

Strengthening Fiscal Frameworks in the Pacific Islands to Support Growth



*Pacific
Way*



*Lifting Potential Growth
in the Pacific Islands*



*Friday, November 22, 2013
Port Vila, Vanuatu*

***Patrizia Tumbarello, IMF
November 22, Port Vila***

Main Messages

Fiscal risks and challenges in the PICs

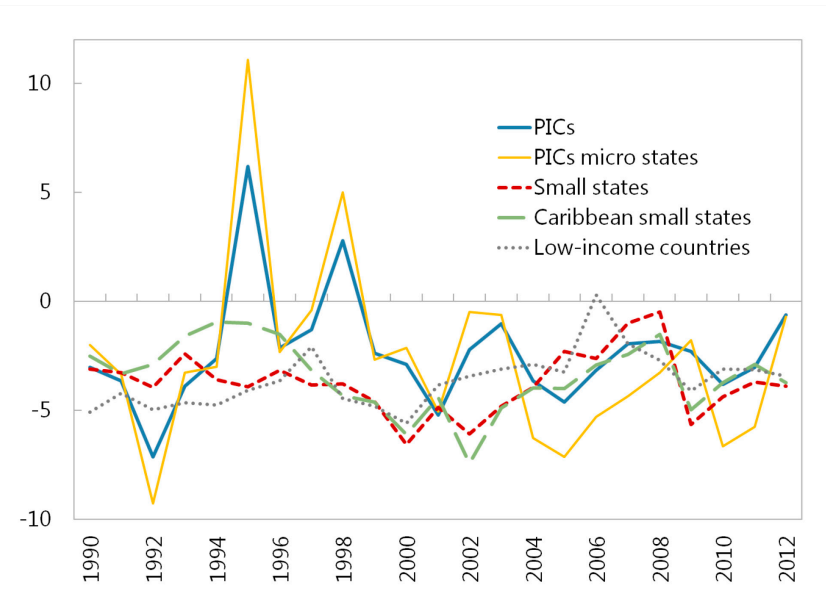
- Volatility and spending rigidities
- Trade-off between building buffers and spending

How to address macro –fiscal stability ?

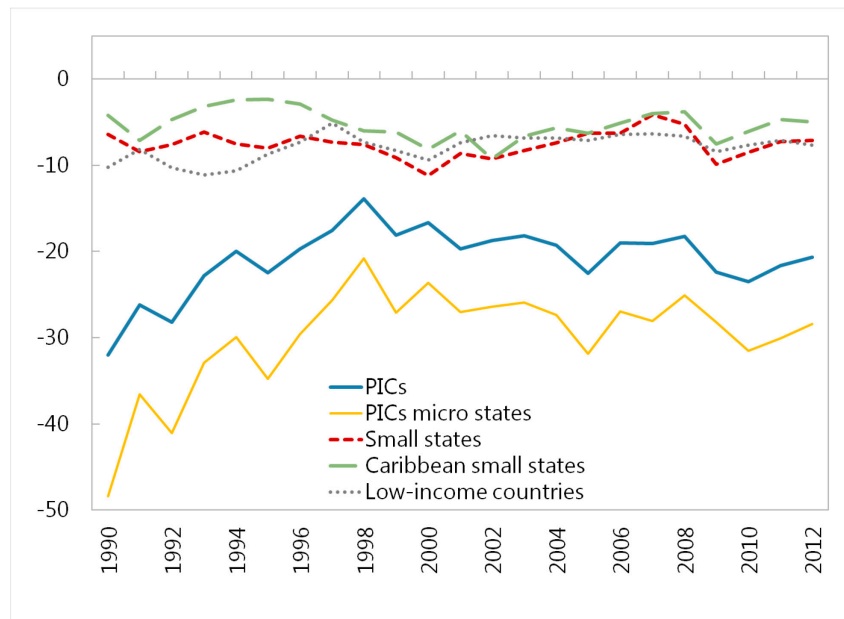
- MT fiscal framework and fiscal anchors for PICs
- Improve spending mix
- Preserve fiscal space

Assessing the fiscal stance in the PICs is complicated

Overall Fiscal Balance Incl. Grants
(In percent of GDP)



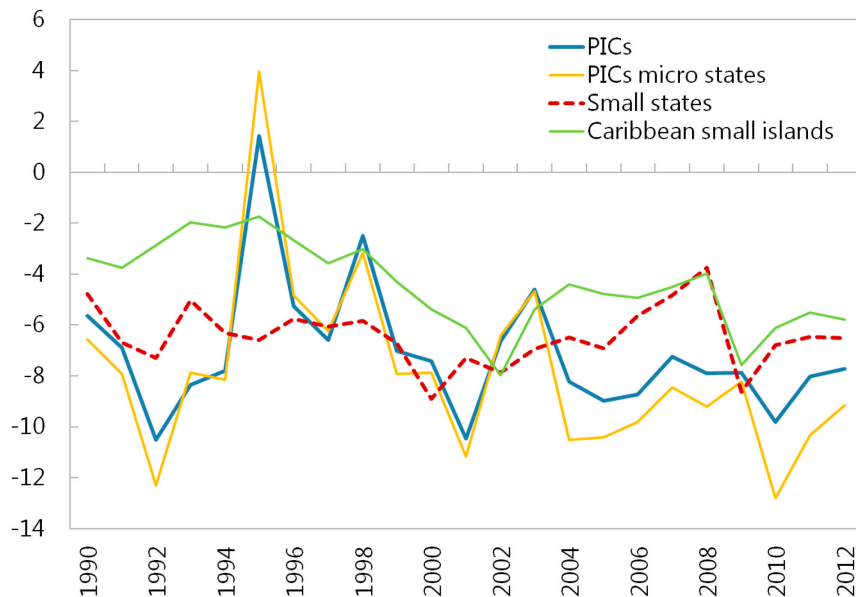
Fiscal Balance Excluding Grants
(In percent of GDP)



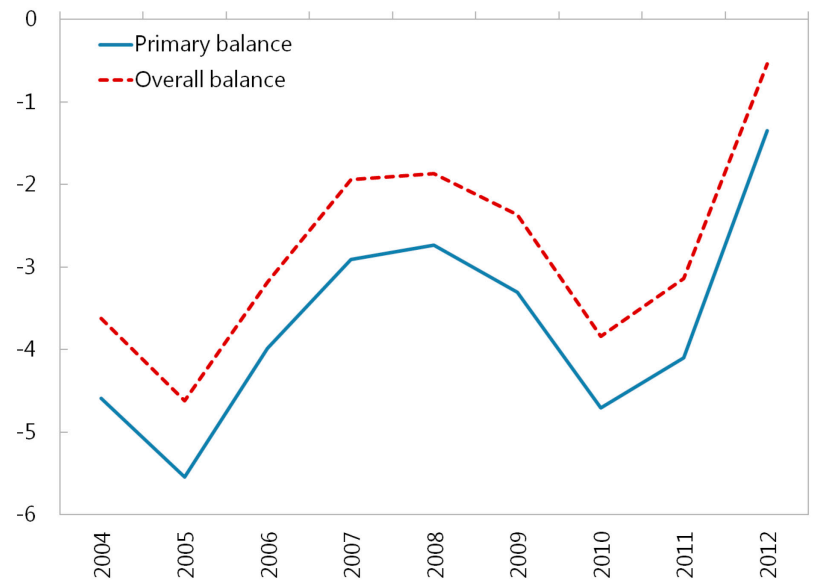
Sources: IMF, WEO; IMF, APD-LISC; and IMF staff estimates.

What is the right fiscal balance?

