INTERNATIONAL MONETARY FUND

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REPUBLIC OF THE MARSHALL ISLANDS

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

February 2014

In the context of the 2013 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**, **Informational Annex**, and **Debt Sustainability Analysis** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 1, 2013, 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 December 19, 2013.
- A **Press Release** summarizing the views of the Executive Board as expressed during its January 8, 2014 discussion of the staff report that concluded the Article IV consultation.
- A **Statement by the Executive Director** for the Republic of Marshall Islands.

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

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STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

December 19, 2013

KEY ISSUES

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

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

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

Key Policy Recommendations.

- A fiscal adjustment of no less than 4.5 percent of GDP by FY2018 is needed to achieve long-term budgetary self-reliance and to build some fiscal buffers, taking the trade-off between consolidation needs and growth implications into account.
- Achieving this target would require public wage moderation, SOE restructuring, swift implementation of the long-awaited tax reform and further reforms to the social security system.
- Growth potential can be enhanced by upgrading human capital and infrastructure and securing better connectivity, in cooperation with development partners and neighbor countries. SOE reforms and measures to facilitate firm access to credit would support private sector development.
- The capacity and oversight authority of the Banking Commission should be strengthened to safeguard financial stability.

Approved By
Stephan Danninger and Ranil M. Salgado

Discussions took place in Majuro on October 24–November 1, 2013. The staff team comprised Ms. Edda Zoli (Head), Mses. Alla Myrvoda and Lian Koon Priscilla Ng, Mr. Ikuo Saito (all APD), and Mr. Kyounghwan Moon (OED). Representatives from the World Bank and the Asian Development Bank also joined the mission. The mission met with Finance Minister Momotaro, Chief Secretary Nemra, Finance Secretary Alfred, Jr., other senior government officials, private sector representatives, donors and the press.

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BACKGROUND

1. The RMI is a small and isolated country, with a dispersed population and limited export base, highly dependent on external aid and vulnerable to climate change. Under the renewed Compact Agreement with the US, the RMI will continue to receive annually declining grants averaging US$45 million (26 percent of GDP as of FY2012) until FY2023.[1] A Compact Trust Fund (CTF) is being built up to provide funding from FY2024 onwards.

RECENT DEVELOPMENTS AND OUTLOOK

A. Recent developments

2. The economy grew by 3.2 percent in FY2012, up from a lackluster 0.6 percent in FY2011. The FY2012 growth pick-up was driven by the double-digit expansion in the fishery sector, increased copra and coconut oil production and the expansion of the education sector (Figure 1). Construction activity, however, continued to contract, owing to delays in the implementation of Compact infrastructure projects. In FY2013 growth is estimated at a weaker rate of 0.8 percent, due to further postponement of some construction activities. Employment has remained stagnant in FY2012, with a slight reduction in private sector employment being offset by a small increase in public sector employment. Outmigration slowed in FY2012, after ten years of average annual outflows rates.

3. Inflation moderated. Year-on-year inflation stood at 4.3 percent in FY2012—1 percentage point lower than in FY2011—and is estimated to have eased even further, to 1.6 percent in FY2013, thanks to subdued world commodity prices.

4. In FY2012 the overall fiscal balance recorded the first deficit (0.8 percent of GDP) since 2005, in spite of favorable growth. The deterioration reflected an increase in transfers to SOEs of 1.1 percent of GDP and a 0.5 percent of GDP rise in the public wage bill, which more than offset an increase in fishing license fees. For FY2013, the fiscal deficit is estimated to have remained at 0.8 percent of GDP, with a further increase in transfers to SOEs broadly offsetting that in fishing license fees. The FY2012 deficit was financed by a drawdown in deposits, while the FY2013 deficit was financed by an Asia Development Bank (AsDB) loan disbursement.

5. The current account deficit including official transfers remained elevated in FY2012 at 8.1 percent of GDP. This was driven by high imports for the airport extension project, financed by capital transfers. Exports continued their expansion, reaching nearly 35 percent of GDP in FY2012. Fishing fees rose to 5.6 percent of GDP in FY2012, from 3.1 percent of GDP in FY2011 (Figure 2). In FY2013 the current account deficit is estimated to have deteriorated to 9.4 percent of GDP, due to the postponement of some donor grants.

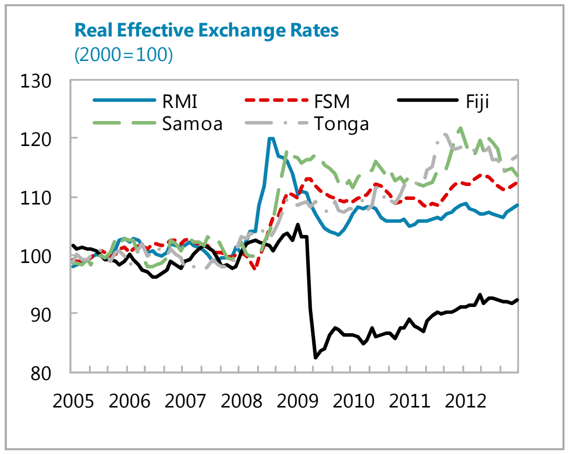
[1] The fiscal year runs from October to September.

B. Outlook and Exchange Rate Assessment

6. While a growth rebound is expected in FY2014, the medium-term outlook is less promising. Growth is projected at 3.2 percent in FY2014, assuming the resumption of Compact funded infrastructure projects. The pickup in related construction activities is expected to continue through FY2017, and unwind in FY2018, with growth slowing significantly in that year. The fishing sector is expected to expand further, but at a slower pace (Box 1). In the medium-long term, growth potential is projected at about 1½ percent—weighted down by the scheduled reduction in Compact grants and limited private sector expansion. Inflation is expected to remain moderate at 1.7 percent in FY2014, thanks to subdued global commodity prices.

7. A fiscal deficit of 0.2 percent of GDP is projected for FY2014. The temporary improvement compared to FY2013 is driven by one-off revenue factors—a grant from Papua New Guinea and a dividend transfer from the Marshall Islands Marine Resource Authority— more than offsetting increases in education and health spending in response to a US request.

8. The current account deficit is expected to widen in FY2014 to nearly 21 percent of GDP. The deterioration will be driven by the acquisition of two ships provided by a donor to improve domestic transportation, and higher imports for the resumption of infrastructure projects. In the medium term, however, the current account will tighten, as the impact of these temporary factors abates, and thanks to some expansion in fish exports and fishing license fees.



9. The real exchange rate is close to its historical value. The real appreciation in FY2008–09 following the global commodity price shock was largely reversed, and the real exchange rate has remained fairly stable since then. Exports have been expanding and unit labor costs in the fishing sector—the main export— have been declining over the past three years. Current account deficits are financed by a stable source of funding and the use of the U.S. dollar as legal tender and the close ties with the United States provide a shelter against external instability.[2]

C. Risks and Spillovers

10. Risks to the outlook are to the downside. In the short-term, further delays in the implementation of infrastructure projects could weigh growth down. The danger of natural disasters

[2] A formal CGER-type analysis was conducted. However, that assessment framework is not fully suitable for the RMI due to data limitations and the special characteristics of its economy, most notably the heavy dependence on aid. The analysis points to a real undervaluation in the range of 9–38 percent, as estimated current account deficit norms are very large—due to a significant economic development gap relative to trading partners and negative oil balances—whereas underlying current account deficits are much smaller, reflecting the impact of stable foreign government grants.

is ever-present. Global oil price shocks would have a detrimental impact on growth and other macroeconomic variables. Longer-term risks include inadequate fiscal consolidation ahead of the scheduled decline in Compact grants, climate change, and continued outward migration of the working-age population. On the upside, a decisive push for structural reforms and additional investment in infrastructure and the fishery sector would support growth (Appendix 1). Due to limited international financial linkages, the RMI remains fairly isolated from spillovers from external financial developments. Spillovers from trade linkages are expected to be limited in the near-medium-term given RMI's low dependence on tourism and relatively stable fish demand.

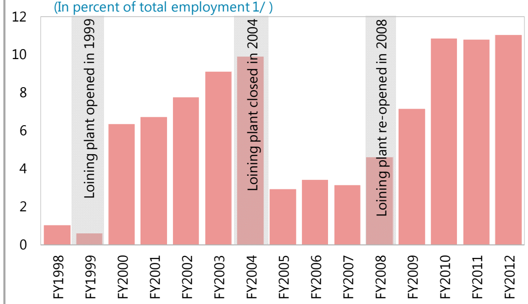
Box 1. Marshall Islands: Will the Fishing Sector be the Driver of Future Growth?

The importance of the fishing sector in the RMI's economy has grown in recent years. In FY2012 fishing activities contributed 1.2 percentage points to real GDP growth and accounted for about 10 percent of total employment as well as value added. Fish is by far the largest export commodity, constituting nearly 90 percent of total exports (excluding re-exports of fuel). Fishing activities are mostly conducted by private companies, although the RMI government has a 49 percent stake in a joint venture with a local private firm.

Fishing license fees increased considerably in recent years, representing nearly 12 percent of fiscal revenues excluding grants in FY2012. This growth was driven by the implementation of the Vessel Day Scheme (VDS) under the Partners to the Nauru Agreement (PNA). Going forward, although the minimum benchmark price for a fishing day is expected to raise, RMI's benefits are likely to be subdued due to the lack of demand for fishing vessel-days in its Exclusive Economic Zone**.**

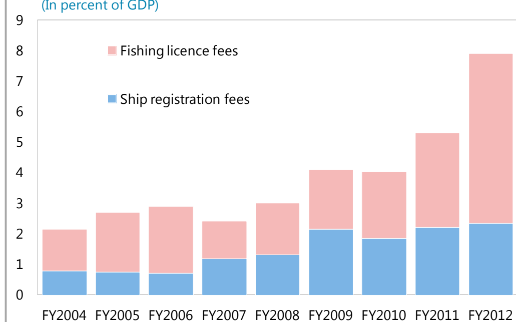
The fishing sector is projected to continue growing in the medium term, but a number of factors challenge its expansion. Additional expensive investment in fishing equipment is needed for further growth. Low pay, worker absenteeism, and scarcity of fresh water is slowing the expansion of fish processing activities. Furthermore, while fish prices have shown a steady upward trend since 2009, recent data point to a decline. Beyond the near term, climate change poses significant risks by affecting the distribution and abundance of tuna and by causing increasingly frequent and severe storms, which result in high operating costs. Growth in the fisheries sector would also be hampered if additional tuna sustainability restrictions were to be implemented.

Employment in Fisheries
(In percent of total employment 1/)



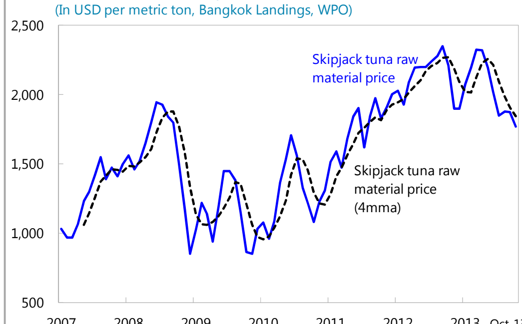
Sources: RMI authorities; and IMF staff calculations.
1/ Includes shore based fish processing and vessel support services. Part time workers may be significant.

Fisheries Licence Fees Inflows
(In percent of GDP)



Sources: RMI authorities; and IMF staff calculations.

Frozen Whole Skipjack Tuna Raw Material Prices
(In USD per metric ton, Bangkok Landings, WPO)



Sources: Thai Union Frozen Products PCL; and IMF staff calculations.

The Authorities' Views

11. Compared to staff's projections, the authorities were more optimistic on growth prospects. While they agreed that the resumption of infrastructure projects would be the main driver of growth in FY2014, they saw better growth prospects from copra production in the medium-term. In their view, the new ships from donors will allow higher coconuts collection from producers, and a planned new copra oil refinery will reduce dependence on some imported inputs and raise the value added of exports. The authorities agreed that foreign grants would continue to provide stable funding for current account deficits, and indicated that the use of the U.S. dollar remained appropriate.

12. The authorities considered natural disasters and commodity price shocks to be the main risks to the outlook. Extreme weather episodes due to climate change have adversely affected the country in recent years and are becoming more frequent. Negative shocks to copra prices would affect production and exports, while oil price increases would raise production costs. The authorities also highlighted upside risks from future construction activity and from the fishing sector, as adjustments that are favorable to the RMI are expected for the Vessel Day Scheme (VDS) and the Partners to the Nauru Agreement (PNA) arrangements (Box 1).

SECURING FISCAL SUSTAINABILITY

13. Government accounts are set to remain in deficit in the near term and beyond. After FY2015 annual deficits are expected to widen to around 2 percent of GDP and persist in the medium term, financed by bilateral and multilateral development partners. This projection reflects the expected increase in expenditure for social security contributions for public sector employees from the forthcoming pension reform (paragraph 17). The forecast assumes higher subsidies to SOEs, driven also by some called guarantees (paragraph 15). Due to projected deficits, the central government debt-to-GDP ratio is expected to increase, while public and publicly guaranteed debt is projected to remain on a downward path, as SOEs are assumed to continue servicing their government guaranteed debt.

Policy Issues and Staff's Views

14. A clear and bold consolidation strategy is urgently needed. Fiscal balances need to turn back into surplus to secure long-term sustainability and build buffers against existing significant fiscal vulnerabilities. These include substantial fiscal risks from SOEs and the social security system (paragraphs 15 and 17), the end of most Compact grants in FY2023, uncertainty about future CTF returns, and prospective costs from climate change.

15. The fiscal adjustment path and composition should strike a right balance between consolidation needs and short-term growth implications. In view of this, staff recommends a permanent cumulative consolidation of no less than 4.5 percent of GDP by FY2018 compared to the baseline. This implies that the government needs to build up a fiscal surplus of 2.6 percent of GDP (about US$4.5 million in FY2012 prices) by FY2018, which will have to be maintained afterwards. This would help the RMI to achieve long-term self sufficiency as well as create some fiscal buffer (Appendix 2). If the government were successful in implementing structural reforms that would boost real growth, the required fiscal surplus from FY2018 would be somewhat lower. The needed adjustment could be achieved through a mix of spending and revenue measures, but that would require strong revenue administration.

- **Fiscal adjustment will necessitate targeted spending cuts.** Containing public wages would be essential to produce fiscal savings and reduce the large public-private sector wage gap (Figure 1). A freeze on the nominal wage, taking into account the increase in social security contributions from the forthcoming reform, would save 1.1 percent of GDP by FY2018. The proposals of the Comprehensive Adjustment Program group, tasked by the government to review public expenditure, provide options for additional spending reductions. These include curbing allowances to civil servants—with estimated savings of up to 1 percent of GDP—and reducing public sector civil servant numbers by a targeted reduction in the work force.

Policy Options for Fiscal Adjustment
Estimated savings and additional revenues
(Percent of GDP)

Expenditure	
Freeze on the nominal public wage	1.1
Cut in civil servant number through attrition	No estimate available
Cut in civil servant allowances	1.0
Reduction in subsidies to SOEs	1.5
Revenue	
Comprehensive tax reform (net)	0.5-1.8
Total	4.1-5.4

Sources: Country authorities; and IMF staff estimates.

- **SOE reforms should be a policy priority.** SOE poor performance continues to be a drain on the budget, requiring average annual subsidies of more than 4 percent of GDP since 2010 (Box 2). Moreover, as of FY2012, the government has guaranteed US$34 million (20 percent of GDP) of their debt, including US$28.1 million debt of the National Telecommunication Authority (NTA). This poses a significant risk on public finances, as the company is unable to meet its repayment obligations and has already defaulted on some monthly payments, forcing the government to step in. Some SOEs are also planning to borrow further in FY2014, with a government guarantee. Staff encourages the authorities to assess thoroughly possible risks from these operations. Furthermore, staff urges the authorities to advance expeditiously SOE restructuring, with support from the AsDB and the World Bank, by addressing the key issues of governance, pricing policies, efficiency, enforcement of customers' payments and cross-subsidization. In view of the needed fiscal adjustment, the aim should be reducing government subsidies to SOEs by at least 1.5 percent of GDP by FY2018. A larger reduction is warranted and may be necessary if revenue gains from the tax reform are on the low end of the forecast range.

- **Approval and swift implementation of the tax reform bill is critical to enhance efficiency and equity as well as tax compliance.** The comprehensive tax reform bill, currently before parliament, can rectify several weaknesses of the current system. The reform would make the wage and salary tax more equitable by eliminating unjustifiable exemptions, introducing a uniform deduction, and increasing progressivity. Replacing existing import duties and local government sale taxes with a broad-based and modern consumption tax will enhance efficiency and tax compliance. The replacement of the Gross Revenue Tax with a new net profit tax for large businesses will make corporate taxation more business friendly. The creation of a new client focused and independent Customs and Revenue Authority and a more effective IT support system will improve revenue administration. By broadening the tax base and enhancing tax administration, the tax reform is expected to generate additional revenues of 0.5-1.8 percent of GDP, depending on compliance.

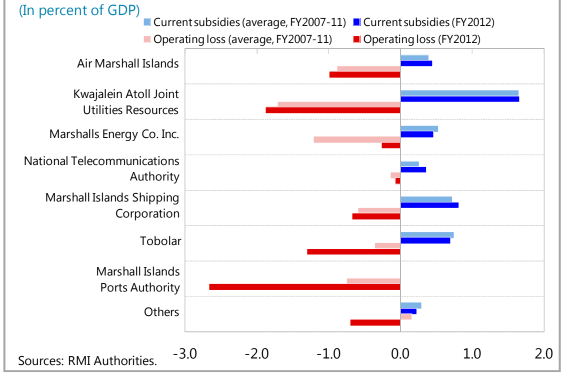
Box 2. Marshall Islands: State-Owned Enterprises: Recent Developments and Prospects for Reform

SOEs' size in the RMI economy is significant, but they have failed to contribute to growth. They have total assets of around US$150 million (85 percent of GDP), and account for nearly 8 percent of total employment. However, between FY2004 and FY2012, SOE cumulative value added growth was only 1.7 percent— merely 1 percent of the increase in total GDP. Most SOEs ran operating losses in FY2012, totaling US$15 million (8.5 percent of GDP)—3.1 percentage points higher than the FY2007-11 average.

