



Republic
of the
Marshall
Islands



August 2019

ECONOMIC BRIEF

RMI
FY 2018





1. Recent Economic Performance FY2018

Economic Performance

The RMI economy performed well in FY2018 with 3.5 percent growth in GDP, nearly sustaining the 4.1 percent attained in FY2017 after the three previous years of weak performance. During FY2018 the largest contributor to economic growth was the manufacturing sector which added 1.2 percent to GDP. This reflects increases in copra processing value added following the large increase in subsidies and producer prices paid to growers. The sector also includes the Pan Pacific fish loining plant where value added also rose significantly. Other major contributors have included the fisheries sector and an increase in construction activity following a resumption in disbursements of the Compact infrastructure grant after the moratorium placed on the use of the grant in FY2014 and FY2015. Performance at Air Marshall Islands, the national airline, has also improved with value added rising significantly (from very low levels), although the entity operates below cost and remains financially insolvent.

Employment

During the amended Compact period employment opportunities have grown by an average 0.7 percent annually. Employment generation in the private sector has fluctuated with the phase of the cycle and has been strongly affected by the closing and re-opening of the fish loining plant. However, at the current time private sector employment is at similar levels to that at the start of the amended Compact. The public sector at large has, however, expanded growing by 1.7 percent during the period. Much of this growth reflects increased employment opportunities in the SOE sector, government

agencies and local government. Hiring at the national government has been more constrained, having grown at a rate comparable to the economy as a whole. Employment at the military base in Kwajalein has dropped by an average of 1.9 percent reflecting implementation of new technology allowing for some job relocations, primarily to Huntsville, Alabama. Since FY2014, however, employment has stabilized. While the growth in employment has been positive during the amended Compact period, it has been unable to provide a sufficient level of job opportunities for a growing labor force.

Inflation

After a period of negative inflation in FY2015-FY2016 with falling world oil prices, inflation stabilized in FY2017 recording a 0.0 percent change and growing modestly by 0.8 percent in FY2018. This follows on from negative inflation of 1.5 and 2.2 percent in the previous two years. The major forces in FY2018 were an increase in food prices of 1.3 percent and a rise in transportation costs of 2.8 percent, reflecting rises in world oil prices. Overall the reduction in the price level since FY2014 over the last 4 years has helped moderate the cost of living.

Wages

Wages have grown modestly in the RMI by 2.5 and 1.5 percent per annum in the private and public sectors, respectively, during the amended Compact period since FY2003. However, once inflation has been taken into account real wages have fallen in the two sectors by 0.1 and 1.0 percent, indicating slowly declining standards of living. Only at the Kwajalein Military base have wages managed to maintain their real levels. The wage differential between the private and public sector, however, remains large.

The RMI economy performed well in FY2018 with 3.5 percent real GDP growth, led by construction activity.



2. The Financial Sector

Banking

Commercial bank lending in the RMI is more active than in the Micronesian sister states of the FSM and Palau and achieved a loans-to-deposit ratio of 56 percent (FSM 22 percent, Palau 13 percent). The greater lending performance reflects the more active lending policy of the local bank: the Bank of the Marshall Islands (BOMI), which is not FDIC insured and comes only under local supervision. However, the inability of businesses to prepare meaningful business plans and financial statements, lack of collateral, and the limited ability to use land as security have inhibited further financial intermediation. One bright spot that has enabled lending against moveable chattels has been the introduction of secure transactions legislation and registry. With limited opportunities, commercial banks have preferred to invest their assets off-shore in less risky and more secure markets.

A particular issue for the RMI has been the world-wide phenomena of "de-risking" by international financial institutions. In order to reduce exposure to money-laundering, financing of terrorism and to avoid stiff penalties imposed by regulatory authorities, international banks are reducing their exposure through limiting Correspondent Banking Relationships (CBR). BOMI has been under threat of loss of its correspondent bank, First Hawaiian Bank. It is understood that First Hawaiian has been satisfied with recent progress at BOMI in tightening AML and CFT procedures, but a permanent CBR solution needs to be found. Until such time BOMI, and the RMI financial sector as a whole, remain at significant risk.

A further issue relating to banking is the high level of consumer debt to household incomes. Consumer debt represents 35 percent of GDP and 61 percent

of compensation of employees. Consumer debt attracts high rates of interest at 13 percent in FY2018 and is largely secured against payroll of public sector employees through direct allotment thus guaranteeing repayment. As a result, employees in government are reported at high risk of debt stress. After payment of taxes, social security contributions, etc. and as much as 50 percent deducted for loan repayments, many national government employees are left with a very low level of net take home pay, thereby threatening their ability to sustain spending on basic family needs.

External Debt

RMI external debt remains significant and was characterized by the IMF in a recent Debt Sustainability Analysis (DSA) as reaching levels that placed the RMI at a "high risk of debt distress". Nevertheless, external debt continued to decline as a percentage of GDP, falling from a level of 72 percent of GDP at the start of the amended Compact period to 33 percent in FY2018. In terms of debt service, total debt repayments of principal and interest represent 10 percent of general fund revenues: a measure of unconstrained government revenues. Debt service was a major issue for the government in the past with periods of delinquency. However, the RMI has resolved these issues and has been up to date during recent years.

As a result of being designated at "high risk of debt distress", the RMI has now been accorded "grant only" status by the World Bank and the ADB and is, for the time-being, ineligible for concessionary loan finance. This has both benefits and costs; however, with respect to debt, the benefit is unambiguous: the RMI is now experiencing a period of enforced declining debt to GDP as existing loans are repaid and new loans are not being undertaken. Recent interest in government to embark on social sector loan funded projects, which is not compliant with the World Bank's grant only status threaten to undermine access to donor grants and needs to be reviewed carefully. It is also understood that viable projects, such as energy sector loans, can be issued an exception to the grant only restrictions on the basis that the terms of the loan are deemed concessional using the World Bank calculation tool.



