INTERNATIONAL MONETARY FUND

IMF Country Report No. 11/339

Republic of the Marshall Islands

2011 ARTICLE IV CONSULTATION

Republic of the Marshall Islands: 2011 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and the Statement by the Executive Director for the Republic of the Marshall Islands.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2011 Article IV consultation with the Republic of the Marshall Islands, the following documents have been released and are included in this package:

- The staff report for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 7, 2011, with the officials of the Republic of the Marshall Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 7, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its November 23, 2011 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for the Republic of the Marshall Islands.

The document listed below will be separately released.

Statistical Appendix Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

November 7, 2011

KEY ISSUES

Economic and political environment. Following a severe recession in FY2008–09, the economy grew by 5.2 percent in FY2010, mainly driven by an expansion in fisheries and exports and moderating fuel prices. The fiscal situation has improved somewhat, but general elections scheduled for late November add to spending pressures.

Outlook and risks. The recovery is expected to continue, but prospects over the medium term are overshadowed by the scheduled declines in foreign grants and sluggish private sector. Risks to the outlook are on the downside, stemming mainly from a protracted global slowdown. The weak financial position of some public enterprises could hinder economic activities and erode public finances. Fluctuations in fuel and food prices would also pose a substantial risk given the RMI's high dependence on commodity imports.

Fiscal sustainability. Achieving long-term budgetary self-reliance and sustained growth remains a challenge. Under the baseline projection, sluggish growth and fiscal adjustment imply a large projected revenue shortfall in FY2023 when Compact grants are set to expire. Closing this revenue gap would require a fiscal adjustment of around 4 percent of GDP over the medium term. It would be important to start implementing reforms early to create fiscal space and address possible setbacks.

Fiscal and structural reforms. To achieve this adjustment would require comprehensive public sector and structural reforms that build on ongoing efforts to unlock private sector growth. These include: (i) swift implementation of tax reform; (ii) targeted expenditure cuts; (iii) accelerated reforms of the state-owned enterprises (SOEs), and; (iv) removal of obstacles to private sector development.

Financial sector. The banking sector remains liquid and profitable, but contributes little to growth. Credit risks from heavily-indebted households could rise. The Banking Commission's oversight should be broadened to include the development bank and private lending institutions to safeguard financial stability.

Approved By
Kenneth Kang and Aasim Husain

Discussions took place in Majuro with Finance Minister Ading, Chief Secretary Nemra, Finance Secretary Alfred, Jr., other senior government officials, political leaders, private sector representatives, donors, and the press. The mission team consists of Mr. Yoshida (head), Mr. Lam, and Ms. Mohammed (all APD). Mr. Yang (Resident Representative for Pacific Island countries), Mr Kaminaga (OED), Mr. Everett (AsDB), and representatives from the World Bank also participated in the discussions.

CONTENTS

INTRODUCTION

1. **The Republic of the Marshall Islands (RMI) is a small island country in the north Pacific highly dependent on external aid, mainly from the United States.** The renewal of the Compact of Free Association Agreement in 2004 has provided a stream of stable, but declining grants aimed primarily at education, health, and infrastructure sectors. After Compact grants expire in 2023, the RMI is expected to complement its domestic revenues with returns from its Compact Trust Fund (CTF), which receives annual savings from fiscal surpluses along with donor contributions.

2. **Achieving fiscal and economic self-sufficiency remains a huge challenge and is exacerbated by the difficult political situation.** Like other small Pacific Island countries, the RMI is vulnerable to external shocks given its geographical remoteness and structural impediments. Given the pressures on public finances from scheduled declines in Compact grants, growth prospects remain weak over the medium term, requiring decisive policy measures to put the economy on a sound footing. The outlook for key reforms, however, is clouded by the political uncertainties surrounding the general elections scheduled in late November.

3. **Against this background, the Article IV discussions focused on policies to achieve long-term economic and fiscal sustainability**. The key issue was how to strengthen fiscal management building on government efforts to implement tax reforms, cut current expenditures, and reform ailing SOEs. Staff also discussed policies to promote the private sector and strengthen the financial system.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent Economic Development

4. **Since the last Article IV consultation, the economy has recovered strongly.** Following a severe recession in FY2008–09, the economy grew by 5.2 percent in FY2010, driven by an expansion of fishery output and exports, and moderating fuel prices. With growth concentrated in only a few sectors, rising unemployment and financial hardship, especially in outer islands (see chart), have driven migration to the urban atolls and the United States. Inflation stabilized in FY2010 following the temporary surge of food and fuel prices in FY2008–09.

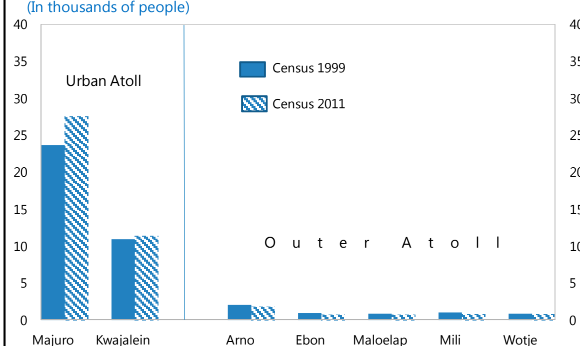
5. **Along with the economic recovery, the overall fiscal balance improved in**

Selected Economic Indicators

	FY2005–09 Average	FY2010 Est.	FY2011 Est.	FY2012 Proj.	FY2016 Medium term Proj.
		(year-on-year changes)			
Real GDP	0.9	5.2	5.0	5.4	1.6
CPI	5.3	1.6	9.5	-0.5	2.0
		(in percent of GDP)			
Current Account Balance 1/	-6.5	-25.0	-12.6	-30.3	-4.7
Overall Fiscal Balance	0.7	4.6	1.4	1.0	1.0

Sources: RMI Authorities and Fund staff estimates.
1/ Including official current transfers.

Population Migration
(In thousands of people)



Source: Data provided by RMI authorities.

FY2010, but mostly as a result of unspent earmarked appropriations. Only a modest surplus ($0.4 million) was recorded in the general fund for discretionary uses in FY2010. The overall surplus in FY2011 is estimated to be modest, with a 5.5 percent across-the-board cut of current expenditures and additional revenues from fishing fees partly offset by temporary tax exemptions on food and other basic consumables and increased subsidies and transfers to public enterprises to cover operating losses. Despite a potential upside of higher fisheries revenue, the fiscal outlook will continue to be hindered by weak financial positions in the SOEs and limited budget planning, unless reforms in these areas are accelerated. Over the medium term, fiscal balance is expected to be modest at about 1 percent of GDP.

6. **The deterioration in the current account is expected to continue until FY2013 due to temporary factors.** The widening of the current account deficit since FY2009 reflects increased imports under the Kwajalein land use agreements (LUA),[1] new investments in the fisheries sector and the airport extension project, which have been financed mainly through foreign direct investment and capital grants. Tourism receipts declined after the discontinuation of charter flight services, but this has had a limited impact on the external balance given its small share in services receipts. Once these temporary factors expire, the current account deficit beyond FY2013 is expected to decline to around 5 percent of GDP. Though external debt is relatively high at about $117 million (about two-thirds of GDP) as of end-FY2011, it is mainly on concessional terms and is expected to decline.

7. **The recovery is likely to continue in the near term, but medium-term prospects are overshadowed by the scheduled declines in Compact grants.** Growth in FY2011 is estimated at about 5 percent, driven by higher fish catches from the newly commissioned purse seiners (fishing boats), large inflows from the Kwajalein LUA, and the FAA-funded airport extension project. Over the medium term, staff expects growth to stay low at around 1½ percent with the growth in fisheries sector partly offset by the decline in Compact grants (about $½ million per annum before adjusting for inflation).

8. **Pressures on domestic prices from rising commodity prices in early 2011 are likely to subside.** Inflation increased following the significant rise in commodity prices in early 2011, but is projected to moderate gradually (Box 1). Domestic price movements over the medium term are projected to be broadly in line with those in the United States reflecting the close trading ties and the use of the U.S. dollar as the legal tender. However, prices are likely to remain highly volatile with fuel and food prices constituting nearly half of the CPI basket.

9. **Risks to the outlook are on the downside.** The economy could face stiff headwinds if the global slowdown proves severe and prolonged (Box 2). Overseas investments are also likely to suffer losses. The weak financial position of the SOEs (operating losses before government contributions among key SOEs were $7 million in FY2010) could erode public finances (Figure 2). Growth could further weaken under a protracted global slowdown if the planned foreign investments in fisheries were withheld due to higher uncertainty. On the upside, further

[1] The LUA was reached between the RMI government and Kwajalein landowners in May 2011, under which the landowners would allow U.S. military operations in Kwajalein until 2066. The agreement also authorized the disbursement of about $32 million from the U.S. government to the landowners. Part of the inflow contributes to the economy through consumption and investment, while a majority is expected to flow out overseas in the form of deposits.

investment in commercial fisheries could generate positive spillovers to the rest of the economy. The pending U.S. funded satellite project in Kwajalein might also create new jobs that offset lay-offs from the downsizing of the Kwajalein military base. Longer-term risks include continued outward migration and shore erosion on local atolls from climate change.

Box. 1. Marshall Islands: The Impact of High Fuel and Food Prices

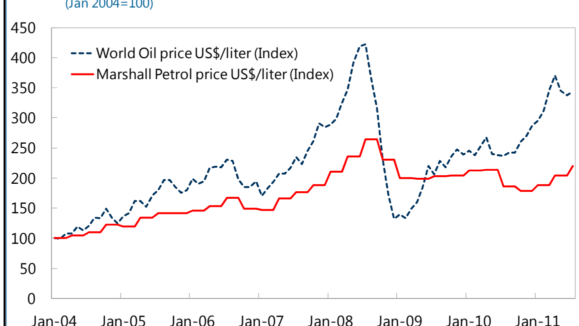
The RMI relies heavily on fuel and food imports and was not shielded from the surge in food and commodity prices. Similar to other Pacific Island countries, which rely heavily on fuel and food imports, the RMI's share of fuel and food imports in merchandise imports are 27.4 percent and 30.5 percent, respectively, as of FY2010.

The RMI has almost full pass-through of food and fuel prices with a lag of about two months for fuel and 3-6 months for food. When commodity prices rose sharply in 2008, inflation soared to 14.7 percent. The price of rice, which is a main imported staple in the RMI and accounts for 13.5 percent of the CPI food basket, also rose significantly.

Domestic prices returned to trend in FY2009–10 as commodity prices subsided, but is estimated to rise in FY2011. In the first four months of 2011, oil prices increased by about 30 percent from the same period in 2010 before moderating in recent months, pushing up the projected year-on-year CPI increase in FY2011 to around 9.5 percent. The recent episode of high global fuel prices did not lead to a drastic increase in RMI's domestic fuel prices as in 2008-09, likely due to tax exemptions on fuel in effect since 2008. Domestic fuel prices are, however, rigid downward due to the limited competition in the supply of fuels.

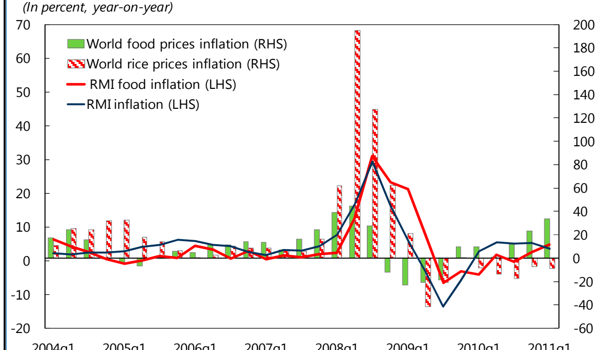
The high and immediate pass-through of commodity prices could worsen both fiscal and external positions. Higher commodity prices would likely raise the import bill and government spending on goods and services. A case in point was the transfer of $8 million from the government to the Marshalls Energy Company (MEC) in 2008 to ensure continued oil procurement in the midst of high world oil prices. This transfer alone constituted 5 percent of GDP. An increase in the oil prices by 30 percent from 2011 level would lower the growth in FY2012 by 1.4 percent (from 5.4 percent in baseline) and the current account balance would worsen.

Index of World Oil Price and Marshall Islands Petrol Price US$/liter
(Jan 2004=100)



Sources: RMI authorities and Fund staff estimates.

Pass-Through of International Food Prices to Domestic Food Inflation
(In percent, year-on-year)



Sources: WEO, RMI authorities, and Fund staff estimates.

Box 2. Marshall Islands: Implications of the Global Slowdown and Financial Turmoil

Although the RMI has so far been weathered well the global financial turmoil, the economy is vulnerable to a protracted global slowdown and deepening financial crisis. In addition to the direct impact of declining asset prices on its sizeable investment overseas, the RMI is likely to be affected through the following channels:

- **Weaker exports and fiscal revenues.** RMI's exports represent around 23 percent of GDP, with the United States and East Asia—mainly China, Taiwan, Province of China, and Japan—as the largest export destinations. A sharp slowdown in advanced economies with spillovers to Asia would reduce demand for fish and copra exports. Lower fish prices would further erode export values and fiscal revenues from fishing fees. Export competitiveness could weaken if the global slowdown led to U.S. dollar appreciation as investors seek safer assets.
- **Uncertainty of foreign direct investment and official aid flows.** Global slowdown could put existing foreign investment plans—particularly in fisheries—on hold as investors face higher uncertainty and tighter financing conditions. Although annual Compact grants are unlikely to change, other aid flows and concessional lending could come under pressure as donors face tighter budget constraints.
- **Insufficient trade finance.** A global slowdown could curtail trade financing, raising the risk of a sharp fall in international trade as happened during 2008-09. Although importers do not rely heavily on trade credits, their overseas suppliers could be adversely affected by tighter credit conditions, forcing them to raise shipping cost or to reduce trade volumes.
- **Lower disposable income.** Many migrant workers in lower-skills jobs in the United States may be at risk in a softening U.S. labor market, requiring more support from their families in the RMI. Returning workers could also put downward pressure on local wages.
- **Declining value of overseas investment.** In addition to the Compact Trust Fund, the banking system and social security fund also have large overseas exposure through their foreign asset holdings, which make up nearly two-thirds of their assets. Much of this comprises of U.S. Treasuries, and U.S. and global equities. Banks' concerns over potential losses could cut back their lending. Lower U.S. interest rates would generate capital gains on their bond holdings, but over the longer term could depress net interest margins.

