

NORTH PACIFIC ISLANDS

Key conditions and challenges

Table 1 2020

Population, million	
Federated States of Micronesia	0.11
Republic of the Marshall Island	0.06
Palau	0.02
North Pacific	0.19
GDP, US\$, billion	
Federated States of Micronesia	0.40
Republic of the Marshall Island	0.22
Palau	0.24
North Pacific	0.87
GDP per capita, current US\$	
Federated States of Micronesia	3523
Republic of the Marshall Island	3810
Palau	13550
North Pacific	4559

Sources: WDI, World Bank staff estimates.

The economic impact of COVID-19 pushed the Federated States of Micronesia (FSM), Republic of the Marshall Islands (RMI) and Palau into recession in FY20. With borders expected to remain closed until at least mid-2021, all three economies are projected to contract further in FY21. While large parts of government revenues are relatively protected from the economic downturn, substantial fiscal risks remain, including due to the scheduled expiry of Compact-related fiscal transfers from the US in 2023-2024.

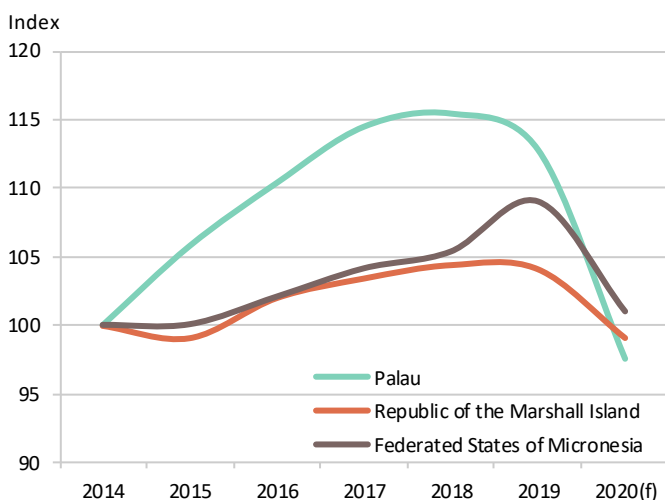
The region's remoteness has helped the North Pacific countries avoid a COVID-19 outbreak, but the prevention strategies have had severe economic consequences. Formal sector employment is estimated to have contracted by 5 to 14 percent across the three economies, and poverty is expected to have increased. Supported by the US, all three nations began their national vaccination programs in December/January. RMI and Palau are on track to vaccinate over 80 percent of their populations by June 2021. In the short term, the key challenges facing the North Pacific countries are: (i) the roll out of a COVID-19 vaccine, thus allowing for strict international border restrictions to be relaxed; and (ii) to support a sustainable and inclusive economic recovery while managing acute fiscal pressures (particularly for Palau). Over the medium term, the key challenge facing the region is the scheduled expiry of Compact-related grants and programs in 2023-2024. This poses a key structural risk to the long-term fiscal sustainability of all three nations, considering the limited space for additional debt. This has been exacerbated by the recent global financial market volatility that have reduced the balances on the nations' various trust funds—which are supposed to replace the expiring Compact-related fiscal transfers. In 2020 the three nations began

negotiations with the US on amending their Compact agreements, but the details of the scope, size and duration of any amendment remain uncertain. Natural disasters pose a constant threat to livelihoods, economic growth, and fiscal sustainability. Sea level rise threatens the physical viability of numerous islands, particularly in RMI. Enhancing resilience to climate change and natural disasters is crucial to achieve sustainable improvements in living standards and poverty reduction. Finally, the lack of recent household data in FSM and Palau poses a risk to policy making and makes it challenging to monitor development progress and impacts of shocks on the poor.

