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Republic of the Marshall Islands: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of the Marshall Islands

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with the Republic of the Marshall Islands, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 8, 2005, with the officials 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 January 12, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 15, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Republic of the Marshall Islands.

The document listed below has been or will be separately released.

Selected Issues Paper and Statistical Appendix

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with the Republic of the Marshall Islands

Approved by David T. Coe and Scott Brown

January 12, 2006

- A staff team comprising Ms. Edison (head), Mr. N'Diaye (both APD), and Mr. Nyberg (FIN) visited Majuro during October 28–November 8, 2005. Mr. Seong (OED) and Mr. Andrews (PFTAC) participated in some of the discussions.

- The team met with Finance Minister Wase, Chief Secretary Muller, Finance Secretary Barton, other senior government officials, and public enterprise managers. The mission also met with U.S. officials from the Office of Insular Affairs of the Department of Interior in Honolulu, who are responsible for monitoring the amended Compact agreement.

- The mission engaged in outreach activities, meeting with private-sector participants, donors, NGOs, and the press. A press statement was issued upon completion of the mission.

- The Republic of the Marshall Islands (RMI) has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. RMI uses the U.S. dollar as its currency.

- Macroeconomic data suffer from serious shortcomings that hamper surveillance.

- RMI is on a 24-month consultation cycle. The last Article IV consultation was concluded on January 26, 2004.

- The authorities published the PIN at the conclusion of the 2003 consultation. They have agreed to consider publication of this report and the selected issues paper, which has not been done for previous consultations.

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Executive Summary

Economic Developments

- **Economic activity picked up in FY2005 (ending September 30).** Real GDP growth is estimated at 3½ percent, partly driven by a more expansionary fiscal stance, and to a lesser extent, improvements in agriculture. Inflation is estimated to have risen to 3½ percent, reflecting higher oil prices.

- **The fiscal position deteriorated in FY2005 to an estimated deficit of 2 percent of GDP, mainly owing to an underperformance of domestic revenue.** The decline in domestic revenue reflected a drop in nontax revenue because of lower fees and charges. On the expenditure side, current expenditure was broadly unchanged, while capital expenditure rose markedly in line with the disbursement of external grants and implementation of previously-planned programs.

- **The current account surplus is estimated to have narrowed in line with a rise in imports,** stemming from higher economic activity. In addition, service receipts declined with the closing of the tuna processing plant.

Policy Discussions

- **Over the longer term, fiscal and structural reforms are necessary to achieve budgetary self-sufficiency.** With the declines in grant funds under the amended Compact of Free Association and the increase in debt service payments, the large government sector will become increasingly unsustainable. A sizeable budget adjustment is needed to build reserves in the trust fund that would allow real GDP growth to remain steady after the grants end in 2023. This will also require the speedy implementation of structural reforms. In this context, there is a need to improve the land registration procedure and to clarify and update the legal framework for secured lending. In addition, efforts aimed at simplifying regulations for domestic and foreign investors should be continued.

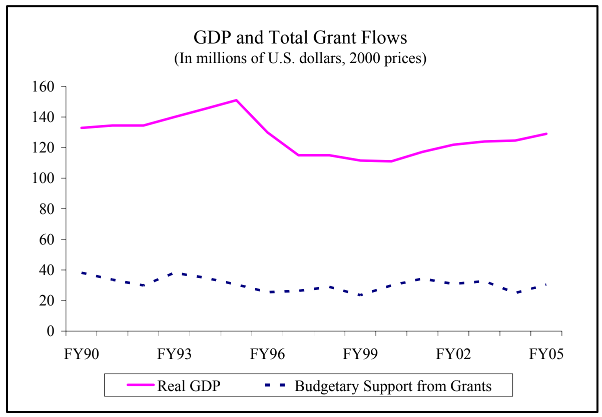
- **The government's first priority should be to achieve a fiscal surplus in FY2006.** Given the size of the medium-term fiscal adjustment that is needed to achieve long-term fiscal sustainability, consolidation should start immediately. In particular, tighter controls on expenditure on goods and services and cuts to the wage bill are warranted. These measures could provide substantial savings, leading to an overall fiscal surplus.

- **Steps have been taken to strengthen financial sector supervision, but additional efforts are needed.** In particular, the development bank should be placed under the supervision of the Banking Commission and tighter controls and reporting requirements for the shipping trust company are warranted. The Banking Commissioner should monitor closely the consequences of the loss of correspondent banking relationship for the Bank of Marshall Islands (BoMI), which by inhibiting its processing of foreign transactions, has resulted in a large shift of demand deposit accounts from BoMI to the remaining commercial bank, thereby reducing competition in the banking sector.

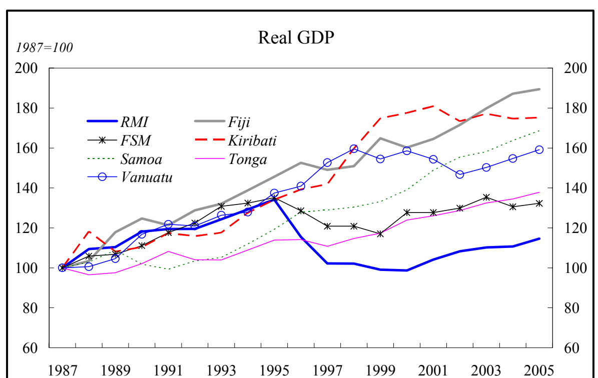
I. Introduction and Background

1. **The Republic of the Marshall Islands consists of 29 low-lying atolls in the central Pacific.** The atolls are made up of over 1200 islets and 5 islands, totaling a land area of 70 square miles across a sea area of over 750,000 square miles. Over two-third of the population, estimated at about 58,000, resides in the Majuro and Kwajalein atolls. The country suffers from development constraints common to many small island economies—such as a narrow production and export base, isolated geography, limited natural resources, and vulnerability to external shocks.

2. **As in most Pacific island countries, the public sector plays a dominant role in the economy of RMI, backed by generous external assistance (Box 1).** Government expenditure accounts for more than 70 percent of GDP, and about 50 percent of government revenue consists of external grants, mainly from the United States under the Compact of Free Association agreement. Consequently, overall economic activity is highly correlated with government expenditure and external grant flows. The private economy remains underdeveloped, primarily providing services to the government, with small contributions from agriculture, fishery, and tourism.



3. **After nearly a decade of growth following independence in 1986, economic activity declined markedly in the mid-1990s.** Real GDP per capita is estimated to have fallen around 30 percent since FY1994. This was a result of declining grant flows and the need to retire public debt, incurred through external commercial borrowing by the government against future Compact revenues. The weak economy reportedly fostered emigration to the United States, as citizens need only a valid passport to work there, and forced large expenditure cuts in part through the implementation of the Asian Development Bank (AsDB) Public Sector Reform Program. Following a period of fiscal consolidation in the late 1990s, economic growth picked up (Table 1). Over the past five years, however, the reduction in civil service employment has been reversed. Also, public debt and government loan guarantees, while currently manageable, are approaching their 1990s levels when loan repayments exerted strain on revenues. Key human development indicators are broadly commensurate with those in other lower-middle income countries (Table 2).



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

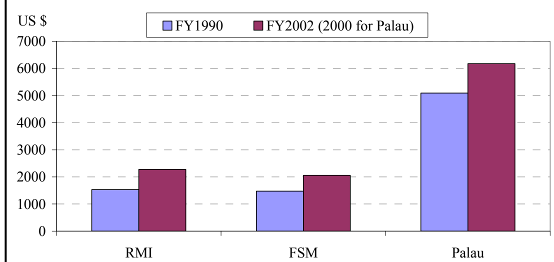
Box 1. Marshall Islands: Comparison with other Compact Countries

The RMI, the Federated States of Micronesia (FSM), and the Republic of Palau (all formerly part of the U.S. Trust Territory of the Pacific Islands) currently have Compact of Free Association agreements with the United States. While the three countries have similar characteristics, with heavy reliance on official grants and dollarization, cross-country comparisons highlight notable differences among them.

Compared with FSM, RMI has experienced higher growth and currently has higher per capita GDP. However, both RMI and FSM have lagged Palau in terms of economic development, and a large part of their population is still in the subsistence sector. Compared with Palau, growth in RMI's private-sector employment has been modest. The difference in economic performances may be partly attributed to geography: Palau is the closest of the three countries to large Asian countries and receives the largest number of international visitors. All three countries have enjoyed price stability during recent years, thanks to their use of the U.S. dollar.

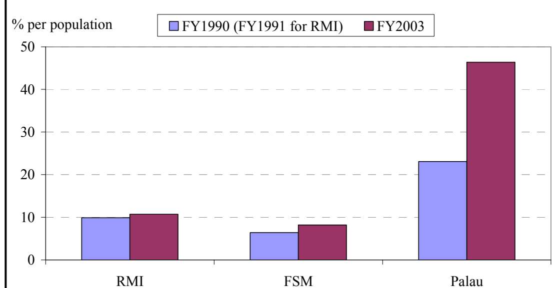
Regarding fiscal performance, the three countries are characterized by low domestic revenue, high dependence on grants, and large current expenditure. As a share of GDP, RMI has an average level of domestic revenue and the smallest capital expenditures. The current level of government debt is high, relative to the other Compact countries, reflecting large concessionary loans from the AsDB. Compared with the mid-1990s, when RMI borrowed against future Compact revenues, the level of external debt has declined as a result of the 2001 repayment of commercial debt, but remains substantially higher than in the FSM and Palau.

Nominal GDP per Capita[1,2]



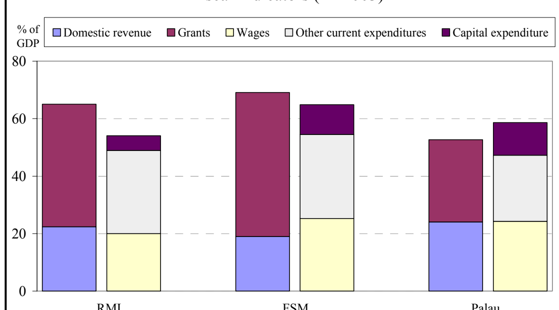
Sources: Data provided by the RMI and FSM authorities; and IMF staff estimates.
[1]Although reliable GDP deflators for long periods are not available, inflation in the FSM does not seem to be higher than those in the other countries for these years.
[2]Data for Palau are for calendar year.

Private Sector Employment[1]



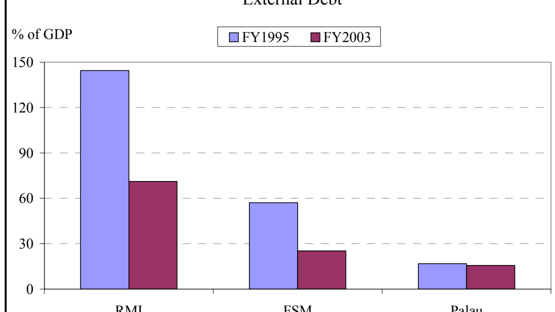
Sources: Data provided by the RMI and FSM authorities; and IMF staff estimates.
[1]Data for Palau are for calendar year.

Fiscal Indicators (FY2003)



Sources: Data provided by the RMI and FSM authorities; and IMF staff estimates.

External Debt



Sources: Data provided by the RMI and FSM authorities; and IMF staff estimates.

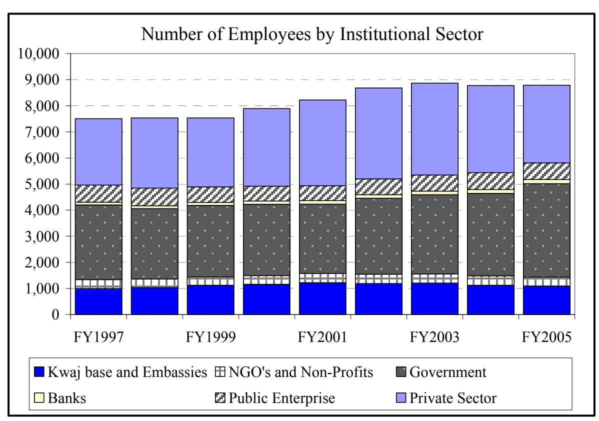
4. **The amended Compact agreement extends U.S. financial support until 2023 with grants declining steadily.** The new agreement reflects a major change from the way past funding has been delivered, mainly through the establishment of a trust fund, grants more focused on key sectors, and enhanced accountability and monitoring. It also includes provisions for the United States to retain access to Kwajalein Atoll, where there is a large U.S. military base. A July 2005 review by the U.S. Government Accountability Office (GAO) identified some shortcomings in the implementation of the agreement to date and provided recommendations to overcome them, some of which are being addressed by both the RMI and U.S. governments (Box 2).