Social Security Sustainability

A major pressing fiscal issue facing the RMI has been the potential collapse of the Social Security system. In an effort to avoid collapse, the Nitijela enacted legislation in 2017 to raise employer and employee contributions from 7 to 8 percent, to increase the maximum quarterly taxable wage from \$5,000 to \$10,000, reduce benefits by 0-10 percent, and extend the retirement age to 65 over a number of years. The impact of the reforms has been to defer the eventual collapse of the fund beyond 2030. While the mismatch between contributions and benefits has narrowed significantly it is projected to worsen over time. With little growth in the work force and increasing numbers reaching retirement age, the system remains fragile. Recognizing these weaknesses, the government transferred \$3.3 million in FY2017 and \$3.0 million in FY2018 to shore up the system's reserve fund. This level of payment must be sustained well into the future to avoid fund collapse without further basic reforms to the system. This will require strong commitment given other priorities the RMI may face post-FY2023.

Cryptocurrency and the SOV

In March of 2018 the RMI declared its intent to issue a digital currency based on block chain technology to be known as the SOV. The SOV is to act as legal currency in the RMI in addition to the use of the U.S. dollar. An "appointed organizer", appointed by cabinet is to take responsibility for the Initial Currency Offering (ICO), development of the block chain technology and software to transact in the currency in the RMI. An initial 24 million SOVs are to be issued, half of which will be held by the RMI government and the remainder owned by the organizer. The Minister of Finance is to be responsible for regulation of the SOV, and the Banking Commissioner will be responsible for compliance with standard Know Your Customer (KYC) procedures.

The passage of the law to issue the SOV as legal tender resulted in a widespread interest and concern from international institutions. While there are many cryptocurrencies in existence, none have been issued as legal tender by a sovereign state. Many central banks have examined the potential to issue a digital currency to the public, backed by

the currency in circulation, but so far have been cautious to issue their own digital currencies. The RMI proposal thus represents an effort not specifically attempted before. While the potential gains from sale of the SOV could be large, many risks have been identified. Anonymity of transactions has been one of the major concerns, especially the facilitation that cryptos afford to money laundering and financing of terrorism (AML and CFT). The RMI proposes to remedy this concern through the KYC provisions in the law. However, it is not clear how these would be maintained in jurisdictions outside the RMI or after the ICO. Clearly, since anonymity is one of the major attractions of cryptos, the absence of this provision would limit its uptake.

Another concern has been the risk to the CBR relationship of the Bank of Marshall Islands with First Hawaiian Bank. Clearly, AML and CFT risks associated with cryptocurrencies may adversely affect BOMI's CBR with First Hawaiian, other international banks, or establishing BOMI's own facilities in the U.S. It is also not clear what the position of the FDIC might be in relationship to the other bank in the RMI, the Bank of Guam, in accepting and holding SOVs on the balance sheet. A further issue is volatility in the value of cryptos, which have displayed high levels of price/value volatility. Should the SOV be taken up actively within the RMI, such volatility could prove highly destabilizing and could disrupt orderly payments. While this might not have been the intention in the design of the system, the currency is being issued as legal tender.

The current position of the government that has emerged since the enactment of the legislation is that the RMI will not proceed with SOV issuance until full approval has been received from U.S. authorities. Selection of an "appointed organizer" will be delayed for a 2 to 3-year period while independent expert advice is sought and resolution of the many risks that have been identified has been found.

Under current policy, the Government of the RMI will not proceed with SOV issuance until full approval has been received from U.S. authorities.



3. Fiscal Performance and Policy

The Fiscal Outturn

The RMI achieved a large fiscal surplus in FY2018 of 2.5 percent of GDP, a reduction from the large 4.4 percent surplus achieved in FY2017. This was the fourth year in a row of strong performance. Revenues contracted from their FY2017 level by 5 percent, reflecting a return of fishing fee income to normal levels after the large drawdown of MIMRA reserves in the prior year. In FY2016 fishing fee income rose to \$26 million reflecting past growth in the vessel day price. With the additional drawdown of \$13 million fishing revenues peaked at \$40 million in FY2017. By FY2018, fishing fee income of \$29 million fell back to normal levels but are still indicative of continuing underlying growth. Tax income continued to be buoyant reflecting the growth in the economy, while fees from the shipping and corporate registry remained steady.

On the expenditure side overall expense remained stationary and the prior upward momentum came to a halt reflecting the reduced level of revenues. However, payroll expense continued to grow as did use of goods and services by 5 and 14 percent, respectively. The main offsetting items were significant reductions in subsidies, grants and other expenses which all contracted from the high levels of the prior year's budget required to maintain overall fiscal balance. While subsidies to Tobolar rose to \$4.5 million, Air Marshall Islands, Kajur, and the National Telecom Authority all experienced reductions. While the government maintained the commitment to Social Security with a \$3 million transfer, it failed to transfer the \$3 million committed to in the FY2018 budget to the Compact Trust Fund. Overall the FY2018 outturn was a stabilization budget after the rapid expansion in expenditures of the prior two years.

The significant improvement in the fiscal position has unfortunately been accompanied by large matching increases in expansionary budgets during the FY2015-FY2017 period. The FY2018 budget stabilized the prior growth, but in real terms it remained 40 percent above the FY2014 level before the boom in fishing fee revenues. While the attainment of significant surpluses is to be congratulated, the lack of discipline in controlling expenditures is of serious concern. Fiscal policy lacks a fiscal responsibility framework to encourage the prudential management of abundant current resources to meet future needs arising from declining Compact grants, an insufficient Compact Trust Fund (CTF) corpus to reliably replace the grants, and an underfunded Social Security system.

Tax Reform

With a tax/GDP ratio of 15 percent RMI revenue effort is low and presents an opportunity to adjust to future fiscal shocks and to create an efficient tax environment that supports private sector development. In 2008, the RMI initiated a process to consider tax reform. With support from the IMF and PFTAC a reform agenda was thrashed out to include a VAT as the center piece, a net profits tax, repeal of the existing gross receipts tax, and the creation of a revenue administration authority. Laws were drafted and submitted to the Nitijela for consideration in November 2011. However, elections have come and gone, and no action has been taken since that date. While there was some renewed interest in the tax reform proposal at the start of the current administration, it failed to garner momentum and with the election coming up in November 2019, little progress is likely to be made until at least the start of 2020.

The failure to reform the tax system has put on hold efforts to improve tax administration: improved management practices, adoption of modern procedures, staff training and new ICT systems. The existing revenue and customs divisions in the Ministry of Finance have endured a long period of neglect and efforts to strengthen capacity should be put in place, regardless of the status of the tax reform initiative. A second phase of the existing World Bank and ADB PFM support would be ideal. New ICT systems are needed both to support tax collection efficiency and improvement of key economic information flows, such as trade data and indicators on domestic businesses production.





