



Pacific Economic Update

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Preface and Acknowledgements

This publication is the inaugural edition of the future publication series on Pacific Economic Update (PEU). It consists of two parts. Part A analyzes the recent economic developments in Pacific Islands. Based on these developments, the PI EU summarizes the outlook for the region's economies and risks to this outlook. Second, the PEU provides an in-depth examination of a public debt issues in the Pacific and proposes policy recommendations to address public debt related challenges. The PEU is intended for a broad set of audience, including regional forums, policy makers, business leaders, international donors and the community of analysts and professionals engaged in the economies of Pacific Island countries.

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PART A:

Hit by yet another shock

Nearly all Pacific Island countries experienced large contractions during the COVID-19 pandemic.¹ The hardest hit were tourism and travel-dependent economies. Just as pandemic-induced recessions are retreating, the region is being hit by a combination of shocks stemming from the war on Ukraine—rising global food and energy prices, tightening global financial conditions and slowing global economic activity—which are expected to affect all PICs. The growth outlook for 2023 is shaped by a weak but ongoing post-pandemic recovery, driven by travel normalization. Inflation is projected to remain elevated but ease from the 2022 highs. Compared to the period before the war on Ukraine, the post-pandemic rebound is projected to be much weaker than expected as these shocks will dampen the recovery and put further pressure on fiscal balances.

¹Pacific Island Countries (PICs) included in this report capture 11 countries, namely: Fiji, Solomon Islands, Vanuatu, Samoa, Tonga, the Federated States of Micronesia (FSM), Palau, Republic of the Marshall Islands (RMI), Kiribati, Nauru and Tuvalu.

1. Recent Economic Developments

1.1 Global economic environment

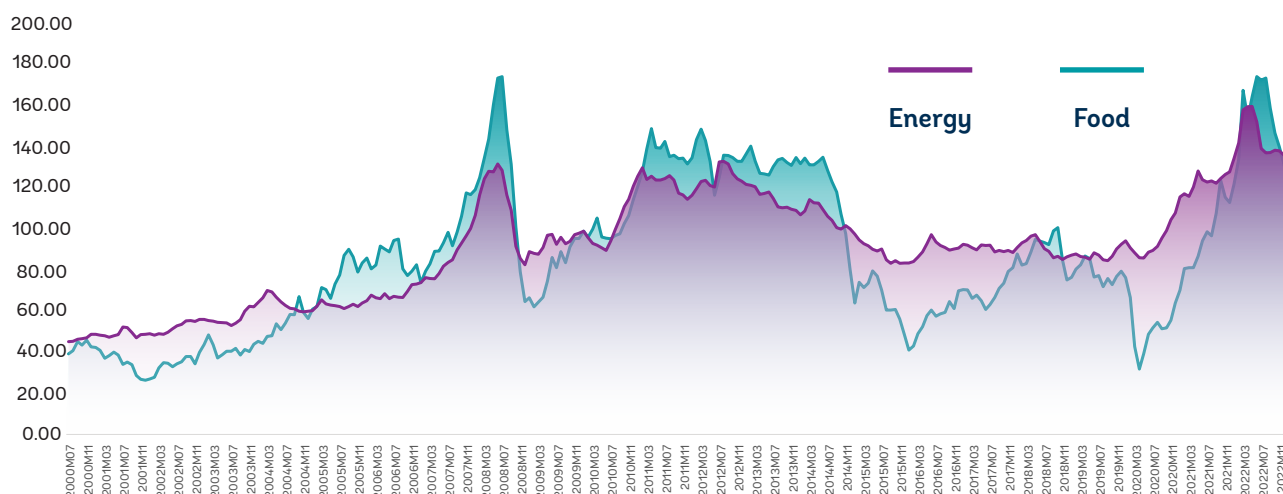


In **2022**

the global economy witnessed the highest energy and food prices in over 20 years

The Russian Federation's invasion of Ukraine exacerbated already elevated food and energy prices due to supply chain disruptions and strong pent-up demand as the pandemic mobility restrictions eased (Figure 1). After the invasion, a combination of sanctions against Russia, further disruptions to logistics channels, and Russia's actions to slow gas flows to Europe, caused substantial spikes in global energy and grain prices in the first nine months of 2022. While energy prices have eased recently, amidst concerns about slowing global growth, the decision by the OPEC+ to restrict crude production in October 2022 does not provide confidence the trend will continue.

Figure 1. Global Food and Energy Prices (2010=100)

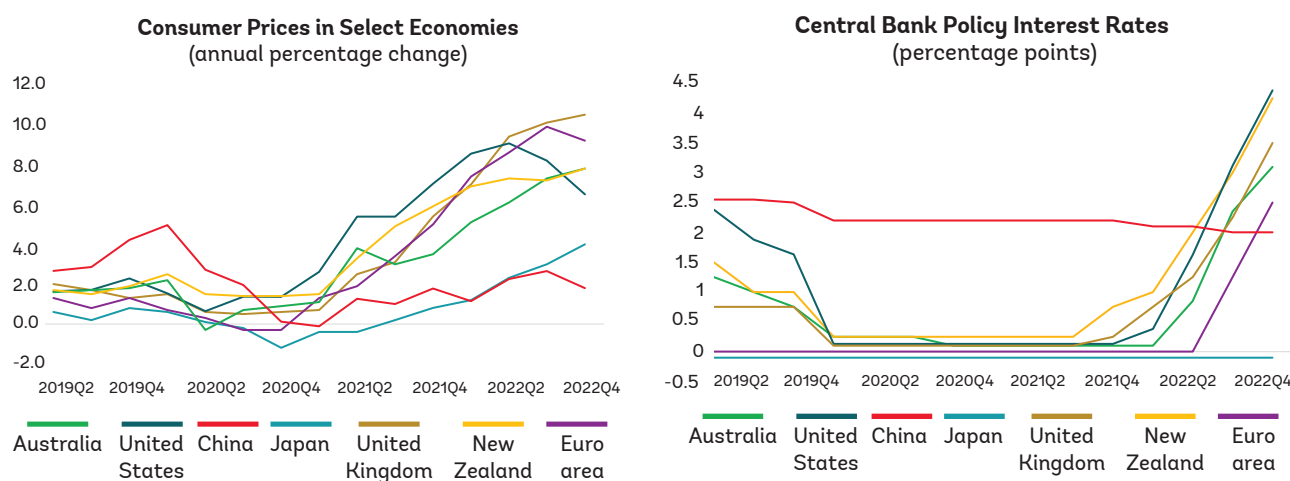


Source: World Bank "Pink Sheet" (February 2023)



Global inflation was relatively high before the war on Ukraine, owing to strong pent-up demand, pandemic-related stimulus, rising energy prices and global supply chain disruptions. Forward guidance by major central banks was that above-target inflation rates were temporary and would fall back to target levels within a year or two. The invasion of Ukraine changed this calculation in two ways: first, it added fuel to already high inflation in advanced economies, and second, it changed the behavior of central banks due to the risk that higher inflation could de-anchor inflation expectations. The trade-off between inaction (higher inflation) versus interest rate hikes (slower growth) became less balanced as higher inflation was eroding real purchasing power and slower growth was an imminent risk. As a result, most central banks have pursued the most aggressive monetary tightening cycle in recent history, except for the Bank of Japan (BoJ) and the People's Bank of China (PBoC). BoJ has been reluctant to raise its policy rate as inflation remains relatively modest (around 4 percent, two percent above target) and the central bank has struggled to arrest decades of low inflation (Figure 2). The PBoC has eased rates due to the country's relatively modest inflation and its attempt to counter slow growth. China's deceleration was driven by a correction in the real estate sector as well as its strict "zero-COVID" policy that triggered frequent lockdowns throughout 2022. The Chinese government has since responded by easing monetary and fiscal policies to boost investment and prevent further contraction in the real estate sector. In late 2022 China abandoned its "zero-COVID" policy, which will improve growth prospects in 2023.

Figure 2. Inflation and Monetary Policy Rates



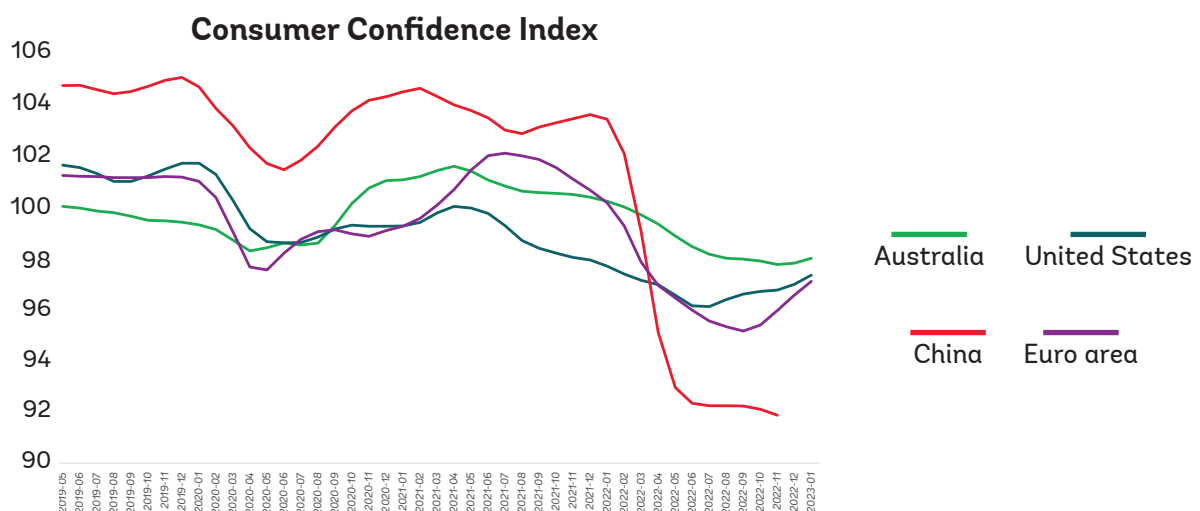
Source: IMF; ECB, BoE, ABS, StatsNZ.

Source: IMF International Financial Statistics; ECB; RBA; Fed; RBNZ; BoJ; BoE.

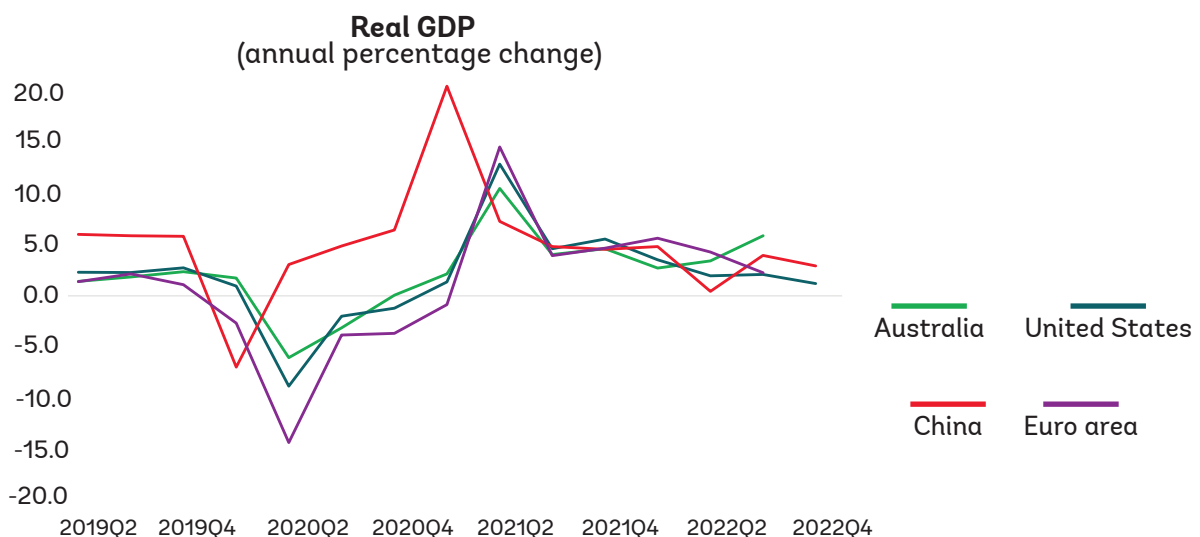


The sharp tightening of monetary and financial conditions, coupled with the unprecedented rise in the cost-of-living unseen since the early 1980s, have led to sharp falls in consumer confidence and global asset prices. In several other countries, lingering COVID-19 flare-ups and the invasion of Ukraine are delivering additional headwinds on activity. As a result, economic activity has decelerated across major markets, including the United States, Euro area and China (Figure 3).

Figure 3. Global Growth: Consumer Confidence and GDP



Source: OECD.



Source: IMF IFS; ECB.

These global developments are affecting East Asian economies,



with spillover effects in the Pacific region.

The path of economic recovery in the East Asia and Pacific region is diverging with growth strengthening in China, though still below potential, while growth in other major economies (notably ASEAN countries) in the region is slowing (World Bank, 2023b). Inflation rates, while still lower than advanced economies, are well above central bank targets in the East Asia and the Pacific, driven by energy and commodity prices.

1.2 The Pacific regional context

PICs

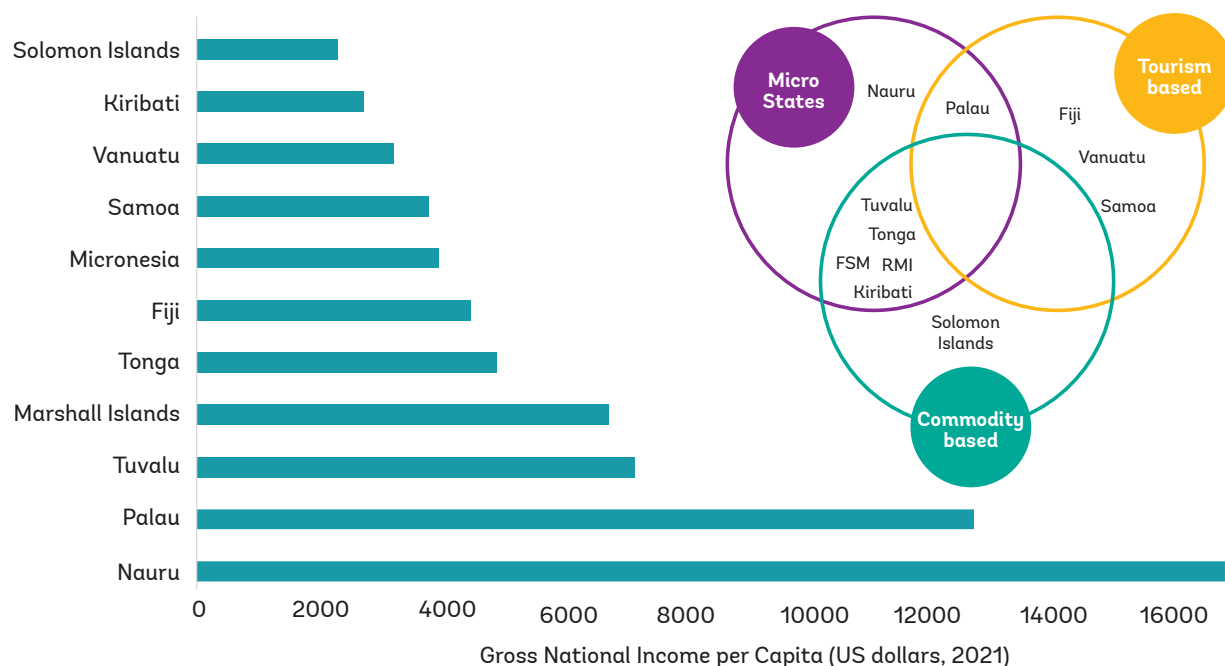
are inherently vulnerable to external shocks arising from



natural disasters, terms of trade, and transmissible diseases.

Owing to their geographic and structural characteristics, PICs are vulnerable to external shocks as small open economies. Natural disasters, such as tropical cyclones, tsunamis, and droughts occur frequently in PICs. The COVID-19 pandemic was particularly challenging for the Pacific. The global halt of travel and mobility restrictions dealt a severe blow to most economies in PICs. However, the heterogeneity within the region, highlighted by tourism and commodity dependence (including fishing and other natural resources), income levels, and fiscal space, either mitigated or amplified the impact of COVID-19 on PICs (Figure 4).

Figure 4. Characteristics of PICs



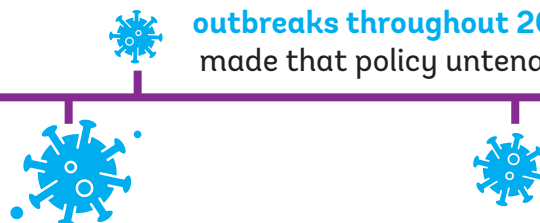
Source: World Bank; and IMF 2021.

1.3 Economic growth

During the first two years of the pandemic, the PICs largely evaded the virus through **strict border closures**,

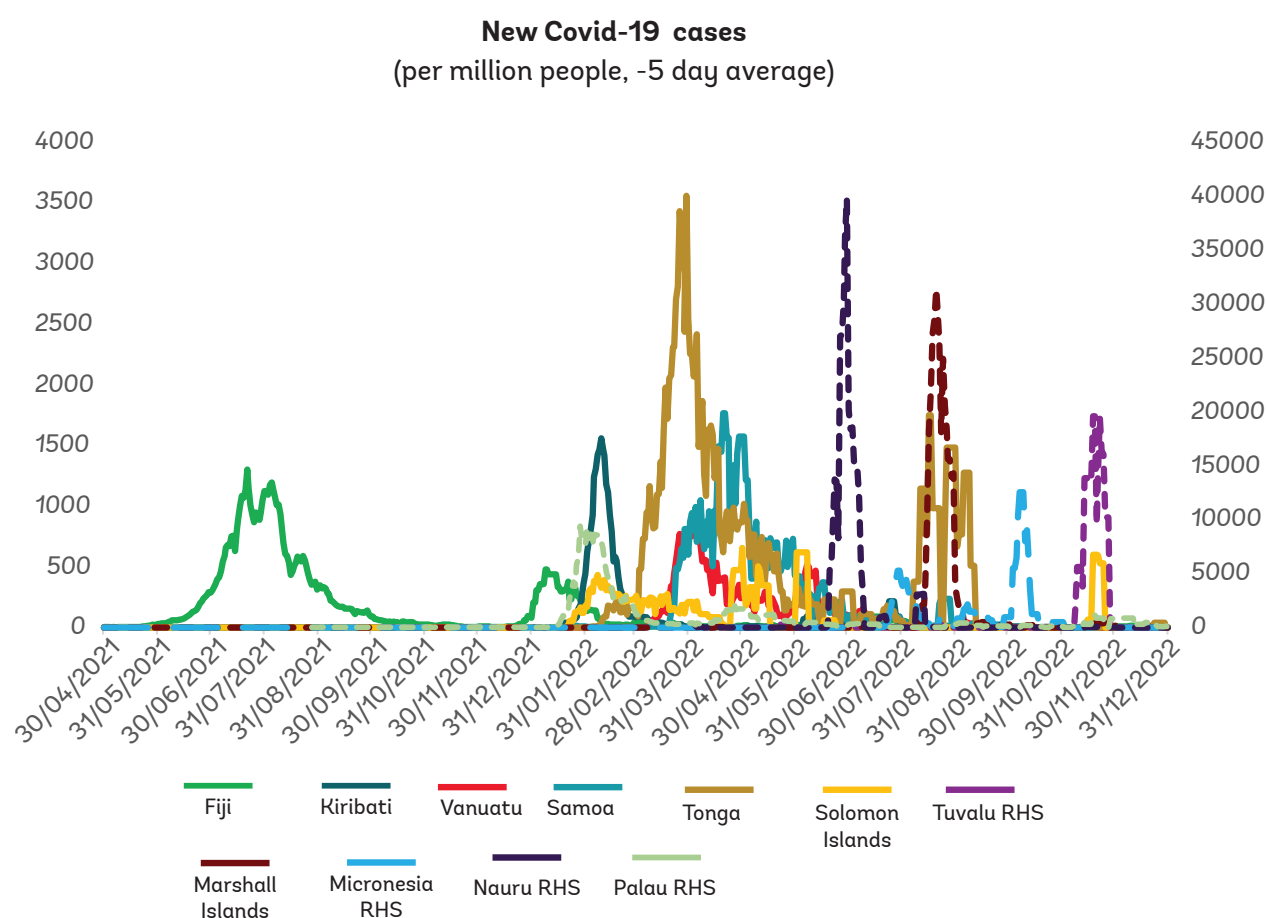


but the **Omicron variant outbreaks throughout 2022** made that policy untenable.

