Republic of the Marshall Islands

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ECONOMIC BRIEF

RMI FY 2017

Graduate School USA

EconMAP
ECONOMIC MONITORING & ANALYSIS PROGRAM

Recent Economic Performance FY2017

1. Economic Performance

The RMI economy performed well in FY2017 with 3.6 percent growth in GDP, improving on the 2.0 percent attained in FY2016 and the two previous years of negative growth. During the last two years the major driver of the improved performance was an increase in construction activity following a resumption in disbursements of the Compact infrastructure grant after the moratorium placed in the use of the grant in FY2014 and FY2015. In FY2017 fisheries production improved with increase in the fish catch. However, regulatory issues in conforming to international shipping requirements, which affected production in FY2016 and FY2017, have now been put in abeyance, while suitable measures to ensure compliance are put in place. Without the impact of fisheries GDP in the underlying economy grew by 2.9 and 2.8 percent in FY2016 and FY2017, respectively. Public administration also had a significant impact on growth during the last two years with the expansionary fiscal policy pursued by Government.

2. Employment

During the amended Compact employment growth averaged 0.7 percent annually, but the majority of the growth was in the in the initial years through FY2010. Since that time, employment levels have remained little changed. While employment at the central government has grown modestly by 0.6 percent since FY2010, that in the public sector at large has grown by 1.8 percent per annum reflecting increased employment opportunities in the SOE sector, government agencies and local government. Meanwhile private sector employment has fallen by 1.9 percent offsetting the increase in the public sector. Clearly, employment generation in recent years has been unable to provide an increasing source of job opportunities for a growing labor force.

3. Inflation

After a period of negative inflation in FY2015-FY2016 with falling world oil prices, inflation in FY2017 stabilized recording a 0.0 percent change. This follows on from negative inflation of 1.5 and 2.2 percent in the previous two years. Food prices fell by 0.5 percent in FY2017 with a small rise in transportation costs of 0.2 percent. Overall the reductions in prices over the last 3 years has helped moderate the cost of living.

4. Wages

Wages have grown modestly in the RMI by 2.5 and 1.4 percent per annum in the private and public sectors, respectively in the amended Compact since FY2003. However, once inflation has been taken into account real wages have fallen in the two sectors by 0.2 and 1.3 percent, indicating declining standards of living. Only at the Kwajaleine Military base have wages managed to maintain their real levels.

> The RMI economy performed well in FY2017 with 3.6 percent growth in GDP driven by increased construction activity.

The Financial Sector

1. Banking

Commercial bank lending in the RMI is more active than in the Micronesian sister states of the FSM and RMI and achieved a loans-to-deposit ratio of 48 percent (FSM 23 percent, Palau 12 percent). The improved 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 under local supervision. However, the inability of businesses to prepare meaningful business plans and financial statements, lack of collateral, 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 remains at significant risk.

A further issue relating to banking is the high level of consumer debt to household incomes. Consumer debt represents 34 percent of GDP and 61 percent of compensation of employees. Consumer debt attracts high rates of interest at 13 percent in FY2017 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, national government employees are left with an average of 15 percent net take home pay.

2. 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 to 35 percent in FY2017. In terms of debt service, total debt repayments of principal and interest represent 11 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 ADB, and is no longer eligible for concessionary loan finance. This has both benefits and costs, but ushers in a period of enforced declining debt to GDP as existing loans are repaid. Recent interest in government to embark on social sector loan funded projects ($80 million, or 34 percent of GDP), 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 viable projects such as energy sector loans can be granted an exception to the grant only restrictions on the basis that the terms of the loan are considered as concessional.

3. 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. However, the mismatch between contributions and benefits remains and is growing 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 to shore up the fund. A level of payment which must be sustained into the future to avoid fund collapse without further basic reforms to the system. This will require strong commitment given other priorities the RMI will face post-FY2023 with anticipated reductions in Compact funding.

4. 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 will 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.

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Another concern has been the risk to the CBR relationship of the Bank of Marshall Islands with First Hawaiian Bank. Clearly, AML and CTT 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 this could prove highly destabilizing and 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 coin issue until this has received approval 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.

