Introducing the Asia & Pacific Small States Monitor

The work on the small states is an important component of the IMF’s global policy agenda. Among the 36 member countries covered by the IMF Asia and Pacific Department (APD), 13 countries are developing small states—most of which are Pacific islands. As part of APD’s ongoing effort to increase its engagement with regional small states and their development partners and enhance information sharing within the IMF, this issue marks the launch of the APD Small States Monitor, a quarterly bulletin featuring the latest economic developments, country notes from the most recent Article IV staff reports, special topics, past and upcoming events, and forthcoming IMF research on small states. In future issues, we will also host contributions from the authorities of small states and their development partners on key policy topics. Our goal is to exchange knowledge and deepen our understanding of the policy challenges these economies face to better tailor our policy advice.

Patrizia Tumbarello, Chief of Pacific Islands Unit, Asia and Pacific Department

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Reef in Chuuk State, Micronesia
(Selection and editing of photo by Michael Spilotro, Media Officer)
**Growth and Inflation** Average growth in the small states in the Asia and Pacific region remained weak (1 percent) in 2013 and underperformed that in other small states—2 percent. However, activity within the Asia-Pacific small states was uneven, with commodity exporters growing at the rate of 3 percent which, while robust, was lower than past rates (Figure 1). Economic performance in the microstates (i.e., countries with a population below 200,000—Kiribati, the Marshall Islands, Micronesia, Palau, Samoa, Tonga, and Tuvalu) lagged behind with growth estimated at less than 1 percent. Inflation has remained broadly in check. These countries remain highly vulnerable to natural disasters as shown by the recent cyclones in Tonga and Vanuatu, and severe floods in Solomon Islands.

**Fiscal Performance** Tax reforms led to strong tax revenue performance in some tourism-intensive economies (Maldives and Samoa), while nontax receipts—mainly fishing license fees—surged in Kiribati and Tuvalu (see special topic). The underlying fiscal position in commodity exporters and in countries dependent on fishing license fees (proxied by the change in the overall fiscal balance excluding natural resources) has deteriorated, however, despite minor changes in the overall fiscal balance because of spending pressures (Figure 2).

**Policy Buffers** External reserves are at comfortable levels in several small states (Bhutan, Solomon Islands, Tonga, and Vanuatu), and fiscal space has been rebuilt in Kiribati, the Marshall Islands, Solomon Islands, and Tuvalu (Figure 3). But more effort is required to rebuild policy buffers in some others to strengthen their resilience to shocks.

**Outlook** Externally financed infrastructure projects and steady growth in Emerging Asia and Australia will underpin APD small states’ short- and medium-term performance under the baseline scenario. Lower commodity prices are expected to contain inflationary pressures. The recent natural disasters are expected to take a toll on economic activity in the short term. Elections in late 2014 in Fiji and Solomon Islands introduce some uncertainty to their outlook. Other risks are mainly external. Negative spillovers from Asian emerging markets in the event of increased financial volatility would pose challenges for APD small states. The key challenge remains how to lift potential growth in the medium term.

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**Special Topic—Leveraging Marine Fishery Resources: Implications for Fiscal Policy**

Fishing license fees are a major source of revenue in several Pacific island countries (Kiribati, the Marshall Islands, Micronesia, and Tuvalu). In 2013 the fee earnings ranged from 15 percent of total revenues in the Marshall Islands to 65 percent in Kiribati. Despite the large fishery-derived wealth, PICs still have enormous untapped marine resources and further efforts are under way to properly leverage and manage them. First, the ratio of the income PICs receive by selling fishing rights to foreign companies to the value of the fish catch is very low. Second, an improperly designed access right scheme could lead to the overexploitation of marine resources. This would mean a decline in the fish supply (mainly tuna) and, eventually, a depletion of fish stocks, which would undermine fiscal sustainability. Finally, the intrinsic volatility of revenue from fishing license fees poses a challenge for fiscal policy.