4. Public Financial Management

Public Expenditure and Financial Accountability (PEFA)

In December 2011, the RMI underwent an external PEFA assessment, and cabinet adopted the report and directed the government to request PFTAC to compile a PFM "roadmap". In collaboration with the government, PFTAC prepared a roadmap 2014-2016, but no action to implement the road map was taken. As part of the ADB 2018-2020 project cycle there is a \$2 million PFM project to support the Ministry of Finance with the PEFA road map providing the focus of the reforms. The major initiative has been strengthening of the Ministry of Finance with improved staffing levels and a focus upon financial management, accounting and controls. An additional focus has been the establishment of an SOE monitoring unit, which is part of the ADB PFM project. Both initiatives are well under way, but whether durable improvements are achieved is yet to be seen. The EU has also agreed to provide budgetary support for the reform of the energy sector (EDF 11, \$9.6 million), and government has committed to public financial management reforms as part of the conditions. Both the ADB PFM, EU energy project, and more recently World Bank interest in the area will support and encourage improved PFM.

Financial Management Information Systems (FMIS)

The FMIS in the RMI is nearing the end of its effective life as the responsible software company is no longer operational. With donor grant support from the World Bank, \$9 million, for budget execution and financial reporting systems, a replacement system is being actively pursued.

The project has now been approved by the Bank's Board, and implementation has now commenced and will take place over a period of years. Enhanced reporting and a new chart of accounts should enable improved information for budgeting, fiscal and performance management.

Public Sector Payroll

With public payroll representing a high proportion of GDP, 22 percent in FY2018, careful monitoring of trends is warranted with anticipation of declining resources post-FY2023. Before the start of the amended Compact period there were 1,909 public servants, which today stands at 2,619. However, a significant increase of 28 percent occurred in the first two years in response to the depressed levels of public employment after the reforms of the late 1990s and incorporation of the Head Start Federal Program into government that was no longer funded as a separate program as had been the case during the original Compact period. Since FY2006 only another 182 positions have been added, representing a 0.6 percent annual growth. Payroll costs on the other hand have risen gradually over the period reflecting a 2 percent annual wage increase. Payroll costs as a percent of GDP government payroll have fallen since FY2004 from 24 to 22 percent. While the government has maintained discipline since FY2006, the increase at the start of the amended Compact may have been excessive in relation to the potential for efficiency gains in the delivery of public services.

SOE Reform

With high levels of subsidies and capital transfers to the SOE sector, at an average of 11 percent of GDP over the last 3 years, the ailing sector remains a major issue of concern and fiscal risk. The recent growth in subsidies for copra producers from €30 to €50 a pound to enhance outer island incomes has had a large fiscal impact. From a level of \$1.4 million in FY2014, payments to Tobolar, the copra processing unit through which the subsidies are channeled, have grown to \$4.5 million in FY2018. During FY2019 the budgeted amount rose to \$6 million, but by mid-fiscal year the funds had been exhausted and a further loan from the Marshall Islands Development Bank had been arranged, bringing the total to \$12 million. While the current

period reflects the looming November 2019 election and income support to the outer islands is important, the level of subsidy has grown at an unsustainable rate.

Recent legislation in the 2015 State Owned Enterprise Act requires SOEs to operate on a commercial basis, with identification of Community Service Obligations (CSOs), and requires the establishment of an SOE monitoring unit in the Ministry of Finance. However, the law was amended to allow an increase in board representation by public officials, from one to three, including government Ministers. This mitigates against the reform objective to eliminate political involvement in SOE management. The law requires SOE management to fall under the Minister of Finance due to the fiscal implications and to support the commercialization objective. While the law provides a sound basis for SOE management, the main challenge will be the lack of capacity and skilled management to implement the law both at the SOE level and in the proposed new SOE monitoring unit. Part of the ADB PFM project provides resources for the establishment of the monitoring unit, which commenced work in 2018.

Booming Donor Support and Capacity Limitations

After a relatively calm period of donor support, the RMI is currently experiencing significant increases in donor activity. Following the determination that the RMI is at high risk of debt distress, the ADB has placed the nation on a grant-only basis, with a current commitment to annual transfers of \$6 million, and further increases to \$13 million planned. Meanwhile, the World Bank has grant resources of \$20 million annually under IDA 18, with a further increase in funding on the horizon. As such, the RMI has a total of over \$130 million of potential ADB and World Bank projects in the pipeline over the next five-year period.

The European Union has an EDF 11 grant of €9 million for energy related investments and budgetary support, coupled with an EU-GIZ Climate Change Resiliency Project of €9.5 million for low carbon emission sea transport. In addition, the Japanese International Cooperation Agency (JICA) has projects of \$10 million, and further contributions from Taiwan (\$4 million) and New

Zealand Aid (\$1 million) are also planned. In all, there is approximately \$250 million in planned projects, a quantum leap in donor-supported activity. While the additional support is welcomed, the RMI remains challenged with limited capacity to implement the projects on the ground. For an office that is pressed to prepare its annual audits on-time, the Ministry of Finance hardly has time to entertain all the visiting missions, let alone prioritize and organize implementation.



5. Private Sector Development

Fisheries and the Domestic Fleet

The fisheries industry in the RMI comprises provision of shore facilities to skip jack tuna purse-seine operators, a home base for long line sashimi grade operations, a fish loining plant, and a variety of small domestic fishing activities. The contribution to the economy has grown significantly during the amended Compact period from \$7.5 million in constant prices at the start to \$15.5 million in FY2018. Total fish licensing and associated fees collected by the Marshall Island Marine Resources Authority (MIMRA) has also grown from \$3.5 million in FY2010 to \$32.2 million in FY2018. Much of the increase has been in the last five years due to the implementation of the Vessel Day Scheme (VDS) of the Parties to the Nauru Agreement (PNA). The PNA is a cartel of 9 Pacific island states, which, due to the introduction of the VDS, has led to a remarkable increase in member country revenues. Daily fishing rates currently average over \$10,000 per vessel day and the RMI received over \$28.8 million of revenues from this one source in FY2018.