Near-term growth prospects would worsen if the global slowdown and financial turmoil proves to be more severe and protracted. During FY2008–09, the economy underwent severe recession where growth fell to 3 percent below its potential and the CTF faced a cumulative investment loss of over 20 percent. A protracted global slowdown this time could also pose significant costs to the RMI. Overseas investments are estimated to have fallen by about 10 percent (based on the CTF's asset allocation) since June. Growth could slow by a half to a range of 2–3 percent in FY2012, and could further weaken if the planned foreign investment in fisheries was held back due to uncertainty of global outlook.

The Authorities' Views

10. **Compared to staff's projection, the authorities expected a higher growth due to the strong expansion of fisheries.** On this basis, officials forecast near-term growth of 9.0 and 8.8 percent in FY2011 and FY2012, respectively, compared to staff's projection of 5.2 percent on average. While sharing the authorities' views that fishery expansion and construction activities have been key drivers of near-term growth, staff sees that the new investment will take time before reaching full operation while the inflows with the LUA has so far had smaller-than-expected positive

spillover to the overall economy. The authorities agreed the growth prospects would be hindered by the scheduled declines in Compact grants over the medium term.

11. **The authorities also emphasized upside risks to the staff projections.** The downsizing of Kwajalein military base was smaller than initially expected (15 layoffs versus 100–120 anticipated), and learning from the previous experience in FY2008–09, the authorities considered themselves better prepared for a surge in food and fuel prices. For instance, electricity tariffs now have a built-in mechanism to reflect global oil price movements. While the authorities recognized the economy's vulnerability to external shocks via trade and foreign investment channels in addition to direct overseas investment losses, they believed that the economy was more resilient this time given the ongoing fishery expansion and construction activities. They also have the policy option to extend some tax exemptions to mitigate the impact of a shock.

12. **Officials also expected better fiscal performances for FY2011–12.** A strong economic recovery would bring in more tax revenues through personal income tax and import duties, while the regional efforts to manage fish stock through the Parties to the Nauru Agreement (PNA) would bring in more fishing fees. Earlier efforts on expenditure control should also improve the fiscal outrun.

B. External Stability and Exchange Rate

Background and Staff's Views

13. **The risks to external stability appear to be limited.** The current account deficits are expected to remain wide until FY2013, mainly related to investment in fisheries and airport extension project mainly financed through foreign direct investments and capital grants. Compact financial flows dominate external balances and will continue to provide a stable source of funding over the next decade. External debt is expected to decline, as debt repayments rise in the coming years. The use of the U.S. dollar as the domestic currency remains appropriate given the small size of the economy and its close financial linkages with the United States.

14. **The RMI's real exchange rate appears to be in line with the medium-term fundamentals of the economy.** The real appreciation in FY2008–09 was largely reversed in the second half of 2009 as domestic prices stabilized. More fundamentally, exports have continued to expand, in contrast to some other Pacific Island countries. In the long run, the expiration of the Compact grants could, however, lead to an erosion of foreign assets undermining external stability unless the authorities undertake needed fiscal adjustments and structural reforms.

Authorities' Views

15. **The authorities agreed that the near-term risks to external stability were contained.** They also indicated the use of the U.S. dollar remained appropriate and the Compact grants would continue to provide stable funding over the next decade. They noted that the fishery expansion seem to suggest the RMI's competitiveness on key sectors had improved.

16. **External debt is not a key concern at the moment.** The authorities noted that, while external debt has slightly risen owing to the new program with the Asian Development Bank (AsDB), a large portion of debt was on concessionary terms with a relatively long grace period. Interest payments would rise in the coming years, but are likely to remain manageable.

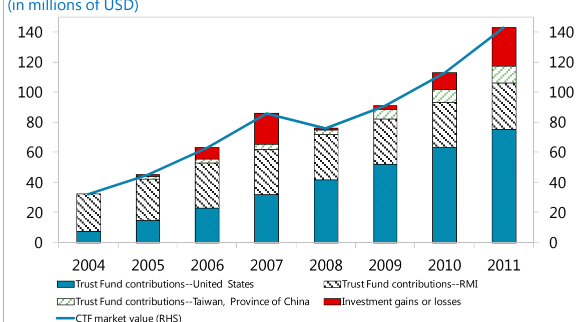
POLICIES TO ACHIEVE SUSTAINABLE GROWTH

A. Fiscal Policy and Public Sector Modernization

Background

17. **Under current policies, the build up in government assets in the Trust Fund is projected to fall short of replacing Compact grants expiring in FY2023.** In particular, the global financial crisis, by reducing investment returns, has made it more difficult to achieve long-term budgetary self-reliance. The market value of the CTF stood at $142 million (82 percent of GDP) as of end-June 2011, but is likely to have declined since then following the deterioration in global equities markets (see chart). Under the assumption that all Compact grants would expire in FY2023, the projected income from the CTF would fall short of replacing these grants by as much as $15.4 million (about 8½ percent of GDP) in FY2023 (see Box 3). Even under a more optimistic assumption that non-Compact sector grants would be extended beyond FY2023, the shortfall—about $4.1 million—is still sizeable and warrants prompt action to ensure sustainability.[2]

Compact Trust Fund: Cumulative Contributions and Investment Returns
(in millions of USD)



Sources: RMI authorities and Fund staff estimates.
1/ Numbers refer to fiscal year ending September 30. CTF balance for 2011 as of June 30, 2011.

[2] The non-Compact sector grants exclude the Supplemental Education Grant (SEG), which is about $6.2 million (before inflation adjustment) per year.

Policy Issues and Staff's Views

18. **Steadily increasing fiscal surpluses to about 5 percent of GDP by FY2016 would help achieve long-term sustainability**. This would involve gradually raising the fiscal surplus by about 1 percent per year for the next four years to 5 percent of GDP in FY2016, and then maintaining the surplus at that level until FY2023. The required fiscal adjustment could increase by 2.3 percentage points if both medium-term growth prospects and investment returns of the CTF worsened from the baseline by 1 percent. Staff reiterated the importance of starting implementing reforms early to create fiscal space and address possible setbacks. Staff supported the recent transfer of $1.1 million to the CTF during FY2011 and the plan to continue such transfers in the FY2012 budget. In view of the substantial adjustment required, higher-than-expected revenues from the fisheries sector should be saved and transferred to the CTF.[3]

19. **Achieving the required fiscal adjustment will require targeted cuts in expenditures.** The government has initiated cumulative across-the-board cuts of over 10 percent in current expenditures over the past two years. To avoid compromising quality public services, such as spending for the poor, a more targeted approach is needed.

[3] The contributions to the Compact Trust Fund (Accounts A and C) are not available for withdrawal prior to FY2023. A separate account (Account D) where the RMI and other donors could contribute to is available for withdrawal if it exceeds $10 million (currently stands at about $7 million), which could be used to mitigate adverse impact of potential shocks.

Box 3. Marshall Islands: Long-term Fiscal Sustainability

This box assesses the RMI's long-term fiscal sustainability under the amended Compact agreement, updating the estimates in the 2009 Article IV Consultation Staff Report. The analysis considers implications for sustainability after the financial provisions under the amended Compact expire in FY2023. Fiscal sustainability is measured by the usable government's asset position as of FY2023 that would generate an investment income large enough to supplement expiring Compact-related grants without significantly disrupting public services and eroding the Compact Trust Fund value. The analysis is based on a broader perspective than what the CTF was designed to specifically support.[1]

The assessment of the long-term fiscal outlook considers three scenarios. The baseline scenario features limited fiscal adjustment and structural reforms, while a policy action scenario takes into account comprehensive fiscal reforms, including swift implementation of tax reforms by FY2012, targeted expenditure cuts, and structural reforms to strengthen private sector development. Finally, under the downside risks scenario, we gauge the impact of possible adverse shocks on the required fiscal adjustment.

1) **Baseline scenario**

This scenario assumes that the government maintains a modest fiscal surplus of about 1 percent of GDP over the medium term, and GDP growth gradually declines to about 1½ percent over the medium term as foreign grants decline while private sector growth remains sluggish, and stays at that level after the financial provisions under the amended Compact expire.

Under the baseline scenario, the CTF's income flows would not be sufficient to cover Compact grants in FY2024. The nominal rate of return in FY2010 was about 8 percent, slightly lower than the projected return of about 10 percent assumed in the 2009 Article IV report. This return is then set to decline to an historical average of 6 percent in the medium term. Compact related grants (net of fiscal surplus) are projected to reach $39.1 million in FY2023. Under the terms of the Compact Agreement and without additional grants, the CTF's investment earnings are projected to be $35.5 million. However, in order to preserve the real value of the fund, the government would only be able to withdraw $23.7 million, leaving a gap of $15.4 million to fully replace expired grants after FY2024 (see text table). Therefore, in the baseline scenario, the government would either need to erode the real value of the CTF or face a large budgetary shortfall.

While higher returns could support the value of the fund, maintaining such high returns over a long period is not realistic. For example, the shortfall would be eliminated if the average rate of return reached 8.2 percent. However, higher returns would be possible with a more aggressive investment strategy, albeit at the cost of higher risks. In that regard, the baseline assumes a relatively conservative investment strategy with an average nominal rate of return of 6 percent.

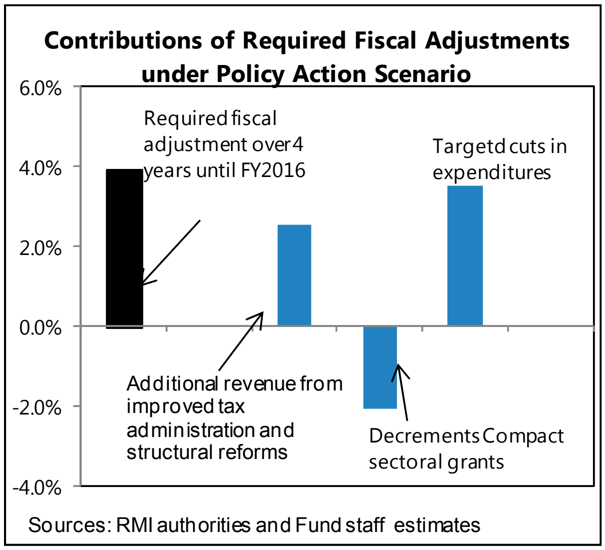
2) **Policy action scenario**

This scenario continues to assume a nominal rate of return of 6 percent. With these assumptions, fiscal sustainability would be achieved with a fiscal surplus of around 5 percent in FY2016. The surplus stays at this level until FY2023 then declines to about 1.5 percent.

[1] The analysis considers that the CTF needs to generate investment income to cover the Compact-sector grants, and the Supplemental Education Grant (SEG) without eroding the present value of the Trust Fund after FY2023.

Box 3. Marshall Islands: Long-term Fiscal Sustainability (Continued)

Long-term sustainability can be achieved through significant fiscal consolidation and structural reforms to boost private sector growth. In the policy action scenario, the government would gradually increase fiscal surplus (by about one percent of GDP each year) and channel the savings into the CTF. Over the medium term, the majority of the fiscal adjustment is financed by reductions in targeted current expenditures (about 3½ percent of GDP), while the comprehensive tax reform could bring in additional revenue of 1 percent of GDP through improved tax administration and tax-base broadening (see chart). In parallel, structural reforms would boost real growth to 2 percent in the long term. Together with the additional earnings resulting from higher balances, the fiscal surplus would eliminate the shortfall of $15.4 million in the baseline scenario (see text table). The required level of fiscal surplus (5 percent of GDP) is similar to that in the 2009 Article IV Consultation estimates.



With fiscal consolidation, the government will be able to rely on a constant revenue stream to finance its expenditures. In particular, under the policy action scenario, the government keeps the level of capital spending roughly constant throughout the projection period. Current expenditures are adjusted such that total revenues can both finance total expenditures and generate enough savings to build up the CTF. After FY2024, there is no need to save additional amounts to top up the CTF, with total revenues including interest income obtained from the CTF used only to finance current level of expenditures.

Required Fiscal Adjustments for Sustainability

Scenarios	Medium-term overall fiscal balance (in percent of GDP)	Total required adjustment (in percent of GDP)
1 Baseline: no policy change	1.0	...
2 Policy action		
Swift tax reforms implementation, accompanied by structural reforms and cut in subsidies	5.0	4.0
3 Downside risks to baseline Growth lower by 1 percentage point and the assumed rate of return lower by 1 percentage point	7.3	6.3

Source: Fund staff estimates.

