

## MACROECONOMIC PERFORMANCE: OVERVIEW<sup>1</sup>

### A. Background

1. Kiribati is among the smallest and most remote economies in the world, comprising one raised coral island and 32 atolls dispersed widely across the Central Pacific Ocean. A total population of 103,000 is spread over 20 inhabited atolls and Banaba Island. More than half of the archipelago's population is concentrated in the urban centers of South Tarawa (33%) and Betio (15%).<sup>2</sup> Total land area is only 811 km<sup>2</sup>, but the country's waters span approximately 5,000 km west to east and 2,000 km north to south. Kiribati's exclusive economic zone is about 3.5 million km<sup>2</sup>, roughly the same size as the land mass of India, with abundant resources including tuna and other marine products.

2. However, with subdued domestic demand from a small and dispersed internal market, along with limited export opportunities due to remoteness and prohibitive transport costs, only a few sectors achieve the necessary economies of scale for efficient production. The narrow economic base necessitates a high dependence on imported goods and foreign exchange inflows including fishing license fees charged to foreign fleets, seafarers' remittances, and official development assistance. This heightens Kiribati's exposure to external economic shocks, which, coupled with its vulnerability to natural disasters, drive large fluctuations in economic growth. The weak and uneven economic performance, in turn, has translated to poor development outcomes.

3. Kiribati is classified as a lower middle income country, with gross national income at about \$2,500 per person as of 2012. While it is in the "medium human development" category, ranking 133<sup>rd</sup> out of 187 countries included in the 2014 Human Development Report<sup>3</sup>, non-income development indicators generally capture extensive hardship. For example, as of 2012, only about two-thirds of I-Kiribati had access to safe drinking water. Even worse, only about 40% had access to improved sanitation facilities. With the impacts of rising sea levels associated with climate change already being felt, hardship and vulnerability are seen to worsen absent extensive adaptation measures and sustained improvements in economic performance.

### B. Economic Performance

4. The economy recorded four consecutive years of growth, averaging 2.1% per annum, from 2001 to 2004 (Figure 1). Economic expansion was generally broad-based, with the agriculture, industry, and services sectors each contributing 0.6–0.8 percentage points to growth over this period, on average. A small contraction was recorded in 2005 due to low agriculture and fisheries output and declines in wholesale and retail trade activity. This was followed by a sharper downturn in 2006, when the economy contracted by 4.5%, amid weak construction activity and wide spillover effects on related services. Construction- and services-driven recovery boosted economic growth to a decadal peak of 7.5% in 2007. Growth remained solid at 2.8% in 2008, supported by a buoyant agriculture and fisheries sector.

5. Lingering impacts of the global financial and economic crisis contributed to successive contractions in 2009 and 2010. High international food and fuel prices, along with declines in

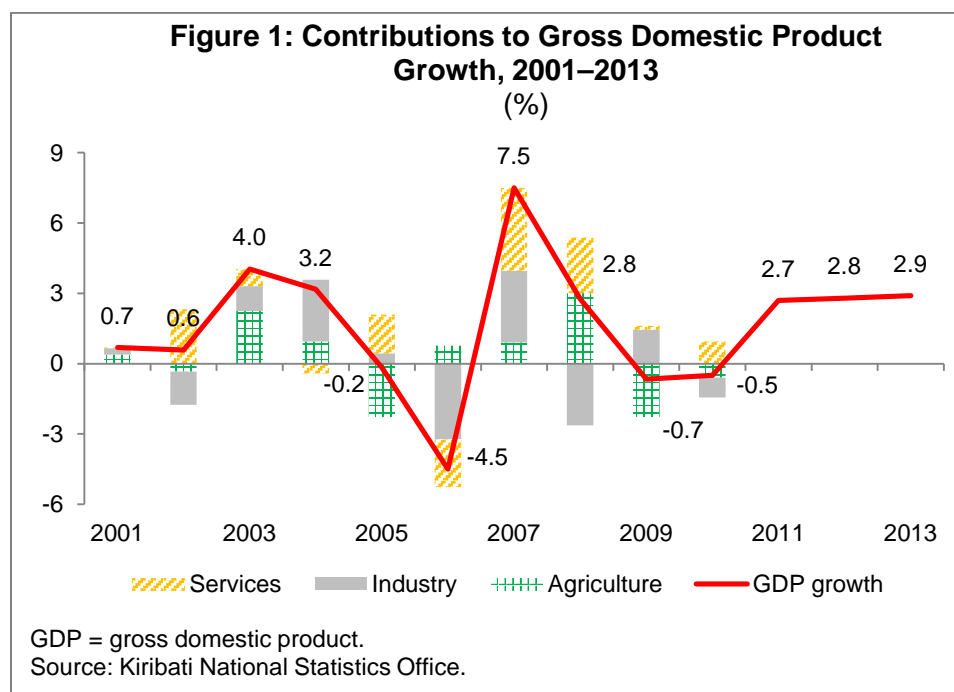
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<sup>1</sup> This summary draws from various issues of ADB's *Asian Development Outlook* and *Pacific Economic Monitor*.