A particular issue of concern for the PNA region is the status of the FSM arrangement (FSMa). The FSMa was established to encourage the development of domestic fishing fleets and to



permit access to fishing resources of other Parties' fleets. Fishing operators are accorded domestic fishing fleet status under the FSMa and pay a reduced daily rate, less than the current bilateral market rate of \$12,000 per day. The issue concerns whether the reduced fishing fee and loss in revenue is offset by increases in benefits to the PNA economies. In the RMI case, Koos fishing company operates 4 purse seiners and a further boat under a joint equity venture with the government. Pan Pacific operates 5 boats and the loining plant, but at significant recorded loss to capture the rent from the reduced domestic fee rate.

An on-going study of the fisheries sector by the Graduate School USA suggests the additional benefits to RMI from domestic vessels compared with bilateral vessels is about \$500 per day. This means discounts to domestic vessels should not exceed \$500 per day. Defining a full price is complicated by transfer fees that the domestic vessels need to pay to other countries when fishing in their territories. Regardless of the definition, the RMI has been selling days at a discount greater than the benefits derived from the domestic vessels. At minimum this means the net loss to RMI economy was \$1 million per year due to discounts between FY2015 and FY2018. For 2019 RMI has increased the fees to domestic vessels meaning the gap may now be reduced and the discounts at a level easier to justify by benefits from domestic vessels.

The World Bank's "Doing Business" Survey

The World Bank's "Doing Business" survey paints a discouraging view of the environment for private sector development. Out of 190 countries the RMI currently ranks 150, 79% down the list, indicating much room for improvement. The RMI fares worse than Palau but better than the FSM, which are ranked 133th and 160th, respectively, but is substantially below most of the South Pacific nations. Samoa is ranked 90th, Tonga 91st, Vanuatu 94th, Fiji 101st, and Papua New Guinea 108th. Overall, the RMI's scores are generally weak. Registering property and protecting investors score in the bottom decile of countries, while scores for getting electricity and resolving insolvency are also very weak.

Private Sector Registration and Licensing

A recent assessment of the private sector (Private Sector Assessment, ADB) for the RMI provides a useful analysis of the regulatory environment for the private sector. The list of areas for reform are many. In the RMI, corporate business registration is conducted through the Attorney General's office. The existing system relies on manual processes that are slow and time consuming. A modern computerized business registration process in the public domain is required so that businesses can be legally identified for commercial transactions. The RMI lacks a business licensing law although local governments have the power to issue licenses and collect fees under the Local Government Act. This has led to a lack of transparency and discretionary decision making at the local level. Reforms could combine registration and licensing into a single process, but local governments would need compensation for lost revenue.

Foreign Direct Investment

FDI is implemented under the Foreign Investment Licensing Act 2005 but appears to have failed to simplify the process as the reform was intended to do. FDI permitting is manually operated and licenses take weeks or months to process. FDI licenses are only issued after all other regulatory requirements, such as corporate registration, local government licensing, foreign work permits, Social Security registration etc. have been fulfilled. To reduce uncertainty, an automatic process is required allowing other legal requirements to be fulfilled on a parallel timeline as required for any other domestic enterprise. There is a substantial list of restricted activities, which appears not to be enforced. This can encourage "front" businesses that distort economic activity and undermine the rule of law. In a modern FDI regime businesses are only required to submit information necessary for statistical and after care procedures, and licenses should be issued in a matter of days.

Land Tenure

In the RMI, like many Pacific Islands economies, land is largely owned by customary groups with

complex governance structures. Banks are reluctant to take customary land either owned or leased for collateral. Non-Marshallese are not allowed to own land and even transactions between Marshallese are rare. A key objective of economic development is to improve tenure security for both landowners and leaseholders by accurately defining and protecting land rights. In 2004 with ADB support a Land Recording and Registration Act was introduced as a voluntary means for custom owners to register land and develop an accessible registry of land transactions. The Land Registration Authority (LRA) was introduced to implement the new legislation. However, the uptake in use of the LRA has been minimal and currently only 7 land parcels have been registered and 35 title applications lodged. Despite the slow uptake, the 2004 legislation and LRA are generally considered to provide a sound basis for land administration. The process of improving public awareness, with both government and private sector backing, needs reinitiating so that secure registration and leasing of land can support its critical role in business and financial development.



6. Compact Issues

The RMI Compact Trust Fund

The RMI Compact Trust Fund experienced market gains during FY2018 of 7.0 percent. Together with a scheduled contribution from the U.S. of \$16.85 million at the outset of the year and of \$2.4 million from Taiwan mid-year, those gains enabled the fund to grow in size by \$45.5 million to an end of FY2018 balance of \$402.4 million. During the period of investment since the outset of FY2006, the annualized rate of return has been 6.68 percent.

Assuming the pledged contributions from Taiwan continue, the CTF would only need to grow at 1.34

percent annually from FY2019-2023 to achieve a level sufficient to provide a smooth transition to CTF distributions from FY2024 onward at the projected real value of FY2023 sector grants (\$26.65 million). While there is a good chance of achieving such returns, this "simple" sustainability estimate relies upon performance during the distribution period at a 5.0 percent real rate of return and does not allow for market volatility. In the presence of market volatility, the Graduate School USA has modelled outcomes under the CTF distribution rules. The model results for the RMI indicate a significant probability of periodic fiscal shocks, including years in which zero dollars are legally available for distribution. Notably, over the period from FY2024-FY2063, 56 percent of cases simulated show one or more years of zero distribution.

No distribution rules would simultaneously allow for (i) protecting the real value of the CTF corpus, (ii) ensuring distributions at or near the real value of the FY2023 grants, and (iii) avoiding year-to-year volatility of distributions. However, recent independent studies have shown that technical improvements to the existing rules could provide objectively better results at no extra cost. A key empirical finding is that once market volatility is accounted for, the size of the CTF would need to be approximately 1.67 times larger than estimated using a simple fixed rate of return with no market volatility. For the RMI, achieving this "SAFER" sustainability estimate of \$909 million for its CTF would require growth at 13.25 percent annually from FY2019-FY2023. The median expected outcome for the value of the CTF at the end of FY2023 is \$664 million which is \$245 million less than the "SAFER" figure described above.