While operating losses are partly motivated by the need to provide essential services to the outer islands at affordable prices, they are also driven by several deficiencies. Lack of investment and maintenance result in inefficient operation in the public transportation companies, Tobolar, and utility providers. The absence of a comprehensive SOE law and of requirements on directors' duties and obligations contribute to poor governance and accountability. Tariffs are sometimes unduly kept below operating costs, and one SOE does not pay the public energy company, thus benefitting from cross subsidization.

Some SOEs' reform initiatives are in train, but the timing of implementation and outcomes remain uncertain. At the authorities' request, the AsDB undertook a review of SOEs in 2010, and recommended reform actions. With technical support from the AsDB, new SOE legislation was drafted in 2011, and now awaits parliament approval. The Marshalls Energy Company has gone through some restructuring, following the adoption of a comprehensive recovery plan in 2009. The AsDB is also helping to develop and implement strategic plans in other SOEs. The World Bank is working with the authorities on a restructuring plan for the National Telecommunication Authority. Reforms, however, face several challenges, including opposition from SOEs, and may require a long time for approval and implementation.

SOEs: Current Subsidies and Operating Losses
(In percent of GDP)

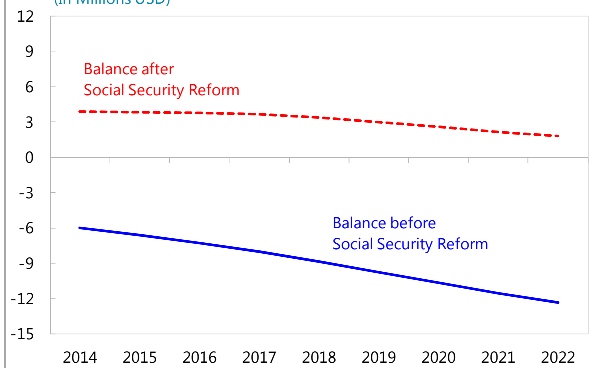


Sources: RMI Authorities.

16. Public Financial Management (PFM) reforms are essential to address existing weaknesses in budget reporting and planning. The authorities have worked with the Pacific Financial Technical Assistance Centre (PFTAC) on a comprehensive medium-term PFM Reform Roadmap, including measures to strengthen the budgeting framework, the accounting system, debt management, and revenue administration. The plan still has to be finalized and approved by cabinet. Furthermore, a *Fiscal Responsibility and Debt Management Act* has been submitted to Parliament, stating that fiscal policy has to achieve and maintain prudent levels of debt, and requiring more stringent and periodic reporting of fiscal developments to parliament. Staff welcomes these initiatives and recommends their rapid approval and implementation. Enhancing the medium-term budgeting framework and integrating it into the annual budget would be particularly important for fiscal policy planning, in view of the scheduled reduction in Compact grants.

17. **Social security liabilities constitute a significant contingent fiscal risk and warrant swift reform.** From FY2008 through FY2013, total benefits and operating expenses exceeded contributions by more than US$14 million, forcing the social security administration to liquify assets. Under the current system, the fund would be depleted by FY2022. A reform bill is currently before parliament envisaging an increase in both the employer's and employee's contribution from 7 to 9 percent, an increase in the retirement age from 60 to 65 and early retirement from 55 to 60, a 22 percent benefit cut, a rise in the taxable ceiling, and measures to reduce misuses of the benefit system. With the reform, the system is projected to record a surplus until FY2022, but further deficits are likely to arise later on. Approving and implementing the reform is an essential first step toward the creation of a more sustainable pension system. Staff encourages the authorities to explore options for even further reforms that would secure full long-term sustainability of the social security system.

Effects of Social Security Reform
(In Millions USD)



Sources: Marshall Islands Social Security System; and IMF staff calculations.

18. **The RMI is assessed to have high risk of external public debt distress, although mitigating factors limit near-term risks.** Currently the ratios of present value (PV) of external public and publicly guaranteed (PPG) debt-to-GDP, exports and revenues are all above their respective reference thresholds. RMI's vulnerability to debt distress is mitigated by the concessionality of most obligations and access to a stable flow of funds from Compacts grants. On the other hand, short-term risks are exacerbated by the uncertainty surrounding SOE reform implementation and their plans to borrow further with government guarantees.

The Authorities' Views

19. **The authorities recognized the need for fiscal adjustment.** They intend to achieve a balanced budget in FY2014 through a 25 percent cut in electricity and travel expenses, and build surpluses over the following years. They agreed on the need to contain wage bills, and noted that nominal wages have been unchanged over the past three years and that no increase is planned going forward. The authorities also intend to reduce personnel through a hiring freeze and natural attrition. They also pointed out that the tax and SOE reform bills currently before parliament will help improve the fiscal accounts.

20. **The authorities were keen to improve fiscal planning and public financial management.** They noted that with the assistance of the AsDB the Ministry of Finance has adopted a fiscal management model that will be used for budgetary planning. They intend to proceed expeditiously with the finalization and implementation of the PFM reform, for which they have requested IMF technical assistance.

21. **The authorities acknowledged the need for further pension reforms.** They are considering converting the social security system to a defined contribution scheme and are seeking technical assistance in this area.

BOOSTING PRIVATE SECTOR DEVELOPMENT AND FINANCIAL STABILITY

A. Private Sector Development

Policy Issues and Staff's Views

22. Going forward, further private sector development will be essential to support and stabilize growth and, hence, secure fiscal sustainability. In spite of the recent expansion of the fishing sector, the public sector remains the main source of economic activity. Private sector development is limited by remoteness, small size, a poor regulatory framework and weak business climate (Box 3 and Figure 3). In addition, SOEs compete against private enterprises in some sectors, such as telecommunications and hospitality, on an unequal footing, given their access to subsidized credit.

23. Policies are needed to enhance private sector growth prospects. The government could work with development partners, the private sector and neighboring countries to upgrade both capital and human resources and to secure cheaper and more reliable air links to and within the country. Structural reforms should address the issues of weak competition due to SOE dominance in some industries and the wide public and private sector wage gap. The authorities could consider the introduction of an insolvency framework and further land registration reforms to facilitate firm access to credit. Furthermore, easing procedures for long-term land leases to nonresidents could help attract foreign direct investment.

The Authorities' Views

24. There was general agreement about the impediments to private sector development. Structural obstacles on land use were regarded as deeply rooted in tradition, and very difficult to remove. The authorities noted that SOE reforms were underway with the assistance of the AsDB and the World Bank, and indicated that a law to liberalize the telecommunication sector was awaiting parliament approval. They also pointed out that the gap between public and private sector wages was due to the fact that the public sector employs more skilled workers than the private sector.

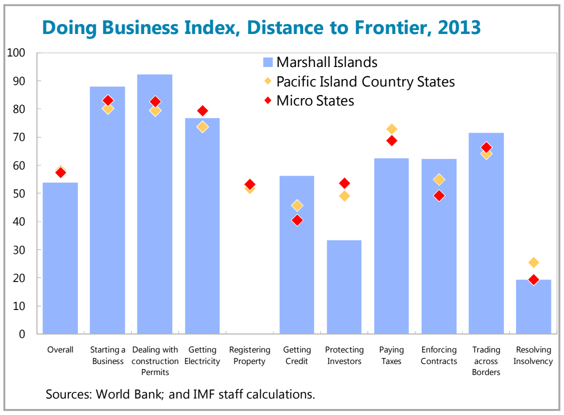
B. Financial Sector

25. Lending conditions are tight, despite ample availability of deposit funding. The loan-to deposit ratio remained low in FY2012, at around 70 percent, with commercial loans representing only about 20 percent of private sector credit. Spreads between lending and deposit rates stayed elevated at around 7 percent, reflecting the high risk in domestic lending (Figure 2 and 3). Banks operated profitably—with a return on assets of nearly 3 percent in FY2012.

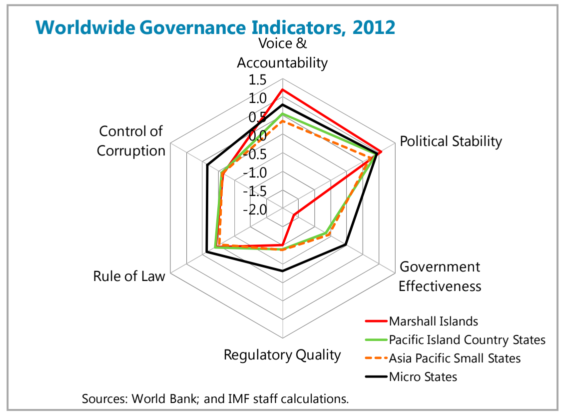
Box 3. Marshall Islands: Obstacles to Private Sector Development

Private sector growth in the RMI faces considerable obstacles. As in other Pacific Island countries (PICs), small market size, remoteness, dispersion over a wide area, and exposure to natural disasters raise business costs and make it difficult to benefit from economies of scale.

Lack of clarity on land ownership has adverse effects on private sector growth. The complex customary land tenure system implies that at least three parties need to jointly agree on whether a transaction can occur, and written documentation of ownership titles is limited. Hence the RMI is ranked at the bottom of the World Bank's indicator for "Registering Property".[1] A voluntary registration scheme, initiated in 2009, has been stalled by land ownership disputes. Thus, investors not only have to navigate through a longer process to lease land, but also face risks of legal contest to land usage. Commercial banks have also shied away from accepting land as collateral given potential difficulties in repossessing the asset in the event of default.



[1] The distance to frontier shown is normalized to range between 0 (worst performance) and 100 (the best performance, the frontier).



[1] Each governance indicator ranges from -2.5 (weak) to 2.5 (strong) governance performance.

The absence of a legislative framework for bankruptcy and limited investor protection also hampers private sector development. Bankruptcy costs are higher than the regional average, at 38 percent of the estate (compared to an average of 31 percent for PICs) and a recovery rate of just 17 cents on the dollar (compared to an average of 27 cents in the dollar for PICs). Investor protection is also weak, reflecting the lack of disclosure requirements, and a low extent of director liability.

The business climate is not conducive to growth due to weak public governance. The RMI scores poorly in World Bank's measure of government effectiveness relative to the PICs and other micro states, due to low scores for public administration quality and budgetary and financial management.

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[1] The World Bank Doing Business indicators should be interpreted with caution due to a limited number of respondents, limited geographical coverage, and standardized assumptions on business constraints and information availability.

26. Household debt remains high. Consumer debt is almost 50 percent of total employees' compensation, and anecdotal evidence suggests that debt servicing in many cases is as high as 90 percent of borrowers' income. Recurrent refinancing of existing consumer loans also appears to be quite common. In addition, there are indications that households are increasingly borrowing at higher interest rates from money-lenders which are not regulated by the Banking Commission. The publicly owned Marshall Islands Development Bank (MIDB), which is outside the Banking Commission's oversight, is engaged in short-term consumer lending as well—an activity regarded as less risky and more profitable.

Policy Issues and Staff's Views

27. Strengthening the regulatory framework will be critical, especially in view of the high level of household indebtedness. Given the high debt service ratios, small shocks to borrowers' disposable income (such as higher social security contributions following the implementation of the pension reform) could produce increasing defaults. Hence, the Banking Commission should consider imposing a ceiling on the allowed debt service ratio. The regulatory authority should also introduce homogenous criteria on non-performing loan classification and require regular data reports, since timely and consistent data are not readily available. The Banking Commission should also enforce the legal requirement for deposit insurance—currently being contravened by one bank—, especially given the absence of any insolvency law to protect depositors.

28. The capacity and oversight authority of the Banking Commission should be enhanced. Resource constraints have limited the Commission's ability to carry out regular on-site bank inspections. Staff also recommends that the Banking Commission be given more authority and autonomy to carry out supervision, as currently, its actions can be reversed by the Cabinet. The MIDB and other nonbank financial institutions that engage in private lending activities should also be brought under the purview of the Banking Commission. The MIDB should refocus on its core mandate of providing commercial lending, rather than consumer loans.

29. The anti-money laundering (AML) framework needs to be stepped up, in particular with regard to the transparency of legal persons. The 2012 OECD Global Forum progress report confirms that measures to ensure availability of information on the beneficial ownership of legal persons still need to be introduced, and effectively implemented. The RMI counts 30,000 active non-resident companies, at risk of misuse in money laundering and tax evasion schemes.

The Authorities' Views

30. The authorities agreed on the need to enhance the capacity of the Banking Commission to carry out on site inspections. They also considered important to introduce a regulatory framework for non-bank moneylenders and were contemplating establishing licensing requirements and setting up a registry. The Banking Commissioner saw the need to limit recurrent loan refinancing and had made recommendations to the Cabinet in this regard. The authorities also shared staff's view that the MIDB should be brought under the Banking Commissioner's oversight. The Commissioner concurred on the importance of establishing a safety net for depositors, but had not formulated a reform proposal yet.

31. The authorities noted that they have made some progress on measures against money laundering. The RMI introduced amendments to existing legislation to cover self-laundering, and addressed some deficiencies on the functionality of the financial intelligence unit. However, budget constraints have resulted in delays in implementing several measures, including on-site reviews of banks and targeted reviews of non-bank institutions.

STAFF APPRAISAL

32. Medium-term growth prospects in the RMI remain weak. In spite of the projected temporary boost from construction projects and some expansion in the fishery sector, beyond the near-term the scheduled decline in Compact grants and sluggish private sector development hinder faster growth.

33. Projected persistent deficits, significant fiscal risks from poorly performing SOEs and the social security system, and the expiration of most Compact grants after FY2023 call for a swift and bold consolidation strategy. This should include urgent and comprehensive SOE restructuring, public wage bill moderation, cuts in civil servants allowances, approval and implementation of the pending tax reform. Approval and implementation of the social security bill currently before parliament, as well as further pension reform, would be essential to secure long-term sustainability. PFM reforms are also needed to improve budget planning, execution and monitoring.

34. The RMI is assessed at high risk of public external debt distress, although the concessionality of most obligations and access to a stable flow of funds from Compact grants mitigate near-term risks. This calls for a very prudent external debt management policy, including seeking concessional loans.

35. The real exchange rate remains close to its historical value. The real appreciation of FY2008–09 has been reversed, and the real exchange rate has remained fairly stable since then. Current account deficits are financed by a stable source of funding and the use of the dollar as legal tender and close ties with the United States provide a shelter against external instability.

36. Private sector development would be critical for both lifting growth and supporting fiscal sustainability. Policies to enhance private sector growth prospects include SOE restructuring and measures to facilitate firms' access to credit and foreign direct investment.

37. Strengthening the regulatory and supervisory framework would enhance financial stability. Given high household debt and debt service ratios, the Banking Commission should consider imposing a ceiling on the allowed debt service ratio and its supervisory authority should be broadened to include all entities engaging in lending activities. There is also a need to improve monitoring of non-performing loans and to increase the Banking Commission's resources. Furthermore, the Banking Commission should be given more authority and autonomy to carry out effective supervision. Depositor protection should also be enhanced.

38. The quality of official statistics is broadly adequate for surveillance, but should be improved. Timeliness and coverage of statistics tend to constrain policy planning and assessment. Additional staff training and capacity building would contribute to improving data quality.

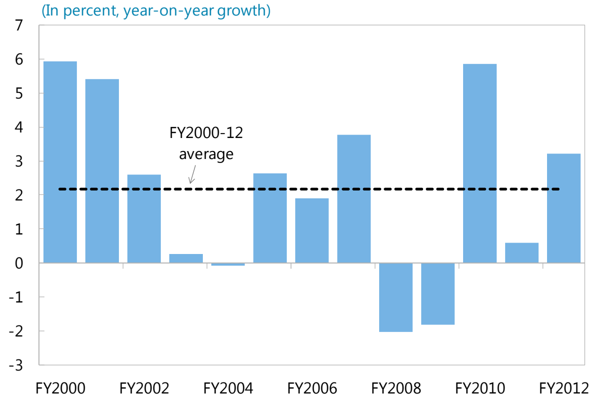
39. The authorities have taken a few steps to implement some of past IMF staff recommendations (Appendix III).

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

Figure 1. Marshall Islands: Real Sector and Fiscal Developments

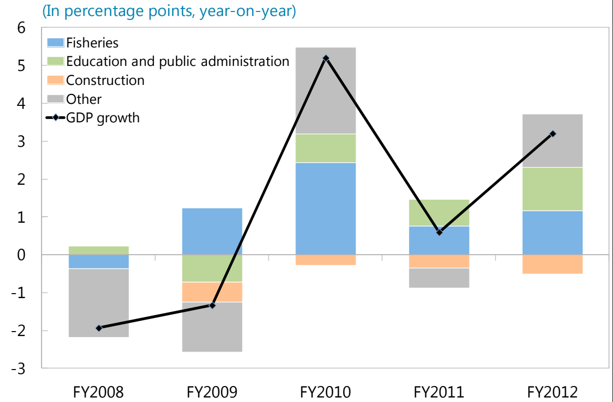
The RMI economy grew at an above-average pace in FY2012,...

Real GDP Growth
(In percent, year-on-year growth)



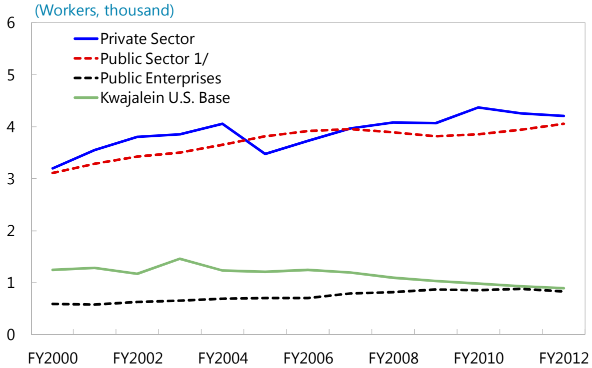
... supported by strong expansion in fisheries as well as education and public administration services.

Contribution to Growth
(In percentage points, year-on-year)



The labor market, however, remained weak, with overall employment at about the same level as a year earlier.

