



# REPUBLIC OF THE MARSHALL ISLANDS

July 2016

## 2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR REPUBLIC OF THE MARSHALL ISLANDS

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Republic of the Marshall Islands, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 25, 2016 consideration of the staff report that concluded the Article IV consultation with Republic of the Marshall Islands.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 25, 2016, following discussions that ended on May 18, 2016, with the officials of Republic of the Marshall Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 8, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association.
- A **Statement by the Executive Director** for Republic of the Marshall Islands.

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**International Monetary Fund**  
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INTERNATIONAL MONETARY FUND



Press Release No. 16/369  
FOR IMMEDIATE RELEASE  
July 28, 2016

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2016 Article IV Consultation with the Republic of the Marshall Islands**

On July 25, the Executive Board of the International Monetary Fund (IMF) concluded the 2016 Article IV consultation<sup>1</sup> with the Republic of the Marshall Islands.

The Republic of the Marshall Islands is an isolated and thinly-populated island state that is vulnerable to climate change owing to its low elevation. Its economy is highly dependent on external aid, as the base for private sector growth is limited by its small size, remoteness, and dispersion over a vast ocean area.

Overcoming the contraction of the previous year, the Marshallese economy is estimated to have expanded by about 0.5 percent in FY2015 (ending September 30), as the fishery sector recovered. Following a moderate inflation of 1.1 percent in FY2014, headline inflation dropped to -2.2 percent in FY2015 amid falling oil and utility prices. The fiscal balance is estimated to have recorded a surplus of about 3 percent of GDP in FY2014–15, due to record-high fishing license fees.

Growth is expected to rise to about 1.5 percent and inflation to about 0.5 percent in FY2016, as the effects of the drought earlier this year are offset by the resumption of infrastructure projects. The fiscal balance is projected to decline to a smaller surplus in FY2016 but, without reforms, would deteriorate to a sizable deficit over the medium term owing to the steady decline in Compact grants until FY2023. After an expected growth rebound fueled by the implementation of delayed infrastructure projects, GDP is projected to grow at the potential rate of 1–1.5 percent over the medium term, absent structural reforms.

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

## Executive Board Assessment<sup>2</sup>

Executive Directors welcomed the improvement in economic activity, but noted that the Republic of the Marshall Islands continues to face significant challenges arising from the scheduled decline in Compact grants, extreme weather-related events due to climate change, and limited private sector activity. Directors underscored the importance of sound macroeconomic policies to ensure long-term fiscal sustainability, safeguard financial stability, reduce vulnerabilities to external shocks, and promote sustainable growth.

Directors emphasized that fiscal consolidation over the medium-term is key to building adequate buffers against existing fiscal vulnerabilities. They agreed that implementation of adjustment efforts envisioned in the Decrement Management Plan will be important. Accordingly, Directors recommended steps to contain expenditure, especially current spending while avoiding delays in infrastructure spending, further reducing subsidies to state-owned enterprises (SOEs), enhancing tax administration, and strengthening tax and social security systems. Accelerating the pace of public financial management reforms will be critical in implementing the needed fiscal adjustment and in addressing the existing weaknesses in budget execution, reporting and planning.

Directors emphasized the need for continued efforts to mitigate climate change risks, including explicit budget provisions for adaptation costs. They also encouraged the authorities to sustain the reform of SOEs to facilitate private sector development. In this regard, Directors highlighted that clarifying community service obligations of SOEs and establishing a centralized monitoring unit, building on the legislation of the SOE Act, will be important.

Directors emphasized the need to strengthen the capacity and oversight authority of the Banking Commission to safeguard financial stability, including the challenges posed by withdrawal of correspondent banking relationships. Efforts should also be made to address the regulatory gaps, including in the AML/CFT framework. Directors encouraged the Banking Commission to consider a ceiling on the allowed household debt service ratio, and introduce stricter criteria on non-performing loan classification. Directors supported the authorities' plans to refocus the Marshall Island Development Bank to its core mandate of providing commercial lending.

Directors emphasized that structural reforms are needed to facilitate private sector growth. Reform effort should be aimed at increasing competitiveness and reducing impediments to doing business, notably by improving access to credit and strengthening the property registration and bankruptcy framework. Enhancing statistics will help strengthen policy planning and analysis.

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

**Marshall Islands: Selected Economic Indicators, FY2012–2021 1/**

Nominal GDP for FY2015 (in millions of U.S. dollars): 184.6

Population (2015 est.): 52,900

GDP per capita for FY2015 (in U.S. dollars): 3489.6

Quota: SDR 3.5 million

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Est.	Proj.					
<b>Real sector</b>										
Real GDP (percent change)	4.0	1.9	-1.1	0.4	1.4	1.7	1.8	1.6	1.6	1.3
Consumer prices (percent change)	4.3	1.9	1.1	-2.2	0.7	1.1	1.8	1.9	2.1	2.1
<b>Central government finances (in percent of GDP)</b>										
Revenue and grants	51.4	53.7	52.2	57.0	66.2	66.4	65.1	63.4	61.5	60.3
Total domestic revenue	19.3	21.4	23.4	26.4	29.0	26.7	26.5	25.9	25.2	25.0
Grants	32.1	32.2	28.8	30.6	37.2	39.8	38.6	37.4	36.3	35.3
Expenditure	52.2	53.9	49.0	54.2	63.9	64.7	64.4	63.4	62.4	61.6
Expense	48.2	50.1	46.1	50.2	54.9	52.5	51.9	51.3	50.8	50.4
Net acquisition of nonfinancial assets	4.0	3.8	2.9	4.0	9.0	12.2	12.5	12.1	11.6	11.2
Net lending/borrowing	-0.7	-0.2	3.2	2.7	2.3	1.7	0.7	-0.1	-0.9	-1.3
Compact Trust Fund (in millions of US\$; end of period)	165.6	206.2	240.1	247.1	279.4	311.7	346.2	383.0	422.2	464.0
<b>Commercial banks (in millions of US\$)</b>										
Foreign assets	62.1	65.6	64.7	90.2	...	...	...	...	...	...
Private sector claims	59.4	67.2	79.4	89.9	...	...	...	...	...	...
Total deposits	85.0	98.4	118.9	155.5	...	...	...	...	...	...
Consumer loans (in percent of total loans)	79.0	71.0	72.2	70.8	...	...	...	...	...	...
One-year time deposit rate (in percent)	1.6	1.3	1.6	1.4	...	...	...	...	...	...
Average consumer loan rate (in percent)	13.8	14.2	13.3	13.2	...	...	...	...	...	...
<b>Balance of payments (in millions of US\$)</b>										
Trade balance	-49.8	-66.8	-67.5	-77.2	-82.9	-87.4	-89.3	-91.2	-93.4	-95.6
Net services	-43.7	-47.7	-40.9	-45.4	-45.9	-48.3	-49.1	-50.4	-51.3	-52.3
Net income	29.3	36.1	45.3	58.5	54.2	55.1	58.1	59.6	60.6	61.6
Unrequited transfers (private and official)	57.8	59.6	54.9	58.1	60.2	62.5	61.4	62.3	62.2	62.0
Current account including official grants 2/ (In percent of GDP)	2.3	-2.9	1.4	-2.9	-1.3	-0.7	-0.5	-2.3	-4.6	-6.9
External PPG debt (in millions of US\$; end of period) 3/ (In percent of GDP)	1.2	-1.5	0.7	-1.6	-0.7	-0.4	-0.2	-1.1	-2.2	-3.2
External PPG debt (in millions of US\$; end of period) 3/ (In percent of GDP)	96.9	98.4	95.5	90.6	85.7	80.4	75.1	76.7	79.1	83.0
External debt service (in millions of US\$) (In percent of exports of goods and services)	52.6	51.8	51.1	49.1	45.6	41.7	37.8	37.5	37.5	38.3
External debt service (in millions of US\$) (In percent of exports of goods and services)	7.2	6.3	6.8	7.2	7.2	7.3	7.3	8.1	8.0	7.4
Exchange rate	8.6	7.6	9.1	10.9	10.8	10.7	10.3	11.0	10.4	9.3
Real Effective Exchange Rate (2010 =100)	100.5	102.0	102.7	106.3	...	...	...	...	...	...
<b>Memorandum Item:</b>										
Nominal GDP (in millions of US\$)	184.4	190.2	186.7	184.6	188.0	192.8	198.6	204.5	210.8	216.7

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

1/ Fiscal year ending September 30.

2/Includes capital grants.

3/ Public and publicly-guaranteed external debt.



# REPUBLIC OF THE MARSHALL ISLANDS

## STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

July 7, 2016

### KEY ISSUES

**Context.** The Republic of the Marshall Islands (RMI) is an isolated and thinly-populated fragile state vulnerable to climate change. Its economy is highly dependent on external aid, as private sector growth is constrained by its small size and remoteness, dispersion over a vast ocean area, and regulatory weakness. The country needs to adapt to climate change, prepare for a sharp reduction in the U.S. grants in FY2023, and enhance the platform for sustainable private-sector growth. Although the economy is expected to expand modestly in FY2016, the fiscal balance will likely fall into deficit in the medium term without a sustained adjustment, undermining long-term self-sufficiency.

#### Key Policy Recommendations.

- A medium-term fiscal surplus of 3 percent of GDP is needed to build adequate buffers ahead of the FY2023 reduction of Compact grants, entailing a gradual fiscal adjustment of about 5 percentage points of GDP over seven years to be achieved by consolidating expenditures and reforming the tax and social security systems.
- Continued efforts to adapt to climate change are recommended, including the explicit budgeting of fiscal provisions. Funding should be sought from diverse sources, including grants and disaster risk insurances.
- To facilitate private sector development, state-owned enterprise (SOE) reform should continue. Building on the SOE Act of October 2015, the authorities should clarify community service obligations and establish a centralized monitoring unit.
- The capacity and oversight authority of the Banking Commission should be strengthened to safeguard financial stability, including the challenges posed by withdrawal of correspondent banking relationships (CBRs).

Approved By  
**Ranil Manohara**  
**Salgado (APD) and**  
**Andrea Richter Hume**  
**(SPR)**

Discussions took place in Majuro on May 9–18, 2016. The staff team comprised Mr. Jaewoo Lee (Head), Mr. Serkan Arslanalp, and Ms. Mari Ishiguro (all APD), joined by Ms. Nancy Lelang (OED) and Mr. Tubagus Feridhanusetyawan (APD). Representatives from the World Bank and the Asian Development Bank also participated in the mission. The mission met with the Speaker of the Parliament Kedi, Finance Minister Wase, other senior government officials, private sector representatives, donors and the press.

## CONTENTS

<b>BACKGROUND</b>	<b>4</b>
<b>DEVELOPMENTS, OUTLOOK AND RISKS</b>	<b>5</b>
A. Recent Developments and Outlook	5
B. External Stability	5
C. Risks and Spillover	8
<b>SECURING FISCAL SUSTAINABILITY</b>	<b>9</b>
<b>ADAPTING TO CLIMATE CHANGE</b>	<b>11</b>
<b>FACILITATING PRIVATE SECTOR GROWTH</b>	<b>12</b>
<b>ENHANCING FINANCIAL STABILITY</b>	<b>14</b>
<b>STAFF APPRAISAL</b>	<b>15</b>
<b>BOXES</b>	
1. Implications of Climate Change	6
2. External Sector Assessment	7
3. SOE Reforms	13
4. Withdrawal of CBRs	15
<b>FIGURES</b>	
1. Real Sector Developments	17
2. Fiscal Developments	18
3. External and Credit Developments	19
<b>TABLES</b>	
1. Basic Data, FY2012–21	20
2. Statement of Government Operations, FY2012–21	21
3. Balance of Payments, FY2012–21	22
4. External and Financial Sector Vulnerability Indicators, FY2012–21	23

5. Deposit Money Banks, FY2012–15 _____	24
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**APPENDICES**

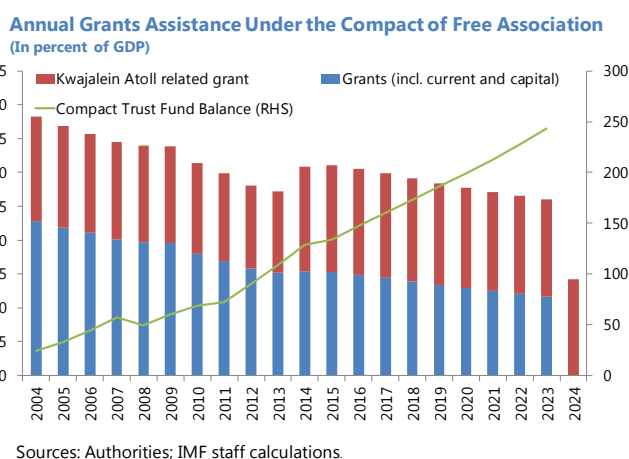
I. The Compact Trust Fund and Its Long-term Outlook _____	25
II. Main Recommendations of the 2013 Article IV Consultation _____	27
III. MDG and Strategic Surveillance Matrix _____	28
IV. Risk Assessment Matrix _____	29

## BACKGROUND

**1. The Republic of the Marshall Islands (RMI) is a small and sparsely-populated country, comprising low-lying atolls vulnerable to climate change** (Box 1). Its economy is highly dependent on external aid, as the base for private sector growth is limited by its small size, remoteness from major traffic routes, dispersion over a vast ocean area, and weaknesses in the regulatory framework. Over the medium term, the country needs to adapt to rising fallouts from climate change, to prepare for a sharp reduction in the U.S. grants in FY2023, and to enhance the platform for sustainable private-sector growth. A new government was formed in January 2016, headed by the first female head of state elected in the Pacific.

**2. Most of the budget grants provided under the U.S. Compact of Free Association (Compact grants) will expire in FY2023, posing a major medium-term fiscal challenge.**<sup>1</sup> The RMI

will receive annual grants averaging US\$36 million (20 percent of GDP) over FY2004–23.<sup>2</sup> Thereafter, investment earnings from the Compact Trust Fund (CTF)—currently being accumulated—are intended to replace the expiring portion of Compact grants (12 percent of GDP) as a revenue source. While the projected balance (\$550 million in FY2023) is likely to generate investment earnings to replace the expiring grants, it will not be sufficient to preserve the real value of CTF (Appendix I). The preservation of the real value of CTF is needed both to safeguard an important resource for future generations and to cope with the market volatility in investment returns.



**3. Relative to the past Fund recommendations, progress has been made including in SOE reforms** (Appendix II). Some reforms now await follow-up implementation, while several delayed reforms—tax and social security—need to be resuscitated. Over a longer term, the RMI needs to make progress toward Sustainable Development Goals (SDGs), building on the progress with core Millennium Development Goals (MDGs) (Appendix III). The RMI's progress in most MDGs was broadly in line with other Pacific islands, while the two MDGs in health areas were achieved fully. This reflected above-average health (and education) expenditures, partly due to a wide geographical dispersion of the population.

<sup>1</sup> The government's fiscal year ends on September 30 of each calendar year. The amended Compact Agreement took effect in FY2004.

<sup>2</sup> This grant amount has already been appropriated by the U.S. Congress and is thus allocated and secured, while annual disbursement follows steps required under the Compact agreement.



## DEVELOPMENTS, OUTLOOK AND RISKS

### A. Recent Developments and Outlook

**4. Real GDP growth is estimated to have returned to a positive territory in FY2015, while CPI inflation has been falling.** Overcoming the contraction of the previous year, the economy is estimated to have expanded by 0.4 percent in FY2015, as the fishery sector recovered. Following a moderate inflation of 1.1 percent in FY2014, headline inflation dropped to -2.2 percent in FY2015 amid falling oil and utility prices. Going forward, growth is expected to rise to 1.4 percent and inflation to 0.7 percent in FY2016, as the effects of the drought earlier this year are offset by the resumption of Compact-funded infrastructure spending.<sup>3</sup> After several years of growth rebound fueled by the delayed implementation of infrastructure projects, GDP is projected to grow at the potential rate of 1–1.5 percent over the medium term, absent structural reforms.

**5. The overall fiscal balance, in surplus over FY2014–15, will likely deteriorate to a deficit over the medium term.** The fiscal balance is estimated to have recorded a surplus of about 3 percent of GDP in FY2014–15, due to record-high fishing license fees. It is projected to decline to a smaller surplus in FY2016 and, without reforms, to a deficit of 2 percent of GDP over the medium term owing to the steady decline in Compact grants until FY2023, and sizable transfers to SOEs and the social security system.

**6. The current account deficit (including official grants) would likely worsen in FY2016 from an estimated 1.6 percent-of-GDP deficit in FY2015.** Weak copra and oil prices<sup>4</sup>, and higher imports due to the resumption of infrastructure projects are projected to worsen the deficit in FY2016–17. Current account deficits are financed by a stable source of funding largely from the United States and grants from other donors.

**7. Banks provide only limited corporate credit despite ample deposits.** Private sector credit reached nearly 50 percent of GDP in FY2015, mainly on account of consumer loans (corporate loans represent only 30 percent of total loans). A legislative framework for bankruptcy is missing, and posting property as collateral is hindered by complex land ownership issues. The loan-to-deposit ratio of the banking system remained low, at around 60 percent as of end-FY2015. Interest rate spreads (between lending and deposit rates) were around 5 percent for corporate loans and 13 percent for consumer loans, reflecting high credit risk.

### B. External Stability

**8. The RMI's external position is assessed to be broadly consistent with underlying fundamentals, with limited risk of external instability due to stable external funding** (Box 2). The current account deficit, once adjusted for a temporary factor, is close to the current account

<sup>3</sup> A temporary hold had been placed on Compact infrastructure projects, pulling down GDP growth over FY2014–15.

<sup>4</sup> Oil re-exports are a major component of the RMI's exports.

norm as estimated by the standard Fund methodology. The real exchange rate so far in FY2016 is 7 percent above the historical average (FY2004–15), narrowing the scope of possible undervaluation of the past, and is now assessed to be broadly in equilibrium albeit subject to a sizable statistical uncertainty. The U.S. dollar is used as the legal tender adequately reflecting the small economic size and close economic ties with the United States. The risks from a heavy reliance on external financing are limited by stable funding, including the Compact grants until FY2023. Nevertheless, it is desirable to strengthen buffers, in preparation for the post-FY2023 period, including by building up the CTF balance to a level sufficient for preserving its real value and by shoring up government deposits which are the first recourse for absorbing short-term liquidity shocks.

### Box 1. Marshall Islands: Implications of Climate Change

*Marshall Islands is one of the most vulnerable countries to climate change and rising sea levels. The related fiscal costs can be large and are explicitly recognized in the macro-framework and the DSA.*

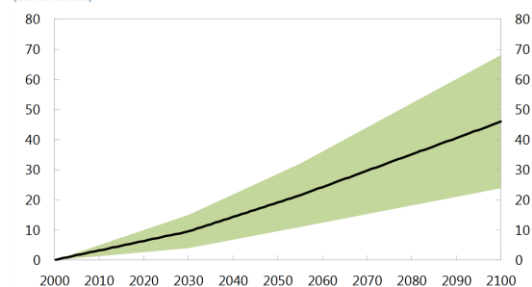
**Many small island states—especially the atoll nations of the Pacific—are among the most vulnerable to climate change and sea-level rise.** Because of their low elevation and small size, low-lying atolls (e.g., Kiribati, the RMI, and Tuvalu) are threatened by future rises in sea level. Depending on carbon emissions, the global mean sea level could rise by up to a meter by 2100 according to the 2014 report of the Intergovernmental Panel on Climate Change (IPCC). This would pose serious risks to the RMI, as a rise of 1 meter could lead to a loss of 80 percent of the land in the capital city of Majuro (IPCC 2001; Calderon and others, 2015).