Making substantial improvements to the terms of the CTF Agreement would require mutual agreement by the original parties, which for the U.S. entails both executive and congressional approval.

Post-FY2023 Uncertainties

Annual sector grants, infrastructure, and disaster assistance are set to expire in FY2024 except for those dedicated to Kwajalein. The loss of approximately \$27.2 million in FY2024, inflation adjusted thereafter, is targeted to be replaced through funding provided from distributions from the Compact Trust Fund; however, there is



considerable uncertainty over the continuation of many other special and Federal programs and services the RMI receives from the US. In particular, the RMI benefits from the Special Education Grant (SEG) \$4.8 million in FY2018, which was cashed out from former Federal programs provided during the original Compact funding period. SEG funding is provided through discretionary, annual Congressional appropriations that will end after FY2023 under current law. There are many further US Federal programs such as Postal Services, FDIC, NOAA, Pell grants, FAA, health programs, etc., which are subject to Congressional authorization.

While the shortfall in fully sustainable distributions from the Compact Trust Fund is estimated to be \$7.0 million after FY2023—representing a 26 percent decline from the \$27.21 million target in FY2024 for sector grants—the range of possible values in the loss of Federal programs may, in a truly severe case, be a further \$20 million or more. In the remaining years of the amended Compact through FY2023, clarity is required on the status of these programs so that the RMI can effectively plan for the onset of the Compact Trust Fund distribution period.

amended Compact the RMI government received \$1 million annually from the registry, which rose to \$7 million in 2018 and is planned to rise to \$8 million in 2020 when the agreement between the RMI and TCMI expires. There is a general lack of factual information and transparency on the operations of TCMI. There is no publicly available financial information or whether the RMI receives a fair share of the earnings, although it is known that in similar jurisdictions the host nations receive a far higher return. There is thus a need for a transparent evaluation, particularly when there is perceived unfairness and loss of royalties potentially due to the RMI. It is understood the government has commissioned a study to evaluate the issue and to recommend a range of alternatives once the current contract expires in 2020.

An emerging issue for the RMI's shipping registry is the implementation of higher port charges at Chinese ports on RMI-registered vessels. The higher costs for RMI-flagged ships for port stops in China has the presumably intended impact of increasing the costs to the RMI of maintaining its diplomatic relationship with Taiwan.



7. Other Issues

Corporate and Shipping Registry

An issue that has attracted considerable interest is the corporate and shipping registry services provided to the RMI by the Trust Company of the Marshall Islands (TCMI), which is a wholly owned subsidiary of a U.S. company, International Registries Inc. The registry provides services for non-resident corporate registration and shipping services. Under the terms of the Compact, vessels registered in the Marshall Islands are treated as if they are US registered vessels and as a result, many large US shipping companies use the Marshall Islands for registering their ships. At the start of the

Statistical Issues

In former Gradual School USA reviews of the RMI, statistical availability has been accorded a high score. Since the start of the amended Compact the RMI has developed a wide range of statistics which enable the monitoring of economic performance. The set of annual economic statistics is produced 11 months after the end of the fiscal year, and a new set of quarterly indicators is now being prepared in time for the regular session of the Nitijela in January and August. The annual statistical update is timed to coincide with the release of the government audits and in time for the JEMFAC annual meeting.

The most recent IMF Article IV staff review found "data provision to be broadly adequate for surveillance, though some shortcomings tend to constrain policy analysis, especially on trade statistics". Weak data systems in Tax and Customs for both trade and the gross revenue taxes inhibit comprehensiveness, timeliness, and need replacement with modern systems. While the more frequent provision of bi-annual quarterly estimates are a welcome addition, the availability of provisional estimates earlier in the year to coincide with budget preparation would be a priority.



8. The Reform Agenda

Progress with Reform

During the amended Compact period, the RMI has entertained numerous reform initiatives that have failed to achieve successful implementation. The expenditure proposals of the Comprehensive Adjustment Program (CAP) were not implemented, and although there has been some renewed interest in the tax reform initiative, it is unlikely to happen during the current administration. While the SOE Act has become law, adoption of the "best practices" enshrined in the Act require effective implementation. There is no doubt the refinancing of the Marshalls Energy Corporation (MEC) debt under an ADB program (policy reform) loan had a beneficial result, but the fiscal targets of the program were not achieved. While the fiscal responsibility and debt management bill of 2012 failed to make progress, developing a fiscal strategy--including a responsibility framework--should remain a high priority for the RMI government. Such a strategy will need to be presented for government consideration and may need to be modified to meet the priorities of a newly organized government in January 2020.

The Long-Term Fiscal Gap

In FY2016 and again in FY2017 the government enacted expansionary budgets increasing expenditures by \$11 million (12 percent) and \$22 million (19 percent), respectively. In FY2017 expenditures were sustained by the drawdown of prior MIMRA savings. In FY2018 total expenditures remained high and only fell by \$3 million to accommodate the reduction in MIMRA resources of \$14 million. While growth in other revenues was favorable the result was a reduced fiscal surplus. At the current rate of fiscal expansion, the remaining fiscal space will soon be exhausted.

The onset of the Compact Trust Fund distribution period in FY2024 and possible large reductions in funding indicate the need for a long-term fiscal strategy. Adjustments due to insufficiency in the size of the Compact Trust Fund are estimated to be about \$7 million or 3 percent of GDP. Potential loss of SEG and other key Federal programs under a severe-case scenario represents a further \$20 million or a total of 12 percent of GDP. Using FY2015 as the base before the recent expansionary budgets indicates the scope for adjustment; real expenditures have risen by \$27 million over the period FY2015-FY2018. However, the severe-case scenario and the need to support the Social Security system, suggest that simply reverting to the FY2015 base may not be sufficient.