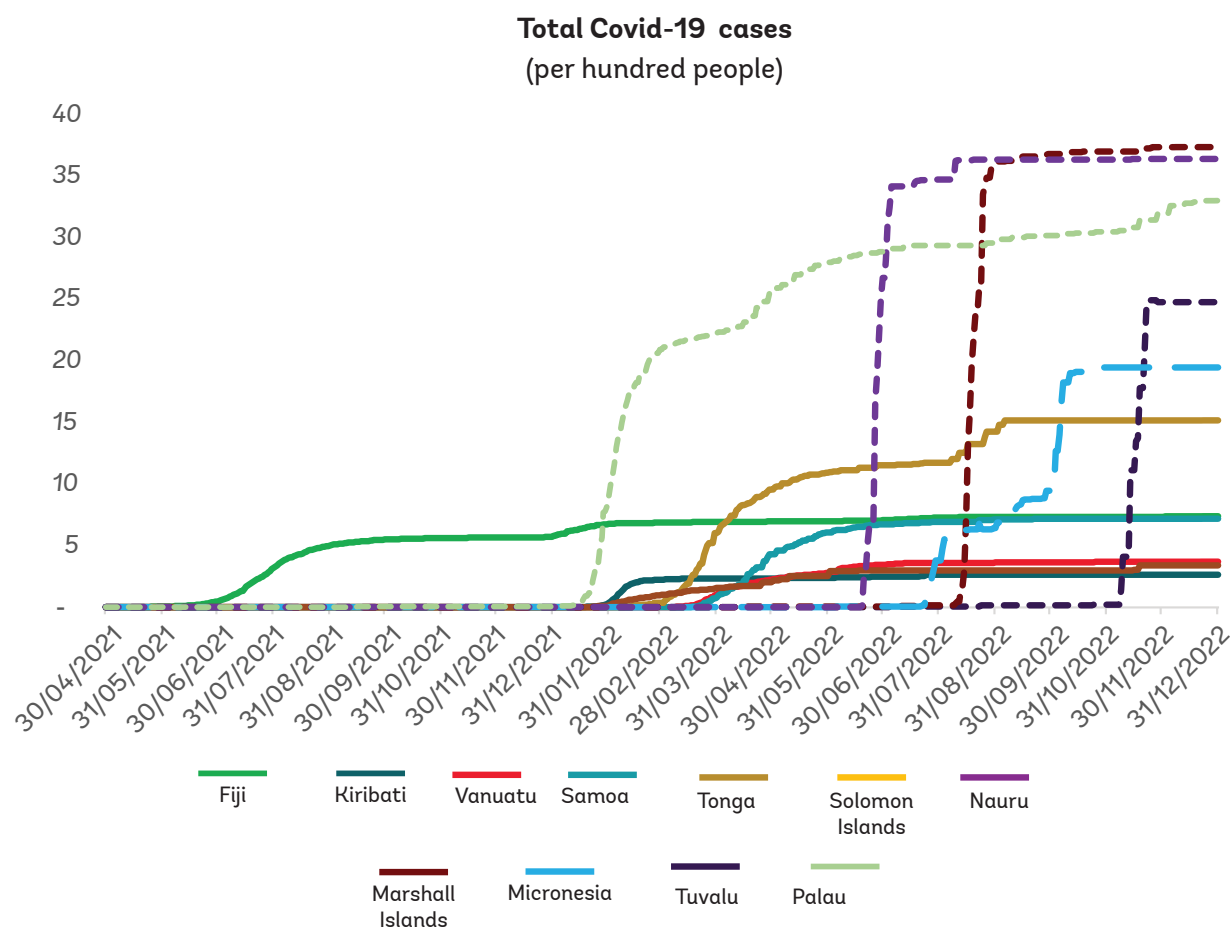


At the earlier stages of the pandemic, remoteness and fast closure of borders mostly spared the PICs from the raging outbreak that was commonplace in the rest of the world. The Delta variant outbreak occurred only in Fiji from June to September 2021, with corresponding stringent local mobility restrictions (Figure 5). The Omicron variant eventually reached the shores of most PICs early 2022, but high vaccination rates in most countries dampened the health impact. Local outbreaks took place in Fiji, Palau, Kiribati, Tonga, Vanuatu, Solomon Islands and Samoa in the first half of 2022. In the second half of 2022, FSM, RMI, Nauru and Tonga experienced more outbreaks. Late in 2022, the virus reached Tuvalu, one of the last places to be affected.

Figure 5. COVID-19 cases in PICs



Source: Our World in Data

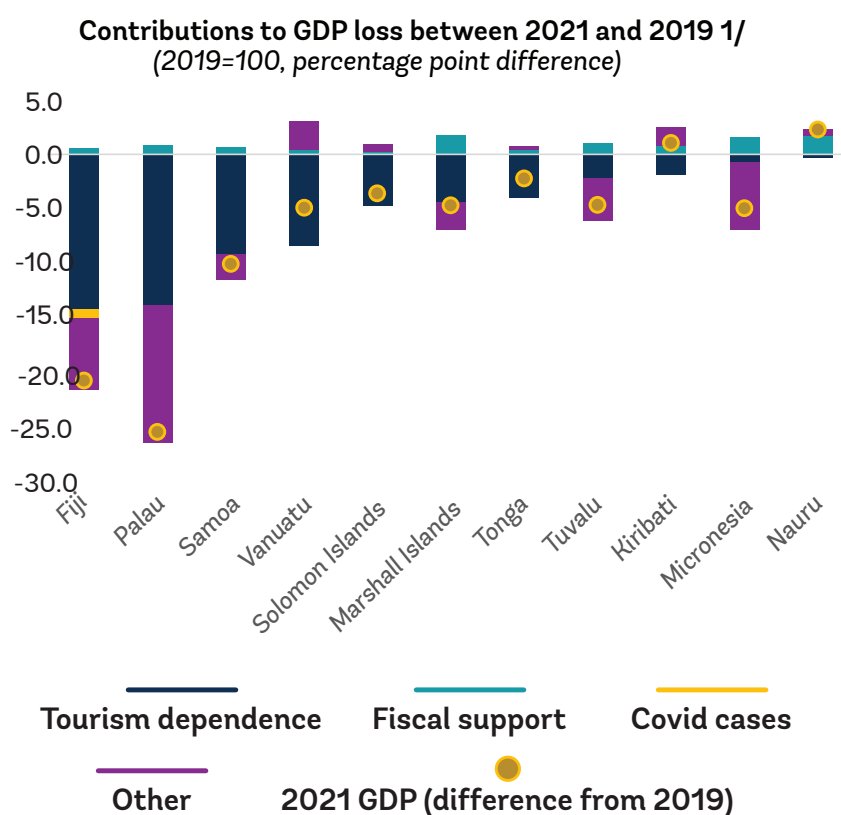
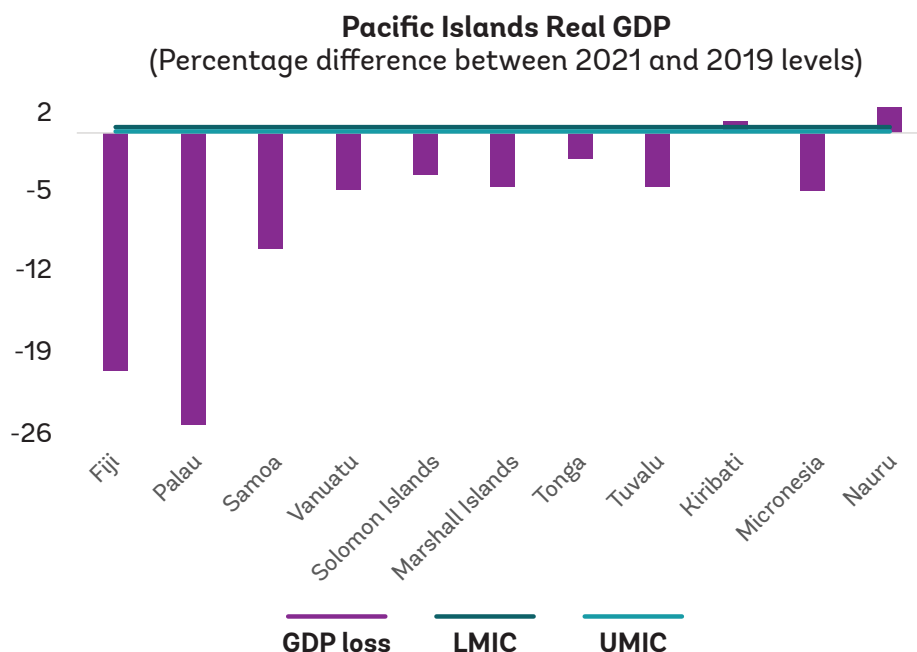


Source: Our World in Data

Pandemic-induced restrictions caused the largest output contractions during **2020-2021** particularly in PICs that **relied on tourism.**

Three factors largely determined the severity of GDP contractions: tourism-dependency, mobility restrictions and government fiscal support, which in most cases was financed by multilateral and bilateral grants. Border closures and mobility restrictions affected all economies at varying degrees throughout 2020-21, with the region experiencing the severest recession in the world. Countries reliant on tourism exports were hit hardest, with output losses of 25 and 20 percent in Palau and Fiji, respectively, relative to the pre-pandemic levels (Figure 6).² On the other hand, fishing dependent and other commodity exporters were more resilient. Kiribati, for instance, weathered the pandemic relatively unscathed. Fiscal support was also key in easing the impact of the pandemic, providing significant levels of cushion in RMI, FSM, Nauru and Tuvalu. The resilience of workers' remittances also played an important mitigating role in several countries (Fiji, Samoa, and Tonga). Despite disruptions to labor mobility schemes, the remittances held up during the pandemic as the Pacific Islanders' diaspora living abroad continued to provide support to families.

Figure 6. Real GDP in PICs, 2019-2021



Source: Country authorities; and World Bank staff estimates

1/ Contributions are estimated using average effects of each factor, derived from OLS regressions. Other factors are residuals. Covid cases are intended to capture the severity of restrictions, as data was not available for all PICs.

²Tourism exporter PICs are Fiji, Palau, Samoa and Vanuatu, countries with at least 20 percent of GDP related to tourism.

Just as the **EAP** region has been emerging from the pandemic,



the **PICs** now have had to deal with another shock stemming from the **Russian invasion of Ukraine**.

Rising food and energy prices, slowing global economic activity, and tightening global financial conditions are expected to affect all PICs to varying degrees. The key transmission channel will operate through trade, with a substantial impact on domestic inflation because most energy and food products are imported. Inflation will be further exacerbated by rising transportation costs for both goods and services. Slowing growth in major markets will also weaken economic rebound in some PICs, particularly in places that rely on tourism service exports (e.g., Fiji, Palau, Vanuatu, and Samoa). While PICs are largely immune to risks of capital flight, some are set to be impacted by tightening global financial conditions (e.g., Kiribati, Micronesia, Tuvalu, Nauru, Palau, Marshall Islands and Fiji). PICs predominantly rely on official financing flows and remittances to fill balance of payments gaps. Private portfolio capital flows are almost non-existent, and deep financial markets are largely absent, unlike larger emerging markets. As a result, PICs are less vulnerable to the risk of capital flight due to US dollar appreciation and tightening global financial conditions. Nevertheless, PICs with significant assets in Sovereign Wealth Funds (SWFs) (e.g., Kiribati, Micronesia, Tuvalu Palau, and Marshall Islands) or domestic debt (e.g., Fiji) could face reduced fiscal revenues from trust funds or increased borrowing costs as a result.³

Rising commodity prices and global inflation has resulted in



surging consumer prices in the Pacific.

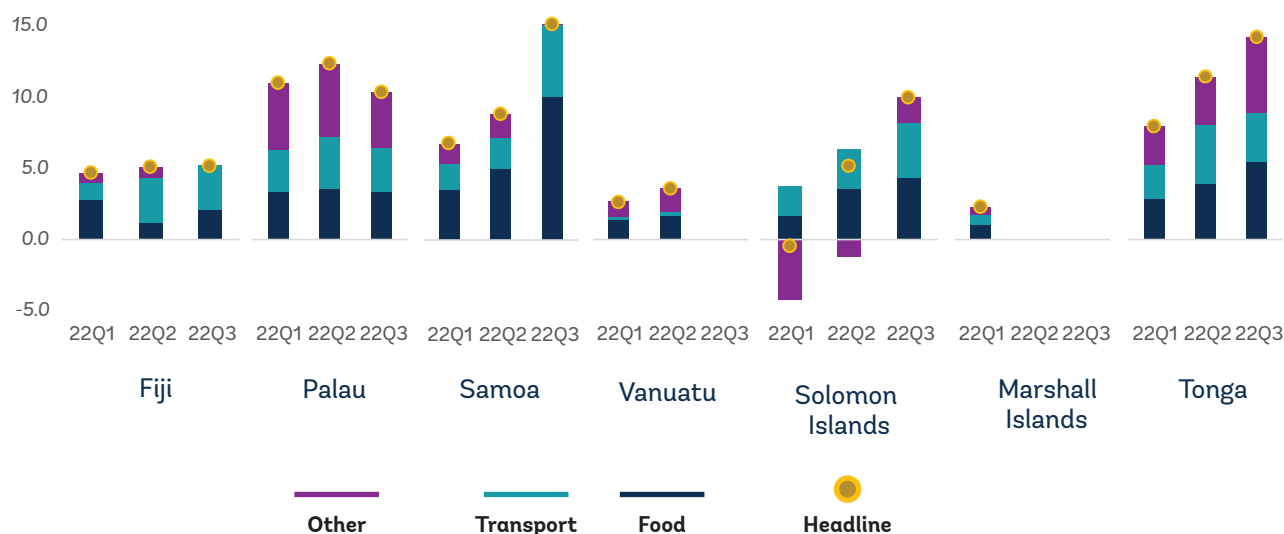


The latest data as of 2022Q3⁴ show that inflation has been accelerating in most of these countries (Figure 7), inching towards 15 percent in Samoa and Tonga. It crossed over 10 percent in Palau and Solomon Islands. Consumer prices have also been rising in Fiji, nearing 5 percent in September 2022. Key factors contributing to inflation have been food and transportation prices.

³Kiribati, Federated States of Micronesia, Tuvalu, Republic of Marshall Islands, and Palau have SWF assets over 100 percent of GDP.

⁴Seven out of the 11 PICs report inflation on regular basis, and often with considerable lags.

Figure 7. Consumer price inflation in select PICs (annual percentage change)