Box 3. Marshall Islands: Long-term Fiscal Sustainability (Continued)

3) **Downside risks scenario**

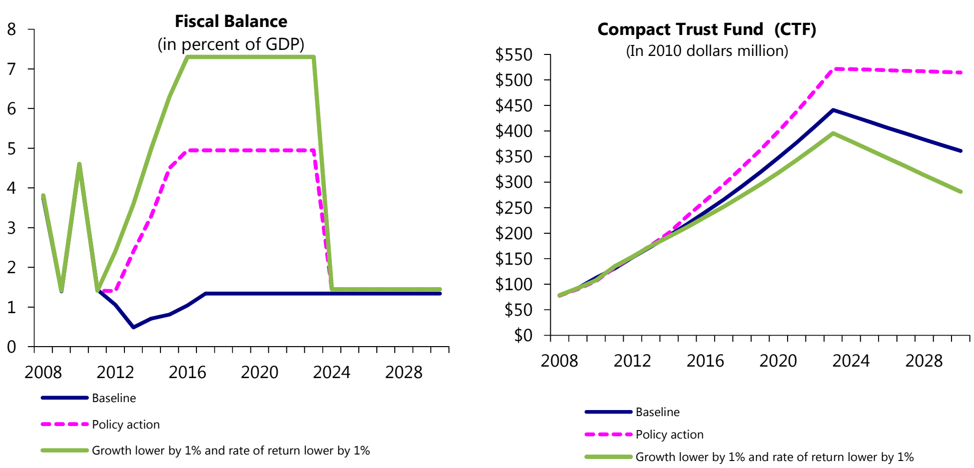
The required fiscal adjustment is sensitive to assumptions on medium-term growth and investment returns. If medium-term growth rate is 1 percentage point lower than the baseline projection and at the same time the assumed rate of return is lower by 1 percentage point until FY2023, the required fiscal surplus would be 7.3 percent of GDP instead of 5 percent of GDP under the baseline, higher by 2.3 percent of GDP.

Marshall Islands Compact Trust Fund (CTF) Scenarios

	Baseline scenario	Policy action scenario 1/
	(In millions of U.S. Dollars)	
Compact Trust Fund in FY2023 (including cumulative savings)	592.4	710.3
Earnings based on Trust Fund assets in FY2024	35.5	42.6
Earnings available for withdrawal 2/	23.7	28.4
Compact grants in 2023 (in/ supp. educational)	42.6	42.6
Compact grants net of fiscal surplus	39.1	28.4
Surplus (+) or Shortfall (-) 3/	-15.4	0.0
Medium-term fiscal balance by FY2016		
in percent of GDP	1.0	5.0

Source: Fund staff calculations.
1/ In the policy action scenario, the government would gradually increase fiscal surplus (by about one percent of GDP each year) over the medium term through tax reforms and targeted expenditure cuts. In parallel, structural reforms would be implemented to boost real growth.
2/ Earnings withdrawn such that the real value of the Trust Fund remains the same.
3/ Calculated as earnings available for withdrawal minus Compact grants in 2023 net of fiscal surplus.

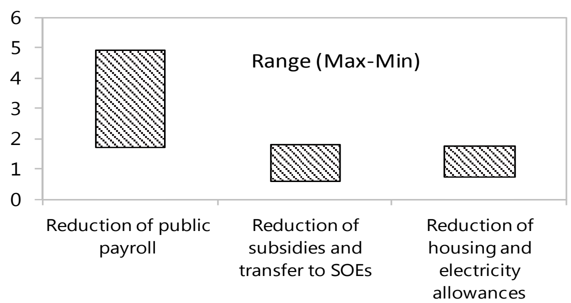
Marshall Islands: Long-Term Fiscal Adjustment Scenarios: FY2008-30 1/



Source: Fund staff estimates
1/ From FY2024 onward, interest income from the Trust Fund is considered as part of domestic revenue.

Targeted cuts in areas proposed by the Comprehensive Adjustment Program (CAP) group could achieve a saving of $7–8 million over the medium term (see chart). These could include:

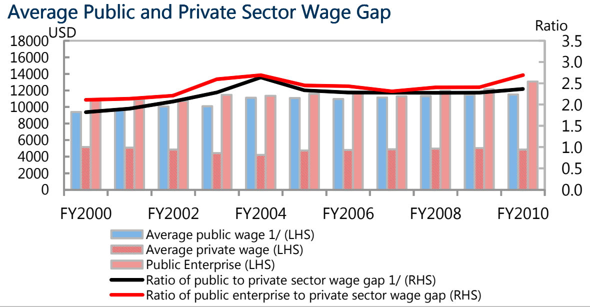
Possible Savings from Expenditure Reforms
(in millions of USD)



Sources: Comprehensive Adjustment Program (CAP) and staff estimates.

- *Containing public sector payroll.* Although the annual average rise in public wages during FY2005–11 was modest at 1.4 percent, average public wages remain around 2½ times higher than comparable wages in the private sector, and a similar gap exists between wages in public enterprises and those in the private sector (see chart). Building on the efforts to identify over-staffing and excess pay, staff recommends limiting public sector payroll further by eliminating redundant vacant positions beginning in FY2012, which could save as much as $1 million. An AsDB consultant will undertake personnel audits beginning FY2012 and provide further assistances in containing the public payroll.

Average Public and Private Sector Wage Gap



Sources: RMI authorities and Fund staff estimates.
1/ Public sector refers to RMI government and local government only.

- *Limiting subsidies to SOEs.* Several SOEs continue to be a large and recurring drain on the budget, with transfers amounting to about $14.2 million per year (nearly 15 percent of the overall budget) on average over FY2007–10. These transfers take the form of pricing subsidies, capital contributions, and payments in kind. The largest recipients are the Marshalls Energy Company (MEC) and Air Marshall Islands (AMI). Staff advises against the proposal to extend a government subsidized loan of $1.5–$2 million to AMI for operating expenses and recommends limiting subsidies to the SOEs and accelerating the reform. The Cabinet has approved a set of good practice principles on SOEs to address governance framework (see Section B). A comprehensive recovery plan for the MEC was separately approved, and early resolution of payment arrears (nearly $9 million) is imperative to address recurring cash flow problems and widening operating losses, which pose significant fiscal risks.

- *Reducing allowances.* As part of the expenditure cuts, the government should adopt the recommendations by the CAP committee to reduce allowances to public officials, in areas such as housing and electricity, thereby saving about $2 million.

20. **Along with these expenditure cuts, swift legislative approval of revenue reforms is imperative to put public finances on a sustainable path**. The government's tax reform plan intends to rectify the drawbacks of existing tax regime (for example, discourage capital investment, regressive nature on personal income tax, and enforcement difficulties) by replacing the gross revenue tax and import duties with a net income tax and a consumption tax.[4] While designed to be revenue-neutral, the tax reform could generate

[4] See Staff Report 2008 Article IV consultation—Selected Issues 'Strengthening the Tax Regime in the Marshall Islands', No. 08/186.

additional revenue and support a more pro-growth business environment by broadening the tax base and improving tax administration. The authorities should look to overcome remaining public concerns regarding the new tax rates, and to bring forward the legislative process as a full package, so as to start implementing the tax reform within FY2012. Systematic consultation and public outreach, including community-based forums, would help mobilize public support. Further efforts to strengthen the tax administration, particularly on identifying unaccounted import duties, would lead to a fairer tax system and bring in additional revenue. As domestic prices stabilize and the economy recovers, temporary tax exemptions effective since the recession in FY2008-09 would need to be wound down.

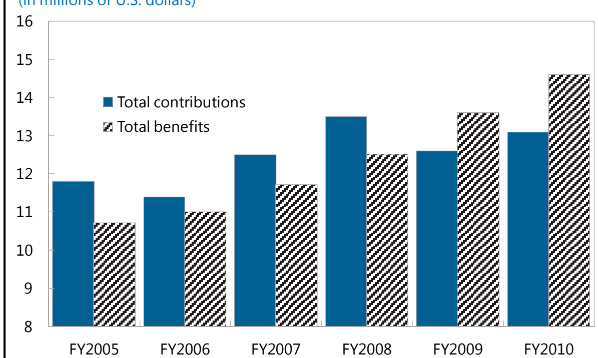
21. **A sound public financial management would improve the efficiency of spending.** In the face of scheduled declines in Compact grants, the authorities have begun to formulate a five-year rolling medium-term budgeting framework to better allocate public resources based on previous performance audit. To enhance the efficiency of spending, staff would recommend:

- Accelerating efforts to enhance public financial management through completing a Public Expenditure and Financial Accountability (PEFA) [5] assessment and modernization of the Financial Management Act to streamline procurement procedures.
- Integrating the medium-term budgeting framework into the annual budget and national development plans.

22. **The capacity for performance audits needs to be strengthened**. The government would benefit from enhancing the capacity of the Office of Auditor General in areas related to investigation and performance audits. In that regard, staff recommends granting the Auditor General the authority to prosecute public sector fraud through delegation by the Attorney General. Staff sees room for further increasing resources to the Office, possibly by utilizing the capacity-building grants under the amended Compact.

23. **The social security system still faces a sizeable unfunded liability.** The Marshall Islands Social Security Administration (MISSA) has partially recovered long-time arrears from local governments, but still faces rising benefit payouts in excess of contributions (about $1 million in FY2009 and $1.5 million in FY2010, see chart).[6] The MISSA has liquidated trust fund assets to finance the shortfall since FY2010. To restore health to the pension system over the medium term, the authorities are considering a transition to a defined contribution scheme. As the transition would take time to be put in place, staff recommends taking interim measures to safeguard the value of the Social Security Fund, including through

Social Security--Shortfall between Benefits and Contributions
(in millions of U.S. dollars)



Source: MISSA.

[5] The Public Expenditure and Financial Accountability (PEFA) allows an objective assessment of a country's public financial management in a standardized manner based on multiple indicators such as budget credibility, comprehensiveness, and transparency.

[6] According to the latest actuarial report in 2009, the MISSA faced $163 million of unfunded liabilities (more than 100 percent of GDP) over the long term. Unfunded liabilities represent the projected difference between the net present value of accrued benefits and the available asset level for meeting them, including the net present value of the projected contributions. The amount varies with the assumptions on investment returns, and expected contributions and benefit payouts.

raising contribution rates, and reviewing the benefit structure. If contribution rate rose by 1 percentage point and benefit was reduced by 10 percent, it could save about $3½ million per year. Increasing the retirement age from 60 to 65 could further reduce benefit payouts by $3.0 million a year.

The Authorities' Views

24. **The government recognizes the need for fiscal adjustment and is aiming to achieve a fiscal surplus in FY2012.** They note that progress has been made in building up the fiscal surpluses. For instance, they transferred $1.1 million during FY2011 to the CTF. The authorities are also targeting a further modest contribution to the CTF in FY2012 by implementing tax reform and intend to reduce allowances, which are part of the recommendations by the CAP and the Tax and Revenue Reform and Modernization Commission (TRRM). The market value of the CTF is likely to have declined in recent months, but the authorities have no plans to switch the investment strategies based on short-term market fluctuations.

25. **While agreeing in principle to the need for expenditure cuts, the authorities expressed concerns over the broader social and economic impact of the reductions.**

- *Public sector payroll*. On public wages, the authorities noted that the large private-public wage gap was primarily driven by higher expatriate wages at the SOEs. The authorities also had frozen or reduced public wages over the past two years, leaving limited room for further cuts. Further payroll reductions could reduce household incomes without a social safety net, as the private sector is unlikely to absorb layoffs. Instead, the authorities preferred starting with eliminating vacant positions, enforcing mandatory retirement rules, and reducing gradually excessive allowances. Staff recognized these risks and supported a targeted gradual approach, but noted that those steps came at a cost by maintaining the large public-private wage gap and hindering private sector employment.
- *Subsidies to SOEs*. The authorities indicated that pressures to support weak SOEs were mounting. The large spending cuts had weakened various public services, making it difficult to reduce further subsidies to SOEs. The government has been addressing the financial problems of SOEs through AsDB assistance. On the proposed support to AMI, the Cabinet preferred granting a low interest government loan to AMI for regular equipment maintenance, instead of leaving it to seek a more costly private loan requiring guarantees.
- *Reducing allowances*. The government planned to propose a bill to reduce allowances to public officials, in areas such as housing and electricity, thereby gradually limiting the expenses by about $2 million.

26. **On the revenue side, the authorities plan to gradually implement tax reform starting in late FY2012 after resolving issues over tax rates.** While the authorities and the public in general favored tax reform, no agreement has been reached over the new tax rates that would be revenue neutral. Against this background, they intend to:

- Put forward tax reform legislation in January 2012—the first Nitijela (Parliament) session after the general elections.
- Recruit an external consultant with donor support to determine appropriate tax rates and ensure a smooth transition.
- Implement tax reforms in stages starting in FY2012 and continue to strengthen tax administration.

27. **The authorities were keen to improve public financial management.** They have undertaken a self assessment of their public financial management system and have sought technical assistance in modernizing the Public Finance Management Act to further streamline the procurement procedures. The authorities noted that they had scaled up

performance budgeting efforts, but have not yet fully integrated so far the five-year medium-term budget framework into the annual budget process.

28. **The authorities welcomed staff recommendation on expanding the audit capacity.** An additional $0.15 million was appropriated to the Office of the General Auditor in the FY2012 budget. This will enhance the capacity for conducting investigation and performance audits, as called for in the latest report by the Public Accounts Committee.

29. **The authorities were considering converting the social security system to a defined contribution scheme.** The Social Security Reform Commission expected the funding gap (about $1.5 million in FY2010) to widen without a change in policy. The Commission hired an actuarial advisor to consider options to safeguard the value of the social security fund. Among the options, the Commission favored a shift of the existing defined benefit scheme to a defined contribution scheme and capping certain benefits.

B. Private Sector Development and Structural Reforms

Policy Issues and Staff's Views

30. **A vibrant private sector is a prerequisite for sustainable economic growth and fiscal adjustments.** Many private sector activities depend largely on government contracts and services provided by inefficient SOEs. To offset the declines in Compact grants, the government should look to provide an enabling environment for private sector growth. Key obstacles include limited access to commercial lending, difficulties in securing land uses, aging infrastructure, and the large gap between public and private sector wages.

