March 2006
IMF Country Report No. 06/97

Republic of the Marshall Islands: Selected Issues and Statistical Appendix

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

Selected Issues and Statistical Appendix

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Approved by the Asia and Pacific Department

February 1, 2006

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I. ECONOMIC DEVELOPMENTS SINCE INDEPENDENCE AND STATISTICAL TABLES[1]

A. Background

1. **The Republic of the Marshall Islands (RMI) consists of a group of atolls and islands in the central Pacific with a total land area of 70 square miles and 750,000 square miles of ocean.** Two-thirds of the population of about 58,000 live in the two major urban centers, Majuro and Ebeye. Like other small Pacific island countries, the country is remote from major markets, and the economy is highly dependent on United States financing provided through the amended Compact of Free Association. Economic activity is dominated by the public sector and the small private sector developed largely to meet the demands of the government and its workers. Contributions also come from agriculture, fisheries, and tourism. As a result of generous external assistance, economic and social conditions are relatively favorable by regional standards with a per capita GDP of around $2,500. This chapter outlines economic developments since independence in 1986, focusing on the challenges posed by dependence on foreign grants, and progress towards achieving budgetary self-reliance.

2. **In 1947, the Marshall Islands became part of the United Nations Trust Territory of the Pacific Islands, under the administration of the United States.** Following increasing demands for autonomy, the country became a republic in 1979. The Compact of Free Association with the United States came into effect in October 1986, under which the RMI has full responsibility for its internal and foreign affairs, while the United States retains responsibility for defense and security. The United States also agreed to provide financial assistance totaling some $620 million over the period 1986–2001, and to create a $150 million Nuclear Trust Fund to compensate the inhabitants of the four atolls affected by U.S. nuclear tests in the 1940s and 1950s.

3. **The government operates under a mixed parliamentary and presidential system**, which includes a head of state, the President, and a bicameral parliament. The Council of Iroij (the upper house) is comprised of 12 tribal chiefs who advise the Presidential Cabinet and review legislation affecting customary law or any traditional practice, including land tenure. Legislative power resides in the Nitijela (the lower house), which consists of 33 senators elected by 24 electoral districts by universal suffrage of all citizens above 18 years of age. The president is elected to a four-year term and appoints cabinet ministers with the approval of the Nitijela. Although no restrictions exist against the formation of political parties, formal political parties do not exist. Instead, there are loosely formed interest groups but without party headquarters, formal platforms or party structures.

[1]Prepared by Hali Edison (Ext. 36946) and Dan Nyberg (Ext. 35919).

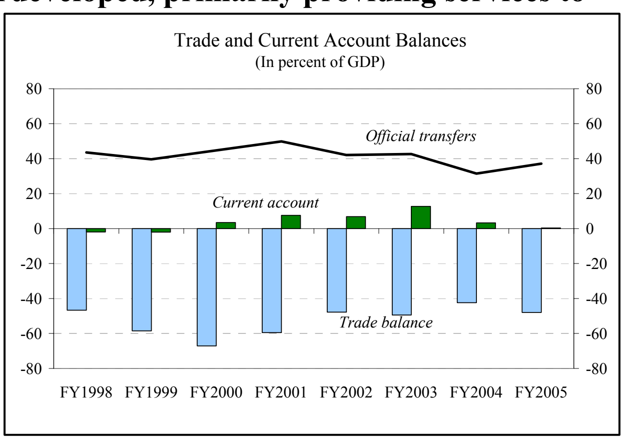
B. Structure of the Economy

4. **Like most other Pacific islands, the RMI faces a variety of geographical constraints, including limited land area, poor soil, the dispersion of the islands, and the remoteness from major markets.** Other obstacles include the acute shortage of skilled labor and a customary land tenure system, which severely limits the use of land as collateral in financial transactions and deters foreign investment. The outer islands operate on a semi-subsistence basis, while the urban centers of Majuro and Ebeye have a more developed cash economy, based mainly on government services and trade. The domestic production base is limited, consisting primarily of copra production, subsistence farming, fishing, and handicrafts.

5. **The public sector plays a dominant role in the economy, backed by external assistance**. Government current expenditure accounts for more than 70 percent of GDP, and about 50 percent of government revenue comes from external grants, mainly from the United States. Consequently, overall economic activity is highly correlated with government expenditure and external grant flows.

6. **The public sector comprises the central government, local governments, trust funds, and non-financial public enterprises.** The central government continues to be heavily dependent on foreign aid, while the main source of local government revenue is sales taxes. The government acts as trustee for a number of trust funds associated with the Compact, although the receipts and expenditures are largely outside the government budget. The Nuclear Trust Fund, set up to compensate inhabitants of the four atolls affected by U.S. nuclear testing, and the Kwajalein Atoll Trust Fund, which compensates land owners for the use of the atoll as a military base, are the largest of the trust funds used to administer payments under the Compact. The non-financial public enterprises, concentrated in utilities, transport, telecommunications and copra production, are important sources of employment, but their financial results have been generally weak.

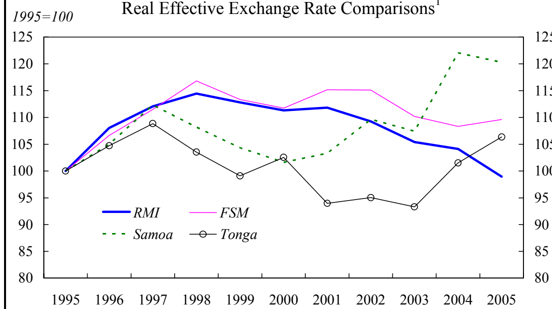
7. **The private economy remains underdeveloped, primarily providing services to the government.** The export sector is small, consisting almost entirely of coconut oil, fish, and re-exports of diesel fuel to fishing boats. Nearly all raw materials, consumer, and capital goods are imported. With exports amounting to about 20 percent of imports, the trade balance is chronically in deficit. Owing to official transfers, however, the current account balance has generally been in surplus, or close to balance.



8. **There is no central bank, as the U.S. dollar is the domestic currency and the sole legal tender.** The use of the U.S. dollar has imparted monetary stability, with inflation

largely mirroring that of the United States. The real effective exchange rate has remained broadly stable, reflecting a low and stable inflation differential with the United States, the largest trading partner. In terms of costs of conducting business, especially for the tourism industry, RMI is perceived as not being competitive relative to other destinations in the Pacific. The lack of competitiveness stems from geographical isolation, limited hotel facilities, and deficient waste management.

Real Effective Exchange Rate Comparisons[1]



Sources: IMF, Information Notice System; and staff calculations.
[1] 2005 data based on January through September average.

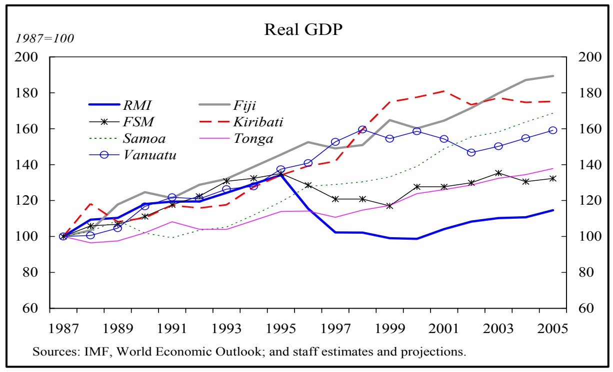
9. **The banking sector is characterized by high intermediation costs and low levels of lending.** The domestic financial sector comprises two commercial banks, insurance agencies, a money remitter, and a development bank. Consumer loans account for the dominant share of loans and are primarily used for construction, travel and education. Most consumer loans are serviced directly through payroll deductions. Longer-term lending is constrained by the land tenure system, which prevents banks from using land property as collateral, as well as by the lack of viable projects. Given the limited opportunities to extend credit domestically, a substantial portion of the total assets of commercial banks are held outside the country. Remittances to the RMI from abroad are estimated to be fairly small in magnitude. When considering that the bulk of the payments to landowners of the Kwajalein atoll, estimated at around $15 million in FY2004, is transferred abroad, there may be a net outflow of remittances.

10. **Employment opportunities have not expanded at the rate of population growth.** Continuously reliable data on unemployment are not available. In the latest official survey, unemployment stood at around 30 percent in 1999, with youth unemployment considerably higher. While access to both primary and secondary education has improved recently, around 30 percent of children do not receive secondary education and drop out rates are high, contributing to the acute skills shortage. Owing to relatively easy emigration rules to the United States, many Marshallese (estimated at around 15,000) have emigrated.

C. Economic Developments: Period of Original Compact

11. **The original Compact of Free Association with the United States, which came into effect in FY1987 (ending September 30), aimed at fostering economic development over a 15-year period.** The Compact provided block grants that were partially indexed to inflation and subject to step-downs in assistance after each five-year period. The RMI also received earmarked grants and program assistance mainly for health and education, with some conditionality and oversight attached to the grants. The limited scope for monetary and exchange rate policies underscored the key role of fiscal policy.