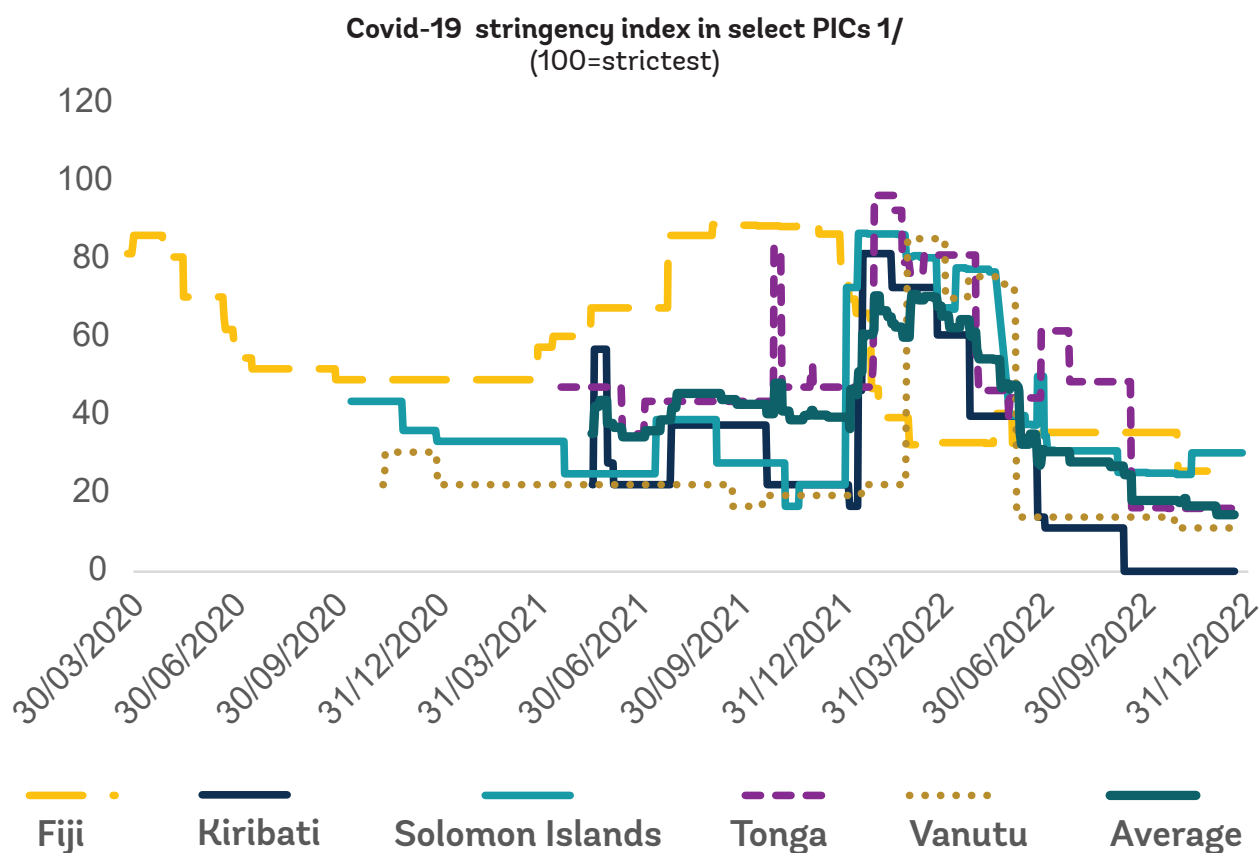


Source: Country authorities, World Bank staff estimates

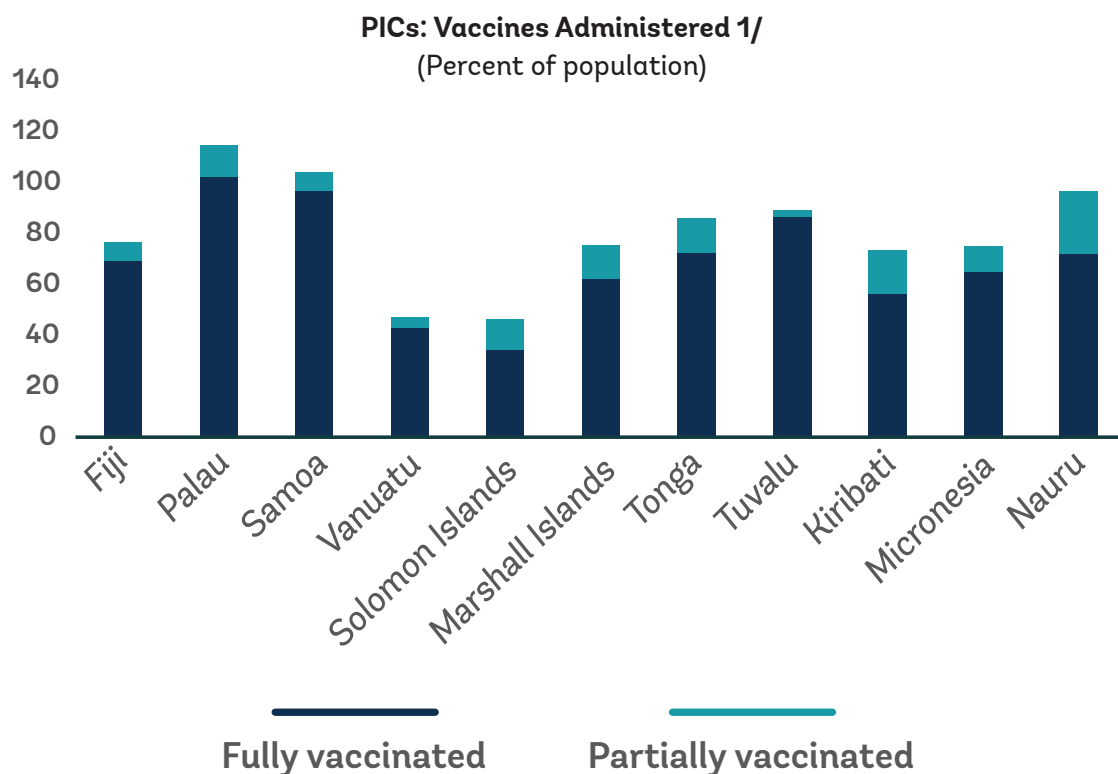


After major outbreaks in 2022, new COVID-19 infections have declined in most of the PICs as of January 2023. Vaccination rates have also increased across the region, with most countries reaching 80 percent vaccine coverage for eligible population. This has allowed most PICs to ease pandemic-related restrictions and open borders during 2022 (Figure 8). As a result, travel and tourism have begun to pick up, and major infrastructure projects resumed. These developments are positively contributing to economic recovery in 2022 and beyond. However, the pace of reopening has been uneven, and normalization of flight connections has been slow, delaying the recovery in tourist arrivals in some countries (Figure 9).

Figure 8. PICs: Covid-19 restrictions and vaccinations



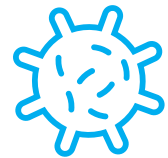
Source: Our World in Data. 1/ Data was not available for other PICs



Source: Our World in Data; ADB Pacific Economic Monitor. 1/ As of end-December, 2022.

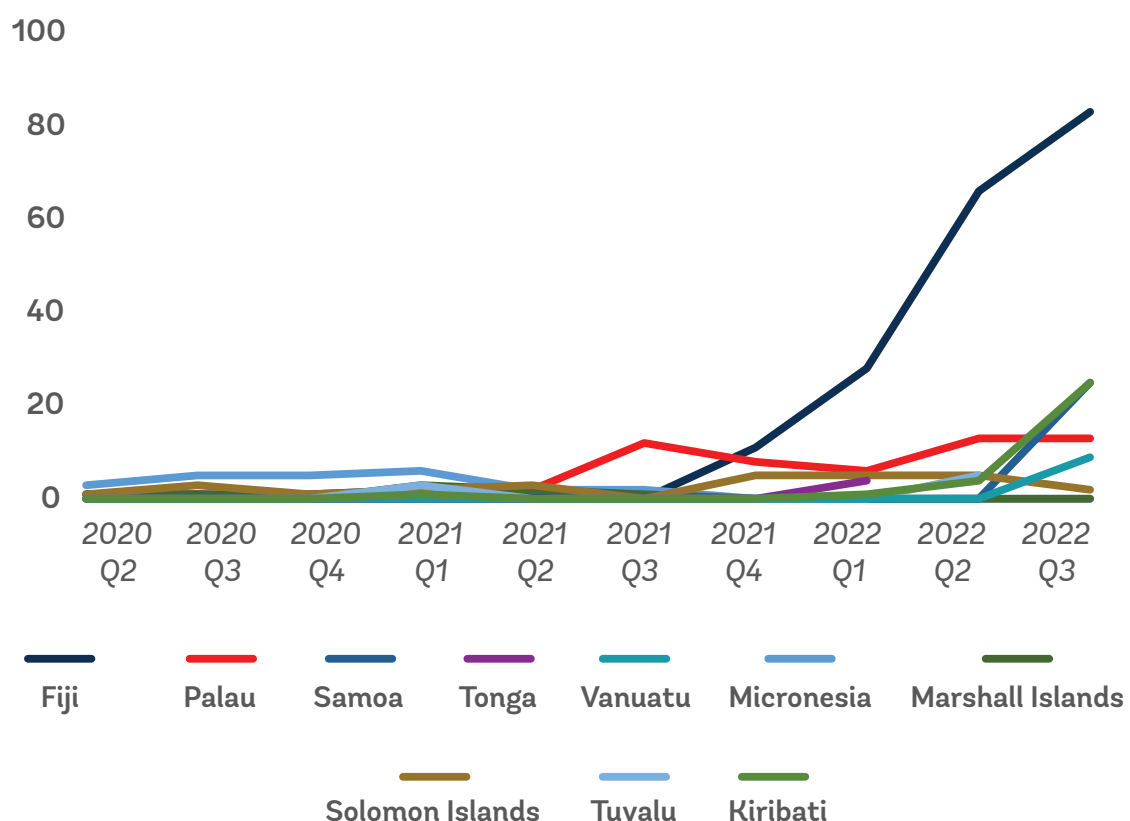


due to uneven border **re-opening, travel normalization, natural disasters, Omicron outbreaks** and **country circumstances**.



Tourism-dependent Fiji is estimated to have rebounded strongly in 2022, with a growth rate of 15 percent, while Palau is estimated to have experienced a third consecutive contraction of 2.5 percent, due to the slow rebound in tourism. Large output gaps still remain in these countries relative to pre-pandemic (Table 1). Given the reliance on tourism, Samoa's economy is estimated to have contracted by another 6 percent, as the border remained closed most of 2022 with an Omicron outbreak occurring in 2022Q2. Solomon Islands registered a third straight fall in GDP in 2022, due to the lingering effects of the November 2021 civil unrest and the COVID-19 community outbreak. The virus is estimated to have held back growth in FSM and Tonga, as well, with Tonga also experiencing the compounding detrimental impacts of a tsunami, which is estimated to have caused damages equivalent to 19 percent of GDP. Moderate economic growth is estimated to have ensued in the remaining PICs throughout 2022, as normalization in travel is contributing to trade and labor flows much needed for large investment projects.

Figure 9. Tourist arrivals in PICs (Share relative to the same quarter of 2019)



Source: IMF Tourism Tracker

Table 1. PICs real GDP growth rates (2019-2022) 1/

	2019	2020	2021	2022 (Est.)
Fiji	-0.6	-17.0	-5.1	15.1
Palau	-1.9	-8.9	-13.4	-2.8
Samoa	4.5	-3.1	-7.1	-6.0
Vanuatu	3.2	-5.4	0.5	2.2
Solomon Islands	1.8	-3.4	-0.2	-4.5
Republic of Marshall Islands	6.6	-2.2	-2.5	1.5
Tonga	0.7	0.5	-2.7	-1.6
Tuvalu	13.8	-4.9	0.3	3.0
Kiribati	-0.5	-0.5	1.5	1.5
Federated States of Micronesia	1.2	-1.8	-3.2	-0.6
Nauru	1.0	0.7	1.5	0.9

Source: Country authorities; IMF and World Bank staff estimates.

1/ Fiscal year ends June 30 for Nauru, Tonga, and Samoa. 31 July for Fiji. 30 September for RMI, FSM and Palau.

All others are based on calendar years.

1.4 Macroeconomic policy response



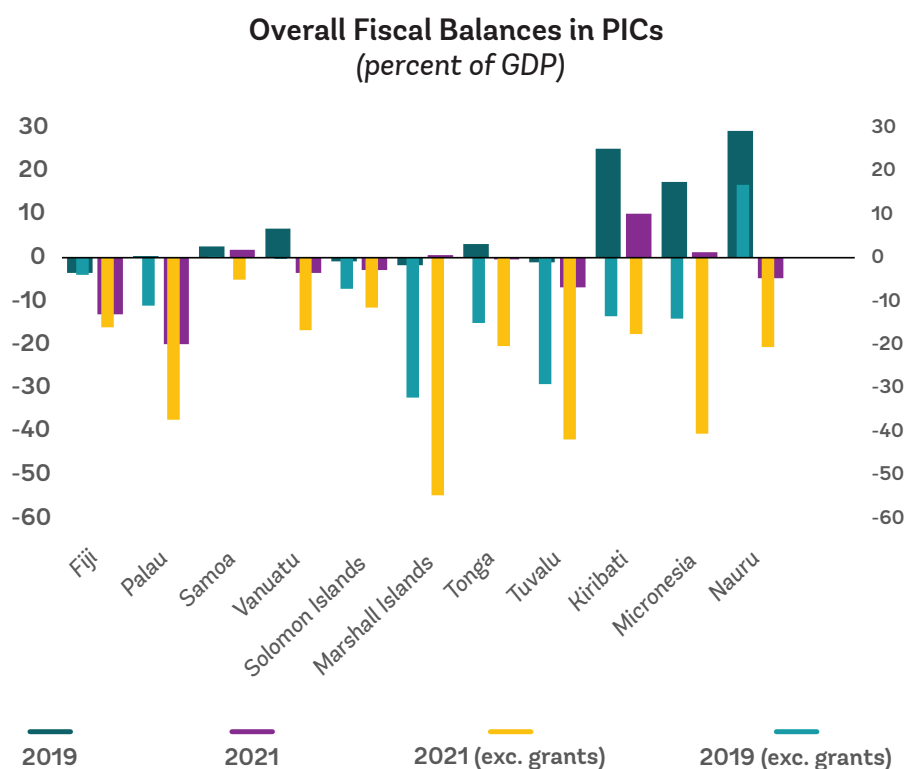
During the pandemic,
fiscal policy was geared
toward protecting lives and livelihoods,



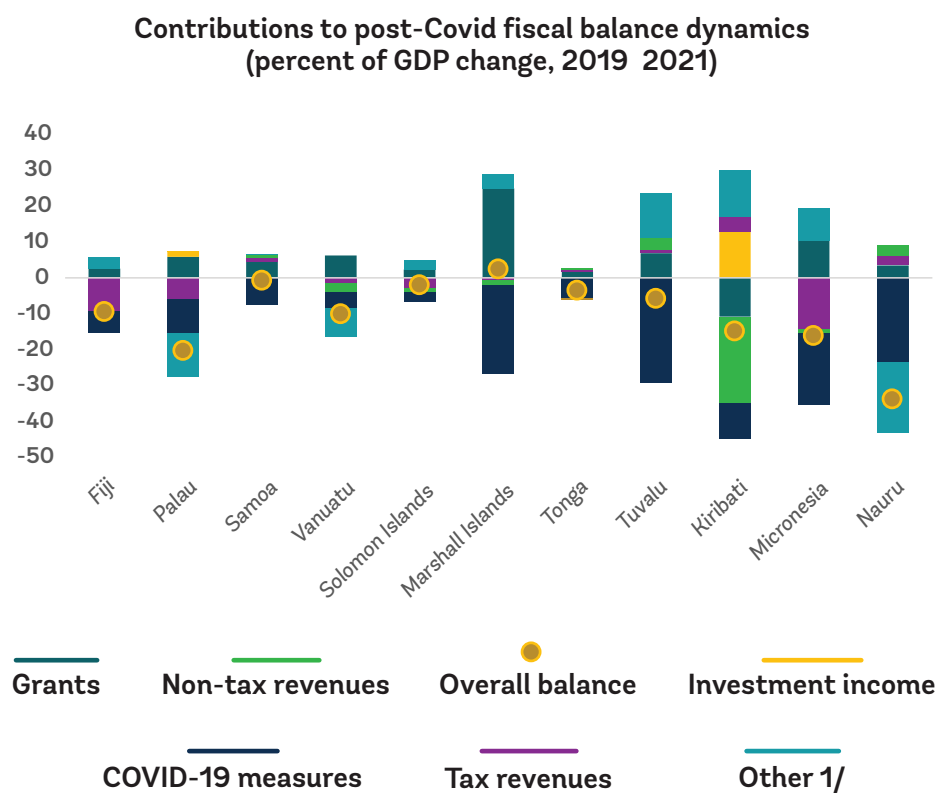
helped by official
support from
development partners.

The unprecedented nature of the pandemic called for unprecedented public policy support in PICs. On average, the PICs spent about 13 percent of GDP between January 2020 and September 2021 on COVID-19 response measures (Figure 10). Average fiscal assistance on health care sector was around 5 percent of GDP, while non-health support to households and businesses averaged around 8 percent of GDP. The size of the fiscal responses also varied across countries, with the largest measures (from 10 to 30 percent of GDP) stemming from the smallest PICs and nations that benefited from elevated fishing revenues prior to the pandemic (Tuvalu, Nauru, RMI, FSM, and Kiribati). In fact, the relative stability in fishing revenues also eased the impact of the pandemic in these countries. Pandemic-support measures, loss of revenues and GDP contractions caused large underlying fiscal deficits (overall balance excluding grants), which exceeded 20 percent of GDP in Tuvalu, RMI, Nauru, FSM and Palau. In these countries, official assistance was key to help finance large support measures and underlying fiscal deficits, significantly easing the overall deficits. However, grants declined in Kiribati as some donor-financed capital projects were delayed and others were completed. The magnitude of GDP contractions nevertheless delivered large overall deficits in Palau and Fiji, which reached 20 and 13 percent of GDP in 2021, respectively.

Figure 10. Fiscal balances in PICs



Source: IMF; World Bank staff estimates.



Source: IMF; country authorities; and World Bank staff estimates 1/ Other factors include, other spending as well as GDP denominator effect

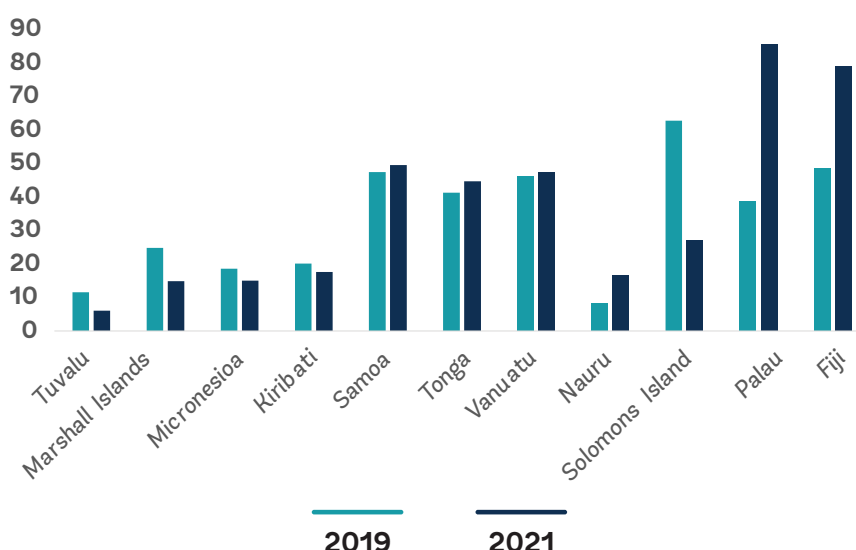


Public debt levels broadly remained stable,

except in tourism dependent countries (Fiji and Palau), Solomon Islands and Nauru.

Public debt dynamics during the pandemic was influenced by the extent of economic recession and the sources of fiscal financing. Countries that saw smaller contractions or received significant grants managed to marginally reduce public debt to GDP ratios between 2019 and 2021, which included Tuvalu, RMI, FSM, Kiribati (Figure 11). Debt to GDP was almost unchanged in Samoa, Tonga and Vanuatu, while it doubled in Solomon Islands reaching almost 16 percent of GDP. At the other extreme, Palau and Fiji accumulated significant debt during the pandemic, driven by large recessions and underlying deficits. Nauru's debt significantly declined as the country reached a settlement on a long-standing external debt of a publicly-owned company.

Figure 11. Public and publicly guaranteed debt (percent of GDP)



Source: IMF; and World Bank staff estimates.