31. **Comprehensive reforms of SOEs are needed to raise their efficiency.** The SOEs are economically significant with total assets of $116 million as of end-FY2008 (about 76 percent of GDP), but their financial performance has been lackluster. Many SOEs have social service obligations, which are often not clearly defined, further complicating resource planning and leading to weak management and underinvestment. In areas where SOEs provide purely commercial services, their operations should be divested or contracted out (for example, government ownership in Majuro Resorts, Inc. and AMI). The authorities are preparing a new SOE policy, which will form the basis for the forthcoming SOE Reform Act, but progress is slow (Box 4). Staff urges the authorities to take full ownership of the reform and swiftly approve the new policy.

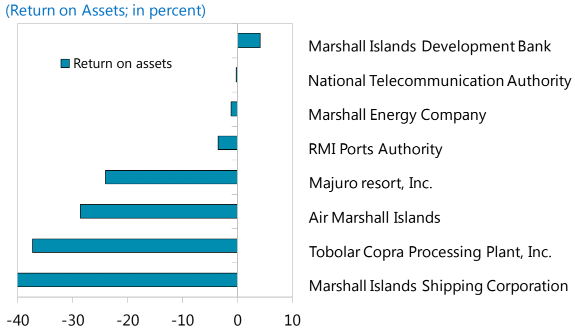
32. **Recent expansion of commercial fishery activities through foreign investment and regional agencies could help spur private sector development.** Commercial fisheries, a key source of employment and growth in recent years, have increasingly diversified operations in harvesting, processing, transshipment, and exports. Taking advantage of this momentum, the government should strengthen the investment environment, including vessel support services, and retail and wholesale areas. In this context, the PNA, in which RMI participates, will contribute to long-term growth by fostering the sustainability of fishery activities through enforcing and exchanging fishing rights.

Box 4. Marshall Islands: State-Owned Enterprises Reform under the AsDB Program

The RMI government entered into a Public Sector Program loan with the AsDB in September 2010. While the primary concern was to resolve the immediate financial difficulty in the Marshalls Energy Company, the program has been designed to support the government in its broader reform initiatives, including fiscal adjustment and SOE performance.[1]

The weak financial position among the SOEs call for immediate reform. The size of the SOEs in the economy is significant, with total assets of $116 million as of FY2008 (about 76 percent of GDP). Long-term financial performance has been poor with recurring operating losses every year during FY2002–08.[2] The cumulative operating losses were $42 million (net of government subsidies and debt forgiveness) and public capital contributions totaled $39 million, adding to a substantial sum of $81 million (about 53 percent of GDP), about 1.7 times the average equity. The losses were so severe that the SOEs sector consumes its own equity every 4.3 years.

Operating Losses among the SOEs
(Return on Assets; in percent)



Source: RMI authorities.
1/ Based on FY2010 audited financial statements. Operating losses shown here are before government and other contributions, and capital injection.

Recognizing the need to reform the SOEs, the government adopted a comprehensive recovery plan (CRP) for the energy company and six good practice principles. The CRP is tailored for the energy company to improve its operational and financial performance, placing it on a more sound commercial footing. The principles aim to strengthen the governance and monitoring framework for SOEs and address corporate planning and pricing issues. Specifically,

1. **Concrete Business Plans.** The government and the SOEs will jointly establish and publicly release the Statements of Corporate Business Plan and performance targets.
2. **Essential Services.** The SOEs will identify essential activities and all non-essential activities would be sold or wound down.
3. **Boards of Directors.** The government ensures qualified and experienced members would serve the Board of Directors in the SOEs and the directors have independence in operation.
4. **Management.** The government would ensure senior management have suitable qualifications and experience.
5. **Cost and Pricing.** The prices and charges would need to be aligned with the total cost of service, except where funded by subsidy from government.
6. **Sound Financial Management.** The SOEs would need to maintain sound and prudent financial management.

Based on these principles, an SOE policy has been drafted, which will serve as a basis for the new SOE Act. The implementation of these good practice principles is slow across the SOEs. The Cabinet has not approved the SOE policy yet, noting the new eligibility of Board directors is too restrictive.

The AsDB also provides technical assistance to selected SOEs as part of the reform. After consultations with stakeholders, three SOEs were selected for reform support in addition to the MEC.[3] The AsDB provides technical assistance in developing medium-term reform plans to improve the viability and sustainability in terms of financial and operational performance. The implementation of the reforms plans over 2012 will be critical to improving the SOEs' performance.

---

[1] See AsDB report on 'Proposed Program Cluster, Loan for Subprogram 1, and Technical Assistance Grant—Republic of the Marshall Islands: Public Sector Program'.

[2] AsDB research shows two largest SOEs—MEC and Marshall Islands Ports Authority—accounted for about 60 percent of total SOEs losses. Only the National Telecommunications Authority achieved a net positive income during the period.

[3] The SOEs under AsDB technical assistance include the Marshall Islands Shipping Corporation, the Tobolar Copra Processing Plant, and the Majuro Water and Sewer Company.

Authorities' Views

33. **The authorities, while noting the business environment remained challenging, planned to take advantage of ongoing recovery to foster growth.** They agreed that many private activities had been dependent on public spending and unemployment remained high. Structural impediments on land uses were deep-rooted, which would take more than political will to rectify, though measures were in place to support long-term land lease. To take advantage of the ongoing recovery, the authorities welcomed recent private investment in niche tourism and were exploring possibilities in expanding the existing joint venture and intended to foster vessel support services. The RMI's participation in the PNA would further strengthen commercial fishing activities.

34. **The authorities indicated SOE reforms are underway with the assistance of AsDB.** With respect to the new SOE policy, the Cabinet found the conditions regarding new eligibility of the Board directors to be too restrictive and required further review before endorsing the policy to be put into the SOE Reform Act. Divesting plans were initiated for Air Marshall Islands and the Majuro Resorts, Inc. but poor maintenance and lingering land issues have deterred investors.

C. Financial Sector

Background

35. **The banking system in general remains liquid and profitable.** The banking sector is primarily financed by deposits, with about two-thirds of deposits allocated for lending. Growth in commercial lending has been constrained by the lack of collateral, high interest rates, and limited investment opportunities. Financing conditions have somewhat tightened in FY2010 as interest rate margin widened, especially on commercial credits. Although banks profitability is reasonable with return on assets at about 5 percent and current nonperforming loans (NPLs) are low at less than 2 percent of outstanding loans, profits could decline if credit risks and NPLs were to rise in the event of a slowdown as many households are heavily indebted with short-term consumer loans. The publicly-owned Marshall Islands Development Bank (MIDB) is increasingly engaged in short-term consumer lending, moving away from its primary mandate of providing credit access for viable businesses. The MIDB also provides banks commercial credit guarantees at low fees.

Policy Issues and Staff's Views

36. **Strengthening the regulatory framework would contribute to stability in the financial sector.** The Banking Commission currently has limited authority and autonomy to undertake appropriate bank supervision under the Banking Act as its actions could be appealed to and reverted by the Cabinet. Staff supports the Banking Commission's efforts to revise the Banking Act to strengthen bank supervision in line with PFTAC assistance and to enhance the AML/CFT regime, particularly regarding the offshore company registration sector. Staff also supports broadening the Banking Commission's oversight to include the MIDB and other nonbank financial institutions that engage in private lending activities.

37. **Financial policies should aim to facilitate credit intermediation and support long-term growth.** The lack of commercial credit has held back new start-ups and viable business opportunities. The act on secured transactions for moveable property has improved access to commercial credit at reduced cost. Refocusing the MIDB towards commercial and mortgage lending, rather than

consumer loans, and further streamlining the land registration process would expand businesses' access to much needed capital.

Authorities' Views

38. **The authorities recognize the heavy household indebtedness and intend to take measures to mitigate risks.** Consumer lending represents about 77 percent of private sector credit and average household debt to income ratio is high at more than 80 percent. However, banks considered risk exposures to be manageable as they granted only short-term loans and required collaterals, personal guarantors, and allotment pledges. The authorities had earlier attempted to limit risk exposures through administrative directives, but these actions were later repealed on the grounds that the Banking Commission was not following the Banking Act.

39. **The authorities agreed on the need to strengthen the regulatory framework.** The Banking Commission had worked with PFTAC in revising the Banking Act to strengthen bank supervision and AML/CFT capacity. The revised Act would broaden Banking Commission's oversight on institutions engaging in private lending activities. The authorities also noted the process would need closer consultations with banks and lending institutions in view of possible impacts on credit supply, particularly on housing loans.

40. **Besides supporting growth, financial policies should also meet broader social objectives.** The Development Bank saw itself as having a broader mandate of assisting individuals who otherwise would be turned away by commercial banks. The authorities viewed high interest rates and lack of commercial credit as partly reflecting high credit risks and limited investment opportunities. The potential fiscal risk arising from the credit guarantees on bank loans through the Development Bank was noted, but the authorities did not see a need to reduce the exposures or revise the pricing of such operations.

D. Other Issues

Staff and Authorities' Views

41. **The authorities and staff agreed that improving the coverage and timeliness of economic statistics would better guide policies.** The Economic Policy, Planning and Statistics Office (EPPSO) has taken a number of steps to improve data collection. The authorities are going to publish the 2011 Census results in the coming months to guide policy planning in demographic and socio-economic developments.

STAFF APPRAISAL

42. **Medium-term growth prospects in the RMI remain weak given the sluggish private sector and the scheduled decline in Compact grants.** The recovery is likely to continue in the near term driven by expanding fisheries sector and ongoing construction activities, but risks are on the downside. Medium-term prospects are constrained by declines in Compact grants in the absence of substantial fiscal and structural reforms.

43. **Risks to external stability appear to be contained.** The RMI's exchange rate appears to be in line with the medium-term fundamentals after the significant real appreciation in FY2008–09 was largely reversed following the stabilization of domestic prices. The use of the U.S. dollar as the domestic currency remains appropriate, given the small economy size and close ties with the United States in trade and finance.

44. **Without significant adjustment, the fiscal situation is likely to worsen.** The RMI has relied heavily on Compact grants to advance its economic development. While the fiscal situation has improved in recent years, the projected value of the CTF is unlikely to generate sufficient income to supplement the expiry of Compact grants in FY2023 without additional contributions. Meanwhile, measures to address the funding gap of the social security system should be taken urgently to ensure inter-generational fairness and to avoid further erosion of the Social Security Fund value. It would be important to start implementing reforms early to create fiscal space and address possible setbacks. Further delays in needed reforms would lead to more costly adjustments in the future.

45. **Securing fiscal sustainability requires tangible progress in fiscal and structural reforms.** Fiscal reforms should aim to swiftly implement the tax reform by bringing forward the legislature and resolving the pending uncertainties on new tax rates, and implement targeted expenditure cuts on public sector payroll, subsidies to SOEs, and excessive allowances. Structural reforms to develop an enabling environment for private sector and facilitate foreign direct investment would enhance long-term growth and generate higher revenue. In that regard, expediting the SOE reform with the assistance of AsDB is a key priority.

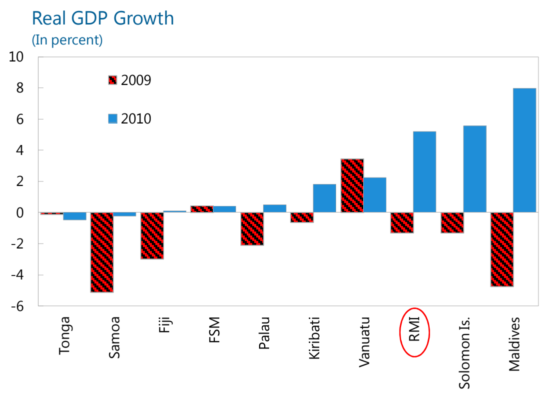
46. **Strengthening the regulatory framework would contribute to stability in the financial sector.** High household indebtedness and the absence of proper regulatory oversight on the Development Bank and other private lending institutions are major risks to the financial system. Efforts to further strengthen banking supervision by broadening the Banking Commission's supervisory authority would be welcome steps. Financial policies should aim to facilitate credit intermediation and support long-term growth. The secured lending act would facilitate commercial lending, but further efforts on land registration are needed to facilitate the use of land for collateral.

47. **The quality of official statistics, while adequate for surveillance, has room for improvement.** Data availability has improved through efforts by the EPPSO, but the coverage and timeliness of statistics tend to constrain policy planning and evaluation. Continued staff training and capacity building would contribute to improving data quality.

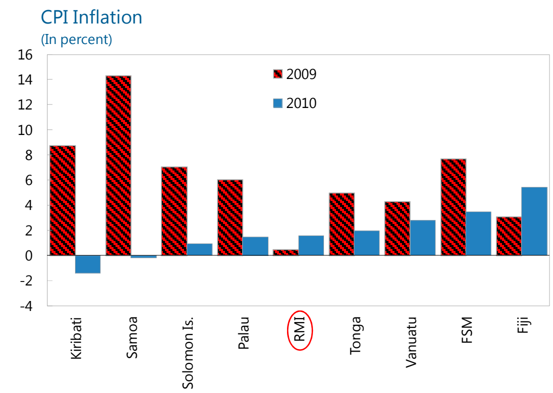
48. **It is recommended that the next Article IV consultation take place on a 24-month cycle.**

Figure 1. Marshall Islands: Regional Comparison of Recent Developments

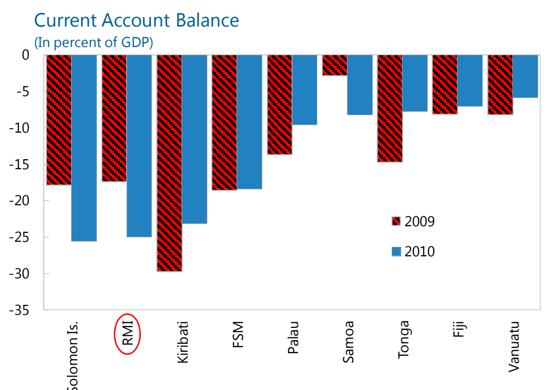
Along with other Pacific Island Countries (PICs), the RMI economy has recovered from the recession in FY2010.