5. **The looming phase-out of Compact grants underscores the need for policy reform to avoid major setbacks—as in the mid-1990s.** In the very near term, economic activity is expected to improve temporarily, in part reflecting the one-off effects of bump-up funds of the amended Compact and special capital-related grants. While the immediate outlook is brightening from increased grant flows, policies will need to take on promptly the longer-term challenge of channeling resources to advance economic self-reliance. In particular, careful management of the grants, along with prudent fiscal policies and structural reforms, will be needed to help lay the foundation for future sustained growth.

6. **At the conclusion of the last consultation in January 2004, Directors stressed** that public sector reform, improvements in infrastructure, health, and education, as well as strengthened private sector development, were essential components of a viable economic strategy for the Marshall Islands. They urged that these reforms be accelerated, but progress to date has been limited.

II. Recent Economic Developments and Near-Term Outlook

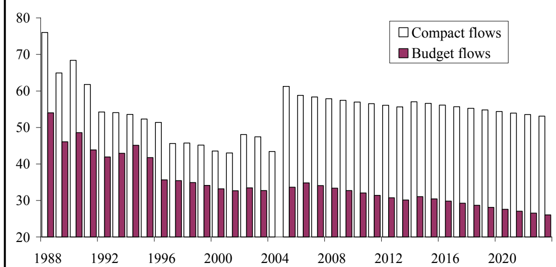
7. **Based on limited data, real output growth appears to have slowed sharply in FY2003 and again in FY2004.** Economic activity has been hampered by delays in implementing an upgraded public works program and the closure of a large privately-owned tuna processing plant because of financial difficulties, leading to an estimated loss of 500 jobs. Civil service employment appears to have increased, primarily as a result of higher spending on education and health in line with the amended Compact agreement. Nevertheless, overall growth in employment continues to fall short of labor supply, and unemployment, especially for school-leavers, has risen above 30 percent. Real growth is expected to have picked up in 2005, reflecting an expansionary fiscal stance and, to a lesser extent, improvements in agriculture.



Box 2. Marshall Islands: Amended Compact of Free Association with the United States

The amended Compact went into effect on May 1, 2004, with the aim of continuing economic assistance during FY2004-23. Its features are as follows:

Marshall Islands: Compact Flows
(In 2003 dollars million, on a fiscal year basis) 1/



1/ Does not include one-time payments for various nuclear settlements. Budgetary flows are obtained by deducting Kwajalein rental payments and trust fund contributions from Compact flows.

- ***Total funding***. Funding of $42.7 million per year in 2004 dollars (roughly 40 percent of GDP at present) includes grants, trust fund contributions, and audit funds. Grants will decline by $0.5 million per year, while the trust fund contribution is augmented by $0.5 million per year. These amounts will be partially adjusted for inflation until 2014, after which grant funding will be fully adjusted for inflation.

- ***Sector allocation***. Grants target six specific sectors: education, health care, public infrastructure, the environment, public sector capacity building, and private sector development, with priority for education and health.

- ***Trust fund***. The amended compact provides for the establishment of a trust fund, which is meant to ensure a sustainable source of revenue to replace grant assistance beginning in 2024. The RMI was required to make a one-time contribution of $30 million to the trust fund. The initial contribution from the United States (of $7 million) will be augmented annually.

- ***Accountability and monitoring mechanisms***. New procedures were introduced to enhance financial accountability and economic management. A U.S.-RMI Joint Economic Management and Financial Accountability Committee (JEMFAC) was established to approve grant allocations and review performance outcomes and audits. The amended compact allows for the possibility that the U.S. government could withhold funds in the case of noncompliance with grant terms and conditions.

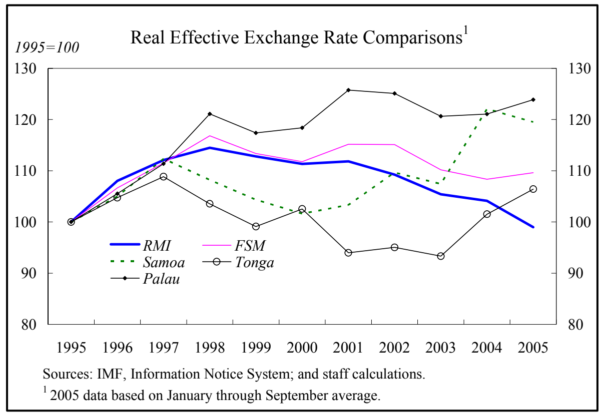
Other provisions of the amended Compact include:

- Rental payments, funded separately from the Compact, for U.S. military use of the Kwajalein Atoll through FY2066. The United States has the option to terminate payments as early as FY2030, with advance notice of seven years, or to extend use through FY2086.
- An extension through FY2023 of some federal education and disaster management services received by RMI under the original Compact.
- Immigration provisions were tightened slightly, with visitors to the United States now required to show a passport.

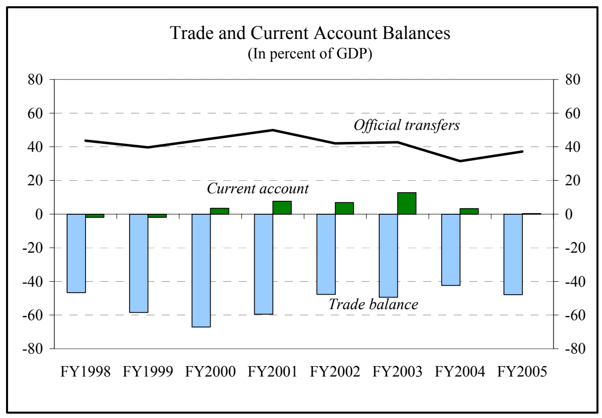
GAO initial review of amended Compact found:

- Progress has been made in the implementation of new funding and accountability requirements in FY2004, but challenges remain mainly related to the agreement’s lack of assessment of the long-term impact of grants and the effective use of funds.

8. **CPI inflation remains subdued, tracking that of the United States.** Inflation picked up to 2.4 percent (year-on-year) in September 2004, and is expected to have risen to 3½ percent in FY2005, reflecting primarily higher fuel costs and, to a lesser extent, higher alcoholic beverage prices following a rise in import duties.



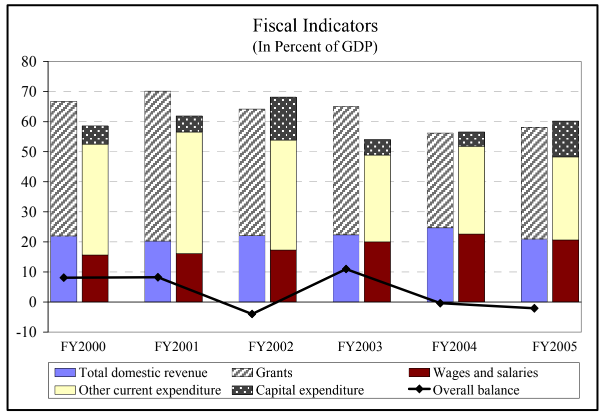
9. **The real effective exchange rate has remained broadly stable,** thanks to a low and stable inflation differential with the United States, the largest trading partner. In terms of costs of doing business, especially for the tourism industry, RMI is perceived as not competitive relative to other destinations in the Pacific, owing to its geographical isolation, limited hotel facilities, and deficient waste management.



10. **The current account surplus narrowed in FY2004, largely reflecting delays in official transfers (Table 3).** The trade balance improved slightly as export growth continued at trend, driven mainly by increases in the re-export of diesel fuel associated with the fishing transshipment base in Majuro, while imports were moderately lower reflecting lower spending on capital project-related imports. In FY2005, the current account surplus is estimated to have narrowed further, in part as a result of higher imports relating to capital projects and the closure of the tuna processing plant. There are no reliable statistics on remittances; however staff estimate the net outflow to be large, reflecting the flow of Kwajalein rental receipts to non-resident landowners.

11. **Gross external debt has risen despite the retirement of the government's commercial debt in FY2001 (Table 4).** Outstanding debt, at nearly 70 percent of GDP, is high, although about 60 percent of it is on concessional terms, primarily owed to the Asian Development Bank. The remaining 40 percent is mainly owed by two utility companies—the Marshall Islands Telecommunications Authority and the Marshalls Energy Company.

12. **The fiscal position deteriorated in FY2004 (Table 5).** This deterioration reflects, on the revenue side, a decline in grants aimed at infrastructure projects owing in part to delays in initiating projects, lower income tax collection, and volatility in non-tax revenue. At the same time, total expenditure increased with some shift in its composition from capital to current expenditure. Spending on wages and goods and services continued to rise, contributing to the



worsening of the fiscal position, and has reached 22½ percent of GDP in FY2004 (up from 15½ percent of GDP in FY2000). The rise in wages and salaries stemmed from increases in the number of civil servants and the harmonization of wage levels in the Ministry of Education. In FY2005, the government's overall deficit is estimated at 2 percent of GDP, mainly stemming from an underperformance of revenue collection. The government has fully met its mandatory contributions to the Compact Trust Fund, amounting to $25 million in FY2003–2004, and $5 million in FY2005–2006.

13. **The near-term outlook is brighter.** Real growth is projected to be 4 percent in FY2006, somewhat above trend, mainly due to higher public expenditure on capital projects. Inflation is expected to rise to around 3 percent, owing to higher oil prices and the lingering impact of increases in tariffs on tobacco and alcohol. The current account surplus (including official grants) is projected to widen, reflecting further increases in official transfers. Meanwhile, the fiscal deficit is expected to be eliminated, in part as a result of improvements in tax collection and expenditure control.

14. **The main downside risks to the outlook stem from capacity constraints that could lead to delays in grant disbursements and from high and volatile oil prices.** To date, the impact of higher oil prices appears to have been moderate, but it could dampen growth going forward. Preliminary estimates suggest that a 10 percent increase in oil prices could lower growth by 1 percentage point and reduce the current account balance by ¾ percent of GDP.

III. Policy Discussions

A. Medium-Term Framework

15. **To help promote longer-term sustainability, RMI will need to consolidate the government sector and vitalize the private sector through structural and fiscal reforms.** Against this background, the policy discussions focused on: (i) the short-term policy measures necessary to achieve fiscal surplus; (ii) the extent of fiscal adjustment required in the medium term to offset the step-downs in the amended Compact grants; (iii) the reforms vital to invigorate growth and employment in the private sector; and (iv) the efforts needed to strengthen financial sector supervision. These areas of focus are consistent with past policy dialogue with the Marshallese authorities (Box 3).

Box 3. Marshall Islands: Policy Dialogue in 2001 and 2003

The staff and the authorities have shared comprehensive views in the past about policy priorities. But frequently the authorities have followed more moderate steps than recommended by the staff, primarily owing to capacity constraints. The advice given in the last two consultations have been broadly consistent with the points highlighted below.

Fiscal Policy

Fund recommendations: Fiscal consolidation, amounting to 4–5 percent of GDP, to build additional reserves in the trust fund. To this end, one focus was on control of current expenditure — especially on wages and goods and services; limiting capital expenditure to Compact priority areas; and raising revenue by bolstering tax administration and broadening the tax base.

Policy Developments: The authorities acknowledged the need to build reserves and have taken preliminary steps by retiring high-cost commercial debt and augmenting institutional capabilities.

Financial Sector Policy

Fund recommendations: Strengthen financial supervision by: (i) improving banking commission data and information collection; (ii) placing the development bank under the supervision of the banking commission; (iii) taking steps to remove RMI from the FATF money laundering list; and (iv) agreeing to the IMF OFC Module 2 assessment.

Policy Developments: The authorities have made efforts to strengthen supervision, including the banking commission conducting on- and off-site bank supervision. A number of decisive steps were taken to discourage money laundering leading to RMI's removal from FATF's list in October 2002. An IMF OFC Module 2 assessment was conducted in 2002.

Structural Reform

Fund recommendations: Remove key impediments to private sector development by clarifying property and land tenure rights, changing existing minimum-wage legislation to increase wage differentiation between skill levels, reducing extensive state involvement in business through privatization, and reducing constraints on foreign investment.

Policy Developments: The authorities passed legislation to address land tenure issues, including the establishment of Land Registration Authorities.

Statistical

Fund recommendations: Core economic data need to be compiled and reported on a timely basis as serious deficiencies impede effective surveillance. Priority should be given to PFTAC's recommendations on statistical improvements, including joining the General Data Dissemination System.

Policy Developments: The authorities have broadly agreed with these priorities, but little progress has been made.

16. **The amended 20-year Compact agreement, which has been in force less than two years, provides RMI an opportunity to achieve economic self-reliance.** The medium-term outlook remains uncertain and hinges on the authorities' commitment to fiscal adjustment and structural reform (Table 6). Growth is likely to falter over the medium term without aggressive fiscal adjustment and structural reforms, owing to declining grant flows and increasing external debt repayments. The longer the adjustment is delayed, the harder it will be for RMI to adjust and achieve self-reliance.