<sup>2</sup> Population figures are as of the *Kiribati 2010 Census of Population and Housing*.

<sup>3</sup> United Nations Development Programme. 2014. *Human Development Report 2014. Sustaining Human Progress: Reducing Vulnerabilities and Building Resilience*. New York.

seafarers' remittances, reduced private consumption and space for fiscal stimulus was limited by the eroding value of the Revenue Equalization Reserve Fund (RERF). The International Monetary Fund (IMF) estimates that the RERF, which is used to finance large portions of government expenditure, lost over \$30 million in assets, the equivalent of roughly 25% of gross domestic product (GDP) in 2009, invested in failed Icelandic banks. Large drawdowns to finance fiscal deficits aimed at countering the impacts of the downturn further exacerbated the erosion in the RERF's value, but were insufficient to prevent economic contraction.



6. Growth stabilized at close to 3% per annum in the period from 2011 to 2013. Major development partner-financed infrastructure projects, including airport and seaport renovation, supported steady growth. State-owned enterprise (SOE) reform expanded opportunities for private sector participation in the retail trade sector, and provided a further boost to economic activity. Kiribati also benefitted from the implementation of a regional vessel day scheme for charging fishing license fees for foreign fleets starting in 2012.<sup>4</sup> In combination with better fishing conditions, the substantial rise in fees led to an immediate doubling of fishing license revenues from the equivalent of 17.4% of GDP in 2011 to 34.8% in 2012, before surging further to 50.5% of GDP in 2013.

7. Kiribati's economic performance in recent years is characterized by the volatility arising from its narrow base. A small local production base leads to high dependence on imports, and with exports mostly limited to only a few products such as copra and fish, large trade deficits persist. On average, merchandise trade deficits were the equivalent of about 52% of GDP from 2009 to 2013. High import dependence means that volatility in international commodity markets,

<sup>4</sup> The Parties to the Nauru Agreement (PNA), which counts Kiribati, the Federated States of Micronesia, the Republic of the Marshall Islands, Nauru, Palau, Papua New Guinea, Solomon Islands and Tuvalu as members, implemented a vessel day scheme starting in 2012. Under the scheme, PNA sets a sustainable total number of "vessel days" to be allocated among its members and sold to foreign fishing fleets (or traded among members). By restricting the supply of available vessel days, PNA aims to not only raise the price of fishing licenses but also safeguard the sustainability of Pacific tuna stocks.

particularly for basic necessities such as food and fuel products, is largely transmitted to the Kiribati economy through its effects on consumption. The small private sector hindered by pervasive SOE presence in sectors that would ordinarily fall within the realm of competitive businesses also translates into a narrow domestic revenue base. This results in perennial fiscal deficits that necessitate large RERF drawdowns and extensive assistance—in form of development project grants, or borrowing, and budget support—from development partners. The overall fiscal deficit averaged about the equivalent of 15% of GDP from 2009 to 2011, before extraordinarily high fishing license revenues helped reverse the trend into a substantial surplus by 2013. It remains to be seen if fishing license revenues can remain at recent high levels. With the public sector dominating the economy—government expenditure is close to the equivalent of about 100% of annual GDP—output is generally subject to boom-and-bust cycles associated with the schedules of large infrastructure projects. Growth tends to accelerate rapidly upon the start of construction, moderate as projects near completion, and dissipate upon the end of the project cycle.

### C. Outlook and Risks

8. Commencement of a delayed development partner-financed project to rehabilitate the South Tarawa road network and Betio causeway, along with continuing work on the Kiritimati and Tarawa airports, are expected to be among the main drivers of growth in the near-term. Project construction, and its demand-enhancing effects on linked services such as transport and wholesale and retail trade, is projected to maintain growth at 3% in 2014 (Table). Growth is then seen to moderate at a steady pace as projects are completed. Private sector sources of growth are likely to remain limited, although recent progress in SOE reform has opened up new opportunities for businesses. Continuing progress in SOE reform, including telecommunications liberalization for example, will help support further private sector development.