Non-commodity Fiscal Balance (In percent of GDP)



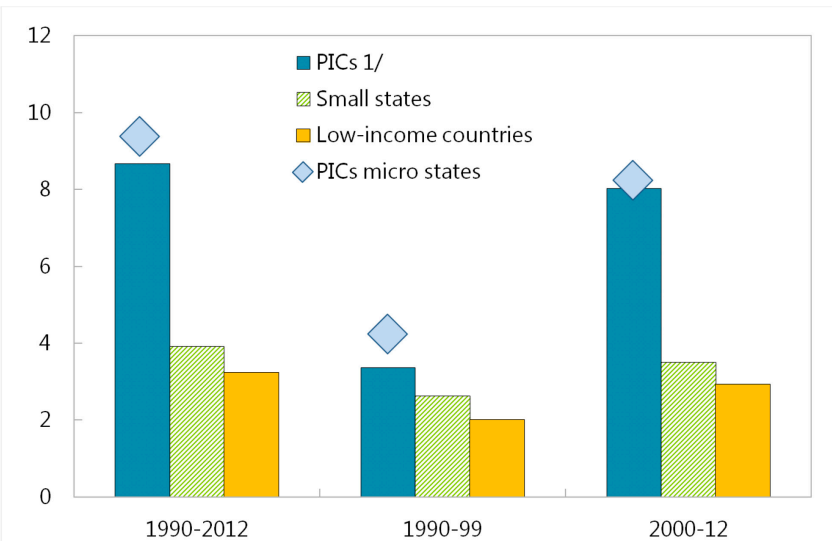
PICs: Overall and Primary Fiscal Balance (In percent of GDP)



Sources: IMF, WEO; IMF, APD-LISC; and IMF staff estimates.

PICs face more fiscal volatility than other small states → managing volatility

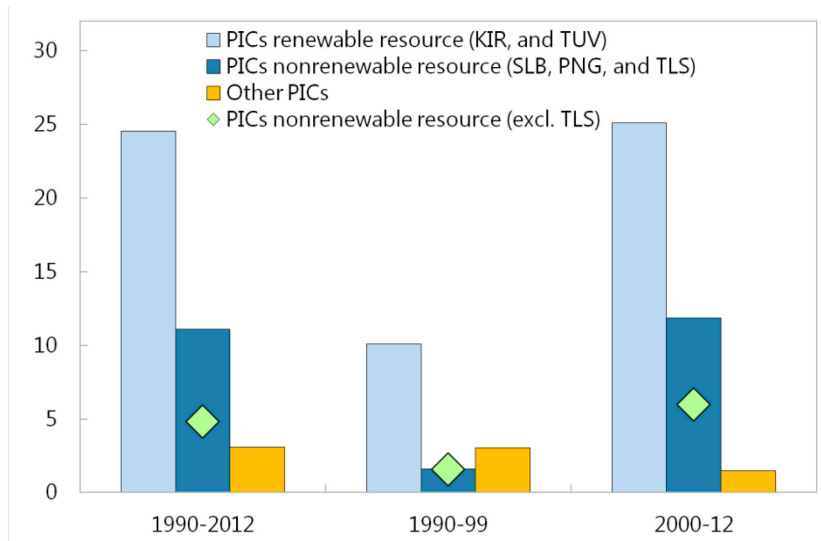
Small states: Volatility of Revenue
Excl. grants (In percent of GDP)



1/ Includes Timor-Leste.

Sources: IMF, WEO; IMF, APD-LISC; and IMF staff estimates.

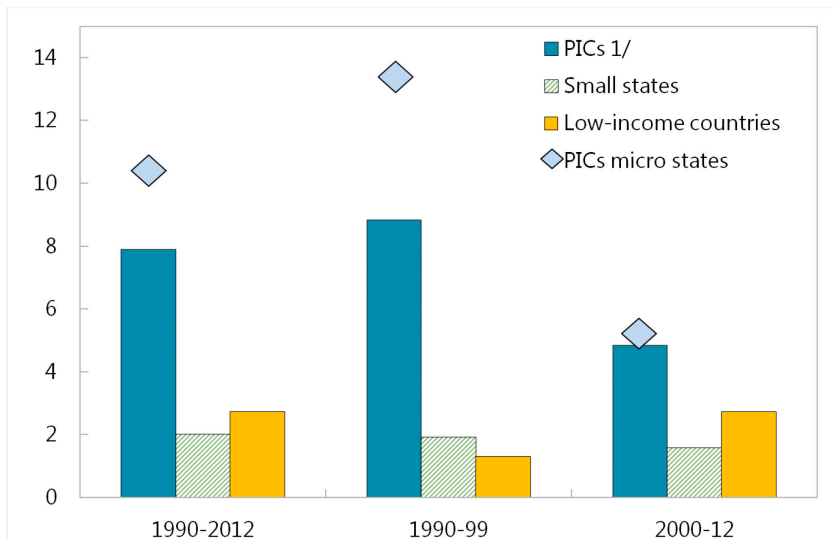
PICs: Volatility of Revenues
Excl. grants (In percent of GDP)



Source: IMF staff estimates.

Volatility of grants complicates policymaking

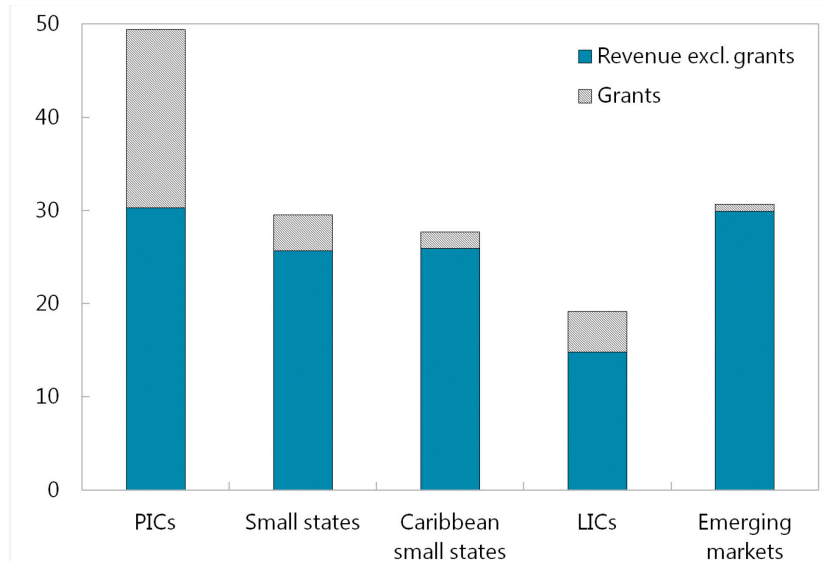
Volatility of Grants (excl. Grants) (In percent of GDP)



1/ Includes Timor-Leste.

Sources: IMF, WEO; IMF, APD-LISC; and IMF, staff estimates.

Revenue and Grants (In percent of GDP)

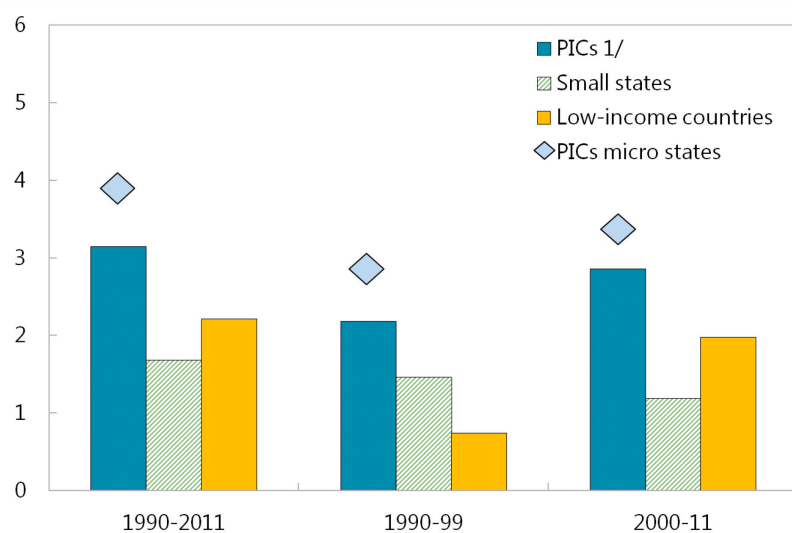


Sources: IMF, WEO; IMF, APD-LISC; and IMF staff estimates.