B. Fiscal Adjustment

17. **The FY2006 budget – approved by Parliament in October – is likely to generate a modest surplus, just under a ¼ percent of GDP.** The improvement in the overall balance is a result of a projected rise in revenue, owing in part to the large disbursement of special infrastructure grants. Domestic revenue is also targeted to increase by 2¼ percent of GDP, reflecting higher income tax revenue and a one-off increase in import duties. The budget projects current expenditure to fall in relation GDP, owing mainly to a decline in goods and services that is partly offset by increases in wages and salaries. Capital expenditure is expected to increase markedly as a result of large inflows of external grants earmarked for special projects, related in particular to the renovation of the Majuro airport.

18. **The staff commended the authorities for their efforts to improve the current fiscal situation, but urged the government to aim for a larger fiscal surplus in FY2006.** Staff strongly recommended that consolidation begin immediately and that the government should target a surplus of about 3 percent of GDP for this year in line with medium-term fiscal sustainability. In particular, staff urged that measures be taken to trim the wage bill and to limit expenditure on goods and services not linked to specific Compact funds. Such measures, as shown in the table, could provide savings of about 3 percent of GDP.

Marshall Islands. Alternative Expenditure-Control Measures

	FY2005	FY2006	
		Current	Alternative
(In millions of U.S. dollars)			
Wage bill	29.8	32.5	29.0
Goods and Services	28.6	29.1	28.6
Overall balance	-3.0	0.2	4.1
(In percent of GDP)			
Wage bill	20.6	21.0	18.8
Goods and Services	19.8	18.9	18.5
Overall balance	-2.1	0.1	2.7

19. **The authorities recognized that fiscal consolidation is necessary.** However, they indicated that their immediate focus is to increase revenue in light of recent experience with substantial shortfalls. In this context, they seek to modify the income tax structure and restructure import duties. They also indicated that they are monitoring expenditure by implementing quarterly budget limits. Staff suggested that the authorities consider trimming expenditures by more than what they had incorporated in this year's budget, especially the wage bill, which had increased by 50 percent from FY2002 to FY2004. The authorities expressed concern about the short-term adverse impact on growth. However, in the staff's view the large increase in capital related grants schedule for this fiscal year would help mitigate the initial adverse effects.

20. **Staff argued that larger long-term fiscal adjustment is unavoidable, given the decline in Compact funds and the increase in debt service payments.** Staff urged the government to establish a medium-term consolidation strategy and take concrete steps to implement it as this would signal to the public the government's commitment to put public finances on sound footing and lay the foundation for private-sector growth. Without such measures, growth is likely to decline as financing constraints would cause capital spending to fall along with the step-down in external grant flows in real terms, necessitating a larger and costly adjustment at a later date.

21. **An illustrative long-run scenario based on sound macroeconomic policies underscores the importance of reforms (Annex I).** This scenario, which was discussed with the authorities, shows that a medium-term fiscal adjustment of about 3 percent of GDP starting in FY2007 onward is needed to build reserves in the trust fund. Although the adjustment seems large, it is 1–2 percentage points less than recommended in the past two consultations, thanks to revised GDP figures and commitment of substantial contributions to the Compact Trust Fund by Taiwan Province of China. Combining fiscal adjustment with structural reform would help secure sustainability and improve the productive capacity of the economy and allow real GDP growth to remain steady at around 2½ percent (in line with the average of other Pacific islands), following a possible modest initial weakening of economic activity as a result of the withdrawal of fiscal stimulus. Growth could be even higher if pay-offs from structural reforms were higher, while the amount of the fiscal adjustment would be lower.

22. **The authorities concurred with the staff's view that the amended Compact provided important opportunities to reorient fiscal policy.** They acknowledged that the endowments of the Compact trust fund were not aimed at fully replacing the grants, and agreed that long-term growth could be hampered in the absence of fiscal adjustment. In particular, they agreed that it is important to maintain budget surpluses and build reserves by setting aside the budget surpluses in the trust fund. They also stressed their concern that debt service payments could take up to 3–4 percent of GDP in the medium to long term. Staff agreed that this debt servicing burden was indeed an issue, which as the baseline scenario in Annex I shows, would require small surpluses to meet debt obligations.

23. **To achieve budgetary surpluses of 3 percent of GDP staff recommended that expenditure-control measures in combination with additional revenue-enhancement measures be adopted, including:**

- **Reduction of the wage bill.** Payroll expenditures, which now account for more than 40 percent of current expenditures, have expanded following the downsizing efforts prior to FY2000. While some of this increase has been associated with Compact-related projects, especially in the education sector, restoring payroll expenditure to the levels envisioned under the AsDB Reduction in Force program could significantly reduce current expenditure. In this context, staff strongly supported policies to reduce the number of civil servants, including attrition and limiting recruitment to key areas. The authorities concurred with the staff noting that they were awaiting concrete recommendations from a technical assistance (TA) report on civil service reform, which would guide their medium-term plan to reduce expenditure. The authorities also indicated their immediate intention to enforce attrition of the government workforce and to realign government wages.

- **Restrain public expenditure.** Efforts are needed to limit increases in spending on goods and services to priority sectors under the Compact. The authorities indicated that in the short term expenditure would be reduced by 1 percent of GDP. In addition, they stated that savings could be realized by closely monitoring transportation costs.

- **Measures to revive revenue growth.** Staff welcomed the proposed changes in the tax regime as spelled out in the FY2006 budget speech, including unifying import duties and adjusting the income tax structure. However, staff also encouraged the authorities to take further measures to broaden the tax base, bolster tax administration, simplify the tax structure, and eliminate the cascading effects of sales taxes. A more comprehensive reform of the tax system could be considered in the medium term, perhaps through the introduction of a VAT or consumption tax.

24. **In addition to fiscal policy measures, fiscal management and governance should be strengthened through greater expenditure control and planning and improved revenue administration.**

- **Fiscal management.** There have been some improvements in this area, including the set up of a medium-term budget and investment framework to meet the accountability requirement of the amended Compact agreement. In light of wide fluctuations in both revenue and expenditure, staff suggested that further strengthening of medium-term planning, including improvements to financial control and reporting, and linking the current year budget to the medium-term framework, could help the authorities maintain fiscal sustainability. The authorities agreed with this suggestion and stated that as a first step, they had initiated a quarterly budget allocation program to better monitor expenditures.

- **Revenue administration.** Progress is also being made in customs reform, but decisive measures to improve governance and administration are needed, including by implementing a data processing and customs management system. In this context, staff supported the authorities' intention to phase in, over the next two or three years, the tax reform program based on improvements in revenue collection and administration, including building a culture and operational capacity in enforcement and compliance. Staff commended the authorities' recent decision to centralize the licensing of import of alcohol and tobacco.

- **Governance.** Staff urged the government to avoid nontransparent quasi-fiscal transactions, such as the FY2003 large trust fund deposit with the development bank, which was then onlent to struggling businesses. This set of transactions was of particular concern as there was a substantial risk that the loans would not be repaid.

25. **Staff strongly recommended prudent management of the Compact Trust Fund in line with international best practices** and the IMF *Guide on Resource Revenue Transparency*, including through a sound, transparent, and accountable governance structure. Furthermore, staff urged that budgetary saving be used to increase the endowment, especially in light of uncertainty on revenue performance. The authorities noted that they were disappointed by the delay in investing the trust fund, but welcomed the recent transfer of the fund and the appointment of an asset manager. They indicated that the public disclosure of reports on the Trust fund's performance has not yet been decided.

C. Structural Reforms to Promote Private Sector Growth

26. **The authorities agreed with staff that private sector growth was key to economic development.** They explained that they are in the process of addressing a number of factors that have impeded private sector development. In this regard, staff urged the authorities to put priority on achieving progress in the following areas:

- **Human resources.** Despite previous efforts to downsize public sector employment, the government continues to be the largest employer. Public sector wages are higher than those in the private sector, hampering labor mobility. In addition, government wages tend to drive up private-sector wages and salaries. Staff recommended and the authorities concurred that greater wage differentiation between skill levels be adopted in the public sector. Furthermore, staff suggested that the minimum wage legislation be reviewed with the objective of lowering the cost of doing business and reducing distortions to the labor market. The authorities noted that their proposed restructuring of the income tax structure, which would increase the initial level of taxable income, in part addresses the minimum wage issue.

- **Role of the public sector.** The government should limit direct and indirect subsidies, which are mainly for copra and inter-island shipping, and move toward managing public enterprises on a commercial basis. The authorities, in general, agreed that subsidies needed to be reduced. They indicated that all exemptions on diesel fuel had been eliminated except those related to electricity. In this context, staff welcomed the recent changes in the electricity pricing mechanism to better reflect world energy prices.

- **Private sector participation.** Staff commended the recent efforts by the authorities to involve the private sector in the reform program by holding outreach retreats and recommended that these efforts be maintained. The authorities noted that they intend to meet more regularly with the business community to share information about government operations and address public concerns. They stated that they have started this process, by holding discussions with the Chamber of Commerce to highlight recent improvements in the customs area, including a program that has been put in place for addressing problems such as smuggling.

- **Capacity constraints on implementation of infrastructure projects.** The new process for implementing capital projects and disbursing sectoral grants as required under the amended Compact agreement has prompted the government to reform its operations, policies, and priorities. Staff welcomed the progress made to extend performance budgeting review beyond the "priority" ministries as required by the amended Compact. Staff encouraged the authorities to continue these efforts to help avoid delays in the implementation of capital projects and improve management practices.

- **Restrictions on foreign investment.** While some progress had been made in streamlining the approval process for foreign investment, it is still often hampered by limited access to land for development, administrative delays in processing the needed licenses, and specific restrictions on permitted areas for foreign investment. Staff welcomed the authorities' plan to amend the Foreign Direct Investment Act in the upcoming Parliamentary session, with measures that are conducive to private sector participation, including streamlining the application process and clarifying existing regulations to remove ambiguities and loopholes. These changes could reduce the cost of doing business and help attract foreign business and eventually contribute to growth and employment.

27. **The authorities acknowledged that progress had been slow on land tenure and secure lending issues.** Currently there are no official records that provide clear and legal evidence of ownership or rights to land, leading to the possibility of disputes and creating uncertainty for potential investors. Since Parliament passed legislation in 2003 to establish a land registry little progress has been made. To date, only one land title has been issued while four other cases are pending. While these measures go in the right direction, further efforts are needed to increase land registration, including expanding outreach programs and possibly lowering application costs, especially for residents of the outer atolls. In addition, RMI still has no effective framework for secured lending against movable property. Clarifying and updating the legal framework for secured lending would lower financial intermediation costs and reorient bank lending toward the private commercial sector.

D. Financial Sector

28. **More decisive steps are needed to strengthen the RMI's financial infrastructure and harness domestic savings for financing growth.** The lack of collateral and the difficulties of foreclosing on defaulters have been significant impediments to business lending. As a result, a significant proportion of commercial bank assets are held in deposits overseas, and lending is concentrated on consumer loans. In addition, the recent loss of the Bank of Marshall Island's correspondent banking relationship, which inhibits its processing of foreign transactions, has resulted in a large shift of demand deposit accounts from BoMI to the remaining commercial bank, thereby reducing competition in the banking sector. Although the short-run impact of this loss seems to be more of an inconvenience, there is a risk that the longer-run impact could be to dampen bank lending if depositors shifted not only demand deposits ($5 million to date), but also other funds away from BoMI to the Bank of

Guam, which tends to maintain only a small loan portfolio in RMI. Staff recommended that the Banking Commission closely monitor the situation.

29. **More generally, staff recommended that financial sector supervision be further strengthened.** While the Banking Commission has begun on-site and off-site supervision, additional steps are needed to continue to improve data and information collection. The authorities concurred with the staff's assessment that the development bank, which is currently not subject to supervision and engages in a broad range of commercial lending activities, should be placed under the supervision of the Bank Commission. While the RMI has taken a number of decisive steps to discourage money laundering and the financing of terrorism, including adopting a modern and comprehensive anti-money laundering law and enforcing regulations, staff encouraged the tightening of controls and reporting requirements for the shipping trust company, which is not currently subject to oversight, although it reports to the Minister of Transport and Communication. Increased monitoring of the ship registry would strengthen the efficacy of the AML/CFT regime and reduce potential risk to their reputation.