**RMI is already becoming more vulnerable to extreme weather events.** With average elevation of just 2 meters above sea level, inundations and large storms are already becoming an increasing threat to the Marshall Islands. In 2008, extreme waves and high tides caused widespread flooding in Majuro, resulting in the government declaring a state of emergency. In 2013, the northern atolls experienced serious drought, resulting in the U.S. President declaring an emergency that activated US\$5.5 million (3 percent of GDP) of drought relief from the United States under the Compact Agreement. In February 2016, the government declared a state of emergency, citing severe drought conditions, consequence of a protracted El Niño system that started building up in early 2015, which was followed by a declaration of emergency by the U.S. President, activating support from the Federal Emergency Management Agency (FEMA).

**In this context, climate change can lead to both structural and cyclical fiscal costs.**

- The **structural** component (2.5 percent of GDP per year) is related to the cost of preparing for climate change, including by building coastal protection. The relative costs of coastal adaptation vary strongly among regions, but small island states are expected to face costs of several percentage points of GDP a year, since most of their population and infrastructure are in the coastal zone (IPCC, 2014). The ADB has estimated these costs in the order of 1½–2½ percent of GDP annually for the Pacific region (ADB, 2013). We take the higher end of this range for the RMI, given its higher vulnerability.<sup>1</sup>
- The **cyclical** component (10 percent of GDP over 20 years) is related to the fact that climate change is a contributing factor to extreme weather events. The Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) reports that disaster-related losses and damages of 10 percent of GDP could occur once every 20 years in the RMI (PCRAFI, 2011).

Sea-Level Rise Projections for the Marshall Islands (centimeters)



Source: Marshall Islands National Weather Service Office.  
Note: The projections for the A1B (medium) emissions scenario (representing 90 percent of the range of models) are shown by the shaded green region. Changes are relative to the average of the period 1980–99.

<sup>1</sup> The IPCC (2014) models suggest that the costs of sea level rise impacts as a percentage of GDP would be highest for the Federated States of Micronesia, Palau, Marshall Islands, and Nauru in the Pacific and Bahamas in the Caribbean.

**Box 2. Marshall Islands: External Sector Assessment**

*On balance, the external position appears to be broadly consistent with underlying fundamentals and risks to external stability are limited owing to stable source of funding from the United States and other donors.*

**Exchange rate Assessment.** The current account balance, once adjusted for the effect of a temporary hold of capital grants (in FY2014–15), is close to the current account norm estimated by the standard Fund methodology (the EBA-lite). While the ELRER approach suggests a moderately weak external position, a larger-than-usual margin of statistical variation may be warranted, given data limitations of the RMI. On balance, the level of the exchange rate is assessed to be broadly consistent with the macroeconomic situation, with little evidence of substantial exchange rate misalignment.

**Marshall Islands: Real Exchange Rate Assessments for 2015 ( in percent)**

	CA Norm 3/	Underlying CA 3/	CA Gap	Misalignment
EBA-lite Current Account (ECA) 1/	-5.9	-3.2	<b>2.7</b>	-15.8
ECA adjusted for a temporary factor 2.	-5.9	-5.8	<b>0.1</b>	-0.7
EBA-lite Real Exchange Rate (ELRER)				<b>9.8</b>

Source: Fund staff calculations

1/ ECA approach calculates the difference between the CA balance and an estimated CA "norm".

2/ Adjusted for the import compression induced by a temporary hold on Compact capital grants.

3/ CA numbers are in percent of GDP.

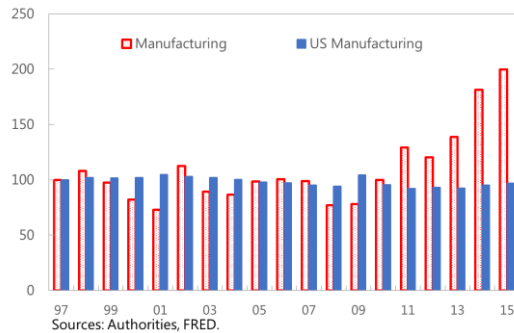
**Competitiveness.** The RMI’s manufacturing unit labor cost has increased steadily, outpacing the United States in recent years. This is due to shortage of skilled workers, aggravated by ongoing migration of workers to the United States, reflecting the wage differential which is a strong incentive for migration for the Marshallese citizens who can work and study in the United States without a separate permit under the Compact Agreement. Such developments do not necessarily worsen external stability as manufacturing exports are already very small and because migration to the United State can increase remittance inflows.

**Net Migration from the RMI to the U.S.**

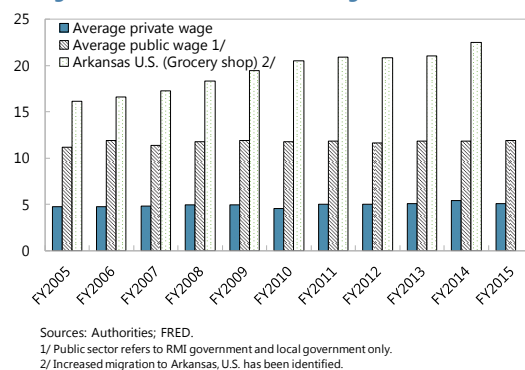
	Net Migration	in % of Population
1990–1996	384	0.8
1997–2003	1181	2.4
2004–2012	794	1.5

Source: RMI FY2014 Economic Review (PIT).

**Unit Labor Cost (FY1997-2015)**  
(1997 = 100)



**Average Public and Private Sector Wages**



**Reserves.** With no central bank or local currency, government’s deposit serves as the means to absorb short-term liquidity shocks. The government’s deposit was around 0.5 months of imports in 2015, slightly lower than the historical average (0.7 months over 21 years), although the steady flow of external grants has shielded the RMI from liquidity squeezes.

**External Financing.** Current account deficits are financed by a stable source of funding largely from the United States. External debt is expected to decline as concessionary loans are paid down in the coming years.

## C. Risks and Spillover

**9. Risks to the outlook are tilted to the downside, albeit limited by several mitigating factors** (Appendix IV). External risks stem from extreme weather-related events, faster-than-anticipated rise in fuel prices, persistently low rates of return on financial assets in the CTF, and potential loss of a correspondent banking relationship. Domestic risks include delays in the implementation of infrastructure projects and inadequate fiscal consolidation. Finally, DSA analysis indicates that the RMI continues to remain at a high risk of external debt distress, but these risks are mitigated by a number of factors, including concessionality of most obligations, stable flow of funds from Compact grants until FY2023, and future investment income from the CTF (after FY2023). On the upside, a decisive push for structural reforms could stimulate growth (see below). Moreover, if downside risks were to materialize, the authorities could accelerate infrastructure spending, financed by allocated but unused funds for capital spending (cumulated sum of 18.5 percent of GDP by FY2015).

**10. Repercussions on the RMI from global developments after the Brexit vote are anticipated to be limited.** Due to limited international linkages other than to the United States via the Compact agreement, the RMI remains fairly isolated from spillovers from external developments. Even if U.S. growth were to slow or the currency to appreciate, the U.S. grants to the RMI would remain unchanged at their pre-allocated levels until FY2023. While the RMI's ship registry business could be affected by a slowdown in global trade, the registry business itself is conducted by an offshore entity which is linked to the domestic economy by a pre-determined annual payment to the RMI government (to be renegotiated in 2019). A possible long-term decline in global asset returns adds to the existing risk factors for managing the CTF.

### The Authorities' Views

**11. The authorities broadly agreed with the staff assessment on economic outlook.** Economic activity was expected to pick up in 2016, albeit gradually owing to possible delays in the disbursement of Compact infrastructure grants and the drought in early 2016. They agreed that, over the medium term, the execution of Compact infrastructure projects will help support growth, while also agreeing with the view that long-term growth potential will remain limited in the absence of a decisive structural reform. The authorities agreed that foreign grants would continue to provide stable funding for current account deficits.

**12. The authorities considered climate change, social security fund liabilities, and public debt to be the main risks to the outlook.** Extreme weather episodes due to climate change, such as droughts, have adversely affected the country in recent years and are becoming more frequent. They noted the large looming contingent liabilities from the social security fund, in the absence of a reform that puts the system on a sustainable path. The authorities also highlighted the still relatively high level of public and publicly-guaranteed debt as a constraint on future prospects.

## SECURING FISCAL SUSTAINABILITY

**13. A medium-term fiscal adjustment is needed to achieve long-term sustainability and build buffers against existing vulnerabilities.** Staff analysis indicates that a fiscal surplus of 3 percent of GDP by FY2023 could help ensure the long-term sustainability of the CTF by preserving its real value, under the expected nominal return of 5 percent per year.<sup>5</sup> This would entail a cumulative fiscal adjustment of 5 percentage points of GDP over seven years, relative to the baseline under which the fiscal balance would deteriorate to a deficit of 2 percent of GDP by FY2023. An adequate adjustment could strengthen fiscal buffers against vulnerabilities including: an outstanding debt which is one of the highest among Pacific small states, substantial contingent liability from SOE subsidies and social security system, the volatility in CTF returns, and prospective costs from climate change.

**14. The staff-recommended surplus target can be attained by undertaking the fiscal adjustment envisioned in the Decrement Management Plan (DMP), complemented by additional reforms.** The authorities developed the DMP as an indicative outline in the face of declining Compact grants but have yet to incorporate it in medium-term budget plans. Fully implemented, the DMP can generate a gradual fiscal adjustment of 4 percentage points of GDP over the remaining seven years of the amended Compact agreement. Additional adjustment of at least 1 percentage point of GDP can come from further reducing SOE subsidies, enhancing tax administration and strengthening tax reforms.

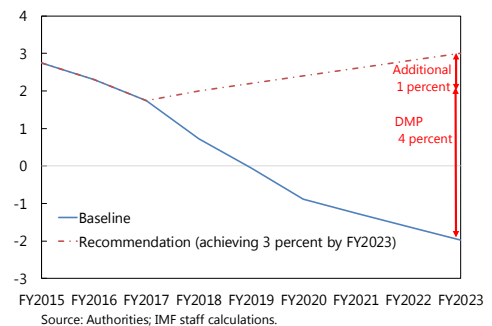
**Fiscal Savings under the Decrement Management Plan (DMP), Cumulative Savings by FY2023 Compared to end-FY2014 Outturn**

	(Million U.S. dollars)	(Percent of GDP)
Expenditure measures	7.7	3.5
Expenditure moderation	4.8	2.2
SEO subsidy reduction	1.7	0.8
Landowner utility transfers	1.2	0.5
Revenue measures	1.2	0.5
Tax reform	1.2	0.5
<b>Total fiscal savings</b>	<b>8.9</b>	<b>4.0</b>

Sources: Republic of the Marshall Islands, Decrement Management Plan (FY2015-23); IMF staff estimates.

- Expenditure compression.* Major components are cuts in the government’s goods and services current expense, SOE subsidies, and utility transfers, which would add up to savings of 3½ percent of GDP by FY2023 (text table). Staff supports the authorities’ initiative for rationalizing current expenditures (including costs of travel, supplies and personnel) through efficiency improvement. This can be best achieved when implemented gradually—to smooth growth impact—and in combination with public financial management (PFM) reforms. Staff also encourages reducing SOE subsidies—6 percent of GDP in FY2015—further than planned under the DMP.

**Fiscal Balance Path**  
(In percent of GDP)



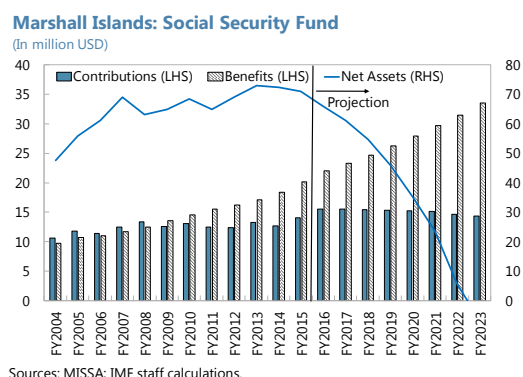
Source: Authorities; IMF staff calculations.

<sup>5</sup> As discussed in Appendix I, a 0.5 percentage point decrease in expected returns would increase the fiscal adjustment need by 1 percentage point of GDP.

- *Revenue mobilization.* The DMP incorporates a tax reform with an estimated revenue impact of ½ percent of GDP, while a larger revenue mobilization will be possible once the new tax system is in place. In line with the Pacific Financial Technical Assistance Centre (PFTAC) recommendations, staff encourages the authorities to push ahead with the reform which includes: (i) reforming the personal income tax; (ii) introducing a net profits tax; (iii) introducing a consumption tax to replace the Gross Revenue Tax (GRT); and (iv) replacing the existing import duties on alcohol, tobacco, motor vehicles and fuels with excise taxes. While the tax reform is still under review, the authorities incorporated into revenue a substantial portion of fishing license fees collected by the Marshall Islands Marine Resource Authority—80 percent of surplus revenues beyond US\$3 million—starting in FY2015.
- *To facilitate domestic revenue mobilization further,* staff also advocates further enhancing tax administration along the latest PFTAC recommendations, by improving core tax functions such as tax payers’ services, collection of tax arrears and outstanding returns, and the audit function.<sup>6</sup>

**15. As a precondition for these medium-term fiscal adjustments to succeed, the social security system needs to be put on a sustainable path and avoid adding a large fiscal drain.**

Under the current structure, the social security fund (SSF) could deplete its reserves after FY2022. Staff supports adopting a reform plan with the following main elements: (i) raise the normal retirement age from 60 to 65; (ii) phase in a less costly benefit scheme plan over several years, with some grandfathering of current retirees; and (iii) strengthen enforcement of contributions and increase the contribution rates. An increase in government funding may be inevitable during the transition to a new system, but caution is strongly urged to guard against institutionalizing it or delaying the reform.<sup>7</sup>



**16. Improving PFM will play a critical role in implementing fiscal adjustment and safeguarding fiscal sustainability.** Staff welcomes the authorities’ renewed focus on PFM reforms, including on process and human resources management. It is important to move expeditiously toward the full implementation of this reform, which is much needed given existing weaknesses in tax administration, budget execution, reporting, and planning that can hamper fiscal adjustment.

<sup>6</sup> Strengthened tax audits uncovered tax under-reporting of about ½ percent of GDP per year in FY2013–14.

<sup>7</sup> The impact on growth will be small, because the direct income effects of later retirement age and higher contributions largely offset each other, while indirect (second-round) income effects would be limited by low fiscal multipliers reflecting the very high openness of the RMI’s island economy.

**The Authorities’ Views**

**17. The authorities agreed with the need for fiscal adjustment to preserve the real value of CTF.** They recognized the necessity to maintain a sizable fiscal surplus and to keep contributing to the CTF, as recommended by the staff. In FY2016, the authorities contributed US\$2.2 million to the CTF. The authorities agreed that a comprehensive reform is required to make the SSF sustainable and in May 2016 set up a task force to recommend reform options to the Cabinet and Parliament. The Ministry of Finance (MoF) was focusing on the human resources management improvement plan as a cross-cutting foundation to ensure the sustainability of PFM reforms, while rallying broader and greater support for many other reforms. In particular, tax reform—deemed necessary by the authorities—might require a recalibration that addresses key concerns of the private sector, before being resubmitted to the new parliament.

**ADAPTING TO CLIMATE CHANGE**

**18. The RMI is one of the countries expected to be most affected by climate change and rising sea levels.** Climate change is expected to lead to both structural and cyclical fiscal costs. The structural component (2.5 percent of GDP per year) is related to the ex-ante cost of preparing for climate change, including by building coastal protection, and is recognized in the baseline medium-term fiscal projections and the DSA. The cyclical component (10 percent of GDP over 20 years), due to extreme weather events, is recognized as a contingent liability shock in the DSA.

**19. Staff supports the authorities’ intensified efforts to mitigate disaster risk and build resilience.** Recognizing that most disasters that would hit the RMI would be climate-change related, the authorities have prepared a Joint National Action Plan (JNAP), which includes climate-change adaptation and disaster risk-management strategies comprising both ex ante and ex post measures. The disaster-response costs could be covered by contingency buffers, disaster risk insurance, and emergency support. The RMI has a maximum amount of US\$15.6 million (8 percent of GDP) available in ex-ante instruments to facilitate disaster response, and can also access emergency support from relevant U.S. agencies (FEMA/USAID) per the Compact agreement.

<b>Marshall Islands: Ex-Ante and Ex-Post Resilience Mechanisms</b>			
		Risk Management	Mechanism
<b>Ex-Ante</b>			
Self Insure	Build buffers		Contingency budget (US\$ 0.2 mn), Disaster Assistance Emergency Fund (US\$ 0.1 mn)
Risk Transfer	Regional pooling		Pacific Catastrophe Risk Insurance Pilot (US\$ 15.3 mn, maximum)
<b>Ex-Post</b>			
Coping	Emergency response and reconstruction		U.S. agencies (FEMA/USAID), Asian Development Bank (AsDB), donors

Sources: Pacific Catastrophe Risk Assessment and Financing Initiative (PFRAFI); and IMF staff estimates.

**20. Staff also recommends explicitly recognizing the adaptation cost in budget and seeking donor funding.** Explicit budgeting will help ensure the continuity—despite medium-term fiscal adjustment—and efficiency on both spending and funding fronts. The structural expenditure should incorporate climate-related costs implicit in other line items, including extra construction

costs for flood-proof structures. Where possible, donor funding (including from the new Green Climate Fund) should be sought, considering fiscal constraints of the RMI. Related, the Ministry of Finance has established a new office—Division of International Development Assistance (DIDA)—to coordinate all international development assistance, including for climate change. The authorities are working with the World Bank on the preparation of a Climate Resilience Project for FY2017, which would help strengthen disaster early warning, improve coastal protection and planning, and provide contingency funds for emergency response to medium-size hazards, including drought and flooding.

### The Authorities' Views

**21. The authorities agreed on the benefit of strengthening planning capacity, including by explicitly recognizing climate change related expenditure in the budget.** They noted that there were already many related expenditures, for example in the form of climate-proofing the airport and schools, but it was viewed to be difficult to track the exact amount for all such expenditures. The authorities also noted that they would continue to participate in the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) pilot insurance program, which provides coverage against tropical cyclones until October 2018. But they would also seek other recourses—self-insurance, other donors (e.g. FEMA), or other insurance arrangements—that could cover “medium-size” risks such as droughts.

## FACILITATING PRIVATE SECTOR GROWTH

**22. SOE reforms will be the first step to facilitating private sector development, a necessity for sustainable growth as external funding declines.** The underperforming SOE sector has not only added to the fiscal burden but may also have limited business opportunities for the private sector. The authorities made progress by restructuring the Marshall Energy Company (MEC), and by legislating the State-Owned Enterprise Act in October 2015 (Box 3). The Act, supported mainly by the ADB, purports to strengthen the corporate governance and monitoring framework, and to turn SOEs at least as profitable and efficient as comparable businesses. Staff commends the authorities for the progress made and recommends additional steps: clarifying the justification of subsidies based on the community service obligations (CSOs) of SOEs, and introducing a centralized monitoring unit for SOE performance. By increasing the transparency of the communal and commercial operations of SOEs, these measures would help improve the efficiency of SOEs and reduce government subsidies. And limiting SOE subsidies to CSOs will strengthen the discipline on SOEs, level the playing field for commercially viable businesses and improve the environment for private sector growth. On these grounds, staff advocated upholding the efficiency-enhancing goal of the SOE Act. However, some counterparts expressed reservations about an amendment to the SOE Act in March 2016, which raised the limit on the number of public officials who can serve on SOE Boards from one to three, noting that it may intensify political interference.