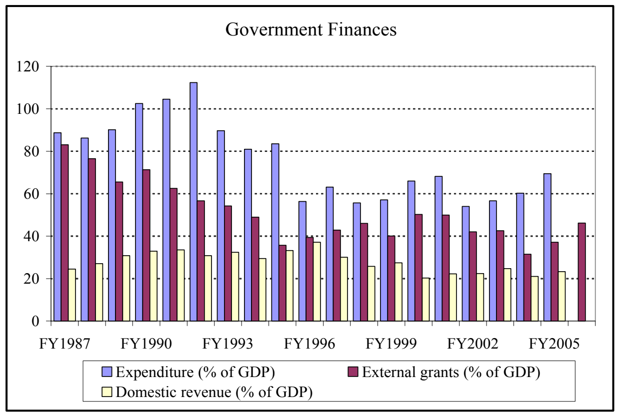
12. **Real GDP grew relatively quickly during FY1987-91, averaging 4.5 percent annually, mainly reflecting Compact-related spending.** The public sector, already large as



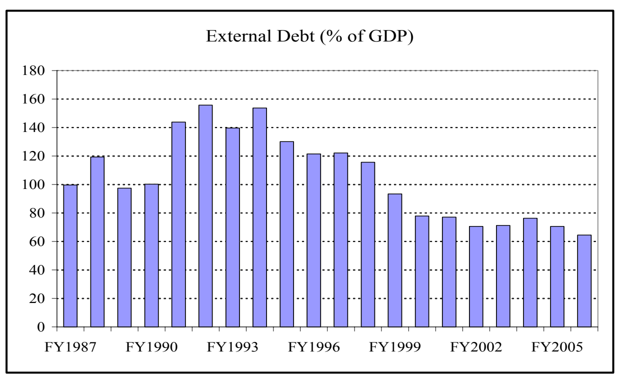
Sources: IMF, World Economic Outlook; and staff estimates and projections.

a legacy of the Trust Territory period, expanded further with the release of Compact funds. Capital spending to modernize the infrastructure picked up sharply. The private sector served mainly government demand and the growing ranks of its employees. Inflation pressures were generally contained.

13. **In the first five years of the Compact, the government initially ran sizeable budget surpluses, averaging 9 percent of GDP.** Faced with the first scheduled decline in grants, fiscal deficits began to appear in the early 1990s, averaging 10 percent of GDP during FY1991–95. Although the reduction in U.S. aid was largely foreseen, government expenditures were not adjusted accordingly. The government borrowed sizeable amounts abroad through medium-term notes secured by future Compact flows, for financing deficits and funding public investment. External public debt reached over 150 percent of GDP in FY1995. In addition, poor-performing public enterprises, including Air Marshall Islands and the copra processing company, necessitated subsidies and exerted further drain on government finances.



14. **In the mid-1990s, the level of public expenditures and external debt was unsustainable.** Faced with the second scheduled decline in external grant assistance in the FY1996, the authorities implemented a public sector reform program. However, this consolidation, together with the impact of a drought, resulted in a large contraction in activity in the mid-1990s. Real GDP declined by 5 percent on average during FY1995–99.



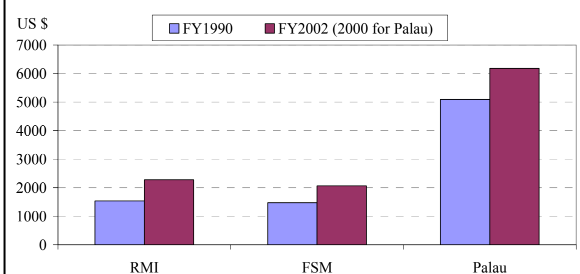
15. **After a five-year fiscal consolidation period, the economy rebounded by the turn of the century, with real GDP growth averaging 3 percent annually in FY2000–03**. Adding to the rebound, during the 2002–03 negotiation of the amended Compact, the U.S. government provided so-called "bump-up" grants at the average level of the first Compact, a sizeable increase from FY2001. These funds both helped to sustain the economic expansion

and brought about an improvement in the overall fiscal position, even as some of the earlier progress in government consolidation was reversed.

16. **Looking back, the first Compact brought limited results in terms of real GDP growth, while fiscal and structural adjustment remained incomplete.** A U.S. Government Accounting Office report in 2000 reviewed the effectiveness of Compact funds in promoting economic self-sufficiency and found that such expenditures had led to little improvement in economic development. In particular, per capita incomes, when adjusted for inflation, had fallen since the beginning of the Compact. The report also stated that funds were mainly spent to maintain high government wages and a high level of public employment that discouraged private sector growth.

17. **In comparison with other Compact countries, RMI grew at a slower pace than Federated States of Micronesia and lagged well behind Palau**. Tax revenue remained low due to longstanding weaknesses, and the wage bill was high. Public-sector wages, aimed at attracting qualified personnel, were increasingly out of line with private sector pay and attracted migration from the outer atolls. Moreover, there were slippages in the administration of Compact funds, including shortcomings in accountability and oversight on the part of both the RMI and U.S. governments, and misuse of funds.

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.

D. Economic Developments: Period of Amended Compact

18. **The amended Compact came into effect in May 2004 and will expire in 2023**. Throughout the period, U.S. funding will remain constant in nominal terms, with annual declines in grants fully offset each year by progressively higher contributions to a Trust Fund. The Compact 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. During the life of the amended Compact, the Trust Fund will be built up with installments from the United States, RMI, and Taiwan P.O.C. The main objective of the Trust Fund is to help achieve budgetary self-sufficiency in the post-Compact era and drawings from this fund, or its use for collateral borrowing, are not permitted until FY2024 (see Selected Issues chapter).

19. **The amended Compact also contains enhanced measures of accountability and monitoring (Box 1).** A U.S.-RMI Joint Economic Management and Financial Accountability Committee 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. Adjusting to

the enhanced accountability and monitoring of the amended Compact poses near-term challenges as capacity constraints have already led to delays in the disbursement of some Compact grants. Other provisions of the amended Compact include rental payments for U.S. military use of the Kwajalein atoll and an extension through FY2023 of some federal education and disaster management services received by RMI under the original Compact.

Real Sector Developments

20. **Based on limited data, real output growth averaged 1¼ percent in FY2003 and FY2004.** Economic activity was hampered by delays in implementing an upgraded public works program and the closure of a large privately owned tuna processing plant. 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. Economic activity picked up in FY2005, reflecting mainly an expansionary fiscal stance.

21. **Activity in the fishing sector recovered moderately in FY2004.** The total catch in 2004 amounted to 42,000 tons compared to 35,000 tons in 2003. However, the number of vessels operating the RMI economic zone declined as a result of the withdrawal of the Japanese tuna fishing fleet. Transshipment activity increased in FY2004, resulting in increased revenue by about 25 percent to $410,000. However, the domestic fishing sector was severely hampered by the closure of the tuna loining plant in August 2004.

22. **A large fraction of Compact-related construction has been held up by administrative delays in the disbursement of funds.** The Majuro Hospital was renovated in FY2004–05, with a grant of approximately US$5.2 million, from the government of Japan. Construction of new education facilities has been held up by the difficulties associated with land tenure. Repaving of the Majuro airport runway is scheduled to be finished in February 2006 at a cost of $16 million.

23. **CPI inflation has remained subdued.** Inflation picked up to 2.4 percent (year-on-year) in September 2004, and is estimated to have risen to 3.5 percent in FY2005, mainly reflecting higher energy prices.

24. **Overall growth in employment continues to fall short of labor supply.** While recent data are unavailable, unemployment is estimated to have remained high and broadly unchanged at over 30 percent. Outside of the public sector, wages in the private sector are estimated to have been stagnant in recent years.

External Developments

25. **The current account surplus including official transfers is estimated to have decreased to $4.4 million (3.3 percent of GDP) in FY2004 and $0.5 million (0.3 percent of GDP) in FY2005.** The trade deficit narrowed in FY2004 as a result of fewer imports owing to delayed implementation of import intensive capital projects. In FY2005, the trade deficit is estimated to have widened as a result of growth of imports exceeding the growth of exports.

26. **The services balance deficit is estimated to have narrowed moderately by $1.9 million to $1.7 million in FY2004.** Service payments in FY2004 have been reduced as a result of declining costs for outpatient services, less expenditure by Marshallese traveling abroad, and reduced freight and insurance payments associated with lower imports. However, costs associated with Air Marshall Islands' leasing and maintenance of aircrafts have been increasing. Service receipts are estimated to be higher in FY2004 as a result of increased numbers of foreign visitors and fishing vessels. Tourism receipts are estimated to have risen to $5 million in FY2004 based on the Marshall Islands Visitors Authority's (MIVA) visitor survey. Receipts from the tuna processing ceased in August 2004.