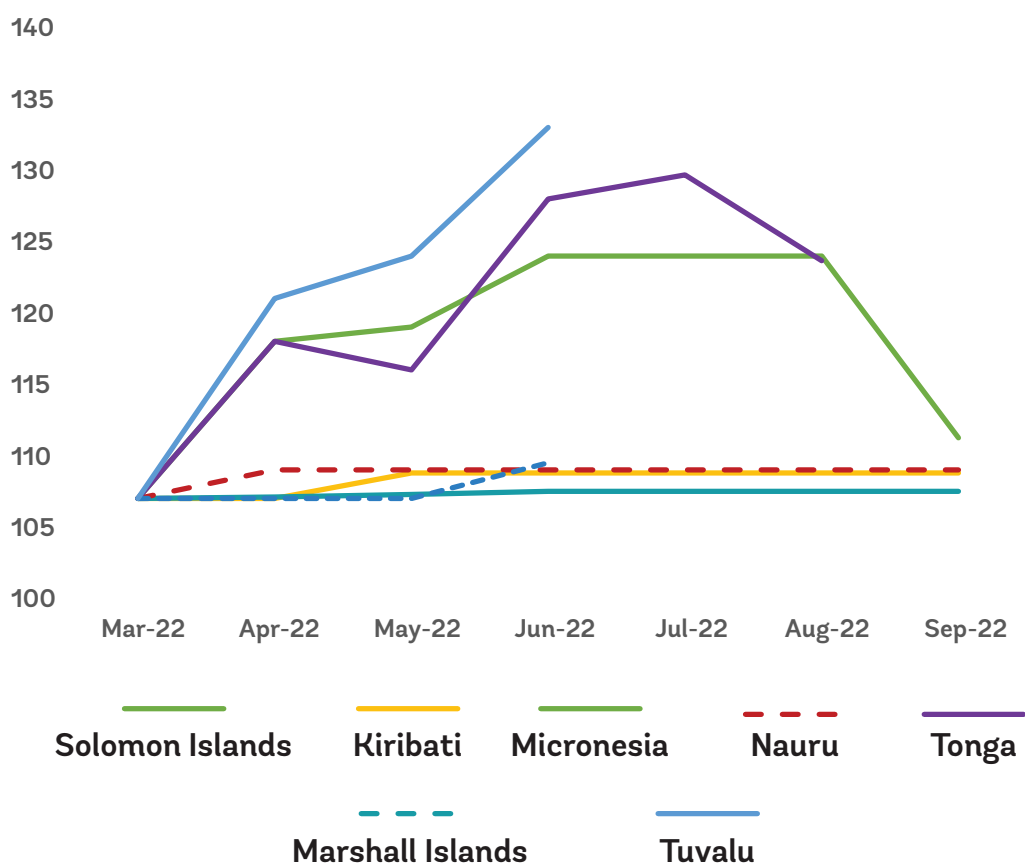
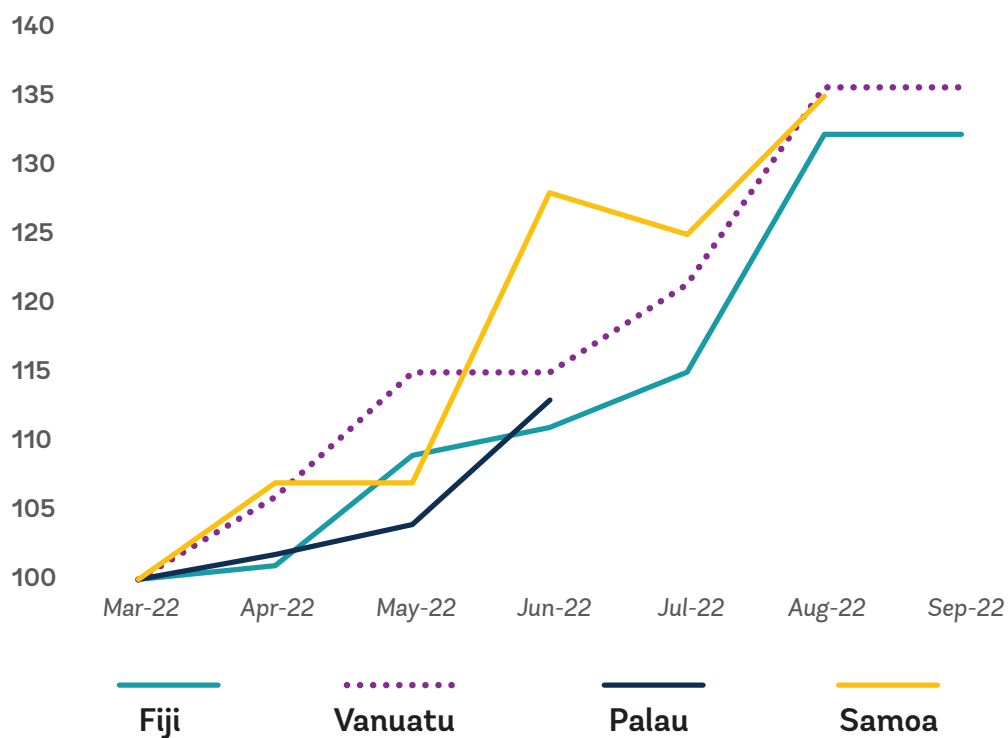
In response to surging inflation during 2022,

PICs have also taken steps to smooth the impact of rising energy and food prices.



Fuel prices have been rising in most of the PICs (Figure 13). As of September 2022, fuel prices have remained relatively stable only in four countries: Nauru, Kiribati, FSM and RMI. Fiscal support to ease the impact of surging energy and prices included both revenue and spending measures. Fiji and Solomon Islands have granted tax exemptions and import duty waivers on select staple foods and energy products. Spending measures included energy subsidies to cover the losses in public utility companies (Nauru, Solomon Islands, Tonga and Kiribati), subsidies on public transportation (Fiji) and near universal cash payouts (Tuvalu), as well as adjustments to public sector wages to cope with higher costs of living (Nauru, Tuvalu).

Figure 12. Fuel prices in PICs (March 2022=100)



Source: ADB; FAO; and World Bank staff estimates.

2. Outlook and Risks

The **global high inflation** and **modest growth**

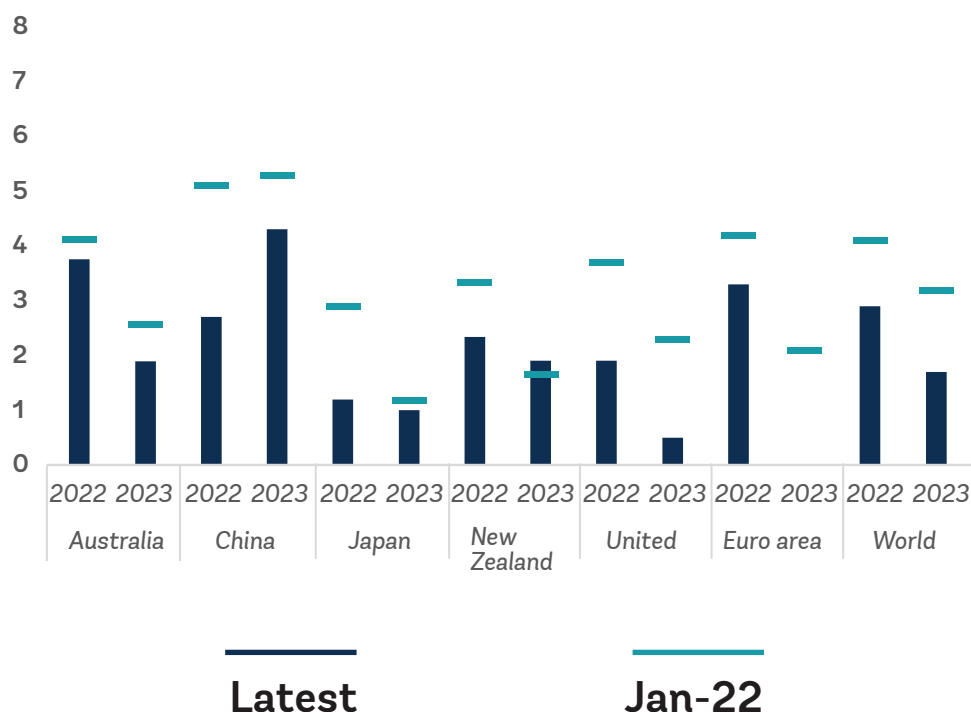


are projected to **dent PICs'**

growth prospects in 2023.

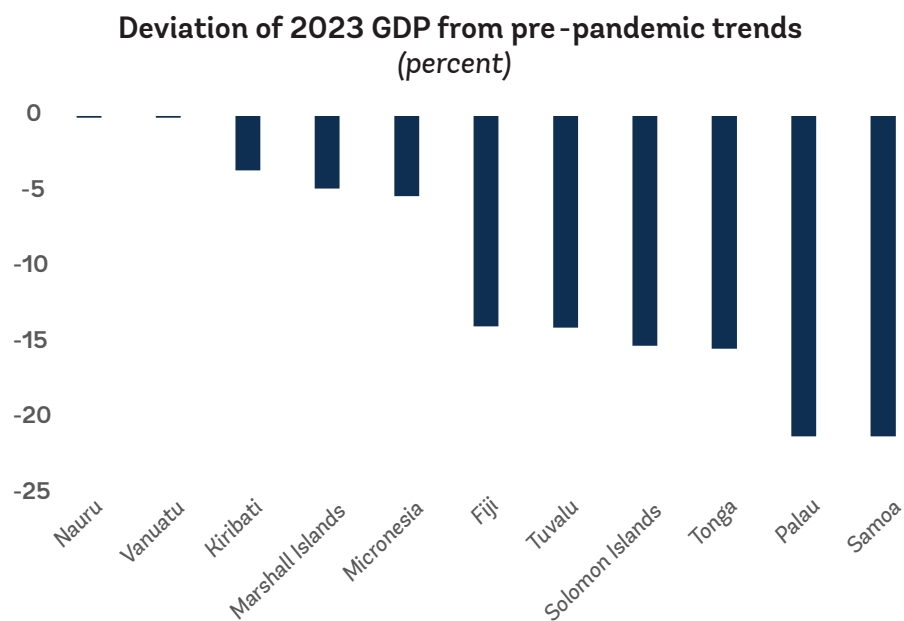
Global growth forecasts have been slashed amidst rising costs of borrowing and living. The slowdown is broad based and affecting all major economies of the world – the US, Euro area and China – which have experienced deceleration in economic activity since the war on Ukraine (IMF, 2022b; World Bank, 2023b). Economic growth in the US is expected to be a meagre 0.5 percent in 2023. Along with the US, major regional trading partners of PICs are also projected to grow at slower paces during 2022-23 (Figure 13). Growth in Australia is expected to decline to 1.9 percent in 2023. Softening aggregate demand in major trading partners does not bode well for PICs, especially for tourism exporters. For commodity exporting PICs (e.g., fish, minerals), the economic prospects will depend on the interplay between export and import prices. As in major economies, the PICs' growth forecasts were knocked down, particularly in the short-term due to the Omicron outbreaks and the spillovers from the war on Ukraine.

Figure 13. Global growth (annual percentage change)

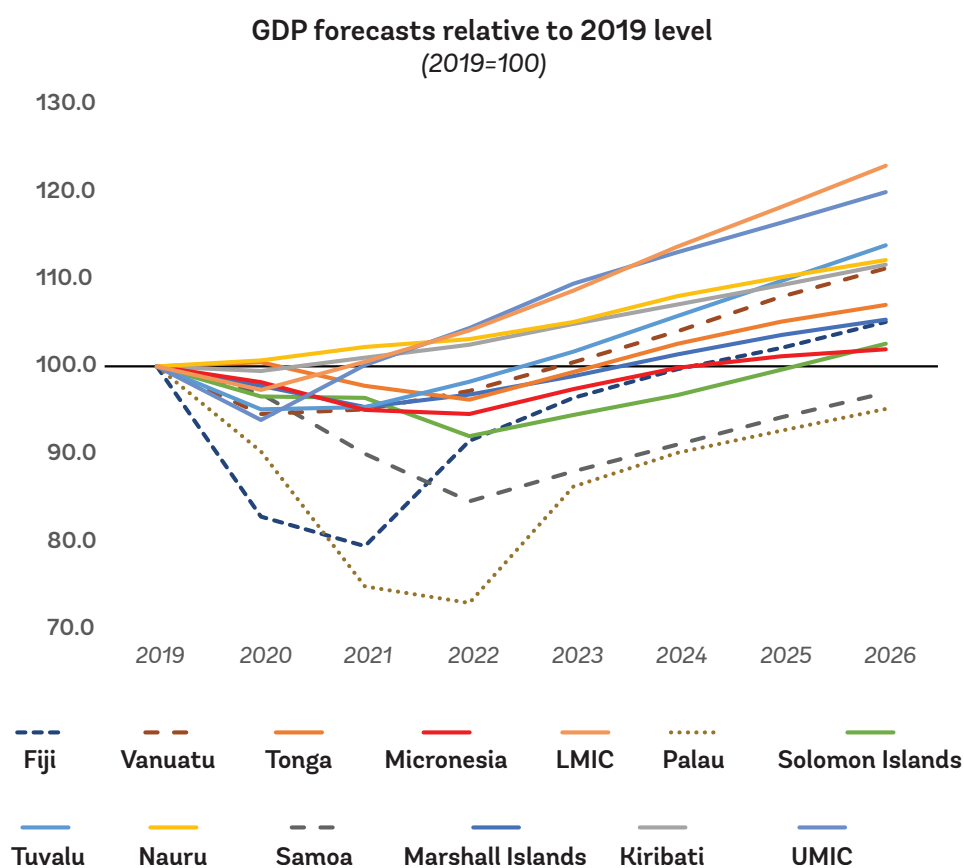


Source: World Bank Global Economic Prospects; IMF WEO.

Figure 14. Pacific Islands GDP



Source: World Bank staff estimates

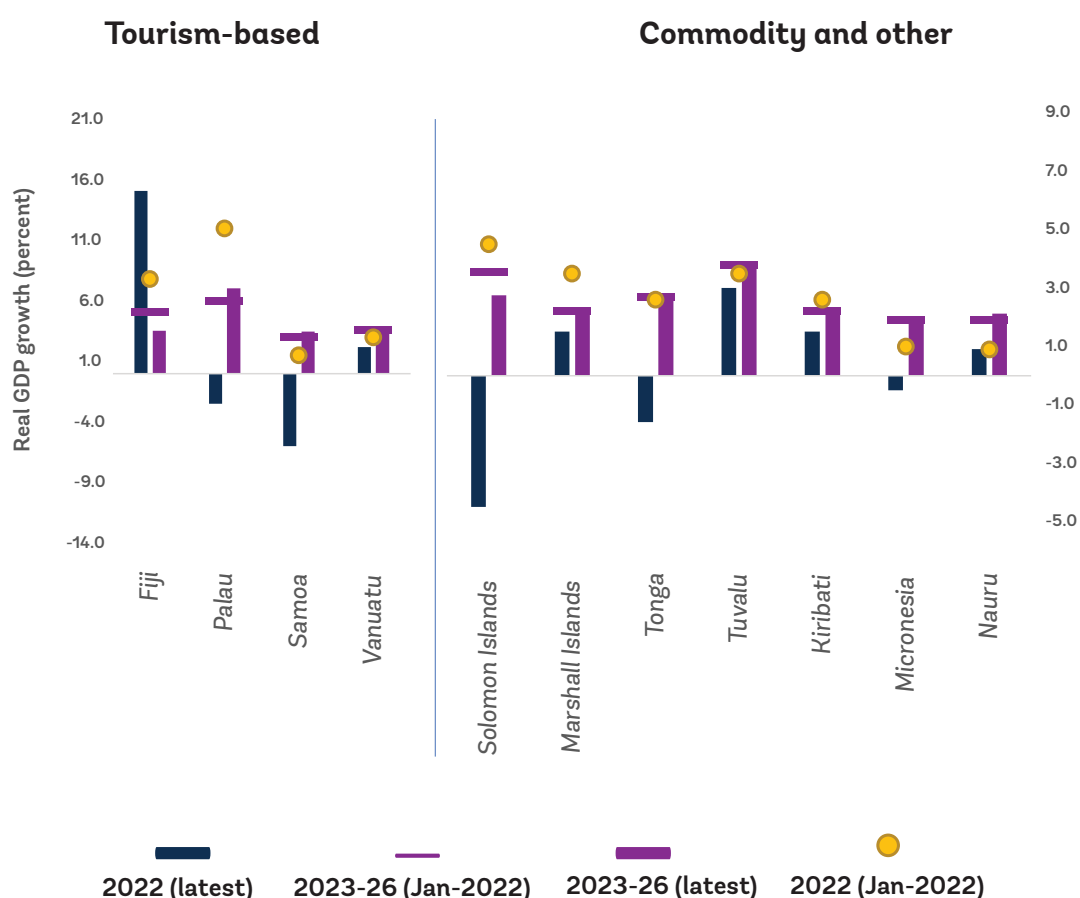


Source: Country authorities; and World Bank staff estimates



The 2023 outlook for the region is shaped by the continued recovery from the pandemic and reopening of borders and international travel. Tourism dependent economies of Palau and Fiji are expected to continue their recoveries in 2023, albeit at a faster pace in Palau, primarily driven by services-related sectors such as accommodation and transport (Table 2). The worse than expected growth performance during 2022 will have a knock-on effect on delaying the closing of output gaps for most countries of the region (Figure 14). All PICs would have reached the 2019 output levels by 2025 except for Samoa and Palau. In Samoa, the rebound is expected to be much slower due to a sluggish tourism recovery and slow reopening compared to Fiji, while in Palau, three consecutive years of recession has reduced the capacity to quickly recover to 2019 GDP levels. Overall, PICs have seen substantial downward revisions to growth (Figure 15a).

Figure 15a. PICs GDP growth forecast revisions



Source: World Bank staff estimates.

Figure 15b. PICs inflation forecast revisions

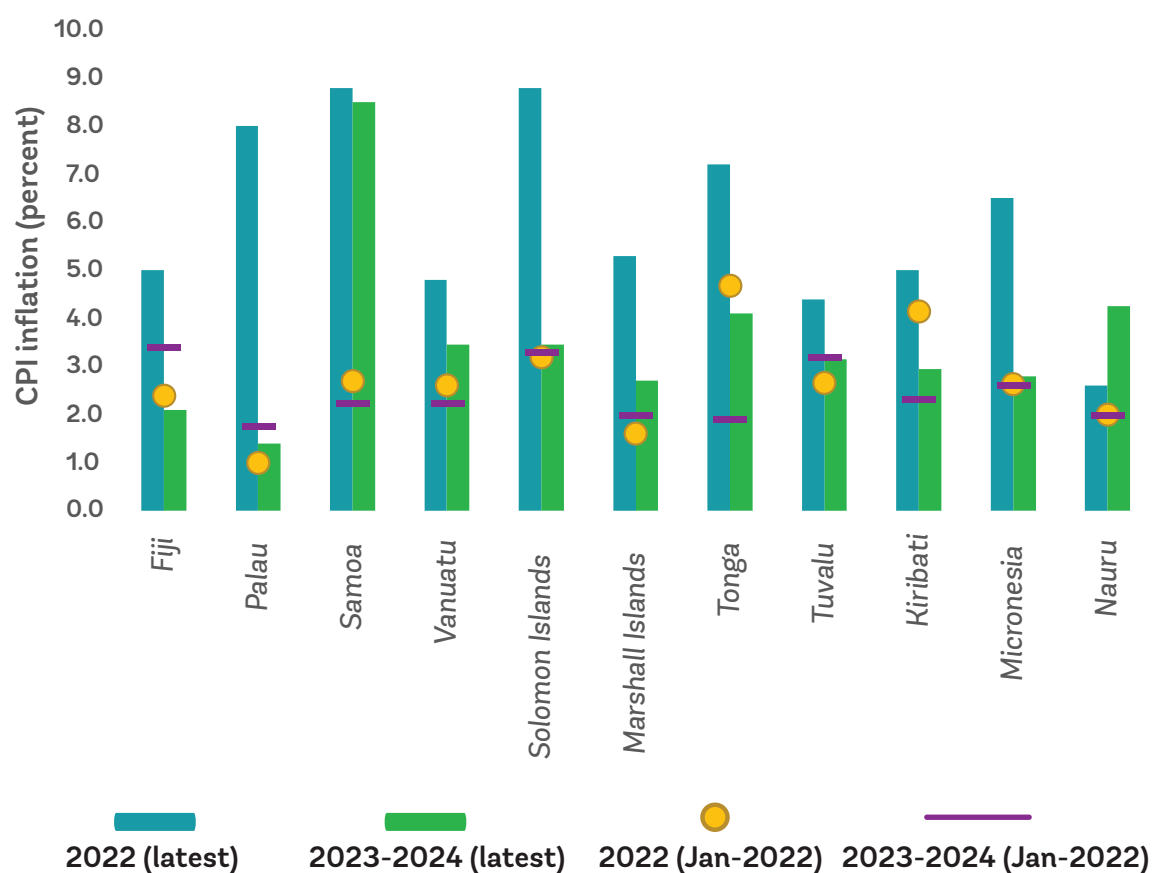


Table 2. PICs GDP growth projections 1/

	2022 (Est.)	2023	2024	2025	2026
Fiji	15.1	5.4	3.4	2.4	2.9
Palau	-2.8	12.3	9.1	4.7	2.7
Samoa	-6.0	4.0	3.5	3.4	3.0
Vanuatu	2.2	3.4	3.5	3.8	3.0
Solomon Islands	-4.5	2.6	2.4	3.0	3.0
Republic of Marshall Islands	1.5	1.9	2.1	2.3	1.7
Tonga	-1.6	3.3	3.2	2.5	1.8
Tuvalu	3.0	3.5	4.0	3.8	3.7
Kiribati	1.5	2.3	2.1	2.1	2.1
Federated States of Micronesia	-0.6	2.9	2.8	1.3	0.8
Nauru	0.9	1.9	2.8	2.0	1.8

Source: Country authorities; IMF and World Bank staff estimates.