E. Other Issues

30. **The RMI's trade regime is relatively open.** The general import duty is currently 8 percent with 5 percent applying to foodstuffs, although a number of products, mainly luxury items such as cars, tobacco products and alcoholic beverages, are subject to other rates ranging from 15 to 150 percent. The authorities indicated that changes to import duties to a uniform rate of 6 percent, while maintaining high tariffs on luxury items and other selected goods, will be considered in the next session of Parliament. Staff viewed this move to simplify import duties as a step in the right direction, which could increase revenue. At present, there are no quantitative restrictions on imports or other significant nontariff barriers to trade, and RMI does not face any difficulties in accessing export markets. The RMI is a member of the Pacific Forum, and is involved in ongoing discussions with the European Union on a trade arrangement under the Economic Partnership Agreement. The RMI is negotiating regional trade arrangements within the Pacific, including the Pacific Agreement on Closer Economic Relations and the Pacific Island Countries Trade Agreement.

31. **There is a need to improve the reliability, coverage, and timeliness of economic statistics for monitoring and policy evaluation.** Staff commended the ongoing efforts to improve data collection, especially in the area of budget monitoring and welcomed the recent efforts to improve the national accounts data. Staff and the authorities concurred that the statistical office would benefit from additional technical assistance to build capacity, especially to maintain the national accounts system. In the longer term they would benefit from help in refining the balance of payments estimates compiled by the Article IV mission and hands on training with the compilation of the fiscal data in Government Financial Statistic (GFS) format. The authorities stressed that they welcomed hands-on help that they have currently received to develop capacity, rather than a list of areas that need improvement without further guidance. They also stated that they understood the value of membership of

the GDDS project, but felt that there was little scope to devote resources to it without more staff engaged in the office.

IV. Staff Appraisal

32. **The policy challenge for RMI is to advance economic self reliance, which will require major, possibly painful, reforms.** Given the anticipated declines in Compact grants and increasing debt service payments, the large government sector will become increasingly unsustainable. Thus, significant fiscal and economic reforms are needed over the medium term to put public finances on a secure footing and encourage private sector development. Prompt adjustment is necessary to avoid more serious fiscal strains. The longer the adjustment is delayed the harder it will be for the country to adjust and achieve economic self-reliance.

33. **In recent years, the authorities have taken steps to place RMI on the path to sustainable development.** Notably, the government has retired high-cost commercial debt and built reserves in order to meet its mandatory contribution requirement to the Compact Trust Fund. In addition, with the help of donors and multilateral agencies, the authorities have begun to augment the government's institutional capabilities, including fiscal budgeting, management, and enhanced financial sector supervision. However, limited progress has been made on many significant structural issues.

34. **In the short term, the government's first priority should be to achieve a larger fiscal surplus in FY2006.** Given the size of the medium-term fiscal adjustment that is necessary to achieve economic self-reliance, consolidation should begin immediately. Ongoing revenue measures would ideally be complemented by action to reduce the wage bill and limit increases in expenditure on goods and services not linked to specific Compact funds. Such measures could provide budgetary savings of around 3 percent of GDP in FY2006.

35. **In the medium term, budgetary surpluses of 3 percent of GDP per annum are needed to ensure fiscal sustainability and allow real GDP growth to remain steady at around 2½ percent (in line with the average of other Pacific islands).** To achieve this degree of consolidation requires substantial cuts in current expenditure in combination with revenue enhancing measures. Policy measures should focus on limiting payroll expenditure and other current expenditure to more sustainable levels. To safeguard core expenditures, revenue measures should contribute to the medium-term adjustment. In this regard, staff welcomed the proposed changes in tax regime as spelled out in the FY2006 budget speech. Further measures should be implemented to revive revenue growth by broadening the tax base, bolstering tax revenue, and simplifying the tax structure. It is also important that the government avoid further external borrowing and efforts should be made to reduce external debt, which is presently about 70 percent of GDP.

36. **In addition, improved fiscal management and governance are necessary.** Steps need to be taken to improve financial control and reporting, and linking the current year

budget to the medium-term framework. Also, decisive measures are necessary to improve governance and administration, including implementing a new customs management system. The recently established Compact Trust Fund needs to be managed in line with international best practices, including through a sound, transparent and accountable governance structure.

37. **Structural reforms are essential to promote sustainable private sector growth.** The main focus for the authorities' reform agenda should be the removal of obstacles for private sector development in key areas. In this regard, further efforts to expand participation in land registration are needed, such as conducting outreach programs and lowering application costs. In addition, updating and clarifying the legal framework for secured lending would also help lower intermediation costs and facilitate the reorientation of commercial bank lending activities toward the private commercial sector. At the same time, the government should take steps to foster greater wage differentiation between skill levels, especially in the public sector.

38. **Measures are required to address current constraints on bank lending.** In order for the banking system to play a full role in the development of the economy, factors that currently impede lending, including the difficulties of using land as collateral and of foreclosing, need attention. In addition, the Banking Commission should monitor closely the consequences of the loss of the correspondent banking relationship for the Bank of the Marshall Islands, which is inhibiting the processing of foreign transactions and to some extent has reduced competition in the banking sector. Although the short-run impact seems to be more of an inconvenience, there is a risk that the longer-run impact could be to dampen bank lending if depositors shifted funds away from BoMI to the Bank of Guam, which tends to maintain only a small loan portfolio in RMI.

39. **Further efforts are needed to strengthen financial supervision.** While the Banking Commission conducts periodic on-site and off-site supervision of the two commercial banks, additional steps are needed to improve data and information collection, including loan quality and remittances. An important priority is to place the development bank under the supervision of the Banking Commission, limiting permitted activities, and its focus should be shifted from consumer loans to more traditional lending activities for a development bank. Also, tighter controls and reporting requirements for the shipping trust company should be put in place. Such a regime will strengthen the efficacy of the AML/CFT regime.

40. **Statistical deficiencies and lack of reporting to the Fund continue to impede effective surveillance.** There are deficiencies in fiscal, monetary, and external data, although recent progress has been made on improving GDP statistics. Further efforts are needed to improve data collection and dissemination.

41. **It is recommended that the next Article IV consultation take place on the 24-month cycle.** The authorities expressed interest in an interim staff visit.

Table 1. Marshall Islands: Basic Data, FY2001–06 1/

Nominal GDP (2004/05): US$ 144.4 million
Population (2004): 57,659
GDP per capita (2003/04): US$ 2,559
Quota: SDR 3.5 million

	2001	2002	2003	2004	Est. 2005	Proj. 2006
Real sector						
Real GDP (percent change)	5.5	4.0	1.8	0.4	3.5	4.0
Consumer prices (percent change)	1.8	-0.4	-0.9	2.0	3.5	2.9
Central government finances (in percent of GDP)						
Revenue and grants	70.1	64.2	65.0	56.2	58.1	69.6
Total domestic revenue	20.3	22.2	22.4	24.7	21.0	23.3
Grants	49.9	42.0	42.6	31.5	37.1	46.2
Expenditure	61.9	68.2	54.0	56.6	60.2	69.4
Current	56.6	53.8	48.9	51.8	48.3	46.7
Capital	5.3	14.3	5.1	4.8	11.9	22.8
Overall balance	8.2	-4.0	11.0	-0.4	-2.1	0.1
Usable government financial assets (in millions of US$; end of period) 2/	4.2	2.7	2.9	4.5	1.1	0.3
Compact Trust Fund (in millions of US$; end of period) 3/	…	…	…	32.0	47.1	60.4
Commercial banks (in millions of US$; end-December) 4/						
Foreign assets	31.7	40.1	48.4	52.3	53.8	…
Private sector claims	40.7	41.2	43.1	43.9	43.1	…
Total deposits	62.2	69.4	72.2	75.4	73.5	…
One-year time deposit rate (in percent)	4.1	4.0	3.9	2.0	2.0	…
Average consumer loan rate (in percent)	16.5	16.5	16.1	19.0	19.0	…
Balance of payments (in millions of US$)						
Trade balance	-69.4	-59.2	-63.3	-57.4	-69.3	-82.8
Net services	-3.4	-6.3	-3.6	-1.7	-6.9	-7.9
Net income	30.6	34.9	41.5	33.3	35.6	38.7
Private and official transfers	51.1	39.2	41.7	30.2	41.0	58.7
Current account including official transfers	8.8	8.6	16.3	4.4	0.4	6.6
(In percent of GDP)	7.6	6.9	12.7	3.3	0.3	4.3
Current account excluding official transfers	-49.3	-43.6	-38.3	-38.2	-53.2	-64.8
(In percent of GDP)	-42.3	-35.2	-29.9	-28.2	-36.9	-42.0
Overall balance 5/	-5.2	13.5	16.4	-23.5	-5.9	-3.3
(In percent of GDP)	-4.5	10.9	12.8	-17.3	-4.1	-2.1
External debt (in millions of US$; end of period) 6/	89.8	87.6	91.2	103.4	100.8	98.2
(In percent of GDP)	77.0	70.6	71.2	76.4	69.8	63.6
External debt service (in millions of US$)	26.3	3.2	4.1	4.1	6.2	4.7
(In percent of exports of goods and services)	135.8	15.1	16.9	14.6	24.4	18.1
Exchange rate						
Exchange rate regime	U.S. dollar is the domestic currency					
Memorandum Item:						
Nominal GDP (in millions of US$)	116.5	124.1	128.1	135.4	144.4	154.5

Sources: Data provided by the RMI authorities; and Fund staff estimates.

1/ Fiscal year ending September 30.

2/ Cash and cash equivalents that are not reserved for specific uses.

3/ Assets in trust funds are treated as non-usable.

4/ Data refer to December within the fiscal year; for example, FY2001 refers to December 2000.

5/ Large negative overall balance in FY04 reflects official capital outflow to the Compact Trust Fund.

6/ Government and government-guaranteed debt only.

Table 2. Marshall Islands: Social Indicators, 2003

	Marshall Islands	Same Region/Income Group East Asia and Pacific	Middle Income
Population			
Total population, mid-year (millions)	0.1	1,855	2,989
Growth rate (percent annual average)	3.7 1/	1.0	0.9
Urban population (percent of population)	66.4 2/	39.1	52.6
Total fertility rate (births per woman)	3.9 3/	2.1	2.1
Life expectancy at birth (years)			
Total	70 3/	70	70
Male	68 3/	68	67
Female	72 3/	71	72
Mortality			
Infant (per thousand live births)	29 3/	32	30
Under 5 (per thousand live births)	61 2/	41	37
School enrollment (percent of school age population)			
Primary school	84 1/	93	93
Female	...	94	93
Access to safe water (percent of population)	85 2/,4/	78	83
Immunization rate (percent of children ages 12-23 months)			
Measles	90 2/	82	87
GDP per capita (US$)	1,854 5/	1,050	1,951

Sources: UNDP, Human Development Report 2004; World Bank, World Development Indicators (WDI) 2005; CIA, The World Factbook; and RMI, 1999 Census of Population and Housing (CPH).

1/ CPH; 1999.
2/ WDI.
3/ CIA; 2005 estimate.
4/ 2002.
5/ FY2004 estimate.

Table 3. Marshall Islands: Balance of Payments, FY2001–06 1/

(In millions of U.S. dollars)