**23. The environment for investments could be further improved by reducing other impediments to doing business.** Based on the World Bank’s ease of doing business survey,



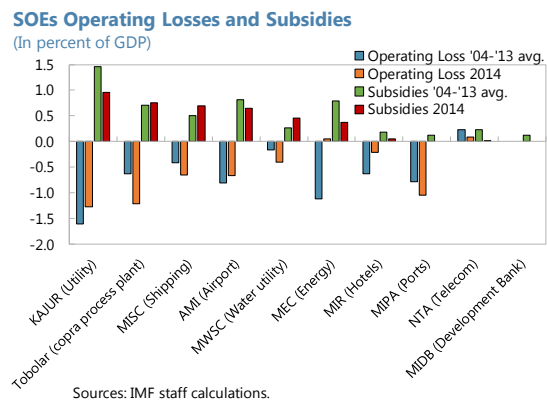
registering property and resolving insolvency were two major concerns.<sup>8</sup> Land registration reforms can help collateralize properties—thereby improving access to credit—and lower hurdles for long-term land leases by nonresidents—thereby facilitating foreign direct investment (FDI). Introducing an insolvency law will provide a missing legislative framework for bankruptcy. In that context, some private sector representatives expressed optimism on potential niche tourism and aquamarine projects, albeit pending the improvement in tourism-related infrastructure and ease of travel. Staff agreed that the RMI appeared to have potential comparative advantage in those areas.

**Box 3. Marshall Islands: SOE Reforms**

SOEs—currently 11 in the RMI—have been incurring losses and receiving government subsidies since FY2004, with significant macroeconomic consequences due to their size. SOEs have total assets of about US\$150 million (80 percent of GDP) and generate 7.5 percent of total employment.<sup>1</sup> They had in FY2014 a loss of US\$9.9 million and subsidies of US\$7.4 million (5.3 percent and 4 percent of GDP).

- **The Marshalls Energy Company (MEC) implemented a comprehensive reform covering governance and financial performance.**

Through continuous effort and ADB support since 2008, the MEC registered a net operating income of US\$0.1 million in FY2014. In 2011, MEC adopted a new tariff template that better aligned the costs and revenues of electricity business. The MEC retired its commercial debt with an ADB loan improving cash flow, improved the efficiency of electricity generation, and retrofitted all Majuro public streetlights to more efficient LED lights (reducing its nonrevenue generation ratio). The recent decline in oil prices was partly passed on to consumers through an electricity tariff cut in December 2014—even lowering CPI inflation—while the tariff rates are still below the cost-recovery level.



- **The State-Owned Enterprise Act was approved by the parliament in October 2015.** This Act strengthens the corporate governance and monitoring framework, which has been identified as a priority for better performance. Given the evidence that good corporate governance rests on a foundation of law and regulation in the long run, many countries are introducing legislation, ownership rules and guidelines, and monitoring structures to place SOEs on a firm commercial footing (ADB, 2011).

<sup>1</sup> Four large SOEs that account for 88 percent of total SOE assets are: Marshall Island Ports Authority, National Telecommunications Authority, Marshall Islands Development Bank (MIDB), and MEC.

<sup>8</sup> These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

## The Authorities' Views

**24. There was general agreement about the need to accelerate SOE reforms, in particular on delineating CSOs and reducing government subsidies.** The authorities noted that the clarification of CSOs is key for the legitimacy of continuing SOE subsidies, and was preparing for the creation of a monitoring unit within the MoF. This would need to be reinforced with PFM reforms, in particular in the areas of program audit and budgeting. The SOE Act amendment on the board composition was to retain the flexibility to tap expertise resident in the public sector. While acknowledging that there was limited voluntary participation in land registration, the authorities hoped that registration would get more active with the re-funding of the registry office in FY2017.

## ENHANCING FINANCIAL STABILITY

**25. Strengthening the regulatory framework will be critical to safeguard financial stability, including by strengthening the capacity and oversight authority of the Banking Commission.** Household debt is high, estimated at about 60 percent of total employee's compensation as of FY2015. The Banking Commission could consider a ceiling on the debt service ratio, and introduce stricter criteria on non-performing loan classification. Staff continues to urge the authorities to broaden the Banking Commission's oversight to the Marshall Island Development Bank (MIDB) and supports the MIDB's effort to refocus on its core mandate of providing commercial lending rather than consumer loans.

**26. Some progress is being made to respond to challenges related to withdrawal of correspondent banking relationships (CBRs)** (Box 4). The RMI's sole domestic commercial bank could lose its CBR with a U.S.-based bank as a result of heightened due diligence by banks in the United States. The consequent loss of access to the U.S. payment and settlement services, given the use of the U.S. dollar as legal tender, could disrupt cross-border payments and economic activity, as well as weaken financial inclusion for outer islands serviced by the domestic bank. In response, the authorities are drafting a new Anti-Money Laundering (AML) legislation in line with Financial Action Task Force (FATF) standards and United Nations Convention against Corruption (UNCAC) rules, have hired external consultants and met with U.S. officials, and also attended in early April a LEG/STI-organized workshop on implementing the international AML/CFT (Combating the Financing of Terrorism) standards. Staff encouraged the authorities to strengthen the implementation of AML/CFT requirements, particularly in relation to Know-Your-Customer requirements, and have an open and regular dialogue with U.S. regulators.

## The Authorities' Views

**27. The authorities agreed on the need to enhance the capacity of the Banking Commission to carry out inspections.** They agreed with the merit of a ceiling on the debt service ratio and stricter criteria on non-performing loan classification. The Banking Commission shared staff's view that the MIDB should be brought under its oversight but highlighted that this would require legislative action. The authorities also noted that they were making progress on measures against

money laundering, and preparing a legislation to have wider oversight power on AML/CFT related matters.

#### Box 4. Marshall Islands: Withdrawal of CBRs

*Marshall Island's sole commercial bank's CBR with a U.S.-based bank has recently become more difficult.*

**Background.** The RMI's only domestic commercial bank has had a CBR with a U.S.-based bank (First Hawaiian Bank, a subsidiary of BNP Paribas), and was recently notified that it may terminate the relationship, due to concerns about the cost of complying with new U.S. regulations, including on AML. As of May 2016, however, the planned termination of the relationship was put on hold.

**Drivers.** A recent IMF survey found that many Pacific islands are experiencing negative effects from the withdrawal of CBRs. Outside the Pacific, there is evidence that similar developments are also taking place in the Caribbean, Middle East, and North Africa. The terminations of CBRs are due to several factors, including the enforcement of stricter global regulatory standards, prudential regulations, sanctions, and tax and AML/CFT requirements. As a result, some business lines are being perceived as too costly in terms of compliance, and therefore being cut off by global banks.

**Offshore companies.** According to the latest AML/CFT assessment by the Asia Pacific Group (APG), the FATF-style regional body of which the RMI is a member, vulnerabilities derive mainly from RMI's offshore company registration sector. For registered non-resident entities, there is no mandatory requirement for legal persons to provide information either on the legal or beneficial ownership of shareholders.

**Remittances.** The cost of transferring remittances to Pacific islands has increased as global banks have closed bank accounts of small money transfer operators, forcing transfer of remittances only through banks. This could be an additional issue for the RMI, given its high reliance on remittances. So far, however, the cost of transferring remittances to the RMI has not been affected significantly, as almost all the remittances come through two large operators (MoneyGram and Western Union) that have existing partnerships with banks.

## STAFF APPRAISAL

**28. The economy faces the medium-term challenge of coping with the reduction in Compact grants from the United States after FY2023, climate change, and limited private sector growth.** The fiscal balance is likely to fall into deficit in the medium term without a sustained fiscal adjustment, undermining long-term self-sufficiency.

**29. Ensuring fiscal sustainability over the medium term calls for decisive fiscal adjustment and social security reform.** Staff encourages that the medium-term budget plans incorporate the fiscal adjustment plan (envisioned in DMP) in response to the scheduled decline in U.S. Compact grants until FY2023, complemented by reforms of the social security and tax systems. Welcoming the formation of a taskforce for social security reform, staff urges timely action to eliminate the risk of a potentially large drain on the government budget. Staff supports the renewed focus on PFM and looks forward to further progress.

**30. Continued vigilance is warranted for both structural and cyclical fiscal costs stemming from climate change.** Staff supports the authorities' intensified efforts to mitigate natural disaster risk and build resilience, including through the Joint National Action Plan (JNAP). Explicit budgeting of adaptation costs would also improve the efficiency on both spending and funding fronts.

**31. SOE reforms should continue, including to facilitate private sector growth.** Staff commends the authorities for restructuring the Marshall Energy Company and enacting the State-Owned Enterprise Act in October 2015. Building on the Act, staff recommends clarifying community service obligations of SOEs and introducing a centralized monitoring unit for SOE performance.

**32. To ensure financial stability, the regulatory and supervisory framework should be strengthened.** Strengthening the Banking Commission's regulatory capacity, including by broadening its oversight to development banks and other entities, continues to be a priority. To deal with potential challenges related to withdrawal of correspondent banking relationships, the authorities should continue to address regulatory gaps, including by bringing the AML legislation in line with international standards, and maintain a close dialogue with the U.S. regulators.

**33. The external position is broadly consistent with underlying fundamentals and risks of external instability remain limited.** The estimated current account gap is small and relatively stable external funding is available for current account deficits at least until FY2023. Thereafter, external stability can be enhanced by stronger buffers including an adequate CTF balance (enough to preserve its real value).

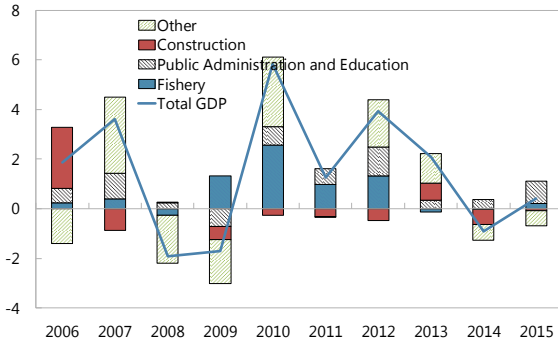
**34. The quality of official statistics is broadly adequate for surveillance, but should be improved.** Efforts to improve the coverage and timeliness of official data, in particular for external and financial sector statistics would help strengthen surveillance and policy formulation.

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

**Figure 1. Marshall Islands: Real Sector Developments**

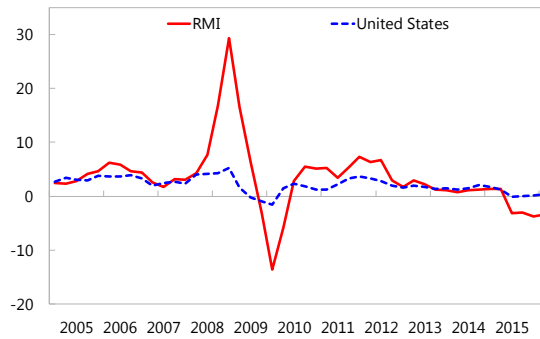
**Real GDP Growth Contribution**

(In percent)



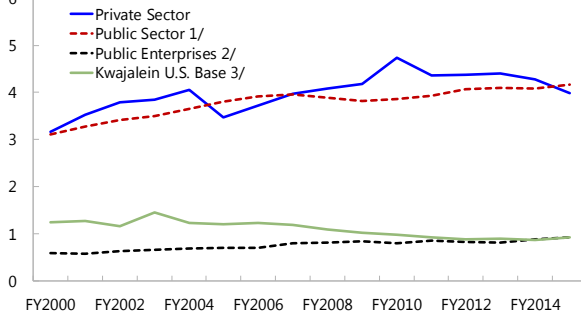
**CPI Inflation**

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



**Employment**

(Workers, thousand)

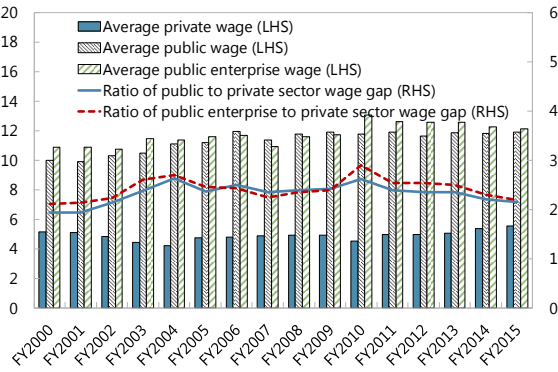


FY2000 FY2002 FY2004 FY2006 FY2008 FY2010 FY2012 FY2014

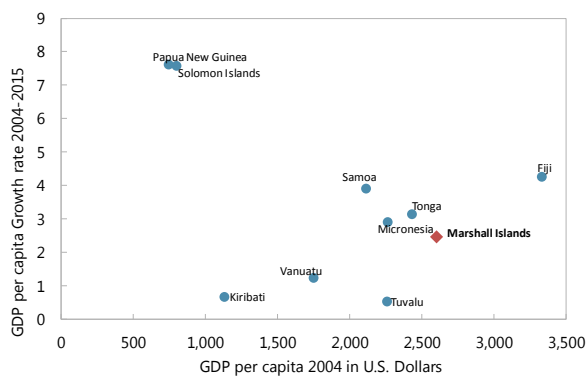
1/ Central and local government.  
2/ State-Owned Enterprises  
3/ U.S. military base hired workers

**Average Public and Private Sector Wages**

(LHS in thousands, USD)

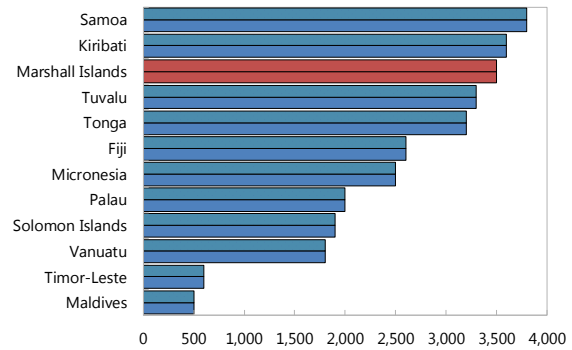


**Pacific Islands: Growth and GDP per capita**



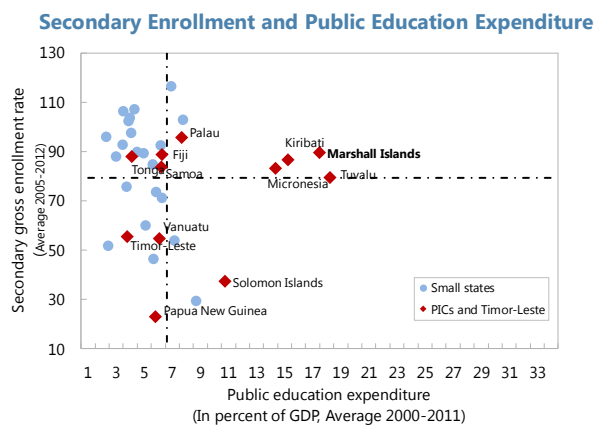
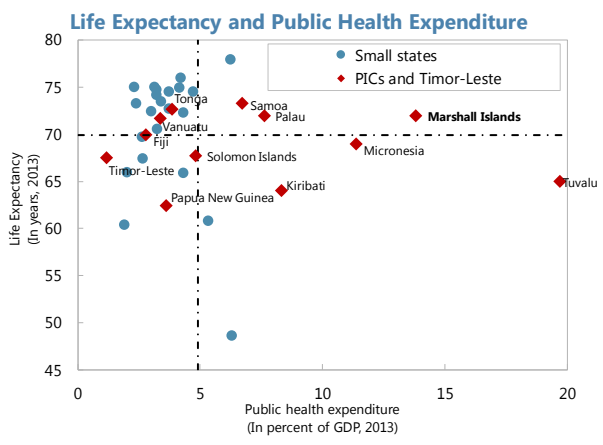
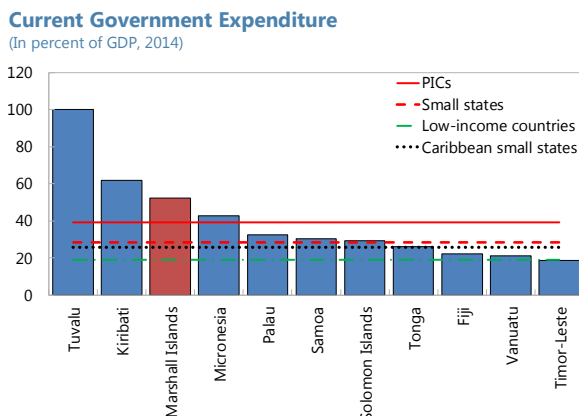
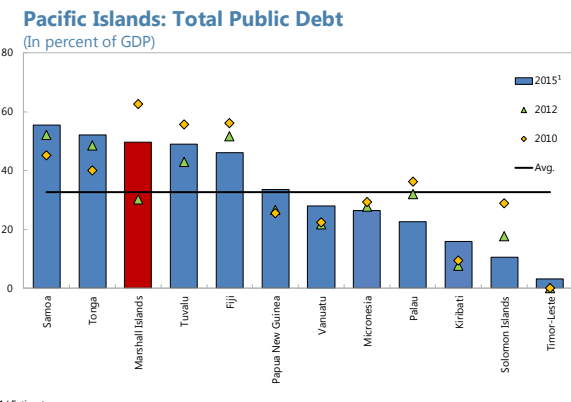
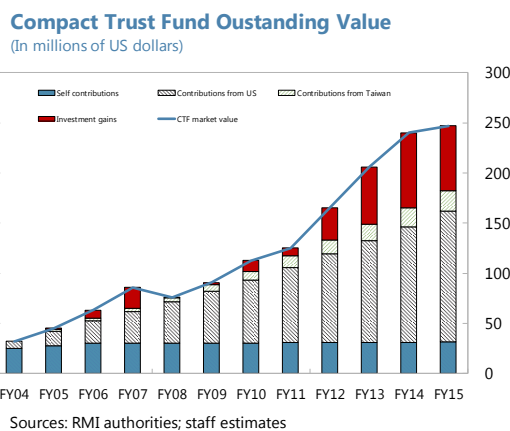
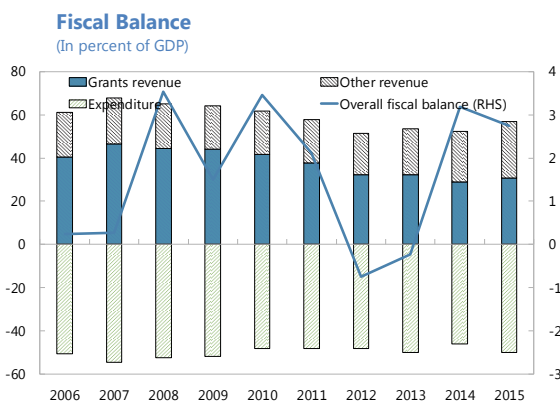
**Pacific Islands: Distance to the Closest Continent**

(In kilometers)



Sources: Country authorities; and IMF staff estimates.

Figure 2. Marshall Islands: Fiscal Developments

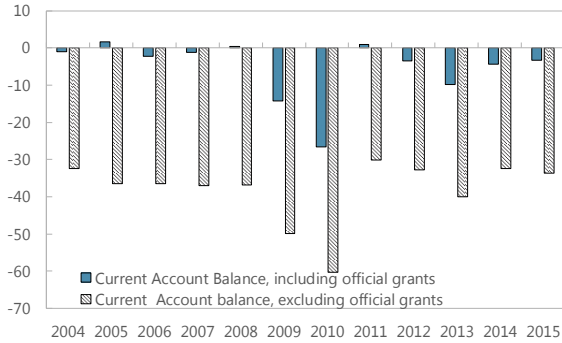


Sources: Country authorities; and IMF staff estimates.

