

NORTH PACIFIC ISLANDS

Table 1 2021

Population, million	
Federated States of Micronesia	0.12
Republic of the Marshall Islands	0.06
Palau	0.02
North Pacific	0.19
GDP, US\$, billion	
Federated States of Micronesia	0.40
Republic of the Marshall Islands	0.24
Palau	0.22
North Pacific	0.86
GDP per capita, current US\$	
Federated States of Micronesia	3475
Republic of the Marshall Islands	4337
Palau	12405
North Pacific	4433

Sources: WDI, World Bank staff estimates.

COVID-19 has led to recessions in the Federated States of Micronesia (FSM), Republic of the Marshall Islands (RMI) and Palau. A gradual recovery is projected from FY22. In the short term, moderate fiscal surpluses are projected for FSM and RMI, while Palau's fiscal deficit will remain sizable. Medium-term fiscal risks are substantial, primarily due to the scheduled expiry of US Compact-related fiscal transfers, highlighting the importance of structural reforms.

Key conditions and challenges

More than 95 percent of the population in **Palau** is fully vaccinated from COVID-19, and almost 70 percent of the population has received a third booster dose. The vaccination rate is relatively lower in **FSM** and **RMI**. Palau's border is now open for fully vaccinated international travelers. However, tourist arrivals are yet to recover with monthly arrival per end-January was only 6% of pre-COVID number. In the short term, the key challenges facing the North Pacific are: (1) The vaccine rollout and management of the pandemic, to pave the way for relaxed border restrictions and gradual recovery of international arrivals. (2) To support a sustainable and inclusive economic recovery while managing fiscal risks (particularly in Palau).

Over the medium term, the key challenge is the scheduled expiry of Compact-related grants and programs in 2023-2024. This poses a key structural risk to long-term fiscal sustainability, considering the limited space for additional debt. This is exacerbated by the fact that the projected annual distributions from the nations' Compact-related trust funds are not sufficient to fully offset the expiring fiscal transfers. Given this risk, reform-based fiscal adjustments, such as domestic revenue mobilization and expenditure rationalization, are critical to cover fiscal gaps. Natural disasters and climate change also pose a threat to livelihoods. Sea level rise threatens the

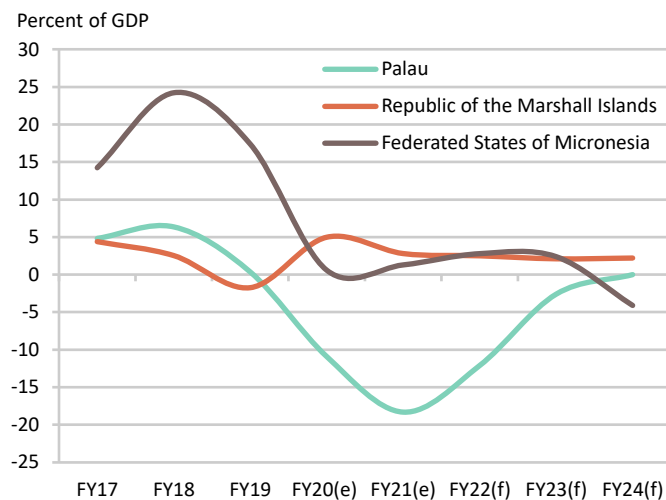
physical viability of numerous islands, particularly in RMI. Finally, governments need to implement structural reforms to ensure sustainable economic recovery that supports livelihood of the bottom 40 percent of households. However, the lack of recent household data makes it challenging to monitor development progress and impacts of shocks while also limits the potential for evidence-based policy.

Recent developments

The economic impact of the pandemic drove **FSM** and **RMI** into the second year of consecutive recession in FY21. Output is estimated to have contracted by a further 3.2 percent in FSM and 2.5 percent in RMI in FY21. Ongoing strict border closures and related trade disruptions have curtailed construction activity, transport and domestic consumption. Large parts of FSM and RMI government revenues have been relatively protected from the downturn in domestic activity, particularly donor grants and fishing revenues. Grants, combined with substantial fiscal buffers in FSM, provided fiscal space for stimulus, which was rolled out during FY20 and FY21. FSM and RMI registered fiscal surpluses of 1.3 percent and 2.8 percent of GDP in FY21, respectively.

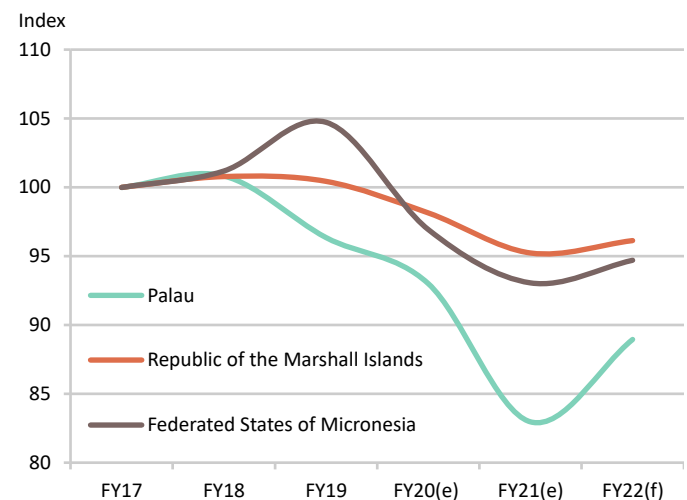
In **Palau**, the pandemic has severely impacted the economy. The tourism industry and its related business activities (around 40 percent of GDP) have been curtailed and trade flows are severely disrupted. GDP is estimated to have contracted further by 17.1

FIGURE 1 North Pacific Islands / Overall fiscal balance (share of GDP)



Sources: National sources via EconMap and World Bank projections.