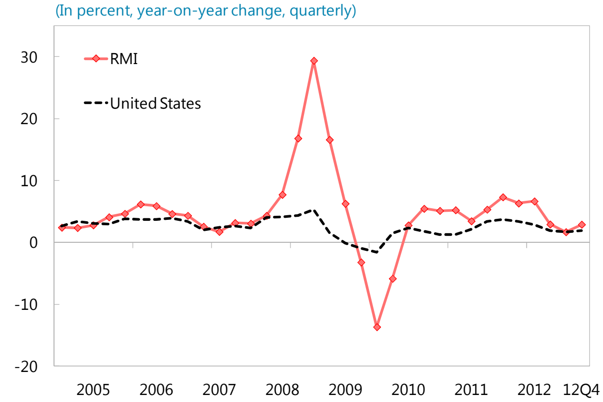
Employment
(Workers, thousand)



1/ Central and local government.

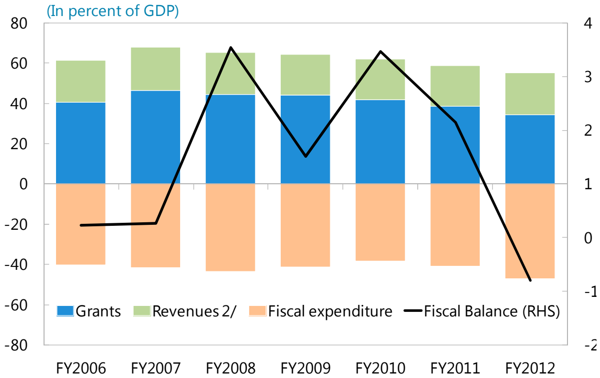
Inflation has moderated, due to subdued global commodity prices.

CPI Inflation
(In percent, year-on-year change, quarterly)



The fiscal balance turned into deficit in FY2012.

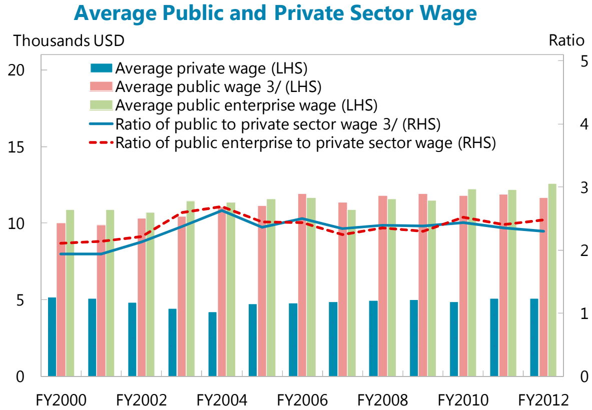
Fiscal Balance
(In percent of GDP)



2/ Excluding grants.

Public sector wages remained significantly higher than private sector wages.

Average Public and Private Sector Wage



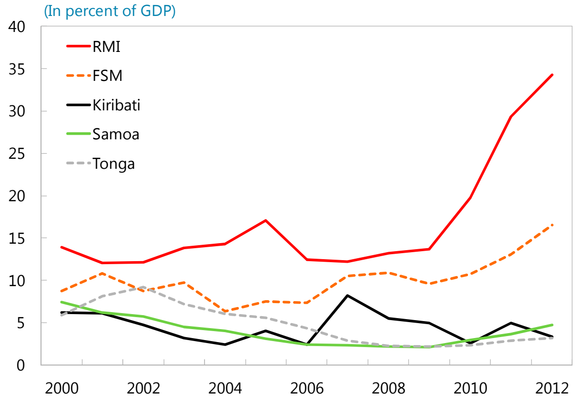
3/ Public sector refers to RMI government and local government only.

Sources: RMI authorities; IMF, World Economic Outlook; and IMF staff estimates.

Figure 2. Marshall Islands: External and Credit Developments

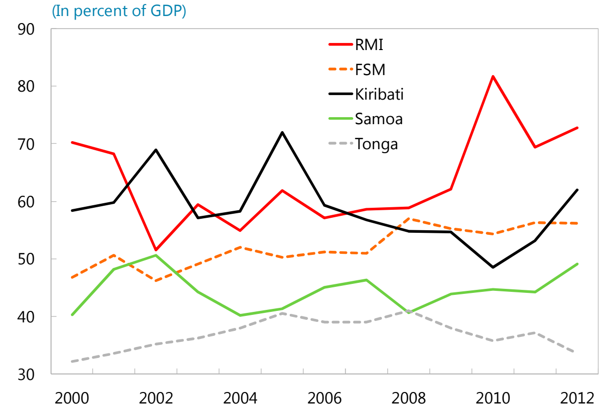
RMI out-performed regional countries in merchandise exports, driven by a pickup in exports of fish and coconut products.

Total Merchandise Exports
(In percent of GDP)



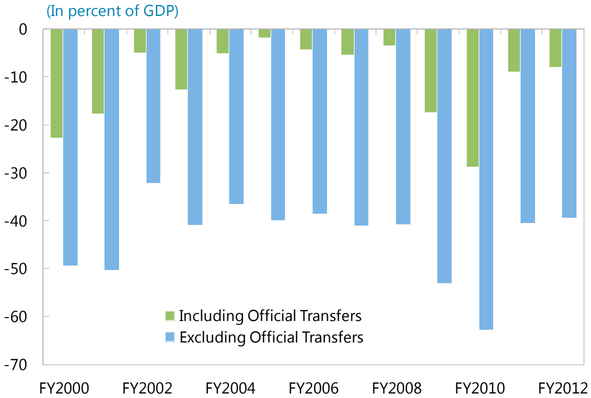
Imports rose as well, in part due to the airport extension projects.

Total Merchandise Imports
(In percent of GDP)



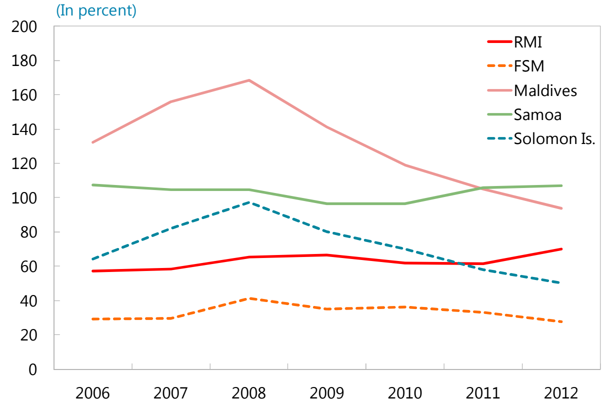
Consequently, the current account deficit stayed high at 8.1 percent of GDP in FY2012.

Current Account Balance
(In percent of GDP)



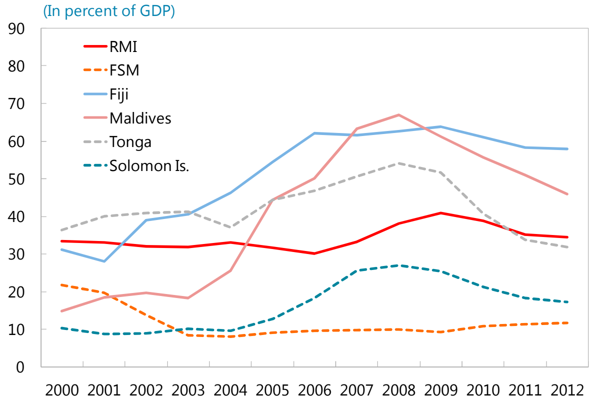
The banking system was liquid…

Loan-to-Deposit Ratio
(In percent)



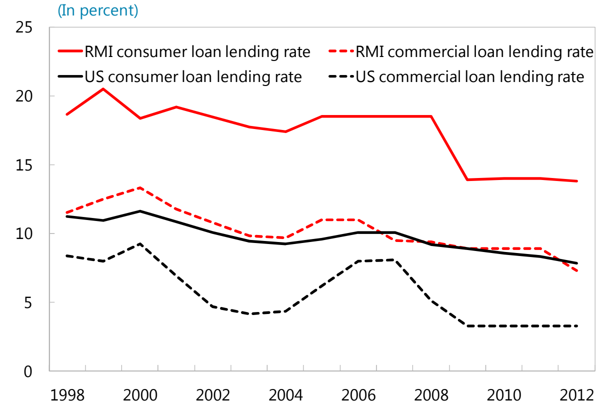
…but credit to the private sector, remained low, constrained by limited commercial lending.

Credit to Private Sector
(In percent of GDP)



While lending rates have trended down over the years, the differential between US and RMI rates remained large.

Consumer and Commercial Lending Rates
(In percent)

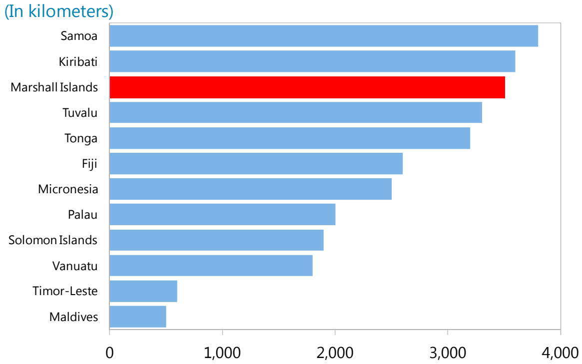


Sources: Country authorities; IMF, World Economic Outlook; Haver Analytics; CEIC; and IMF staff estimates.

Figure 3. Marshall Islands: Factors Impacting Private Sector Development

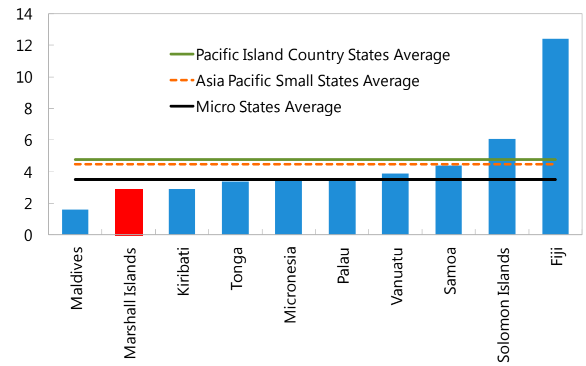
The RMI is one of the most geographically remote countries in the world, even compared to the PICs.

Small States—Asia and Pacific Region: Distance to the Closest Continent
(In kilometers)



There are limited transport connections between RMI and the rest of the world.

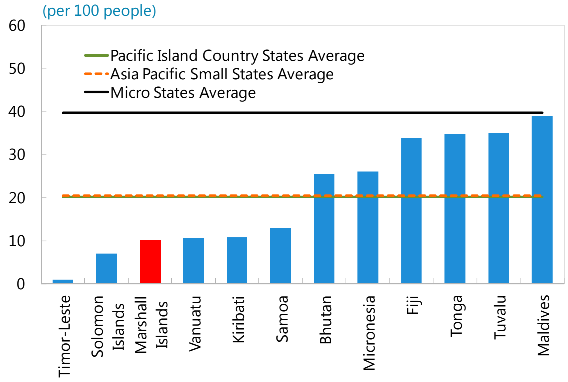
Liner Shipping Connectivity Index, 2012 1/



1/ The higher the index, the more connected the country is to global shipping networks. The index takes a value of 100 for the country with the highest connectivity in 2004.

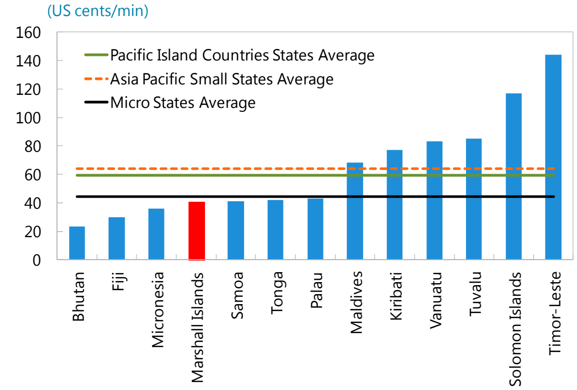
Internet coverage suggests that international communication links are poor.

Internet Users, 2012
(per 100 people)



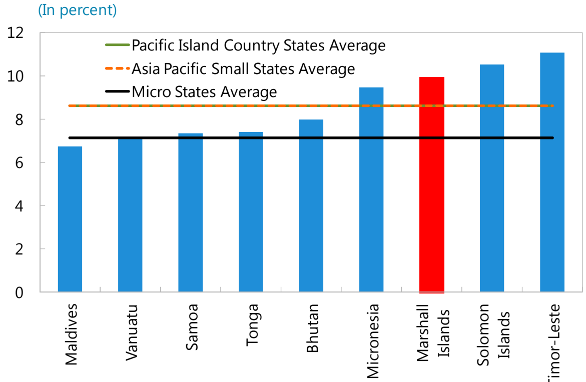
Telecommunications costs, however, can be cheaper than in other Asia Pacific small countries.

Skype Pay as You Go Rate, 2013
(US cents/min)



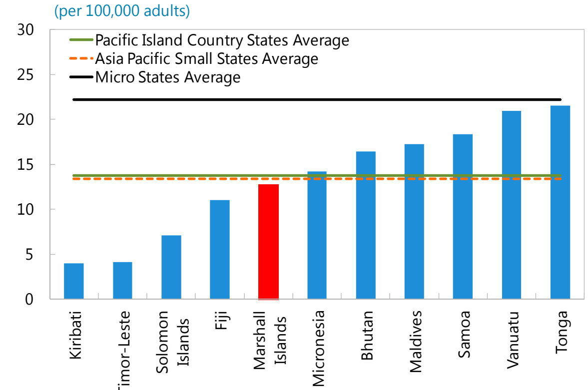
The gap between lending and deposit rates remain large.

Gap Between Lending and Deposit Interest Rate, 2012
(In percent)



The RMI is fairly well serviced by bank branches relative to other small Asia Pacific states, especially in urban areas.

Commercial Bank Branches, 2011
(per 100,000 adults)



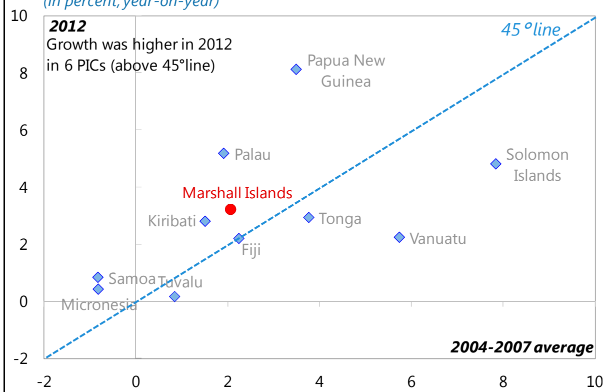
Sources: Country Authorities; South Pacific Applied Geoscience Commission; Skype; United Nations Environment Program; World Bank; and IMF staff calculations

Figure 4. Marshall Islands: Comparison with Other Pacific Island Countries (PICs)

The RMI economy expanded by a faster-than-average rate in FY2012, as is the case for five other PICs.

Real GDP Growth

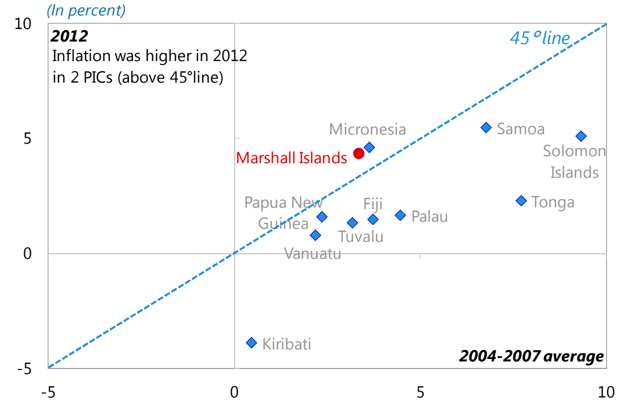
(In percent, year-on-year)



Unlike most of the PICs, RMI inflation in FY2012 was higher than in 2004-2007.

Inflation

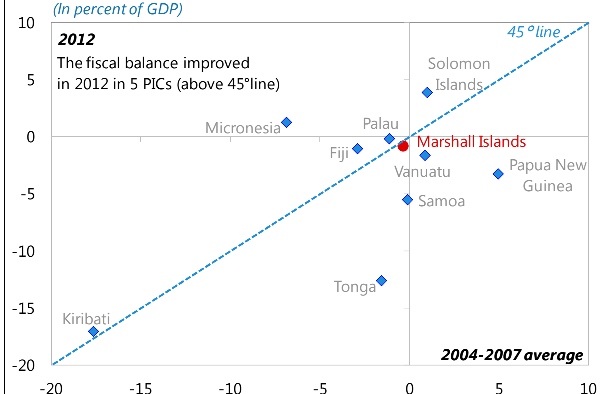
(In percent)



The RMI, together with another four PICs, saw its fiscal balance weaken relative to the FY2004-2007 period.

Fiscal Balance

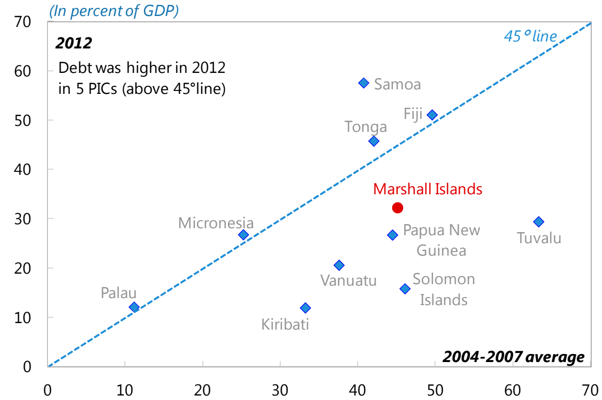
(In percent of GDP)



However, government debt at the RMI was lower than in the pre-global financial crisis period.

