June 2008
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Republic of the Marshall Islands: 2008 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

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 2008 Article IV consultation with the Republic of Marshall Islands, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 2, 2008 with the officials of the Republic of Marshall Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 9, 2008. 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 June 4, 2008 discussion of the staff report that concluded the Article IV consultation.

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.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with the Republic of the Marshall Islands

Approved by Jeremy Carter and Scott Brown

May 9, 2008

- **Discussions.** December 4–12, 2007 and March 31–April 2, 2008 with Finance Ministers Wase and Ading, Chief Secretary Nemra, Finance Secretary Barton, Banking Commissioner Muller, other senior government officials, private-sector participants, donors, and the press.
- **Team.** Ms. Edison (head), Mr. Rozhkov (both APD), and Mr. Lam (FIN). Mr. Na (OED) participated in the discussions.
- **Outreach.** Staff presented their research in an open forum and issued a press statement.
- **Mission focus.** Policy measures needed to achieve fiscal sustainability and boost private-sector growth.
- **Exchange rate.** The Marshall Islands has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange system is free of restrictions on the making of payments and transfers for current international transactions. The U.S. dollar is legal tender.
- **Technical assistance.** PFTAC has provided assistance in bank supervision, cash management, revenue forecasting, and balance of payments statistics.
- **Statistical issues.** Economic monitoring and policy evaluation are constrained by quality of economic reporting.
- **Past Fund advice.** For a description of the issues discussed in the 2005 Article IV consultation, see: http://www.imf.org/external/np/sec/pn/2006/pn0626.htm. The authorities have broadly agreed with the Fund advice, but implementation has frequently been more gradual than recommended by the staff.

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EXECUTIVE SUMMARY

The Republic of the Marshall Islands (RMI) relies heavily on grants from the United States under the Compact of Free Association. These grants are mainly used to sustain a large public sector, which dominates the economy. The RMI has experienced seven years of continuous growth, partly reflecting increased inflow of financial resources from the amended Compact. In the past two years, however, growth has slowed and inflation has been somewhat volatile and rising, driven in part by rising fuel prices and food prices. The authorities and the staff agreed that growth is likely to slow further in 2008.

Given the planned steady decline in Compact grants, and the substantial increase of debt payments in the near future, the current size of government is not sustainable. Fiscal consolidation and structural reforms are therefore needed, to ensure long-term fiscal sustainability and to boost private sector development. The authorities recognized the need for fiscal consolidation, but indicated that this is very challenging given existing expenditure obligations.

To achieve long-term external sustainability, the fiscal position needs to be substantially improved. The fiscal objectives will have to be more ambitious than those set by the previous government and stated in the FY2008 Budget, which was to balance the budget and achieve a fiscal surplus "where possible." The staff recommends aiming for a modest fiscal surplus in FY2008 and further adjustment of ½ percent of GDP per annum for the next 4–5 years through cuts to current expenditure and revenue-raising measures. These surpluses should be used to build reserves in the Compact Trust Fund to ensure budgetary self-sufficiency.

Structural reforms are essential to promote sustainable private sector growth. The long-term aim of these reforms should be to replace the government as the primary engine of growth. This will entail shoring up infrastructure, resolving land issues, and scaling back the government's commercial activities. Such measures could reduce the cost of doing business, facilitate commercial bank lending, and promote private-sector development. The authorities concurred that structural reforms are needed to complement fiscal consolidation.

Decisive steps are needed to strengthen the RMI's financial infrastructure and harness domestic savings for financing growth. Measures to reduce impediments to commercial lending should be introduced, including the rapid implementation of secured lending by establishing a registry for collateral. The authorities agreed that widespread reliance on personal credit warrants careful monitoring. To safeguard against potential non-performing loans, the banking commissioner should ensure that banks are classifying and provisioning properly against problem loans.

I. BACKGROUND

1. **The Republic of the Marshall Islands (RMI), scattered across an area of nearly 1 million square miles in the Central Pacific, is heavily dependent on external grants.** Like other small Pacific island countries, RMI is remote from major markets, has a narrow production and export base, and is vulnerable to external shocks and climate change (Box 1). The most important aid source has been U.S. financing, primarily through the Compact of Free Association (Compact). The Compact (amended in 2004) extends the U.S. financial support until 2023. Taiwan Province of China has also given substantial aid to support development expenditure and contributed to the Compact Trust Fund (CTF).

2. **As in past consultations, this year's discussions focused on policies to put public finances on a secure footing and improve growth prospects.** Achieving this goal will require fiscal consolidation, reform of public enterprises, and other structural measures. Since the last Article IV, the fiscal position has improved slightly, but limited progress has been made on structural reforms, and key tax reforms have not been implemented.

3. **National elections at the end of 2007 resulted in a new President and a coalition government.** The new government has underscored the need to review various aspects of the amended Compact agreement, especially the land use agreement regarding Kwajalein where the United States operates a military base. In the short run, the new government is not expected to change economic policies significantly, but could provide a fresh impetus to advance reforms.

II. RECENT ECONOMIC DEVELOPMENTS

4. **Recent economic performance has been lackluster.** Real GDP growth slowed, on average, to 1.3 percent in FY2005–06 (fiscal year ending September 30), from about 4 percent in the previous four years (Table 1 and Figure 1). During FY2006, a financial crisis of the energy company–a public enterprise– required a large cash injection from the government to sustain electricity production.[1] The problem was resolved in early FY2007 with the refinancing of $12 million of the company's expensive short-term debt. Economic activity started to pick up in early FY2007, driven by the construction of a convention center, the

Selected Economic Indicators

	Average FY2001-04	FY2005	FY2006	FY2007
		(year-on-year changes)		
Real GDP	4.3	1.7	0.8	2.3
CPI	0.6	3.5	5.3	2.9
Employment	3.5	-5.0	4.7	3.1
		(in percent of GDP)		
Current account balance including current transfers	-16.1	-5.7	-1.6	-3.1

Sources: Staff estimates, and RMI authorities.

[1] The main factor leading to the difficulty of the energy company was that its long-time supplier discontinued the sale of fuel on a consignment basis, a practice that had been in effect for over a decade. This required the energy company to seek other sources of funding for its fuel inventory. In addition, the energy company was slow to adjust tariffs but has since adopted a template for tariffs that automatically adjusts to changes in world oil prices.

refurbishing of a fish processing plant, and the influx of visitors from charter flights. Growth in FY2007 is estimated to have been around 2.3 percent. Unemployment, especially youth unemployment, remains high, contributing to emigration to the United States, which is relatively easy under the Compact agreement.

Box 1. Marshall Islands: Vulnerabilities to Climate Change

With an average elevation two meters (7 ft) above sea level—the highest land elevation is only six meters—RMI is highly susceptible to a rising sea level induced by global warming. Fragile coral reefs fringe the atolls and serve as the only line of defense against ocean surge. Climate change has increased the likelihood of sudden erosion due to storm surges and seasonal typhoons. Coastal erosion is evident throughout the islands. On Majuro Atoll, the airport has flooded several times, despite an eight-foot-high seawall. Water shortages and drought have also struck. The small land area in various atolls and islands leaves little room for adaptation alternatives, such as retreating to higher elevations or building preventive dikes, in face of rising sea levels.

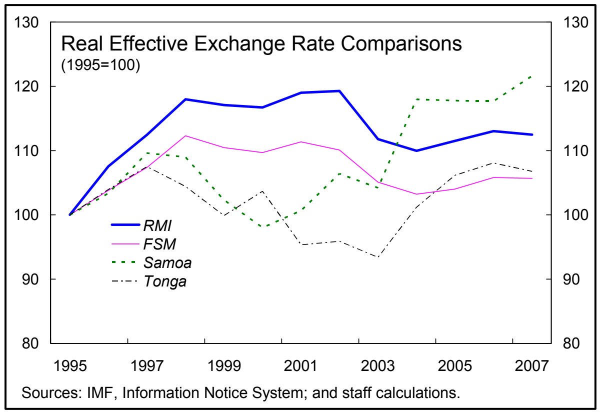
The key economic effects of climate change include:

- *Direct*. Nearly half of total exports come from climate-sensitive sectors, such as fishing and copra production. In addition, disruption in air transport would affect tourism and business climate.
- *Budgetary*. Additional capital expenditure for either preventive or restorative measures may be required in the medium term. Also, the decline in exports and tourism could mean a reduction of tax revenue.

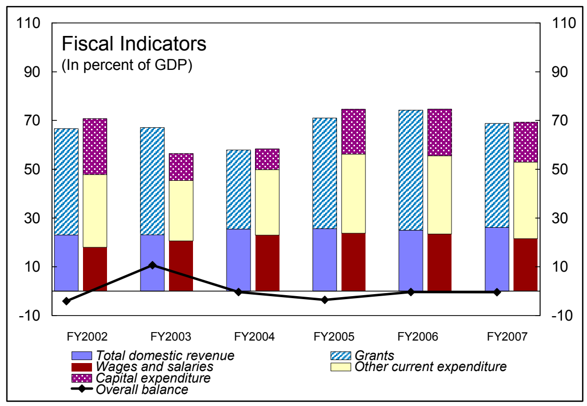
The authorities are currently engaged in regional and international efforts in raising the general awareness and assessing the vulnerabilities due to climate change. The United States and RMI governments have initiated a disaster fund with the Compact grant of roughly $200,000 per annum to finance potential losses arising from natural disasters. The country is also involved in climate change issues, including the implementation of the United Nations Framework Convention on Climate Change.

5. **CPI inflation has risen but remains reasonably contained.** Inflation averaged about 4 percent (year-on-year) in the last two years, reflecting higher electricity costs and prices of food and oil. The U.S. dollar is the official currency and has provided a strong anchor for inflation expectations.

6. **Exports have been held back mainly by structural problems.** Exports declined after the tuna processing plant closed in 2005 and have not recovered. The real effective exchange rate has remained broadly unchanged over the past decade, reflecting a relatively stable inflation differential with the United States, a large trading partner, and a weakened U.S. dollar. Tourism is modest, owing to weak infrastructure and few overseas flights compared to other pacific islands, but RMI has been trying to attract more tourists by using charter flights.[2]



7. **The fiscal position improved in FY2006, but the overall balance remained slightly negative at around ½ percent of GDP (Table 2 and Figure 2).** This outcome masks some of the problems the government faced early in the fiscal year, including difficulty in meeting bi-weekly payroll, missed social security payments, delayed payments to vendors, and arrears to the Asian Development Bank (AsDB). Improvements in collection of taxes (and tax arrears) as well as grants from Taiwan Province of China eased the situation.[3] The outcome reflects mainly increased funds from the Compact agreement, some of which were previously delayed. In FY2007, the government's overall deficit is estimated to have remained roughly constant at ½ percent of GDP.