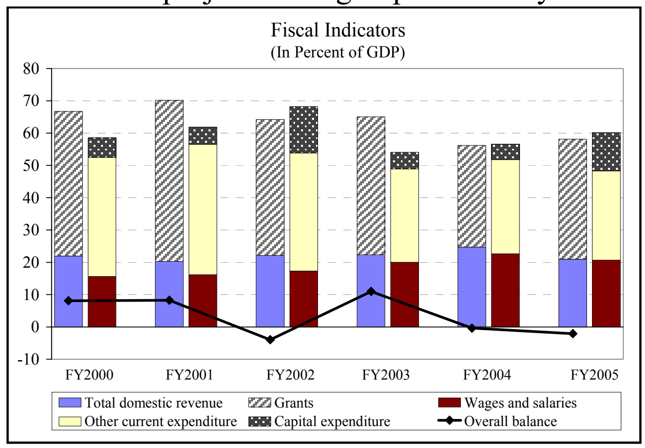
27. **The surplus in the income balance deteriorated by 20 percent in FY2004 due to lower disbursement of Compact grants.** The income balance is expected to improve slightly in FY2005 as grant disbursements are increased. Fishing rights fees are estimated to have declined to $0.9 million in FY2004 from $1.7 million in FY2003. Registration revenue from the ship registry are set at a $1 million flat fee to the government, regardless of the growth in registrations. The number of vessels registered with the Trust Company of Marshall Islands increased to 719 in 2004, up from 626 in 2003. Labor income of the roughly 1200 Marshallese working at Kwajalein Base is estimated to have declined slightly (-1 percent) in FY2004, but is expected to increase by 5 percent to $18.6 million in FY2005. Other income receipts, mainly from U.S. payments to Kwajalein land-owners, are estimated around $15 million for FY2004–05, which is roughly unchanged from FY2003. Interest payment on the external debt is estimated in the range of $2.3–2.5 million annually for the period FY2004–06. This represents a slight decrease from the $2.1 million paid in FY2003.

28. **The deficit in the capital account is estimated to have worsened to $27.7 million in FY2004, which includes the government's $25 million contribution to the Compact Trust Fund.** In FY2005, the deficit is projected at $7.5 million, including a $2.5 million contribution to the Trust Fund.

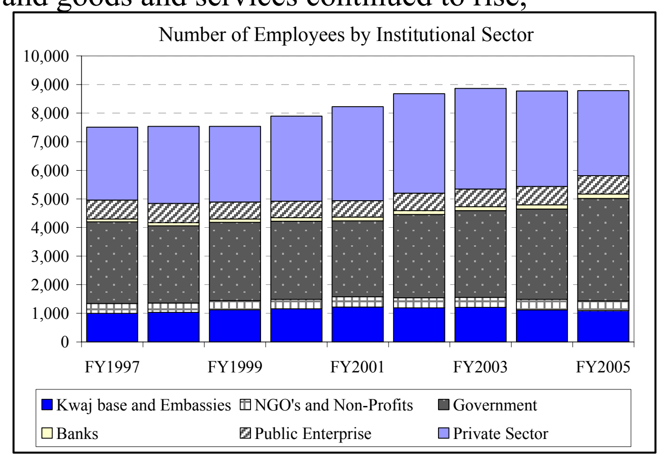
29. **The trade regime in the RMI is relatively open.** Imports are freely allowed, other than when expressly prohibited for environmental, health or safety reasons, and there are no significant nontariff barriers to trade. The RMI does not face any difficulties in accessing export markets. The general import duty is currently 8 percent, but there are a number of exceptions: foodstuffs carry an import duty of 5 percent and a range of products are subject to rates ranging from 15 to 150 percent. The authorities have indicated their intention to unify import duties to a uniform rate of 6 percent, which will be considered in the next session of Parliament.

Fiscal Developments

30. **The fiscal position deteriorated in FY2004.** This deterioration reflected, 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. Non-tax revenues in FY2004 were marked by a decline in fishing rights and other non-tax revenue (which among other things include the ship registry fees), and a large increase in fees and charges. The increase in fees an charges stemmed in part from the authorities' decision to transfer the health fund from the social security accounts to the Ministry of Health.



31. **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 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. The number of RMI government employees has risen from 1464 in FY2000 to 1712 in FY2004. At the same time, the average annual salary rose from $10,514 to $13,776. Over the two years FY2003–04, the government made large contributions, amounting to around 10 percent of GDP each year, to the Compact Trust Fund, in line with requirements under the amended Compact.



32. **In FY2005, the government's overall deficit is estimated at 2 percent of GDP, mainly reflecting an underperformance of revenue collection.** The poor performance of domestic revenue contrasts with a large inflow of capital-related and other committed grants. The decline in domestic revenue was mainly accounted for by a decline in non tax revenue, while tax revenue remained broadly unchanged. Non-tax revenue fell primarily because of lower fees and charges and other non taxes. Although tax revenue remained unchanged, it masks a significant increase in import duties, reflecting recent measures aimed at improving customs, which was offset by a decline in gross revenue tax collection. On the expenditure side in FY2005, current expenditure was broadly unchanged, while capital expenditure rose markedly in line with the disbursement of grants. Regarding current expenditure, the slight

decline in spending on wages and salaries as well as goods and services was offset by higher subsidies and transfers.

33. **The FY2006 budget envisages a small overall surplus of around ¼ percent of GDP.** The budget projects a dramatic rise in revenue, mainly owing to the disbursement of special grants for building infrastructure. At the same time, domestic revenues are targeted to increase by 2¼ percent of GDP, reflecting higher income tax, gross revenue tax, and one-off increase in import duties and fishing rights. Current expenditure is also projected to rise, owing to an increase in wages and salaries in relation to GDP, which is partly offset by a decline in goods and services. Capital expenditure is also expected to increase markedly as a result of large inflow of external grants earmarked for special projects, related in particular to the renovation of the Majuro airport.

34. **Gross external debt has risen despite the retirement of the government's commercial debt in FY2001**. The outstanding external debt, at nearly 70 percent of GDP, is high, although about 60 percent 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. Against the background of declining Compact grants, servicing the external debt will increasingly absorb fiscal resources. Interest payments in FY2005 rose marginally to 1.1 million from $0.8 million, but debt repayment remained marginal.

Financial Sector Developments

35. **The financial sector is small and intermediation costs are high.** Following the withdrawal of the Bank of Hawaii from the RMI in November 2002, two commercial banks remain in operation: the Bank of Marshall Islands (BoMI) and the Bank of Guam. In February 2005, BoMI lost its correspondent banking relationship, which leaves Bank of Guam (BoG) as the only bank with the ability to conduct external banking operation. As a result, BoG has seen significant growth in deposits.

36. **Despite the withdrawal of the Bank of Hawaii, activity in the banking sector has recently been buoyant.** Consumer loans have risen by 11 percent since FY2001 and deposits increased by 22 percent over the same period. Foreign assets have increased by 67 percent since FY2001 as most of the deposits are transferred abroad. Banking activity was also fueled by Marshall Island Development Bank (MIDB) lending, which has expanded its consumer and commercial loan portfolio. Owing to healthy interest margins and low levels of non-performing loans, the MIDB has incurred substantial profits in recent years.

37. **The RMI was removed from the FATF money laundering list of non-cooperative countries in 2002, but remains on the OECD tax haven list.** The Banking Commissioner continues to track all large transactions intermediated through the financial system, and conducts regular on- and off-site supervision of the commercial banks. The MIDB is currently unsupervised. The Financial Intelligence Unit, comprising representatives from the

Banking Commission, the offices of the attorney general, tax and police, meet to review bank disclosure information.

E. Policy Challenges Ahead

38. **The attainment of stable economic growth and financial independence are major policy challenges.** The amended 20-year Compact agreement provides an opportunity to promote budgetary self-reliance and lessen the dependence on foreign aid. At this point, the medium term outlook remains uncertain and hinges on the authorities' commitment to structural and fiscal reform. In the absence of structural reform to promote private sector growth and fiscal consolidation, growth is likely to falter in the medium term, owing to declining Compact grants and increasing external debt repayments. However, if fiscal consolidation and structural reform are undertaken, the illustrative scenario indicates that RMI can grow sustainably, and on par with other Pacific island countries, even after the expiration of the Compact in 2023.

Fiscal Reforms

39. **Budgetary surpluses of 3 percent of GDP annually are needed to ensure fiscal sustainability over the medium term.** An illustrative scenario underscores the importance of fiscal reforms. Without such actions, a small fiscal surplus would still have to be achieved, to meet debt obligations. Fiscal reserves would remain at very low levels, and only modest headway made at reducing expenditure and increasing revenue. As a result, fiscal expenditure would shrink over the medium term as grant inflows decline. The burden of adjustment would fall mostly on capital spending, including infrastructure maintenance, leading to weaker growth. At the end of the amended Compact, the RMI would likely draw the entire annual returns from the trust fund, causing the fund to begin to decline in real terms. Initially, the real GDP growth rate would be 2¼ percent per annum, but it would gradually fall to zero as government expenditure declines and private sector growth would remain anemic.

40. **Under the fiscal reform scenario, it could be assumed that a medium-term fiscal adjustment would be introduced**. The adjustment strategy would involve 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. Despite reduced Compact inflows, the government would build sizeable reserves while maintaining capital expenditure. This would secure long-term fiscal sustainability, 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.