**Figure 3. Marshall Islands: External and Credit Developments**

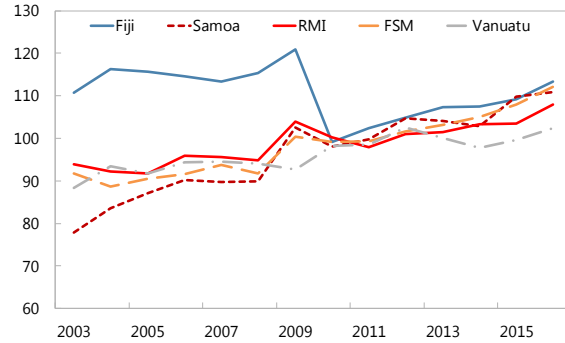
**Current Account Balance**

(In percent of GDP)



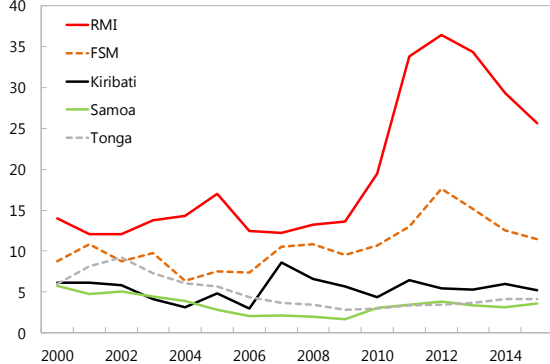
**Real Effective Exchange Rates**

(Index 2010=100)



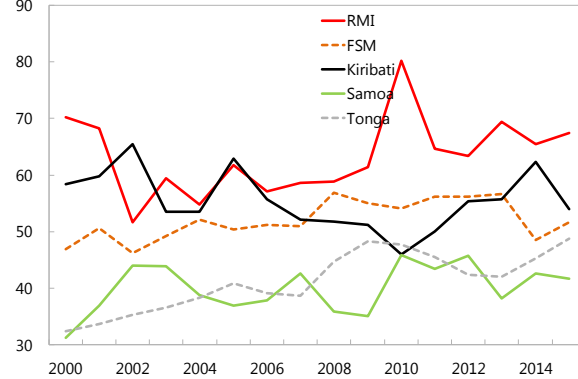
**Total Merchandise Exports**

(In percent of GDP)



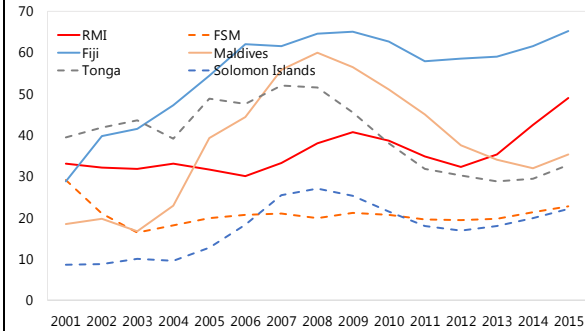
**Total Merchandise Imports**

(In percent of GDP)



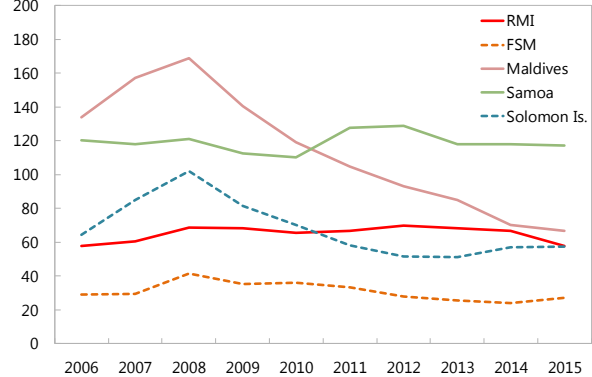
**Credit to Private Sector**

(In percent of GDP)



**Loan-to-Deposit Ratio**

(In percent)



Sources: Country authorities; and IMF staff estimates.

**Table 1. Marshall Islands: Basic Data, FY2012–21 1/**

Nominal GDP for FY2015 (in millions of U.S. dollars): 184.6

Population (2015 est.): 52,900

GDP per capita for FY2015 (in U.S. dollars): 3489.6

Quota: SDR 3.5 million

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Est.	Proj.					
<b>Real sector</b>										
Real GDP (percent change)	4.0	1.9	-1.1	0.4	1.4	1.7	1.8	1.6	1.6	1.3
Consumer prices (percent change)	4.3	1.9	1.1	-2.2	0.7	1.1	1.8	1.9	2.1	2.1
<b>Central government finances (in percent of GDP)</b>										
Revenue and grants	51.4	53.7	52.2	57.0	66.2	66.4	65.1	63.4	61.5	60.3
Total domestic revenue	19.3	21.4	23.4	26.4	29.0	26.7	26.5	25.9	25.2	25.0
Grants	32.1	32.2	28.8	30.6	37.2	39.8	38.6	37.4	36.3	35.3
Expenditure	52.2	53.9	49.0	54.2	63.9	64.7	64.4	63.4	62.4	61.6
Expense	48.2	50.1	46.1	50.2	54.9	52.5	51.9	51.3	50.8	50.4
Net acquisition of nonfinancial assets	4.0	3.8	2.9	4.0	9.0	12.2	12.5	12.1	11.6	11.2
Net lending/borrowing	-0.7	-0.2	3.2	2.7	2.3	1.7	0.7	-0.1	-0.9	-1.3
Compact Trust Fund (in millions of US\$; end of period)	165.6	206.2	240.1	247.1	279.4	311.7	346.2	383.0	422.2	464.0
<b>Commercial banks (in millions of US\$)</b>										
Foreign assets	62.1	65.6	64.7	90.2	...	...	...	...	...	...
Private sector claims	59.4	67.2	79.4	89.9	...	...	...	...	...	...
Total deposits	85.0	98.4	118.9	155.5	...	...	...	...	...	...
Consumer loans (in percent of total loans)	79.0	71.0	72.2	70.8	...	...	...	...	...	...
One-year time deposit rate (in percent)	1.6	1.3	1.6	1.4	...	...	...	...	...	...
Average consumer loan rate (in percent)	13.8	14.2	13.3	13.2	...	...	...	...	...	...
<b>Balance of payments (in millions of US\$)</b>										
Trade balance	-49.8	-66.8	-67.5	-77.2	-82.9	-87.4	-89.3	-91.2	-93.4	-95.6
Net services	-43.7	-47.7	-40.9	-45.4	-45.9	-48.3	-49.1	-50.4	-51.3	-52.3
Net income	29.3	36.1	45.3	58.5	54.2	55.1	58.1	59.6	60.6	61.6
Unrequited transfers (private and official)	57.8	59.6	54.9	58.1	60.2	62.5	61.4	62.3	62.2	62.0
Current account including official grants 2/ (In percent of GDP)	2.3	-2.9	1.4	-2.9	-1.3	-0.7	-0.5	-2.3	-4.6	-6.9
	1.2	-1.5	0.7	-1.6	-0.7	-0.4	-0.2	-1.1	-2.2	-3.2
External PPG debt (in millions of US\$; end of period) 3/ (In percent of GDP)	96.9	98.4	95.5	90.6	85.7	80.4	75.1	76.7	79.1	83.0
	52.6	51.8	51.1	49.1	45.6	41.7	37.8	37.5	37.5	38.3
External debt service (in millions of US\$) (In percent of exports of goods and services)	7.2	6.3	6.8	7.2	7.2	7.3	7.3	8.1	8.0	7.4
	8.6	7.6	9.1	10.9	10.8	10.7	10.3	11.0	10.4	9.3
<b>Exchange rate</b>										
Real Effective Exchange Rate (2010 =100)	100.5	102.0	102.7	106.3	...	...	...	...	...	...
<b>Memorandum Item:</b>										
Nominal GDP (in millions of US\$)	184.4	190.2	186.7	184.6	188.0	192.8	198.6	204.5	210.8	216.7

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

1/ Fiscal year ending September 30.

2/Includes capital grants.

3/ Public and publicly-guaranteed external debt.



**Table 2. Marshall Islands: Statement of Government Operations, FY2012–21 1/**

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
				Est.					Proj.	
(In millions of U.S. dollars)										
Revenue	94.8	102.1	97.5	105.1	124.5	128.1	129.3	129.6	129.7	130.7
Taxes	29.2	30.4	29.1	30.9	31.3	31.9	33.7	34.9	35.8	36.5
Taxes on income, profits, and capital gains	11.3	11.9	11.5	11.8	12.0	12.3	12.7	13.0	13.4	13.8
Taxes on goods and services	10.5	10.5	10.6	11.5	11.6	11.7	12.9	13.5	13.7	13.8
Taxes on international trade and transactions	6.9	7.5	6.9	7.4	7.6	7.8	8.0	8.2	8.5	8.7
Other taxes	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Grants 2/	59.2	61.3	53.9	56.5	70.0	76.6	76.6	76.5	76.5	76.4
Current	53.5	56.7	51.7	55.4	55.1	55.0	55.0	55.0	54.9	54.9
Capital	5.4	4.2	1.9	1.1	10.9	15.2	15.1	15.1	15.1	15.1
Other revenue	6.4	10.4	14.5	17.7	23.3	19.5	19.0	18.1	17.4	17.7
Property income	4.3	8.1	11.7	15.1	21.1	17.4	16.9	15.9	15.2	15.5
Sales of goods and services	1.4	1.4	1.6	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Expenditure	96.2	102.5	91.5	100.1	120.2	124.7	127.8	129.7	131.5	133.4
Expense	88.9	95.3	86.1	92.6	103.3	101.1	103.0	105.0	107.1	109.2
Compensation of employees	38.6	40.5	40.3	40.8	41.0	46.3	46.9	47.4	48.1	48.7
Wages and salaries	33.2	34.7	34.4	35.0	35.2	35.4	35.9	36.4	36.9	37.5
Use of goods and services	28.1	28.5	25.4	25.2	27.3	26.8	27.6	28.5	29.3	30.2
Interest	1.4	1.2	0.7	0.3	1.3	1.2	1.1	1.1	1.1	1.1
Subsidies	8.8	9.7	5.8	11.5	12.0	12.3	12.7	13.1	13.5	13.9
Grants	5.0	4.7	5.8	7.3	11.4	7.2	7.4	7.6	7.8	8.0
Other expense	7.0	10.8	8.2	7.5	10.3	7.3	7.3	7.3	7.3	7.3
Net acquisition of nonfinancial assets	7.3	7.2	5.4	7.4	16.9	23.6	24.8	24.7	24.4	24.2
Net Operating Balance 3/	5.9	6.7	11.4	12.5	21.2	26.9	26.3	24.6	22.6	21.5
<b>Net lending (+)/borrowing (-)</b>	<b>-1.4</b>	<b>-0.4</b>	<b>5.9</b>	<b>5.1</b>	<b>4.3</b>	<b>3.3</b>	<b>1.4</b>	<b>-0.1</b>	<b>-1.9</b>	<b>-2.7</b>
Net acquisition of financial assets	4.2	-6.4	-1.8	-1.2	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	-2.8	6.8	-4.2	-3.9	-4.3	-3.3	-1.4	0.1	1.9	2.7
(In percent of GDP)										
Revenue	51.4	53.7	52.2	57.0	66.2	66.4	65.1	63.4	61.5	60.3
Taxes	15.9	16.0	15.6	16.8	16.6	16.6	17.0	17.1	17.0	16.9
Grants	32.1	32.2	28.8	30.6	37.2	39.8	38.6	37.4	36.3	35.3
Other revenue	3.4	5.5	7.8	9.6	12.4	10.1	9.6	8.9	8.3	8.2
Expenditure	52.2	53.9	49.0	54.2	63.9	64.7	64.4	63.4	62.4	61.6
Expense	48.2	50.1	46.1	50.2	54.9	52.5	51.9	51.3	50.8	50.4
Net acquisition of nonfinancial assets	4.0	3.8	2.9	4.0	9.0	12.2	12.5	12.1	11.6	11.2
Net operating balance	3.2	3.5	6.1	6.8	11.3	14.0	13.2	12.0	10.7	9.9
<b>Net lending/borrowing</b>	<b>-0.7</b>	<b>-0.2</b>	<b>3.2</b>	<b>2.7</b>	<b>2.3</b>	<b>1.7</b>	<b>0.7</b>	<b>-0.1</b>	<b>-0.9</b>	<b>-1.3</b>
Memorandum item:										
Compact Trust Fund Balances (in million of US\$)	165.6	206.2	240.1	247.1	279.4	311.7	346.2	383.0	422.2	464.0
Outstanding government debt (in million of US\$)	67.9	68.7	65.0	62.2	58.6	55.3	53.8	53.9	55.9	58.8
Outstanding government debt (percent of GDP)	36.8	36.1	34.8	33.7	31.2	28.7	27.1	26.4	26.5	27.1
Nominal GDP	184.4	190.2	186.7	184.6	188.0	192.8	198.6	204.5	210.8	216.7

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

1/ Fiscal year ending September 30.

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

3/ Net operating Balance is the difference between revenue and expense

**Table 3. Marshall Islands: Balance of Payments, FY2012–21 1/**  
(In millions of U.S. dollars)

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
				Est.				Proj.		
<b>Current account balance</b>	<b>-6.3</b>	<b>-18.8</b>	<b>-8.2</b>	<b>-5.9</b>	<b>-14.4</b>	<b>-18.1</b>	<b>-18.8</b>	<b>-19.7</b>	<b>-22.0</b>	<b>-24.3</b>
Goods Balance	-49.8	-66.8	-67.5	-77.2	-82.9	-87.4	-89.3	-91.2	-93.4	-95.6
Exports, f.o.b.	67.2	65.3	54.8	47.3	46.8	48.5	50.8	53.1	55.3	57.3
Imports, f.o.b.	-116.9	-132.1	-122.2	-124.5	-129.6	-136.0	-140.1	-144.2	-148.7	-152.9
Services Balance	-43.7	-47.7	-40.9	-45.4	-45.9	-48.3	-49.1	-50.4	-51.3	-52.3
Exports of Services	16.3	17.7	19.2	18.6	19.3	19.8	20.4	21.1	21.7	22.4
Imports of Services	-60.0	-65.3	-60.1	-64.1	-65.2	-68.1	-69.5	-71.4	-73.1	-74.7
Primary Income Balance	29.3	36.1	45.3	58.5	54.2	55.1	58.1	59.6	60.6	61.6
Inflows	58.7	65.1	69.6	84.1	81.2	82.4	84.8	86.8	88.3	89.7
Of which Labor income	18.5	19.2	19.1	20.1	20.3	20.5	20.8	21.2	21.5	21.8
Outflows	-29.5	-29.1	-24.3	-25.6	-27.0	-27.3	-26.7	-27.2	-27.7	-28.1
Secondary Income Balance	57.8	59.6	54.9	58.1	60.2	62.5	61.4	62.3	62.2	62.0
Inflows	66.0	68.5	64.3	68.1	69.0	71.6	70.7	71.8	72.0	72.1
Of which Government grants	54.1	57.3	52.3	56.0	56.8	59.3	58.2	59.2	59.1	59.1
Compact current grants	31.7	29.5	29.1	35.5	33.0	33.0	32.9	32.9	32.8	32.8
Other budget and off-budget grants	22.5	27.9	23.2	20.5	23.8	26.3	25.3	26.3	26.3	26.3
Outflows	-8.2	-9.0	-9.4	-10.0	-8.8	-9.0	-9.3	-9.5	-9.8	-10.1
Of which Household remittances	-6.7	-7.4	-7.7	-8.3	-8.4	-8.7	-8.9	-9.2	-9.5	-9.7
Current account in percent of GDP	-3.4	-9.9	-4.4	-3.2	-7.6	-9.4	-9.5	-9.6	-10.4	-11.2
Current account including official grants 2/ (In percent of GDP)	2.3	-2.9	1.4	-2.9	-1.3	-0.7	-0.5	-2.3	-4.6	-6.9
Current account excluding current official grants (In percent of GDP)	-60.4	-76.2	-60.5	-62.0	-71.2	-77.3	-77.0	-78.8	-81.1	-83.4
Capital and financial account 3/	22.6	26.8	23.9	11.2	14.4	18.1	18.8	19.7	22.0	24.3
Of which Official capital grants	5.4	4.2	1.9	1.1	10.9	15.2	15.1	15.1	15.1	15.1
Of which: Foreign direct investment	4.7	4.6	3.7	2.8	2.8	2.8	2.8	2.8	2.8	2.8

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

1/ Fiscal year ending September 30.

2/ Includes capital grants.

3/ Errors and omissions averaged \$20 million during FY2004-2014.

**Table 4. Marshall Islands: External and Financial Sector Vulnerability Indicators, FY2012–21**

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
				Est.			Proj.			
<b>Financial indicators</b>										
Commercial bank deposits (12-month percent change) 1/	-13.4	15.8	20.8	30.8	...	...	...	...	...	...
Private sector credit (12-month percent change)	-1.3	13.1	18.2	13.2	...	...	...	...	...	...
Foreign assets/total assets (percent)	52.2	49.4	41.2	46.9	...	...	...	...	...	...
Consumer loans (in percent of total private sector loans)	79.0	71.0	72.2	70.8	...	...	...	...	...	...
<b>External indicators</b>										
Exports (percent change)	14.8	-2.7	-16.1	-13.6	-1.2	3.8	4.7	4.4	4.1	3.6
Imports (percent change)	4.5	13.0	-7.5	1.9	4.1	4.9	3.0	3.0	3.1	2.8
Current account balance (percent of GDP)										
Including official grants 2/	1.2	-1.5	0.7	-1.6	-0.7	-0.4	-0.2	-1.1	-2.2	-3.2
Capital and financial account balance (percent of GDP)	12.2	14.1	12.8	6.1	7.6	9.4	9.5	9.6	10.4	11.2
<i>Of which</i> : FDI (percent of GDP)	2.5	2.4	2.0	1.5	1.5	1.4	1.4	1.4	1.3	1.3
Gross official reserves (in millions of U.S. dollars) 3/	4.7	2.9	6.6	8.0	...	...	...	...	...	...
Gross official reserves (in months of imports of goods and services)	0.3	0.2	0.4	0.5	...	...	...	...	...	...
External PPG debt (percent of GDP) 4/	52.6	51.8	51.1	49.1	45.6	41.7	37.8	37.5	37.5	38.3
External PPG debt (in percent of exports of goods and services) 4/	116.1	118.6	129.0	137.4	129.6	117.6	105.4	103.5	102.7	104.2

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

1/ The deposit decline in FY2012 is due to expatriation of rent income received by Kwajalein landowners in previous years.

2/ Includes capital grants

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

4/ Public and publicly-guaranteed external debt.