**Economic and Fiscal Outlook, 2012–2017**

Item	2012	2013	2014p	2015p	2016p	2017p
Real GDP (% change)	2.8	2.9	3.0	2.7	2.5	2.4
Inflation (% p.a.)	(3.0)	(1.5)	2.5	2.5	2.5	2.5
Current revenue (% of GDP)	54.0	69.9	39.1	40.9	40.5	40.2
<i>Fishing licenses (% of GDP)</i>	<i>34.8</i>	<i>50.5</i>	<i>22.8</i>	<i>22.2</i>	<i>21.7</i>	<i>21.1</i>
Current expenditure (% of GDP)	61.0	59.8	61.7	56.7	54.9	53.7
Current fiscal balance (% of GDP)	(6.9)	10.1	(22.6)	(15.8)	(14.5)	(13.6)
Overall fiscal balance (% of GDP)	(6.7)	10.3	(25.8)	(20.4)	(19.4)	(18.8)
External debt (% of GDP)	8.1	8.0	11.4	15.5	19.9	24.4
RERF balance (2006 A\$ per capita)	4,592	5,058	4,837	4,643	4,472	4,326
Nominal GDP (\$ million)	175.1	169.8	164.3	170.3	176.7	183.4

GDP = gross domestic product, p = projection, p.a. = per annum.

Note: Numbers in parenthesis are negative.

Source: Asian Development Bank.

9. Fiscal sustainability remains a primary concern. Some uncertainty remains regarding the sustainability of fishing license revenues at recent high levels, as the implementation of the vessel day scheme coincided with the positive impact of the El Niño weather pattern on fish stocks near the equator. If the recent increases are more attributable to the El Niño effect, then these will likely be transitory and revenues can be expected to revert back toward previous levels. From a peak of \$80 million (or the equivalent of 50% of GDP) in 2013, the IMF projects that fishing license revenues could stabilize at close to \$40 million (just over 20% of GDP) from

2014 to 2019, under conservative scenarios. This is seen to result in a reemergence of the government's chronic current fiscal deficits after a reprieve in 2013, when historically high fishing license revenues helped generate a surplus equivalent to 10% of GDP.

10. A current fiscal deficit of \$37.1 million, the equivalent of 22.6% of GDP, is projected for 2014. Budget support grants amounting to \$14.0 million<sup>5</sup> will finance part of the 2014 deficit, but the bulk of financing will be sourced from RERF drawdowns. Annual RERF drawdowns are projected to exceed \$20 million from 2014 to 2019, averaging an equivalent of about 13% of GDP over this period. At this rate, the RERF balance is projected to again gradually decline in real per capita terms, further highlighting growing concerns regarding the fund's sustainability. Under a strong reform scenario, the RERF per capita balance can be stabilized through tighter fiscal consolidation aimed at narrowing the current fiscal deficit and corresponding drawdowns to the equivalent of 3.6% of GDP by 2024. The external debt burden is also projected to rise steadily with new loans to finance infrastructure and human capital investment, as well as climate change adaptation.

11. This leaves government with very limited options for fiscal maneuver. Fiscal buffers will need to be restored to enhance government's ability to respond to shocks, particularly given the imminent impacts of climate change, which represents the single most critical risk to long-term welfare in Kiribati. Already, sea levels are reportedly rising by as much as 2.9 millimeters per year, much higher than the observed global average of 1.0–2.0 millimeters.<sup>6</sup> Inundation of lower-lying outer islands is contributing to further congestion in main population centers, and seawater contamination is threatening freshwater supply across the country. Incidence and spread of diseases may rise with congestion and increasingly critical water and sanitation problems. Production of copra and other agricultural products are also adversely affected by coastal area inundation, saltwater intrusion, and erratic rainfall. Loss of land, water, and economic resources, along with a higher risk of diseases, could render the capital of Tarawa unlivable by 2050 without substantial progress in climate change adaptation efforts.

## **D. Policy Issues**

12. Kiribati uses the Australian dollar as its official currency. The IMF concludes that this remains appropriate given Kiribati's strong linkages with the Australian economy, as well as limited local capacity to conduct monetary policy.<sup>7</sup> However, adoption of the Australian dollar precludes independent monetary and exchange rate policy, leaving fiscal policy and broad structural reform as government's main policy instruments to stimulate economic growth.