Fiscal Performance and Policy

1. The Fiscal Outturn

The RMI achieved a large fiscal surplus in FY2017 of 4.3 percent of GDP; the third year in a row of strong performance. Revenues grew strongly reflecting very buoyant growth in taxes, but also large increases in non-tax revenue: fishing fees and receipts from the corporate and ship registry. From a level of $4 million in FY2012 fishing fees received by government attained a level of $40 million in FY2017 up from $26 million a year earlier. However, this included a large transfer of prior fishing receipts accumulated by MIMRA, but not dispersed to government. The FY2017 revenue receipts were thus exceptional and are expected to return to former levels in FY2018.

On the expenditure side, payroll expense grew strongly in FY2017 by 8 percent ($3.5 million) breaking with the restrained growth of prior years. Use of goods and services grew modestly by 1 percent ($0.2 million). Subsidies and transfers which also grew strongly by $3.6 million or 30 percent and continues to pose a significant fiscal threat. The other most rapidly growing item was "other" expenditures which ballooned out by $6.4 million or 82 percent. Overall FY2017 was a "blow out" year for public expenditures, which grew by $15 million or 14 percent.

The very significant improvement in the fiscal position has unfortunately been accompanied by large matching increases in expansionary budgets during the last three fiscal periods. 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.

2. Tax Reform

With a tax/GDP ratio of 18 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. It is understood that there is some reconsideration of the proposal. However, it is now 30 months into the electoral cycle and time is running out if passage of the laws is to be activated before elections present themselves again at the end of 2019.

> RMI achieved a large fiscal surplus in FY2017 of 4.3 percent of GDP, but while revenues boomed expenditures grew apace undermining fiscal discipline.

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.

Public Financial Management

1. 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; six key areas were selected out of the 30 included in the road map. One of which was the establishment of an SOE monitoring unit, which is part of the ADB PFM project. 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 and EU energy project will support and encourage improved PFM.

2. 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 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.

3. Public Sector Payroll

With public payroll representing a high proportion of GDP, 22 percent in FY2017, careful monitoring of trends is warranted with anticipation of declining resources post-FY2023. At the start of the amended Compact there were 1,999 public servants, which today stands at 2,484. However, the significant increase of 20 percent occurred in the first two years in response to the depressed levels of public employment after the reforms of the late 1990s. Since FY2006 only another 82 positions have been added. 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 has fallen slightly since FY2004. While the government has maintained discipline since FY2006, the increase at the start of the amended Compact indicates the scope for right sizing when the government was operating in a leaner environment and indicates the potential for efficiency gains.

> Subsidies and transfers to State Owned Enterprises reach 7.5 percent of GDP and continue to threaten fiscal stability.

4. SOE Reform

With high levels of subsidies and capital transfers to the SOE sector, at an average of 10 percent of GDP over the last 3 years, the ailing sector remains a major issue of concern. 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.

5. Booming Donor Support and Capacity Limitations

After a period of relative calm in donor support, the RMI has embarked on a period of significant activity. As a result of the policy to declare the RMI at high risk of debt distress, the ADB has placed the nation on a grant only basis with a commitment to an annual transfer of $6 million with a likely further increase to $13 million. Under IDA 18 and with grant only status, the World Bank is understood to have resources to the tune of $20 million annually. As such, the RMI has a total of over $130 million of potential projects in the pipeline. The EU has an EDF 11 grant of €9 million for energy related investments and budgetary support, coupled with a GIZ project of €9.5 million for low carbon emission sea transport. JICA has projects of $10 million with further contributions from Taiwan of $4 million and $1 million under NZ aid. All in all, there is approximately $250 million in possible projects, a quantum leap in planned donor supported activity, but there is a severely 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.

Private Sector Development

1. 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 from $8.5 million in constant prices at the start to $17.6 million in FY2017. Total fish licensing and associated fees collected by the Marshall Island Marine Resources Authority (MIMRA) has also grown from $1.3 million to $34.1 million in FY2017, much of it in the last four years due to the implementation 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 Vessel Day Scheme (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 $25.4 million of revenues from this one source in FY2017.