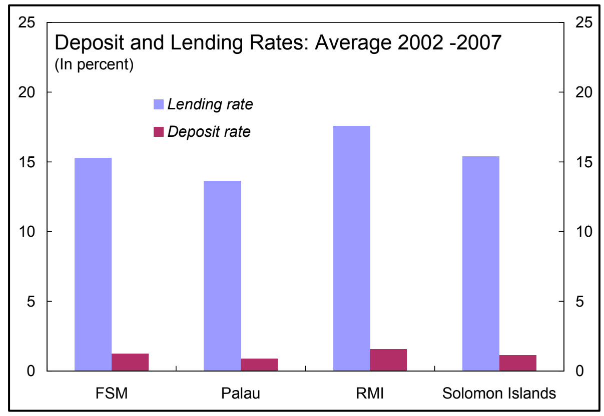


8. **The government has fully met its mandatory contributions to the CTF.** The CTF is now invested in a portfolio of U.S. and international stocks and bonds, and the income of the fund exceeded projections in FY2006 and FY2007. A conflict between the trustee and the investment advisor over the custodial rights has been resolved.

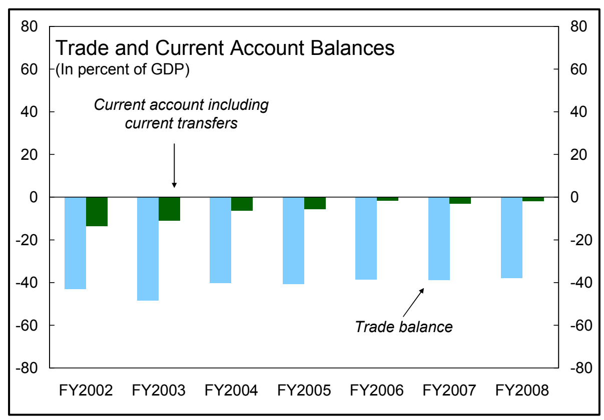
[2] Japan Airlines started operating charter flights to the Marshall Islands in early 2007 with six charter flights visiting RMI during 2007.

[3] The government has limited access to borrowed funds. In the past, when faced with a cash crunch the Ministry of Finance has either arranged an advance to be taken from the following year's grant receipts or used grant money as a stopgap measure. The amended Compact does not permit such activities.

9. **The banking system, which consists of two banks, provides little domestic credit to the commercial sector (Figure 3).**[4] Around 75 percent of total bank lending is in high-interest short-term consumer loans, rather than commercial loans, owing to the lack of adequate collateral.[5] Average bank lending rates tend to be slightly higher in RMI than in other Pacific countries. The non-bank sector consists of one small moneylender and several small money transfer companies that operate with remittances. In addition, one of the banks has recently become involved in microfinance, funded by a $0.7 million government guaranteed loan from Taiwan Province of China. In 2007, a third bank was licensed to operate in the RMI, and is expected to begin banking operations in 2008.



10. **The current account balance (including current transfers) has improved but was in deficit of 1.6 percent of GDP in FY2006 (Table 3 and Figure 4).** The trade deficit remained stable, with a decline in both exports and imports, stemming from a decrease in the re-export of diesel fuel. Net services and income in the current account narrowed slightly, owing to higher pay for local workers employed in the Kwajalein U.S. military base. Current transfers increased, thanks to higher Compact grants. Staff estimate that the net outflow of private transfers is large, reflecting the flow of Kwajalein rental receipts to non-resident landowners.[6] In FY2007, the current account (including current transfers) is estimated to be in deficit around 3 percent of GDP, largely reflecting declines in grants, particularly related to infrastructure.



11. **Gross external debt remains high (Table 4).** The outstanding public and publicly guaranteed debt is estimated to be around $100 million, or about 70 percent of GDP at the end of FY2006. This includes $12 million of new publicly guaranteed debt of the energy company. Nearly 60 percent of the outstanding debt is on concessional terms, owed primarily

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[4] There is evidence, however, that loans to small businesses are often classified as personal loans to the business owners, to simplify the approval process.

[5] Typical interest rates on consumer loans are 18–20 percent, despite the fact that these loans are usually guaranteed by salary allotments, with debt payments deducted from the paycheck by the borrower's employer.

[6] There are no reliable statistics on remittances.

to the AsDB. The remaining is mainly owed by two utility companies in the public enterprise sector. The debt service was $6.3 million in FY2006, or about 20 percent of exports of goods and services, but has risen significantly in FY2007 reflecting repayments of arrears to the AsDB and large interest payments related to the short-term financing for the energy company.

III. Discussions with the Authorities

12. **Most of the discussions focused on two key issues: achieving fiscal sustainability and boosting private-sector growth.** Given the decline in external grants under the amended Compact (and set to expire in 2023) and increases in debt service payments, maintaining the current size of government is not sustainable over the longer term. Fiscal consolidation and structural reforms are therefore needed, to ensure long-term fiscal sustainability and to boost private sector development. There was broad agreement that such reforms would be difficult and challenging. Nevertheless, the government recognized that viable alternatives are lacking, and without these reforms the underlying vulnerabilities are likely to grow.

A. The Outlook and Exchange Rate Regime

13. **Activity is slowing with real GDP growth of less than 2 percent a year likely over the medium term.** For the immediate future, staff projects growth of about 1.2 percent in FY2008 and 1.8 percent in 2009, constrained by rising energy costs and a large reduction in employment at the military base in Kwajalein (Table 5). The significant loss of revenue from the military downsizing will be partially offset by the launching of a tuna processing plant. High energy and food costs are creating inflationary pressure. The external position is expected to remain roughly balanced, given projected disbursements of foreign grants and limited access to other sources of external financing.

14. **Risks to the outlook are on the downside.** While infrastructure spending will continue, problems with the energy company could resume, especially if oil prices continue to rise, and the lengthy grounding of the domestic airline could undercut the nascent tourist business. With the United States downsizing its activity on Kwajalein, the knock-on effects on Marshallese employment and revenue could be dramatic. In addition, global financial disturbances could depress the rate of return on the CTF, further undermining fiscal sustainability. Structural reforms to improve the investment climate will be important to safeguard even the baseline growth scenario.

15. **Although full dollarization deprives RMI of a policy instrument to help safeguard stability, enhance competitiveness, and deal with external shocks, it is appropriate given RMI's size, administrative capacity, and close ties to the United States.** The authorities underscored that RMI does not have the capacity to conduct independent exchange rate and monetary policy. Over the next fifteen years, external stability is not at risk given the flow of Compact grants until 2023. However, over the longer term

(after 2023) insufficient fiscal adjustment could eventually lead to a depletion of the CTF and possibly mounting external debt.

B. Fiscal Consolidation

16. **The key issue for external stability in the long term (after 2023) is fiscal sustainability.** In this context, the staff urged the government to aim for a modest fiscal surplus in FY2008, recognizing that under the current circumstances it may be difficult to achieve rapid fiscal adjustment without hurting growth. Given the size of adjustment, the staff proposed that fiscal consolidation proceed by ½ percent of GDP per annum for the next 4–5 years, using the surpluses to build reserves in the CTF (Box 2).[7] The new government recognized that this adjustment was necessary to achieve the goal of budgetary self-sufficiency by the end of the Compact in FY2023, but indicated that it would be very challenging given its existing expenditure commitments. The staff emphasized that the longer the adjustment is delayed the harder it will be for the country to adjust and achieve sustainable growth in the longer term.

17. **The authorities recognized that they would need to make difficult cuts to current expenditure in the short term.** The staff noted that the level of current expenditure is not sustainable, and expressed concerns that a sizeable portion of Taiwan Province of China grants are used for financing current expenditure, rather than capital expenditure. The authorities argued that this is necessary since they are facing high debt-service payments and are actively seeking additional donor contributions. The mission advised the following menu of measures be phased in over the next several years to achieve the needed fiscal adjustment:

- *Wage bill*. Payroll expenditure needs to be cut as it has expanded significantly since the previous downsizing efforts, and is equal to 22 percent of GDP (up from 16 percent of GDP in FY2000). The authorities responded that in the FY2009 budget they are considering a wage and hiring freeze and eliminating vacant positions, which could yield a savings of about $0.5 million, nearly ½ percent of GDP.

- *Subsidies.* The authorities accepted the need to improve performance of public enterprises, and noted significant progress has been achieved in recent years, particularly the Social Security Administration and the Marshall Islands Shipping Corporation, reducing the burden on the budget. The staff encouraged that the large electricity subsidies to Majuro landowners (roughly 1 percent of GDP) should be scaled back, especially given the escalating fiscal impact.

[7] Chapter 1 of the Selected Issues describes various scenarios in detail.

Box 2. Marshall Islands: Fiscal Sustainability After 2023

Budgetary self-sufficiency of the RMI after 2023 will depend on whether the earnings from the Compact Trust Fund (CTF) will be enough to offset the elimination of Compact grants. Chapter 1 of the Selected Issues considers several alternative scenarios, some of which are summarized below.

Baseline scenario

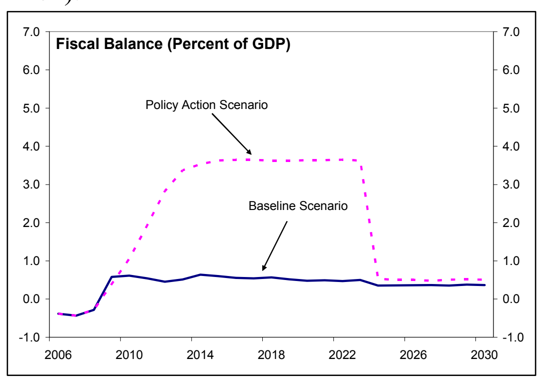
The baseline scenario assumes that structural reforms are not undertaken, and the fiscal balance is kept around ½ percent of GDP until 2023, which is adequate for making debt payments, but not for adding reserves to the CTF. Under this scenario, CTF earnings in 2024 (assuming constant real value of the CTF) are projected to be $22.5 million lower than the Compact grants they are supposed to replace.

Alternatives without policy action

Staff projections show that securitization of $100 million of future U.S. contributions to the CTF will only reduce the 2024 shortfall by $1 million. The benefits of securitization therefore do not justify taking additional risks. Similarly, additional help from donors (within the realistic limits) will reduce the shortfall, but not eliminate it. For example, an additional $5 million per year until 2023 will only eliminate less than ¼ of the shortfall after 2023 ($4 million).

Policy action scenario

Structural Reform. This scenario assumes that the a uthorities implement structural reforms only. This action leads to an increase in GDP growth and higher budget revenues, narrowing the fiscal gap in 2024. However, structural reforms alone (without fiscal consolidation) would not be sufficient to eliminate the shortfall, which remains at $20 million.



Fiscal Consolidation and Structural Reform. Projections show that, in addition to structural reform, the authorities need to achieve a fiscal surplus of about 3 percent of GDP within 5 years, and maintain it until 2023. This would allow adding reserves to the CTF. In addition, it will result in a substantial fiscal surplus by 2023, reducing the amount of Compact grants that need to be replaced. CTF earnings after 2023 would then be sufficient to compensate for the elimination of Compact grants, and the CTF can be kept constant in real terms, ensuring long-term fiscal sustainability.