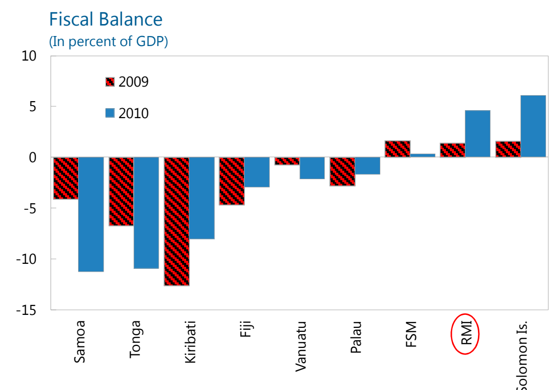
Inflation pressure from higher fuel and food prices for other PICs have subsided. RMI CPI has slightly picked up in FY2010.



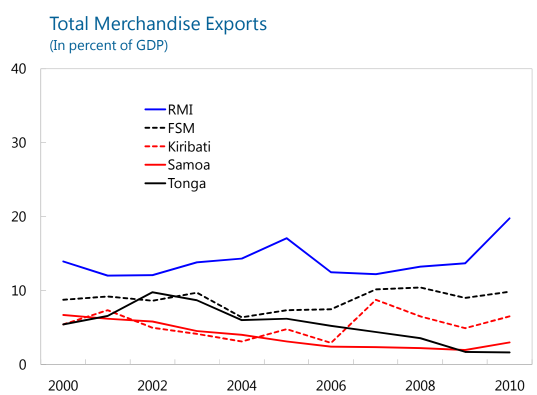
The large current account deficits reflect Compact related spending and temporary factors arising from foreign direct investment and grants in fisheries sector and construction projects.



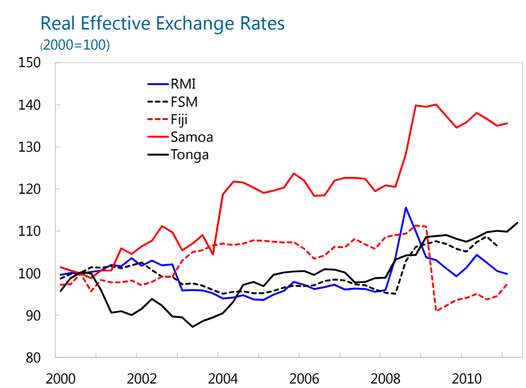
The fiscal balance has also improved relative to other PICS.



RMI exports have continued to expand, in contrast to other PICs.



RMI's real appreciation of the effective exchange rate in FY2008-2009 was largely reversed in the second half of 2009 as domestic prices stabilized.



Sources: RMI authorities and Fund staff calculations.

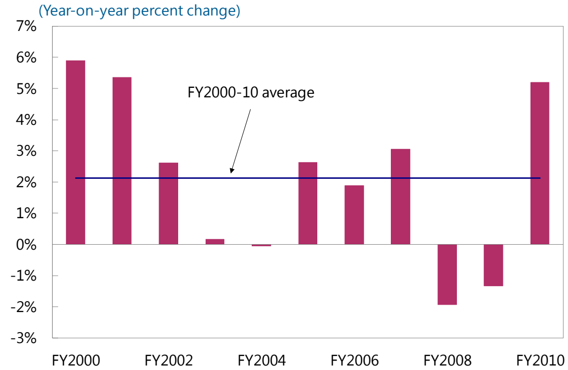
Note: RMI and FSM stand for the Republic of Marshall Islands and the Federated States of Micronesia, respectively. The top four charts are sorted by 2010 data.

Figure 2. Marshall Islands: Economic Developments and Outlook

The economy grew by 5.2 percent in FY2010 after two consecutive years of contraction, mainly driven by an expansion of fisheries sector and recovery of external demand.

Real GDP Growth

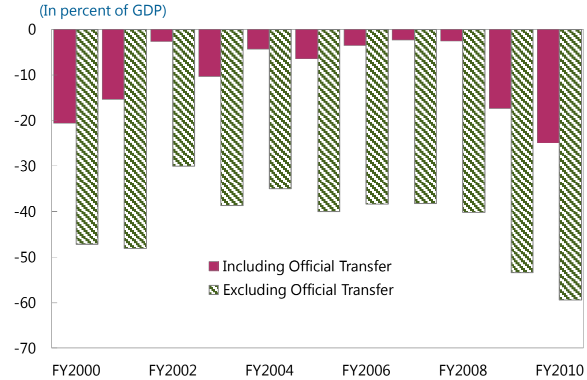
(Year-on-year percent change)



The current account deficit remains sizeable due to an expansion in the fishery sector and construction projects largely funded by FDI and foreign grants.

Current Account Balance

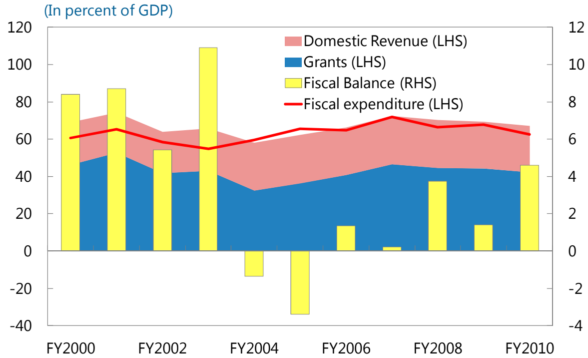
(In percent of GDP)



A large part of the fiscal surplus in FY2010 was due to the unused balances for specific sector appropriations.

Fiscal Balance 1/

(In percent of GDP)

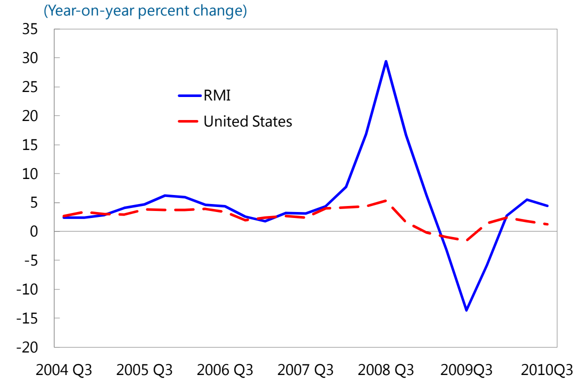


1/ Total revenue is the sum of grants and domestic revenue (stacked in chart).

Inflation remained modest…

CPI Inflation

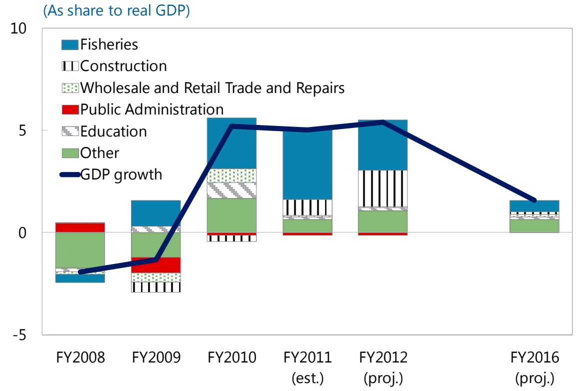
(Year-on-year percent change)



The recent growth trend is mainly driven by an expansion of fisheries sector and increase in construction activities.

Contribution to Growth

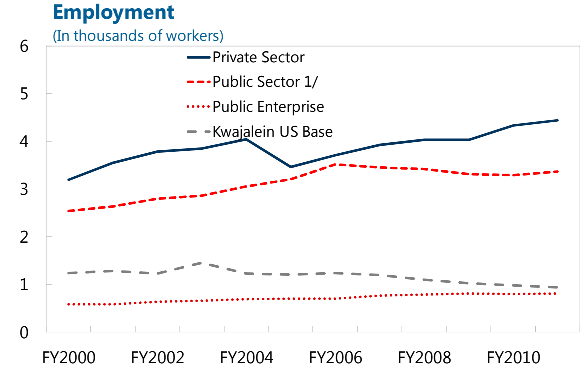
(As share to real GDP)



While private sector employment improved over the years, recent growth has been concentrated in a few sectors.

Employment

(In thousands of workers)



1/ Refers to RMI government and local government only.

Sources: RMI authorities and Fund staff calculations.

Table 1. Marshall Islands: Basic Data, FY2007–12 1/

Nominal GDP for FY2010 (in millions of U.S. dollar):	162.94
Population (2010):	52,371
GDP per capita for FY2010 (in U.S. dollar):	3,111.16
Quota:	SDR 3.5 million

					Est.	Proj.
	2007	2008	2009	2010	2011	2012
Real sector						
Real GDP (percent change)	3.0	-1.9	-1.3	5.2	5.0	5.4
Consumer prices (percent change)	2.6	14.7	0.5	1.6	9.5	-0.5
Central government finances (in percent of GDP) 2/						
Revenue and grants	72.3	70.2	69.2	67.0	63.6	62.9
Total domestic revenue	25.8	25.6	25.0	24.7	24.1	22.9
Grants	46.5	44.5	44.3	42.3	39.5	40.0
Expenditure	72.0	66.4	67.8	62.4	62.1	61.9
Current	54.9	54.3	56.7	51.7	51.6	49.0
Capital	17.2	12.1	11.2	10.7	10.5	12.9
Overall balance	0.2	3.7	1.4	4.6	1.4	1.0
Memorandum item: including the new ADB loans to MEC 3/						
Financing: gross borrowing (in USD million)	0.1	0.0	0.0	0.0	9.5	0.0
Compact Trust Fund (in millions of US$; end of period)	85.7	75.7	90.9	112.8	142.8	165.2
Commercial banks (in millions of US$)						
Foreign assets	60.7	57.1	63.6	71.8	74.1	...
Private sector claims	49.9	58.2	62.0	63.3	61.9	...
Total deposits	85.5	89.0	93.3	102.1	102.6	...
One-year time deposit rate (in percent)	4.1	3.6	6.0	3.5	3.5	...
Average consumer loan rate (in percent)	18.5	18.5	13.9	14.0	14.2	...
Balance of payments (in millions of US$)						
Trade balance	-69.6	-69.8	-73.3	-93.3	-73.7	-101.8
Net services	-39.0	-39.5	-54.0	-42.8	-45.6	-48.1
Net income	43.1	43.2	40.8	34.5	41.7	30.2
Unrequited transfers (private and official)	62.0	62.2	60.2	60.9	55.8	63.7
Current account including official current transfers 4/	-3.5	-3.9	-26.4	-40.7	-21.8	-55.9
(In percent of GDP)	-2.4	-2.6	-17.4	-25.0	-12.6	-30.3
Current account excluding budget grants 4/	-57.3	-61.2	-80.8	-96.9	-77.0	-119.0
(In percent of GDP)	-38.3	-40.1	-53.3	-59.4	-44.3	-64.6
External debt (in millions of US$; end of period) 5/	99.1	94.6	106.8	113.4	117.0	110.5
(In percent of GDP)	66.2	62.0	70.4	69.6	67.4	60.0
External debt service (in millions of US$)	16.8	7.5	7.8	9.7	9.7	10.1
(In percent of exports of goods and services)	59.4	24.7	24.8	22.2	18.4	17.1
Exchange rate						
Real Effective Exchange Rate (2000 =100)	96.5	102.7	104.5	101.8	101.2	...
Memorandum Item:						
Nominal GDP (in millions of US$)	149.7	152.6	151.6	162.9	173.7	184.3

Sources: RMI authorities and Fund staff estimates.

1/ Fiscal year ending September 30 unless otherwise stated.
2/ The central government finance numbers do not not include the first tranche disbursement of $9.5 million in early FY2011 and a projected second tranche disbursement of the new ADB loan to the Marshalls Energy Company.
3/ The payments by the government to MEC will be recorded as subsidy to public enterprises of $8.5 million and increase of gross borrowing of $9.5 million in FY2011. The second tranche of $5 million is expected to be in FY2013.
4/ Official transfers include current transfers but exclude capital transfers and Trust Fund contributions.
5/ Includes government and government-guaranteed debts.

Table 2. Marshall Islands: Statement of Government Operations, FY2007–12 1/

	FY2007	FY2008	FY2009	FY2010	FY2011 Est.	FY2012 Proj.
			(In millions of U.S. dollars)			
Revenue	108.2	107.1	104.9	109.2	110.4	116.0
Taxes	27.1	26.2	24.3	25.2	24.8	24.8
Taxes on income, profits, and capital gains	17.1	16.8	16.6	17.0	16.2	16.9
Taxes on international trade and transactions	9.4	8.7	7.1	7.7	6.8	7.0
Other taxes	0.6	0.7	0.6	0.5	1.8	0.9
Social contributions	6.3	6.9	6.7	7.2	7.2	7.2
Grants 2/	69.6	68.0	67.1	68.9	68.5	73.7
Other revenue	5.2	6.0	6.8	7.9	9.9	10.2
Property income	1.5	1.9	1.6	2.1	4.0	4.3
Sales of goods and services	1.2	1.5	1.4	1.5	0.4	0.5
Miscellaneous and unidentified revenue	2.4	2.7	3.8	4.3	5.5	5.5
Expenditure	107.8	101.3	102.8	101.7	107.9	114.1
Expense	82.1	82.9	85.9	84.3	89.7	90.3
Compensation of employees	33.5	34.2	34.3	35.0	35.0	35.4
Wages and salaries	33.5	34.2	34.3	35.0	35.0	35.4
Use of goods and services	31.7	34.9	37.5	33.3	36.6	37.7
Interest	0.9	1.3	0.9	0.9	0.9	1.0
Subsidies	7.9	6.9	7.5	6.7	5.2	5.4
Grants	8.2	5.6	5.7	8.4	12.0	10.8
Net acquisition of nonfinancial assets 3/	25.7	18.5	16.9	17.5	18.2	23.8
Net lending (+)/borrowing (–)	0.4	5.7	2.1	7.5	2.5	1.9
Net acquisition of financial assets	-1.4	4.6	0.0	5.0	9.5	-0.9
Net incurrence of liabilities	-1.7	-1.1	-2.2	-2.4	7.0	-2.8
Net financing 4/	0.4	5.7	2.1	7.5	2.5	1.9
			(In percent of GDP)			
Revenue	72.3	70.2	69.2	67.0	63.6	62.9
Taxes	18.1	17.1	16.1	15.5	14.3	13.5
Social contributions	4.2	4.5	4.4	4.4	4.1	3.9
Grants	46.5	44.5	44.3	42.3	39.5	40.0
Other revenue	3.4	4.0	4.5	4.9	5.7	5.6
Expenditure	72.0	66.4	67.8	62.4	62.1	61.9
Expense	54.9	54.3	56.7	51.7	51.6	49.0
Net acquisition of nonfinancial assets	17.2	12.1	11.2	10.7	10.5	12.9
Net lending/borrowing	0.2	3.7	1.4	4.6	1.4	1.0
Memorandum items:						
Compact Trust Fund Balances (in million of US$)	85.7	75.7	90.9	112.8	142.8	165.2
Outstanding government debt (in million of US$) 5/	61.7	60.6	58.8	69.3	76.3	73.5
Nominal GDP	149.7	152.6	151.6	162.9	173.7	184.3

Sources: RMI authorities and Fund staff estimates.