Regional cooperation to strengthen control over marine resources and extract more revenue has been facilitated by the 1982 Nauru Agreement among eight Pacific island countries. This agreement sought to strengthen the bargaining power of license-issuing countries and regional control to stop illegal fishing. The regional license scheme regulated only the maximum number of vessels eligible for access rights in the region. Under that scheme, PICs were not able to realize the full benefit of their fishing wealth; specifically, there was a large disproportion between the value of catches by foreign companies and revenues received by PICs. In 2007, Nauru Agreement members introduced a new mechanism, the vessel day scheme, to extract more rent and strengthen PICs’ bargaining power. The scheme did this by moving away from setting a limit on the number of vessels in the region (205) to limiting the total number of fishing days. Under the vessel day scheme, Nauru Agreement members jointly agreed to allocate a fixed number of transferable fishing days to each member according to the size of its Exclusive Economic Zones and historical catch. The fishing companies pay a flat fee per vessel per day. Nauru Agreement members further strengthened the vessel day scheme in 2011 by introducing a minimum fee for fishing per vessel day, operating de facto as an oligopolistic cartel. The minimum fee was set at US$5,000 effective in 2012 and raised to US$6,000 effective in January 2014.
Preliminary data suggest that overall fishing license fee revenue almost quadrupled, from about US$60 million in 2010 to US$230 million in 2012,\(^4\) with the largest increases occurring in Kiribati and Tuvalu. Under the vessel day scheme, access to fishing grounds is tightened, and fishing fleets compete among themselves for available fishing vessel days. In addition, by limiting the number of fishing vessel days, the vessel day scheme also limits fishing volume available to the companies. This has helped curb overfishing and helped raise fish prices. Despite the higher revenue, there is scope for improving the scheme as it now covers only members of the Nauru Agreement. The ratio of revenue to the value of the catch is still low because the price of tuna has risen. The World Bank sees scope for enhancing the competitiveness of fishing arrangements and consistency among the regional agreements beyond the Nauru Agreement and provides assistance in this regard.

From a fiscal policy perspective, there is uncertainty about whether the recent surge in earnings will be enduring and consistent with long-term resource sustainability or whether it should be seen only as a windfall—which countries should either use to build buffers and enhance resilience to shocks or spend wisely on health, education, or infrastructure to lift potential growth. Finally, even with considerable scope for improving the scheme, other factors, such as the El Niño cycle (which affects fish movement) and the exchange rate of national currencies against the U.S. dollar (which is the invoice currency of most license fees) will continue to contribute to the volatility in these nontax revenues. This suggests the need for countries highly dependent on fishing license fees to enhance their fiscal frameworks. They can do this by strengthening the medium-term orientation of fiscal policy (as opposed to a year-by-year formulation based on volatile and uncertain revenue) and using as a fiscal anchor a measure of structural balance—defined as the overall balance minus a normal level of fishing license fees (using backward-and forward-looking averages)—to reduce the budget’s exposure to volatile fishing license fees. This suggests the need for countries highly dependent on fishing license fees to enhance their fiscal frameworks.\(^5\) Moreover, strengthening the framework for managing fishing rights at the regional level is key given the risk of depletion of marine resources.

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\(^1\)Prepared by Ezequiel Cabezón, Sergei Dodzin, and Yiqun Wu (Pacific Islands Unit, Asia and Pacific Department).


\(^3\)The members of the Nauru Agreement are: Kiribati, the Marshall Islands, Micronesia, Nauru, Palau, Papua New Guinea, Solomon Islands, and Tuvalu.


Country Notes

Marshall Islands

Context: The Republic of the Marshall Islands (RMI) is going through a period of output fluctuations. The economy expanded in FY2012 by 3.2 percent, supported by export growth, but in FY2013 is estimated to have slowed to 0.8 percent due to the postponement of infrastructure projects. A fiscal deficit of 0.8 percent of GDP was recorded in FY2012 and another deficit of similar magnitude is estimated for FY2013.

Outlook and Risks: A growth rebound is expected in FY2014, assuming the resumption of infrastructure projects. A sustained increase in growth is hindered by the scheduled reduction in Compact grants and limited private sector expansion. Near-term risks are on the downside, stemming from possible further delays in project implementation. Insufficient fiscal buffers and public contingent liabilities constitute key risks for the medium to long term.