CTF Earnings: Annual Surplus (+) or Shortfall (-) After 2023 (US$ millions) 1/

Baseline scenario	-22.5
I. No policy action	
Securitization of future U.S. contributions 2/	-21.5
Additional $5 mln per year from donors	-18.5
II. Policy action	
Structural reforms (without fiscal consolidation)	-20.1
Fiscal consolidation and structural reforms	0.0

Source: IMF staff calculations
1/ Calculated as the difference between CTF earnings available for withdrawal in 2024 (so that the real value of the CTF is kept constant) and the Compact grants in FY2023 (estimated at $47 million).
2/ Assumes securitization of $100 million in FY2010, with all incurred debt repaid before FY2023.

- *Other expenditure.* The new government plans to cut discretionary expenditure by 5 percent in the FY2009 budget. There was broad agreement that efforts should focus on limiting spending on travel, energy consumption, and use of government vehicles.

18. **The authorities acknowledged the need to raise additional revenue.** So far, the authorities have focused their efforts on tax collection, where progress has been achieved by strengthening the tax audit unit, and pursuing more aggressively the non-compliant businesses. Nevertheless, tax non-compliance is estimated to remain high, particularly in the informal sector, and the team urged the authorities to take steps to reduce it. Additional measures should include:

- *Tax administration.* The authorities concurred that it is important to eliminate the dual and duplicate efforts by the national and local governments in revenue collection. They also indicated that the imminent adoption of a new customs program should assist in the collection of import duties.

- *Tax policy.* The authorities agreed that progress on tax reform had lingered, but indicated that the new government is considering implementing a comprehensive tax reform.[8] The mission encouraged the authorities to request technical assistance from PFTAC and study the implementation of tax reform in Federated States of Micronesia.

- *Non-tax revenue*. The structure of the fees collected from fishing rights and the ship registration company should be reviewed, to ensure that the government revenue is maximized. The authorities indicated that revenues from the ship registration had recently been increased and that additional revenue from fishing rights would likely be small.

19. **There was broad agreement that in addition to fiscal measures, improvements in fiscal management and governance are necessary.** To avoid major cash flow problems, the staff encouraged the authorities to utilize the enhanced cash management and commitment control designed by PFTAC. The authorities acknowledged that strict monitoring and expenditure controls are needed but noted that the uptake of the new system had been slow, partly reflecting capacity constraints. There was broad agreement that the government accounts needed to be simplified by reducing the number of separate line ministry funds, which exceed 50. Line ministries should remit fees and charges collected directly to the Ministry of Finance.

20. **The financial situation of the local Majuro government is a cause for concern.** It is currently in receivership because of a combined debt of $3 million to the national government and the social security administration. This debt has accumulated because of low

[8] Chapter 2 of the Selected Issues discusses various options for the tax reform.

tax compliance and the lack of effective control over spending.[9] Staff urged for a speedy resolution of this issue and greater accountability of the use of funds in the future. The authorities lamented that this is a problem and could take considerable time to resolve.

21. **The Compact Trust Fund is an important cornerstone of RMI's future.** The team strongly recommended that prudent management of the CTF in line with international best practices be adopted and that the funds be managed in a transparent manner. The authorities have announced that they are investigating securitizing future trust fund contributions of the United States. The staff cautioned the authorities to weigh carefully the costs and benefits of such a scheme as their calculations indicated the benefits of this may be small and may not justify additional risk (Box 2).

C. Structural Reform

22. **The authorities concurred that structural reforms are needed to complement fiscal consolidation to boost private-sector growth.** A dynamic private sector is vital to absorb redundant labor from the public sector and ameliorate the impact of declining external support. The mission recommended that the authorities commit to a timeline for implementing various measures to ensure effective monitoring and accountability.

23. **Narrowing the wage gap between the public and private sectors would help to create a level playing field for skilled workers, and improve labor mobility.** The authorities acknowledged that despite previous efforts to downsize public sector employment, the government continues to be the largest employer. The public-private wage gap remains large, with public sector wages on average almost 50 percent above those in the private sector. The mission suggested that, as a first step, a greater wage differentiation between skill levels could be adopted in the public sector.

24. **The difficult business environment has held back growth.** According to the World Bank's 2007 Ease of Doing Business, RMI was ranked lower than all other Pacific island countries, except the Federated States of Micronesia. Key areas of reform include:

- *Land registration.* Some progress has been made in registering land, but further efforts need to be placed on strengthening the land registration authority so that applications are not bogged down in the courts. The authorities noted that land ownership issues remain one of the biggest obstacles to foreign investment, and stressed their commitment to continue reform in this area.

- *Investment climate.* There are substantial administrative delays and restrictions to foreign investment, including access to land, and limits on foreign workers. The authorities

[9] Unlike the national government, local governments do not conduct tax audits, exacerbating the problem of low compliance.

recognized that there was scope for improving business registration and licensing, especially reducing the number of permits and decreasing the time lag for obtaining them.

D. Financial Sector

25. **More decisive steps are needed to strengthen the RMI's financial infrastructure and harness domestic savings for financing growth.** The mission encouraged the introduction of measures that would reduce impediments to lending, especially to small private businesses. In particular, the team welcomed the recent adoption of the new legislation on secured lending and supported its rapid implementation, including the establishment of a registry for collateral. Although currently there are no signs of distress in the banking system, the widespread reliance of Marshallese households on high-interest personal credit warrants careful monitoring**.** The Banking Commissioner agreed that, to safeguard against potential non-performing loans, it will be necessary to ensure that banks are properly classifying problem loans and adequately provisioning against them.

26. **Financial sector supervision has been strengthened, but several shortcomings in banks' operations need to be addressed.** The mission endorsed the Banking Commission moves to strengthen the AML/CFT framework.[10] Staff also recommended that the Banking Commissioner continues to avoid regulatory changes that would introduce administered interest rates as this could limit banks ability to price credit risk. In addition, the microfinance operation and the non-bank activities of one of the banks need to be closely monitored. The development bank should be placed under the Banking Commission's jurisdiction and its activities are limited and its accounts audited. Looking forward, additional steps are needed to improve data and information collection, including on loan quality and remittances, and regular reports should be issued. The authorities broadly agreed with the mission's recommendations.

27. **The recent licensing of the third bank is an encouraging development.** The arrival of a new bank may help to increase competition in the banking sector and put downward pressure on interest rates. The mission encouraged the authorities to ensure that the new bank operates in a transparent manner, and complies with existing prudential rules and regulations.

E. Other Issues

28. **There is an urgent need to improve the reliability, coverage, and timeliness of economic statistics for monitoring and policy evaluation.** The mission commended ongoing efforts by the Economic Policy, Planning and Statistics Office (EPPSO), which has a limited number of staff, to improve data collection. Nonetheless, EPPSO could benefit from ongoing and frequent technical support from outside consultants to help not only with the

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[10] RMI was removed from the FATF list of non-cooperative countries and territories in 2002, and from the OECD tax haven list in 2007.

compilation of existing statistics, but also further develop data for the balance of payments and compilation of the fiscal data in Government Financial Statistics format.

29. **The RMI is involved in several regional and preferential trade agreements.** The mission supported the ongoing discussion with the European Union on a new trade arrangement under the Economic Partnership Agreement. Staff also welcomed the RMI's involvement in regional fora that promote cooperation among Pacific island countries in areas of common political and economic interest, including the Pacific Agreement on Closer Economic Relations and the Pacific Island Countries Trade Agreement.

IV. Staff Appraisal

30. **Achieving economic self-reliance remains the main policy challenge for the RMI, and will require difficult reforms.** Given that the Compact grants are decreasing steadily every year, and debt payments will increase substantially in the near future, the current size of the government is not sustainable. Fiscal consolidation and structural reforms are therefore needed, to ensure long-term fiscal sustainability and to boost private sector development.

31. **In recent years, the authorities have taken important policy actions to move the RMI toward lasting growth; it is essential to avoid letting this reform momentum stall.** Notably, the government has met its mandatory contribution to the Compact Trust Fund, and has successfully reformed its social security administration into a well-performing institution. In addition, the authorities have devoted considerable efforts in improving tax administration. Notwithstanding these commendable achievements, significant challenges remain.

32. **To achieve long-term external sustainability, the fiscal position needs to be substantially improved.** Staff recommends a fiscal surplus of about 3 percent of GDP in the medium term – a much more ambitious objective than stated in the FY2008 Budget. In order to reach this target, difficult cuts to current expenditure and additional revenue-raising measures will have to be implemented in the near term. The authorities' intended wage and hiring policy for FY2009 is a solid step toward cutting payroll expenditure. Immediate steps also need to be taken to address the tax non-compliance. The authorities need to avoid slippages in FY2008 and take concrete measures in subsequent years.

33. **The Compact Trust Fund is a cornerstone of RMI's future.** Prudent and transparent management of the CTF in line with international best practices should be adopted. In this context, the authorities also need to weigh carefully the costs and benefits of securitizing future U.S. contributions as the benefits of such a scheme may be small and may not justify additional risk.

34. **In addition, it will be important to pursue more aggressive structural reforms to energize private-sector activity and employment.** The long-term aim is to replace the government as the primary engine of growth. This will require shoring up infrastructure, resolving land issues, and scaling back the government's commercial activities. Such

measures could reduce the cost of doing business, facilitate commercial bank lending, and promote private-sector development.

35. **Progress has been made in strengthening financial sector supervision; however, further efforts are needed to ensure that the system performs its role in the development of the economy.** There are no signs of distress in the banking system, and the banking commission has made substantial progress in strengthening the AML/CFT framework. Nevertheless, asset quality has to be carefully monitored, as reliance on high-interest consumer loans remains high, and many households are reported to be heavily in debt. The recently adopted legislation on secured lending is an important step in removing obstacles to commercial lending, and should be implemented as quickly as possible.

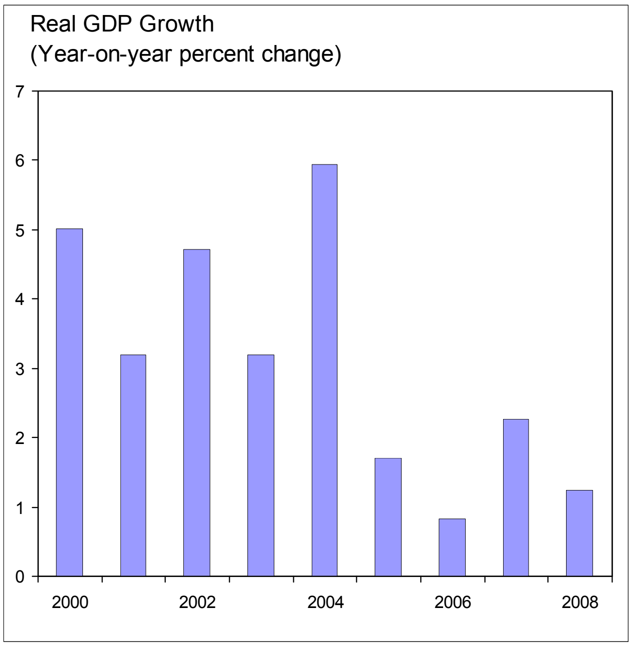
36. **Given the lack of administrative capacity and market structure to have active exchange rate and monetary policies, and the close ties to the United States, dollarization is an appropriate framework for RMI.** The authorities successfully maintain an exchange system free of restrictions on international payments and transfers for current transactions.