Channels of fiscal volatility

Volatility of Remittances

(In percent of GDP)

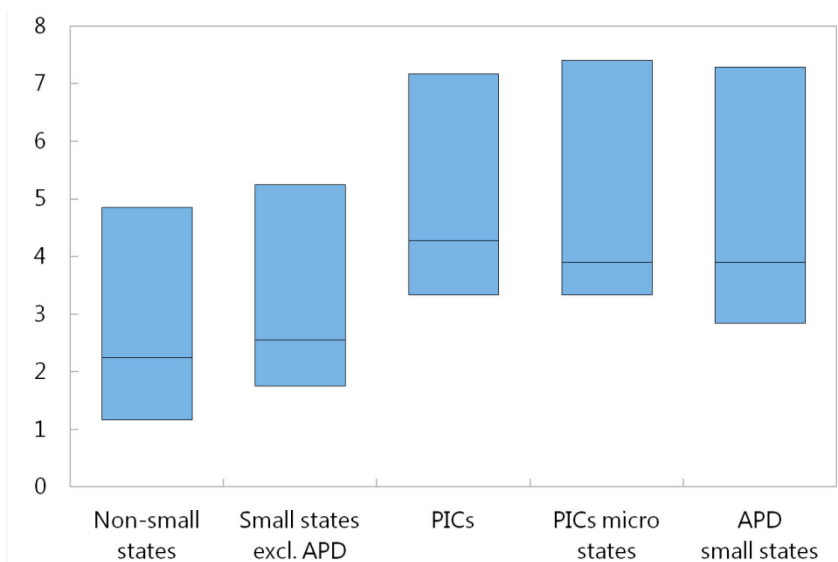


1/ Includes Timor-Leste.

Sources: IMF, WEO; IMF, APD-LISC; and IMF, staff estimates.

Volatility of the Terms of Trade

(Standard deviation; Weighted terms of trade)

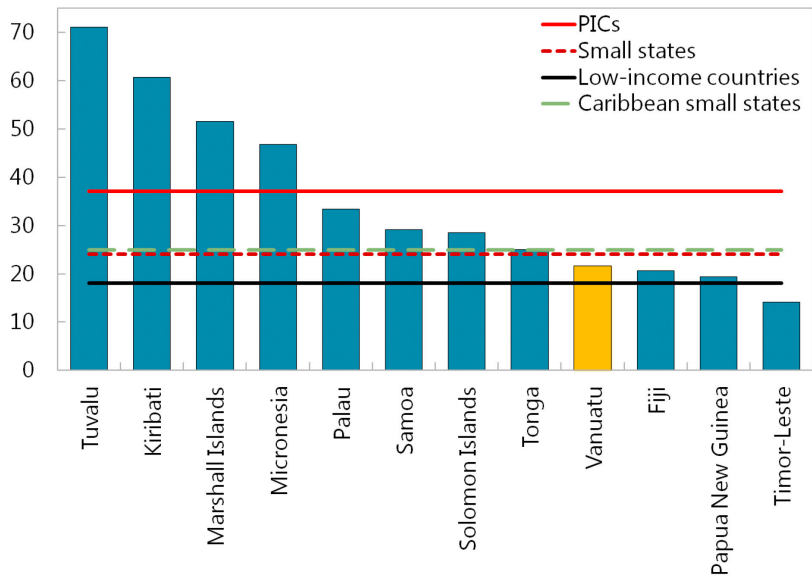


—: in the boxes represent the median. The boxes represent 50 percent of the observations. The bottom of the box represents the 25th percentile and the top the top the 75th percentile.

Spending rigidities: high current spending

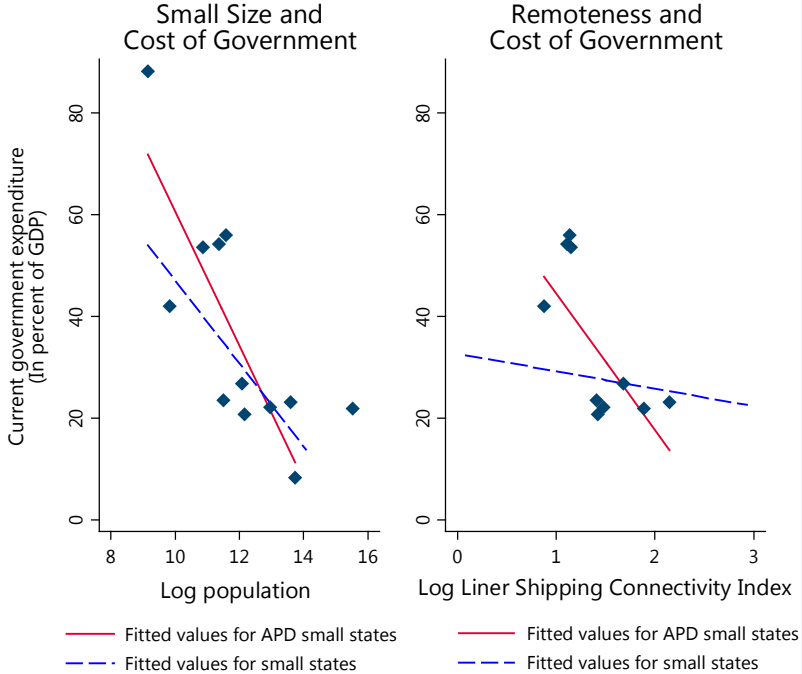
Current Government Expenditure

(In percent of GDP; 2012)



Sources: IMF, WEO; IMF, APD-LISC; and IMF, staff estimates.

Cost of Government

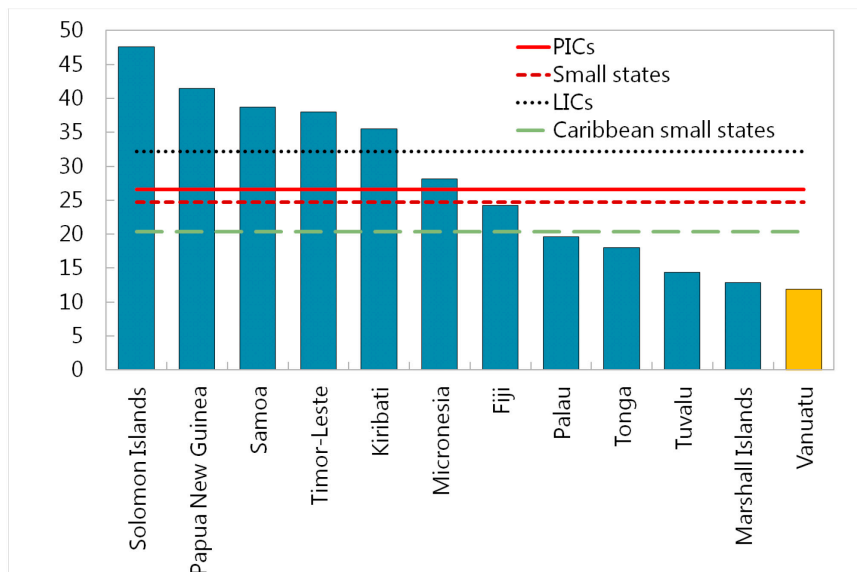


Sources: World Bank, WDI; IMF, WEO; and IMF staff calculations.