Policy Issues: The RMI faces persistent budget deficits, substantial fiscal risks from poorly performing state-owned enterprises (SOEs) and the social security system, and the expiration of most Compact grants after FY2023. Private sector development is limited by remoteness, small market size, SOE dominance in some sectors and a weak business climate, constraining growth, and making fiscal sustainability more challenging. Household debt and debt service ratios are high, while the supervisory power and capacity of the Banking Commission is hindered by institutional and resource constraints.

Source: Latest IMF Article IV Staff Report

Fiji

Context: Fiji is one of the largest and most developed of the Pacific island economies, with a per capita income of US$4,200. Growth in recent decades has been sluggish owing to persistent political turmoil, external shocks, and slow progress on structural reforms. Unemployment at nearly 9 percent continues to be stubbornly high, with youth and underemployment at significantly higher rates. The political environment remains complex as Fiji prepares for transition to a democratic government in 2014, although the strained relations with traditional development partners have started to ease. Lately, economic activity has picked up, partly driven by supportive policies.

Outlook and Risks: Economic growth is expected to have increased to around 3 percent in 2013, fueled by consumption and investment spending both by the public and private sectors. In 2014, growth is projected to moderate to 2¼ percent, in line with estimated potential. While strong linkages with Asia would help in the event of a global downturn, Fiji remains vulnerable to global commodity price shocks and natural disasters.

Policy Issues: The current configuration of mildly expansionary fiscal policy and accommodative monetary policy is broadly appropriate as the unemployment rate remains high and inflationary pressures dissipate. The key policy challenges are to raise potential growth, reduce vulnerability to shocks, and further reduce poverty. Although the authorities have recently implemented some structural measures—improving infrastructure, enhancing land-leasing efficiency, restructuring the sugarcane industry, among others—the need for deeper and faster reform to support higher growth and reduce unemployment and poverty is urgent.

Source: Latest IMF Article IV Staff Report

Photos and images: The World Fact Book; Destination360

Marshall Islands

Majuro Atoll

Fiji

Sigatoka, Island of Viti Levu
DMD Zhu’s Interview on the Pacific Island Countries in Business Melanesia

How involved is the IMF in the Pacific?
The IMF is greatly involved in the Pacific particularly in the areas of policy or financial programs. We provide macro policy consultations and macro policy assessments to help countries in the region form their own policy because macro stability is the most important thing for a country.

We also provide technical assistance. We have had a technical assistance center in the Pacific for 20 years now, as capacity building is important for the small countries in the region. So gradually we help Governments in building their capacity in areas such as tax, administration, revenue process, expenditure, financial regulation and such.

We do a lot of training for the region. We also do multinational surveillance, so we bring in the international picture to the region which is important as the region is part of the whole world. Last but not least of these important issues is that if the members are in need, we provide financial support.

You mentioned the importance of macro policies for the region can you give us some specific examples?

Take for example tax policy - How do you set the proper tax rates? How do you class tax, how do you tax income tax or VAT? You make sure the tax collected is enough revenue to support the Government, to support the country, but you don’t want to over tax anyone. You may want the burden of tax to be evenly shared among the rich and poor. You don’t want it to be shared only among the poor people or only among the rich. Those are very important issues. The tax policy is a very important issue for a country.

What do you see as priority areas for the region?

It’s growth. Let me emphasize - sustainable economic inclusive growth.

There are two sides of policy. The first priority is still maintaining macro stability, if you have macro instability where inflation is high, you would not be able to do it.

The second issue is - you need structural reform, you need investments in infrastructure, investments in education, investments in capacity building, you need to improve the business environment to bring in more private sector to do that.

Those are the two major priorities that can be addressed for 2014 by the region.

How would you describe the IMF’s relationship with Pacific island countries?

We have a very good relationship with the region. We are committed to the region. We have a new agenda which is based on cooperation between the IMF and the region. We aim to lift the profile of the region.