	2001	2002	2003	2004	Est. 2005	Proj. 2006
Trade balance	-69.4	-59.2	-63.3	-57.4	-69.3	-82.8
Exports, f.o.b.	10.0	11.4	14.2	15.7	16.5	16.2
Imports, f.o.b.	-79.4	-70.6	-77.5	-73.1	-85.8	-99.0
Net services	-3.4	-6.3	-3.6	-1.7	-6.9	-7.9
Receipts	9.3	9.6	10.3	12.1	9.0	9.6
Travel	3.1	3.4	4.0	5.0	5.5	6.0
Transshipments	1.3	1.2	1.1	1.3	1.4	1.4
Other	4.9	5.1	5.1	5.7	2.1	2.2
Payments	-16.8	-20.2	-17.5	-16.6	-18.6	-20.1
Freight and insurance	-7.8	-10.6	-11.6	-11.0	-12.9	-14.9
Transportation	-1.7	-2.5	-2.1	-1.7	-1.7	-1.8
Communications	0.0	0.0	0.0	0.0	0.0	0.0
Other	-7.3	-7.1	-3.8	-3.9	-4.0	-3.4
Other	4.0	4.3	3.6	2.8	2.7	2.5
Net income	30.6	34.9	41.5	33.3	35.6	38.7
Receipts	33.2	37.0	43.6	35.6	38.1	40.9
Fishing rights fees	2.9	3.3	1.7	0.9	1.5	2.4
Registration fees	0.7	0.6	1.0	1.0	1.0	1.0
Interest and dividend earnings	2.6	-0.2	7.4	1.0	1.7	3.0
Labor income	18.6	17.7	17.8	17.6	18.6	19.1
Other	8.4	15.6	15.6	15.0	15.2	15.5
Payments	-2.6	-2.1	-2.1	-2.3	-2.5	-2.3
Interest payments	-2.6	-2.1	-2.1	-2.3	-2.5	-2.3
Unrequited transfers	51.1	39.2	41.7	30.2	41.0	58.7
Private	-7.0	-13.0	-12.9	-12.4	-12.6	-12.8
Inflows	0.6	0.4	0.3	0.3	0.4	0.4
Outflows	-7.7	-13.4	-13.2	-12.7	-13.0	-13.2
Official	58.1	52.2	54.6	42.6	53.6	71.4
Compact grants 2/	31.4	32.7	32.7	20.5	35.4	37.5
Other	26.7	19.5	21.9	22.1	18.2	34.0
Current account including official transfers	8.8	8.6	16.3	4.4	0.4	6.6
(In percent of GDP)	7.6	6.9	12.7	3.3	0.3	4.3
Current account excluding official transfers	-49.3	-43.6	-38.3	-38.2	-53.2	-64.8
(In percent of GDP)	-42.3	-35.2	-29.9	-28.2	-36.9	-42.0
Capital and financial account	-16.9	2.0	-6.8	-27.7	-7.5	-10.3
Direct investment, net	0.1	0.1	-1.9	0.1	2.1	0.1
Short-term liabilities, net 3/	-2.2	-6.6	-8.1	-4.9	-4.9	-5.6
Medium-term liabilities, net	-14.8	8.6	3.3	2.1	-2.2	-2.3
Inflows	9.2	9.6	4.3	2.3	0.0	0.0
Outflows	-24.0	-1.1	-1.1	-0.2	-2.2	-2.3
Other net government flows 4/	0.0	0.0	0.0	0.0	0.0	0.0
Of Which:						
Transfer to Compact Trust Fund	…	…	…	-25.0	-2.5	-2.5
Errors and omissions	2.9	2.9	6.9	-0.2	1.2	0.4
Overall balance	-5.2	13.5	16.4	-23.5	-5.9	-3.3
Gross official reserves 5/	4.2	18.4	34.1	10.6	4.8	1.5
Of which: usable government financial assets	4.2	2.7	2.9	4.5	1.1	0.3
(In months of imports of goods and services)	0.5	0.4	0.4	0.6	0.1	0.0

Sources: Data provided by the RMI authorities; and Fund staff estimates.

1/ Fiscal year ending September 30.

2/ Compact funding pertaining to the Kwajalein Atoll Trust Fund and Kwajalein resident and landowner compensation payments are classified as income rather than official transfers.

3/ Includes changes in social security fund investments, banking system assets held overseas, and government assets held in the capital and special fund accounts.

4/ Changes in government assets, excluding the general fund.

5/ Including MIITF which is deposited in domestic financial institutions.

Table 4. Marshall Islands: External Vulnerability Indicators, FY2001–06

	2001	2002	2003	2004	Est. 2005	Proj. 2006
Financial indicators 1/						
Commercial bank deposits (12-month percent change)	2.9	15.3	4.0	4.4	-2.5	...
Private sector credit (12-month percent change)	3.3	1.2	4.6	1.8	-1.8	...
Foreign assets/total assets (percent)	43.0	48.1	52.4	54.4	56.8	...
Nonperforming loans (in percent of total loans) 2/	2.4	2.5	1.5	2.0	2.0	...
External indicators						
Exports (percent change)	14.7	13.5	24.4	10.8	5.2	-1.8
Imports (percent change)	-4.6	-11.1	9.8	-5.7	17.3	15.4
Current account balance (percent of GDP)						
Including official transfers	7.6	6.9	12.7	3.3	0.3	4.3
Excluding official transfers	-42.3	-35.2	-29.9	-28.2	-36.9	-42.0
Capital and financial account balance (percent of GDP)	-14.5	1.7	-5.3	-38.9	-6.9	-8.3
Of which : FDI (in millions of U.S. dollars)	0.1	0.1	-1.9	0.1	2.1	0.1
Gross official reserves (in millions of dollars) 3/	4.2	18.4	34.1	10.6	4.8	1.5
Gross official reserves (in months of imports of goods and services)	0.5	2.4	4.3	1.4	0.5	0.1
Gross official reserves (in percent of broad money)	...	...	...	...	...	...
Short-term external debt	...	...	...	...	...	...
Total external debt (percent of GDP)	77.0	70.6	71.2	76.4	69.8	63.6
Total external debt (in percent of exports of goods and services)	464.2	416.8	373.1	372.4	395.0	379.8
External debt service (in percent of exports of goods and services)	135.8	15.1	16.9	14.6	24.4	18.1

Sources: Data provided by the RMI authorities; and Fund staff estimates.

1/ Financial indicators are on calendar year basis.

2/ Preliminary figures. Defined as loans with arrears in excess of 90 days.

3/ Measured by the end-of-period stock of government financial assets held in commercial banks. The large reduction in FY2004 is mainly attributable to a $25 million transfer from the intergenerational trust fund to the Compact Trust Fund, which will be majority-controlled by the United States.

Table 5. Marshall Islands: Central Government Finances, FY2001–06 1/

	2001	2002	2003	2004	Est. 2005	Proj. 2006
	(In millions of U.S. dollars)					
Total revenue and grants	81.7	79.7	83.3	76.1	83.9	107.5
Total domestic revenue	23.6	27.5	28.7	33.4	30.3	36.0
Taxes	18.4	20.1	23.1	22.5	22.1	25.9
Income	9.6	9.6	12.0	10.6	9.8	11.2
Gross revenue	3.8	3.5	3.4	4.0	2.9	4.2
Imports	4.0	6.0	6.6	6.2	7.8	8.7
Other	0.9	1.0	1.0	1.7	1.6	1.8
Nontax	5.3	7.4	5.6	11.0	8.1	10.1
Fishing rights	1.8	3.3	1.7	0.9	1.5	2.4
Fees and charges 2/	1.0	1.6	0.8	7.8	4.9	5.7
Investment income	0.4	0.4	0.2	0.1	0.0	0.2
Other	2.0	2.1	2.8	2.1	1.7	1.8
Grants	58.1	52.2	54.6	42.6	53.6	71.4
Of which : current grants	34.8	32.9	35.4	39.5	39.7	57.9
Compact 3/	31.4	32.7	32.7	20.5	35.4	37.5
Other	26.7	19.5	21.9	22.1	18.2	34.0
Total expenditure	72.1	84.6	69.2	76.6	86.9	107.3
Current expenditure	65.9	66.8	62.6	70.1	69.7	72.1
Wages and salaries	18.8	21.5	25.6	30.7	29.8	32.5
Goods and services	30.2	30.8	26.1	30.6	28.6	29.1
Interest payments	1.5	0.6	0.9	0.8	1.1	0.8
Subsidies to public enterprises	4.2	5.4	3.1	4.8	5.3	4.5
Other subsidies and transfers	11.2	8.6	7.0	3.2	4.9	5.2
Capital expenditure 4/	6.2	17.8	6.6	6.5	17.2	35.2
Current balance	-7.6	-6.4	1.4	2.8	0.3	21.9
Overall balance	9.6	-4.9	14.1	-0.5	-3.0	0.2
Financing	9.6	-4.9	14.1	-0.5	-3.0	0.2
Net government debt repayment	14.8	-8.6	-3.3	-2.1	0.4	1.0
Principal repayment	24.0	1.1	1.1	0.2	0.4	1.0
Gross borrowing	9.2	9.6	4.3	2.3	0.0	0.0
Change in government financial assets	-5.2	3.6	17.3	1.5	-3.4	-0.8
Of which : Trust Fund	…	16.2	17.1	7.5	10.1	10.7
	(In percent of GDP)					
Revenue and grants	70.1	64.2	65.0	56.2	58.1	69.6
Revenue	20.3	22.2	22.4	24.7	21.0	23.3
Grants	49.9	42.0	42.6	31.5	37.1	46.2
Expenditure	61.9	68.2	54.0	56.6	60.2	69.4
Current	56.6	53.8	48.9	51.8	48.3	46.7
Capital	5.3	14.3	5.1	4.8	11.9	22.8
Current balance	-6.5	-5.2	1.1	2.1	0.2	14.2
Overall balance	8.2	-4.0	11.0	-0.4	-2.1	0.1
	(In millions of U.S. dollars)					
Memorandum items:						
Foreign Contributions	...	...	...	7.2	12.8	11.0
Compact Trust Fund	...	...	...	7.0	12.6	10.7
Disaster Fund	...	...	...	0.2	0.2	0.2
Trust Fund Balances	…	15.0	31.2	38.2	51.2	62.0
Intergenerational	…	15.0	31.2	6.2	3.7	1.2
Compact	…	…	…	32.0	47.1	60.4
Disaster	…	…	…	…	0.4	0.4
Total government financial assets	29.0	32.6	50.0	58.7	68.2	78.3
Of which						
Usable government financial assets 5/	4.2	2.7	2.9	4.5	1.1	0.3
Outstanding government debt	49.6	58.2	62.4	64.5	64.2	63.2
Government Guaranteed Debt	40.1	29.4	28.7	38.9	36.6	35.1
Nominal GDP	116.5	124.1	128.1	135.4	144.4	154.5

Sources: Data provided by the RMI authorities; and Fund staff estimates.

1/ The fiscal year ends on September 30.
2/ From FY2004 onward figures include fees and charges related to the Ministry of health health fund.
3/ Does not include Compact funds earmarked for Kwajalein rental payments and trust fund contributions.
4/ For FY02, capital expenditure include a $10.4 million loan write-off of two public enterprises. For FY05, capital expenditure include an additional $6 million financing of capital projects. For FY06, projections include $16 million grant for the construction of an Airport and a $6 million for capital projects.
5/ Cash and cash equivalents that are not reserved for specific uses.

Table 6. Marshall Islands: Medium-term Scenario, FY2006–11 1/

	2006	2007	2008	2009	2010	2011
Real sector						
Real GDP (percent change)	4.0	3.5	3.0	2.5	2.3	1.8
Consumer prices (percent change)	2.9	2.4	2.4	2.4	2.4	2.4
Central government finance (in percent of GDP)						
Revenue and grants	69.6	60.1	58.4	57.2	56.0	55.0
Total domestic revenue	23.3	22.0	21.8	21.7	21.6	21.5
Grants	46.2	38.1	36.7	35.5	34.4	33.6
Expenditure	69.4	59.3	57.8	56.6	55.4	54.6
Current	46.7	46.3	45.7	45.5	45.4	45.0
Capital	22.8	13.0	12.2	11.1	10.1	9.5
Overall balance	0.1	0.8	0.6	0.6	0.5	0.5
Usable government financial assets						
(In millions of US$; end of period) 2/	0.3	0.4	0.4	0.4	0.5	0.4
Trust Funds (in millions of US$; end of period) 3/	60.4	76.1	93.4	112.4	133.4	156.3
Balance of payments (in millions of US$)						
Trade balance	-82.8	-68.0	-66.5	-70.0	-73.4	-76.5
Net services	-7.9	-5.2	-4.5	-4.5	-4.4	-4.1
Net income	38.7	39.9	41.1	42.3	43.4	44.6
Private and official transfers	58.7	40.3	40.1	39.5	39.3	39.1
Current account including official transfers	6.6	7.0	10.3	7.3	5.0	3.1
(In percent of GDP)	4.3	4.3	5.9	4.0	2.6	1.5
Current account excluding official transfers	-64.8	-46.3	-43.0	-45.6	-47.9	-49.8
(In percent of GDP)	-42.0	-28.2	-24.9	-25.2	-25.2	-25.2
Overall balance	-3.3	-0.2	0.1	0.0	0.0	0.0
(In percent of GDP)	-2.1	-0.1	0.0	0.0	0.0	0.0
External debt (in millions of US$; end of period) 4/	98.2	98.3	95.8	95.0	91.8	90.1
(In percent of GDP)	63.6	60.0	55.5	52.4	48.3	45.5
External debt service (in millions of US$)	4.7	5.0	5.9	5.7	6.0	6.0
(In percent of exports of goods and services)	18.1	18.6	20.4	18.7	18.4	17.3

Sources: Data provided by the RMI authorities; and Fund staff estimates.

1/ Fiscal year ending September 30.
2/ Cash and cash equivalents that are not reserved for specific uses.
3/ Assets in trust funds are treated as non-usable.
4/ Government and government-guaranteed debt only.

MARSHALL ISLANDS: LONG-RUN FISCAL ADJUSTMENT SCENARIOS

The assumptions in both illustrative scenarios are based on the economic provisions of the amended Compact (outlined in Box 2).

Baseline

The authorities run a small surplus, necessary to meet debt obligations. Fiscal reserves remain at very low levels, and the authorities make only modest headway in reducing expenditure and increasing revenue. This reflects spending pressures from a growing population, difficulties in reducing public expenditure in a society that is characterized by traditional relationships built on the exchange of patronage, and an underdeveloped private sector. Current expenditure decreases annually by about ¼ percent of GDP, forced essentially by financing constraints. Revenue growth lags real GDP growth by ½ percentage point, roughly in line with the tax elasticity of the past decade.