PICs' share of capital spending is in line with other small states but volatility is not

Capital Expenditure

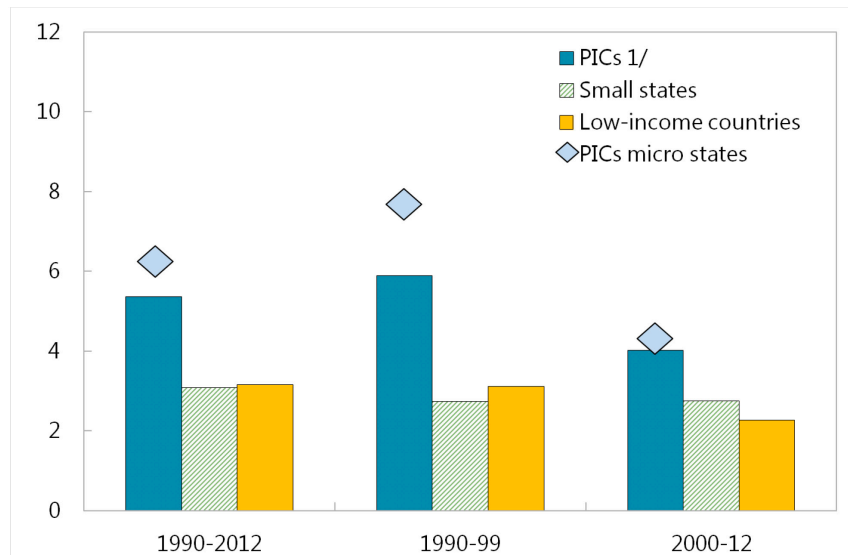
(In percent of total government expenditure)



Sources: IMF, WEO; IMF, APD-LISC; and IMF, staff estimates.

Volatility of Capital Expenditure

(In percent of GDP)



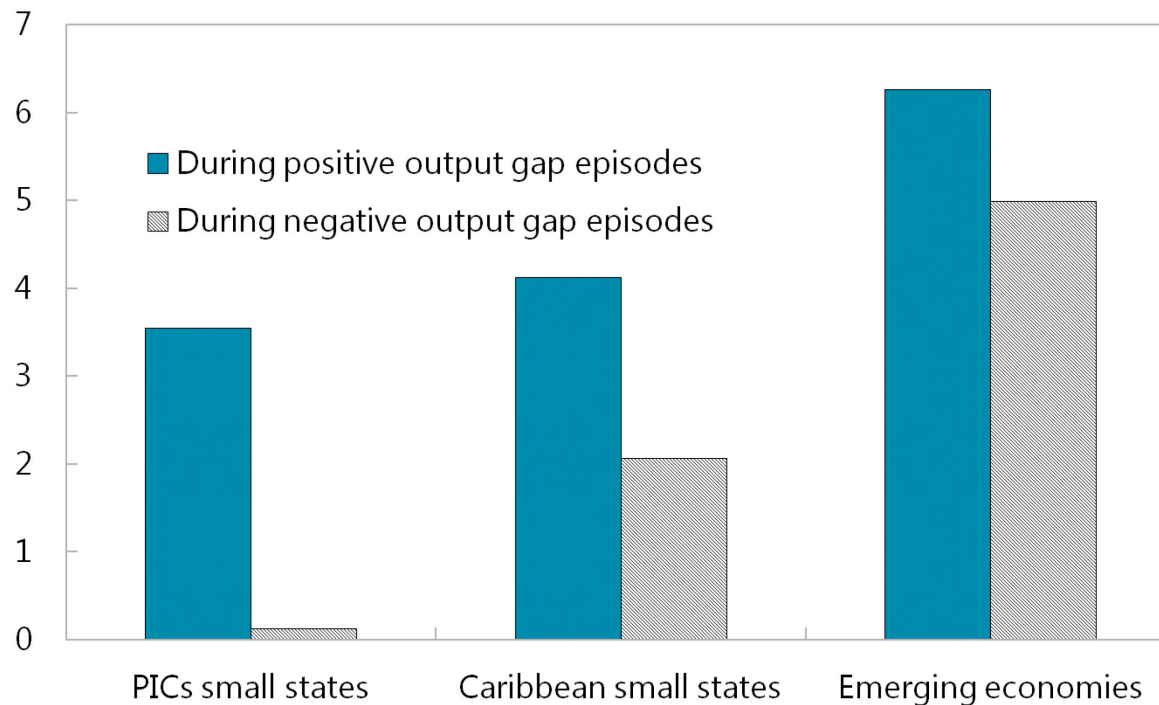
1/ Includes Timor-Leste.

Sources: IMF, WEO; IMF, APD-LISC; and IMF, staff estimates.

Procyclical bias → higher spending during good times and vice versa

Real Primary Government Expenditure^{1/}

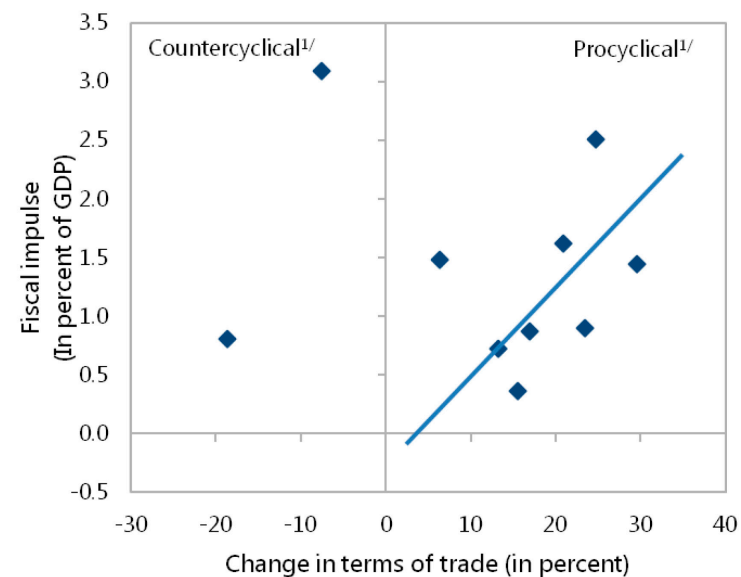
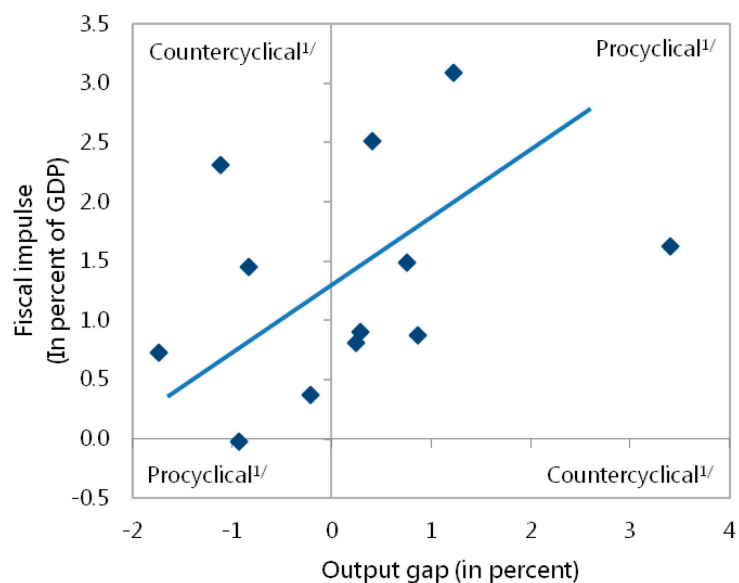
(Average percent change year-to-year; 1990-2012)



Source: IMF staff estimates.

1/ Procyclical bias is measured by the difference between the bars within the group.