41. **Given the Trust Fund's role in securing long-term budgetary self-reliance, it's of key importance that it is managed in a transparent manner**, including through a sound and accountable governance structure. Furthermore, any budgetary saving should be used to increase the endowment, especially in light of uncertainty on revenue performance.

Structural Reforms

42. **Structural reforms need to complement fiscal reform to encourage private sector development**. To promote private sector development, past and current Fund advice has focused on clarifying property and land tenure rights, changing existing minimum-wage legislation to increase wage differentiation between skill levels, trimming extensive state involvement in business through privatization, and reducing constraints on foreign investment.

- Foreign direct investment is limited owing to uncertainty regarding land tenure rights for foreign investors and the application for expatriate labor permits is a complex and time consuming task.

- The development of the tourism sector continues to be hampered by the distance from major markets, competition from other lower-cost destinations, limited tourism infrastructure, and infrequent air service.

- The minimum wage is high by regional standards, skews competition for the private sector, and encourages migration from the outer atolls.

- The government has repeatedly launched public enterprises in areas such as fisheries and outer island shipping that lost money and competed directly with private firms.

- Bank lending continues to be limited by the difficulties of using land as collateral and of foreclosing. In order for the banking system to play a full role in the development of the economy, longer-term bank lending needs to be facilitated by improvements in the newly established land registry.

Box 1. Marshall Islands: Comparison of Original and Amended Compact

The original Compact of Free Association (the Compact) came into effect in October 1986. The three goals for RMI of the original Compact were: (i) to secure self-government; (ii) assure certain national security rights; and (iii) assist in efforts to promote economic self-sufficiency. Under the Compact agreement, the United States provided $640 million in grants over the period 1986 to 2001 with declining block grants every five years. These funds were provided to cover general government and capital expenditures. At least 40 percent of the total grants were to be devoted to capital projects, although this was a cumulative requirement that did not have to be satisfied in any particular year. Annual reports were required on economic performance and grants usage and consultations. The Compact also contained provisions allowing citizens of the RMI to easily migrate and work in the United States. If a new funding agreement was not in place by the time of expiration of the original Compact in October 2001, a provision specified that aid would be given for an additional two years at the average level of the first 15 years ($42 million).

The amended Compact came into effect on May 1, 2004, with the aim to continue economic assistance covering FY2004–23. The total amount of $42.7 million per year (roughly 40 percent of GDP) includes grants, audit funds ($0.5 million), and trust fund contributions.

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. In addition to providing sector grants, the amended compact provides for the establishment of a trust fund that is intended as a sustainable source of revenue to replace grant assistance beginning in 2024. Initially, the RMI is required to provide $30 million to set up the trust fund, while the United States' initial contribution of $7 million will be augmented annually. Sector grants decline by $0.5 million per year in nominal terms, while the trust fund contribution is augmented by $0.5 million per year.

New procedures were introduced to enhance financial accountability and economic management. A U.S.-RMI Joint Economic Management and Financial Accountability Committee 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 for U.S. military use of the Kwajalein Atoll through FY2066 with the United States having the option to terminate payments as early as FY2030, with advance notice of seven years, or 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 from the RMI required to show a passport.

Table I.1. Marshall Islands: Gross Domestic Product, FY2000–05 1/

	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005 Est.
	(In thousands of U.S. dollars)					
Private Enterprise	35,116	38,421	37,449	37,189	38,997	43,572
Compensation of employees	18,093	19,678	20,175	19,706	19,377	18,570
Operating surplus (gross)	17,023	18,744	17,273	17,483	19,620	25,003
Public Enterprise	5,713	4,832	8,625	7,606	7,407	9,235
Compensation of employees	7,940	8,069	8,098	9,180	9,125	9,665
Operating surplus (gross)	-235	-628	4,121	703	-492	926
Less Subsidies	-1,993	-2,609	-3,594	-2,277	-1,227	-1,356
Finance (Banks)	5,541	6,059	5,655	6,180	6,910	7,779
Compensation of employees	1,833	2,103	2,353	2,265	2,341	2,576
Operating surplus (gross)	3,708	3,956	3,303	3,915	4,570	5,203
Government (compensation of employees)	34,743	36,513	39,857	43,597	47,616	47,847
RMI Government	19,446	20,779	23,523	26,842	30,385	29,778
Government Agencies	7,629	8,054	8,450	8,821	9,012	9,312
Local Government	7,668	7,679	7,884	7,934	8,219	8,757
NGOs (compensation of employees)	1,779	1,972	2,076	2,025	2,033	1,903
Households	16,578	16,979	16,712	17,258	18,071	19,242
Mixed Income	2,915	2,689	2,275	2,904	3,168	3,551
Copra production	1,183	949	478	1,027	1,186	1,384
Fishing	556	556	576	605	640	703
Handicrafts	954	954	989	1,038	1,099	1,207
Other	222	230	233	235	244	257
Subsistence	6,878	7,259	7,312	7,172	7,447	7,841
Home Ownership	6,785	7,031	7,125	7,181	7,456	7,850
Indirect taxes less Subsidies	11,566	11,773	13,686	14,208	14,386	14,778
Import and fuel taxes	4,523	4,451	6,323	7,040	6,681	7,768
Other Indirect taxes	3,461	3,892	3,645	3,528	4,133	4,528
Indirect taxes (Local Government)	3,583	3,430	3,719	3,640	3,573	2,482
Nominal GDP (Gross)	111,035	116,549	124,060	128,063	135,420	144,357
	(In percent of GDP)					
Private Enterprise	31.6	33.0	30.2	29.0	28.8	30.2
Public Enterprise	5.1	4.1	7.0	5.9	5.5	6.4
Finance (Banks)	5.0	5.2	4.6	4.8	5.1	5.4
Government (compensation of employees)	31.3	31.3	32.1	34.0	35.2	33.1
NGOs (compensation of employees)	1.6	1.7	1.7	1.6	1.5	1.3
Households	14.9	14.6	13.5	13.5	13.3	13.3
Indirect taxes less Subsidies	10.4	10.1	11.0	11.1	10.6	10.2

Source: Data provided by the RMI authorities.

1/ The fiscal year ends on September 30.

Table I.2. Marshall Islands: Copra Production, Producer Prices, and Export Unit Values, CY2000–05

	CY2000	CY2001	CY2002	CY2003	CY2004	CY2005 Est.
Production (in short tons)	4,273	5,063	2,653	4,283	4,868	5,725
Average producer prices (in U.S. dollars per short ton)	277	187	180	240	240	240
Total income (in thousands of U.S. dollars)	1,184	947	478	1,028	1,168	1,374
Export unit value (in U.S. dollars per short ton) 1/	225	72	380	304	201	460

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

1/ Export unit values are estimated by dividing the value of exports of coconut oil and copra cake by total copra production.

Table I.3. Marshall Islands: Majuro Consumer Price Index, CY2003–05 1/

Groups	All Groups	Food	Alcoholic Beverages	Housing, Utilities and Major Appliances	Apparel	Transport.	Medical Care	Recreation	Education and Comm.	Other Goods and Services
Weights	100.00	35.91	1.68	17.07	4.33	13.73	2.23	2.32	6.56	16.17
					(2003Q1 = 100)					
CY2003	100.9	102.8	101.3	99.4	101.1	98.4	100.0	99.8	100.0	100.8
CY2004	103.1	106.2	106.8	99.4	103.9	101.5	100.0	97.9	105.5	101.1
CY2005	107.7	106.6	124.7	109.0	103.1	114.5	100.0	93.1	113.0	103.2
2003										
March	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
June	100.5	102.3	100.0	99.3	99.7	98.1	100.0	100.2	100.0	100.5
September	101.0	103.1	103.8	99.2	102.1	97.7	100.0	100.1	100.0	101.1
December	102.0	105.7	101.5	99.0	102.8	97.8	100.0	99.1	100.0	101.7
2004										
March	102.2	106.3	102.27	99.02	105.73	97.95	100	99.62	100	100.82
June	102.5	106.64	102.27	99.44	103.71	99.19	100	100.93	100	100.36
September	103.4	105.79	102.27	100.37	103.6	102.15	100	96.74	111.08	100.98
December	104.4	106.26	120.27	98.9	102.43	106.89	100	94.18	111.08	102.13
2005										
March	105.1	105.3	120.3	103.7	102.8	107.1	100.0	92.6	111.1	102.4
June	106.7	106.7	123.5	105.9	102.4	110.7	100.0	95.2	111.1	104.2
September	108.3	107.3	126.4	107.1	103.8	118.4	100.0	94.5	113.8	103.1
December	110.8	107.1	128.6	119.5	103.5	121.7	100.0	90.3	115.9	103.3
					(Annual average change in percent)					
CY 2004	2.2	3.4	5.4	0.1	2.7	3.2	0.0	-2.0	5.5	0.3
CY 2005	4.4	0.3	16.8	9.7	-0.7	12.7	0.0	-4.8	7.0	2.1
					(Four-quarter percent change)					
2004										
March	2.2	6.3	2.3	-1.0	5.7	-2.1	0.0	-0.4	0.0	0.8
June	2.0	4.3	2.3	0.1	4.0	1.1	0.0	0.8	0.0	-0.1
September	2.4	2.6	-1.5	1.1	1.5	4.6	0.0	-3.4	11.1	-0.1
December	2.4	0.5	18.5	-0.1	-0.3	9.3	0.0	-4.9	11.1	0.4
2005										
March	2.8	-0.9	17.6	4.7	-2.8	9.3	0.0	-7.1	11.1	1.6
June	4.1	0.0	20.7	6.5	-1.3	11.6	0.0	-5.7	11.1	3.8
September	4.7	1.4	23.6	6.7	0.2	15.9	0.0	-2.3	2.5	2.1
December	6.2	0.8	6.9	20.8	1.0	13.9	0.0	-4.2	4.3	1.1

Source: Data provided by the RMI authorities.

