in visa fees, which are projected to raise A$18 million.
Policy challenge—saving windfalls to rebuild fiscal buffers that finance services

All three of the small island economies urgently need to rebuild fiscal buffers to fund future service delivery. Recent windfall gains from fishing licenses and other revenues provide opportunities for these countries to save the proceeds in trust funds and gradually reduce their reliance on financial assistance from development partners. Near-term revenue generation must be balanced, however, with ensuring the sustainability of revenue sources to the extent that individual country policy can do so.

Proper management of windfall revenue streams from the new fishing license regime can help stabilize trust funds in Kiribati and Tuvalu, whose values fell during the global financial crisis and have struggled to recover amid continuing withdrawals to finance annual budget deficits. Although Kiribati has been able to contain its fiscal deficit using higher fishing license revenues in 2012 and 2013, government revenues have not been sufficient to enable the government to add funds to its Revenue Equalization Reserve Fund, which has recently declined in value in per capita terms and is now well below the government’s benchmark of A$4,500 per head (Figure 3.38.5). To improve the financial outlook for the fund over the long run, the government needs to deposit more revenue into it, but this requires enhanced revenue collection and restrained expenditures.

The Tuvalu Trust Fund has also languished below its target maintenance value since 2008. This has prevented the government from transferring resources to the Consolidated Investment Fund, which finances budget deficits, during the past several years. The Consolidated Investment Fund was nearly depleted in 2012, which prompted an A$4 million contribution from Australia (Figure 3.38.6).

In Nauru, the mismanagement of the NPRT almost completely depleted it in the early 2000s from a peak value of about A$1.5 billion in 1990. Remaining assets are now being liquidated and the capital distributed to landowners. Meanwhile, the emergence of windfall gains from the RPC and fishing licenses has again focused attention on the need for a new trust fund to save excess revenues toward providing a source of income when the phosphate is mined out. Primary phosphate reserves are almost completely exhausted, and secondary phosphate reserves are expected to last only 10–20 years. Such a trust fund would also be useful in managing emerging inflationary pressures, but would need to incorporate lessons from the Tuvalu and Kiribati trust funds to avoid repeating the mistakes of the NPRT.