NORTH PACIFIC ECONOMIES

Pandemic impacts began to dissipate in the Federated States of Micronesia and the Marshall Islands, but contraction continued in Palau. Recovery is expected with border reopening and incipient revival in Palau's key tourism markets. Inflation will be driven by high international commodity prices, but effects will differ in each economy. The anticipated renewal of compacts with the US brightens economic and fiscal prospects but requires strengthened implementation capacity and public financial management.

Federated States of Micronesia

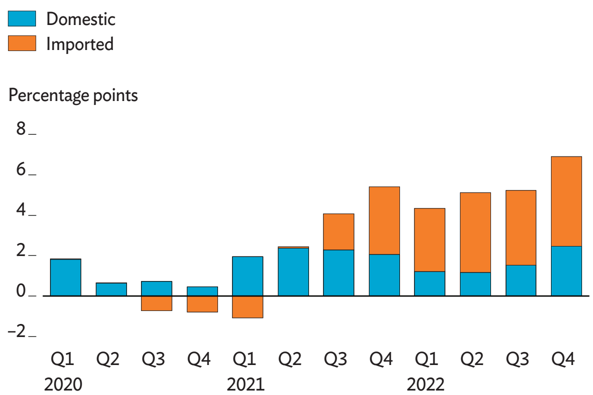
The economy has started to recover from the COVID-19 pandemic. GDP grew by an estimated 2.0% in fiscal year 2022 (FY2022, ended 30 September 2022 in all three North Pacific economies) following contraction by 1.3% in FY2021. The gradual easing of public health measures and reopening of international borders underpinned a rebound in transportation, hotels and restaurants, construction, and agriculture. Further support came from government economic stimulus and social protection packages.

Inflation accelerated on higher import prices and stronger economic activity. Consumer prices rose by 5.0% in FY2022, the fastest in nearly a decade, on a spike in international commodity prices after the Russian invasion of Ukraine and with economic normalization following the relaxation of mobility restrictions. Imports led the rise in prices (Figure 2.38.1).

The fiscal surplus continued to shrink. The national government's fiscal surplus is estimated to have declined from the equivalent of 5.8% of GDP in FY2021 to 4.4% in FY2022 as grants from development partners normalized. Grant funding and fishing license fees nevertheless supported the government's fiscal position, allowing external debt to shrink to 11.3% of GDP at the end of FY2022.

Figure 2.38.1 Inflation Contributions in the Federated States of Micronesia

Higher import prices have fueled inflation.



Q = quarter.
Source: Federated States of Micronesia Statistics Office.

Sustained recovery is expected to bring the economy back to its pre-pandemic level. FY2023 will be the first full year since pandemic measures were rolled back and borders reopened, facilitating the implementation of government projects and general economic activity. Growth in construction, transportation, hotels and restaurants, and retail trade is seen to restore the economy to its pre-pandemic level this year before growth slows to the long-term average in FY2024 (Table 2.38.1). Elevated consumer

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Table 2.38.1 Selected Economic Indicators, %

All three North Pacific economies are seen to return to economic growth in the near term.

	2021	2022	2023	2024
Federated States of Micronesia				
GDP growth	–1.3	2.0	4.1	0.5
Inflation	1.8	5.0	3.6	0.4
Marshall Islands				
GDP growth	1.1	–0.9	1.5	2.0
Inflation	2.2	3.3	3.7	3.5
Palau				
GDP growth	–17.1	–1.0	3.8	6.5
Inflation	0.5	10.2	5.0	5.5

GDP = gross domestic product.
Note: Years are fiscal years ending on 30 September of that year.
Source: Asian Development Bank estimates.

prices, particularly for transportation and retail trade, pose a risk to the outlook in the near term. Inflation averaged 6.9% year on year in the first quarter (Q1) of FY2023, during which transportation and utility prices climbed by 18.8%.

Inflation is likely to stay elevated in the near term but progressively decline. Consumer inflation is projected to slow to 3.6% in FY2023 and further to 0.4% in FY2024 in line with international commodity prices, particularly energy and food. The outlook remains uncertain, however, and will depend on the inflationary impacts of the Russian invasion of Ukraine and growth in the major economies.

Fiscal surpluses are seen to increase on improved economic prospects. The winding down of pandemic assistance to households, higher economic activity, and the renewal of the Compact of Free Association with the US are expected to bolster public finances over the next 2 years. The government signed a memorandum of understanding (MOU) with the US for increased financial assistance under the renewed compact, but the capacity of the national and state governments to harness this for service delivery and investment is a persistent issue.