Government Debt

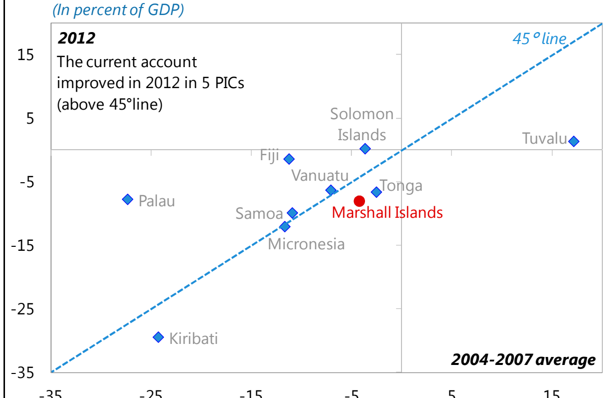
(In percent of GDP)



The RMI's current account deficit worsened in FY2012 compared the pre-crisis period due to high imports for the airport expansion.

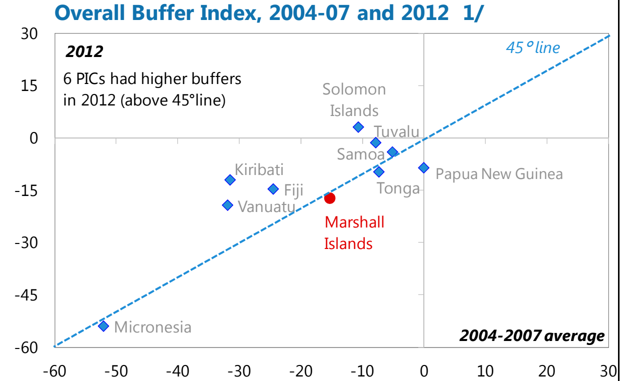
Current Account Balance

(In percent of GDP)



While most PICs had increased or maintained their buffers to economic shocks relative to the pre-crisis period, the RMI experienced a deterioration.

Overall Buffer Index, 2004-07 and 2012 1/



1/ The overall buffer index is the sum of five marcoeconomic variables (inflation, fiscal balance, current account balance, government debt and foreign reserves) normalized by their respective standard deviations during 2004-07.

Sources: Country authorities; and IMF staff estimates.

Table 1. Marshall Islands: Basic Data, FY2009–18 1/

Nominal GDP for FY2012 (in millions of U.S. dollars): 172.5
Population (2011): 53,158
GDP per capita for FY2012 (in U.S. dollars): 3,232
Quota: SDR 3.5 million

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Est.			Proj.		
Real sector										
Real GDP (percent change)	-1.8	5.9	0.6	3.2	0.8	3.2	1.7	1.5	1.4	1.0
Consumer prices (percent change)	0.5	1.8	5.4	4.3	1.6	1.7	1.8	1.9	2.1	2.2
Central government finances (in percent of GDP)										
Revenue and grants	64.3	62.0	58.5	55.0	51.4	62.9	60.2	59.3	58.5	55.7
Total domestic revenue	20.3	20.1	20.2	20.6	20.6	22.7	21.9	22.0	22.1	22.2
Grants	44.1	41.8	38.3	34.3	30.8	40.2	38.2	37.3	36.4	33.4
Expenditure	62.8	58.5	56.4	55.8	52.2	63.1	62.3	61.4	60.5	57.6
Expense	52.1	48.4	48.7	51.5	51.1	53.5	52.3	51.6	50.9	50.4
Net acquisition of nonfinancial assets	10.7	10.1	7.7	4.2	1.1	9.6	10.0	9.8	9.5	7.1
Net lending/borrowing	1.5	3.5	2.2	-0.8	-0.8	-0.2	-2.2	-2.1	-2.0	-1.9
Compact Trust Fund (in millions of US$; end of period)	90.9	112.8	125.2	165.6	205.8	234.6	265.9	299.8	336.5	376.3
Commercial banks (in millions of US$)										
Foreign assets	63.6	71.8	71.9	62.1	...	...	...	...	...	...
Private sector claims	62.0	63.3	60.2	59.4	...	...	...	...	...	...
Total deposits	93.3	102.1	98.2	85.0	...	...	...	...	...	...
One-year time deposit rate (in percent)	6.0	3.5	3.5	3.5	...	...	...	...	...	...
Average consumer loan rate (in percent)	13.9	14.0	14.0	14.0	...	...	...	...	...	...
Balance of payments (in millions of US$)										
Trade balance	-73.5	-100.8	-68.6	-66.5	-63.8	-95.9	-74.1	-74.7	-75.0	-72.8
Net services	-53.5	-41.3	-43.9	-48.1	-48.8	-50.3	-51.4	-52.6	-53.8	-54.9
Net income	40.6	35.1	38.6	41.4	42.2	47.7	49.1	49.8	50.6	51.2
Unrequited transfers (private and official)	60.0	60.1	58.6	59.3	54.1	60.8	56.0	55.9	55.7	55.5
Current account including official current transfers	-26.4	-46.9	-15.3	-13.9	-16.4	-37.7	-20.4	-21.6	-22.6	-20.9
(In percent of GDP)	-17.4	-28.8	-9.0	-8.1	-9.4	-20.6	-10.9	-11.2	-11.4	-10.3
Current account excluding budget grants	-80.7	-102.4	-69.2	-68.1	-65.6	-93.8	-72.0	-73.2	-74.3	-72.8
(In percent of GDP)	-53.2	-62.8	-40.5	-39.5	-37.4	-51.3	-38.3	-38.0	-37.6	-36.0
External PPG debt (in millions of US$; end of period) 2/	105.9	103.2	100.7	96.4	96.4	94.2	96.0	97.7	99.2	100.6
(In percent of GDP)	69.7	63.3	58.9	55.9	55.0	51.5	51.1	50.7	50.1	49.7
Exchange rate										
Real Effective Exchange Rate (2005 =100)	109.4	106.6	105.9	107.5	...	...	...	...	...	...
Memorandum Item:										
Nominal GDP (in millions of US$)	151.8	163.0	170.9	172.5	175.4	182.8	187.8	192.7	197.8	202.3

Sources: RMI authorities; and IMF staff estimates and projections.
1/ Fiscal year ending September 30.
2/ Public and publicly-guaranteed external debt.

Table 2. Marshall Islands: Statement of Government Operations, FY2009–18 1/

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
					Est.			Proj.		
	(In millions of U.S. dollars)									
Revenue	97.7	101.0	100.0	94.8	90.2	115.0	113.0	114.3	115.7	112.7
Taxes	27.6	28.2	29.0	29.2	29.0	30.3	31.1	31.9	32.8	33.5
Taxes on income, profits, and capital gains	11.2	10.8	10.9	11.3	11.5	12.0	12.3	12.6	12.9	13.2
Taxes on goods and services	8.6	9.2	9.0	10.4	10.6	11.0	11.3	11.6	11.9	12.2
Taxes on international trade and transactions	7.1	7.7	7.7	6.9	6.2	6.7	6.9	7.0	7.2	7.4
Other taxes	0.6	0.5	1.4	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Grants 2/	66.9	68.2	65.5	59.2	54.1	73.5	71.8	71.9	72.0	67.7
Other revenue	3.2	4.6	5.5	6.4	7.2	11.2	10.0	10.4	11.0	11.5
Property income	1.6	2.1	3.2	4.3	5.3	9.3	8.2	8.6	9.1	9.6
Sales of goods and services	1.6	2.5	2.3	2.0	1.9	1.9	1.9	1.9	1.9	1.9
Expenditure	95.4	95.4	96.3	96.2	91.6	115.3	117.1	118.3	119.6	116.5
Expense	79.1	78.9	83.2	88.9	89.6	97.8	98.2	99.5	100.8	102.0
Compensation of employees	37.0	37.6	37.7	38.6	38.9	39.3	40.6	41.1	41.6	42.1
Wages and salaries	37.0	37.6	37.7	38.6	38.9	39.3	40.6	41.1	41.6	42.1
Use of goods and services	22.9	22.2	24.4	24.9	24.8	29.7	29.0	29.7	30.5	31.2
Interest	0.9	0.9	1.4	1.4	1.4	1.4	1.4	1.6	1.7	1.9
Subsidies	8.5	6.6	6.1	8.8	9.9	9.7	9.6	9.5	9.3	9.2
Grants	0.3	0.0	1.3	1.3	0.3	0.3	0.3	0.3	0.3	0.3
Other expense	9.6	11.5	12.2	13.9	14.4	17.4	17.4	17.4	17.4	17.4
Net acquisition of nonfinancial assets	16.2	16.5	13.1	7.3	2.0	17.6	18.9	18.9	18.8	14.4
Gross Operating Balance	18.5	22.1	16.8	5.9	0.6	17.2	14.7	14.8	14.9	10.6
Net Operating Balance	18.5	22.1	16.8	5.9	0.6	17.2	14.7	14.8	14.9	10.6
Net lending (+)/borrowing (–)	2.3	5.7	3.7	-1.4	-1.4	-0.3	-4.1	-4.0	-3.9	-3.8
Net acquisition of financial assets	-5.2	-7.6	10.0	4.2	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	3.8	1.9	-13.7	-2.8	1.4	0.3	4.1	4.0	3.9	3.8
	(In percent of GDP)									
Revenue	64.3	62.0	58.5	55.0	51.4	62.9	60.2	59.3	58.5	55.7
Taxes	18.2	17.3	17.0	16.9	16.5	16.6	16.6	16.6	16.6	16.6
Grants	44.1	41.8	38.3	34.3	30.8	40.2	38.2	37.3	36.4	33.4
Other revenue	2.1	2.8	3.2	3.7	4.1	6.1	5.3	5.4	5.5	5.7
Expenditure	62.8	58.5	56.4	55.8	52.2	63.1	62.3	61.4	60.5	57.6
Expense	52.1	48.4	48.7	51.5	51.1	53.5	52.3	51.6	50.9	50.4
Net acquisition of nonfinancial assets	10.7	10.1	7.7	4.2	1.1	9.6	10.0	9.8	9.5	7.1
Net operating balance	12.2	13.6	9.8	3.4	0.3	9.4	7.9	7.7	7.6	5.3
Net lending/borrowing	1.5	3.5	2.2	-0.8	-0.8	-0.2	-2.2	-2.1	-2.0	-1.9
Memorandum item:										
Compact Trust Fund Balances (in million of US$)	90.9	112.8	125.2	165.6	205.8	234.6	265.9	299.8	336.5	376.3
Outstanding government debt (in million of US$)	60.5	60.4	59.7	55.6	58.0	58.3	62.4	66.5	70.4	74.2
Outstanding government debt (percent of GDP)	39.9	37.0	34.9	32.2	33.0	31.9	33.2	34.5	35.6	36.7
Nominal GDP	151.8	163.0	170.9	172.5	175.4	182.8	187.8	192.7	197.8	202.3

Sources: RMI authorities; and IMF staff estimates and projections.

1/ Fiscal year ending September 30.

2/ Does not include Compact funds earmarked for Kwajalein rental payments and Trust Fund contributions.

Table 3. Marshall Islands: Balance of Payments, FY2009–18 1/

(In millions of U.S. dollars)

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
Current account balance	***-26.4***	***-46.9***	***-15.3***	***-13.9***	***-16.4***	***-37.7***	***-20.4***	***-21.6***	***-22.6***	***-20.9***
Goods and services balance	*-127.0*	*-142.1*	*-112.5*	*-114.6*	*-112.7*	*-146.2*	*-125.5*	*-127.3*	*-128.8*	*-127.6*
Trade Balance	-73.5	-100.8	-68.6	-66.5	-63.8	-95.9	-74.1	-74.7	-75.0	-72.8
Exports, f.o.b.	20.8	32.3	50.1	59.1	62.3	65.4	68.3	71.2	74.6	77.9
Imports, f.o.b.	-94.3	-133.1	-118.7	-125.6	-126.1	-161.3	-142.3	-145.9	-149.6	-150.7
Net Services	-53.5	-41.3	-43.9	-48.1	-48.8	-50.3	-51.4	-52.6	-53.8	-54.9
Receipts	10.6	12.1	13.0	13.1	13.6	14.3	14.8	15.3	15.9	16.4
Payments	-64.1	-53.3	-57.0	-61.2	-62.5	-64.6	-66.2	-67.9	-69.6	-71.3
Net Income	40.6	35.1	38.6	41.4	42.2	47.7	49.1	49.8	50.6	51.2
Receipts	52.9	51.7	55.8	60.1	61.9	68.3	70.5	72.1	73.9	75.8
Labor income	20.1	19.1	18.9	18.5	18.5	18.5	18.5	18.5	18.5	18.5
Payments	-12.3	-16.6	-17.2	-18.7	-19.7	-20.6	-21.4	-22.3	-23.3	-24.5
Unrequited Transfers	60.0	60.1	58.6	59.3	54.1	60.8	56.0	55.9	55.7	55.5
Inflows	64.5	65.4	64.6	65.6	60.7	67.7	63.3	63.5	63.7	63.9
Government grants	54.3	55.5	53.9	54.1	49.2	56.0	51.6	51.6	51.7	51.8
Compact current grants	34.3	32.3	30.9	31.7	31.2	33.5	33.4	33.4	33.4	33.3
Other budget and off-budget grants	20.0	23.2	23.0	22.5	17.9	22.6	18.2	18.3	18.4	18.5
Outflows	-4.4	-5.3	-6.0	-6.3	-6.6	-6.9	-7.3	-7.6	-8.0	-8.4
Current account including current official transfers	-26.4	-46.9	-15.3	-13.9	-16.4	-37.7	-20.4	-21.6	-22.6	-20.9
(In percent of GDP)	-17.4	-28.8	-9.0	-8.1	-9.4	-20.6	-10.9	-11.2	-11.4	-10.3
Current account excluding current official grants	-80.7	-102.4	-69.2	-68.1	-65.6	-93.8	-72.0	-73.2	-74.3	-72.8
(In percent of GDP)	-53.2	-62.8	-40.5	-39.5	-37.4	-51.3	-38.3	-38.0	-37.6	-36.0
Capital and financial account	54.6	53.8	39.9	23.8	23.8	51.4	35.6	35.5	34.4	28.8
Official capital grants	13.2	13.3	12.0	5.4	2.7	12.1	16.5	16.5	16.5	12.1
Foreign direct investment	14.6	38.0	4.8	3.4	4.1	4.1	4.1	4.1	4.1	4.1

Sources: RMI authorities; and IMF staff estimates and projections.

1/ Fiscal year ending September 30.

Table 4. Marshall Islands: External Vulnerability Indicators, FY 2009–18

	FY2009	FY2010	FY2011	FY2012	FY2013 Est.	FY2014 Proj.	FY2015 Proj.	FY2016 Proj.	FY2017 Proj.	FY2018 Proj.
Financial indicators										
Commercial bank deposits (12-month percent change) 1/	4.8	9.4	-3.8	-13.4	…	…	…	…	…	…
Private sector credit (12-month percent change)	6.5	2.1	-4.9	-1.3	…	…	…	…	…	…
Foreign assets/total assets (percent)	52.1	53.7	54.5	52.2	…	…	…	…	…	…
Consumer loans (in percent of total private sector loans)	74.4	76.8	81.4	79.0	…	…	…	…	…	…
External indicators										
Exports (percent change)	2.7	55.2	55.2	18.0	5.4	4.9	4.4	4.4	4.7	4.5
Imports (percent change)	4.8	41.1	-10.8	5.8	0.4	27.9	-11.8	2.5	2.5	0.7
Current account balance (percent of GDP)										
Including official current transfers	-17.4	-28.8	-9.0	-8.1	-9.4	-20.6	-10.9	-11.2	-11.4	-10.3
Excluding budget grants	-53.2	-62.8	-40.5	-39.5	-37.4	-51.3	-38.3	-38.0	-37.6	-36.0
Capital and financial account balance (percent of GDP)	35.9	33.0	23.4	13.8	13.5	28.1	19.0	18.4	17.4	14.2
Of which : FDI (percent of GDP)	9.7	23.3	2.8	2.0	2.4	2.3	2.2	2.1	2.1	2.0
Gross official reserves (in millions of U.S. dollars) 2/	8.8	8.5	6.8	4.7	…	…	…	…	…	…
Gross official reserves (in months of imports of goods and services)	0.7	0.5	0.5	0.3	…	…	…	…	…	…
External PPG debt (percent of GDP) 3/	69.7	63.3	58.9	55.9	55.0	51.5	51.1	50.7	50.1	49.7
External PPG debt (in percent of exports of goods and services) 3/	337.1	232.8	159.5	133.5	127.0	118.3	115.6	112.8	109.6	106.6

Sources: RMI authorities; and IMF staff estimates and projections.

1/ The deposit decline in FY2011-12 is due to expatriation of rent income received by Kwajalein landowners in previous years.
2/ Measured by the end-of-period stock of government financial assets held in commercial banks.
3/ Public and publicly-guaranteed external debt.