Procyclical bias fiscal policy

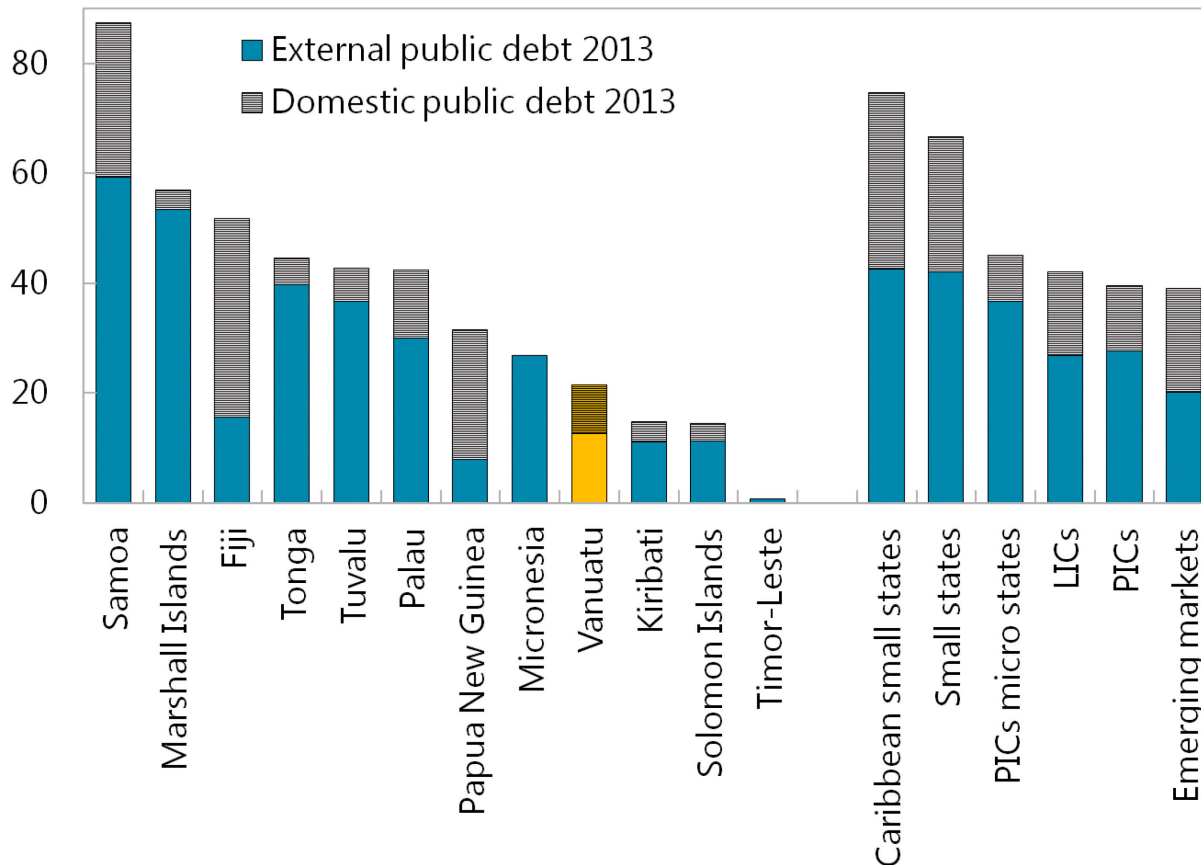


Source: IMF staff calculations, based on IMF, WEO.

1/ Indicates quadrants.

Public debt is still in check relative to other peers...

(In percent of GDP)

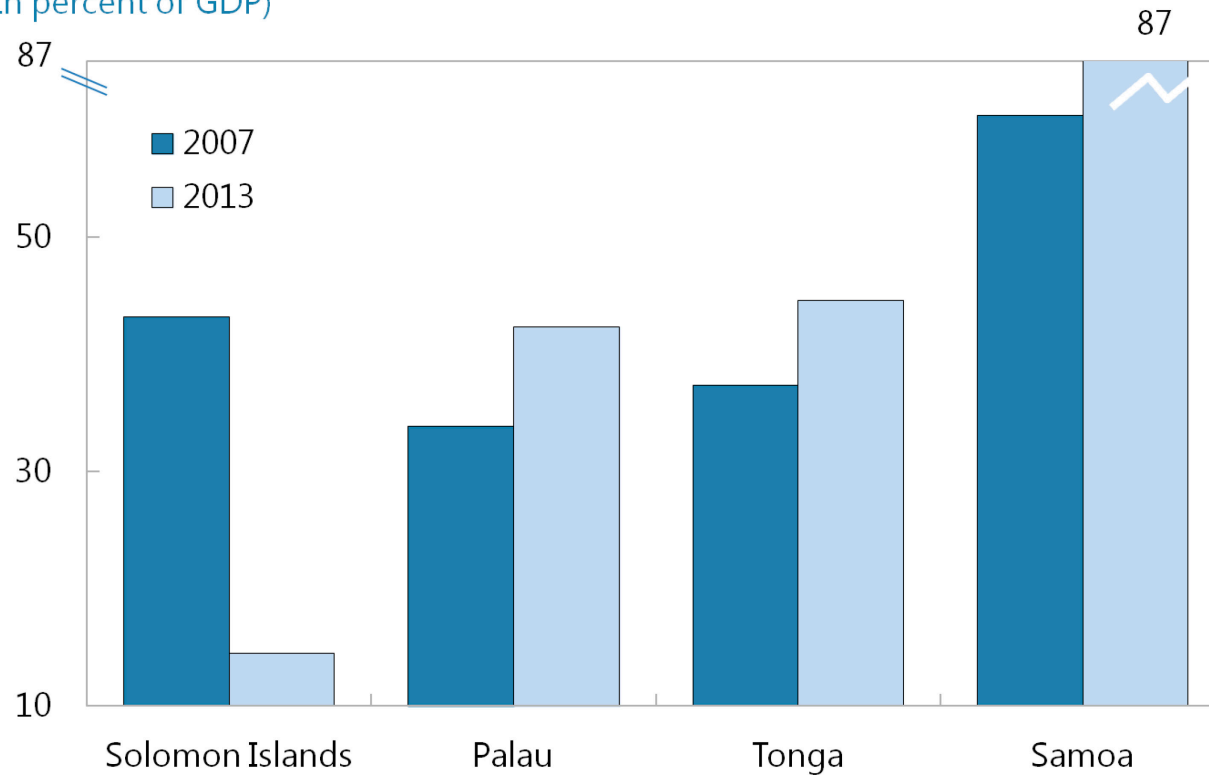


Sources: IMF, WEO; IMF, APD-LISC; and IMF staff estimates.

... but it is on the rise in some

Selected PICs: Gross Public Debt

(In percent of GDP)



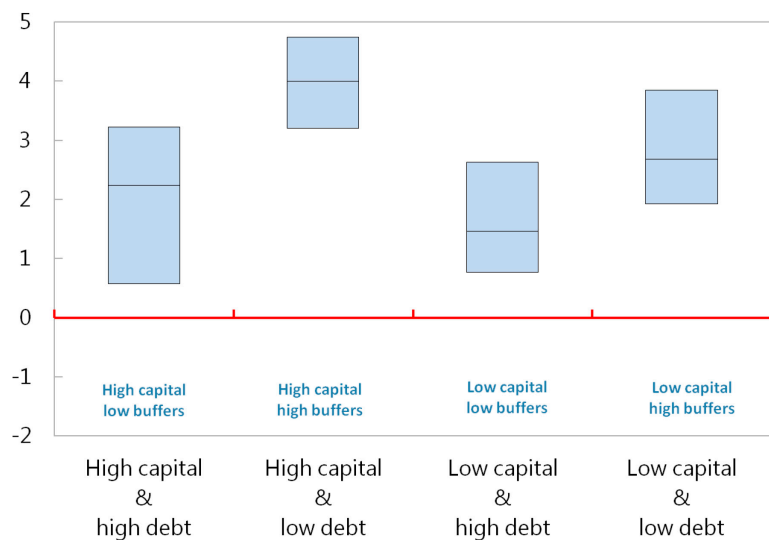
Sources: IMF, WEO; and IMF staff estimates.

