NORTH PACIFIC ECONOMIES

Economic performance improved as visitor arrivals to Palau picked up, and the Federated States of Micronesia and the Marshall Islands had their first full year without pandemic-related mobility restrictions. Growth in the North Pacific is expected to continue with inflation moderating in line with international price trends. Stronger public sector management and long-term fiscal planning will be key to harness the benefits from the renewed Compacts of Free Association (COFAs) with the United States (US), as well as to build resilience to future shocks.

Federated States of Micronesia

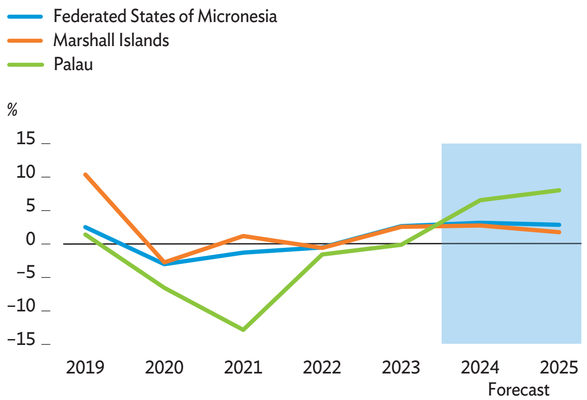
Growth returned as economic activity resumed in earnest. The economy expanded by 2.6% in fiscal year 2023 (FY2023, ended 30 September 2023 for all three North Pacific economies), reversing the 0.6% contraction in FY2022 (Figure 2.38.1). The removal of pandemic-related restrictions, notably border controls, enabled public infrastructure projects and general economic activity to resume. Construction, transportation, hotels and restaurants, and retail trade drove growth.

Inflation remained elevated. Revived domestic demand led to economic growth. However, the resulting rise in prices, boosted by global food and fuel prices, drove up inflation from 5.0% in FY2022 to 5.3% in FY2023.

The fiscal surplus fell despite higher revenues. The government realized a fiscal surplus equivalent to 3.0% of GDP in FY2023, down from 8.6% in FY2022. This was due to base effects from high corporate income tax revenues paid by foreign firms in FY2022, as well as higher national government wages and a resumption in capital spending that offset increased tax revenues from the economic recovery. External debt was equivalent to 12.5% of GDP at the end of FY2023, down from 14.0% a year earlier.

Figure 2.38.1 Gross Domestic Product Growth

The economies of the Federated States of Micronesia and Marshall Islands grew faster due to revived economic activity, while the contraction in Palau slowed as tourism continued to recover.



Note: Years are fiscal years ending on 30 September of that year.

Source: Asian Development Bank estimates; International Monetary Fund country reports.

Higher public investment should support continued growth. The economy is projected to grow by 3.1% in FY2024 and 2.8% in FY2025 (Table 2.38.1). The recovery of tourism and increased public investment—supported by the renewed COFA once it enters into force—will likely drive construction, expand output, and stimulate other economic sectors. Even

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Table 2.38.1 Selected Economic Indicators, %

Recoveries have commenced, and inflation is decreasing from its recent highs.

	2022	2023	2024	2025
Federated States of Micronesia				
GDP growth	–0.6	2.6	3.1	2.8
Inflation	5.0	5.3	4.1	3.5
Marshall Islands				
GDP growth	–0.7	2.5	2.7	1.7
Inflation	3.2	6.5	5.5	3.7
Palau				
GDP growth	–1.7	–0.2	6.5	8.0
Inflation	13.2	12.4	5.5	1.0

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

with the new COFA providing much-needed fiscal space to expand investments, a declining workforce caused by out-migration poses a significant downside risk as it could jeopardize implementation of large public projects.

Inflation is expected to ease only gradually as domestic factors push up prices. Inflation is forecast at 4.1% in FY2024. An expected drop in international prices will moderate inflation, but upward price pressure will likely come from increased demand as the economy recovers, as well as water scarcity from El Niño and its subsequent impact on food production. Inflation is projected to decline to 3.5% in FY2025 as El Niño ends and international prices continue to soften.

Fiscal deficits are likely in the near term, though the renewed COFA, once approved, could lead to a surplus. The government is projected to incur fiscal deficits equivalent to 4.6% of GDP and 3.0% in FY2025. Higher expenditures, driven mainly by a larger public payroll and continued spending, will likely outpace increased revenues. However, the fiscal outlook in the medium and long term is expected to improve with the resumption of financial assistance under the renewed compact with the US. External debt is expected to rise to 15.9% of GDP in FY2024 before easing to 15.0% in FY2025.