1/ Fiscal year ends June 30 for Nauru, Tonga, and Samoa. 31 July for Fiji. 30 September for RMI, FSM and Palau. All others are based on calendar years.

Inflation is estimated
to moderate in

2023, 

owing to easing
global food



and
energy price
inflation.

Like growth, short-term inflation projections have also been revised substantially compared to the pre-invasion of Ukraine forecasts ([Figure 15b](#)). High imported energy and food prices will translate into elevated consumer prices in most PICs. Inflation rates are expected to ease during 2023, from the highs of 2022, helped by declining outlook for international commodity prices as well as decreasing costs of international shipping. The highest inflation rates during 2023 inflation are predicted in Samoa (12 percent), Tonga (8.9 percent) and Palau (8.1), while the lowest rates are forecasted in Fiji and RMI, at around 2-3 percent.

Table 3. PICs consumer price inflation projections 1/

	2019	2020	2021	2022 (Est.)	2023	2024
Fiji	-0.9	-2.8	3.0	5.0	2.0	2.2
Palau	0.6	0.7	0.5	12.3	8.1	4.2
Samoa	2.2	1.5	-3.0	8.8	12.0	5.0
Vanuatu	2.7	5.3	3.0	4.8	3.9	3.0
Solomon Islands	1.6	3.0	-0.1	8.8	3.4	3.5
Republic of Marshall Islands	-0.5	-0.2	3.5	5.3	3.0	2.4
Tonga	3.5	0.4	1.4	8.5	8.9	4.2
Tuvalu	3.5	1.6	6.7	4.4	3.1	3.2
Kiribati	-1.8	2.5	3.0	5.3	8.6	4.6
Federated States of Micronesia	2.2	0.9	2.1	6.5	3.5	2.1
Nauru	4.3	1.0	2.0	2.6	4.2	4.5

Source: Country authorities; IMF and World Bank staff estimates.

1/ Fiscal year ends June 30 for Nauru, Tonga, and Samoa. 31 July for Fiji. 30 September for RMI, FSM and Palau. All others are based on calendar years.



The projected forecasts

on **inflation and growth** are subject to significant downside risks and some upside risks.



Downside risks relate to global commodity prices, growth, and natural disasters. International food and energy prices could rise further or stay elevated for longer-than-expected due to ongoing or deepening war on Ukraine. In this scenario, 2023 inflation in the region could turn out higher than envisaged and further erode disposable incomes and weaken private consumption. If advanced country growth is slower than anticipated, or risk falling into a recession (World Bank, 2023b), projected recoveries in tourism flows may fail to materialize and weaken prospects in tourism dependent economies. There is also the risk of pre-COVID airline routes failing to fully recover, due to long-term scarring of the industry. This will increase the cost of travel the region. Finally, the region's vulnerability to natural disasters and climate change remains a major underlying adverse risk. An important upside risk includes a stronger than expected recovery in China, due to the rapid relaxation of zero-COVID policy, which could increase outbound tourism to Pacific Islands. Another upside risk is lower than expected outlook on global commodity price inflation, although the positive impact on PICs might take longer due to sticky prices.



Materialization of **downside risks** would exacerbate the region's precarious fiscal situation and deepen financing gaps,

while **upside risks** would provide only **modest relief** from medium-term fiscal challenges.



Should downside risks materialize, fiscal revenues would fall, while spending pressures would increase leading to potentially wider fiscal deficits, and debt sustainability challenges. Given that most PICs are at a high risk of debt distress or face elevated debt burdens, there is limited ability for PICs to increase fiscal deficits. Fiscal consolidation and enhancing spending efficiency are needed and should be carefully managed to mitigate adverse consequences on growth while targeting social assistance toward the most vulnerable. As highlighted in our focus section, materialization of upside risks would provide some fiscal relief. Nonetheless, PICs will still require longer-term measures to broaden the revenue base, enhance public spending efficiency, and build fiscal buffers to finance critical development needs that include the foundations for inclusive and stable growth as well as climate adaptation.

A decorative lei graphic composed of various tropical motifs including hibiscus flowers, geometric patterns, and leaf-like shapes in shades of blue, teal, and yellow. It is positioned in the upper right corner of the page, partially overlapping the background image and the title area.

PART B SPECIAL FOCUS:

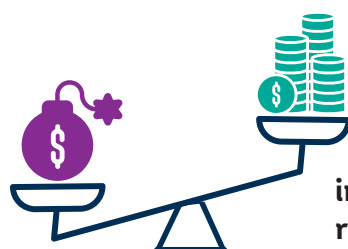
Structural debt vulnerabilities loom large

Despite having relatively low public debt-to-GDP ratios in most countries, the risk of debt distress is high in PICs due to low debt-carrying capacity. The low debt-carrying capacity is driven by structural characteristics of PICs that influence their institutional strength, potential economic growth, and reserve buffers to absorb shocks. The COVID-19 pandemic further exposed these structural vulnerabilities as sharp GDP contractions created large fiscal pressures in many small PICs that rely on imports, tourism, and travel. Absent external grants and concessional financing from development partners, public debt levels would have risen much more. Ongoing high import prices are contributing to fiscal pressures in PICs. Under these circumstances, fiscal prudence and improved spending efficiency are critical to keep fiscal deficits in check and manage financing needs. Over the medium-term, PICs should look toward broadening the revenue base, enhancing public spending efficiency, and generating fiscal savings to finance critical development needs, including the foundations for stable and inclusive growth as well as climate adaptation. Development partners would need to continue to play a key role in providing technical assistance, grants, and concessional financing to support these efforts.

3. Public debt sustainability in PICs

3.1 Underlying debt vulnerabilities

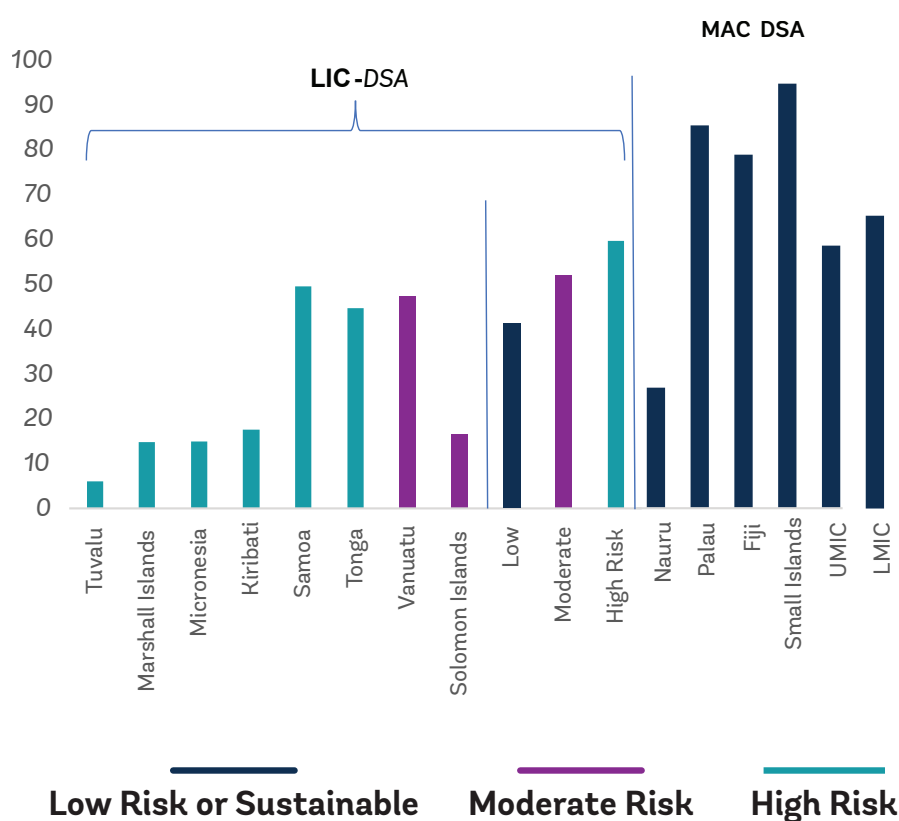
Debt-to-GDP ratios



in most PICs are relatively low.

At of end-2021, public debt to GDP ratios were less than 25 percent in five PICs, namely, Tuvalu, RMI, FSM, Kiribati and Solomon Islands (Figure 16). Another four PICs had debt levels lower than 50 percent of GDP. Only in Palau and Fiji debt was higher than 70 percent of GDP. Compared to other upper-middle income (UMIC) and lower-middle income (LMIC) countries, debt levels for several PICs were at the lower end of the spectrum.

Figure 16. Public debt in PICs (2021, percent of GDP)



Source: IMF; and World Bank staff estimates



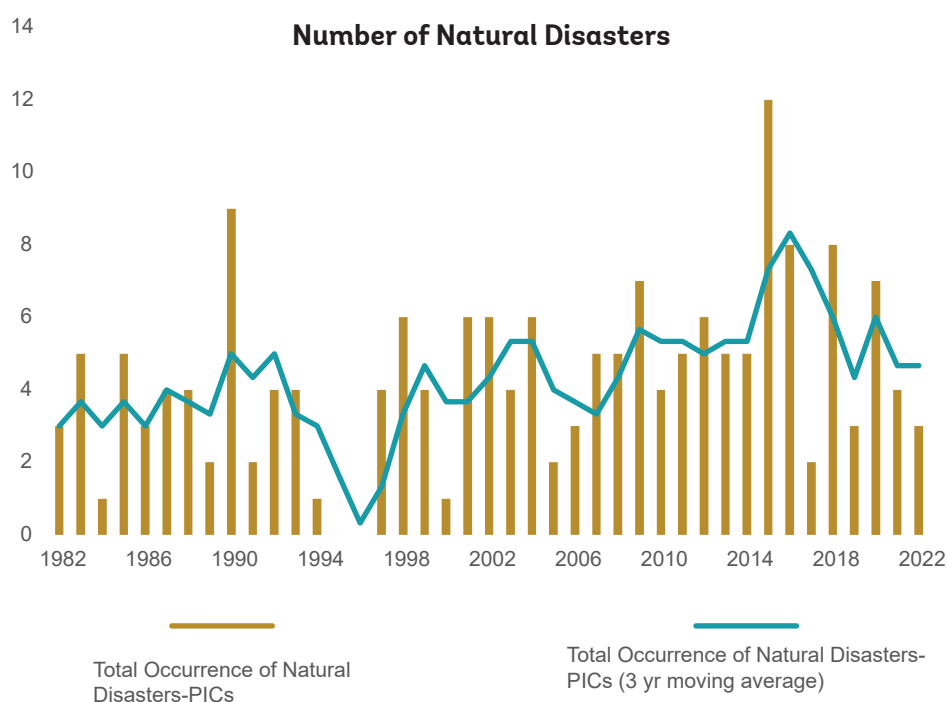
However, **smallness, remoteness and susceptibility to external shocks and natural disasters affect potential growth,**



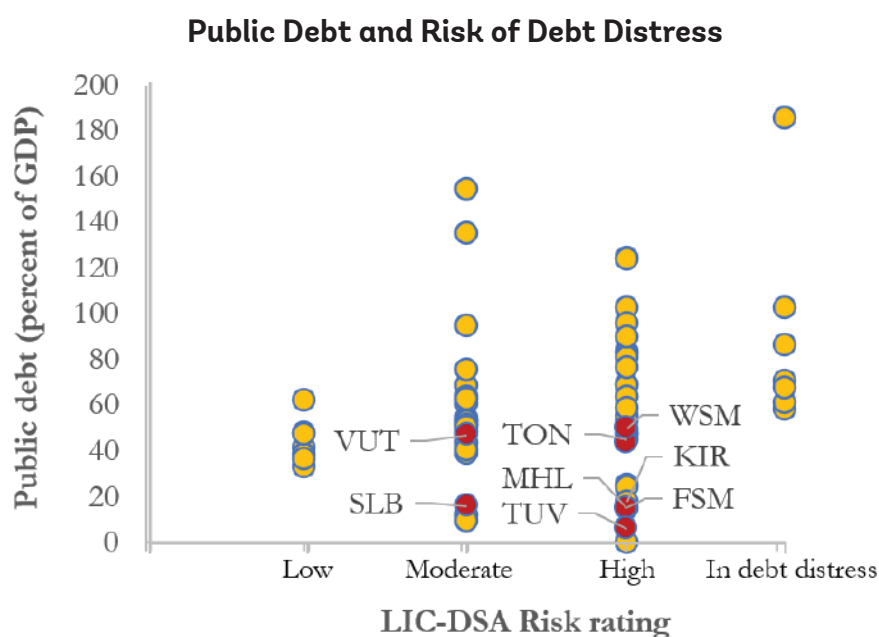
reserve buffers and **institutional strength, constraining debt-carrying capacity** in PICs.

Several structural characteristics affect debt-carrying capacity in PICs. Compared to average UMIC and LMIC, PICs have much smaller populations and economies based on a few economic sectors, in addition to remoteness to large markets (World Bank. 2023c). These two imply a low potential for economic diversification and stable high growth. As a result, the ability to generate large and stable fiscal and export revenues to service debt is limited. These characteristics also reduce opportunities for private sector growth and tend to increase the relative size of the public sector (World Bank, 2023c). Given high trade dependence, PICs are vulnerable to external global shocks as seen most recently with the impact of the COVID-19 pandemic and the spillovers from the invasion of Ukraine on commodity prices, particularly food and fuel. Moreover, PICs are prone to natural disasters such as drought, flooding, cyclones, and volcanoes (Figure 17, top panel). Climate change has also increased the frequency and severity of natural disasters, in addition to heightening the risk of inundation in some of the Pacific Islands. Contingent liabilities arising from State-owned Enterprises (SOEs) are an additional source of risk. The combination of all these risks, including the modest institutional capacity in the Pacific to manage them, implies that debt carrying capacity is classified as either weak or medium in most Pacific Low-Income Country Debt Sustainability Analysis (LIC-DSA) countries, which results in lower calculated “debt thresholds” on the present value of public debt used in World Bank-IMF DSA methodology (Box 1). When incorporating projected increases in the present value of current and projected debt, most PICs fall above country-specific thresholds that classify them as either moderate or high risk of debt-distress (Figure 17, bottom panel; IMF, 2017).

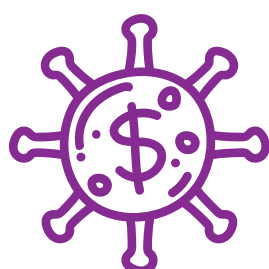
Figure 17. PICs: Public Debt and Natural Disasters



Source: CRED/UCLouvain, The International Disasters Database.



Source: Joint World Bank-IMF Debt Sustainability Analysis data as of October 2022



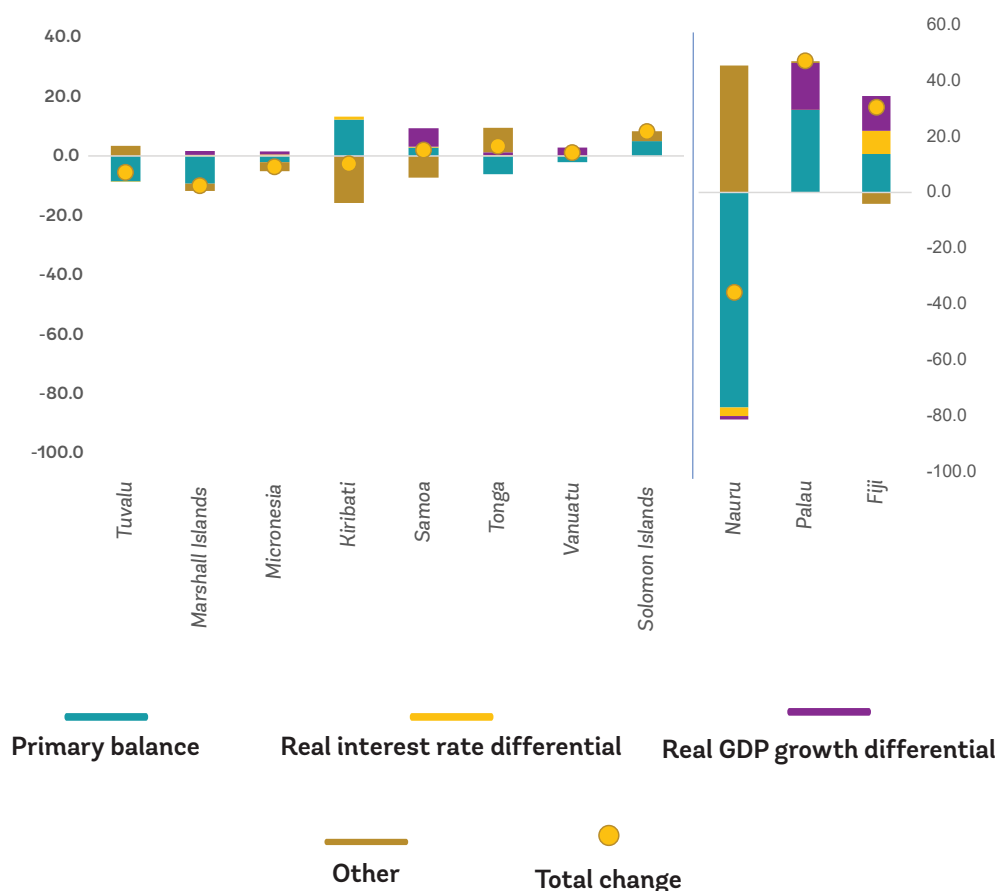
The **pandemic** clearly exposed these risks,

increasing primary deficits (excluding grants) and financing needs in PICs.