Fiscal anchor for the PICs

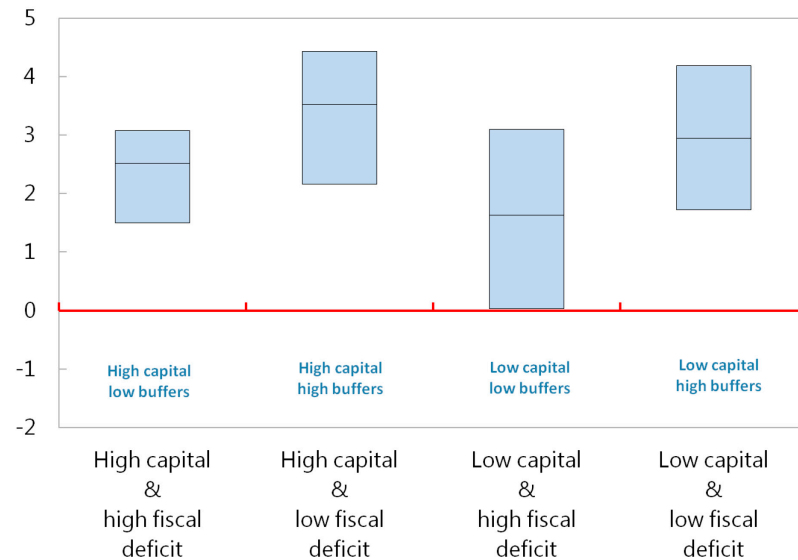
- Commodity exporters (well established literature); PNG, Timor-Leste (resource-rich countries) target non-commodity balance → **wealth fund**
- Palau (tourism)
- Marshall Islands, Micronesia, Palau, Tuvalu (trust funds)
- Kiribati (RERF)

Mix of expenditure and fiscal buffers matter for growth

Real GDP per Capita Growth
(In percent; 1990-2012)



Real GDP per Capita Growth
(In percent; 1990-2012)



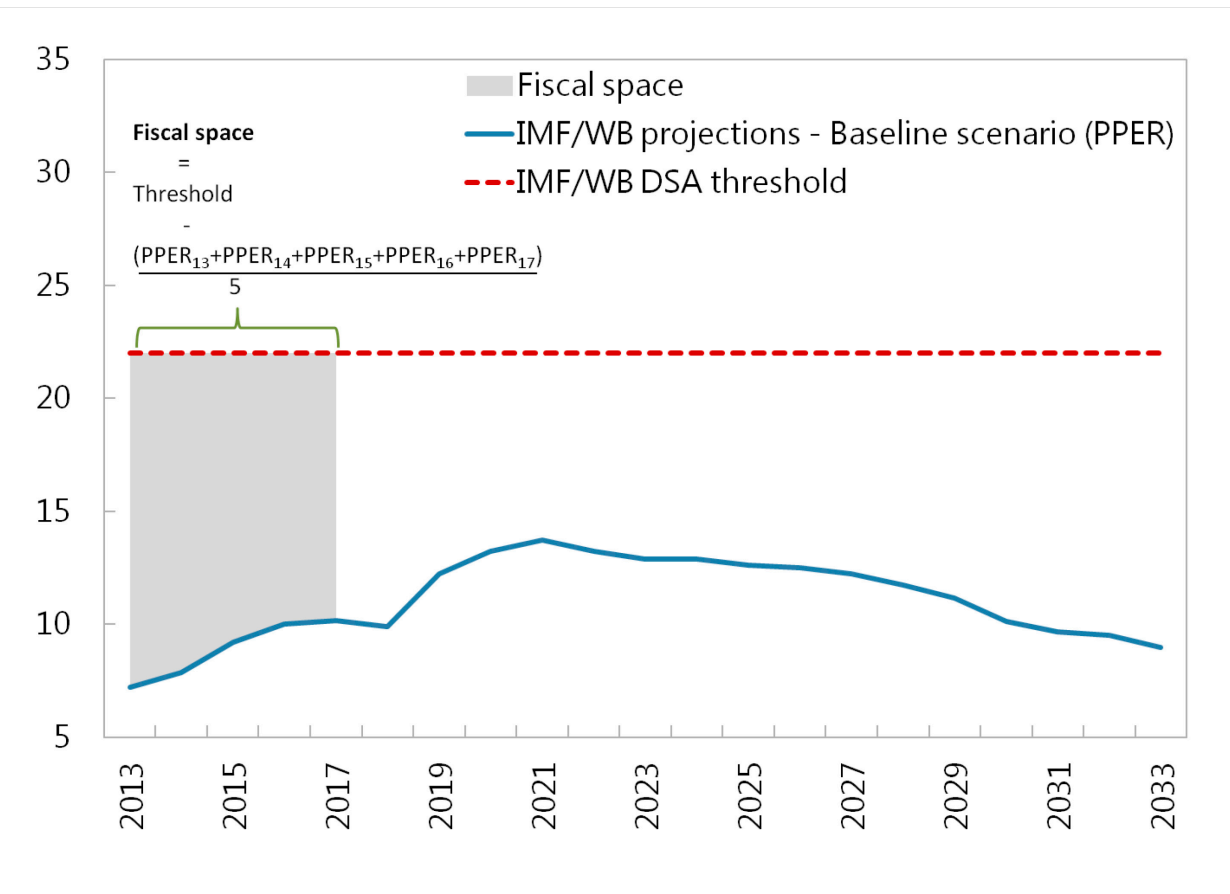
Source: IMF staff estimates

What is the size of buffers that Pacific islands need?

- **Qualitatively:** they face more shocks → PICs need more buffers than comparators
- **Quantitatively:** Size of their fiscal space and development needs
- ✓ We developed **three methodologies** to answer this question for the PICs: two measures of fiscal space and one measure of the opportunity cost of building fiscal buffers

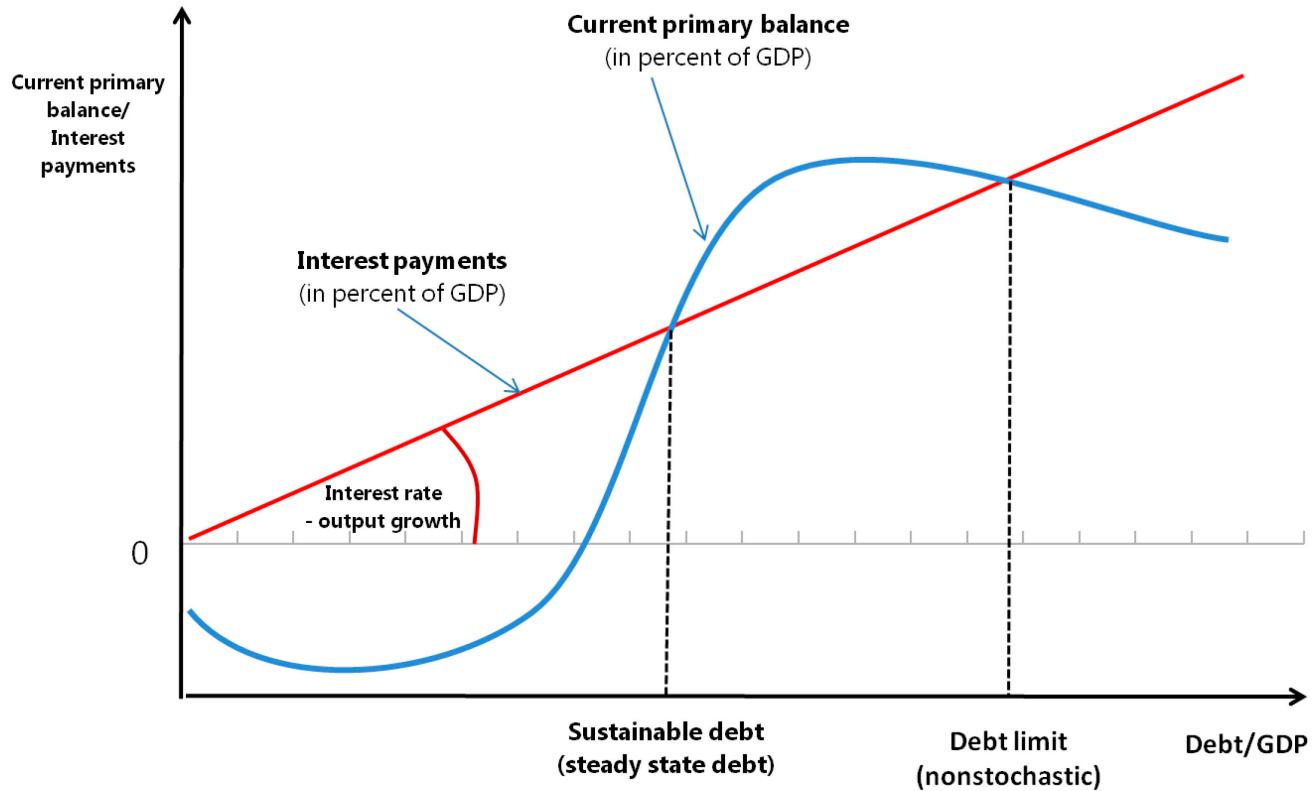
Computing fiscal space using the DSA

Pacific Island Country: Debt Sustainability Analysis (Debt service-to-revenue ratio; in percent)