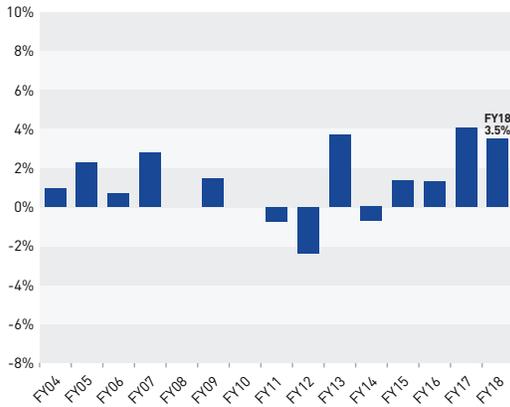
Commitment to Reform

While there is significant uncertainty on the level of funding post-FY2023, there is thus a need to revisit the reform agenda. Firstly, to act on the issue of fiscal responsibility, reverse out at least a portion of the recent expansionary budgeted expenditures, and allocate resources to the CTF and Social Security system, and set the nation on a path of long-term fiscal sustainability. Secondly, the reform agenda outlined in the CAP, tax reform, and SOE Act all remain highly relevant and in need of implementation. Despite announced commitments to reform, successive governments have tended to operate fiscal policy on the basis of appropriating all available resources; therefore, a break from past practice will be required to achieve lasting reforms and improved long-term economic and fiscal management. There is a need for donor support to provide the right incentives and conditions to foster a better result.

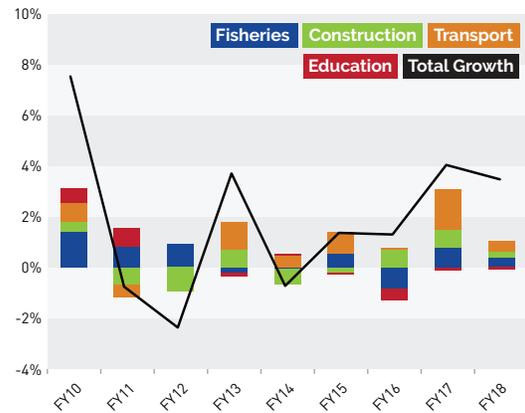
Using FY2015 as the base before the recent expansionary budgets indicates the scope for adjustment; real expenditures have risen by \$27 million over the period FY2015-FY2018.



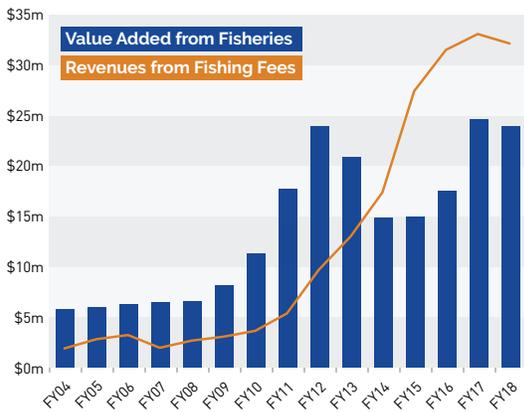
Economic growth improves in the last two years after a period of weak performance



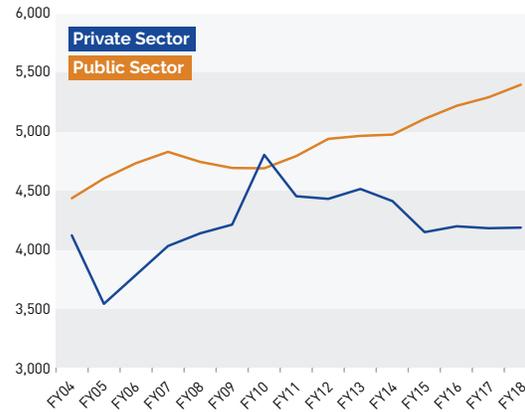
Economic growth in last two years has been **driven** by fishing, construction and transportation



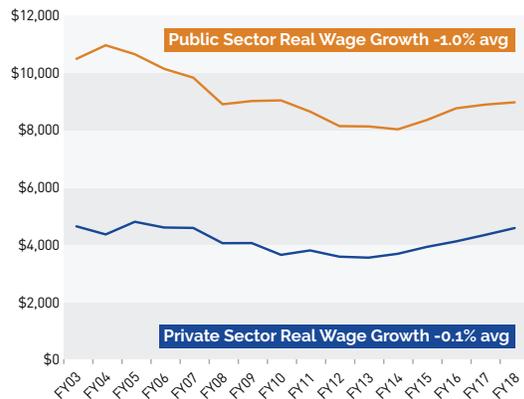
Strong growth in fisheries and revenues from the Vessel Day Scheme (VDS)



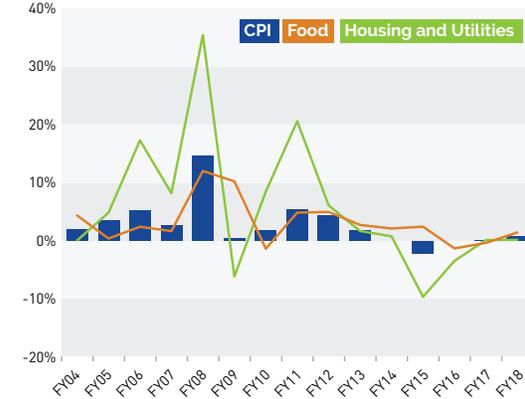
Significant growth in **public sector employment** but lackluster **private sector performance**



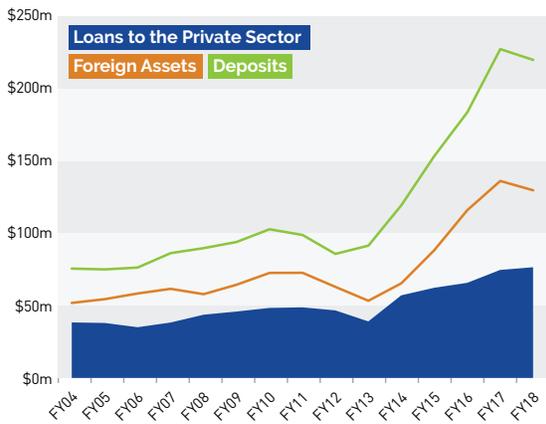
Real wages decline but recent improvement with low or negative inflation: wages differential remains large



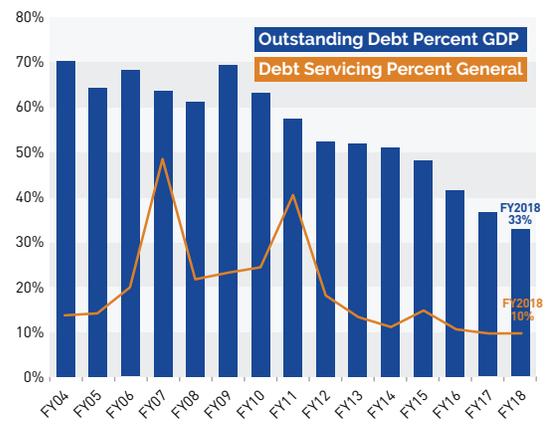
Inflation turned negative in FY15 and FY16 and remains **very subdued** in the last two years