Primary deficits and economic contractions were the major factors increasing financing needs, particularly for countries highly dependent on tourism such as Fiji and Palau (Figure 18). Despite having substantial tourism sectors, financing needs rose more modestly in Samoa and Vanuatu, helped by greater revenues and under execution of capital expenditures. Debt grew much faster in Fiji and Palau compared to Samoa and Vanuatu given Fiji and Palau's higher deficits, which were mostly financed by concessional debt. Samoa used cash reserves to fill its financing gap, while Vanuatu had a milder recession and was able to increase fiscal revenues during 2020-2021 through receipts from its Economic Citizenship Program. Several countries were able to even reduce financing needs and debt to GDP ratios, helped by strong revenues and milder recessions, notably in fishing dependent economies including Tuvalu, RMI, FSM, and Kiribati, while Nauru was aided by the Regional Processing Centre supported by Australia.⁵ In Kiribati, declines in grants and non-tax revenues and COVID-19 support measures increased the primary deficit and financing needs, but the debt to GDP ratio fell as the deficit was financed through sovereign reserve withdrawals. The increases in interest rates (the interest rate differential) only played a substantive role in Fiji, owing to its large share of domestic debt which tends to have a market determined floating interest rate.

⁵World Bank. 2023c. Systemic Country Update PIC-9. Washington, DC: The World Bank.

Figure 18. Public Debt Dynamics in PICs (2019-2021, percent of GDP)



Source: IMF; World Bank staff estimates

The classification of **“high risk of debt distress”** in most PICs indicates that public debt **could become unsustainable** if fiscal discipline is relaxed or official financing is not forthcoming.

Regardless of whether debt to GDP ratios fell or increased during the pandemic, PICs’ projected public debt vulnerabilities remained elevated or increased due to weaker potential to carry debt and/or increased projected financing needs. Six out of the eight countries that employ LIC-DSA are classified as high risk of debt distress, while the remaining two, namely, Vanuatu and Solomon Islands) are classified at moderate risk (Table 4). On the other hand, the capacity to absorb shocks is much higher in Vanuatu than in Solomon Islands, implied by the borrowing space. While projected public debt is classified as sustainable in three Market Access Countries (MAC)-DSA countries, the risks rose in Palau and Fiji, because of significant expansion in debt levels during the pandemic, which are projected to linger under forecast horizons.

Table 4. Evolution of PICs DSA risk ratings 1/

	2015	2016	2017	2018	2019	2020	2021
Kiribati	H	H	H	H	H	H	H
Marshall Islands	H	H	H	H	H	H	H
Micronesia	H	H	H	H	H	H	H
Samoa	M	M	H	H	H	H	H
Tonga	M	M	M	H	H	H	H
Tuvalu	H	H	H	H	H	H	H
Vanuatu	M	M	M	M	M	M	M
Solomon Islands	M	M	M	M	M	M	M
Fiji	S	S	S	S	S	S	S /2
Palau	S	S	S	S	S	S	S
Nauru	n/a	n/a	n/a	n/a	n/a	U	S

Source: IMF and World Bank staff estimates.

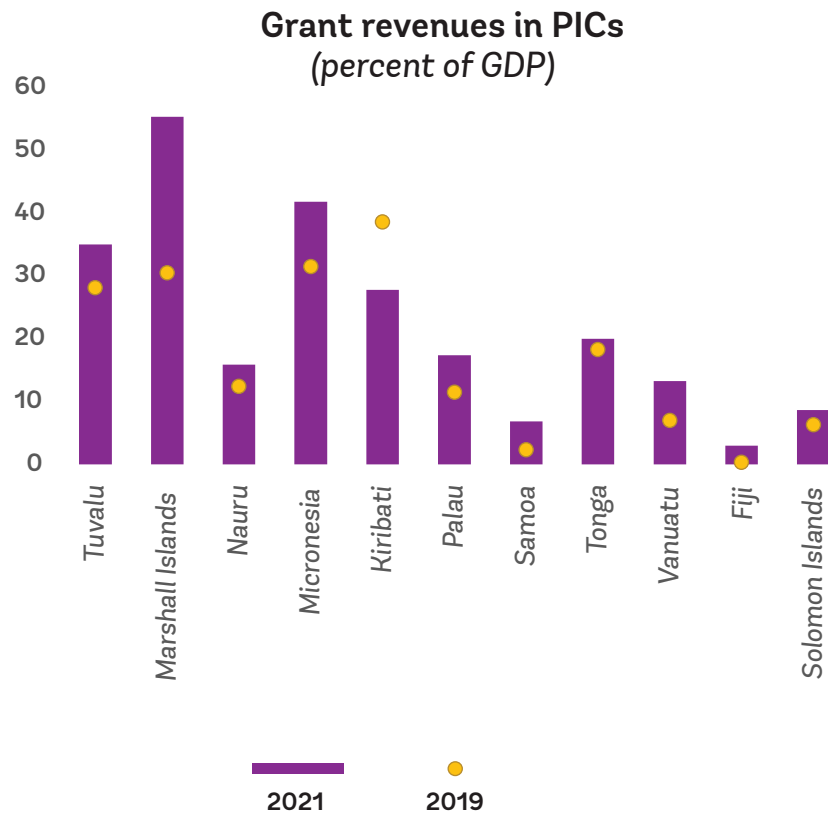
1/ Colors indicate: Green –Low risk of debt distress; Orange –Medium risk; Red – High risk. S-Sustainable; U-Unsustainable.

2/Fiji's public debt sustainability assessment is conditional upon projected fiscal consolidation under the baseline forecasts.

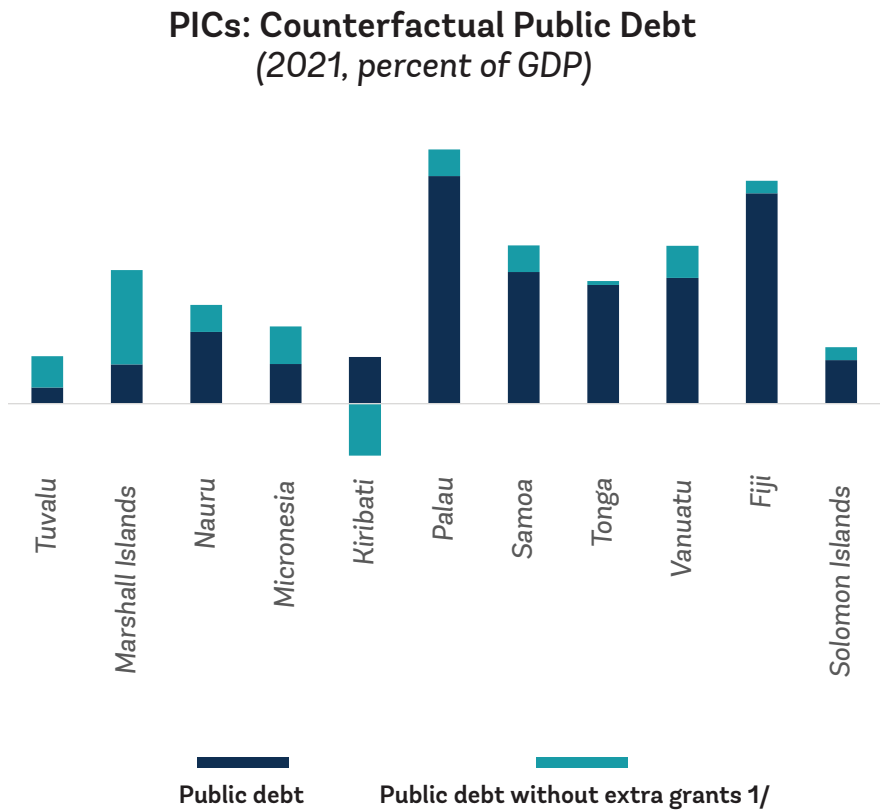


External grants form an important source of fiscal revenues in many PICs and play a crucial role in financing public spending on human and physical capital. Even prior to the pandemic, grants were above 25 percent of GDP in Tuvalu, RMI, FSM and Kiribati, and above 10 percent of GDP in Nauru, Palau and Tonga (Figure 19). During the pandemic, the region received significantly more official development partner assistance, which helped reduce underlying fiscal deficits in all countries, leading to manageable primary deficits. Without such a crucial ramp-up in external assistance, PICs would have struggled both to finance pandemic-related support measures and secure funding for rising underlying development needs. In a counterfactual case, where grants would have remained at the 2019 levels, the increased primary balances would have added to the further debt-build up, eroded fiscal cash buffers, or resulted in reduced spending during a time of economic stress. In RMI, for instance, without donor grant support, public debt to GDP ratio would have been three times higher than the actual level.

Figure 19. External grants in PICs



Source: IMF; World Bank staff estimates.



Source: IMF; World Bank staff estimates.

1/ Calculated as cumulative nominal difference in 2020-2021 grants relative to 2019 level.

Box 1. Debt Sustainability Analysis in Pacific Island Countries

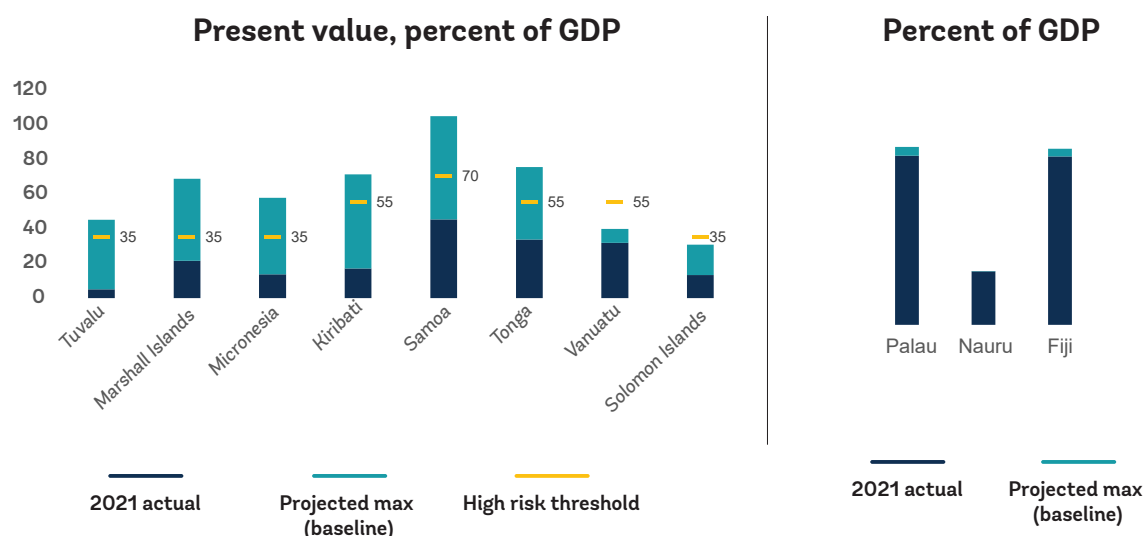
IMF-World Bank Low-Income Countries (LIC) Debt Sustainability Analysis (DSA) is used for most PICs. The DSAs help guide government borrowing decisions with their current and prospective ability to service debt, given their specific circumstances. Eight of the PICs debt sustainability analyses are produced using the IMF-WB LIC-DSA framework (LIC-DSA).¹ The LIC-DSA also provides guidance for development partner lending and grant-allocation decisions to ensure that official resources to LICs are provided on terms that are consistent with the recipient's long-term debt sustainability and achieving development objectives. Depending on a country's debt-carrying capacity (based on macroeconomic and institutional strength), country-specific debt level and debt service ratios are set. The debt-carrying capacity ratings are based on the Composite Indicator, calculated using the IMF WEO data for macroeconomic indicators (real GDP growth, remittances, reserves, and world growth) and the World Bank's Country Policy and Institutional Assessment (CPIA). Debt sustainability in Fiji, Palau and Nauru is assessed using the IMF's Market Access Countries DSA, a framework for countries that largely receive financing through market-based instruments and on non-concessional terms.²

Debt Burden Thresholds and Benchmarks for LIC-DSA					
	PV of external debt in percent of		External debt service in percent of		PV of total public debt in percent of
	GDP	Exports	Exports	Revenue	GDP
Weak	30	140	10	14	35
Medium	40	180	15	18	55
Strong	55	240	21	23	70

Public debt assessments attempt to qualify whether debt is sustainable, and in the case of low-income countries, also rate the risk of debt distress. LIC-DSAs attempt to gauge the risk of external and overall debt distress based on four categories: low risk (when there are no breaches of specific thresholds under both projected baseline and risk scenarios); moderate risk (when thresholds are breached in risk scenarios); high risk (when thresholds are breached in the baseline scenario); and in debt distress (when a distress event—such as arrears or a restructuring—has occurred or is considered imminent). Market Access Countries' (MAC)-DSA aims to provide a bottom-line assessment of whether public debt is sustainable or not. MAC-DSA also includes indicative benchmarks of the level of public debt and gross financing needs, at 50 and 10 percent of GDP respectively for emerging markets.

PICs' LIC-DSA risk is elevated. Two factors largely impact DSAs in PICs: 1) debt-carrying capacity, 2) projected levels of present value (PV) of public debt under the baseline and the most extreme scenario. The debt-carrying capacity is weak (resulting in a 35 percent of PV debt to GDP benchmark) in four PICs due to fragile macroeconomic fundamentals and modest institutional capacity, while it's medium (55 percent of PV debt to GDP benchmark) in other three. Only Samoa possesses strong debt carrying capacity (70 percent of PV debt to GDP benchmark) among LIC-DSA PICs. These imply lower country-specific debt thresholds for most PICs. Under baseline forecasts, which predominantly assume loan financing of gross financing needs, the thresholds are breached in most PICs under the baseline scenario. These result in high risk of debt distress, except for Vanuatu and Solomon Islands, where the breaches happen only under extreme-shock scenarios. However, for all PICs public and external debt is deemed sustainable, accounting for the fact that grants and concessional financing play a significant role in financing underlying deficits. Therefore, grants are essential to make debt sustainable in PICs, given the high risk of debt distress classification under LIC-DSAs.

Public and Publicly Guaranteed Debt



Joint World Bank - IMF Debt Sustainability Analysis data as of October 2022.

¹"Review of the Debt Sustainability Framework for Low Income Countries: Proposed Reforms." IMF Policy Paper, IMF, Washington DC, 2017

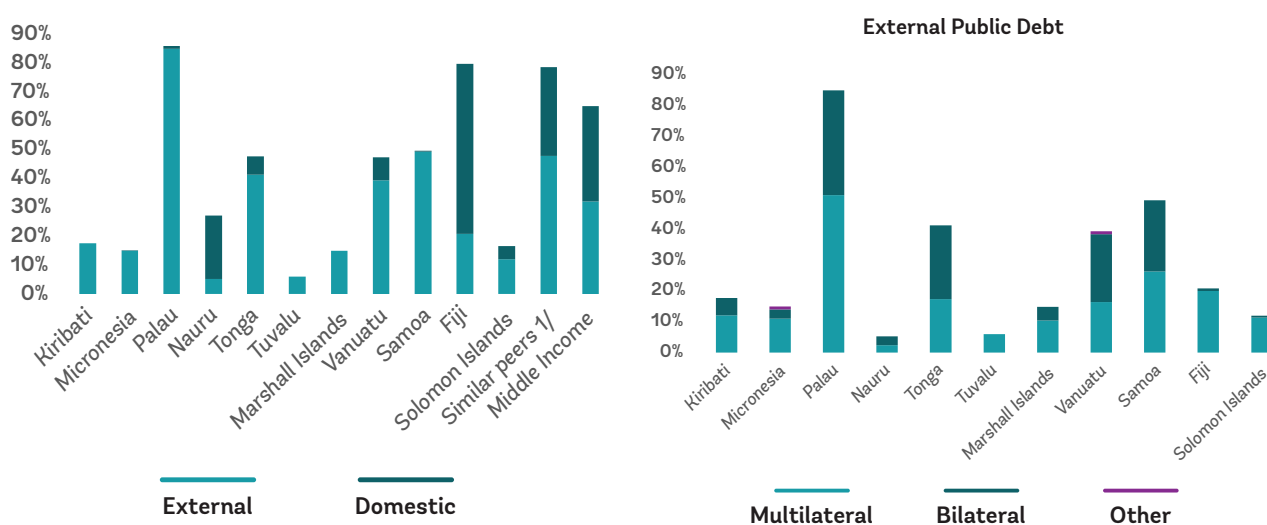
²"Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis." IMF Policy Paper, IMF, Washington DC, 2011

Public debt in the Pacific

is largely characterized by long-term concessional borrowing from **official creditors** to PICs and an absence of **private creditors**.

Largely reflecting shallow domestic financial markets and a lack of access to international capital markets, most public debt in PICs is held by multilateral or bilateral creditors at concessional or highly concessional terms (Figure 20). Only Nauru and Fiji have a substantial share of domestic debt. In most PICs with significant external debt, more than half of the debt stock is owed to multilateral institutions, primarily the ADB and World Bank. Tonga and Vanuatu are the two countries which also received significant amount of loans from the China Export-Import Bank, accounting for about 49 and 30 percent of the debt stock. Official credit that is highly concessional provides some cushion to PICs, because such debt typically comes with extended grace periods and maturities, low interest rates, and is often increased in the case of financing challenges.⁶

Figure 20. Composition of public debt in PICs (2021, percent of GDP)



Source: IMF and World Bank staff estimates.

1/ Similar peers: Cabo Verde, Comoros, Dominica, Guinea-Bissau, Guyana, Jamaica, Sao Tome and Principe, St. Vincent and the Grenadines and Timor-Leste.

⁶Most multilateral lending is concessional with extended grace periods, while the terms of bilateral credits vary by lending country. Bilateral credits are typically concessional or highly concessional, but exact terms and grace periods can be substantially different between lending countries.

3.2 Vulnerabilities amidst global inflation

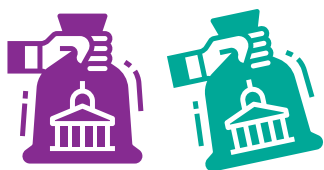


In PICs, **fiscal policy** is the key tool to



smooth the **impact of high inflation on the poor.**

All PICs are either dollarized or operate under a pegged exchange rate regime against a basket of currencies, which predominately include the US, Australian and New Zealand dollars and Japanese yen.⁷ Exchange rate movements merely reflect cross-rate movements in the case of currency baskets, or the bilateral movements in dollarized economies. As such, PICs lack independent monetary policy to control inflation as they target an exchange rate or simply use a foreign currency for domestic transactions. During 2022, dollar strength due to tightening global financial conditions caused depreciation in basket pegs and in countries that use the Australian dollar, exacerbating the inflationary impact of commodity prices. The reverse was true for countries tied to the US dollar. Given the lack of monetary policy, fiscal policy remains the only tool to help economic agents cope with the rising costs of living. The PICs have adopted both spending and revenue measures to support businesses and households struggling with the pandemic shock and rising inflation.