13. Improving the quality of fiscal policy is crucial for both managing short-term macroeconomic fluctuations and building long-term foundations for sustained growth. On the revenue side, the recent strong performance of fishing license revenues offers a key opportunity to restore fiscal buffers. In 2013, much higher-than-expected fishing license revenues enabled the government to deposit \$16 million into the RERF, temporarily arresting the rapid depletion in the fund's balance. While the IMF expects fishing license revenues to stabilize at a lower level over the medium-term, these will remain by far the largest source of government revenue. In the medium-term, revenues should be channeled toward productive public expenditure, for example

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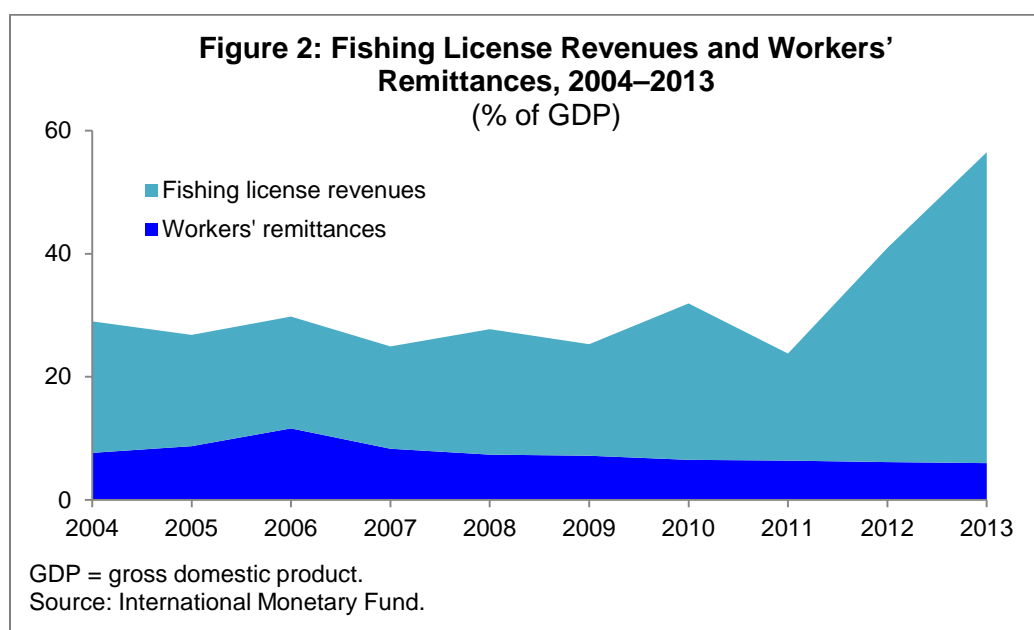
<sup>5</sup> This includes \$3.0 million from the ADB under the present Strengthening Fiscal Stability Program policy-based operation; \$2.8 million from the Government of New Zealand; and \$8.2 million from the World Bank.

<sup>6</sup> World Bank. 2009. *Reducing the Risk of Disasters and Climate Variability in the Pacific Islands—Republic of Kiribati Country Assessment*. Washington, DC.

<sup>7</sup> IMF. 2014. *Kiribati Article IV Consultation 2014*. Washington, DC.

to support human capital development through education and health spending. Further, in years when fishing license revenues come in stronger-than-expected due to El Niño or other transitory factors, windfalls can again be used to replenish RERF assets and to fund capital investments.