1/ The fiscal year ends on September 30.
2/ Does not include Compact funds earmarked for Kwajalein rental payments and trust fund contributions.
3/ For FY11-13, capital expenditure includes additional capital projects financed by U.S. grants for the airport road construction with a total of US$14 million.
4/ Excluding Compact Trust Fund.
5/ Central government debt to AsDB.

Table 3. Marshall Islands: Balance of Payments, FY2007–16 1/

(In millions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
					Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Trade balance	-69.6	-69.8	-73.3	-93.3	-73.7	-101.8	-81.3	-57.0	-59.2	-57.7
Exports, f.o.b.	18.3	20.2	20.8	32.3	40.8	46.9	53.8	55.2	56.3	58.4
Imports, f.o.b. 2/	-87.9	-90.0	-94.1	-125.5	-114.5	-148.6	-135.1	-112.2	-115.5	-116.1
Net services	-39.0	-39.5	-54.0	-42.8	-45.6	-48.1	-48.1	-45.7	-46.3	-46.4
Receipts	10.0	10.2	10.5	11.3	11.6	12.0	12.3	12.7	13.0	13.4
Payments	-49.0	-49.8	-64.6	-54.1	-57.2	-60.1	-60.4	-58.4	-59.3	-59.9
Net income	43.1	43.2	40.8	34.5	41.7	30.2	28.7	31.9	33.1	33.3
Receipts 3/	56.8	56.1	52.9	51.2	87.1	53.7	54.8	58.9	60.5	61.7
Of which: Labor income	22.3	19.9	20.1	19.0	19.0	17.2	17.2	17.2	17.2	17.2
Payments 3/	-13.7	-12.9	-12.1	-16.6	-45.5	-23.5	-26.1	-27.0	-27.4	-28.4
Unrequited transfers	62.0	62.2	60.2	60.9	55.8	63.7	62.1	60.2	60.7	61.4
Inflows	65.8	66.3	64.6	66.2	61.4	69.4	67.8	66.0	66.5	67.3
Budget grants	53.7	57.2	54.4	56.2	55.1	63.1	61.4	59.5	60.0	60.7
Compact current grants 4/	30.8	39.7	43.1	42.5	41.4	43.6	42.6	43.5	43.5	43.5
Other budget grants	22.9	17.5	11.3	13.7	13.7	19.5	18.8	16.0	16.5	17.2
Outflows	-3.9	-4.1	-4.4	-5.3	-5.6	-5.7	-5.7	-5.8	-5.8	-5.9
Current account including current official transfers 5/	-3.5	-3.9	-26.4	-40.7	-21.8	-55.9	-38.6	-10.6	-11.6	-9.4
(In percent of GDP)	-2.4	-2.6	-17.4	-25.0	-12.6	-30.3	-20.2	-5.5	-5.9	-4.7
Current account excluding budget grants	-57.3	-61.2	-80.8	-96.9	-77.0	-119.0	-100.0	-70.2	-71.7	-70.1
(In percent of GDP)	-38.3	-40.1	-53.3	-59.4	-44.3	-64.6	-52.5	-36.3	-36.4	-34.8
Capital and financial account	20.6	38.9	50.5	51.3	23.1	55.3	35.8	7.8	8.3	7.8
Official Capital Grants	16.6	11.3	13.2	13.3	12.8	12.7	12.6	13.6	13.5	13.4
Trust Fund Grants	11.4	10.5	14.9	13.5	15.4	14.9	15.5	16.2	16.8	17.5
Foreign Direct Investment 2/	7.0	5.7	14.6	37.1	4.0	36.9	20.5	4.0	4.0	4.0

Sources: RMI authorities and Fund staff estimates.

1/ Fiscal year ending September 30.

2/ The significant rise of imports between FY2010 and FY2013 reflects the purchase of new purse seiners mainly financed by foreign direct investment (FDI).

3/ A Land Use Agreement was reached between the RMI government and Kwajalein landowners in May 2011, authorizing $32 million held in escrow to be disbursed from the U.S. government to the landowners. Most amount will eventually be transferred out from RMI as many landowners reside abroad.

4/ Compact funding pertaining to the Kwajalein Atoll Trust Fund and Kwajalein resident and landowner compensation payments are classified as income rather than official transfers. Trust Fund contributions by the U.S. and Taiwan, Province of China, are regarded as capital transfers.

5/ Official transfers include current transfers but excludes capital transfers and Trust Fund contributions.

Table 4. Marshall Islands: External Vulnerability Indicators, FY2007–12

	2007	2008	2009	2010	2011	2012
					Est.	Proj.
Financial indicators						
Commercial bank deposits (12-month percent change) 1/	13.3	4.1	4.8	9.4	0.5	...
Private sector credit (12-month percent change) 2/	15.5	16.6	6.5	2.1	-2.2	...
Foreign assets/total assets (percent)	55.6	50.1	52.1	53.7	54.4	...
Nonperforming loans (in percent of total loans) 3/	2.0	0.8	1.1	1.1	...	...
Consumer loans (in percent of total private sector loans)	75.0	84.7	72.4	76.8	74.8	...
External indicators						
Exports (percent change)	2.4	10.4	2.7	55.2	26.4	14.9
Imports (percent change)	7.3	2.4	4.5	33.4	-8.8	29.8
Current account balance (percent of GDP)						
Including official current transfers	-2.4	-2.6	-17.4	-25.0	-12.6	-30.3
Excluding budget grants	-38.3	-40.1	-53.3	-59.4	-44.3	-64.6
Capital and financial account balance (percent of GDP)	13.7	25.5	33.3	31.5	13.3	30.0
Of which : FDI (percent of GDP)	4.7	3.7	9.7	22.8	2.3	20.0
Total external debt (percent of GDP)	66.2	62.0	70.4	69.6	67.4	60.0
Total external debt (in percent of exports of goods and services)	350.0	310.8	340.8	260.5	223.3	187.8
External debt service (in percent of exports of goods and services)	59.4	24.7	24.8	22.2	18.4	17.1

Sources: RMI authorities and Fund staff estimates.

1/ The large increase in deposits in 2007 reflects a government guaranteed loan to the Marshalls Energy Company (MEC). Data for 2011 are for the first 6 months only.

2/ Data for 2011 are for the first 6 months only.

3/ Defined as loans with arrears in excess of 90 days.

Table 5. Marshall Islands: Medium-term Scenario, FY2007–16 1/

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
					Est.	Projections				
Real sector										
Real GDP (percent change)	3.0	-1.9	-1.3	5.2	5.0	5.4	2.6	0.6	1.4	1.6
Consumer prices (percent change)	2.6	14.7	0.5	1.6	9.5	-0.5	1.5	1.7	1.9	2.0
Central government finance (in percent of GDP) 2/										
Revenue and grants	72.3	70.2	69.2	67.0	63.6	62.9	60.9	59.1	58.5	58.0
Total domestic revenue	25.8	25.6	25.0	24.7	24.1	22.9	22.8	23.0	23.1	23.1
Grants	46.5	44.5	44.3	42.3	39.5	40.0	38.2	36.1	35.4	34.9
Expenditure	72.0	66.4	67.8	62.4	62.1	61.9	60.4	58.4	57.7	56.9
Current	54.9	54.3	56.7	51.7	51.6	49.0	48.4	48.6	48.1	47.6
Capital	17.2	12.1	11.2	10.7	10.5	12.9	12.0	9.8	9.6	9.3
Overall balance	0.2	3.7	1.4	4.6	1.4	1.0	0.5	0.7	0.8	1.0
Compact Trust Fund (in millions of US$; end of period)	85.7	75.7	90.9	112.8	142.8	165.2	190.7	218.3	248.2	280.5
Balance of payments (in millions of US$)										
Trade balance	-69.6	-69.8	-73.3	-93.3	-73.7	-101.8	-81.3	-57.0	-59.2	-57.7
Net services	-39.0	-39.5	-54.0	-42.8	-45.6	-48.1	-48.1	-45.7	-46.3	-46.4
Net income	43.1	43.2	40.8	34.5	41.7	30.2	28.7	31.9	33.1	33.3
Private and official transfers	62.0	62.2	60.2	60.9	55.8	63.7	62.1	60.2	60.7	61.4
Current account including official current transfers 3/	-3.5	-3.9	-26.4	-40.7	-21.8	-55.9	-38.6	-10.6	-11.6	-9.4
(In percent of GDP)	-2.4	-2.6	-17.4	-25.0	-12.6	-30.3	-20.2	-5.5	-5.9	-4.7
Current account excluding budget grants 3/	-57.3	-61.2	-80.8	-96.9	-77.0	-119.0	-100.0	-70.2	-71.7	-70.1
(In percent of GDP)	-38.3	-40.1	-53.3	-59.4	-44.3	-64.6	-52.5	-36.3	-36.4	-34.8
External debt (in millions of US$; end of period) 4/	99.1	94.6	106.8	113.4	117.0	110.5	108.7	102.1	96.2	90.0
(In percent of GDP)	66.2	62.0	70.4	69.6	67.4	60.0	57.0	52.9	48.8	44.7
External debt service (in millions of US$)	16.8	7.5	7.8	9.7	9.7	10.1	10.0	9.1	8.2	8.3
(In percent of exports of goods and services)	59.4	24.7	24.8	22.2	18.4	17.1	15.2	13.4	11.9	11.5

Sources: RMI authorities and Fund staff estimates.

1/ Fiscal year ending September 30.

2/ The central government finance numbers do not not include the first tranche disbursement of $9.5 million in early FY2011 and a projected second tranche disbursement of the new AsDB loan to the Marshalls Energy Company.

3/ Budget grants are official current transfers which exclude capital transfers and Trust Fund contributions.

4/ Government and government-guaranteed debt only.

INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

STAFF REPORT FOR THE 2011 Article IV Consultation INFORMATIONAL ANNEX

November 7, 2011

Prepared By

Asia and Pacific Department
(In consultation with other Departments)

CONTENTS

ANNEX I. FUND RELATIONS

(As of September 30, 2011)

I. **Membership Status:** Joined May 21, 1992; Article VIII

II. **General Resources Account:**

	SDR Million	Percent Quota
Quota	3.50	100.00
Fund holdings of currency	3.50	100.00
Reserve position in Fund	0.00	0.01

III. **SDR Department:**

	SDR Million	Percent Allocation
Net cumulative allocation	3.33	100.00
Holdings	3.33	100.00

IV. **Outstanding Purchases and Loans:** None.

V. **Financial Arrangements:** None.

VI. **Projected Obligations to Fund:** None.

VII. **Exchange Rate Arrangements.**

The U.S. dollar is legal tender and the official currency. The Marshall Islands maintains an exchange system that is free of restrictions on the making of international payments and transfers for current and capital transactions.

VIII. **Article IV Consultation:**

The Marshall Islands is on a 24–month consultation cycle. The 2009 Article IV Consultation discussions were held during November 10–18, 2009. The Executive Board discussed the staff report and concluded the consultation on February 3, 2010.

IX. **Technical Assistant:** Technical assistance on tax policy, bank supervision, and statistics has been provided mainly through PFTAC.

X. **Resident Representative:** Mr. Yongzheng Yang has been the Resident Representative for Pacific Island Countries since September, 2010. He is based in Suva, Fiji.

ANNEX II. RELATIONS WITH THE WORLD BANK GROUP

1. The Bank team led by Mr. Suri and the Fund team led by Mr. Yoshida maintain a close working relationship and have an ongoing dialogue on macroeconomic and structural issues.

2. The teams agreed that the RMI's main macroeconomic challenges are to achieve (i) long-term budgetary self-reliance and (ii) facilitating a greater role for the private sector in delivering services and generating employment.

3. Based on this shared assessment, the teams identified several reform areas as critical in view of their central role in achieving fiscal consolidation and fostering sustained growth:

- Civil service reform. The public sector wage bill is similar to that in other small Pacific Island Countries, but large by international standards of economies of comparable scale, and unsustainable in light of declining US Compact grants. Reducing the public wage bill to sustainable levels and reducing labor market inefficiencies will likely require a reduction of the civil servant workforce and in pay to bring compensation in line with private sector services costs. Such reforms would, however, need to be cognizant of the constraints imposed on employment opportunities by the small size of the economy and the current limited potential for private sector growth.