37. **Data provision, while adequate for surveillance, constrains policy evaluation.** The authorities willingly share available data, yet deficiencies exist in nearly all areas of economic statistics. Further efforts are needed to build local capacity to produce these statistics.

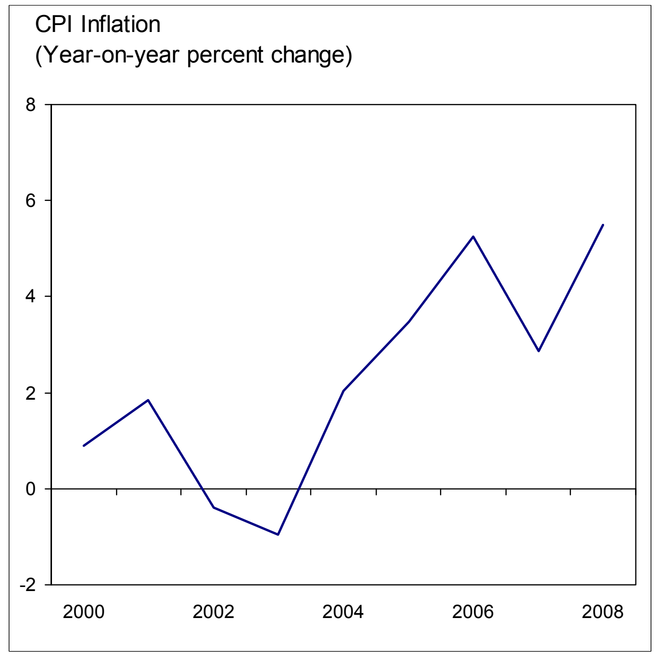
38. **It is recommended that the next Article IV consultation take place on the 24-month cycle.**

Figure 1. Marshall Islands: Economic Developments

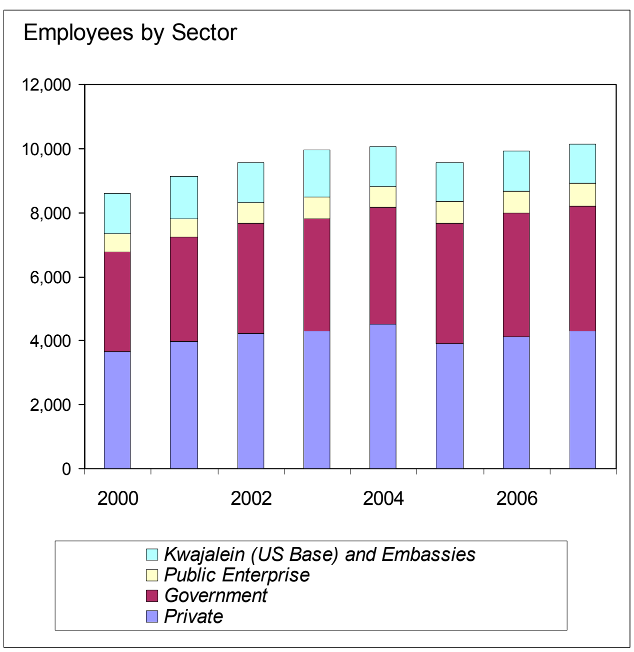
Growth picked up in 2007 but is expected to slow in 2008.



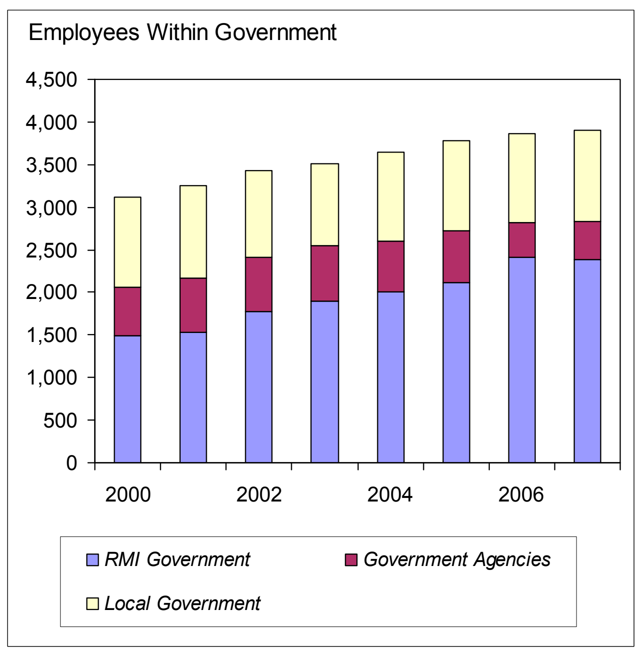
Inflation has increased, reflecting higher energy and food prices.



Growth in employment has increased, following the closing of the fish processing plant in 2005.



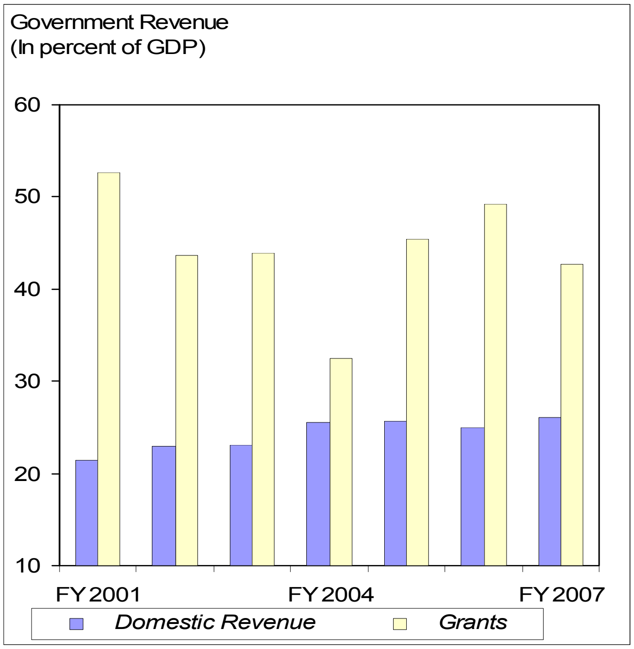
Employment in the RMI government has increased steadily since 2000.



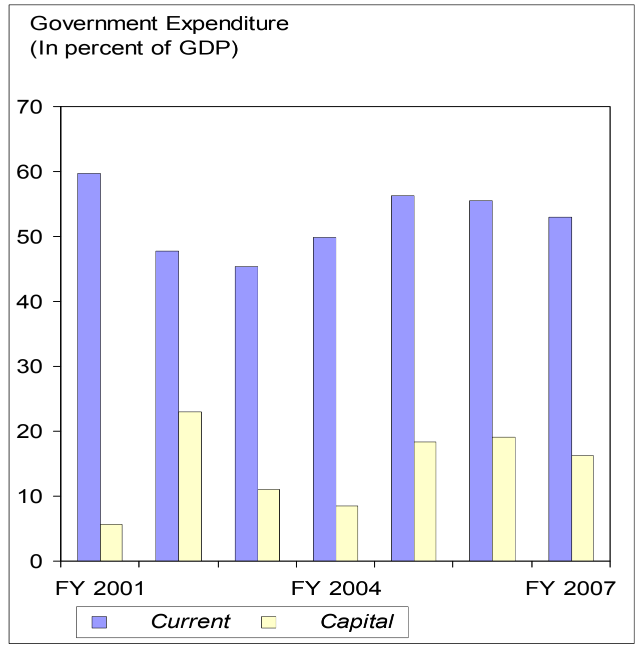
Sources: Fund staff estimates and RMI authorities.

Figure 2. Marshall Islands: Fiscal Indicators

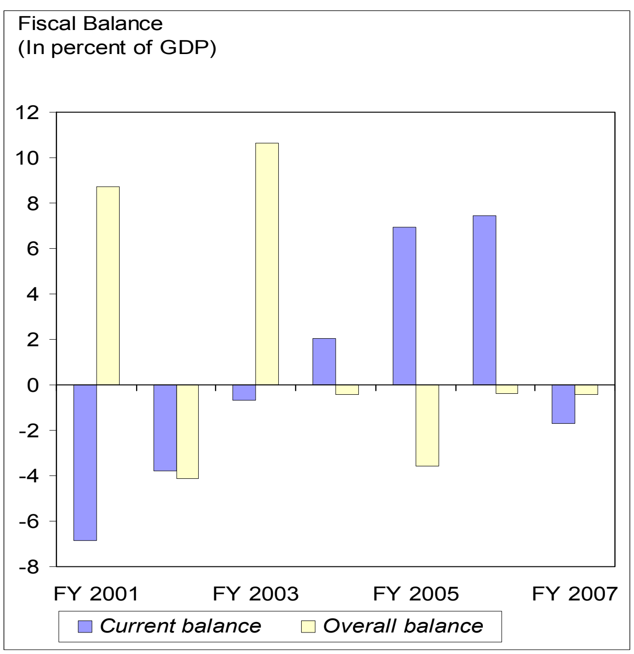
Volatile external grants remain an important part of the revenue.



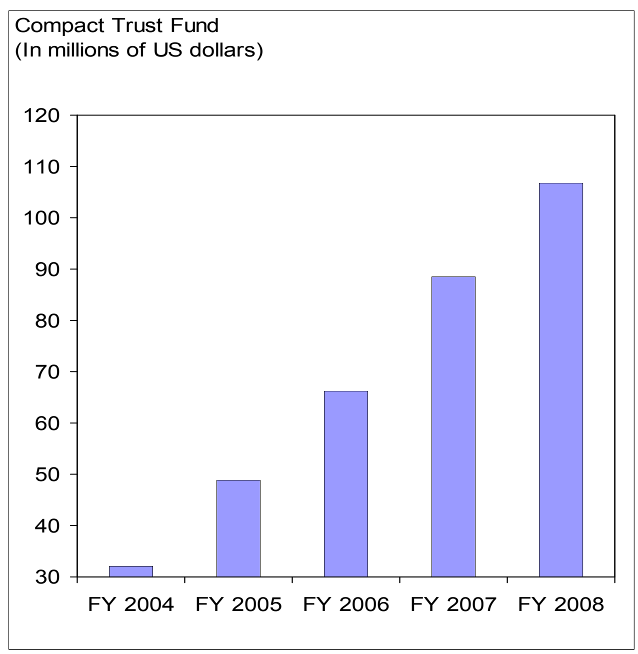
Current spending is a significant share of total expenditure.