**Table 5. Marshall Islands: Deposit Money Banks, FY2012–15**

	FY2012	FY2013	FY2014	FY2015 Est
( In millions of U.S. dollars)				
<b>Assets and Liabilities</b>				
Assets 1/	118.9	132.8	156.9	192.2
Foreign assets	62.1	65.6	64.7	90.2
Claims on central and local governments	3.4	6.5	0.3	0.0
Claims on private sector	59.4	67.2	79.4	89.9
Unclassified assets	-6.0	-6.0	3.8	6.0
Liabilities 1/	118.9	132.8	156.9	192.2
Deposits	85.0	98.4	118.9	155.5
Central government deposits 2/	4.7	2.9	6.6	8.0
Foreign liabilities	3.2	3.7	4.4	5.1
Capital accounts	29.7	29.7	32.7	30.4
Unclassified liabilities	1.0	1.0	0.8	1.2
<i>Memorandum items:</i>				
Loan/deposit ratio (in percent)	69.9	68.3	66.8	57.8
Deposits (percent change)	-13.4	15.8	20.8	30.8
Loans (percent change)	-1.3	13.1	18.2	13.2
Consumer loans (in percent of total loans)	79.0	71.0	72.2	70.8
<b>Income and expense</b>				
Interest Income	8.1	8.9	9.1	9.8
Interest and fees on loans	8.0	8.8	9.0	9.7
Deposits with banks	0.1	0.1	0.1	0.2
Interest Expense	1.1	1.1	1.1	1.2
Deposits	1.1	1.1	1.1	1.2
Net interest income	7.0	7.9	8.0	8.6
Provision for loan losses	0.0	0.0	0.1	0.1
Net interest income after loan loss provisions	7.0	7.8	8.0	8.5
Noninterest Income:	1.7	1.8	2.5	3.3
Noninterest Expense	5.4	5.9	5.3	6.0
Net Income (Loss)	3.3	3.8	5.1	5.8
<b>Interest rates (percent) 3/</b>				
Deposit rates				
Savings accounts 4/	0.6	0.6	0.4	0.2
Time deposits 5/				
Three months	0.9	0.9	1.0	0.9
Six months	1.1	1.0	1.0	1.0
One year or more	1.6	1.3	1.6	1.4
Loan rates 6/				
Consumer loans	13.8	14.2	13.3	13.2
Commercial loans	7.3	7.6	5.5	4.9
<i>Memorandum item:</i>				
Return on assets	2.8	2.9	3.3	3.0

Sources: RMI authorities; and IMF staff estimates.

1/ Fiscal-year basis - 5 quarter average.

2/ Includes deposits of Social Security administration and other trust funds.

3/ Year average

4/ Average of rates offered by deposit money banks.

5/ Average of minimum rates offered by deposit money banks.

6/ Average of maximum rates charged by deposit money banks.

## Appendix I. The Compact Trust Fund and Its Long-term Outlook

*The Compact Trust Fund is expected to build sufficient resources to compensate for expiring Compact grants in FY2023. But, to preserve the value of the fund in real terms, fiscal surpluses are needed.*

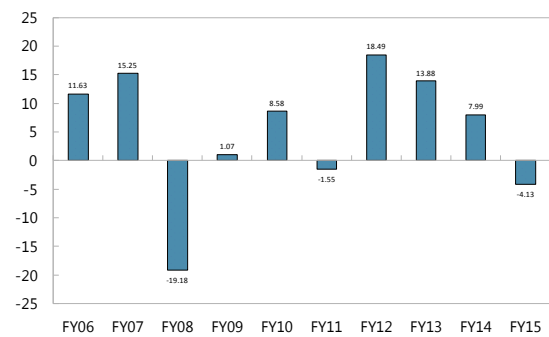
**The Compact Trust Fund (CTF) was created in 2004 to contribute to the long-term budgetary self-reliance of the RMI.** The fund aims to provide the RMI with an ongoing source of revenue after the Compact Agreement with the U.S. terminates in FY2023. In particular, US\$27 million (12 percent of GDP) of Compact-related grants are expected to be terminated in FY2024.

**Structure of the fund.** The contributions to the CTF are not available for withdrawal prior to FY2024. From FY2024 onwards, annual investment earnings from the CTF can be withdrawn to finance budget needs up to a limit.<sup>1</sup> In years when investment earnings are not sufficiently high, the C account of the fund can be used to make up for the shortfall.<sup>2</sup> A separate account (Account D) to which the RMI and Taiwan Province of China (POC) have contributed can also be used as a buffer, as long as its assets exceed US\$10 million.

**Contributions to the fund.** The value of the CTF (excluding the D account) was US\$247 million as of end-FY2015. Of this amount, US\$181 million came from contributions, particularly from the RMI (US\$31 million), Taiwan POC (US\$21 million), and the United States (US\$129 million). Moreover, the D account of the CTF has received contributions from the RMI and Taiwan POC, and held US\$12 million as of end-FY2015.

**Fund performance.** The current investment strategy of the CTF (in place since October 2012) stipulates that 60 percent of the fund is invested in equities, while the rest is split between fixed income (20 percent) and alternative investments (20 percent). As of end-FY2014, the fund’s average annual nominal return rate since inception was 6.0 percent, net of fees. As of end-FY2015 (at a relatively low point in financial markets due to the summer market turmoil in 2015), the average return declined to 4.9 percent, although it has bounced back toward its previous historical average since then.

Marshall Islands CTF: Weighted Annual Investment Return (Percent)



Sources: Fiscal Year 2015 Annual Report.

**Governance of the fund.** The CTF is administered by an independent committee that exercises oversight and fiduciary responsibility over the fund (except for the D account). Four voting members on the committee are appointed by the United States (from Departments of Education, Interior, and

<sup>1</sup> Annual distributions from the CTF, starting in FY2024, can only come from investment earnings from the previous year up to a maximum limit equivalent to expired grant assistance amount as of FY2023, fully adjusted for inflation.

<sup>2</sup> Investment earnings above 6 percent are transferred to the C account of the fund. The C account is capped at three times the projected grant assistance in FY2023. As of end-FY2015, it held US\$48 million (nearly two times the projected amount).

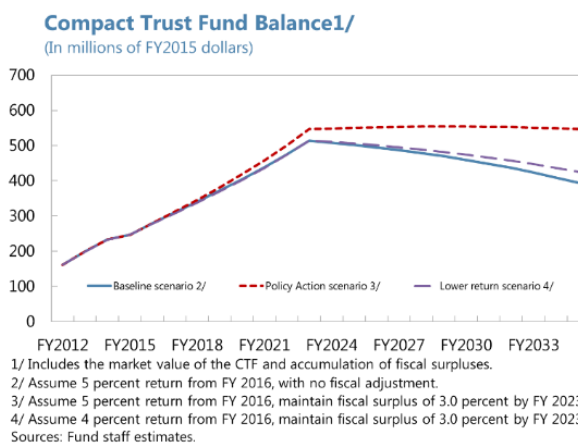
State), two by the RMI, and one by Taiwan POC. A custodian bank (State Street Bank) and a professional investment advisor (Mercer Investment Management) help manage the fund.

**Review.** An independent external evaluation of the fund was conducted in FY2015. The review found the fund to be generally well governed and its service provider performance in line with industry standards. It recommended working with the investment adviser to apply a “glide path” toward a more conservative investment strategy to protect capital, as the build-up period nears its end. This may reduce the volatility and absolute level of returns over time.

### Scenarios

**Two scenarios are considered to assess the long-term outlook and the implications for RMI’s fiscal sustainability.** Under the baseline scenario, the projected value of the CTF is likely to generate sufficient income to supplement the expiry of Compact grants in FY2023, but not preserve the *real* value of the CTF. In the policy action scenario, the real value of the CTF is preserved.

**Baseline scenario.** If the fund averages a 5 percent nominal return annually from FY2016 onwards, the distribution from the estimated assets for FY2024 would probably provide revenue equivalent to about 132 percent of the Amended Compact’s Section 211(a) FY2023 sector grant level. Under this scenario, however, long-term self-sufficiency would not be secured because the real value of the CTF will likely decline over time. Therefore, in the baseline scenario, the government would either need to erode the real value of the CTF or face a large budgetary shortfall (about 3 percent of GDP). Moreover, it should be noted that even achieving this simple level of sufficiency does not eliminate the risk of subsequent fiscal shocks if the CTF investment returns are weak for a number of years.



**Policy action scenario.** Under this scenario, the government is assumed to undertake a fiscal adjustment of 5 percent of GDP over the medium-term (from FY2017 to FY2023) to build a budget surplus of 3 percent of GDP by FY2023 and transfer the surpluses to the CTF. Under this course of action, the real value of the CTF would be preserved.

**Sensitivity to investment returns.** However, this outcome is sensitive to the assumption on CTF annual investment returns, which have been volatile in the past. By staff estimates, a 0.5 percentage point decrease in expected returns would increase the fiscal adjustment need to by 1 percentage point of GDP from the suggested policy action scenario.

## Appendix II. Main Recommendations of the 2013 Article IV Consultation







Fund Recommendations	Policy Actions
<b>Fiscal Policy:</b>	
A fiscal adjustment of no less than 4.5 percent of GDP by FY2018, including by :	Fiscal balance worsened in FY2012 and FY2013, recording the first deficits since FY2005. In FY2014, and FY2015, the fiscal position returned to surplus. A fiscal adjustment plan (DMP) was prepared in 2014.
- Reduction of public payroll	Nominal growth of public wage in FY2013-14 was better contained than in the past. However, FY2015 public wage bill increased, reflecting higher employee qualifications in health and education.
- Reduction of subsidies to SOEs	After falling in FY2014, SOE subsidies increased in FY2015 including due to capital expenditures. The SOE Act was legislated in FY2015.
- Legislative approval of revenue reforms	Bills to comprehensively reform the tax system are under review, but need to be resubmitted in the new parliament
- Better public financial management	The Cabinet approved medium-term PFM Reform Roadmap (PFTAC TA). A progress report was prepared in October 2015. Currently focused on human resources management.
Continuing budget transfers to the CTF	Transfers were made in FY2015 (U.S. 0.65 million) and FY2016 (U.S. 2.2 million), first time since FY2012.
Reforming the social security system	Reform bills are under review, but need to be resubmitted in the new parliament. A task force on social security reform was established.
<b>Growth Policy:</b>	
Comprehensive reforms of SOEs	SOE Act (in line with ADB advice) was legislated.
<b>Financial Sector Policy:</b>	
Strengthening the regulatory framework	Banking Act is under revision to bring more of the financial system under Banking Commissions' supervision.
Refocusing the MIDB towards commercial and mortgage lending	MIDB has adopted the 2016-2020 Strategic Plan to shift towards commercial and mortgage lending.
<b>Other issues:</b>	
Improving the coverage and timeliness of economic statistics	No action. Shortage of trained staff.

## Appendix III. MDG and Strategic Surveillance Matrix

Millennium Development Goal Achievements				
<b>Goals /Targets</b>			<b>Assessment</b>	
Goal 1: Eradicate extreme poverty and hunger			Not achieved <sup>1/</sup>	
Goal 2: Achieve universal primary education			Mixed	
Goal 3: Promote gender equality and empower women			Mixed	
Goal 4: Reduce child mortality			Achieved	
Goal 5: Improve maternal health			Achieved	
Goal 6: Combat HIV/AIDS, malaria and other diseases			Mixed	
Goal 7: Ensure environmental sustainability			Mixed	
Goal 8: Develop a global partnership for development			Not Assessed	
Sources: 2015 Pacific Regional MDGs Tracking Report, Pacific Islands Forum Secretariat				
1/ This assessment was due to lack of data to measure the progress.				
Multi-year Surveillance Matrix including SDG 1/				
Issues to Cover	Macro-criticality	Traction with authorities	Article IV Agenda	Background work
1. Traditional macroeconomic Issues (Real, Fiscal, BOP, MON)	<b>H</b>	<b>H</b>	X	
<b>Issues for Further Integration</b>				
2. Macro-financial Issues 2/ 2-1. Capital Inflows and Spillovers 2-2. Financial Development, Deepening and Inclusion 2-3. Financial Cycle and Macro-implications 2-4. Balance Sheet Analysis 2-5. Macroprudential Policy 2-6. Financial Supervision and Regulation 2-7. Macroeconomic Shocks and Financial Stress	L M L N/A N/A H N/A	L M L L L H L	X	Withdrawal of correspondent banking relationships
3. SDGs/FfD Commitments 3-1. Domestic Revenue mobilization 3-2. Infrastructure Investment 3-3. Building Policy space/economic resilience 3-4. Environmental sustainability, equity/inclusion 3-5. Fragile and Conflict-Affected States need 3-6. Domestic financial market promotion 3-7. Data enhancement	H M H M N/A H H	H M M M N/A M H	X X X X X	Fiscal Adjustment SOE/Compact Trust Fund Private sector development Statistics TA follow-up
4. Fund's New "Core" Issues 4-1. Gender 4-2. Income Inequality 4-3. Climate Change	L M H	L M H	X	Climate Change
1/ Based on staff assessment of macro-criticality and priority for the RMI. H, M, L stand for High, Medium and Low.				
2/ Based on MCM Assessment of Pilot Countries' Reports				



### Appendix IV. Risk Assessment Matrix <sup>1/</sup>

Risk		Relative Likelihood	Impact if Realized	Potential Impact	Staff Advice on Policy Response
External risks	Natural disasters and climate change 	H	H	Growth slowdown due to impairment of infrastructure (flooding), weaker agricultural production (droughts or flood), impaired fishing activity	<b>To minimize exposure:</b> Ensure fiscal buffers, Purchase additional natural disaster insurance.  <b>If risk materializes:</b> Changes in the composition of public expenditure or additional revenues would be needed to finance the reconstruction (may require additional foreign aid).
	Faster-than-anticipated rise in fuel prices to \$70 	L	M	Deterioration in current account, moderate negative impact on growth	<b>To minimize exposure:</b> Prepare for a potential rebound of fuel prices in SOE energy sector by reducing subsidies to the SOEs, and ensure they build buffers in the good time.
	Persistently low rates of return on financial assets in the CTF below 5 percent in nominal terms 	L-M	M	A 0.5 percent decline in the expected return on the CTF assets would require 1 percentage points of GDP in additional fiscal consolidation	<b>If risk materializes:</b> Additional fiscal savings should be saved to ensure long-term sufficiency of the CTF in real terms beyond FY2023.
	Reduced financial services by global/regional banks (i.e. withdrawal of correspondent banking relationships) 	M	M	Shock to remittances flows, loss of correspondent banking services disrupting financial sector	<b>To minimize exposure:</b> Ensure transparency, improve banking regulation and supervision, liaise closely with the U.S. regulators.
Domestic risks	Faster progress on fiscal reforms 	M	H	Fiscal position deteriorates less than expected due to implementation of measures under the DMP.	<b>If risk materializes:</b> Additional fiscal savings should be saved to ensure long-term sufficiency of the CTF in real terms beyond FY2023.
	Delays in implementation of infrastructure projects 	L-M	M-H	Short-term growth would be adversely affected.	<b>To minimize exposure:</b> More oversight on project selection and implementation would be required.  <b>If risk materializes:</b> Technical assistance in these areas could be requested from relevant international organizations.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff’s subjective assessment of the risks surrounding the baseline (“low” is meant to indicate a probability below 10 percent, “medium” a probability between 10 and 30 percent, and “high” a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The blue arrows indicate whether the risk is to the upside or downside.



# REPUBLIC OF THE MARSHALL ISLANDS

## STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 7, 2016

Prepared By

Asia and Pacific Department  
(In consultation with other departments)

### CONTENTS

FUND RELATIONS _____	2
RELATIONS WITH THE WORLD BANK GROUP _____	3
RELATIONS WITH THE ASIAN DEVELOPMENT BANK _____	4
RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE ____	6
STATISTICAL ISSUES _____	9

## FUND RELATIONS

(As of May 31, 2016)

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

**General Resources Account:**

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

**SDR Department:**

	SDR Million	Percent Allocation
Net cumulative allocation	3.33	100.00
Holdings	3.36	101.07

**Outstanding Purchases and Loans:** None

**Latest Financial Arrangements:** None

**Projected Payments to Fund<sup>1</sup>**

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

	Forthcoming				
	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>
Principal					
Charges/Interest		0.00	0.00	0.00	0.00
<b>Total</b>		0.00	0.00	0.00	0.00

**Exchange Rate Arrangements.**

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

**Article IV Consultation:**

**The Marshall Islands is on a 24-month consultation cycle.** The 2013 Article IV Consultation discussions were held during October 24–November 1, 2013. The Executive Board discussed the staff report and concluded the consultation on January 8, 2014.

**Technical Assistance:** Technical assistance on revenue administration, social security reform, public financial management, bank supervision, and statistics has been provided mainly through PFTAC.

**Resident Representative:** Mr. Tubagus Feridhanusetyawan has been the Resident Representative for Pacific Island Countries since September, 2014. He is based in Suva, Fiji.

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

## RELATIONS WITH THE WORLD BANK GROUP

**The Bank and the Fund teams maintain a close working relationship and have an ongoing dialogue on macroeconomic and structural issues.** The teams agreed that the RMI's main macroeconomic challenge is to secure fiscal sustainability by maintaining adequate fiscal balance and building buffers against existing fiscal vulnerabilities. Based on this shared assessment, the teams identified these reform areas as critical in view of their central role in achieving fiscal sustainability and fostering equitable growth: (i) public sector enterprise reform to reduce the drain on public finances and provide reliable services supporting private sector development; (ii) recognizing climate change adaptation and response costs on both spending and funding fronts; and (iii) enhancing financial sector stability, including addressing challenges from potential de-risking activities of international banks.

**The teams agreed on close cooperation going forward and the table below lists the teams' separate and joint work programs during 2016 and 2017.** Since gaining IDA eligibility, RMI has received grants in support of ICT sector reforms in the form of: (i) a US\$3 million ICT-focused Development Policy Operation, disbursed in June 2013; and (ii) a US\$1.25 million grant from the Pacific Regional Infrastructure Facility. In addition, the RMI has received grants in support of the fisheries sector in the form of a US\$6.75 million grant and US\$1.83 Global Environment Facility Grant under the Pacific Regional Oceanscape Program (PROP). Finally, the RMI participates in the Pacific Resilience Project (PREP), the Pacific Catastrophe Risk and Financing Insurance (PCRAFI) grant component of which totaled US\$1.5 million.

<b>Title</b>	<b>Products</b>	<b>Provisional Timing of Missions</b>	<b>Status</b>
1. Bank Work Program	ICT Technical Assistance Grant PROP PREP (PCRAFI) Coastal Protection Renewable Energy	Q3 2016 Q4 2016 Q4 2016 Q1 2017, Q2 2017 Q4 2016, Q12017	Implementing Implementing Implementing Preparation Preparation
2. Fund Work Program	Article IV consultation mission to review macroeconomic developments and update long-term debt sustainability assessment	Biennial	Ongoing
3. Joint Work Program	Mutual update on work program developments and information sharing	Semi-annual	Ongoing

## RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank (AsDB) has been working with the Government of the RMI since 1990 and has approved 14 loans for \$92.63 million, 50 technical assistance projects for \$21.48 million, and 5 grants for \$11.06 million. Cumulative disbursements for lending and grants financed by Ordinary Capital Resources (OCR), the Asian Development Fund (ADF), and other special funds amount to \$79.3 million.

In recent years, AsDB has helped the RMI in a variety of development areas. In 2012, AsDB approved the second subprogram under the Public Sector Program, broadening and deepening the work of the first subprogram. Subprogram 2 helped the RMI to adopt and implement reform plans to improve the performance of selected state-owned enterprises (SOEs), complete a public sector workforce audit and planning exercise, and achieve various expenditure targets. In the same year, three technical assistance projects were approved. These included support for implementing the government's new national development plan, implementation of the RMI's early grade learning assessments at selected primary schools, and preparations for the Ebeye Water and Sanitation Project. A technical assistance grant was also approved in 2012, under the Water Financing Partnership Facility, to enhance water sector operations in Majuro, the RMI's most populous atoll.

In 2013, AsDB approved two grants totaling \$300,000, under its Asia Pacific Disaster Response Fund, to help the RMI counter the impacts of a drought that had affected the country earlier in the year.