FIGURE 2 North Pacific Islands / Formal sector employment (Index, 2017=100)



Sources: National sources via EconMap and World Bank projections.

percent in FY21, after more than 90 percent drop in tourist arrivals. The fiscal deficit widened to over 18 percent in 2021 driven by a decline in non-grant revenues and a rise in health spending and relief measures for firms and households. This deficit has been financed by external borrowing, which is estimated to have raised general government debt to around 85 percent of GDP from around 39 percent in FY19.

Outlook

The timing and shape of the economic recovery in the North Pacific depends on when international arrivals can fully resume and the fallout of the Russia-Ukraine war. For FSM and RMI, easing border restrictions will facilitate entry of foreign workers, merchandise imports and business travels, while for Palau, increase in international arrivals will boost the tourism recovery. Conditional on the easing of restrictive arrivals by mid-2022 and a recovery in global economy, a rebound is projected in FY22. The economies of the FSM and RMI are projected to grow by 0.4 percent and 3.0 percent, due to the expected pick-up in construction, tourists, and foreign workers

arrival. The **Palauan** economy is projected to grow by 7.2 percent, on the back of gradual recovery of the tourist arrivals to around one-third of the pre-crisis level. However, strong resurgence of the virus globally or local outbreaks could necessitate a significant tightening of containment measures and delays in reopening, which can derail the recovery and dampen growth prospects. Fiscal surpluses of 2.8 percent and 2.5 percent of GDP are projected in FSM and RMI, as tax revenues recover in line with economic activity. Another large deficit of 12.1 percent is projected in Palau, as non-grant revenues remain around 7 percent below pre-crisis levels.

GDP is not expected to recover to pre-crisis levels until FY23 in RMI and FY24 in FSM. For **Palau**, GDP is projected to remain on a relatively lower trajectory, compared to pre-pandemic level, until tourist arrivals fully recover in FY24. For all three countries, the negotiation with the U.S on Compact-related fiscal transfers is ongoing, and the terms and timing remain uncertain. Fiscal risks are tilted to the downside with potential reduction in grant revenues. Under current policies, the FSM will face a fiscal cliff in FY24 and projected fiscal deficit of 4-5 percent of GDP from FY24 onwards. In RMI, the fiscal surplus is projected to decline from 5

percent of GDP in FY20 to 2.2 percent of GDP by FY24. Palau is projected to have a fiscal deficit of 2.6 percent of GDP in FY23 before return to a balance in FY24 due to increase in tourism receipt and full implementation of tax reform bill.

Poverty in the North Pacific is expected to have risen relative to pre-crisis levels. The sharp economic contraction in FY20 and FY21 led to formal-sector job losses and lower demand for goods in the informal economy. The rebound in formal sector jobs in FY22 is expected to be slow. For Palau, the severe impacts on economic activity and jobs have led to increased vulnerability for substantial number of households that predominantly work in the tourism sector. For FSM and RMI, many households rely on annual remittance inflows (around 6 percent and 13 percent of GDP, respectively) that dropped in FY21 and is estimated to remain depressed in FY22 due to the impacts of the pandemic on US labor market conditions. There are only recent poverty estimates for RMI, in which poverty is predicted to fall slightly in FY22, if economic growth materializes. In FSM, the country with the highest poverty rate in the North Pacific, poverty reduction is likely to be slower, given the huge share of informal sector and lower rebound of economic growth in FY22.

TABLE 2 North Pacific Islands / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2019	2020e	2021e	2022f	2023f	2024f
Real GDP growth, at constant market prices						
Federated States of Micronesia	1.2	-1.8	-3.2	0.4	3.2	1.9
Republic of the Marshall Islands	6.6	-2.2	-2.5	3.0	2.4	2.6
Palau	-1.9	-9.7	-17.1	7.2	16.2	4.5
Upper middle-income poverty rate (\$5.5 in 2011 PPP)^{a,b}						
Republic of the Marshall Islands	22.5	24.0	26.7	24.5	24.1	23.0

Sources: ECONMAP, IMF, and Worldbank.

e = estimate; f = forecast.

Note: Values for each country correspond to their fiscal years ending September 30.

(a) Calculations based on EAPPOV harmonization, using 2019-HIES.

(b) Projection using neutral distribution (2019) with pass-through = 1 (High) based on GDP per capita in constant LCU.