1/ The CPI index developed in 1977 was revised. The revised CPI index, starting in 2003Q1, consists of prices of 61 goods and services collected in Majuro organized into nine groups. The CPI index is rebased to 2003Q1=100 from 1982=100.

Table I.4. Marshall Islands: Employment by Sector, FY2000–04[1/]

	FY2000	FY2001	FY2002	FY2003	FY2004
Total	8,004	8,554	9,087	9,289	9,161
Public sector employees	3,258	3,374	3,714	3,780	3,795
Private sector employees	4,746	5,180	5,373	5,509	5,366
Of which:					
Agriculture	21	16	14	34	42
Manufacturing	47	41	48	49	43
Construction	506	545	608	536	499
Retail	1,500	1,668	1,652	1,551	1,545
Average wages (in U.S. dollars)					
Public Sector	9,912	9,852	10,257	10,593	11,220
Private Sector	9,327	9,396	9,535	9,603	10,202
Memorandum item:					
Estimated population[2/]	52,671	54,584	56,639	57,149	57,659

Source: Marshall Islands Social Security Administration (MISSA).

1/ Based on MISSA payroll data. Figures partially reflect improvements in data coverage.
2/ Based on the projections made in the 1999 Population Census Report.

Table I.5. Marshall Islands: Balance of Payments, FY2000–05 1/

(In millions of U.S. dollars)

	FY2000	FY2001	FY2002	FY2003	FY2004 Est.	FY2005 Est.
Trade balance	-74.5	-69.4	-59.2	-63.3	-57.4	-69.3
Exports, f.o.b.	8.8	10.0	11.4	14.2	15.7	16.5
Imports, f.o.b.	-83.2	-79.4	-70.6	-77.5	-73.1	-85.8
Net services	-1.6	-3.4	-6.3	-3.6	-1.7	-6.9
Receipts	9.0	9.3	9.6	10.3	12.1	9.0
Travel 2/	3.0	3.1	3.4	4.0	5.0	5.5
Transshipments	1.1	1.3	1.2	1.1	1.3	1.4
Other	4.9	4.9	5.1	5.1	5.7	2.1
Payments	-15.0	-16.8	-20.2	-17.5	-16.6	-18.6
Freight and insurance	-7.6	-7.8	-10.6	-11.6	-11.0	-12.9
Transportation	-1.4	-1.7	-2.5	-2.1	-1.7	-1.7
Communications	0.0	0.0	0.0	0.0	0.0	0.0
Other	-6.0	-7.3	-7.1	-3.8	-3.9	-4.0
Other 3/	4.4	4.0	4.3	3.6	2.8	2.7
Net income	37.0	30.6	34.9	41.5	33.3	35.6
Receipts	40.2	33.2	37.0	43.6	35.6	38.1
Fishing rights fees	3.7	2.9	3.3	1.7	0.9	1.5
Registration fees	1.1	0.7	0.6	1.0	1.0	1.0
Interest and dividend earnings	9.3	2.6	-0.2	7.4	1.0	1.7
Labor income	17.7	18.6	17.7	17.8	17.6	18.6
Other	8.5	8.4	15.6	15.6	15.0	15.2
Payments	-3.3	-2.6	-2.1	-2.1	-2.3	-2.5
Interest payments	-3.3	-2.6	-2.1	-2.1	-2.3	-2.5
Unrequited transfers	42.9	51.1	39.2	41.7	30.2	41.0
Private	-6.8	-7.0	-13.0	-12.9	-12.4	-12.6
Inflows	0.6	0.6	0.4	0.3	0.3	0.4
Outflows	-7.4	-7.7	-13.4	-13.2	-12.7	-13.0
Official	49.7	58.1	52.2	54.6	42.6	53.6
Compact grants 4/	31.1	31.4	32.7	32.7	20.5	35.4
Other	18.6	26.7	19.5	21.9	22.1	18.2
Current account including official transfers	3.8	8.8	8.6	16.3	4.4	0.4
(in percent of GDP)	3.4	7.6	6.9	12.7	3.3	0.3
Current account excluding official transfers	-45.9	-49.3	-43.6	-38.3	-38.2	-53.2
(in percent of GDP)	-41.4	-42.3	-35.2	-29.9	-28.2	-36.9
Capital and financial account	-10.5	-16.9	2.0	-6.8	-27.7	-7.5
Direct investment, net	0.1	0.1	0.1	-1.9	0.1	2.1
Short-term liabilities, net 5/	-4.9	-2.2	-6.6	-8.1	-4.9	-4.9
Medium-term liabilities, net	-5.6	-14.8	8.6	3.3	2.1	-2.2
Inflows	11.1	9.2	9.6	4.3	2.3	0.0
Outflows	-16.7	-24.0	-1.1	-1.1	-0.2	-2.2
Other net government flows 6/	0.0	0.0	0.0	0.0	-25.0	-2.5
Transfer to Compact Trust Fund	…	…	…	…	-25.0	
Errors and omissions	11.3	2.9	2.9	6.9	-0.2	1.2
Overall balance	4.6	-5.2	13.5	16.4	-23.5	-5.9
Gross reserves 7/	9.4	4.2	18.4	34.1	10.6	4.8
Of which: usable government financial assets	9.4	4.2	2.7	2.9	4.5	1.1
(in months of imports of goods and services)	1.2	0.5	0.4	0.4	0.6	0.1

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

1/ Fiscal year ending September 30.
2/ Prior to 2004, the estimated number of vistitors to the RMI only include air arrivals.
3/ Net payments to the National Telecommunications Authority.
4/ Compact funding pertaining to the Kwajalein Atoll Trust Fund and Kwajalein resident and landowner compensation payments are classified as income rather than official transfers.
5/ Includes changes in social security fund investments, banking system assets held overseas, and government assets held in the capital and special fund accounts.
6/ Changes in government assets, excluding the general fund.
7/ Approximated by changes in usable government financial assets.

Table I.6. Marshall Islands: Exports by Product Category, CY2000–05

(In thousands of U.S. dollars)

Product	CY2000	CY2001	CY2002	CY2003	CY2004	CY2005
Copra cake	149	169	154	*230*	*209*	107
Coconut oil, crude	815	197	853	*1,070*	*770*	2,526
Frozen fish	2,500	2,450	2,550	*3,350*	*2,513*	0
Reexport of diesel fuel	8,411	9,030	9,680	*9,342*	11,315	13,300
Animal feed	400	420	525	*400*	375	0
Other exports	-251	500	500	500	500	500
TOTAL	12,024	12,765	14,262	14,892	15,682	16,433

Source: Data provided by the RMI authorities.

Table I.7. Marshall Islands: External Debt and Debt-Service Obligations, FY2000–05[1/]

(In millions of U.S. dollars)

	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005
Total debt outstanding	91.9	89.8	87.6	91.2	103.4	100.8
(in percent of GDP)	82.8	77.0	70.6	71.2	76.4	69.8
Debt service	20.6	26.3	3.2	3.9	4.2	6.2
(in months of exports of goods and services)	13.9	16.3	1.8	1.9	1.8	2.9
Amortization	17.3	23.7	1.1	1.9	1.7	3.8
Interest Payment	3.3	2.6	2.1	2.1	2.5	2.4
Of Which:						
Medium-term bond issues						
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding principal	22.6	0.0	0.0	0.0	0.0	0.0
Amortization	16.3	22.6	0.0	0.0	0.0	0.0
Interest	1.7	0.9	0.0	0.0	0.0	0.0
Asian Development Bank						
Disbursements	11.1	9.2	9.6	5.0	2.3	0.0
Outstanding principal	37.5	46.8	56.3	60.5	62.6	62.3
Amortization	0.0	0.0	0.1	0.8	0.2	0.4
Interest	0.0	0.0	0.4	0.5	0.8	0.8
Other central government[2/]						
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding principal	1.9	1.9	1.9	1.9	1.9	1.7
Amortization	0.0	0.0	0.0	0.0	0.0	0.2
Interest	0.0	0.0	0.0	0.0	0.0	0.0
National Telecommunications Authority						
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding principal	18.8	18.2	17.6	17.0	16.3	15.6
Amortization	0.5	0.6	0.6	0.6	0.7	0.7
Interest	1.0	0.9	0.9	0.9	0.8	0.8
Marshalls Energy Company, Inc.						
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding principal	12.8	12.3	10.7	10.2	9.8	9.3
Amortization	0.7	0.5	0.4	0.4	0.5	0.5
Interest	0.5	0.7	0.8	0.7	0.6	0.6

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

1/ Fiscal year ending September 30.