In 2015, AsDB approved the Ebeye Water and Sanitation Project, which aims to reduce the incidence of waterborne diseases by improving access to safe water and sanitation on the island. AsDB, with financing from the Government of Australia, is helping to implement three community projects under the "quickwins" banner. The projects will upgrade the Ebeye drainage system to mitigate flooding; construct new saltwater wells to increase the yield of saltwater to the island's desalination plant; and establish a community radio station to help disburse information on, and increase awareness of, safe water use.

Through regional technical assistance projects, AsDB has helped the RMI improve governance within SOEs and develop SOE policy and legislation, which was passed by the country's parliament in September 2015. AsDB has helped the government develop a financial management model and, through the AsDB national development coordination officer, provided technical support on accounting to the Ministry of Finance.

The Country Operations Business Plan (COBP) 2016–18 for the RMI has four areas of strategic focus to support the country's medium-term development: better and more sustainable infrastructure, improved quality of basic education, better public sector management, and the implementation of structural reform. These strategic pillars align with the core priorities identified in the government's NSDP, while also reflecting AsDB's Interim Pacific Approach, 2015 and the Midterm Review of Strategy 2020, AsDB's corporate strategy.

The government has sought AsDB assistance for development issues on the country's outer islands, and to further improve the quality of basic education. AsDB will support integrated strategic planning for investments in renewable energy and the institutional strengthening of the Ministry of Finance. Future AsDB operations will also be complemented by regional technical assistance programs, particularly in the areas of economic management, private sector development, and public sector management.

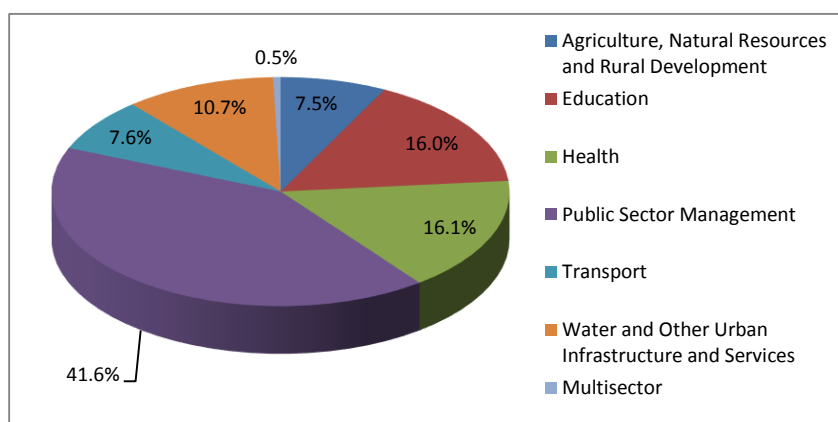
**Table 1. Asian Development Bank: Loan, Grant, and Technical Assistance Approvals  
(In millions of U.S. dollars)**

	2012	2013	2014	2015	1990–2015
Loans	5.00	0.00	0.00	0.00	92.63
Sovereign	5.00	0.00	0.00	0.00	92.63
Nonsovereign	0.00	0.00	0.00	0.00	0.00
Grants	0.00	0.30	0.00	9.00	11.06
ADF	0.00	0.00	0.00	5.00	5.00
JFPR	0.00	0.00	0.00	0.00	1.76
Others	0.00	0.30	0.00	4.00	4.30
Technical assistance	1.23	0.00	0.37	0.00	21.48
TASF	0.23	0.00	0.00	0.00	12.09
JFPR/JSF	0.00	0.00	0.00	0.00	6.11
Others	1.00	0.00	0.37	0.00	3.28
<b>Total</b>	<b>6.23</b>	<b>0.30</b>	<b>0.37</b>	<b>9.00</b>	<b>125.16</b>

Sources: Loans, TA, Grant and Equity approvals database.

Notes: Amounts are net of cancellations. Sovereign loans include only those funded by OCR and ADF. Grants-Others include other Special Funds and grant cofinancing. Technical assistance-Others include those funded from sources other than TASF, JSF and JFPR.

**Figure 1. Asian Development Bank: Cumulative Lending and Grants by Sector, at end-2015**



Sources: Listing of Loans, TA, Grant and Equity Approvals (OSFMD website).

Notes: Includes sovereign, non-sovereign loans, ADF grants and grants from Other Special Funds.

## RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE

The Pacific Financial Technical Assistance Centre's (PFTAC)<sup>1</sup> assistance to the RMI during the past years has focused on public financial management, revenue administration, financial supervision, and macroeconomic analysis and forecasting through missions, regional seminars and workshops.

### Public Financial Management

Following PFTAC's joint work with authorities in 2011 on a Public Expenditure and Financial Accountability assessment, assistance was provided in 2013 to develop a draft Public Financial Management (PFM) reform Roadmap which was approved by the Cabinet in 2015. Future TA in RMI is expected to focus on supporting the authorities to finalize the roadmap, including moving towards medium-term budgeting, modernization of legislation and financial instructions and strengthened cash management, accounting and financial reporting. In 2013 PFTAC provided assistance in analyzing the funding situation for the Social Security fund and developing options to improve its sustainability. A Pension Workshop was held in April 2016 in coordination with MISSA, PFTAC, and IMF's Expenditure Policy Division; and TA was provided to the Ministry of Finance in May 2016 on improving medium-term expenditure and revenue forecasting in cooperation with PFTAC's Macro-Economics Advisor.

### Revenue Administration

In 2008, the Minister of Finance set up the Tax and Revenue Reform and Modernization Commission (TRRM) to make recommendations to reform the revenue collection system and to strengthen the capabilities and effectiveness of the Division of Customs, Treasury, Revenue and Taxation (DCTRT). The TRRM reported back in 2010 and recommended a comprehensive revenue reform to introduce an income tax and domestic sales tax. Subsequent PFTAC advice highlighted revenue leakage in the sales tax proposal and the recommendation was changed to introduce a VAT. Since then PFTAC provided assistance to develop a high level implementation plan for the revenue reforms (2010); helped draft legislation for the income tax, VAT and excise taxes and revenue administration activities (2010–11); and has continued to support the DCTRT in revenue administrative reforms and provided assistance in the development of a Strategic and Operational Plan in 2015. More recently, and after the November, 2015 elections, DCTRT advised that the new Government had signaled its intention to resurrect the tax reform which had stalled over the last few years.

### Financial Sector Regulation and Supervision

At the request of the Commissioner, an Advisor visited the Banking Commission in July 2008, January 2010 and February 2011. The focus of the missions was to strengthen the capacity of the authorities to conduct off-site surveillance of banks with a number of recommendations to improve

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

the prudential reporting requirements for banks, and the expansion of the off-site monitoring database. The visits included providing hands-on training and support to Commission staff in assessing credit risk in the bank's loan portfolio through the use of financial statement analysis, reviewing the appropriateness of loan repayment structures and repayment histories, and assessing the adequacy of collateral. The visit also resulted in the development of a standardized examination report to assist the Commission in presenting examination findings and recommendations. At the request of the Commission, a draft regulation to clarify and ensure the proper calculation of the single borrower limit (Section 130(1)(a) of the Banking Act) was also prepared during this period.

The Banking Commission is a member of the Association of Financial Supervisors of Pacific Countries (AFSPC), which is supported by PFTAC, and has benefited from participation in the AFSPC annual meetings and associated regional training workshops provided by PFTAC on financial supervision issues. In 2015, a new Banking Commissioner was appointed with a new team. A training and development needs assessment needs to be performed in light of the complete staff turnover.

### **Economic and Financial Statistics**

The Economic Policy, Planning and Statistics Office (EPPSO) has received significant training since 2005 on balance of payments and national accounts statistics. In recent years, PFTAC statistics advisors have delivered an annual sub-regional national accounts course to compilers from RMI as well as Palau and the Federated States of Micronesia, as all three countries use variants of a common compilation system that is run by two external consultants. They are funded by the U.S. Department of Interior and visit RMI annually to update the national accounts and also BOP statistics for inclusion in the Annual Compact Report.

The consultants' mandate is to produce estimates rather than train staff; as a result, staff from RMI lacked knowledge and confidence in this field and so the courses sought to teach them what the systems did as well as bolstering their compilation and analytical skills. The most recent course was run in April 2016 and focused on the use of household income and expenditure data in estimating GDP, rebasing and practical skills for compilation and reporting. It has been highlighted as one of PFTAC's success stories in terms of sustainability as staff are proving to be much more capable and independent. Following the conclusion of the JSA project in 2015, a PFTAC-funded government finance statistics mission is scheduled for September 2016.

### **Macroeconomic analysis and forecasting**

Work commenced with the Ministry of Finance in April 2016 to improve medium-term budgeting and fiscal planning. Technical Assistance is being provided jointly with the PFTAC Public Financial Management Advisor. A Financial Management Model (FMM), which was developed by the Asian Development Bank, is being modified so that projections are consistent with macroeconomic forecasts produced by external consultants, and information on likely medium-term cost increases due to demographic flows and past decisions on policy enhancements and approved projects. Moreover, the usability of the FMM is being enhanced so that it can be used to analyze the impact of economic shocks or proposed policy changes on key variables such as cash reserves and public debt. Participants from the RMI took part in workshops on *Medium-term Expenditure Planning for National Sustainable Development* in November 2015 and on *Forecasting Tax Revenues* in April 2016.



## STATISTICAL ISSUES

<b>Assessment of Data Adequacy for Surveillance</b>
<b>(As of June 2016)</b>
<p><b>General:</b> Data provision is broadly adequate for surveillance and the authorities willingly share available data, though some shortcomings tend to constrain policy analysis, especially on trade statistics. The Economic Policy, Planning and Statistics Office (EPPSO) was established in February 2003 and took efforts in building local capacity to collect and disseminate economic and social statistics. Through the close collaboration of EPPSO and various ministries, an external consultant team in the Pacific Islands Training Initiative (<a href="http://www.pitiviti.org">www.pitiviti.org</a>), funded by the U.S. Department of Interior, prepares a comprehensive set of annual statistics covering key areas beginning FY2008. Previously, extensive Fund technical assistance was provided through the Pacific Financial Technical Assistance Center (PFTAC) in preparation of the balance of payments and national account statistics. Data shortcomings include the coverage and timeliness of data releases.</p>
<p><b>National Accounts:</b> National income accounts from (the latest data through FY2015) have been prepared by the external consultants dating back to FY1997, though the official website lags far behind in presenting what is available. Some shortcomings remain, for instance, investment, consumption and savings indicators are not available. The national census was conducted in early 2011.</p>
<p><b>Employment:</b> Data on employment and wages are available and classified by sectors based on the filings to Social Security Administration. However, no unemployment data are available.</p>
<p><b>Price statistics:</b> The new consumer price index (CPI), rebased in 2003Q1, and replaced the previous CPI developed in the 1980s. The updated CPI is based on the information from the Household Income and Expenditure Survey 2002, conducted with assistance from the U.S. Department of the Interior and the U.S. Census Bureau.</p>
<p><b>Government finance:</b> Fiscal data are regularly compiled for budget control, and with the help of the consultants they are consolidated into a format suitable for analysis. Annual financial audits on the central government and component units were published. The RMI presents fiscal data using Government Finance Statistics Manual 2001 (GFSM 2001) format and has submitted data to the Government Financial Statistics Yearbook for 2008–13. Recent TA work successfully mapped various elements to GFSM 2014 to enable public sector consolidation.</p>
<p><b>Monetary statistics:</b> A reporting system has been established for domestic banking institutions on the basis of monthly reporting forms and guidelines developed by the 1993 STA mission. Even though data are reported by banks to the Banking Commissioner, they are not published or reported to the Fund. Tables on basic balance sheet items as well as income and expenses are prepared for inclusion in the Annual Compact Report.</p>
<p><b>Balance of payments:</b> The EPPSO has made important progress in the improvement of Marshall Islands' ESS during the JSA ESS Project. The sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) was adopted and balance of payments and international investment position (IIP) statistics started to be submitted to STA in 2014. Following the implementation of a unit dedicated to the compilation of statistics, the EPPSO took over the ownership of ESS compilation, currently conducted solely by external consultants. Nevertheless, the unit is staffed by a sole compiler and some reliance on the consultants still remains. Further actions still need to be undertaken by the EPPSO to collect proper data on external debt statistics (EDS), foreign direct investment (FDI) statistics, and proper data on banks' external assets and liabilities.</p>
<b>Data Standards and Quality</b>
Does not participate in the IMF's General Data Dissemination System. No data ROSC is available.
<b>Reporting to STA (Optional)</b>
No data are reported to STA.

**Marshall Islands: Table of Common Indicators Required for Surveillance  
As of June 2016**

	Date of Latest Observation	Date Received	Frequency of Data <sup>7</sup>	Frequency of Reporting <sup>7</sup>	Frequency of Publication <sup>7</sup>
Exchange Rates	Jun. 2016	Jun. 2016	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	FY2015	June 2016	A	A	A
Reserve/Base Money	NA	NA	NA	NA	NA
Broad Money	NA	NA	NA	NA	NA
Central Bank Balance Sheet	NA	NA	NA	NA	NA
Consolidated Balance Sheet of the Banking System	End-FY2015	June 2016	A	A	A
Interest Rates <sup>2</sup>	End-FY-2015	June 2016	A	A	A
Consumer Price Index	Q1 FY2016	June 2016	Q	Q	Q
Revenue, Expenditure, Balance/Composition of Financing <sup>3</sup> General Government <sup>4</sup> and Central Government	FY2015	June 2016	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	FY2015	June 2016	A	A	A
External Current Account Balance	FY2015	June 2016	A	A	A
Exports and Imports of Goods and Services	FY2015	June 2016	A	A	A
GDP/GNP	FY2015	June 2016	A	A	A
Gross External Debt	FY2015	June 2016	A	A	A
International Investment Position <sup>6</sup>	FY2015	June 2016	A	A	A

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

<sup>2</sup> Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Includes external gross financial asset and liability positions vis-à-vis nonresidents.

<sup>7</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).



# REPUBLIC OF THE MARSHALL ISLANDS

July 7, 2016

## STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION— DEBT SUSTAINABILITY ANALYSIS

Approved By  
**Ranil Salgado and  
Andrea Richter Hume  
(IMF), and Satu  
Kahkonen (IDA)**

Prepared by staff of the International Monetary Fund and the International Development Association.

*The 2016 Debt Sustainability Analysis (DSA) assesses that the Republic of the Marshall Islands (RMI) remains at high risk of debt distress. Currently, the ratios of the present value (PV) of external public and publicly-guaranteed (PPG) debt to GDP and exports are above their respective policy-dependent indicative thresholds. Moreover, the PV of the external debt-to-GDP ratio is expected to remain above its indicative threshold throughout the entire projection period and, for most indicators of external debt, indicative thresholds would be breached under stress test scenarios. Although the RMI does not currently face any debt servicing risk due to concessionality of debt obligations and access to a stable flow of funds from Compact grants until FY2023, risks from contingent liabilities and lack of fiscal buffers call for a fiscal reform strategy. Thus, the government needs to adhere to its existing consolidation plans to generate sufficient fiscal surpluses by FY2023 to shore up the Compact Trust Fund, while safeguarding social spending and economic growth.*

## BACKGROUND

- 1. The RMI's PPG debt is almost entirely external.** According to the limited data available, the domestic component—held by domestic banks—is only 6 percent of the total. Private sector external debt is also estimated to be small, representing less than 2 percent of GDP.
- 2. PPG external debt has been on a downward trajectory since the early 2000s.** It declined from 73.7 percent of GDP in FY2002 to 49.1 percent of GDP at end FY2015. About two-thirds is central government debt contracted with the Asian Development Bank (AsDB) on concessional terms, while the remainder is state-owned enterprise (SOE) debt guaranteed by the government.
- 3. The analysis is based on the standard DSA framework for low-income countries (LICs).** The framework assesses the evolution of debt against the respective policy-dependent indicative thresholds to ascertain debt sustainability.<sup>1</sup> RMI's policies and institutions, as measured by the CPIA, averaged 2.7 over the past 3 years. Hence the country is classified as a "weak" performer and is assessed against relatively lower debt thresholds.

## UNDERLYING ASSUMPTIONS

- 4. The economy is estimated to have returned to a positive growth in FY2015, led by the fishery sector, and is expected to expand further in FY2016.** Following a contraction in FY2014, real GDP growth was estimated at 0.4 percent in FY2015 and is expected to rise to 1.4 percent in FY2016, as the effects of the drought earlier this year are offset by the resumption of Compact-funded infrastructure spending. The fiscal balance is estimated to have recorded a surplus of 3 percent of GDP in FY2014–15, due to record-high fishing license fees. It is projected to decline to a smaller surplus in FY2016 and, without reforms, to a deficit of 2 percent of GDP over the medium term due to the steady decline in Compact grants until FY2023. Potential GDP growth is projected to be 1-1.5 percent over the medium term, absent structural reforms. Box 1 summarizes the medium-term macroeconomic framework underlying this DSA update, which is also consistent with the outlook for the Compact Trust Fund (CTF) summarized in Box 2.

## EXTERNAL DSA

- 5. Under the baseline scenario, RMI's external PPG debt trajectory remains above the indicative threshold for a protracted period of time.** The present value (PV) of external PPG debt is estimated at 40.0 percent of GDP in FY2015, 10 percentage points above the indicative threshold of 30 percent and is not anticipated to fall below that limit over the projection period. Debt accumulation is expected to remain positive at least until FY2036, reflecting government deficit

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<sup>1</sup> The low-income country debt sustainability framework recognizes that better policies and institutions allow countries to manage higher levels of debt, and thus the threshold levels for debt indicators are policy-dependent. In particular, the quality of a country's policies and institutions is measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index and classified into three categories: strong, medium, and weak. For the analysis, a 5 percent discount rate is assumed for present value calculations.

financing. The grant element of new borrowing is expected to increase after FY2018, as the share of concessional loans from multilateral partners in the financing mix is projected to rise. The PV of external PPG debt-to-export ratio is currently above the indicative threshold of 100 percent, but is projected to fall below it in FY2017, thanks to the projected export expansion. The PV of external PPG debt-to-revenue ratio is currently below the indicative threshold of 200 percent, and expected to remain below it during the projection period. As most of external PPG debt is on concessional terms, the debt service to export and revenue ratios are expected to remain below the indicative thresholds over the long-term horizon.

**6. Stress tests confirm the vulnerability of the debt position relative to GDP, exports, and revenues.** In the most extreme shock scenario—with export value growth in FY2017–18 one standard deviation below the historical average—the PV of the debt-to-export ratio would remain above its relevant threshold at the end of the projection period. The debt service-to-exports ratio would also remain above its indicative threshold at least until FY2036. These highlight the sensitivity of the external debt position to exports, including in fishing, which historically had high volatility. Under a more benign scenario whereby key macroeconomic variables are assumed at their historical averages—characterized by positive primary balances—the PV of the debt-to-GDP, and debt-to-exports would fall below their indicative thresholds in FY2016.<sup>2</sup>

## PUBLIC DSA

**7. Total PPG debt follows very closely the dynamics of PPG external debt.** The PV of PPG debt-to-GDP and to revenue ratios is projected to decline very slowly over the projection period. The debt dynamics is particularly sensitive to growth shocks. Under the most extreme shock, the PV of debt-to-GDP and debt-to-revenue would remain on an upward trend at least until FY2036. Under a shock to the primary balance, the debt service-to-revenue ratio would also keep growing throughout the projection period.

## THE AUTHORITIES VIEWS

**8. The authorities agreed with the DSA findings, noting that the current risk of debt distress is high.** They saw the need for fiscal adjustment and improvements in public financial management. They emphasized that a Decrement Management Plan (DMP) was developed to implement a fiscal adjustment in the face of declining Compact grants. They also noted that the Public Financial Management Reform Roadmap (PFMRR) was adopted in August 2014. The Ministry of Finance is leading the effort in implementing its recommendations and targeted activities, including financial accountability, transparency and budget oversight, and aid coordination.