- Reform of the revenue system. The existing tax system lacks the ability to raise needed additional revenue, discourages private investment, and is inequitable. Raising additional revenue while supporting private sector growth requires implementation of a comprehensive tax reform program and strengthening tax administration.

- Public sector enterprise reform. Many state-owned enterprises (SOE) are a drain on the public finance and provide unreliable or costly services undermining private sector development. To improve their performance, reforms are needed to strengthen efficiency, better delineate commercial and non-commercial services, and introduce tariff systems that better reflect cost of services. In areas where SOEs provide purely commercial services, divestment should be considered.

- Structural reforms in the telecommunication and energy sectors. An improved regulatory environment and private investment in telecommunications is required to facilitate broader access to and reduce the costs of delivering social services and create opportunities for private sector development. An improved regulatory and tax framework in the energy sector is required to i) alleviate existing excessive petroleum price margins which increase living costs and impede private sector growth, ii) ensure security of supply, and iii) generate higher government revenues.

- Improved aid management and coordination. Existing donor flows are poorly coordinated and reporting arrangements are inadequate. This leads to inefficiency in public service delivery and weakens macroeconomic management. Aid-reporting systems should be improved to ensure strengthened coordination and better information on donor expenditure.

4. The teams agreed on close cooperation going forward. The below table lists the teams' separate and joint work programs during October 2011-September

2012. The Bank recently reclassified RMI from an IBRD to an IDA eligible country. The implications of this change for the Bank's potential lending program have been discussed with the Fund.

Marshall Islands: Bank and Fund Planned Activities in Macro-critical Structural Reform Areas

October 2011–September 2012

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank Work Program	Work towards liberalization and the introduction of competition in the telecommunications sector, through TA and a sectoral Development Policy Operation.	Oct 2011 Jan 2012	FY2013
	A Development Policy Operation, supported by TA in the energy sector, aimed at achieving improved regulation and taxation of fuel products, improved management within the state-owned electricity utility, and compliance with international safety standards.	Oct 2011 Jan 2012	FY2012
2. Fund Work Program	Article IV mission to review macroeconomic developments and update long-term fiscal sustainability assessment	Sep/Oct 2011	Nov 2011
	PFTAC Technical assistance: Tax reform		Ongoing
	PFTAC Technical assistance: Banking law review		Ongoing
	PFTAC Technical assistance: PEFA assessment		Tentative
3. Joint Work Program	Mutual update on work program developments and information sharing	Semi-annual	Ongoing

ANNEX III. RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Prepared based on input from the AsDB staff.

The country strategy of the Asian Development Bank (AsDB) for the Republic of the Marshall Islands (RMI) is set out in AsDB's "Pacific Approach 2010–14" and the "Country Operations Business Plan 2012–14". The Country Operations Business Plan has four areas of strategic focus: (i) macroeconomic and fiscal management, (ii) private sector development, (iii) human capacity development, and (iv) environment and climate change. The operational focus of AsDB over 2012–14 is on supporting the government's efforts to restore macroeconomic stability after the global financial crisis and achieve long-term fiscal sustainability. AsDB is proposing an indicative lending program of $5 million over 2012–14 to support the implementation of the government's reform initiatives and the adjustments required to achieve fiscal sustainability. Technical assistance (TA) of $725,000 is proposed for 2012 and 2013 for strengthening economic policy and planning and enhancing public sector service delivery. AsDB's program in the RMI is also supported using regional TA and grants.

Since joining the AsDB in April 1990, the RMI has received 13 loans totaling $87.63 million. AsDB loans have covered education, fisheries, health, water, and transport sectors, and support for public sector reform and structural adjustment (see table). One loan assisted emergency typhoon rehabilitation. From 2003 to 2009, AsDB's program for the RMI focused on TA rather than loans. Lending resumed in 2010 with the approval of a program loan for $9.5 million to support public sector reform. As of end December 2010 TA grants totaling $19.58 million for 48 TA projects had been approved. These comprised both project preparatory and advisory TA. The TA program has covered a wide range of sectors and issues from support to AsDB loans to building capacities in development banking, tourism management, environmental protection, economic policy formulation, as well as in developing the private sector and reforming the civil service.

In July 2010, a $1.76 million grant was approved for improving energy supply for poor households. The grant is (i) supporting the installation of prepayment meters for Marshalls Energy Company (MEC) customers to reduce household expenditure on electricity and improve household management of utility bills, (ii) connecting unserviced poor households and improving power supply to poor areas in Majuro, Wotje, and Jaluit, (iii) and trialing of a coconut oil–diesel blend as alternative fuel in the MEC power generators to earn additional income for poor producers of copra in outer atolls.

In August 2010, a $3 million regional grant was approved for social protection of the vulnerable in the Cook Islands, the RMI and Tonga. Approximately $1.2 million of the grant is allocated to the RMI, largely for providing direct support to the vulnerable for coconut tree planting and enhancing government capacity to identify the vulnerable population.

Over 2010 the AsDB provided support for public sector reform initiatives by deploying technical experts to address human resource, energy, and public finance matters. This support resulted in the approval of the $9.5 million program loan referred to above – the majority of which was used to repay a loan held by the MEC with the Bank of Guam which improved cash flow and released funds for generator refurbishment. Accompanying the loan was $900,000 of TA to continue to support the RMI's reform efforts over 2011 and 2012. Technical experts are currently providing support on state-owned enterprise reform, budget preparation and monitoring, debt management, and human resources reform.

Table 1: Asian Development Bank
Loans to the Republic of the Marshall Islands by Sector
(In millions of U.S. dollars; as of December 31, 2010)

Sector	Number	Amount
Agriculture and Natural Resources	1	6.95
Education	2	14.83
Energy	0	0.00
Finance	0	0.00
Health and Social Protection	2	14.95
Industry and Trade	0	0.00
Public Sector Management	4	33.50
Transportation and Information and Communication Technology	1	7.00
Water Supply and Other Municipal Infrastructure and Services	2	9.90
Multisector	1	0.50
Total	13	87.63
Memorandum Items:		
Technical Assistance	48	19.58
Grants	1	1.76

ANNEX IV. RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE

The Pacific Financial Technical Assistance Centre (PFTAC)'s[1] assistance to the RMI during the past years has focused on financial supervision, public expenditure management, and tax administration policy through numerous missions, regional seminars and workshops which RMI officials attended. PFTAC also organized one secondment for a staff of member countries to banking supervision agency of a non-member country.

Public Financial Management

In the past years PFM activity in RMI has increased significantly. A peripatetic consultant was fielded by PFTAC to work on fiscal forecasting and again in June 2008 for one final visit to anchor the system and provide training. A cash management manual was developed by PFTAC and training provided on its operation in early 2007. A peripatetic consultant has since provided training on the operation of the system to line ministries and visited RMI in January 2008, along with the PFTAC advisor, to provide further training and to review the system. The PFTAC advisor visited RMI again in May 2009 to provide training. PFTAC is meanwhile developing a commitment control manual for RMI and a commitment control system may be installed, and training provided once the government's feedback of the draft commitment control manual is received. PFTAC also carried out an assessment of the IFMIS systems in RMI in December 2009 with a view to recommend next steps to improve the operation of the system.

Tax Administration and Policy

In 2008, the Minister of Finance set up the Tax and Revenue Reform and Modernization Commission (TRRM) to make recommendations to reform the revenue collection system and to strengthen the capabilities and effectiveness of the Division of Revenue and Taxation (DRT). The TRRM reported back in 2010 and recommended a comprehensive revenue reform to introduce an income tax and domestic sales tax. Subsequent PFTAC advice highlighted revenue leakage in the sales tax proposal and the recommendation was changed to introduce a VAT. Since then PFTAC has provided assistance to develop a high level implementation plan for the revenue reforms (2010); draft legislation for the income tax, VAT and excise taxes and revenue administration activities (2010–11); and draft a terms of reference for the recruitment of a long term consultant who will assume the role of Assistant Secretary of the duration for the reforms (2011). PFTAC is currently assisting with recruitment of the Assistant Secretary. Once the Assistant Secretary is recruited (1st quarter of 2012) PFTAC has undertaken to provide assistance to develop an information technology strategic plan for both tax and customs and will continue to provide support and advice to the Assistant Secretary.

[1] Prepared based on the input from the PFTAC staff. PFTAC, which is located in Suva, Fiji, is a multi-donor TA institution financed by the IMF, AsDB, AusAID, NZAID, Japan, and Korea, with the IMF as the Executing Agency. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tokelau, Tonga, Tuvalu, and Vanuatu.

Financial Sector Regulation and Supervision

At the request of the Commissioner, the Advisor visited the Commission in July 2008. The focus of the mission was to strengthen the capacity of the authorities to conduct off-site surveillance of banks with a number of revisions recommended to the prudential reporting requirements for banks and expansion of the off-site monitoring database. The mission also included training in the analysis of financial statements to assess a borrower's credit risk.

A follow-up visit to with the Commission was conducted in January 2010 to provide training and support to Commission staff in conducting an on-site CAMELS-focused bank examination. The visit included providing hands-on training and support to Commission staff in assessing credit risk in the bank's loan portfolio through the use of financial statement analysis, reviewing the appropriateness of loan repayment structures and repayment histories, and assessing the adequacy of collateral. The visit also resulted in the development of a standardized examination report to assist the Commission in presenting examination findings and recommendations. At the request of the Commission, a draft regulation to clarify and ensure the proper calculation of the single borrower limit as provided in Section 130(1)(a) of the Banking Act was also prepared during this visit.

In February 2011 training and support was provided to Commission staff in conducting a follow-up examination to assess efforts by a bank to correct weaknesses and concerns noted as a result of an earlier examination. As a result of the follow-up visit, assistance was provided to the Commission in drafting an appropriate regulatory response to the examination findings. Future visits with the Commission will include expanding and revising on-site examination procedures to allow for risk-focused procedures in order to improve examination efficiencies.

Economic and Financial Statistics

The Economic Policy, Planning and Statistics Office (EPPSO) received significant training since 2005 on balance of payments and national accounts statistics, including through participation on a PFTAC regional national accounts statistics course conducted in Pohnpei, Federated States of Micronesia in 2006. Despite the extensive training, these statistics continued to be compiled by external consultants. The previous PFTAC Statistics Advisor provided some technical backstopping to the national accounts consultant, and in July 2007 visited RMI to assist with the improvement and compilation of their Balance of Payments (BOP) statistics. The mission was carried out in conjunction with the two consultants who are funded by the U.S. Department of Interior to update the Annual Compact Report.

In November 2008, the current PFTAC Advisor undertook a joint BOP and national accounts statistics mission to RMI to continue development work on BOP and NA sources and methods, as well as to assist in updating BOP and NA estimates. The EPPSO counterpart left in early 2009 and there is currently no statistics staff at EPPSO. As a result, two consultants funded by the U.S. Department of Interior visit RMI annually to update the BOP and national accounts statistics for inclusion in the Annual Compact Report.

ANNEX V. STATISTICAL ISSUES

As of October 31, 2011

Assessment of Data Adequacy for Surveillance

General: Data provision is broadly adequate for surveillance and the authorities willingly share available data, though some shortcomings tend to constrain policy analysis, especially on trade statistics. The Economic Policy, Planning and Statistics Office (EPPSO) was established in February 2003 and took efforts in building local capacity to collect and disseminate economic and social statistics. Through the close collaboration of EPPSO and various ministries, an external consultant team in the Pacific Islands Training Initiative (www.pitiviti.org), funded by the U.S. Department of Interior, prepares a comprehensive set of annual statistics covering key areas beginning FY2008. Previously, extensive Fund technical assistance was provided through the Pacific Financial Technical Assistance Center (PFTAC) in preparation of the balance of payments and national account statistics. Data shortcomings include the coverage and timeliness of data releases.

National Accounts: National income accounts from (the latest data through FY2010) have been prepared by the external consultants dating back to FY1997. Some shortcomings remain, for instance, investment and savings indicators are not available. The national census was conducted in early 2011 and final results are under preparation with the assistance of the South Pacific Commission.

Employment: Data on employment and wages are available and classified by sectors based on the filings to Social Security Administration. However, no unemployment data are available.

Price statistics: The new consumer price index (CPI), rebased in 2003Q1, replaced the previous CPI developed in the 1980s. The updated CPI is based on the information from the Household Income and Expenditure Survey 2002, conducted with assistance from the U.S. Department of the Interior and the U.S. Census Bureau.

Government finance: Fiscal data are regularly compiled for budget control, and with the help of the consultants they are consolidated into a format suitable for analysis. Annual financial audits on the central government and component units were published. The RMI does not present fiscal data using Government Finance Statistics Manual 2001 (GFSM 2001) format.

Monetary statistics: A reporting system has been established for domestic banking institutions on the basis of monthly reporting forms and guidelines developed by the 1993 STA mission. Even though data are reported by banks to the Banking Commissioner, they are not published or reported to the Fund. Tables on basic balance sheet items as well as income and expenses are prepared for inclusion in the Annual Compact Report.

Balance of payments: Through the collaboration with the EPPSO, the external consultants provide annual update on the balance of payment statistics. Without mandatory reporting, statistics on exports and imports are incomplete. Limited data are available on services, factor income, and private transfers, hindering analysis of external sector developments.

Data Standards and Quality

Does not participate in the IMF's General Data Dissemination System.
No data ROSC is available.

Reporting to STA (Optional)

No data are reported to STA.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/148
FOR IMMEDIATE RELEASE
December 2, 2011

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2011 Article IV Consultation with the Republic of the Marshall Islands

On November 23, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of the Marshall Islands (RMI).[1]

Background

The RMI's economy is highly dependent on external aid, and the private sector growth is sluggish. A renewed Compact of Free Association agreement ("Compact") with the United States provides a stream of stable, but declining grants aimed primarily at education, health, and infrastructure sectors. These grants have been a boon to social and economic growth, but have come at the expense of fostering economic dependence on foreign income. The economy is dominated by a large public sector and private businesses contribute little to growth. The banking sector is small.