2/ Includes financial assistance from the Federal Emergency Management Agency, the National Marine Fisheries Service, and Taiwan Province of China.

Table I.8. Marshall Islands: Central Government Finances, FY2000–06 [1/]

	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005 Est.	FY 2006 Proj.
	(In millions of U.S. dollars)						
Total revenue and grants	74.1	81.7	79.7	83.3	76.1	83.9	107.5
Total domestic revenue	24.4	23.6	27.5	28.7	33.4	30.3	36.0
Taxes	17.0	18.4	20.1	23.1	22.5	22.1	25.9
Income	8.7	9.6	9.6	12.0	10.6	9.8	11.2
Gross revenue	3.2	3.8	3.5	3.4	4.0	2.9	4.2
Imports	4.2	4.0	6.0	6.6	6.2	7.8	8.7
Other	0.9	0.9	1.0	1.0	1.7	1.6	1.8
Nontax	7.3	5.3	7.4	5.6	11.0	8.1	10.1
Fishing rights	3.7	1.8	3.3	1.7	0.9	1.5	2.4
Fees and charges	0.9	1.0	1.6	0.8	7.8	4.9	5.7
Investment income	0.5	0.4	0.4	0.2	0.1	0.0	0.2
Other	2.3	2.0	2.1	2.8	2.1	1.7	1.8
Grants	49.7	58.1	52.2	54.6	42.6	53.6	71.4
Of which: current grants	26.7	34.8	32.9	35.4	39.5	39.7	57.9
Compact [2/]	31.1	31.4	32.7	32.7	20.5	35.4	37.5
Other	18.6	26.7	19.5	21.9	22.1	18.2	34.0
Total expenditure	65.1	72.1	84.6	69.2	76.6	86.9	107.3
Current expenditure	58.2	65.9	66.8	62.6	70.1	69.7	72.1
Wages and salaries	17.4	18.8	21.5	25.6	30.7	29.8	32.5
Goods and services	25.5	30.2	30.8	26.1	30.6	28.6	29.1
Interest payments	2.0	1.5	0.6	0.9	0.8	1.1	0.8
Subsidies to public enterprises	5.0	4.2	5.4	3.1	4.8	5.3	4.5
Other subsidies and transfers [3/]	8.0	11.2	8.6	7.0	3.2	4.9	5.2
Subsidies and transfers	13.1	15.4	14.0	10.0	8.0	10.2	9.7
Grants and subsidies	5.0	5.4	4.7	8.3	8.0	2.3	2.1
Transfers	8.1	10.0	9.3	1.7	0.0	7.9	7.6
RIF payment [4/]	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	6.8	6.2	17.8	6.6	6.5	17.2	35.2
Current balance	-7.2	-7.6	-6.4	1.4	2.8	0.3	21.9
Overall balance	9.0	9.6	-4.9	14.1	-0.5	-3.0	0.2
Financing	9.0	9.6	-4.9	14.1	-0.5	-3.0	0.2
Net government debt repayment	5.6	14.8	-8.6	-3.3	-2.1	0.4	1.0
Principal repayment	16.7	24.0	1.1	1.1	0.2	0.4	1.0
Gross borrowing	11.1	9.2	9.6	4.3	2.3	0.0	0.0
Asset sales [5/]	-1.3	0.0	0.0	0.0	0.0	0.0	0.0
Payment to refunded bond escrow	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in government financial assets	4.6	-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	66.7	70.1	64.2	65.0	56.2	58.1	69.6
Revenue	22.0	20.3	22.2	22.4	24.7	21.0	23.3
Grants	44.8	49.9	42.0	42.6	31.5	37.1	46.2
Expenditure	58.6	61.9	68.2	54.0	56.6	60.2	69.4
Current	52.4	56.6	53.8	48.9	51.8	48.3	46.7
Wages and salaries	15.6	16.1	17.3	20.0	22.6	20.6	21.0
Goods and services	22.9	25.9	24.8	20.4	22.6	19.8	18.9
Capital	6.1	5.3	14.3	5.1	4.8	11.9	22.8
Current balance	-6.5	-6.5	-5.2	1.1	2.1	0.2	14.2
Overall balance	8.1	8.2	-4.0	11.0	-0.4	-2.1	0.1
	(In millions of U.S. dollars)						
Memorandum items:							
Total expenditure excl. non-compact grants	46.5	45.4	65.1	47.3	54.5	68.6	73.3
Total government financial assets	34.2	29.0	32.6	50.0	58.7	68.2	78.3
Change in government fund balances	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total government assets	34.2	29.0	32.6	50.0	58.7	68.2	78.3
Of which: Trust Fund	…	…	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
Usable government financial assets [6/]	9.4	4.2	2.7	2.9	4.5	1.1	0.3
Outstanding government debt	64.5	49.6	58.2	62.4	64.5	64.2	63.2
Nominal GDP	111.0	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/ Does not include Compact funds earmarked for Kwajalein rental payments and trust fund contributions.
3/ For FY2003, transfers include operating transfers amounting 16 million to the Compact Trust Fund.
4/ Payments under early retirement and separation program (Reduction In Force) financed by an AsDB loan.
5/ Negative sign indicates a sale.
6/ Cash and cash equivalents that are not reserved for specific uses.

Table I.9. Marshall Islands: Central Government Current Expenditure, FY2000–04[1/]

(In millions of U.S. dollars)

	FY2000	FY2001	FY2002	FY2003	FY2004
Government	8.3	10.7	19.2	13.0	10.9
President and Cabinet	1.1	1.4	10.5	1.5	1.9
Advisory Council of High Chiefs (Iroij)	0.4	0.4	0.4	0.4	0.4
Legislature (Nitijela)	1.1	1.3	1.4	1.6	1.5
Commissions, agencies, and offices	0.8	0.9	0.8	0.4	0.5
Special/Other	5.0	6.8	6.2	9.1	6.6
Ministries	38.9	45.0	39.0	29.8	35.5
Health and Environment	8.0	8.2	9.3	7.3	7.5
Education	11.1	12.4	12.0	7.4	7.4
Transportation and Communications	1.4	4.3	1.7	1.7	3.8
Interior and Social Welfare	1.2	2.9	1.8	1.9	3.4
Public Works	4.6	5.3	1.4	1.3	2.2
Social Services	0.0	0.0	0.0	0.0	0.0
Resources and Development	3.4	2.0	0.6	0.7	1.1
Foreign Affairs	2.2	2.1	2.5	2.7	2.9
Finance	2.5	1.7	2.1	1.8	2.4
Justice	2.5	2.7	1.9	2.5	3.3
Auditor General	0.7	0.9	1.1	0.9	0.6
Chief Secretary	0.6	1.4	0.6	0.6	0.8
Other	0.8	1.1	4.0	1.0	0.0
Interest payments	2.0	1.5	0.6	0.9	0.8
Subsidies to public enterprises	5.0	4.2	5.4	3.1	4.8
TOTAL	58.2	65.9	66.8	62.6	70.1

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

1/ Fiscal year ending September 30.

Table I.10. Marshall Islands: Assets and Liabilities of Deposit Money Banks, CY2000–05 1/

(In millions of U.S. dollars)

	CY2000	CY2001	CY2002	CY2003	CY2004	CY2005 Latest
Assets	68.8	73.7	83.5	92.3	96.0	94.7
Foreign assets	30.6	31.7	40.1	48.4	52.3	53.8
Claims on central and local governments	0.0	0.0	0.0	0.0	0.0	0.0
Claims on public enterprises	2.8	-3.0	-1.5	1.3	1.3	0.0
Claims on private sector	39.4	40.7	41.2	43.1	43.9	43.1
Consumer	26.6	33.1	36.8	39.5	38.6	37.8
Commercial	12.8	7.6	4.4	3.6	5.3	5.3
Unclassified assets	-4.0	4.3	1.4	2.3	-1.5	-2.2
Liabilities	68.8	73.7	83.5	92.3	95.9	94.7
Deposits	58.5	62.2	69.4	72.2	75.4	73.5
Demand deposits	19.9	19.7	22.3	24.1	27.7	25.1
Time deposits	18.6	23.0	20.2	20.1	20.1	25.1
Savings deposits	13.4	15.0	17.4	18.0	19.0	23.9
Central government deposits 2/	6.6	4.6	9.0	10.0	8.6	8.0
Foreign liabilities	2.7	2.7	2.8	3.4	4.4	5.5
Capital accounts	7.0	7.7	12.8	13.8	15.7	17.3
Unclassified liabilities	0.5	0.9	0.4	0.6	0.5	0.5
Memorandum items:						
Loan/deposit ratio (in percent)	72.1	60.5	47.0	49.4	60.0	59.0
Deposits (12-month percent change)	7.7	6.4	15.3	4.0	0.0	0.0
Loans (12-month percent change)	9.9	-10.6	3.2	-0.6	3.0	0.0
Consumer loans (in percent of total loans)	63.1	87.8	85.0	89.7	85.0	88.0
Commercial loans (in percent of total loans)	30.3	20.2	10.7	7.1	12.0	12.0
Nonperforming loans (in percent of total loans) 3/	2.2	2.4	2.5	1.5	2.0	2.0

Source: Data provided by the RMI authorities.