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<sup>2</sup> Holding the set of key variables related to debt dynamics at ten-year averages does not appear to provide a relevant comparator to the baseline. In particular, the scenario in which variables are at their historical levels is regarded as too benign due to historically smaller current account deficits that were financed in the past by large one-off FDI.

However, these efforts continue to require consistent attention and action to realize the full benefit of the Reform Roadmap.

## CONCLUSIONS

**9. The standard DSA framework for LICs suggests that the RMI is at high risk of debt distress.** The baseline scenario indicates that the PV of the external debt-to-GDP ratio would breach the indicative threshold throughout the entire projection period. Furthermore, stress tests suggest that RMI's external PPG debt trajectory could remain above relevant thresholds for an even more protracted period of time. RMI's vulnerability to debt distress is mitigated by a number of factors: most debt is on concessional terms and from development partners; the decline in external support from the Compact will be gradual, sheltering the country from the risk of a sudden stop in foreign financing; and the government is building up the CTF that will provide a stable source of funding after FY2023. On the other hand, vulnerabilities are exacerbated by the lack of fiscal buffers, uncertainty about prospective SOE losses, contingent liabilities from climatic events, the social security system, and uncertainty on prospective income returns from the CTF. Thus, the government needs to adhere to its existing consolidation plans to generate sufficient fiscal surpluses by FY2023 to shore up the Compact Trust Fund, while safeguarding social spending and economic growth.

### Box 1. Marshall Islands: Macroeconomic Assumptions

*The key assumptions of the 2016 DSA are consistent with the macroeconomic framework outlined in the 2016 Article IV Report. Relative to the previous DSA, short-term indicators have improved somewhat mainly due to the upward revision of fiscal revenues, notably from fishing license fees, but the long-term dynamics remain broadly unchanged.*

**GDP growth** is projected to rise from 0.4 percent in FY2015 to 1.3 percent over the medium term. The medium-term projections reflect the decline in Compact grants and limited private sector expansion.

The **GDP deflator** is expected to remain about 1 percentage point below CPI inflation growth, at around 1 percent.

A **fiscal deficit** of around 1–3 percent of GDP is projected in FY2020–36. The wage bill is assumed to remain constant as a percent of GDP beyond FY2020, while subsidies to SOEs are assumed to decline very moderately in real terms. On the revenue side, Compact grants in nominal terms are projected to decrease according to schedule, while grants from other donors are expected to remain stable at an annual average of about 12 percent of GDP. The tax revenues-to-GDP ratio is assumed to remain broadly unchanged at around 15 percent of GDP, as the baseline scenario does not incorporate any tax reforms. Fishing license fees are assumed to increase moderately. Beyond FY2023, expenditures are expected to follow trends in revenues and grants.

**External financing:** In the absence of access to the international capital market and a very limited domestic market, the financing gap is assumed to be financed by a combination of bilateral loans from development partners and multilateral concessional lending. The annual interest rate on bilateral loans is assumed at 3 percent, consistent with the rate currently charged to public entities by bilateral development partners. In the medium term, it is assumed that the RMI will also be eligible for IDA-like concessional lending.

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

The **current account deficit** (including official transfers) is expected to gradually deteriorate from 1.6 percent of GDP in FY2015 to around 5 percent of GDP by FY2023 and remain at that level thereafter. The deficit is assumed to be financed by a combination of bilateral loans from development partners and multilateral concessional lending.

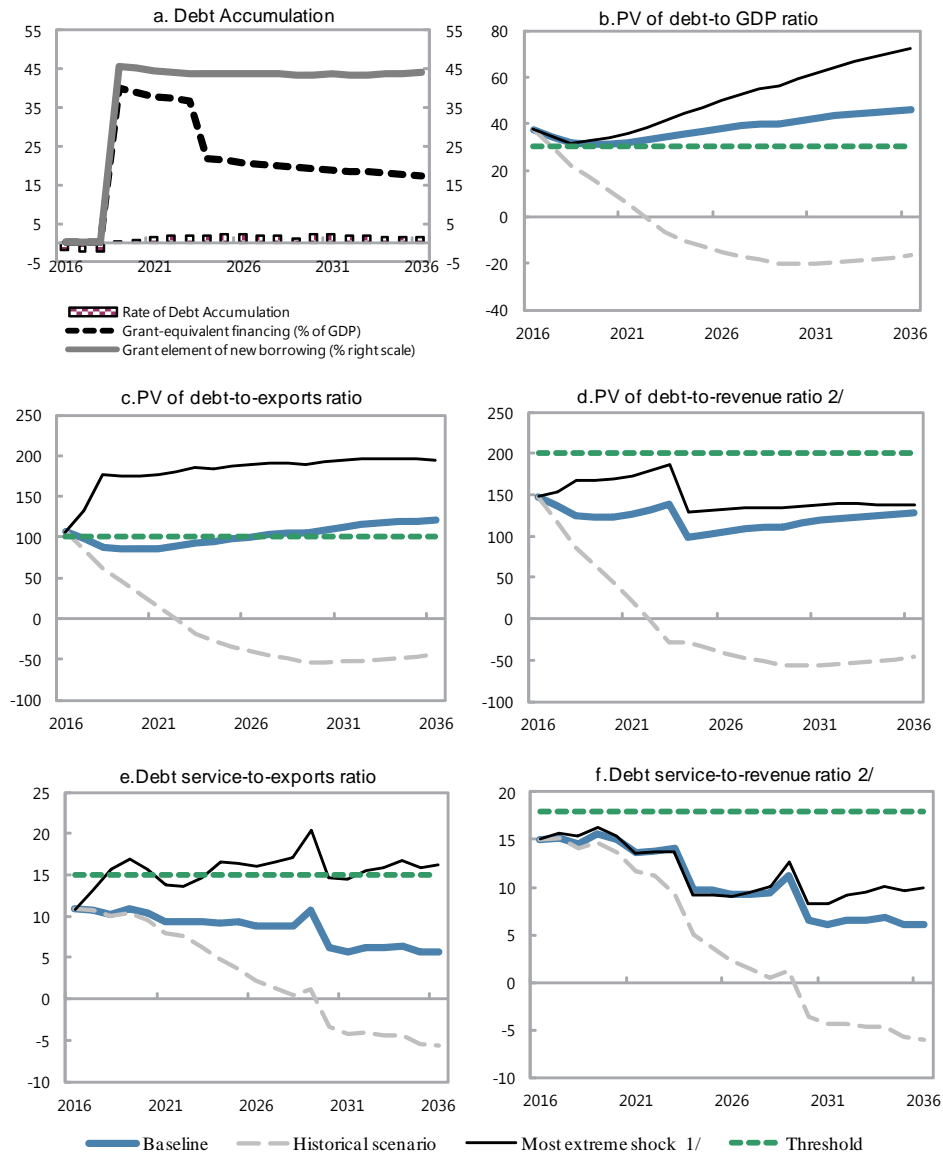
### Box 2. Brief Overview of the Compact Trust Fund Under the Baseline Scenario

**The Compact Trust Fund (CTF) was established in FY2004 to contribute to the long-term budgetary self-reliance of the RMI after most of the recurrent Compact sector grants expire in FY2023.** The CTF is administered by an independent committee formed by representatives from the RMI, United States, and Taiwan Province of China, and is managed by a professional investment advisor. The RMI's contributions to the CTF have not been steady over the years and depend on the country's fiscal position. Contributions have been mainly provided by the United States, followed by Taiwan Province of China. From FY2024 onwards, income returns from the CTF can be withdrawn to finance budget needs, under some limitations.

**Under the baseline scenario, the CTF is assumed to yield an average annual nominal return of 5 percent, in line with the historical track record.** Under this assumption, long-term self-sufficiency will not be secured because the real value of the CTF will decline over time, even though income flows in the years immediately after FY2023 are expected to be sufficient to cover the anticipated reduction in grants. Compact-related grants are expected to be reduced by US\$27 million in FY2024, while CTF's investment earnings are projected at US\$36 million. As the gap between investment returns and grant reduction is expected to be too small to compensate for inflation, the real value of the fund is projected to start declining in FY2024. These projections are sensitive to the assumption on CTF annual investment returns, which have been quite volatile in the past.



**Figure 1. Marshall Islands: Indicators of Public Guaranteed External Debt Under Alternative Scenarios FY2016–36 1/**

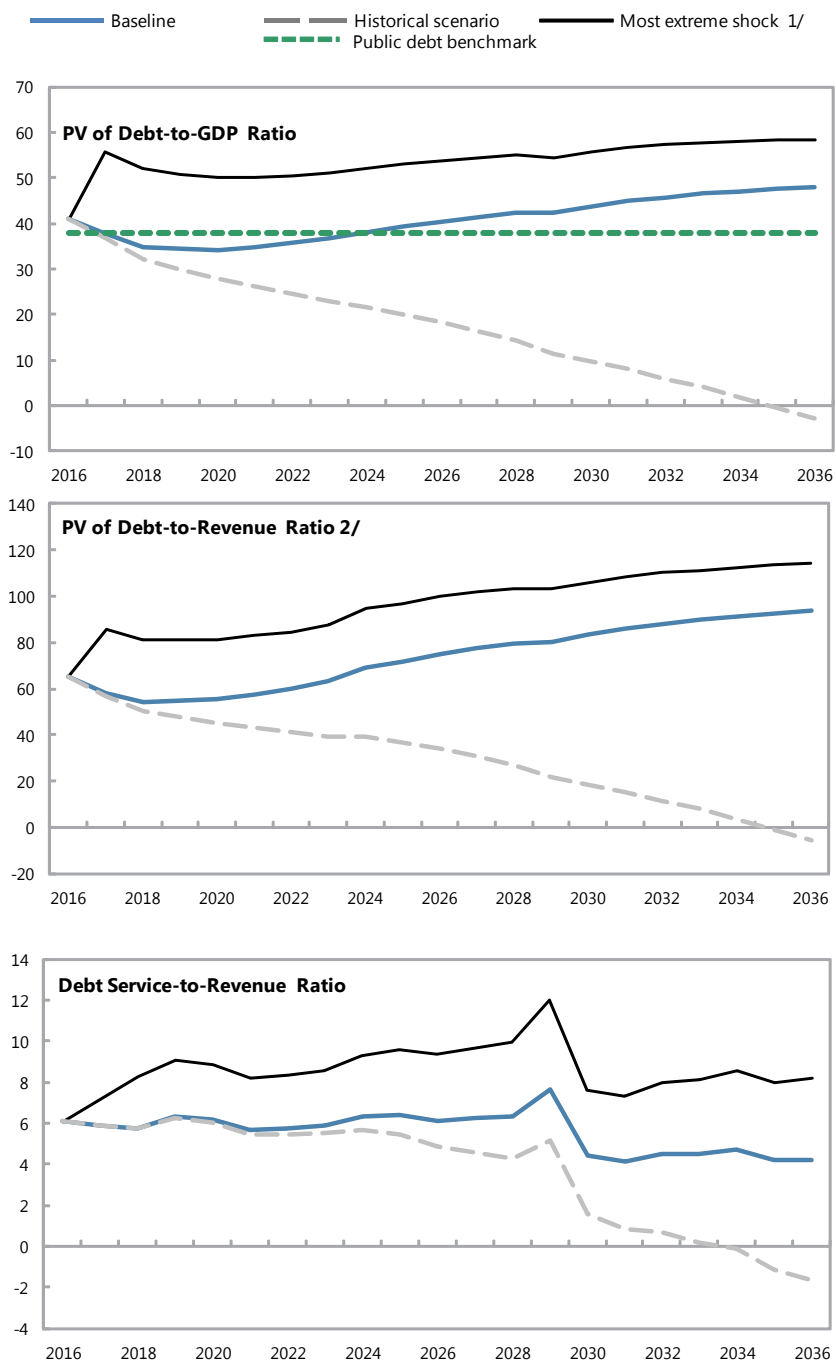


Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b, it corresponds to a Terms shock; in c. to a Exports shock; in d. to a Exports shock; in e. to a Exports shock and in figure f. to a Growth shock

2/ Revenues are defined exclusive of grants. Revenues increase in FY2024 due to annual distributions from the Compact Trust Fund (CTF) starting that year.

**Figure 2. Marshall Islands: Indicators of Public Debt Under Alternative Scenarios, FY2016–36**



Sources: Country authorities; and staff estimates and projections.  
 1/ The most extreme stress test is the test that yields the highest ratio on or before 2026.  
 2/ Revenues are defined inclusive of grants.

**Table 1. Marshall Islands: External Debt Sustainability Framework,  
Baseline Scenario, FY2013–36 1/  
(In percent of GDP, unless otherwise indicated)**

	Actual			Historical Average	Standard Deviation	Projections						2016-2021			2022-2031	
	2013	2014	2015			2016	2017	2018	2019	2020	2021	Average	2026	2036	Average	
<b>External debt (nominal) 1/</b>	<b>53.7</b>	<b>53.1</b>	<b>51.1</b>			<b>47.6</b>	<b>43.6</b>	<b>39.7</b>	<b>39.3</b>	<b>39.3</b>	<b>40.0</b>				<b>47.2</b>	<b>63.6</b>
<i>of which: public and publicly guaranteed (PPG)</i>	51.8	51.1	49.1			45.6	41.7	37.8	37.5	37.5	38.3				45.6	62.4
Change in external debt	-0.6	-0.6	-2.0			-3.6	-3.9	-3.9	-0.4	-0.1	0.7				1.4	1.5
Identified net debt-creating flows	5.8	3.4	2.3			5.5	7.2	7.4	7.7	8.6	9.5				6.6	4.9
<b>Non-interest current account deficit</b>	<b>8.5</b>	<b>3.1</b>	<b>1.9</b>	<b>4.6</b>	<b>8.4</b>	<b>6.5</b>	<b>8.4</b>	<b>8.5</b>	<b>8.7</b>	<b>9.5</b>	<b>10.3</b>				<b>7.2</b>	<b>5.2</b>
Deficit in balance of goods and services	60.2	58.0	66.4			68.5	70.4	69.7	69.2	68.8	68.5				64.1	59.4
Exports	43.6	39.6	35.7			35.2	35.5	35.9	36.3	36.5	36.8				37.8	37.9
Imports	103.8	97.7	102.2			103.6	105.9	105.5	105.5	105.3	105.2				101.9	97.3
Net current transfers (negative = inflow)	-31.3	-29.4	-31.5	-35.5	4.9	-32.0	-32.4	-30.9	-30.5	-29.5	-28.6				-17.4	-15.4
<i>of which: official</i>	-30.1	-28.0	-30.4			-30.2	-30.7	-29.3	-28.9	-28.1	-27.3				-14.9	-12.9
Other current account flows (negative = net inflow)	-20.3	-25.6	-33.0			-30.0	-29.6	-30.2	-30.1	-29.8	-29.6				-39.5	-38.8
<b>Net FDI (negative = inflow)</b>	<b>-2.4</b>	<b>-2.0</b>	<b>-1.5</b>	<b>-5.3</b>	<b>6.9</b>	<b>-1.5</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.3</b>	<b>-1.3</b>				<b>-1.3</b>	<b>-1.3</b>
<b>Endogenous debt dynamics 2/</b>	<b>-0.3</b>	<b>2.3</b>	<b>1.9</b>			<b>0.5</b>	<b>0.2</b>	<b>0.3</b>	<b>0.4</b>	<b>0.4</b>	<b>0.5</b>				<b>0.7</b>	<b>0.9</b>
Contribution from nominal interest rate	1.4	1.3	1.3			1.2	1.1	1.0	1.0	1.0	1.0				1.2	1.7
Contribution from real GDP growth	-1.1	0.5	-0.2			-0.7	-0.8	-0.7	-0.6	-0.6	-0.5				-0.6	-0.8
Contribution from price and exchange rate changes	-0.5	0.5	0.8			...	...	...	...	...	...				...	...
<b>Residual (3-4) 3/</b>	<b>-6.4</b>	<b>-4.0</b>	<b>-4.3</b>			<b>-9.0</b>	<b>-11.1</b>	<b>-11.3</b>	<b>-8.1</b>	<b>-8.7</b>	<b>-8.8</b>				<b>-5.2</b>	<b>-3.4</b>
<i>of which: exceptional financing</i>	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0				0.0	0.0
PV of external debt 4/	...	...	42.0			39.4	36.4	33.3	33.0	32.8	33.4				39.3	47.0
In percent of exports	...	...	117.4			112.0	102.7	92.9	90.9	89.9	91.0				104.2	123.9
<b>PV of PPG external debt</b>	<b>...</b>	<b>...</b>	<b>40.0</b>			<b>37.4</b>	<b>34.5</b>	<b>31.5</b>	<b>31.1</b>	<b>31.1</b>	<b>31.7</b>				<b>37.8</b>	<b>45.8</b>
In percent of exports	...	...	111.8			106.4	97.2	87.7	85.9	85.1	86.3				100.2	120.8
In percent of government revenues (excluding grants)	...	...	151.6			147.9	137.2	123.8	122.3	123.2	126.8				105.2	127.9
<b>Debt service-to-exports ratio (in percent)</b>	<b>7.6</b>	<b>9.1</b>	<b>10.9</b>			<b>10.8</b>	<b>10.7</b>	<b>10.3</b>	<b>11.0</b>	<b>10.4</b>	<b>9.3</b>				<b>8.8</b>	<b>5.7</b>
<b>PPG debt service-to-exports ratio (in percent)</b>	<b>7.6</b>	<b>9.1</b>	<b>10.9</b>			<b>10.8</b>	<b>10.7</b>	<b>10.3</b>	<b>11.0</b>	<b>10.4</b>	<b>9.3</b>				<b>8.8</b>	<b>5.7</b>
<b>PPG debt service-to-revenue ratio (in percent)</b>	<b>15.5</b>	<b>15.5</b>	<b>14.8</b>			<b>15.1</b>	<b>15.2</b>	<b>14.5</b>	<b>15.6</b>	<b>15.0</b>	<b>13.6</b>				<b>9.2</b>	<b>6.0</b>
Total gross financing need (Millions of U.S. dollars)	17.9	8.8	8.0			16.5	20.7	21.5	23.1	25.2	26.9				22.5	19.0
Non-interest current account deficit that stabilizes debt ratio	9.1	3.7	4.0			10.0	12.3	12.5	9.0	9.5	9.5				5.8	3.8
<b>Key macroeconomic assumptions</b>																
Real GDP growth (in percent)	2.1	-0.9	0.4	1.5	2.6	1.4	1.7	1.8	1.6	1.6	1.3				1.6	1.3
GDP deflator in US dollar terms (change in percent)	1.0	-0.9	-1.5	1.5	1.8	0.5	0.8	1.3	1.3	1.5	1.5				1.1	1.1
Effective interest rate (percent) 5/	2.6	2.4	2.4	2.9	0.4	2.3	2.3	2.4	2.7	2.7	2.7				2.5	2.8
Growth of exports of G&S (US dollar terms, in percent)	-0.6	-10.8	-10.8	8.2	23.4	0.2	3.4	4.3	4.0	3.8	3.5				3.2	2.7
Growth of imports of G&S (US dollar terms, in percent)	11.6	-7.7	3.4	4.1	9.0	3.3	4.7	2.7	2.9	2.9	2.8				3.2	1.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	...	...	...	45.5	45.1	44.6				45.1	43.8
Government revenues (excluding grants, in percent of GDP)	21.4	23.4	26.4			25.3	25.1	25.4	25.5	25.2	25.0				36.0	35.8
Aid flows (in Millions of US dollars) 7/	66.2	53.9	56.5			70.0	76.6	76.6	84.2	84.6	85.5				54.8	57.9
<i>of which: Grants</i>	61.3	53.9	56.5			70.0	76.6	76.6	76.5	76.5	76.4				43.7	47.4
<i>of which: Concessional loans</i>	4.9	0.0	0.0			0.0	0.0	0.0	7.6	8.2	9.1				11.1	10.4
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			...	...	...	39.9	38.8	37.8				20.5	17.2
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			...	...	...	93.1	92.7	92.2				85.9	87.3
<b>Memorandum items:</b>																
Nominal GDP (Millions of US dollars)	190.2	186.7	184.6			188.0	192.8	198.6	204.5	210.8	216.7				244.3	310.5
Nominal dollar GDP growth	3.2	-1.8	-1.1			1.8	2.5	3.0	3.0	3.1	2.8				2.7	2.4
PV of PPG external debt (in Millions of US dollars)	...	...	73.8			70.3	66.5	62.5	63.7	65.5	68.8				92.4	142.2
(Pvt-Pvt-1)/GDPT-1 (in percent)	...	...	...			-1.9	-2.0	-2.1	0.6	0.9	1.5				-0.5	2.1
Gross workers' remittances (Millions of US dollars)	7.4	7.7	8.3			8.4	8.7	8.9	9.2	9.5	9.7				11.0	14.0
PV of PPG external debt (in percent of GDP + remittances)	...	...	38.3			35.8	33.0	30.1	29.8	29.8	30.4				36.2	43.8
PV of PPG external debt (in percent of exports + remittances)	...	...	99.3			94.3	86.3	77.9	76.4	75.8	76.9				89.5	108.0
Debt service of PPG external debt (in percent of exports + remittances)	...	...	9.7			9.6	9.5	9.1	9.8	9.2	8.3				7.8	5.1