Fiscal expenditure shrinks over the medium term as grant inflows decline. The burden of adjustment falls mostly on capital spending—including infrastructure maintenance—leading to weaker growth. At the end of the Compact, the RMI draws the *entire* annual returns from the trust fund, causing the fund to begin to decline in real terms. Initially, the real GDP growth rate is 2¼ percent per annum, but it gradually falls to zero as government expenditure declines and private sector growth remains anemic.

Adjustment

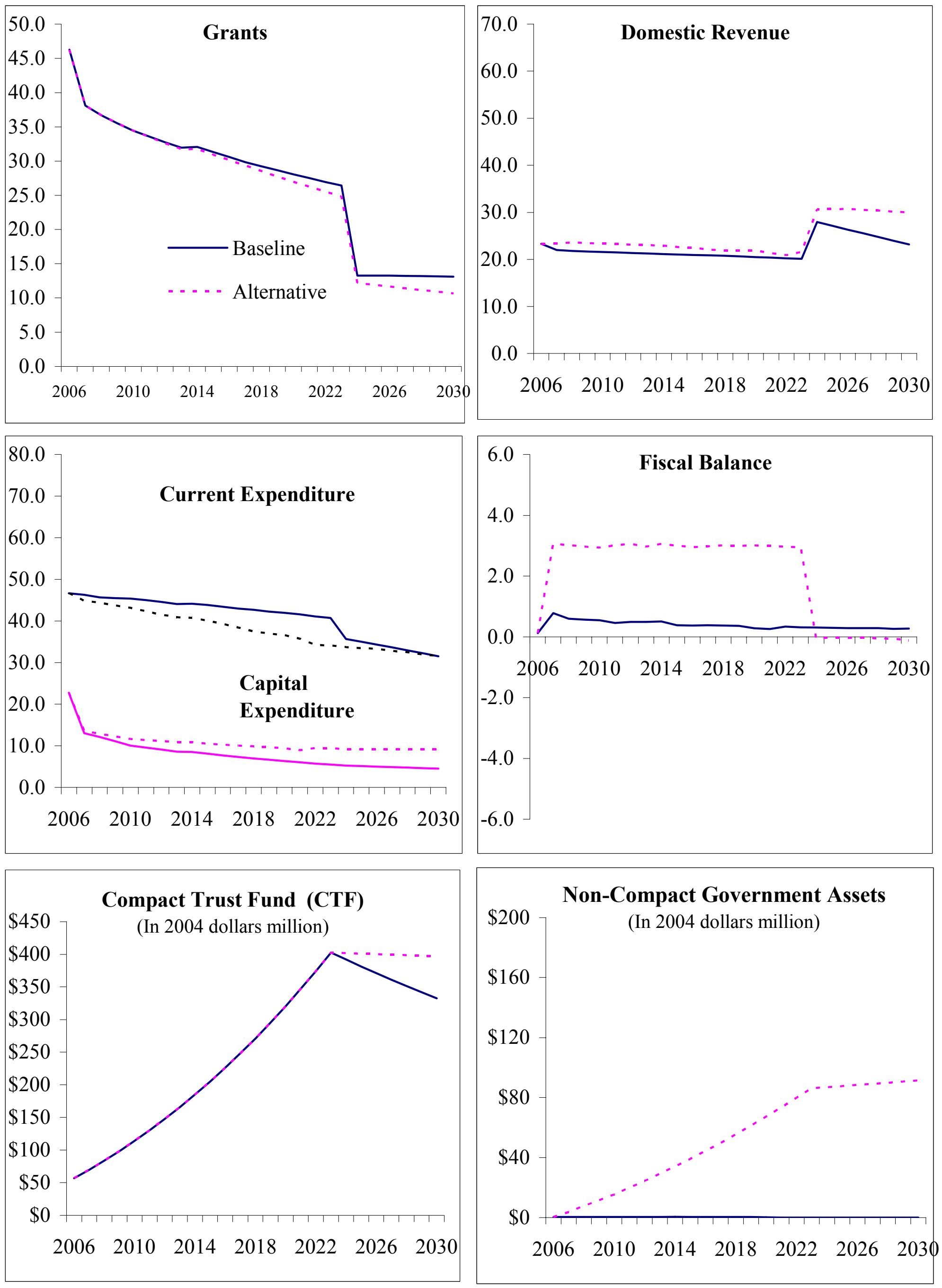
The authorities pursue an adjustment strategy including: concerted expenditure control, improved tax administration and reform, and enhanced fiscal management and governance; public investment in priority areas, especially health, education, and infrastructure; and limited withdrawals from the trust fund to maintain its real value after FY2023.

A budget surplus of about 3 percent of GDP is targeted from FY2006 onward. Despite reduced Compact inflows, the government is able to build sizeable reserves while maintaining capital expenditure at near 10 percent of GDP. It is notable that the government's commitment to build reserves in the trust fund during the past four years has been supported by the public. This secures long-term fiscal sustainability, improves the productive capacity of the economy, and allows real GDP growth to remain steady at around 2½ percent (in line with the average of other Pacific islands).

There are other ways to reach this same outcome. For example, another alternative adjustment strategy—based on lower surpluses in the near to medium term owing to even higher capital expenditure than the 10 percent of GDP assumed in the adjustment scenario (primarily financed through Compact grants)—could possibly deliver higher growth in the long run and hence help maintain the real value of the trust fund after 2023. However, the returns on such an investment, like human capital, could take years to materialize and are difficult to quantify, especially in light of the substantial migration flows of higher-skilled workers to the United States. Following such a strategy could be a missed opportunity to save and build reserves for longer-term sustainability and stability.

Marshall Islands: Long-Term Fiscal Adjustment Scenarios: FY2006–30 [1]

(In percent of GDP)



[1] From FY2024 onward, interest income from the trust fund is considered as part of domestic revenue.

MARSHALL ISLANDS: FUND RELATIONS
(As of November 30, 2005)

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

II. **General Resources Account:**

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

III. **SDR Department:**

	SDR Million	Percent Allocation
Holdings	None	n.a.

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

V. **Financial Arrangements:** None

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

VII. **Exchange Rate Arrangements:**

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

VIII. **Article IV Consultation:**

The Marshall Islands is on a 24-month consultation cycle. The 2003 Article IV consultation discussions were held during October 17–28, 2003. The Executive Board discussed the staff report and concluded the consultation on January 26, 2004.

IX. **Technical Assistance:** As indicated below.

X. **Resident Representative:** None

Marshall Islands: Technical Assistance from Headquarters, 1992–2005

Source	Purpose	Time of Delivery
FAD	Assess technical assistance needs in fiscal management	August 1992
LEG	Banking legislation	March 2003
MAE	Assess technical assistance needs in banking supervision	August 1992
MAE	Banking Commissioner	October 1994– July 1996
MAE	Preliminary assessment of off-shore financial center	March 2000
MAE	Assessment of off-shore financial center	May 2002
MFD	Follow-up OFC/AML/CFT	February 2004
MFD	Bank supervision	March 2004
MFD	Bank supervision	February 2005
STA	Assess technical assistance needs for the development of economic statistics	August 1992
STA	Establish reporting system for banking statistics	April 1993

MARSHALL ISLANDS: RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE[1]

The PFTAC's assistance to the RMI has mostly focused on financial supervision and public expenditure management. Most of the assistance was provided prior to 2003 and there have been no missions to RMI in the last two years. The RMI sent officials to regional seminars and workshops, and the PFTAC organized one secondment in banking supervision.

Public Financial Management

There was a heavy concentration of missions in the period prior to 2003. An ongoing action plan was developed covering basic improvements from a very low base included a timetable for budget preparation, enhanced internal consistency of numbers, and a simple medium-term budgeting framework. However, implementation of the action plan has slipped and other donors have now become involved in the reform process.

Tax Administration and Policy

In July 2003, PFTAC designed a modernization strategy and action plan for customs, including improvements to the Customs Act, automation, compliance units, and training. No progress was made on those reforms. The authorities have recently shown renewed interest in tax reforms and, if requested, PFTAC will provide resources to assess the revenue system, design a tax administration modernization plan, and review exemptions.

Financial Sector Regulation and Supervision

The Centre provided substantial hands-on training to the two previous Banking Commissioners, covering both on-site and off-site inspections. The last Commissioner benefited from attendance at two PFTAC-sponsored regional conferences on banking supervision, and participated in a course run by the U.S. Federal Reserve Board in 2002. Following involvement with the Offshore Financial Centers assessment in 2002, PFTAC provided assistance to draw up a program to better comply with the Basel Core Principles and also guided the RMI during the closure of a foreign bank's branch operations.

Economic and Financial Statistics

An August 2002 review of the statistical system recommended an increase in staffing and proposed a two-year work program. Statistical work was then integrated into the new Economic Policy, Planning and Statistics Office. A June 2003 update recommended the use of an external advisor and further efforts to recruit and train staff for the unit as donor agencies, including the U.S. Census Bureau, need more and better-trained counterpart staff to make further progress. A website, hosted by the Secretariat of the Pacific Community (SPC), for disseminating statistics was established but the RMI has not yet implemented PFTAC's recommendation to join the GDDS.

[1] Prepared on the basis of the input from the PFTAC staff. PFTAC, which is located in Suva, Fiji, is a multi-donor technical assistance 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, Tokelau, Tonga, Tuvalu, and Vanuatu.

MARSHALL ISLANDS: RELATIONS WITH THE WORLD BANK GROUP[1]

Total commitments:	None
IFC investments:	None
Recent reports:	Pacific Regional Strategy FY2006-2009, May 2005.
	Embarking on a Global Voyage: Trade Liberalization and Complementary Reforms in the Pacific, September 2002.

Since becoming a World Bank Group member in May 1992, the Marshall Islands has received a grant of US$150,000 from the Institutional Development Fund. The fund was approved in May 1993 to assist the Presidential Committee on the rationalization of the public service. The prepared report detailing an action plan for public sector reform was accepted by the Government, and the recommendations were implemented in joint assistance with the UNDP.

The Bank's fifth biennial Regional Economic Report for its Pacific Island member countries, including Marshall Islands, was issued in September 2002. The report focuses on the efforts of Pacific Island Countries to integrate more closely with the global economy. It evaluates their strategy to enter into a regional trade agreement, and analyzes the interaction of trade liberalization with complementary reforms in taxation, and the public sector.

The new Pacific Regional Strategy, which covers the Marshall Islands, will direct the Bank's work in the region from 2006-2009. It focuses on creating an environment conducive to generating sustainable economic growth and employment, while recognizing that small populations and marked remoteness of the Pacific island countries pose significant development challenges to the region. The Bank seeks to play a selective role in the Marshall Islands, focusing on policy advice to leverage donor resources and build local capacity.

The Marshall Islands is an IBRD-eligible country.

[1] Prepared on the basis of the input from the World Bank staff (as of August 2005).

Marshall Islands: Relations with the Asian Development Bank[1]

The Asian Development Bank (AsDB) has approved eleven loans totaling about US$78.1 million to the Republic of the Marshall Islands (RMI) since it joined the Bank in April 1990.

In November 2000, the AsDB approved the Skills Training and Vocational Education Project for US$6.8 million, to help implement a national skills training system. This loan is due to close at the end of August 2005.

In May 2001, the AsDB approved a US$12 million Fiscal and Financial Management Program to: (i) ensure a sustainable income flow for future generations; (ii) strengthen public sector financial and economic management; (iii) stabilize the fiscal position; (iv) enhance the policy environment for the private sector; and (v) improve the effectiveness of the public service. The program was supported by a package of technical assistance (TA), and the loan and TA closed on schedule during the second quarter of 2004.

In November 2002, the AsDB approved the Outer Island Transport Infrastructure Project for US$7 million, aimed at improving the safety, frequency, and reliability of shipping and transport services in the outer islands. Though subject to some delays this project has now commenced.

In October 2003, the AsDB approved an advisory technical assistance for improving the performance of Economic Policy, Planning, and Statistics office. This TA was extended to July 2005.

In November 2003, the AsDB approved a project preparatory technical assistance for youth social services. This TA was due for completion in September 2005. The Government has decided to forgo ADB loan funds and to use its own funds to finance a new agency that will contract out the provision of welfare and other services to youth at risk to non-government service providers.

In November 2004, the AsDB approved an advisory technical assistance to help improve the environment for private sector development. Continued assistance to the Land Registration Authority, the establishment of a Commercial Registration Authority, a study of the status and trends of land tenure, and continuation of the administrative barriers working group are all components of this TA.