A particular issue of concern for the PNA region is the operation of the FSM Arrangement (FSMA). The FSMA was established to encourage the development of domestic fishing fleets and 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, about half the going rate. 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 loss to capture the rent from the reduced domestic fee rate. A comprehensive analysis is needed to evaluate whether the domestic fleet makes a contribution to the RMI economy in excess of that generated from third party foreign fleets, and thus whether the nation would be better advised to license all of its Party Allowable Effort (PAE) at full VDS rates.

2. 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 scores 149, 78% down the list indicating that there is much room for improvement. The RMI fares worse than Palau but better than the FSM, which are ranked 130th and 155th, respectively, but is substantially below most of the South Pacific nations. Tonga is ranked 89th, Samoa 87th, Vanuatu 90th, Fiji 101st, and Papua New Guinea 109th. 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.

3. 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.

> RMI scores poorly on World Bank "doing business" survey: 149 our 190 countries.

4. Foreign Direct Investment

FDI is implemented under the Foreign Investment Licensing Act 2005 but appears to have failed to simplify the process. 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 separate 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 required for statistical and after care procedures, and licenses should be issued in a matter of days.

5. 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 update, 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.

Compact Issues

1. The RMI Compact Trust Fund

The RMI Compact Trust Fund experienced market gains during FY2017 of 14.1 percent. Together with a scheduled contribution from the U.S. of $16.1 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 $62.4 million to an end of FY2017 balance of $356.9 million. During the period of investment since the outset of FY2006, the annualized rate of return has been 6.46 percent. Assuming the pledged contributions from Taiwan continue, the CTF would only need to grow at 2.1 percent annually from FY2018-2023 to achieve a level sufficient to provide a smooth transition to CTF distributions from FY2024 onward at the real value of FY2023 sector grants ($26.55 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 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.

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 finding is that once market volatility is accounted for, the size of the CTF would need to be approximately 1.6 times larger than estimated using a simple fixed rate of return with no market volatility. For the RMI, achieving this "SAFER" sustainability estimate for its CTF would require growth at 12.2 percent annually from FY2018-FY2023.

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.

2. Post Amended Compact Uncertainties

Annual sector grants, infrastructure, and disaster assistance are set to expire in FY2024 except for those dedicated to Kwajalein. The loss of approximately $26.5 million annually 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

> Significant adjustment will be required post FY2023 to reduced funding from the Compact Trust Fund and uncertain access to U.S. special and Federal programs.

Education Grant (SEG), which was cashed out from former Federal programs provided in the original Compact. Funding is provided through annual Congressional appropriations whose continuation post-FY2023 will end under current law. There are many further US Federal programs such 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 $5 million after FY2023, the range of possible values in the loss of Federal programs may in the worst 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 arrival of the Compact Trust Fund era.

Other Issues

1. 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 amended Compact the RMI government received $1 million annually from the registry, which rose to $7 million in 2017 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. There is thus a need for a transparent evaluation, particularly when there is perceived unfairness and loss of royalties to the RMI. It is understood that the RMI government is currently conducting a study of the corporate and shipping registry, which should inform negotiations as the RMI enters into a new agreement after 2020.

2. Statistical Issues

In former Gradual School 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 on which to monitor 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 provisions of bi-annual quarterly estimates is a welcome addition, the availability of provisional estimates earlier in the year to coincide with budget preparation would be a priority.

The Reform Agenda

1. Progress with Reform

During the amended Compact, 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 is renewed interest in the tax reform initiative, the outcome is uncertain with a lack of public awareness of what the reforms entail. While the SOE Act has become law, adoption of the "best practices" enshrined in the Act require effective implementation. The fiscal responsibility and debt management bill of 2012 appears to be no longer part of the legislative agenda. While there is no doubt the refinancing of the Marshalls Energy Corporation (MEC) debt under an ADB program (policy reform) loan had a beneficial result, the fiscal targets of the program were not achieved.