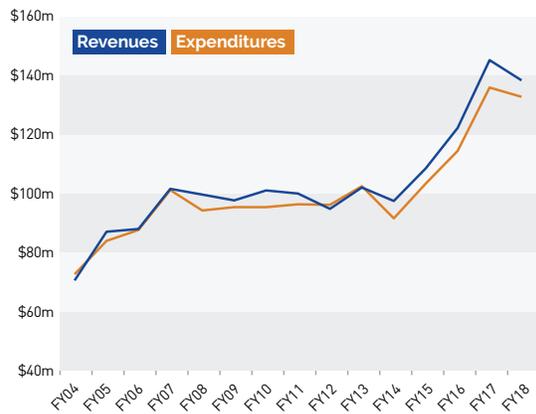
Commercial bank lending remains weak, funds invested off-shore



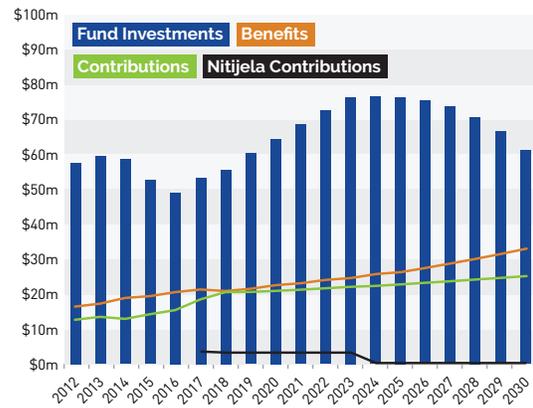
External debt has been falling rapidly with adoption of grant only status



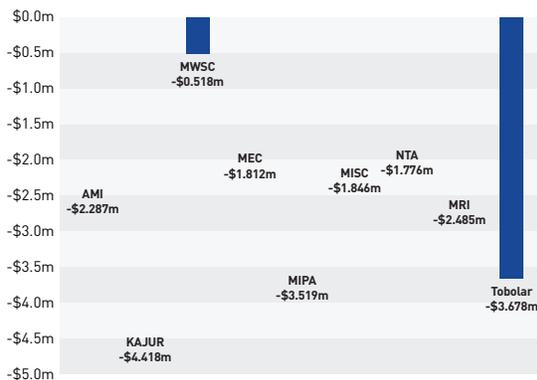
RMI executes expansionary budgets since FY2015 but overall fiscal of 2.5 percent attained in FY18



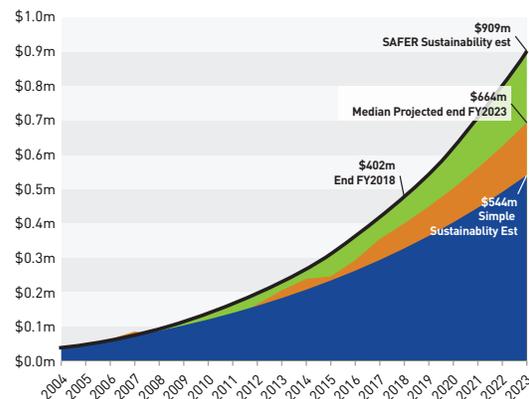
Social Security Funds now projected to increase after recent reforms and critical Nitijela contributions, but projected to decline after FY24 without further support



Subsidies to ailing SOE sector are a persistent drain on fiscal resources



CTF likely to exceed Simple Sustainability estimate, yet projected to fall \$245 million short of the SAFER Sustainability estimate, implying substantial volatility risk remains.