Upcoming IMF Cross-Country Research Papers on Small States

- Pacific Island Countries: Strengthening Fiscal Frameworks to Support Growth and Macro Stability, Emanuele Baldacci, Ezequiel Cabezon, and Patrizia Tumbarello (APD)
- Economic Growth and Fiscal Multipliers in the Small States: An Application to the Pacific Islands, Sergei Dodzin and Xuefei Bai (APD)
- Inflation Drivers and Exchange Rate Pass-through in the Pacific Island Countries, Xuefei Bai, Yiqun Wu, and Patrizia Tumbarello (APD)
- Pacific Island Countries: in Search of a Trade Strategy, Hong Chen, Lanieta Rauqueuq, Shiu Raj Singh, Yiqun Wu, and Yongzheng Yang (APD)
- Labor Market Issues in the Caribbean: Scope to Mobilize Employment Growth, Magda Kandil, Qiao Chen, Xin Li, Genevieve Lindow, Mario Mansilla, Joel Okwuokei, Marika Santoro, Jochen Schmittmann, and Solomon Stavis (Western Hemisphere Department—WHD)
Useful Links

IMF Resident Representative Office in the Pacific Islands
http://www.imf.org/external/region/pis/rr/

IMF Regional Office for Asia and the Pacific (OAP)
http://www.imf.org/external/oap/

Pacific Financial Technical Assistance Centre (PFTAC)
http://www.pftac.org/

The World Bank

Asian Development Bank
http://www.adb.org/publications/series/pacific-economic-monitor

Pacific Islands Forum Secretariat
http://www.forumsec.org/

The Commonwealth
http://thecommonwealth.org/

Upcoming Events on Small Islands/States

- **2014 Forum Economic Ministers Meeting**, July 8-11, 2014, Honiara, Solomon Islands
- **The 45th Pacific Islands Forum Meeting**, July 29-August 1, 2014, Koror, Palau
- **South-Pacific Governors’ Meeting**, December 4-6, Fiji

Recent IMF-Related Events on Small States

- **PFTAC Steering Committee Meeting**, November 21, 2013 in Port Vila, Vanuatu (see photos on following page)—http://afspc.pftac.org/events/2, co-hosted by PFTAC and the government of Vanuatu
In 2013, growth was generally weak in APD small states. Despite a drop in commodity output, net commodity exporters continued to outperform other countries in the group.

Tourist arrivals picked up in the Maldives, mainly from China and Europe. Cyclone Evan hurt tourism in Fiji and Samoa in early 2013, but the sector has since improved. Tourism took a hit in Palau as a result of the cessation of direct flights to Emerging Asia, the US$ appreciation, and high-tourism-related fees.

...largely because of low food price inflation in most small states...

Inflation remained broadly contained in late 2013 (with the exception of Bhutan which is tracing Indian inflation)...

...owing to the pass-through of lower global food prices.


Sources: Country authorities; and IMF staff estimates.
Tax revenues were buoyant in some tourism-intensive economies owing to a tourism tax rate hike in Maldives and greater tax compliance in Samoa and Vanuatu linked to tax reforms.

Nontax revenues, which exceed 50 percent of total revenues in Kiribati and Tuvalu, increased in these countries, driven by strong growth in fishing license fees (see special topic).

Although the overall fiscal balance remained unchanged in resource-rich countries...

...relative to 2012...

...because of spending pressures.


Sources: Country authorities; and IMF staff estimates.
Reserve buffers were at a comfortable level in most APD small states in 2013—and larger relative to the pre-crisis level—but more effort is required in some others.

The money supply expanded as countries did not fully sterilize foreign aid inflows.

Fiscal space has been rebuilt, especially in Kiribati and Solomon Islands, but it has narrowed in Maldives, Palau, Tonga, and Samoa...

...and the large current account deficits remain a concern in several small states.

The exchange rate depreciated in small states with links to the Australian dollar (Kiribati and Tuvalu) and Indian rupee (Bhutan), and appreciated in those with links to the U.S. dollar. Exchange rate appreciation in some countries...

...led to a higher import bill.

Note: Latest data as of December 2013.

Source: Country authorities, and IMF staff estimates.
APD small states are a heterogeneous group...

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<tr>
<th>Country</th>
<th>Main Sources of Foreign Exchange</th>
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<tr>
<td>Tuvalu</td>
<td>Fishing license fees, aid</td>
<td>Australia, New Zealand</td>
</tr>
</tbody>
</table>

Foreign aid is essential...

APD Small States: External Grants, 2013

...their small size...

APD Small States by Population Size

Only a small group relies on tourism, some others on remittances to support their income...

APD Small States: Tourism Receipts and Remittances, 2013

...and some on fishing license fees.

APD Small States: Fishing License Fees, 2...