2. The Long-term Fiscal Gap

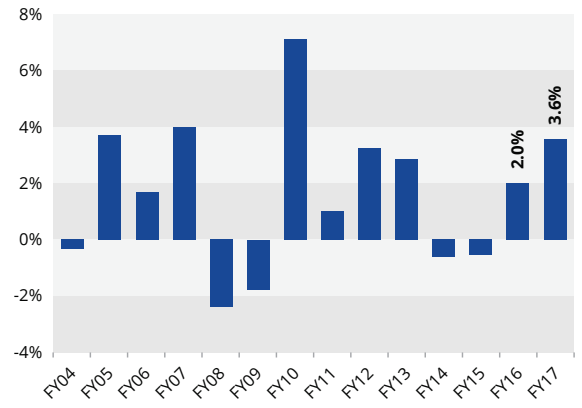
In FY2016 and again in FY2017 the government enacted expansionary budgets increasing general fund appropriations by $12 million (26 percent) and $25 million (44 percent), respectively. In FY2017 expenditures were sustained by the drawdown of prior MIMRA savings. In FY2018 general fund expenditures were cut by $9 million reflecting the lack of savings to sustain the prior level of expenditures, as use of MIMRA/fishing fee resources fell by $14 million. While the current level of expenditures can be sustained through the continuing use of abundant fishing revenues, the onset of the Compact Trust Fund era in FY2024 and looming reductions in funding indicate the need for a long-term fiscal strategy. Adjustments due to insufficiency in the Compact Trust Fund are estimated to be about $5 million or 2 percent of GDP. Potential loss of SEG and other key Federal programs under a worst-case scenario represents a further $20 million or 7 percent of GDP. Using FY2015 as the base before the recent blow out budgets indicates the scope for adjustment. Planned general fund expenditures rose by $20 million over the period FY2015-FY2018. However, the worst-case scenario and need to support the Social Security system, suggest that simply reverting to the FY2015 base may not be sufficient.

3. Commitment to Reform

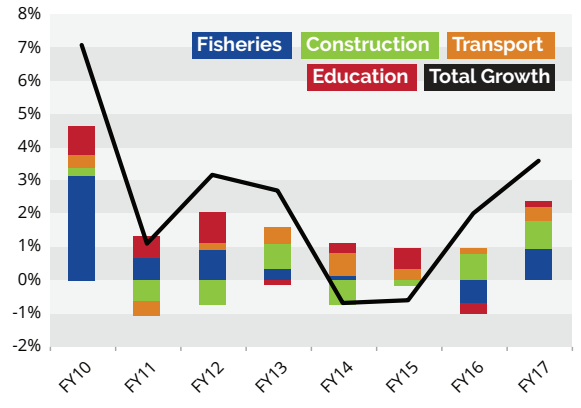
While there is significant uncertainty on the level of funding post-FY2023, there is thus a need to revisit the reform agenda. Firstly, to revisit the issue of fiscal responsibility, reverse out the recent expansionary budgeted expenditures, and allocate resources to the CTF and SS, and set the nation 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.

> While the current level of expenditures can be sustained through the continuing use of abundant fishing revenues, the onset of the Compact Trust Fund era in FY2024 and looming reductions in funding indicate the need for a long-term fiscal strategy.

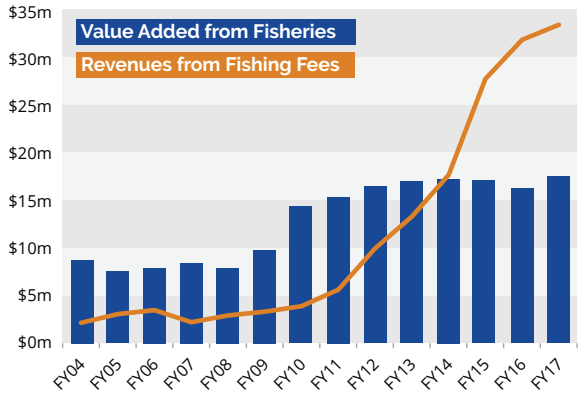
Economic growth improves in FY2016 and FY2017, after two years of negative growth and stagnation