The overall fiscal balance has been in deficit for the last 4 years.



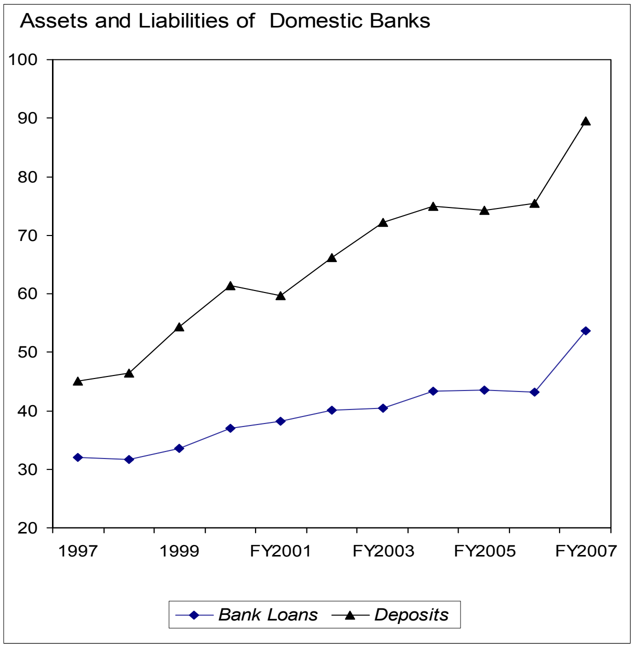
The Compact Trust Fund has been steadily growing, but may not be enough to assure budgetary self-sufficiency.



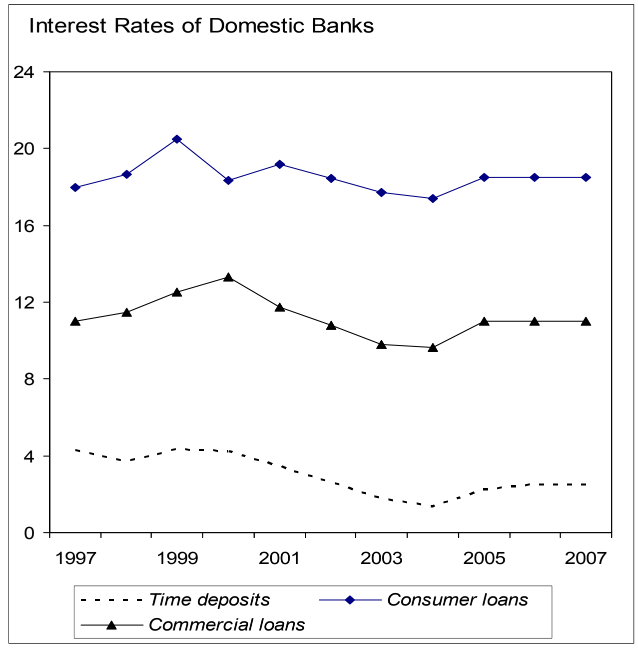
Source: Fund staff estimates and RMI authorities.

Figure 3. Marshall Islands: Financial Developments

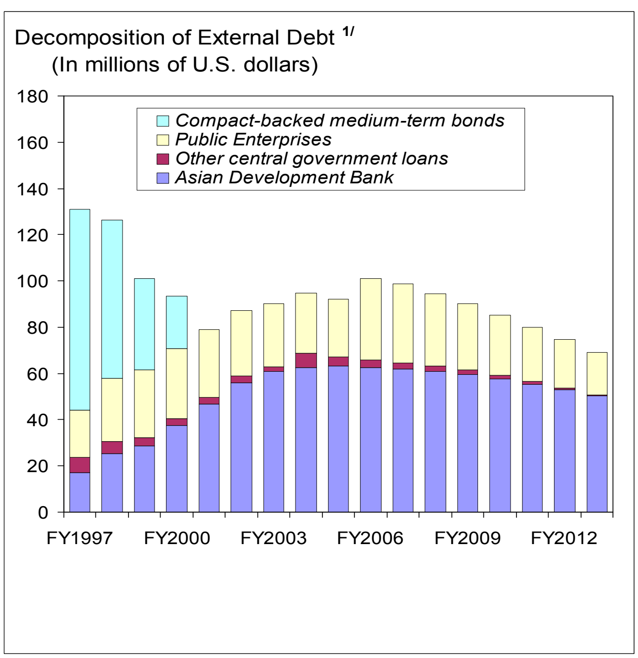
There is a large gap between bank deposits and bank lending, with most of the deposits accumulating abroad.



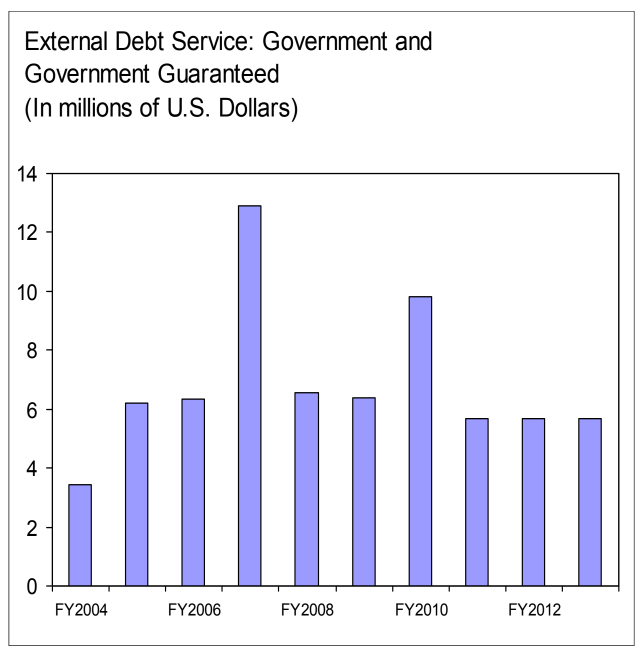
Interest rate spreads are very high.



External debt has improved since the 1990s, but remains high.



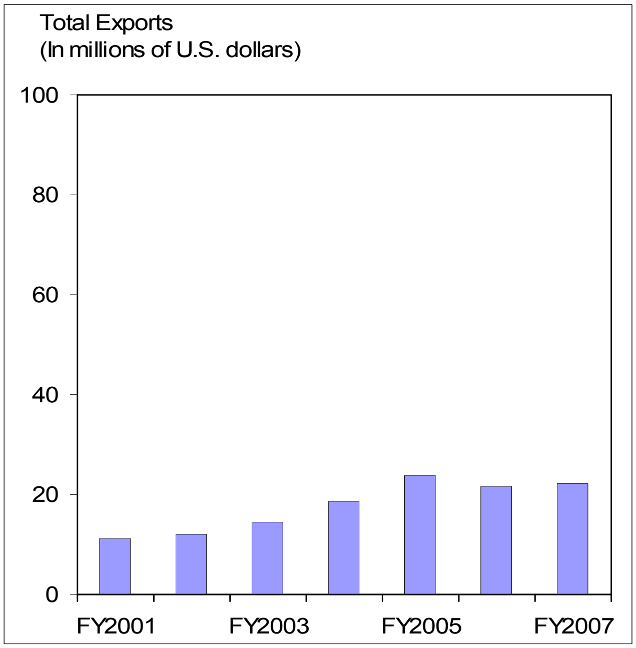
External debt service could prove burdensome in the years to come.



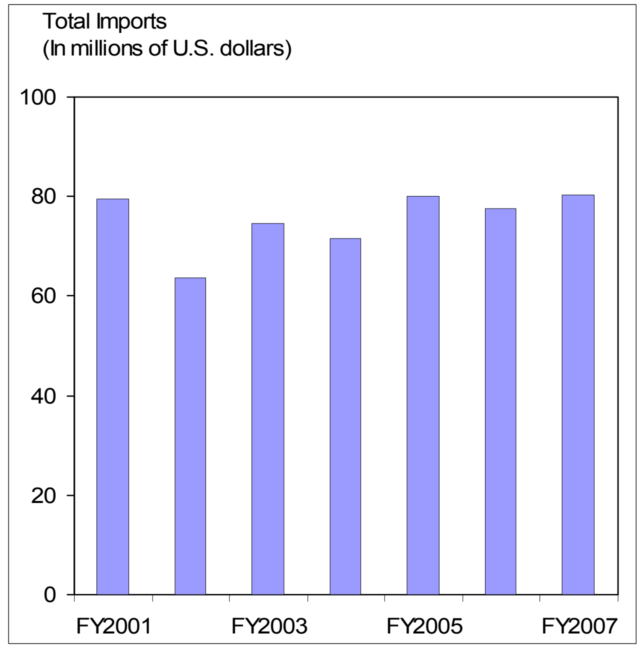
Source: Fund staff estimates and RMI authorities.

Figure 4. Marshall Islands: External Developments

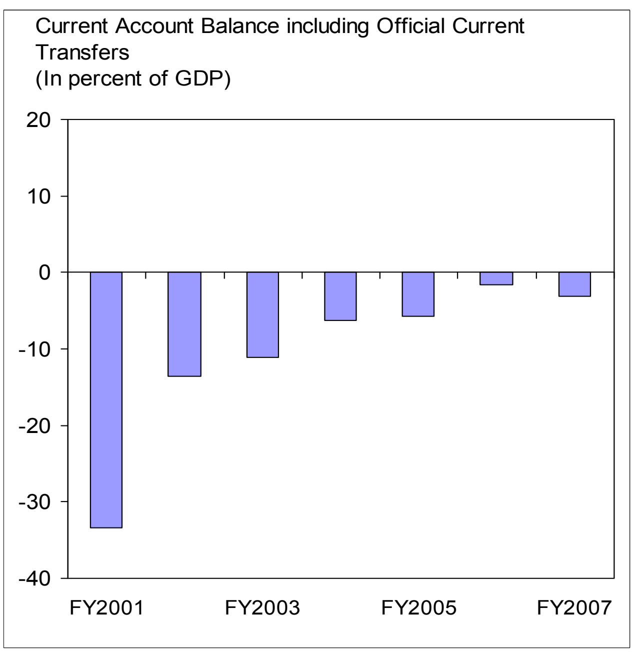
Total exports have increased since 2001...