Computing fiscal distress

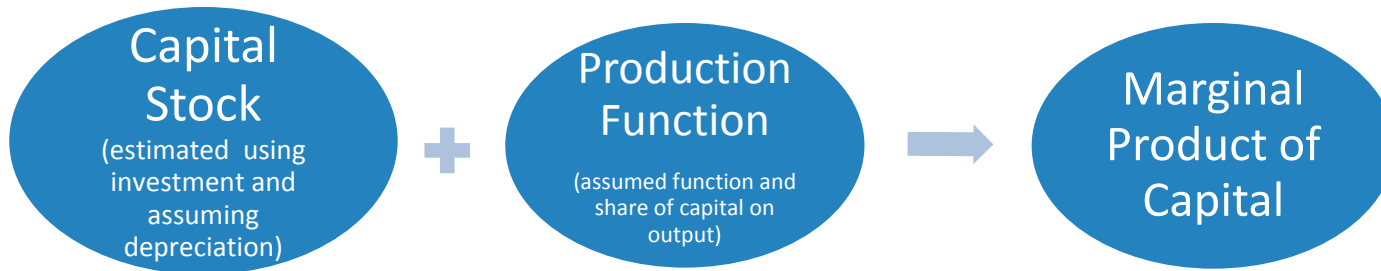
Determination of Sustainable Debt



Opportunity Cost of Building Fiscal Buffers

- **The opportunity cost of buffers is the return of public investment**
 - The resources forgone for keeping resources as buffers is the return of public investment
 - Return of public investment is the **marginal product of capital**.

Computation Marginal Return of Capital



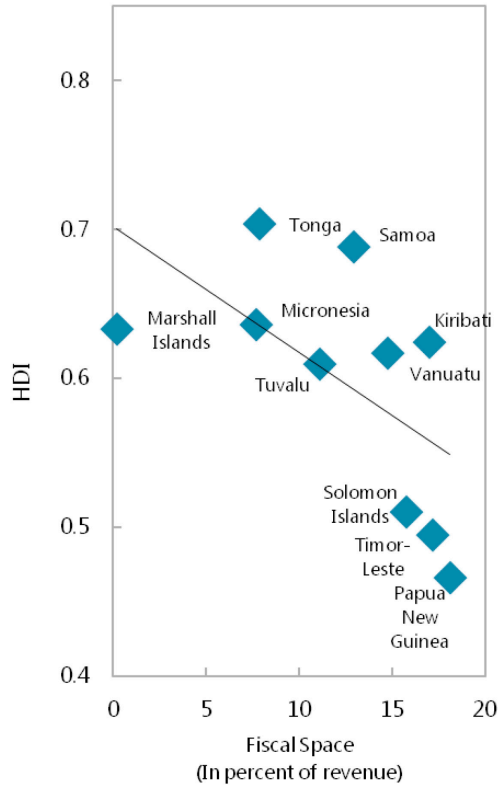
Computing the opportunity cost of fiscal buffers

Country	Social Return of Capital (a)	Average Interest Rate on Public Debt (b)	Social Return of Capital Net of Interest Rate Payments (c) = (a) - (b)
Fiji	13.1	7.2	5.9
Kiribati	14.8	3.2	11.6
Marshall Islands	10.0	1.4	8.6
Micronesia	13.0	2.7	10.2
Palau	6.2	3.0	3.2
Papua New Guinea	12.8	4.1	8.7
Samoa	13.9	3.7	10.2
Solomon Islands	13.9	1.5	12.4
Timor-Leste	15.6	2.1	13.6
Tonga	10.3	2.2	8.1
Vanuatu	11.0	3.6	7.4
PICs	12.2	3.1	9.1
Memorandum:			
Advanced	10.6
Emerging	11.9
LICs	14.2

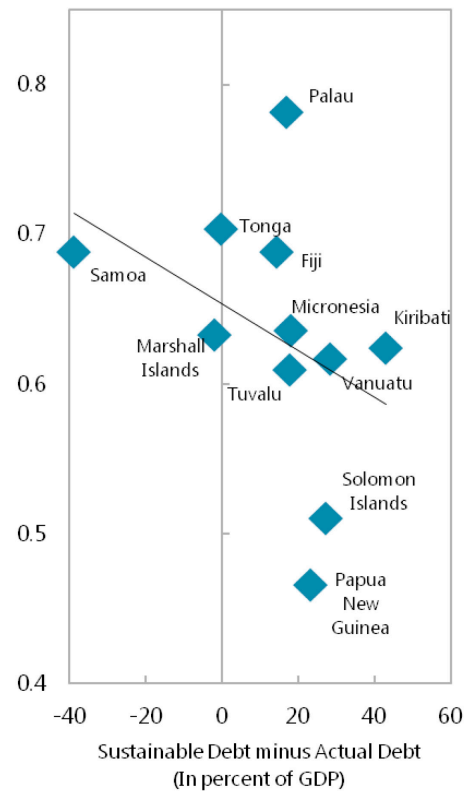
Note: Share of capital in income was assumed at 0.3 and the depreciation was assumed at 0.07. An alternative computation using estimations of shares of capital income by country groups provides similar conclusions (it results in higher returns for the PICs, emerging economies and LICs and lower returns for the advanced economies) although.

Fiscal space and development

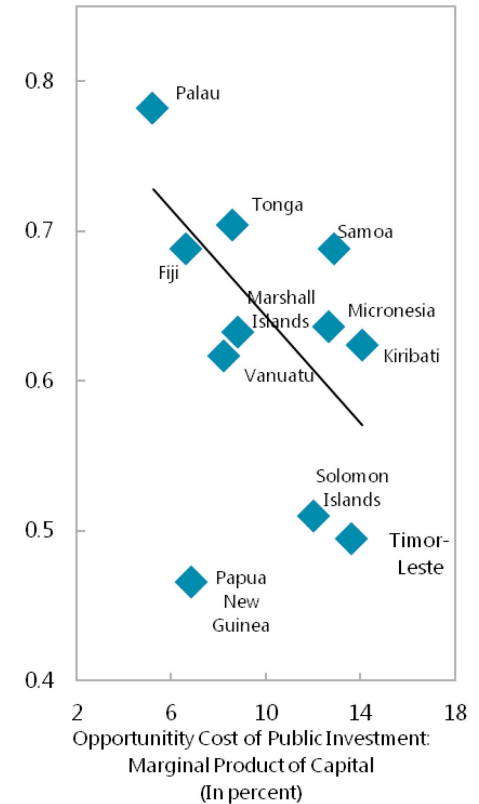
Fiscal Space and HDI



Fiscal Distress and HDI

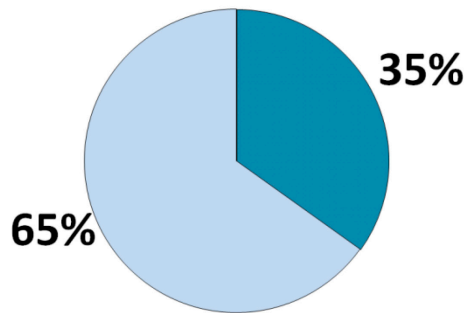


Opportunity Cost of Fiscal Buffers and HDI



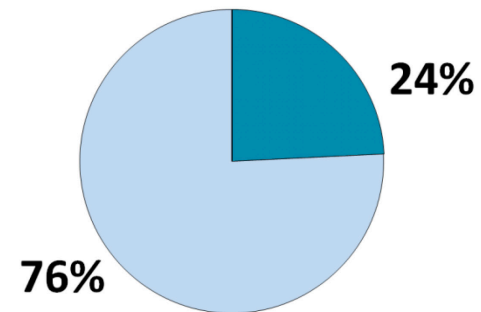
Events analysis: public spending episodes