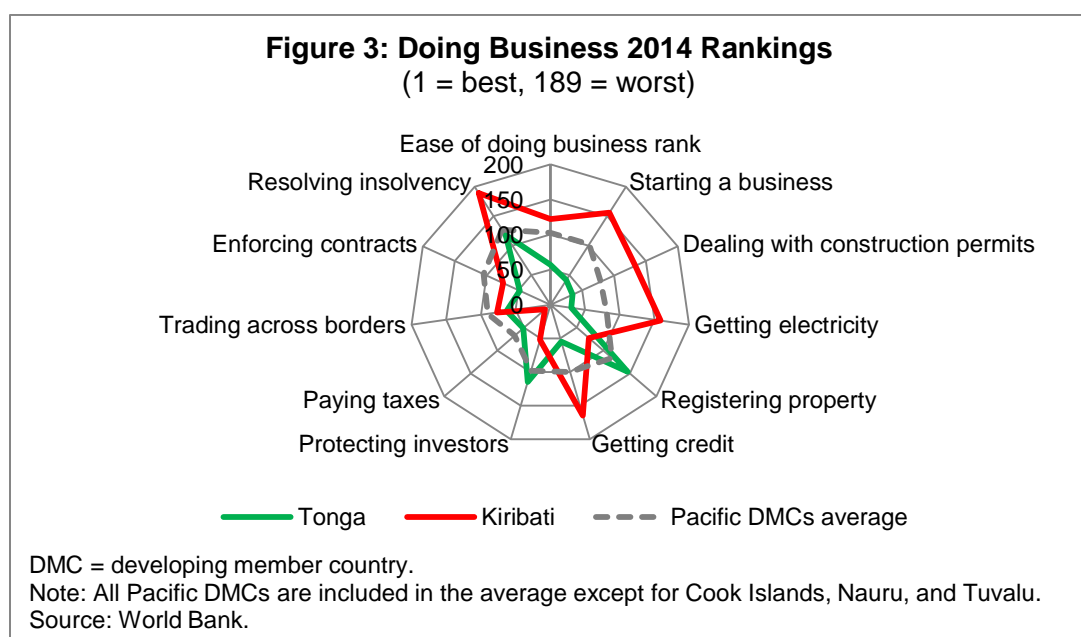
14. Fishing license fees also contribute toward reducing chronic imbalances in external accounts. Kiribati's small production and export base results in large merchandise trade deficits. These are partly offset by fishing license revenues, investment income from the RERF, seafarers' remittances, and budget support grants that reduce the resulting current account deficit. While remittance inflows from I-Kiribati seafarers have stagnated since the onset of the global financial and economic crisis, fishing license revenues have generally remained stable, and were the economy's by far largest foreign exchange earner in 2012 and 2013 (Figure 2).



15. The sheer size of Kiribati's exclusive economic zone represents massive potential as a foundation for long-term development. This is particularly true in the context of recent progress in regional collective action in tuna resources management. Efficient collection of fishing license fees that reflect the value of fish catch while also safeguarding sustainability of stocks is the key toward fully harnessing this potential. Prudent utilization of fishing license revenues can then help translate Kiribati's vast marine resource wealth into growth-enhancing investments.

16. On the expenditure side, Kiribati will need to build on its ongoing public investment program to further enhance connectivity with the global market and between widely dispersed domestic markets. This should include continuing road network rehabilitation and upgrading, airport and seaport improvement projects, and possibly information and communication technology (ICT) development. Infrastructure investment will be important in supporting the development of potential niche markets in the outer islands, such as, the planned development of Kiritimati Island as a fishing and surfing-based tourism destination. Outer island development, in turn, will help raise the inclusiveness of growth and potentially ease congestion problems in the urban centers of South Tarawa and Betio. Complementary investments in basic services such as energy and water and sanitation are also required to raise the population's living standards and improve the business environment.

17. Structural reform to stimulate private sector development is another important policy tool that government can utilize to broaden the economic base for more sustained growth over the longer-term. Even in the midst of daunting geographical challenges, recent experience has demonstrated that improvements in the policy and institutional environment can help strengthen private sector activity in Kiribati. The development of an SOE reform policy framework, and the institutionalization of an SOE Reform Steering Committee, led to the successful privatization of Kiribati Supply Company Limited (KSCL). After years of losses from its activities as a supplier of general hardware merchandise including construction materials and electrical fittings, KSCL was sold to a local company in October 2011. Exposed to competition, the private company now offers a wider product range at lower prices. Privatization of KSCL not only opened up opportunities for the private sector and contributed to a recent pickup in retail activity, it also freed up scarce public resources that were previously tied up as subsidies to a non-profitable SOE. With the policy framework and steering committee in place, the government can progress with its broader SOE reform agenda.



18. According to the World Bank's *Doing Business 2014* report, Kiribati ranks 122<sup>nd</sup> out of 189 surveyed countries in the overall ease of doing business (Figure 3). While Kiribati performs well in some areas such as paying taxes and protecting investors, it ranks particularly poorly in terms of resolving insolvency, getting credit, getting electricity, and starting a business. Inefficiencies in the financial sector, infrastructure, and the regulatory framework should therefore be targeted through further reform to enhance the business environment.