1/ On a calendar-year basis. The deposit money banks comprise the Bank of Hawaii (until 2002), the Bank of Guam, and the Bank of the Marshall Islands.
2/ Includes the deposits of social security administration and other trust funds.
3/ Nonperforming loans are defined as those with arrears in excess of 90 days.

Table I.11. Marshall Islands: Interest Rates of Deposit Money Banks, CY2000–05[1/]

(In percent per annum)

	CY2000	CY2001	CY2002	CY2003	CY2004	CY2005
Deposit rates						
Savings accounts[2/]	2.9	2.5	2.5	2.5	1.0	1.0
Time deposits[3/]						
Three months	4.6	3.3	3.1	2.9	1.0	1.0
Six months	4.9	3.5	3.5	3.5	2.0	2.0
One year or more	6.2	4.1	4.0	3.9	2.0	2.0
Loan rates[4/]						
Consumer loans	19.2	16.5	16.5	16.1	19.0	19.0
Commercial loans	11.7	12.9	12.7	12.5	11.0	11.0

Source: Data provided by the RMI authorities.

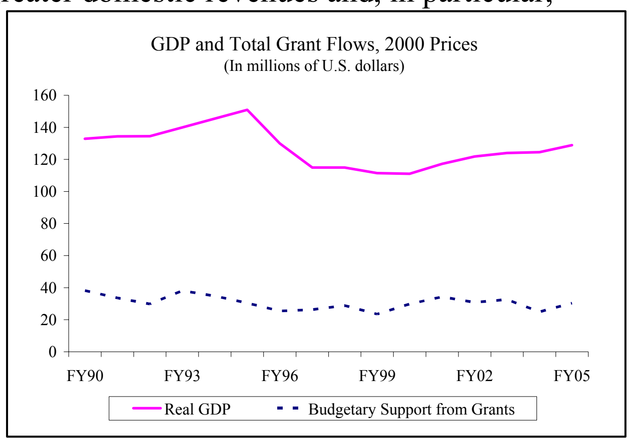
1/ At end–December.
2/ Average of rates offered by deposit money banks.
3/ Average of minimum rates offered by deposit money banks.
4/ Average of maximum rates charged by deposit money banks.

II. Compact Trust Fund: Lessons From The Pacific[1]

A. Overview

1. **With scarce land resources, a narrow production and export base, and geographic isolation, the Republic of Marshall Islands (RMI)–like many Pacific islands countries–has limited prospects for sustainable development and depends heavily on external assistance.** Since independence in 1986, the country has relied heavily on grants, which originate mainly from the United States, first under an initial Compact of Free Association (1986-2001) and then under an amended Compact agreement covering (FY2004-23).

2. **After the Compact grants expire in 2023, the RMI is expected to adjust to a lower level of external financing** through greater domestic revenues and, in particular, income from financial assets saved in a trust fund. However, as the experience of the mid-1990s shows, such an adjustment may not be smooth. In the mid-1990s, the RMI had to deal with declining Compact grant flows in real terms and the need to retire external public debt incurred as a result of borrowing by the government against future external grants. Adjustments to these factors have led to major setbacks in economic activity, from which the country has to date still not fully recovered. Moreover, domestic revenue sources remain limited and underdeveloped, in part reflecting the small size of the private sector.



3. **Reflecting the large inflow of grants, the public sector dominates the economy.** Public expenditure is over 70 percent of GDP and the government sector accounts for about half of total employment. 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. Structural bottlenecks contribute to limit the size of the private sector, exacerbated by the high public sector wages, which are double those in the private sector according to statistics published by RMI's statistics agency.

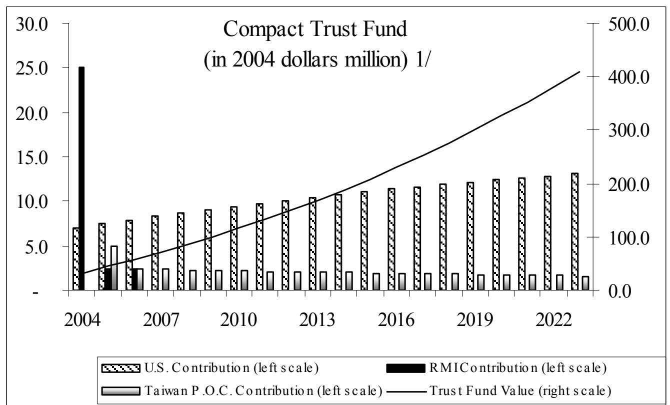
4. **Under the amended Compact, the United States has agreed in addition to providing sector grants, to contribute to the establishment of a trust fund with an overall mandatory contribution from the RMI** (totaling $30 million). The financial assets

[1] Prepared by Papa N'Diaye (Ext. 39751).

built in the trust fund are expected to provide a new source of revenue that will help ensure fiscal sustainability and budgetary self reliance. However as other countries' experiences suggest, achieving such objectives require early emphasis on prioritization and consolidation of government expenditure and prudent and transparent management of these assets. Against this background, this chapter presents the key features of trust funds in the Pacific to highlight best practices in terms of management and the challenges RMI face.

B. Key Features of the Trust Fund

5. **The RMI established in 1999 the Marshall Islands Trust Fund (MITTF) to help the government achieve budgetary self reliance,** ahead of the negotiation of the Compact of Free Association agreement with the United States. The MIITF was set up with funds from the RMI, the Asian Development Bank (AsDB), and the U.S. government. The funds provided by the U.S. government were meant to ensure a continued flow of assistance during the two-year period when the Compact was being negotiated (2002-2003). The MITTF endowment amounted to over US$31 million by end-FY2003 (September 30). During the negotiation of the amended Compact, the RMI proposed that a trust fund be included as part of the terms of the agreement. This trust fund, which was to be named Compact Trust fund (CTF), aimed to help ensure fiscal sustainability and budgetary self reliance.



1/ CTF accumulation based under a 6 percent rate of return assumption.
2/ RMI contirbution based on the medium term budget framework.

6. **Under the amended Compact, the CTF was initially to be funded by the RMI and the United States.** The RMI's contribution was set to an overall amount of US$30 million, settled in initial contribution of US$25 million in FY2004 followed by two installments of US$2.5 million in FY2005-06. These contributions were met by the RMI government mainly by transferring funds from the MIITF to the CTF. The United States in turn contributed initially US$7 million to the CTF in FY2004. This contribution is set to increase annually by US$0.5 million through 2023, with a partial inflation adjustment applied to the sum (at two-thirds of the U.S. annual inflation rate). However the U.S. annual addition of US$0.5 million to trust fund contributions is in fact matched by a concomitant decline in its budgetary grant support for the RMI.[3] Contributions from the U.S. government and the

[3] Recommendations with respect to changing from partial to full inflation adjustment would be considered during U.S. Congress reviews of the Compact on the 5th, 10th and 15th anniversaries of the agreement.

RMI government were supplemented by that of the Taiwan P.O.C. government, which committed to provide substantial installments over a 20-year period starting FY2004.

7. **Reflecting the participation of its stakeholders, the CTF is administered by a seven-member committee,** with four voting members appointed by the United States, two appointed by the RMI, and one appointed by Taiwan P.O.C. Decisions regarding the operations, supervision, and management are governed by majority vote. The committee has selected one investment advisor in late FY2005 for a period of five years with the option of terminating its contract when deemed appropriate. Prior to that decision, the CTF was invested in money market funds, earning a rate of return slightly over 3½ percent, much lower than the nominal rate of return of 6 percent assumed by the U.S. State Department.

8. **The committee sets the objective of the fund to maximize total returns, while preserving the capital.** While the choice of the investment portfolio is ultimately at the discretion of the money managers, the committee establishes a set of guidelines and evaluates the performance of the assets against U.S. benchmarks. For example, the assets can be invested in equities, fixed income securities, and cash equivalents in accordance with an undisclosed approved asset allocation. Any change to the asset allocation requires prior approval of the CTF committee. The performance of the equity holdings will be evaluated against that of the S&P500 stock index, with a goal to exceed its total rate of return over a five-year rolling period.[4] The investment advisor is required to provide to the committee monthly statements and an end-of-quarter review of the market value holdings, performance, and information on recommended strategic or tactical asset allocation changes. However, it has not yet been decided whether the CTF's operations, investment objectives, and results will be made available to the public.