Table 5. Marshall Islands: Deposit Money Banks, FY2009–12

	FY2009	FY2010	FY2011	FY2012
	(In millions of U.S. dollars)			
Assets and Liabilities				
Assets 1/	122.0	133.6	132.0	118.9
Foreign assets	63.6	71.8	71.9	62.1
Claims on central and local governments	1.7	3.7	5.2	3.4
Claims on public enterprises	0.0	0.0	0.0	0.0
Claims on private sector	62.0	63.3	60.2	59.4
Unclassified assets	-5.3	-5.2	-5.3	-6.0
Liabilities 1/	122.0	133.6	132.0	118.9
Deposits	93.3	102.1	98.2	85.0
Central government deposits 2/	8.8	8.5	6.8	4.7
Foreign liabilities	2.4	2.8	2.9	3.2
Capital accounts	25.6	27.4	29.1	29.7
Unclassified liabilities	0.7	1.3	1.8	1.0
Memorandum items:				
Loan/deposit ratio (in percent)	66.5	62.0	61.3	69.9
Deposits (percent change)	4.8	9.4	-3.8	-13.4
Loans (percent change)	6.5	2.1	-4.9	-1.3
Consumer loans (in percent of total loans)	74.4	76.8	81.4	79.0
Income and expense				
Interest Income	9.0	9.1	8.6	8.1
Interest and fees on loans	8.9	8.9	8.4	8.0
Deposits with banks	0.1	0.1	0.1	0.1
Other interest income	0.1	0.0	0.0	0.0
Interest Expense	1.4	1.6	1.4	1.1
Deposits	1.4	1.6	1.3	1.1
Other interest expense	0.0	0.0	0.0	0.0
Net interest income	7.6	7.5	7.2	7.0
Provision for loan losses	0.3	0.3	0.0	0.0
Net interest income after loan loss provisions	7.3	7.2	7.2	7.0
Noninterest Income:				
Service charges and fees	0.7	0.7	0.8	0.8
Other noninterest income	1.0	1.1	0.9	1.0
Total noninterest income	1.7	1.8	1.8	1.7
Noninterest Expense				
Salaries and employee benefits	2.7	2.9	2.9	2.9
Occupancy	0.4	0.4	0.4	0.4
Furniture and equipment	0.1	0.1	0.1	0.1
Other operating expense	2.2	2.4	2.2	2.0
Total noninterest expense	5.4	5.8	5.7	5.4
Net Income (Loss)	3.6	3.2	3.3	3.3
Interest rates (percent) 3/				
Deposit rates				
Savings accounts 4/	1.1	0.5	0.5	0.6
Time deposits 5/				
Three months	2.5	2.0	2.0	0.9
Six months	3.0	2.1	2.1	1.1
One year or more	6.0	3.5	3.5	1.6
Loan rates 6/				
Consumer loans	13.9	14.0	14.0	13.8
Commercial loans	8.9	8.9	8.9	7.3
Memorandum item:				
Return on assets	3.0	2.4	2.5	2.8

Sources: RMI authorities; and IMF staff estimates.

1/ Fiscal-year basis - 5 quarter average.
2/ Includes deposits of Social Security administration and other trust funds.
3/ Year average
4/ Average of rates offered by deposit money banks.
5/ Average of minimum rates offered by deposit money banks.
6/ Average of maximum rates charged by deposit money banks.

Table 6. Marshall Islands: Millennium Development Goals (MDGs) Indicators

	1990	1995	2000	2005	2010	2011	2012
Goal 1: Eradicate extreme proverty and hunger							
Poorest quintile's share in national income or consumption, percentage	...	...	...	...	...	...	...
Proportion of own-account and contributing family workers in total employment	...	...	...	...	...	...	...
Goal 2: Achieve universal primary education							
Net enrolment ratio in primary education	...	...	...	...	...	99.4	...
Proportion of pupils starting grade 1 who reach last grade of primary	...	...	...	78.4	...	...	...
Goal 3: Promote gender equality and empower women							
Ratio of girls to boys in primary, secondary and tertiary education							
Gender Parity Index in primary level enrolment	...	...	0.96	1.26	...	0.99	...
Gender Parity Index in secondary level enrolment	...	...	...	1	...	...	...
Gender Parity Index in tertiary level enrolment	...	...	...	...	...	...	...
Share of women in wage employment in the non-agricultural sector	...	...	...	...	...	...	...
Proportion of seats held by women in national parliament	...	...	...	3	3	3	3
Goal 4: Reduce child mortality							
Children under five mortality rate per 1,000 live births	49	42.2	41.4	40.2	38.8	38.5	37.9
Infant mortality rate (0-1 year) per 1,000 live births	38.8	34	33.4	32.6	31.5	31.3	30.9
Children 1 year old immunized against measles, percentage	52	57	94	86	97	97	...
Goal 5: Improve maternal health							
Proportion of births attended by skilled health personnel, percentage	...	...	...	...	99	...	...
Current contraceptive use among married women 15-49 years old, percentage	...	...	...	...	...	...	...
Adolescent birth rate, per 1,000 women	...	105.2	...	107.6	...	...	...
Antenatal care coverage	...	...	...	...	...	...	...
At least one visit, percentage	...	...	...	...	...	...	...
At least four visits, percentage	...	...	...	...	...	...	...
Unmet need for family planning, percentage	...	...	...	...	...	...	...
Goal 6: Combat HIV/AIDS, malaria and other diseases							
Men 15-24 years old with comprehensive correct knowledge of HIV/AIDS, percentage	...	...	...	...	...	...	...
Women 15-24 years old with comprehensive correct knowledge of HIV/AIDS, percentage	...	...	...	...	...	...	...
Tuberculosis incidence rate per year per 100,000 population (mid-point)	137	190	263	363	502	536	...
Tuberculosis detection rate under DOTS, percentage (mid-point)	...	...	25	59	70	47	...
Tuberculosis treatment success rate under DOTS, percentage	...	25	91	87	80	...	...
Goal 7: Ensure environmental sustainability							
Proportion of land area covered by forest, percentage	72.2	...	72.2	72.2	72.2	...	...
Carbon dioxide emissions (CO2), thousand metric tons of CO2 (CDIAC)	48	66	77	84	103	...	...
Carbon dioxide emissions (CO2), metric tons of CO2 per capita (CDIAC)	1.0151	1.2939	1.4767	1.6142	1.9061	...	...
Consumption of all Ozone-Depleting Substances in ODP metric tons	1.2	1.3	0.6	0	0.2	0.2	...
Proportion of terrestrial and marine areas protected, percentage	0.05	...	0.67	...	0.71	...	0.71
Proportion of the population using improved drinking water sources	92	93	93	94	94	94	...
Proportion of the population using improved sanitation facilities	65	67	70	73	75	76	...
Goal 8: Develop a global partnership for development							
ODA received in small island developing States as a proportion of their gross national incomes	...	25.44	38.88	31.86	45.89	38.2	...
Developed country imports from developing countries, admitted duty free, percentage	...	...	85.6	97.9	92.9	84.9	...
Fixed telephone lines per 100 inhabitants	1.06	6.24	7.67	...	...	...	...
Mobile cellular subscriptions per 100 inhabitants	0	0.52	0.86	1.27	...	...	...
Internet users per 100 inhabitants	0	0	1.53	3.88	7	8.06	10

Sources: United Nations Millennium Development Goals Indicators 2013. http://mdgs.un.org/unsd/mdg/Data.aspx

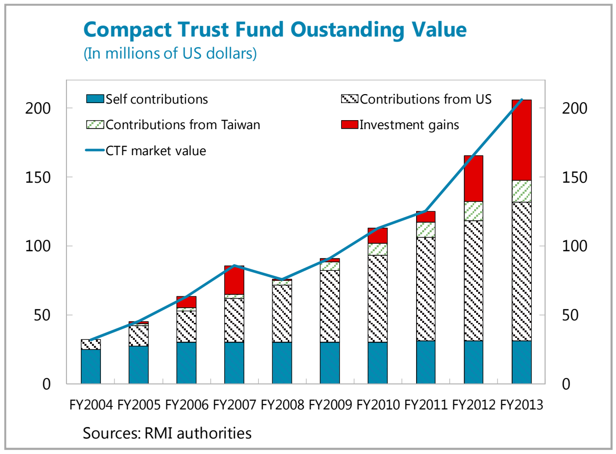
Appendix 1. Marshall Islands: Risk Assessment Matrix 1/

Sources of Risks	Likelihood and Transmission Channel	Potential Impact	Policy Response
Global/external:			
Natural disasters	**Medium**	**Medium** Growth would slow as ongoing investment projects get delayed and fishing activity is impaired. Flooding could also damage infrastructure.	Changes in the composition of public expenditure or additional revenues would be needed to finance the reconstruction. Additional foreign aid would likely be required.
Global oil price shocks triggered by geopolitical events (driving oil prices to US$150 per barrel)	**Low**	**High** The shock would raise the current account deficit, worsen the fiscal position through its impact on the government-owned Marshalls Energy Company, raise inflation, and lower growth.	Additional fiscal savings would be needed.
Domestic:			
Slow progress in fiscal reforms	**High**	**High** A lack of progress in tax, expenditure, and SOE reforms would undermine fiscal consolidation. Concerns about fiscal sustainability could lead to an acceleration of outward migration.	Reacceleration of fiscal reforms would be needed.
Delays in implementation of infrastructure projects	**Medium** .	**High** Short-term growth would be adversely affected.	More oversight on project selection and implementation would be required. Technical assistance in these areas could be requested from relevant international organizations.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff's views on the source of risks and overall level of concern as of the time of discussion with the authorities.

Appendix 2. Marshall Islands: The Compact Trust Fund-Long-term Outlook and Implications for Fiscal Sustainability

Compact Trust Fund (CTF) returns have been volatile.[1] In FY2008, net return on assets was negative (-23 percent), substantially eroding the market value of the CTF. The fund again experienced a negative return in FY2011, after modest gains in FY2009–10. Strong performance in FY2012-13 has brought the value of the CTF to around US$206 million (120 percent of GDP) as of end-FY2013.[2]



The CTF is administered by an independent committee. Four voting members on the committee are appointed by the United States, two by the RMI, and one by Taiwan Province of China.[3] A custodian and a professional investment advisor help to manage the Fund.

Two scenarios are considered to assess the long-term outlook and the implications for RMI's fiscal sustainability. Long-term self-sufficiency is assumed to be achieved if after FY2023 the CTF can generate enough investment income to cover the reduction in Compact-sector grants and the Supplemental Education Grant, without eroding the real value of the CTF.[4]

1. Baseline scenario

Under this scenario of unchanged fiscal policies, persistent fiscal deficits are projected until FY2033, the last year of the analysis, and are assumed to be financed by external borrowing from bilateral and multilateral development partners. This projection reflects also the expected increase in expenditure for social security contributions for public sector employees from the forthcoming pension reform. In view of projected deficits, no additional contributions from the government to the CTF are assumed. The CTF net investment return is assumed at 6 percent, consistent with previous staff analysis and an earlier study by the US Government Accountability Office. This is slightly above the 5.6 percent net average return since the CTF's inception in 2004, which, however, reflects the impact of unusually dismal earnings in the aftermath of the global financial crisis.

[1] The Compact Trust Fund for the RMI was created in 2004 to contribute to the long-term budgetary self-reliance by providing the RMI Government with an ongoing source of revenue after FY2023. The amended Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of the revenue that will be generated by the Trust Fund, nor is there any commitment regarding the degree to which the revenue will contribute to the long-term budgetary self-reliance of the RMI.

[2] In addition to this, the D account of the CTF, which received contributions from the RMI's government and Taiwan Province of China, held US$11.4 million as of end-FY2013.

[3] The CTF committee has no oversight or fiduciary responsibility of the D account.

[4] The analysis is thus based on a broader perspective than what the CTF was designed to specifically support.

Under the baseline scenario, long-term self sufficiency will not be secured because the real value of the CTF will decline over time, even though income flows in the years immediately after FY2023 are expected to be sufficient to cover the anticipated reduction in grants. Compact-related grants are expected to be reduced by US$32.0 million in FY2024, while the CTF's investment earnings are projected at US$37.6 million. The gap between the investment return and reduction in grants will be too small to compensate for the increase in inflation,[5] so the real value of the fund will start declining in FY2024.

2. Policy action scenarios

In the first scenario, the government is assumed to undertake a fiscal adjustment of 0.9 percent of GDP each year starting in FY2015— building a surplus of 1.7 percent of GDP in FY2018— and maintain the same surplus after FY2018, and transfer surpluses to the CTF or invest them in another trust fund with the same return. Under this course of actions the real value of the total asset would be preserved at least until FY2033, the last projection year. The surplus required to achieve self sufficiency is lower than past staff's estimates due to the improved performance of the CTF. However, this outcome is sensitive to the assumption on investment returns.[6] For example, a 1 percentage point decline in investment return would increase the needed adjustment to more than 6 percent of GDP over a 4-year period. Hence, to cushion against CTF return volatility, and taking account the growth implications of fiscal adjustments, staff recommends a permanent cumulative consolidation of no less than 4.5 percent of GDP by FY2018.

Required Minimum Fiscal Adjustments under Different Scenarios

		Rate of Return (In percent)	Real Growth Rate in FY2018 (In percent)	Fiscal Surplus in FY2018 (In percent of GDP)	Adjustment over 4 years (In percent of GDP)
Baseline Scenario		6.0	1.0	-1.9	-
Policy Action Scenario	(1) Without structural reforms	6.0	1.0	1.7	3.6
	(2) With structural reforms	6.0	2.0	1.5	3.4
Downside Scenario	(1)	5.5	1.0	3.1	5.0
	(2)	5.0	1.0	4.4	6.3

Source: IMF staff estimates.

[5] Inflation is measured by the GDP deflator.

[6] On the other hand, if the government were successful in implementing structural reforms that would boost real growth to 2 percent by FY2018, the required fiscal surplus from FY2018 onwards would fall to 1.5 percent.

Appendix 3. Marshall Islands: Main Recommendations of the 2011 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal Policy:	
Steadily increasing fiscal surpluses to about 5 percent of GDP by FY2016, starting from FY2013, including by :	Fiscal balance worsened in FY2012 and the first deficit since FY2005 was recorded.
- Reduction of public payroll	Nominal growth of public wage in FY2010-12 was better contained than in the past.
- Reduction of subsidies to SOEs	Subsidies to SOEs significantly increased and are expected to remain elevated.
- Legislative approval of revenue reforms	A bill to comprehensively reform the tax system is under parliamentary discussion and the authorities expect its approval in January 2014.
- Better public financial management	The authorities have worked with the PFTAC on a comprehensive medium-term PFM Reform Roadmap, which is to be approved by the Cabinet. They have also been cooperating with the AsDB to use a fiscal management model for budget planning. A Fiscal Responsibility Bill is in Parliament.
Continuing transfers to the CTF	No transfers were made in FY2013 and no transfers are planned for FY2014.
Reforming the social security system	A bill to increase contributions, increase the pension age, and cut benefits is under parliamentary discussion.
Growth Policy:	
Comprehensive reforms of SOEs	SOE reforms are underway with the assistance of the AsDB and the World Bank. A bill to liberalize the telecommunication market is in Parliament.
Financial Sector Policy:	
Strengthening the regulatory framework	No action
Refocusing the MIDB towards commercial and mortgage lending	No action
Other issues:	
Improving the coverage and timeliness of economic statistics.	The authorities recently published the 2011 Census.

INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 19, 2013

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of November 30, 2013)

Membership Status: Joined May 21, 1992; Article VIII

General Resources Account:

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

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	3.33	100.00
Holdings	3.36	101.08

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund[1]

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest		0.00	0.00	0.00	0.00
Total		0.00	0.00	0.00	0.00

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.

Article IV Consultation:

The Marshall Islands is on a 24-month consultation cycle. The 2011 Article IV Consultation discussions were held during September 29–October 7, 2011. The Executive Board discussed the staff report and concluded the consultation on November 23, 2011.

Technical Assistance: Technical assistance on public financial management and revenue administration has been provided through PFTAC. STA has also provided technical assistance on government finance statistics in May 2013, and external sector statistics in May-Jun 2013.

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

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

RELATIONS WITH THE WORLD BANK GROUP

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

The teams agreed that the RMI's main macroeconomic challenges are to (i) address short term macro volatility arising from the deterioration in the fiscal deficit and slowdown in economic growth, (ii) to achieve long-term budgetary self-reliance and (ii) facilitate a greater role for the private sector in delivering services and generating employment.

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 freeze in the civil servant workforce and aligning compensation 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. Careful consideration needs to be given to the potential of a comprehensive tax reform program, including strengthening tax administration, for raising additional revenue while supporting the private sector.
- Public sector enterprise reform. Many state-owned enterprises (SOE) are a drain on 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 will likely facilitate broader access to and reduce the costs of delivering social services and create opportunities for private sector development. Tackling Marshall Islands Energy Company's operating losses will improve the reliability of electricity supply and reduce dependency on government transfers.
- 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. Enhancing the recently introduced aid reporting and coordination functions of the Economic Policy, Planning and Statistics Office (EPPSO) is a step in the right direction to consolidate information on donor expenditures.

The teams agreed on close cooperation going forward. The table below lists the teams' separate and joint work programs during October 2013-September 2014. Since gaining IDA eligibility, RMI has received two grants in support of ICT sector reforms (i) a US$3 million ICT-focused Development Policy Operation, disbursed in June 2013, and (ii) a US$1.25 million grant from the Pacific Regional Infrastructure Facility.

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

October 2013–September 2014

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Bank Work Program	Support government in its design and implementation of ICT policy, legal and regulatory reforms of the ICT Sector as sectoral Development Policy Operation and a Technical Assistance Grant.	Dec 2013 Feb 2014 April 2014	DPO #1 FY2013 #2 FY2014 – #3 FY2015 TA FY2013 – FY2016
2. Fund Work Program	Article IV consultation mission to review macroeconomic developments and update long-term fiscal sustainability assessment	Oct/Nov 2013	Jan 2013
3. Joint Work Program	Mutual update on work program developments and information sharing	Semi-annual	Ongoing

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The country strategy of the Asian Development Bank (AsDB)[1] for the Republic of the Marshall Islands (RMI) is set out in AsDB's "Pacific Approach 2010–14" and the "Country Operations Business Plan 2014-2016". The Country Operations Business Plan has three areas of strategic focus that are relevant to the medium-term development of the RMI: (i) macroeconomic and fiscal management, (ii) human capacity development, and (iv) infrastructure development. AsDB is proposing an indicative lending and grant program of $20 million over 2014–16 comprising a water supply and sanitation project for Ebeye, fully financed through grants from the Government of Australia and a standby investment project to be determined following the preparation of the National Development Plan 2014–16. Technical assistance (TA) of $725,000 is proposed for 2014 and 2015 for improving state-owned enterprise performance and to prepare a potential investment project. 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 14 loans totaling $92.63 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 (Subprogram 1 of the RMI Public Sector Reform Program) for $9.5 million to support public sector reform. As of end December 2012 TA grants totaling $21.11 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 2012, a loan of $5 million for Subprogram 2 of the RMI Public Sector Reform Program was approved. This phase further broadens and deepens the reform initiatives that began under Subprogram 1. Subprogram 2 supported the introduction of new legislation covering SOEs, tax, and fiscal responsibility and debt management; the adoption and implementation of reform plans for selected SOEs to improve their performance; the completion of a public sector workforce audit and planning exercise; and the achievement of various expenditure targets.