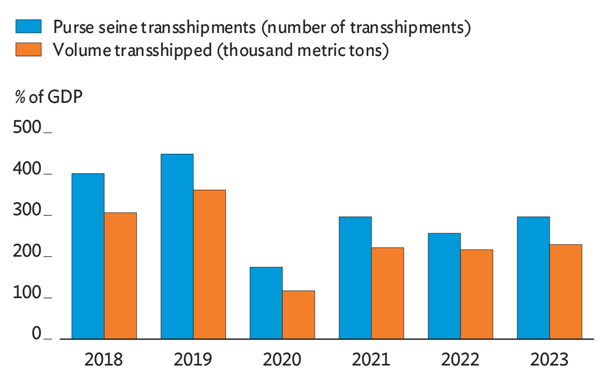
The renewed compacts brighten North Pacific fiscal and growth prospects. On 9 March 2024, the US President signed into law the third COFA renewal agreements with all three North Pacific economies. Once their governments complete the approval process, the agreements will provide substantial financial support to the North Pacific for 20 years while the US retains access to their airspace and waters. Besides adding significant fiscal resources, the financial support should increase public investment and potentially deliver economic benefits. Enhanced public investment and quality infrastructure, by improving connectivity and the business environment, can attract private sector investment and raise potential growth.

Marshall Islands

The economy grew by 2.5% in FY2023 after contracting by 0.7% in FY2022. Revived fisheries and construction output contributed significantly to the rebound. The number of purse seine transshipment vessels calling at Majuro Port rose by 15.6% (year-on-year) during FY2023, with the related volume of tuna transshipped up by 4.8% (Figure 2.38.2). Public infrastructure projects funded by development partners and preparations for the June 2024 Micronesian Games drove construction output. Spending in the months leading to the November 2023 elections also contributed to the increased economic activity.

Figure 2.38.2 Tuna Transshipment in Majuro Port, Marshall Islands

Transshipments increased in 2023.

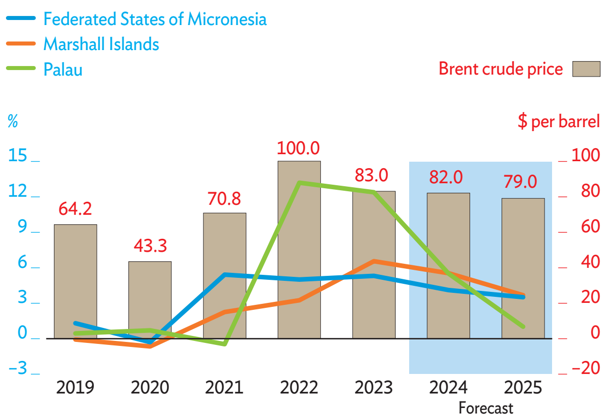


GDP = gross domestic product.
Note: Years are fiscal years ending on 30 September of that year.
Sources: Marshall Islands Marine Resources Authority. 2023. Annual Report FY2022. Majuro; *The Marshall Islands Journal*. 2024. Tuna operations strong in 2023. 18 January.

International price movements and domestic supply constraints pushed up prices. Inflation rose to 6.5% in FY2023 from 3.2% in FY2022 (Figure 2.38.3). The cost of imported fuel remained high especially in the early part of the fiscal year, affecting utility and transportation prices, while food costs mirrored international price trends. The suspension of the Marshall Islands' sole air cargo carrier between February and June 2023 disrupted local supply chains, adding to price pressures arising from revived domestic demand.

Figure 2.38.3 Inflation

Inflation has been elevated due to a combination of international price movements and domestic pressures.



Note: Years are fiscal years ending on 30 September of that year.

Source: Asian Development Bank estimates; International Monetary Fund country reports.

The fiscal position was largely balanced in FY2023. Tax collection increased by 14% due to economic recovery, which helped sustain revenue levels despite small declines in grants from development partners and nontax revenues. However, capital spending grew by 67% due to public infrastructure projects and preparations for the Micronesian Games. As a result, the fiscal surplus declined from 0.7% of GDP in FY2022 to 0.1% of GDP in FY2023. External debt declined from 24.5% of GDP at the end of FY2022 to 21.1% at the end of FY2023, supported by continued access to grant financing.

Growth is projected at 2.7% in FY2024 and 1.7% in FY2025. The expansion in fisheries and construction output will likely continue in the near term, while hosting the Micronesian Games in June 2024 is expected to increase business activity and stimulate growth in FY2024. However, the economy is projected to grow at a slower pace in FY2025 once the stimulus from the Micronesian Games fades.