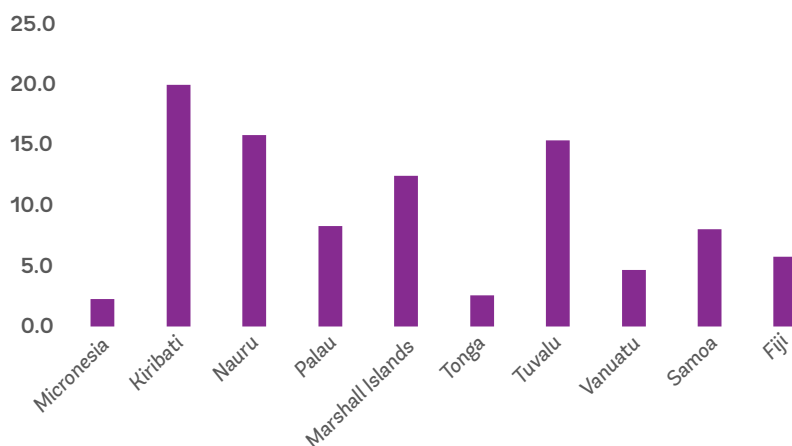


Rising energy and food subsidies,

as well as fiscal support to SOEs and households, add to public spending pressures.

Caps on energy, transportation and food prices will necessitate fiscal support to producers to cover losses, resulting in increased subsidy transfers in Fiji, Nauru, Kiribati and RMI (Figure 21). In PICs where public wages and cash transfers are linked to inflation, current spending levels will rise further.

Figure 21. PICs: Subsidies, Grants, Current Transfers (percent of GDP, 2015-2020)



Source: World Bank staff estimates

⁷Fiji, Solomon Islands, Vanuatu, Samoa, and Tonga peg their currencies against a basket. Marshall Islands, Micronesia and Palau use the US dollar, while Kiribati, Nauru and Tuvalu use the Australian dollar.

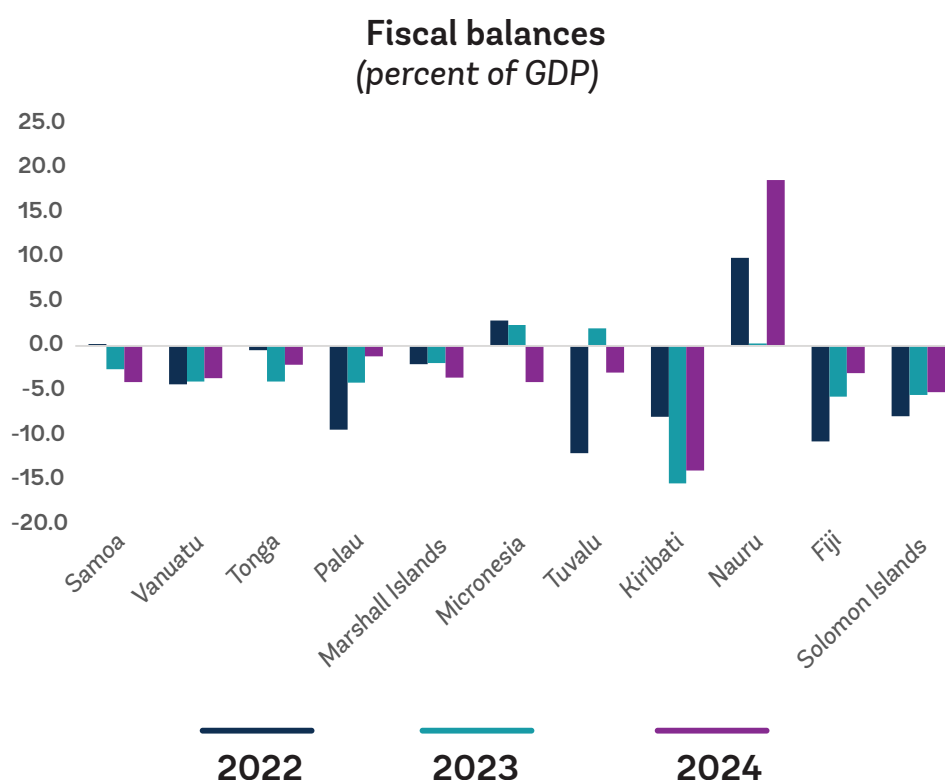


While narrowing, deficits are projected to linger

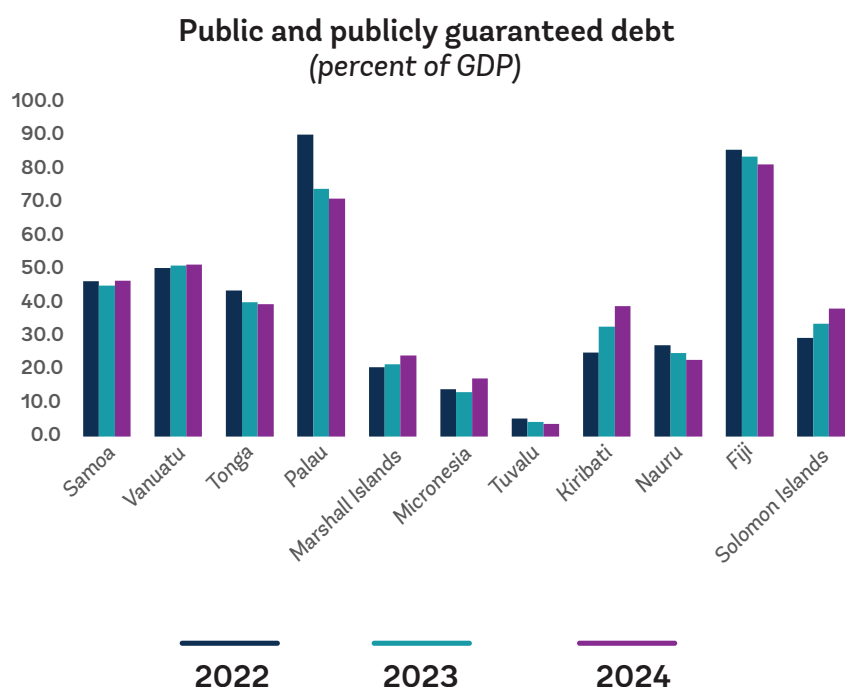
and will keep public debt levels broadly the same in the **short-term**.

Helped by post-pandemic reopening, and unwinding of pandemic support, fiscal balances are forecast to improve in 2023 and 2024 in six PICs (Figure 22). This will be more pronounced in tourism-dependent economies, particularly in Fiji and Vanuatu, and to a lesser degree in Palau, due to a delayed tourism recovery. Fiscal balances are expected to slightly deteriorate in Samoa, Tonga, RMI, FSM, driven by post-disaster reconstruction spending and reduction in grant revenues. On the other hand, Kiribati is anticipated to register a significant increase in its fiscal deficit, as increases in subsidies and transfers during the pandemic are expected to remain. Except for Nauru, all countries are projected to register fiscal deficits, although the levels will differ across countries. Resulting gross financing needs are expected to rise over the longer term (until 2040) and will contribute to a debt build-up or reduced the fiscal buffers.

Figure 22. PICs: Fiscal balance and public debt projections



Source: World Bank staff estimates



Source: World Bank staff estimates



External grants have played a major role in helping to finance immediate and long-term development needs in PICs. Over the medium and long-term, external concessional financing is projected to return to pre-pandemic levels compared to the peaks of 2020-21 ([Figure 24](#)), while fiscal spending is projected to remain high due to ongoing development spending needs and the rising cost of climate adaptation. Under the baseline projections with ongoing deficits, continued reliance on concessional debt financing will increase the present value of public debt ([see Box 1](#)).



PICs should increase fiscal prudence given (i) rising public spending pressures amidst higher inflation; (ii) post-COVID spending pressures; and (iii) low debt carrying capacity and elevated levels of public debt in some MAC-DSA countries. As a result, PICs should strive to generate fiscal savings over time to cope with future shocks, rely on concessional financing, improve revenue mobilization, and increase the efficiency of current spending.

4. Creating fiscal space while mitigating risks

4.1 Immediate fiscal policy response



Despite the COVID-19 pandemic now turning into an endemic challenge and expectations of economic acceleration as travel and tourism are starting to gradually return, several countries have maintained temporary pandemic-era fiscal support, such as tax and duty exemptions, and spending support measures, like Kiribati's unemployment payments. Given fiscal constraints, these programs, if still needed, should be adjusted to more sustainable adaptive social protection programs to support long-term development and reduce fiscal vulnerabilities. While a few countries may have adequate fiscal space to sustain these temporary programs, like FSM and Nauru, removal of temporary pandemic support can help improve fiscal buffers against likely future shocks.

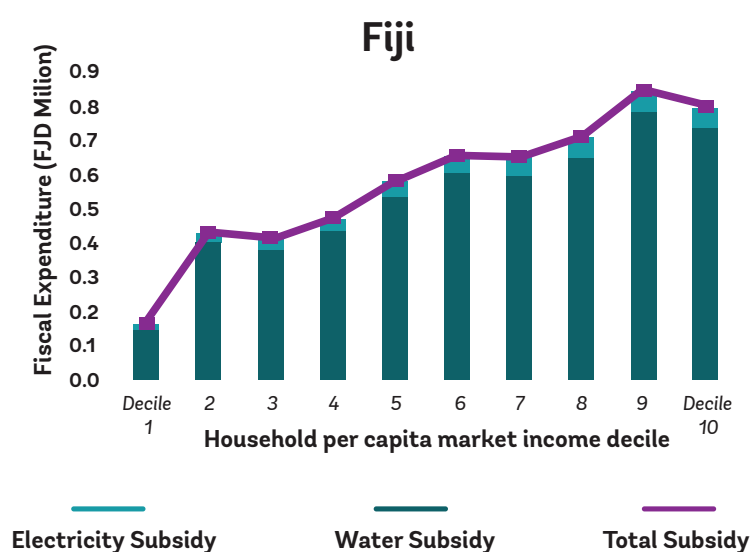


Given the projected slow recovery and profile of domestic revenues and grants, any additional fiscal support should come from the reallocation of budget spending to maintain prudent fiscal positions. Countries should avoid increasing non-discretionary spending, such as the overall wage bill, in response to rising inflation. Instead, targeted cash transfers should be prioritized. To the extent possible, increased transfers to the poor should be financed through savings from efficiency gains in public investments, the wage bill, and purchases of goods and services.

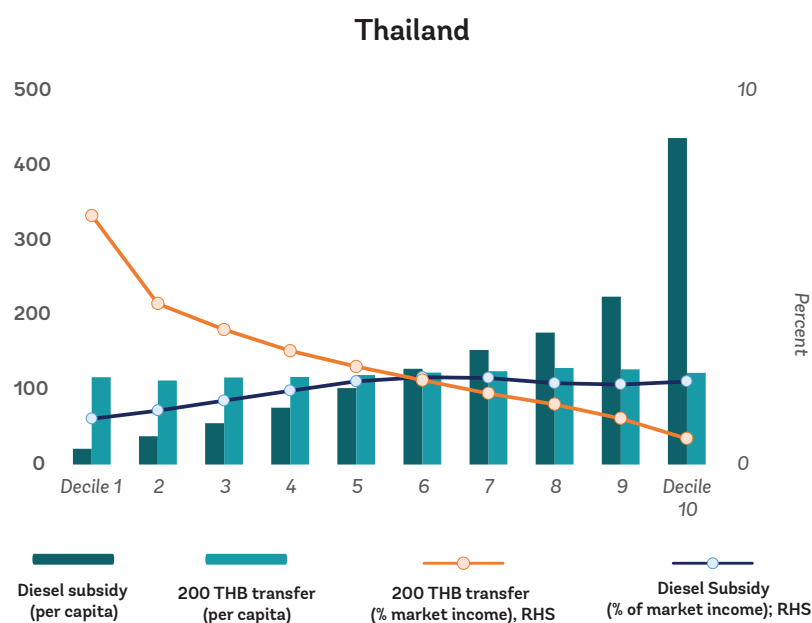


As much as possible, countries should refrain from capping prices and providing direct and indirect subsidies on energy and food products. First, price caps create market distortions, leading to excess demand and product shortages. While fuel subsidies may help ease some of the burden of rising costs, they encourage overconsumption, contribute to fossil fuel consumption and tend to benefit firms and the rich more than the poor. Evidence from Fiji suggests that electricity and water subsidies mainly benefit the higher income households (Figure 23, top panel). When analyzing the distributional impact of diesel subsidies and untargeted cash transfers in Thailand, the World Bank (2022) found that even untargeted cash transfer of THB200 per capita (USD6.00 per capita) was worth more to beneficiaries in the bottom deciles of income distribution when compared to fuel subsidies, both in absolute terms and as a share of their per capita income (Figure 23, bottom panel). For households in the middle of the income distribution, the benefits of cash transfers and diesel subsidies were almost equal. On the other hand, households at the upper end of the distribution, benefitted more from diesel subsidies compared to untargeted cash transfers. In countries with adequate means-tested targeting systems, cash transfers to the vulnerable households should be used instead of subsidies. As the evidence from Thailand shows, even untargeted cash transfer is less distortionary than direct subsidies, an option that could be considered for PICs without social protection systems. Other options could include utility fee moratoria or waivers for specific users, combined with public provision of key staple goods.

Figure 23. Distributional impact of fuel subsidies



Source: World Bank staff estimates.



Source: World Bank 2022.



Countries may look toward large infrastructure projects to solve development challenges, but these projects should be well studied for sustainability and financed through grants or by concessional borrowing. Non-concessional borrowing in PICs is extremely risky given limited revenue growth potential and the region's high exposure to economic shocks and natural disasters. Such borrowing would also breach the obligations of countries with high risk of debt distress under IDA Sustainable Development Finance Policy. There are numerous examples of countries which used non-concessional loans to finance non-economically viable infrastructure projects and struggled to service the resulting debt obligations. Any such big-ticket public spending should be weighed against the costs vs the social and private benefits, while exploring cheaper alternatives and conducting economic viability assessments. Once the project has been evaluated and is well aligned with the development and climate adaptation needs of the country, only then should PICs consider loan financing at highly concessional terms.

4.2 Medium term fiscal policy response



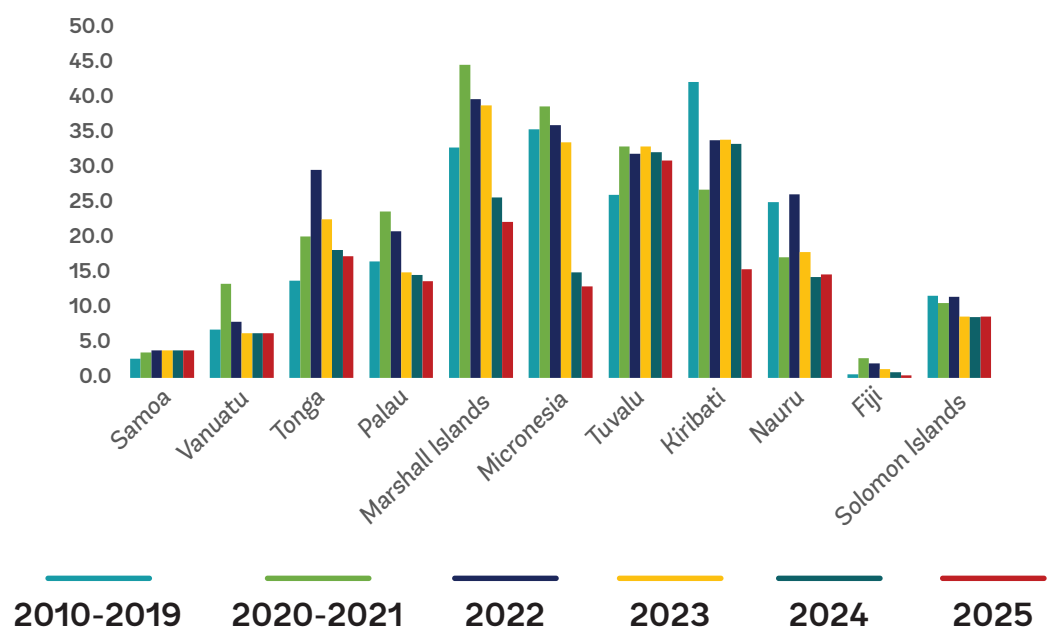
Over the medium-term, the region will need to raise additional



fiscal savings as official assistance is expected to return to pre-pandemic levels.

As in the past, grants will always remain an important source of fiscal revenues in PICs. However, grants may remain the same or decline over the coming years, while economic vulnerabilities may increase (Figure 24). Putting aside the potential for greater external economic and natural disaster shocks, PICs should strive to spend within their means and use fiscal saving to finance spending on human capital and climate adaptation. To achieve these goals, PICs should embark upon fiscal consolidation efforts once the pandemic-driven output gaps are closed.

Figure 24. Grants revenue projections in PICs (percent of GDP)

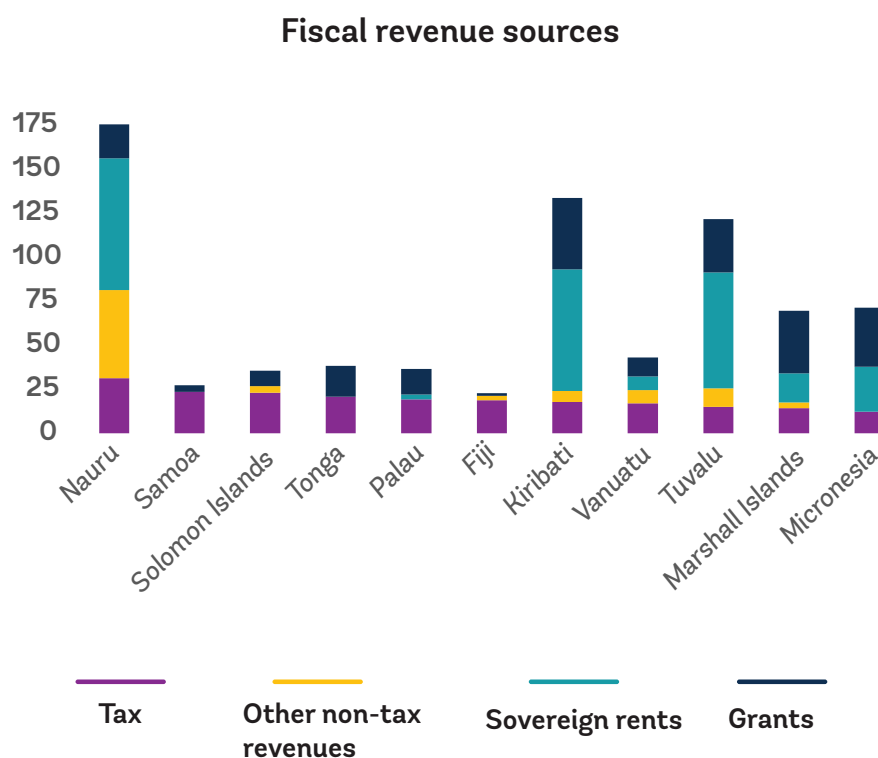


Source: World Bank staff estimates.