In 2012, three TA projects were approved. The first for strengthening economic policy and planning will support the implementation of the government's new national development plan, once it is finalized. The second, a regional TA with financing from the Japan Fund for Poverty Reduction, will support RMI's early-grade learning assessments at selected primary schools. The objective is to assist RMI begin the process of systematically measuring how well children in the early grades of primary school are acquiring reading and mathematics skills, and ultimately spur more effective efforts to improve performance in the core learning areas. The third, a project preparatory TA is supporting the design work for the Ebeye water and sanitation project.

[1] Prepared based on input from the AsDB staff.

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, 2012)

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	5	38.50
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	14	92.63
Memorandum Items:		
Technical Assistance	48	21.11
Grants	1	1.76

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE

The Pacific Financial Technical Assistance Centre's (PFTAC)[1] assistance to the RMI during the past years has focused on public financial management, revenue administration, and financial supervision through numerous missions, regional seminars and workshops which RMI officials attended.

Public Financial Management

Over the 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. In 2008, training on the operation of the system was provided to line ministries by a peripatetic consultant and a PFTAC advisor, as well as a review of the system. The PFTAC advisor visited RMI again in May 2009 to provide training. PFTAC is also developing a commitment control manual for RMI, and carried out an assessment of the IFMIS systems in RMI in December 2009.

Following on PFTAC's assistance in developing a draft Public Financial Management (PFM) reform Roadmap in 2013, future TA in RMI is expected to focus on supporting the authorities to finalize the roadmap. Activities to support the roadmap's implementation are expected to include moving towards medium-term budgeting, modernization of legislation and financial instructions and strengthened cash management, accounting and financial reporting. PFTAC will also provide assistance in analyzing the funding situation for the Social Security fund and developing options to improve its sustainability.

Revenue Administration

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). The adviser was recruited in 2012 and PFTAC plays a mentoring role in assisting the adviser to promote the tax reform agenda and improve the overall level of tax administration. The reform program has been advanced at a cautious rate with a considerable amount of public involvement. The DRT is optimistic that the reform

[1] Prepared based on inputs 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.

package will be passed by February 2014 and will take effect on October 1st 2014. PFTAC will continue to provide TA to support DRT during the implementation process and will provide follow up TA after October 2014 to ensure that new system operates effectively.

Financial Sector Regulation and Supervision

At the request of the Commissioner, an 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 improve the prudential reporting requirements for banks, and the 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 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 onsite 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 has just been replaced in August this year. 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.

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance
As of October 1, 2013
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, consumption and savings indicators are not available. The national census was conducted in early 2011.
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 has recently started to 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 updates 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. Institutional arrangements and cooperation between EPPSO, the government, and other institutions involved in the compilation and dissemination of external sector statistics are partially in place, but should be further enhanced. The lack of dedicated staff at EPPSO for the compilation of ESS is an important hindrance to efforts towards the improvement of Marshall Islands' balance of payments statistics.
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.

Marshall Islands: Table of Common Indicators Required for Surveillance
As of October 31, 2013

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]
Exchange Rates	Oct. 2013	Oct. 2013	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	FY2012	Aug. 2013	A	A	A
Reserve/Base Money	NA	NA	NA	NA	NA
Broad Money	NA	NA	NA	NA	NA
Central Bank Balance Sheet	NA	NA	NA	NA	NA
Consolidated Balance Sheet of the Banking System	End-FY2012	Aug 2013	A	A	A
Interest Rates[2]	June 2013	Oct. 2013	A	A	A
Consumer Price Index	Q2 FY2013	Oct. 2013	Q	Q	Q
Revenue, Expenditure, Balance/Composition of Financing[3] General Government[4] and Central Government	FY2013	Oct. 2013	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	FY2012	Aug. 2013	A	A	A
External Current Account Balance	FY2012	Aug. 2013	A	A	A
Exports and Imports of Goods and Services	FY2012	Aug. 2013	A	A	A
GDP/GNP	FY2012	Aug. 2013	A	A	A
Gross External Debt	FY2012	Aug. 2013	A	A	A
International Investment Position [6]	FY2012	Aug. 2013	A	A	A

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

REPUBLIC OF THE MARSHALL ISLANDS

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

December 19, 2013

Approved By
Stephan Danninger, Ranil Salgado, Jeffrey D. Lewis and Sudhir Shetty (World Bank)

Prepared by staff of the International Monetary Fund and the World Bank.

The Debt Sustainability Analysis (DSA) indicates that the Republic of the Marshall Islands (RMI) is at high risk of debt distress. Currently the ratios of present value (PV) of external public and publicly guaranteed (PPG) debt to GDP, exports and revenues are all above their respective indicative thresholds, and the PV of the debt-to-GDP ratio is expected to remain above its critical threshold throughout the entire projection period. Although under the baseline some indicators of external debt distress would fall below their policy-dependent indicative thresholds in FY2014, the thresholds would be breached under all scenarios with stress tests. Even though short-term risks are mitigated by the concessionality of most obligations and access to a stable flow of funds from Compact grants, risks from public contingent liabilities and lack of fiscal buffers call for a bold fiscal reform strategy.

BACKGROUND

1. RMI's PPG debt is almost entirely external. According to the limited data available, the domestic component—held by domestic banks— is only 3 percent of the total.

2. PPG external debt has been on a downward trajectory since the early 2000s. It declined from 73.7 percent of GDP in FY2002 to 55.9 percent of GDP at end FY2012. About 64 percent is central government debt contracted with the Asian Development Bank (AsDB), on concessional terms; while the remainder is State Owned Enterprise (SOE) government guaranteed debt toward bilateral development agencies.

3. Although data availability is scant, private sector external debt is estimated to be small. The only available data is on deposit money banks' external liabilities, representing less than 2 percent of GDP. Non-financial corporations' external debt is expected to be very limited.

4. The analysis is based on the standard DSA framework for Low Income Countries (LICs).[1] Debt sustainability is assessed in relation to policy-dependent debt burden thresholds.[2] RMI's policies and institutions, as measured by the CPIA, averaged 2.72 over the past 3 years. Hence the country is classified as a "weak" performer and is assessed against lower thresholds compared to countries with a stronger governance and policy environment.

5. The key assumptions of the DSA are consistent with the macroeconomic framework set out in the 2013 Article IV Report (Box 1). Under the baseline, the fiscal projections envisage an annual central government deficit of 1.9–3.5 percent of GDP in FY2015–33. The financing gap is assumed to be financed by a combination of bilateral loans from development partners and multilateral concessional lending. The DSA is also consistent with the baseline scenario for the Compact Trust Fund (CTF) outlook presented in Annex 2 of the 2013 Article IV Report and summarized in Box 2.

PPG EXTERNAL DEBT SUSTAINABILITY

6. Under the baseline scenario, RMI's external PPG debt trajectory remains above the debt-burden threshold for a protracted period of time. The Present Value (PV) of external PPG debt is expected at 43.7 percent of GDP in FY2013, nearly 14 percentage points above the indicative threshold of 30 percent and is not anticipated to fall below that limit over the projection period. Debt accumulation is expected to remain positive at least until FY2033 reflecting government deficit financing. The grant element of new borrowing is expected to increase after FY2018, as the share of concessional loans from multilateral partners in the financing mix is projected to rise. The PV of external PPG debt-to-export ratio is currently close to the critical threshold of 100 percent, but is projected to fall below it in FY2014, thanks to the projected export expansion. The PV of external PPG debt-to-revenue ratio is also above the indicative threshold of 200 percent, and also expected to fall below it in FY2014. As most of external PPG debt is on concessional terms, the debt service to export ratio is already below the relevant threshold, while the debt service to revenue ratio is expected to remain close to the threshold limit for a protracted period.

[1] A 5 percent discount rate is assumed for the analysis.

[2] The low-income country debt sustainability framework (LIC-DSF) recognizes that better policies and institutions allow countries to manage higher levels of debt, and thus the threshold levels for debt indicators are policy-dependent. In the LIC-DSF, the quality of a country's policies and institutions is measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index and classified into three categories: strong, medium, and weak.

Box 1: Marshall Islands: Macroeconomic Assumptions

GDP growth is projected to decline from 3.2 percent in FY2012 to about 1½ percent over the medium term, weighted down by the decline in Compact grants and limited private sector expansion.

The **GDP deflator** is expected to remain about 1 percentage point below CPI inflation growth, consistent with historical trends. CPI inflation is assumed to approach over the medium-long term the US rate of 2.2 percent.

A **fiscal deficit** of around 1.9–3.5 percent of GDP is projected until FY2033. Wage bills are assumed to grow in line with the GDP deflator and also reflect increased social security contributions due to the forthcoming pension reform.[1] Subsidies to SOEs are assumed to decline very moderately in real terms. On the revenue side, Compact grants in nominal terms are projected to decrease according to schedule, while grants from other donors are expected to remain stable at an annual average of about 6 percent of GDP. The tax revenues-to-GDP ratio is assumed to remain broadly unchanged, as the baseline scenario does not incorporate any impact from the tax reform awaiting approval. Fishing licenses fees are assumed to increase moderately.

External Financing: In the absence of access to the international capital market and a very limited domestic market, the financing gap is assumed to be financed by a combination of bilateral loans from development partners and multilateral concessional lending. The annual interest rate on bilateral loans is assumed at 3 percent, consistent with the rate currently charged to public entities by bilateral development partners. In the medium term, it is assumed that the RMI will also be eligible for IDA and IDA-like concessional lending. The RMI benefits from the exception provided to small states that allows them to access IDA resources even though their per capita GNI exceeds the current IDA threshold of US$1205 (Atlas Methodology).

The **Compact Trust Fund** (CTF) outlook is summarized in Box 2.

The **current account deficit** is expected to widen in FY2014, driven by the acquisition of two ships provided by donors and higher imports for the resumption of infrastructure projects. It is expected to tighten in the medium term, as the impact of these temporary factors abates, and thanks to some expansion in fish exports and fishing license fees.

[1] If the pension reform were not approved, the fund of the social security administration would be depleted in FY2022, thereafter imposing on the government an implicit liability of over $12 million (5 percent of GDP) per year, due to the projected deficits of the social security administration in the absence of reforms. With the reform the system is projected to record a surplus until FY2022, but further deficits are likely to arise later on.

7. **Stress tests confirm the vulnerability of the debt position relative to GDP, exports and revenues.** In the most extreme shock scenario—with export value growth in FY2014–15 one standard deviation below the historical average— the PV of the debt to export ratio would only fall below its relevant threshold at the end of the projection period while the PV of debt-to-GDP ratio remains above the threshold. The debt to revenue ratio would fall below its relevant threshold not earlier than FY2024. Under a more benign scenario whereby key macroeconomic variables are assumed at their historical averages—characterized by positive primary balances— the PV of the debt-to-GDP, debt-to-exports, and debt-to-revenue ratios would fall below their critical thresholds in FY2014 or FY2015.

Box 2: Brief Overview of the Compact Trust Fund Under the Baseline Scenario

The Compact Trust Fund (CTF) was established in FY2004 to contribute to the long-term budgetary self-reliance of the RMI after the current Compact Agreement with the US terminates in FY2023. The CTF is administered by an independent committee formed by representatives from the RMI, USA, and Taiwan Province of China, and is managed by a professional investment advisor. RMI's contributions to the CTF have not been steady over the years and depend on the country's fiscal position. Contributions have been mainly provided by the US and, to a lower extent, by Taiwan Province of China. From FY2024 onwards, income returns from the CTF can be withdrawn to finance budget needs, under some limitations.[1]

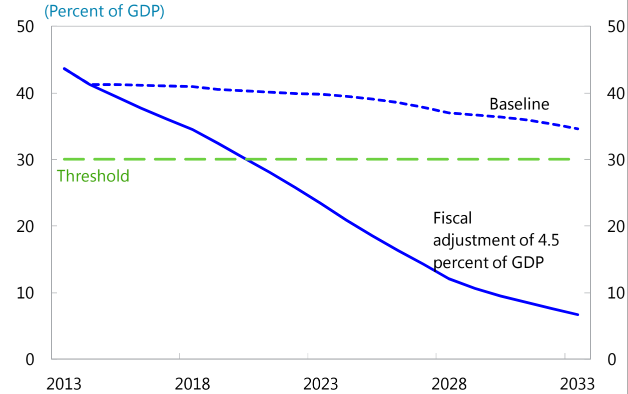
Under the baseline scenario, the CTF is assumed to yield an average annual return of 6 percent. Under this assumption, long-term self-sufficiency will not be secured because the real value of the CTF will decline over time, even though income flows in the years immediately after FY2023 are expected to be sufficient to cover the anticipated reduction in grants.[2] Compact-related grants are expected to be reduced by US$32 million in FY2024, while CTF's investment earnings are projected at US$37.6 million. As the gap between investment returns and grant reduction is expected to be too small to compensate for inflation, the real value of the fund is projected to start declining in FY2024. These projections are sensitive to the assumption on CTF annual investment returns, which have been quite volatile in the past.

[1] Annual distributions from the CTF, starting in FY2024, can only come from earnings from the previous year up to a maximum limit (grant assistance amount as of FY2023, fully inflation adjusted). The following analysis does not take into consideration funds held in the D account, which held US$11.4 million at end-FY2013 and is under a different governance structure.

[2] The baseline scenario assumes no contribution of the RMI into the CTF going forward, due to projected fiscal deficits.

8. **Fiscal consolidation would greatly reduce the risk of debt distress.** Under staff's recommended fiscal adjustment of 4.5 percent of GDP by FY2018, the PV of the debt-to-GDP would fall below the relevant threshold in FY2021. All other external debt distress indicators would remain below the policy-dependent indicative thresholds during the projection period.

PV of Debt-to-GDP Ratio Under Different Scenarios
(Percent of GDP)



Source: IMF staff estimates.

9. **Taking into account the current dominant role of the public sector, the fiscal adjustment path and composition would need to strike a right balance between consolidation and growth implications.** Consolidation measures should include SOE reforms, selective spending cuts, improved public financial management, social security reforms, and approval and swift implementation of the tax reform bill.

PUBLIC SECTOR DEBT SUSTAINABILITY

10. Total PPG debt follows very closely the dynamics of PPG external debt. The PV of PPG debt-to-GDP and to revenue ratios is projected to decline very slowly over the projection period. The debt dynamics is particularly sensitive to growth shocks. Under the most extreme shock, the PV of debt-to-GDP and debt-to-revenue would remain on an upward trend at least until FY2033.[3] Under a shock to the primary balance, the debt service-to-revenue ratio would also keep growing throughout the projection period.

THE AUTHORITIES VIEWS

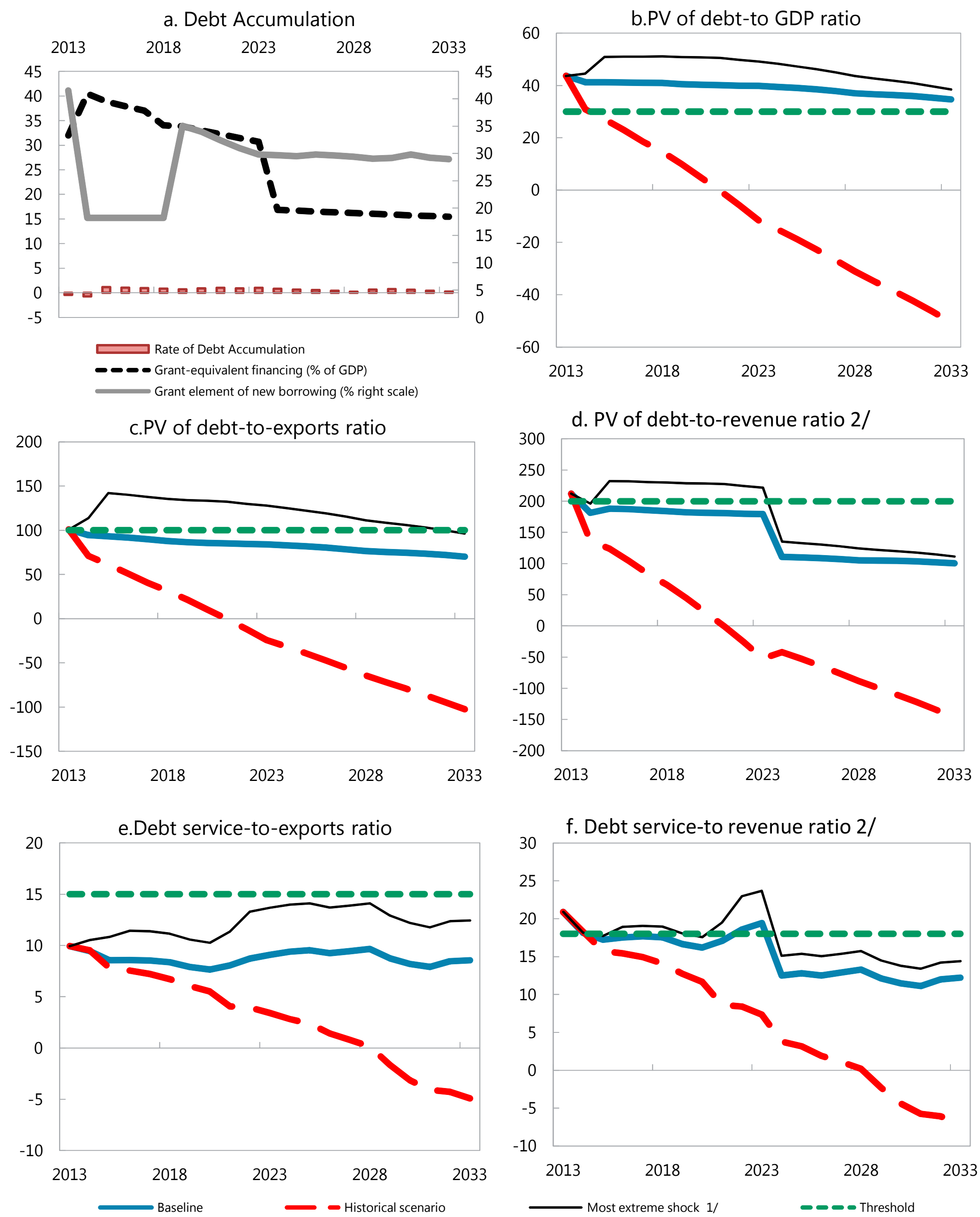
11. The authorities recognized the risks posed by PPG debt. They saw the need for fiscal adjustment and improvements in public financial management. They emphasized that a *Fiscal Responsibility and Debt Management Act* is before parliament. A comprehensive public financial management reform, including measures to enhance debt management, has also been developed and is awaiting cabinet approval.