9. **The RMI will be able to withdraw from FY2024 onward an amount not exceeding the Compact grant flows in the FY2023** (adjusted for inflation). If the CTF income is less than the previous year's distributions, the principle of the fund will be left untouched, unless the CTF committee decides that there is a special need to tap into the fund. Also, the RMI may place additional funds (above the initial deposit) in the CTF, and has discretionary withdrawal rights to that amount and any associated returns. In this connection, as stated in the 2006 Budget speech the RMI government aims to build up assets amounting to up to US$10 million in a separate account, which will be used as a buffer against adverse fiscal shocks. More generally, the trust fund incorporates built-in mechanisms that provide some protection against unforeseen events by making provisions for annual income above the benchmark projected nominal rate of return of 6 percent to be set aside in a buffer account. This amount can be tapped when the fund's rate of return is below the benchmark rate.

[4] The investment policy guidelines stipulate that "the Trust Fund committee expects equity money managers to seek to produce a cumulative annualized total return net-of-fees and commissions that exceeds the S&P500 over a moving five year period."

C. Lessons from Practices in the Pacific

10. **There are several trust funds operating in the Pacific, some of which were set up from a windfall of resources, others from donors funds.** These funds were generally put in place to provide a source of revenue for financial and economic self reliance, or more generally, economic development. Multinational institutions, such as the AsDB, and donors have found this channel as an effective means for improving aid effectiveness, although some uncertainty remains on how it compares with more traditional forms of assistance.

Kiribati's Revenue Equalization Reserve Fund (RERF)

11. **Since independence, the Kiribati's RERF has been presented a success story.** The RERF was established in 1956 by the British colonial government using phosphate mining royalties to provide budgetary support after depletion and closing of the phosphate mine in 1979. The government of Kiribati is the trustee and beneficiary of the RERF, deciding on the RERF's investment strategy and choosing the amounts of drawdowns, with the committee in charge of managing the funds chaired by the Minister of Finance and Economic Planning. With sound fiscal management, financial assets in the fund increased substantially, reaching A$658 million by end-2000, from A$68 million in 1979. The government minimized during that period its drawdowns for budgetary purposes, reinvesting most earnings. Between 1996 and 2000, average drawdowns were limited to 5.6 percent of GDP per annum, allowing the government to effect a 55 percent real increase in value of the assets per citizen. The strong performance of the trust fund was supported by the stock market boom of the late 1990's with returns peaking at about 13 percent.

12. **However, the experience starting in 2001 has brought to the fore the importance of fiscal prudence.** Starting in 2001, the government began drawing heavily from the RERF, reaching about 25 percent of GDP by 2004. Specifically, in 2001 expenditures rose sharply and despite near record levels of revenues, budget financing from the RERF rose to 13½ percent of GDP. During 2001–03, the correction in stock markets caused the rate of return to turn sharply negative. In 2004, drawdowns to finance the deficit reached 24½ percent of GDP. As a result of persistent drawings and average negative rates of returns, the real per capita value of the fund declined.[5] This decline occurred notwithstanding the Parliament's decision to maintain in principle the RERF's real per capita value because the 1979 Public Finance Act only set general principles to guide investment and the government did not need parliamentary approval to increase drawings above budgeted levels.

Tonga Trust fund (TTF)

13. **The Tonga trust fund was established as an off-budget fund in 1988,** initially from the sale of passports to citizens of China residing in Hong Kong S.A.R. and

[5] See Purfield, C., " Managing Revenue Volatility in a Small Island Economy: The Case of Kiribati—International Monetary Fund, Working Paper 05/154.

subsequently proceeds from the lease of Tongan satellite space. The TTF was to be used in exceptional circumstances and for future major development projects.

14. **The Tonga trust fund was managed by a board of trustees chaired by the Prime Minister and including the Minister of Finance and the Minister of Justice.** The legal structure of the fund aimed at providing some protection to the fund, including through investment guidelines and requiring annual audits by the Auditor general and publication of the audits in the Gazette and its presentation to the Legislative assembly. However in practice, the management of the TTF was characterized by a lack of transparency, unclear investment guidelines, and weak governance and public accountability on investments. The funds were invested offshore and its operations and investment objectives and results, in terms of portfolio allocation and returns, were not published. The fund's accounts, while audited by the auditor's general, were not subject to external or more independent auditing. Furthermore, the investment strategy was ill-defined as it resulted in a large concentration of assets in high-risk instruments. As a result, the TTF which reached a book value of about US$37 million at end-June 2000, declined to about US$3 million at end-June 2002. Since then, the fund had been reportedly lost. The government filed suit in the U.S. courts against the financial advisor of the fund for fraudulent management. An out-of-court settlement was reached in 2004, which stipulates that neither the financial advisor nor the Tongan government admitted any liability.

Tuvalu Trust Fund

15. **The Tuvalu trust fund, after which the RMI trust fund was modeled, was established in 1987** from funds mainly donated by Australia, the United Kingdom, and New Zealand to help the country achieve budgetary self reliance and lay the foundation for sustainable economic growth.[6]

16. **Initial contributions totaled $A27.1 million, including about $A8 million from each of Australia, Great Britain, and New Zealand, and $A1.6 million from Tuvalu.** Smaller contributions were also received from Japan and Korea (amounting to $A0.7 million and $A0.05 million). After ten years, the fund reached $A45 million with a real rate of return averaging 6½ percent, providing $A25.1 million in revenue for Tuvalu, of which $A9.7 million were used to finance the budget, $A7 million were reinvested in the fund, and A$8.4 million were held in a buffer account (referred to as "B account"). It is estimated as of Spring 2004 that the market value of the fund reached over $A80 million. At the same time, budgetary aid fell to about 4 percent of total budget revenue, from about 16 percent in 1996.

17. **The key features of the Tuvalu trust fund management structure include:**

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[6] See "Trust funds in the Pacific, their role and future," the Asian Development Bank, 2005 for a comprehensive review of trust funds in the Pacific.

- The trust fund was managed by a board of trustees chaired by a Tuvalu representative and including representatives of the three initial contributors.
- Reputable professional investment managers were selected.
- The fund performance was monitored by actuarial consultants.
- External auditors provided independent audits to facilitate assessment of the fund's performance and prevent mismanagement.
- The board benefits from advice from an independent advisory committee including Tuvalu and donor representatives.
- Trust fund earnings are deposited into the B account while the principal would remain in the main account, the "A account". Funds in the B account were used to smooth the contributions to the recurrent budget, allowing the government to build up savings in good times and run deficits in bad ones. Overall, this stabilization fund helped facilitate fiscal management.

18. **Part of the success of the Tuvalu trust fund stems from the fact that successive governments have consistently pursued prudent fiscal management practices.** The government factored into its budget drawdown based on the board's and advisor committee's medium-term objectives of four percent growth in real terms for the fund.

Palau's Compact Trust fund

19. **Palau established a trust fund with a 50-year lifespan under the Compact of Free Association agreement with the United States in 1995.** The trust fund was funded through two disbursements by the United States of US$66 million and US$4 million in 1994/95 and 1996/1997, respectively. Somewhat like RMI, the proceeds from the trust fund were to be used only after the annual Compact grants end in 2008/09 to provide a steady source of income. The only exception was that, starting in 1998/99, a maximum of US$5 million (indexed at 5 percent inflation) could be withdrawn from the Trust Fund for current operations and maintenance purposes. With an assumed rate of return of 12½ percent, it was intended to produce an annual distribution of US$15 million starting in 2009/10 to replace Compact grants, even if the maximum early withdrawals were made.

20. **The Trust Fund is managed by international fund managers and the Board of Trustees reports to the President with an investment strategy, reporting, auditing, and drawdowns set by legislation.** The investment strategy has been to maintain about 60 percent of the funds in the U.S. stock market, which experienced a strong bull run prior to 2001, helping to achieve double digit returns. However, with the correction to stock prices that started in 2001, the trust fund posted substantial losses in FY2001-02. As a result, the fund's balance at US$152 million at end-FY2005, was US$80 million lower than initially envisaged. Going forward based on the initial withdrawal schedule and with an assumed low-

risk rate of return of 6 percent (as assumed in the case of RMI), the fund is projected to be depleted in 2024, 20 years before schedule.[7]

D. Conclusions

21. **The RMI's trust fund appears to have sound institutional and governance structures well suited for prudent risk management practices of the funds in efficient and sound markets.** However, there remains a need for a transparent framework that ensures accountability and clarity of the trust fund management activities and results in line with the IMF guidelines,[8] including disclosing publicly the objectives and performance of the trust fund. Most related to the management of the trust fund is its performance, which in turn raises the question of whether the fund will generate sufficient returns to fully replace the US grant assistance after 2023.[9]

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[7] See Chapter III of this year's accompanying selected issues paper for the 2005 Article IV consultation with Palau.

[8] Guide on Resource Revenue Transparency, International Monetary Fund, June 2005. and Guidelines for Foreign Exchange Reserve Management, International Monetary Fund, September, 2001.

[9] See SM/04/9, Chapter II, International Monetary Fund.