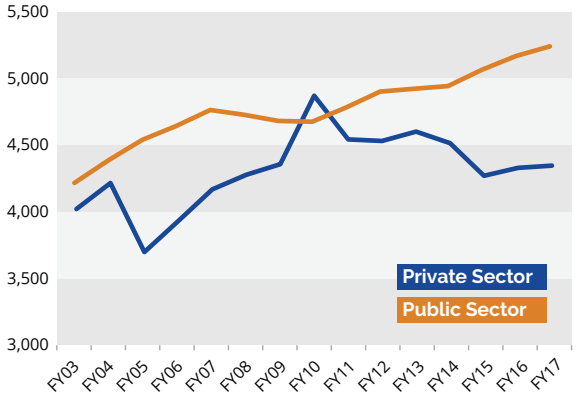
Economic growth in FY2017 is broad based with fisheries and construction being the main drivers



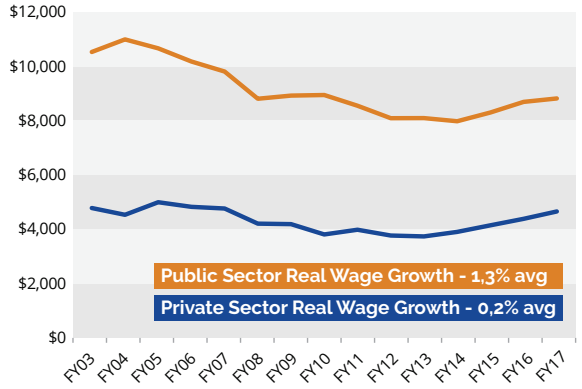
Strong Growth in fisheries and revenues from the Vessel Day Scheme (VDS), $m



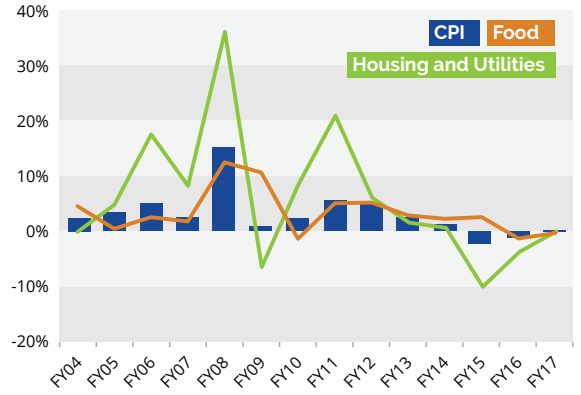
Significant growth in **public sector employment**, but lackluster **private sector performance**



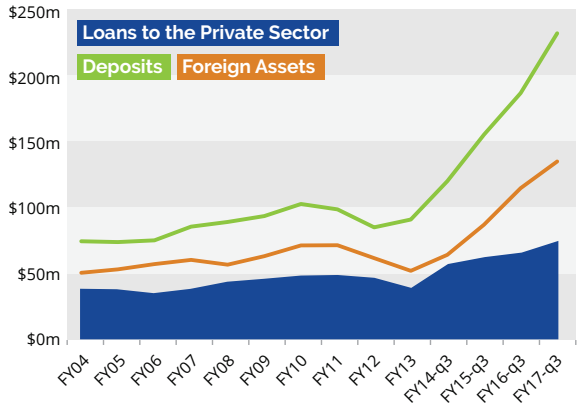
Real wages decline, but recent improvement with negative inflation; wage differential remains large



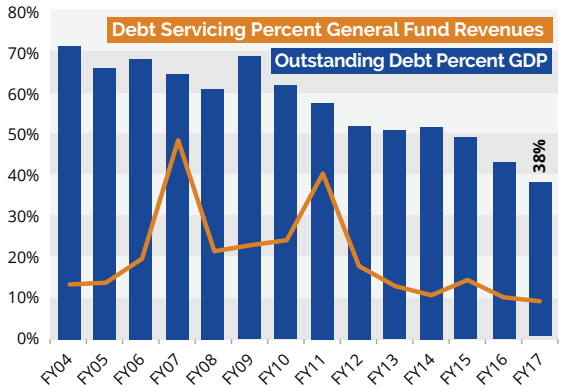
Inflation turns negative in FY15 and FY16 and remains unchanged in FY17