CONCLUSIONS

12. The standard DSA framework for LICs suggests that the RMI is at high risk of debt distress. The baseline scenario indicates that the PV of debt-to-GDP ratio would breach the threshold throughout the entire projection period. Furthermore, stress tests suggest that RMI's external PPG debt trajectory could remain above relevant thresholds for an even more protracted period of time. RMI's vulnerability to debt distress is mitigated by a number of factors, as most debt is on concessional terms and from development partners, the decline in external support from the Compact will be gradual, sheltering the country from the risk of a sudden stop in foreign financing, and the government is building up a trust fund that will provide a stable source of funding after FY2023. On the other hand, vulnerabilities are exacerbated by the lack of fiscal buffers, uncertainty about prospective SOE losses and by their plans to borrow further with government guarantees, future contingent liabilities from the social security system even after the approval of the pending pension reform, and uncertainty on prospective income returns from the CTF. These vulnerabilities call for an immediate and bold fiscal adjustment strategy.

[3] The scenario in which variables are at their historical levels is regarded as too benign and has been omitted since it generates negative debt due to historical primary surpluses.

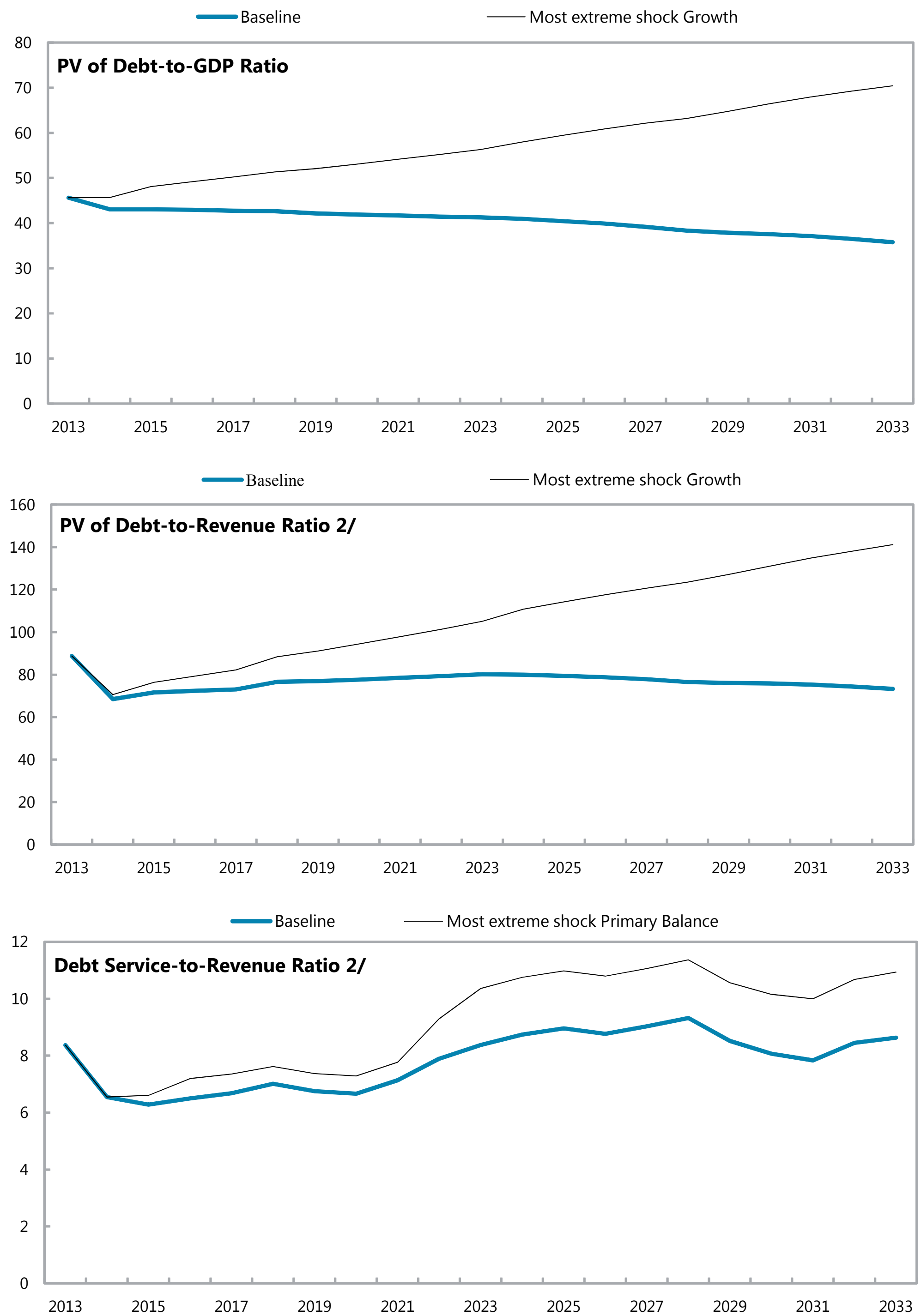
Figure 1. Marshall Islands: Indicators of Public Guaranteed External Debt Under Alternative Scenarios FY2013–33 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in FY2023. In figure b. it corresponds to a Exports shock; in c. to a Exports shock; in d. to a Exports shock; in e. to a Exports shock and in figure f. to a Exports shock
2 / Revenues are defined exclusive of grants.

Figure 2. Marshall Islands: Indicators of Public Debt Under Alternative Scenarios, FY2013–33



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in FY2023.
2/ Revenues are defined inclusive of grants.

Table 1. Marshall Islands: External Debt Sustainability Framework, Baseline Scenario, FY2010–33 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/	Standard 6/	Projections									
				Average	Deviation							FY2013-FY2018			FY2019-FY2033
	FY2010	FY2011	FY2012			FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	Average	FY2023	FY2033	Average
External debt (nominal) 1/	65.0	60.6	57.8			56.8	53.3	52.8	52.3	51.7	51.3		51.8	48.6	
of which: public and publicly guaranteed (PPG)	63.3	58.9	55.9			55.0	51.5	51.1	50.7	50.1	49.7		50.4	47.6	
Change in external debt	-6.3	-4.3	-2.9			-1.0	-3.5	-0.4	-0.5	-0.6	-0.5		0.3	-0.6	
Identified net debt-creating flows	0.5	3.1	5.5			6.5	16.6	7.8	8.3	8.6	7.8		11.8	12.0	
Non-interest current account deficit	26.6	7.4	6.5	7.6	8.1	7.9	19.4	9.6	10.0	10.2	9.1		13.1	13.0	11.5
Deficit in balance of goods and services	87.2	65.9	66.4			64.2	80.0	66.8	66.0	65.1	63.1		61.8	58.6	
Exports	27.2	36.9	41.9			43.3	43.6	44.2	44.9	45.7	46.6		47.5	49.3	
Imports	114.3	102.8	108.3			107.5	123.5	111.0	110.9	110.8	109.7		109.3	107.9	
Net current transfers (negative = inflow)	-36.9	-34.3	-34.4	-37.3	3.5	-30.8	-33.2	-29.8	-29.0	-28.2	-27.4		-23.3	-9.7	-15.5
of which: official	-34.0	-31.5	-31.4			-28.0	-30.7	-27.5	-26.8	-26.2	-25.6		-22.5	-10.7	
Other current account flows (negative = net inflow)	-23.7	-24.2	-25.5			-25.5	-27.4	-27.4	-27.1	-26.8	-26.6		-25.3	-35.9	
Net FDI (negative = inflow)	-23.3	-2.8	-2.0	-4.8	7.2	-2.4	-2.3	-2.2	-2.1	-2.1	-2.0		-1.8	-1.3	-1.6
Endogenous debt dynamics 2/	-2.7	-1.4	1.0			1.0	-0.5	0.4	0.5	0.5	0.8		0.5	0.3	
Contribution from nominal interest rate	2.2	1.6	1.5			1.5	1.3	1.2	1.2	1.2	1.3		1.2	1.1	
Contribution from real GDP growth	-3.9	-0.4	-1.9			-0.5	-1.7	-0.9	-0.8	-0.7	-0.5		-0.8	-0.7	
Contribution from price and exchange rate changes	-1.0	-2.6	1.4			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	-6.9	-7.5	-8.4			-7.5	-20.2	-8.2	-8.8	-9.2	-8.3		-11.5	-12.6	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	46.7			45.5	43.0	42.9	42.8	42.7	42.5		41.2	35.7	
In percent of exports	...	...	111.5			105.1	98.6	97.1	95.4	93.3	91.2		86.8	72.4	
PV of PPG external debt	...	...	44.9			43.7	41.2	41.2	41.2	41.0	41.0		39.8	34.6	
In percent of exports	...	...	107.1			100.9	94.6	93.2	91.7	89.8	87.8		83.9	70.3	
In percent of government revenues (excluding grants)	...	...	217.4			212.1	181.5	188.1	187.2	185.7	184.2		179.5	100.5	
Debt service-to-exports ratio (excluding grants, in percent)	16.5	8.5	10.2			9.9	9.5	8.5	8.6	8.5	8.4		9.1	8.6	
PPG debt service-to-exports ratio (excluding grants, in percent)	16.5	8.5	10.2			9.9	9.5	8.5	8.6	8.5	8.4		9.1	8.6	
PPG debt service-to-revenue ratio (excluding grants, in percent)	22.3	15.5	20.7			20.9	18.1	17.2	17.5	17.7	17.6		19.4	12.2	
Total gross financing need (Millions of U.S. dollars)	12.6	13.1	15.2			17.3	38.8	21.1	22.6	23.8	22.1		36.4	48.7	
Non-interest current account deficit that stabilizes debt ratio	32.9	11.7	9.4			8.9	22.9	10.1	10.5	10.8	9.5		12.8	13.6	
Key macroeconomic assumptions															
Real GDP growth (in percent)	5.9	0.6	3.2	1.4	2.5	0.8	3.2	1.7	1.5	1.4	1.0	1.6	1.5	1.5	1.5
GDP deflator in US dollar terms (change in percent)	1.5	4.2	-2.2	1.9	1.9	0.9	1.0	1.0	1.1	1.2	1.3	1.1	1.3	1.3	1.3
Effective interest rate (percent) 5/	3.3	2.5	2.5	2.9	0.5	2.6	2.4	2.4	2.4	2.4	2.5	2.4	2.5	2.2	2.4
Growth of exports of G&S (US dollar terms, in percent)	41.1	42.5	14.4	12.2	18.1	5.2	4.8	4.3	4.2	4.5	4.3	4.5	3.2	3.2	3.2
Growth of imports of G&S (US dollar terms, in percent)	17.7	-5.8	6.3	6.0	8.5	1.0	19.7	-7.7	2.5	2.5	1.2	3.2	2.7	2.8	2.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	41.5	18.2	18.2	18.2	18.2	18.2	22.1	29.8	29.0	30.4
Government revenues (excluding grants, in percent of GDP)	20.1	20.2	20.6			20.6	22.7	21.9	22.0	22.1	22.2		22.2	34.5	30.8
Aid flows (in Millions of US dollars) 7/	68.2	75.5	59.2			59.1	76.4	78.4	78.6	78.8	74.4		79.2	56.0	
of which: Grants	68.2	65.5	59.2			54.1	73.5	71.8	71.9	72.0	67.7		68.1	44.0	
of which: Concessional loans	0.0	10.0	0.0			5.0	2.9	6.6	6.7	6.8	6.7		11.1	11.9	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			32.0	40.5	38.9	37.9	37.0	34.1		30.7	15.5	21.5
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			95.0	96.9	93.1	93.0	92.9	92.6		90.2	84.8	86.9
Memorandum items:															
Nominal GDP (Millions of US dollars)	163.0	170.9	172.5			175.4	182.8	187.8	192.7	197.8	202.3		232.4	306.7	
Nominal dollar GDP growth	7.4	4.8	0.9			1.7	4.2	2.7	2.6	2.6	2.3	2.7	2.8	2.8	2.8
PV of PPG external debt (in Millions of US dollars)			77.4			76.6	75.3	77.4	79.3	81.2	82.9		92.6	106.3	
(PVt-PVt-1)/GDPt-1 (in percent)						-0.4	-0.7	1.1	1.0	0.9	0.8	0.5	1.0	0.3	0.7
Gross workers' remittances (Millions of US dollars)	5.0	5.7	6.0			6.4	6.7	7.0	7.4	7.7	8.1		10.4	17.1	
PV of PPG external debt (in percent of GDP + remittances)	...	...	43.3			42.2	39.8	39.7	39.7	39.5	39.4		38.1	32.8	
PV of PPG external debt (in percent of exports + remittances)	...	...	98.8			93.1	87.3	86.0	84.5	82.7	80.9		76.7	63.1	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	9.4			9.2	8.7	7.9	7.9	7.9	7.7		8.3	7.7	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that PV of private sector debt is equivalent to its face value.
5/ Current-year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
7/ Defined as grants, concessional loans, and debt relief.
8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Marshall Islands: Sensitivity Analysis for Key Indicators of PPG External Debt, FY2013–33 (In percent)

	Projections							
	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	**FY2023**	FY2033
PV of debt-to GDP ratio								
Baseline	44	41	41	41	41	41	**40**	35
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	44	31	27	23	18	15	**-12**	-51
A2. New public sector loans on less favorable terms in 2013-2033 2	44	41	42	43	43	44	**48**	56
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	44	43	44	44	44	44	**43**	37
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	44	45	51	51	51	51	**49**	38
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	44	42	42	42	42	42	**41**	35
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	44	44	45	45	45	45	**43**	36
B5. Combination of B1-B4 using one-half standard deviation shocks	44	43	42	42	42	42	**41**	36
PV of debt-to-exports ratio								
Baseline	101	95	93	92	90	88	**84**	70
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	101	71	61	51	40	31	**-24**	-102
A2. New public sector loans on less favorable terms in 2013-2033 2	101	95	95	95	94	94	**102**	113
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	101	95	93	92	90	88	**84**	70
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	101	114	142	140	138	135	**128**	96
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	101	95	93	92	90	88	**84**	70
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	101	102	102	100	98	96	**91**	73
B5. Combination of B1-B4 using one-half standard deviation shocks	101	97	94	92	90	88	**84**	71
PV of debt-to-revenue ratio 5/								
Baseline	212	181	188	187	186	184	**179**	100
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	212	136	124	104	84	66	**-52**	-146
A2. New public sector loans on less favorable terms in 2013-2033 2	212	182	191	193	195	196	**217**	161
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	212	189	202	201	199	197	**192**	108
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	212	196	232	232	231	230	**221**	111
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	212	183	192	191	189	188	**183**	102
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	212	195	205	204	203	202	**195**	104
B5. Combination of B1-B4 using one-half standard deviation shocks	212	189	192	191	190	188	**183**	104

Table 2. Marshall Islands: Sensitivity Analysis for Key Indicators (continued) of PPG External Debt, FY2013–33 (In percent)

Debt service-to-exports ratio								
Baseline	10	9	9	9	9	8	**9**	9
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	10	10	8	8	7	7	**3**	-5
A2. New public sector loans on less favorable terms in 2013-2033 2	10	9	8	9	9	9	**10**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	10	9	9	9	9	8	**9**	9
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	10	11	11	11	11	11	**14**	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	10	9	9	9	9	8	**9**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	10	9	9	9	9	9	**10**	9
B5. Combination of B1-B4 using one-half standard deviation shocks	10	10	9	9	9	9	**9**	9
Debt service-to-revenue ratio 5/								
Baseline	21	18	17	18	18	18	**19**	12
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	21	18	16	15	15	14	**7**	-7
A2. New public sector loans on less favorable terms in 2013-2033 2	21	18	17	18	18	18	**22**	16
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	21	19	18	19	19	19	**21**	13
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	21	18	18	19	19	19	**24**	14
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	21	18	18	18	18	18	**20**	12
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	21	18	18	18	18	18	**21**	13
B5. Combination of B1-B4 using one-half standard deviation shocks	21	19	18	18	18	18	**20**	13
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	25	25	25	25	25	25	**25**	25