RMI summary economic indicators, FY2010-FY2018

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Per Capita Income measures									
GDP current prices, \$ million	162.2	174.3	182.9	187.7	185.1	184.6	200.6	212.9	221.0
Population	52,921	53,158	53,356	53,554	53,753	53,952	54,153	54,354	54,556
GDP per capita \$	3,064	3,280	3,427	3,505	3,443	3,422	3,704	3,917	4,051
GNI per capita \$	3,742	3,975	3,976	4,173	4,287	4,598	4,849	5,032	5,175
GNDI per capita \$	4,734	4,937	4,950	5,232	5,216	5,607	5,828	5,957	6,169
National accounts									
GDP, at constant prices \$ million, FY2015 prices	182.5	181.2	176.9	183.4	182.1	184.6	187.0	194.6	201.4
GDP, % growth	7.6	-0.8	-2.4	3.7	-0.7	1.4	1.3	4.1	3.5
GDP, % growth (excluding purse seine fishing boats)	6.1	-1.5	-3.4	4.1	-0.6	0.9	2.3	3.5	3.3
Prices (annual percent change)									
Consumer price index	1.8	5.4	4.3	1.9	1.1	-2.2	-1.5	0.1	0.8
Employment and Wages									
Number of employees	10,974	10,689	10,804	10,924	10,857	10,753	11,040	11,136	11,307
% change	5.2	-2.6	1.1	1.1	-0.6	-1.0	2.7	0.9	1.5
Private sector	4,803	4,452	4,430	4,513	4,411	4,148	4,197	4,181	4,186
% change	14.1	-7.3	-0.5	1.9	-2.3	-6.0	1.2	-0.4	0.1
Public sector	3,327	3,384	3,418	3,464	3,468	3,511	3,581	3,624	3,755
% change	0.2	1.7	1.0	1.3	0.1	1.2	2.0	1.2	3.6
Average annual wage	9,104	9,560	9,497	9,615	9,789	10,173	10,549	10,893	11,198
% change	-3.6	5.0	-0.7	1.2	1.8	3.9	3.7	3.3	2.8
Private sector	4,857	5,337	5,243	5,291	5,554	5,789	5,987	6,322	6,722
% change	-8.7	9.9	-1.8	0.9	5.0	4.2	3.4	5.6	6.3
Public sector	13,004	13,049	12,982	13,259	13,266	13,673	14,270	14,561	14,897
% change	2.4	0.3	-0.5	2.1	0.1	3.1	4.4	2.0	2.3
Average annual real wage (less inflation)	8,596	8,817	8,724	8,807	8,858	9,147	9,524	9,671	9,833
% change	-5.1	2.6	-1.1	1.0	0.6	3.3	4.1	1.5	1.7
Government Finance Statistics, \$ millions									
Revenue	101.0	100.0	94.8	102.1	97.5	108.6	122.4	145.5	138.6
Tax revenue	25.6	25.6	25.6	26.7	24.7	25.9	28.9	30.4	32.1
Grants	68.2	65.5	59.2	61.3	53.9	58.7	59.1	65.3	67.3
Other revenue	7.3	8.9	10.0	14.0	18.9	23.9	34.4	49.9	39.2
Expense	-78.9	-83.2	-88.9	-95.3	-86.1	-96.4	-108.4	-123.2	-122.9
Compensation of Employees	-37.6	-37.7	-38.6	-40.5	-40.3	-41.4	-42.4	-45.9	-48.2
Use of goods and services	-24.3	-26.8	-28.1	-28.5	-25.3	-26.3	-32.0	-32.2	-36.8
Other expense	-17.0	-18.7	-22.2	-26.4	-20.5	-28.8	-34.0	-45.2	-38.0
Net Worth and its Changes	-22.1	-16.8	-5.9	-6.7	-11.4	-12.1	-14.0	-22.3	-15.7
Nonfinancial assets	-16.5	-13.1	-7.3	-7.2	-5.4	-7.0	-6.2	-12.9	-10.1
Financial assets	-6.3	11.2	5.9	-0.4	-2.1	-2.3	-5.8	-10.0	0.0
Financial liabilities	0.6	-14.9	-4.5	0.8	-3.8	-2.9	-2.0	0.7	-5.6
Overall fiscal balance	5.7	3.7	-1.4	-0.4	5.9	5.2	7.8	9.4	5.6
(In percent of GDP)									
Revenue	62.3	57.4	51.8	54.4	52.7	58.8	61.0	68.3	62.7
Taxes	15.8	14.7	14.0	14.2	13.4	14.0	14.4	14.3	14.5
Domestic revenues	20.3	19.8	19.5	21.7	23.6	27.0	31.6	37.7	32.3
Grants	42.0	37.6	32.4	32.7	29.1	31.8	29.5	30.7	30.5
Expense	-48.7	-47.7	-48.6	-50.8	-46.5	-52.2	-54.0	-57.9	-55.6
Compensation of Employees	-23.2	-21.6	-21.1	-21.6	-21.8	-22.4	-21.1	-21.5	-21.8
Use of goods and services	-15.0	-15.4	-15.4	-15.2	-13.7	-14.2	-15.9	-15.1	-16.7
Non Financial Assets	-10.2	-7.5	-4.0	-3.8	-2.9	-3.8	-3.1	-6.1	-4.6
Overall fiscal balance	3.5	2.1	-0.8	-0.2	3.2	2.8	3.9	4.4	2.5

RMI summary economic indicators, FY2010-FY2018 cont'd

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Money and Banking (\$ million)									
Assets	133.6	132.0	118.9	110.8	147.3	151.3	156.9	161.2	160.3
Foreign assets	71.8	71.9	62.1	52.5	60.9	62.6	64.7	69.9	70.4
Loans	63.3	60.2	59.4	60.0	73.3	75.6	79.4	82.3	81.5
Commercial loans	14.7	11.2	12.5	20.8	21.0	20.9	22.1	22.4	22.9
Consumer loans	48.6	49.0	46.9	39.2	52.3	54.8	57.4	59.9	58.6
Other	-1.5	-0.1	-2.6	-1.6	13.2	13.1	12.8	9.0	8.4
Liabilities	133.6	132.0	118.9	110.8	147.3	151.3	156.9	161.2	160.3
Deposits	102.1	98.2	85.0	90.8	112.4	114.6	118.9	125.4	123.0
Other	4.1	4.7	4.2	3.9	4.5	5.4	5.3	5.5	5.8
Capital	27.4	29.1	29.7	16.2	30.5	31.3	32.7	30.3	31.5
Loans to deposit ratio, %	62.0	61.3	69.9	66.1	65.2	66.0	66.8	65.6	66.3
Balance of Payments \$ million									
Trade balance	-84.1	-51.2	-44.4	-65.5	-55.8	-52.9	-49.3	-54.4	-61.9
Service balance	-33.0	-35.2	-37.6	-38.6	-33.2	-33.3	-33.4	-40.5	-37.3
Primary Income balance	35.9	37.0	29.3	35.8	45.4	63.5	62.0	60.6	61.3
Secondary Income balance	52.5	51.1	52.0	56.7	49.9	54.4	53.0	50.3	54.2
Current Account, balance	-28.7	1.8	-0.8	-11.7	6.3	31.8	32.4	16.0	16.3
Capital Account, balance	26.6	21.9	16.0	23.3	17.0	16.1	18.3	20.1	16.5
Financial account balance	32.3	18.6	17.1	28.9	6.1	-3.8	-9.6	-11.8	-6.5
International Investment position (IIP), \$ million									
Total stocks, net	244.4	224.9	235.8	235.4	247.9	253.9	277.2	308.7	309.7
Direct investment, net	n.a.								
Portfolio investment, net	276.5	254.4	270.8	281.7	278.5	256.0	245.9	251.5	253.6
Other investment, net	-32.1	-29.5	-35.0	-46.2	-30.6	-2.1	31.2	57.2	56.1
memo: COFA Trust Fund	119.6	132.7	175.0	217.5	252.2	259.1	307.8	372.1	418.4
External Debt, \$ million									
Gross External Debt Total	102.8	100.3	96.0	97.6	94.6	89.0	83.5	77.9	72.5
Gross External debt as % of GDP	63.4	57.5	52.5	52.0	51.1	48.2	41.6	36.6	32.8
Debt Service	8.7	15.2	6.9	5.7	5.1	7.6	6.9	7.9	7.1
Debt service as % of national gov. revenues	24.4	40.5	18.1	13.2	11.0	14.7	10.5	9.6	9.6





August 2019

ECONOMIC BRIEF

RMI FY 2018

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