In December 2004, the AsDB approved an advisory technical assistance to assess the ownership and demand for improved education through extensive, informed, and facilitated

[1] Prepared on the basis of input from the AsDB staff.

participatory processes. This is a pilot exercise designed to test the demand for civil service reform. The project was due to be completed by end August 2005.

As of end December 2004, TA grants totaling US$18.0 million for 46 TA projects have been approved. These comprise both project preparatory and advisory TA. Project preparatory TA has focused on public sector reform, fisheries, education, health, water, sanitation, youth, and outer island infrastructure, whereas advisory TA has focused on institutional development, policy reforms, and capacity building.

The overall framework for the AsDB country strategy for the RMI is set out in Pacific Strategy, 2005 to 2009, Responding to the Priorities of the Poor. The country strategy for the RMI was updated in 2004 in a fully participatory manner engaging representatives of civil society as well as government in formulating a new strategy. The new strategy is aligned with the Strategic Results Areas of the new regional strategy. In this regard, the AsDB will help RMI to improve the environment for private sector business, help improve the productivity of public service delivery, and in support of both these objectives, help strengthen governance, most especially policy formulation.

AsDB published a Pacific Island Economic Report on the RMI in 2001 known as Meto 2000. This is currently being updated. In March 2003, AsDB also published a participatory assessment of poverty under the title "Priorities of the People, Hardship in the Marshall Islands." Over the past twelve months, AsDB has funded a series of four retreats between representatives of elected and executive leadership of the RMI, USDOI, leaders of civil society, and officials of AsDB. These retreats have focused on overall development, and particularly on private sector development and tax policy.

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, 2004)

New Sector[1]	Number	Amount
Agriculture and Natural Resources	1	6.95
Education	2	14.80
Energy	0	0.00
Finance	0	0.00
Health, Nutrition, and Social Protection	1	5.70
Industry and Trade	0	0.00
Law, Economic Management, and Public Policy	3	24.00
Transportation and Communication	1	7.00
Water Supply, Sanitation, and Waste Management	2	9.90
Multisector	2	9.75
Total	12	78.10
Memorandum Item:		
Technical Assistance	46	18.00

[1] ADB's new list of Sectors, as of 7 June 2004.

MARSHALL ISLANDS: STATISTICAL ISSUES

Economic and financial data provided to the Fund suffer from serious shortcomings that hamper surveillance. A new Economic Policy, Planning, and Statistics Office (EPPSO) was established in February 2003 to collect and disseminate statistical data. However, EPPSO still lacks qualified statistical staff and the capacity to produce timely data. The publication of the *Quarterly Bulletin of Statistics* was resumed in June 2003, containing mainly CPI data. Other quarterly and monthly statistical data are not published or transmitted to the Fund. Extensive Fund technical assistance has been provided from headquarters and the Pacific Financial Technical Assistance Centre, but many recommendations have not been implemented. The authorities have expressed an interest in participating in the IMF General Data Dissemination System (GDDS). The Marshall Islands would then be eligible for follow-up technical assistance under the Pacific Regional GDDS project funded by Japan.

Real Sector

Preliminary national income accounts (the latest data through 2004) have been prepared by an AsDB consultant on an institutional approach with data going back to 1997. Shortcomings with these data remain, especially with the deflators to create real GDP, operating surpluses, and employment data sources, but these estimates represent an improvement over earlier estimates. Previously the data were prepared on a production basis since 1991. The new consumer price (CPI) index rebased in 2003 replaced the CPI index developed in the 1980s. The updated CPI is based on 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, but they are not consolidated into a format suitable for analysis. The authorities received technical assistance on budgetary accounting in 1994 and 2001. The Marshall Islands do not report Government Finance Statistics for publication in the *GFS Yearbook* and *IFS*.

Monetary Accounts

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. In March 2005, STA held a regional seminar at the Singapore Training Institute to introduce the standardized report forms for monetary statistics but unfortunately Marshall Islands officials did not participate.

Balance of Payments

Balance of payments data are not compiled, although technical assistance has been provided in this area. Compilation of import statistics has been hampered, mainly due to backlogs in data entry, and inappropriate classification and coding. With no compulsory reporting, export statistics are incomplete. Only limited data are available on services, factor income, and private transfers, and there are no data on private capital flows.

Marshall Islands: Table of Common Indicators Required for Surveillance
(As of December 20, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	12/2/05	12/2/05	Daily	Daily	Daily
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	FY2005	11/7/05	Annually	Staff Visits	NA
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	NA	NA	NA	NA	NA
Interest Rates[2]	FY2005	11/7/05	Annually	Staff Visits	Annually
Consumer Price Index	3Q/2005	9/16/05	Quarterly	Quarterly	Quarterly
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	FY2005	11/7/05	Annually	Annually	Annually
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	FY2005	11/7/05	Annually	Annually	Annually
Stocks of Central Government and Central Government-Guaranteed Debt[5]	FY2005	11/7/05	Annually	Annually	Annually
External Current Account Balance	FY2005	11/7/05	Annually	Staff Visits	NA
Exports and Imports of Goods and Services	FY2005	11/7/05	Annually	Staff Visits	Annually
GDP/GNP	FY2005	11/7/05	Annually	Staff Visits	Annually
Gross External Debt	FY2005	11/7/05	Annually	Annually	Annually

[1] Includes government financial assets deposited in commercial banks.
[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] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA); Staff visits(V)

INTERNATIONAL MONETARY FUND
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March 8, 2006

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with the Republic of the Marshall Islands

On February 15, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of the Marshall Islands.[1]

Background

The Republic of the Marshall Islands (RMI), a small Pacific island country, is heavily dependent on external assistance. Government expenditure accounts for more than 70 percent of GDP, and about 50 percent of government revenue consists of external grants, mainly from the United States. Consequently, overall economic activity is highly correlated with government expenditure and external grant flows. The private economy remains underdeveloped, primarily providing services to the government, with small contributions from agriculture, fishery, and tourism.

After nearly a decade of growth following independence in 1986, economic activity declined markedly in the mid-1990s. Real GDP per capita is estimated to have fallen around 30 percent since FY1994. This was a result of declining grant flows and the need to retire external public debt incurred through external commercial borrowing by the government against future Compact revenues. The weak economy reportedly fostered emigration to the United States, as citizens need only a valid passport to work there, and forced large expenditure cuts in part through the implementation of the Asian Development Bank Public Sector Reform Program.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Following a period of fiscal consolidation in the late 1990s, economic growth picked up. Over the past five years, however, the reduction in civil service employment has been reversed. Also, Public debt and government loan guarantees, while currently manageable, are approaching their 1990s levels when loan repayments exerted strain on revenues.

The amended Compact agreement extends U.S. financial support until 2023 with grants declining steadily. The new agreement reflects a major change from the way past funding has been delivered, mainly through the establishment of a trust fund, grants more focused on key sectors, and enhanced accountability and monitoring. It also includes provisions for the United States to retain access to Kwajalein Atoll, where there is a large U.S. military base.

Based on limited data, real output growth appears to have slowed sharply in FY2003 and again in FY2004. Economic activity has been hampered by delays in implementing an upgraded public works program and the closure of a large privately owned tuna processing plant because of financial difficulties, leading to an estimated loss of 500 jobs. Civil service employment appears to have increased, primarily as a result of increased spending on education and health in line with the amended Compact agreement. Nevertheless, overall growth in employment continues to fall short of labor supply, and unemployment, especially for school-leavers, has increased above 30 percent. Real growth is expected to have picked up in 2005, reflecting an expansionary fiscal stance and, to a lesser extent, improvements in agriculture.

The current account surplus narrowed in FY2004, largely reflecting delays in official transfers. The trade balance improved slightly as export growth continued at trend, driven mainly by increases in the re-export of diesel fuel associated with the fishing transshipment base in Majuro, while imports were moderately lower reflecting lower spending on capital project-related imports. In FY2005, the current account surplus is estimated to have narrowed further, in part as a result of higher imports relating to capital projects and the closure of the tuna processing plant. There are no reliable statistics on remittances; however staff estimate the net outflow to be large, owing to the Kwajalein landowners investing their rental receipts abroad.

The fiscal position deteriorated in FY2004. This deterioration reflects, on the revenue side, a decline in grants aimed at infrastructure projects owing in part to delays in initiating projects, lower income tax collection, and volatility in non-tax revenue. At the same time, total expenditure increased with some shift in its composition from capital to current expenditure. Spending on wages and goods and services continued to rise contributing to the worsening of the fiscal position, and has reached 22½ percent of GDP in FY2004, up from 15½ percent of GDP in FY2000. The rise in wages and salaries stemmed from increases in the number of civil servants and the harmonization of wage levels in the Ministry of Education. Over the two years FY2003-04, the government met its mandatory contributions to the Compact Trust Fund, amounting to US$25 million. In FY2005, the government's overall deficit is estimated at 2 percent of GDP, mainly stemming from an underperformance of revenue collection.

Executive Board Assessment

Executive Directors welcomed the steps taken by the authorities to move the Marshall Islands toward lasting growth, including steps to improve fiscal sustainability through the retirement of high-cost commercial debt, and by building reserves to meet its mandatory contribution requirement to the Compact Trust Fund. While commending progress made in strengthening the government's institutional capacity, Directors underscored that, given the anticipated declines in Compact grants and prospective increases in debt-service payments, further fiscal and structural reforms are needed to advance to economic self-reliance.

With growth projected to pick up in the near term, it was emphasized that actions to achieve a larger fiscal surplus than budgeted in FY2006, consistent with medium-term fiscal sustainability, should be given priority. Directors stressed the importance of restraining current expenditures, especially on wages, and goods and services not linked to specific Compact funds, and further measures to enhance the revenue base. Some Directors, while recognizing the magnitude of the medium-term fiscal challenge, considered that an abrupt fiscal contraction could weigh on economic growth, and proposed that, with the support of the Fund's staff, the authorities could develop a program for the medium term that would avoid high upfront impact on employment.

Directors underscored the need to maintain substantial fiscal surpluses over the medium term in order to ensure fiscal sustainability and to avoid the further accumulation of external debt. In this regard, most Directors welcomed the tax measures proposed in the FY2006 budget speech, and observed that additionally broadening the tax base and simplifying the tax structure will be needed to revive revenue growth. On the expenditure side, while calling on the authorities to reduce outlays, Directors stressed the importance of protecting core expenditure.

Directors underlined the need to improve fiscal management and governance. They encouraged the authorities to strengthen the budgetary process by linking the current year budget to the medium-term framework. In addition, Directors called on the authorities to decisively improve governance and administration by implementing a new customs management system and managing the Compact Trust Fund in line with international best practices. They urged the authorities to avoid nontransparent quasi-fiscal operations.

Directors observed that the exchange regime, with the U.S. dollar as the sole legal tender, has imparted monetary stability, with domestic inflation largely mirroring that of the United States. Directors commended the authorities' commitment to an open trade regime, and welcomed the prospective participation of the Marshall Islands in regional trade arrangements.

Looking ahead, Directors underscored the critical importance of structural reforms to promote lasting private sector-led growth. In this regard, they noted that further efforts are needed to expand participation in land registration and to clarify the legal framework for secured lending, in order to help lower intermediation costs and facilitate the reorientation of commercial bank lending activities toward the private commercial sector. In addition, Directors encouraged steps to foster greater wage differentiation across skill levels, especially in the public sector.

Directors urged the authorities to step up efforts to address current constraints on bank lending, allowing the banking system to play a full role in the development of the economy. In this connection, they encouraged the Banking Commission to address the consequences of the loss of the correspondent banking relationship for one of the major banks, which currently inhibits the processing of foreign transactions and could dampen future bank lending.

Directors called for further efforts to strengthen financial supervision. They welcomed recent progress made by the Banking Commission in on-site and off-site bank examination, while noting that additional steps are needed to improve data and information collection, including loan quality and remittances. Directors called for the development bank to be placed under the supervision of the Banking Commission, with tighter controls and with activities limited to those traditional for a development bank. Directors urged further strengthening of the AML/CFT regime, including through tighter controls and reporting requirements for the shipping trust company.

Directors encouraged the authorities to improve the reliability, coverage, and timeliness of statistics to enhance monitoring and policy evaluation. They supported the authorities' request for additional technical assistance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the 2005 Article IV Consultation with the Marshall Islands is also available.