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as  $[r - g - p(1+g)] / (1+g+p+gp)$  times previous period debt ratio, with  $r$  = nominal interest rate;  $g$  = real GDP growth rate, and  $p$  = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes. This line item also reflects projected capital transfers for investment projects.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

**Table 2. Marshall Islands: Sensitivity Analysis for Key Indicators of PPG External Debt, FY2016–36 (In percent)**

	Projections							2036
	2016	2017	2018	2019	2020	2021	2026	
<b>PV of debt-to GDP ratio</b>								
<b>Baseline</b>	37	34	31	31	31	32	<b>38</b>	46
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	37	30	22	17	11	6	<b>-15</b>	-17
A2. New public sector loans on less favorable terms in 2016-2036 2	37	34	31	32	34	36	<b>50</b>	72
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	37	35	33	33	33	34	<b>40</b>	49
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	37	38	43	42	42	43	<b>48</b>	49
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	37	35	32	32	32	33	<b>39</b>	47
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	37	37	36	36	36	37	<b>42</b>	47
B5. Combination of B1-B4 using one-half standard deviation shocks	37	36	36	36	36	37	<b>42</b>	49
<b>PV of debt-to-exports ratio</b>								
<b>Baseline</b>	106	97	88	86	85	86	<b>100</b>	121
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	106	84	61	46	30	15	<b>-40</b>	-44
A2. New public sector loans on less favorable terms in 2016-2036 2	106	97	88	90	93	98	<b>132</b>	190
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	106	97	88	86	85	86	<b>100</b>	121
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	106	132	177	175	174	176	<b>189</b>	195
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	106	97	88	86	85	86	<b>100</b>	121
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	106	106	102	100	99	101	<b>112</b>	125
B5. Combination of B1-B4 using one-half standard deviation shocks	106	108	112	110	109	111	<b>125</b>	143
<b>PV of debt-to-revenue ratio</b>								
<b>Baseline</b>	148	137	124	122	123	127	<b>105</b>	128
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	148	118	86	65	44	22	<b>-42</b>	-47
A2. New public sector loans on less favorable terms in 2016-2036 2	148	137	124	128	134	143	<b>139</b>	202
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	148	141	131	130	131	134	<b>111</b>	135
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	148	153	167	166	168	173	<b>133</b>	138
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	148	139	127	126	127	130	<b>108</b>	131
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	148	149	143	142	144	148	<b>117</b>	132
B5. Combination of B1-B4 using one-half standard deviation shocks	148	144	143	141	143	147	<b>118</b>	136

**Table 2. Marshall Islands: Sensitivity Analysis for Key Indicators of PPG External Debt, FY2016–36 (In percent) (concluded)**

	Projections							2036
	2016	2017	2018	2019	2020	2021	2026	
<b>Debt service-to-exports ratio</b>								
<b>Baseline</b>	11	11	10	11	10	9	<b>9</b>	6
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	11	11	10	10	9	8	<b>2</b>	-6
A2. New public sector loans on less favorable terms in 2016-2036 2/	11	11	10	11	10	9	<b>10</b>	15
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	11	11	10	11	10	9	<b>8</b>	9
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	11	13	16	17	16	14	<b>16</b>	16
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	11	11	10	11	10	9	<b>8</b>	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	11	11	10	11	10	9	<b>9</b>	10
B5. Combination of B1-B4 using one-half standard deviation shocks	11	12	12	13	12	10	<b>10</b>	11
<b>Debt service-to-revenue ratio</b>								
<b>Baseline</b>	15	15	14	16	15	14	<b>9</b>	6
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2016-2036 1/	15	15	14	15	14	12	<b>2</b>	-6
A2. New public sector loans on less favorable terms in 2016-2036 2/	15	15	14	15	15	14	<b>11</b>	16
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	15	16	15	16	15	14	<b>9</b>	10
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	15	15	15	16	15	14	<b>11</b>	11
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	15	15	15	16	15	13	<b>9</b>	10
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	15	15	15	16	15	13	<b>10</b>	10
B5. Combination of B1-B4 using one-half standard deviation shocks	15	15	15	16	15	14	<b>10</b>	10
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 5/	40	40	40	40	40	40	<b>40</b>	40

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

**Table 3. Marshall Islands: Public Sector Debt Sustainability Framework, Baseline Scenario, FY2013–36**  
(In percent of GDP, unless otherwise indicated)

	Actual			Average <sup>5/</sup>	Standard Deviation <sup>5/</sup>	Estimate					Projections				
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-21 Average	2026	2036	2022-36 Average
<b>Public sector debt 1/</b>	55.2	54.6	52.6			49.0	45.1	41.1	40.7	40.6	41.3		48.3	64.5	
<i>of which: foreign-currency denominated</i>	55.2	54.6	52.6			49.0	45.1	41.1	40.7	40.6	41.3		48.3	64.5	
Change in public sector debt	0.8	-0.6	-2.0			-3.6	-4.0	-4.0	-0.4	-0.1	0.7		1.4	1.4	
Identified debt-creating flows	-1.4	-2.2	-2.1			-2.3	-1.5	-1.0	-0.6	-0.3	0.1		1.2	1.5	
Primary deficit	-1.1	-4.5	-4.0	-3.4	1.7	-2.5	-1.3	-0.7	-0.5	-0.1	0.2	-0.8	1.1	1.3	1.1
Revenue and grants	53.7	52.2	57.0			62.5	64.9	64.0	62.9	61.5	60.3		53.8	51.1	
<i>of which: grants</i>	32.2	28.8	30.6			37.2	39.8	38.6	37.4	36.3	35.3		17.9	15.3	
Primary (noninterest) expenditure	52.6	47.7	52.9			60.0	63.6	63.3	62.4	61.4	60.5		54.9	52.4	
Automatic debt dynamics	-0.3	2.3	1.9			0.2	-0.2	-0.3	-0.2	-0.2	-0.1		0.1	0.2	
Contribution from interest rate/growth differential	-0.3	2.3	1.9			0.2	-0.2	-0.3	-0.2	-0.2	-0.1		0.1	0.2	
<i>of which: contribution from average real interest rate</i>	0.8	1.8	2.1			0.9	0.7	0.5	0.5	0.4	0.5		0.7	1.0	
<i>of which: contribution from real GDP growth</i>	-1.1	0.5	-0.2			-0.7	-0.8	-0.8	-0.6	-0.6	-0.5		-0.6	-0.8	
Contribution from real exchange rate depreciation	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	2.2	1.6	0.1			-1.3	-2.5	-3.0	0.2	0.2	0.6		0.1	-0.1	
<b>Other Sustainability Indicators</b>															
<b>PV of public sector debt</b>	...	...	43.5			40.9	37.9	34.7	34.3	34.2	34.7		40.5	47.9	
<i>of which: foreign-currency denominated</i>	...	...	43.5			40.9	37.9	34.7	34.3	34.2	34.7		40.5	47.9	
<i>of which: external</i>	...	...	40.0			37.4	34.5	31.5	31.1	31.1	31.7		37.8	45.8	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	4.0	2.6	3.4			4.7	5.9	6.3	6.7	6.7	6.6		7.1	5.5	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	76.4			65.4	58.4	54.3	54.6	55.6	57.6		75.2	93.8	
PV of public sector debt-to-revenue ratio (in percent)	...	...	165.0			161.6	150.7	136.6	134.8	135.4	138.7		112.6	133.8	
<i>of which: external 3/</i>	...	...	151.6			147.9	137.2	123.8	122.3	123.2	126.8		105.2	127.9	
Debt service-to-revenue and grants ratio (in percent) 4/	6.2	6.9	6.8			6.1	5.9	5.8	6.3	6.2	5.7		6.1	4.2	
Debt service-to-revenue ratio (in percent) 4/	15.5	15.5	14.8			15.1	15.2	14.5	15.6	15.0	13.6		9.2	6.0	
Primary deficit that stabilizes the debt-to-GDP ratio	-1.9	-3.9	-2.0			1.1	2.7	3.3	-0.1	0.0	-0.5		-0.3	-0.1	
<b>Key macroeconomic and fiscal assumptions</b>															
Real GDP growth (in percent)	2.1	-0.9	0.4	1.5	2.6	1.4	1.7	1.8	1.6	1.6	1.3	1.6	1.3	1.3	1.3
Average nominal interest rate on forex debt (in percent)	2.6	2.4	2.3	2.9	0.5	2.3	2.2	2.4	2.6	2.6	2.6	2.4	2.7	2.8	2.7
Average real interest rate on domestic debt (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real exchange rate depreciation (in percent, + indicates depreciation)	0.0	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	1.0	-0.9	-1.5	1.5	1.8	0.5	0.8	1.3	1.3	1.5	1.5	1.1	1.1	1.1	1.1
Growth of real primary spending (deflated by GDP deflator, in percent)	5.8	-10.0	11.4	0.7	5.4	14.9	7.8	1.3	0.1	-0.1	-0.1	4.0	0.2	0.9	0.3
Grant element of new external borrowing (in percent)	...	...	...	...	...	...	...	...	45.5	45.1	44.6	45.1	43.8	44.0	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

**Table 4. Marshall Islands: Sensitivity Analysis for Key Indicators of Public Debt FY2016–36**

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
<b>PV of Debt-to-GDP Ratio</b>								
<b>Baseline</b>	41	38	35	34	34	35	40	48
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	41	37	32	30	28	26	18	-3
A2. Primary balance is unchanged from 2016	41	37	33	31	30	29	24	8
A3. Permanently lower GDP growth 1/	41	38	35	35	36	37	49	81
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	41	39	38	39	39	41	53	74
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	41	38	34	33	33	34	40	47
B3. Combination of B1-B2 using one half standard deviation shocks	41	38	34	34	34	35	44	59
B4. One-time 30 percent real depreciation in 2017	41	56	52	51	50	50	54	58
B5. 10 percent of GDP increase in other debt-creating flows in 2017	41	44	41	40	40	41	47	53
<b>PV of Debt-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	65	58	54	55	56	58	75	94
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	65	57	50	47	45	43	34	-6
A2. Primary balance is unchanged from 2016	65	57	51	50	48	47	44	16
A3. Permanently lower GDP growth 1/	65	59	55	56	57	60	89	153
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	65	60	58	59	62	65	96	142
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	65	58	53	53	54	56	74	92
B3. Combination of B1-B2 using one half standard deviation shocks	65	58	52	53	55	58	81	115
B4. One-time 30 percent real depreciation in 2017	65	86	81	81	81	83	100	114
B5. 10 percent of GDP increase in other debt-creating flows in 2017	65	67	64	64	65	68	87	105
<b>Debt Service-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	6	6	6	6	6	6	6	4
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	6	6	6	6	6	5	5	-2
A2. Primary balance is unchanged from 2016	6	6	6	6	6	6	5	0
A3. Permanently lower GDP growth 1/	6	6	6	6	6	6	7	7
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	6	6	6	7	6	6	7	7
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	6	6	6	6	6	6	6	4
B3. Combination of B1-B2 using one half standard deviation shocks	6	6	6	6	6	6	6	5
B4. One-time 30 percent real depreciation in 2017	6	7	8	9	9	8	9	8
B5. 10 percent of GDP increase in other debt-creating flows in 2017	6	6	6	7	6	6	7	5

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

**Statement by Grant Johnston, Second Alternate Executive Director for Republic  
of the Marshall Islands and Nancy Jane Lelang, Advisor  
July 25, 2016**

On behalf of our authorities in the Republic of Marshall Islands (RMI) we welcome the staff report and thank the mission team for its productive engagement and policy advice. Our authorities agree with staff on the challenges facing the country and the need to build fiscal sustainability. They also commend the mission team for its particular focus on climate change adaptation, which is a major issue for the RMI given its natural geographical features. The RMI comprises small, sparsely-populated and low-lying atolls and islands spread across 750,000 square miles of the Pacific Ocean. Its extreme remoteness, low population, small private sector and narrow production base means the country is highly dependent on external aid, with grants making up over half of government revenue. The RMI is very low lying, with an average elevation of only 2 meters, and is regularly affected by flooding, storms and drought.

The country's immediate fiscal challenges are shaped by the forthcoming expiry of many current grants made under the Compact of Free Association. In 2023, these will be replaced by ongoing distributions from an investment fund – the Compact Trust Fund (CTF) – which is currently being built up through contributions from the United States, Taiwan POC and the RMI itself. However, the current track for contributions, together with expected investment returns, is not enough to ensure that the CTF can replace the expiring grants each year and also maintain the Fund's real value over time. There are two other major fiscal risks. The RMI's State-owned Enterprises (SOEs) make up a significant part of the economy but persistently make losses and require government subsidies. The Social Security Fund (SSF) – a government-run, defined-benefit pension scheme – currently has assets of around US\$70 million but, under current settings, could be depleted by 2023 as the payment of pension benefits rises.

### **Economic outlook**

**Authorities broadly agree with the staff assessment on the RMI's economic outlook.** They agree that, over the medium term, Compact infrastructure projects will help support growth, but that long-term growth potential – estimated at 1-1.5 percent – will remain limited in the absence of decisive structural reforms. The authorities consider climate change to be one of the main risks to the outlook, as extreme weather episodes have adversely affected the country in recent years and are becoming more frequent. They note the large looming contingent liabilities from the SSF in the absence of reform to put the system on a sustainable path. The authorities also highlight the relatively high level of public and publicly-guaranteed debt as a constraint on future prospects.

### **Fiscal sustainability**

**The RMI authorities agree with the need to undertake a fiscal adjustment and to transfer resulting surpluses to the CTF in the period leading up to 2023.** Staff calculate that an adjustment of 5 percent of GDP over this period, to build a budget surplus of 3 percent, would be required to replace the expiring Compact grants and preserve the real value of the CTF. As the report points out, however, this is sensitive to assumptions around



investment returns. Authorities agree with the recommendation made by the independent external evaluator that the CTF adopt a more conservative investment strategy heading towards 2023, given that 80 percent of the fund is currently invested in equities and alternative investments. The RMI is expected to post a surplus of 2.3 percent in 2016 and has made a contribution of US\$2.2 million to the CTF. Going forward, authorities will look to find expenditure savings across agencies, while protecting the health and education sectors, as envisioned in the Decrement Management Plan and complemented by additional reforms.

**Authorities agree that comprehensive reform is required to put the SSF on a sustainable path, as under current settings it could be depleted by 2023.** They have drafted a reform bill which is currently being discussed in workshops amongst stakeholders. A committee has been established to modify this bill to promote sustainability and at the same time ensure vulnerable older people are protected. Authorities advise that good communication and education will be required around these social security reforms.

**Implementing public financial management reforms is another important policy priority.** Authorities intend to make progress in areas that need improvement like accounting, auditing, budgeting, human resource capacity and information, as well as updating the current financial management information system. They are seeking technical assistance and funding support from donors to assist in implementing these reforms.

**On the revenue side, new measures will be introduced in a coordinated manner to balance the need for consolidation with implications for growth.** Authorities are intending to resubmit tax reform proposals to the new parliament after consultation with the private sector, and are securing technical assistance to help draft several tax bills. They advise that the first bill will be to establish an improved and independent revenue-collecting agency. This is expected to generate additional government revenue through improving core tax functions such as taxpayers' services, auditing, and collection of tax arrears and outstanding returns. Subsequent tax reform bills are intended in line with recommendations from the Pacific Financial Technical Assistance Centre although may require some recalibration that addresses key concerns of the private sector.

**There is general agreement about the need to accelerate SOE reforms, in particular to reduce overall government subsidies and make it clear where remaining subsidies exist as a result of specific community service obligations on those SOEs.** Authorities have already restructured the Marshalls Energy Company to improve governance and financial performance. The State-Owned Enterprise Act was passed in October 2015 to strengthen corporate governance and monitoring of SOEs, and authorities are preparing for the creation of an SOE monitoring unit within the Ministry of Finance. They note comments in the report about an increase in the limit on the number of public officials allowed to serve on SOE boards but make the point that this change was to retain flexibility to tap expertise resident in the public sector.

### **Financial stability**

**RMI authorities remain committed to strengthening the country's financial sector and working to resolve issues with correspondent banks and their home authorities.** They agree on the need to enhance the capacity, oversight and autonomy of the Banking

Commission but highlighted that bringing the Marshall Island Development Bank (MIDB) under the Commission's oversight would require legislation. For its own part, the MIDB is refocusing on its core mandate of providing commercial lending, rather than making consumer loans. As with other small island states, the potential loss of correspondent banking relationships is a very significant concern to the RMI authorities. To help prevent this, authorities are preparing legislation to bring AML/CFT rules into line with international standards. They appreciate the constructive engagement they have had with U.S. regulators and the assistance they have received in preparing to reform the financial sector. They intend to request stronger support, and in particular funding support, to implement the necessary reforms.

### **Climate change and natural disasters**

**The RMI is expected to be one of the countries most affected by climate change and rising sea levels.** Our authorities appreciate the continued support the RMI receives from members of the international community. Authorities have intensified their efforts to mitigate natural disaster risks including through the Joint National Action Plan that contains climate change adaption and disaster risk management strategies. Examples of projects include constructing sea walls, distributing water tanks and building disaster-resilient infrastructure.

**Authorities agree on the benefit of strengthening planning capacity, including by explicitly identifying and reporting on climate change-related elements in the budget.** This explicit budgeting of adaption costs could support access to donor funding, which the authorities would welcome given the RMI's current fiscal position. The RMI would therefore appreciate any technical assistance that could help authorities track such expenditures, as doing so with accuracy is a significant challenge. The RMI is a member of the Pacific Catastrophe Risk Assessment and Financing Initiative pilot insurance program which provides coverage against tropical cyclones until October 2018. But it will also seek other means – self-insurance, other donors or other insurance arrangements – that could cover “medium-sized” risks such as droughts and floods.