Following a severe recession in FY2008-09, the economy grew by 5.2 percent in FY2010, driven by an expansion of fishery output and exports, and moderating fuel prices. Inflation increased following the significant rise in commodity prices in early 2011, but is projected to moderate gradually.

The overall fiscal balance improved in FY2010 along with the economic recovery, but

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm

mostly as a result of unspent earmarked appropriations. Only a modest surplus of $0.4 million was recorded in the general fund for discretionary uses in FY2010. The overall surplus in FY2011 is estimated to be modest; with a 5.5 percent across-the-board cut of current expenditures and additional revenues from fishing fees partly offset by temporary tax exemptions on food and other basis consumables and increased subsidies to state-owned enterprises (SOEs) to cover operating losses. Despite a potential upside of higher fisheries revenue, the fiscal outlook will continue to be hindered by weak financial positions in the SOEs and limited budget planning. Over the medium term, fiscal balance is expected to be modest at about 1 percent of GDP.

The deterioration in the current account is expected to continue until FY2013 due to temporary factors. The widening of the deficit since FY2009 reflects increased imports under the Kwajalein land use agreements, new investments in the fisheries sector and the airport extension project, which have been financed mainly through foreign direct investment and capital grants. Once these temporary factors expire, the current account deficit beyond FY2013 is expected to decline to around 5 percent of GDP. Though external debt is relatively high at about $117 million as of end-FY2011, it is mainly on concessional terms and is expected to decline.

The recovery is likely to continue in the near term, but growth over the medium term is expected to stay low at around 1½ percent with the growth in fisheries sector partly offset by the decline in Compact grants. The economy could face stiff headwinds if the global slowdown proves severe and prolonged. Long-term risks include continued outward migration and shore erosion on local atolls from climate change.

The global financial crisis has made it more difficult to achieve long-term budgetary self-reliance and sustained growth. Under current policies, the buildup in government assets in the Compact Trust Fund is projected to fall short of replacing Compact grants expiring in FY2023. Closing the revenue gap would require a substantial fiscal adjustment over the medium term.

Executive Board Assessment

Executive Directors welcomed the economic recovery and the positive near-term outlook. However, they noted that the medium-term prospects remain weak and, like other island economies with limited natural resources and remote location, the Marshall Islands is highly vulnerable to external shocks. The key challenges are to strengthen medium- and long-term growth prospects, and to secure a sustainable fiscal position without compromising priority social and infrastructure spending as Compact grants are phased out.

Directors agreed that fiscal sustainability calls for sustained efforts to achieve higher budgetary savings and a faster build-up of assets in the Compact Trust Fund over the medium term. To this end, they urged swift implementation of fiscal and structural reforms to boost fiscal revenue and contain public spending. Key measures will include the implementation of tax reform, the containment of the public sector payroll, a reduction of subsidies to state-owned enterprises and allowances to public officials, and improvements in public financial management. Putting the social security system on a sounder financial footing will also be important.

Directors considered that the planned reforms of state-owned enterprises are essential to both fiscal adjustment and the development of the private sector. They encouraged the authorities to complement these reforms with further steps to improve the business environment, including a streamlined land registration process.

Directors took note that the banking sector is liquid, well-capitalized, and profitable. Nevertheless, they considered the high level of household indebtedness a financial risk that could be exacerbated by the development bank's shift toward short-term consumer lending. In this context, Directors supported steps to broaden regulatory oversight, including as regards the regime against money laundering and terrorism financing, and to facilitate credit to businesses.

Marshall Islands: Selected Economic Indicators FY2004–09 1/

Nominal GDP for FY2010 (in millions of U.S. dollar):	162.94
Population (2010):	52,371
GDP per capita for FY2010 (in U.S. dollar):	3,111.16
Quota:	SDR 3.5 million

	2007	2008	2009	2010	Est. 2011	Proj. 2012
Real sector						
Real GDP (percent change)	3.0	-1.9	-1.3	5.2	5.0	5.4
Consumer prices (percent change)	2.6	14.7	0.5	1.6	9.5	-0.5
Central government finances (in percent of GDP 2/						
Revenue and grants	72.3	70.2	69.2	67.0	63.6	62.9
Total domestic revenue	25.8	25.6	25.0	24.7	24.1	22.9
Grants	46.5	44.5	44.3	42.3	39.5	40.0
Expenditure	72.0	66.4	67.8	62.4	62.1	61.9
Current	54.9	54.3	56.7	51.7	51.6	49.0
Capital	17.2	12.1	11.2	10.7	10.5	12.9
Overall balance	0.2	3.7	1.4	4.6	1.4	1.0
Memorandum item: including the new AsDB loans to MEC 3/						
Financing: gross borrowing (in USD million)	0.1	0.0	0.0	0.0	9.5	0.0
Compact Trust Fund (in million of US$; end of period)	85.7	75.7	90.9	112.8	142.8	165.2
Commercial banks (in millions of US$)						
Foreign assets	60.7	57.1	63.6	71.8	74.1	…
Private sector claims	49.9	58.2	62.0	63.3	61.9	…
Total deposits	85.5	89.0	93.3	102.1	102.6	…
One-year time deposit rate (in percent)	4.1	3.6	6.0	3.5	3.5	…
Average consumer loan rate (in percent)	18.5	18.5	13.9	14.0	14.2	…
Balance of payments (in millions of US$)						
Trade balance	-69.6	-69.8	-73.3	-93.3	-73.7	-101.8
Net services	-39.0	-39.5	-54.0	-42.8	-45.6	-48.1
Net income	43.1	43.2	40.8	34.5	41.7	30.2
Unrequited transfers (private and official)	62.0	62.2	60.2	60.9	55.8	63.7
Current account including official current transfers 4/	-3.5	-3.9	-26.4	-40.7	-21.8	-55.9
(In percent of GDP)	-2.4	-2.6	-17.4	-25.0	-12.6	-30.3
Current account excluding budget grants 4/	-57.3	-61.2	-80.8	-96.9	-77.0	-119.0
(In percent of GDP)	-38.3	-40.1	-53.3	-59.4	-44.3	-64.6
External debt (in millions of US$; end of period) 5/	99.1	94.6	106.8	113.4	117.0	110.5
(In percent of GDP)	66.2	62.0	70.4	69.6	67.4	60.0
External debt service (in millions of US$)	16.8	7.5	7.8	9.7	9.7	10.1
(In percent of exports of goods and services)	59.4	24.7	24.8	22.2	18.4	17.1
Exchange rate						
Real Effective Exchange Rate (2000 =100)	96.5	102.7	104.5	101.8	101.2	…
Memorandum Item:						
Nominal GDP (in millions of US$)	149.7	152.6	151.6	162.9	173.7	184.3

Sources: RMI authorities and IMF staff estimates.

1/ Fiscal year ending September 30 unless otherwise stated.

2/ The central government finance numbers do not include the first tranche disbursement of $9.5 million in early FY2011 and a projected second tranche disbursement of the new AsDB loan to t he Marshalls Energy Company.

3/ The payments by the government to MEC will be recorded as subsidy to public enterprises of $8.5 million and increase of gross borrowing of $9.5 million in FY2011. The second tranche of $5 million is expected to be in FY2013.

4/ Official transfers include current transfers, but exclude capital transfers and Trust Fund contributions.

5/ Includes government and government-guaranteed debts.

Statement by Christopher Legg, Executive Director for the Republic of the Marshall Islands, and Messrs. Craig Fookes and Mack Kaminaga, Advisors to the Executive Director
November 23, 2011

The Republic of the Marshall Islands (RMI) wishes to express appreciation to the mission team for their constructive engagement and concise report. With this in mind, the authorities agree with the substance of the report, which correctly identifies the size of the fiscal challenges, highlights the need for growth in the private sector, and emphasizes the need for a gradual transition towards self sustainability as aid flows under the Compact scheme come to an end in 2023.

The economic outlook

The economy has recovered strongly with growth of 5.2% in 2010 following strong growth in fisheries and a moderate recovery in exports (mainly coconut oil and tourism). Much of this growth has been concentrated in a small number of sectors and, as a result, there has been rising unemployment and financial hardship on many of the outer islands. Looking forward, the authorities are more optimistic than staff about growth over the short-term. Forecast growth of 9% and 8.8 % in 2011 and 2012 respectively is expected to be driven by a continued expansion in fisheries.

A slight fall in petrol prices has allowed the current account to narrow. A spike in imports following the renewed US lease on Kwajalein military base led to a peak in the current account, although the balance should moderate to 5% through 2013 as temporary factors start to unwind. While foreign debt is high at about two thirds of GDP, much of this is covered by concessionary loans. But, over the medium term, active steps will need to be taken to secure additional export revenue to cover the cost of imports.

While the outlook is positive for 2012, there are growing risks to the forecasts. Risk remains weighted to the downside as any slowdown in the US or Asia would affect exports. On the other hand, stronger global growth or an increase in the cost of petrol would have an impact on the fiscal position and flow through to domestic inflation. While, as the staff note, the use of the US dollar continues to be appropriate, a fixed exchange rate and lack of independent monetary policy will continue to place a significant strain on the stabilization role of fiscal policy. Despite this, the authorities remain optimistic that recent reforms, such as a decision to allow electricity tariffs to float in line with world oil prices, will put them in a better place to absorb shocks, should the situation deteriorate.

Fiscal sustainability

Having gained political independence in 1979, the RMI continues to grapple with challenges associated with gaining economic and fiscal self sufficiency. These challenges include: geographic isolation; limited economies of scale associated with a population of only 60,000; and the persistent threat of natural disaster, given the high point on most islands is a little over six meters. The authorities continue to appreciate the support provided by the United States through the provision of a range of essential services, grants made through the Compact of Free Association, and via employment income for the 20,000 Marshallese citizens currently living and working in the United States.

With the Compact due to expire in 2023, the authorities are well aware that fiscal self sufficiency must remain an overriding goal. Given the Compact currently accounts for over 51.1% of government revenue, the authorities have set up, and continue to make contributions to, a Compact Trust Fund (CTF), which will provide a stream of income beyond 2023. The authorities contributed $1.1 million to the CTF in 2011 bringing the current balance to $142 million (86% of GDP). Strong forecast growth (8.8 in 2012 should allow a transfer of a similar size next year.

Despite efforts to the contrary, the financial crisis and sluggish global recovery have weighed on the CTF returns and, as a result, a projected budget shortfall could occur in 2023. Achieving and maintaining the necessary 5% surplus through 2023 (as staff calculations suggest) presents an enormous task. It is worth emphasizing that the RMI has no social safety net and growth in employment in the private sector has remained muted. Thus, while the authorities' would prefer a stronger response along the lines suggested by staff, they remain cognizant of the potential for severe distributional consequences.

Despite these concerns, the authorities have still taken immediate steps to strengthen the fiscal position. Over the last two years, the RMI has frozen public sector wages and cut current expenditures by over ten percent. Immediate steps have also been taken to improve tax collection, but the current tax structure is now considered to be largely outdated. Exploratory work has started to build consensus for reform as employment growth in the private sector will require revenue to be raised in a way that does not unduly weigh on growth. As a result, a full review of the tax system is scheduled for 2012 and the authorities expect to retain the services of a consultant to help with the design of an appropriate tax structure.

Public financial management has also been identified as a weakness and the authorities have sought technical assistance on a review of the Public Finance Management Act. A key goal is to improve allocation of resources by increasing the focus placed on how the budget will evolve over the medium term. Work to improve the fiscal position over the medium term has been supported by a policy of gradual attrition that will act to reduce the public sector headcount over time. The authorities are also investigating ways to better manage the large unfunded pension liability.

Structural reform agenda

Growth in the private sector will need to be part of the solution if the RMI is to strengthen its public finances without undue social cost. The fishing industry stands out as a recent success story, providing a potential source of employment growth over the near term. The Nauru Agreement has clarified property rights across the western Pacific by bringing nearly 4.5 million square kilometers of ocean under management. License fees are expected to grow as the agreement manages between 25-30 percent of the global tuna supply. More effective management and a strong focus on sustainability will also ensure that the fishery resource is able to generate an ongoing stream of revenue.

Closer to home, the authorities aim to lift domestic investment. A large proportion of private sector activity relies on public spending and government contracts. With this in mind, the authorities are looking to divest assets and are also taking steps to improve the operation of key SOEs. The ADB has provided advice on the new SOE Act, which will clarify SOE mandates based on clear commercial principles. Legislation has already been drafted and is expected to pass once comments from the RMI Cabinet have been taken into account. The authorities have also attempted to divest Air Marshall Islands and the Majuro resorts.

Domestic investment could benefit from steps to reduce administrative delays, transaction costs, and general investment uncertainty. Work is underway to streamline barriers to private sector investment, but success will ultimately require a difficult process of institutional reform and work to overhaul and modernize traditional legal frameworks. Most notably, the authorities have signaled resolve to address the uncertainty created by the traditional Marshallese land tenure system. Uncertainty about use of land, given its de facto use as a shared asset, has complicated investment in fixed plant and equipment. The issues are complex. However, recent progress has been made to provide a legal basis for long-term land leases.

Financial sector

The financial sector has remained focused on consumer lending and has contributed little to overall economic growth. While the sector has remained profitable, much of the rapid growth in credit has been in consumer loans. The authorities are monitoring high levels of household debt and intend to begin work on strengthening the regulatory framework. With this goal in mind, the domestic banks will be consulted early next year on proposed revisions to the Banking Act. The second priority is to increase the flow of credit to businesses. A lack of collateral has limited lending into this sector. However, it is hoped that legislation passed on secured lending and changes to property law will facilitate increased business lending, perhaps through the use of land as collateral.