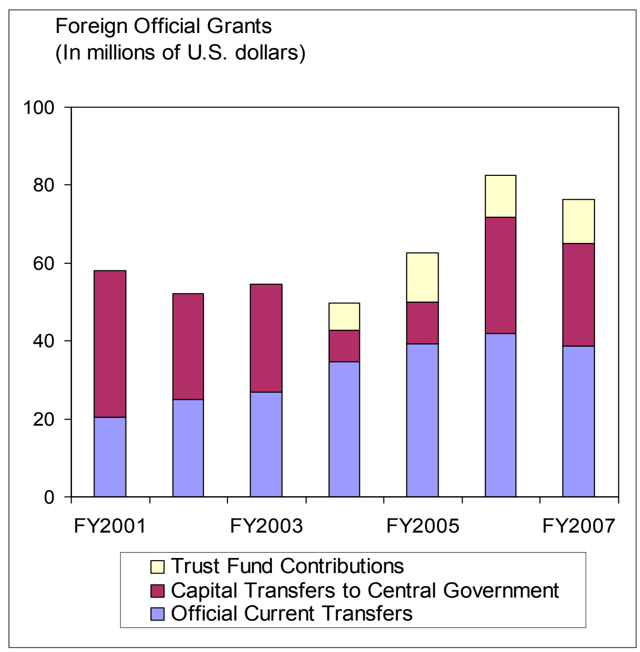
...but total Imports are much larger than exports.



The current account has improved, largely driven by the increase in official transfers.



Foreign grants, including trust fund contributions, are large with the increase in FY2006 reflecting grants to improve the airport.



Sources: Fund staff estimates and RMI authorities.

Table 1. Marshall Islands: Basic Data, FY2004–08 1/

Nominal GDP (2005/06):	US$ 145.6 million
Population (2006):	52,709
GDP per capita (2005/06):	US$ 2,735
Quota:	SDR 3.5 million

	2004	2005	2006	2007	2008
				Est.	Proj.
Real sector					
Real GDP (percent change)	5.9	1.7	0.8	2.3	1.2
Consumer prices (percent change)	2.0	3.5	5.3	2.9	5.5
Central government finances (in percent of GDP)					
Revenue and grants	57.9	71.0	74.3	68.8	60.6
Total domestic revenue	25.5	25.7	25.0	26.1	23.3
Grants	32.5	45.4	49.3	42.7	37.3
Expenditure	58.3	74.6	74.7	69.2	60.9
Current	49.9	56.2	55.5	52.9	50.5
Capital	8.5	18.4	19.1	16.3	10.4
Overall balance	-0.4	-3.6	-0.4	-0.4	-0.3
Usable government financial assets					
(In millions of US$; end of period) 2/	4.5	1.6	3.0	1.3	-0.1
Compact Trust Fund (in millions of US$; end of period) 3/	32.0	48.9	66.2	88.5	106.7
Commercial banks (in millions of US$; end-December)					
Foreign assets	51.0	53.6	57.6	60.9	…
Private sector claims	43.4	43.6	43.2	53.6	…
Total deposits	74.9	74.3	75.5	89.6	…
One-year time deposit rate (in percent)	2.1	3.5	4.0	4.0	…
Average consumer loan rate (in percent)	17.4	18.5	18.5	18.5	…
Balance of payments (in millions of US$)					
Trade balance	-52.9	-56.2	-56.1	-58.2	-60.1
Net services	-8.0	-11.1	-8.7	-7.4	-6.8
Net income	29.9	32.3	32.9	35.0	36.8
Private and official current transfers	22.7	27.0	29.7	26.0	27.0
Current account including official current transfers 4/	-8.2	-7.9	-2.3	-4.7	-3.1
(In percent of GDP)	-6.3	-5.7	-1.6	-3.1	-2.0
Current account excluding official transfers	-43.0	-47.1	-44.3	-43.3	-43.1
(In percent of GDP)	-32.7	-34.1	-30.4	-28.9	-27.2
Overall balance 5/	-23.5	-5.3	-0.7	-1.6	-1.4
(In percent of GDP)	-17.9	-3.8	-0.5	-1.1	-0.9
External debt (in millions of US$; end of period) 6/	94.7	91.7	99.7	98.7	99.8
(In percent of GDP)	72.1	66.3	68.5	65.9	63.0
External debt service (in millions of US$)	4.1	6.2	6.3	12.9	6.6
(In percent of exports of goods and services)	12.9	17.6	19.0	37.0	17.1
Exchange rate					
Real Effective Exchange Rate (1995 =100)	110.0	111.5	113.0	112.7	...
Memorandum Item:					
Nominal GDP (in millions of US$)	131.3	138.3	145.6	149.7	158.4

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 fund are treated as not available for budget financing.
4/ Official transfers include current transfers but exclude capital transfers and Trust Fund contributions.
5/ Large negative overall balance in FY04 reflects official capital outflow to the Compact Trust Fund.
6/ Includes government and government-guaranteed debts.

Table 2. Marshall Islands: Central Government Finances, FY2004–08 1/

	2004	2005	2006	2007 Est.	2008 Proj.
	(In millions of U.S. dollars)				
Total revenue and grants	76.1	98.3	108.1	103.0	96.0
Total domestic revenue	33.4	35.5	36.4	39.1	36.9
Taxes	22.5	24.3	25.1	27.1	26.4
Nontax	11.0	11.2	11.2	12.0	10.5
Grants	42.6	62.8	71.7	63.9	59.1
Of which : current grants	34.7	51.9	55.3	37.6	41.8
Compact 2/	20.5	27.6	35.5	40.9	42.3
Other 3/	22.1	35.2	36.2	23.0	16.8
Total expenditure	76.6	103.2	108.7	103.6	96.5
Current expenditure	65.5	77.8	80.8	79.2	80.0
Of which:					
Wages and salaries	30.1	32.8	34.1	32.1	33.7
Goods and services	26.8	31.2	32.9	33.5	32.5
Capital expenditure 4/	11.1	25.5	27.8	24.4	16.5
Current balance	2.7	9.6	10.8	-2.6	-1.3
Overall balance	-0.5	-5.0	-0.6	-0.6	-0.4
Financing	6.9	11.9	16.7	21.7	17.8
Net government debt repayment	-2.1	-0.5	0.6	1.0	1.0
Principal repayment	0.2	0.5	0.7	1.0	1.0
Gross borrowing	2.3	1.0	0.1	0.0	0.0
Change in government financial assets	9.0	12.4	16.1	20.7	16.8
Of which : Trust Fund	7.5	16.9	17.3	22.3	18.3
	(In percent of GDP)				
Revenue and grants	57.9	71.0	74.3	68.8	60.6
Revenue	25.5	25.7	25.0	26.1	23.3
Grants	32.5	45.4	49.3	42.7	37.3
Expenditure	58.3	74.6	74.7	69.2	60.9
Current	49.9	56.2	55.5	52.9	50.5
Capital	8.5	18.4	19.1	16.3	10.4
Current balance	2.0	6.9	7.4	-1.7	-0.8
Overall balance	-0.4	-3.6	-0.4	-0.4	-0.3
Memorandum items:					
Foreign Contributions	7.2	12.8	10.7	11.7	12.4
Compact Trust Fund	7.0	12.6	10.7	11.4	12.2
Disaster Fund	0.2	0.2	0.0	0.2	0.2
Trust Fund Balances	38.2	52.6	67.9	90.6	109.3
Intergenerational	6.2	3.7	1.7	1.7	1.7
Compact	32.0	48.9	66.2	88.5	106.7
Disaster	…	0.0	0.1	0.5	0.9
Total government financial assets	59.0	71.4	87.5	108.2	125.0
Of which:					
Usable government financial assets 5/	4.5	1.6	3.0	1.3	-0.1
Outstanding government debt	64.5	65.7	65.8	64.8	63.8
Government guaranteed debt	38.9	39.3	45.8	37.8	35.3
Nominal GDP	131.3	138.3	145.6	149.7	158.4

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/ In FY05 and FY06, includes grants of $12.7 million and $13.3 million for the construction of the Airport.
4/ For FY05-08, capital expenditure includes additional capital projects financed by Taiwan POC and U.S. grants for the airport.
5/ Cash and cash equivalents that are not reserved for specific uses.

Table 3. Marshall Islands: Balance of Payments, FY2004-08 1/
(In millions of U.S. dollars)

	2004	2005	2006	2007 Est.	2008 Proj.
Trade balance	-52.9	-56.2	-56.1	-58.2	-60.1
Exports, f.o.b.	18.6	24.0	21.6	22.1	24.3
Imports, f.o.b.	-71.5	-80.1	-77.7	-80.3	-84.4
Net services	-8.0	-11.1	-8.7	-7.4	-6.8
Receipts	12.8	11.3	11.8	12.8	13.9
Payments	-20.8	-22.4	-20.5	-20.2	-20.7
Net income	29.9	32.3	32.9	35.0	36.8
Receipts	36.4	39.0	41.4	43.7	45.1
Of which: Labor income	17.6	18.6	19.1	19.7	20.4
Payments	-6.4	-6.7	-8.5	-8.7	-8.3
Unrequited transfers	22.7	27.0	29.7	26.0	27.0
Private	-12.0	-12.2	-12.4	-12.6	-12.9
Inflows	0.3	0.4	0.4	0.4	0.4
Outflows	-12.4	-12.5	-12.8	-13.0	-13.4
Official	34.7	39.2	42.0	38.6	40.0
Compact grants 2/	28.4	34.4	38.0	33.6	35.3
Other	6.3	4.8	4.0	5.0	4.6
Current account including current official transfers 3/	-8.2	-7.9	-2.3	-4.7	-3.1
(In percent of GDP)	-6.3	-5.7	-1.6	-3.1	-2.0
Current account excluding official transfers	-43.0	-47.1	-44.3	-43.3	-43.1
(In percent of GDP)	-32.7	-34.1	-30.4	-28.9	-27.2
Capital and financial account	-25.8	0.4	10.5	10.3	4.6
Official Capital Grants	14.9	23.5	40.4	37.8	29.6
Capital transfers to central government	7.9	10.9	29.7	26.3	17.4
Trust Fund contributions	7.0	12.6	10.7	11.4	12.2
Direct investment, net	4.1	6.5	6.2	12.2	5.5
Short-term liabilities, net 4/	-13.6	-12.1	-19.9	-13.0	-13.4
Medium-term liabilities, net	2.3	-3.5	2.4	-6.0	-0.2
Inflows	6.1	1.0	9.8	12.0	7.6
Outflows	-3.8	-4.5	-7.4	-18.0	-7.8
Other net government flows 5/	-33.5	-14.0	-18.6	-20.7	-16.8
Errors and omissions	34.1	7.6	-8.2	-5.6	-1.5
Overall balance	-23.5	-5.3	-0.7	-1.6	-1.4
Gross official reserves 6/	10.6	5.3	4.6	3.0	1.6
Of which: Usable government financial assets	4.5	1.6	3.0	1.3	-0.1
(In months of imports of goods and services)	0.6	0.2	0.4	0.2	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. Trust Fund contributions by the U.S. and Taiwan, POC, are regarded as capital transfers.
3/ Official transfers include current transfers but excludes capital transfers and Trust Fund contributions.
4/ Includes changes in social security fund investments, banking system assets held overseas, and government assets held in the capital and special fund accounts.
5/ Changes in government assets, excluding the general fund.
6/ Including MIITF which is deposited in domestic financial institutions.