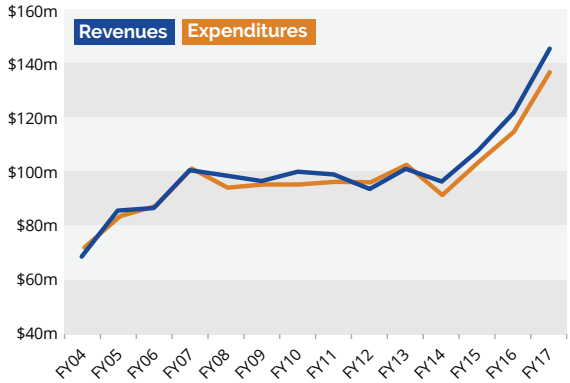
Commercial bank **lending remains weak**, funds invested off-shore, $m



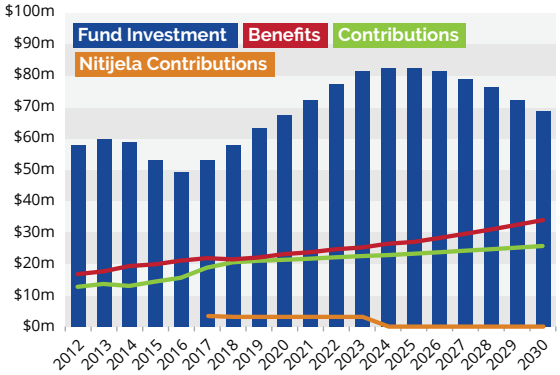
External debt is high but declining due to adoption of grant only status



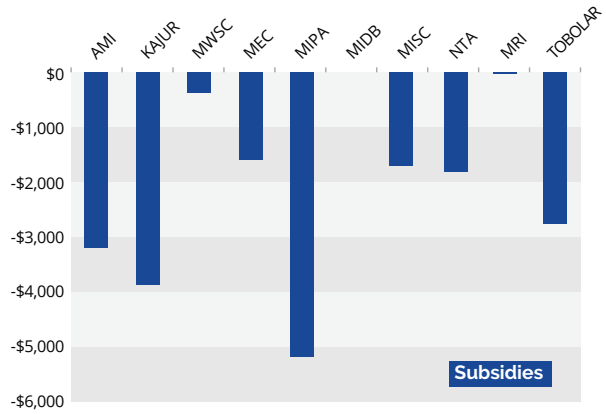
RMI executes blow out budgets in FY15 through FY17, but maintains overall 3% of GDP fiscal balance, $m



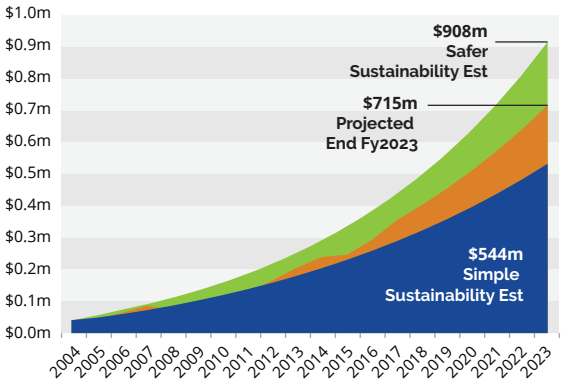
Social security funds now projected to **increase** after recent reforms and Nitijela contributions, but projected to decline after FY25 without government support, $m



Subsidies to the ailing SOE sector are a persistent drain on fiscal policy, $'million



Trust Fund likely to achieve simple sufficieny estimate to replace FY2023 sector grants, but remains subject to volatility risk