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Revenues are defined exclusing of grants.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Marshall Islands: Public Sector Debt Sustainability Framework, Baseline Scenario, FY2010–33
(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	FY2010	FY2011	FY2012	Average 5/	Standard Deviation 5/	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2013-18 Average	FY2023	FY2033	FY2019-33 Average
Public sector debt 1/	65.5	62.0	57.9			56.9	53.4	52.9	52.4	51.8	51.4		51.9	48.7	
Change in public sector debt	-5.3	-3.6	-4.1			-1.0	-3.5	-0.4	-0.5	-0.6	-0.5		0.3	-0.6	
Identified debt-creating flows	-8.4	-5.2	0.2			-0.2	-2.1	0.8	0.7	0.6	0.7		2.2	2.1	
Primary deficit	-5.7	-3.7	-0.7	-1.7	8.6	-0.7	-1.1	1.0	0.9	0.8	0.6	0.2	2.4	2.4	2.2
Revenue and grants	62.0	58.5	55.0			51.4	62.9	60.2	59.3	58.5	55.7		51.5	48.8	
of which: grants	41.8	38.3	34.3			30.8	40.2	38.2	37.3	36.4	33.4		29.3	14.3	
Primary (noninterest) expenditure	56.3	54.8	54.2			50.7	61.8	61.1	60.2	59.3	56.3		53.9	51.2	
Automatic debt dynamics	-2.7	-1.4	1.0			0.5	-1.0	-0.2	-0.1	-0.1	0.1		-0.2	-0.3	
Contribution from interest rate/growth differential	-2.5	0.0	-1.5			0.2	-1.4	-0.7	-0.6	-0.6	-0.3		-0.6	-0.7	
of which: contribution from average real interest rate	1.4	0.4	0.4			0.7	0.4	0.2	0.1	0.2	0.2		0.2	0.1	
of which: contribution from real GDP growth	-3.9	-0.4	-1.9			-0.5	-1.8	-0.9	-0.8	-0.7	-0.5		-0.8	-0.7	
Contribution from real exchange rate depreciation	-0.2	-1.4	2.5			0.3	0.4	0.5	0.5	0.4	0.4		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	3.0	1.6	-4.3			-0.8	-1.4	-1.2	-1.3	-1.2	-1.2		-2.0	-2.7	
Other Sustainability Indicators															
PV of public sector debt	...	...	46.8			45.6	43.1	43.0	42.9	42.8	42.6		41.3	35.8	
of which: external	...	...	44.9			43.7	41.2	41.2	41.2	41.0	41.0		39.8	34.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	-0.1	1.6	6.6			5.6	4.9	6.5	6.5	6.4	6.2		8.2	7.7	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	85.2			88.7	68.5	71.5	72.4	73.1	76.6		80.2	73.2	
PV of public sector debt-to-revenue ratio (in percent)	...	...	226.9			221.5	189.7	196.4	195.2	193.4	191.7		186.1	103.7	
of which: external 3/	...	...	217.4			212.1	181.5	188.1	187.2	185.7	184.2		179.5	100.5	
Debt service-to-revenue and grants ratio (in percent) 4/	7.2	5.4	7.8			8.4	6.5	6.3	6.5	6.7	7.0		8.4	8.6	
Debt service-to-revenue ratio (in percent) 4/	22.3	15.5	20.7			20.9	18.1	17.2	17.5	17.7	17.6		19.4	12.2	
Primary deficit that stabilizes the debt-to-GDP ratio	-0.4	-0.2	3.4			0.3	2.4	1.4	1.4	1.4	1.1		2.1	3.0	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	5.9	0.6	3.2	1.4	2.5	0.8	3.2	1.7	1.5	1.4	1.0	1.6	1.5	1.5	1.5
Average nominal interest rate on forex debt (in percent)	3.3	2.5	2.5	3.0	0.5	2.6	2.3	2.4	2.4	2.4	2.5	2.4	2.5	2.2	2.4
Average real interest rate on domestic debt (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real exchange rate depreciation (in percent, + indicates depreciation)	-0.3	-2.1	4.0	0.3	1.8	0.5	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	1.5	4.2	-2.2	1.9	1.9	0.9	1.0	1.0	1.1	1.2	1.3	1.1	1.3	1.3	1.3
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	0.0	0.0	0.0	0.2	-0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	41.5	18.2	18.2	18.2	18.2	18.2	22.1	29.8	29.0	...

Sources: Country authorities; and staff estimates and projections.
1/ Public and publicly guaranteed debt. Gross debt is used.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Marshall Islands: Sensitivity Analysis for Key Indicators of Public Debt FY2013–33

	Projections							
	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2023	FY2033
PV of Debt-to-GDP Ratio								
Baseline	46	43	43	43	43	43	41	36
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	46	43	41	39	37	35	20	-18
A2. Primary balance is unchanged from 2013	46	43	42	41	40	38	28	-2
A3. Permanently lower GDP growth 1/	46	43	44	44	45	45	49	70
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	46	46	48	49	50	51	56	70
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	46	49	53	53	53	53	53	47
B3. Combination of B1-B2 using one half standard deviation shocks	46	47	49	50	50	51	54	61
B5. 10 percent of GDP increase in other debt-creating flows in 2014	46	50	51	51	50	50	49	44
PV of Debt-to-Revenue Ratio 2/								
Baseline	89	68	72	72	73	77	80	73
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	89	68	68	66	63	63	39	-37
A2. Primary balance is unchanged from 2013	89	69	70	69	68	69	54	-5
A3. Permanently lower GDP growth 1/	89	69	72	74	75	80	92	138
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	89	71	76	79	82	88	105	141
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	89	78	89	90	91	96	102	96
B3. Combination of B1-B2 using one half standard deviation shocks	89	73	79	81	84	89	102	122
B5. 10 percent of GDP increase in other debt-creating flows in 2014	89	80	84	85	86	91	96	89
Debt Service-to-Revenue Ratio 2/								
Baseline	8	7	6	7	7	7	8	9
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	8	7	6	6	6	7	7	2
A2. Primary balance is unchanged from 2013	8	7	6	6	7	7	8	4
A3. Permanently lower GDP growth 1/	8	7	6	7	7	7	9	12
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	8	7	6	7	7	7	10	13
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	8	7	7	7	7	8	10	11
B3. Combination of B1-B2 using one half standard deviation shocks	8	7	7	7	7	7	10	12
B5. 10 percent of GDP increase in other debt-creating flows in 2014	8	7	7	7	7	7	10	10

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

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IMF Executive Board Concludes 2013 Article IV Consultation with the Republic of the Marshall Islands

On January 8, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of the Marshall Islands.

The Republic of the Marshall Islands (RMI) is a small, isolated and disperse country, highly dependent on external aid. GDP growth picked up in fiscal year (FY) 2012 (fiscal year, ending September 30) to 3.2 percent, lifted by a surge in fishery output and higher copra and coconut oil production. In FY2013, however, growth is expected to have slowed to 0.8 percent, dragged down by delays in the implementation of infrastructure projects. Meanwhile, inflation is estimated to have eased from 4.3 percent in FY2012 to 1.6 percent in FY2013, thanks to subdued global commodity prices. The fiscal balance slipped into deficit in FY2012, and is expected to stay at -0.8 percent of GDP in FY2013, driven by large transfers to poorly performing state-owned enterprises (SOEs). The current account deficit including official transfers remained elevated at 8.1 percent of GDP in FY2012, as high imports more than offset a pickup in exports and an increase in receipts from fishing license fees. Lending conditions have remained tight, with the banking sector providing only limited credit to businesses.

Although the RMI’s economic performance is expected to strengthen in FY2014, prospects over the medium to long-term are less sanguine. In FY2014, GDP growth is projected to rebound to 3.2 percent, driven by the resumption of Compact-funded infrastructure projects. In the longer term, however, growth is expected to slow to around 1½ percent, weighted down by the scheduled reduction in Compact grants and limited private sector growth. While the fiscal deficit is expected to decline in FY2014 thanks to one-off revenues, it is projected to widen again to around 2 percent of GDP in FY2015, and persist in the medium-term, driven by high subsidies to SOEs and increased expenditures for social security contributions for public sector employees from the upcoming pension reform.

[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.

Executive Board Assessment[2]

Executive Directors noted that the Republic of the Marshall Islands's recent output volatility and external imbalances reflect its narrow productive and export base, and vulnerability to external shocks. Medium-term growth prospects are constrained due to the unique challenges of small, remote island economies and the decline in Compact grants. Directors underscored the need for measures to promote fiscal and debt sustainability and foster private sector development and economic diversification.

Directors called for the implementation of a bold, but balanced fiscal consolidation strategy to secure long-term fiscal sustainability and build policy buffers. They welcomed the authorities' plans to achieve a balanced budget in FY2014 and future surpluses through cuts in electricity and travel expenses and moderation of the public sector wage bill. They also encouraged swift approval and implementation of the pending tax reform, designed to promote efficiency and equity and boost tax compliance.

Directors stressed the need to address fiscal risks as part of a comprehensive adjustment strategy. They called for containment of subsidies to state-owned enterprises and their comprehensive restructuring with the assistance of the World Bank and Asian Development Bank. Directors also recommended parliamentary approval of the social security reform bill.

Directors welcomed the authorities' initiatives to enhance public financial management and recommended the rapid approval and implementation of reforms to strengthen resource allocation and the medium-term budgeting framework. They looked forward to parliamentary approval of the Fiscal Responsibility and Debt Management Act.

While recognizing the challenges posed by RMI's remoteness and small size, Directors underscored the importance of promoting diversified, inclusive growth through improvements to the regulatory framework and the business climate, including in the areas of investor protection and land reform. They recommended enhanced collaboration with development partners, the private sector and neighboring countries to upgrade both human capital and infrastructure.

Directors emphasized the need to strengthen the autonomy, capacity and supervisory authority of the Banking Commission over both bank and nonbank financial institutions, with a view to improving financial surveillance. They also called for efforts to address shortcomings in the Anti-Money Laundering/Combating the Financing of Terrorism (AML-CFT) framework.

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[2] 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.

Marshall Islands: Basic Data, FY2009–18 1/

Nominal GDP for FY2012 (in millions of U.S. dollar):	172.5
Population (2011):	53,158
GDP per capita for FY2012 (in U.S. dollar):	3,232
Quota:	SDR 3.5 million

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Est.			Proj.		
Real sector										
Real GDP (percent change)	-1.8	5.9	0.6	3.2	0.8	3.2	1.7	1.5	1.4	1.0
Consumer prices (percent change)	0.5	1.8	5.4	4.3	1.6	1.7	1.8	1.9	2.1	2.2
Central government finances (in percent of GDP)										
Revenue and grants	64.3	62.0	58.5	55.0	51.4	62.9	60.2	59.3	58.5	55.7
Total domestic revenue	20.3	20.1	20.2	20.6	20.6	22.7	21.9	22.0	22.1	22.2
Grants	44.1	41.8	38.3	34.3	30.8	40.2	38.2	37.3	36.4	33.4
Expenditure	62.8	58.5	56.4	55.8	52.2	63.1	62.3	61.4	60.5	57.6
Expense	52.1	48.4	48.7	51.5	51.1	53.5	52.3	51.6	50.9	50.4
Net acquisition of nonfinancial assets	10.7	10.1	7.7	4.2	1.1	9.6	10.0	9.8	9.5	7.1
Net lending/borrowing	1.5	3.5	2.2	-0.8	-0.8	-0.2	-2.2	-2.1	-2.0	-1.9
Compact Trust Fund (in millions of US$; end of period)	90.9	112.8	125.2	165.6	205.8	234.6	265.9	299.8	336.5	376.3
Commercial banks (in millions of US$)										
Foreign assets	63.6	71.8	71.9	62.1	...	...	...	...	...	...
Private sector claims	62.0	63.3	60.2	59.4	...	...	...	...	...	...
Total deposits	93.3	102.1	98.2	85.0	...	...	...	...	...	...
One-year time deposit rate (in percent)	6.0	3.5	3.5	3.5	...	...	...	...	...	...
Average consumer loan rate (in percent)	13.9	14.0	14.0	14.0	...	...	...	...	...	...
Balance of payments (in millions of US$)										
Trade balance	-73.5	-100.8	-68.6	-66.5	-63.8	-95.9	-74.1	-74.7	-75.0	-72.8
Net services	-53.5	-41.3	-43.9	-48.1	-48.8	-50.3	-51.4	-52.6	-53.8	-54.9
Net income	40.6	35.1	38.6	41.4	42.2	47.7	49.1	49.8	50.6	51.2
Unrequited transfers (private and official)	60.0	60.1	58.6	59.3	54.1	60.8	56.0	55.9	55.7	55.5
Current account including official current transfers	-26.4	-46.9	-15.3	-13.9	-16.4	-37.7	-20.4	-21.6	-22.6	-20.9
(In percent of GDP)	-17.4	-28.8	-9.0	-8.1	-9.4	-20.6	-10.9	-11.2	-11.4	-10.3
Current account excluding budget grants	-80.7	-102.4	-69.2	-68.1	-65.6	-93.8	-72.0	-73.2	-74.3	-72.8
(In percent of GDP)	-53.2	-62.8	-40.5	-39.5	-37.4	-51.3	-38.3	-38.0	-37.6	-36.0
External PPG debt (in millions of US$; end of period) 2/	105.9	103.2	100.7	96.4	96.4	94.2	96.0	97.7	99.2	100.6
(In percent of GDP)	69.7	63.3	58.9	55.9	55.0	51.5	51.1	50.7	50.1	49.7
Exchange rate										
Real Effective Exchange Rate (2005 =100)	109.4	106.6	105.9	107.5	...	...	...	...	...	...
Memorandum Item:										
Nominal GDP (in millions of US$)	151.8	163.0	170.9	172.5	175.4	182.8	187.8	192.7	197.8	202.3

Sources: RMI authorities; and IMF staff estimates and projections.
1/ Fiscal year ending September 30.

Statement by Jong-Won Yoon, Executive Director, and Kyounghwan Moon, Advisor to the Executive Director of the Republic of the Marshall Islands
January 8, 2014

The Republic of the Marshall Islands (RMI)' authorities wish to express their appreciation to the mission team for their constructive policy consultation and the well-structured report. Due to the unique challenges of micro states such as extreme remoteness, small population, dispersion and narrow production base, the RMI has undergone difficulties in achieving self-sustaining economy, and has relied on external supports. The authorities appreciate the continued support from the international community, particularly from the United States, in providing financial support through the Compact of Free Association.

The RMI authorities are broadly in line with the staff report, which properly identifies the country's economic status and highlights the need for securing fiscal sustainability and boosting private sector development. They will continue their efforts to address the challenges and rebuild policy buffers for enhancing economic resilience and promoting potential growth.

Recent Economic Development

Economic growth of the RMI has fluctuated over the past few years, showing its vulnerability to external shocks. Real GDP growth, which picked up by 3.2 percent in FY2012 from 0.6 percent in FY2011, is projected to slow down to below one percent in FY2013 due to delays in project implementation of Compact infrastructure projects. As those projects start to resume, growth is expected to reach above three percent in FY2014.

Risks to growth are tilted to the downside. As staff noted, main sources of domestic risks include further delays in project implementation, insufficient fiscal consolidation and contingent liabilities in the public sector. The danger from natural disasters and commodity price shocks also pose considerable risks to the outlook, reinforcing the importance of maintaining large policy buffers to absorb shocks. There are also upside risks, such as bold implementation of structural reforms and better prospects of copra production from new ships and a new copra oil refinery.

The authorities are committed to their continued efforts for a gradual transition toward self sustainability as the Compact comes to an end in FY2023. Last December, they reviewed the progress of the RMI's National Strategic Plan, which sets goals for sustainable development of the country. No transfers from the authorities were made to the Compact Trust Fund (CTF) in FY2013 due to fiscal deficits. Nevertheless, the authorities acknowledged the importance of securing long-term self sufficiency of the CTF, which will be a source of revenue after FY2023.

Fiscal Sustainability

The authorities agree with staff that considerable fiscal adjustment is crucial while taking into account the right balance between consolidation needs and growth implications.
A fiscal adjustment of 4.5 percent of GDP by FY2018 is not an easy task, but the authorities fully recognize the need for fiscal consolidation, noting that further delay would make it difficult to achieve sustainable growth. They aim to reach a balanced budget in FY2014 from the

consecutive deficits of 0.8 percent in the previous two years. Fiscal position would be further improved once the pending tax and SOE reform bills are passed in the Parliament this year. The authorities will continue to freeze the nominal wages so as to reduce the public-private sector wage gaps over time, which are partly due to the differences in skills between workers.

Tax reform will contribute to enhancing efficiency and compliance in the tax system. The purpose of this comprehensive tax reform bill, which is under discussion in the Parliament, is to modernize the tax system by broadening the tax base and strengthening tax administration through measures such as introducing a consumption tax and establishing an independent Customs and Revenue Authority. The authorities will continue their efforts for approval and implementation of this significant bill.

The authorities are actively working to implement SOE reforms. Liberalizing the telecommunication sector is under discussion in the Parliament and an initial study has been completed on the feasibility of privatizing the airline sector. The authorities note that SOEs have become a substantial burden on the government, and reassure that they would push forward the SOE bill to be passed in the Parliament, which contains international best practices of good governance, commercial test and less government involvement. In restructuring SOEs, the authorities will give proper consideration to the impact on the most vulnerable people, who depend on the services of SOEs.

The authorities are exploring ways to reform the social security system to secure its sustainability. It is estimated that the social security fund will be depleted by 2022 under the current system and this may result in a considerable contingent fiscal risk. In this sense, the authorities have drafted a reform bill, which is pending the Parliament approval. The bill aims to cut current benefits by 22 percent and to increase contribution and retirement age, thereby producing $3 million/year surplus. The authorities are also considering converting to a defined benefit scheme and, in this regard, the Fund's technical assistance would be appreciated in this area.

Strengthening public financial management is another important policy priority for the government. The authorities have worked with the Asian Development Bank (ADB) and the Pacific Financial Technical Assistance Centre (PFTAC) in preparing a roadmap for fiscal prudence and public debt management. This would improve allocation of resources and enhance the medium-term budgeting framework.

Financial Sector Development

The authorities agree to the need for strengthening regulatory framework. The financial sector remains focused on consumer lending and the authorities are aware of the need for vigilance in monitoring high levels of household debt. They are also considering bringing in medium and small moneylenders under the formal regulatory framework.

Enhancing the capacity of the Banking Commission is also important for financial stability. The role of the Banking Commission has been expanded for on/off-site examinations of banks and the authorities welcome staff's recommendation to increase the Commission's resources and to put the Marshall Islands Development Bank under the supervision.

Boosting Private Sector Development

Private sector could play a more dynamic role as the engine of economic growth. The contribution of private sector on economic growth has increased to 29.5 percent (FY2010–FY2012) from 26.7 percent (FY1997–FY1999), reflecting the rise of the fisheries sector. The authorities will continue to take further steps to improve business environment and to encourage entrepreneurship in achieving a self-sustaining business sector. The fisheries sector would continue to be a source of growth and business development in niche/eco-tourism could also be a profitable one.

The authorities will continue their efforts for easing the obstacles to private sector development. They emphasize that there were some progress in registering land and that they will tackle further the land ownership issue, while noting that this will take considerable time and effort due to the complex nature of the Marshallese land tenure system. Ensuring proper infrastructure and legislative framework will help reduce costs in running businesses and providing a level playing field to investors will attract foreign direct investment.