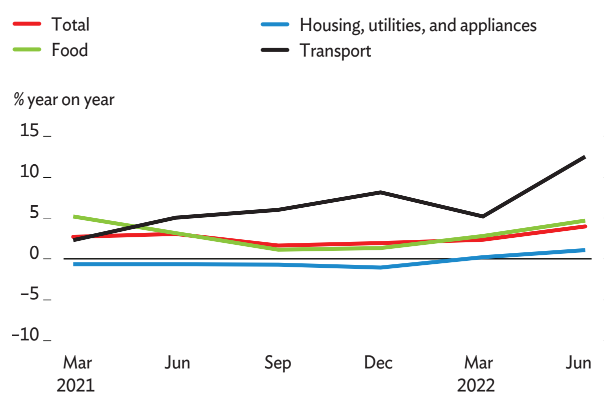
Marshall Islands

The impact of the pandemic was less severe than initially predicted. The Marshall Islands economy contracted by 0.9% in FY2022, reversing growth of 1.1% in FY2021. Border restrictions shrank onshore fishery support services, including a tuna loining plant, and other private sector activities such as construction and hospitality services. Offsetting this decline was expansion in domestic retail trade, reflecting pandemic mitigation supported by development partners, and other fishery activities, including commercial fishing.

Inflation was lower than elsewhere in the subregion, but price pressures increased. Inflation was 3.3% in FY2022, driven by transportation and food, but lower than in other North Pacific economies (Figure 2.38.2). Housing and utility prices recorded smaller increases, but at the end of FY2022 the Marshalls Energy Company reported that higher international fuel prices had doubled its fuel costs and that it would need subsidies or higher tariffs to offset sizable losses.

Figure 2.38.2 Inflation in the Marshall Islands

Food and transportation costs exerted most of the upward pressure on inflation.

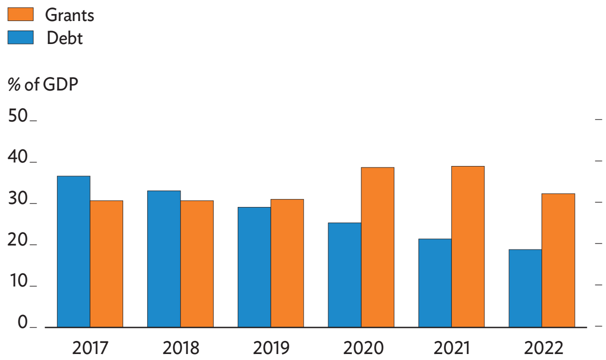


Source: Graduate School USA Economic Monitoring Analysis Program.

Grants declined, causing a fiscal deficit. The government incurred a fiscal deficit equal to 2.6% of GDP in FY2022 as a 15% drop in grants and reduced fishing license revenue caused resources to decline faster than expenditure. However, grant funding—elevated in previous years as development partners supported pandemic response—continued to limit the need to borrow. Public debt declined to the equivalent of 18.9% of GDP at the end of FY2022 (Figure 2.38.3).

Figure 2.38.3 Marshall Islands Debt

Public debt continued to decline as grant funding limited the need to borrow.



GDP = gross domestic product.
Note: Years are fiscal years ending on 30 September of that year.
Source: Graduate School USA Economic Monitoring Analysis Program.

Recovery is expected as borders reopen. Growth is forecast at 1.5% in FY2023 and 2.0% in FY2024 as business begins to return to pre-pandemic levels. Nauru Airlines' expansion of connections between Australia and five Pacific economies including the Marshall Islands could facilitate visitor arrivals.

Inflation will accelerate on both domestic and international price movements. Inflation is projected to reach 3.7% in FY2023 because of revived business activity and increased power tariffs in the major urban centers of Majuro and Ebeye. Higher international fuel prices and continued expansion in demand will likely keep inflation elevated at 3.5% in FY2024.

Continued fiscal deficits are anticipated despite prospects for an extended relationship with the US. The government is likely to incur a fiscal deficit equal to 2.9% of GDP in both FY2023 and FY2024. With the end of grant inflow in response to COVID-19, and with higher prices, spending growth is expected to outpace revenue expansion, as was observed before the pandemic. However, continued grant funding will help drive down external debt to the equivalent of 15.8% of GDP in FY2023 and 12.9% in FY2024.

In January 2023, the Marshall Islands signed an MOU with the US to guide ongoing negotiations on the Compact of Free Association. Final agreement is expected ahead of the expiration of the existing compact on 30 September 2023. The proposed compact, subject to approval by the US Congress, would increase financial assistance and contribute to the Compact Trust Fund in support of public services, infrastructure, and climate adaptation.