RMI summary economic indicators, FY2010-FY2017

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Per Capita Income measures								
GDP current prices, $ million	168.3	175.5	186.6	192.9	185.8	182.1	197.0	206.8
Population	52,921	53,158	53,356	53,554	53,753	53,952	54,153	54,354
GDP per capita $	3,180	3,302	3,497	3,602	3,457	3,375	3,638	3,804
GNI per capita $	**3,831**	**4,015**	**4,039**	**4,282**	**4,371**	**4,662**	**4,842**	**5,016**
GNDI per capita $	4,955	5,105	5,135	5,496	5,424	5,745	5,955	6,105
National accounts								
GDP, at constant prices $ million, FY2004 prices	**149.3**	**150.9**	**155.7**	**159.9**	**158.8**	**157.8**	**160.9**	**166.7**
GDP, % growth	**7.1**	**1.1**	**3.2**	**2.7**	**-0.7**	**-0.6**	**2.0**	**3.6**
GDP, % growth (excluding purse seine fishing boats)	5.0	0.3	2.0	2.7	-0.5	-1.1	2.9	2.8
Prices (annual percent change)								
Consumer price index	1.8	5.4	4.3	1.9	1.1	-2.2	-1.5	0.0
Employment and Wages								
Number of employees	10,955	10,672	10,778	10,896	10,826	10,696	10,960	11,066
% change	5.2	-2.6	1.0	1.1	-0.6	-1.2	2.5	1.0
Private sedctor	4,937	4,570	4,557	4,636	4,538	4,266	4,332	4,350
% change	13.2	-7.4	-0.3	1.7	-2.1	-6.0	1.6	0.4
Public sector	4,653	4,768	4,896	4,918	4,940	5,071	5,182	5,260
% change	-0.1	2.5	2.7	0.5	0.4	2.6	2.2	1.5
Average annual wage	9,121	9,577	9,519	9,656	9,838	10,226	10,618	10,951
% change	-3.7	5.0	-0.6	1.4	1.9	3.9	3.8	3.1
Private sedctor	5,028	5,548	5,468	5,519	5,837	6,074	6,340	6,750
% change	-7.8	10.3	-1.4	0.9	5.8	4.1	4.4	6.5
Public sector	12,123	12,195	12,030	12,260	12,215	12,432	12,832	13,025
% change	2.0	0.6	-1.4	1.9	-0.4	1.8	3.2	1.5
Average annual real wage (less inflation)	8,612	8,832	8,744	8,844	8,903	9,194	9,587	9,723
% change	-5.1	2.6	-1.0	1.1	0.7	3.3	4.3	1.4
Government Finance Statistics, $ millions								
Revenue	101.0	100.0	94.8	102.1	97.5	108.6	122.4	145.5
Tax revenue	28.2	29.0	29.2	30.4	29.1	31.4	34.6	37.1
Grants	68.2	65.5	59.2	61.3	53.9	58.7	59.1	65.3
Other revenue	4.6	5.5	6.4	10.4	14.5	18.4	28.7	43.1
Expense	-78.9	-83.2	-88.9	-95.3	-86.1	-96.4	-108.4	-123.2
Compensation of Employees	-37.6	-37.7	-38.6	-40.5	-40.3	-41.4	-42.4	-45.9
Use of goods and services	-24.3	-26.8	-28.1	-28.5	-25.3	-26.3	-32.0	-32.2
Other expense	-17.0	-18.7	-22.2	-26.4	-20.5	-28.8	-34.0	-45.2
Net Worth and its Changes	-22.1	-16.8	-5.9	-6.7	-11.4	-12.1	-14.0	-22.3
Nonfinancial assets	-16.5	-13.1	-7.3	-7.2	-5.4	-7.0	-6.2	-12.9
Financial assets	-6.3	11.2	5.9	-0.4	-2.1	-2.3	-5.8	-10.0
Financial liabilities	0.6	-14.9	-4.5	0.8	-3.8	-2.9	-2.0	0.7
Overall fiscal balance	**5.7**	**3.7**	**-1.4**	**-0.4**	**5.9**	**5.2**	**7.8**	**9.4**
(In percent of GDP)								
Revenue	60.0	57.0	50.8	52.9	52.5	59.6	62.1	70.4
Taxes	16.8	16.5	15.7	15.7	15.7	17.3	17.6	17.9
Domestic revenues	19.5	19.7	19.1	21.1	23.5	27.4	32.1	38.8
Grants	40.5	37.3	31.7	31.8	29.0	32.3	30.0	31.6
Expense	-46.9	-47.4	-47.6	-49.4	-46.3	-53.0	-55.0	-59.6
Compensation of Employees	-22.4	-21.5	-20.7	-21.0	-21.7	-22.7	-21.5	-22.2
Use of goods and services	-14.4	-15.3	-15.1	-14.8	-13.6	-14.4	-16.2	-15.6
Non Financial Assets	-9.8	-7.5	-3.9	-3.7	-2.9	-3.8	-3.1	-6.3
Overall fiscal balance	**3.4**	**2.1**	**-0.7**	**-0.2**	**3.2**	**2.8**	**4.0**	**4.5**