Recent developments

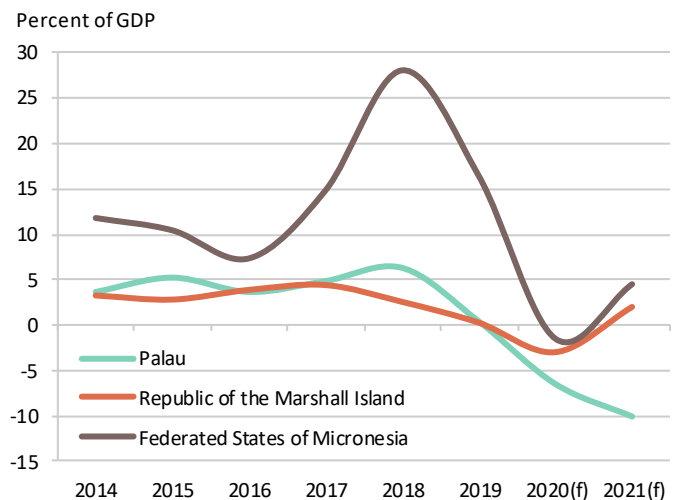
Prior to the pandemic, FSM and RMI had each registered five consecutive years of positive growth, and the longest period of sustained economic expansion since 2003. However, the economic impact of the pandemic is expected to have driven both economies into recession in FY20 with output contracting by around 1.5 percent in FSM and 4.5 percent in RMI, as strict border closures and related trade disruptions have curtailed construction activity, transport and domestic consumption. In some cases, quarantine requirements have led to delays in goods, food and fuel imports—raising concerns of food shortages. Large parts of FSM and RMI government revenues have been relatively protected from the downturn in domestic

FIGURE 1 North Pacific Islands / Formal sector employment (Index, 2014=100)



Sources: National sources via EconMap and World Bank projections.

FIGURE 2 North Pacific Islands / Overall fiscal balance (share of GDP)



Sources: National sources via EconMap and World Bank projections.

activity—particularly donor grants and fishing revenues, which remained relatively strong in FY20. Grants from the ADB and the U.S. (along with other partners, including the World Bank)—combined with substantial fiscal buffers in FSM—provided the fiscal space for economic and social stimulus packages of 12 and 19 percent of GDP, while limiting the projected FY20 budget deficits to 1.5 to 3 percent of GDP.

In **Palau**, the pandemic represents an economic shock of unprecedented scale. The tourism industry (40 percent of GDP) is at standstill, trade flows are severely disrupted, and business activities have been curtailed. The economy entered the COVID-19 crisis on a weak footing, having contracted by over 4 percent in FY19 due to a fall in tourist arrivals. The government continued to implement its structural reform of the tourism sector away from a high-volume model and towards a high-quality model of sustainable ecotourism development. The collapse in tourist arrivals is estimated to have resulted in a further 10 percent GDP contraction in FY20. A substantial fall in tax receipts, combined with required

spending for the health sector and to support businesses and households, led to a deficit of over 6 percent of GDP in FY20. This has been financed by external borrowing, which raised public external debt to GDP to 42 percent.

Outlook

The economic impact of COVID-19 is projected to lead to further contractions in economic activity in all three countries in FY21. The economies of the **FSM** and **RMI** are projected to contract by a further 3.5 percent and 1 percent, owing to very restrictive border and customs policies that are expected to be maintained until at least mid-2021. This will further depress tourism receipts and restrict the entry of foreign workers and merchandise imports—curtailing construction activity. The **Palauan** economy is expected to contract by a further 4 percent in FY21, as the nation's strict arrivals policies are extended into 2021, with tourism arrivals unlikely to recovery until FY22. Fiscal accounts are expected to return to surplus in FY21 in

FSM and RMI, as foreign grant assistance and fishing receipts remain resilient, and stimulus spending is unwound. However, another large deficit is projected in Palau. This is expected to be financed by additional external borrowing, which is projected to raise public external debt to GDP to over 53 percent.

Poverty is expected to increase in the North Pacific. Economic contraction is expected to lead to additional formal-sector job losses and lower demand for goods in the informal economy across the three countries. The severe impacts on economic activity and jobs is expected to have led to increased vulnerability for many Palauan households—particularly for the substantial non-resident population that predominantly work in the tourism sector. The RMI and FSM receive annual remittance inflows of around 14 percent and 6 percent of GDP, respectively. These flows are projected to decline due to the impacts of the pandemic on US labor market conditions. An economic rebound is projected in FY22 for all three nations—conditional on a recovery in the global economy and the easing of restrictive domestic arrivals policies.

TABLE 2 North Pacific Islands / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2018	2019 e	2020 e	2021 f	2022 f	2023 f
Real GDP growth, at constant market prices						
Republic of the Marshall Islands	3.3	6.6	-4.5	-1.0	3.0	2.0
Federated States of Micronesia	0.2	1.2	-1.5	-3.5	2.5	1.0
Palau	4.1	-4.2	-10.0	-4.0	12.0	6.0

Sources: EconMAP, IMF, and World Bank.
e = estimate; f = forecast.

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