Marshall Islands: Selected Economic Indicators, FY2001–06 1/

	2001	2002	2003	2004	Est. 2005	Proj. 2006
Real GDP (percent change)	5.5	4.0	1.8	0.4	3.5	4.0
Consumer prices (percent change)	1.8	-0.4	-0.9	2.0	3.5	2.9
Central government finances (in percent of GDP)						
Revenue and grants	70.1	64.2	65.0	56.2	58.1	69.6
Grants	49.9	42.0	42.6	31.5	37.1	46.2
Expenditure	61.9	68.2	54.0	56.6	60.2	69.4
Current	56.6	53.8	48.9	51.8	48.3	46.7
Capital	5.3	14.3	5.1	4.8	11.9	22.8
Overall balance	8.2	-4.0	11.0	-0.4	-2.1	0.1
Usable government financial assets (in millions of US$; end of period) 2/	4.2	2.7	2.9	4.5	1.1	0.3
Compact Trust Fund (in millions of US$; end of period) 3/	…	…	…	32.0	47.1	60.4
Commercial banks (in millions of US$; end-December) 4/						
Foreign assets	31.7	40.1	48.4	52.3	53.8	…
Private sector claims	40.7	41.2	43.1	43.9	43.1	…
Total deposits	62.2	69.4	72.2	75.4	73.5	…
One-year time deposit rate (in percent)	4.1	4.0	3.9	2.0	2.0	…
Average consumer loan rate (in percent)	16.5	16.5	16.1	19.0	19.0	…
Balance of payments (in millions of US$)						
Trade balance	-69.4	-59.2	-63.3	-57.4	-69.3	-82.8
Net services	-3.4	-6.3	-3.6	-1.7	-6.9	-7.9
Net income	30.6	34.9	41.5	33.3	35.6	38.7
Private and official transfers	51.1	39.2	41.7	30.2	41.0	58.7
Current account including official transfers	8.8	8.6	16.3	4.4	0.4	6.6
Current account excluding official transfers	-49.3	-43.6	-38.3	-38.2	-53.2	-64.8
Overall balance 5/	-5.2	13.5	16.4	-23.5	-5.9	-3.3
External debt (in millions of US$; end of period) 6/	89.8	87.6	91.2	103.4	100.8	98.2
(In percent of GDP)	77.0	70.6	71.2	76.4	69.8	63.6

Sources: Data provided by the RMI authorities; and IMF staff estimates.

1/ Fiscal year ending September 30.

2/ Cash and cash equivalents that are not reserved for specific uses.

3/ Assets in trust funds are treated as non-usable.

4/ Data refer to December within the fiscal year; for example, FY2001 refers to December 2000.

5/ Large negative overall balance in FY04 reflects official capital outflow to the Compact Trust Fund.

6/ Government and government-guaranteed debt only.

Statement by Richard Murray, Alternate Executive Director for Republic of the Marshall Islands and Byung-Hee Seong, Advisor to Executive Director February 15, 2006

Key Points

- The RMI remains highly dependent on external aid and is characterized by the dominant public sector with limited private sector development.
- My authorities plan to introduce further fiscal reform measures to help lay the groundwork for more sustainable growth.
- Private sector development will be a major component of the long-term strategies for stable economic growth.
- My authorities value highly the Fund's support in capacity building activities in the Marshall Islands.

The Republic of the Marshall Islands wishes to express its appreciation to the Fund and its staff for the production of a well-structured report, successfully highlighting the country's general characteristics, its economic status, and the challenges it faces. The studies in the Selected Issues Paper address issues of contemporary economic importance and provide helpful insights on challenges to long-term economic self-reliance. My authorities value highly the Fund's contribution to the economic policy dialogue and its support in capacity-building activities in the Marshall Islands.

My authorities are also deeply grateful for the ongoing support from the international community and, in particular, from the United States (US). The relationship with the US is significant, valued and long term, and is not only evident in financial support through the amended Compact of Free Association with the United States but in capacity building and other areas such as people flows. The operation of the Compact itself brings a degree of capacity building, such as in the requirements for procurement and tendering processes.

The RMI remains highly dependent on external aid and the public sector is dominant while private sector development is limited.

The RMI is made up of 29 coral atolls and five single islands scattered across an exclusive economic zone of nearly 1 million square miles, and has been independent only since 1986. As staff note, a significant proportion of the government budget remains externally funded, primarily by the US. For some key sectors, reliance on US support has increased in recent years, especially with new financial backing under the amended Compact. For example, the US funded 68 percent of the recurrent education budget in FY1999 and in FY2006 this will increase to 88 percent. For health, the US share has increased from 42 to 53 percent over the same period. The public sector remains the major source of economic activity. As of 2005, the government sector, inclusive of state owned enterprises (SOEs) accounted for approximately 40 percent of GDP and some 41 percent of total formal sector employment. My authorities recognize that the current size of the public sector is not sustainable, given the impending fiscal pressures.

The private sector is not thriving in terms of employment, contribution to GDP, or revenues. With the closure of the tuna loining plant in late 2004, net private sector employment growth has been flat and minimal. In terms of its share of overall GDP, the private sector has fallen from 36.6 percent to 35.6 percent since 2000. Growth in aggregate gross business revenues has also been flat to minimal in real (inflation adjusted) terms over time.

The RMI is well aware that this is neither desirable nor sustainable given the unsuccessful experiment with state-led development in the past and the impending fiscal pressures of the future. My authorities are mindful of the fact that the challenges facing the RMI and its people in 2006 and beyond, are neither easy nor quick to overcome.

Some achievements have been made

The RMI has made progress in a number of areas. The RMI, under the amended Compact, has established a national trust fund, Compact Trust Fund (CTF), that will help provide some stability to the long-term fiscal balance. My authorities have met the requirement to contribute to the CTF, $30 million, or over 20 percent of GDP in 2005. Second, the RMI successfully reformed its social security administration, transforming it from one of the worst run social security programs in the Pacific to one that is now healthy and performing well. Third, the RMI has made strong advances in its health management system, improving on-island diagnostic capabilities and significantly reducing its off-island referrals costs. Fourth, the establishment of the Economic Policy, Planning, and Statistics Office (EPPSO) has strengthened policy and planning capabilities, including improved collection, analysis and dissemination of data. Above and beyond these specific accomplishments, the RMI has maintained strong political and social stability.

The economy has started to show signs of improvement

The economy has started to show signs of development in recent years as the Government begins to reap the benefits of a prudent fiscal policy put in place since 2004. Estimates of Gross Domestic Product (GDP) show promising signs of growth in the economy. While these growth figures are promising, most of this growth reflects the impacts of the bump-up in funding after the end of the first 15 years of the Compact and the one-off impact of the injections of grant funds under the amended Compact. The public sector has grown as these revenues have come into the Government's budget and the challenge now is to translate this into sustainable growth in the private sector in the medium to long term. It is anticipated that substantial infrastructure developments planned in 2006 will help to kick-start this process while taxation reforms in the pipeline and further improvements in the business environment will help to place this growth on a sustainable path.

Repayment efforts will be maintained, but debt service payments will be a considerable burden to the RMI in the medium- to long-term

Recent policy analysis from EPPSO has reviewed the government's debt situation. The Government's debt situation while manageable, is again approaching levels of concern experienced in the 1990s when bond repayments absorbed most of the Compact revenues. By 2001, commercial debt had been eliminated but during the 1990s the Government had acquired other debts by taking a number of AsDB Loans on concessional terms. The AsDB lending, while heavily concessional, is not cost-free. This is becoming apparent with the ramping up of repayments of much of the AsDB lending in the 1990s as the grace periods expire. This will place increasing pressure on the Government's fiscal situation over the next five years and beyond.

My authorities plan to introduce further fiscal reform measures to help lay the groundwork for a more sustainable growth

My authorities recognize the need for fiscal consolidation and the magnitude of the fiscal challenge ahead of them, which is well-captured in staff's long-run scenarios set out clear and concise in Annex I. The scenario suggests that a medium-term fiscal adjustment of about 3 percent of GDP starting in FY2007 is needed to build reserves in the Trust Fund. They acknowledge the need to maintain budget surpluses and set aside the surpluses in the Trust Fund. My authorities firmly stand committed to prudent fiscal policy through improving the tax system and prioritizing expenditures in a consistent and plausible manner. On the other hand, we do not consider an abrupt fiscal contraction of almost 5 percent of GDP in 2006 to be a sensible economic or policy strategy to address a medium-term issue, especially at a time when restoration of a reasonable rate of economic growth is a high priority.

My authorities are looking to improve the country's revenue raising capability through simplification and streamlining to improve efficiency. The goal is to maintain revenues in the short-term but to encourage economic activity in the long-term. The 2006 budget which includes income tax restructuring and import tax simplication will take some initial steps in this direction. Modifying the income tax structure aims at relieving the heavy burden on low-income earners by restructuring the income tax regime to improve fairness. The intent of the review of import duties is to simplify administration while minimizing government's loss of revenue.

My authorities are committed to further tax reform to enhance administration of the current tax regime, including future import duty restructuring. They have initiated a dialogue with the private sector and civil society about ways that this might be approached. Consultations have raised serious issues regarding administration that the Government is already addressing through, among other things:

- implementation of taxation and customs management information systems;
- recruitment of auditors and the introduction of a regular tax auditing program supported by training; and
- increased penalties and prosecution through regulatory and legislative changes.

My authorities are well-aware that their personnel expenditures need to be restrained if they are to attain an appropriate fiscal balance. Growth in the Government's payroll is unsustainable and appears to be crowding out employment in the private sector. To keep these costs under control, an internal personnel audit will be undertaken to verify positions, salaries, and attendance among other things. Complementing this, the Government will establish a more rigorous monitoring system for public service employees to improve the budgeting process, given that such a large proportion of the Government's budget is consumed by personnel expenditures. In an effort to rationalize government spending patterns, they are allocating ministry and agency spending based on a quarterly allotment instead of annual allotment from fiscal year 2006 onward. They also are waiting for concrete recommendations from a technical assistance (TA) report on civil service reform, which would help guide their medium-term plan to reduce expenditure.

My authorities believe that private sector development will be a major component of the long-term strategies for stable economic growth

Recent analyses into private sector development offer numerous suggestions on how to create a more enabling environment for private sector growth. My authorities are well cognizant of the need to rationalize state involvement in the economy (via reform and privatization of state-owned enterprises), improve financing for growth and entrepreneurship, provide the necessary regulatory infrastructure that provides policy certainty, strengthen institutions (including improving access to land), lower business costs, and improve enforcement of (debt) contracts. They acknowledge that little progress has been made on the land registry since the establishment of the Land Registration Authority in 2003. As in many Pacific Island countries, land tenure is still a complicated and indigenous issue in terms of collective ownership. They welcome the staff's suggestions for expanding outreach programs and lowering application costs, and will take this advice into consideration in their own policy deliberations. They will maintain their efforts to enhance private sector participation by holding outreach retreats and regular dialogue with the private sector. In order to attract more foreign investment, my authorities also plan to amend the Foreign Direct Investment Act in the next Parliamentary session.

In order to increase the trade openness of the economy, the RMI is negotiating regional trade arrangements within the Pacific, including the Pacific Agreement on Closer Economic Relations (PICTA) and the Pacific Island Countries Trade Agreement (PACER). The RMI is also a member of the Pacific Forum and is actively participating in the Pacific Plan for Strengthening Regional Cooperation and Integration in the context of economic growth, sustainable development, good governance and security.

Despite some improvement of financial sector supervision, further efforts are needed for strengthening supervision

The financial sector in the RMI is small and, for a variety of reasons, credit has been increasingly concentrated in the form of relatively small consumer loans, for which there is strong demand. Banking supervision has been fortified in the past couple of years with the provision of additional resources to the Banking Commissioner and the commencement of on-site and off-site bank examinations. As staff note, further improvements are still needed and this will be a continuing process as local staff gain experience. They are grateful for the extensive technical assistance provided in this area.

My authorities share staff's concerns on the consequences of the loss of the corresponding banking relationship for the Bank of the Marshall Islands. They take note of a possible long-term risk to bank lending and will pay due attention to the situation. Regarding the development bank, my authorities concur with the staff's assessment and believe that the Fund's advice on the proper design of a development bank, including the operation of the Board as well as the supervisory framework, would be helpful against the background of its expanding consumer and commercial loan portfolio.

The RMI has implemented AML/CFT measures and was removed from the FAFT's list in October 2002. The Fund has given clear advice of the need to further strengthen the AML/CFT framework, which my authorities will need to address.

My authorities value highly the Fund's support in capacity-building activities in the Marshall Islands

My authorities remain committed to further improvement in data collection and dissemination. While some progress has been made in strengthening the statistical data base in the RMI, significant efforts are still needed for effective surveillance, especially in national accounts statistics, and fiscal, monetary, and external data. My authorities welcome hands-on help for building capacity and request continued technical assistance in the areas of expertise of the Fund, especially in the areas of fiscal management and audit. Furthering the tax reform agenda may also require Fund support.

For the first time since joining the Fund in 1992, my authorities indicate that they consent to the Fund's publication of the Staff Report and the Selected Issues Paper.