Small States: Public Expenditure Expansion Episodes



- Expansions led by capital expenditure
- Expansions led by noncapital expenditure (misuse of fiscal space)

Emerging and Developing Countries: Public Expenditure Expansion Episodes



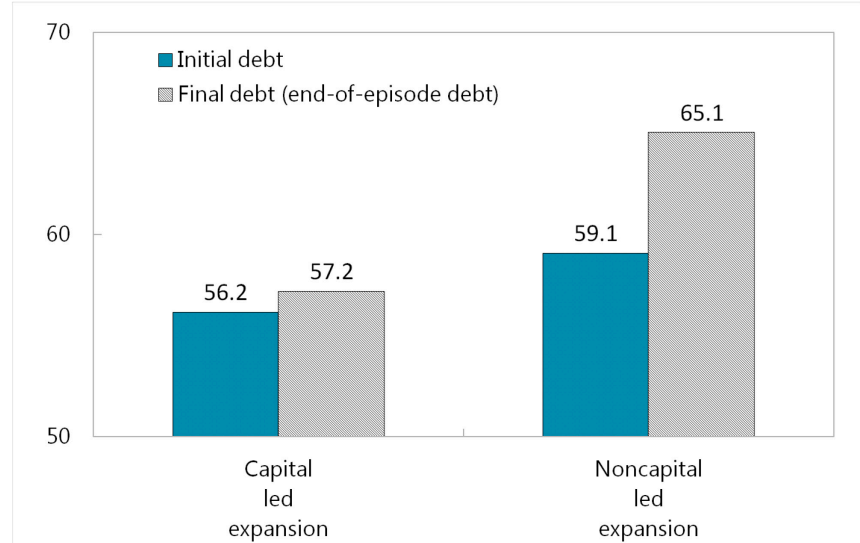
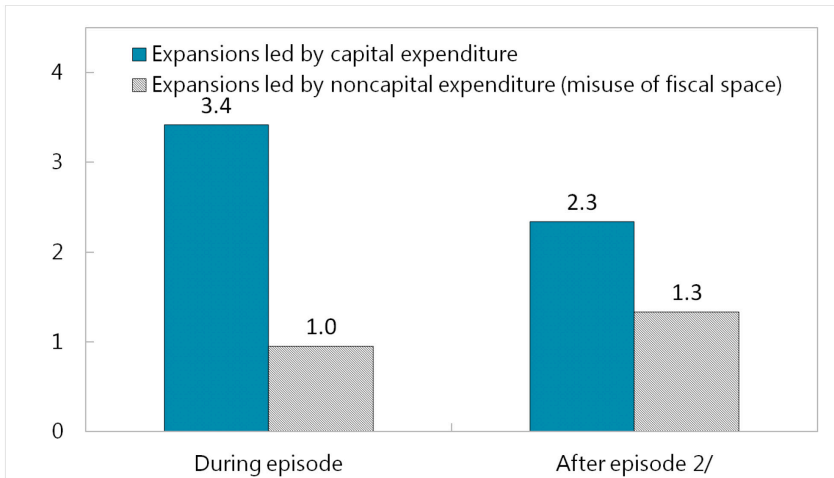
- Expansions led by capital expenditure
- Expansions led by noncapital expenditure (misuse of fiscal space)

Source: IMF staff estimates

Small states: different mix of spending matters for growth and debt

Small States: Real GDP per Capita During Public Expenditure Expansion^{1/}
(Year-to-year percent change)

Small States: Public Debt During Public Expenditure Expansion^{1/}
(In percent of GDP)



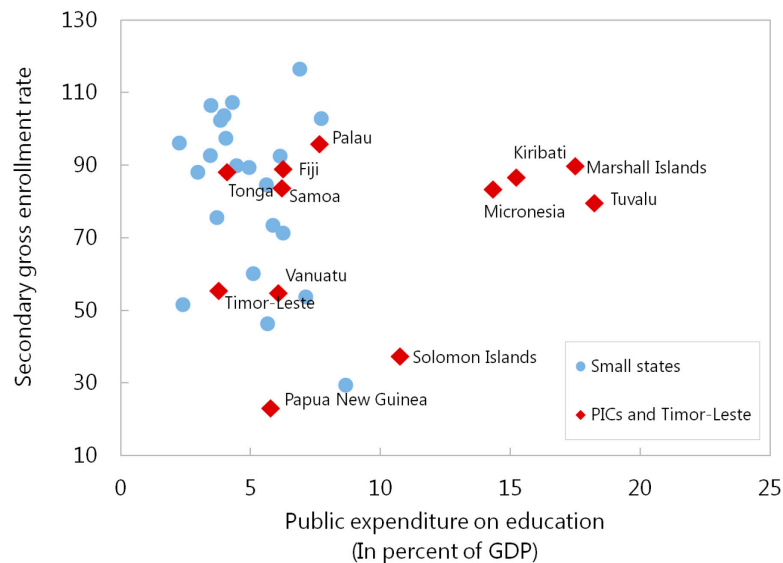
1/ Includes only public expenditure episodes that resulted in higher deficits.

2/ Three year average after the episode.

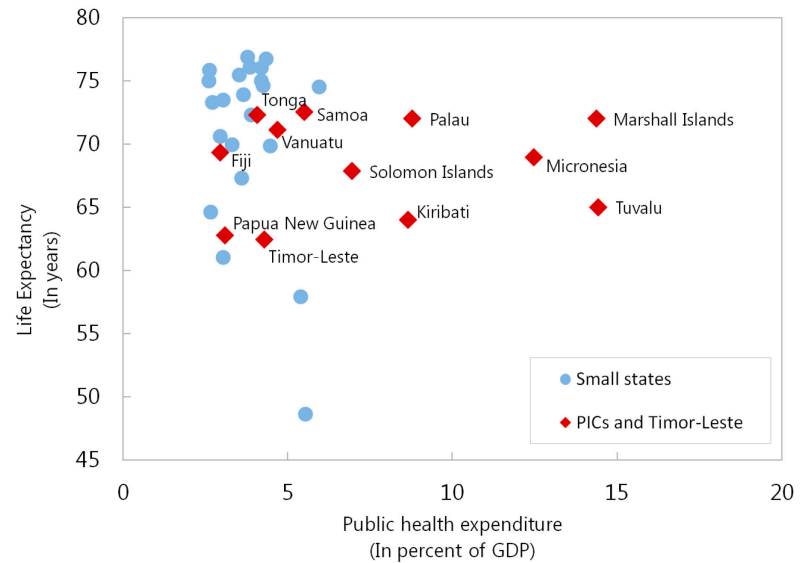
Source: IMF staff estimates

Expenditure with high cost and still improvable outcomes

Public Expenditure in Education and Secondary Enrollment



Life Expectancy and Public Health Expenditure



Source: IMF staff estimates

Policy matters

- Strengthen fiscal frameworks to manage volatility, (long-term orientation of fiscal policy) to support growth and ensure debt sustainability
- Building buffers is important but so too is the spending mix
- Improve institutions and governance