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Money and Banking ($ million)								
Assets	133.6	132.0	118.9	110.8	147.3	151.3	156.9	161.2
Foreign assets	71.8	71.9	62.1	52.5	60.9	62.6	64.7	69.9
Loans	63.3	60.2	59.4	60.0	73.3	75.6	79.4	82.3
Commercial loans	14.7	11.2	12.5	20.8	21.0	20.9	22.1	22.4
Consumer loans	48.6	49.0	46.9	39.2	52.3	54.8	57.4	59.9
Other	-1.5	-0.1	-2.6	-1.6	13.2	13.1	12.8	9.0
Liabilities	133.6	132.0	118.9	110.8	147.3	151.3	156.9	161.2
Deposits	102.1	98.2	85.0	90.8	112.4	114.6	118.9	125.4
Other	4.1	4.7	4.2	3.9	4.5	5.4	5.3	5.5
Capital	27.4	29.1	29.7	16.2	30.5	31.3	32.7	30.3
Loans to deposit ratio, %	62.0	61.3	69.9	66.1	65.2	66.0	66.8	65.6
Balance of Payments $ million								
Trade balance	-90.9	-64.5	-60.7	-78.0	-72.8	-65.7	-72.4	-73.8
Service balance	-33.1	-35.3	-38.5	-41.3	-35.5	-36.0	-38.3	-45.5
Primary Income balance	34.4	37.9	28.9	36.4	49.1	69.4	65.1	67.5
Secondary Income balance	59.5	58.0	58.5	65.0	56.6	58.4	60.2	59.5
Current Account, balance	-30.1	-3.9	-11.8	-17.9	-2.5	26.0	14.7	7.7
Capital Account, balance	18.6	14.5	8.6	15.9	9.6	8.5	10.9	9.8
Financial account balance	32.6	18.5	17.3	29.2	5.7	-4.5	-10.1	-12.5
International Investment position (IIP), $ million								
Total stocks, net	244.4	224.9	235.8	235.4	247.9	253.9	277.2	308.7
Direct investment, net	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Portfolio investment, net	276.5	254.4	270.8	281.7	278.5	256.0	245.9	251.5
Other investment, net	-32.1	-29.5	-35.0	-46.2	-30.6	-2.1	31.2	57.2
memo: COFA Trust Fund	119.6	132.7	175.0	217.5	252.2	259.1	307.8	372.1
External Debt, $ million								
Gross External Debt Total	102.8	100.3	96.0	97.6	94.6	89.0	83.5	77.9
Gross External debt as % of GDP	61.1	57.2	51.5	50.6	50.9	48.9	42.4	37.7
Debt Service	8.7	15.2	6.9	5.7	5.1	7.6	6.9	7.9
Debt service as % of national gov. revenues	24.4	40.5	18.1	13.2	11.0	14.7	10.5	9.6

August, 2018

ECONOMIC BRIEF

RMI FY 2017

The RMI Economic Brief is produced annually to provide an independent assessment of the Republic of the Marshall Islands' economic performance and policy environment, as well as independently verified economic statistics. The RMI Economic Brief summarizes the full RMI Economic Review, which is developed to assist the government of the RMI and the U.S. Department of the Interior's Office of Insular Affairs to fulfill their respective reporting requirements under the RMI Compact of Free Association with the United States.

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