Inflation will moderate, even as domestic demand exerts price pressures. Inflation is expected to slow to 5.5% in FY2024. However, as domestic demand will likely increase due to the hosting of the Micronesian Games, prices could remain elevated. In addition, the ongoing El Niño has led to water scarcity, affecting food prices. Nevertheless, as the El Niño subsides and domestic demand normalizes, inflation should decline to 3.7% in FY2025.

Power outages in Majuro pose a serious downside risk. In December 2023, the country's capital began experiencing prolonged power outages due to widespread breakdowns in its aging electricity infrastructure, causing the government to declare a state of emergency on 25 January 2024. If not resolved quickly, the situation will significantly affect connectivity, economic activity, and the availability of goods.

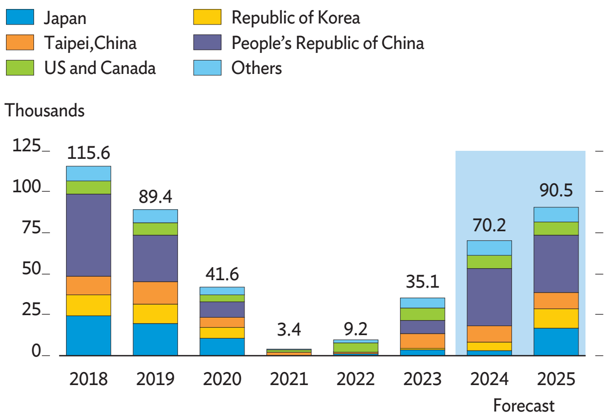
The fiscal position will likely slip into deficit in the near term, but renewed compact grants would brighten this outlook. A surplus equivalent to 0.2% of GDP is forecast for FY2024 as tax collections continue to rise, enabling revenues to just cover increased expenditures. The government has approved a withdrawal of $19.4 million from its Compact Trust Fund for education, health, and infrastructure management. A fiscal deficit equivalent to 1.0% of GDP is expected in FY2025 as expenditures grow faster than revenues, but there is a significant upside risk from the possible resumption of compact grants this year. External debt is projected to increase slightly from $59.7 million (equivalent to 21.2% of GDP) at the end of FY2023 to $62.3 million (19.4%) by the end of FY2025.

Palau

The economy contracted for the fourth consecutive year despite recovery in tourism. GDP contracted by 0.2% in FY2023. This was a substantial improvement on the contraction of 1.7% in FY2022 and largely reflected a 279.1% growth in tourist arrivals as flights from Taipei,China and Macau, China resumed. Despite this increase, the number of visitors remained substantially below pre-pandemic levels (Figure 2.38.4).

Figure 2.38.4 Visitor Arrivals in Palau, by Source

Visitor arrivals, though improving, remain well below pre-pandemic levels.



US = United States.

Note: Years are fiscal years ending on 30 September of that year.

Sources: Palau Bureau of Budget and Planning, Palau Bureau of Immigration, and Palau Visitors Authority.

International price movements and domestic factors kept inflation elevated. Prices grew by 12.4% in FY2023, driven by high international prices for food and fuel in late 2022 and the start of the Palau Goods and Services Tax (PGST). The largest price increases were for food (16.3%), housing and utilities (14.6%), and transport (13.1%).

The fiscal deficit narrowed despite the subdued economic recovery. Reforms starting in January 2023, including the PGST, lifted tax revenue to the equivalent of 20.8% of GDP in FY2023, higher than the average of 17.2% in FY2020–FY2022. Expenditure continued to decline as public infrastructure projects wound down. The fiscal deficit thus fell to the equivalent of 0.5% of GDP in FY2023 from 3.0% in FY2022. Public debt equaled 91.8% of GDP at the end of FY2023, slightly down from 92.7% a year earlier.

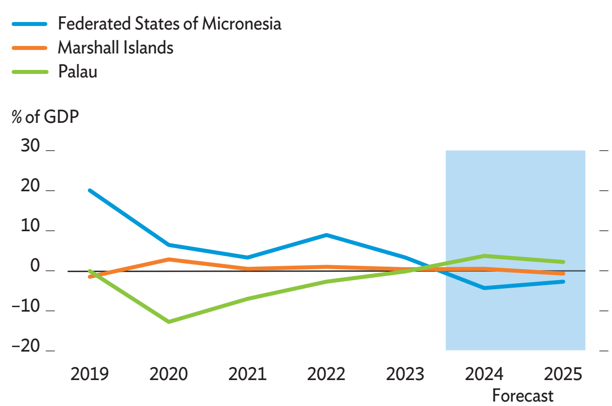
Growth is expected to resume as tourism and construction recover. The economy is forecast to grow by 6.5% in FY2024 and 8.0% in FY2025. Tourism arrivals should continue to rise, reaching pre-pandemic levels only after FY2025. In addition, election-related spending should boost output in the latter half of FY2024. Construction is expected to rebound with the implementation of new public infrastructure projects.