Palau

The economy contracted for a seventh consecutive year. Palau's economy contracted by a further 1.0% in FY2022 for a cumulative decline of 26.8% during the COVID-19 pandemic. Including a tourism-induced decline before the pandemic, the economy has now lost about a third of annual output since FY2015. The onset of COVID-19 in January 2022 dampened economic activity, particularly in Q2 FY2022. After supporting the economy during the height of the pandemic, construction fell by about 20% as projects were completed. Although visitor arrivals nearly tripled to 9,247 in FY2022, they remained well below pre-pandemic levels of about 90,000.

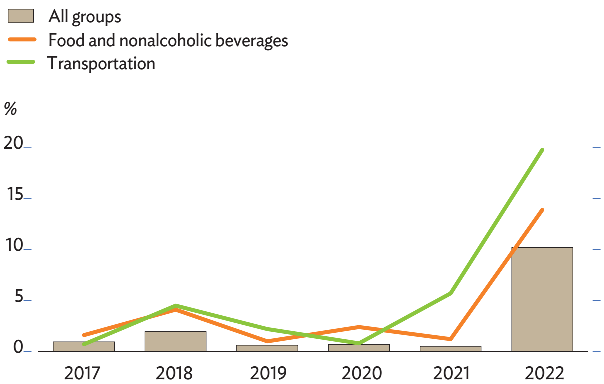
Limited flight connections constrained recovery in tourism. Arrivals from the US and Canada in FY2022 were 70% of their pre-pandemic levels and more than 60% of all arrivals. Tourism from other smaller markets, mainly the Philippines, reached 27% of pre-pandemic levels. By contrast, arrivals from Palau's top four sources of tourists—Japan, the People's Republic of China, the Republic of Korea, and Taipei,China—were 0.1%–7.0% of the pre-COVID numbers. These trends reflect the incomplete restoration of direct flight connections, currently available only from Guam and Manila.

Inflation reached a historic high on elevated international commodity prices. Palau relies heavily on imported commodities, and fuel price shocks following the Russian invasion of Ukraine pushed inflation to 10.2% in FY2022 (Figure 2.38.4), with transportation peaking at 23.6% and food costs at 14.8% in Q3 FY2022 before easing slightly.

The fiscal deficit lingered with weak revenue. Tax revenue remained low, equal to 16.8% of GDP in FY2022 and down from an average of 20.4% in FY2015–FY2019. However, expenditure fell as COVID-19 assistance declined and capital projects wound down. Consequently, the fiscal deficit narrowed

Figure 2.38.4 Inflation in Palau

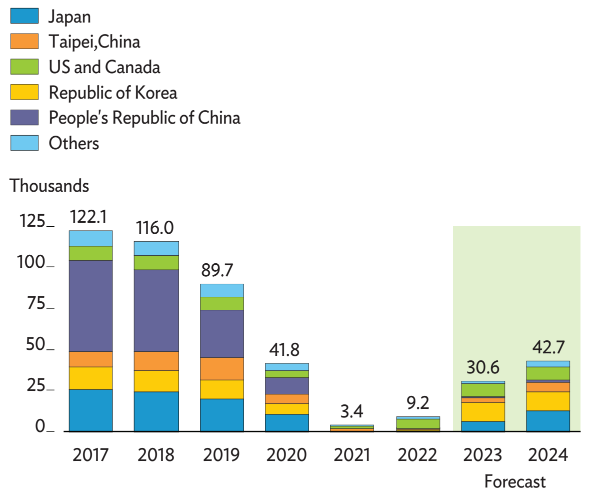
Consumer price inflation accelerated to double digits as transportation and imported food prices spiked.



Note: Years are fiscal years ending on 30 September of that year.
Source: Palau Bureau of Budget and Planning.

Figure 2.38.5 Visitor Arrivals in Palau, by Source

Tourism is expected to recover gradually with higher arrivals from the Republic of Korea and the US.



Note: Years are fiscal years ending on 30 September of that year.
Source: Palau Bureau of Budget and Planning, Palau Bureau of Immigration, and Palau Visitors Authority.

from the equivalent of 17.2% of GDP in FY2021 to 9.0% in FY2022. A significant risk nonetheless comes from increased subsidies to state-owned enterprises to compensate for rising fuel prices. After 3 successive years of fiscal deficits, public debt increased to equal 90.3% of GDP at the end of FY2022, almost tripling levels prior to COVID-19.

Continued tourism recovery underpins an outlook for a return to growth. Latest assessments point to continuing recovery in tourism from the US and renewed arrivals from the Republic of Korea, which rebounded strongly late last year in neighboring tourist destinations including Guam and Saipan. However, recovery in arrivals from other main source markets, particularly Japan, may take longer. Visitor arrivals are projected to reach about 31,000 in FY2023 and 43,000 in FY2024 (Figure 2.38.5), pushing growth to 3.8% in FY2023 and 6.5% in FY2024. An upside risk to this outlook would be unexpectedly rapid revival in tourism demand and reestablished direct flights from major markets in East Asia.