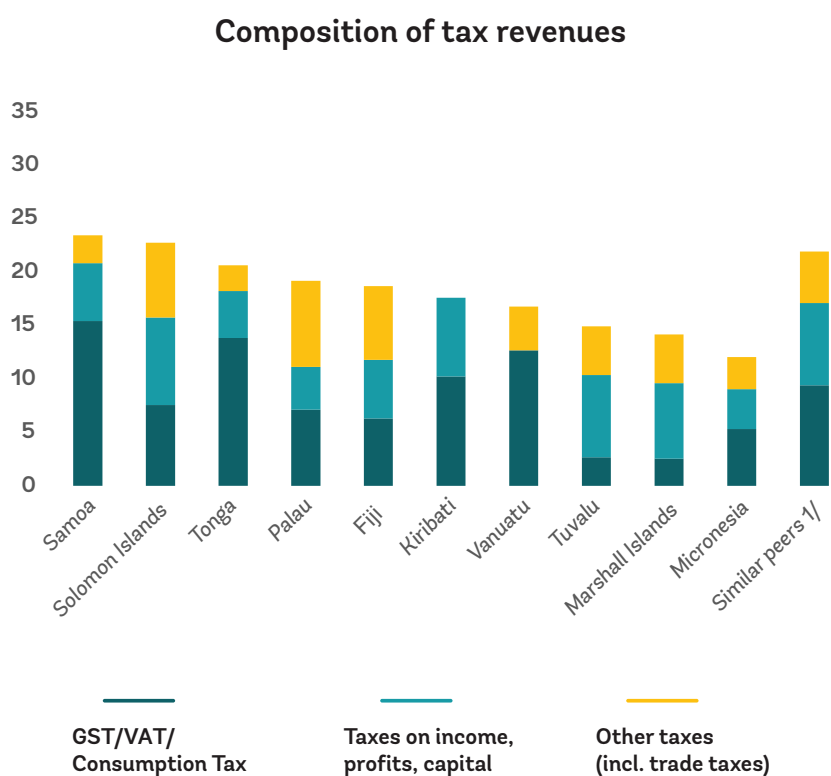


There exists a large variation in the composition of fiscal revenues in PICs. Nauru, Tuvalu, RMI, FSM and Kiribati receive a significant portion of their revenues from non-tax-based sources, namely, sovereign rents (e.g., fishing licenses), grants and other non-tax revenues (Figure 25). In the long-term, sovereign rents will likely shrink as the natural resources providing the underlying rents are depleted. They may also be volatile. Countries should not rely solely on sovereign rents for ongoing spending needs but treat them largely as windfalls that should be invested in enhancing future productivity (such as in education) or be used as buffer for shocks. There could also be some room to increase near-term sovereign rents, for instance, by renegotiating the fishing licenses. While the level of total tax revenues is broadly comparable to peers, PICs could benefit substantially from improving efficiency in tax collection and eliminate numerous tax exemptions (World Bank, 2023d). For instance, Tonga received 30 percent less in tax revenues in the first half of FY20 due to VAT exemptions. Samoa's tax exemptions resulted in 2.9 percent of GDP forgone tax revenue. With tax exemptions, governments often aim to encourage investment and provide relief to low-income households. But tax exemptions are not transparent and the true costs are often hidden while the intended outcomes are rarely observed. In the case where a strong social benefit can be identified, a subsidy is more transparent and the benefits can be evaluated against costs. Tax exemptions in PICs amount to substantial fiscal costs (IMF, 2022e). When granted to individual projects and specific companies, exemptions also reduce competition and increase the potential for corruption.

Figure 25. PICs: Composition of fiscal revenues, 2015-2020 (percent of GDP)



Source: World Bank staff estimates

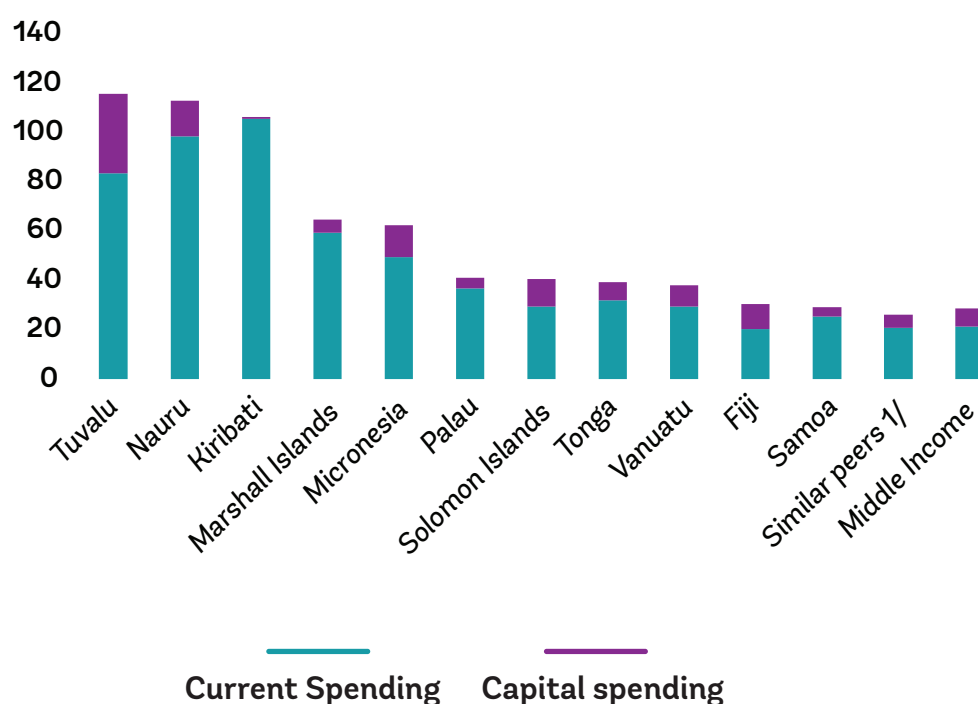


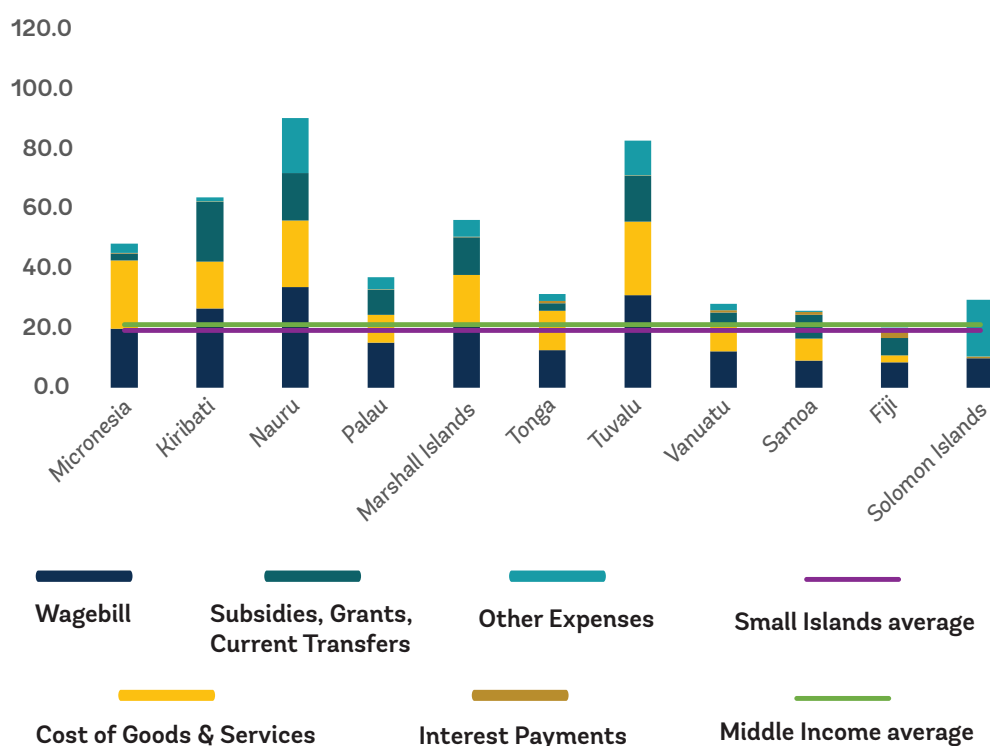
1/ Similar peers: Cabo Verde, Comoros, Dominica, Guinea-Bissau, Guyana, Jamaica, Sao Tome and Principe, St. Vincent and the Grenadines and Timor-Leste.



PICs capital and current spending to GDP ratios are higher than peer countries (Figure 26, top panel). However, rather than reflecting excessive spending, this is largely the result of structural factors pertaining to remoteness and smallness. In the case of capital spending key contributors include: i) high dispersion of the population; ii) high cost of importing capital goods and building materials; iii) frequent natural disasters; and iv) relatively high share of grant-financed capital projects (World Bank, 2023d). The main drivers of high current spending are the wage bill and goods and services spending (Figure 26, bottom panel). The high wage bill is caused by governments' key role as the primary service provider, given the high fixed costs of providing public services that are spread across a small population, and the small size of the domestic private sector. On the other hand, high spending on goods and services is due to the high costs associated with the large share of needed imports, compounded by remoteness and shipping costs, as well as the substantial recurrent spending associated with delivering public services to small, dispersed populations.

Figure 26. PICs: Composition of public expenditures, 2015-2020 (percent of GDP)

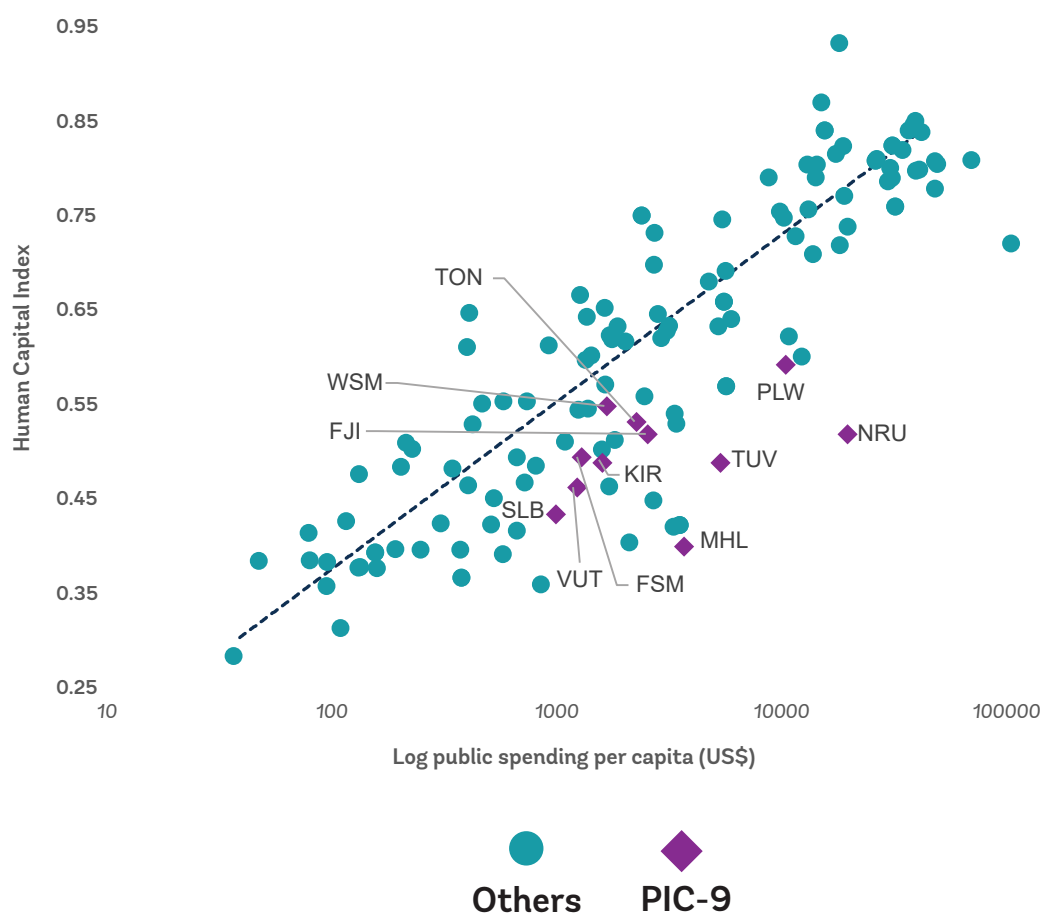




Hence, **reforms** should focus **on improving spending efficiencies.**

The level of human capital in PICs is below the predicted levels in relation to their public spending, suggesting room for efficiency gains (Figure 27). For instance, Nauru, RMI, and Tuvalu significantly fall behind the predicted levels of human capital, at given levels of public spending. More broadly, PICs human development index lags due to low learning-adjusted years of schooling, low life expectancy due to non-communicable diseases (NCDs) and poor infant health outcomes in some PICs. These are driven by poor quality of education and the high prevalence of NCDs. For example, RMI, Kiribati and Tuvalu rank first, second and fourth in the world, respectively, in terms of the prevalence of diabetes. Garcia-Escribano et al. (2022) find that policymakers can improve spending efficiency by increasing the allocation of spending towards essential health coverage, reducing income inequality, and fighting corruption.

Figure 27. Public spending efficiency

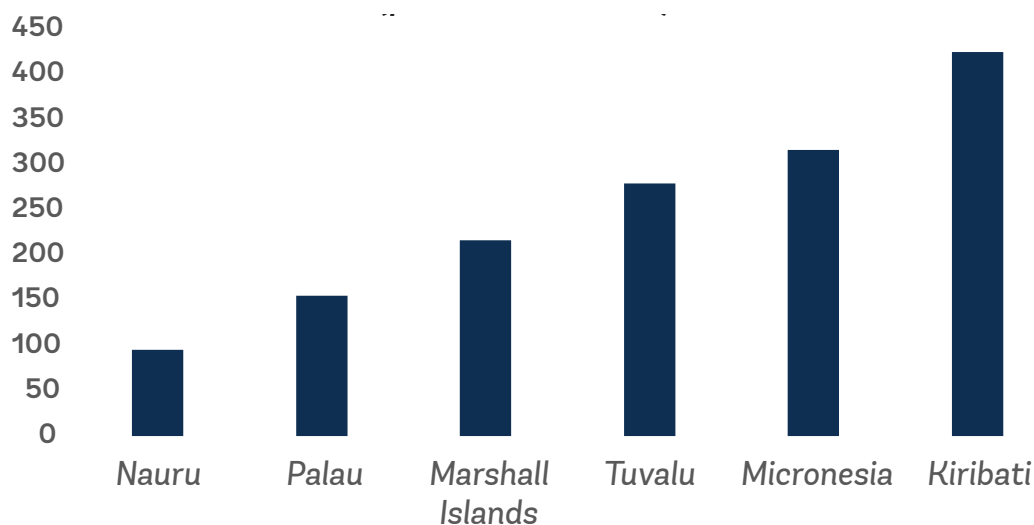


Source: World Bank staff estimates



FSM, Palau, RMI, Kiribati, Nauru, and Tuvalu have sizeable assets in their SWFs. The SWF asset size ranges from 80 percent of GDP in Nauru to over 400 percent of GDP in Kiribati (Figure 28). The primary purpose of SWFs is to enhance fiscal sustainability, by insulating the economy from large windfall revenues in the form of sovereign rents or commodities exports, but they can also support macro-fiscal stabilization during crises. Other PICs, such as Solomon Islands and Vanuatu, can consider establishing SWFs, by channeling some fiscal savings generated from consolidation measures and during economic booms. In doing so, all PICs should ensure strong governance and transparency of SWF, while setting operational rules that are simple, transparent, and limit discretion.

Figure 28. Sovereign Wealth Fund Assets (percent of GDP)

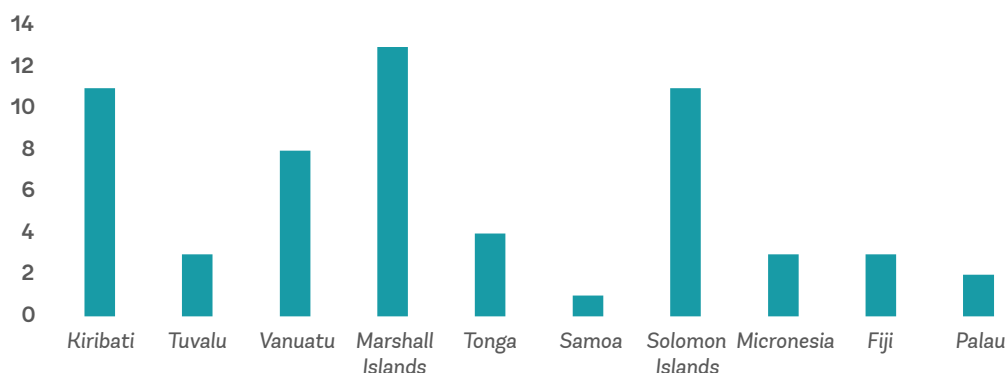


Source: World Bank staff estimates



Ongoing development priorities to achieve sustainable development goals and climate change pose significant challenges for the Pacific. PICs are some of the most exposed countries in the world, which require significant investment in climate adaptation infrastructure (Figure 29, World Bank, 2016). Climate change could also increase the frequency of natural disasters, such as tropical cyclones and droughts, posing additional risk to the economies of PICs. Given fiscal and financial constraints, external donor assistance is essential for filling PICs' financing gaps in climate adaptation and mitigation, but also large development needs. Development partners could also provide additional grants to finance these needs.

Figure 29. Annual costs of climate adaptation 1/ (percent of GDP)



Source: World Bank staff estimates

1/ The adaptation costs of coastal protection, based on the worst-case climate change scenario by 2040



Conclusion

After more than two years of managing the COVID-19 pandemic, the PICs were hit by another shock of rising energy and food prices. The PICs' economies experienced a significant downturn during the pandemic, most dramatically in tourism dependent countries. Just as economies were beginning to see some rebound after more than two years of border closures, the region was hit by the global commodity price shock. As a result, domestic inflation rates have spiked, and recoveries are projected to be weaker than envisaged a year ago. Authorities have attempted to help ease the rising cost of living for households and businesses, but ongoing untargeted support is not sustainable given fiscal constraints and lack of debt carrying capacity.

In dealing with the challenges of rising inflation, tepid recovery from the pandemic and global slowdown, the PICs should strike a balance between supporting livelihoods and reducing future public debt risks. The need for fiscal support during the current environment of high inflation and tepid economic recovery is understandable as it provides the much-needed relief for vulnerable households and businesses to navigate the crisis. Nonetheless, these support measures create significant fiscal burdens, and are unsustainable, particularly if the high energy and food prices persist longer than envisaged. Most PICs already face low capacity to finance unexpected shocks which would be further tested by a natural disaster event. Therefore, PICs should tread a delicate balance between fiscal support measures and achieving fiscal sustainability. Any forthcoming fiscal support should be well-targeted, time-bound and deficit-neutral.

Over the medium-term, fiscal efficiency gains and ongoing donor support is critical to finance key development challenges and climate adaptation. Revenue-based fiscal consolidation measures could include improving the efficiency of tax collections and eliminating tax exemptions. On the expenditure side, PICs have limited room to sharply cut spending given the expected modest growth and ongoing development needs. Therefore, it becomes imperative to improve the efficiency of public spending, to maximize social dividends for every dollar spent. Resulting savings from fiscal consolidation measures could help build sovereign wealth funds to provide added fiscal buffers during shocks and economic downturns. Due to high vulnerability to disasters and climate change, PICs will need to seek ongoing concessional financing for critical climate adaptation and development needs.



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