Table 4. Marshall Islands: External Vulnerability Indicators, FY2004–08

	2004	2005	2006	2007	2008
				Est.	Proj.
Financial indicators 1/					
Commercial bank deposits (12-month percent change) 2/	4.4	-0.8	1.6	18.7	...
Private sector credit (12-month percent change)	1.8	0.4	-0.8	24.1	...
Foreign assets/total assets (percent)	54.4	56.1	58.6	54.0	...
Nonperforming loans (in percent of total loans) 3/	2.0	2.0	2.0	2.0	...
External indicators					
Exports (percent change)	28.7	28.6	-10.1	2.6	10.1
Imports (percent change)	-4.1	12.0	-3.0	3.4	5.1
Current account balance (percent of GDP)					
Including official current transfers	-6.3	-5.7	-1.6	-3.1	-2.0
Excluding official transfers	-32.7	-34.1	-30.4	-28.9	-27.2
Capital and financial account balance (percent of GDP)	-19.7	0.3	7.2	6.9	2.9
Of which : FDI (in millions of U.S. dollars)	4.1	6.5	6.2	12.2	5.5
Gross official reserves (in millions of dollars) 4/	10.6	5.3	4.6	3.0	1.6
Gross official reserves (in months of imports of goods and services)	1.9	1.0	0.8	0.5	0.3
Total external debt (percent of GDP)	72.1	66.3	68.5	65.9	63.0
Total external debt (in percent of exports of goods and services)	301.4	260.2	298.7	282.9	260.9
External debt service (in percent of exports of goods and services)	12.9	17.6	19.0	37.0	17.1

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

1/ Financial indicators are as of end December.

2/ The large increase in financial indicators in 2007 reflect a government guaranteed loan to energy company.

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

4/ Measured by the end-of-period stock of government financial assets held in commercial banks.

Table 5. Marshall Islands: Medium-term Scenario, FY2006–13 1/

	2006	2007	2008	2009	2010	2011	2012	2013
		Est.	Projections					
Real sector								
Real GDP (percent change)	0.8	2.3	1.2	1.8	2.0	2.1	1.9	1.9
Consumer prices (percent change)	5.3	2.9	5.5	3.5	3.0	2.7	2.4	2.4
Central government finance (in percent of GDP)								
Revenue and grants	74.3	68.8	60.6	59.8	58.7	57.6	56.5	55.7
Total domestic revenue	25.0	26.1	23.3	23.8	23.8	23.7	23.5	23.6
Grants	49.3	42.7	37.3	36.0	34.8	33.9	33.0	32.1
Expenditure	74.7	69.2	60.9	59.2	58.0	57.1	56.1	55.1
Current	55.5	52.9	50.5	49.9	49.3	48.7	48.1	47.6
Capital	19.1	16.3	10.4	9.3	8.8	8.4	7.9	7.5
Overall balance	-0.4	-0.4	-0.3	0.6	0.6	0.5	0.5	0.5
Usable government financial assets								
(In millions of US$; end of period) 2/	3.0	1.3	-0.1	0.0	0.1	0.2	0.2	0.3
Trust Fund (in millions of US$; end of period) 3/	66.2	88.5	106.7	126.8	148.8	172.8	199.0	227.5
Balance of payments (in millions of US$)								
Trade balance	-56.1	-58.2	-60.1	-62.8	-65.4	-67.6	-69.7	-71.8
Net services	-8.7	-7.4	-6.8	-6.6	-6.4	-6.1	-5.8	-6.1
Net income	32.9	35.0	36.8	38.2	39.4	40.6	41.4	43.5
Private and official transfers	29.7	26.0	27.0	27.1	26.2	26.4	26.1	25.8
Current account including official current transfers	-2.3	-4.7	-3.1	-4.2	-6.1	-6.7	-7.9	-8.5
(In percent of GDP)	-1.6	-3.1	-2.0	-2.5	-3.5	-3.7	-4.2	-4.3
Current account excluding official transfers	-44.3	-43.3	-43.1	-44.4	-45.7	-46.6	-47.8	-48.3
(In percent of GDP)	-30.4	-28.9	-27.2	-26.7	-26.2	-25.7	-25.3	-24.5
Overall balance	-0.7	-1.6	-1.4	0.7	-0.4	0.2	-0.1	0.0
(In percent of GDP)	-0.5	-1.1	-0.9	0.4	-0.2	0.1	0.0	0.0
External debt (in millions of US$; end of period) 4/	99.7	98.7	99.8	96.8	90.2	87.3	84.0	80.8
(In percent of GDP)	68.5	65.9	63.0	58.2	51.8	48.0	44.2	40.7
External debt service (in millions of US$)	6.3	12.9	6.6	6.4	9.8	5.7	5.7	5.7
(In percent of exports of goods and services)	19.0	37.0	17.1	15.6	22.6	12.3	11.5	10.8

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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by Asia and Pacific Department
(In consultation with other departments)

May 9, 2008

Contents Page

ANNEX I. MARSHALL ISLANDS: FUND RELATIONS
(As of March 31, 2008)

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 2005 Article IV Consultation discussions were held during October 28–November 8, 2005. The Executive Board discussed the staff report and concluded the consultation on February 15, 2006.

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

X. **Resident Representative:** None.

MARSHALL ISLANDS: TECHNICAL ASSISTANCE FROM HEADQUARTERS, 1992–2008[1]

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

[1] Technical assistance has been provided through PFTAC since 2005 – see Annex II.

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

Since becoming a World Bank Group member in May 1992, the Marshall Islands has received a grant of $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.

On June 12, 2007, the World Bank Board of Executive Directors approved $9.5 million provided by the Global Environment Facility to fund renewable energy electricity supplies for rural communities in Marshall Islands, amongst other Pacific Island countries. The project in the Marshall Islands is led by the International Finance Corporation (IFC), the World Bank's private sector arm. IFC is currently advertising for a 5–year term Management Consultant to assist with the implementation of the project.

The World Bank Group has released major pieces of analytical work, some of which has led to implementation of technical assistance. Recent reports include:

- Doing Business 2008: Comparing Regulation in 178 Countries, September 2007;
- Opportunities to Improve Social Services: Human Development in the Pacific Islands, July 2007;
- At Home and Away – Expanding Job Opportunities for Pacific Islanders through Labour Mobility, August 2006;
- The Pacific Infrastructure Challenge, 2006; and
- Not If, But When: Adapting to Natural Hazards in the Pacific Islands Region, 2006.

The Marshall Islands is an IBRD-Eligible Country.

[1] Prepared by World Bank staff (East Asia Pacific).

ANNEX III. MARSHALL ISLANDS: RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

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

ADB loans have covered education, fisheries, health, water, and transport, and support for public sector reform and structural adjustment. One loan assisted emergency typhoon rehabilitation. Since 2002, ADB's program for the RMI has increasingly focused on grant technical assistance rather than loans. All ADB loans to the RMI have now been closed. Further lending is not envisaged at this time.

As of end December 2007, technical assistance (TA) grants totaling almost $18.8 million for 46 TA projects have been approved. These comprise both project preparatory and advisory TA. The TA program has covered a wide range of sectors and issues from support to ADB loans to building capacities in development banking, tourism management, environmental protection, economic policy formulation, as well as in privatizing state-owned enterprises, developing the private sector, and reforming the civil service.

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 Secure Transactions Agency, a study of the status and trends of land tenure, and continuation of the administrative barriers working group are all components of this TA. This is scheduled for completion in November 2009.

In May 2006, the AsDB approved an advisory technical assistance to support the collaborative design and society-endorsed delivery of initial pilot Ministry of Education personnel performance audits. The intent is to improve employee productivity. The TA also supports more effective delivery of youth-at-risk welfare services through continued outsourcing to civil society organizations. Completion is scheduled in May 2008.

In December 2006 a $150,000 grant from the MfDR Cooperation Fund was approved for improving independent policy results-based management. This will build both RMI country statistics generation and policy analytical capacities and, at the same time, continue to strengthen country demand for an independent monitoring of, and management for, development results. This will provide support through to 31 December 2009.

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

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

RMI was updated in 2003, 2004 and then again in 2006 in a fully participatory manner engaging representatives of civil society as well as government in formulating a new strategy. ADB's strategy in the RMI over 2007–2011 sets out planned technical assistance projects that will focus on increasing public sector productivity as a means to improve the delivery of public services, enhance the environment for private sector development, and boost governance. The strategy fosters greater community participation in development and will concentrate on achieving measurable results in the short term.

AsDB published a Pacific Island Economic Report on the RMI in 2006, known as "Juumemmej." This thought provoking analysis of economic and social policy issues has stimulated dialogue within the RMI and among development partners on ways for moving forward. In January 2007, AsDB released a book documenting experiences, successes, and challenges of pilot testing participatory budgeting at the local level in three countries, including the RMI.

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, 2007)

Sector	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	18.76

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

The PFTAC's assistance to the RMI during the past two years has focused on financial supervision and public expenditure management across seven missions. The RMI has sent 16 officials to regional seminars and workshops, and the PFTAC organized one secondment in banking supervision.

Public Financial Management

In the last two years, PFM activity in RMI has increased significantly. A peripatetic consultant was fielded by PFTAC to work on fiscal forecasting and another consultant is expected to visit RMI in June 2008 for one final visit to anchor the system and provide training. A cash management manual was developed by PFTAC and training provided on its operation in early 2007. A peripatetic consultant has since provided training on the operation of the system to line ministries and visited RMI in January 2008, along with the PFTAC Advisor, to provide further training and to review the system. PFTAC is meanwhile developing a commitment control manual for RMI, and training will be provided once the Government's feedback of the draft commitment control manual is received.

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.

A short PFTAC Mission took place in December 2007 and provided short-term revenue enhancing measures including integration of local and national government taxes, as well as discussions about longer-term revenue reforms to address the narrow tax base and low levels of compliance.

[1] Prepared based on 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.

Financial Sector Regulation and Supervision

Following a mission by a peripatetic advisor in April 2006, the PFTAC advisor visited RMI in May 2006 and recommended that the Banking Commission expand the scope of its on-site examinations of banks to include operational and liquidity risk management. Also in 2006, the Advisor provided comments to the Commission on an application to establish a new bank in Majuro. In March 2007, the Advisor assisted the Banking Commission to conduct an on-site examination covering these areas and AML/CFT compliance at one bank. The Advisor also provided the Commission with draft prudential guidelines on operational and liquidity risk, as well as a critique of the Commission's statistical returns. In November 2007, the Advisor assisted the Commission in conducting an on-site examination at one bank to follow up on actions taken to resolve concerns arising from the March 2007 AML/CFT examination. PFTAC also arranged and provided financial assistance in 2007 for the Assistant Banking Commissioner to be attached to the Hawaiian bank supervisory authority to participate in an on-site examination. At the request of the Commissioner, the Advisor plans a visit for July 2008. The focus of the mission will be to provide training in credit (loan) analysis and classification and off-site monitoring and surveillance of banks.