Inflation is forecast to moderate to 5.5% in FY2024 and 1.0% in FY2025. Prices will likely fall as international food prices decline and the base effect from the PGST introduction fades.

Fiscal surpluses are expected to return. Recent reforms should maintain strong tax collection while keeping expenditures in check. A surplus equivalent to 3.4% of GDP is projected for FY2024, narrowing to 1.9% in FY2025 as spending rises (Figure 2.38.5). Once the renewed COFA enters into force, financial assistance under the agreement will boost the amount of grants. Higher growth, combined with the return of fiscal surplus, would ensure a sustainable and declining debt-to-GDP ratio. However, increasing subsidies to state-owned enterprises and grants to government entities—including the social security system—could become a significant fiscal drain if critical reforms are not implemented.

Figure 2.38.5 Fiscal Positions

Budget surpluses are narrowing and deficits returning, but the COFA renewals should brighten fiscal prospects.



GDP = gross domestic product.

Note: Years are fiscal years ending on 30 September of that year.

Source: Asian Development Bank estimates; International Monetary Fund country reports.

Policy Challenge—Strengthening Public Sector Management and the Long-term Fiscal Framework to Harness the Benefits of Growth

Once the renewed COFAs enter into force, North Pacific governments will have additional fiscal space; thus, it is essential to enhance public sector management and develop a fiscal framework to increase public investment efficiency. The renewed compacts will channel $7.1 billion to the three North Pacific economies over 20 years to support government operations and capital investment. These resources will help upscale productive investments and support more broad-based, inclusive, and sustainable growth. To do this, it is critical to upgrade public investment management, enhance the quality of public investment, and manage risk. Addressing capacity constraints and improving expenditure efficiency would also help raise potential economic growth.

Developing a sustainable spending plan over the medium-term can also reduce economic volatility and improve the quality of public service. This will require a long-term reform agenda and additional capital resources to support complementary investments. The extra funds available through the renewed COFA should provide fiscal headroom to support large investments. However, this requires accompanying reforms to improve domestic resource mobilization (DRM) and ensure ample fiscal buffers to help mitigate external shocks—including those from disasters and public health emergencies. Higher quality infrastructure and an improved business environment supported by reforms can be instrumental in achieving private sector-led growth.

To this end, efforts are ongoing to strengthen tax systems. North Pacific economies began implementing DRM measures to help build fiscal self-sufficiency while the previous compact was in effect. Recent measures range from direct revenue-enhancing policies to administrative improvements:

- Pursuant to its Public Financial Management Reform Roadmap 2023–2026, the Federated States of Micronesia has begun training relevant government staff in audit and tax administration and use of the Automated Systems for Customs Data (ASYCUDA). It is preparing to implement a new financial management information system (FMIS) and it has introduced a set of standard operational budgetary procedures.

- The Marshall Islands is focusing on strengthening tax administration. It has begun implementing a new FMIS to improve monitoring revenue and debt. The government will also adopt ASYCUDA to help strengthen customs revenue collection.

- Palau implemented a package of tax reform measures including the PGST, a business profits tax, and a reduced wage tax for certain income levels. The package updates an inefficient, distortionary tax regime, broadens the revenue base, and promotes equity.

To further enhance DRM, a programmatic approach is needed, complemented by measures to build the capacity to manage and use these increased fiscal resources. North Pacific governments recognize the importance of prioritizing and phasing in DRM measures. This approach not only minimizes the burden on limited government staff but also ensures that measures taken build upon each other. The Federated States of Micronesia has drawn up a roadmap to guide its DRM efforts, while the Marshall Islands uses an approach that focuses on improving administrative efficiency before developing revenue-enhancing measures. Palau, on the other hand, is fine-tuning its tax reforms before modernizing supporting tax and customs systems. In addition, to ensure expanded fiscal resources are managed and utilized efficiently, the North Pacific governments need to address understaffing and skills gaps by improving education and training and creating career pathways to help attract workers into public service and strategic economic sectors.