Inflation will likely ease but remain elevated. Following lower food and transportation price inflation since Q4 FY2022, and with expectations of lower international oil prices, inflation is seen to ease to 5.0% in FY2023. In line with a projected slight uptick in oil prices, it is expected to accelerate again to 5.5% in FY2024.

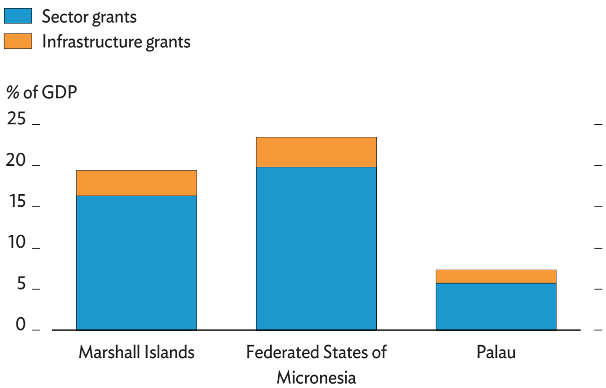
Fiscal accounts are likely to remain in deficit. Anticipated gradual economic recovery should mean recovery in tax collection. However, comprehensive tax reform may entail temporary adjustment costs that could constrain revenue in FY2023. As spending normalizes while pandemic-related grants fade, the gradual recovery in revenues is seen to translate into fiscal deficits remaining at the equivalent of about 10% of GDP in FY2023 and FY2024. While recent developments suggest expanded financial assistance from the US, the projected near-term fiscal gap will likely necessitate further borrowing.

Policy Challenge—Managing Available Fiscal Resources

Renewal of annual financial assistance from the US can boost longer-term prospects. Each of the three North Pacific economies has a Compact of Free Association with the US that provides substantial financial assistance and an open migration policy, while allowing the US access to geopolitically important airspace and waters (Figure 2.38.6). In January 2023, Palau and the US signed an MOU outlining a broad

Figure 2.38.6 Average Ratio of Compact Grants, FY2010–FY2019

US Compact assistance is significant across all North Pacific economies.



GDP = gross domestic product.

Notes: Fiscal year ends 30 September for all 3 economies. For the Federated States of Micronesia, the chart covers FY2009-FY2018 (the latest available data).

Source: ADB estimates based on data from Graduate School USA Economic Monitoring Analysis Program.

framework for continuing their partnership. The MOU more than doubles assistance in the coming 20 years over the previous 2 decades. The Marshall Islands likewise signed an MOU that provides for considerable US assistance. On 11 February, the Government of the Federated States of Micronesia (FSM) announced an MOU providing for continued economic assistance, increased sector grants, and funding infusion into the FSM's Compact Trust Fund. The government had earlier reported consensus on increasing annual sector grant assistance to $140 million, or $2.8 billion over 20 years, and a $500-million contribution to the trust fund spread over 2 years.

Harnessing additional resources requires strengthening absorptive capacity. To translate expanded fiscal resources into improved development outcomes, the parties to the agreements must build on lessons from previous experience. Chief among them is the need to build more efficient systems and expand absorptive capacity, particularly for using compact infrastructure grants. The Marshall Islands and Palau have lower ratios of capital expenditure to GDP than their Pacific peers. While capital spending is higher in the FSM, significant room remains for increases, as its unspent infrastructure grants were estimated at $246 million in FY2021, equal to 61% of GDP. Steps should be supported and sustained to address understaffing and lack of specific technical skills in project management offices, ensure compliance with US building codes and standards, and continuously update development planning and programming practices.

Reforms are critical to improve absorptive capacity and the development effectiveness of economic assistance to the North Pacific. In 2020, the Marshall Islands finalized its National Strategic Plan, 2020–2030, which includes an infrastructure pillar. Similarly, Palau developed its National Infrastructure Investment Plan, 2021–2030, and is updating its national development plan for 2023–2028. The FSM Infrastructure Development Plan, FY2016–FY2025, is due to be updated soon to ensure that it can likewise continue to provide strategic guidance toward efficiently implementing project pipelines. Over the longer term, needs include sustained capacity building and supplementary support for project management offices from development partners, along with more flexible and differentiated approaches to project implementation tailored to the contexts of small island developing states.

Prudent public financial management remains key to resilience. Another important lesson is the importance of building fiscal buffers to cushion the impact of economic downturns. The COVID-19 pandemic highlights the need to invest in resilience, as do extreme weather events and other disasters. The proposed renewed compacts will support this through contributions to North Pacific trust funds and expanded assistance that will free up other fiscal resources for establishing and building reserves. These may be for funding general government operations or for more specific purposes, such as post-disaster emergency response.