Economic and Financial Statistics

The Economic Policy, Planning and Statistics Office (EPPSO) increased its staff by one in 2005, to work on macroeconomic statistics. However, the statistics continue to be compiled by consultants, despite the staff member's having been trained in national accounts. The PFTAC Advisor conducted a national accounts training course in Pohnpei in 2006. The Advisor has provided some technical backstopping to the national accounts consultant over the last two years, and in July 2007 visited RMI to assist with the improvement and compilation of their Balance of Payments (BOP) statistics. This mission was in conjunction with the two consultants who were funded by the US Department of Interior to update the 2007 Annual Compact Report, including the economic statistics. In July 2007, the Advisor undertook a BOP mission to update and improve estimates and methodology in conjunction with the ADB team to prepare data for the US Compact Report.

ANNEX V. MARSHALL ISLANDS: STATISTICAL ISSUES

Data provision, while adequate for surveillance, constrains policy evaluation. The authorities willingly share available data, yet deficiencies exist in nearly all areas of economic statistics. Further efforts are needed to build local capacity to produce these statistics. A new Economic Policy, Planning, and Statistics Office (EPPSO) was established in February 2003 to collect and disseminate statistics. However, EPPSO still lacks sufficient qualified statistical staff and capacity to produce timely data. It should further develop data for the balance of payments and compilation of the fiscal data in Government Financial Statistics format. The publication of the *Quarterly Bulletin of Statistics* was resumed in June 2003, containing mainly CPI data. Other quarterly and monthly 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 (PFTAC), but many recommendations have not been implemented. The authorities have expressed an interest in participating in the IMF General Data Dissemination System (GDDS).

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 compute real GDP, operating surpluses, and employment data sources, but these estimates represent an improvement over earlier ones. Previously the data were prepared on a production basis since 1991. The new consumer price index(CPI), rebased in 2003, replaced the CPI index developed in the 1980s. The updated CPI is based on the information from the *Household Income and Expenditure Survey 2002*, conducted with assistance from the U.S. Department of the Interior and the U.S. Census Bureau.

Government Finance

Fiscal data are regularly compiled for budget control, 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.

Balance of Payments

Compilation of balance of payments data has improved somewhat recently with assistance from PFTAC. 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 reliable data on remittances and private financial flows.

Marshall Islands: Table of Common Indicators Required for Surveillance
(As of March 31, 2008)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	03/31/08	03/31/08	Daily	Daily	Daily
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	FY2006	09/2007	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]	FY2007	03/2008	Annually	Staff Visits	Annually
Consumer Price Index	1Q/2008	03/2008	Quarterly	Quarterly	Quarterly
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	FY2006	09/2007	Annually	Annually	Annually
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	FY2006	09/2007	Annually	Annually	Annually
Stocks of Central Government and Central Government-Guaranteed Debt[5]	FY2006	09/2007	Annually	Annually	Annually
External Current Account Balance	FY2006	08/2007	Annually	Staff Visits	NA
Exports and Imports of Goods and Services	FY2006	08/2007	Annually	Staff Visits	Annually
GDP/GNP	FY2006	08/2007	Annually	Staff Visits	Annually
Gross External Debt	FY2006	09/2007	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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International Monetary Fund
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IMF Executive Board Concludes 2008 Article IV Consultation with Republic of the Marshall Islands

On June 4, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Republic of the Marshall Islands.[1]

Background

The Republic of the Marshall Islands (RMI), scattered across an area of nearly 1 million square miles in the Central Pacific, is heavily dependent on external grants. Like other small Pacific island countries, RMI is remote from major markets, has a narrow production and export base, and is vulnerable to external shocks and climate change. The most important aid source has been U.S. financing, primarily through the Compact of Free Association (Compact).

RMI has grown continuously the past seven years, partly reflecting increased inflow of financial resources from the amended Compact with the United States. However, real GDP growth slowed, on average, to 1.3 percent in FY2005-06 (fiscal year ending September 30), from about 4 percent in the previous four years. Growth in FY2007 is estimated to have picked up to around 2.3 percent, driven by the new infrastructure construction and the influx of visitors. Nevertheless, unemployment remains high (especially among youth). The current account deficit increased to 3 percent of GDP in FY2007. Gross public and publicly guaranteed external debt is high, at about 70 percent of GDP at end-FY2006. The banking

[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.

system is small, and provides little domestic credit, mostly concentrated in short-term consumer loans.

Inflation averaged about 4 percent (year-on-year) in the last two years, reflecting higher electricity costs and prices of food and oil. The U.S. dollar is the official currency and has provided a strong anchor for inflation expectations. The real effective exchange rate has remained broadly unchanged, reflecting a relatively stable inflation differential with the United States, a large trading partner, and a weakened U.S. dollar.

The fiscal position improved in FY2006-07, but the overall balance remained slightly negative at around ½ percent of GDP. The improvement reflects mainly the increased capital funds from the Compact agreement. The government has fully met its mandatory contributions to the Compact Trust Fund (CTF).

Growth is expected to moderate to about 1.5 percent on average in FY2008-09. Rising energy costs and a reduction in employment at the U.S. military base in Kwajalein will constrain growth. High energy and food costs are creating inflationary pressure. The external position is expected to remain roughly balanced, given the continual disbursement of foreign grants. The risk to this outlook is mainly on the downside. Further increases in oil prices could depress activity and the grounding of the domestic airline could reduce the nascent tourist business. In addition, global financial disturbances could depress the rate of return on the CTF, thereby undermining fiscal sustainability.

Executive Board Assessment

Executive Directors welcomed the recent steps taken by the authorities to move the Marshall Islands toward lasting growth. At the same time, they underscored the substantial challenges facing the economy, owing to the country's geographical remoteness, narrow production base, and increasing vulnerabilities to climate change and rising food and oil prices. In addition, the country faces anticipated declines in Compact grants and increases in debt-service payments. Against this background, Directors encouraged the authorities to press ahead with critical fiscal and structural reforms, with a view to spurring private sector-led growth and economic self-reliance.

Looking ahead, Directors emphasized that fiscal consolidation will be essential to maintain external stability and achieve budgetary self-reliance, and called for more ambitious fiscal objectives than those stated in the most recent budget. In particular, the authorities should aim for achieving, and maintaining, a fiscal surplus of about 3 percent of GDP in the medium term, to build reserves in the CTF and prepare for the elimination of Compact grants after 2023. Directors underlined that, as the level of current expenditure is not sustainable, steps to rationalize current expenditures, including for public sector wages and subsidies, will be essential, along with measures to raise tax and nontax revenue.

Directors stressed that the CTF is the cornerstone of the Marshall Islands' future. They urged the authorities to adopt prudent and transparent management of the CTF, in line with international best practices. Directors called on the authorities to weigh carefully the costs and benefits of securitizing future U.S. contributions before reaching a decision.

Directors underscored the importance of ambitious structural reforms to promote sustainable private sector growth and to complement fiscal consolidation, while reducing the dominant role of the public sector in the economy. These reforms should include shoring up infrastructure, resolving land issues, and scaling back the government's commercial activities. Directors encouraged the authorities to improve the country's business environment, in particular to spur nascent industries in the tourism, fishing, and shipping sectors.

Directors welcomed the progress that has been made in strengthening financial sector supervision. At the same time, they emphasized that further steps are needed to bolster the country's financial infrastructure and to ensure that the system performs its role in the development of the economy. Directors urged the authorities to introduce measures to reduce impediments to commercial lending. They also stressed the need to carefully monitor the widespread reliance on high-interest personal credit, and to safeguard against potential non-performing loans.

Directors encouraged the authorities to improve the coverage, reliability, and timeliness of key economic statistics, with the help of technical assistance from donors.

Marshall Islands: Selected Economic Indicators FY2004–08 1/

	2004	2005	2006	Est. 2007	Proj. 2008
Real sector					
Real GDP (percent change)	5.9	1.7	0.8	2.3	1.2
Consumer prices (percent change)	2.0	3.5	5.3	2.9	5.5
Central government finances (in percent of GDP)					
Revenue and grants	57.9	71.0	74.3	68.8	60.6
Total domestic revenue	25.5	25.7	25.0	26.1	23.3
Grants	32.5	45.4	49.3	42.7	37.3
Expenditure	58.3	74.6	74.7	69.2	60.9
Current	49.9	56.2	55.5	52.9	50.5
Capital	8.5	18.4	19.1	16.3	10.4
Overall balance	-0.4	-3.6	-0.4	-0.4	-0.3
Usable government financial assets					
(In millions of US$; end of period) 2/	4.5	1.6	3.0	1.3	-0.1
Compact Trust Fund (in millions of US$; end of period) 3/	32.0	48.9	66.2	88.5	106.7
Commercial banks (in millions of US$; end-December) 4/					
Foreign assets	51.0	53.6	57.6	60.9	…
Private sector claims	43.4	43.6	43.2	53.6	…
Total deposits	74.9	74.3	75.5	89.6	…
One-year time deposit rate (in percent)	2.1	3.5	4.0	4.0	…
Average consumer loan rate (in percent)	17.4	18.5	18.5	18.5	…
Balance of payments (in millions of US$)					
Trade balance	-52.9	-56.2	-56.1	-58.2	-60.1
Net services	-8.0	-11.1	-8.7	-7.4	-6.8
Net income	29.9	32.3	32.9	35.0	36.8
Private and official transfers	22.7	27.0	29.7	26.0	27.0
Current account including official current transfers 5/	-8.2	-7.9	-2.3	-4.7	-3.1
(In percent of GDP)	-6.3	-5.7	-1.6	-3.1	-2.0
Current account excluding official transfers 5/	-43.0	-47.1	-44.3	-43.3	-43.1
(In percent of GDP)	-32.7	-34.1	-30.4	-28.9	-27.2
Overall balance 6/	-23.5	-5.3	-0.7	-1.6	-1.4
(In percent of GDP)	-17.9	-3.8	-0.5	-1.1	-0.9
External debt (in millions of US$; end of period) 7/	94.7	91.7	99.7	98.7	99.8
(In percent of GDP)	72.1	66.3	68.5	65.9	63.0
External debt service (in millions of US$)	4.1	6.2	6.3	12.9	6.6
(In percent of exports of goods and services)	12.9	17.6	19.0	37.0	17.1
Exchange rate					
Real Effective Exchange Rate (1995 =100)	110.0	111.5	113.0	112.7	...
Memorandum Item:					
Nominal GDP (in millions of US$)	131.3	138.3	145.6	149.7	158.4

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

1/ Fiscal year ending September 30 unless otherwise stated.
2/ Cash and cash equivalents that are not reserved for specific uses.
3/ Assets in trust funds are treated as non-usable.
4/ Data are in calendar basis ending in December; for example, FY2001 refers to Jan-Dec 2001.
5/ Official transfers include current transfers but exclude capital transfers and Trust Fund contributions.
6/ Large negative overall balance in FY04 reflects official capital outflow to the Compact Trust Fund.
7/ Includes government and government-guaranteed debts.